

# How we analyse the costs and benefits of our policies

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This is not the latest version. To find our latest Statement of Policy on cost benefit analyses, which provides the latest guidance on how we assess the costs and benefits of our policies, please visit [Measuring our impact before we intervene](#).

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# Foreword

Analysis of the impacts of our interventions sits at the heart of the FCA's work. In particular, cost benefit analysis (CBA) helps us to use our rule-making powers appropriately and proportionately.

As the NAO has observed, much of the value of CBA lies in the discipline and challenge it presents to decision making, rather than in the precise results themselves. Expected policy impacts are always uncertain before a policy has been implemented, but the process of undertaking the analysis helps focus attention on the most costly and most beneficial aspects of policies.

CBA is also about transparency. We are legally required to do a CBA of certain regulatory proposals, so setting out our analysis publicly is an important part of the FCA being accountable.

The FCA and its predecessor FSA have used CBA since 2001. Since the FSA published a guide to CBA in 2006, there have been a number of developments that have affected how we do CBAs. These include the adoption of field experiments to better understand the likely impact of public policies; the Financial Services and Markets Act requirement to provide an estimate of not only the costs but also the benefits (subject to exemptions) of a proposed rule; the requirements in the Small Business, Employment and Enterprise Act 2015; and our renewed focus on impact evaluation as articulated in Our Mission.

We think it is important to be clear about why, when and how we do CBA in developing policy interventions. We are publishing this paper on how we do CBAs alongside a paper on field trials and an Occasional Paper on techniques that can be used to estimate the benefits of some of our policy interventions. In April 2018, we also published a Discussion Paper on how we are using ex post impact evaluation of our interventions.

Taken together, this suite of documents gives a rounded picture of how we assess the impact of our interventions.

We intend to keep our approach to measuring impact up to date and evolving over time, and welcome views from stakeholders at any point about the approach and techniques we use.

Mary Starks

Chief Economist and Director of Competition

# 1.Introduction

Our Mission, published in April 2017, explained how we regulate to deliver good outcomes for a wide range of users of financial services. It set out the framework for how we make strategic decisions. The framework starts with identification of harm, moves on to use of diagnostic tools and remedy tools, and finishes with evaluation of our decisions.

This paper focuses on cost benefit analysis, which is an essential part of the diagnostic and remedy design work we do before exercising our rule-making powers.

## What is Cost Benefit Analysis?

Cost benefit analysis (CBA) provides a structured way to assess what costs and benefits a policy is expected to generate. It attempts to describe and quantify where possible the likely impacts of a policy. This includes impact on industry, consumers, markets and the FCA.

## Why we do CBA

In the early stages of policy work, high level cost benefit analysis helps us choose among several options. Later, once a policy option has been selected, a full CBA helps us understand the likely impacts of the policy and whether our proposed intervention is proportionate to the harm we are concerned about. FSMA does not require us to prove mathematically that benefits exceed costs. We do though need to show that the proposed rules advance our operational objectives, having regard to the principle that a burden or restriction which is imposed should be proportionate to the benefits which are expected to result<sup>1</sup>.

CBA is also about transparency and making sure we are using our powers appropriately. We are legally required to undertake and publish a CBA before proposing or amending rules, so this tool is an important part of the FCA's accountability framework.

## Purpose of this paper

Since the FSA last published the approach to CBAs in 2006, there have been several important developments, including: in 2007, the removal of the statutory duty in the Financial Services Market Act 2000 (FSMA) to conduct a CBA when consulting on guidance; modifications by the Financial Services Act 2012 to the FCA's consultation obligations in

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<sup>1</sup> See s.3B(1)(b) FSMA.

FSMA<sup>2</sup>; the requirements in the Small Business, Employment and Enterprise Act 2015 (see Chapter 7); the adoption of behavioural research for public policy<sup>3</sup>; the renewed focus on evaluation in [Our Mission](#); and the introduction of our standardised costs methodology (see Annex 1).

This paper explains how we go about analysing and estimating the costs and benefits of our policies<sup>4</sup>. It outlines the steps we take and the key challenges we face. It sets out:

- how we use CBA to inform decisions,
- what level of detail and accuracy we aim for,
- how we gather the evidence we need,
- how we deal with uncertainty.

The paper discusses what we typically cover in the CBAs that accompany our policy Consultation Papers. On costs, it presents our new standardised approach to estimating compliance costs. This is designed to increase consistency of compliance cost estimates and reduce the information-gathering burden on firms. On benefits, it illustrates the types of benefits that we aim for when we intervene in financial markets, the challenges in quantifying these, and the continuing efforts we are making in this area.

The paper is part of a suite of papers on how we use economic and related analysis to understand our impact on markets. The other papers are:

- a Discussion Paper on our [ex post impact evaluation framework](#)
- a paper on how we use field trials to better understand the likely impact of our interventions
- an Occasional Paper (OP) on measuring benefits

## Structure of the paper

This paper is set out as follows:

- Our legal and analytical frameworks for undertaking CBA and how we use CBA in the development of a policy, together with a discussion on accuracy and use of evidence, are set out in Chapter 2

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<sup>2</sup> For example, the nature of the obligation to carry out a cost benefit analysis when proposing to make rules was modified. The FSA was required to estimate only the costs of a proposed rule and analyse the benefits under s.155 FSMA. The FCA is now required by s.138I FSMA to analyse the costs and benefits and to provide an estimate of both costs and benefits (subject to certain exemptions).

<sup>3</sup> See [‘How and When we use field trials’](#) and [‘Applying behavioural economics at the Financial Conduct Authority’](#)

<sup>4</sup> Previous publications by the FSA on CBA include: FSA OP3 (1999) [‘Cost-benefit analysis in financial regulation: How to do it and how it adds value’](#); FSA (2000) [‘Practical cost benefit analysis for Financial Regulators Version 1.1.’](#); FSA (2006) [‘A guide to market failure analysis and high level cost benefit analysis’](#).

- What we generally cover in the CBA that accompanies our Consultation Papers (CPs) is presented in Chapter 3
- Chapters 4-6 discuss how we estimate costs, benefits and how we handle distributional issues
- Chapter 7 concludes by outlining the interaction between FSMA CBAs and Enterprise Act (EA) impact assessments

The annex provides further detail on our standardised costs model.

## 2. The framework in which we use Cost Benefit Analysis

In this chapter we cover the legal obligations and analytical framework for our cost benefit analyses (CBAs). We then explain how we use CBAs to inform policy and discuss accuracy and use of evidence.

### Our legal obligations on CBA

The Financial Services and Markets Act 2000 (FSMA), specifies, subject to some exemptions, that before making any rules we must publish a draft of the proposed rules (s.138I of FSMA). This must be accompanied by, among other things<sup>5</sup>, a cost benefit analysis. This is defined as an analysis of the costs together with an analysis of the benefits that will arise if the proposed rules are made. The CBA also needs to include an estimate of those costs and benefits unless, in our opinion, they cannot be reasonably estimated, or it is not reasonably practicable to produce an estimate. In those cases, we must include a statement of our opinion and explain why no estimate of those specific costs or benefits is required.

In accordance with FSMA, our Consultation Papers (CPs) that propose new rules include a CBA,<sup>6</sup> unless we consider that they will entail either no cost increase or that any cost increase will be of 'minimal significance' (compared to a scenario of no FCA intervention). In those cases, we are required to include a statement of our opinion that no CBA is required and an explanation of it.

The consultation procedures do not apply to rules made by the FCA where we consider that the delay involved in complying with those procedures would be prejudicial to the interests of consumers.<sup>7</sup>

In determining our general approach to CBA we have also regard to the regulatory principles in Section 3B of the Financial Services and Markets Act 2000 (FSMA), including the need to use our resources in the most efficient and economic way.

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<sup>5</sup> An explanation of the purpose of the proposed rules, any statement prepared under s.138K(2) FSMA about mutual societies, a compatibility statement regarding s.1B(1),(5)(a) FSMA and notice that representations about the proposals may be made to the FCA within a specified time (see s.138I(2) FSMA).

<sup>6</sup> This is typically a self-standing annex to the CP that builds on the information provided in the main paper on rationale and proposals for intervention.

<sup>7</sup> S.138L FSMA sets out the general consultation exemptions. See PS14/18 '[Credit broking and fees](#)' (Overview, page 4) for an example of a case in which we have used this exemption. In these circumstances, we are still required to consult the PRA.

Following the implementation of the Small Business, Enterprise and Employment Act 2015, as amended by the Enterprise Act 2016 (EA), we are also obliged to report the impacts on business of our activities to the Regulatory Policy Committee (RPC)<sup>8</sup>. We discuss this and interactions between CBAs and Impact Assessments (IAs) at Chapter 7.

### **Box 1. CBA and Guidance<sup>9</sup>**

FSMA mandates the provision of CBA for new rules but not for guidance. However, it is our policy to produce a CBA for general guidance about rules<sup>10</sup> if a high level assessment of the impact of the proposal identifies an element of novelty which may be in effect prescriptive or prohibitive such that significant costs may be incurred.

For example, see 'GC17/1 – Changes to the way firms calculate redress for unsuitable defined benefit pension transfers' at <https://www.fca.org.uk/publication/guidance-consultation/gc17-01.pdf> or 'GC13/5 Supervising retail investment advice: inducements and conflicts of interest' at <https://www.fca.org.uk/publication/guidance-consultation/gc13-05.pdf>

We do not produce a CBA if the detailed steps mentioned in the guidance are the kind of detailed steps that followed predictably from the rule and that one would reasonably expect firms to take to comply with the rule.

