

Agenda

Advancing economics in business

A strategy for evidence-based regulation

Cost-benefit analysis of proposed regulation can be challenging and costly. So how can economic regulators ensure that their decisions are based on a sound impact assessment? Peter Andrews, Head of Economics of Financial Regulation, UK Financial Services Authority, explains the strategy and tools required for effective, evidence-based regulatory oversight

When the Financial Services Authority (FSA) proposes to make rules, it is subject to a requirement in the Financial Services and Markets Act 2000 to publish an estimate of the costs and an analysis of the benefits that would arise if the rules were made. UK government departments are subject to substantially similar requirements imposed through the Impact Assessment scheme operated by the Better Regulation Executive from the Department of Business, Enterprise and Regulatory Reform. Similar arrangements apply to the Directorates General in the European Commission and to the Lamfalussy Committees (which advise the Commission on financial regulation).

The main aims of these requirements seem to be to deter regulation where it is unlikely to produce net benefits, and to help regulators choose the best of the options open to them. There is much industry and academic debate about at least two aspects of these requirements. One is the feasibility of reliable ex ante measurement of the impacts of regulation. The other is the extent to which various aspects of political economy may undermine these requirements even if they can be operated successfully from a technical perspective.

In this article I do not intend to take issue with the proponents of either of these debates. Let us suppose instead that there are significant practical barriers to the success of ex ante analysis of proposed regulation, for this indeed seems to be a fact of life. As an aside, however, we should note that it does not follow from this that ex ante analysis of proposed regulation is necessarily not worthwhile. It may be worthwhile, and whether it has been worthwhile can be considered empirically after the fact, case by case.

My main theme here is as follows. Since ex ante analysis is challenging, it makes sense to consider whether the response to the challenge ought to be to make ex ante analysis part of a wider strategy for evidence-based regulation. It may be that weaknesses in

ex ante impact analysis can be offset, and the valuable contribution of ex ante analysis secured, by complementing it through the use of other techniques. In this article, I explain the wider strategy that has been developed in the FSA to try to make the FSA a genuinely evidence-based regulator.

One more introductory point may be necessary. I am not concerned here with the intrinsic quality of impact assessments or of wider policy-making processes. It goes without saying that careless, rushed or under-resourced impact assessment is dangerous. It also goes without saying that those who set standards without defining them carefully—and without collecting the data that allows compliance with the defined standard to be monitored and breaches sanctioned—may well be wasting resources: where would be the incentive to comply and, if there is not compliance, from where will the benefits materialise?

Instead I am dealing with the tools of evidence-based regulation at a conceptual level, and am assuming that they may be used properly. I hope that this will not prove to be similar to the case of the economist on a desert island who, when asked how to open the cans of food present, replied: 'let us assume a tin opener ...'

A long-term strategy for evidence-based regulation

The aim of the FSA's long-term strategy for evidence-based regulation is to obtain the information to make sensible business decisions about future regulation and to assess how successful or costly its interventions in markets are in practice. The latter activity can lead to adjustments to existing regulation. Recent revisions to the conduct of business rules for investment business (NEWCOB) and for general insurance are examples.

The key elements of the strategy are as follows.

- 1 **Focused, policy-relevant microeconomic research (internal or external) on relevant markets.**
- 2 **Market failure analysis.**
- 3 **Ex ante cost–benefit analysis (CBA).**
- 4 **Ex post impact assessment (a combination of research, formal CBA and indicators).**

I will explain the role of each of these elements of the strategy before discussing what ought to be measured in the case of a financial regulator responsible for prudential, conduct-of-business and financial markets regulation. I will then conclude this section by commenting briefly on the tools that can be used to make the measurements.

Microeconomic research

The FSA is neither a competition regulator nor a price regulator. The only instruments for pursuing its statutory objectives that the FSA can bring to bear are a set of interventions in economic markets. The FSA changes the conditions for the supply of financial services, and changes the nature of demand in financial markets. It influences the prices at which financial services can be supplied, and it increases the minimum quality of offerings. It cannot command and control markets, but can only work through markets. Thus the FSA is in a broad sense an ‘economic’ regulator.

