FINANCIAL CONDUCT AUTHORITY

Individual Accountability: Extending the Senior Managers and Certification Regime: Cost-Benefit Analysis

Consultation Papers
CP17/25 and CP17/26***

July 2017

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How to navigate this document onscreen

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1 Introduction

1.1 As of June 2017 the FCA regulates approximately 47,430 non-banking firms authorised by the Financial Services and Markets Act (FSMA). We are the only regulator ('solo-regulator') for 46,870 firms, and we also regulate a further 560 insurers jointly with the PRA. For banks dual-regulated by us and the PRA, in March 2016 we replaced the current Approved Persons Regime (APR) with the Senior Managers and Certification Regime (SM&CR).

1.2 For insurers, the Senior Insurance Managers Regime (SIMR) introduced by the PRA, and related changes to APR made by the FCA, were introduced as part of the implementation of the EU Solvency II Directive. This paves the way for applying the SM&CR to these firms. Although the PRA and FCA regimes incorporated some of the ideas and principles underpinning the SM&CR, not all of the elements of the SM&CR are currently in place for insurers.

1.3 Parliament's changes to FSMA in May 2016 mean we now need to replace the APR with the SM&CR for all FSMA-authorised firms.

1.4 We now have powers to:

- make certain roles 'Senior Managers' – a new type of function where the people doing these jobs need approval from the FCA, and at least once a year firms need to make sure Senior Managers are suitable for their jobs
- make certain roles 'significant harm functions' under the Certification Regime – we will not approve these people but firms need to make sure they are suitable to carry out their roles, at least once a year
- apply Conduct Rules to almost all employees in financial services firms

1.5 The policy proposals discussed in CP17/25 and CP17/26 implement the SM&CR extension for almost all solo-regulated firms and insurers, respectively. This will change how we regulate people, and the way they're assessed and held accountable for what they do.

1.6 The key aims of the SM&CR are to:

- encourage staff to take personal responsibility for their actions
- improve conduct at all levels
- make sure firms and staff clearly understand and can demonstrate who does what

1.7 This document sets out the cost-benefit analysis (CBA) in relation to CP17/25 and CP17/26 which we're required to carry out under Section 138I of FSMA.

1.8 This CBA is structured as follows:

- Chapter 2 discusses market failures and explains the different elements of the proposals
- Chapter 3 discusses our assessment of compliance costs for firms and costs to the FCA
- Chapter 4 discusses indirect costs and wider impact
- Chapter 5 discusses the potential benefits from a reduction in misconduct, and therefore the potential reduction in harm to consumers and other market participants
- Chapter 6 illustrates the potential benefits by showing evidence of harm caused by misconduct
- Chapter 7 concludes by comparing costs and benefits

1.9 A summary of this CBA is provided in Annex 1 of CP17/25 and CP17/26.

2 Market failures and the SM&CR toolkit

Identifying market failures

2.1 Our SM&CR proposals seek to address market failures in order to prevent harm from occurring. Whilst we expect firms to identify and rectify problems themselves, we will work with them to help ensure their systems and controls, governance, and culture enable them to comply fully with our rules.

2.2 There have been a number of conduct failings in recent years, following the financial crisis in 2008. LIBOR manipulation, FX rigging, and PPI represent three major incidents where misconduct has occurred in the market place to the detriment of customers. Furthermore, our experience tells us that these poor conduct practices are not unique to any one sector of the firms we regulate.

2.3 The FCA believes that better governance and accountability will lead to an improved culture within firms and one which is more focussed on customer outcomes. This is the key driver for introducing the SM&CR to all our FSMA-authorised firms.

2.4 There are two areas of harm in particular in markets served by solo-regulated firms and insurers (the firms in scope of the proposed policy) that the SM&CR looks to address:

- information asymmetry: firms have more information than their regulator(s) and firms' employees have more information than firms' owners (for example, shareholders)
- behavioural biases affecting employees

2.5 A given market can be affected by one of the above failures occurring in isolation or, as often happens, by a combination of failures. For example, a large degree of market power can interact with consumers' behavioural biases, such as reliance on rules of thumb or overconfidence, and asymmetric information.[1]

Information asymmetry

Firms have more information than their regulator(s)

2.6 Regulators make rules and supervise firms to ensure that the markets they regulate function well. However, they have incomplete information about the compliance of the firms they supervise.

2.7 Information asymmetry between firms and regulators arises because it's impossible for regulators to monitor all the activities and outcomes in financial markets to detect misconduct. This is an overarching problem, which might lead to firms not complying with the rules they're subject to because they may expect not to get caught.

1 Iscenko, et al. 2016, p.5

2.8 This creates a situation akin to a 'principal-agent problem', ie a situation where the firm (the 'agent') can behave in a way that is not optimal from the perspective of the regulator (the 'principal') because the regulator has incomplete knowledge about the agent's actions.

2.9 A regulated firm may decide to pursue its own goals (eg expansion into other markets and growth of market share in the pursuit of higher profit) regardless of whether their strategy execution is compliant with regulations. This pursuit of the firm's self-interest may harm the firm's customers and possibly the wider market. Regulators have limited ability to detect and prevent non-compliant behaviour and the subsequent harm.[2]

Firms' employees have more information than firms' owners (for example, shareholders)

2.10 Principal-agent problems also exist within financial services firms, such as those between managers and their staff or compliance officers and other employees. Employees within firms may also have more information about activities and outcomes within the firm than the firms' owners. This imperfect knowledge can be exploited by employees at the expense of firms, as well as consumers and markets.

2.11 Senior staff and owners of firms have incentives to prevent misconduct within their firms, including possible fines and redress payments, and potentially the loss of consumers' confidence and market share. The owners of firms will bear the costs of misconduct through lower profits and a reduction in the value of the firm.

2.12 Consequently, senior staff and owners attempt to monitor staff. They introduce systems and controls, some of which are regulatory requirements, to minimise the risk of misconduct and avoid significant regulatory penalties.

2.13 However, employees' incentives may be different to firms' incentives. Employees may engage in misconduct to benefit themselves, for example, through behaviour that leads to a higher bonus, but which will ultimately harm the firms' consumers or its long-term profits.

2.14 Furthermore, as firms can't monitor employees perfectly, they may be unable to punish employees for misconduct (eg if they've moved firms or if responsibility is not clear), then this information asymmetry can lead to misconduct in markets.

2.15 This information asymmetry can be further aggravated by behavioural biases that affect staff and may have a negative impact on their behaviour and decisions, which potentially may go unnoticed by compliance staff or Senior Managers.

Behavioural biases affecting employees

2.16 Organisational theorists suggest that cognitive and informational difficulties are pervasive in firms[3] and there are a number of case studies of systematic flaws in firms' decision making.[4] There is no reason to believe that these problems arise only in firms outside the financial sector. These biases may aggravate the information asymmetry problems discussed above.

2 This is the standard economic view on regulation, expressed by Laffont and Tirole 1993.

3 Das and Teng 1999 provide an overview and discuss how biases affect strategic decision making. Iscenko, et al. 2016 draw on insights from the psychological literature and discuss biases and other factors that influence effective compliance.

4 Langevoort 1997 pp.104, 123-5. Similarly, Lovallo and Sibony 2010 p.3.

Information transmission

2.17 Decision making can be impeded when the information flow within firms is biased towards positive outcomes or progress.

2.18 Because senior members of staff commonly monitor the individual performance of and information from junior team members, employees are aware that passing negative information upwards may not reflect well on their performance.

2.19 As a result, whilst positive information may be cascaded to the senior management relatively quickly, negative information may take longer to cascade, or indeed not be shared at all.[5] This can lead to an overly optimistic assessment by the senior management, who lack all the relevant information.

Cognitive limitations

2.20 Peoples' decision making can be impaired by cognitive limitations, including errors due to lack of time.

2.21 For example, people use two generic modes of cognitive function, corresponding roughly to intuition and reasoning. They rely on the quicker 'intuition' mode and may later confirm their assessment using the slower, controlled and rule-governed mode of 'reasoning'.

2.22 While this might work well where decisions are simple or where both modes work together, the shortcomings of intuitive assessments can affect an employee's 'reasoning process', leading them to flawed decisions.[6]

Bias blind spots

2.23 Evidence suggests that people believe that they are, on average, less biased in their judgement and behaviour than their peers. This has a detrimental effect on judgements and behaviours that rely on comparing one's own accuracy to that of peers.[7] The belief that a peer's judgement is biased may lead managers and other employees to be less likely to listen to useful advice from others.

2.24 Firms may be able to use their organisational structure and expertise to mitigate the effects of behavioural biases, as it's easier to identify biases in others than it is in oneself. This tendency (known as the 'bias blind spot') may be due to people placing more value on the thinking they used to reach their judgements, without taking into account the judgements made by others.[8]

2.25 Organisations may be able to structure themselves in a way that allows them to identify biases in their employees and mitigate their effects.[9] This would benefit consumers where such biases may have led to consumer harm, for example due to poor product design or mis-selling. However, it's not clear whether biased managers will be able to achieve this since their own biases may influence the design of these structures and, as a result, affect their operation.

5 Merkl-Davis and Brennan 2007.
6 See Certo, Connelly and Tihanyi 2008; Kahneman 2003 summarises the psychological literature on biases in decision making more generally.
7 Scopelliti et al 2015.
8 Gilovich, Pronin and Ross 2004.
9 See Sunstein and Thaler 2009 more generally on choice architecture.

Joint decision making

2.26 More broadly, biases may not be accounted for in organisational structure or joint decision making, potentially leading to dramatic consequences.[10]

2.27 The FCA and PRA's joint report on HBOS provides a financial services example, highlighting the lack of challenge at Board level as one of the reasons behind its failure.[11]

2.28 Also, in its review of the RBS take-over of Fortis and ABN Amro, the FSA found evidence of defective decision making in the form of overconfidence. One former RBS Board member thought that there was an element of 'group-think'[12] in the decision and that no Board member had ever expressed concerns about the deal.[13]

2.29 Such group-think might lead to or aggravate misconduct. For example, it might result in ineffective governance structures with inadequate systems and controls in place.

Overconfidence

2.30 Another type of bias affecting Senior Managers' decision making is overconfidence.

2.31 When people assess their skill relative to their peers, they tend to overstate their abilities. Because they're more likely to attribute favourable outcomes to their own actions (but unfavourable outcomes to bad luck), executives are particularly prone to overconfidence.

2.32 The literature attributes this to three main factors: (i) the illusion of control, (ii) strong commitment to positive outcomes and, (iii) abstract reference points (such as their average peer rather than an individual or small group of colleagues). These factors make it hard to compare performance across individuals.

2.33 Academic studies have found that overconfidence has an impact on the capital structure of the firm. Malmendier and Tate,[14] for example, find that CEOs under or over invest depending on the source of finance used. Consequently, poor investment strategies are used by firms.

2.34 Overconfident managers are more likely to be promoted to CEO, although they do not invest enough effort in the creation of information because they are overconfident in the accuracy of the information they have.[15]

2.35 Overconfidence might also lead to financial misreporting: while this might initially be unintentional and may only reflect the over-optimism of the executives, overconfident executives are more likely to intentionally misreport if the firm's performance does not meet their (overly) optimistic expectations.[16]

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10 See Walsh 1995 pp.280-2 for examples.
11 FCA and PRA, The failure of HBOS plc (HBOS) 2015, p.213. Available here.
12 The term group-think refers to the psychological phenomenon that people within a group strive for consensus. People who disagree with the opinion or decisions of the group frequently remain quiet to maintain group cohesiveness and solidarity.
13 See the FSA Report 2011, pp.228-9. Available here.
14 Malmendier and Tate 2005.
15 Goel and Thakor 2008.
16 Schrand and Zechman 2012.

Remedying the market failures: the SM&CR toolkit

2.36 As discussed at the start of this chapter, we believe our SM&CR proposals help address the market failures we have outlined and will ultimately lead to better governance and accountability within the firms that we regulate. As discussed in CP17/25 and CP17/26, the proposed SM&CR changes aim to increase individual accountability for senior staff, increase oversight over a wide range of staff through the Certification Regime, and ensure financial services staff are subject to new conduct rules.

2.37 Below we describe the different elements of the policy and the type of firm to which they apply.

Our approach to designing the SM&CR

2.38 There are many types of firms that will now be under the SM&CR, ranging from very small firms with limited permissions to some of the largest global firms.

2.39 Because of these differences, the new regime needs to be proportionate and flexible enough to accommodate the different business models and governance structures of firms.

