

# The cost of regulation study

Commissioned by the Financial Services Authority  
and the Financial Services Practitioner Panel

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# FSA Foreword

I am pleased to publish this report by Deloitte - commissioned jointly by the FSA and the Practitioner Panel – on the costs financial services firms incur in complying with the Financial Services and Markets Act 2000 (FSMA). The report determines and analyses costs which firms consider they would not incur other than to comply with specific FSA rules. These costs, the incremental regulatory costs, are analysed rule by rule. The findings of this study will help us make better informed decisions about whether these costs are justified by the benefits they produce or whether the rules which generate the costs should be changed or removed.

The report analyses costs of regulation in three sectors: two wholesale (corporate finance, institutional fund management); and one retail (investment and pension advice). The results are specific to each sector, and no general conclusion about the total cost of regulation across the UK financial services industry can be drawn from them.

## Background to the study

We are determined to strike the right balance between discharging our statutory duties and avoiding unjustified costs. We can do this only with a sound understanding of both the benefits and the costs of regulatory action.

The Deloitte report on costs of regulation breaks new ground by providing a more complete and detailed analysis of costs than any previous study. This has been a major piece of work and I am grateful to the Deloitte team for their hard work in producing this report.

I would especially like to thank all the firms who contributed to the study. I recognise it required a substantial time commitment. The most practical reward will emerge from the FSA acting on the findings.

In parallel to this study we have taken new advice on methods of assessing the benefits of regulation in the specific context of financial services and the outcome of this exercise is also being published today. The methodology Oxera has developed will help us to make better analyses of the inter-relationship between the costs and related benefits of specific regulatory interventions.

## Summary of findings

Overall, the study confirms that much of what regulation requires is good business practice. However, it does identify costs related to a number of specific rules which firms consider incremental to the everyday running of their business.

I see the main findings that have emerged as follows:

- The incremental costs of regulation in the wholesale sectors, where a lighter regime applies, were lower than in the retail sector covered. It is not unexpected that in the retail market incremental costs are markedly higher given that the FSA has a clear need to protect consumers in their dealings with an industry where the gap in knowledge between the provider and seller on the one hand and the typical buyer on the other is acknowledged to be a major problem.
- Across all the three sectors, the direct FSMA related fees collected by the FSA (comprising levies funding the FSA, the Financial Ombudsman Service and the Financial Services Compensation Scheme) were the highest incremental cost. Firms also recorded cumulatively significant costs of record keeping requirements, spread across a large number of separate rules.
- In the Corporate Finance and Institutional Fund Management sectors, no individual requirement other than FSA fees generated typical costs exceeding 0.1 per cent of operating costs of a typical firm; rules related to training when looked at in combination were, however, relatively more significant in the Corporate Finance sector.

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<sup>1</sup> "rule" is defined for these purposes as an individual FSA rule, or the combination of a body of rules within the handbook that can be clustered and summarised as serving one particular objective.

- No individual rules imposed costs in the two wholesale sectors that are therefore likely to be material to firms' business decisions. As such, the level of identified incremental costs both in Institutional Fund Management and in Corporate Finance supports the findings of other studies that regulatory costs in the UK are not generally seen as a barrier to the nation's international competitiveness in wholesale markets, and may even be one significant factor among many in its popularity as a destination for mobile capital.
- Most of the highest incremental cost rules in the IPA sector related to point of sale disclosure. Firms told Deloitte that in the absence of regulatory rules they would in particular spend less on: the production of suitability letters; the provision of key features/simplified prospectus for packaged products; ensuring that products sold are suitable for clients' needs; and tailoring of projections in key features documents to clients' circumstances. Other rules creating incremental costs of 0.1 per cent or more of operating costs for a typical firm were: rules on maintaining employees' competence, including attendance at FSA seminars; attention given to cluster reports, speeches, etc; and (for relevant firms) the provision of periodic statements to customers when such firms maintain a customer portfolio/account.
- The study has interesting findings on whether regulation bears more heavily on small firms. In the investment and pension advice ('IPA') market during this study period, perhaps contrary to expectations, incremental compliance costs are not shown as being proportionally higher for smaller firms. This appears to reflect the nature of the regulation in this sector, which is mostly transaction-based. It might also reflect the lack of any significant regulatory change during this period, meaning that firms had very low one-off costs and one-off costs might have been proportionally higher for small than for large firms.
- In the two wholesale sectors, incremental costs were proportionally higher for small firms. But important reasons for this included differing choices about compliance and risk by large and small firms. Many large firms choose to level up their compliance activities across countries or businesses. This reduces the extent to which individual rules create incremental costs. Equally, small firms typically took the view that, in the absence of individual rules, they would cease to carry on compliance activities that large firms typically see as part of their business model. This increases the extent to which individual rules create incremental costs for small firms.

One of the other major findings of this study is that the estimated incremental costs of regulation differ markedly between firms within a sector. There are a number of explanations for the wide dispersion between firms within each sector, including:

- different levels of efficiency in compliance between firms;
- different views between firms about what constitutes acceptable compliance with FSA requirements. Some firms' responses suggested they were willing to bear substantial risk in their interpretation of FSA rules, whereas others are choosing to interpret rules more strictly than is perhaps required by the FSA;
- different judgement between firms as to which activities are deemed by management to be incremental. Specific activities regarded by a significant majority of firms as being integral to their normal business practice, appear to be regarded by a small minority of other firms as being primarily or solely driven by regulation. It is of particular interest that in the IPA sector in particular there is no clustering of findings around specific firms or rules in this regard. The key finding here is that this is heavily influenced by judgement and that this judgement varies quite widely between firms.

The inter-action of these influences is particularly complex and it is not possible to establish from this study how far the dispersions are explained by each of these influences. The conclusion that we reach is that the way these influences are experienced by individual firms is highly specific to each firm's own circumstances. We should recognise therefore that when asked to consider the specifics of any deregulatory measure, firms may plan to respond in many different ways.

Nevertheless, I believe that the study does help us to understand more clearly where the costs of regulation are greatest both between and in each of these sectors, and the FSA's response must be to prioritise accordingly our ongoing work to deliver a truly proportionate regulatory regime.

I also reflect that this study highlights the significance of the direct costs to industry of the levies and fees that fund the FSA, the FOS and the FSCS. All three organisations are obliged to operate with due regard to economy and efficiency and we take our responsibilities for this very seriously, setting out each year in published Business Plans our respective requirements for resources to fund our operations, and the use to which these will be put. FOS case fees and FSCS compensation levies, however, have a difference characteristic and might perhaps more legitimately be classified as costs of firms' failure rather than costs of regulation.

The key issues that arise in that regard are therefore not so much economy and efficiency, but rather those of fairness and sustainability. There are already reviews in train to consider the related issues and to determine the optimal approach to, and sources of funding for, these fees and levies.

## Next steps

The FSA is today also publishing a progress report on its Better Regulation Action Plan. Included in this plan are the steps the FSA is taking to use the results of this study to assess the comparative benefits of regulatory requirements that generate the highest costs.

In taking this work forward the FSA will particularly benefit from two specific insights gained from this study. First, while, it is clear from anecdotal evidence that the costs of changing business processes due to the introduction of new or changed regulatory requirements are often quite material, this study shows that once embedded in a businesses ongoing operations, the degree to which most such processes are seen as incremental is generally quite limited.

Put another way, once a business has incurred the cost of implementing a process to comply with a regulatory rule, it typically forms the view that the process is one that, at least in part, serves a business purpose and would be maintained even in the absence of the rule that may have provided the original stimulus. As such, the cost savings attached to the removal of any one underlying rule may only be marginal.

Secondly, this study highlights that the experience of a typical firm is of a long tail of low incremental costs attaching to a large number and a wide range of rules. The dispersion of firms' experiences of regulation, and the limited potential cost savings for most firms from removing any particular rule, will provide a complex and challenging backdrop for us in taking forward our policy reviews.

Some initiatives are already underway, such as the simplification of conduct of business rules coinciding with the implementation of MiFID and the review of conduct of business regulation. We will use the findings of this study to inform these ongoing reviews, and to determine where additional or follow-up pieces of work should be focused.

Roy Leighton in his foreword to this report urges us to focus specifically on the costs imposed by rules related to training and competence, complaints, retail conduct of business and record keeping requirements. We will in particular look at these areas to enable us to form a clear view on the degree to which the related costs are proportionate. Where they are not we will change or remove the rules in question.

**John Tiner**

# Financial Services Practitioner Panel Foreword

## Practitioner Panel Survey 2004

Repeated industry surveys undertaken by the Financial Services Practitioner Panel (the Panel) have identified the costs and burdens of regulation as being possibly the single biggest issue of concern to regulated firms. Our last survey – the results of which were published in December 2004 – was particularly striking in this regard; with the majority of firms considering that the costs associated with FSA regulation were either high or excessive. There was also a strong belief that those costs would continue to rise for the foreseeable future. Smaller firms (and/or those operating in a retail environment) typically felt the effect of regulatory costs the greatest, with many seriously beginning to wonder whether continuing to operate in the financial services marketplace remained a commercially viable and sustainable proposition.

In the face of these stark and worrying views, which were based on a sample of over 3,000 regulated firms, the FSA felt compelled to give this matter urgent priority and consider how best to tackle the costs issue. However, this presented a problem in itself. The Panel findings were based on perception – rather than hard and clear accounting information – and there was no definitive financial evidence to either support those views, or to provide an accurate and authoritative calculation of those costs (and the drivers thereof). Clearly, the FSA could not be expected to take robust action until such reliable information could be established.

## Action taken

So, in early 2005, the FSA invited the Panel to be co-joined in a study intended to do just that. The Panel was delighted to accept that invitation and called for a gritty cost accounting exercise. We considered that this would be a crucial piece of work, and that our participation at governance and oversight level as joint mandators would help to ensure that it was undertaken in a manner which the industry would support and where the results would have the public credibility that would be essential.

As far as we are aware, no-one in the UK had ever attempted to evaluate the costs of regulation in such a comprehensive and methodical way. So this work was truly ground-breaking in its nature and scope. We knew at outset that the exercise would present significant challenges along the way. And that it would not be without its limitations. However, we agreed wholeheartedly with the FSA that – simply because it would be difficult, and might not produce perfect or completely unambiguous conclusions – these were not reasons to shy away from undertaking this study, and make every effort to secure the best and most valuable output that was possible.

The Panel was represented on the project's Steering Group by Jonathan Bloomer (my Deputy Chairman), Ruthven Gemmell (who, as Chair of the Smaller Businesses Practitioner Panel, ensured a suitable smaller firm focus) and myself. On that group we sat alongside John Tiner, David Kenmir and Kari Hale from the FSA.

The Panel's view was that this work required a strong management accountancy emphasis, as opposed to an academic one. And after evaluating a number of firms who might undertake the work, the Steering Group considered that the proposal and methodology put forward by Deloitte best met the aspirations in that regard. I do not plan to comment here at length about the methodology, although I encourage you to carefully study this – it is covered in some detail by Deloitte themselves elsewhere in this report. Nor shall I comment substantively on any of the individual figures and numbers that you will see contained in the report – again, I will concentrate on what can (and/or should) be deduced from these, and on the key high-level messages and expectations emerging.



It was never going to be possible to produce statistically reliable, totally consistent or 100% accurate answers to the question of costs as firms analyse and retain their data in different ways. We accept that the associated questionnaire sent to firms was long and complex, which many firms found daunting and this contributed to some firms' lack of willingness to participate.

It is also important to state that the study covered the audited financial results for 2004 (or in some cases periods ending in early 2005). Therefore, the emerging findings pre-date several new instances of regulation; the most obvious ones being the FSA's Treating Customers Fairly initiative (which practitioners will say is highly cost and time intensive), the incoming Markets in Financial Instruments Directive, Depolarisation/menu and the recent introduction of electronic reporting. We would also note that the cost of prudential capital is not included in this work, nor are opportunity costs.

The FSA must therefore review and react to the Deloitte conclusions in light of the above and understand that the issue of costs is an ever moving (and, inevitably, rising) one.

However, what this study does do is provide a solid and indicative basis on which to pinpoint a number of specific areas of the Rules within the FSA Handbook that attract and drive the highest incremental costs – i.e. those that firms would not otherwise incur in the course of good business practice. From that, it is then possible to consider where those costs might be disproportionate to the benefits that they are designed to secure.

Three financial services sectors were included in the study: Corporate Finance, Institutional Fund Management and Investment and Pension Advice. As John Tiner observes in his Foreword, the range of incremental costs varies significantly both within and between these sectors; for which there are a number of possible explanations.

## Project results

In terms of the specific outcomes, I do not intend to include too much here in respect of the Corporate Finance and Institutional Fund Management sectors of analyses. Generally, those conclusions speak for themselves. Suffice to say that, overall, the incremental costs of regulation in these areas are comparatively low; and, in the Panel's view, are not unreasonable or troubling. This reflects largely on the wholesale nature of the activities involved, and the typical lack of private customers. That is, however, not to say that there are some aspects that the FSA should not take careful note of, and on which the Panel will seek to engage in dialogue with the FSA over time. But we would not necessarily regard these as a matter of top priority.

By far the most pointed findings from this study relate to the retail-oriented Investment and Pensions Advice sector. There are a number of areas where the Panel would expect to see the FSA take quick and decisive action in order to mitigate these costs (where that can be justified on objective cost/benefit grounds). We acknowledge that there are a number of strategic initiatives already in train that are likely to encompass some of the areas in question – for example, as part of the FSA's Better Regulation agenda and the Conduct of Business simplification project. However, the findings and messages emanating from the Deloitte research deserve discrete, dedicated and close attention from the FSA; with a clearly defined action plan. It should not simply be taken that these will be subsumed within other, high-level workstreams.

In particular, there are high costs associated with training and competence, and with the complaints regime operated by the FSA. There are also high costs in relation to various of the Conduct of Business rules. To be clear, no firm disputes the need to develop and assess the capability of its staff, to have in place arrangements for handling dissatisfied consumers, and to treat their customers fairly at the point-of-sale (and thereafter). But it is the highly prescriptive nature of these requirements as currently framed in the FSA Handbook that generates the significant incremental costs.

Linked to this is the wider issue of record-keeping and evidence. Firms feel that the costs associated with having to demonstrate to the FSA (and the Financial Ombudsman Service (FOS)) that they are acting in an appropriate and compliant way, are significant. This is an issue that merits particular consideration. As we move toward a more principles-based regime where, in the FSA's own words, the focus should be on the outcome rather than the process, the Panel believes that – subject to the general expectations being clear – firms' senior management are better placed to judge the risk involved here, rather than have it determined for them by the regulator.

## The cost of regulation study

Regulatory fees and levies are also – inevitably – major drivers of incremental costs. In that context, we note that reviews are already ongoing into the funding frameworks for the FOS and the Financial Services Compensation Scheme – these are set to consider whether the current arrangements are equitable as between firms of various types and sizes. The Panel also intends to input towards the upcoming HM Treasury value for money evaluation of the FSA, to be undertaken by the National Audit Office.

## Going forward

If the efforts to reduce costs are to be truly successful, it will not only require a review and revision of the Handbook as it is set out on the page, but will also require a step-change in the culture of both regulator and regulated.

On paper, the FSA's ongoing shift toward a more principles-based approach should have consequential cost advantages for firms. It should provide a flexible and pragmatic backdrop for them to comply with their regulatory obligations in a way that best suits their individual type, size and model of business. However, there is a real and growing fear among practitioners that, whether due to a lack of will, expertise or training, the FSA and its staff will fail to supervise and enforce against principles in the manner and spirit that it says it will. As a result, firms will not have sufficient confidence to exercise their own judgement and will take an overly-cautious view about compliance with their regulatory responsibilities. The Panel remains in very regular discussion with the FSA on the subject of principles-based regulation as it evolves.

At the same time, it is necessary for the industry to embrace the FSA's deregulatory work, and not position itself against it. If the FSA is seen to be delivering on its part of the bargain, then so must we in particular, the respective imperatives between firm's senior management and their compliance teams – who typically favour the security of prescriptive rules – need to be reconciled.

The Panel welcomes the commitments set out by John Tiner in his Forward to this report. We shall work together with the FSA to ensure that these are indeed delivered. But will be rigorous in our representations where we feel that the FSA is failing to do so.

The industry rightly has an expectation that this piece of work will contribute to seeing real and meaningful improvements in the way that it is regulated and, specifically, on the issue of costs. The Panel urges the FSA not to let us down.

Finally, I would like to take this opportunity to especially thank those firms that took the time and trouble to take part in this important project. It was not easy and was a burden on their management, operational and financial staff and we really appreciate their very diligent work. My appreciation also goes to other members of the Steering Group – from both the Panel and the FSA side – to the FSA team that have taken things forward on a day-to-day basis, to Deloitte for their sterling efforts and to my fellow Panel members for their views and guidance as this work has progressed.

**Roy Leighton**



# 1. Executive Summary

## 1.1 Introduction

### Ground breaking study into the costs of regulation

It is now 6 years since the enactment of the Financial Services & Markets Act 2000 ('FSMA' or 'Act') and there has been significant regulatory evolution since that date, both as a result of international legislative changes and through changes in market practice and expectations.

In June 2005, the Financial Services Authority ('FSA') commissioned Deloitte & Touche LLP ("Deloitte") to undertake a study with the aim of measuring the financial costs of regulation imposed upon the UK financial services industry since the introduction of the FSMA by carrying out research among a sample of regulated firms ("the Study" or "the Report"). The Study was conducted by Deloitte on behalf of the independent Financial Services Practitioner Panel ('FSPP') and the FSA, and sought to provide a quantitative addition to the biennial survey conducted by the FSPP.

Together with other aspects of the FSA's commitment to the "Better Regulation" agenda, the FSA and the FSPP will use the results of the Study to assist them in determining whether for any areas of the FSMA regime, the costs of regulation are found to be disproportionate to the benefits. The Study deals only with the cost of regulation. It does not seek to capture or quantify the benefits nor does it deal with the opportunity cost of regulation.

### Sample of firms across 3 sectors of the financial services market

The Study has been undertaken across three regulated sectors of the UK financial services market:

- Corporate Finance ('CF');
- Institutional Fund Management ('IFM'); and
- Investment & Pension Advice to retail customers ('IPA').

The reasons for selecting these three sectors and the definition of them for the purposes of the Study are explained in Section 2. Regulatory capital requirements were not considered to be substantial in any of the three sectors selected for the purposes of this Study and accordingly the Study does not consider any cost implications arising from capital requirements. The Study's findings are based upon a sample of 68 firms which were selected as typical firms of different sizes and business models in each sector. It may be helpful to the reader to consider the Study as consisting of 68 separate case studies, each of which was chosen on the basis of specific characteristics. The following table indicates the number of firms by size; further details of the sample characteristics can also be found in Section 2.

**Figure 1.1 – characteristics of the firms that responded to the survey**

	Small	Medium	Large	Total
Corporate Finance	5	4	4	13
Institutional Fund Management	3	5	8	16
Investment & Pension Advice	23	6	10	39
Total	31	15	22	68

Deloitte ("We") would like to take the opportunity to thank the firms who contributed the time and resource to participate in the Study. We would also like to thank the sector specialists in Deloitte and the FSA who also contributed their thoughts to this study and the members of the Steering Group for their guidance and support.

### Use of a robust cost allocation methodology

Participating firms were required to follow a robust cost allocation methodology to determine the impact of individual rules on a firm's cost base. Firms were required to use their last audited financial statements as the basis for completing the Study, which in most cases related to the year ended 31 December 2004. The principle steps of the cost allocation methodology, described in Section 3, were to:

1. allocate costs from the general ledger into prescribed types of cost category and identify the proportion of those costs that related to the sector within the Study;
2. analyse the costs identified above into prescribed business activities, such as Marketing, Advising & Selling and Post-Sale client servicing;
3. identify within each business activity the proportion of costs that relate to each regulated activity, which corresponded to FSA Handbook rules, groups of rules or in a very few cases FSA Principles;
4. for each regulated activity quantify those costs incurred by firms in undertaking regulated activities which would not be incurred in absence of the FSMA; and
5. if appropriate, identify additional costs that would be incurred in the absence of FSMA.

Regulatory requirements may place both a one-off and ongoing cost on a firm. One-off costs arise from the implementation of new handbook rules or other FSA requirements. The Study sought to identify one-off costs, but many firms found it difficult in practice to do so. The Study was based on firm's last set of audited financial data and therefore the degree to which new regulatory requirements had been imposed depended on the sector in question and each firm's financial reporting period (either the financial year ending in 2004 or 2005). The impact of one-off costs was most readily identified within the Investment & Pension Advice sector where specific questions were asked regarding the costs of Treating Customers Fairly, Implementation of the menu and Implementation of depolarisation as these were initiatives introduced in the period.

### The importance of understanding the definition of incremental regulatory cost

Key terms used within the Study are contained in a Glossary included as Appendix 1 to this Report. It is important, however, that the reader understands up front what costs we have asked firms to identify and measure in completing the Study.

The key aim of the Study was to identify which individual rules were most costly for participating firms, thereby quantifying those costs incurred by firms in undertaking regulated activities which would not be incurred in absence of the FSMA. These costs were defined as incremental regulatory costs. This definition required firms to consider only ongoing costs, and therefore one-off costs incurred by firms as a result of new regulatory requirements imposed upon them were excluded. What our Study sought to identify is the potential annual compliance cost saving if an individual rule was removed. In considering what costs might be avoided in the absence of a particular rule, firms were asked to consider a time horizon of approximately five years.

Firms were asked to assess incremental regulatory costs on a rule by rule basis rather than on the basis of removing the FSMA as a whole. The rationale behind this was to identify the specific drivers behind incremental regulatory costs at a Handbook rule (or in some cases principle) level and each decision was taken independently of all others. Therefore, whilst it is possible to add up the individual incremental costs, this does not reflect the total incremental cost of regulation to a firm. Further explanation regarding this can be found in Section 3.

In determining incremental regulatory costs, firms were asked to quantify the total costs firms incur in meeting their regulatory responsibilities whilst undertaking regulated activities. As such, total costs will include embedded costs that a firm would have ordinarily incurred for commercial or other purposes. These costs were defined as cost of business activities affected by regulation.

## The need to ensure the consistency and comparability of findings

Our methodology has been designed in a way to achieve a level of consistency in how participating firms have completed the Study. Our approach is described in more detail in Sections 2 and 3, but in summary:

- Participating firms attended either a workshop or face-to-face meetings where the methodology was explained; and
- Firms were provided with a combination of assistance and written guidance notes during the completion of the Study.