When an economic regulator is considering past or future interventions in economic markets, one would expect it to want to know how the relevant markets are working from an economic perspective. Not knowing this would obviously increase the risk of interventions having severe perverse effects. Providing this understanding is the point of the microeconomic research that the FSA undertakes itself or requisitions from others.¹

In addition to helping in the design and reform of regulation, such research can contribute significantly to ex ante CBAs (and may be framed as ex post CBAs). For example, if research shows the wedge between costs and prices, it is telling us something about the size of the benefits to consumers that may arise from the enhanced competition that may result from the FSA requiring firms to reduce the information asymmetry between themselves and consumers. Of course, establishing a likelihood of benefits may require further research—for example, theoretical work on models of competition and laboratory work on how consumers’ decisions actually change under the influence of enhanced information sets.

Market failure analysis

The FSA has committed itself to intervening in markets only where the ‘strong’ test of market failure is met. In other words, it is not enough for there to be a market

imperfection in the sense of any deviation from the economists’ notion of a perfectly efficient market. Rather, the nature of the market imperfection must be such that there is a realistic expectation that the benefits of regulatory intervention will exceed the costs. This position has been best stated by the FSA’s Chairman, Callum McCarthy, in the FSA’s ‘Guide to Market Failure Analysis’.²

From an organisational perspective, use of market failure analysis (MFA) has significant advantages over use of CBA not preceded by MFA. MFA can be deployed at a very early stage in the policy-making process before detailed policy options have been developed, and before significant resources have been spent on a project. Thus it does not face the hurdles of convincing individuals, who have become committed to detailed and cleverly designed courses of action, or others who may have invested significant amounts of scarce resources in a project, that proceeding is not a good idea. In fact, the FSA uses MFA in part as a project hurdle. The idea is that if there is not agreement about the presence of a relevant market failure (in the strong sense), any planned project does not proceed.

Substantively, MFA also has important advantages as part of the suite of evidence used by the FSA in its regulatory strategy. It should mean that the expected benefits of projects chosen by the FSA are greater than would otherwise be the case. It helps materially in any related CBA by providing rigorous evidence of the causation mechanisms that are expected to give rise to benefits.

Ex ante CBA

Ex ante CBA or impact assessment is important because of the discipline it imposes on regulators who, like the FSA, are imposing delegated legislation on industries. As Oliver Wendell Holmes, the 19th-century US poet and physician, observed, the black letter lawyer who knows nothing of the economy is a public enemy. A century later, Holmes’s related prediction, that lawyers would need to become well-informed about economics, perhaps remains unfulfilled in the UK!

However, as already stated, ex ante CBA is challenging. Leaving aside issues of political economy, we must recognise that the current market is known only imperfectly. Moreover, the market that will develop under any proposed regulation is of course uncertain. The difference between these two markets—the difference that needs to be reflected in the CBA—is therefore uncertain. And data about the future does not exist.

These challenges are an important reason why the FSA has gone beyond the statutory requirement for CBA and embraced a wider strategy for evidence-based regulation. Practical experience suggests that

well-targeted research and MFA greatly facilitate CBAs and thereby improve the quality of decision-making.

The FSA's approach to CBA has a clear focus on doing only just enough work to assist decision-making.³

Ex post CBA

Ex post CBA is an important addition to ex ante CBA or impact assessment. It is easier than ex ante analysis because one can observe the way in which markets have changed since a regulatory intervention and, in principle, data about the change is available. Its great advantage is that it can tell financial regulators what actually works, which, for policy-makers facing large amounts of uncertainty, seems almost too good to be true. It is not too good to be true, provided that we collect the data.

Even in ex post CBA, assessing benefits is harder than dealing with compliance costs. On the former, the FSA requisitioned valuable help from Oxera, which, in 2006, developed a framework for assessing the benefits of financial regulation.⁴

Having described the main elements of the evidence-based strategy and how these may complement each other, making each element more likely to be successful, I turn to items that it may be useful for a financial regulator to measure. In the long run, a financial regulator needs a set of major, trackable indicators of the efficiency of the markets affected by financial regulation. These will show the progress that is being made in correcting the market failures that justify regulation in the first place. These indicators could include:

- the cost of investing;
- the cost of capital;
- availability of capital;
- availability of loans;
- impacts of regulation on GDP;
- consumption efficiency (quality-adjusted price);
- default rates (eg, as an indicator of suitability);
- persistency of contracts (incidence of—costly—early termination);
- quality of advice (a statistic on suitability);
- market cleanliness (incidence of suspicious price movements).

