



UK
FINANCE

IMPROVING COST/ BENEFIT ANALYSES BY FINANCIAL-SERVICES REGULATORS

19 September 2020



1. INTRODUCTION

CONTEXT

1. We have prepared this paper, with the support of Avantage Reply, at the request of HM Treasury (HMT) officials ahead of an anticipated consultation on their approach to the next phase of the financial-services future regulatory-framework review later in 2020. It follows on our previous response in October 2019 to HMT's call for evidence on regulatory coordination in respect of recommendations for improving cost/benefit analyses (CBAs) by financial-services regulators in the UK.¹
2. The paper's focus is identifying the current way regulators analyse the costs and benefits of their interventions and the mechanisms for scrutinising these analyses. Through desktop research into a broad range of current regulatory and supervisory norms in relation to CBAs, not only within the UK financial-services sector but also across other UK sectors and in jurisdictions outside the UK, and subsequently through discussions with members, we have developed a set of recommendations and measures that HMT should investigate and consider in order to strengthen those practices.
3. The information collected during the research includes guidelines and frameworks from HMT, the Prudential Regulation Authority (PRA), the Financial Conduct Authority (FCA), the Payment Systems Regulator (PSR) and non-financial-services regulatory bodies in the UK such as the Office of Communications (Ofcom) and the Office of Gas and Electricity Markets (Ofgem). Financial and non-financial regulatory agencies outside the UK, such as the European Commission (EC) and the Treasury Board of Canada Secretariat (TBS), were also considered. We note that where other regulators refer to "impact analysis" in their documentation, we have considered it to be conceptually equivalent to CBAs. While there may be differences in how these terms are applied in practice, we believe the conceptual underpinnings are similar.
4. This paper has been drafted over a six-week period on a best-efforts basis. The evidence and range of observed practices are based on desktop research into a selected sample of regulators and industry bodies and may not represent the full range of regulatory practice. We are nonetheless confident that our recommendations would bring about significant improvement in CBAs conducted by financial-services regulators if implemented in the right way.
5. During the process of drafting the paper, the Regulatory Policy Committee (RPC) published its paper "Impact assessments: room for improvement?"² This highlighted some considerations based on the RPC's experience of independently scrutinising UK-government regulatory policies. We note that several observations made by the RPC directly support recommendations made in this paper. Where this is the case, we have also provided appropriate reference to the RPC's paper.

1 <https://www.ukfinance.org.uk/system/files/HMT%20call%20for%20evidence%20on%20regulatory%20coordination%20-%20UK%20Finance%20response.pdf>.

2 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/906260/RPC_Impact_Assessments_Room_for_Improvement.pdf.

SUMMARY OF THE CURRENT LEGISLATIVE FRAMEWORK FOR CBAs IN FINANCIAL SERVICES

6. Section 138I of the Financial Services and Markets Act 2000 (FSMA), as amended, requires the FCA to publish a CBA alongside a draft of any rules it proposes making. It does not have to estimate costs or benefits that, in its opinion, cannot reasonably be estimated. Section 138J of FSMA applies similarly to the PRA, as does section 104 of the Financial Services (Banking Reform) Act 2013 (FSBRA) in respect of draft requirements the PSR proposes imposing. Neither the FCA nor the PSR is required to undertake a CBA of any guidance it gives.
7. The legislative requirements for CBAs outlined in FSMA and FSBRA also do not articulate any specific measures that might considerably enhance their quality, effectiveness or value.
8. Finally, while individual regulators (e.g. the FCA) have established their own frameworks and approaches for conducting CBAs, they are not observed to be consistently applied. Other regulators (e.g. the PRA) have not documented and published such frameworks.
9. Against this backdrop, we make the following observations and recommendations for HMT's consideration to enhance the CBAs prepared by financial-services regulators.

OBSERVATIONS AND RECOMMENDATIONS

10. Regulators can intervene through a range of measures, not limited solely to formal rulemaking. They frequently articulate their expectations through guidance, discussion papers and other publications, and regulated firms are often expected in practice to comply fully or otherwise have a compelling explanation of why they have not done so. To that extent, not mandating CBAs for all interventions that effectively impose regulatory change can lead to an incomplete assessment of its impact.
11. Equally, permitting regulators not to conduct CBAs where costs or benefits cannot be reasonably estimated or it is not reasonably practicable to produce an estimate can create a perverse situation in which regulatory interventions with significant potential impacts (both benefits and costs) may not be fully assessed merely because it is difficult to undertake an assessment.
12. Therefore, regulators should be required to conduct CBAs for all interventions, whether or not in the nature of formal rulemaking. In addition, the scope of exceptions to this requirement should be limited to instances in which there are significant extenuating circumstances rather than merely some degree of impracticality. The reasons for availing of any such exceptions should be properly and publicly evidenced.

- **This is recommendation 1: requirement to conduct CBAs.**

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13. Financial-services markets are complex and operate within a multiagency regulatory landscape. They can be affected not only by changes promoted by one or more regulators but also by wider regulatory or legislative initiatives. The underlying complexities of these markets cannot be fully assessed through static or standalone CBAs that focus on the immediate impacts of single policy proposals by a single regulator.
 14. In addition, conducting only standalone CBAs inherently assumes that previous regulatory interventions were perfectly designed and implemented so that augmenting them incrementally is always the best option. This is not always a valid assumption.
 15. Therefore, requirements for CBAs should be clarified to include cumulative-impact assessments. In addition, CBAs should consider not only first-order impacts but also potential second- and third-order impacts, as well as feedback loops, so that they are robust and effective.
 - **This is recommendation 2: cumulative-impact analysis. It was previously made in paragraph 100 of our response to HMT's call for evidence on regulatory coordination.**
 16. We observe that, in a vast majority of cases, CBAs outline one potential approach to rulemaking and analyse that approach in some detail. However, CBAs should not be focused solely on one potential option or policy approach but instead analyse a full spectrum of options, from "do nothing" through to formal rulemaking. Within this analysis, options to adopt non-regulatory solutions or improve supervision and better enforce current rules and guidance should be clearly considered. We believe the consideration of a wide set of options will bring analytical rigour to CBAs and improve the quality of regulatory interventions.
 - **This is recommendation 3: options analysis. It was previously made in paragraph 101 of our response to HMT's call for evidence on regulatory coordination.**
 17. In the same way that all forward-looking assessments are based on assumptions, CBAs are subject to limitations and potentially significant variations against forecasts. Therefore, it is important to undertake an appropriate sensitivity analysis of options to assess the range of benefits and costs under varying assumptions. This is critical to establishing, with a higher level of confidence, that the range of benefits of a regulatory intervention will exceed the range of the costs.
 - **This is recommendation 4: sensitivity analysis. It was previously made in paragraph 102 of our response to HMT's call for evidence on regulatory coordination.**

