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

Policy Statements
PS18/14 and PS18/15***

July 2018

Contents

How to navigate this document onscreen

returns you to the contents list

i takes you to helpful abbreviations

1 Introduction

1.1 As of January 2018 the FCA regulates approximately 47,500 non-banking firms authorised under the Financial Services and Markets Act (FSMA). We are the only regulator ('solo-regulator') for 46,940 firms, and also regulate a further 560 insurers jointly with the PRA.[1]

1.2 In May 2016, the Bank of England and Financial Services Act 2016 made changes to the Financial Services and Markets Act 2000 (FSMA). These changes require us to extend the Senior Managers and Certification Regime (SM&CR) to all firms authorised to provide financial services under FSMA. This will change how we regulate individuals in financial services, as well as the way they are assessed and held accountable for what they do.

1.3 For insurers, the PRA's Senior Insurance Managers Regime (SIMR) and related changes to the FCA's Approved Persons Regime (APR) were introduced as part of the implementation of the EU Solvency II Directive. We are now extending the remaining elements of the SM&CR to all of these firms.

1.4 The aim of the new SM&CR is to reduce harm to consumers and strengthen market integrity by creating a system that better allows firms and regulators better to hold individuals to account. As part of this, the SM&CR aims to:

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

1.5 Our application of the SM&CR for these firms is designed to be clear, simple and proportionate. As part of this, we have divided solo-regulated firms into 3 tiers (Enhanced, Core and Limited Scope). We have also applied the requirements proportionately to insurers, with more comprehensive requirements applying to Solvency II insurers and large non-directive firms (NDFs) than small NDFs,[2] Insurance Special Purpose Vehicles (ISPVs) and insurers in run-off.

1.6 The near-final rules set out in the Policy Statements implement the SM&CR extension for almost all solo-regulated firms and insurers discussed in the Consultation Papers CP17/25 and CP17/26, with minor amendments. The main amendments are set out in the introductory chapters of the Policy Statements. They do not lead to significant changes in the estimated costs and benefits set out below, and hence do not require an additional cost-benefit analysis (CBA) under section 138I(5) of FSMA.

1 For banks that we dual-regulate with the PRA, we replaced the current Approved Persons Regime (APR) with the Senior Managers and Certification Regime (SM&CR) in March 2016.

2 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.

1.7 We have updated our CBA and published it alongside the Policy Statements. This is because of the importance of the SM&CR for the financial services sector, changes in the number of firms in the different tiers, and the complexity of the CBA. This document sets out the CBA in relation to the near-final rules.

Updates to the firm population

1.8 We have used updated information on the numbers of firms in the different tiers, gathered in January 2018. The number of firms in the solo-regulated population, and each of the tiers (Enhanced, Core and Limited Scope), has changed for 4 main reasons:

- Since we gathered the data for the CP CBA published alongside CP17/25 and CP17/26 some firms have gained, changed or lost authorisations, or changed their permissions or legal form, and as a result they have entered or left the market or changed tiers.
- Following further analysis of the firms in the dataset, we found that our list of firms in the Limited Scope tier contained all firms with General Insurance (GI) intermediation permissions. This was a misclassification – only firms with GI intermediation as secondary activity should have been included in the group of Limited Scope firms. We have therefore reclassified 6,900 firms from the Limited Scope tier to the Core tier in our final CBA. 58 of these re-categorised firms responded to our survey so our compliance costs estimates have changed accordingly (because these firms' estimated costs are now included in the Core tier estimates rather than the Limited Scope tier estimates).[3]
- In CP17/25 we consulted on the criteria that decide whether a firm will be in the Enhanced tier, including a consumer credit lending revenue based criterion, an intermediation criterion drawn from section B of the RMAR and a criterion for assets under management. We have used 3-year rolling averages for these 3 criteria, as specified in the near-final rules (see pp.52-3 of the Policy Statement PS18/14).
- We exclude 39 retail investment firms and 4 debt purchasers from the Enhanced tier, as feedback suggested that they aren't in scope of this tier in the legal instrument as drafted. In the CP CBA these were included in the Enhanced tier, whereas in this updated CBA we have categorised them as Core firms.[4] We plan to separately consult at a later date on amending our rules so that the Enhanced tier of the SM&CR applies to some additional retail investment firms and debt purchasers who are not currently caught by our rules.

1.9 The analysis for insurers is not affected by these changes. However, we have updated the information used for the analysis of harm (Chapter 6) to reflect some updated information on insurers.

1.10 We have updated our CBA to reflect the above changes. The effects of these changes are explained in chapters 3, 5 and 6.

3 Table 4 below shows the number of firms and number of survey responses per tier.
4 We will consult on applying the Enhanced regime to these firms in due course.

1.11 We believe that it is reasonable to conclude that the SM&CR will be net beneficial as:

- the responses to the consultation didn't include relevant new information or suggest improvements to the methodology
- the reduction in harm required for the SM&CR to be net beneficial is 9-17% for solo-regulated firms (9-16% in the CP CBA)[5] and 1-2% for insurers (the same as in the CP CBA) (see Chapter 7)

1.12 This CBA is structured as follows:

- Chapter 2 discusses market failures and explains the different elements of the SM&CR extension
- 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

5 Reclassifying the 6,900 firms from Limited Scope to Core, but not considering any of the remaining changes leads to the same breakeven figures for solo-regulated firms as in the CP CBA (9-16%).

2 Market failures and the SM&CR toolkit

Identifying market failures

2.1 Our SM&CR extension seeks to address market failures in order to prevent harm from occurring. While we expect firms to identify and rectify problems themselves, we will work with them to help make sure their systems and controls, governance, and culture allow 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 3 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 aren't unique to any one sector of the firms we regulate.

2.3 We believe that better governance and accountability will lead to an improved culture within firms and one which is more focussed on customer outcomes. This should result in a reduction in harm and is a key driver for introducing the SM&CR to all our FSMA-authorised firms.

2.4 There are 2 areas where harm may arise in particular in markets served by solo-regulated firms and insurers (the firms in scope of the rules) 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 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.[6]

Information asymmetry

Firms have more information than their regulator(s)

2.6 Regulators make rules and supervise firms to make sure 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 is 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 are subject to because they may not expect to get caught.

6 Iscenko, et al. 2016, p.5

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

2.9 A regulated firm might 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 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.[7]

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 the avoidance of 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 As firms can't monitor employees perfectly, they may be unable to punish employees for misconduct (eg if they have moved firms or if responsibility is not clear). 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.[8] There are a number of case studies of systematic flaws in firms' decision making.[9] 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.

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

8 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.

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

Information transmission

2.17 Decision making can be hindered 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, while 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.[10] 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 2 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.[11]

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.[12] 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 is 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.[13]

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.[14] 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 is 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.