Naturally, in using any of these measures, it is important to control for non-regulatory drivers of change, and to accept that the results are approximations of regulatory performance. The FSA is still developing its measures, some of which can be seen in the Operating Performance Review (OPR) in its Annual Report. OPR indicator 9 deals with the costs and benefits of regulation, while indicator 5 deals with market cleanliness.

The tools that can be used to develop measures such as those described above include the following.

- 1 **Surveys and other data gathering**—eg, of firms' strategic projects on regulation, to identify the costs of regulation; consumers' valuation of regulation, as was undertaken in the case of custody, etc.
- 2 **Behavioural experiments**—eg, as described in the London School of Economics' work for the FSA on general insurance disclosure; such experiments might seek to identify whether, for example, consumers' behaviour actually changes in response to regulatory disclosures.⁵
- 3 **Accounting exercises**—eg, the FSA's cost of regulation studies.
- 4 **Data envelopment analysis**—eg, of consumption efficiency in the mortgage market.⁶
- 5 **Regression**—eg, see the FSA Occasional Papers on firms' responsiveness to capital standards and market cleanliness.
- 6 **Simulation**—eg, the evolutionary dynamical simulator, which academics are seeking to apply to some current regulatory proposals (with a view to identifying how markets may evolve with and without certain regulatory interventions), and simulations of the impacts of FSA capital standards on UK GDP, which the FSA is trying to develop, reflecting in part work previously carried out by the National Institute of Economic and Social Research.
- 7 **Statistical analysis to help determine the firms on which to spend supervisory resources, or to determine what combination of detection, enforcement and penalties would rationally deter cheating by firms.**

Conclusion

As I stated at the beginning of this article, the FSA is in an important sense an economic regulator. As such, it needs to understand the economics of the markets in which it is intervening. The overall strategy for evidence-based regulation described here should:

- improve our understanding of:
 - whether we should intervene;
 - where regulatory initiatives may lead;
 - what we have achieved;
- build a virtuous circle over time: knowing what we have achieved will help decisions on whether and how to intervene in the future;
- provide a discipline over initiatives, so that the FSA can pick those that will provide the biggest payoff;
- help the FSA to combine tools optimally: evidence on the impacts of supervision and enforcement matters as much as evidence on the impacts of rules, guidance and principles.

Peter Andrews

¹ Some of this work is published in FSA Occasional Papers, which are available on the FSA website at: <http://www.fsa.gov.uk/Pages/Library/research/economic/index.shtml>.

² FSA (2006), 'A Guide to Market Failure Analysis and High Level Cost Benefit Analysis', November, p. 6, available at http://www.fsa.gov.uk/pubs/other/mfa_guide.pdf.

³ See <http://www.fsa.gov.uk/pubs/other/CBA.pdf>.

⁴ Oxera (2006), 'A Framework for Assessing the Benefits of Financial Regulation', report prepared for the FSA, September. Available at http://www.fsa.gov.uk/pubs/other/oxera_framework.pdf.

⁵ De Meza, D., Irlenbusch, B. and Reyniers, D. (2007), 'Information versus Persuasion: Experimental Evidence on Salesmanship, Mandatory Disclosure and the Purchase of Income and Loan Payment Protection Insurance', London School of Economics, November.

⁶ See <http://www.fsa.gov.uk/Pages/Library/research/economic/index.shtml>.

If you have any questions regarding the issues raised in this article, please contact the editor, Derek Holt: tel +44 (0) 1865 253 000 or email d_holt@oxera.com

Other articles in the May issue of *Agenda* include:

- from sleeping giant to fast-moving asset: six challenges for infrastructure investment
- the ties that bind: when is retaliation effective and credible for tacit collusion?
- who's cashing in on mergers? measuring the benefits of consolidation

For details of how to subscribe to *Agenda*, please email agenda@oxera.com, or visit our website

www.oxera.com