The Study was designed to make best use of information already prepared by the participating firms to support their financial statements and other existing reporting requirements. Whilst this approach has resulted in a degree of inconsistency between firms in the classification of total costs, as explained below, this does not compromise the incremental regulatory cost findings. Consequently our analysis has focused on the incremental results.

The inconsistency referred to above is best illustrated by an example. Within the IPA sector, a significant cost is incurred in respect of client meetings. These meetings are part of the sales process and thus fall within the business activity of Advising and Selling as defined for the Study. Broadly, we identified two approaches to step 3 of the methodology: either the entire costs of the meeting are identified by a firm as relating to a regulated activity, because the conduct of the meeting is subject to Conduct of Business rules, or, alternatively, only the costs of complying with the Conduct of Business rules in that meeting are considered as the regulatory costs. Both these approaches will give the same results in steps 4 and 5, where the incremental regulatory costs are identified and thus we considered both approaches valid for the purposes of the Study.

The cost of business activities affected by regulation should therefore be viewed only as a step within our methodology to determine the incremental regulatory cost. It should not be considered as a measure for extrapolating the cost of the FSMA to the UK financial services industry. Accordingly, and in line with the overall aim of the Study, this report will focus on those areas identified by firms as having the highest incremental regulatory cost.

As part of the quality assurance process, the findings have been discussed with a Steering Group made up of both FSA and FSPP members and other stakeholders at the FSA including the EFR (Economics of Financial Regulation) Department and members of the Policy and Supervisory divisions.

## Key findings of the Study

The Study confirmed that firms do not typically seek to measure and monitor the cost of undertaking regulatory activities for internal or external financial reporting purposes.

We also found that there was a wide distribution of costs identified by firms within the same sector, which indicates that the link between the cost of regulation and firms is a particularly complex one.

The key findings of the Study are contained in the following sections of the Executive Summary:

1.2 – Corporate Finance

1.3 – Institutional Fund Management

1.4 – Investment & Pension Advice

Our findings, unless identified as otherwise, are reported as medians. The use of medians, rather than arithmetic means, in our report has been driven by the presence of various outliers, i.e. responses from some firms which varied widely from all other firms' responses. The median value represents the value in the middle of the distribution of values, i.e. that value for which half of the entries are higher and the other 50% of entries are lower. This measure is therefore not sensitive to the value of the extremes, and for example, would not change if the maximum value doubled. It only depends on the relative position of the value within the observations.

Where possible we have sought to identify the underlying cause of outlier responses. Where these are due to the different impact of regulation on different business models it is

likely to be of interest to the reader. However, in some cases it may be due to either differences in firm efficiency or different attitudes to, and appetites for, regulatory risk. The Study was not designed to measure either of these two factors. Finally, outlier results may occur where firms have misunderstood or misinterpreted the requirements of the Study. Our challenge and review processes will mitigate this in part but some level of differences due to inconsistent interpretations of key terms is inevitable given the requirement for firms to make subjective judgements.

In interpreting the findings contained within this report we draw your attention to Part 1.6 of this Executive Summary, which highlights certain limitations in the reliability of data obtained.

## 1.2 Corporate Finance findings

The results indicate that both the cost of business activities affected by regulation and incremental regulatory costs in the Corporate Finance sector are comparatively low.

**FSMA does not impose significant costs on the provision of corporate finance advice to the institutional market**

The incremental regulatory costs reported for each rule were significantly less than 1% of a firm's cost base. The rules do not, in most firms' view, require significant additional processes or procedures to be implemented to ensure compliance with the FSMA. This has a direct impact on the level of costs reported by firms. This result is logical since the provision of corporate finance advice is almost wholly to institutional clients and the number of prescriptive rules applying to these firms is low.

We found three key drivers of incremental regulatory cost in the Corporate Finance sector and we set out here a summary of each of these drivers. Our detailed findings relating to these drivers can be found in Section 4.

**Size of firm impacts the level of incremental regulatory cost**

The results indicate that the size of the firm will be a factor in the level of incremental regulatory cost incurred and some small firms indicated that they would cease some regulatory compliance activities completely to reduce administrative burdens if rules were removed. This was most marked in respect of governance activities.

**Large firms will apply a global approach to regulation**

Some large firms, due to their global presence, will primarily monitor and manage financial performance, including their cost base, by division rather than legal entity. This makes it difficult to distinguish between costs incurred in undertaking business in the UK and overseas. Firms with global operations may also apply a global approach to regulation in which they apply a common set of standards which incorporate all necessary local regulatory requirements. Consequently, this has reduced the level of incremental regulatory costs reported by those medium and large firms in instances where an overseas regulator imposes equivalent or super-equivalent regulatory standards to those required under the FSMA.

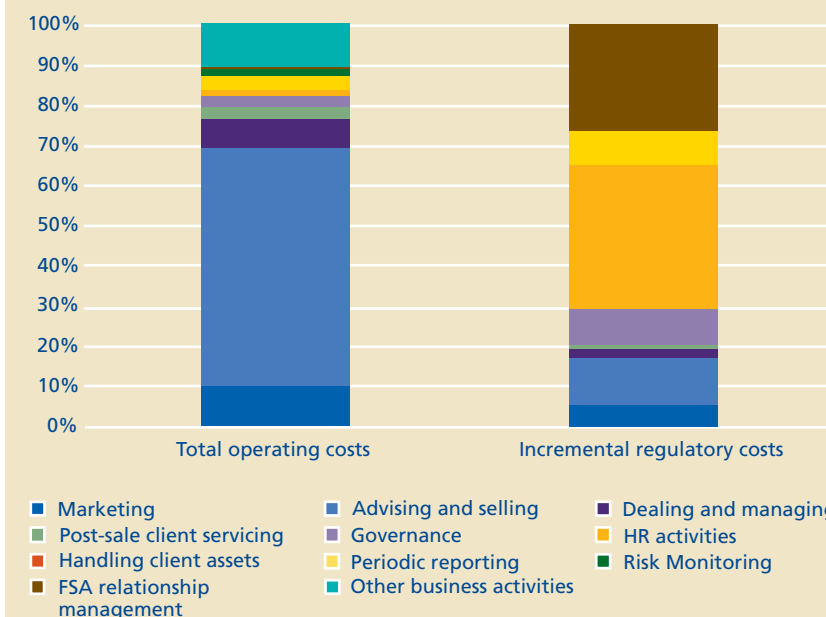
This approach to regulation is consistent with the degree to which the business model in the corporate finance advice market is more transportable – proximity of firms to their customers is perhaps less relevant than other sectors such as the IPA market.

**Maintaining employee competence and keeping up to date with FSA communications were viewed by firms as the most costly regulatory activities**

The business activity with the highest incremental regulatory cost was Human Resource related activities. Human Resource activities included mostly the Training & Competence and Fit and Proper requirements. Within the twenty FSA Handbook rules reported as incurring the highest incremental regulatory costs, five related to this activity.

Figure 1.2 summarises the firms' total cost base and incremental regulatory costs by business activity. This highlights the relative significance of Human Resource related activities, compared to the other business activities, from a regulatory perspective.

Figure 1.2 – Impact by business activity



In particular firms reported that the highest areas of incremental regulatory cost related to maintaining employee competence and keeping up to date with FSA seminars, cluster reports and speeches.

Collectively firms reported incremental regulatory costs of 0.19% associated with Human Resources activities. Whilst this is not perhaps as significant as costs reported in the other two sectors, and the aggregation of costs attributed to a number of rules by different firms is not statistically reliable, firms have consistently identified it as the area of highest incremental regulatory cost.

### 1.3 Institutional Fund Management findings

**FSMA imposes relatively low costs on the institutional fund management market**

The results indicate that the incremental regulatory cost in the IFM sector is higher than Corporate Finance, but significantly lower than the Investment & Pension Advice sector. This is not unreasonable given that many detailed areas of regulation are aimed at firms who deal with private customers and do not have as much impact on firms who deal only with institutional clients.

We found three key drivers of incremental regulatory cost in the IFM sector and we set out here a summary of each of these drivers. Our detailed findings relating to these drivers can be found in Section 5.

**Firms will often apply retail standards to institutional businesses on operational efficiency and cost grounds**

Whilst the results showed some evidence of the impact of size the pattern was less conclusive than that for the Corporate Finance sector. The drivers of incremental regulatory cost varied depending upon the size of the firm. Some medium/large firms indicated that their costs were high because other parts of their groups perform retail regulated business, which are subject to more detailed regulation, but they apply the same compliance standards and procedures across the firm.

**Small IFM firms have proportionately higher incremental regulatory costs than medium/large IFM firms**

Incremental regulatory costs are proportionately higher for small firms because regulatory activities take up a greater proportion of their time compared to medium/large firms. Some small firms indicated that they would cease all related regulatory compliance activity if the rules were removed whereas medium/large firms indicated that in most areas they would continue to perform these activities as they are now considered best practice and embedded in their businesses. This is likely to reflect the organisational differences between large and small firms as well as different risk appetites between firms of all sizes. Business activities where small firms would save more cost than medium/large firms if rules were removed are Dealing and managing, Governance, HR activities, Periodic reporting and Risk monitoring.

**Dealing and managing activities were viewed by firms as the most costly business activity affected by regulation**

Dealing and managing business activities feature as the activities which incur the highest incremental regulatory cost. This indicates that IFM firms attribute a high cost to activities around best execution and customer order priority. This finding is in line with our expectations for cost drivers for firms in the this sector and this is the most costly business activity affected by regulation in the IFM sector.

However, as the incremental cost is relatively low, despite the relatively high total business activity cost of Dealing and Managing, firms indicate that much of this cost would be incurred in the absence of the FSMA.

**Retail markets would appear to create higher levels of incremental cost**

## 1.4 Investment & Pension Advice findings

The IPA sector is characterised by the diversity of both the size of firms and business models represented within it. The Study includes firms ranging from a sole trader IFA business to the sales force of a large retail bank. Participating firms include representatives from both independent and tied business models, and include both networks and network member firms.

Firms have reported the highest level of incremental regulatory costs in the provision of investment and pension advice sector. More detailed Conduct of Business rules govern the operations of firms providing advice in the IPA sector than for firms operating with institutional or professional customers.

**Incremental regulatory cost does not vary significantly by size of firm**

One of the key findings of the study in this sector, perhaps contrary to expectations, is that small firms in our Study did not incur proportionately higher incremental regulatory costs than the large firms.

The explanation behind the differences is complex but includes:

- The higher complaints costs incurred by some large firms in the banking and life assurance sector, some of which are deemed to be incremental; and
- The higher costs of training and competence incurred by some large firms who continued to recruit and train new advisors and where some of the costs are deemed to be incremental.

The following business activities account for the highest incremental regulatory costs:

- Advising and Selling;
- FSA relationship management;
- Post Sale Client Servicing, including dealing with complaints;
- Human Resources, including training and competence; and
- Risk monitoring, including the requirement to hold Professional Indemnity Insurance.

**Advising & selling recorded the highest incremental regulatory costs**

Advising and Selling business activities are subject to more detailed and greater number of FSA rules. These business activities also account for a considerable proportion of staff time and therefore cost is attributed to these activities in IPA firms.

Eleven Advising and Selling activities feature in the top twenty business activities reporting the highest incremental regulatory costs.

The five incrementally highest areas of business activities affected by regulation within 'Advising and Selling' are:

- Production of the suitability letter (0.4%);
- Provision of key features (0.1%);
- Ensuring products sold are suitable for client needs (0.1%);
- Tailoring of projections in key feature documents (0.1%); and
- Performance of 'know your customer' checks (0.1%).

It should be noted that the costs resulting from these rules are not all considered to be



100% incremental as firms generally appear to recognise the need to conduct these activities; the incremental element of costs arises from the way in which the activities are required to be carried out.

A greater proportion of the costs associated with the production of the suitability letter was considered incremental among small IFA firms than among larger firms.

**Some small firms consider PII to be an incremental regulatory cost**

The main incremental cost within the Risk Monitoring business activity, is Professional Indemnity Insurance (PII). However, PII does not feature in the top twenty incremental regulatory costs. This is principally because many of the small firms who included costs reported low incremental costs against this rule (ie they would choose to insure even in the absence of the rule).

A small number of small intermediary firms reported the incremental regulatory costs of PII to be high – in other words they would not buy or would reduce their cover in the absence of the rule.

## 1.5 Aggregated findings

**The impact of FSMA varies significantly by sector**

The Study has collected data from 68 firms in respect of over 100 individual rules and areas of rules. This level of detail was obtained to provide the best evidence as to the specific rules that impose the greatest cost on the financial services industry.

In completing the Study, firms were asked to assess incremental regulatory costs on a rule by rule basis rather than on the basis of removing the FSMA as a whole. The rationale behind this was to identify the specific drivers behind incremental regulatory costs at a Handbook rule (or in some cases principle) level. The Study was not designed to provide statistically reliable estimates of the incremental cost of regulation across the three sectors concerned and as already mentioned a simple summation of the results for individual rules does not provide an accurate estimate of the total incremental cost for a firm. Nevertheless, the range of firm results gives some indication of the difference between sectors. This is unsurprising given the differing extent of regulatory intervention in the sectors.

**Markedly higher costs for the retail market**

The costs indicated by firms operating in the Investment & Pension Advice sector are noticeably higher than for the other two sectors. Given the nature of the regulatory regime applying to retail customers, it is perhaps expected that the costs reported in the Study are markedly higher in the retail market than the institutional market.

The areas of the FSMA causing the highest incremental regulatory cost do vary between sector and to a lesser extent by firm. Generally, however, firms have indicated that the specific FSA Handbook rules with the highest incremental regulatory costs are within the business activities of Advising & Selling, Human Resources (which includes Training and Competence) and Post Sale Client Servicing.

**Directly attributable fees were found to be the highest incremental cost across all 3 sectors**

Firms were asked to identify direct and indirect costs which they felt were incremental in nature. In all three sectors, the regulatory activity which reported the highest incremental regulatory costs was Regulatory Fees and Levies. Therefore, the most costly area of regulation identified by firms is the direct costs imposed upon them.

The incremental regulatory costs reported for Regulatory Fees and Levies varied by sector, as highlighted in the table below. Regulatory Fees and Levies are compared below with the cost attributed to the second most significant regulatory activity, in order to highlight how their relative importance varied by sector:

**Figure 1.3 – Comparison between incremental cost of regulatory fees and the incremental costs of the second most significant regulatory activity**

	Regulatory Fees and Levies	Second most significant regulatory activity
Corporate Finance	0.26%	0.08%
Institutional Fund Management	0.33%	0.27%
Investment & Pension Advice	2.71%	0.41%

Regulatory Fees and Levies comprises the annual fees and levies charged to regulated firms in respect of the FSA, the Financial Services Compensation Scheme (FSCS) and the Financial Ombudsman Service (FOS). The table below details how these Regulatory Fees and Levies are split between these bodies.

**Figure 1.4 – Breakdown of Regulatory Fees**

Sector	FSA	FSCS	FOS
Corporate Finance	77%	18%	5%
Institutional Fund Management	94%	5%	1%
Investment & Pension Advice	68%	28%	5%

Note: the proportions reported above reflect the fees paid for the respondent firms as a whole due to problems in disaggregating fees across different business lines and divisions.

**Across all three sectors, firms recorded cumulatively significant costs for record keeping requirements**

Generally the trends identified in the Study are sector specific, however the record keeping requirements within the FSA Handbook did indicate that incremental regulatory costs were of significance across all three sectors.

The record keeping rules are associated with many different areas of FSMA. The incremental regulatory costs are high in cumulative terms, but the costs are attributable to a wide range of record keeping activities. Firms reported that it was necessary to evidence compliance with areas of the FSA Handbook to ensure they could demonstrate the basis for decisions or processes after the event, should they be challenged through the supervisory or complaints process at a later date.

**Firms were unable to identify/quantify cost savings as a result of regulation**

The Study has focused on obtaining estimates of the incremental cost of an individual rule and has not sought to examine the benefits derived from those rules. However, in estimating the costs that would be saved as a result of the removal of a rule, firms were asked to consider what costs might also arise as a result of this action. Whilst firms were able to identify such costs in principle; such as increased legal costs if complaints rules were removed, they were unable to quantify hypothetical costs.

**Firms do not generally seek to measure and monitor their costs in terms of regulatory activity – the costs of complying with the FSMA requirements are now largely embedded into firms operating infrastructure**

## 1.6 Comments on the reliability of the findings

In undertaking a Study of this complexity and magnitude, there are risks regarding data quality which should be considered alongside the findings within the Report. Firms do not generally seek to measure and monitor their costs in terms of regulatory activity – the costs of complying with the FSMA requirements are now largely embedded into firms' operating infrastructure. As a result, firms have applied subjective judgement and made estimates to quantify the total and incremental regulatory costs of regulation. The following factors should be considered in considering the reliability of the results presented:

- There are many firms making up the financial services industry; they offer many different products and services, they organise themselves in different ways, they are subject to a range of international competitive pressures and range in size from the very big to the very small. The Study has not included sufficient firms to generate results that can be statistically proven. However, the Study has captured a range of firms which we believe exhibit a range of characteristics of the three sectors concerned. Our approach to selecting the sample is described in Section 2.
- Participating firms ranged from the very small to the very large. In the case of some large firms, internal management or statutory financial information did not identify the costs attributable to the sector of the market in question. In these cases, firms determined the cost base by allocating a proportion of the firm or a specific divisions' cost base using an appropriate measure, such as headcount or revenue.
- The methodology utilised a form of full cost apportionment model, commonly referred to as Activity Based Costing ('ABC') and required firms to allocate both direct costs, such as staff costs, and indirect costs, such as property. Most firms elected to apportion all cost types to regulated activities by applying the percentage of staff costs apportioned to each business activity.
- Similarly, in order to simplify the approach for firms, the costs for regulatory activities were determined using an average staff cost per hour, which creates a blended rate for each activity regardless of whom within the organisation might ordinarily undertake the activity.
- As explained above, the Study analyses the costs of FSMA regulation from firms' actual cost information. Therefore, it excludes any opportunity costs, i.e. revenue or profit foregone by taking the course of action required by regulation. For example, the opportunity costs that may have been suffered by a firm as a result of restrictions on a firm's ability to maintain vertical relationships under polarisation rules, have not been captured within the results.
- Firms will operate with different degrees of efficiency. Within the regulatory costs reported we have not been able to identify to what extent the costs reflect levels of inefficiency. Similarly, a firm's attitude to risk may have a bearing on their approach to, and costs of, regulatory compliance. It has not been practicable to quantify how these factors influence firms' costs of regulation.
- The methodology behind the Study requires firms to make judgements and estimates where necessary. Whilst the methodology was supported by detailed guidance notes and in many cases assistance from Deloitte during the completion of the questionnaire, there remains some risk that firms interpret the requirements differently.

## 2. Background



In May 2005, the FSA and Financial Services Practitioner Panel (FSPP) jointly commissioned a ground-breaking study to measure the real costs of financial regulation and appointed Deloitte to carry out research among regulated firms.

The drivers behind the Study were two-fold:

- Industry practitioners' concern about rising costs of regulation, and in particular the burden on smaller retail businesses as reported in the 2005 practitioners' survey, but the lack of conclusive information (as reflected in the differing results of other studies). For this reason the Study was based on the actual costs of a firm, as reported in its latest available audited financial statements.
- The FSA's commitment to the "Principles of Good Regulation" requiring that the costs of regulation should be proportionate to the benefits which are expected to result. For this reason the Study was designed to measure the costs of compliance with individual rules in order to identify those that give rise to the greater incremental cost.

### 2.1 Governance

We were appointed by a Steering Group made up of the following members of the FSA and the FSPP:

- John Tiner (Chief Executive, FSA)
- David Kenmir (Managing Director, Regulatory Services, FSA)
- Kari Hale (Director, Finance, Strategy & Risk, FSA)
- Jonathan Bloomer (FSPP)
- Roy Leighton (FSPP)
- Ruthven Gemmill (FSPP and Chair of Small Business Practitioner Panel)

We have met monthly with the Steering Group during the course of the Study. At these meetings we have discussed and agreed our approach for all key aspects of the Study including:

- The methodology underpinning the quantification of costs;
- The form and content of the questionnaire completed by firms;
- The identification of the sample of firms;
- Analysis and interpretation of the findings; and
- The timetable, including the publishing of results, for the Study.

We have also discussed the findings of the Study with the FSPP and other stakeholders at the FSA including the EFR (Economic of Financial Regulation) Department and members of the Policy and Supervisory divisions.

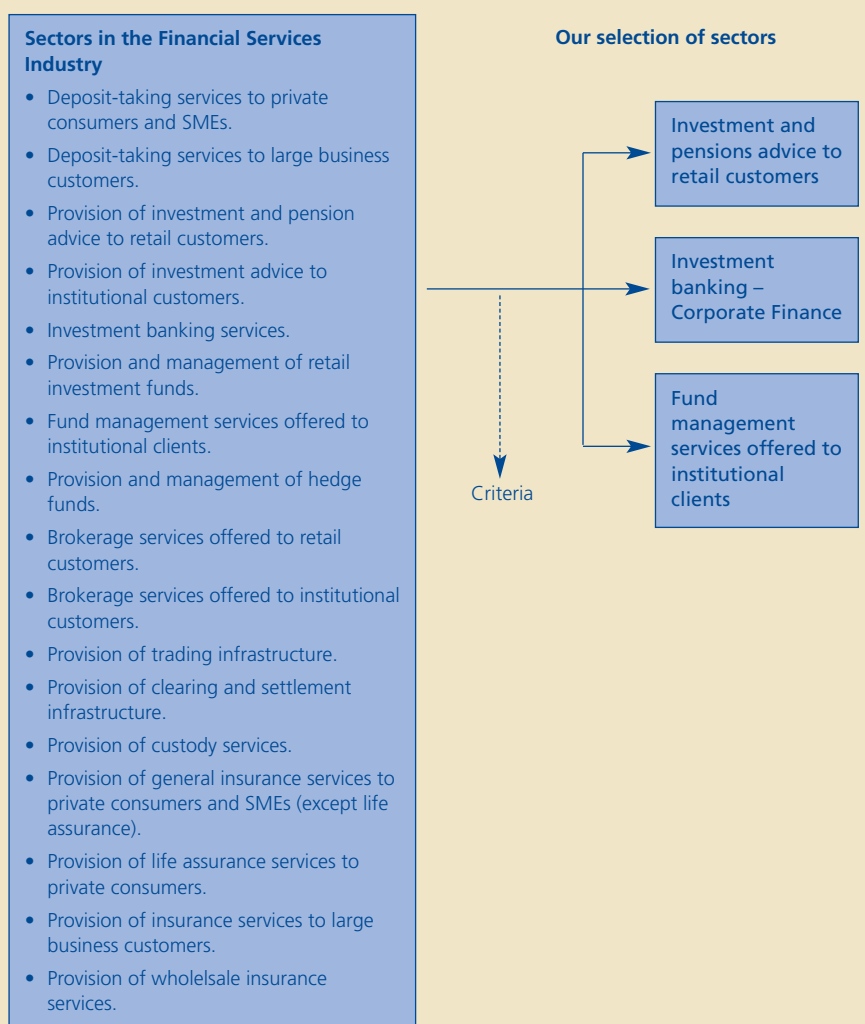
## 2.2 Sectors selected for the Study

The requirements of the Study were to select three sectors of the financial services industry ("sectors") which would reflect the diversity in the types of firms which operate in the industry. The sectors chosen include a range of firms from small Independent Financial Advisors ('IFA') to wholesale firms which operate in internationally competitive markets.