## **Analytical framework for our CBAs**

The analytical framework for our CBAs is aligned with the framework for effective regulatory intervention detailed in [OP13 'Economics for Effective Regulation'](#) (EFER) and [Our Mission's](#) decision-making framework. The framework set out in EFER makes sure that our interventions come from a good understanding of drivers of poor outcomes in financial markets, and, in turn, that a robust assessment of expected impacts is reported in the CBA. The diagram at Figure 1 shows how CBAs, our Mission decision-making framework and the EFER framework all fit together.

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<sup>8</sup> We publish an annual report. You can see the 2017 report at

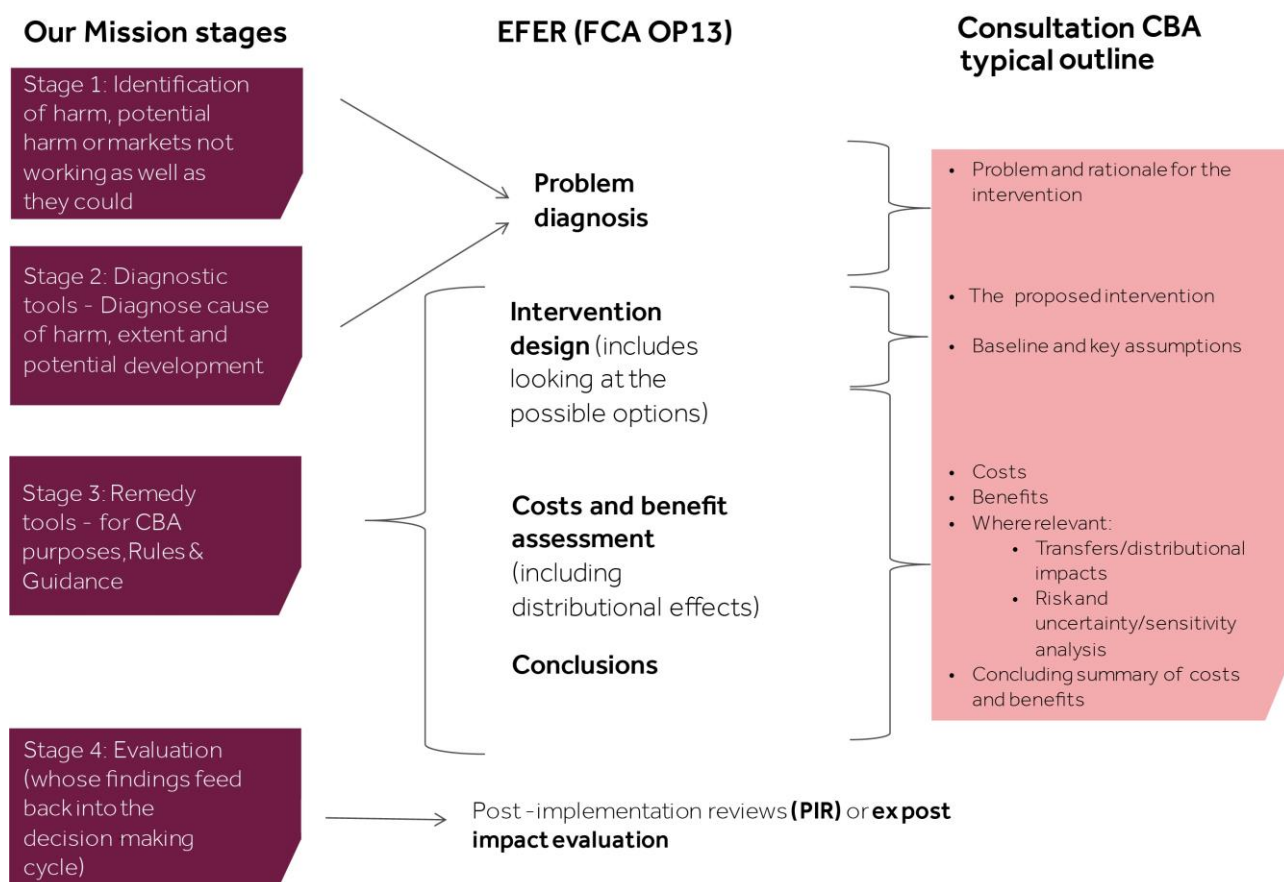
<https://www.fca.org.uk/publication/corporate/enterprise-act-annual-report-2017.pdf>

<sup>9</sup> See s.139A (on power of the FCA to give guidance) and s.139B (on meaning of general guidance) of FSMA.

<sup>10</sup> On our high level position over CBA of guidance please see, in 2015, [The FCA's approach to advancing its objectives](#), at paragraphs 2.6 and 2.19, where we say 'We will only make new rules and guidance if we think they will deal with the problem we have identified effectively and proportionately. We normally carry out cost benefit analyses to assess if the rules and guidance we make are proportionate'.



**Figure 1: How CBAs relate to our Mission decision-making framework and the Economics for Effective Regulation framework**



We set out our approach to problem diagnosis in the Mission and in EFER and we set out our approach to evaluation in the Mission and in the [ex post impact evaluation framework](#).

We focus in this document on the costs and benefit assessment. But it is important that this assessment is seen as part of a wider consideration which includes identifying harm and the causes of harm and designing the intervention.

The key steps involved in CBA are set out in table 1.

**Table 1. Key steps to identify and estimate likely impacts**

Key steps to assess impact	Description	Other points
Counterfactual or baseline scenario	What would have happened in absence of the intervention	If the baseline is the present state of the market, we look at whether the market is rapidly expanding or declining (to avoid under/over estimating impacts). See Chapter 3.
Identification of direct impacts	Direct costs and benefits to market participants and to FCA	Costs of complying with new regulatory requirements (or savings from removal of requirements). See Chapter 4 and Annex 1. Costs to FCA of managing new/ extended reporting systems, supervising and enforcing new rules. Benefits to consumers (financial loss prevented, or other improvement in consumers' well-being). See Chapter 5.
Identification of indirect impacts	Impacts that are not an aim of the policy or a direct result from complying with the rules.	This step considers in what ways the intervention changes how the market works, i.e. how behaviours of firms and consumers would change in response to the direct constraints and costs the intervention imposes.
Quantification of impacts	Quantification of any incremental costs and benefits, when possible. As well as estimates of direct and indirect impacts, this may include transfers between different types of agents.	There are financial components (eg variations in prices multiplied by number of transactions, variations in financial losses from unsuitable products) and non-financial components (eg welfare gains, psychological benefits, time saved, welfare effects of innovation). See Chapter 5 as well as EFER.
Monetisation of impacts	Quantified impacts are converted into monetary impacts, where reasonably practicable	For some of the non-financial components there are well-established measures, e.g. using salaries to infer the opportunity cost of working time. Other non-financial effects are more difficult to measure, as they require an attempt to estimate changes in consumers' welfare (welfare analysis). <sup>11</sup> We cannot always monetise all aspects of welfare, but we can get to some of them (for example wellbeing) quantitatively.

<sup>11</sup> For a discussion on what can be done to measure these impacts see OP '[Estimating the benefits of interventions that affect consumer behaviour](#)' as well as EFER. See also Chapter 5.

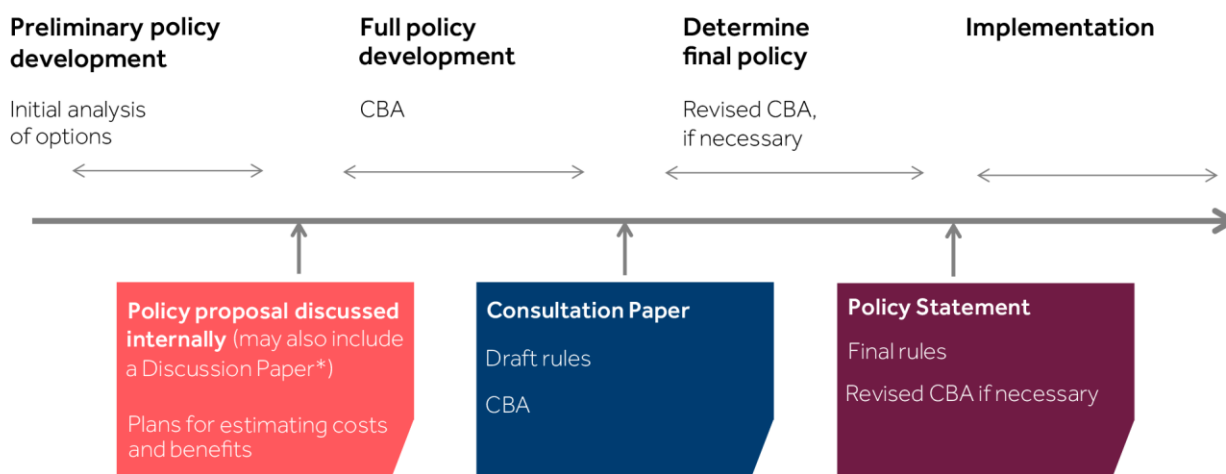
## How we use CBAs in informing policy

The process of undertaking a CBA helps us to:

- think through the likely impact of a proposal
- identify alternative options for achieving the desired outcome
- make sure the consultation exercise is meaningful by being explicit about intended and unintended impacts
- determine whether the costs are proportionate in light of the expected benefits
- determine whether there are any groups of society that will be disproportionately affected
- assess whether market processes (competition, innovation) will be affected for better or worse

During the development of a policy, our analysis of likely costs and benefits will develop in parallel.

**Figure 2: How our analysis develops through the different stages of policy development**



\* A Discussion paper may include some provisional impact assessment/option appraisal, in advance of the full, statutory, CBA.