10 Merkl-Davis and Brennan 2007.
11 See Certo, Connelly and Tihanyi 2008; Kahneman 2003 summarises the psychological literature on biases in decision making more generally.
12 Scopelliti et al 2015.
13 Gilovich, Pronin and Ross 2004.
14 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.[15]

2.27 The FCA and PRA's joint report on HBOS provides a financial services example. It highlights the lack of challenge at Board level as one of the reasons behind its failure.[16]

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'[17] in the decision and that no Board member had ever expressed concerns about the deal.[18]

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 are 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 3 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,[19] for example, find that CEOs of Forbes 500 firms under or over invest depending on the source of finance used. Consequently, poor investment strategies are used by firms. This overconfidence may also apply to senior decision makers at firms outside of the Forbes 500 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.[20]

2.35 Overconfidence might also lead to financial misreporting. This might initially be unintentional and may only reflect the over-optimism of the executives. However, overconfident executives are more likely to intentionally misreport if the firm's performance doesn't meet their (overly) optimistic expectations.[21]

15 See Walsh 1995 pp.280-2 for examples.
16 FCA and PRA, The failure of HBOS plc (HBOS) 2015, p.213.
17 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.
18 See the FSA Report 2011, pp.228-9.
19 Malmendier and Tate 2005.
20 Goel and Thakor 2008.
21 Schrand and Zechman 2012.

Remedying the market failures: the SM&CR toolkit

2.36 We designed the SM&CR to help address the market failures outlined above and to improve governance and increase accountability within the firms that we regulate. The SM&CR changes aim to:

- increase individual accountability for senior staff
- increase oversight over a wide range of staff through the Certification Regime
- 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 A wide variety of firms will now be under the SM&CR, ranging from very small firms with limited permissions to some of the largest global financial services firms.

2.39 Because of these differences, we designed the new Regime to be proportionate and flexible enough to accommodate different business models and governance structures of firms. For solo-regulated firms the Regime therefore includes:

- a standard set of requirements for all FCA solo-regulated firms known as the 'Core' tier for the SM&CR
- 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' tier
- a reduced set of requirements for a group of solo-regulated firms we are defining as 'Limited Scope'

2.40 Insurers (that are regulated by both the FCA and PRA) will have to comply with both regulators' specific rules. The FCA's SM&CR for insurers requires Solvency II firms and large non-Directive firms (NDFs) to implement all elements of the Regime, while small NDFs, Insurance Special Purpose Vehicles (ISPVs) and small firms in runoff will have to implement only a subset of the requirements.

2.41 Annex 2 provides an overview of the toolkit for solo-regulated firms and insurers. Tables 1 and 2 provide a glossary of terms.

Table 1. Table of firm types

Firm type	Description
Limited Scope Firm	Firms that have 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 • all sole traders • authorised professional firms whose only regulated activities are non-mainstream regulated activities • oil market participants • service companies • energy market participants • subsidiaries of local authorities or registered social landlords • insurance intermediaries whose principal business is not insurance intermediation and who only have permission to carry on insurance mediation activity for non-investment insurance contracts • authorised internally managed Alternative Investment Funds (AIFs)
Core Firm	Firms that will have a baseline of SM&CR requirements applied.
Enhanced Firm	A small proportion of solo-regulated firms that will have to apply extra rules. If a firm meets one or more of 6 criteria below, they will be an Enhanced firm:
	Definitional criteria • A firm that is a Significant IFPRU firm • A firms that is a CASS Large firm
	Criteria calculated on a rolling average • Firms with Assets Under Management of £50 billion or more as a 3 year rolling average • Firms with current total intermediary regulated business revenue of £35 million or more per annum calculated as a 3 year rolling average • Firms with annual revenue generated by regulated consumer credit lending of £100m or more calculated as a 3 year rolling average.
	Criteria calculated as a point in time • Mortgage lenders and administrators (that are not banks) with 10,000 or more regulated mortgages outstanding at the latest reporting date.

Table 2. Glossary of SM&CR Tools

Tool	Description
Ancillary Staff	Employees who are not covered by the Conduct Rules, such as cleaners, receptionists, catering staff and security staff.
Certification Function	A function performed by employees 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 people for these functions.
Certification Regime	The part of the Regime that covers Certification Functions.
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.

Tool	Description
Duty of Responsibility	Every Senior Manager will have a Duty of Responsibility as a result of FSMA. This means that if a firm breaches one of our requirements, the Senior Manager responsible for that area could be held accountable if they didn't take reasonable steps to prevent or stop the breach.
Fit and Proper Requirements	Firms must make sure all Senior Managers and people performing Certification Functions (ie 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.
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.
Individual Conduct Rules	These are basic standards of behaviour that apply to all individuals performing financial services activities in firms. 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, and within 7 days if the person is a Senior Manager.
Other Overall Responsibility Function	A SMF 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 SMF.
Overall Responsibility	A requirement for every area, activity and management function of the firm to have a Senior Manager with overall responsibility for it.
Prescribed Responsibilities (PRs)	FCA-defined responsibilities that must be allocated to an appropriate Senior Manager.
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).
Responsibilities Maps	A document setting out a firm's governance and management arrangements, and how responsibilities are allocated to individuals within the firm.
Senior Management Functions (SMFs)	The roles where the people doing them need to be approved by the FCA. These are defined in our Handbook.
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.
Senior Managers	The people who perform a SMF. These people need FCA approval to do their jobs.
Senior Managers Regime	The part of the Regime for Senior Managers. This includes SMF, SoRs, Duty of Responsibility, Fit and Proper, PRs, Regulatory References and criminal records checks. For Enhanced Firms, it also includes Responsibilities Maps, Handover Procedures and Overall Responsibility.
Statement of Responsibilities (SoRs)	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 when there is a significant change, and be kept up to date.

Counterfactual

2.42 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 to solo-regulated firms and insurers as a direct result of the SM&CR. The cost estimates are based on an updated population of firms in the different tiers as at January 2018.

3.2 Specifically, as also explained at para 1.8, the updated data for the population of firms in the different tiers differs from the data used in the CP CBA as it reflects the following:

- Movements due to variations in authorisations and cancellations since the CP – There is a net increase of approximately 70 firms due to movements in our population of regulated firms. There is an increase of approximately 230 firms in the Limited Scope tier and a reduction of ca. 150 firms in the Core tier.

- Following further analysis of our dataset, we found that the list of firms in the Limited Scope tier contained all firms with General Insurance (GI) intermediation permissions. This was a misclassification – only firms with GI intermediation as secondary activity should have been included in the group of Limited Scope firms. This has led to a reclassification of 6,900 firms from the Limited Scope tier to the Core tier.[22] This also meant that 58 of the survey respondents were reclassified from Limited Scope to Core. Our compliance costs estimates have changed accordingly.[23]

- Changes to our approach to the criterion for the Enhanced tier – We have made minor changes (as described at pp.52-3 of PS18/14) to 3 of the Enhanced criteria based on CP responses. This, along with updating the data on the firms in scope for changes in authorisations and cancellations, has resulted in a reduction of 23 firms in the Enhanced population.