### Sectors selected using classifications

For the selection of the markets we have relied on the division of the financial services industry undertaken by a consultancy in their report for the Office of Fair Trading. They based their classification process on economic principles. Those high-level markets were primarily identified from the perspective of demand- and supply- side substitution following common practice in competition policy. Therefore, relying on this division of markets should facilitate subsequent comparison of the costs of discretionary regulation in particular markets, including competition effects, with the benefits derived from that regulation.

Figure 2.1 – Sector selection



We developed a methodology to define and then select the three most relevant sectors for the Study using the following criteria:

### Criteria applied for the selection of sectors

1. Sectors should be selected that facilitate useful conclusions regarding the cost of regulation with respect to:
  - the relative sizes of firm;
  - the extent of integration with large financial services firms;
  - geographical location;
  - discretionary and mandatory regulations;

- the impact of UK versus international competition;
  - the cost differential of dealing with institutional versus retail consumers; and
  - the impact of new regulations and/or step changes to existing regulations.
2. Data should be obtainable: consideration was given to what data could practically be obtained from firms and to the extent that data would be reliable.
  3. Externally validated data sources should be available so that information provided by sample firms through interviews and questionnaires could be compared against reliable data.
  4. Small firms should be represented: at least one of the chosen markets should include smaller firms where it was considered that costs of regulation may be proportionally higher.
  5. Sectors must be identifiable by survey participants as distinct activities or groups of activities so that firms which perform other activities outside the selected sectors can segregate the costs associated with the selected sectors.
  6. Sectors should be internationally recognisable: it will also be useful to define the selected sectors such that they are internationally recognisable for use in future cost comparisons.
  7. Minimise effort of data production: sample firms should be able to produce data with reasonable ease and minimum data manipulation.

Based on these criteria three sectors were chosen. Investment banking services – corporate finance advice, Fund management services offered to institutional clients, and Investment and pension advice to retail customers. In order to select samples of firms from these sectors FSA provided a list of firms with the above permissions and details of the number of registered individuals by firm. For firms in the Fund management services offered to institutional clients sector we also requested details of firms’ total funds under management. The three sectors were defined as follows:

**Sector: Investment banking services – corporate finance**

This regulated market encompasses financings, flotations, mergers and acquisitions, corporate broking, investor relations for clients and research activities directed at corporate clients. This sector was defined as:

- All those firms, or parts of firms, carrying out activities requiring either or both of the following permissions:
  - All firms within the fee block activity group A.14, Corporate Finance and all London Investment Banking Association members; and/or
  - All firms with individuals registered under the CF23 controlled function (Corporate finance adviser function).

From this sector we selected a sample based on the number of registered Approved Persons per firm and on the type of firms which comprise the sector. We chose a sample of large (100+ Approved Persons), medium (20-100 Approved Persons) and small (less than 20 Approved Persons) firms, which was selected from two types of firm: integrated investment banks and specialist corporate finance firms.

**Figure 2.2 – Distribution of Corporate Finance sample across size and business model**

Type of firm	Large 100+ Approved persons	Medium 20-100 Approved persons	Small Less than 20 Approved persons
<b>Integrated firm LIBA Member</b>	4-6 UK owned – with/without Bank US owned – with/without Bank European owned – with/without Bank	N/A	N/A
<b>Specialist firm Corporate Finance Adviser</b>	N/A	4-5	4-6



Figure 2.2 opposite indicates the breakdown of the sample initially identified with the FSA across the two dimensions that we used to define the sample: firms' business model, and size of firm.

The benefits of the selection of this sector include the characteristics described below.

- There will be a range of size of firm from sole practitioners up to global investment banks enabling conclusions to be drawn about the effect of firm size on the impact of regulation.
- There will be a range of vertical integration from advice only firms to those offering underwriting and distribution and ongoing corporate broking services.
- Similarly there will be horizontal integration with structuring advice supported by transaction capability and balance sheet usage in some firms.
- This is an international sector and there is no inherent requirement for the service provider to be physically located near the customer or market, there is a relatively low infrastructure requirement and the business might be expected to be mobile in response to changes in cost or regulation.
- There have been recent changes in the regulatory requirements covering this sector, predominantly discretionary changes made in response to market events for example the extension of Chinese walls to analysts.

**Sector: Fund management services offered to institutional clients**

This regulated market encompasses all investment management services provided by the firm to segregated or pooled portfolios and other types of investment structures offered to Intermediate Customers and Market Counterparties wherever they may be based. It does not include any investment management services provided to Private Customers or to Undertakings for Collective Investment in Transferable Securities vehicles as these are subject to a separate specialist handbook. This sector was defined as:

- All those firms, or parts of firms, carrying out activities requiring the following permissions:
  - Managing investments; and/or
  - All firms with individuals registered under the CF27 controlled function (Investment management function).

From this sector we selected a sample based on the total funds under management (FUM) per firm and on the type of firms which comprise the sector. We chose a sample of large (£50bn+ FUM), medium (£5bn to £50bn FUM) and small (less than £5bn FUM) firms, which was selected from two types of firm: integrated investment banks and life insurance firms and specialist fund management firms.

**Figure 2.3 – Distribution of Institutional Fund Management sample across size and business model**

Type of firm	Large (>£50bn)	Medium (£5bn – £50bn)	Small (Less than £5bn)
<b>Integrated firm</b>	5-6 2 part of bank/3-4 part of life company	N/A	N/A
<b>Specialist firm</b>	4-5	4-5	4-5

Figure 2.3 above indicates the breakdown of the sample initially identified with the FSA across the two dimensions that we used to define the sample: firms' business model, and size of firm. Also in this sector the initial sample was adjusted to reflect the limited diversity of firms' characteristics within each cell of the above table.

The benefits of the selection of this sector include the characteristics described below.

- Compared to the other two markets selected this market has a structurally more homogeneous population. However, the sector does include firms of varying sizes and business focus (eg small hedge fund managers and larger fund managers that are subsidiaries of life companies).

- Whilst many fund managers also operate in other markets such as retail funds and may also provide for example, custody services, there has always been a degree of separation of activities, the institutional market is highly segregated and we expect that cost data will be capable of separation from other activity costs.
- The regulations applicable to this sector have been largely stable for several years. However more recent changes including those relating to softing and bundling will provide the ability to track some lifecycle costs.
- The services provided to UK clients by UK firms are not essentially different to those that would be provided by international firms to international clients (although the tax position will differ by jurisdiction) so it should be possible to draw international comparisons from the results when the study is widened to non-UK firms.

**Sector: Investment and pension advice to retail customers**

This regulated market includes firms operating different business models:

- those operating as an appointed representative of a single provider dependent upon that provider's compliance resources (both employed and self-employed);
- bancassurance operators offering tied, multi-tied or independent services;
- appointed representatives of an IFA network;
- directly authorised independent/multi-tied advisors using the services of an IFA service provider for regulatory support;
- directly authorised independent/multi-tied advisors with their own compliance infrastructure.

This sector was defined as:

- All those firms, or parts of firms, carrying out activities requiring either or both of the following permissions:
  - Advising on investments (except on Pension transfers and Pension opt outs); and/or
  - Advising on Pension transfers and Pension opt outs.

From this sector we selected a sample based on the number of registered advisers per firm and on the type of firms which comprise the sector. We chose a sample of very large (500+ advisers), large (100-500 advisers), medium (10-100 advisers) and small (less than 10 advisers) firms, which was selected from three types of firm: banks/building societies, IFAs/multi-tied advisers and life insurance firm advisers.

**Figure 2.4 – Distribution of investment and pension advice sample across size and business model**

Type of firm	V. Large (500 advisers +)	Large (100-500 advisors)	Medium 10-100 advisors)	Small (less than 10 advisors)
<b>Bank/ Building Society</b>	3-4 2 with own provider/JV, 1 tied/multi-tied	3-4 1-2 Independent, 2 Tied	3 2 tied, 1 multi-tied	N/A
<b>IFA/Multi-tied</b>	5-6 1 with advanced technology, 1 without, 1 with employed salesforce, 1 without. Mix of complex pensions/tax/ simpler advice 2 network head offices	3-4 1-2 part of wider organisation (eg general insurance), mix of complex v simpler advice	4-5 1 EBC, 1 High Street IFA, 1 network member 1 independent, mix of complex v simpler advice	20 5 network members, 15 'independents', mix of complex v simpler advice
<b>Life company advisors</b>	3 2 employed and tied, 1 multi-tied	3 Self-employed appointed representatives	N/A	N/A

Figure 2.4 opposite indicates the breakdown of the sample initially identified with the FSA across the two dimensions that we used to define the sample: firms' business model, and size of firm.

It should be noted that this original sample was then revised, mainly as a consequence of the limited diversity within the sector which limited the possibility of achieving the sample. For example, very large and large firms were collapsed in one category. In analysing the results we have also found there was limited scope to break down the results according to the different types of business model.

The benefits of the selection of this sector include the characteristics described below.

- The retail advice market is highly fragmented with firms ranging in size from sole traders with turnover of less than £200,000 per annum to large firms with several thousand advisors enabling analysis of the impact on costs by size of firm.
- The sector contains firms that operate different business models:
  - from those operating as an appointed representative of a single provider dependent upon that providers compliance resources to network members of IFA firms and large directly authorised independent advisors.;
  - from firms operating through high street branches to mass market consumers (eg bank advisors) to those operating through call centres and the internet enabling conclusions to be drawn on physical location; and
  - from advice that is an integral part of a larger financial services business (eg a bank) to specialist firms focused only on the delivery of advice.
- The sector provides evidence of the lifecycle impact of regulation with some regulations remaining largely unchanged for many years (eg suitability) and others only recently amended (eg new disclosure requirements).

# 3. Methodology

## **Firms do not typically seek to measure and monitor the cost of regulatory activities**

### 3.1 Introduction

The aim of the study was to determine a reliable estimate of the incremental costs imposed on the financial services industry by financial regulation.

We believe that this is the first attempt to estimate the cost of regulation using, as far as possible, auditable evidence rather than perception and as a consequence there was no existing methodology or approach to follow. It is also the case that there is no single definition of the cost of regulation and that it is interpreted in different ways by different people.

Our approach to this task was to build a cost allocation model that identified the drivers of costs incurred by a business. This model, applied to cost data from a sample of firms, would enable us to draw consistent comparisons and conclusions on the costs and of their drivers.

This section of the Report gives a high level description of the cost allocation methodology.

### 3.2 Nature of data to be collected

The study is based on firms' actual cost information and their judgement regarding specific cost drivers. The cost information analysed in the study reflects, where possible, each firm's last audited financial accounts at the time of the data request (August 2005 to December 2005) and requested that all financial information should be based on UK Generally Accepted Accounting Practice ("UK GAAP"). Where a company was part of a group, we requested that the reported costs related only to the legal entity invited to participate in the study.

Together with the completed spreadsheet questionnaire firms were also asked to supply a copy of their last audited financial accounts for the legal entity selected for the Study, with the intention of providing an audit trail.

### 3.3 Assistance for firms

We put in place a number of measures to assist firms who took part in the Study. These measures were as follows:

- Firms who accepted our invitation to take part in the Study were either invited to attend a Cost Briefing Workshop or a one to one briefing. At these meetings, firms received further explanation of the cost allocation methodology and data requirements. Firms were able to meet designated Deloitte staff with whom they would have the opportunity to raise specific issues and concerns both at the workshop and thereafter at any point whilst they were completing the data collection spreadsheets.
- Following the workshops or one on one meetings, each firm was required to complete the data collection spreadsheet. A Deloitte team member was available by telephone to provide support as necessary. The Deloitte team answered various queries from firms during this period, including issues relating to the interpretation of cost categories and terms used in the data collection spreadsheet and how to allocate costs from firms' own cost categories into the cost categories required in the spreadsheet.
- For firms that required additional support, Deloitte provided assistance in completing the questionnaire. This was typically offered to the small IFA firms where time pressure was a constraint in participating in the Study.

**It was important in designing the methodology to give guidance to firms on what could reasonably be identified as incremental**

## 3.4 Definition of incremental costs

The incremental costs of FSMA regulation are those costs incurred in complying with regulation that would not be incurred or would not have been incurred (the latter relates just to the year for which data is being collected) in the absence of the FSA mandatory rules (including those implementing EU directives) developed under FSMA. In addition to costs imposed by FSA regulation, firms were also asked to consider costs resulting from FOS and FSCS as these bodies are also established under FSMA.

### Regulatory overlap

There are regulatory activities required by FSA regulation which may also be required by other regulatory or legal bodies both in the UK or abroad. For those regulatory requirements where there is overlap with non-FSA regulation, the incremental costs of the FSA regulation are likely to be small or even zero. This is because in assessing incremental costs we are considering the removal only of FSA rules and not the requirements of other regulators or statutes. For example:

- The Criminal Justice Act 1993 makes insider dealing a criminal offence. Therefore, firms must ensure that appropriate arrangements exist to manage possible conflicts of interest even in the absence of specific FSA requirements.
- The Money Laundering Regulations 2003 include requirements regarding identification and internal reporting procedures, systems, training and record-keeping, which would apply, even if the FSA removed its related rules on such requirements.
- The Trade Descriptions Act 1968 requires that any descriptions of goods and services given by a person acting in the course of a trade or business should be accurate and not misleading. Therefore, even if the FSA rules requiring that financial promotions are clear and not misleading were dropped, it is likely that firms may still incur some of the costs related to those requirements anyway.

An exception to this suggestion is represented by the requirements dictated by the EU directives which are implemented through the FSA. Although these requirements would need to be enforced even in the absence of the FSA, we instructed firms to consider the cost related to the FSA rule as incremental, even if the rule is dictated by a EU directive.

### Commercial overlap

In considering the incremental costs of FSA regulation firms were also asked to consider whether they may still need to incur those costs anyway because of their customers and counterparties expectations. In this case there may be some overlap between regulatory and commercial requirements. For example:

- If the FSA prudential rules were dropped, firms may consider reviewing the amount of capital to be held. However, they should consider whether they would still want to maintain similar amounts of capital in order to meet credit ratings or counterparty expectations.
- FSA rules require firms to maintain some professional indemnity insurance (PII). In considering how much of the PII costs are incremental, they should consider the extent to which they may still want to hold PII insurance to cover your firm against the risk of customer claims for compensation against possible wrong or negligent services or advice. It is possible that clients may require firms to carry a certain level of PII as a precondition for carrying out business with them.

### Examples to assist firms in making judgements about regulatory costs

There are other activities that firms may want to undertake in the absence of specific FSA requirements, in order to maintain their reputation, according to industry practice or for any other business reasons. We set out some further examples below where an activity that ensures compliance with an FSA rule may nevertheless be continued at least to some extent even in the absence of that rule:

- Firms may want to ensure that they establish and maintain systems and controls and internal reporting lines which are appropriate to the business. The Financial Reporting Council Combined Code on Corporate Governance 2003 requires firms to maintain sound systems of internal control so those requirements might overlap to some extent with FSA rules on systems and controls. Firms may consider however to what extent due to FSA regulation they have more complex and expensive systems and control procedures than they would otherwise do.
- Firms may want to ensure that certain standards are maintained in financial promotions. For example, standards set by the Advertising Standards Authority require that financial products can be understood easily by customers and that they contain certain information.
- Firms may want to have appropriate processes to ensure that customers are treated fairly. Consideration of the customer throughout the product lifecycle from design to after sales service is increasingly important due to consumers' increased financial awareness.
- Firms may take steps to ensure the products they are selling to the customer are suitable for their needs. This may include to some extent determining customers' attitudes and requirements; and recording such facts for future reference.
- Firms may take reasonable steps to ensure that customers understand the risks associated with the financial products they are considering purchasing. Depending on the extent to which customers are financially sophisticated, they may want to provide some information on the risk associated with the financial products and to do so in a way that the customer can reflect on the information at a later date.
- They may want to obtain sufficient information about the knowledge and skills of possible new recruits, in order to ensure that new joiners representing the firm are likely to provide a good service and give sound advice.
- Firms may want to organise and provide sufficient training to ensure employees remain competent to do their job and provide quality of service. Similarly, attaining specialist exams may be a feature of membership of certain trade bodies or groups independently of any FSA requirements.
- Firms may want to perform sufficient checks to ensure that employees are "fit and proper". Advisors are placed in a position of trust with customers' finances and so firms may want to maintain some form of "fit and proper" checks to establish and monitor the advisors' circumstances, even in the absence of 'fit and proper' rules.
- Firms may want to undertake some monitoring of sales procedures to ensure customers are offered quality of service. Internal audit function may continue to some extent to monitor advisors, whether self-employed or employees of the firm, to ensure that they adhere to the procedures in place for the firm.
- Firms may take steps to ensure that customer complaints are handled adequately, for example requiring that complaints are handled within reasonable time periods, or that customers are adequately compensated for poor service.
- Firms may want to maintain adequate records and have procedures in place to ensure those records are produced, for example in respect of obligations imposed by other regulators to produce accounts, in dealing with tax authorities or in defending their behaviour against challenge from consumers.

Firms were asked to explain the reasoning behind their views on the extent to which the costs incurred in relation to these regulatory activities were incremental.



### Ongoing and one-off costs

Firms were asked to consider the incremental costs of FSA regulation for particular rules, rather than the incremental costs if the entire FSA regulatory framework was withdrawn. In the Study we attempted to distinguish between:

- Ongoing incremental costs: these are the costs incurred in complying with regulation which firms would avoid in subsequent years if a particular rule was no longer mandatory. In considering what costs might be avoided in the absence of a particular rule, we have asked firms to consider a fairly long time-horizon in which all ongoing costs could be avoided (e.g. 5 years). We assumed that in this period they should assume that everything other than the removal of a particular FSA rule stays the same (i.e. the market place and the firm's business strategy in the long term are the same as for the year for which they have provided cost data). It should also be assumed that the ongoing costs incurred in the last audited financial year are representative of the ongoing costs in subsequent years; and
- One-off incremental costs: these are the costs incurred in complying with regulation which firms would not have incurred had a particular rule not been mandatory. We asked firms to only consider costs included in the accounts of the year for which data was provided.

## 3.5 Methodology for the calculation of incremental costs

**The process for allocating costs was derived from activity based costing methodology**

Our methodology for deriving the incremental costs of regulation involved asking firms to follow the process described below.

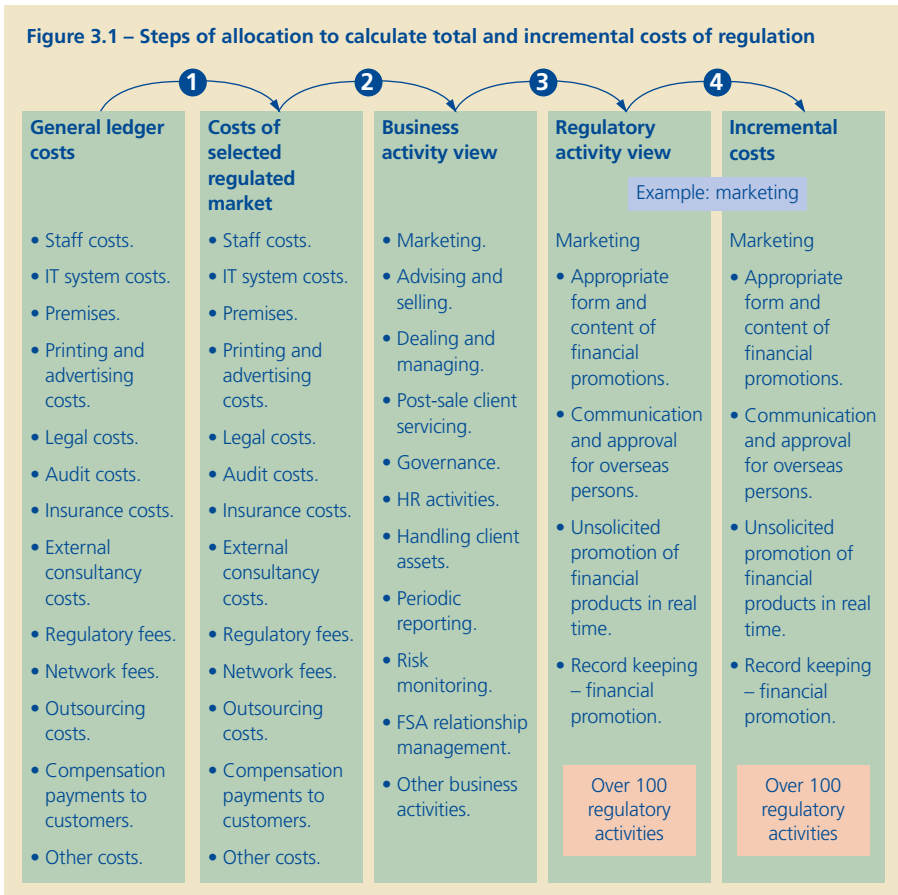
Firms were asked to:

- Put the general ledger costs into the cost categories defined and identify the proportion of the general ledger costs that relate to the "selected regulated market", i.e. the market (among the three selected for the study) in respect of which the firm has been invited to take part in the study.
- Breakdown ledger costs into the relevant business activities, which have been defined to comprise the principal activities performed by a business in the selected regulated market and include both activities that are connected with complying with FSMA regulation and activities which are independent from it.
- Identify within each business activity the proportion of costs that relate to each regulatory activity. Regulatory activities are activities which are required to comply with FSA regulation under FSMA. It is important to note that these activities may have been undertaken regardless of FSA requirements. For example, some of the regulatory activities may also be undertaken in response to commercial imperatives, such as the FSA requirement to know your customers. Although this is considered a regulatory activity in this study, it is likely that a firm would have undertaken this activity at least in part in the pursuance of its own business interest. Therefore, the costs of regulation identified by this study will encompass some costs that a firm would have ordinarily incurred for commercial purposes.
- For each of these regulated activities firms were asked to estimate the costs that the business would not incur if specific FSA regulatory requirements were not mandatory, and identify the additional costs that would be incurred in the absence of FSA regulation.