2.40 We propose:

- applying a standard set of requirements to all FCA solo-regulated firms known as the 'Core Regime' for the SM&CR
- having extra requirements for a small number (fewer than 1%) of solo-regulated firms whose size, complexity and potential impact on consumers warrant more attention – these additions are called the 'Enhanced Regime'
- applying a reduced set of requirements for a group of solo-regulated firms we are defining as 'Limited Scope'

2.41 Insurers that are regulated by both the FCA and PRA would have to comply with both regulators' specific rules. The FCA's SM&CR for insurers would require Solvency II firms and large non-Directive firms (NDFs) to implement all elements of the regime, while small NDFs[17], Insurance Special Purpose Vehicles (ISPVs) and small firms in runoff will have to implement a subset of the requirements. The SM&CR for insurers is composed of elements introduced by the statutory framework and discretionary proposals in the enhanced and core regime.

2.42 Figure 1 provides an overview of the toolkit for solo-regulated firms and insurers. Table 1 is a glossary with references to a more detailed description of the policy in the relevant Consultation Paper.

17 Small non-directive firms (small NDFs) are insurers that are not subject to Solvency II and have assets relating to all regulated activities carried on by the firm of £25 million less. NDFs exceeding this threshold qualify as 'large' NDFs.

Figure 1: Overview of the toolkit for solo-regulated firms and insurers

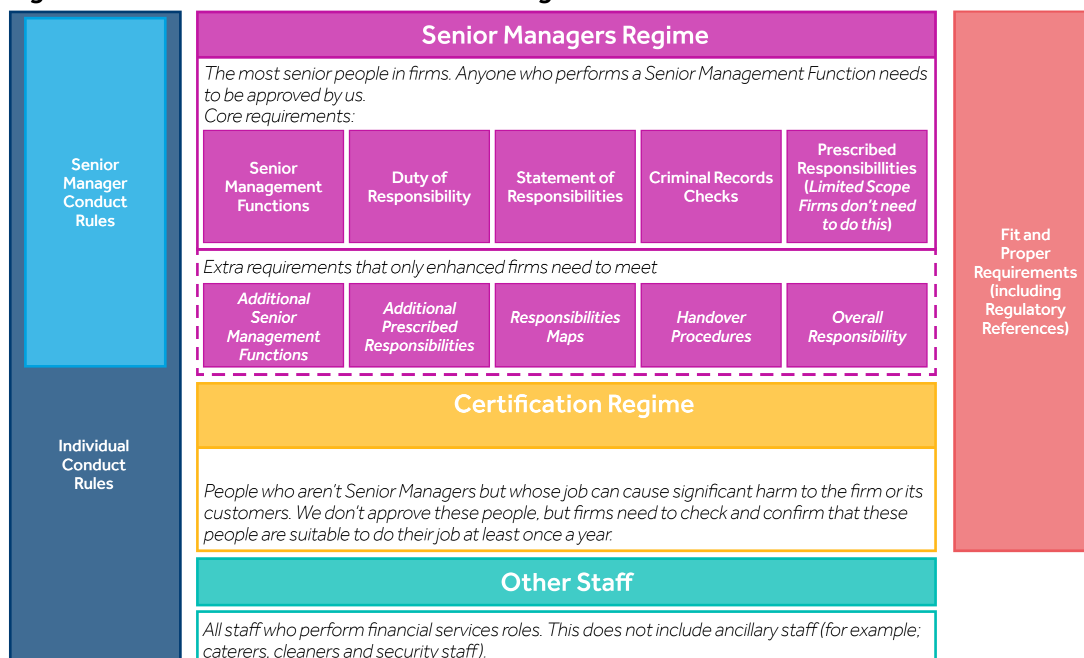

Table 1: Glossary (firm type)

Firm type	Description
Limited Scope Firm	Firms that will be subject to fewer requirements than core firms. This covers all firms that currently have a limited application of the Approved Persons Regime, including: • Limited Permission Consumer Credit Firms • sole traders • authorised professional firms whose only regulated activities in are non-mainstream regulated activities • oil market participants • service companies • energy market participants • subsidiaries of local authorities or registered social landlords • insurance intermediaries who only have permission to carry on insurance mediation activity in relation to non-investment insurance contracts • Internally Managed AIFs
Core Firm	Firms that will have a baseline of SM&CR requirements applied.
Enhanced Firm	A small number of solo-regulated firms that will have to apply extra rules.
Solvency II firms (including large non-Directive firms)	Insurance firms that will have to apply full scope requirements.
Small Non-Directive Firms and Insurance Special Purpose Vehicles	Insurance firms that will have to apply fewer requirements.

Table 2: Glossary (SM&CR elements)

Tool	Description	Who does it apply to?	Where can I read more in the CP for solo regulated firms?	Where can I read more in the CP for insurers?
Ancillary Staff	Employees who are not covered by the Conduct Rules, such as cleaners, receptionists, catering staff and security staff.	All firms	Chapter 7 paragraph 14	Chapter 6 paragraph 14
Certification Function	A function performed by employees who are not Senior Managers but who could pose a risk of 'significant harm' to the firm or its customers. The Certification Functions are defined in our Handbook but we do not approve these people.	All firms	Chapter 5 paragraph 6	Chapter 4 paragraph 7
Certification Regime	The part of the regime that covers Certification Functions.	All firms	Chapter 5	Chapter 4
Criminal Records Checks	A requirement on firms to conduct criminal records checks for Senior Managers and Non-executive Directors (where a fitness requirement applies) as part of checking that they are fit and proper.	All firms	Chapter 6 paragraph 8	Chapter 5 paragraph 8
Duty of Responsibility	Every Senior Manager will have a duty of responsibility as a result of FSMA. This means that if a firm breaks one of our requirements, the Senior Manager responsible for that area could be held accountable if they did not take 'reasonable steps' to prevent or stop the breach.	All firms	Chapter 4 paragraph 20	Chapter 3 paragraph 48
Fit and Proper Requirements	Firms must make sure all Senior Managers and people performing Certification Functions (i.e. people under the Certification Regime) are fit and proper to perform their role. This must be done on appointment and at least once a year.	All firms	Chapter 6	Chapter 5
Handover Procedures	A firm must take all reasonable steps to make sure a new Senior Manager has all the information and materials they need to do their job.	Enhanced Firms and Solvency II (including and large non-Directive firms)	Chapter 8 paragraph 36	Chapter 3 paragraph 80

Tool	Description	Who does it apply to?	Where can I read more in the CP for solo regulated firms?	Where can I read more in the CP for insurers?
Individual Conduct Rules	These are basic standards of behaviour that people performing financial services activities in firms are expected to meet. Firms need to train their staff on the Conduct Rules and how they apply to them. Firms will need to report breaches of Conduct Rules resulting in disciplinary action to us every year.	All firms	Chapter 7	Chapter 6 paragraph 8
Other Overall Responsibility	A Senior Management Function that applies where a senior executive is the most senior person responsible for an area of the firm's business but they do not perform any other Senior Manager Function.	Enhanced Firms and Solvency II (including and large non-Directive firms)	Chapter 8 paragraph 16	Chapter 3 paragraph 17
Overall Responsibility	A requirement for every area, activity and management function of the firm to have a Senior Manager with overall responsibility for it.	Enhanced Firms and Solvency II (including and large non-Directive firms)	Chapter 8 paragraph 23	Chapter 3 paragraph 17
Prescribed Responsibilities	FCA-defined responsibilities that must be allocated to an appropriate Senior Manager.	All firms **except** Limited Scope Firms	Chapter 4 paragraph 37; Chapter 8 paragraph 19; Chapter 9 paragraph 11	Chapter 3 paragraph 54
Regulatory References	Information that firms need to share with each other when an employee or director moves from one firm to another (for candidates of Senior Managers Functions, Non-executive Directors and Certification Functions).	All firms	Chapter 6 paragraph 12	Chapter 5 paragraph 12
Responsibilities Maps	A document setting out a firm's governance and management arrangements, and how responsibilities are allocated to individuals within the firm.	Enhanced Firms and Solvency II (including and large non-Directive firms)	Chapter 8 paragraph 33	Chapter 3 paragraph 75
Senior Management Functions	The roles where the people doing them need to be approved by the FCA. These are defined in our Handbook.	All firms	Chapter 4 paragraphs 12 and 15 ; chapter 8 paragraph 16; chapter 9, paragraphs 2 and 9	Chapter 3 paragraph 12

Tool	Description	Who does it apply to?	Where can I read more in the CP for solo regulated firms?	Where can I read more in the CP for insurers?
Senior Manager Conduct Rules	These are additional Conduct Rules that apply to all Senior Managers. Firms need to train Senior Managers so they understand what the Conduct Rules are and how they apply to them. Firms will need to report breaches of all Individual and Senior Manager Conduct Rules by Senior Managers resulting in disciplinary action to us within 7 days.	All firms	Chapter 7	Chapter 6 paragraph 8
Senior Managers	The people who perform a Senior Management Function. These people need our approval to do their jobs.	All firms	Chapter 4 paragraph 12 and 15; chapter 8 paragraph 16; chapter 9 paragraph 2 and 9	Chapter 3 paragraph 4
Senior Managers Regime	The part of the regime for Senior Managers. This includes Senior Management Functions, Statement of Responsibilities, Duty of Responsibility, Fit and Proper, Conduct Rules, Prescribed Responsibilities, Regulatory References and criminal records checks. For Enhanced Firms, it also includes Responsibilities Maps, Handover Procedures and Overall Responsibility.	All firms	Chapter 4; chapter 8 and chapter 9	Chapter 3
Statement of Responsibilities	A document that every Senior Manager needs to have that sets out what they are responsible and accountable for. This needs to be submitted to us when a Senior Manager is being approved, and be kept up to date.	All firms	Chapter 4 paragraph 16	Chapter 3 paragraph 69

Counterfactual

2.43 The costs and benefits of the SM&CR need to be assessed against an appropriate counterfactual in order to provide a baseline against which to consider possible costs. We have considered other ongoing regulatory initiatives and believe that the current market conditions, where firms are subject to the Approved Persons Regime, is an appropriate counterfactual.

3 Compliance costs and costs to the FCA

Introduction

3.1 In this chapter we present estimates of the compliance costs solo-regulated firms and insurers will incur as a direct result of the proposed SM&CR. Firms will incur both one-off and ongoing costs as a consequence of the proposals.

3.2 We also estimate the costs that the FCA will incur from implementing the new regime.

Measuring the costs

3.3 Firms incur compliance costs in meeting the requirements placed on them by regulators. For example, additional staff time may be required for training and supervision, or because new IT equipment is needed to document compliance. Some of these costs are one-off costs (for example, system changes), while others will be incurred on an ongoing basis (for example, certification or training on Conduct Rules for new joiners).

3.4 To assess these costs, we sent questionnaires to about 2,000 firms, on a legal entity level.[18] We received responses from 255 firms. We discarded 28 responses where firms had either obviously misunderstood the purpose of the survey or provided incomplete responses. We used responses from 190 solo-regulated firms and 37 insurers in our analysis. As there are fewer solo-regulated firms that will fall in the Enhanced Regime, and fewer small non-directive insurers (NDFs), there were fewer responses from these categories of firms.

3.5 For sampling purposes, to ensure that firms in the different policy regimes (Limited Scope, Core, Enhanced and insurers)[19] were sufficiently represented, we used the current number of approved persons (APs) as proxies for the complexity of their governance and scope for harm deriving from potential misconduct. Since details of the proposed policy had not been finalised when we issued our survey to firms in September 2016, it was not possible to consider the factors that determine which regime a firm has to apply in the sampling process.

3.6 We split the firms in scope of the SM&CR proposal into six categories according to the number of Approved Persons they employ and drew random samples from the six categories. We used the number of Approved Persons as an indicator of regulatory complexity, which would increase the costs of the regime. Sampling across these categories, we sought to ensure that we received cost information from a range of firms that reflected the variety of firms in the industry.

18 To increase the number of expected responses by insurers the original sample of 1,740 firms contacted on 28 September 2016 was enlarged by a further sample of 276 insurers on 2 November 2016.

19 See the 'Glossary' in Chapter 2 for how we define Limited Scope, Core, Enhanced and insurance firms.

3.7 Table 3 below summarises the number of firms in each sampling category (and the number of firms drawn on a legal entity basis) and responses received. The table shows the number of firms in the different regimes for the population in scope, the sample and the resulting dataset.

Table 3: Number of firms in the population, sample and survey data

Category	Number of Approved Persons	Number of firms in population	Number of firms in sample	Number of responses used in analysis
1	0–2	36,660	648	42
2	3–4	4,430	337	41
3	5–8	3,340	360	52
4	9–29	2,420	423	56
5	30–59	300	128	19
6	60+	280	120	17
Total	Not applicable	47,430	2,016	227

FCA analysis.

