

FINANCIAL SERVICES AND MARKETS BILL: REGULATORY IMPACT ASSESSMENT

PURPOSE AND INTENDED EFFECT

i. Issue and objective

1. The Bill gives effect to the proposals to reform the regulation of the financial services industry, announced in broad terms by the Chancellor in his statement to Parliament of 20 May 1997. It creates a single, statutory regulator for the UK financial services industry, with a single set of functions and powers. The Financial Services Authority (FSA) will take over the responsibilities of, and have powers equivalent to those of the eight existing regulators for banks, building societies, friendly societies, insurance companies and investment firms. The FSA will also be responsible for the authorisation of those members of the professions carrying on business regulated under the Bill and will have significant responsibilities in relation to Lloyd's.

ii. Risk assessment

2. Regulation of the financial services industry protects against market failure. Prudential regulation reduces the chance of losses resulting from incompetent or dishonest management, giving consumers confidence in firms and markets. Regulation of a firm's conduct of business with its customers is designed not only to protect against dishonesty or negligence, but also to protect consumers from asymmetries of information.

3. However, the current system of regulation is costly, inefficient and confusing for both regulated firms and their customers. Existing arrangements for financial services regulation involve a large number of regulators, each responsible for different parts of the industry, operating under a patchwork of separate powers. In recent years there has been a blurring of the distinctions between different kinds of financial services business. This has added further to the complexity of financial regulation.

BENEFITS

Benefits to businesses

4. Combining the existing regulators should produce economies of scale, making regulation more cost-effective and producing savings in compliance costs and regulatory fees. These savings are considered later in the assessment. Increased confidence resulting from improvements to the regulatory framework should give the UK's financial services industry a competitive advantage, thereby enhancing its growth prospects.

Benefits to consumers

5. Around 90% of UK households use financial services products. Consumers will benefit because:

- the FSA will have a greater ability to target supervisory resources to where they are most needed. The regulatory framework will be better able to identify and resolve problems which cut across existing regulatory boundaries;
- there will be single points of access for enquiries, complaints and compensation. The complaints-handling arrangements will, for the first time, be compulsory for all regulated financial services firms and will improve handling of complaints which cut

across boundaries;

- the international role and status of the FSA should lead to improved regulatory cooperation, benefiting consumers using financial services across national borders; and
- an improved regulatory framework should increase consumer confidence and understanding in the financial services sector. Consumers may as a result be willing to use the services of the sector more extensively to make provision for future needs. To the extent that better regulation improves the operation of the market, the products they select will be more closely matched to their needs.

Business sectors affected

6. The UK's financial sector affected by the reforms accounts for about 7% of GDP. Around 34,000 businesses will be affected, split broadly as follows:

Banks	550
Building Societies	70
Friendly Societies	280
Insurance Companies	800
PIA firms (providers of retail financial services)	
- authorised	4,000
- appointed representatives	10,500
IMRO firms (fund managers etc.)	1,050
SFA firms (securities and derivatives firms)	1,300

The FSA will have significant responsibility in relation to Lloyd's (including about 13 members' agents and 65 managing agents). Approximately 16,000 professional firms (mainly solicitors and accountants) are currently authorised by their professional bodies, the vast majority on a precautionary basis. Authorisation of such firms will in future be a responsibility of the FSA. In most cases, only a small part of their business is financial services to be regulated under the Bill. In addition, the FSA will have registration functions in relation to about another 13,000 mutual organisations

Compliance costs for typical firms Non-recurring

7. Two main types of non-recurring costs will result from the proposals: one-off transitional costs to the regulator and compliance costs to firms. The FSA estimates its transitional costs, including establishing the single complaints-handling and compensation schemes, to be approximately £15 million. These costs will be financed by borrowing and will be repaid over time from regulatory fees paid by authorised persons.

8. Non-recurring compliance costs will arise because firms will need to adapt to the new regime, training staff and adjusting their systems and compliance manuals to reflect the new handbook. However, the requirements will, in most areas, be broadly consistent with those in existing rules, which will reduce the extra training necessitated by the Bill.

9. An initial estimate is that the one-off transitional cost might be equivalent to 5% of the existing annual compliance cost. For firms regulated by more than one body, this might rise to 10%. To take an example, for a securities firm, assuming an average incremental compliance cost of £97,000 per annum, the transitional costs, depending on the number of supervisors it has

currently, could be between £4,900 and £9,700.(1)

10. The Bill will give the FSA responsibility for regulating those carrying on investment business who are currently supervised by Recognised Professional Bodies and gives the FSA significant responsibilities in relation to Lloyd's. The alterations to the existing regulatory framework in these areas may create higher transitional costs than for other firms. However, it is expected that it will be possible to limit the need for professional firms to be authorised on a precautionary basis. This could lead to a significant reduction in the overall number of authorised professional firms and the corresponding overall compliance costs.

Recurring

11. Recurring costs for firms also derive from regulatory fees and compliance costs. Future regulatory costs depend only in part on changes introduced by the Bill. Other factors, such as prevailing salary rates, are important.