The purpose of allocating the different cost categories across the business activities was to ensure that only a reasonable proportion of business costs are attributed to regulatory activities.

### Steps of allocation

The allocation process to determine the total and incremental costs of regulation can be summarised in Figure 3.1 overleaf. Steps 1 to 3 progress towards calculating the total costs of regulation. Step 4 results in a measure of the incremental costs of regulation.



**Step 1 – Allocation of general ledger costs to selected regulated market**



In Step 1 firms were requested to identify the costs of the selected regulated market for each of the thirteen categories of costs shown in Figure 3.1. The total costs of the selected regulated market will be a subset of the firm’s total expense base for a firm operating in more than one financial services sector.

We instructed firms participating in the study in respect of their retail investment and pension advice activities that they should include costs associated with advice given on investment contracts with a protection element e.g. investment bonds and endowments but that all costs relating to advice given on General Insurance, pure protection and mortgages, costs relating to product design, product development underwriting or administration and costs relating to the prudential requirements for life insurers, banks or intermediary activities other than advice (e.g. investment management) should be excluded from their study.

### Step 2 – Allocation of selected regulated market costs to business activities



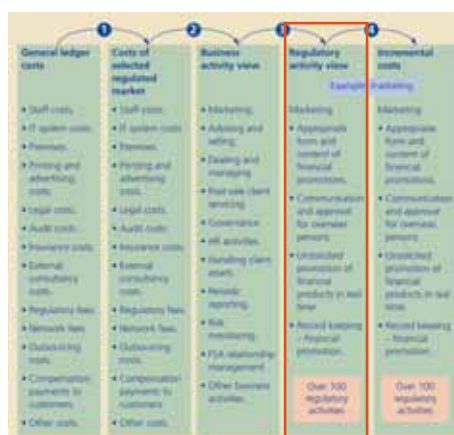
In Step 2 firms were asked to allocate one of the relevant market costs across eleven “business activities”. The purpose of this allocation step is to ensure that only a reasonable proportion of the total costs of a business activity are apportioned to the costs of regulatory activities in subsequent stages.

First firms were asked to allocate staff costs. The allocation was based on the number of “Full Time Equivalent” (FTE) employees that work in each of the business activities. While most large firms were able to identify teams of individuals which correspond to the different activities, small firms often had to estimate the proportion of time that their personnel was spending on the different activities, because the same individuals spent their time on more than one business activity.

For the other cost categories, where possible, firms were asked to indicate which proportion of the costs they could allocate directly to a specific business activity. All costs that were not allocated directly would be allocated in proportion of allocation of staff costs to the different activities (Firms could also specify those activities to which costs would be automatically allocated).

At the end of this process firms were able to breakdown the costs incurred in the selected market according to two dimensions: cost category and business activity.

### Step 3 – Allocation of business activity costs to regulatory activities



In Step 3 firms were asked to derive the total costs of FSA, FOS and FSCS regulation by apportioning a share of the cost of each business activity to regulatory activities.

It was specified that in attributing costs to the regulatory activities listed, firms should ensure that only the costs incurred that are consistent with complying with FSA requirements are attributed, and not those costs arising from additional requirements from any other regulators. Similarly, where firms had chosen for business reasons to do more of a regulatory activity than is strictly required by FSA regulation, the additional costs incurred should not be attributed to regulation in the Study.

## The cost of regulation study

For those regulatory activities where the FSA requirements relate to the quality of an action rather than a requirement to do something specific, account should be taken of the fact that compliance might be guaranteed by maintaining minimum standards and that where a firm has chosen to do more than is strictly required, the additional costs should not be attributed to FSA regulation.

In this step firms were asked to specify which costs attributed to the particular regulatory activities were incurred on a one-off rather than ongoing basis.

Firms were asked to define the allocation of cost to the different regulated activities separately for the different cost categories. This process started with the allocation of staff costs. For each activity, which was mapped to one or more handbook rules, firms were asked to estimate how much time each year they would spend on this specific activity. For certain type of activities, for which the time spent would depend to a specific driver, (e.g. number of new customers), firms were asked to relate the time spent to the value of the driver (e.g. if a firm spent on average one hour to perform the KYC procedures for each of their new client, and they had 1000 new customer each year, they would spend approximately 1000 hours a year on this activity). For other activities, for which the activity was not related to any specific driver (e.g. the appointment of an MLRO) firms would enter directly the time spent on the activity for the financial year considered. The staff cost allocated to the regulated activity was then calculated by multiplying the number of hours spent on the activity by the hourly cost of the activity, which is calculated on the number of the FTEs working for the firm.

For all other cost categories, firms were requested, where possible, to allocate the business activity cost directly to the various regulated activities. For certain costs that could not be allocated directly, they were then allocated automatically in proportion to the staff costs allocated to these activities. This corresponded to assuming that these costs would fundamentally vary with the number of people working on each activity. Conversely, for other categories, such as external consultancy costs, it was assumed that if the costs could not be allocated directly, they would not relate to, nor affect the cost of regulation.

### Step 4 – Identification of incremental costs of FSA regulation



In Step 4 firms were requested to estimate the incremental costs of regulation.

This is the step through which we sought to determine how much of each type of cost firms would avoid if the FSA dropped specific Handbook Rules (it is assumed that firms would continue to be subject to the other Handbook rules together with the relevant general statutory and legal framework (e.g. Companies Act, Money Laundering Regulations, labour laws, tax laws, etc.)).

The incremental costs are analysed for both one-off and ongoing costs:

- For those costs that have been classified as ongoing in Step 3, the methodology sought to determine the costs that firms would not incur in the future if a particular regulatory activity was no longer mandatory. In considering what costs might be avoided in the absence of a particular rule, firms should consider a fairly long time-horizon in which all ongoing costs could be avoided (e.g. 5 years). Under this time-horizon firms were asked to assume that everything else other than the removal of a particular FSA rule stayed the same (i.e. the market place and the firm's business strategy in the long term was the same as for the year for which the cost data was provided).

This assumption was required because we were seeking to identify the effect of removal of a single rule, not the entire regulatory regime. The use of a 5 year time horizon was to capture the impact of a rule removal on all costs including those, such as IT costs, that may be fixed in the short term. Firms were also asked to assume that the ongoing costs that were incurred in the last audited financial year were representative of the ongoing costs in subsequent years.

- For those costs that were classified as one-off costs in Step 3, the methodology sought to determine the costs that firms would not have been incurred if a particular rule had not been in place.

In analysing the incremental costs firms were asked to consider carefully to what extent, even in the absence of a specific FSA requirement, they may have needed to incur those costs anyway for compliance with similar requirements. These recommendations could be set by other regulators, to comply with an appropriate business practice or simply to meet customers' expectations. In such cases we suggested that their incremental costs of regulation would be small.

Firms were also specifically asked to consider the additional costs which are incurred in the absence of regulation in the context of the analysis of incremental costs.

In practice, firms were asked to indicate, for each regulated activity, the percentage of the cost that they had allocated to the regulated activity which would be spent in absence of the FSA requirement. In particular they were asked to define percentages separately for each cost category, and for those categories for which they identified one-off costs, to define percentages specifically for the one-off costs. However, firms had the possibility to automatically set the percentages for incremental costs for all cost categories to those defined for the staff cost analysis (on the assumption that the same percentage would be appropriate for different cost categories).

#### Additional costs incurred in the absence of regulation

In the previous section we discussed how firms were asked to identify those costs that would not be incurred in the absence of FSA regulation. The results obtained above may constitute an overestimate of the incremental costs of regulation on the basis that it did not consider that regulation could also allow firms to reduce costs in some areas. In order to quantify this effect, firms were specifically asked to identify such costs. Some examples are provided below:

- Firms may have suggested that withdrawing FSA rules would reduce significantly the staff and systems costs incurred in undertaking KYC checks. However, it is possible that at the same time legal costs may increase as there may be a higher probability that some of firms' customers may default on payments.
- Firms may think that the FOS places significant incremental costs on their business. However, in the absence of these requirements the courts may still oblige firms to compensate customers for poor service. It might also be expected that they would in the ordinary course of business make payments to customers to protect the client relationship and maintain goodwill between the two parties.

Additional examples were provided in the guidance notes to the questionnaire.

## 3.6 Review and analysis of firms responses

The data collected from firms through the questionnaire forms the basis for our estimate of the cost of regulated activities and the incremental cost of FSMA regulation. There were several steps between receiving the completed questionnaires and the stage at which they were used to produce the outputs of our analysis. The main activities within this process were the following:

- Initial review of questionnaires, to identify potential errors in data entries or inconsistency in the interpretation of the questionnaire;
- Comparing questionnaires with peer firms;
- Discussion with firms following our initial review and comparisons with other questionnaires;

### Analysis focused on ensuring comparability of results

- Standardising the data, to enable comparison of outputs from different firms; and
- Analysis of distribution of costs between the different firms.

We discuss these phases below.

### Initial review of questionnaires

Once we received the questionnaires, we examined them to assess whether the data input by firms was consistent with the methodology we had developed in conjunction with the FSA and whether there were any possible data entry errors. Some examples of the issues that we identified in this phase were:

- Over-allocation of costs to a particular activity: in some instances firms had set up the value of the drivers in such a way that more than 100% of the ledger costs in one business activity were allocated through to various regulatory activities in that business activity. This could be the case, for example, if a firm had allocated to the regulatory activities in a specific business activity a number of hours of staff time that exceeds the capacity of the FTE's allocated to the business activities as a whole.
- Incorrect interpretation of the percentage for calculation of incremental costs: in some cases, firms misunderstood the interpretation of the questionnaire's input. Instead of interpreting it as the percentage of costs that would be incurred anyway if the FSA rule were removed, they filled the questionnaire with the percentage of cost they believed to be incremental (for example, a 100% entry would in fact mean that that 0% of the cost would be incurred if the FSA rule was removed).
- Estimates of time per driver inconsistent with the value of the driver: we found a number of entries for which the estimate of the time for sub-driver was inconsistent with the value of the sub-driver used. For example, a number of firms overestimated the time per transaction that they would spend on a particular rule. Given the high number of transactions, this resulted in an estimate of the staff time which was order of magnitudes higher than what other firms had estimated.

### Comparing questionnaires with peer firms

An additional element to validate a firm's questionnaire entries was to compare its inputs with the inputs of other firms operating in the same market, of similar business model or size. We have highlighted some of the entries that diverged widely from the other firms' returns, and added these to the list of issues identified in the previous phase. We then sought to discuss all these issues with firms to understand the approach they had used and whether they were consistent with the methodology that we had developed and described in the questionnaire's guideline notes. Substantial limitations on our ability to undertake this phase effectively were imposed by the timeline of our interaction with firms. Because of the delay in the submission of responses by many of the firms, the review of the questionnaires for many of the firms was undertaken based on just a small sample of comparative firms being available.

### Further discussions with firms

As a result of the initial review of the questionnaires, we engaged in further conversations with firms to discuss the issues identified by our analysis and asked them to reevaluate the questionnaire entries appropriately, to reflect the potential errors and anomalies identified.

In most cases this process resulted in changes in the questionnaire inputs. However, in a number of other cases, firms explained to us how they estimated their figures and the reasons for which they believed that the numbers provided were the correct numbers to be used.

### Inclusion of firms' responses in outputs of study

In reality for several respondents, the process of reviewing and discussing questionnaires was stopped before all the issues raised could be resolved or the questionnaire could be completed in all sections. Time and resource constraint, and the requirement to produce final results to the FSA and the steering Committee, imposed an end on the review process. This forced us to make a judgement call on whether the responses could be used even if some of the issues remained unresolved.



For this we examined each case individually, looking at the trade off between including questionnaires with some known problems but that provided one more observation to the sample and losing all the information altogether. We looked at both the completeness of the response and at the number of issues outstanding and we selected the 68 firms that we have used to produce all the outputs in this report. The criteria used to decide whether to include or exclude a certain firm in the sample include:

- If the response was only completed for a selection of business activities or regulated activities only, (e.g. only for the marketing business activity) we excluded the response from our sample. This is because it would have not been possible for us to understand how the allocation to this activity had been performed and how the ledger costs had been allocated to the various business and regulated activities.
- However, the results from one firm were included in the study, although this firm had filled only the section of the questionnaire relating to the “incremental percentage”, i.e. the percentage of costs that would be incurred even in absence of a specific FSA rule, for all regulatory activities but had not filled the cost allocation part of the questionnaire. We included this firm responses when we summarised the firms responses on the incremental percentages, and we excluded it when we summarised the absolute level of incremental costs relative to total market costs.
- When the unresolved issues did not appear to be significant to the total result and, for example, only related to small potential adjustments to a limited number of regulated activities, we included the responses in the sample.
- When the unresolved issues included a large number of regulated activities or were likely to produce a significant impact on the value of incremental costs, we decided to leave the questionnaire out of the study.
- The responses from a number of firms were excluded because of the over-allocation of costs to a specific business activities, when for example, the costs allocated to the various regulated activities exceeded the overall cost of the business activity.

### **Standardising the data, to enable comparison of outputs from different firms**

The firms that took part in the Study vary widely in size, even within each of the categories based on size used to stratify the population of firms when we chose the sample for the analysis (we broke down firms into small, medium and large categories). The variation in size may limit the extent to which it is possible to compare the costs that two firms have spent to comply with a specific regulatory activity. We would expect, for example, that a large firm would incur more costs (in absolute terms) to comply with a specific regulated activity than a firm of smaller size.

We therefore believed it was necessary, in order to be able to compare entries from different firms, to standardise these costs, i.e. to find a measure that would be equivalent for firms of different sizes.

Among the possible different measures that would be available, we chose to show costs of business and regulatory activities as a percentage of all costs incurred by the firm in the selected market in the relevant period (for example, Corporate Finance). This measure is useful because it indicates what proportion of the firm's cost is represented by a certain activity (this is an attempt to consider the activities of the firm in the selected market as a separate firm/unit and understand what proportion of this firm/unit is spent on each regulatory activity). We have used this measure throughout our report to summarise and compare data from different firms.

An alternative measure that we tested is the proportion of regulatory cost per FSA authorised person working in the firm. However, we have not used this measure because it may fail to account for differences in the amount of time that each approved person spends with the firm (for example part-time versus full-time) and the success of each firm to attract business (for example, more successful firms may have more clients and transaction per approved person and would therefore incur in higher regulatory cost).

Another possible measure that can be used to compare the data collected from different firms is the time spend and unit cost with reference to the sub-driver (e.g. number of hours and cost incurred on KYC activities for each new client) for each of the activities for which we have defined a sub-driver. This measure is in itself already standardised, because it expresses the cost relative to the value of the defined driver. In our report we have sometimes referred to this measure when trying to interpret firms responses at a specific rule level.

### Considerations regarding reporting of results

#### Aggregating the data: obtaining relevant outputs from firms' responses

The data collected from firms provides the following information, reflecting the main steps of our methodology:

- Total costs incurred by firms in the selected market, broken down by firm, cost category and business activity.
- Total cost of regulated activities broken down by firm, cost category and regulated activity.
- Incremental cost of regulated activities broken down by firm, cost category and regulated activity (the percentage of the regulatory activity cost that is considered to be incremental is also recorded).
- Indication of the sub-driver used for the allocation of costs to the different business and regulated activities. These would include the value of the sub-drivers (such as the number of new clients, the number of transactions) and the time spent by staff for each unit of the driver (e.g. time spent per new client or transaction).

In analysing this data, it is important to define the level of aggregation on which the analysis should focus. As we have just described above, the raw data is broken down by firm, business activity, regulated activity and cost category.

There are two dimensions across which we have aggregated results: the first one relates to the level at which we consider firms' cost, the second related to how we summarise costs across different firms.

#### Aggregating costs within firms

Within each firm, the first level of aggregation is to add together, for each firm and regulatory activity, the cost of the different cost categories. There is limited scope for looking at the breakdown of cost between the different cost categories. This is because the majority of the firms has used the allocation of staff costs (based on the definition of drivers) to allocate all other cost categories to the different business and regulatory activities.

A further level of aggregation is to add together the cost of the regulatory activities into the relevant business activities. This would indicate in which business areas are incurred the majority of the cost of the regulatory activity and where the proportion of incremental costs is higher. It is important to note that, because of our definition of incremental costs, the aggregation of incremental costs needs to be interpreted carefully, and should only be used as an indication of the magnitude of the costs in each area and not as a reliable estimate. In fact, when firms were asked to identify the proportion of costs that could be avoided if the FSA regulation were to be lifted, they were asked to estimate this proportion at the regulatory activity level (i.e. they were asked to estimate the effect of removing the specific rule, while keeping the rest of the FSA regulation in place). It is possible that the cost impact of lifting more than one FSA requirement at the same time could differ from the sum of the incremental costs associated with the removal of the single rules alone.

#### Aggregating across firms

We looked at summarising results across firms at two different levels: at a more general level we aggregated the data by the three main market selected for the study (Corporate Finance, Institutional Fund Management and Investment and Pension advice). For some selected output, we also highlighted the differences in responses between firms of different size within each market. Because of the limited size of the sample, it was not possible to analyse separately the results for the different types of business model within the Investment and Pension Advice sector (IFAs, Life companies and Building Societies).

### Analysis of the distribution of cost entries

The second step in analysing the data, after it had been standardised in the way that was described above, consisted in analysing the distribution of each of the variables collected. This allowed us to identify the extent to which the responses to our questionnaires vary between the different firms. This is relevant for the following reasons.

- First it would indicate whether there are any responses that differ widely from the other firm's responses. If "extreme" values are shown for a specific firm, we seek to understand what originates the difference in the value. It is possible that the impact of regulation on the firm is substantially different from other firms' or that the firm has a different view on how they would react to the removal of the FSA rule, which would be reflected in a different estimate of the proportion of the regulatory activity cost that is incremental. It is also possible that the value is incorrect and that it represents a mistake in the way in which the firm entered the data or interpreted the methodology. Where possible, we have tried to contact firms and understand why their value deviated from the other firms' values.
- The distribution of responses is in itself an interesting output of the analysis, because it can help us understand whether many of the firms are affected in a similar way by FSA regulation or whether it is possible to identify a number of natural clusters into which firms could fall, based on the way in which they view regulation affects them (e.g. 50% of firms find that dealing with a certain rule is costly and think they would reduce their cost this were removed, the other 50% of firms would not modify their behaviour and do not identify any incremental costs).

### Choice of a representative value for the market segment

The distribution of values across the different firms would also provide indication on the most appropriate measure to be used to summarise values for each market segment. In particular the average and the median value may differ and provide different indications in the case in which values are not uniformly or normally distributed.

In this report we have used median values to summarise outputs at a rule level. The median value represents the 50% percentile value, corresponding to the value for which 50% of observations are higher than this value and the other 50% are lower. This measure would generally not be affected by a limited number of outliers, because its value does not depend on the absolute value of the variables but only on the way in which the variables are distributed. This measure could be preferable when it is possible to state that the outlier does not represent a firm with specific characteristics, but a firm that failed to fill the questionnaire appropriately.

When we derive aggregated values across regulatory activities (at the business activity level or at the firm level), there are two options for the calculation. Since there are two dimensions across which to aggregate (the aggregated results are derived by summing together the values by rules and by calculating the median value across firms/regulated activities), the order in which these operations are undertaken affects the value and the meaning of the measure.

- Median by firm: these are obtained by first adding for each firm the values of all regulated activities to derive a firm incremental cost of regulation and subsequently by taking the mean or median value for each firm. This therefore represents the mean or median value of the different firms' incremental costs, on the assumption that for each firm the incremental costs recorded for each activity can be summed up to calculate total incremental cost for that firm.
- Median by rule: here the order of aggregation is opposite. First for each regulated activity (which maps to one or more rules) the mean of medians is calculated, and then the mean or median values for each activity are summed to calculate a value that characterises the sample. The incremental cost calculated in this way represents the total incremental cost for a theoretical firm for which the value of each regulated activity corresponds to the mean or median value in the industry.

The difference between median by firm and median by rule is mainly determined by the way in which the extreme values are distributed across firms. It appears that the extreme values for the different rules are associated with different firms, which means that many firms stated that they incurred costs much higher than the average value in some activities and not in others, but no firms have incremental costs above average level for all rules.

## The cost of regulation study

The effect of this is that, while the extreme values do not affect the median value if considered at a rule level (used to calculate the median by rule), they would affect the median value at the aggregated level (median by firm), because most of the firms total incremental costs, which determine the value of the median by firm, reflect the magnitude of these extreme values in a limited number of activities. Because of the difficulties this causes in identifying an appropriate measure for the aggregation and recognising that the methodology was not designed to achieve aggregated results, we have chosen not to report these measures.

# 4. Corporate Finance

## Introduction

This section of the report summarises the incremental regulatory costs of regulation as reported by respondents to the survey who provide corporate finance services. For the purposes of the Study we defined corporate finance as the regulated market which encompasses financings, flotations, mergers and acquisitions, corporate broking, investor relations for clients and research activities directed at corporate clients.

The firms who provided responses in relation to this sector included businesses operating in predominately one of three types of firms:

- Global firms undertaking corporate finance activities within the UK market;
- Mid-size firms operating in the UK as part of a group which operates out of a small number of overseas locations; and
- UK domiciled boutiques dedicated to providing services and advice to the UK market only.

As already explained, the methodology of the Study was designed to identify the particular rules made under the FSMA that were considered, by firms in the Corporate Finance sector, to give rise to the highest incremental costs measured as a proportion of the total operating costs of the firm.