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18. Where proposed interventions would mandate or promote the provision of new products or services, CBAs could be improved by undertaking market assessments that demonstrate there is enough interest in supplying and consuming them. This could prevent regulators from considering policy options that, while guided by the right principles, are ineffective because of inadequate market acceptance.
- **This is recommendation 5: market assessment. It was previously made in paragraph 102 of our response to HMT's call for evidence on regulatory coordination.**
19. As a major global financial centre, the UK benefits from consistency in regulation and supervision with other important centres. The terms of the UK's future relationship with the EU from the end of 2020 are not finalised at the time of writing this paper. However, it is reasonably clear that many UK firms will have a significant interest in maximising consistency of approach between UK and EU regulatory authorities. While undertaking CBAs, regulators should consider whether rules with the same policy objectives exist in other centres (e.g. the EU and the US) in order to promote consistency. We observe that this is a relatively established practice in several other centres.
- **This is recommendation 6: comparative analysis. It was previously made in paragraph 101 of our response to HMT's call for evidence on regulatory coordination.**
20. We identify a range of potential approaches to independent scrutiny of CBAs, from an internal review by another department to external scrutiny by an independent body, whether specific to financial services or economy-wide, and with the possibility of either direct intervention or simply the ability to comment on the quality of the CBAs produced by regulators. We believe HMT should consider this range of practices to develop a view of the most appropriate model, with a focus on the three-lines-of-defence concept.
- **This is recommendation 7: independent scrutiny. It was previously made in paragraph 90 of our response to HMT's call for evidence on regulatory coordination.**
21. These recommendations do not operate in a vacuum. They interact with and reinforce each other. For example, cumulative-impact analysis by itself can be informed through sensitivity and options analysis.

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22. As an overarching principle, encapsulating all our recommendations, we believe that CBAs should adopt a risk-based approach. This would improve their effectiveness by ensuring regulatory interventions are high quality, deliver desired outcomes and minimise the likelihood of regulatory failure. Based on this principle:
- CBAs should be required for all regulatory interventions, even in cases where it is difficult to arrive at a rigorous estimate of costs and benefits, and with exceptions only in cases where there are clear and robustly justified extenuating circumstances,
 - CBAs should include risk assessments, including qualitative assessments of the potential for adverse effects or regulatory failure, and normally also an attempt at quantitative assessment of costs and benefits, with appropriate caveats, even in cases where estimation is challenging,
 - cumulative-impact assessments could lead to identification, and even removal of bad or ineffective regulation,
 - options analysis should aim to take a risk-adjusted view of costs and benefits that is informed by sensitivity analysis,
 - sensitivity analysis of costs and benefits should include full transparency about the methods and models used for quantification and their underlying assumptions,
 - sensitivity analysis should also assess risks that the methods used do not fully capture the potential for unintended and unforeseen outcomes, which might invalidate the CBA and potentially lead to regulatory failure,
 - consistency analysis should be transparent about the risks of departure from (exceeding or falling short of) international norms and standards, and
 - independent scrutiny, potentially based on a three lines-of-defence model, should involve independent oversight of the rigour with which the first line of defence—the lead policy unit—has accounted for the risks associated with regulatory intervention.
23. Enhancing CBAs by adopting these measures would provide significant additional transparency to firms, and the market as a whole, about regulators' underlying decision-making processes. Publication of detailed CBAs would also align with industry expectations regarding the transparency of regulatory interventions.
24. We are mindful that robust CBAs are a means to the end of good regulatory decision-making. They should no more frustrate that outcome through ill-considered or disproportionate application than through their neglect. Done well, we see no incompatibility between observing the discipline and delivering the outcome.
25. We hope that these observations and recommendations, along with the evidence provided in this paper, are helpful to HMT in informing the next phase of the future regulatory-framework review.

2. RECOMMENDATIONS

RECOMMENDATION 1: REQUIREMENT TO CONDUCT CBAs

26. We recommend that financial-services regulators be required to conduct CBAs for all regulatory interventions, not just formal rulemaking.

CONTEXT

27. Regulators have a range of tools available to achieve their statutory objectives. Apart from formal rulemaking, these include guidance, discussion papers, supervisory statements and other documents, as well as making significant changes to supervisory practices. They all create expectations with which firms must generally comply and that can also have consequences for customers, markets and the wider economy.
28. As the PRA Rulebook FAQs note, “The Rulebook only contains rules. The Related Links sidebar for each Part contains links to relevant documents, webpages, and guidance, which may include supervisory statements. It will also include the relevant policy statements and consultation papers for the rules. Firms may find these useful to read alongside the relevant Part in the Rulebook.”³ This clearly sets the expectation that firms should consider additional sources in seeking to comply with PRA rules. The same construct applies to the other regulators.
29. Given the above, there is a strong case for regulators to conduct CBAs not only for formal rulemaking but also for other interventions that might impose material costs or burdens on firms or where there is clear merit in assessing potential costs and benefits in a rigorous manner. Yet they often do not where there is no statutory requirement, as was the case for the FCA’s guidance consultation on branch and ATM closures or conversions.⁴ Here, the FCA noted, “There is no statutory requirement in the Financial Services and Markets Act 2000 for a cost benefit analysis (CBA) on guidance. In accordance with our approach to analysing costs and benefits, we only produce a CBA for guidance where we identify an element of novelty which may contain certain prescriptive expectations.”
30. We also note that FSMA permits the FCA and the PRA not to estimate costs or benefits where, in the regulator’s opinion, these cannot reasonably be estimated or it is not reasonably practicable to produce an estimate. In such instances, the CBA need only include a statement of the regulator’s opinion and an explanation of it.
31. We believe this creates the potential for regulators not to conduct CBAs even where there are significant costs or impacts attached to a regulatory intervention. For example, in its Quarterly Consultation No 28, the FCA asserted that it could not quantify what impact a rule change to make clear the ability of the Financial Services Compensation Scheme to declare in default certain firms and successors subject to a new moratorium under the then-Corporate Insolvency and Governance Bill would have because it did not know how many companies would apply to enter the new moratorium.⁵

³ <http://www.prulebook.co.uk/home/Help>.

⁴ <https://www.fca.org.uk/publication/guidance-consultation/gc20-02.pdf>.

⁵ <https://www.fca.org.uk/publication/consultation/cp20-7.pdf>.

EVIDENCE

32. Several regulators and other bodies highlight the requirement to conduct CBAs for interventions whether they are legislative, regulatory or non-regulatory in nature.
33. The EC notes, “An impact assessment is required for Commission initiatives that are likely to have significant economic, environmental or social impacts. Provided that the above conditions are fulfilled, impact assessments should be carried out for both legislative and non-legislative initiatives as well as delegated acts and implementing measures, taking into account the principle of proportionate analysis.”⁶ It is clear from this statement that the Commission expects assessments to be carried for interventions that are not be in the nature of formal rulemaking.
34. TBS outlines similar expectations: “Hence, all regulatory departments and agencies are expected to show that the recommended option maximizes the net economic, environmental, and social benefits to Canadians, business, and government over time more than any other type of regulatory or non-regulatory action.”⁷
35. The EC recognises that conducting assessments may present challenges. However, it reiterates their importance, particularly in instances where reasonable estimates cannot be derived. It notes, “Assessing impacts can be particularly challenging at the EU level. . . . It is often difficult, therefore, to provide accurate estimates, at the Commission proposal stage, even of direct impacts such as compliance or implementation costs. Nevertheless, “known unknowns” should not be cast aside in the analysis. On the contrary, they should be readily acknowledged. In case of lack of data or uncertainties, the qualitative assessment needs to be strengthened (e.g. based on theoretical approaches), while being transparent about the impact that such uncertainties may have on the comparison of options.”⁸
36. This examples clearly articulate the expectation that regulators should not avoid undertaking a CBA merely on the grounds of impracticality or difficulties in estimation.