The problem diagnosis and design of interventions stages may suggest a number of policy options. We assess the different options with a high level analysis, mostly qualitative, and use information we have in-house or that we have gathered through engagement with the industry. We focus on what firms would need to do to comply and how firms and consumers might react. This exercise helps us discard any options that we judge ineffective or disproportionate, and decide which option looks most appropriate.

Once we have identified a preferred option, we explain the reasons for our proposal in the CP and produce a FSMA-compliant CBA for consultation on this option, which is supported by sufficient evidence. This CBA is included within the documents, typically CPs, presenting our proposed interventions. Having made adequate enquiries, we use the best available information we have at the time of consulting. We also take into account stakeholders' views, in response to the consultation, on our estimates of the costs and the benefits before a rule is finally made.

If, after considering all consultation responses, we decide to go ahead with the intervention we will confirm the CBA in a Policy Statement (PS). We publish an account of the representations made (including any challenges to our proposals) and our response to them. If the rules, in our opinion, differ significantly from those consulted on, we are also required to publish the details of the difference together with a cost benefit analysis<sup>12</sup>.

Even if no rule changes are being made, we may publish a revised CBA, alongside the PS, to highlight any key changes from the consultation CBA, for example, if evidence from the consultation has led us to significantly revise our estimates.

## **Accuracy, detail and use of evidence**

Undertaking a CBA encourages us to think broadly about the impacts of the policy from the outset, and also identify unintended consequences, well before impacts are monetised.

The resources we dedicate to regulation are proportionate to the effects. We have to consider the costs of doing the CBA in increasing detail relative to the magnitude of the policy intervention. The costs of doing the CBA include:

- resource costs of spending more time and effort on an issue
- opportunity cost of spending time on something else that could be more important
- cost of delaying the implementation of any response to the ongoing harm identified

We devote a proportionate effort to CBA. And even where this effort is considerable, there remains significant uncertainty in the results (see section on risk and uncertainty in Chapter 3

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<sup>12</sup> See s.138I(5) FSMA. See for example [PS 14/16 'Detailed rules for the price cap on high-cost short-term credit'](#). We must also publish any statement prepared under s.138K(4) FSMA in relation to mutual societies.

and [EFER](#), box 7). As EFER puts it 'it would only be proportionate to carry out additional analysis up to the point where it can realistically deliver additional and reliable knowledge that can materially inform the decision about the appropriate course of action'.

### **Box 2. Mandatory requirements**

Often we are mandated to implement new policies by government (or, historically and at present, the European Union). Even if we have little discretion about the manner in which we implement such policies, we are required to produce a CBA to fulfil our statutory duty. However, when doing so we are mindful of the requirement to use our resources in the most efficient and effective way (see FSMA s.3B(1)(a)). For example, for the MiFID CPs we focused our CBA efforts on our proposed discretionary elements more than on the mandatory elements.

### **What level of accuracy and detail we aim for**

The National Audit Office (NAO) has observed that it is the process of doing an impact assessment (IA), more than the document itself, which adds value to policy-making (Ashcroft (2003) p155). Similarly, a great deal of the value of CBA lies in its contribution to our decision making, rather than in the precision of the results themselves.

We are required to analyse and prepare reasonable estimates of the costs and benefits of our proposed rules. To see whether the overall costs we may impose look justified, it is better that we recognise broadly all likely costs and benefits than estimate with exactitude partial elements of the impacts. Spurious accuracy can also be misleading as to the level of confidence we have in our estimates.

### **How we gather evidence**

The data available to inform estimates, as well as the proportionality of gathering more data, has a bearing on the level of detail in a CBA.

We make use of the best available internal information, including the judgement and experience of FCA supervisors and sector experts, information from previous CBAs and consultations<sup>13</sup>. There may be data available that is sufficient for our purposes, for example from:

- data cited in our previous publications, field trials or evaluations of previous policies
- our regulatory data, previous data requests, the Financial Lives Survey

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<sup>13</sup> For information on compliance costs specifically, see Annex 1, which discusses our standardised costs model.

- external information sources (eg UK and international research/publications, ONS data, business surveys)

When the above is not sufficient to produce reasonable estimates, we supplement this with evidence from informal consultation with stakeholders (such as industry representatives), stakeholder working groups and, where necessary and practical, with bespoke data requests to firms.

When information is not readily available, nor forthcoming, we use our judgement and experience.

When planning consultation on new requirements for markets that rely on consumer responses<sup>14</sup>, we often consider whether experimental research, such as real world field trials or hypothetical choice experiments, might help us test and refine our proposals and increase our certainty of whether they will be effective<sup>15</sup> (on this, see '[How and when we use field trials](#)').

Some remedies may be ruled out at an early stage on the basis of in-house evidence and knowledge. Collecting evidence externally and testing become more important the more intrusive/complex the remedies<sup>16</sup>.

High impact and potentially controversial remedies often require bespoke modelling which may quantify costs in detail. For instance modelling might be undertaken using firm-level regulatory data, which allows detailed cost breakdowns to be presented according to firm characteristics. This is often less practical for interventions of lesser significance and limited uncertainty, for which cost estimates are most usually calculated on an 'average firm' basis.<sup>17</sup>

## **How we treat compliance cost survey responses**

Compliance cost surveys are a possible source of evidence (though we have developed standardised cost estimates for common compliance costs - see Chapter 4 and Annex 1). Breaking down costs by constituent elements and staff hours helps us compare responses from different firms and understand the assumptions they have made.

Surveys often result in a wide range of estimates of the resources required to implement the same intervention. Firms' IT and governance systems vary, and even among firms of similar size different firms' business models will be affected by regulation in different ways.

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<sup>14</sup> We could use lab experiment evidence for thinking about changing incentives for firms and firm employees and seeing how employees respond, though historically we have used them mostly for retail markets.

<sup>15</sup> See for example the work we commissioned on [Prompts and Alerts Design](#)

<sup>16</sup> We apply a proportionality test once we have determined that the evidence collected is at least adequate for FSMA purposes.

<sup>17</sup> When our rules impact differently on different kinds of firms we recognise this by using 'average firm' figures for types of firm affected (eg large vs small firms, or firms in different regimes, as in [SM&CR extension CBA](#)). However, it is important to note that firms will be affected by interventions differently according to their precise structure, existing approaches and how they are affected by the policy.

For these reasons, we do not generally discount 'outliers' from cost surveys outright. Generally, if unusually high costs look correct for a type of firm but not the majority of firms in the market, we will be careful not to conflate average costs. We will scale up the information from the sample so it is representative of the population of firms affected by the proposal, for example by adopting weights. In some cases we may want to understand the reason why a reported cost or resource use is significantly above the average. For instance we may check with the firm that they have understood the proposed change and that the costs are solely the result of the regulatory change.

If there is still uncertainty about the robustness of the estimate in the CBA due to outliers, we explain this in the CBA and use ranges for our cost estimates. If we have reasonable grounds to believe that the firm was mistaken in providing the figure it did, we may discount those reported costs and explain why we have done so. This is less likely to happen when we ask for detailed breakdowns of compliance costs, as in those cases we have a better understanding of what the figures represent.

# 3. What we cover in the Cost Benefit Analysis that accompanies a Consultation Paper

Chapters 3-6 describe what each section of the cost benefit analysis (CBA) typically includes when we publish it with a Consultation Paper (CP):

- i. problem and rationale for the intervention (or market failure analysis),
- ii. our intervention,
- iii. baseline and key assumptions,
- iv. costs,
- v. benefits,
- vi. any distributional impacts, when relevant,
- vii. risks and uncertainty, when relevant, and
- viii. a concluding summary of costs and benefits.

This chapter discusses the elements (i) to (iii), (vii) and (viii). Aspects iv, v and vi are discussed at Chapters 4-6.

## Problem and rationale for the intervention

This section of a CBA briefly outlines the problem we are seeking to address<sup>18</sup>, clearly setting out the rationale for the designed intervention. It identifies the ways in which the markets are not working well and how regulation could make them work better (market failures). It specifies the drivers and describes the harm that the policy package aims to address.

Among the drivers, we include the relevant standard market imperfections that economics traditionally indicates as the main reasons to intervene in a market:

- Asymmetric information, typically arising when consumers know less than suppliers about key characteristics of products and services
- Market power curbing effective competition, which often results in poor quality and high prices

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<sup>18</sup> This, and the proposed intervention, will have been discussed in detail in the CP.



- Externalities, where firms or other agents impose negative consequences from choices taking into account only one's own benefits (e.g. excessive risk when one does not suffer all potential consequences)
- Regulatory failures, where existing rules prove ineffective or even detrimental and need to be removed or amended

Among the drivers of harm we also look into behavioural biases affecting choices by firms and, more often, by consumers. They are often key to the success or failure of regulatory interventions (see [FCA OP 1](#)).

The analysis describes how these imperfections and biases interact to cause harm in the markets and help us consider whether and how to intervene. The types of harm that are relevant to our objectives are summarised in both [EFER](#) and [Our Mission \(see Table 2\)](#):

**Table 2. Types of harm and relevance**

Type of harm	Relevant FCA operational objective(s)
Confidence and participation threatened by unacceptable conduct such as market abuse, unreliable performance or by disorderly failure	Market integrity Consumer protection Effective competition
Buying unsuitable or mis-sold products; customer service/treatment	Consumer protection Effective competition
Important consumer needs are not met because of gaps in the existing range of products, consumer exclusion, lack of market resilience	Consumer protection Effective competition
Prices too high or quality too low	Effective competition
Risk of significant harmful side-effects on wider markets, the UK economy and wider society, eg crime/terrorism	Market integrity

## Our intervention

This section of a CBA briefly outlines the proposed intervention (which is described in more detail in the CP) so that the CBA can be easily understood as a stand-alone document.