## Incremental costs are proportionately higher for small firms

The reported results for medium/large firms tend toward the lower end of the distribution range and those for small firms tend toward the upper end. Incremental regulatory costs are higher for small firms because regulatory activities take up a greater proportion of their time compared to medium/large firms. In addition, there are a number of rules imposing relatively fixed costs such as preparing and submitting returns to the FSA and these contribute to the different results for small and medium/large firms.

Some small firms indicated that they would cease some regulatory compliance activities if the rules were removed to reduce some administrative burden on themselves. Where they would save the most costs in comparison to the medium/large firms fell within the following business activities: Governance, FSA Relationship Management, Periodic Reporting and Advising and Selling.

## Firms will often apply common standards across all areas of the firm on operational efficiency and cost grounds

Some of the medium/large firms participating in the Study indicated that where they had global operations they apply a common set of compliance standards and procedures across the firm to incorporate all necessary local regulatory requirements. Because of this some larger firms may have had difficulty in quantifying the incremental regulatory costs in certain areas of the Handbook.

Where a firm has chosen to “over comply” in this way there is a risk of over reporting regulatory costs if a rule made under FSMA has been applied across a range of activities where it is not required by regulation. However, almost all the firms exhibiting this behaviour reported very low incremental costs recognising the limited impact of the individual FSA rule on their cost base.

Further, a number of firms indicated that were the rules removed they would continue to carry out certain regulatory compliance activities as they considered them to be best practice. This is “evident” in particular with the large and medium firms due to the regulatory compliance functions being embedded in the businesses and a common set of compliance standards being applied across a firm that also undertakes other regulated business activities.

**Activities with the highest incremental regulatory costs**

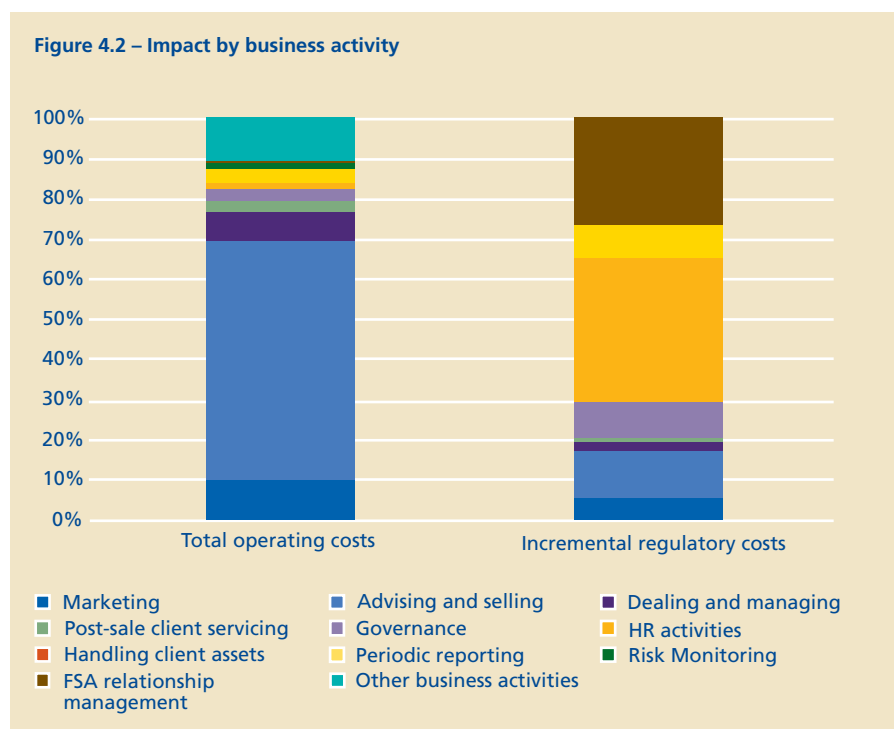
Identified below are the 20 individual regulated activities with the highest incremental regulatory costs in the CF sector.

**Figure 4.1 – The activities with the highest incremental regulatory costs in the CF sector**

Regulatory activity definition	Business activity	% of total cost	No of firms recording costs
FSA fees	FSA relationship management	0.26%	10
Keeping up to date with FSA seminars, cluster reports, speeches.	HR activities	0.08%	4
Maintaining employee's competence (including FSA seminars, cluster reports, speeches)	HR activities	0.05%	10
Creation of Chinese Walls.	Dealing and managing	0.04%	4
Preparing and submitting quarterly/ monthly and annual financial return and annual accounts to FSA.	Periodic reporting	0.03%	9
Maintain records of reports sent to customers.	Dealing and managing	0.03%	2
Customers understanding of risk.	Advising and selling	0.03%	5
Providing information and reports to the FSA.	FSA relationship management	0.03%	4
Monitoring and maintaining externally generated financial resources in excess of requirement.	Periodic reporting	0.03%	3
Providing written notice to employees on restrictions regarding employee dealing.	Dealing and managing	0.02%	5
Reporting to FSA annually on relevant business conducted.	Post-sale client servicing	0.02%	2
Submission of forms to become authorised or vary permissions and modify rules.	FSA relationship management	0.02%	2
Communication and approval of financial promotions for overseas person or unauthorised person.	Marketing	0.02%	2
Ensuring that all employees are aware of firms money laundering policies and receive appropriate training.	HR activities	0.02%	9
Attaining employee's competence.	HR activities	0.02%	9
Responding to Consultation papers and rule changes.	FSA relationship management	0.02%	6
Cooperation with FSA information gathering exercises.	FSA relationship management	0.02%	9
Determining training needs and organising appropriate training for employees.	HR activities	0.02%	9
Record keeping – training of employees	Governance	0.02%	9
Money Laundering – Identification of the client.	Advising and selling	0.02%	10

### Business activities with the highest incremental regulatory costs in the CF sector

Individual activities can appear in the table in Figure 4.1 as a result of the extent of cost of undertaking the activity and the percentage of the activity that is considered incremental. Figure 4.2 shows the firms’ total cost base and **incremental regulatory costs** by business activity. This highlights the relative significance of Human Resource related activities, compared to the other business activities, from a regulatory perspective.



### FSA fees

The regulatory activity within FSA Relationship Management with the highest incremental cost was FSA Fees which was considered 100% incremental and averaged 0.33% of total operating costs for the firms in the sample. This cost category includes fees paid to the FSCS and FOS as well as the FSA annual fee although for firms operating in the institutional sector there should be limited costs associated with FSCS and FOS due to the customer coverage of those schemes. Our findings are consistent with this; the table below summaries how the fees are split between the three organisations.

**Figure 4.3 – Breakdown of Regulatory Fees**

Sector	FSA	FSCS	FOS
Corporate Finance	77%	18%	5%

Note: the proportions reported above reflect the fees paid by the respondent firms as a whole rather than limited to the CF sector. This is due to problems in disaggregating fees across different business lines and divisions within a firm.

### Human resources activities were viewed by firms as the most costly regulatory activities

Five human resources related regulated activities feature in the top 20 activities with the highest incremental regulatory cost. This indicates that firms attribute a relatively high cost to maintaining employee competence, training, keeping up to date with FSA consultations, seminars, cluster reports and speeches and other human resources activities.

### Keeping up to date with FSA seminars, cluster reports, speeches (TC2.6)

Summing the median incremental cost of all the HR activities in the table results in a figure of 0.19% although it is possible that there is overlap between the similar categories that would cause this figure to be overstated. Nevertheless, as most firms reported costs against most HR activities and our review process focused on identifying areas of over allocation we do not consider this level of incremental cost unrealistic.

Four firms provided data for the activity, “keeping up to date with FSA seminars, cluster reports and speeches” with the majority of these being at the smaller end of the scale in terms of firm size.

The absence of data from larger firms may reflect the fact that the process of supervision is different for firms of different sizes and those subject to close and continuous supervision keep up to date with FSA changes in different ways.

**Maintaining employees' competence (including FSA seminars, cluster reports, speeches) (TC 2.6)**

Ten firms provided data for this activity, indicating that every firm in the CF sector incurs costs in maintaining their employees' competence. The median percentage of firms' total costs that are incremental is 0.05%, with a range of response from 0% to 0.53%.

Those firms reporting a higher incremental cost were those where employees spent a longer time on this activity. Smaller firms tended to report higher incremental percentages but lower incremental costs indicating that they spend less time in this activity than larger firms but are more likely to consider that they would stop it in the absence of regulatory requirements.

Some firms noted that the incremental time/cost related to the levels of documentation of consideration of employee competence that would not otherwise be maintained.

**Firms identified advising and selling activities as costly activities**

Advising and selling activities are identified as costly business activities but only two activities appear in the top 20 table of the highest incremental regulatory cost. This indicates that whilst firms attribute incremental costs to "customers understanding of risk" and "money laundering – identification of the client" most advising and selling costs are considered as part of the business of the firm and would be incurred in the absence of regulation.

**Firms identified the incremental regulatory cost of SYSC as 0.05% of their total costs**

Most of the costs associated with governance activities are considered as normal business costs and only one governance activity features in the top 20 activities with the highest incremental regulatory cost. This relates to the record keeping of training of employees and may overlap to some extent with the HR activities discussed above.

The incremental costs attributed to governance activities suggest a greater disparity between large and small firms than other business activities with small firms indicating that they would save more of their costs if the rules on governance activities were removed than medium/large firms. Small firms indicated that the incremental cost of SYSC is 0.37%, compared to 0.02% for medium/large firms. This is not surprising given the anecdotal attribution of costs to requirements to evidence governance practices rather than governance itself and this is more likely to be considered incremental in a smaller firm.

**Some firms identified dealing and managing activities as incurring incremental regulatory costs**

Three dealing and managing activities feature in the top 20 regulated activities which incur the highest total regulatory cost as a percentage of total cost although none of them was reported on by many firms participating in the Study. This is likely to be a reflection on the fact that dealing and managing is not a necessary activity within the sector chosen – Corporate Finance Advice – and thus the results are not interpreted further.

**Creation of Chinese Walls (COB 2.4, 7.1, 7.16)**

Four firms provided data for this activity, all firms providing a response fell within the larger firm category with a range of response from 0% to 0.10%. Removal of these rules would therefore have no impact on the costs of smaller firms who do not attribute cost to this area.

**Preparing and submitting quarterly/monthly and annual financial return and annual accounts to FSA**

Nine firms provided data for this activity. The median percentage of firms' total costs that are incremental is 0.03%, with a range of response from 0% to 0.45%.

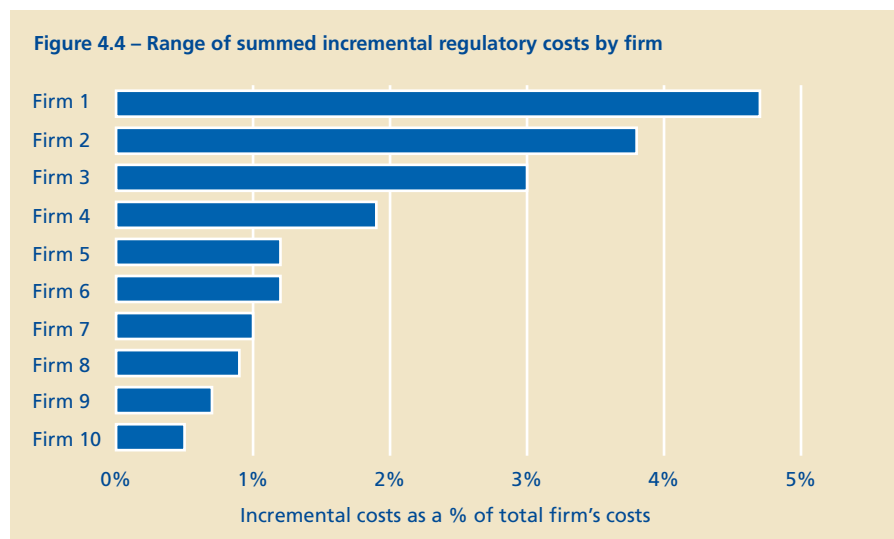
Small firms indicated the higher level of incremental costs which is consistent with the relatively fixed nature of these costs and consistent views on the incremental percentage.

The remaining activities in the Top 10 ranking all received responses from fewer than half the firms participating in the Study. The median response from those that did respond attributed a maximum of 0.03% of the firms cost base to the incremental impact of any individual rule. Further analysis is not considered relevant given both the low number of firms reporting any incremental impact from these rules and the size of the impact that is reported.



## Distribution of responses

Whilst the Study was focused on obtaining information at the individual rule level and the methodology does not permit the calculation of a reliable total cost by firm, nevertheless it is interesting to note the range of responses achieved by summing the individual incremental costs by firm.



This distribution pattern supports the view that the link between regulation and a firm's cost base is a complex one given that the results from firms operating in the same financial sector and subject to the same regulation under FSMA can differ by a factor of over 7 although for all of these firms the summed incremental regulatory costs accounted for less than 5% of the operating cost base.

The results in the chart have been derived by summing the responses to each individual rule for each firm; as such there is likely to be overstatement of costs in areas where a number of different activities take place, each of which could be individually discontinued without impacting business operations but which in total could not.

The chart shows an even distribution of results with no particular clustering around any point which makes it impossible to identify a "typical" or "average" firm based on the results derived from summing the individual rule responses by firm.

An alternative approach, to derive a "median" firm from the data by summing the median result for each individual rule, would produce a result below the midpoint of the chart above supporting the view that the results contain an element of overstatement as a result of the methodology used for the Study.

# 5. Institutional Fund Management

## IFM sector: structural issues

This section of the report summarises the incremental costs of regulation as reported by respondents to the survey who provide fund management services to institutional clients. The firms who provided responses in relation to this sector included those with a mix of retail and institutional business as well as those engaged solely in the wholesale markets. In both cases the information requested related only to the costs incurred in respect of services to institutional clients. This required some respondents to apportion certain overhead costs to produce an estimate of total operating costs for the sector subject to the study.

In addition, in the fund management sector it is not unusual for different legal entities within a group to carry out different functions across a wide range of products or markets. Our sample was based on legal entities authorised by the FSA; for some respondents part of the fund management service is carried out by another group entity in exchange for either a management recharge or a revenue share. In these circumstances firms were asked to look through the recharge when allocating costs to general ledger type. For firms operating a revenue share model it was not possible to incorporate their data completely into the cost allocation model. This was taken into account in the analysis of results in the sector.

## Different attitudes to incremental cost identified in firms of different sizes

Whilst the incremental regulatory cost of regulation tends to be lower for medium/large firms than for small firms, the drivers of incremental cost are different. For medium/large firms, some firms indicated that costs arose because other parts of their groups perform retail regulated business, which are subject to the more detailed regulation applicable to dealings with private customers, but they apply the same compliance standards and procedures across the firm. In these cases the costs incurred from this “over-compliance” are not strictly incremental as they are not incurred in direct response to a regulatory requirement under FSMA. However, the firms themselves consider these costs to be imposed by regulation and it is the case that if the “over-complied” rule were removed costs would be reduced. Incremental regulatory costs are higher for small firms because regulatory activities take up a greater proportion of their time compared to medium/large firms.

Some small firms also indicated that their incremental regulatory costs were higher than for medium/large firms because they would cease much related regulatory compliance activity if the rules were removed whereas medium/large firms indicated that in most areas they would continue to perform these activities as they are now considered best practice and embedded in their businesses. Business activities where small firms would save significantly more cost than medium/large firms if rules were removed are Dealing and managing, FSA relationship management, Governance, HR activities, Marketing, Periodic reporting and Risk monitoring.

## Activities with the highest incremental regulatory costs in the IFM sector

We identified the 20 regulated activities with the highest incremental regulatory costs in the IFM sector.

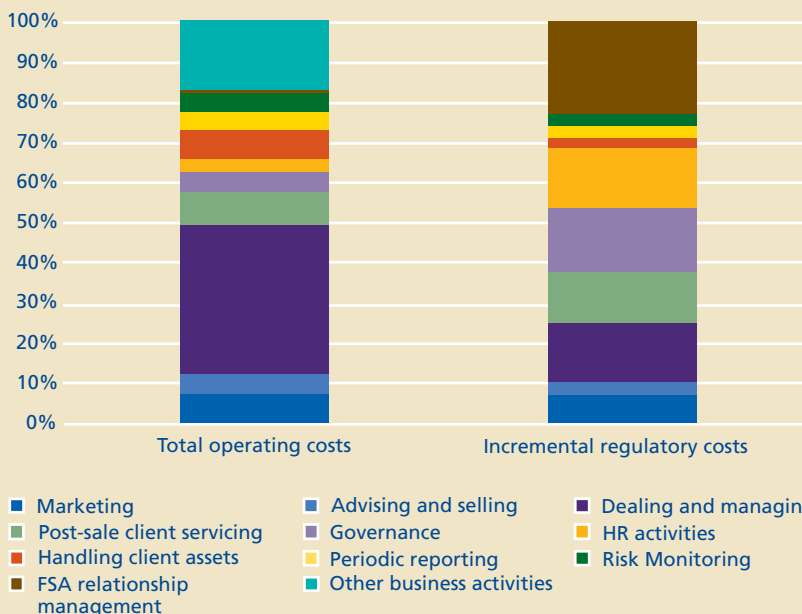
Figure 5.1 – The activities with the highest incremental regulatory costs in the IFM sector

Regulatory activity definition	Business activity	% of total cost	No of firms recording costs
FSA fees	FSA relationship management	0.33%	14
Establishment and maintenance of systems and controls in relation to the management of operational risk (for insurers).	Risk monitoring	0.27%	4
Appropriate form and content of financial promotions	Marketing	0.08%	11
Retention and record of customer order information.	Dealing and managing	0-.08%	5
Performing regular stock reconciliations of safe custody investments or notify FSA if not compliant with this.	Handling client assets	0.08%	3
Taking reasonable care to ascertain the price which is the best for the customer.	Dealing and managing	0.04%	14
Record keeping – Transaction confirmation.	Post-sale client servicing	0.04%	6
Requirement to not churn or switch	Advising and selling	0.03%	7
Preparing and submitting quarterly/monthly and annual financial return and annual accounts to FSA.	Periodic reporting	0.03%	11
Confirmation of transactions	Post-sale client servicing	0.02%	7
Provision of periodic statements to customers when firm maintains a customer portfolio/account.	Post-sale client servicing	0.02%	8
Keeping up to date with FSA consultations	HR activities	0.02%	9
Responding to Consultation papers and rule changes.	FSA relationship management	0.01%	12
Providing written notice to employees on restrictions regarding employee dealing.	Dealing and managing	0.01%	13
Record keeping – transactions entered into	Governance	0.01%	6
Determining training needs and organising appropriate training for employees.	HR activities	0.01%	13
Keeping up to date with FSA seminars, cluster reports, speeches.	HR activities	0.01%	6
Keeping up to date with relevant FSA sector emails.	FSA relationship management	0.01%	10
Making transaction reports to the FSA when entering into certain reportable transactions.	Post-sale client servicing	0.01%	6

### Business activities with the highest incremental regulatory costs in the IFM sector

Figure 5.2 summarises the firms' total cost base and incremental regulatory costs by business activity. Differently from what was found in the other two sectors, no cost category appears dominant at the incremental cost level. While firms indicated that the highest proportion of operating costs is spent in the Dealing and Managing activity, this activity is not dominant at the incremental cost level which suggests that only a small percentage of these costs are incremental for this business activity.

Figure 5.2 – Impact by business activity



### FSA relationship management

The activity with the highest incremental cost was FSA relationship management which was considered 100% incremental and averaged 0.33% of total operating costs for the firms in the sample. This cost category includes fees paid to the FSCS and FOS as well as the FSA annual fee although for firms operating in the institutional sector there should be limited costs associated with FSCS and FOS due to the customer coverage of those schemes. Our findings are consistent with this.

Figure 5.3 – Breakdown of Regulatory Fees

Sector	FSA	FSCS	FOS
Institutional Fund Management	94%	5%	1%

Note: the proportions reported above reflect the fees paid for the respondent firm's as a whole due to problems in disaggregating fees across different business lines and divisions.

Other FSA relationship management activities in the top twenty include responding to consultation papers and rule changes and keeping up to date with relevant FSA sector emails, both of which contribute an incremental 0.1% to the average operating cost base of a firm in this sector. The majority of respondents recorded costs in these categories suggesting that it is not only the larger firms who spend time in this way. Again, these costs were entirely incremental.

### Appropriate form and content of financial promotions (COB 3.6, 3.8,3.9 & 3.10)

The third highest incremental rule was ensuring that financial promotions comply with the rules concerning form and content. Eleven firms provided data for this activity with a range of responses from 0% to 0.83%.

A mix of medium/large and small firms indicated costs for this activity and there was a relationship between the time spent per financial promotion and the incremental cost as a percentage of firms' total costs. There were three outliers in this analysis. One firm indicated that it spent significantly more time per financial promotion than the other firms (22 hours). One firm indicated a relatively high amount of time spent per financial promotion (5 hours) but a low incremental cost as a percentage of its total costs because although the firm spent significant cost per financial promotion, it did not issue many promotions in total. Also, one firm indicated that it spent very little time per financial promotion (0.5 hours) but it has significantly higher incremental cost as a percentage of its total costs. This is because if firm is a small firm which issues a high number of financial promotions compared to other small firms and has indicated the cost of this activity to be 100% incremental.

**Dealing and managing activities were viewed by firms as the most costly regulatory activities**

Dealing and managing was the business activity which attracted the highest cost allocation in step 2 of the methodology.

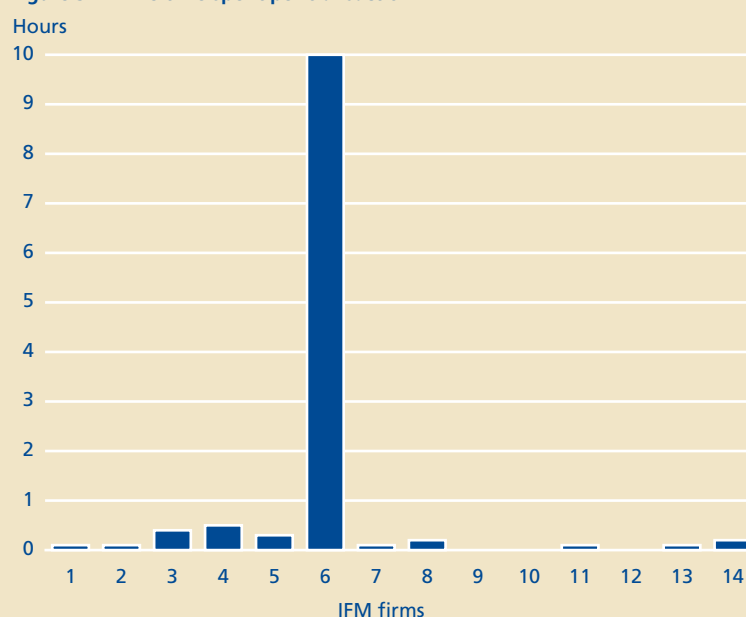
Summing the median incremental costs of all rules in this area results in a figure of 0.23% of operating costs although the degree of overlap in the rules may cause this figure to be overstated. There is no significant difference reported by firms of different sizes. This is consistent with the transactional nature of activity in this area and relatively low fixed costs of compliance. This appears to be the case even though compliance in this area is highly automated and therefore we might expect some element of fixed cost attributable to systems development or implementation. The lack of identification of such costs indicates that the on-going business use of systems overwhelms the regulatory compliance requirements and incremental costs are low.