- Movement of certain firms from the Enhanced to the Core tier – We have excluded 39 retail investment firms and 4 debt purchasers from the Enhanced tier, as they weren't and aren't in scope of this tier in the legal instrument as drafted. In the CP CBA these were included in the Enhanced tier whereas in this updated CBA we have categorised them as Core firms.[24]

22 The number of insurance intermediation firms whose intermediation business is not secondary to the firms' main business activity (which are Core firms)

23 For solo-regulated firms we have also amended the calculation of the Enhancements estimates as follows. Cost items we had removed from survey responses (IT costs, training cost and costs for adjustments) are now only excluded only from the lower bounds of our estimates. For insurance, we have amended the calculation of the ongoing costs: 1) the costs of Prescribed Responsibilities now include training costs and exclude IT costs in the upper bound for the Senior Managers Regime; 2) record keeping costs are now removed in the lower bound for the Certification Regime; 3) the costs of training for Handover Arrangements are now excluded only from the lower bound. These amendments do not change the compliance cost estimates presented below to a significant extent.

24 We will consult on applying the Enhanced regime to these firms in due course.

3.3 The updated population (mainly the reclassification) leads to changes to the compliance cost estimates compared to the CP CBA, as outlined in detail below. The 58 survey respondents reclassified as Core submitted much higher compliance cost estimates than the respondents which remain in the Limited Scope tier. The resulting much lower estimates of the average costs per Limited Scope firm and total costs for the Limited Scope tier almost outweigh the higher costs for Core firms (per firm and total)[25]. In addition, the total costs for the Enhanced tier are lower because fewer firms are now in this tier. Table 6 shows the total costs per tier. However, overall the total impact on the estimated compliance costs over 10 years is approximately neutral and almost the same as originally consulted on. The estimated reduction in harm required for the SM&CR for solo-regulated firms to be net beneficial hence changes only slightly (see paragraph 7.6). The changes in the cost estimates for insurers are minimal and do not change the estimated reduction in harm required for the SM&CR for insurers to be net beneficial.

3.4 We also estimate the costs that the FCA will incur from implementing the new Regime.

Measuring the costs

3.5 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).

3.6 To assess these costs, we sent questionnaires to about 2,000 firms, on a legal entity level.[26] 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 tier, and fewer small non-directive insurers (NDFs), there were fewer responses from these categories of firms.

3.7 For sampling purposes, we used the current number of approved persons (APs) in a firm as proxies for the complexity of their governance and scope for harm deriving from potential misconduct. We did this to make sure that firms in the different policy tiers (Limited Scope, Core, Enhanced and insurers)[27] were sufficiently represented. The details of the SM&CR extension weren't finalised when we issued our survey to firms in September 2016. So, it wasn't possible to consider in the sampling process the factors that decide which tier of the regime a firm has to apply.[28]

25 These changes in average costs are mainly driven by the movement from limited scope to core of a small number of large firms in our survey with high estimated compliance costs. The median cost is less affected than the average cost by such movements and so it may be more reflective of the costs a 'typical firm' in each tier may incur. In contrast to the average cost, the median cost for the core tier falls and is unchanged for limited scope firms as a result of the updated population compared to the CP CBA. However, as we discuss in paragraph 3.61, any measure of the central tendency of the distribution of firms' costs is not representative of the costs of any particular firm.

26 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.

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

28 Such factors are the criteria used to determine whether a firm has to apply the Enhancements (Responsibilities Maps, Allocation of Overall Responsibility and Handover Arrangements) and whether a firm currently applies exceptions under the Approved Persons Regime.

3.8 We split the firms in scope of the SM&CR extension into 6 categories according to the number of APs they employ and drew random samples from the 6 categories. We used the number of APs as an indicator of regulatory complexity, which would increase the costs of the Regime. Sampling across these categories, we sought to make sure that we received cost information from a range of firms that reflected the variety of firms in the industry.

3.9 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 reflecting the populations of firms in scope when we drew the sample in autumn 2016. The table shows the number of firms in the different tiers for the population in scope, the sample and the resulting dataset.

Table 3: Number of firms in the population, sample and survey data, Autumn/winter 2016

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. * The number of firms here reflects the situation in autumn/winter 2016 when we sampled the firms.

3.10 Table 4 shows the number of firms (based on the updated information from January 2018) and the number of responses by the different policy tiers. It includes the estimated number of employees (based on our survey data) in scope for each tier. The breakdown is therefore different to that provided in Table 3, which focuses on sampling categories according to the number of Approved Persons. The number of employees is the total across the firms, rather than number in scope of the Regime. This is relevant 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. Differences in the total figures shown in tables 3 and 4 arise because of differences in the population of firms in scope of the SM&CR extension when we carried out the survey in autumn 2016 and in January 2018 (see also paragraphs 1.8 and 3.2).

Table 4. Updated number of firms in the population, sample and survey data, January 2018

Policy tier	Number of firms in population*	Number of employees in population, '000**	Number of firms in sample	Number of responses
Limited Scope	26,120	575	271	9
Core	20,540	2,067	1349	171
Enhanced	280	191	68	10
Small NDF insurer	170	10	84	6
Large NDF and Solvency II insurer	390	187	244	31
Total	47,500	3,029	2,016	227

FCA analysis. * The number of firms reflects the situation in January 2018. **Estimated based on survey data. Due to the small number of responses the estimate for Small NDF insurers is not reliable (see paragraph 3.70 for details). A number of firms have not stated the number of employees in their response to our survey and are not included in the estimation of the number of employees.

3.11 We have weighted the survey responses so that the weighted survey data accurately reflect the characteristics of the population.[29] We expected more complex firms to incur more costs from complying with our rules and less complex firms to incur lower costs. Further, some types of firm were much more likely to respond than others. The weighting of responses made sure that our estimates of the overall costs to industry weren't biased by the differing complexity of firms or the varying levels of response rates for different types of firms.

3.12 To weight the survey responses and so make sure 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)[30]
- 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

3.13 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).

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

29 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.

30 Firms in the fixed portfolio have closer contact with supervisors since misconduct, or other problems, are likely to have 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.

3.15 In our survey we asked firms about 8 ways they may incur costs to implement each of the 11 policy elements,[31] 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. The survey also included a description of the expected Regime as well as a list of guidance documents that had already been published. Our view is that respondents will hence have been aware that they would have to familiarise themselves with the details of the rules and guidance and will have factored that into their cost estimates.

3.16 Where an element is disapplied for specific types of firm, these costs haven't been used for the estimates below. Eg. sole traders do not have to implement the Prescribed Responsibilities.

3.17 Overall our approach has sourced cost estimates directly from firms who will be affected by our rules. We have used this data to estimate overall costs. Considering the limitations discussed below we have calculated 2 types of estimates:

- **the 'reported estimates'** based on the cost figures as provided by firms: these estimates haven't been moderated down other than in a small minority of cases where there were obvious misunderstandings
- **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 3.27 to 3.29 for details

3.18 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 chapters below and present the reported estimates in Annex 1.

Limitations

3.19 Our estimates are subject to a number of uncertainties.

3.20 **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). This results in inaccurate cost estimations.

3.21 **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 have weighted responses to make the sample as representative as possible for the firms in scope of the rules and make our estimates as representative as possible of industry costs. However, there may be some unobservable characteristics of firms that affect

31 Senior Manager Functions (SMFs), Statement of Responsibility, Prescribed Responsibilities and Criminal Record Checks, Regulatory Reference checks for SMFs, and Certified Staff, Regulatory References for Certified Staff, Conduct Rules and the Enhancements.

the costs of implementation, for which we haven't controlled. 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 haven't been able to model reliable cost estimates.