CONCLUSION

37. We recommend that regulators be required to conduct CBAs for all interventions, not just formal rulemaking, where significant costs may be imposed. Quantitative estimates should be supplemented by qualitative assessments where necessary
38. Equally, the conditions under which regulators are not required to undertake CBAs should be limited to robustly documented extenuating circumstances and not merely considerations of reasonable practicality.

6 <https://ec.europa.eu/info/sites/info/files/better-regulation-guidelines-impact-assessment.pdf>.

7 <https://www.tbs-sct.gc.ca/rtrap-parfa/analys/analys-eng.pdf>.

8 Ibid.

RECOMMENDATION 2: CUMULATIVE-IMPACT ANALYSIS

39. We recommend that CBAs conducted by regulators include cumulative-impact analysis.

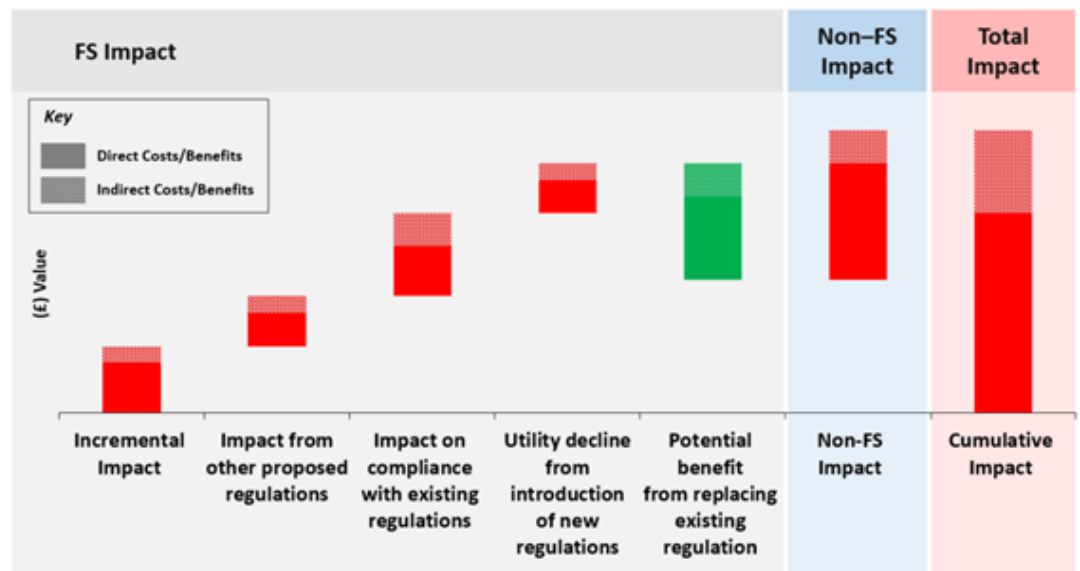
CONTEXT

40. FSMA and FSBRA do not require regulators to conduct a cumulative-impact analysis as part of CBAs. As a result, CBAs conducted in the UK are typically standalone and focus on estimating the incremental costs and benefits arising from introducing a specific new regulatory change.

Example of a cumulative-impact assessment

The implementation costs to a firm of complying with an existing or proposed “regulation A” would be £1 million. Complying with a proposed new “regulation B” would cost the firm £4 million. However, because of the introduction of the new “regulation B,” it would cost £8 million to comply with both regulations—an extra £3 million compared to the sum of individual costs (e.g. because existing resources that could meet either regulation need to be supplemented to meet both).

- 41. The following graphic outlines the key elements that should be considered within cumulative-impact analysis.
- 42. As the graphic highlights, a proposed intervention may have direct as well as indirect impacts, and both should be assessed as part of a CBA. Regulators should also consider whether the collective impact of multiple regulatory changes is significant even if the impact of each individually is not.
- 43. The FCA provides some guidance on accounting for cumulative effects. Compliance costs are defined as costs incurred as a direct result of meeting the requirements of a new regulation.⁹ The FCA also seeks to identify strictly incremental costs/benefits as opposed to mere transfers between consumer types or from firms to consumers. However, given the non-binding nature of such guidance, it is not consistently or rigorously applied.¹⁰



9 <https://www.fca.org.uk/publication/corporate/how-analyse-costs-benefits-policies.pdf>.

10 <https://www.fca.org.uk/publication/occasional-papers/occasional-paper-13.pdf>.

EVIDENCE

44. Based on a review of comparative practices, we believe CBAs should include an evaluation not only of standalone or incremental impacts but also of any additional impacts that result from interaction with other past, present and foreseeable changes in the regulatory, legislative or economic environment.
45. The Australian Office of Best Practice Regulation (OBPR),¹¹ the EC,¹² Ofgem¹³ and TBS¹⁴ point out a wide range of potential impacts, including economic, environmental and social effects, that should be considered when CBAs are performed. Impacts that are indirect or outside the market should be considered, in addition to more obvious direct impacts of the proposed regulation on affected sectors.
46. The requirement to account for the cumulative costs of regulation is explicitly articulated in some instances. The US Office of Information and Regulatory Affairs (OIRA) notes, “Where appropriate and feasible, agencies should consider cumulative effects and opportunities for regulatory harmonization as part of their analysis of particular rules, and should carefully assess the appropriate content and timing of rules in light of those effects and opportunities. Consideration of cumulative effects and of opportunities to reduce burdens and to increase net benefits should be part of the assessment of costs and benefits . . . Agencies should avoid unintentional burdens that could result from an exclusive focus on the most recent regulatory activities.”¹⁵
47. The Centre for European Policy Studies (CEPS)–Economisti Associati¹⁶ and HMT¹⁷ provide examples of categories that should be considered within indirect costs (e.g. indirect compliance costs, substitution effects and transaction costs) and indirect benefits (e.g. positive spillover effects related to third-party compliance and wider macroeconomic benefits) during the impact-assessment process.
48. CEPS–Economisti Associati also describes the concept of second-order effects of legislation, or “ultimate impacts,” defining these as a result of a combination of direct and indirect costs and benefits associated with a regulatory intervention.¹⁸
49. To ensure cumulative effects are appropriately considered, OIRA suggests taking a number of steps, including, “Early consultation with, advance notice to, and close engagement with affected stakeholders to discuss potential interactions between rulemakings under consideration and existing regulations as well as other anticipated regulatory requirements,” and, “Early engagement with state, tribal, and local regulatory agencies to identify opportunities for harmonizing regulatory requirements, reducing administrative costs, avoiding unnecessary or inconsistent requirements, and otherwise improving regulatory outcomes.”¹⁹

¹¹ https://www.pmc.gov.au/sites/default/files/publications/cost-benefit-analysis_0.pdf.