**Taking reasonable care to ascertain the price which is the best for the customer (COB 7.5)**

The individual rule in the dealing and managing activity recording the highest incremental cost was “taking reasonable care to ascertain the price which is best for the customer”. All firms provided data for this activity. The median percentage of firms’ total costs that are incremental is 0.04%, with a range of response from 0% to 2.25%.

The majority of firms indicated that this activity is automated as part of the dealing process. This is reflected in the fact that for all firms except one the time spent on the activity per transaction was low: within the range of 2 seconds and 30 minutes. The response from the one firm which indicated that it spent significantly more time per transaction can be explained by the nature of the investments in which it deals.

**Figure 5.4 – The time spent per transaction**



The median incremental cost of 0.04% is lower than expected given that dealing and managing activities are the costliest activities for IFM firms. Firms indicated two reasons for this. Firstly, the activity is now an integrated part of the dealing process: firms’ systems are designed to facilitate best execution and if the rule was removed these systems would not be changed. Secondly, achieving best execution is generally considered best practice by firms.

**Requirement to not churn or switch (COB 7.2)**

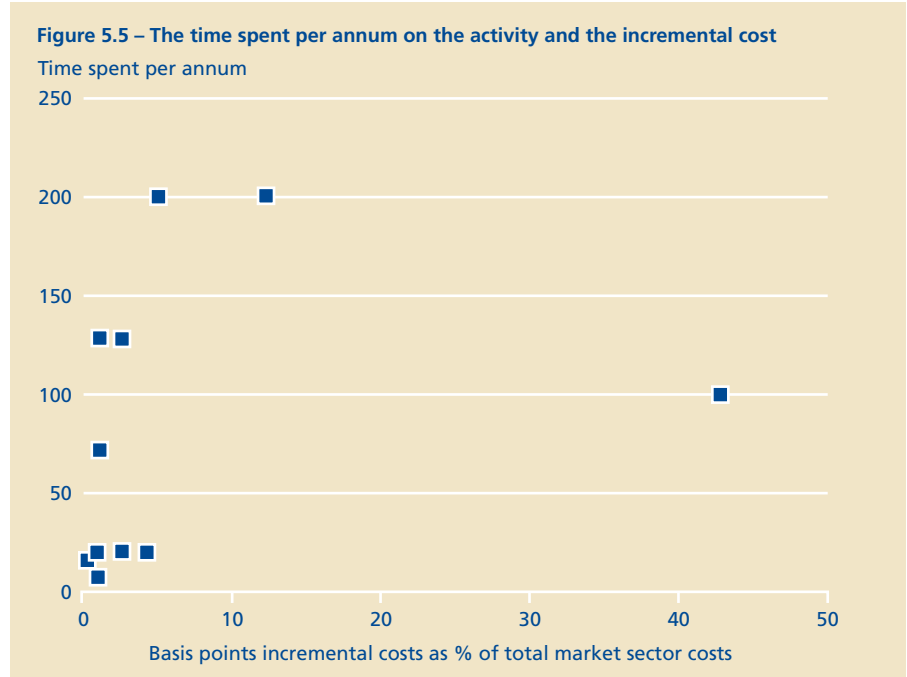
Whilst the requirement to not churn or switch has been categorised as within advising and selling rather than dealing and managing, the cost drivers for the results reported are consistent with those for best execution discussed above. Seven firms provided data for this activity. The median percentage of firms’ total costs that are incremental is 0.03%, with a range of response from 0% to 0.16%.

For all firms the time spent on the activity per transaction was very low: within the range of 0.2 seconds and 9 minutes. Some firms indicated that this process was automated within their dealing systems. These findings indicate that costs for this activity are driven largely by the number of transactions a firm performs and any fixed costs relating to systems are not considered incremental.

**Preparing and submitting quarterly/monthly and annual financial return and annual accounts to FSA (SUP 16.7)**

Eleven firms provided data for this activity. The median percentage of firms' total costs that are incremental is 0.03%, with a range of response from 0% to 0.43%.

The firm reporting the highest incremental cost does not spend proportionately longer on the activity than others in the Study but has a low total cost base and high average hourly staff costs, so the time spent on this regulatory activity constitutes a greater proportion of the firm's total costs.



**Firms identified the incremental regulatory cost of human resources activities as 0.08% of their total costs**

The incremental costs of HR activities are 0.08% with four human resources activities featuring in the top 20 regulated activities with the highest incremental regulatory cost. The main causes of incremental cost in HR activities are the requirements to maintain employees competence and keep up to date with FSA consultations. In the former case it is the overall level of cost rather than the incremental % that causes its place in the top 20. Not all firms recorded costs in the Keeping up to date category which may be explained by different interpretations of the similar sounding requirements of "keeping up to date with FSA consultations" and "keeping up to date with FSA seminars". This indicates that firms attribute a relatively high cost to maintaining employee competence, training, keeping up to date with FSA consultations, seminars, cluster reports and speeches and other human resources activities.

Small firms indicated that they would save significantly more of their costs if the rules on human resources activities were removed than medium/large firms. This is consistent with other findings regarding the level of documentation required to evidence compliance which, in general, is greater than that which would be kept by small firms in the absence of the relevant rule.

**Maintaining employees' competence (including FSA seminars, cluster reports, speeches) (TC 2.6)**

Thirteen firms provided data for this activity, indicating that almost every firm in the IFM sector incurs costs in maintaining their employees' competence. The median percentage of firms' total costs that are incremental is 0.02%, with a range of response from 0% to 0.80%. Again, as noted in the discussion of dealing and managing activities this figure ignores any overlap in regulation or costs.

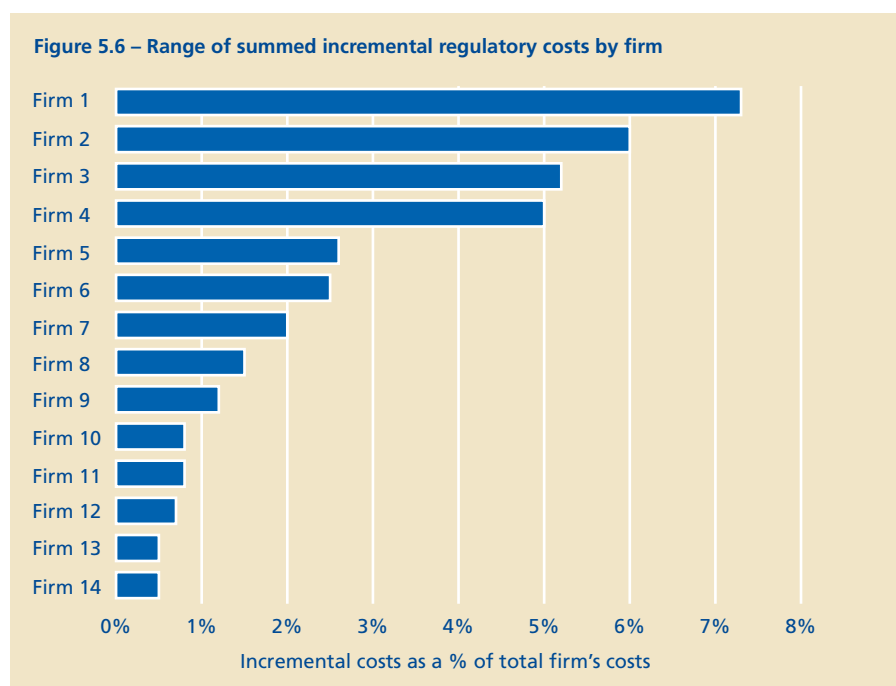
The main influences on the response appear to be the amount of time spent on maintaining competence per employee in IFM and the percentage of this time that is considered to be incremental.

As noted for the Corporate Finance sector, smaller firms attributed relatively higher incremental costs in this activity which may again reflect the different supervisory regimes applying to firms of different sizes.

The remaining activities in the Top 10 ranking all received responses from fewer than half the firms participating in the Study. The median response from those that did respond attributed a maximum of 0.03% of the firms cost base to the incremental impact of any individual rule. Further analysis is not considered relevant given both the low number of firms reporting any incremental impact from these rules and the size of the impact that is reported.

### Distribution of responses

The range of total incremental costs by firm is shown in the chart below. The Study methodology does not support the calculation of a total cost by firm but the wide dispersion of responses underlines the complexity of the link between regulatory requirements and operating costs.



The difference between the highest and lowest responses will be explained by a combination of factors including the firm's efficiency and attitude to risk as well as differences due to firm organisation and business model.

The response by firm, as shown above, will also contain an element of overstatement as a result of both the methodology (which was designed to measure the impact of individual rules) and the "over-compliance" noted in the behaviour of some firms.

## 6. Investment & Pension Advice

### IPA sector a mix of different business models

This section of the report summarises the incremental regulatory costs of regulation as reported by respondents to the survey who provide advice on investment and pension products to individual customers. As noted earlier, this part of the study did not include the costs associated with:

- The provision of mortgage advice;
- The provision of general insurance advice;
- The design, administration/management of investment and pension products;
- The management of life firms; and
- Non-advised sales of investment and pension products.

The firms who provided responses in relation to this sector included businesses operating in a number of different sub-sectors, specifically:

- Banks providing advice through one or more sales forces (either tied, limited choice or whole of market/IFA);
- Life assurance firms with a tied salesforce; and
- Independent, whole of market or limited range intermediary firms (for convenience, referred to as the 'IFA sector'). This group of respondents included members of networks. In this instance, both the network head offices and member firms were surveyed and the results combined to provide a composite result for the firms in question (ie the head office results are not reflected in the results below on a stand-alone basis).

Different approaches to completing the Study and different emerging results have been identified across these three groups.

Within each of these groups, the sample represented large, medium and small firms and results have been analysed by size where appropriate.

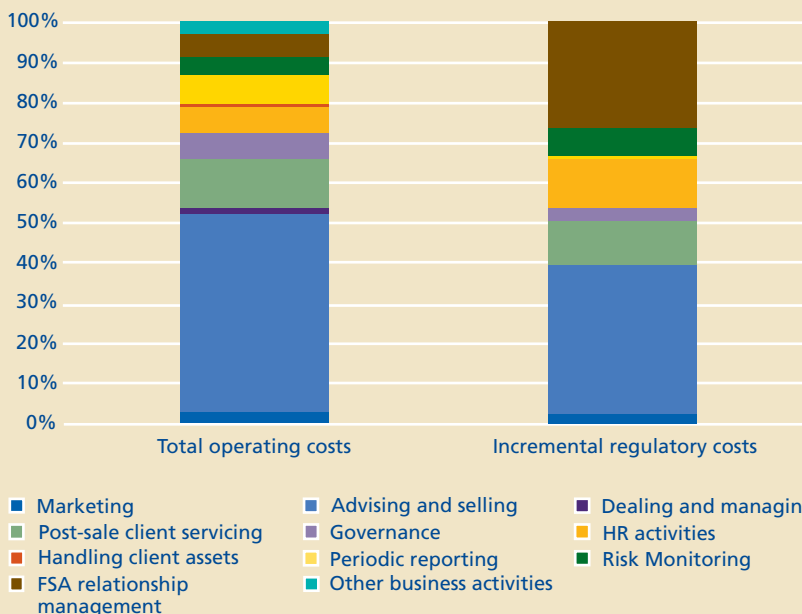
Within the 'IFA sector' we recognise that several sub-models exist where firms operate in different markets with different client types. In some instances, we have recognised below where different costs arise as a consequence of these different models.

### The highest costs within the IPA sector sit within the advising and selling business activity

As demonstrated by the chart below, within this sector the activity of 'Advising and Selling' attracts the highest share of costs, whether looked at from the point of view of total market sector costs or incremental regulatory costs. This might be expected given the nature of the businesses in question and the focus of COB rules on this activity.



Figure 6.1 – Share of costs by business activity



The analysis of incremental regulatory costs reveals that FSA relationship management – an activity that includes FSA fees as well as keeping up to date with FSA consultations and other activities – is the second highest cost for firms and accounts for a considerably larger share of incremental regulatory costs than of market costs. Similarly risk monitoring and human resources activities (largely training and competence) are higher as a share of incremental regulatory costs than of total costs.

By contrast only a small proportion of Governance and Periodic Reporting costs are considered to be incremental. Firms generally consider these to be activities that they would undertake irrespective of the requirements of the rule book. Marketing costs also diminish as firms move from total towards incremental regulatory costs.

**Top twenty incremental rules confirm focus on advising and selling**

The table below reveals how the total incremental regulatory costs break down by specific FSA rule or group of rules.

**Figure 6.2 – Top twenty rules for incremental regulatory costs for the Investment & Pension Advice sector (Median)**

Regulatory activity definition	Business activity	% of total cost	No of firms recording costs
FSA fees	FSA relationship management	2.71%	30
Production of suitability letter	Advising and selling	0.42%	32
Maintaining employee's competence including FSA seminars, cluster reports, speeches.	HR activities	0.13%	31
Provision of key features/simplified prospectus for packaged products.	Advising and selling	0.12%	31
Provision of periodic statements to customers when firm maintains a customer portfolio/account.	Post-sale client servicing	0.11%	9
Ensuring products sold are suitable for client needs (including research and sales meeting).	Advising and selling	0.10%	32
Tailoring of projections in key feature documents to client circumstances.	Advising and selling	0.10%	28
Performance of know your customer checks.	Advising and selling	0.08%	32
Record keeping – know your customer	Advising and selling	0.07%	30
Disclosure of charges.	Advising and selling	0.06%	30
Keeping up to date with relevant FSA sector emails	FSA relationship management	0.05%	20
Keeping up to date with FSA seminars, cluster reports, speeches.	HR activities	0.05%	26
Disclosure in letters to private customers.	Advising and selling	0.05%	17
Customers understanding of risk.	Advising and selling	0.04%	32
Cooperation with FSA information gathering exercises.	FSA relationship management	0.04%	22
Submission of forms to become authorised or vary permissions and modify rules.	FSA relationship management	0.04%	18
Appropriate form and content of financial promotions.	Marketing	0.04%	21
Provision of written notice regarding use of decision tree for investment products.	Advising and selling	0.03%	5
Maintaining records of projections provided to clients.	Advising and selling	0.03%	25
Implementation of the menu/IDD (set up costs only).	Governance	0.03%	26

With one exception, we examine below those rules which appear in the top ten. We also examine those business categories which are not represented in the top twenty and ask why not.

The exception regarding detailed analysis is the rule relating to “Provision of periodic statements for customers when firms maintain a customer portfolio”. Nine firms reported costs against this rule even though the rule does not apply to advice given on packaged products. Only when a firm maintains a discretionary portfolio for a client is there a responsibility imposed on them to report against the portfolio. We do not believe that any of the firms surveyed has the relevant permission for this activity. Therefore we conclude that firms undertaking this activity are doing so on a voluntary basis and that the costs cannot therefore be considered to be incremental as defined for the purposes of the Study.

## FSA Relationship Management

For many firms, the single largest area of incremental cost lies in the payment of fees to the FSA. As reported in the Executive Summary, the breakdown of these costs is as follows:

- Annual fees paid by firms to the FSA (68%);
- Annual fees paid to the Financial Services Compensation Scheme (28%); and
- Annual levy paid to the Financial Ombudsman Service (5%).

On average firms in this sector would save almost 3% of their costs were these fees not payable. Whilst firms were asked to consider what costs might take their place (for example, legal fees for court cases, marketing costs to reassure customers of the integrity of the firm) respondents found this hypothetical case difficult to assess. In reality, in the absence of any one of these components of cost firms might find that replacement costs would arise, thus reducing or potentially eliminating the cost saving.

An analysis by size of company reveals that, for this cost category, smaller firms experience a potentially greater cost saving as a % of total market sector costs than large and medium sized firms.

**Figure 6.3 – FSA Relationship Management – Incremental regulatory costs of fees**

Size	Median
Large	1.03%
Medium	1.71%
Small	3.57%

Other FSA relationship management issues which did not appear in the top ten ranking but are nevertheless highly incremental in nature included:

- Cooperation with FSA information gathering exercises – this rule attracted an incremental cost value of 0.04% of total market sector costs and appeared in the top twenty ranking of rules;
- Notification of auditor appointment and findings;
- Submission of forms to become authorised or vary permissions and modify rules – this rule appeared at number 16 in the ranking and attracted an incremental cost of 0.04% of total market sector costs;
- Keeping up to date with relevant FSA sector emails – this activity did appear in the top twenty incremental regulatory costs, attracting 0.05% of total market sector costs;
- Notification to the FSA of changes to the firm’s standing data;
- Giving the FSA notice of intention of establishing branches in the EEA and details of changes;
- Verifying standing data on a yearly basis through the FSA website and updating if necessary;
- Keeping and reviewing details of the activities of all EEA branches;
- Disclosing to the FSA appropriately anything relating to the firm of which the FSA would reasonably expect notice;
- Reporting on suspicious activities – Money Laundering;

### PI costs for small firms were significant but we observed differing views regarding the incremental nature of costs

- Co-operation with the Financial Ombudsman;
- Providing information and reports to the FSA;
- Responding to Consultation papers and rule changes; and
- Responding to direct requests from the FSA not relating to the Rules (e.g. "Dear CEO letters").

The requirement to hold professional indemnity insurance does not appear in the table of top twenty costs although for many individual firms it is one of the higher incremental costs and anecdotal comments from the intermediary sector would suggest that small firms find this requirement particularly burdensome. This is supported by the analysis of costs for large v small firms in the sample.

Many of the large firms reported no or very low costs against this rule, predominantly because they are a part of a larger firm which is subject to different prudential and insurance requirements. Small firms by contrast generally reported significantly higher costs against this rule. The incremental cost for small firms was 0.93% compared to zero for large firms and 0.08% for medium sized firms.

We believe that it is possible that some firms have understated the cost of insurance for their firm due to the way in which the questionnaires were completed. Many small firms focused on allocating staff costs in detail and allowed the system to force through an allocation of most other costs in the same proportions. However, this was not possible for insurance costs where firms were required to input the insurance costs and specify the percentage that was incremental. Only one third of firms (11) input specific insurance costs and allocated them as incremental thus potentially understating the incremental cost of PI.

Among those firms who did clearly allocate costs, incremental regulatory costs rose to 3.12% of total market sector costs, with two clear camps emerging:

- Seven of the 11 firms reported 100% of the costs to be incremental, implying that they would not purchase any PI insurance cover were it not required by FSA. All but one of these firms is an IFA; and
- Four reported none of the costs to be incremental, suggesting that they believe PI cover to be critical for their business. All of these firms are either banks or life firms with tied salesforces.

Once again, firms reporting high incremental regulatory costs were unable to tell us what other costs might rise in the event that they cease to purchase PI insurance. A prudent firm might choose to increase the amount of capital it holds to reserve for future claims against the firm. We have not been able to quantify this effect.

### Advising & Selling Activities

We consider below seven of the rules associated with the business activity of advising and selling of investment/package products to retail customers. The following rules attract costs which appear in the top ten rankings of incremental regulatory costs for the sector:

- Ensuring products are suitable for client needs;
- Production of suitability letter;
- Tailoring of projections in key features;
- Provision of key features for packaged products;
- Performance of Know Your Customer (KYC) checks;
- Record Keeping – KYC; and
- Disclosure of charges.

Other advising and selling activities either incurred low costs or were not considered incremental by most firms, that is, they would undertake the activity even in the absence of the rule.

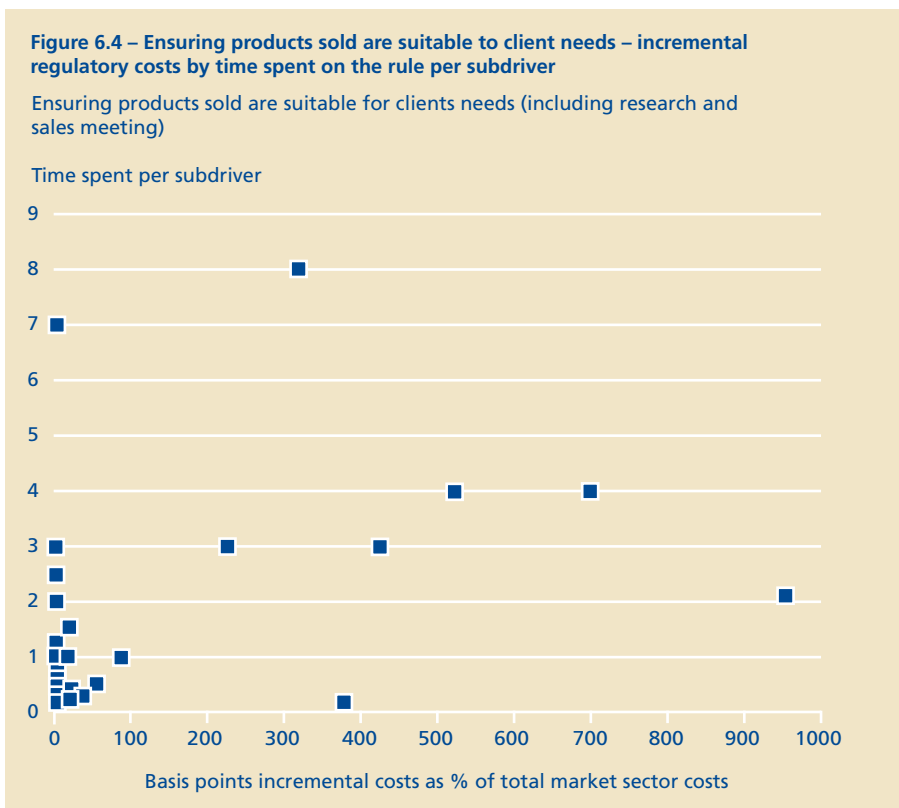
**Ensuring Products Sold are Suitable for Client Needs (including Research and Sales Meeting) – (Rule ref. COB 5.3)**

All firms in the sample reported costs associated with this activity (32 firms). The activity attracted a median score of 0.1% of total market sector costs.