3.22 **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 haven't attempted to account for this in the estimates. We have assumed that all costs are additive.

3.23 **Incentive to over-estimate:** Firms might prefer a less onerous Regime and might overstate the costs of the different elements.

3.24 **Difference between survey and policy results in cost overestimation:** We carried out the survey before our policy was finalised to inform our consideration of different policy options. Therefore, the near-final rules differ, sometimes significantly, from the Regime described in the survey documents.

3.25 For example, under the rules 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, while Limited Scope firms will have to implement the elements of the Core tier, in some cases the application will be partial (for example, often only 1 Senior Management Function will apply to them, and the conduct rules will apply only to financial services staff).

3.26 Since the near-final rules have fewer requirements than the Regime described in the survey documents the estimates below tend to be an overestimate of the true costs. The reported costs in Annex 1 are almost certainly over-estimates of the likely true costs.

Revised estimates

3.27 Because of 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 haven't 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.

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

3.29 When considering the cost estimates for the 8 cost categories and 11 policy elements, 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 Managers Regime

Senior Management Functions (SMFs)

3.30 The SM&CR extension doesn't 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

3.31 There are a number of other requirements in the SM&CR that apply to 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 won't restructure themselves multiple times). Similarly firms won't need to monitor staff independently for each of these elements of the SMR separately.

3.32 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.

3.33 Similarly, there are 3 policy elements which only apply to Enhanced firms:

- Responsibilities Maps
- allocation of Overall Responsibility
- handover procedures

3.34 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 3 Enhanced policy elements.

Fit and Proper requirements

3.35 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 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.

3.36 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).

3.37 We believe that criminal record checks won't require changes in the organisational structure. This is 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. Likewise, training on the details of the criminal record checks required under the SM&CR may be necessary when these are introduced. However, ongoing training on these changes will replace training on current requirements. So it will most likely not give rise to ongoing costs over and above the costs for complying with the current Regime.

3.38 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.

Certification Functions (Significant Harm Functions)

As with SMFs, some firms may wish to use the introduction of Certification Functions as an opportunity to make changes to their organisational structure in order to make sure that appropriate groups of people become certified. 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 the Certification Regime.

Conduct Rules

3.39 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.

3.40 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

3.41 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

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

3.43 Firms may adapt their existing training to cover the different aspects of the Regime. If so, they won't incur ongoing training costs over and above those they already incur for the current Regime.

3.44 In practice, we believe firms will have a single team or person dealing with regulatory references for both SMFs and Certification Staff. 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 Certification Staff. As a result we have discounted these cost categories for Certification Staff (but retained them for SMFs).

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

Compliance costs for solo-regulated firms

3.46 Below we show 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 paragraphs 3.17 and 3.28 we believe these are a better reflection of the true costs firms will incur to comply with the rules. The estimates including all the cost figures as provided by firms are included in Annex 1.

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

Table 5. The number of solo-regulated firms in each tier

Regime	Number of firms
Limited Scope	26,120
Core	20,540
Enhanced	280
Total	46,940

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

3.49 Firms in the Core tier will need to implement all the elements in the Core tier, while the approximately 280 firms in the Enhanced tier will have to implement both the Core and Enhanced elements.

3.50 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.

3.51 Limited Scope firms will have to implement most of the elements of the Core tier, but in some cases the application will be partial (for example, only 1 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. So 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.

3.52 Limited Scope firms 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

3.53 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.

3.54 The compliance costs per firm, as well as the total compliance costs for each tier and the SM&CR, have changed compared to the CP CBA. This is due to the updated population of firms, as described at paragraph 3.2.

3.55 Following those changes, only 9 survey respondents are classified as Limited Scope. The cost estimates provided by the 9 respondents are very low (£350 to £380 one-off and around £1 ongoing). To assess the validity of these estimates, we compared the 9 survey respondents with the population of firms in the Limited Scope tier. We considered the proportion of authorised professional firms, Limited Permission Consumer Credit Firms, sole traders, oil or energy firms, international service firms and secondary general insurance intermediaries as well as the number of approved persons. After a careful analysis of the comparison, we saw no reason to believe that these 9 respondents aren't representative for Limited Scope firms.

3.56 Low compliance costs for Limited Scope firms are reasonable because many of these firms will have a very small number of staff providing financial services. Many of these firms may only have 1 SMF, while some firms (the majority of not-for-profit debt advice bodies, for example) may have none. Implementing the SM&CR extension may involve defining, allocating and documenting the new roles and obligations at implementation. Such firms may conduct their business in almost the same way as under the Approved Persons Regime. Moreover, Limited Scope firms generally have fewer certified members of staff and will therefore be less affected by the SM&CR extension than solo-regulated firms in other tiers.

3.57 Nevertheless we have sought to avoid the risk of underestimating the compliance costs for the Limited Scope tier. We have derived estimates for the Limited Scope tier by including 22 similar Core firms (firms with 1 approved person). These estimates are shown below. [32 33]

3.58 As noted in the CP CBA, we asked firms to estimate costs for the Enhanced elements, in addition to the costs they would incur from implementing the Core requirements. We only received responses from 10 firms in the Enhanced tier and we are not able to perform sense checks as for the Limited Scope tier (see above). As a result, the cost estimates for the Enhanced tier are less reliable than those for firms in the other tiers.

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

Tier	One-off, £m	Ongoing, £m
Limited scope *	24.7 – 25.8	3.1 – 10.4
Core **	397.4 – 401.1	120.1 – 162.2
Enhanced	132.8 – 133.3	17.6 – 27.4
Total	554.9 – 560.3	140.8 – 200.0

Source: FCA survey of firms (undertaken Q4 2016). *Limited Scope shows the estimates including the 22 additional Core firms with 1 Approved Person. **We have assumed that 39 RMA-B firms and 4 large debt purchasing firm incur Enhanced firm costs for the Core elements as they are large firms who are likely to have higher implementation costs than other Core firms. I.e. we have used the average costs for the Senior Managers Regime, Certification Regime and Conduct Rules for a firm in the Enhanced tier for these 43 firms when calculating the total cost for all solo-regulated firms.

The costs of the Core and Enhanced requirements

3.59 Tables 7 and 8 show the average one-off and annual ongoing compliance costs per firm and the total for solo-regulated firms in scope of the extension of the SM&CR.

3.60 The Senior Managers Regime, Certification Regime and Conduct Rules are the Core requirements of the SM&CR extension and apply to all firms in scope. Responsibilities maps, Allocation of overall responsibility and Handover arrangements (the Enhancements) are only applicable for Enhanced firms[34].

3.61 The average costs reported in the tables are derived from the sample of firms in the Core tier, Limited Scope, and Enhanced tier in complying with all the applicable Core and Enhanced requirements (Senior Managers Regime, Certification Regime and Conduct Rules as well as the Enhancements). The figures are therefore averages over the full range of costs different types of firms might incur. These averages are typically not the costs any individual firm will incur. For example, certification won't apply to many Limited Scope firms. Therefore, the estimated average costs for the Certification Regime for these firms are low.