3.8 Table 4 presents the same data as Table 3 but this time it's presented by the different policy regime proposed and includes the estimated number of employees based on our survey data in scope for each regime. Note that for Limited Scope firms, the number of employees presented is total across the firms, rather than number in scope of the Regime. This is because the Conduct Rules will only apply to financial services (or related ancillary) activities, which is typically a subset of employees in limited scope firms.

Table 4: Number of firms in the population, sample and survey data

Policy regime	Number of firms in population	Number of employees in population, thds*	Number of firms in sample	Number of responses
Limited Scope	32,800	2,497	707	67
Core	13,720	301	920	113
Enhanced	350	233	61	10
Small NDF insurer	170	10	84	6
Large NDF and Solvency II insurer	390	187	244	31
Total	47,430	3,228	2,016	227

FCA analysis. *Estimated based on survey data. Due to the small number of responses the estimate for Small NDF insurers is not reliable (see paragraph 3.58 for details). A number of firms have not stated the number of employees in their response to our survey and are hence not included in the estimation of the number of employees.

3.9 We have weighted the survey responses so that the weighted survey data accurately reflect the characteristics of the population.[20] We expected more complex firms to incur more costs from complying with our proposals. Further, some types of firm were much more likely to respond than others. The weighting of responses ensured that our

20 We regressed an indicator for having responded (taking the value 1 if so and 0 if not) on these characteristics and used the inverse predicted values of this logistic regression as the survey weights. We thank Susan Purdon for advice on the calculation of the survey weights.

estimates of the overall costs to industry were not biased by the differing complexity of firms or the varying levels of response rates for different types of firms.

3.10 To weight the survey responses and so ensure that the sample was representative of the population of firms, we used the following characteristics:

- FCA supervisory portfolio (ie whether the firm is in the fixed or flexible portfolio)[21]
- whether the firm is regulated only by the FCA or by the FCA and PRA
- whether the firm is a large insurer (ie Solvency II or large NDF) or a small NDF insurer
- categories used for sampling
- whether the firm is a sole trader or limited permission consumer credit firm

3.11 We asked firms for estimates of the costs caused by the different SM&CR elements (for example, Senior Manager Functions, Significant Harm Functions, Criminal Records Checks and Conduct Rules).

3.12 We used the weighted survey data to calculate average one-off compliance costs and annual ongoing compliance costs for firms (on a legal entity basis) in the different regimes and used the number of firms within these regimes to scale up these costs to estimate costs for the whole industry. Costs to the FCA are based on estimates provided by the FCA's Project Management team.

3.13 In our survey we asked firms about eight ways they may incur costs to implement each of the eleven policy elements[22], on a one-off and on an ongoing basis. These included changes to organisational structure, required adjustments (most commonly hiring new staff), training costs, staff monitoring, staff time, IT changes, and record keeping. The breadth of these questions, with an 'other cost' category, will mean all the compliance costs for implementing the regime should have been captured.

3.14 Where we are proposing that an element be disapplied for specific types of firm, these costs have not been used for the estimates below. Eg sole traders do not have to implement the Prescribed Responsibilities requirement.

3.15 Overall our approach has sourced cost estimates directly from firms who will be affected by our proposals. We have used this data to estimate overall costs. Considering the limitations discussed below we have calculated two types of estimates,

- the '**reported estimates**' based on the cost figures as provided by firms: these estimates have not been moderated down other than in a small minority of cases where there were obvious misunderstandings

21 Firms in the fixed portfolio have closer contact with supervisors since misconduct, or other problems, would likely imply greater scope for harm (to consumers, market integrity or competition in the interest of consumers) than in firms in the flexible portfolio; see the FCA website for details.

22 Senior Manager Functions (SMFs), Statement of Responsibility, Prescribed Responsibilities and Criminal Record Checks, Regulatory Reference checks for SMFs, Significant Harm Function (SHF), Regulatory References for SHFs, Conduct Rules and the enhancements (Responsibilities Maps, Allocation of Overall Responsibility and Handover Arrangements).

- the '**revised estimates**' where we have omitted cost items which, in our view, appeared unlikely to arise when implementing the given policy element; see paragraphs 3.22 to 3.40 for details.

Considering the limitations to both types of estimates (discussed below) we believe that the revised estimates are closer to the true costs to firms. For that reason we present these estimates in the relevant CBA chapters and present the reported estimates in Annex 1.

Limitations

3.16 Our CBA estimates are subject to a number of uncertainties.

3.17 **Misunderstandings of policies results in reporting inaccuracies:** This is a new regime with new concepts for the majority of firms in scope. Our analysis of firms' responses suggests that some firms may have misunderstood elements of the policy and misinterpreted how they will apply or the extent to which they will replace existing compliance activities (such as training on current requirements of the APR), thereby resulting in inaccurate cost estimations.

3.18 **Small sample size reduces reliability:** There is uncertainty when collecting data from a small number of firms to reflect a large and diverse population. We've weighted responses to make the sample as representative as possible for the firms in scope of the proposed policy and make our estimates as representative as possible of industry costs. However, there may be some unobservable characteristics of firms that affect the costs of implementation, for which we have not controlled. We also note that for some parts of the regime the number of responses is low, increasing the uncertainty around the estimates for these elements. For small NDFs and small insurers in run-off, the low number of responses has meant we have not been able to model reliable cost estimates (see also paragraph 3.58).

3.19 **Costs assumed as additive rather than incremental:** While we have added up the costs of the individual elements, the costs that firms incur in practice to implement one element of the regime may, in some instances, reduce the cost of implementing other elements. However, as we have no evidence for this effect we have not attempted to account for this in the estimates. We have assumed that all costs are additive.

3.20 **Incentive to over-estimate:** We note that firms might prefer a less onerous regime and might overstate the costs of the different elements.

3.21 **Difference between survey and policy results in cost overestimation:** We carried out the survey before our policy was finalised in order to inform our consideration of different policy options. Therefore, the proposals in CP 17/25 and CP 17/26 differ, sometimes significantly, from the regime described in the survey documents. For example, under our proposals for core firms, only the Chair needs approval, but non-executive directors chairing committees do not (while non-executive directors chairing committees in banks need approval). Similarly, whilst Limited Scope firms will have to implement the elements of the Core Regime, in some cases the application will be partial (for example, often only one Senior Management Function will apply to them, and the conduct rules will apply only to financial services staff).

Since the proposed regime has fewer requirements than the regime described in the survey documents the estimates presented below tend to be an overestimate of the true costs. The reported costs presented in Annex 1 are almost certainly over-estimates of the likely true costs.

Revised estimates

3.22 Given the number of limiting factors described above, we have also calculated 'revised estimates'. However we recognise that this methodology as described below also has limitations, predominantly that in the revised estimates we have excluded the cost category 'changes to the organisational structure' for some policy elements. This may reduce the costs to a greater extent than intended because some firms have reported total costs in this category. We have not attempted to split these total costs across cost categories ourselves since there was no justifiable way of doing so. Moreover, some firms appear to have allocated the total costs by attributing equal amounts to each cost category.

3.23 Given this limitation tends to result in underestimates, whilst the other general limitations tend to result in overestimates, we believe the revised estimates more closely reflect the costs that firms will incur in practice on a one-off and ongoing basis.

3.24 When considering the cost estimates for the eight cost categories and eleven policy elements (see paragraph 3.13), we believe that some of the numbers reported to us in the survey are unlikely to be incurred by firms in practice. We have therefore attempted to identify these and excluded these costs from the 'revised estimates' presented in Tables 6 to 12 and 16. The section below explains which cost categories we have discounted.

Elements of the Senior Management Regime

Senior Manager Functions (SMFs)

3.25 The SM&CR proposals in our CP do not require firms to reorganise themselves or hire new people to fill specific roles. However, we recognise that some firms may wish to use the implementation of the SM&CR as an opportunity to make changes to their governance arrangements in order to ensure clarity of responsibilities. Therefore firms may incur one-off costs through changes to organisational structure and required adjustments, such as recruitment or redundancies. However, we do not think it is likely that firms will incur such costs on an ongoing basis. Therefore, our revised estimates discount ongoing costs for changes to the organisational structure.

Other elements of the Senior Managers Regime

3.26 There are a number of other requirements in the SM&CR that flow logically from SMFs, namely Statements of Responsibilities and Prescribed Responsibilities. These are policy elements that, once a firm has established its SMFs, need to be provided in line with that structure, for example by documenting the responsibilities of Senior Managers in a Statement of Responsibilities or by allocating the Prescribed Responsibilities. These activities by themselves do not result in any organisational restructuring or related adjustments (in practice firms will not restructure themselves multiple times). Similarly firms will not need to monitor staff independently for each of these elements of the SMR separately.

3.27 Therefore, our revised estimates discount any one-off or ongoing costs provided by firms for changes to the organisational structure, required adjustments and staff monitoring associated with Statements of Responsibilities and Prescribed Responsibilities.

3.28 Similarly, there are three policy elements which only apply to enhanced firms: responsibilities maps, allocation of overall responsibility and handover procedures. As with Prescribed Responsibilities and Statements of Responsibility, these elements flow from the SMF structure once established, and do not by themselves require restructuring, adjustments or monitoring. Therefore our revised estimates discount any one-off or ongoing costs provided by firms for changes to the organisational structure, required adjustments and staff monitoring associated with those three enhanced policy elements.

Fit and proper requirements

3.29 Firms are currently required to provide a regulatory reference to another firm on request. We therefore believe it is likely that firms will have the infrastructure already in place to provide references, making any ongoing costs of organisational requirements or required adjustments negligible. However we acknowledge that firms may wish to make organisational changes or required adjustments at commencement of the Regime, for example by hiring more staff in their HR department, to reflect that firms must both seek and provide references for all roles in scope of these rules. Therefore our revised estimates retain the costs associated with organisational structure and required adjustments on a one-off basis but discount them on an ongoing basis. We have done this for references associated with both Senior Managers and Certified staff.

3.30 Furthermore, we do not believe that regulatory references will, in and of themselves, result in any additional staff monitoring costs either on a one-off or ongoing basis. References should reflect internal records that are already required by other elements of the regime such as fit and proper checks for a certified staff member, or conduct rule breaches. Our revised estimates therefore discount any one-off or ongoing costs associated with staff monitoring of regulatory references (for Senior Managers and Certified staff).

3.31 We believe that criminal record checks will not require changes in the organisational structure because they relate to individuals and whether they are fit and proper, not how the business is organised. Similar to references, we acknowledge that firms may wish to make adjustments at commencement of the Regime to reflect that such checks are now mandatory (for example by hiring more HR staff), however we do not think that these costs will be incurred on an ongoing basis in practice. Likewise, training on the details of the criminal record checks required under the SM&CR may be necessary when these are introduced, but ongoing training on these changes will replace training on current requirements so will most likely not give rise to ongoing costs over and above the costs for complying with the current regime.

3.32 Hence our revised estimates discount the one-off and ongoing costs for changes to the organisational structure, as well as the ongoing costs for required adjustments and training associated with criminal records checks.

Significant harm functions (SHFs)

3.33 As with SMFs, some firms may wish to use the introduction of SHFs as an opportunity to make changes to the organisational structure in order to ensure that appropriate

groups of people become SHFs. Therefore they may incur one-off costs for changes to the organisational structure and other required adjustments, but we do not think that these structure changes or adjustments will be required on an ongoing basis. Therefore our revised estimates discount the ongoing costs provided by firms for changes to organisational structure or required adjustments associated with SHFs.

Conduct Rules

3.34 Some firms stated costs for changes to the organisational structure from the conduct rules. We do not believe that such changes would be required in practice. Our revised estimate therefore discounts one-off and ongoing costs for such changes. Some firms also reported costs for required adjustments. However it is not clear why such adjustments would give rise to ongoing costs. We have therefore discounted these ongoing costs as well.

3.35 Firms may have underestimated the extent to which they can amend existing training on appropriate behaviour and compliance with the APR, to provide training on Conduct Rules. Since this will lead to one-off costs only, we have discounted ongoing training costs (if any) in the revised estimates.

IT systems

3.36 We acknowledge that some firms will need to make adjustments to their IT systems when they implement the new regime, for example to capture new roles or requirements. However, we do not think that firms will need to update these systems on an ongoing basis, over and above the existing maintenance that would be required. Therefore, our revised estimates discount ongoing costs associated with IT system changes.

Lower bound of the revised estimate

3.37 There are additional cost categories that we are sceptical will actually arise. Therefore, we also present below estimates discounting these additional cost categories as lower bounds of our revised estimates.

3.38 Firms may adapt their existing training to cover the different aspects of the proposed regime. If so, they will not incur ongoing training costs over and above the ongoing training costs which they already incur for the current regime.