As explained in Our Mission, it is helpful for us to set out a clear causal analysis (or causal chain) of how an intervention is intended to work and improve the functioning of markets. This shows what the causal links are between the intervention and the harm we are trying to address (see

[SME Access to FOS](#) CBA, page 33, for an example). It helps us identify and focus, for the quantitative analysis, on those areas where impacts are likely to be most significant. It also helps us take decisions on the types of evidence gathering to do. For example if the causal chain is based on consumers responding in a particular way, we can develop evidence (such as online trials or large scale field trials) so that we know (with some degree of certainty) what the consumer response is. We will, wherever appropriate, include a causal chain in the CBA. As explained in our [ex post impact evaluation framework](#), setting out causal chains in CBAs also helps us plan ex post evaluations of regulatory interventions<sup>19</sup>.

### **Box 3 - Packages of regulatory change**

We often introduce a package, ie multiple, changes, as it is rare that a single solution can address the harm and problems we have identified in the market. In those instances we may have one overarching CBA or individual CBAs for each element of the policy.

It makes sense to analyse the compliance costs of a proposed complex policy package as a whole. Firms generally respond strategically (for example in providing training or recruiting new staff) to a package of regulatory changes. This is particularly so if the changes are closely related or the timing of their implementation is relatively close.

At times we implement one element of a larger regulatory change, e.g. rules that are part of wider government reform. In those instances it may be difficult or impossible to estimate the benefits that are solely generated by the FCA requirements.

## **Baseline and key assumptions**

### **Baseline**

We analyse the impacts of the policy against a baseline, or 'counterfactual' scenario, which describes what would happen in absence of the proposed interventions. That is we compare a 'future' under the policy, with an alternative 'future' without the policy. In many cases the baseline will be to assume that the current observed situation in the market or sectors affected would continue into the future without the intervention. However, there may be some circumstances where the counterfactual is not exactly the same as the current market conditions and regulatory environment:

- We may observe that the volume, value and number of firms in the market are rapidly expanding or shrinking, or there could be reasons to expect it to vary significantly in the near future.
- Other key dimensions are changing or expected to change, eg price levels, macroeconomic conditions, and interest rates.

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<sup>19</sup> For a more detailed discussion on the links between ex ante CBA and ex post evaluation see Box 2 of our [ex post impact evaluation framework](#).

- Other interventions (by us or other relevant national and international regulators) may be in the pipeline.
- Consumers and firms may be 'learning' and adapting their behaviour.

We would expect to adopt a baseline different to the current situation where these considerations are significant enough and readily observable. We will explain in the CBA the reasons for adopting a different baseline.

## Other assumptions

Any CBA is subject to some assumptions and we will set out key assumptions in the CBA. Some assumptions are similar across CBAs. The table below summarises those assumptions that are typically used in a CBA.

**Table 3. Key Assumptions**

Key assumptions	Description
<b>Prices and averages</b>	Estimates are in <b>nominal terms</b> for the most recent year data are available. Where applicable, we use <b>average cost/benefit per firm/consumer</b> in the sector to estimate total costs and benefits. This avoids situations such as finding a net beneficial rule where only a small proportion of consumers benefit. We are not required to present an average but this is often the easiest way to conduct the calculations. We conduct CBA across the market, or potentially on specific groups (see Chapter 6). We do not do a cost benefit assessment on each individual or each firm.
<b>Period covered</b>	We distinguish between one-off impacts and those expected to be realised across a number of years. When rules are expected to have impacts over an indefinite period of time, it is helpful to aggregate monetary impacts arising over time in net present value terms, over a <b>10 year period</b> , unless there are good reasons not to (eg strong uncertainties in future years, as is often the case with the markets and services in our scope). <sup>20</sup> This is useful especially when benefits arise over a long period of time and one-off costs are significant.
<b>Discount rate</b>	We may use a discount rate to determine the present value of the stream of costs and benefits expected to arise in the future. In most cases we use the HM Treasury Green Book recommended <b>discount rate, which is currently 3.5%</b> , <sup>21</sup> as it is common to all in the public sector.
<b>Compliance</b>	We generally assume there will be <b>100% compliance</b> with the new policy we implement. This allows us to establish all potential costs and benefits and avoid double-counting when establishing impacts of future interventions.

<sup>20</sup> Standard practice in the public sector (also used in reporting to the Regulatory Policy Committee) is to assume ten years as the duration of impacts, unless there are reasons to assume a shorter/longer duration, and use discount factors recommended in HMT's Green Book. See p.24 and Annex 6 in the Green Book [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/220541/green\\_book\\_complete.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/220541/green_book_complete.pdf)

<sup>21</sup> This means that the present value of an expected benefit of £100 due to arise one year from now is  $100/1.035=96.62$ . If it occurs after two years, the value decreases to  $100/1.035^2=93.35$ .

	By implication, when considering the baseline, we assume compliance with existing previous rules. <sup>22</sup>
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Further assumptions may be made about behavioural reactions once the interventions are implemented. For example:

- market entry/exit,
- consumers' behavioural reactions (eg from new requirements affecting the information they receive, when we do not have field trial evidence)
- price increases to pass on (some of) the costs of compliance to consumers
- price reductions from stronger competition

The assumptions we take, where material to the CBA, will be set out in the CP.

We also set out the number of firms/consumers affected based on best available data.

## Summary comparison of costs and benefits

FSMA does not require us to prove mathematically that benefits exceed costs. We do though need to show that the proposed rules advance our operational objectives, having regard to the principle that a burden or restriction which is imposed should be proportionate to the benefits which are expected to result<sup>23</sup>. Our Mission makes clear that adding public value is at the centre of our decision-making framework. When we quantify and monetise the main benefits as well as the costs, we seek to articulate why overall we think the intervention adds public value.

Net benefits are often expressed based on the observable benefits and costs and subject to non-monetised aspects. This is because CBAs rarely prove that estimated monetary benefits exceed the estimated monetary costs. There are important components of the public value of our activities that we cannot express in monetary terms and there are inherent assumptions and uncertainties.<sup>24</sup> For example, net benefits often arise from competition and better consumer choice. However, those benefits are harder to estimate than the costs of compliance (see Chapter 6). More competition, for instance, is likely to yield benefits to consumers and the economy in the long run, but specific and short term impacts are hard to predict because they depend on behavioural reactions on the demand and supply sides. Unless we have

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<sup>22</sup> Where we collect compliance costs information from firms, we have sometimes had to discard or discount the costs provided to us. This is because instead of reporting only their expected incremental costs, they mistakenly included costs incurred to comply with existing regulations. If we were to count these costs we would account for the same costs in different CBAs. See for example CP 17/20.

<sup>23</sup> See s.3B(1)(b) FSMA.

<sup>24</sup> As put in the Mission (p.21): "the benefits and costs of regulatory action cannot easily be quantified, and the issues we face are often too complex to reduce regulatory judgement to simple numerical analysis."

evidence from similar interventions or experiments,<sup>25</sup> we may not be able to provide a robust estimate of all, or some, benefits to consumers. Other reductions in harm, such as improving confidence in financial markets, are normally discussed in qualitative or quantitative terms, but not monetised, as it is difficult to place a value on these benefits and may be impossible to identify.

## **Risk and uncertainty (or sensitivity analysis)**

In this section of the CBA we recognise any key risks and uncertainties. Establishing potential costs and benefits before the event is intrinsically subject to uncertainties. Sampling and limitations of modelling may lead to errors in estimation. There may be uncertainties over the behavioural reactions on demand and supply sides (see previous section)<sup>26</sup>, the future macroeconomic environment, concurrent policy interventions and other factors outside our control.

Sensitivity or scenario analyses help us identify significant areas of uncertainties or risks to the success of the policy and determine if it is worth pursuing a policy further. They help establish which factors will shift the magnitude of the impacts: eg growth in market values/volumes, interest rates, life expectancy, default rates, or other parameters that may be relevant in the specific context of our intervention.

In the presence of uncertainties, we use ranges and round our estimates, to avoid suggesting a misleading degree of precision. The ranges we use are influenced by the level of uncertainty around the estimates. When we use ranges we set out why we are using them and what the range is.

We often present answers to calculations as rounded figures because they are based on estimated figures.

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<sup>25</sup> We can run our own field trial if we think the consumer behaviour is a key driver of benefits of the proposed policy and there are high costs/high risks with the intervention (see '[How and when we use field trials](#)').

<sup>26</sup> This is reduced if we are able to run a field trial or have other evidence that is equally valid.

## 4. How we analyse and estimate costs

We aim to provide estimates of the costs that our interventions impose except for circumstances where we are not required to do so under FSMA. In these cases, as outlined in FSMA, we explain why we have not provided an estimate in the cost benefit analysis (CBA). This chapter outlines the different types of costs we include in our CBAs and how we estimate them: costs to firms (cost of compliance, indirect cost, reduction in profits), costs to consumers and costs to the FCA. We also discuss here our efforts to reduce the burden on business and our Standardised Costs Model (on which see also Annex 1).

### Costs to firms

#### Costs of compliance

Compliance costs are the costs incurred as a direct result of meeting the requirements of a new regulation. They are the incremental changes that firms would not have undertaken in the absence of the regulation.

Not every requirement of a regulation incurs a cost of compliance for industry. Where new requirements are closely aligned with current business-as-usual practices, then the regulation may be met without material incremental costs compared to the counterfactual. For example, a written disclosure requirement might impose one-off costs, but ongoing costs might be negligible if the disclosure is fully absorbed into the business-as-usual practice of contacting customers.

Table 4 shows the steps we take to estimate compliance costs.

When our cost estimates are subject to significant uncertainty, we generally err on the side of higher rather than lower estimates. This ensures a cautious approach to policymaking and reduces the risks of underestimating costs (see Chapter 3 for more detail on how we deal with uncertainty).