A small number of firms allocated a very high proportion of the costs associated with this activity as incremental (vertical axis on the chart below). On average firms considered almost 30% of their time associated with this regulated activity to be incremental (i.e. driven solely by the existence of the FSA rule). A small number of firms identified more than 60% of their costs as incremental. Some firms consider a high proportion of costs to be incremental on the basis that they would not undertake as much formal and documented research on products and providers in the absence of the rule.

When considering the proportion of costs that firms report to be incremental, it is important to note that firms have adopted different approaches to attributing costs to a regulated activity. Where firms attributed a significant proportion of their time and costs to a regulated activity, they tended then to attribute a lower percentage as incremental. Conversely, where firms had already narrowed down those costs attributed to a regulatory activity to being those costs strictly associated with the rule, they tended to allocate a higher proportion as incremental.

For some firms, high costs were driven by their spending more time than average on this activity (vertical axis on the chart below) as shown in the chart below. On average, firms claim to spend 1.7 hours on this regulated activity. However, the higher than average incremental cost for one firm is driven by their stating that they spend 8 hours on this activity. Higher than average time can reflect a firm’s involvement in more complex advice which may require more time spent carrying out research or attending sales meetings.



Removal of the rule could lead to less time being spent by some firms:

- a) Researching products;
- b) Documenting their research; and
- c) Explaining their research to customers.

## Production of Suitability Letter (Rule ref COB 5.3)

This activity involves the provision by a firm or individual advisor of a written document when they give advice to a customer in order to demonstrate that the advice they have provided is suitable. The FSA Conduct of Business rules set out that it is a requirement for all pension and investment advice firms to provide a suitability letter before conclusion of a sale of a financial product. The rules and guidance also stipulate the content of the letter in so far as the rules set out that the letter must explain the reason for the sale and highlight any necessary consequences or possible disadvantages arising.

All firms in the pension and investment advice sample allocated cost against this activity. The median incremental cost is 0.41%, making this the most costly rule for firms (after FSA fees).

Detailed analysis highlights one outlier firm with high incremental costs, its high incremental regulatory costs are a function of:

- Allocating a very high proportion of staff time to this regulated activity (for several firms this activity represented one of the most costly activities in advising and selling);
- The view that a reasonably high proportion of these costs are incremental (50% compared to an average of 30%); and
- The time taken on the activity being higher than average (3.5 hours per client compared to an average of 1.4).

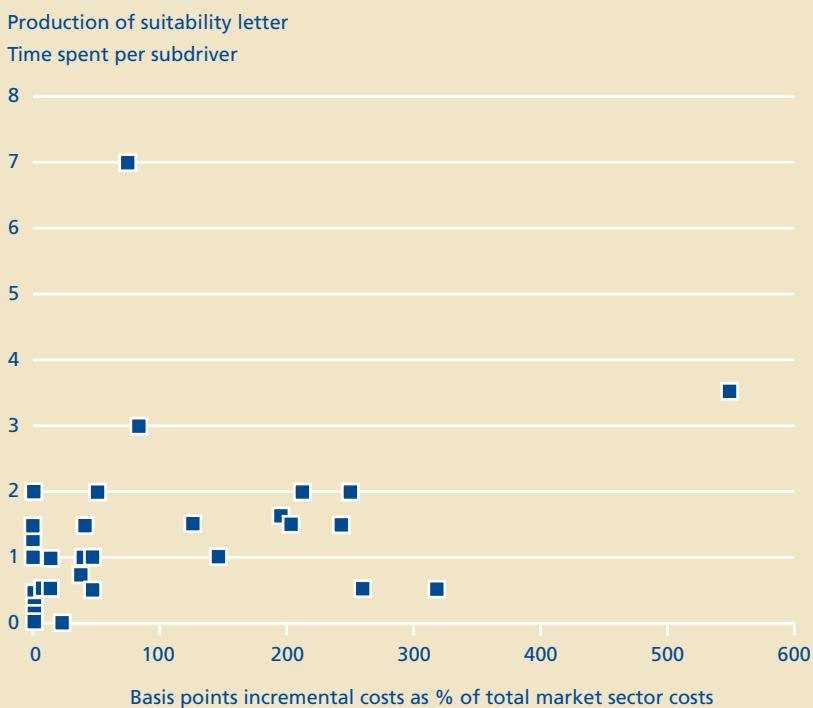
Opinions are divided on the extent to which the production of a suitability letter is an incremental cost:

- Five firms (two of them banks) consider the production of letters to be wholly incremental and would not produce them at all were the rule to be removed;
- A further seven consider that they would save at least 50% of the costs currently with their production, among them some of the largest and smallest firms in the sample; and
- The majority would scale back their activity but would not make significant savings from the removal of this rule.

The analysis also reveals significant differences between firms in the time taken to produce suitability letters:

- One firm, notable for operating at the more complex end of the pensions market, records seven hours of time per suitability letter. This firm may also have included in its analysis some of the time spent on research and analysis of products in order to complete the letter.
- A further two spend more than 2 hours in the production of letters, suggesting each letter is tailored to some extent.
- The majority report spending 2 hours or less per letter. For these firms letter production may be more automated/standardised.

**Figure 6.7 – Production of suitability letter – incremental regulatory costs by time spent on the rule per subdriver**



Removal of this rule suggests that:

- a) Some firms would not confirm or justify their recommendations to clients in this form;
- b) Others would produce more standardised and simpler letters for clients.

**Tailoring of Projections in Key Feature Documents to Client Circumstances – (Rule ref. COB 6.6)**

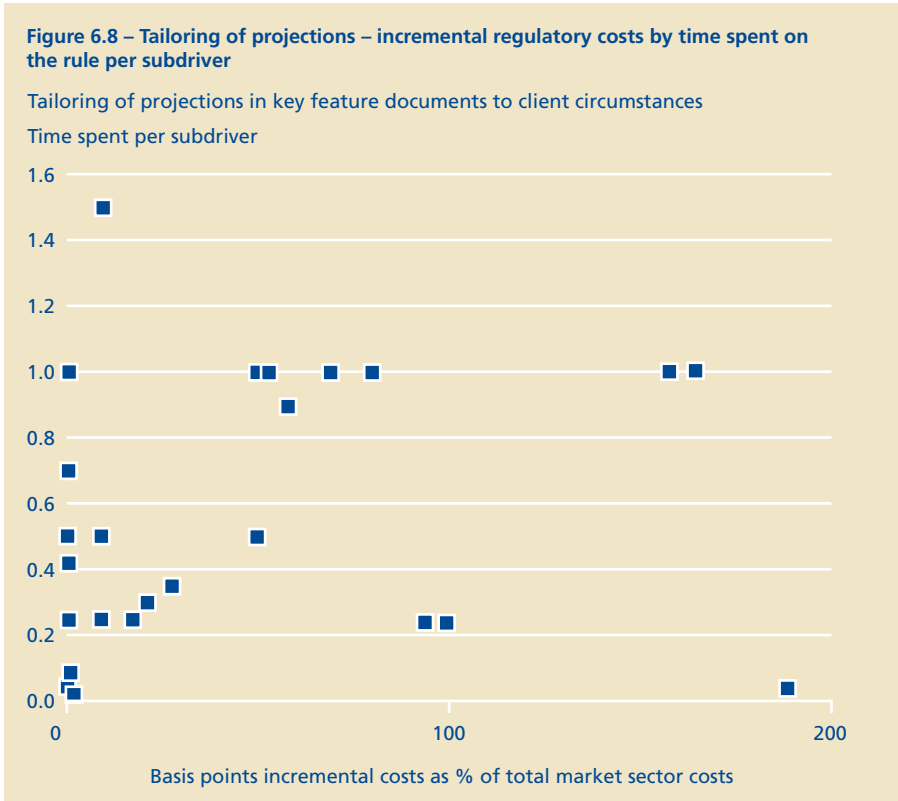
A total of 28 firms in the pension and investment advice sample allocated cost against this activity. The rule attracted a median score of 0.1% of total market sector costs.

Participant firms recorded time spent obtaining projections from providers and delivering them to customers, and the associated costs that were considered to be incremental resulted in the ninth place ranking of this rule. A number of different projections may be required per client. Although FSA rules do not require tailored projections to be produced in every instance, it is clear that many firms spend a significant amount of time on this activity. Possible explanations include:

- firms are generating more individual projections than the rules require, perhaps because maintaining a portfolio of projections to re-use is more complex and costly than creating new projections for each circumstance or because they misinterpret the requirements; or
- client circumstances and projections vary too much or too frequently to use previously prepared projections, thus leading to new projections being required for most client situations.

Two firms report high incremental regulatory costs against this rule due to their belief that 100% (or close to 100%) of the costs they incur against this regulatory activity is incremental.

Figure 6.8 shows the length of time firms attributed to this rule. The mean time spent per projection is 0.5 hours with a range from zero to 1.5 hours.



The firm with the highest incremental regulatory costs associated with this rule is offering tied advice. There is no clear rationale for this firm having significantly higher incremental regulatory costs to its peers.

In the absence of this rule, firms would use more generic projections, thus reducing the amount of time and other costs (eg systems) attributed to this rule. Some consumers, as a result, might find that the projections they receive are not as appropriate to their personal circumstances as is the case today.

**Provision of Key Features/  
Simplified Prospectus for Packaged  
products – (Rule ref. COB 6.2)**

Firms are required to provide customers (and prospective customers) with key features relating to the products that they recommend (in a format prescribed by FSA).

A total of 31 firms in the pension and investment advice sample allocated cost against this activity. The rule attracted 0.12% of total market sector costs (median). Responses ranged from 0.00% to 2.73% and this rule is fourth in the top twenty ranking.

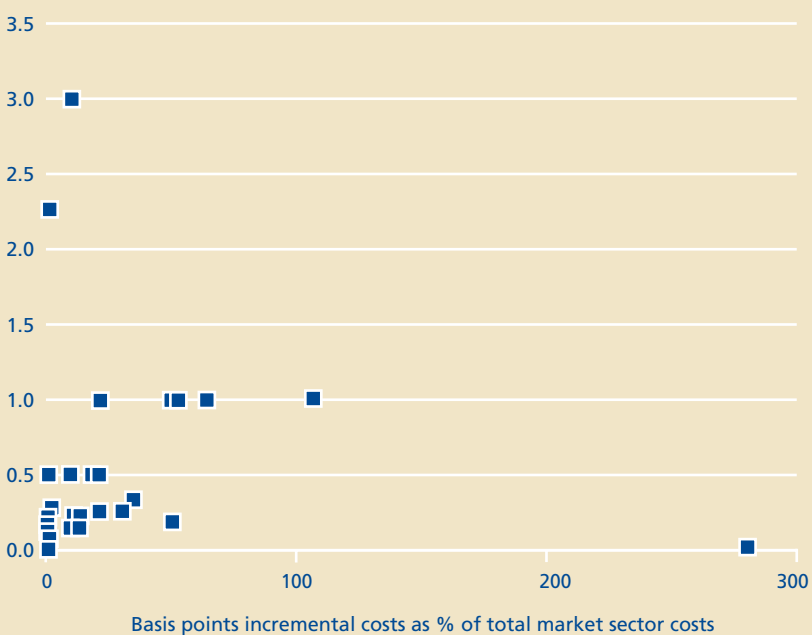
The chart below reveals one outlier for this rule (2.73% of costs) but that this result is driven neither by the view that a high proportion of this cost is incremental nor taking more time to provide key features.



**Figure 6.9 – Provision of key features – incremental regulatory costs by time spent on the rule per subdriver**

Provision of key features/simplified prospectus for packaged products

Time spent per subdriver



The respondent which represents an outlier from the majority of the firms is a large firm with a tied sales force. It produces its own key features and therefore has, in common with a small number of other large respondents, high advertising and printing costs allocated to this rule. Unlike some other large firms, it considers that there are some cost savings that it could make if this rule were reduced. For many firms in the sample, the costs of producing key features are met by the providers and therefore cost savings would be felt by the life company or fund manager not by the intermediary firm itself.

Were this rule to be removed, the main cost saving would be in the production of key features, replacing them with more standard or less bulky material. Some time might also be saved in ensuring that customers are provided with correct documentation. There may be some reduction in the provision of information at point of sale.

**Performance of Know Your Customer Checks – (Rule ref. COB 5.2)**

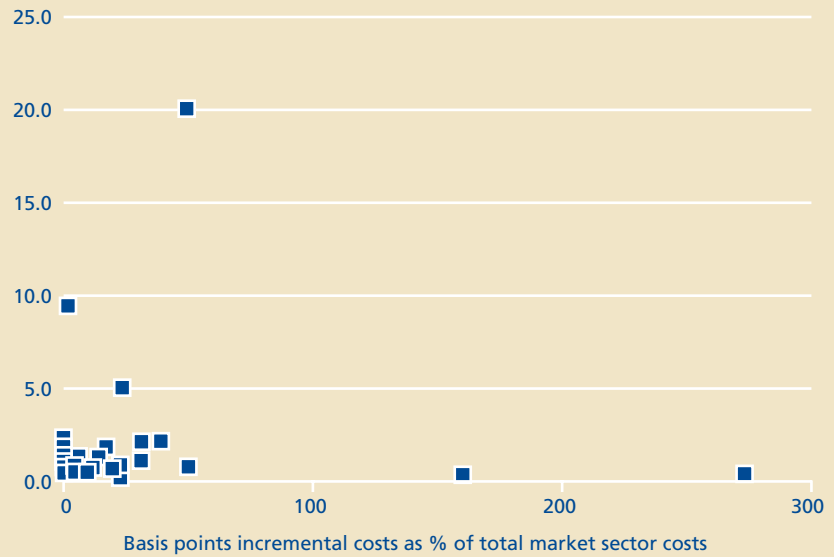
A total of 32 firms in the pension and investment advice sample allocated cost against this activity with a range from 0.00% to 2.75%. The median score for this rule was 0.08% of total market sector costs.

As the chart below indicates, there are two distinct outliers on incremental regulatory costs. Their high costs are in the main driven by their assessing a relatively high proportion of their costs to be incremental. Both are large firms who allocate a significant proportion of their costs to this activity and then state that a significant proportion of those costs are incremental. Other firms allocate less cost to the activity and/or spend less time on the activity and/or consider less of it to be incremental.

**Figure 6.10 – Performance of KYC checks – incremental regulatory costs by time spent on the rule per subdriver**

Performance of know your customer checks

Time spent per subdriver



In the absence of this rule, most firms would save some costs by reducing the amount of time spent collecting information by collecting more focused information.

**Record Keeping – Know Your Customer – (Rule ref. COB 5.2)**

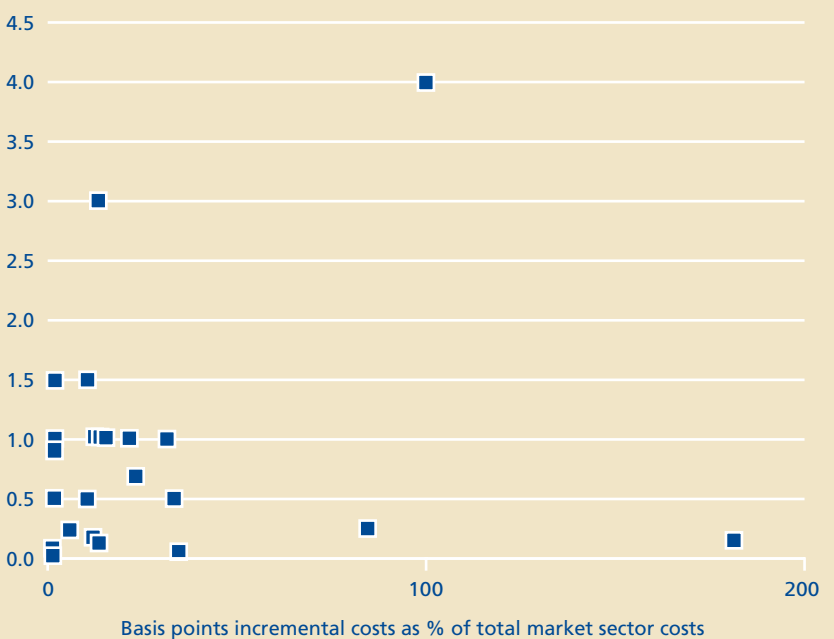
A total of 30 firms in the pension and investment advice sample allocated cost against this activity. This rule attracted a median score of 0.07% of total market sector costs. Responses ranged from 0.00% to 1.76%.

As the chart below reveals, there are three outliers, one of whom is an outlier due to above average time spent on the activity (4 hours against an average of 0.8 hours). All three consider more than 30% of the costs that they allocate to this activity to be incremental, significantly more than other respondents.

**Figure 6.11 – Record keeping KYC – incremental regulatory costs by time spent on the rule per subdriver**

Record keeping – Know your customer

Time spent per subdriver



In the absence of this rule, almost all firms would be able to save costs as a result of documenting and keeping less information regarding their customers.

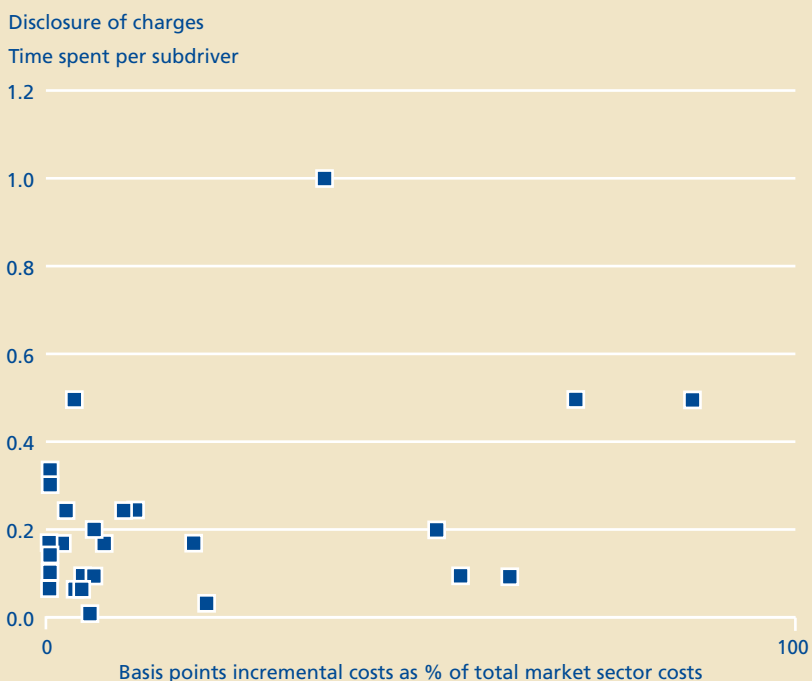
**Disclosure of charges, remuneration and commission (COB 5.6 & 5.7)**

30 firms attached costs to this rule. The rule attracted a median score of 0.06% of total market sector costs. Responses ranged from 0% to 0.86%.

Analysis of responses reveals a wide range of responses in terms of the percentage of costs that firms believe to be incremental. Several firms claim that 100% of the costs of disclosure are incremental, in other words they would not make the disclosure were it not mandatory to do so. Many others believe that they would make some form of disclosure but that it would not incur such significant costs as today's requirements.

With one exception, respondents claimed to spend half an hour or less on this disclosure.

**Figure 6.12 – Disclosure of charges, remuneration and commission – incremental regulatory costs by time spent on the rule per subdriver**



In the absence of this rule, firms consider that they would either:

- reduce the amount and complexity of information which they supply to customers on charges; or
- cease to provide such information altogether.

**Post Sale Client Servicing Activities**

With the exception of the provision of periodic statements referred to above, no post sale client servicing activity enters the top ten.

**HR Activities**

Two activities relating to training and competence appear in the top twenty mean or median scores. They are:

- Keeping up to date with FSA seminars, cluster reports and speeches; and
- Maintaining employee competence.

Rules relating to this business activity which do not attract top ten scores include:

- Attaining employee competence;
- Obtaining information about the knowledge and skills of the individual, including Fit and Proper;
- Keeping up to date with FSA consultations;

- Supervision and monitoring of employees not assessed as competent;
- Record Keeping – compliance with Training and Competence rules;
- Determining training needs and organising appropriate training for employees;
- Ensuring and recording that all employees have passed appropriate examinations; and
- Ensuring that all employees are aware of firms money laundering policies and receive appropriate training.

These rules either do not attract significant costs and/or are not considered to be incremental to normal business practice.

**Maintaining Employee’s Competence– (Rule ref. TC 2.6)**

A total of 25 firms in the pension and investment advice sample allocated cost against this activity with responses ranging from 0% to 3.62%. The median score for this rule was 0.13% of total market sector costs, making it the second most costly rule (behind provision of suitability letters).

Analysis of the responses reveals one outlier with costs of 3.62% of total market sector costs, eight firms with between 0.5% and 1.5% incremental regulatory costs and the remaining firms with negligible incremental regulatory costs. Those with moderate to high costs include both large and small firms and operate in both the IFA and tied sectors.

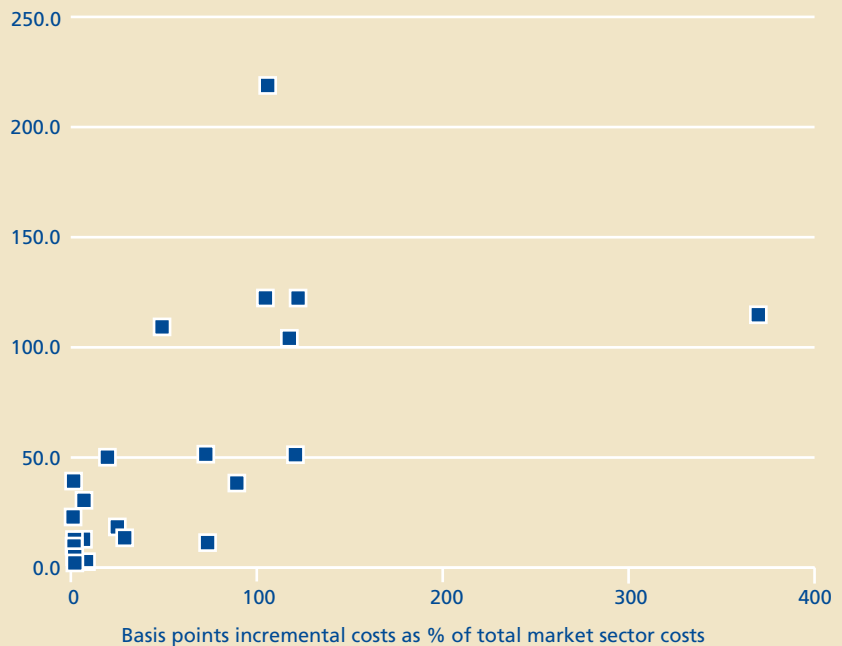
The analysis reveals significant differences in the amount of time devoted to this activity. Those with high costs are typically spending more time on this activity (more than 50 hours per employee per year). Many of those with low incremental regulatory costs against this activity are spending less than 10 hours per employee per year on maintaining employee competence.