32 When assessing the changes due to the reclassification of firms, we noted that one of the firms reclassified from Limited Scope to Core is part of a group of firms which includes entities in the Enhanced regime. The same applies to the Core firm with the highest expected compliance costs. If these 2 firms are excluded in the calculations of the compliance cost estimates for the Core regime the average one-off costs per Core firm are £15,870 to £16,050 and the average ongoing costs per Core firm are £4,940 to £68,850. The total one-off costs for the Core regime are £325.2m to £328.8m and the total ongoing costs are £101.2m to £140.5m. Due to differences in business models, some of the firms in scope of the SM&CR may plausibly have higher compliance costs than the remaining firms in their regime. We have therefore not excluded these firms in our estimates for the total compliance costs for each regime and the SM&CR in total. Weighing the survey responses ensures that they do not have an unduly large effect on the compliance cost estimates.

33 In our view the adjusted estimates are sufficient for the purposes of this CBA. Surveying further Limited Scope firms was hence not necessary.

34 Given the distribution of costs provided by firms in our sample, the median costs for firms are lower than the average costs reported in the table. Any measure of the central tendency of the distribution of firms' costs is not representative of the costs of any particular firm.

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

Element	Limited Scope, per firm £	Core, per firm £	Enhanced, per firm £	Total for all solo-regulated firms, £m
Senior Managers Regime	680	11,610	227,210	330.1
Certification Regime	160 – 210	3,830 – 4,000	203,140 – 205,020	149.1 – 154.5
Conduct Rules	100	3,000	23,820	72.0
Responsibilities Maps	na	na	5,480	1.6
Allocation of overall responsibility	na	na	3,710	1.1
Handover Arrangements	na	na	4,110	1.2
Total	950 – 990	18,440 – 18,620	467,470 – 469,350	554.9 – 560.3

Source: FCA survey of firms (undertaken Q4 2016). Columns may not sum to their totals due to rounding. 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 2 figures are the same. We have assumed that 39 RMAB firms and 4 large debt purchasing firms incur Enhanced firm costs for the Core elements as they are large firms who are likely to have higher implementation costs than other Core firms. I.e. we have used the average costs for the Senior Managers Regime, Certification Regime and Conduct Rules for a firm in the Enhanced tier for these 43 firms when calculating the total cost for all solo-regulated firms.

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	70 – 330	3,010 – 4,550	43,920 – 76,540	77.9 – 127.0
Certification Regime	20 – 40	1,480 – 1,920	11,450 – 12,280	34.6 – 44.4
Conduct Rules	20	1,250	5,590	28.0
Responsibilities Maps	na	na	420 – 880	0.1 – 0.2
Allocation of overall responsibility	na	na	140 – 450	0.0 – 0.1
Handover Arrangements	na	na	350 – 670	0.1 – 0.2
Total	120 – 400	5,730 – 7,720	61,870 – 96,410	140.8 – 200.0

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 2 figures are the same. We have assumed that 39 RMAB firms and 4 large debt purchasing firm incur Enhanced firm costs for the Core elements as they are large firms who are likely to have higher implementation costs than other Core firms. I.e. we have used the average costs for the Senior Managers Regime, Certification Regime and Conduct Rules for a firm in the Enhanced tier for these 43 firms when calculating the total cost for all solo-regulated firms.

3.62 A small number of firms will have to implement the 3 additional elements required under the Enhanced tier (responsibilities maps, allocation of overall responsibility and handover arrangements). The estimated costs of implementing these are set out in Tables 7 and 8. We have estimated that 280 firms will have to implement the Enhanced elements.

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

Costs for insurers

3.64 Table 9 shows the number of insurers that will fall under the 2 tiers based on the updated data extracted in January 2018. Updating the data lead only to minimal changes in the estimated compliance costs shown below.

Table 9. The number of insurers in each tier

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

Source: FCA internal data.

3.65 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 won't apply to small NDF insurers.

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

Overall costs to insurers

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

3.68 The tier for small NDFs will also apply to small insurers in run-off.[35] Although we contacted all small NDFs and 23 of the 42 small insurers in run-off, we had only 6 responses to our survey from these insurers, 2 of which were from small insurers in run-off.[36]

3.69 Further, the costs reported by these 6 firms varied considerably, with 3 firms reporting zero costs, 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 tier applies to different types of insurers. Because of the variability of the cost estimates and the small number of responses, we consider that the averages for the 6 firms are not reliable estimates of the one-off and ongoing compliance costs for small NDFs and small insurers in run-off.[37]

3.70 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 doesn't arise for other types of insurers (ie Solvency II and large NDFs), where there is less variability as we received many more responses.

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

36 We note that we increased our sample of insurers to increase the number of responses from insurers (see footnote 23). Notwithstanding this, we received very few responses overall.

37 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 10. Total one-off and annual ongoing costs for the tiers 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 – 3.6
Total	8.8 – 8.9	3.2 – 4.2

Source: FCA survey of firms (undertaken Q4 2016). *As explained in paragraph 3.70 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 2 figures are the same.

3.71 Our survey asked insurers to report the additional costs they would incur in implementing the SM&CR extension. 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

3.72 Tables 11 and 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.

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 won't provide a reliable estimate of the costs for NDFs, for the reasons set out in paragraph 3.70.

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 – 3,750	1.5 – 2.1
Certification Regime	630 – 1,010	0.4 – 0.6
Conduct Rules	1,420	0.8
Responsibilities Maps*	580 – 700	0.4
Allocation of overall responsibility*	190 – 250	0.1
Handover Arrangements*	250 – 480	0.1 – 0.3
Total	5,760 – 7,630	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 won't provide a reliable estimate of the costs for NDFs, for the reasons set out in paragraph 3.70.

Costs to the FCA

3.73 We 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.

3.74 We have updated these costs from those published in the CBA alongside the two Consultation Papers. This is because the programme of work we have to undertake to deliver the regime has developed since we published the Consultation Papers.

3.75 We have developed the policy, leading to the publication of near-final rules via the Policy Statements. The costs of policy development are captured within the staff costs in Table 13.

3.76 Leading up to commencement, there will be an increase in staff costs as we 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.

3.77 We will also incur costs in developing the IT infrastructure to support the implementation of the new Regime.

3.78 Further, given the scale of the Regime, in the period up to implementation and the period afterwards, we will provide training and communications to our 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, consultancy and communication, £m	Total, £m
Year 1	£0.8	–	–	£0.8
Year 2	£2.4	£0.1	£0.7	£3.2
Year 3	£3.0	£1.8	£1.3	£6.1
Year 4	£1.7	£0.7	£0.8	£3.2
Total	£7.9	£2.6	£2.8	£13.3

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

3.79 Following the implementation, there is not expected to be any significant change in the level of resources we use, 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 Regime. 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. 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 are 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 haven't estimated the indirect costs or wider market changes. This is because these costs can't 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. 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 Increased monitoring could benefit 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 are responsible for (beyond what is required to implement the Regime), 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 is 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 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 designed to be 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 2 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, it is also possible 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 evidence from other industries that regulation can delay and prevent innovation. However, innovation in financial services hasn't 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 rules, we might see less of this type of harmful innovation.

4.17 It has also been recognised that regulation can also foster innovation. Under the rules we might expect the innovation that occurs to have larger benefits for consumers, rather than innovations that increase profits at the expense of consumers. We support such innovation through initiatives such as project Innovate.