3.39 In practice, we believe firms will have a single team or person dealing with regulatory references for both SMFs and SHFs. Firms are also likely to use a single IT system for these. We therefore see scope for double counting by including one-off costs for changes to IT systems and one-off costs for training for both SMFs and SHFs. As a result we have discounted these cost categories for SHFs (but retained them for SMFs).

3.40 Moreover, since the new requirements regarding criminal record checks for SMFs and regulatory references for SMFs and SHFs will likely require only one-off changes to the checks and processes a firm currently carries out, we believe that firms may not incur ongoing costs for increased record keeping for these policy elements.

Compliance costs for solo-regulated firms

3.41 Below we present the revised estimates calculated excluding cost categories that are unlikely to be borne in practice, and the lower bounds of these estimates (as discussed above). For the reasons explained in paragraph 3.15 and 3.23 we believe these are a better reflection of the true costs firms will incur to comply with the proposed policy. The estimates including all the cost figures as provided by firms are included in Annex 1.

3.42 Table 5 shows the number of solo-regulated firms that will fall under the different regimes.

Table 5: The number of solo-regulated firms in each regime

Regime	Number of firms
Limited Scope	32,800
Core	13,720
Enhanced	350
Total	46,870

Source: FCA internal data.

3.43 The majority of firms will be Limited Scope firms. A significant number of firms are in the Core Regime and only a very small proportion of firms are in the Enhanced Regime.

3.44 Firms in the Core tier will need to implement all the elements in the Core Regime, while the approximately 350 firms in the Enhanced tier will have to implement both the Core and Enhanced elements.

3.45 The Limited Scope tier covers sole traders, limited permission consumer credit firms, general insurance intermediaries whose regulated business is secondary to their main business activity (secondary general insurance intermediaries), as well as a number of other types of smaller firms.

3.46 Limited Scope firms will have to implement most of the elements of the Core Regime, but in some cases the application will be partial (for example, only one Senior Management Function will apply to them). In the survey, we asked these firms to report the cost for the full suite of the functions, even though they will probably incur lower costs due to this partial application. Therefore the costs they reported are an overestimate of their actual costs in practice. It is not possible to identify the costs of the narrower scope of the requirements for Limited Scope firms from the survey.

3.47 Sole traders, limited permission consumer credit firms and secondary general insurance intermediaries also won't have to implement the Prescribed Responsibilities element of the regime. This is reflected in the cost estimates presented below.

Overall costs to solo-regulated firms

3.48 Table 6 shows the overall industry-wide costs for all solo-regulated firms, broken down into one-off and ongoing costs for Limited Scope firms, Core firms and Enhanced firms.

Table 6: Total one-off and annual ongoing costs for the regime for all solo-regulated firms

Regime	one-off, £m	Ongoing, £m
Limited scope	194.3 – 196.3	65.4 – 81.1
Core	190.5 – 193.1	53.2 – 76.0
Enhanced	162.2 – 162.9	21.5 – 33.5
Total	547.1 – 552.3	140.0 – 190.5

Source: FCA survey of firms (undertaken Q4 2016).

The costs of the Core and Enhanced requirements

3.49 Tables 7 and 8 show the average one-off and annual ongoing compliance costs per firm and the total for solo-regulated firms (46,870). The tables report the average costs for the firms in the Core Regime, Limited Scope, and Enhanced Regime in complying with all the Core and Enhanced requirements (Senior Managers Regime, Certification Regime and Conduct Rules).

3.50 Responsibilities maps, allocation of overall responsibility and handover arrangements have been separated from 'Senior Managers Regime' as these are only applicable for Enhanced firms.

Table 7: Average one-off costs per firm and total one-off costs for all solo-regulated firms for the different policy elements by requirement
***Note:** (Columns may not sum to their totals due to rounding)*

Element	Limited Scope, per firm £	Core, per firm £	Enhanced, per firm £	Total for all solo-regulated firms, £m
Senior Managers Regime	3,620	8,640	227,210	316.3
Certification Regime	1,390 – 1,450	2,730 – 2,920	203,140 – 205,020	153.6 – 158.8
Conduct Rules	910	2,510	23,820	72.5
Responsibilities Maps	na	na	5,480	1.9
Allocation of overall responsibility	na	na	3,710	1.3
Handover Arrangements	na	na	4,110	1.4
Total	5,920 – 5,980	13,880 – 14,070	467,470 – 469,350	547.1 – 552.3

Source: FCA survey of firms (undertaken Q4 2016). Costs from Prescribed Responsibilities do not apply to Limited Scope firms and are hence excluded from the calculations. Where we present one figure for the revised estimate this is because the two figures are the same.

Table 8: Average annual ongoing costs per firm and total annual ongoing costs for all solo-regulated firms for the different policy elements by requirement

Element	Limited Scope, per firm £	Core, per firm £	Enhanced, per firm £	Total for all solo-regulated firms, £m
Senior Managers Regime	1,020 – 1,390	2,010 – 3,260	43,920 – 76,540	76.3 – 116.8
Certification Regime	510 – 630	1,040 – 1,450	11,450 – 12,280	35.1 – 44.7
Conduct Rules	460	820	5,590	28.3
Responsibilities Maps	na	na	420 – 1,010	0.1 – 0.4
Allocation of overall responsibility	na	na	140 – 590	0.0 – 0.2
Handover Arrangements	na	na	350 – 490	0.1 – 0.2
Total	1,990 – 2,470	3,870 – 5,540	61,870 – 96,500	140.0 – 190.5

Source: FCA survey of firms (undertaken Q4 2016). Costs from Prescribed Responsibilities do not apply to Limited Scope firms. Columns may not sum to their totals due to rounding. Where we present one figure for the revised estimate this is because the two figures are the same.

Costs of the Enhanced requirements

3.51 A small number of firms will have to implement the three additional elements required under the Enhanced Regime (responsibilities maps, allocation of overall responsibility and handover arrangements). The estimated costs of implementing these are set out in Tables 7 and 8. We've estimated that 350 firms will have to implement these Enhanced elements.

3.52 Firms in the Enhanced Regime will also need to get an additional number of Senior Management Functions approved, as well as allocate additional Prescribed Responsibilities to their Senior Managers.

3.53 In our survey, we asked firms to estimate costs for these Enhanced elements, in addition to the costs they would incur from implementing the Core requirements. However, we only received responses from ten firms in the Enhanced Regime. As a result, we conclude that the cost estimates for the Enhanced elements are less reliable than those for firms in the other regimes.

Costs for insurers

3.54 Table 9 shows the number of insurers that will fall under the proposed regime.

Table 9: The number of insurers in each regime

Regime	Number of firms
Small NDFs and ISPVs	170
Solvency II firms and Large NDFs	390
Total	560

Source: FCA internal data (September 2016).

3.55 Small NDFs and Insurance Special Purpose Vehicles (ISPVs) are subject to a streamlined regime compared to Solvency II firms and Large NDFs. For example,

responsibilities maps, allocations of overall responsibility requirements and handover arrangements will not apply to small NDF insurers.

3.56 Large NDFs and Solvency II firms are subject to additional requirements.

Overall costs to insurers

3.57 Table 10 shows the overall industry costs for all dual-regulated insurers.

3.58 The regime for small NDFs will also apply to small insurers in run-off.[23] Although we contacted all small NDFs and 23 of the 42 small insurers in run-off, we had only six responses to our survey from these insurers, two of which were from small insurers in run-off.[24] Further, the costs reported by these six firms varied considerably, with three firms reporting zero costs for the proposals, and others reporting £72,900 for one-off costs and £86,900 for ongoing costs (the highest estimates). This large variability might be plausible because the regime applies to different types of insurers. However, given the variability of the cost estimates and the small number of responses, we consider that the averages for the six firms are not reliable estimates of the one-off and ongoing compliance costs for small NDFs and small insurers in run-off.[25] The costs for small NDFs and small insurers in run-off, and the total costs below are reported only for information, in compliance with FSMA. This problem does not arise for other types of insurers (ie Solvency II and large NDFs), where there is less variability as we received many more responses.

Table 10: Total one-off and annual ongoing costs for the regime for insurers, £m

Regime	one-off, £m	Ongoing, £m
Small NDFs and small insurers in run-off*	0.8 – 0.9	0.6
Solvency II and large NDFs	8.0 – 8.1	2.6 – 3.5
Total	8.8 – 8.9	3.2 – 4.1

Source: FCA survey of firms (undertaken Q4 2016). *As explained in paragraph 3.58 the cost for small NDFs and small insurers in run-off are not reliable. Where we present one figure for the revised estimate this is because the two figures are the same.

3.59 Our survey asked insurers to report the additional costs they would incur in implementing the proposed regimes. These costs should be in addition to costs incurred in implementing the Senior Insurance Managers Regime (SIMR), which is already in place. Some insurers may have reported the costs of implementing the SIMR in their costs and so may have overstated their costs.

The costs of the SM&CR tools

3.60 Table 11 and Table 12 show the average one-off and annual ongoing compliance costs, per dual-regulated insurer and for all dual-regulated insurers. The average costs per firm for the baseline tools apply to all insurers (560). Solvency II firms and large NDFs will also be subject to additional requirements (responsibilities maps, allocation of overall responsibility and handover arrangements). We have estimated that 390 Solvency II firms and large NDFs will have to implement these additional elements.

23 Insurers in run-off are considered to be small if they have technical provision or reserves of £25m or less. The policy proposal applicable to those firms was decided after the survey.

24 We note that we increased our sample of insurers to increase the number of responses from insurers (see footnote 16). Notwithstanding this, we received very few responses overall.

25 For the same reason the difference between the compliance costs for all insurers and for large insurers is not a reliable estimate for the compliance costs of small insurers.

Table 11: Average and total one-off costs for all insurers by requirement

Element	Average one-off costs per insurer, £	One-off costs, all insurers, £m
Senior Managers Regime	8,110	4.5
Certification Regime	1,850 – 2,060	1.0 – 1.1
Conduct Rules	4,220	2.3
Responsibilities Maps*	680	0.4
Allocation of overall responsibility*	330	0.2
Handover Arrangements*	660	0.4
Total	15,860 – 16,070	8.8 – 8.9

Source: FCA survey of firms (undertaken Q4 2016). *These elements apply only to large NDFs and Solvency II insurers. The difference between the costs reported here and the figures reported in Table 10 will not provide a reliable estimate of the costs for NDFs, for the reasons set out in paragrpagh 3.58.

Table 12: Average and total annual ongoing compliance costs for all insurers by requirement

Element	Average ongoing costs per insurer per year, £	Ongoing costs, all insurers per year, £m
Senior Managers Regime	2,680- 3,820	1.5 – 2.1
Certification Regime	690 – 1,010	0.4 – 0.6
Conduct Rules	1,420	0.8
Responsibilities Maps*	580 – 700	0.3 – 0.4
Allocation of overall responsibility*	190 – 250	0.1
Handover Arrangements*	250	0.1
Total	5,820 – 7,460	3.2 – 4.1

Source: FCA survey of firms (undertaken Q4 2016). *These elements apply only to large NDFs and Solvency II insurers. The difference between the costs reported here and the figures reported in Table 10 will not provide a reliable estimate of the costs for NDFs, for the reasons set out in paragrpagh 3.58.

Costs to the FCA

3.61 The FCA will incur additional short-term costs as the regime is developed and implemented. These costs are set out in Table 13. They will be recouped through fees to industry. Firms might pass these costs on to consumers in the form of higher prices.

3.62 The FCA will have to develop the policy surrounding the proposals, leading to the publication of final rules via a Policy Statement. These are captured within the staff costs in Table 13.

3.63 Leading up to commencement, there will be an increase in staff costs as the FCA will need to support firms transitioning from the current APR to the new SM&CR, including processing applications for approval of new Senior Managers required from the start of the new regime. We expect that the majority of these staff costs will be incurred in the 2 years before the introduction of the regime. Some of the staff will be reassigned and some will join on a temporary basis to help with the implementation.

3.64 The FCA will also incur costs in developing the IT infrastructure to support the implementation of the new regime.

3.65 Further, given the scale of the regime, in the period up to implementation and the period afterwards, the FCA will provide training and communications to its staff and also provide communications to industry.

Table 13: Costs to the FCA from implementing the regime

Year	FCA staff costs, £m	IT system change costs, £m	Training, Communication and consultancy costs, £m	Total, £m
Year 1	0.8	-	-	0.8
Year 2	2.8	0.9	0.9	4.6
Year 3	3.3	1.9	0.9	6.1
Year 4	1.0	0.8	0.1	1.9
Total	7.9	3.6	1.9	13.4

Source: FCA data. IT system change costs include contingency. Each year represents a financial year (April to March) up until the Regime is implemented.