¹² Ibid.

¹³ https://www.ofgem.gov.uk/system/files/docs/2019/11/rrio-2_eso_cba_guidance.pdf.

¹⁴ Ibid and <https://www.canada.ca/en/treasury-board-secretariat/services/federal-regulatory-management/guidelines-tools/policy-cost-benefit-analysis.html>.

¹⁵ <https://www.whitehouse.gov/sites/whitehouse.gov/files/omb/assets/inforeg/cumulative-effects-guidance.pdf>.

¹⁶ https://ec.europa.eu/smart-regulation/impact/commission_guidelines/docs/131210_cba_study_sg_final.pdf.

¹⁷ https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/685903/The_Green_Book.pdf.

¹⁸ Ibid.

¹⁹ Ibid.

50. Further, CEPS–Economisti Associati,²⁰ HMT²¹ and TBS²² expect the incremental costs and benefits of each option to be assessed in addition to the base-case or business-as-usual scenario that considers current arrangements.
51. Cumulative-impact analysis, where possible, should also consider the following key elements:
 - an assessment of the costs and benefits of a proposed regulation to sectors outside financial services (OBPR²³ and TBS²⁴), and
 - an assessment of the timelines over which proposed or additional changes are expected to be introduced. Where several regulatory proposals are introduced in a short timeline, costs may increase and/or benefits decrease simply because of timing issues, or the ranking of options may change as a result (OIRA²⁵).

CONCLUSION

52. Based on the findings listed above, we recommend that CBA requirements include a clear expectation that regulators assess both the incremental and the cumulative impact of regulatory change.

RECOMMENDATION 3: OPTIONS ANALYSIS

53. We recommend that CBAs conducted by regulators include appropriate analysis of potential options.

CONTEXT

54. Regulators face multiple choices and options when contemplating a regulatory intervention. Initially, they should identify which markets may not be working well and how regulatory intervention could make them better. As the FCA itself notes, one of the drivers for market imperfections is regulatory failure, where existing rules prove ineffective or even detrimental and need to be removed or amended.²⁶
55. To optimise the outcomes of interventions, CBAs should analyse the full spectrum of options available to regulators, including an option to “do nothing,” through self-regulation, to formal rulemaking on a topic. The spectrum of options should also include, where relevant, non-regulatory measures such as market-driven approaches, improved supervisory practices and better enforcement of existing rules.

20 Ibid.

21 Ibid.

22 <https://www.tbs-sct.gc.ca/rtrap-parfa/analys/analys-eng.pdf>.

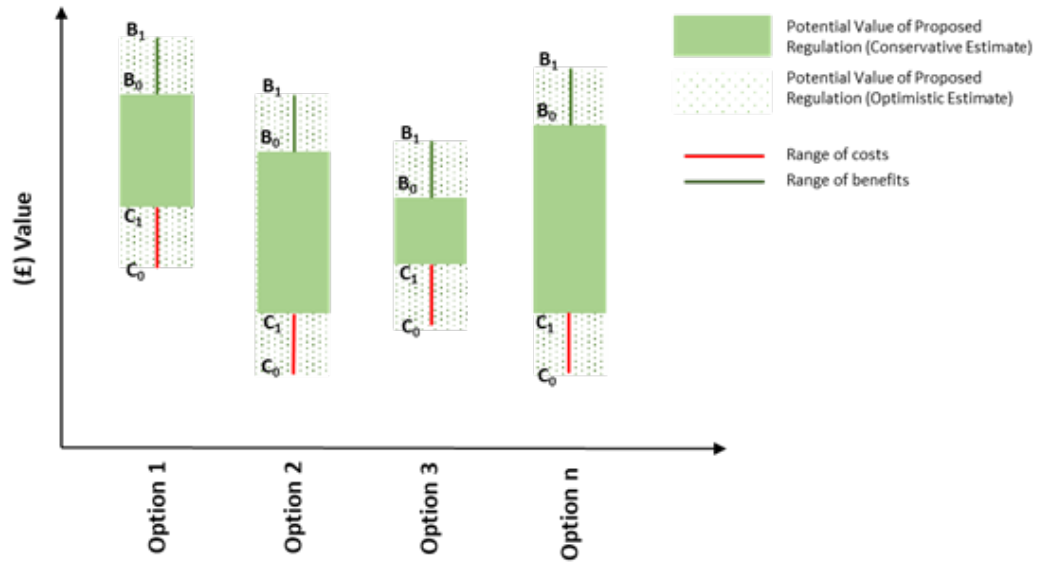
23 Ibid.

24 Ibid.

25 Ibid.

26 <https://www.fca.org.uk/publication/corporate/how-analyse-costs-benefits-policies.pdf>.

56. The following graphic outlines how options analysis can be a key ingredient of CBAs.



57. As an illustration, where regulators consider only one option (Option 1), they maximise the absolute level of benefits to the system but at a higher cost of intervention. Option n provides a lower level of total benefits, but with its lower cost, provides a higher level of net benefits.

EVIDENCE

58. Several authorities worldwide consider options analysis to be a key ingredient of CBAs. As HMT notes, “Generating a long-list of options at the start of the appraisal process ensures that a full range of possibilities are considered. . . . Starting out with a narrow set of options or a pre-determined solution may miss the opportunity to explore more novel, innovative solutions that might offer better social value.”²⁷ The EC echoes similar sentiments.²⁸

59. Nevertheless, before initiating regulatory change, a regulator must have a clear rationale based on strategic objectives, evidence or experience of market failure, shortcomings in an existing policy or distributional objectives the government aspires to meet (the EC,²⁹ HMT³⁰ and the RPC³¹). It could also be provided by the priorities and desired outcomes articulated by HMT in a strategy and policy statement developed pursuant to our recommendation in our response to its call for evidence on regulatory coordination.