12. Co-location of some of the FSA's constituent regulators has produced cost-savings, due to efficiency gains. The FSA's budget for 1998/99 shows that on-going expenditure for the combined regulator (including the PIA, IMRO and SFA) will be £147.2 million, compared with a sum of £148.6 million for the predecessor bodies' original "business as usual" budgets, a saving of £1.4 million or £5.7 million in real terms (using the GDP deflator for 1997-98 to 1998-99). However, it is expected that increased property and salary costs arising from the future collocation of the remaining supervisors will offset these gains to a greater or lesser extent.

13. Compliance costs will depend on the requirements in the FSA's handbook of rules and guidance. In constructing its handbook, the FSA will be able to combine the best elements of each of the existing rulebooks and remove unnecessary compliance burdens. Its incentives to do so should be sharpened by the obligation under the Bill to have regard to the need to be efficient and economic and to ensure that the costs and restrictions on firms are proportionate to the benefits. The FSA will be obliged to consult on its fees and proposals to make rules. Its consultation will include an analysis of the costs and benefits of the proposals, unless it expects

(1) Estimates of average incremental compliance costs in paragraphs 9 and 16 are based on mid-points of data presented by Franks, Schaeffer and Staunton, "The direct and compliance costs of financial regulation," *Journal of Banking and Finance*, December 1997. Incremental compliance costs are those costs of complying with regulations that would not be incurred by a well run business in the absence of the regulations there to be no material increase in costs.

14. For those firms currently subject to more than one regulator, the measures in the Bill will create further savings. Reductions will come from having a single handbook of rules and guidance and the removal of duplication in compliance related activities (e.g. monitoring visits and regulators' requests for information). The management of these firms will have to spend less of their time in dealing with regulators, problems caused by inconsistencies between the rules will be eliminated, fewer returns will have to be made to regulators, the relationships with the regulators will be more easily manageable and some firms may have less need to create separate subsidiaries.

15. The FSA has made a preliminary estimate that over 800 firms currently have more than one

regulator and at least another 750 firms are members of groups which are subject to more than one regulator. These firms tend to be the larger firms and so account for a far larger proportion of total compliance costs than is implied by their number. For example, the great majority of life offices are regulated both by the PIA and by the Treasury's Insurance Directorate. All but the smallest banks are members of at least one SRO, as well as being supervised by the FSA, and some fund managers are regulated by more than one SRO.

16. To illustrate possible impacts, an initial estimate might be that recurrent compliance costs for firms supervised by more than one body could be reduced by between 2.5% and 5%. For an investment management firm currently regulated by more than one supervisor, its annual savings might be between £575 and £1150, assuming its incremental compliance cost is £23,000 per annum. For a securities firm supervised by more than one body, the savings might be between £2,500 and £4,900, based on an average incremental compliance cost of £97,000.

17. Given the early stage of the development of the FSA handbook, it is not possible at this stage to make a reliable estimate of total compliance cost savings. It is nevertheless clear that there is scope for substantial savings. For example, the 800 or more firms which currently have more than one financial regulator are maintaining something approaching 1,700 relationships with regulators. This suggests that as many as 900 such relationships will fall away, yielding useful savings in managers' and regulators' time.

18. All firms will also face recurring costs from the complaints-handling and compensation schemes. The Financial Services Ombudsman Scheme will be funded from a combination of a levy on all authorised firms and case fees. The Financial Services and Markets Compensation Scheme will be funded from levies imposed on the industry, although there will be separate funds for different industry sectors. These costs will depend on the number of complaints and claims on the compensation scheme funds and the limits on payments to claimants set by the FSA. Most firms already belong (either on a compulsory or voluntary basis) to one or more of the existing schemes and so much of the funding will not be an additional cost.

Impact on small business

19. A number of types of small business will be affected by the Bill, including, for example, Independent Financial Advisers (IFAs) and small stockbrokers. In practice, diseconomies of scale mean that the non-recurring transitional costs might be proportionally higher for a small firm than for a larger company.

20. The FSA estimate that the average ongoing incremental compliance cost for an IEA firm with one adviser is currently £2,400. The one-off cost may be greater than the £120 the assumptions in paragraph 9 might produce. For example, if the Bill gave rise to 10 hours of work, assuming average marginal earnings of £31 per hour, the one-off cost would be £310. Recurring costs resulting directly from the Bill will, however, be neutral and small firms may see cost savings from an improved FSA handbook.

Other costs

21. The legislation will result in some Government expenditure. The new Financial Services and Markets Tribunal will be funded by the Government. The costs will depend on the number of cases heard by the Tribunal but provision has been made for costs of £2 million per year. Currently, the Government makes provision for up to £60,000 per annum for the Financial Services Tribunal. The

Government does not currently fund the costs of the other tribunals of the FSA's predecessor bodies.

22. The Office of Fair Trading estimate that the competition provisions in the Bill will, in real terms, result in a negligible increase in recurring costs. Existing costs to the Government are £207,000 per annum.

Summary and Recommendation

23. The proposals in this Bill should lead to savings for a significant proportion of authorised persons from overall reduction in compliance costs and there are expected to be efficiency savings. In addition there will be other significant benefits, especially to consumers from an improved regulatory framework. Comments are welcome on the assumptions made and the resulting estimates.

Enforcement, Sanctions, Monitoring and Review

24. The regulatory framework contained in the Bill places responsibility, wherever possible, onto the FSA for monitoring and enforcing requirements imposed by or under the legislation. The legislation will also provide for a number of criminal sanctions. A number of bodies, generally including the FSA, will have prosecution powers under the Bill.