3.66 Following the implementation, there's not expected to be any significant change in the level of resources used by the FCA, relative to the costs of regulating the current regime.

4 Indirect costs and wider impact

Introduction

4.1 This chapter sets out the indirect costs of implementing the proposed policies. Indirect costs come from people altering their behaviour as a result of the policy, rather than as a direct result of complying with the policy itself. For example, placing higher levels of responsibility on Senior Managers may mean some leave financial services, increasing recruitment costs.

4.2 The extension of the SM&CR to solo-regulated firms and insurers will have significant indirect impact on markets. This is due to the number of firms affected by the new regime, as well as the extent of the policies themselves and the changes they're designed to bring about.

4.3 The SM&CR may bring about indirect costs through increased employee monitoring and operational inefficiencies, caused by changes to peoples' behaviour and incentives (including from over-reactions, see below). There may also be an impact on competition in some markets but these will be market specific and may be positive or negative (we discuss the benefits to competition in Chapter 5). We might also expect some potential consequences for the labour market.

4.4 We have not estimated the indirect costs or wider market changes. This is because these costs cannot be reasonably estimated nor is it reasonably practicable to produce an estimate of them.

4.5 The impact of the new regime on the wider market is highly complex and inherently uncertain. Further, attempting to develop an estimate of these costs and impact would mean significant data collection from firms across the industry, creating costs for firms and, even then, may not lead to meaningful estimates. As a result, it is not possible to provide an estimate of these effects.

4.6 In our survey, we asked about other expected effects for firms and the wider market, and we have used these responses to inform our analysis.

4.7 In this section, we discuss how both solo-regulated firms and insurers may be affected by complying with the new regime.

Operational efficiencies

4.8 Operational efficiency is achieved when a firm's resources are allocated in such a way that produces the highest level of output possible. Regulatory changes may alter operational efficiency by changing behaviour in firms and staff.

Monitoring of staff and activity

4.9 By increasing accountability for individuals within firms, staff (especially Senior Managers) will have more responsibility for managing risks in their areas. Managers are likely to respond to this increase in responsibilities by increasing the monitoring activity so, for example, increasing reporting and sign-off procedures.

4.10 This increased monitoring could be beneficial for firms, as increased monitoring of decision making and behaviour would increase compliance with regulation and potentially improve business decision making (for example, firms may identify problems and issues earlier).

4.11 There could be additional costs as resources are diverted away from other, more profitable activities. This may result in a less efficient allocation of resources. For example, firms' managers may devote excessive resources to monitoring the areas they're responsible for (beyond what is required to implement the proposed policy), and lose focus on the wider performance of their business. However, despite these factors the overall effect is unclear.

Firm decision making

4.12 As individuals will face greater responsibility and accountability for their actions and decisions, it's likely that this will change how decisions are made by Senior Managers and other decision makers within firms. This is one benefit of the regime but it has the potential to reduce the quality of decision making within financial services.

4.13 One respondent to our survey said 'the FCA should reflect on whether creating an overly prescriptive regime risks narrowing the focus of Senior Managers (particularly Non-executive Directors) to the point where they are unable to apply their skills and experience to the best advantage of firms and their customers. While we expect Senior Managers to focus on the proposed regime, they still have strong incentives to manage firms in the interests of the firm and its owners. Further, the requirements of the regime are proportionate to the complexity of individual firms and the risks they pose to consumers from misconduct.

Competition

4.14 We do not expect a significant net change in competition, although there may be several effects pulling in different directions. Some of the impacts will lead to positive changes (discussed below) but there may also be a reduction in competition in some markets.

Product innovation

4.15 Increased accountability at the senior level of a firm may affect innovation in two ways.

4.16 There is the risk of delay to innovation through process change (eg more stringent internal review and sign off). In the extreme, there is also the possibility that innovation is foregone entirely due to changes to incentives and behavioural change (eg Senior Managers are less willing to take risks and more hesitant to commit to innovations). There is in fact evidence from other industries that regulation can delay and prevent innovation. As such, innovation in financial services has not always led to improved outcomes for consumers. For example, payment protection insurance (PPI) sold

alongside credit was an innovation that did immense harm to consumers. As a consequence of the proposals, we might see less of this type of harmful innovation.

4.17 However, it has also been recognised that regulation can also foster innovation. Under the proposals we might expect the innovation that occurs to have larger benefits for consumers, rather than innovations that increase profits at the expense of consumers. The FCA supports such innovation through initiatives such as project Innovate.

Firm exit and barriers to entry

4.18 One concern is that the costs of implementing the regime may lead to firms leaving the market. Smaller firms may be particularly vulnerable, where the fixed costs of compliance may be a larger proportion of profits. However, this may be less of a concern than might be expected, given the size and overall cost of the regime, for several reasons.

4.19 Firstly, smaller firms will be less complex and, therefore, the costs of implementing any individual element of the regime will be smaller. Secondly, we're proposing a tiered approach and so smaller firms will generally incur smaller costs than larger ones.

4.20 However, we still might expect some firms to close down, or exit regulated financial markets, as a result of the effect of the regime, as the additional costs makes them unprofitable.

4.21 Even if there is an increase in firm exit, it's unlikely that this will materially affect competition in financial markets. We would need a significant player or a large number of smaller firms to leave to create concerns about a significant reduction in competition. Importantly, we are unlikely to see a negative effect on competition that is in interest of consumers, if firms that cannot meet basic standards leave the market.[26]

4.22 The one exception to this is for those sectors where financial services are ancillary to non-financial products (for example, a car dealership that offers credit). These firms may decide to stop offering financial services products, even in the face of a small increase in compliance costs, due to the small margins inherent in ancillary services, possibly causing a loss of convenience to consumers. In sectors such as this we may see some change in the structure of the market. However, we still expect that such changes would not materially affect competition in these markets.

4.23 Increasing the fixed costs of providing financial services will also discourage market entry, particularly at the margins. As we note above, the costs of the proposals do vary with complexity of the firm but are not materially affected by changes in the scale of the firm. We might expect, therefore, a reduction in the number of firms entering the industry.

4.24 The SM&CR will apply to all FCA FSMA-authorised firms. On the one hand, this may raise standards of conduct and firm culture across the board, increasing the integrity of the domestic market, making products and services more attractive to consumers and drawing in foreign investment and business. On the other hand, it will increase costs for domestic firms, which may result in domestic firms being put at a competitive disadvantage against foreign firms. This may be a particular concern to larger firms, whose senior staff tend to be more internationally mobile.

26 The FCA has a duty to promote effective competition in the interests of consumers (FSMA, Section 1E).

Loss of certain individuals from the Financial Services Register

4.25 One of the consequences of the proposals is that the number of pre-approved persons will be far smaller, with the FCA focussing the regulatory 'gateway' on Senior Managers. As a result, many of those Approved Persons currently on the Financial Services Register[27] (the Register), will become Significant Harm Functions (SHFs) under the SM&CR and therefore not need to be pre-approved by the FCA[28], or be on the Register.

4.26 The loss of these people from the Register was of particular concern to several survey respondents. Some were worried that the new regime may not adequately replace the guaranteed benchmark of authenticity which the Register provides. A survey respondent commented that '[I]t is vital to the financial adviser market that the FCA retains its controls on publishing the FS Register as this is an important guard against fraudsters as a place to validate the qualification and authorisation of individuals.'

4.27 Some consumers use the Register to check that an adviser is legitimate and qualified to provide advice. Removing this information could, therefore, make it harder for smaller firms to gain the confidence and business of consumers.

4.28 It's not clear how important the Register is for consumers, even if they currently use it to check an advisor's status. We don't have data evidencing the extent to which consumers and industry use the Register to help assess the people they're dealing with, or whether these data add significant information over and above other sources.

4.29 The Senior Managers of authorised firms will still be on the Register, and consumers can check if a particular adviser is certified by calling an authorised firm directly.

Impact on price and quality

4.30 Some of the costs of implementation may be passed on to consumers in the form of higher prices.[29] However, this effect will be far from uniform. The degree to which consumers pay these costs, rather than firms through lower profits, will depend on the intensity of competition.

4.31 Some markets will experience lower prices as exploitative behaviour is reduced under the regime and prices fall, even with significant compliance costs. Further, where our rules increase competition, as well as improve standards in firms and compliance, both now and in the future, they will lead to lower prices for consumers.

4.32 The quality of products and services offered to consumers is likely to increase as a result of the changes proposed. Higher standards of conduct and compliance within firms and across the industry are likely to deliver better value and quality, which consumers value. With lower levels of misconduct, consumers will get the products they expect. Service levels are also likely to improve and, where things do go wrong, matters will be resolved more quickly.

27 The Financial Services Register is a public record that shows details of firms, individuals and other bodies that are, or have been, regulated by the Prudential Regulation Authority (PRA) and/or the Financial Conduct Authority (FCA), see https://register.fca.org.uk/.

28 We discuss the resulting cost savings in the Chapter on benefits (from paragraph 5.29).

29 See OFT, Cost pass-through: theory, measurement and potential policy implications 2014. Available here.

Labour market effects

Wage compensation

4.33 The SM&CR will increase accountability throughout organisations, with particular emphasis on the top two tiers of the firm's governance. As such, individuals may seek higher wages for taking on more responsibility (and with it potential liability).

4.34 In addition, individuals with skills that are readily used in non-financial markets may have greater bargaining power to increase fixed pay, because they can easily work in other non-financial sectors and would want increased pay to compensate them for the increased accountability in financial services. As such, the proposals could discourage individuals from joining financial services firms as they may prefer to work in other sectors which are not subject to these rigorous requirements.

4.35 If the staff affected perform roles that are fixed costs for firms, such as the CEO, such increases in wages may be easier for larger firms to accommodate as they can spread these costs over a larger number of sales and still maintain profit levels. If, on the other hand, the roles affected are ones where the number of roles varies according to the quantity of sales, then the impact will depend on consumers' demand for the product. Some of these recruitment costs will be passed on to consumers, but the more responsive consumers are to higher prices, the less these costs can be passed through.

Recruitment

4.36 Increasing the accountability of staff at all levels of financial services firms may, all other things being equal, reduce the attractiveness of working in financial services. This will make it harder to attract and retain staff to the firms affected by the proposals. There may be an increase in recruitment costs, as it may be harder and take slightly longer to get suitable candidates into a role.

4.37 Staff may also be more likely to leave their roles and this higher staff turnover will increase recruitment costs. This higher turnover may also lower the quality of staff in financial institutions if this leads to experienced people leaving financial services and new staff having less experience and knowledge of the industry. An opposing effect arises if, as a result of the higher costs of recruiting, individuals move less often between firms and firms delay or avoid these recruitment costs, possibly at the expense of the efficient running of the firm.

4.38 On the other hand, regulatory references increase the amount of information that firms have about prospective employees. This greater knowledge should help firms identify individuals who may not be suitable for their business or who are not suitable to work in financial services. This in turn may improve the profitability of firms – by avoiding unsuitable staff, they are able to deliver better products and services to consumers. One respondent to our survey said the regulatory references and the introduction of the Certification Regime might help to identify potentially harmful staff before they are recruited.

Increase in risk-taking managers

4.39 Contrary to its intention, the SM&CR may increase the proportion of excessive risk-takers at the top levels of firms. Risk-averse people may be put off applying for Senior Manager posts by the perception of increased accountability (and therefore potential liability). This would leave a pool of applicants more prepared to take risks and potentially engage in reckless behaviour, which is precisely the outcome which the proposals aim to avoid.

Wider compliance with regulation

4.40 Some survey respondents questioned the proportionality and complexity of the regime. There was a worry that the FCA has not got the balance between proportionality and simplicity/consistency correct. If many firms can't understand the regime, it is likely that it will not be complied with.

4.41 As noted in the compliance costs sections above, the FCA will provide training and communications to industry to help ensure that firms understand their obligations under the new proposed regime.

4.42 The evidence from tax literature is that a respected and supported regulation system increases compliance.[30] The same is almost certainly true in financial services. If firms disagree with the proposed regime, this has implications for firms' attitude to regulation.[31] If their attitude is positive, firms generally accept that the regulatory framework is fair and justifiable; this makes voluntary compliance more likely. If regulations are seen as unfair and unjustifiable then the response can be a culture of non-compliance and disregard for the regulations. It is also possible that non-compliance for one set of regulations affects compliance with the wider regulatory regime.

Distorted behaviour due to criteria for Enhanced firms

4.43 Firms may try to avoid meeting the criteria that pull them from the Core Regime into the Enhanced Regime. That is, firms would incur costs, or not undertake certain business, if this meant that they would avoid the costs and extra requirements of the Enhanced Regime.