**Table 4. Steps to estimating compliance costs**

Steps	Description
<b>(1) Average per-firm costs</b>	
(a) Firm's functions affected	The most common functions affected by interventions are compliance, human resources and training, IT, legal, sales and marketing, and senior management.
(b) Incremental activities by those functions	The time staff (of different types and levels) needs to devote to implementing the intervention, and any other direct expenditure firms will incur on average. As noted in Chapter 2, we recognise that impacts may differ for different kinds of firms and, when possible and relevant, we use average figures accordingly (eg average costs per large and per small firm).
(c) One-off costs of regulatory change	One-off costs arise from activities such as learning new rules, training staff on new procedures or implementing a new IT system.
(d) Familiarisation with CPs; 'gap analysis' (legal review of the new requirements against current practices)	Costs associated with firms reading and digesting FCA publications in most circumstances. Rather than ask firms for these costs on a repeated basis, we have developed standardised costs, based on the length of documents and legal annexes and assumptions of how many staff read and review FCA publications (see Annex 1 on our standardised costs).
(e) Ongoing, annual, compliance costs	Ongoing costs are incurred by firms on a regular basis during the time the rule is in place. They may include factors such as longer sales processes or annual governance reviews.
(f) Monetising	Compliance costs are generally monetised on the basis of the opportunity cost of staff time. There may also be costs for external compliance or legal advice. To put a cost on time, we use salary information for a range of occupations in financial services sourced from salary benchmarking survey data, national statistics, or other research. We then add an allowance for overheads of 30% to time costs to account for non-wage labour costs <sup>27</sup> .
<b>(2) Extrapolating to the population of firms affected</b>	Once we have average per-firm costs, we can multiply these by the total population affected. Per-firm averages can apply either to all firms in the sectors affected, or to some subsets of firms. For instance we may decide to estimate costs for large, medium and small firms according to various definitions, especially concerning changes affecting IT or governance systems where large firms operate in a different manner to small firms, on average. The precise segregation method will depend on the intervention in question and the evidence we have available. See Annex 1 for the approach we use in the standardised costs model.

<sup>27</sup> As outlined in HM Treasury Green Book 2018, the opportunity cost of labour should include the total value of the output produced by employees. This is the cost of employees' time, based on Full Time Equivalent (FTE) costs and includes pension costs, National Insurance, allowances, benefits and basic salary. On the allowance for overheads to be used, see Measuring Administrative costs: UK Standard Cost Model Manual, 2005, at <http://webarchive.nationalarchives.gov.uk/20090609014336/http://www.berr.gov.uk/files/file44503.pdf> ([https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/685903/The\\_Green\\_Book.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/685903/The_Green_Book.pdf)).

## **How we aim to reduce burden to firms**

Information from firms is often important to understand fully the implications of an intervention and the resources that are needed to comply. But we need to consider the burden surveys place on firms.

We need to make a reasonable estimate of costs, except where exemptions apply. We may be able to do so from internal information, which we may then test with firms. If this is not possible, and in the case of complex or significant interventions, we may undertake a specific survey. Other decision factors include time constraints and the perceived likelihood of receiving adequate information (sometimes uncertainty may also be high among firms).

To reduce the burden of regular smaller-scale cost surveys, as well as the resources that we spend on CBAs, we have recently started using a standardised model. This model factors in different costs for firms of different sizes and estimates some common cost elements of a CBA. We use the model where the nature of the expected impact lends itself to using standardised assumptions about the likely costs. See Box 4 and Annex 1 for more details on the model and some of its assumptions.

By combining the standardised costs model with best practice on cost surveys, we aim to reduce the need to conduct compliance cost surveys over the longer term and reduce the burden on firms.



#### **Box 4 - The standardised costs model**

Forming an objective view of compliance costs can be difficult, particularly if firm survey data are used in generating cost estimates. Firms themselves may find it challenging to provide a view of the costs involved in implementing regulations from past experience, because many costs of new regulations are absorbed into 'business as usual' costs, which are not allocated to projects, or because of the effort required to locate the information. Firms may also not answer survey questions consistently, for example by providing total rather than incremental costs.

To reduce this risk, we have developed a model of standardised parameters and assumptions to be used in estimating certain compliance costs. For example, the number of firms in each sector, salaries and overheads and discount rate (see Annex 1 for further detail). The standardised costs model is designed to speed up and standardise some common recurring costs such as familiarisation, gap analysis, training and customer transaction changes.

The model is based on our understanding of how certain compliance costs are structured, and draws on a set of assumptions. By applying some variables specific to the intervention at hand (principally for how many hours of time a certain activity requires for different types of firms) we can estimate certain common compliance costs.

The assumptions underpinning the model are based on consultation with firms and trade bodies, discussions with software vendors, a review of previous CBAs, internal consultation and desk-based research. We expect to refine the model over time as new evidence becomes available, for example via consultations.

#### **Compliance cost surveys**

When we conduct firm surveys, we choose a sample size that allows us to achieve a reasonable estimate, where practicable, ie a relatively small sample that nevertheless reflects market structure and gives broadly representative results. In doing so, we consider the likely survey response rate. Response rates vary according to the type of intervention and also on whether we are using our legal powers to gather information or the survey is voluntary.

Surveys that ask respondents to provide aggregated cost estimates of each intervention are difficult to use more than once. The aggregated information is specific to the intervention in hand. It can be hard to identify analogous interventions for which the estimates could

contribute to in a future CBA, or to inform our understanding of the different elements of compliance costs.

Rather than asking firms for aggregated cost estimates of a forthcoming regulation, in cost surveys we prefer, where appropriate, to ask firms for more detailed information. Asking firms to identify the main incremental effects of the regulation and how much staff time each of these elements is likely to require, plus any additional expenditure, provides more useful information.

With such structured information, our understanding of compliance costs improves and this can reduce the number of surveys required in the future. The more we understand how much staff time different elements usually require, the easier it is to standardise certain elements of costs, and the lower the need to undertake surveys over the longer term.

## **Indirect costs**

Indirect costs occur once consumers and firms have changed their behaviour in response to the intervention. These reactions often lead to further costs (or benefits) on different parties, for example firms passing compliance costs through to consumers via higher prices.

Some of our interventions may indirectly affect the fixed costs of the business. For example, the [Senior Managers and Certification Regime CBA](#) noted that placing higher levels of responsibility on senior managers may mean some staff leave the financial services sector, increasing future recruitment costs. Of particular relevance to the objectives of the FCA, analysis of indirect effects often includes an assessment of the effects on competition.

Indirect costs and wider market changes are more difficult to estimate reasonably than compliance costs. This is especially the case for indirect effects further removed from the initial intervention and in other markets. Firms and consumers' reactions tend to be uncertain and it is often unfeasible to estimate effects that involve the uncertain reactions of multiple parties. In our CBAs we aim at least to describe the likely indirect effects of our policies.

If firms gain wider benefits or cost savings from the changes they make (eg the regulation leads to system changes that will benefit the firm and would not have been undertaken otherwise), then we capture these benefits in the benefit section.

## **Reduction in profits**

Estimating impacts on revenues (and, hence, profits) requires an assessment not only of direct impacts (eg bans on some activities) but also of expected reactions (eg firms passing costs onto consumers, fiercer competition leading to lower prices, and entry/exit of firms). In our

[CBA on the competition remedy for guaranteed asset protection insurance](#), for example, we estimated the reduction in revenue firms would experience under the rules. We consider the expected indirect effects based on how we think actors in the market will respond to our intervention.

When impacts cannot reasonably be estimated, we are not required to, and do not, undertake any quantification.

## Costs to consumers

Some interventions may create additional costs to consumers, e.g. if new rules may limit some consumers' access to credit, or when we mandate that consumers should receive additional services (e.g. advice) which, while creating benefits, may also result in higher prices<sup>28</sup>. There may also be time costs, for example, the time it takes to read additional disclosure, or the additional time taken in shopping around (see for example para 16 of the CBA on [Packaged bank accounts](#)). There may be unintended costs to consider (see the [CBA for our proposed rent-to-own intervention](#) for a discussion of some of these costs to consumers, such as reduced convenience from changes in sale processes). Risks of unintended costs from a policy can be taken into consideration or mitigated by testing so we have a better understanding of what consumers will actually do (see for example [annex 4, paragraph 4 of our Credit Card Market Study](#)).

## Costs to the FCA

The CBA considers whether the intervention causes an increase in the cost of our activities beyond business as usual, e.g. following an expansion in our remit.

Policy development costs are excluded (as in most part these are sunk costs, ie costs that cannot be recovered). Often the rules being implemented will be supervised using existing regulatory resources. It is not possible to estimate these costs, even though we might expect an opportunity cost of less effective supervision of existing rules due to supervision of the new rules.

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<sup>28</sup> We are careful not to double count here the monetary cost to the firm of providing the advice with the costs passed through to consumers.

## 5. How we analyse and estimate benefits

Understanding benefits is central to understanding our impact. The process of searching for evidence on benefits encourages a rigorous assessment of the impact of regulations, even if the results may be unclear. Most of the benefits from our policies fall on consumers, though some or all firms may be positively affected too, eg new entrants.

### Benefits to firms

The cost benefit analysis (CBA) considers reductions in costs of compliance from deregulation and other interventions that foster efficiency gains. This may include guidance that makes it easier to understand and comply with existing rules.

There may also be gains to firms from pro-competition interventions, as well as benefits from easier market access.

### Benefits to consumers

As outlined in Chapter 2 the CBA presents an analysis of the benefits to consumers arising from our rules. If feasible, it also sets out an estimate (ie a quantification and, if possible, monetisation<sup>29</sup>) of these benefits. We refer to 'consumers' here in a broad sense, ie we include intermediate customers (eg SMEs) or financial intermediaries that benefit from our interventions.