Firm exits 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. 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 are implementing 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 more firms exit, it is unlikely that this will significantly affect competition in financial markets. To raise concerns about a reduction in competition a significant player or a large number of smaller firms would need to leave. Importantly, if firms that can't meet basic standards leave the market, a negative effect on competition that is in interest of consumers is unlikely.[38] If such firms leave the market that is also a benefit.

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 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. This might cause 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 significantly 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 Regime do vary with complexity of the firm but are not significantly affected by changes in the scale of the firm. So, we might expect, 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 for larger firms, whose senior staff tend to be more internationally mobile.

Loss of certain individuals from the Financial Services Register

4.25 One consequence of the Regime is that the number of approved persons will be far smaller, with the FCA focussing the regulatory 'gateway' for Senior Managers. As a result, many of those Approved Persons currently on the Financial Services Register[39]

38 The FCA has a duty to promote effective competition in the interests of consumers (Financial Services and Markets Act, Section 1E).
39 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/.

(the Register), will become Certified under the SM&CR and won't need to be approved by the FCA,[40] 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 make it harder for smaller firms to gain the confidence and business of consumers.

4.28 It is not clear how important the Register is for consumers, even if they currently use it to check an advisor's status. We do not have data evidencing the extent to which consumers and industry use the Register to help assess the people they are 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.[41]

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.[42] 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 SM&CR. 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.

Labour market effects

Wage compensation

4.33 The SM&CR will increase accountability throughout organisations, with particular emphasis on the top 2 tiers of the firm's governance. As such, individuals may seek higher wages for taking on more responsibility (and with it potential liability).

40 We discuss the resulting cost savings in the Chapter on benefits (from paragraph 5.32).
41 A further consultation on whether details of Certified Staff should be available on a public register will follow this year (CP18/19).
42 See OFT, Cost pass-through: theory, measurement and potential policy implications 2014.

4.34 In addition, individuals with skills that are readily used in non-financial markets may have greater bargaining power to increase fixed pay. This is 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. The Regime 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 Regime. 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 turnover will increase recruitment costs. This higher turnover may lower the quality of staff in financial institutions if experienced people leave financial services and new staff have less experience and knowledge of the industry. The opposite will happen 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 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 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 behave recklessly, which is precisely what the rules 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 we haven't got the balance between proportionality and simplicity/consistency correct. If many firms can't understand the Regime, it is likely that it won't be complied with.

4.41 As noted in the compliance costs sections above, we will provide training and communications to industry to help make sure that firms understand their obligations under the new Regime.

4.42 The evidence from tax literature is that a respected and supported regulation system increases compliance.[43] The same is almost certainly true in financial services. If firms disagree with the Regime, this has implications for firms' attitude to regulation.[44] 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 tier into the Enhanced tier. 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 tier.

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 tier. This also since firms would need to avoid meeting the thresholds over 3 consecutive years to remain in the Core tier.

43 Heady and Miles 2016.
44 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.[45] Ultimately, its main aim is to drive culture change by making Senior Managers accountable and by applying baseline standards to all financial services staff.[46]

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 extension shares the same framework as the SM&CR for banks. Benefits established in the CBA for the banking regime have been cited here where relevant.[47]

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, specific 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 action** through Statements of Responsibilities and Responsibilities Maps,[48] Prescribed Responsibilities, Overall Responsibility requirement 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 approved people.

45 '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.
46 '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.
47 Europe Economics 2014, p 4.
48 Responsibilities 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 approved by the FCA, using information requested in our survey.

5.5 We haven't 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 can't 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 doesn't 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, Senior Managers must comply with specific 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. The requirements will also increase the oversight provided by Senior Managers, which may lead to increased training and monitoring of junior staff. Increased monitoring can reduce information asymmetry and, therefore, the principal agent problem identified in Chapter 2.

5.10 In the context of culture, research suggests that firms being tough on small initial infractions to combat incremental wrong-doing could also be effective in achieving a positive culture, and the Conduct Rules appear to be an effective tool to achieve this.[49]

49 Iscenko, et al. 2016 p. 36.

5.11 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

5.12 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 and may undermine market integrity. Increasing the regulator's ability to identify instances of misconduct not only reinforces deterrence but allows for actual instances to be managed more swiftly.

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

5.14 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. 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.

5.15 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. In turn, this 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.

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

5.17 Regulatory references requirements 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.[50] This will improve firms' ability to identify prior instances of misconduct, and help them assess whether potential recruits are fit for the role.

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

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

Broader scope for the FCA to take disciplinary actions

5.19 The Parliamentary Commission on Banking Standards' (PCBS) final report on banks found that under the APR, 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.[51] It is likely that this issue also applies to financial firms outside the banking sector.

5.20 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…'.[52] 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.

5.21 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 Responsibilities Map when deciding the extent of the Senior Manager's responsibilities in the firm.

5.22 For the most significant firms, Prescribed Responsibilities and the Overall Responsibilities requirement[53] will reduce 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 for misconduct.

5.23 Conduct Rules will apply beyond Senior Managers to cover a much broader range of employees within firms (for 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.

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

51 PCBS 2013.
52 Becker 1968; Iscenko, et al. 2016
53 The Overall Responsibility requirement will not apply to Core Firms, small NDFs and ISPVs.

Encouraging effective competition

5.25 As 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. Under the Regime the same standards apply to all firms,[54] 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

5.26 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

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

5.28 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'.[55] 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.

5.29 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.[56] 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.

5.30 Removing 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.[57] Increasing accountability should lead to improved decision making and result in better outcomes for firms and consumers.

54 Exceptions are Appointed Representatives which are not in scope of the SM&CR extension, except if they are also Limited Scope firms.
55 Brest and Krieger 2010, p.628.
56 Lerner and Tetlock 1999, p.263.
57 Armstrong and Huck 2010; Baker, Ruback and Wurgler 2002.

Improved staff hiring processes and professionalism

Improved professionalism

5.31 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
- making sure that they have taken reasonable steps to ensure that the decisions made by people in their areas are appropriate
- making sure that people working at all levels in their areas of responsibility meet appropriate standards of conduct and competence

5.32 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 approved people

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

5.34 As the 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.[58]

5.35 Some of the people currently requiring our approval and who won't 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 that the removal of certified individuals from the approval process will reduce the downtime between outgoing staff and new hires. This will help reduce the cost of lost productivity associated with staff turnover. For some firms this will constitute a net cost saving.

5.36 Firms in the Limited Scope and in the Core tier will have a very small number of people in roles that will no longer require approval (up to 2 on average because these firms do not currently have many people approved). Firms in the Enhanced tier have on average 13 individuals in roles that will no longer require approval. The expected average annual saving for all firms is £99 (£0, £166 and £3,741 for firms in the Limited Scope tier, Core tier and Enhanced tier, respectively). This will total savings to firms of £4.6m per year.

5.37 Insurers didn't identify any cost savings for the number of individuals requiring approval. This is because they may have underestimated the number of roles that will no longer require approval, assuming that the SM&CR extension would be very similar to the existing PRA Senior Insurance Managers Regime (SIMR).

58 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.