27 Ibid
 28 Ibid
 29 Ibid
 30 Ibid
 31 Ibid

60. OBPR³² and Ofcom³³ advise on the specific options to be considered in the analysis, including keeping regulation unchanged/business as usual as well as improving implementation/enforcing existing regulation, revising the current regulatory framework and removing existing regulation. As OBPR states, “Identify a range of genuine, viable, alternative policy options to be analysed. You must consider at least three options, one of which must be non-regulatory. Your agency is responsible for the choice of options. A ‘do nothing’ or ‘business as usual’ option will usually provide the base case against which the incremental costs and benefits of each alternative are determined. In some cases, doing nothing may be the best option available.”³⁴
61. The requirement to amend or repeal one or more existing regulations if a new initiative imposes an additional burden is articulated in Canadian³⁵ and US³⁶ law. It was also an initiative introduced by previous UK governments, initially on a one-in, one-out basis requiring each department to:
- assess the net cost to business of complying with any proposed regulation,
 - ensure the net cost to business was validated by the RPC, and
 - find a deregulatory measure that relieved business of the same net cost.³⁷
62. This was updated to one-in, two-out³⁸ and subsequently one-in, three-out.³⁹
63. Such measures can be seen as blunt instruments, but they may equally prevent an undesirable accumulation of regulation over time. While we do not, therefore, recommend a mechanical implementation of one-in, n-out, we do agree that ineffective regulation should be amended or removed, and the process of conducting a CBA may identify opportunities for this.
64. The EC,⁴⁰ OBPR⁴¹ and TBS⁴² require consideration of non-regulatory (e.g. market-oriented) options as a part of a CBA. This is significant since it recognises regulatory interventions might not necessarily lead to the optimum outcomes in all cases. As an example, TBS notes, “When regulating, one should consider alternative regulatory options within the regulatory framework, non-regulatory options, and the combination of regulatory and non-regulatory instruments. This is because the recommended regulatory policy has to be proven superior not only to other regulatory options, but also to the non-regulatory alternatives and their combination. Regulatory options are a command and control approach where the government requires stakeholders to comply by law in order to attain a certain objective. This is in contrast to non-regulatory approaches that are designed to achieve the same objective through the forces of the market. Non-regulatory options are market-oriented approaches, including taxes, charges or fees, tradable permits, subsidies, deposit-refund systems, and so on.

32 Ibid

33 https://www.ofcom.org.uk/_data/assets/pdf_file/0029/45596/condoc.pdf

34 Ibid.

35 <https://laws-lois.justice.gc.ca/eng/acts/R-4.5/page-1.html?txthl=one#s-5>.

36 <https://www.govinfo.gov/content/pkg/FR-2017-02-03/pdf/2017-02451.pdf>.

37 <https://www.gov.uk/government/publications/one-in-one-out-statement-of-new-regulation>.

38 <https://www.gov.uk/government/collections/one-in-two-out-statement-of-new-regulation>.

39 <https://www.gov.uk/government/news/government-going-further-to-cut-red-tape-by-10-billion>.

40 Ibid.

41 Ibid.

42 <https://www.canada.ca/en/treasury-board-secretariat/services/federal-regulatory-management/guidelines-tools/policy-cost-benefit-analysis.html>.

Nevertheless, one should consider those options that have the potential to be more efficient or cost-effective. The initial selection of alternatives is likely to be based on a preliminary analysis of their characteristics or on the prior experience of other jurisdictions that have employed such options.”⁴³

65. Additionally, the EC,⁴⁴ HMT⁴⁵ and Ofgem⁴⁶ set out an expectation of considered but discounted options to be included in the final report/statement, with the rationale/justification for the exclusion provided. This ensures there is appropriate transparency when regulators decide to remove certain options from their analysis.
66. Also, CEPS–Economisti Associati points out that the base-case scenario should be considered as both dynamic and forward-looking (i.e. it should not only take into account the current conditions and regulatory landscape but also incorporate the potential evolution of the problem in the absence of the suggested intervention).⁴⁷
67. The consideration of different options is mentioned in the FCA’s current CBA framework, but we do not observe it being implemented consistently.⁴⁸ The FCA only performs a high-level options analysis at the initial stage of policymaking to rule out obviously inefficient options and select the most feasible solution.⁴⁹ However, in cases where there are multiple root causes of a problem, the FCA indicates it would consider combining different options to come to an appropriate solution to the overall issue.
68. Where regulators conduct options analysis only informally before the commencement of a formal CBA, an explicit requirement to make this public will help formalise the analysis.

CONCLUSION

69. Considering the evidence across sectors and jurisdictions, we conclude that CBA requirements should include the analysis of available options.
70. More specifically, they should set out factors that have to be taken into account when the range of options is defined, specific types of option that have to be included in the analysis and a requirement that information about the analysis be provided in the final report or statement.

43 <https://www.tbs-sct.gc.ca/rtrap-parfa/analys/analys-eng.pdf>.

44 Ibid.

45 Ibid.

46 Ibid.

47 Ibid.

48 Ibid.

49 <https://www.fca.org.uk/publication/occasional-papers/occasional-paper-13.pdf>.

RECOMMENDATION 4: SENSITIVITY ANALYSIS

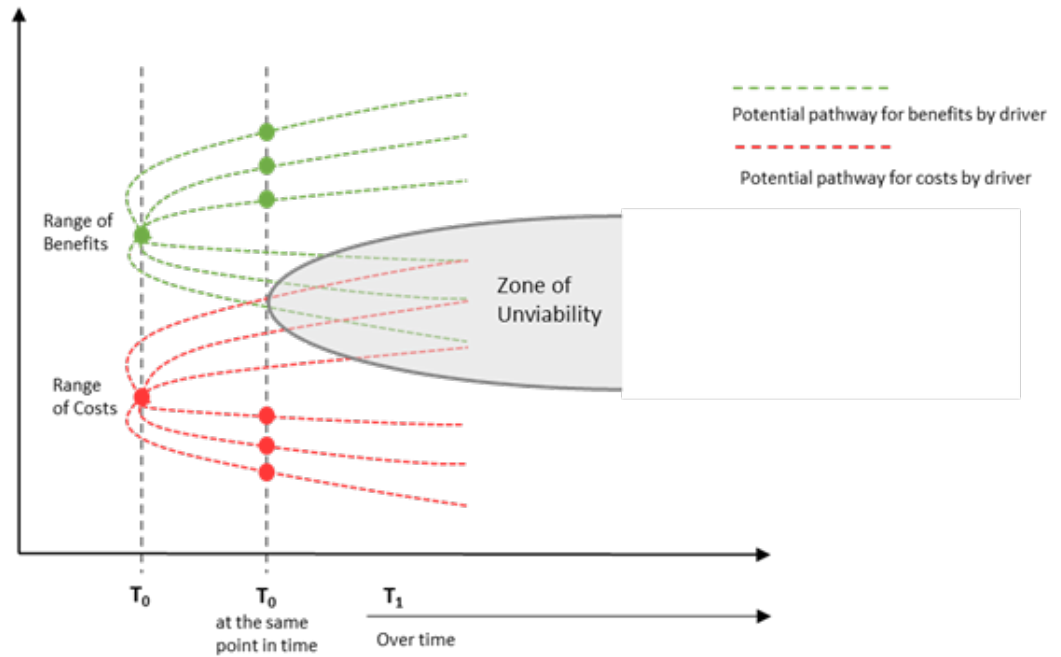
71. We recommend that CBAs conducted by regulators include appropriate analysis of sensitivities to relevant drivers, with full transparency about the methods, models and assumptions that have been used. They should also include an assessment of the overall risks of intervention, including the possibility that the models used do not capture the possible outcomes fully and the intervention may fail.