4.44 Given the criteria used and the costs incurred, it seems unlikely that firms would act in this way, as the increase in costs is relatively small, compared to the revenue and profit needed to be a firm in the Enhanced Regime.

30 Heady and Miles 2016.
31 This concept is analogous to "tax morale". See Luttmer and Singhal 2014.

5 Benefits

Introduction

5.1 A robust individual accountability regime can reinforce acceptable standards of behaviours and be a critical factor in deterring misconduct.[32] Ultimately, its main aim is to drive culture change by making Senior Managers accountable and by applying baseline standards to all financial services staff.[33]

5.2 This will result in decreased misconduct and, therefore, benefit consumers and firms, as well as the market as a whole. Our SM&CR proposals share the same framework as the SM&CR for banks. Therefore, benefits established in the CBA for the banking regime have been cited here where relevant.[34]

5.3 The SM&CR will drive the reduction of harm by:

- **Driving up culture and standards** through increased accountability at the senior level supported by a new duty of responsibility on Senior Managers, senior Conduct Rules and the Certification Regime and clarity about each individual's responsibilities, as well as the regime's effect on the likelihood of detecting and sanctioning misconduct more generally (see below).
- **Increasing the likelihood of instances of misconduct being identified** through the application of Conduct Rules and associated reporting requirements, and firm-level assessment of fitness and propriety.
- **Broadening scope for the FCA to take disciplinary actions** through Statements of Responsibilities and Responsibilities Maps,[35] Prescribed Responsibilities, overall responsibilities requirements, and Conduct Rules.
- **Encouraging effective competition** through the consistent application of the Certification Regime and individual Conduct Rules as firms compete on providing good-value products and services to consumers, rather than competing to exploit them.
- **Better decision making within firms** through increased accountability and clarity about each individual's responsibilities.
- **Improved staff hiring processes and professionalism** through regular fit and proper checks, conditional approvals, regulatory references, and reducing the number of pre-approved people.

32 'Regulators should consider developing a culture of accountability in their public messaging, laws, enforcement strategies and prosecutions to punish egregious conduct and reinforce compliant behaviour.' IOSCO 2015, p.32. Available here.

33 'It is in the areas of morality and culture that there is greatest scope for firms to act. At heart, poor culture within a firm amounts to a failure of leadership. Managers influence culture through the tone they set and their expectations of staff, including challenge of poor behaviour and of the norms and beliefs that sustain poor behaviour.' See Iscenko, et al., 2016.

34 Europe Economics 2014, p 4. Available here.

35 Governance Maps will apply to a subset of firms only, ie Enhanced, Solvency II and large non-Directive Firms.

- **Improved trust in financial services** as all of the above will help raise public confidence in the industry as well as clarify the FCA's expectations on firms.

5.4 This chapter explores the above benefits in more detail. We firstly discuss academic studies on the mitigating effect of greater accountability and better governance on different market failures. Secondly, we discuss the cost savings due to the reduced number of people who need to be pre-approved by the FCA, using information requested in our survey.

5.5 We have not attempted to quantify these effects (but for the effect of a reduction of the number of preapproved roles) because we believe that the scale of such benefits cannot be reliably estimated. Even using proxies would have required data across a very large number of firms and products. In our view, the expected lack of reliability of these estimates does not justify the costs to both the FCA and the industry.

Driving up culture and standards

5.6 Culture is both a major driver of, and potential mitigant to, misconduct. The ambition of the SM&CR is that firms' senior management develop and foster a culture that has the fair treatment of customers and market integrity at its core.

5.7 The Senior Managers Regime focuses on Senior Managers, ie key decision makers, board members, executive committee members and individuals below this level if they have ultimate responsibility (under the governing body) and oversight of activities, functions or areas of the business.

5.8 Senior Managers will be subject to a duty of responsibility, ie a statutory requirement to take reasonable steps to prevent regulatory breaches in their areas of responsibility. In addition, we're proposing that Senior Managers must comply with senior Conduct Rules, including taking reasonable steps to ensure that:

- the business is controlled effectively and complies with relevant requirements
- any delegation is made to an appropriate person and is properly overseen
- they disclose appropriately to the regulators any relevant information

5.9 The above requirements encourage good decision making as they help firms to design clear structures and clear areas of responsibility, including because members of staff will likely take action themselves to promote customers' interest or address problems, rather than wait for others to do so. They will also increase the oversight provided by Senior Managers, which in turn may lead to increased training and monitoring of junior staff. Increased monitoring can alleviate information asymmetry and, therefore, the principal agent problem identified in Chapter 2. In the context of culture, research suggests that being tough on small initial infractions to combat incremental wrong-doing could also be effective in achieving a positive culture, and the proposed Conduct Rules appear to be an effective tool to achieve this.[36]

36 Iscenko, et al. 2016 p. 36.

5.10 Moreover, the Certification Regime should prove a useful tool for firms attempting to improve their culture, through senior management setting the 'tone from the top' and assessing a wide range of employees through their annual fitness and propriety assessments.

Increased likelihood of identifying misconduct

5.11 The overarching aim of regulating individuals in financial services is to reduce misconduct and to create a system in which any misconduct is swiftly identified and addressed, and to enable firms and regulators to hold those responsible to account. The ability to take action and to impose sanctions on individuals in cases of misconduct creates incentives for good conduct. Where misconduct or poor behaviour remains undetected, it can result in significant harm being caused to consumers. Increasing the regulator's ability to identify instances of misconduct not only reinforces deterrence but allows for actual instances to be managed more swiftly.

5.12 Below we provide examples of how the features of the SM&CR contribute to reducing harm to consumers by increasing the chances of misconduct being identified.

5.13 We expect that the Senior Managers Regime will result in increased monitoring of the firms' activities by Senior Managers, as well as more effective systems and controls being put in place. For example, Statements of Responsibilities and Responsibilities Maps will clearly set out the areas Senior Managers are accountable for (under their duty of responsibility). This will incentivise Senior Managers to put appropriate safeguards in place and to increase their own internal monitoring. This in turn will increase the likelihood of potential or actual instances of misconduct or poor practice being detected.

5.14 Applying the Conduct Rules to staff outside of those approved by the regulator should increase the sense of individual responsibility on all members of staff. This in turn should incentivise staff to be proactive in their identification of misconduct, for example through whistleblowing processes, rather than taking a reactive approach and assuming it is the responsibility of others.

5.15 Annual fitness and propriety checks of certified individuals further increases monitoring of staff and will help the firm to identify any misconduct. The requirement for an annual reassessment of an individual's fitness and propriety will alleviate the problem of approval/certification being viewed merely as a gateway, after which monitoring will decrease and poor behaviour is less likely be detected. Compared to the current APR, the SM&CR expands the pool of staff that will now requiring the ongoing fitness assessments, improving monitoring for a greater number of staff.

5.16 Regulatory references requirements also help firms identify candidates' past misconduct when recruiting. These requirements were based on the 2015 'Fair and Effective Markets Review', which recommended mandating regulatory references to help firms prevent the 'recycling' of individuals with poor conduct records between firms.[37] This will improve firms' ability to identify prior instances of misconduct, and help them assess whether potential recruits are fit for the role.

37 See the Bank of England's website for details.

5.17 The reporting requirements associated with breaches of the Conduct Rules will allow for such regulatory intelligence to be collected and will help in the identification of breaches.

Broader scope for the FCA to take disciplinary actions

5.18 The Parliamentary Commission on Banking Standards' (PCBS) final report on banks found that under the Approved Persons Regime, top staff were faced with little realistic prospect of financial penalties, or more serious sanctions appropriate to the severity of the failure, which has often left people beyond effective enforcement.[38] It's likely that this issue also applies to financial firms outside the banking sector.

5.19 The new policies will encourage the clear allocation of management responsibilities among Senior Managers. This will make it easier for the FCA during an investigation, and firms more generally, to identify the Senior Managers responsible for the areas of the business where misconduct occurred. This should improve individual accountability among senior management and incentivise higher standards. Consistent with Becker, Iscenko et al. state that 'when judging potential costs, firms take into account the probability of getting caught and the nature, size and speed of the punishment if they are caught…'.[39] If Senior Managers perceive that the regulator is likely to take action against them, where they are at fault for misconduct, and that they could have to pay a sufficiently high penalty, Senior Managers will be incentivised to run the areas of the firm for which they are responsible more effectively, and rule breaches by their firms should be less common. Some of the key elements of the policy in this regard are set out below.

5.20 The duty of responsibility is complemented by Statements of Responsibilities and Responsibilities Maps, which make clear who is responsible for which business area. When bringing enforcement action against a Senior Manager – whether under the Conduct Rules, the duty of responsibility or otherwise – the regulator will consider the Statement of Responsibilities and the firm's management Responsibilities Map when determining the extent of the Senior Manager's responsibilities in the firm.

5.21 For the most significant firms, Prescribed Responsibilities and the overall responsibilities requirement[40] will mitigate the risk that responsibility gaps occur in oversight and accountability. A clear allocation of responsibility and effective tools supporting this will make people more likely to incur regulatory sanctions.

5.22 In addition, Conduct Rules will apply beyond Senior Managers to cover a much broader range of employees within firms (in relation to their financial services activities, whether regulated, unregulated) than under the current system. This will allow the regulator to pursue wrongdoing in firms wherever it is found, without the technical restrictions that can prevent action at present. This should incentivise better firm conduct and culture, benefitting consumers.

5.23 Finally, a requirement on firms to report breaches of the Conduct Rules by their staff reinforces the importance of complying with the Conduct Rules.

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38 PCBS 2013. Available here.
39 Becker 1968; Iscenko, et al. 2016.
40 The overall responsibility requirement will not apply to Core Firms, small NDFs and ISPVs.

Encouraging effective competition

5.24 Given the regime should improve compliance and reduce misconduct, we might expect increased competition in the interests of consumers, rather than competition between firms seeking to exploit consumers' information asymmetries or their behaviour. By reducing exploitation, firms acting in the best interests of consumers are more likely to get business, leading to stronger competition and better, cheaper products for consumers. Moreover, under the proposed regime the same standards apply to all firms[41], so that in that respect all firms will compete on an improved level-playing field.

Better decision making with firms through increased accountability

Clarity of decision making

5.25 The SM&CR will help clarify who is responsible for what in a firm. This should lead to better decision making as Senior Managers, as well as other staff within the firm, have transparency regarding who is responsible for what, and how those responsibilities interact with others within the firm.

Reduction in management biases

5.26 Academic literature suggests that increased accountability results in people attempting to remove their own biases when making decisions.

5.27 It has been noted that 'accountability is likely to reduce error and bias in contexts in which, for whatever reasons, people tend to make mistakes that they could have prevented with extra attention or effort'.[42] This is because decision makers are more likely to identify their own sources of bias when they need to justify their decisions to others who do not necessarily view the decision with the same bias.

5.28 On a similar note, Lerner and Tetlock provide a straightforward rationale for scenarios where accountability lessens bias: when participants expect to have to justify their judgements, they want to avoid appearing foolish in front of an audience.[43] Therefore, biases linked to lack of effort or self-critical awareness of one's judgement processes will be reduced as people are more likely to be self-critical and search for reasons to justify their actions.

5.29 Eliminating such biases is particularly important among Senior Managers, who as a group generally fail to attach sufficient weight to the likelihood of negative outcomes, be over-optimistic and more willing to take risks than the average employee.[44] Increasing accountability should lead to improved decision making and result in better outcomes for firms and consumers.

41 Exceptions are Appointed Representatives which are not currently in scope of the proposed policy. We will confirm our approach to these in a follow-up consultation paper.

42 Brest and Krieger 2010, p.628.

43 Lerner and Tetlock 1999, p.263.

44 Armstrong and Huck 2010; Baker, Ruback and Wurgler 2002.

Improved staff hiring processes and professionalism

Improved professionalism

5.30 The SM&CR will improve professional standards and culture within financial services firms by making all Senior Managers accountable for:

- decisions and conduct that fall within their areas of responsibility
- ensuring that they have taken reasonable steps to ensure that the decisions made by people in their areas are appropriate
- ensuring that people working at all levels in their areas of responsibility meet appropriate standards of conduct and competence

5.31 Furthermore, the Certification Regime will make firms more accountable for the suitability of their staff. The Regime requires firm to check and confirm ('certify') at least annually, that those below Senior Manager performing roles which could have significant impact on the firms or its customers, are fit and proper to do so. This should help drive up standards of professionalism across industry.

Reduction in the number of pre-approved people

5.32 The SM&CR will bring lower staff recruitment costs as regulatory pre-approval will be required for a narrower set of individuals than under the current regime, where everyone performing controlled functions needs to be pre-approved by the regulator. Under the SM&CR, only those performing Senior Manager Functions will require pre-approval.