Conditional approvals and regulatory references

5.38 A further element of the SM&CR extension which will be of benefit to firms are the new policies of conditional and time-limited approvals for Senior Managers.

5.39 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.

5.40 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 approval.

5.41 The requirement for regulatory references will also improve firms' recruitment processes. These are a valuable way for firms to get relevant information about individuals being recruited. 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

5.42 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 mixed with asymmetric information; consumers believe that firms are capable of acting in consumers' interest but choose instead to act in their own interests.[59]

5.43 According to the 2016 Edelman Trust Barometer, in 2012 financial services was the least-trusted industry in the UK.[60] The erosion of trust in the financial services industry causes problems because some market transactions do not take place if parties can't trust their counterparties. As a result, a poor reputation (or lack of trust) over time results in lower consumer welfare and lower profits.[61]

5.44 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.[62] Our new regulations are designed to reduce misconduct, and increase misconduct being identified and remedied. This will promote a culture of increased good conduct and integrity at the individual level which is crucial to bring about cultural change at the firm level.[63] Ultimately, this will help raise public confidence in the industry and reduce the risk of reputational losses.[64]

59 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.

60 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.

61 Vanston 2012.

62 Armour, Mayer and Polo 2015.

63 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.

64 See Chater and Decision Technology Limited 2015, p.4.

5.45 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.

6 Illustration of potential benefits

Introduction

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 SM&CR extension seeks to address.

6.2 We are unable to give an estimate of the benefits, ie a reduction of the harm likely achieved by the Regime, as it is 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 Regime here would require significant amounts of data from across financial services. Even if we collected such data, we could not use these data to properly assess the benefits from the Regime. This is because it would likely not cover all past misconduct and because it is not clear to what extent the Regime 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 Regime.

6.3 In this chapter we use the updated (January 2018) information on the firms in the different tiers to illustrate the potential benefits. Since in the data on redress and fines only a small number of firms are now in a different tier, the analysis is largely the same as in the CP CBA.

Types of harm

6.4 Misconduct in financial services may cause 2 main types of harm to consumers.

6.5 One type is the harm to consumers caused ex-ante by the presence of market failures. For example, consumers may anticipate that a firm won't act in their best interest when it provides a given financial product or service. So they may decide not to buy a product that would be beneficial for them or may decide to buy a less suitable product. Similarly, misconduct may create the perception that firms sell the product at a higher price or a price that doesn't 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.[65] Given the number of markets firms affected by the SM&CR participate in, it hasn't been possible to quantify this type of harm.

6.6 The second type of harm is 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 doesn't suit their needs), loss of time and negative psychological effects, such as distress.

65 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 Quantifying this type of harm accurately would mean 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.

6.8 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 Regime in reducing this harm.

Evidence on current harm from misconduct

6.9 We use 3 sources of data to provide an estimate of the level of harm caused by firms affected by the SM&CR extension:

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

Data on redress

6.10 Data on complaints and redress paid by financial service firms are collected by the FCA and the Financial Services Compensation Scheme (FSCS).[66] Harm includes the time, effort and potentially the stress complainants have suffered.[67]

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

6.12 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.

6.13 There are 2 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 doesn't account for any wasted resources providing consumers with products and services that led to poor consumer outcomes.

6.14 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.

66 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.

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

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.)

6.15 To calculate the extent of harm, we firstly estimated the number of problems with financial services which didn't lead to complaints. A survey of consumers provided us with an estimate of the proportion of problems for which consumers make complaints.[68] The survey found that 69% of the problems caused by solo-regulated firms didn't 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.

6.16 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.

6.17 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 not leading to complaints generates the lower bound of 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.

6.18 We acknowledge that those who have experienced a problem but didn't make a complaint may have had less severe problems than those who did. 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 do not lead to redress being paid at all. These complaints may compensate for some of this bias.

6.19 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.

6.20 Potential redress won't capture the harm of many types of misconduct that the Regime seeks to address:

- We have no information about complaints resolved within a single business day. So, 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.[69]
- Even when eligible for redress through the FOS, consumers may choose to proceed to court and such actions are not included in our data.

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

69 In particular, they exclude all firms that do not 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 has consulted on increasing those thresholds and will publish the Policy Statement in Summer 2018.

- 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 is 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.

6.21 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 weren't made.

Data on the costs of handling complaints

6.22 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.[70]

6.23 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).[71]

Data on fines

6.24 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, we will impose a financial penalty, and no redress will be paid. This can happen for a number of reasons. For example, where a rule breach may have caused a risk of serious harm (justifying a penalty) but the problem didn't materialise so there was no loss requiring redress. In many insider dealing and market abuse cases, victims who suffer 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 to consumers but we will decide not to impose a financial penalty because we do not 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.[72]

6.25 It is important to note, however, that the size of a financial penalty won't, 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 we determine 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 got a

70 FCA, Improving complaints handling: Consultation paper CP14/30 2014, p.34.

71 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.

72 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.

settlement discount. Harm is measured by unpaid redress, complaints-handling costs and fines. Since the data on these are partly historic, it hasn't always been possible to identify which tier would apply for each firm (eg Limited Scope, Core or Enhanced for solo-regulated firms). Where this wasn't possible, firms have been grouped into the Core tier. Results for all firms are therefore more reliable than those for the different tiers.

6.26 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 extension of the SM&CR seeks to address this harm.

6.27 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.

6.28 We began regulating consumer credit firms in April 2014. In our analysis, we will have underestimated the redress, complaints and fines for these firms as we 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

	Redress, £m				Total, £m	
Tier	Lower (Unpaid redress)	Upper (any problem)	Admin. Costs, £m	Fines, £m	Lower (Unpaid redress)	Upper (any problem)
All firms	1,444.5	2,093.4	114.1	63.2	1,621.7	2,270.7
Enhanced	115.6	167.6	37.6	42.2	195.4	247.3
Core	1,310.1	1,898.7	61.1	21.1	1,392.3	1,980.8
Limited Scope	18.8	27.2	15.3	0.0	34.1	42.5

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

	Redress, £m				Total, £m	
Tier	Lower (Unpaid redress)	Upper (any problem)	Admin. Costs, £m	Fines, £m	Lower (Unpaid redress)	Upper (any problem)
All insurers	144.7	253.8	80.2	5.0	229.9	339.0
Solvency II, large NDFs	144.6	253.8	80.1	5.0	229.7	338.9
Small NDFs, small insurers in run-off	0.1	0.1	0.1	0.0	0.2	0.2

7 Conclusion: Comparison of costs and benefits

7.1 To understand whether the Regime is 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 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 SM&CR extension to break even.[73]

7.2 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 3.19 to 3.27). However, accepting these limitations the following analysis shows that the rules are likely to be proportionate to the scale of the likely harm in financial services that the Regime seeks to address.

7.3 To allow us to compare these costs with the illustrative harm we assume both occur each year over a 10-year period.[74] 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.[75]

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' in Table 16. We give 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 doesn't 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 Regime to breakeven. The analysis indicates that for solo-regulated firms a 9-17% reduction in the harm identified would lead to benefits that are larger than the compliance costs. The corresponding figures for the Core tier are 9-15%, which are within the range for all solo-regulated firms. For insurers, a greater than 1-2% reduction in harm would outweigh the compliance costs. The range for the harm reduction required for solo-regulated firms and insurers is given in the final column of Table 16.[76] These ranges do not significantly differ from those shown in the CP CBA

73 This approach is frequently used in situations where the benefits are not fully quantifiable; see Andrews, et al. 2016, p.40.