CONTEXT

72. Like all forward-looking assessments based on assumptions, CBAs are subject to limitations and potentially significant variations against forecasts. Therefore, it is important to undertake appropriate sensitivity analysis of options to assess the range of benefits and costs under varying assumptions.

73. We consider that such sensitivity analysis is only meaningful where there is full transparency concerning the methods and models used to quantify costs and benefits and their variation under different scenarios. This involves taking into account a range of potential changes in key input variables and analysing the sensitivity of the expected outcomes to these changes. This is critical to establishing, with enough confidence, that the benefits of a regulatory intervention are likely to exceed the costs by a reasonable margin.

74. The following graphic outlines the concept of sensitivity analysis when applied to CBAs.



75. Regulatory interventions are complex, and their effectiveness (adjusting benefits for costs) can be affected by a host of underlying drivers, including macroeconomic indicators (e.g. interest rates), firm-specific factors (e.g. solvency and liquidity conditions) and political developments (e.g. Brexit). Regulators should therefore analyse the impact of underlying drivers on the range of costs and benefits before making decisions about interventions. As the graphic demonstrates, under a set of sensitivities, desirable interventions may quickly become unviable as costs start exceeding benefits or the ranking of options based on net benefits may change.
76. Robust sensitivity analysis and assessment of the overall risks of intervening may highlight potential unintended consequences, which may in turn affect the overall assessment of the likely costs and benefits, leading to deleterious outcomes or outright regulatory failure.

EVIDENCE

77. According to guidance from HMT, the Public Service Transformation Network and New Economy,⁵⁰ as well as EU law⁵¹ and TBS⁵², sensitivity analysis should address a number of potential dependencies on which the CBA relies and measure their impact on the outputs, including assumptions and modelling techniques used in the assessment, key variables and parameters, data inputs and potential errors in data. As TBS notes, “Cost-benefit analysis relies on projections that use assumptions, parameters, data input and modelling techniques. Sensitivity analysis is a process to determine how plausible changes in the above factors affect the estimated costs and benefits of a regulatory proposal. Such analysis provides a range of costs and benefits that reflect uncertainty in the estimates. Departments must conduct a sensitivity analysis for regulatory proposals that have significant costs. Low-cost regulatory proposals that quantify or monetize costs or benefits do not require a sensitivity analysis, but they may include a qualitative description of the likely impact of uncertainty in key variables and assumptions on costs and benefits estimates.”⁵³
78. CEPS–Economisti Associati⁵⁴ and OBPR⁵⁵ specify three possible approaches to sensitivity analysis:
 - worst-/best-case scenario analysis,
 - partial sensitivity analysis, and
 - Monte Carlo sensitivity analysis.
79. HMT recommends performing sensitivity analysis at least on the preferred option for the policy/legislation, but where the results are found highly sensitive to certain inputs, the analysis may need to be extended to other considered options.⁵⁶
80. TBS accounts for the proportionality principle in assessing new policy/legislation by requiring sensitivity analysis only for regulatory initiatives potentially resulting in significant costs.⁵⁷

50 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/300214/cost_benefit_analysis_guidance_for_local_partnerships.pdf.

51 <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32015R0207>.

52 <https://www.canada.ca/en/treasury-board-secretariat/services/federal-regulatory-management/guidelines-tools/policy-cost-benefit-analysis.html>.

53 Ibid.

54 Ibid.

55 Ibid.

56 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/685903/The_Green_Book.pdf.

57 Ibid.

81. The FCA recognises sensitivity analysis as a key part of a CBA but does not provide sufficient detail on how it should be conducted.⁵⁸ In the presence of uncertainties, it suggests using a range of values when estimating impact to avoid suggesting a misleading degree of precision.
82. Finally, we observe that banking and finance firms are expected to conduct appropriate stress testing, scenario analysis and sensitivity analysis of their projections to enhance their credibility and analytical rigour. Regulators would benefit from applying similar approaches to the CBAs they conduct.

CONCLUSION

83. Considering the evidence, regulators should provide a sufficient level of detail about sensitivity analysis conducted as part of a CBA. This should include transparency about methods and models, potential dependencies that need to be tested/examined (e.g. assumptions and data), possible approaches that can be used to conduct the analysis, the extent of analysis required depending on the initial outcomes and the principle of proportionality.
84. An overall risk assessment should be provided, taking into account the risk that the methods used do not capture possible unintended outcomes and that these could result in adverse effects or outright regulatory failure.

RECOMMENDATION 5: MARKET ASSESSMENT

85. Where proposed interventions aim to mandate or promote the provision of new products or services (e.g. cheque imaging or open banking), we recommend that regulators validate them through appropriate market assessments. These assessments should also be undertaken where a proposed intervention aims to constrain or stop the delivery of a product or service (e.g. payday loans).

CONTEXT

86. Assessment of the affected market and engaging with market participants at an early stage of policymaking is essential to ensuring there is enough interest in the products and services to be mandated or promoted before regulatory intervention is undertaken. This should include assessing whether there is likely to be a two-way market, with both providers and consumers having an interest in participating. The assessments should include a “bottom-up” approach, where surveys or research are used to define stakeholders’ attitude and preferences as well as potential demand for the product or service. Analysis of market data should also be conducted, including but not limited to price trends, forecasts, supply curve and macroeconomic inputs. The market assessment should also consider various projections and scenarios (e.g. base case, high case and low case), while modelling should aim to optimise/balance projected supply and demand in order to minimise costs and maximise positive impact on consumers’ welfare as well as net welfare.

58 <https://www.fca.org.uk/publication/corporate/how-analyse-costs-benefits-policies.pdf>.

87. As such, the assessment should involve engagement with representative groups of stakeholders rather than a merely formal consultation, both at the initial stage of intervention and also subsequently for the CBA, with sufficient time allowed for all parties to undertake a proper investigation into the likely functioning of the market. The feedback received should ideally be included in the final report, with details of how it was considered.
88. The FCA and PRA seek stakeholders' feedback on the consultation papers they publish. The FCA's framework briefly explains that it will take into account stakeholders' views in response to CBA consultations before a rule is finally made.⁵⁹ However, it does not set specific expectations in relation to market assessments.

EVIDENCE

89. An important part of market assessment is engagement with stakeholders before the proposed regulatory intervention. HMT⁶⁰ and Ofcom⁶¹ recommend engaging at an early stage of impact assessment, while TBS⁶² requires regulators to obtain feedback before publication and the EC at the inception stage of the process, when the problem, policy objective and options are defined.⁶³
90. The EC has developed and adopted a consultation strategy for obtaining stakeholder feedback that includes, but is not limited to, predefined means of communication and corresponding timelines.⁶⁴
91. Our members consider that stakeholders should be given enough time to review each initiative thoroughly and provide feedback. The EC,⁶⁵ Ofcom,⁶⁶ Ofgem⁶⁷ and TBS⁶⁸ point out that information related to consultations with stakeholders, including a summary and evidence of their engagement, should be incorporated in the final report or statement.