It may be helpful, at times, to distinguish consumer benefits across different consumer groups, for example, by age, income, financial knowledge, vulnerability or protected characteristics, to see whether they are concentrated on certain consumer groups.<sup>30</sup> In practice this can be challenging to do for a number of reasons (eg data availability, or being able to establish a reasonable counterfactual against which to measure our impacts).

As set out in Chapter 6, it is also helpful to understand whether any of the benefits to some consumer groups come at the expense of other groups<sup>31</sup> (ie they are a transfer from one group to another). This helps us to assess whether a regulatory intervention is unambiguously

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<sup>29</sup> 'Quantification' is the process of expressing the number of individuals/firms for whom harm will reduce as a result of our regulatory intervention. 'Monetisation' is the process of placing a monetary value on the harm reduction resulting from our regulatory intervention.

<sup>30</sup> This can be helpful to do especially if we think benefits are positive but a small minority of people will be adversely affected whilst a large majority of people will be only marginally better off. For a discussion on transfers between consumers and the Equality Act 2010 see Chapter 6.

<sup>31</sup> A 'group' here could refer to firms or to a collection of consumers, though this will vary by intervention in terms of scale and attributes. As we set out below, we pay attention, in particular, to consumers and consumer groups demonstrating 'vulnerable' characteristics.

positive for consumers or, makes some better off at the expense of others (which, as we explain in Chapter 6, can still be viewed as net beneficial).

The rest of this section sets out: the types of benefits that might arise to consumers in particular; the process of estimating consumer benefits; and our continuing efforts to estimate benefits.

### **Types of benefits to consumers from financial regulation**

Consumer benefits arise when there are improvements to market outcomes that result from our regulatory intervention. This improvement in consumer outcomes is measured against a 'baseline' (as explained in Chapter 2).

Consumer benefits originate from reducing the harm that we believe consumers experience in the absence of regulatory intervention. As we have seen, the drivers of harm are likely to be linked closely to the prevailing market failures we are intervening to address. Identifying the various harms, and the drivers of these harms, then, helps set out the consumer benefits that we expect will arise through our regulatory intervention.

Consumer benefits are the final outcome in this process of harm reduction. For example, an intervention that provides consumers with clearer information might lead to a final benefit of lower prices for consumers. Along the way, there may be other steps (which we term 'intermediate outcomes'<sup>32</sup>) that help achieve the lower prices. These intermediate outcomes, in this example, might include more shopping around. To be clear, we do not believe that increased shopping around, in its own right, is a benefit. But it can be a process that leads to beneficial consumer outcomes, both directly (as consumers find better deals) and indirectly (as firms come under pressure to come up with better offers).

The types of benefits consumers are likely to experience as a result of financial regulation are set out below in Table 5.

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<sup>32</sup> There are other benefits that may not be clear 'consumer benefits' – at least in the beginning. For example, better regulatory reporting data in the short-term is a benefit to the FCA. In time, this should help the FCA to reduce consumer harm (and, therefore, lead to consumer benefits).

**Table 5: Types of benefits to consumers from regulatory intervention in financial markets** (from [EFER](#) and a review of the CPs we published in the past 4 years)

Consumer benefit type	Description	Illustrative examples
Lower prices	<p>The benefit arises when the amount paid for a product (of a given quality) by current consumers in the market falls. It is the result of addressing 'the excessive price' harm.</p> <p>It is good to be aware of scenarios where the price for the 'basic' good falls, but the price of an 'add-on' rises to offset this. This may not, ultimately, lead to lower prices.</p> <p>This type of benefit also occurs when there are market efficiency gains (eg reduced costs to trade) or where regulated firms save costs thanks to some deregulatory measure and, if the market is competitive, they are passed on to consumers as lower prices for the services they provide.</p>	Introducing a <a href="#">price cap on high-cost short-term credit</a> (HCSTC) loans to reduce the cost of HCSTC for consumers who remain in the market.
Reduction in the probability of individuals' financial loss	The benefit arises by reducing the financial losses to consumers from unsuitable product purchases (e.g. unsuitable retail investments). This relates to reducing the probability of such a loss taking place.	The avoidance of costs associated with court action (including the opportunity cost saving of time dealing with the <a href="#">FOS</a> ) and ensuring consumer access to redress in case of a bankruptcy (for example, with the <a href="#">FSCS</a> )
More appropriate consumer transactions	<p>Benefits arise from an improved matching of products/services to consumer needs. As a result, consumers may value the product/service above its cost of production.</p> <p>There may also be an increase in trust. Consumers may now participate in the market where they did not before, eg confidence to invest in stocks.</p> <p>Improved matching might address a range of issues. This includes: excess mark-ups; low market confidence; and/or market access problems caused by regulatory barriers.</p> <p>More appropriate transactions may occur from consumers making more informed decisions for a given set of choices (an improvement in the information set), or for a given understanding of products &amp; services, the range of choices changes to better suit consumer needs (an improvement in the choice set).</p> <p>The benefit may arise by consumers engaging with a new product/service which meets their needs. It is worth noting that more transactions are not always a</p>	An intervention that combines: i) a delay concluding an add-on sale (such as our <a href="#">Guaranteed Asset Protection insurance intervention</a> ); and ii) the mandatory provision of product information might help consumers better match their needs to more appropriate products/services. For example, more time and information to make a more considered purchase might lead some consumers buying a cheaper, standalone alternative to an add-on insurance product or choosing not to buy the product at all.

Consumer benefit type	Description	Illustrative examples
	good thing.	
Psychological (eg avoided stress)	The reduction of negative psychological impacts may relate to mitigating the sale of unsuitable or unreliable products, or reducing unexpected poor service quality.	A <a href="#">cap on HCSTC</a> blocks some consumers from the market protecting them from default/missed payments (the straightforward cost to default/missed payments). Additional to that there is also the psychological cost of default, ie the stress associated with potential late payments to those consumers for whom the product appears to be detrimental (on debt and distress see <a href="#">Gathergood and Guttman-Kenney 2016</a> and <a href="#">Guttman-Kenney and Hunt 2017</a> ).
Time saved	Time can be saved through, for example, better quality transactions, avoiding the effort of seeking compensation or through easier shopping around.	Firms can either show a projected future pension annuity or show the age at which funds expire ( <a href="#">see pension reforms</a> ). This makes it easier to summarise information in a single table and results in time saved for the consumers, who can compare annuity projections faster and more easily.
Future gains from innovation	This can include the prospect of better quality products/services for (some) consumer types or lower prices owing to reduced costs.	Innovation and improvements to banking services encouraged by <a href="#">Open Banking</a> .
Probability reduction of major market disruption	Probability of major market infrastructure disruption multiplied by the typical losses to market participants as a result of such an event (side effects harm).	Improvement in conduct standards for a given market can reduce the likelihood of major market disruption (see for example <a href="#">MiFID II</a> ).
Reduction in likelihood of financial crisis	Probability of a financial crisis multiplied by the GDP crisis occurring (side effects harm).	An increase in capital requirements for banks will help to reduce the GDP loss incurred during a financial crisis for a given probability, by increasing the available resources of a bank to continue to carry out operations in the event of a financial strain ( <a href="#">see Recovery and Resolution Directive</a> ). In addition, an improvement in conduct standards for large financial institutions can reduce the probability of a crisis.

## The process of estimating consumer benefits

Table 6 sets out a process for estimating consumer benefits, once they have been identified. It includes identifying the consumer benefits, quantifying who is affected by the harm and would benefit from the proposed intervention, monetising those benefits and looking at 'break-even' analysis relative to the costs.

The ability to carry out all elements of the process in Table 6 will depend on various factors. These include, but are not limited to: the consumer benefit type(s); the market; the intervention; and the available data. It also depends on proportionality. Even if all of the information is available, the estimation process may be extremely time-consuming relative to the additional insight it yields.

**Table 6: Description of the various stages when estimating consumer benefits**

Stage	Description
<b>Identifying the benefits</b>	Benefits correspond to a reduction in a harm identified within the market, consistent with the Mission's framework.
<b>Quantifying those affected by harm</b>	Attempting to identify the number of individuals affected by a particular harm to be addressed by the policy. Depending on the data available, this could either take the form of simply quantifying the number of consumers in a given market for which harm is present or, if a richer dataset is available, quantifying those within a market who are particularly affected by harm.
<b>Quantifying those who receive a benefit (ie those for whom harm is reduced)</b>	Attempting to identify and quantify the number of individuals for whom harm will be reduced as a result of the policy. This requires both the estimate of those within a market specifically affected by a harm (set out above), and an estimate of the proportion of those individuals who will potentially benefit as a result of the remedy.
<b>Monetising benefits</b>	<p>Providing a monetary value on the reduction in harm experienced as a result of the policy. In addition to an estimate of the proportion of individuals in a given market for whom the harm is reduced, this requires an estimate of the monetary value to individuals of reducing the harm. It also requires consideration of whether the benefits are one-off or ongoing. Sometimes, consumer benefits may take time to be realised (eg a regulatory intervention that changes consumer behaviour may not lead to the desired effect on day one).</p> <p>Consumer benefits require careful presentation, especially if we want to compare them with cost changes. For example, saying that 1,000 consumers will avoid purchasing products currently sold at £1,000 does not imply a benefit (ie avoided detriment) of £1m, unless we consider that the value of those products is £0.</p>