74 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.

75 We use 3.5%, the interest rate used by HM Treasury for policy appraisal.

76 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.

accompanying consultation papers, CP17/25 and 17/26 (was 9-16% for solo-regulated firms and 1-2% for insurers).[77]

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

Tier	Compliance cost PV, £m	Total estimated harm PV, £m*	Required reduction in harm to breakeven*
Solo-reg. firms	1,726.7 – 2,242.2	13,487.1 – 18,884.2	9% – 17%
Insurers	36.5 – 45.3	1,911.9 – 2,819.6	1-2%

FCA analysis. This shows the share of the compliance costs (net of cost savings due to fewer 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 Regime, 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 3.19-3.26).

7.9 Notwithstanding the uncertainties and limitations inherent in estimating costs and benefits of such wide reaching rules, we still believe it is reasonable to conclude that the reduction in harm resulting from our policy interventions will outweigh the implementation costs, and that the SM&CR extension will therefore be net beneficial (as at the consultation stage).

77 The figures for the Core regime weren't included in the CP CBA.

Annex 1
Reported estimates

The tables below show the estimated compliance costs based on the cost estimates as provided by the survey respondents, ie without omitting any cost items (see also paragraphs 3.17/8 above). As in the main part of this CBA the estimates for the Limited Scope tier are based on responses by 9 Limited Scope firms and 22 similar Core firms (with 1 approved person). The 39 retail investment firms and 4 debt purchasers are included in the Core tier.

Table A1: Total one-off and annual costs for the Regime: solo-regulated firms

Tier	one-off	ongoing
Limited scope	32.4	58.7
Core	475.9	353.0
Enhanced	170.5	46.0
Total	678.8	457.7

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	830	14,030	275,230	399.3
Certification Regime	210	4,090	205,110	156.3
Conduct Rules	200	3,910	88,100	114.2
Responsibilities Maps	na	na	13,090	3.7
Allocation of overall responsibility	na	na	8,700	2.5
Handover Arrangements	na	na	10,070	2.9
Total	1,240	22,030	600,310	678.8

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	2,050	11,250	111,180	320.4
Certification Regime	110	2,850	22,320	68.7
Conduct Rules	80	2,810	20,610	66.4
Responsibilities Maps	na	na	3,180	0.9
Allocation of overall responsibility	na	na	2,540	0.7
Handover Arrangements	na	na	2,040	0.6
Total	2,250	16,900	161,880	457.7

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

Tier	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 3.70 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 10 won't provide a reliable estimate of the costs for NDFs, for the reasons set out in paragraph 3.70. *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 ongoing costs per insurer, £	Ongoing costs, all insurers, £
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 10 won't provide a reliable estimate of the costs for NDFs, for the reasons set out in paragraph 3.70. *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)

Tier	Compliance cost PV	Total estimated harm PV		Required reduction in harm to breakeven*
		Lower bound	Upper bound	
Solo-reg. firms	4,090.0	13,487.1	18,884.2	22-33%
Insurers	99.9	1,911.9	2,819.6	4-5%

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
Summary of SM&CR Tools

Summary of SM&CR Tools: solo-regulated firms

Tool	Limited Scope	Core	Enhanced	EEA Branches	Third Country Branches
SMFs	• SMF29 – Limited Scope Function • SMF16 – Compliance Oversight • SMF17 – MLRO	• SMF1 – CEO • SMF3 – Executive Director • SMF9 – Chair • SMF27 – Partner • SMF16 – Compliance Oversight • SMF17 – MLRO	• SMF1 – CEO • SMF2 – CFO • SMF3 – Executive Director • SMF27 – Partner • SMF4 – CRO • SMF5 – Head of Internal Audit • SMF9 – Chair • SMF10 – Chair of the Risk Co • SMF11 – Chair of the Audit Co • SMF12 – Chair of the Remuneration Co • SMF13 – Chair of the Nominations Co • SMF14 – Senior Independent Director • SMF16 – Compliance Oversight • SMF17 – MLRO • SMF18 – Other Overall Responsibility • SMF24 – COO	• SMF21 – EEA Branch Manager Function • SMF17 – MLRO	• SMF19 – Head of Third Country Branch • SMF3 – Executive Director • SMF16 – Compliance Oversight • SMF17 – MLRO

Tool	Limited Scope	Core	Enhanced	EEA Branches	Third Country Branches
Prescribed Responsibilities	• None apply	• 6 apply	• 12 apply	• None apply	• X apply
Duty of Responsibility	Applies to all firms				
Statements of Responsibilities	Applies to all firms				
Responsibilities Maps	X	X	✓	X	X
Handover Procedures	X	X	✓	X	X
Overall Responsibility	X	X	✓	X	X
Certification Regime	Applies to all firms				
Fit and Proper	Applies to all firms				
Conduct Rules	Applies to all firms				

Summary of SM&CR Tools: insurers

Tool	Solvency II & Large NDFs	Small NDFs & Small Run – off firms	EEA Branches	Non-EEA Branches	ISPVs
Senior Management Functions (FCA only)[76]	• SMF3 -Executive Director • SMF27 – Partner • SMF18 – Other Overall Responsibility • SMF16 – Compliance Oversight • SMF17 – Money Laundering Reporting Officer • SMF13 – Chair of Nominations Committee • SMF15 – Chair of the With – Profits Committee[77] • SMF23b – Conduct Risk Oversight Officer (Lloyd's)	• SMF3 – Executive Director • SMF27 – Partner • SMF16 – Compliance Oversight • SMF17 – Money Laundering Reporting Officer	• SMF21 – EEA Branch Senior Manager • SMF17 – Money Laundering Reporting Officer	• SMF3 – Executive Director • SMF16 – Compliance Oversight • SMF17 – Money Laundering Reporting Officer • MF22 – Other Local Responsibility function	• SMF3 – Executive Director • SMF16 – Compliance Oversight
Duty of Responsibility	Applies to all firms				
Prescribed Responsibilities	19 in total, 3 FCA only	9 in total, 3 FCA only	N/A	14 in total, 3 FCA only	4 in total, 2 FCA only
Statements of Responsibilities	Applies to all firms				
Responsibilities Maps	✓	X	✓	✓	X
Handover Procedures	✓	X	X	X	X
Overall Responsibility	✓	X	X	✓	X
Certification Regime	Applies to all firms				
Fit and Proper	Applies to all firms				
Conduct Rules	Applies to all firms				

78 Note that these functions only apply where the firm already has someone fulfilling the role or if it is a required function for the firm type.
79 Note this includes the person(s) responsible for the with-profits advisory arrangement where relevant.

Annex 3
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Annex 4
Abbreviations 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
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 PS18/14 and PS18/15.
Please write to the email addresses given in the Policy Statements if you have comments on this cost-benefit analysis.

You can download the above Policy Statements from our website: www.fca.org.uk.

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