Examples of market assessment

Ofgem commissioned a CBA for interconnectors applying for its cap-and-floor regime in the second window. This used three core market-development scenarios and examined a series of sensitivities on a project-specific basis to test the robustness of interconnector welfare and value.⁶⁹

Ofcom's CBA of the future use of the 700 MHz band assessed what use of this radio spectrum would be most beneficial to end-users by considering the demand for different options.⁷⁰

59 Ibid.

60 Ibid.

61 Ibid.

62 Ibid.

63 Ibid.

64 Ibid.

65 Ibid.

66 Ibid.

67 Ibid.

68 Ibid.

69

70 https://www.ofcom.org.uk/__data/assets/pdf_file/0025/28492/consultation-future-use-700MHz-band.pdf.

CONCLUSION

92. Based on the findings above, we conclude that market assessment should be part of any CBA mandating or promoting new products or services.
93. In addition, the CBA requirements should specify at what stages of the process consultations with stakeholders should take place, what formal process should be undertaken to ensure an appropriate level of communication and feedback, and what information with regard to the consultations should be included in the final document.

RECOMMENDATION 6: COMPARATIVE ANALYSIS

94. We recommend that CBAs conducted by regulators consider whether interventions with the same policy objectives exist in other major banking and finance sectors in order to learn from experience and promote an appropriate degree of consistency.

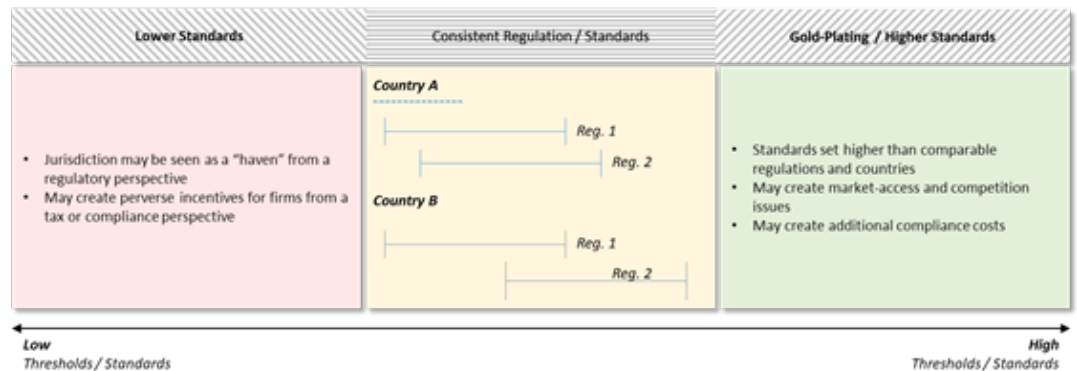
CONTEXT

95. As a major global financial centre, the UK benefits from consistency in regulation and supervision with other such centres and with international standards, such as those promoted by the Basel Committee on Banking Supervision (BCBS).
96. The terms of the UK's future relationship with the EU from the end of 2020 have not been finalised at the time of writing. However, it is reasonably clear that many UK firms will have a significant interest in maximising consistency of approach between UK and EU regulatory authorities. Consistency of approach is likely to remain a key determining factor in the continued success of the UK as a global financial centre.
97. Consistency in financial-services regulation was also highlighted in the background briefing notes to the December 2019 Queen's speech: "The Government will set out further measures to ensure the UK maintains its world-leading regulatory standards and remains open to international markets after we leave the EU in due course."⁷¹ Openness to international markets is heavily dependent on consistency of regulation.
98. In its updated policy statement on prudential standards in the Financial Services Bill, HMT also highlighted the need for regulators to consider international standards in prudential regulation: "The accountability framework will include additional requirements to ensure that the wider objectives of the government and Parliament are taken into account. This will include the impact of regulatory requirements on UK competitiveness, international developments in prudential regulation (including international standards, where applicable), and our relationships with other jurisdictions, such as financial services equivalence."⁷²

71 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/853886/Queen_s_Speech_December_2019_-_background_briefing_notes.pdf.

72 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/893792/Prudential_policy_draft_policy_statement_V4.pdf.

99. The following graphic clarifies the concept of consistency analysis further.



100. As the graphic highlights, consistency is attained when regulation introduced in one jurisdiction is broadly consistent with the range of practices observed in comparable jurisdictions for the same or similar purposes. The nature of the consistency can vary between adopting identical or similar mechanisms, such as rules, through to adopting different mechanisms that target similar outcomes. Where regulators establish more stringent requirements than their peers in other jurisdictions, this may constitute unnecessary and potentially damaging "gold-plating," significantly increasing compliance costs for firms. Where more stringent rules are justified (e.g. because of specific local conditions or cultural differences), this should be made clear as part of the CBA.
101. Where regulators establish lower standards, this may create perverse incentives for firms from a compliance or tax perspective. The risks of this should be carefully assessed. Again, the reasons for departing from international norms should be documented
102. We believe regulatory coordination and communication is a key enabler of consistency. When evaluating consistency of approach, regulators should consider the experience not only of other financial-services regulators in the UK and overseas but also, where relevant, of other sectoral regulators. The UK Regulators Network is a prime expression of the intent to engage and learn from best practice

EVIDENCE

103. Major regulators and supervisors promote consistency in financial regulation. For example, the BCBS notes that, "A key component of the Basel Committee's work is to ensure strong regulatory regimes and effective supervisory systems across its member jurisdictions. Public confidence in banks, prudential ratios, and a level playing field cannot be assured unless the Basel standards are consistently adopted and implemented. The lessons of the recent financial crisis have underscored the need for full, timely and consistent implementation of the Basel standards."⁷³

73 <https://www.bis.org/bcbs/publ/d434.pdf>.

104. According to HMT,⁷⁴ Ofcom⁷⁵ and TBS,⁷⁶ information on international practices and relevant experience in other jurisdictions should be used in an impact-assessment process (e.g. to complement the list of available options or provide evidence of the practicality of the proposed intervention). As TBS notes, “The initial selection of alternatives is likely to be based on a preliminary analysis of their characteristics or on the prior experience of other jurisdictions that have employed such options.”⁷⁷
105. In line with the EC, the impact assessment should include the reasons for any divergence of a proposed regulation from international standards or similar legislation in other jurisdictions where it might result in a significant negative impact on trade and investment flows.⁷⁸
106. CEPS–Economisti Associati suggests that existing international regulatory standards can be considered among other alternative options to address a problem.⁷⁹
107. With regard to accounting for international practices and relevant regulations outside the UK, the FCA framework recommends considering past policy interventions and best practices, both in the UK and elsewhere, when alternative options are chosen.⁸⁰
108. When discussing equivalence in the area of financial services, the EC notes that, “Equivalence decisions can bring benefits in terms of improving cross-border business conditions and creating new opportunities, thus contributing to fair and open trade between the EU and third countries.” These activities enable a “coherent prudential regime to apply to EU banks and other financial institutions operating outside the EU, thus lowering the cost of EU firms’ investments/exposures in third countries by facilitating capital management in particular.”⁸¹
109. HMT⁸² and the RPC⁸³ highlight the consistency of approach to impact assessment expected within the UK.