5.33 As the pre-approval process will necessarily involve time and financial costs to firms, the reduction in the number of people going through the process will significantly reduce the associated time and costs in the staff recruitment process.[45]

5.34 Some of the people currently requiring our approval and who will not be performing Senior Manager Functions under the new regime will instead require Certification. This takes place at firm level and so gives firms more control over the speed of their recruitment process. It is likely, therefore, that the removal of certified individuals from the pre-approval process will reduce the downtime between outgoing staff and new hires, helping to reduce the cost of lost productivity associated with staff turnover. For some firms this will constitute a net cost saving.

5.35 Firms in the Limited Scope and in the Core Regime will have a very small number of people in roles that will no longer require pre-approval (up to 2 on average because these firms do not currently have many people approved). Firms in the Enhanced Regime have on average 13 individuals in roles that will no longer require pre-approval. The expected average annual saving for all firms is £102 (£14, £222 and £3,741 for firms in the Limited Scope Regime, Core Regime and Enhanced Regime, respectively). This will total savings to firms of £4.8m per year.

5.36 Insurers did not identify any cost savings in relation to the number of individuals requiring pre-approval. This is because they may have underestimated the number of

45 However, we note the added costs for firms from the increased set of staff requiring Certification. This is reported in the section on firms' compliance costs.

roles that will no longer require pre-approval, assuming that the new SM&CR regime would be very similar to the existing PRA Senior Insurance Managers Regime (SIMR).

Conditional approvals and regulatory references

5.37 A further element of the policy proposals which will be of benefit to firms are the new policies of conditional and time-limited approvals for Senior Managers.

5.38 This could be beneficial to a firm, for example, where they want to appoint a candidate on an interim basis while a permanent candidate is found. A conditional approval could be granted to a candidate who is an experienced Senior Manager but is new to the sector and lacks specific technical knowledge. This conditional approval would require a candidate to undertake the necessary technical training after their appointment.

5.39 These new policies benefit firms by increasing the flexibility around the hiring process, reducing recruitment costs, reducing downtime between outgoing and incoming staff, reducing lost-productivity costs, and reducing the likelihood of costs being duplicated where an initial candidate is rejected from pre-approval.

5.40 The requirement for regulatory references will also improve firms' recruitment processes. These are a valuable way for firms to get relevant information about individuals they are recruiting. They will help to improve the standard of information shared by previous employers and prevent people from being 'recycled' between firms.

Improved trust in financial services

5.41 High-profile scandals and mis-selling can severely damage the industry's reputation, while high consumer trust may lead to a greater demand for services and advice, benefiting consumers and firms. Low trust has been identified as being primarily a reputational issue intertwined with asymmetric information distortions: consumers believe that firms are capable of acting in consumers' interest but choose instead to act in their own interests.[46]

5.42 According to the 2016 Edelman Trust Barometer, in 2012 financial services was the least-trusted industry in the UK.[47] The erosion of trust in the financial services industry causes problems because some market transactions don't take place if parties cannot trust their counterparties. As a result, bad reputation (or lack of trust) over time translates into lower consumer welfare and lower profits.[48]

5.43 Armour, Mayer and Polo argued that reputational losses can be an important deterrent to misconduct especially when it affects a firm's customers, suppliers and investors.[49] Our new regulations are designed to reduce the instances of misconduct occurring, and increase episodes of misconduct being identified and remedied. This will promote a culture of increased good conduct and integrity at the individual level which is crucial

46 Trust in financial services is low: in 2015, globally it is the second-least trusted industry and only 36% of UK consumers state they have trust in financial services firms. See Chater and Decision Technology Limited 2015, p.4. Available here.

47 In 2015, trust in financial services was at 36% in the UK. In 2016, trust in this industry was 5% higher at 41%; see Edelman website.

48 Vanston 2012.

49 Armour, Mayer and Polo 2015.

for inducing a cultural change at the firm level.[50] Ultimately, this will help raise public confidence in the industry and mitigate the risk of reputational losses.[51]

5.44 Better conduct, with increased compliance, will ultimately lead to lower regulatory costs and fines, which could lead to welfare gain, whether due to higher profits or due to lower prices or an improved product range.

50 Christine Lagarde, Managing Director at the International Monetary Fund in 2015 in a speech on The Role of Personal Accountability in Reforming Culture and Behavior in the Financial Services Industry.

51 See Chater and Decision Technology Limited 2015, p.4... Available here.

6 Illustration of potential benefits

6.1 In this chapter, we discuss the types of harm that might arise and summarise the available evidence on past misconduct. We use this evidence to illustrate the harm that the proposals seek to address.

6.2 We're unable to provide an estimate of the benefits, ie a reduction of the harm likely achieved by the proposal, as it's not reasonably practicable to do so. Misconduct has specific effects depending on the rules breached and markets affected. Consequently, to assess the benefits of the policies proposed here would require significant amounts of data from across financial services. Even if we collected such data, we couldn't use these data to properly assess the benefits from the proposals. This is because it would likely not cover all past misconduct and because it is not clear to what extent the proposed policies would reduce misconduct. Misconduct is by its very nature hidden, until some of this misconduct is discovered. Individuals are unlikely to admit engaging in misconduct, or by how much they might reduce misconduct under the proposals.

Types of harm

6.3 Misconduct in financial services may cause two main types of harm to consumers.

6.4 One type is the harm to consumers caused ex-ante by the presence of market failures. For example, consumers may anticipate that a firm will not act in their best interest when it provides a given financial product or service. Therefore they may decide not to buy a product that would be beneficial for them or may decide to buy a product that suits their needs less well. Similarly, misconduct may create the perception that firms sell the product at a higher price or a price that does not reflect the true value of the product for the consumer. In either case, consumers will buy less than in the absence of misconduct, resulting in loss of consumer welfare.[52] Given the number of markets firms affected by the SM&CR participate in, it has not been possible to quantify this type of harm.

6.5 The second type of harm consists in problems that consumers experience with the financial products or services they have bought. Such problems include financial loss (eg from buying a product that does not suit their needs), loss of time and negative psychological effects, such as distress.

6.6 Quantifying this type of harm accurately would involve considering all the harm customers experience from problems with financial products and services. This is not possible because the data required are not available. However, it is possible to derive a reasonably illustrative estimate of this harm using data on redress and fines. Harm also arises from the costs of dealing with problems so we include these costs in our measure of harm.

52 In situations where some consumers gain and others lose due to a given market failure, this loss is the net loss of consumer welfare compared to the counterfactual (see also the discussion of trust in the previous section).

6.7 Below, we provide an illustrative quantification of the known harm from misconduct. The approach we use allows us to provide a crude estimate of harm that actually occurred and the potential benefits of the proposed policies in reducing this harm.

Evidence on current harm from misconduct

6.8 We use three sources of data to provide an estimate of the level of harm caused by firms affected by these proposals:

- redress paid to compensate for harm
- costs of handling complaints
- the fines for misconduct imposed by the FCA

Data on redress

6.9 Data on complaints and redress paid by financial service firms are collected by the FCA and the Financial Services Compensation Scheme (FSCS).[53] Harm includes the time, effort and potentially the stress complainants have suffered.[54]

6.10 The proposed SM&CR aims to reduce harm from misconduct generally, regardless of whether the problems prevented would have been subject to redress or not.

6.11 The redress paid by firms compensates consumers for the harm caused and should put them back in the position they would have been in if the problem had not occurred. A reduction in the problems that would have been redressed reduces both the harm to consumers and the amount of redress paid and so could be seen as net neutral.

6.12 There are two reasons why this may not be the case. Redress may not fully compensate the consumer for the time and effort needed to deal with the problem and the distress it may have caused them. Further, while redress compensates the consumer, it does not account for any wasted resources providing consumers with products and services that led to poor consumer outcomes.

6.13 We assess the harm that the SM&CR might reduce by estimating the harm to consumers who have experienced a problem but who didn't complain and receive redress. Consequently, our estimate of harm is the redress that is due to these consumers, assuming that where redress is paid there is no further harm. We complement this by estimating the upper bound of harm assuming that the redress payments do not compensate customers for any of the harm experienced. Since the latter is the far cruder approximation, the true amount of harm will be much closer to the first estimate of harm than to the upper bound. (This also because our estimated number of complaints not made is a lower bound, as explained below.)

6.14 To calculate the extent of harm, we firstly estimated the number of problems with financial services which did not lead to complaints. A survey of consumers provided us with an estimate of the proportion of problems for which consumers make

53 We use the redress payments pre-abatement, ie the redress that the FSCS would have paid in absence of limits to its payments. Some of the redress payments reported to the FCA may be capped due to payment limits, in particular the limit to redress awarded by the FOS. Most cases the FOS deals with are not affected by this limit; see their website.

54 This might be the case if the complaint was adjudicated by the FOS; see their website.

complaints.[55] The survey found that 69% of the problems caused by solo-regulated firms did not lead to complaints. The corresponding share for insurers is 57%. There are some limitations with these survey data. The survey was conducted online by a panel of consumers and so some consumers were underrepresented, such as older consumers or the financially vulnerable. Also, due to the survey's recruitment methods, respondents are more likely to be more financially savvy than a randomly selected nationally representative population. Therefore, they may have a higher propensity to complain than an average consumer – as a result, our estimate is likely to be a conservative lower bound of the true number of unmade complaints.

6.15 Secondly, using redress data, we also calculated the average redress paid when a complaint is made. Combining the average redress payment and our estimate of the number of problems generates our estimate of the average extent of harm per year. The upper bound is calculated by multiplying the average redress payment by all problems incurred regardless of whether redress was paid.

6.16 We acknowledge that those who have experienced a problem but have not actually made a complaint may have had less severe problems than those who made a complaint. They might have received smaller redress payments than those who have complained, but we have no data that would allow us to assess how much smaller the redress payments might be. While we could be biasing our estimates upwards, the data we use to calculate average redress include many complaints that don't lead to redress being paid at all. These complaints may compensate for some of this bias.

6.17 We exclude redress that is attributable to PPI, as this was an exceptionally large redress exercise and including it may bias upwards our estimate of harm.

6.18 Potential redress will not capture the harm of many types of misconduct that the proposed regime seeks to address:

- We have no information about complaints resolved within a single business day. Therefore, our estimates ignore this type of harm.
- The FCA complaints data include only complaints by eligible persons, ie consumers who are natural persons, micro-enterprises or small charities and trusts.[56] Even when eligible for redress through the FOS, consumers may choose to proceed to court and such actions are not included in our data.
- The redress data only cover cases where a cash value can be easily identified. They do not include other types of redress, such as extending the cover provided by an insurance policy.
- In many instances, consumers may not realise there's a problem, eg they may not realise they received poor advice.
- Many types of misconduct, especially those affecting market integrity or competition, won't lead to complaints and redress, even though significant harm to markets and consumers is likely.

55 Unpublished FCA Consumer Insight Sector Survey. Conducted by GfK.

56 In particular, they exclude all firms that don't meet the current size thresholds of up to €2m turnover or balance sheet and fewer than 10 employees, charities with an annual income of less than £1m, and trustees of trusts with a net asset value of less than £1m. The FCA will consult on increasing those thresholds in Summer 2017.

Each of these points will lead to an underestimate of the harm. We consider that these taken together will cancel out any potential upward bias from using the average redress paid for complaints, extended to estimate harm where complaints were not made.

Data on the costs of handling the complaints

6.19 The FCA and FSCS complaints and redress data include information on the number of complaints firms deal with. The costs of handling these complaints are significant. The FCA estimated that the cost of escalating a consumer complaint was between £20 and £330.[57]

6.20 We estimate this complaints-handling cost by multiplying the average number of complaints per year between 2013 and 2015 by the mid-point of the costs of escalating a consumer complaint (£175).[58]

6.21 We don't yet have data on the number of complaints resolved within a business day or the cost of handling those. The figures on complaints' handling costs are therefore likely to be a lower bound of the actual costs.

Data on fines

6.22 Sometimes, the financial penalties imposed on firms by the FCA and the redress paid to consumers address the same misconduct. But in many other cases, the FCA will impose a financial penalty, and no redress will be paid. This can happen for a number of reasons, including where a rule breach may have caused a risk of serious harm (justifying a penalty) but the risk never crystallised so no actual loss was incurred requiring redress. In many insider dealing and market abuse cases, victims who have suffered loss may not receive redress. This because they are often removed from the perpetrators and may not know that they have been harmed by the misconduct or may believe it is not worthwhile to pursue the matter. In some cases, redress will be payable but the FCA will decide not to impose a financial penalty because it doesn't consider the threshold for enforcement action has been met, even though misconduct may have occurred. Given this, there is merit in looking at financial penalties alongside redress when assessing the harm and potential harm caused by illegal behaviour.[59]

6.23 It is important to note, however, that the size of a financial penalty will not, on its own, provide a complete picture. The penalty amount reflects a variety of factors, not just the harm or potential harm caused by the rule breach. DEPP 6.5 in our Handbook sets out how the FCA determines the appropriate level of financial penalty. The factors we may take into account include depriving a person of the financial benefit derived directly from the breach (whether or not the breach was deliberate or reckless), the penalty's deterrence value and whether the person on whom the penalty was imposed obtained a settlement discount. Harm is measured by unpaid redress, complaints-handling costs and fines. Since the data on these are partly historic data, it has not always been possible to identify which regime would apply for each firm. Where this was not possible, firms have been grouped into the Core tier. Results for all firms are therefore more reliable than those for the different regimes.