Several firms believe a high proportion of this cost to be incremental. Those with low costs tend to believe that less of their costs are incremental.

**Figure 6.13 – Maintaining employee competence – incremental regulatory costs by time spent on the rule per subdriver**

Meeting employee’s competence (including FSA seminars, cluster reports, speeches)

Time spent per subdriver



In the absence of this rule, some firms could save costs by reducing the amount of time devoted to maintaining employee competence, in particular in relation to FSA-related issues.

## Keeping up to date with FSA seminars, cluster reports and speeches

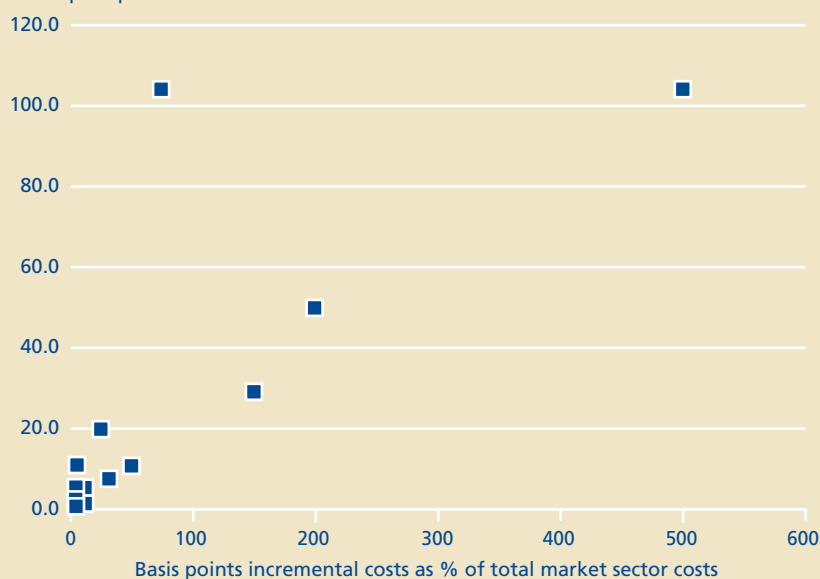
26 firms reported costs against this activity. Anecdotal evidence from firms would suggest that this activity gives rise to considerable costs and responses ranged from 0% to 4.96% of total costs. The median score for this rule was 0.05% of total market sector costs.

The analysis of responses reveals one significant outlier. This firm, a small IFA, claims to spend 104 hours per employee per year on this activity (compared to a mean of 15 hours) and believes that 100% of that cost is incremental. Several other firms believe a very significant proportion of the costs associated with this rule to be incremental. However, for all of the costs to be saved, it is reasonable to assume that not only would this rule need to be removed but most other rules to which seminars, cluster reports and speeches apply would also have to be removed. In the absence of the removal of other rules, it is reasonable to expect that firms would continue to need to keep up to date for the benefit of their own businesses.

**Figure 6.14 – Keeping up to date with FSA seminars etc – incremental regulatory costs by time spent on the rule per subdriver**

Keeping up to date with FSA seminars, cluster reports, speeches

Time spent per subdriver



In the absence of this rule, it is clear that some firms would not change their behaviour since they allocate little time to this activity at present. However, other firms would reduce the amount of time devoted to maintaining an understanding of FSA activity in these areas.

## Governance not considered to be a high incremental cost associated with FSA rules.

None of the governance rules against which the survey collected costs appears in the top ten. One rule – Implementation of menu/IDD – appears at number 20. These costs are one-off costs and are analysed below. Other governance rules that did not attract high incremental regulatory costs included:

- Allocation of rules and responsibilities between directors and senior management to maintain appropriate systems and controls;
- Establishing and maintaining systems and controls appropriate to the business;
- Setting up appropriate reporting lines and communicating to the rest of the firm;
- Record keeping – split of responsibilities between directors and senior managers;
- Using national and international findings on material deficiencies;
- Commissioning a report from the MLRO once a year on money laundering systems;
- Record keeping – training of employees;
- Record keeping – transactions entered into;

## The cost of regulation study

- Record keeping – identity of clients;
- Maintaining authorisation;
- One off projects and initiatives to implement changes as a result of the FSA's Treating Customers Fairly campaign; and
- Implementation of depolarisation (one off strategies only).

## Risk Monitoring

Other than the requirement to hold PI insurance (analysed above), none of the risk monitoring rules attracted high mean or median incremental regulatory costs as a percentage of total market sector costs. Rules against which costs were reported included those below, although not all are relevant to this market sector:

- Monitoring large exposures on daily basis and ensuring exposures within FSA limits;
- Calculating the position risk requirement;
- Reconciling all balances and positions on a frequent basis (at least once a year);
- Calculating counterparty risk requirement (CRR) at least once a day;
- Calculating minimum position risk requirement (PRR) in respect of any position ;
- Calculating FER for any exposure in a foreign currency;
- Calculating CRR on a counterparty exposure;
- Calculating large exposure requirement (LER) on all large exposures;
- Keeping accounting records on a continual basis;
- Maintaining of adequate records and establishment of procedures/controls to ensure records produced accurately/on timely basis;
- Keeping accounting records on a continual basis;
- Ensuring that records are protected from loss unauthorised access/alteration/destruction;
- Establishment and maintenance of systems and controls in relation to the management of operational risk (for insurers);
- Requirement to hold financial resources to cover liabilities;
- Requirement to notify FSA and keep records about changes to PII insurance;
- Requirement to keep records relating to IPRU risk monitoring for 6 year period;
- Requirement to hold Professional Indemnity Insurance; and
- Ensuring that records are protected from loss unauthorised access/alteration/destruction.

## Periodic reporting

Similarly, none of the individual rules relating to periodic reporting attracted high incremental regulatory costs. Although some of these activities are considered to be highly incremental in nature (ie the activities would largely not be undertaken in the absence of the FSA requirement) they are not in themselves high cost activities. These activities included:

- Monitoring and maintaining minimum levels of financial resources, calculated in accordance with FSA rules;
- Calculating the firm's tangible net worth;
- Monitoring and maintaining externally generated financial resources in excess of requirement;
- Notifying of defaults on counterparty obligations and large exposures;
- Monitoring and maintaining externally generated financial resources in excess of FSA requirements;
- Reporting annually to FSA on firm's controllers and any changes in control;

- Reporting annually to FSA on firm's close links and any changes in close links;
- Preparing and submitting quarterly/monthly and annual financial return and annual accounts to FSA; and
- Submitting a list of appointed representatives to FSA on an annual basis.

## Marketing

The survey collected data in relation to only four rules under the marketing banner. Only one appeared in the top twenty incremental scores – appropriate form and content of financial promotions.

Many firms within the sample recorded no or very low costs against this rule. Most IFAs and some larger distributors fall into this group. The financial promotions that they use are often produced by the product manufacturers (see provider costs below). The incremental regulatory costs of checking that financial promotions provided by third parties is extremely low for most IFAs.

Among the larger groups who do produce their own financial promotions, time spent on checking financial promotions is noticeably higher (e.g. 25 or 45 hours), a significant proportion of which is considered to be incremental (50%-94%).

Other marketing rules which attracted low incremental regulatory costs as a percentage of total market sector costs included:

- Communication and approval of financial promotions for overseas person or unauthorised person;
- Producing key features that have appropriate form and content; and
- Record keeping – financial promotions.

## One off costs

Data was collected for three specific named examples of one off costs:

- "One off projects and initiatives to implement changes as a result of the FSA's Treating Customers Fairly campaign";
- "Implementation of the menu/IDD (set up costs only)"; and
- "Implementation of depolarisation (one off strategies only)".

Firms also had the opportunity to record staff time/costs against any other significant one off cost category of their choice: "Other". None of the firms in our sample recorded costs against this category, suggesting that either the firms did not consider there to be any other significant one off costs not already mentioned in the questionnaire or that they were exhibiting "questionnaire fatigue".

No specific rule references were allocated to these one off cost categories. The costs are specific examples of one off project costs rather than attributable to particular FSA rules.

With the exception of one firm, only staff costs were recorded against these examples. All of these examples of one off costs were a subset of the business activity 'Governance'.

## Treating customers fairly ('TCF')

A total of 21 firms recorded one off costs against this category. 11 of these were medium/large firms. The remaining 10 firms were small firms. Treating customers fairly ('TCF') attracted a median score of 0.01% of total market sector costs as a one-off cost.

Of the three one off costs, TCF is the least likely to be considered as incremental. This is unsurprising as TCF is considered to be good business practice.

Anecdotally firms told us that the costs recorded here were for senior management time on their TCF project. The one firm that recorded cost types other than staff costs recorded these as IT systems costs (although these were very minimal) and printing and advertising costs (again, very minimal).



## Implementation of Menu/IDD

More firms recorded one off costs for this area than for any other one off cost type. 26 firms recorded one off costs against this category (nine large/medium firms, 17 small firms). It was also regarded as the most incrementally costly one off cost area and attracted 0.02% of total market sector costs (median).

Firms who reported costs in this category tended to feel that all or a very high proportion of the costs incurred were incremental in nature, or put another way, the introduction of this rule caused firms to incur costs that they would otherwise not have done.

Anecdotal evidence gathered during discussion with firms suggests that the costs recorded in this area were due to having to make several revisions to the layout of the menu/IDD documentation they handed out to clients. Firms initially found the rules difficult to follow and several stated that the uncertainty created, led to the revisions.

## Implementation of depolarisation

Against this category of one-off cost:

- the least number of firms recorded costs against this cost category compared to the other two costs above – a total of 17 firms recorded one off costs against this category (seven large/medium, 10 small); and
- those who did report costs recorded the highest average staff time of the three one off cost types.

Among those firms who reported costs 0.02% of total market sector costs were attributed to one-off costs against this FSA change to the rule book (median).

For some firms in this sector, year end data used to drive their responses to the survey may have meant that some costs attached to this activity were not collected. For others, the implementation costs were captured by their year end data. The one-off costs for this activity will have arisen in the period leading up to 1st June 2005 as strategies for depolarisation were evolving.

Although this was an enabling piece of regulatory change, several firms felt that the costs were incremental due to their having to consider different possible strategies for their business in the light of regulatory change, costs which they would not have incurred had a) the regulations on polarisation not previously existed and b) the changes facilitating different models arisen.

Where costs were recorded, only staff time was included against this cost category. Discussions with firms suggest that primarily project time attributable to considering different strategies was recorded.

## Provider costs in support of the 'IFA' sector

In order to complete the picture of costs in this sector of the market, we sought to include those costs which are incurred by life offices and other providers (in the main retail fund managers) who operate in the IFA sector in support of that sector. Whilst several companies were asked to complete the survey, only one was able to do so in detail with one other providing qualitative feedback. In order to maintain confidentiality, we have therefore not published any quantitative results but rather have summarised the nature of the feedback.

Costs and incremental costs associated with FSA rules incurred by providers in support of the IFA sector fall into two main categories:

- Marketing support in the form of financial promotions. Key feature documents and some other marketing support used in the IFA sector is generally produced by the providers. The costs are not explicitly passed on to intermediaries. A proportion of the costs of producing this material is considered to be incremental due to the specific requirements of FSA rules.
- Governance costs. Providers report spending considerable time (and therefore cost) in supporting the intermediary sector in the interpretation, understanding and implementation of FSA consultations and rule changes, much of which is considered incremental in nature. Firms may also attribute a proportion of their FSA fees to support of the IFA sector along with some FSCS fees.

Providers also report some one-off costs in support of the IFA sector in relation to depolarisation and menu implementation.

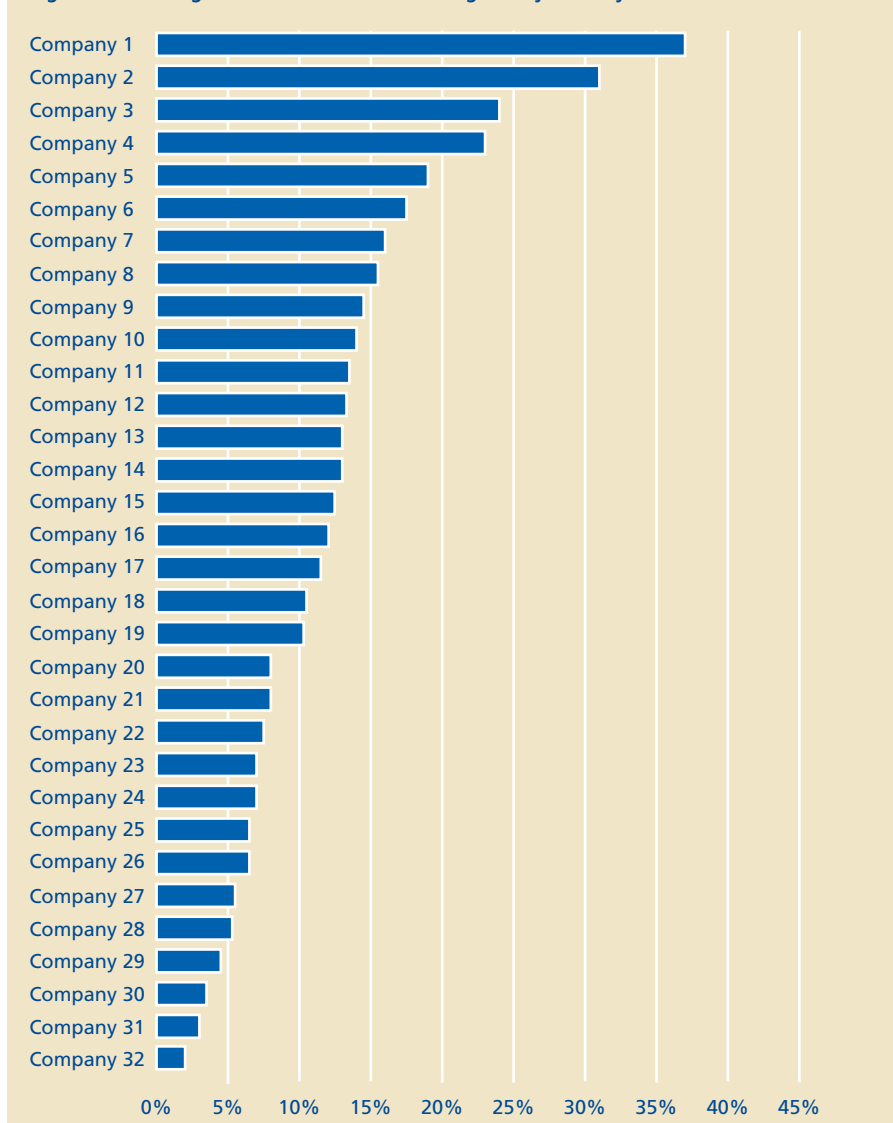
**Incremental regulatory costs are significantly higher in the retail market**

The results in Figure 6.16 indicate that the range of incremental regulatory costs associated with regulated activities is significantly wider in the IPA sector than either Corporate Finance or Institutional Fund Management with the range of results more than six times wider than that shown in the other two sectors. This is because whilst the low end of the range is comparable with the other sectors, the higher responses indicate a much higher level of incremental costs. The methodology, as explained in section 3, was not designed to capture a reliable measure of total costs, either for an individual firm or a sector and there are valid reasons why these totals are not an accurate figure. Nevertheless, the indication of higher incremental costs in the IPA sector, compared to Corporate Finance and Institutional Fund Management is also supported by anecdotal evidence and is considered directionally correct.

This is not unexpected given that firms in this sector are exposed to a large number of detailed rules designed to afford protection to the consumer.

**Considerable distribution around the midpoint.**

**Figure 6.15 – Range of summed incremental regulatory costs by firm**



The firms at the top end of the chart with high total incremental regulatory costs include both large and small firms, as do those at the bottom end of the scale. No distinct business models emerge as giving rise to high or low incremental regulatory costs. The analysis does not support the hypothesis that smaller firms incur greater incremental costs of regulation as a proportion of their total cost base than large firms.

As already noted, the results obtained for a firm by summing the incremental costs of each rule are subject to overstatement as a result of both the overlapping nature of some of the rules (and consequential potential for duplication of cost savings) and the existence of outlier results. These outliers have been discussed, where relevant, in the analysis earlier in this section but have not been excluded from the data used to prepare the chart above. If they were, so that a “median firm” were created from the median result for each individual rule, then the total figure for this “median firm” would be towards the low end of the chart.

# Appendix 1 – Glossary

<b>Additional costs incurred in the absence of regulation</b>	Costs that are not incurred under regulation but which would be incurred if areas of regulation were withdrawn.
<b>Advising and selling</b>	Interacting with the client, covering credit checks, conducting fact finds, researching products available in the market, assessing the suitability of products for clients, disclosing the financial products offered by the firm, negotiating contractual arrangements, providing terms and conditions of business and closing transactions.
<b>Business activities</b>	Principal activities performed by a business in the selected regulated market including activities that are connected with complying with FSMA regulation and activities which are independent from it.
<b>Cost of business activities affected by regulation</b>	Total cost incurred in meeting regulatory responsibilities whilst undertaking regulated activities.
<b>Costs of regulation</b>	The costs of regulation are the costs arising from FSA regulation, as well as from the Financial Ombudsman Scheme (FOS) and the Financial Services Compensation Scheme (FSCS). The costs of regulation represent the costs of adhering to the FSA Handbook, the actions specifically required in the guidance that supports the rules in the Handbook or responses to written instructions.
<b>Dealing and managing</b>	Carrying out transactions or funds transfers for clients.
<b>Direct cost</b>	Costs that have been directly incurred in a particular business activity.
<b>FOS</b>	Financial Ombudsman Service.
<b>FSA</b>	Financial Services Authority.
<b>FSA relationship management</b>	Dealing with queries and investigations from regulators, notifying them of relevant events/issues, paying regulatory fees and dealing with forthcoming regulation.
<b>FSCS</b>	Financial Services Compensation Scheme.
<b>FSMA</b>	Financial Services & Markets Act.
<b>FSP</b>	Financial Services Practitioner Panel.
<b>Governance</b>	Establishing and complying with the firm's overall governance processes. Includes activities performed for maintaining the firm's reputation and maintaining the quality of the products and services offered by the firm. It also includes activities undertaken in order to maintain authorisation and anti-fraud controls.
<b>Handling client assets</b>	Handling of client assets/money and acting as agent for the client.
<b>HR activities</b>	HR activities related to new and existing employees (for example benefits scheme, management of payroll, etc). Checking employees' competence and providing and receiving appropriate training.
<b>IFA</b>	Independent Financial Advisor.

<b>Incremental regulatory cost</b>	Cost incurred in undertaking regulated activities which would not be incurred in absence of the FSMA.
<b>Indirect cost</b>	Any other cost which is not defined as a direct cost.
<b>Institutional Fund Management</b>	<p>All those firms, or parts of firms, carrying out activities requiring the following permissions:</p> <ul style="list-style-type: none"> <li>• Managing investments; and/or</li> <li>• All firms with individuals registered under the CF27 controlled function (Investment management function).</li> </ul>
<b>Investment &amp; Pension Advice to retail customers</b>	<p>All those firms, or parts of firms, carrying out activities requiring either or both of the following permissions:</p> <ul style="list-style-type: none"> <li>• advising on Investments (except on Pension transfers and Pension opt outs); and/or</li> <li>• advising on Pension transfer and Pension opt outs.</li> </ul>
<b>Investment Banking – Corporate Finance</b>	<p>All those firms, or parts of firms, carrying out activities requiring either or both of the following permissions:</p> <ul style="list-style-type: none"> <li>• all firms within the fee block activity group A.14, Corporate Finance and all London Investment Banking Association members; and/or</li> <li>• all firms with individuals registered under the CF23 controlled function (Corporate finance adviser function).</li> </ul>
<b>Market cost</b>	Costs allocated to selected regulated market.
<b>Marketing</b>	Determining the firm's marketing strategy, understanding and researching the client base and prospecting for clients. Also includes designing, developing and promoting the financial products and services offered by the firm.
<b>Median</b>	Value in the middle of a distribution of values. The median value represents the 50% percentile value, corresponding to the value for which 50% of observations are higher than this value and the other 50% are lower.
<b>One-off incremental costs</b>	Costs incurred in complying with regulation which firms would not have incurred had a particular rule not been mandatory and are not recurring.
<b>Ongoing incremental costs</b>	Recurring costs incurred in complying with regulation which firms would avoid in subsequent years if a particular rule was no longer mandatory.
<b>Opportunity cost</b>	Revenue or profit foregone by taking the course of action required by regulation.
<b>Periodic reporting</b>	Periodic reporting and compliance with financial, tax and regulatory requirements.
<b>Post-sale client servicing</b>	Reporting to clients and regulators on transactions carried out, dealing with customers' queries and complaints, retaining customers and routing periodic surveillance to regulators.

<b>Regulated activities</b>	Activities which are required to comply with FSA regulation under FSMA. Nevertheless, some of the costs incurred in those regulatory activities may have been incurred regardless of FSA requirements. For example, some of the regulatory activities may also be undertaken in response to commercial imperatives, such as the FSA requirement to know your customers. Although this is considered a regulatory activity in this study, it is likely that firms would have undertaken this activity at least in part in the pursuance of its own business interest. Therefore, the costs of regulation identified by this study encompass some costs that firms would have ordinarily incurred for commercial purposes.
<b>Risk monitoring</b>	Monitoring the firm's risk exposure and taking action to manage the risk.
<b>Selected regulated market</b>	One of the three market sectors selected for the Study.

# Notes

# Notes





# Contacts

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