CONCLUSION

110. Considering the evidence across sectors and jurisdictions, we conclude that CBA requirements should include a clear expectation to review consistency of proposed regulatory change with international standards and regulation in other jurisdictions. Consistency should be assessed relation to both mechanisms and targeted outcomes

74 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/685903/The_Green_Book.pdf.

75 https://www.ofcom.org.uk/__data/assets/pdf_file/0029/45596/condoc.pdf.

76 <https://www.tbs-sct.gc.ca/rtrap-parfa/analys/analys-eng.pdf>.

77 Ibid.

78 Ibid.

79 Ibid.

80 <https://www.fca.org.uk/publication/occasional-papers/occasional-paper-13.pdf>.

81 <https://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:52019DC0349&from=EN>.

82 Ibid.

83 Ibid.

RECOMMENDATION 7: INDEPENDENT SCRUTINY

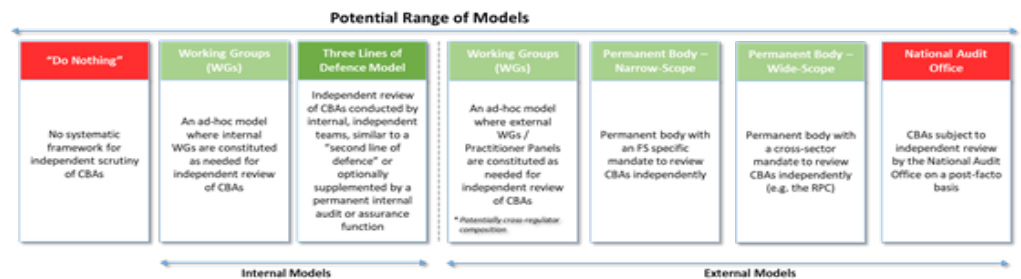
111. We recommend that CBAs conducted by regulators be subject to appropriate independent scrutiny, aligned to the nature and scale of the proposed intervention, to avoid potentially deleterious decision-making.

CONTEXT

112. Within the financial-services sector (and, indeed, beyond), there is established precedent of the three-lines-of-defence model, where independent review and challenge to the first line is typically provided by the second and independent assurance by the third. We believe this serves as an effective model for providing independent scrutiny to CBAs produced by “first-line” policy teams within regulators.

113. Other models may be equally worthy of consideration, based on policy objectives, complexity of implementation and scale of intervention. The graphic below illustrates the range of these models. What matters is that the scrutiny function is independent, effective and accountable for the exercise of its role.

114. While the graphic shows the range of options as a continuum, several them may coexist. For example, the three-lines-of-defence model may exist alongside an independent, external body providing further review and challenge to CBAs conducted by regulators. Conceptually, this is similar to the BCBS’s sentiment that “there are additional external levels of controls that complement the three existing internal layers of controls. . . . Particular to the regulated financial sector are the requirements to be subject to review by industry-specific regulatory bodies (e.g. insurance or bank supervisory authorities) that reside outside the organisation.”⁸⁴



115. While we outline “do nothing” and the National Audit Office (NAO) at each end of the continuum, we do not believe they present credible alternatives. The evidence below argues that the former is not a good option. Equally, the value of independent scrutiny is diminished where it is undertaken with a substantial time lag in an ex post facto audit-based fashion. Retrospective NAO review is a supplementary procedure rather than a realistic alternative.

84 <https://www.bis.org/fsi/fspapers11.pdf>.

EVIDENCE

116. As RegWatchEurope notes, “Independent scrutiny regarding the assessments and figures is a vital element in order to ensure comprehensive quantification, credibility and transparency.”⁸⁵
117. There is an established body of evidence in relation to the three-lines-of-defence model in the financial-services sector. As the BCBS notes, “Following extensive discussions within the industry, a three-lines-of-defence model was finally developed by the Institute of Internal Auditors in 2013. It has become the most common benchmark for assigning control and risk management responsibilities to business functions in an organisation. . . . The main value added of this model is to allow for a coordination of control responsibilities in an effective and efficient manner.”⁸⁶
118. Draft guidelines on internal governance recently published by the European Banking Authority focus on the three-lines-of defence model and the independent scrutiny and assurance provided by the second and third lines as an integral part of the structure and operation of financial-services firms.⁸⁷
119. The evidence for other independent-scrutiny models, including external bodies, is also extensive. The EC requires impact assessments to be evaluated by an independent regulatory body on an ex ante basis (i.e. prior to publication of the final report).⁸⁸ It notes that, “All new financial interventions which entail significant expenditure (in excess of €5 million) should be accompanied by an ex-ante evaluation as required by the Financial Regulation. The major programmes of the multi-annual financial framework will generally be accompanied by impact assessments which fulfil the requirement for an ex-ante evaluation but which also entail consultation of stakeholders and scrutiny by the Regulatory Scrutiny Board,” and, “The Commission's Regulatory Scrutiny Board scrutinises the quality of all draft IAs and issues one or more opinions on the draft IA report which are also available during the decision-making process. A positive opinion of the RSB is required before an initiative can proceed.”⁸⁹
120. Within the UK, the RPC, an independent body sponsored by the Department for Business, Energy and Industrial Strategy, assesses the quality of evidence and analysis used to inform regulatory proposals affecting the economy, businesses, civil society, charities and other non-governmental organisations. In a recent report, it noted that, “Independent scrutiny helps ensure that robust analysis and credible evidence is available to inform significant policy decisions and provides confidence in the analysis to external stakeholders.”⁹⁰

85 <https://www.regwatcheurope.eu/wp-content/uploads/2020/02/One-in-one-out.pdf>.

86 Ibid.

87 https://eba.europa.eu/sites/default/documents/files/document_library/Publications/Consultations/2020/EBA%20launches%20consultation%20to%20revise%20its%20Guidelines%20on%20internal%20governance%20%28EBA/CP/2020/20%29/898012/CP%20on%20Guidelines%20on%20internal%20governance%20under%20CRD.pdf.

88 <https://ec.europa.eu/info/sites/info/files/better-regulation-guidelines-impact-assessment.pdf>.

89 Ibid.

90 Ibid.

CONCLUSION

121. Based on a review of the comparative evidence, we conclude that a robust framework for CBAs should include appropriate independent scrutiny. While we have a preference for the independent, internal scrutiny provided within a framework based on the three-lines-of-defence model, we note that other models exist and may be deployed in a variety of ways to enhance the quality and robustness of CBAs.
122. We believe that HMT should establish rules to ensure that the results of independent scrutiny are made public in an appropriate and timely manner. We also believe that the results of independent scrutiny applied to CBAs are a key ingredient for the evaluation of performance of financial-services regulators.