Stage	Description
<b>Break-even analysis<sup>33</sup></b>	<p>Break-even analysis should be viewed, primarily, as a tool that helps to set quantified costs in context. It helps demonstrate a policy's proportionality by encouraging policymakers to examine the likelihood that the benefits (or harm reduction) will be large enough for the policy to be net beneficial. This is done by setting the required change in benefits against the estimated costs. If all costs have been quantified, and (some of) the benefits have been, the difference between quantified costs and benefits can be calculated. If it is not reasonably practicable to estimate the benefits (ie the reduction of harm), it may be possible to estimate the value of 'harm' in the market currently.</p> <p>Depending on whether 'benefits' or 'harm' are estimated, the difference when compared against a policy's quantified costs can be framed as either: a) the minimum threshold of benefits required for the policy to be net beneficial; or b) the reduction in 'harm' required for the policy to be net beneficial. This can be expressed either as an absolute value, or as a percentage change in terms of quantified benefits and harm respectively. Since benefits are effectively a reduction in harm, these 2 measures will generally be equivalent.</p> <p>Once these values are estimated, we are able to consider whether the required change in benefits/ harm is reasonable. Ie can the remedy be expected to deliver additional benefits or a reduction in harm that outweighs the estimated costs, and makes the implementation net beneficial.</p> <p>If we have confidence in our estimates of some of the key benefits and they exceed the costs, that will be a factor in the assessment of what is reasonably required when estimating the other benefits.</p>

Estimating benefits is, generally, not straightforward. Lab or field trial results can prove a helpful data source for estimating benefits<sup>34</sup>. Data issues aside, it is challenging, technically, to estimate some consumer benefits. For example, some benefits are of psychological nature (eg avoidance of stressful situations). There are methods to monetise their values, often derived from health economics, which may be worth attempting to use for large scale interventions that reinforce consumer protection. See '[Estimating the benefits of interventions that affect consumer behaviour](#)' OP for a discussion of some of these. This remains an ongoing area of development in cost benefits analysis.

<sup>33</sup> The FCA used this type of approach when considering the impact of extending the Senior Managers & Certification Regime to all FCA firms (<https://www.fca.org.uk/publication/consultation/cp17-25.pdf>). See pages 61-66 for a summary of the analysis or refer to <https://www.fca.org.uk/publication/research/cba-extension-senior-managers-certification-regime.pdf> for the full CBA.

<sup>34</sup> On how findings from field trials can help inform policymaking see '[How and When we use Field Trials](#)'.

## **Our continuing efforts to estimate benefits**

We reviewed all CPs we published between April 2013 (when the FCA came into existence) and 2017, but for the CPs proposing minor changes. We found that we were able to quantify and monetise some consumer benefit types more frequently than others. And, even for those categories where we were able to quantify and monetise benefits, we were not always consistently able to do this (e.g. although we might be able to monetise the benefit of lower prices in one setting, we might be unable to do this in another setting).

We are looking at how we can continue to make benefits estimation easier and more effective. This will help balance the Enterprise Act requirement to report on costs imposed on business. For example, we would like to see whether we can develop approaches to estimating common, yet challenging, benefit types (such as for example psychological benefits). The Occasional Paper '[Estimating the benefits of interventions that affect consumer behaviour](#)' considers consumer benefits in the presence of behavioural biases and discusses a few techniques that might be used to estimate some of the more technically-challenging impacts.

## 6. How we consider distributional issues

In its basic form, the tool of cost benefit analysis (CBA) in the economic literature is neutral with respect to the distribution of benefits and costs. It is not concerned with pure transfers between firms and consumers. The net benefit of a regulation is equal to the total benefit (both financial and non-financial) accruing to firms and consumers across the economy, minus the total cost of implementing the change.

By contrast, policy decision-makers are often concerned with whether and how benefits and costs are transferred and redistributed between different groups. For example transfers between firms and consumers, between different types of firms (eg impacts on small firms), and between different types of consumers (eg with respect to income, gender or age of individuals).

The need for distributional analysis in a CBA is decided on a case by case basis. We do have to consider (though not quantify) impact on mutual societies and whether this is different to impact on other persons to whom the rule applies<sup>35</sup>. We also have to consider impact on different groups of people with protected characteristics, for purposes of the Equality Act 2010.

Typically, when we expect transfers to arise, we try to estimate them and indicate the benefits to some groups (eg lower prices to consumers) as well as the costs to others (eg lost revenues to firms).

The following sections discuss: (i) transfer between firms and consumers; (ii) transfers between firms; and (iii) transfers between consumers.

### Transfers between firms and consumers

Where we are correcting market failure in a way that leads to a transfer from firms to consumers who would otherwise be harmed, we count that as a benefit.

There will be cases when we enhance price competition among firms for similar products (see for example our CBA for [Implementing information prompts in the annuity market](#)). In the short term, when price levels decrease, consumers enjoy a lower expenditure, but this is equivalent to lower revenues or profits to firms. The CBA will generally report the expected amounts in terms of benefits to consumers, and costs to firms. In the long

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<sup>35</sup> See s.138K FSMA.

term, however, we expect improvements in competition to create greater benefits as they deliver innovation, efficiency gains and better allocation of scarce resources (see Box 5).

Similarly, when we help consumers engage with their finances and they avoid overspending on products they do not need, this entails lower charges to consumers and revenues to firms (see for example our CBA on [Guaranteed Asset Protection insurance](#)). It also has some net, positive impacts as less time and resources are wasted on these transactions.

We consider the effect of these transfers in the context of our objective to protect consumers.

**Box 5. Do pro-competition interventions lead to additional net benefits as well as transfers?**

Pro-competition interventions reduce the 'deadweight loss' ie a loss to consumers which does not represent a benefit to firms (or vice versa) arising from market power. The number of mutually beneficial transactions increases, as by reducing monopoly power we increase the volume of business and lower prices. With lower prices, more consumers may decide to buy the products and services affected by our intervention, so that gains on the demand side (final consumers or, in wholesale markets, business) exceed losses among suppliers.

## Transfers among firms

Interventions can affect different firms in different ways.<sup>36</sup> Interventions aiming to improve conduct also lead to transfers among firms, as bad firms lose while good conduct firms gain in relative terms. Price interventions will typically benefit more efficient firms, while less efficient firms exit the market. Pro-competition interventions also cause transfers among firms, as the ones providing better value for money increase their profits and low-value providers lose out, leading to ambiguous aggregate impacts on firms in the short term. In the longer run, the aggregate impacts on firms and the economy from competition are generally positive, as efficiency and productivity increase. We will normally flag the possibility of this redistribution within the industry affected, without speculating on its magnitude as this is usually not possible to quantify.

## Transfers between consumers

Some consumers may gain financially at the expense of others. Such transfers arise when regulation changes or creates some form of financial cross-subsidy between consumer groups. For example, regulation that encourages switching may lead to transfers from less sophisticated to more sophisticated consumers (see our CBA on [Cash savings remedies](#) ). In those cases the CBA usually presents the net effects along with a discussion on the two groups of consumers (eg whether they are more or less sophisticated or vulnerable consumers).

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<sup>36</sup> See Chapter 4 for a discussion on costs falling differently on different types of firms (for example small as opposed to large firms).

## **Box 6. Distributional impacts and welfare weights**

The '[Green Book](#)' states that distributional effects should be proportionately considered and clearly identified and quantified, where relevant and significant. This means showing how costs and benefits accrue to different groups in society. At times, this might involve using welfare weights.<sup>37</sup> The Green Book indicates the possibility to include distributional weights into impact assessments, based on income levels of those affected (though low income, even when observable, is only one aspect of vulnerability).

We do not tend to apply explicit quantitative welfare weights in our CBA, but we do try to be transparent about how different key stakeholders will be affected. This means that we qualitatively assess the relative impacts of our interventions. For example, we might decide to proceed with an intervention even if the expected monetised costs exceed the monetised benefits. This might happen when we make a judgement about non-monetised benefits, or we think that benefits accrue to people most in need. For example, when we foster access and enhance protection to those who face difficult circumstances. Our Mission states that we devote special attention to the vulnerable, who are less able to engage with markets and prone to suffer disproportionately when things go wrong (see also our [Approach to Consumers](#)).

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<sup>37</sup> The difficulty of such approaches is that weights generally have to be determined on a subjective basis. One commonly used weighting approach is the assumption of equal weights for all people, regardless of income, in areas such as health or education, even though those with higher incomes would generally be willing to pay more for a given benefit.

## 7. Interaction between CBAs and Enterprise Act Impact Assessments

Following the enactment of the Enterprise Act 2016, we are obliged to report impacts on business of the 'qualifying regulatory provisions' (QRPs) we make to the Regulatory Policy Committee (RPC), appointed under the Small Business, Enterprise and Employment Act 2015.

Some of our activities are covered by exclusions<sup>38</sup> and so do not count as QRPs (for example our fees-raising, pro-competition interventions, measures relating to systemic financial risk, implementation of EU obligations, imposition of fines and redress, investigations/enforcement on specific firms, policy development activities such as consultation to firms, and temporary measures). Costs, as well as savings to firms (eg from deregulation) are estimated across a 10-year period, separating one-off from ongoing components, and are turned into a 'BIT' (business impact target) score. Increments to our costs (when our measures extend the scope of our activities beyond 'business as usual') are also included, as we are funded by the firms we regulate.

If in our cost benefit analyses (CBAs) we have estimated impacts on firms when possible and 'reasonably practicable', there is little substantive difference between the CBA and the impacts on firms we report to the RPC. There is a key presentational difference: our CBA will include, and effectively net off, benefits to consumers, whereas Impact Assessments cover only costs and savings to business. So the numbers in CBAs and IAs will look very different, but can be reconciled.

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<sup>38</sup> The exclusions are set out in a Ministerial Statement which must be renewed for each Parliament. Please see 2018 Ministerial statement [here](#).