57 FCA, Improving complaints handling: Consultation paper CP14/30 2014, p.34. Available here.

58 Using an average for several years partly accounts for the fact that the redress payments fluctuate over time. Since the redress payment after the implementation of the SM&CR may be different, these figures are illustrative.

59 Fines imposed in 2013, 2014, 2015 and 2016 are available here, here, here and here, respectively. We considered cases that led to a fine of £50,000 or more.

6.24 Table 14 and Table 15 show the average annual figures of unpaid redress, complaints-handling costs (admin. costs) and fines, which illustrate the extent of the harm caused by misconduct. The proposed SM&CR seeks to address this harm.

6.25 Since redress, number of complaints, complaints handling costs, and fines may vary over time, we used the annual averages for the years 2013 and 2015 (2013 to 2016 for fines). These figures may not be reflective of the redress, complaints-handling costs or fines imposed in the years after the SM&CR extension comes into force.

6.26 The FCA began regulating consumer credit firms in April 2014. In our analysis, we will have underestimated the redress, complaints and fines for these firms as the FCA didn't collect regulatory data from them prior to their authorisation.

Table 14: Estimated unpaid redress, complaints-handling costs and fines per year, solo-regulated firms

Regime	Redress, £m		Admin. Costs, £m	Fines, £m	Total, £m	
	Lower (Unpaid redress)	Upper (any problem)			Lower (Unpaid redress)	Upper (any problem)
All firms	1,461.9	2,118.6	116.9	66.8	1,645.6	2,302.4
Enhanced	84.9	123.1	26.5	50.6	162.1	200.2
Core	1,021.3	1,480.1	59.6	10.0	1,090.9	1,549.7
Limited Scope	355.6	515.4	30.8	6.2	392.7	552.4

FCA analysis. Columns and rows may not sum to their totals due to rounding.

Table 15: Estimated unpaid redress, complaints-handling costs and fines per year, insurers

Regime	Redress, £m		Admin. Costs, £m	Fines, £m	Total, £m	
	Lower (Unpaid redress)	Upper (any problem)			Lower (Unpaid redress)	Upper (any problem)
All insurers	134.3	235.7	77.3	4.5	216.1	317.5
Solvency II, large NDFs	134.3	235.6	77.2	4.5	216.0	317.3
Small NDFs, small insurers in run-off	0.1	0.1	0.1	0.0	0.2	0.2

FCA analysis. Columns and rows may not sum to their totals due to rounding.

7 Conclusion: Comparison of costs and benefits

7.1 To understand whether the proposed policies are likely to be beneficial overall, we have compared the revised compliance costs estimated in Chapter 3 (net of cost savings due to a smaller number of roles requiring pre-approval) with the illustrative harm we estimated in Chapter 6. We used this to assess the percentage reduction of the harm identified that would be required for the proposed policy packages to break even.[60]

7.2 We recognise that we have only presented an illustrative estimate of harm and have to accept a degree of uncertainty inherent in our compliance cost analysis (see paragraphs 3.16 to 3.24). However, accepting these limitations the following analysis demonstrates that the proposals are likely to be proportionate to the scale of the likely harm in financial services that our proposals seek to address.

7.3 To enable us to compare these costs with the illustrative harm we assume both occur each year over a 10-year period.[61] We also include the one-off costs at the start of this 10-year period.

7.4 To create an overall measure of the costs and benefits over the 10-year period, we converted them to 'present values' (PV) and then added them. The PV reflects that society prefers to receive goods and services sooner rather than later and to defer costs to future generations. That is, costs incurred in the future are valued less than costs incurred immediately.[62]

7.5 The PVs of the costs and harm over the 10-year period are presented in the columns labelled 'Compliance cost PV' and 'Total estimated harm PV' inTable 16. We present ranges for the estimates of harm and the costs. The range for the estimated harm is calculated using the different estimates for harm we calculated using redress data. The lower bound comes from assuming that redress fully compensates the harm which a consumer experienced, whereas the upper bound assumes that redress does not compensate any harm caused by misconduct. The compliance costs are those discussed in Chapter 3.

7.6 Using the revised cost estimates and the range for the estimates of harm for both solo-firms and insurers, we can provide a range for the required reduction in harm necessary for the proposed regime to breakeven. The analysis indicates that for solo-regulated firms a 9-16% reduction in the harm identified would lead to benefits that are larger than the compliance costs. For insurers, a greater than 1-2% reduction in harm would outweigh the compliance costs. The range for the harm reduction required for each policy regime is presented in the final column of Table 16.[63]

60 This approach is frequently used in situations where the benefits are not fully quantifiable; see Andrews, et al. 2016, p.40.
61 If we chose a longer period, the increase in our estimate of the PV of the harm would increase by more than the PV of the compliance costs because of the one-off costs of implementing the regime.
62 We use 3.5%, the interest rate used by HM Treasury for policy appraisal.
63 The lower break-even percentage is calculated using the lower of the compliance cost estimates and the upper bound of the illustrative harm, while the higher percentage is calculated using the higher of the compliance cost estimates and the lower bound of the illustrative harm.

Table 16: Reduction in harm needed to break even, all firms by 10-year present value

Regime	Compliance cost PV, £m	Total estimated harm PV £m*	Required reduction in harm to breakeven*
Solo-reg. firms	1,710.7 – 2,150.7	13,685.9 – 19,148.0	9-16%
Insurers	36.7 -44.6	1,797.5 – 2,640.2	1-2%

FCA analysis. This shows the share of the compliance costs (net of cost savings due to fewer pre-approvals) against the unpaid redress, complaints handling costs and fines using an interest rate of 3.5%. *While the lower bound of the total illustrative harm may underestimate the harm to some extent, the upper bound is a considerable overestimate of the harm.

7.7 It also appears likely that the additional, non-quantifiable benefits of the proposed policies, such as better decision making or improved trust in financial services, will outweigh the indirect costs (discussed in Chapter 5 and Chapter 4, respectively), including the costs to the FCA which are small compared to the compliance costs.

7.8 We acknowledge that there are limitations to our analysis, regarding our illustrative estimation of harm in Chapter 6 and regarding our compliance cost estimation in Chapter 3 (see paragraphs 3.17-3.23).

7.9 Notwithstanding the uncertainties and limitations inherent in estimating costs and benefits of such wide reaching policy proposals, we believe it is reasonable to conclude that the reduction in harm resulting from our policy interventions will outweigh the implementation costs, and therefore be net beneficial.

Annex 1
Reported estimates

Table A1: Total one-off and annual ongoing costs for the regime for all solo-regulated firms, £m

Regime	one-off	ongoing
Limited scope	224.7	144.0
Core	234.3	207.0
Enhanced	208.3	56.2
Total	667.3	407.2

Source: FCA survey of firms (undertaken Q4 2016).

Table A2: Average one-off costs per firm and total one-off costs for all solo-regulated firms for the different policy elements by requirement

Element	Limited Scope, per firm £	Core, per firm £	Enhanced, per firm £	Total for all solo-regulated firms, £m
Senior Managers Regime	4,120	10,820	275,230	379.3
Certification Regime	1,480	2,990	205,110	160.7
Conduct Rules	1,250	3,260	88,100	116.2
Responsibilities Maps	na	na	13,090	4.5
Allocation of overall responsibility	na	na	8,700	3.0
Handover Arrangements	na	na	10,070	3.5
Total	6,850	17,080	600,310	667.3

Source: FCA survey of firms (undertaken Q4 2016). Costs from Prescribed Responsibilities do not apply to Limited Scope firms and are hence excluded from the calculations. Columns may not sum to their totals due to rounding

Table A3: Average annual ongoing costs per firm and total annual ongoing costs for all solo-regulated firms for the different policy elements by requirement

Element	Limited Scope, per firm £	Core, per firm £	Enhanced, per firm £	Total for all solo-regulated firms, £m
Senior Managers Regime	2,390	11,050	111,180	268.7
Certification Regime	1,040	2,020	22,320	69.5
Conduct Rules	960	2,020	20,610	66.3
Responsibilities Maps	na	na	3,180	1.1
Allocation of overall responsibility	na	na	2,540	0.9
Handover Arrangements	na	na	2,040	0.7
Total	4,390	15,090	161,880	407.2

Source: FCA survey of firms (undertaken Q4 2016). Costs from Prescribed Responsibilities do not apply to Limited Scope firms. Columns may not sum to their totals due to rounding

Table A4: Total one-off and annual ongoing costs for the regime for insurers, £m

Regime	one-off	ongoing
Small NDFs and small insurers in run-off*	1.6	1.7
Solvency II and large NDFs	11.1	8.4
Total	12.7	10.1

Source: FCA survey of firms (undertaken Q4 2016). *As explained in paragraph 3.37 the costs for small NDFs and small insurers in run-off are not reliable.

Table A5: Average and total one-off costs for all insurers by requirement

Element	Average one-off costs per insurer, £	One-off costs, all insurers, £m
Senior Managers Regime	10,160	5.6
Certification Regime	2,120	1.2
Conduct Rules	7,630	4.2
Responsibilities Maps*	1,220	0.7
Allocation of overall responsibility*	520	0.3
Handover Arrangements*	1,250	0.7
Total	22,900	12.7

Source: FCA survey of firms (undertaken Q4 2016). The difference between the costs reported here and the figures reported in Table 13 will not provide a reliable estimate of the costs for NDFs, for the reasons set out in paragraph 3.46. *These elements apply only to large NDFs and Solvency II insurers.

Table A6: Average and total annual ongoing compliance costs for all insurers by requirement

Element	Average one-off costs per insurer, £	One-off costs, all insurers, £m
Senior Managers Regime	8,310	4.6
Certification Regime	1,700	0.9
Conduct Rules	5,740	3.2
Responsibilities Maps*	1,210	0.7
Allocation of overall responsibility*	370	0.2
Handover Arrangements*	890	0.5
Total	18,220	10.1

Source: FCA survey of firms (undertaken Q4 2016). The difference between the costs reported here and the figures reported in Table 13 will not provide a reliable estimate of the costs for NDFs, for the reasons set out in paragraph 3.46. *These elements apply only to large NDFs and Solvency II insurers.

Table A7: Reduction in harm needed to break even, all firms by 10-year present value (£m)

Regime	Compliance cost PV	Total estimated harm PV		Required reduction in harm to breakeven*
		Lower bound	Upper bound	
Solo-reg. firms	4,130.6	13,685.9	19,148.0	22-30%
Insurers	99.9	1,797.5	2,640.2	4-6%

FCA analysis. This shows the share of the compliance costs against the unpaid redress, complaints handling costs and fines using an interest rate of 3.5%. *While the lower bound may underestimate the harm to some extent, the upper bound is a considerable overestimate of the harm.

Annex 2
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Annex 3
Abbreviations used in this document

AP	Approved Person
APR	Approved Persons Regime
CASS	Client Assets Sourcebook
CBA	Cost-Benefit Analysis
CEO	Chief Executive Officer
CP	Consultation Paper
DEPP	Decision Procedure and Penalties Manual
DNB	DeNederlandsche Bank
FCA	Financial Conduct Authority
FOS	Financial Ombudsman Service
FRN	Firm Reference Number
FSA	Financial Services Authority
FSCS	Financial Services Compensation Scheme
FSMA	Financial Services and Markets Act
IFPRU	Prudential Sourcebook for Investment Firms
IOSCO	International Organization of Securities Commissions
ISPV	Insurance Special purpose vehicle
IT	Information Technology
NDF	Non-Directive Firm
PCBS	Parliamentary Committee on Banking Standards
PPI	Payment Protection Insurance
PRA	Prudential Regulation Authority
PV	Present Value
SHF	Significant Harm Function
SIMR	Senior Insurance Managers Regime

SM&CR	Senior Managers and Certification Regime
SME	Small and Medium Enterprise

The policy to which this cost-benefit analysis refers is outlined in CP17/25 and CP17/26. Please write to the email addresses given in the consultation papers if you have comments on this cost-benefit analysis.

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