# Annex 1 - The Standardised Costs Model

The standardised costs model is designed to speed up and standardise the assessment of some common recurring costs in our cost benefit analyses (CBAs). This Annex describes the approach we take in using this model and provides details on some of its key underlying assumptions. Setting out our approach and assumptions provides transparency for external stakeholders.

## Approach

The standardised costs model is a framework for estimating common types of compliance costs. The framework is based on our understanding of how certain compliance costs are structured, drawing on a 'core' set of assumptions. Costs can then be estimated in a bottom-up manner by supplying some variables specific to the intervention —principally relating to how many hours of time a certain activity requires of different types of firms.

The model's assumptions are based on a review of previous CBAs, internal consultation, and desk-based research. This was combined with consultation with firms and trade bodies, and discussions with software vendors.

This model does not represent a new approach to CBAs; it helps to estimate costs in a manner consistent with our previous approaches. Certain costs will be presented in a more standardised and explicit way. When we use the standardised costs framework we are still required to meet all of the current CBA requirements as specified by FSMA. We do not plan to use the model for particularly large or complex interventions, or will use it only as a sense check in those circumstances. The main purpose of the model is to facilitate and improve consistency of CBAs of smaller and simpler interventions, eg changes to internal governance processes, or small changes to disclosure that require amendments on the firm's website.

## When we will use the standardised cost model

The standard costs framework requires information and estimates specific to the intervention. In this sense, it is partially standardised but cost estimates themselves vary by intervention.

We will use the standardised costs model when we wish to estimate the types of costs the model covers (see below for a list), and where we believe the approach is



appropriate. E.g. if we think the large/medium/small firm distinction is not appropriate, a CBA can still take a separate approach. If there is a complex impact on customer transactions, it makes more sense to estimate it separately rather than force it through the approach provided in the standardised costs model. Equally we may combine a particular assumption within the model with separate information. For some CBAs we will still conduct bespoke research and conduct surveys of firms.

Whenever the model is used, we will explain the relevant assumptions so that the reader is able to understand our estimates.

## **Updating the model**

The core assumptions contained in the model are not fixed over time. We have set out in this Annex the current assumptions used but we will review and update the assumptions on an ongoing basis as new evidence becomes available.

## **Implications**

One of the main implications of the approach is that only in rare circumstances will CBAs contain no quantified costs. Accounting for familiarisation and gap analysis costs, for example, will in the majority of cases mean that at least some costs are quantified in CBAs.

The model is particularly useful at the option appraisal stage of policymaking, as it allows us to compare the potential costs of different intervention options in a more effective way.

## **How the standardised costs model works**

The standardised costs model helps estimate costs predominantly on the basis of staff time. The key pieces of information that we require to estimate the costs of an intervention are what incremental tasks a new rule requires of firms, and how much staff (or external contractor) time is required to complete those tasks. This time is likely to vary according to a firm's size and their activity in that market.

Most cost estimates are then based on a calculation like the one below (separately for each size of firm). This approach is common to our previous CBAs:

Additional minutes of staff time  $\times$  average cost of time per minute  $\times$  number of firms

To put a cost on time, we have sourced salary information for a range of occupations in financial services. Figures for large and medium firms are based on the 2016 Willis

Towers Watson UK Financial Services Report. Small firm salaries were sourced from a systematic review of adverts on the website of Reed, cross-referenced with other publicly available sources. We add an allowance for overheads of 30% to all time costs to account for non-wage labour costs (see Measuring Administrative costs: [UK Standard Cost Model Manual, 2005](#) ). Salary estimates are uprated using ONS earnings inflation figures.

In each CBA we aim to identify the firms that we expect to be affected by the intervention. If it is not possible to identify all of the firms affected, we will make an approximation. If we know which firms are affected, we can take account of their size (see Box 7) and apply different assumptions of compliance costs for large, medium and small firms. We can use regulatory data reported by those firms, for instance the number of advisers reported in retail mediation activity (RMA) returns.

### **Box 7: Firm size**

The model distinguishes between costs incurred by firms of different sizes. We have classified all regulated firms as large, medium or small using data from annual FCA fee blocks.

There is no standard way to define firm size using available FCA data. Data on total employees is not available. Ranking firms by revenue or FCA fees can create perverse results because of multiple tariff bases. Instead we use underlying tariff base data to give each firm a rank among all firms that use the same tariff base (annual income, gross premium income etc.). We then take each firm's maximum rank (many firms use multiple tariff bases) to order firms. The top 250 firms are classified as large, firms from 251 to 1750 classified as medium, and all the rest as small. This means that the size categories are fixed, but in future we will explore the possibility of size definitions that vary by sector or area.

## **Main sections of the model**

The sub-sections below summarise the key sections and the main assumptions used in the standardised costs framework. These are baseline assumptions; other figures will be used if there is better information available and we will update these figures over time as new evidence becomes available.

## Familiarisation and gap analysis

Familiarisation and gap analysis refers to firms reading and familiarising themselves with the detailed requirements of new rules, guidance or good and bad practice, and checking their current practices against these expectations. Familiarisation estimates are based on the length of FCA publications such as CPs, and gap analysis estimates are based on the length of the legal instrument or good/bad practice text. The salary used is an average of the compliance function.

There are 3 scenarios for how many staff may read a publication. The choice of scenario is intended to reflect how the proposals will impact the firm:

**Table A1: Familiarisation - the number of people per firm assumed to read new FCA publications**

	<b>Large firm</b>	<b>Medium firm</b>	<b>Small firm</b>	<b>Use</b>
Standard	20	5	2	Publications that have a bearing on the business model of the firms in question, eg medium and large impact CPs
Minor	6	4	1.5	Small-scale changes, eg low impact CPs and thematic reviews
Very small	3	1.5	1	Certain letters and technical notes requiring attention but no action by firms

Gap analysis costs are estimated using a combination of assumptions regarding the size of a legal team or equivalent (using the salary of a legal professional), and the time each member of that team takes to review 50 pages of legal text (e.g. CP instrument).

**Table A2: Gap analysis - legal review team size and days to review 50 pages of legal text**

	<b>Scenario</b>	<b>Use</b>	<b>Large firm</b>	<b>Medium firm</b>	<b>Small firm</b>
Size of legal or compliance team	Standard	(Eg) Standard rule making and new guidance	4	2	1
	Minor	(Eg) Deregulations and redrafting	2	1.5	1
Days per team member to review 50 pages of legal text	Standard	(Eg) Standard rule making and new guidance	4	3	1
	Minor	(Eg) Deregulations and redrafting	2	1	0.5

## Training

Training includes information given to staff, ranging from informal memos and oral updates, through to formal classroom-based training delivered by a professional.

Based on the project's research, all large firms and 40% of medium firms are assumed to have in-house training departments. The costs of in-house training are assumed to be: the cost of time of staff to design and deliver training; the cost of time of attendees; and any time attendees spend familiarising themselves with the training material. The costs of external training are assumed to be: the costs of purchasing training courses from external providers; the cost of time of attendees; and any time attendees spend familiarising themselves with the training material.

**Table A3: Main assumptions used for training (prices are on a 2017 basis)**

<b>Firms</b>	<b>Variable</b>	<b>Assumption</b>
All firms	Number of classroom training hours per day	6 hours
	Average number of participants per class (to calculate delivery hours)	15
Firm with in-house training function	Hours of preparation per hour of bespoke training	40 hours
	Hours of preparation per hour of basic training	8 hours
Firms without in-house training function	Cost of external training course per person per day	£700
	Premium per day rate for external training (eg major changes such as MiFID II)	£1000

## IT development

FCA regulations may require firms to undertake changes that necessitate modifications to IT systems, additional work by IT staff or purchase of outside IT assistance. We take a different approach for large and medium firms compared with small firms.

### Large and medium firms

For one-off IT development costs, the main assumption contained in the standardised cost model is an archetypal project structure for all large and medium firms. These firms are assumed to have (or incur costs as if they have) in-house IT capability. This is an average cost structure based on our research of common types of regulation-driven IT projects.

To calculate the total resources of the project, it is necessary to provide a total number of project days, which can be split according to the structure. We can calculate the total hours of different types of staff, and use salary estimates to derive a total cost estimate. The model currently contains a number of scenarios of project size that can be refined and mapped to interventions over time.

**Table A4: IT cost estimate structure for large and medium firms**

Element	Percentage of resource
Business analysis	15%
Design	15%
Programming/coding	55%
Project management	10%
Testing	10%
Senior management	5%

### Small firms

We assume small firms do not have in-house IT departments. So the model does not contain assumptions about the structure of IT costs. For small firms, we will estimate IT costs based on informal or formal consultation, or using other evidence, as per current CBA practice.

### Governance changes

Governance changes relate to regulatory interventions that require firms to change, in some way, their internal processes or governance arrangements. The main costs relate to the opportunity cost of staff time required by the intervention.

The way such costs are estimated in the model is to derive a total number of hours of project team staff, and any time required by senior leadership. This time will depend on the regulation, but the model contains assumptions related to the size of these teams in different firms which enable us to derive the total time. (For example, an hour of company board time would be multiplied by the average board size.)

**Table A5: Governance changes - number of staff in project and leadership teams**

Variable	Large firm	Medium firm	Small firm
Size of change management project team	8	6	2
Average size of company board	10	8	2
Average size of executive committee	8	6	2

## **Customer transaction and sales changes**

Customer transactions and sales changes refer to various regulatory requirements that change the length of a particular firm process such as a customer sales process or a transaction.

The key inputs to estimate these costs are the total number of relevant transactions (based on evidence such as the total number of sales of a product per year) and the additional minutes of staff time that the intervention requires. These inputs are not standardised, but the model provides a framework to undertake this type of calculation quickly for the specific firms affected.