Title:
A new approach to financial regulation: statutory instruments
IA No:

Lead department or agency:
HM Treasury

Other departments or agencies:

Impact Assessment (IA)

Date: 15/10/2012

Stage: Consultation

Source of intervention: Domestic

Type of measure: Secondary legislation

Contact for enquiries:
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Summary: Intervention and Options

RPC Opinion: AMBER

Cost of Preferred (or more likely) Option				
Total Net Present Value	**Business Net Present Value**	**Net cost to business per year** (EANCB on 2009 prices)	**In scope of One-In, One-Out?**	**Measure qualifies as**
£540m	NA	NA	No	NA

What is the problem under consideration? Why is government intervention necessary?

The tripartite system of financial regulation failed to ensure financial stability – in particular by failing to identify the risk posed by the rapid and unsustainable increase in debt in the economy. This resulted in considerable economic costs in lost output and in substantial deterioration in public finances. The regulatory system cannot be restructured without primary legislation.

What are the policy objectives and the intended effects?

The objective is to reform the financial services regulatory system to avoid a repeat of the financial crisis. The legislation will create a Financial Policy Committee to take charge of macro-prudential regulation. The Bank of England will regulate settlement systems and central counterparty clearing houses. The PRA – a Bank of England subsidiary – will undertake the prudential regulation of deposit-takers, insurers and certain investment firms using a more judgement-based approach. The FCA will regulate conduct of business generally, market conduct, investment exchanges and listing. The FCA will also be responsible for consumer protection in financial services and for prudential regulation of non-PRA regulated firms.

What policy options have been considered, including any alternatives to regulation? Please justify preferred option (further details in Evidence Base)

Two options have been considered at this stage: "do nothing" (the base case option in which the proposed regulatory reforms would not be made) and the preferred two regulator model of the PRA and FCA. The preferred option is justified by the reduction in the probability of a serious financial crisis ocuring in the UK. A serious financial crisis would lead to substantial losses in output. The benefits of the preferred option (equal to the change in the expected net present value of lost output) will outweigh the costs (which comprise the transitional costs for the authorities and for firms which will be regulated by the PRA and the FCA and the additional ongoing administrative costs for the authorities and the additional compliance costs for these firms.

Will the policy be reviewed? It will not be reviewed. **If applicable, set review date:** Month/Year

Does implementation go beyond minimum EU requirements?			N/A		
Are any of these organisations in scope? If Micros not exempted set out reason in Evidence Base.	**Micro** Yes	**< 20** Yes	**Small** Yes	**Medium** Yes	**Large** Yes
What is the CO_2 equivalent change in greenhouse gas emissions? (Million tonnes CO_2 equivalent)			**Traded:** NA	**Non-traded:** NA	

I have read the Impact Assessment and I am satisfied that, given the available evidence, it represents a reasonable view of the likely costs, benefits and impact of the leading options.

Signed by the responsible Minister: Date: 12/1/13

Summary: Analysis & Evidence

Policy Option 1

Description:

FULL ECONOMIC ASSESSMENT

Price Base Year 2011	PV Base Year 2011	Time Period Years 10	Net Benefit (Present Value (PV)) (£m)		
			Low: 540	**High:** 10,370	**Best Estimate:** 540

COSTS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low	185		68	**630**
High	245		93	**860**
Best Estimate	245		93	**860**

Description and scale of key monetised costs by 'main affected groups'

Development and implementation costs (spread over about 2 years) for existing public authorities and two new regulators; ongoing costs for two new regulators. Transitional and ongoing costs for: firms (deposit takers, insurers and certain investment firms) subject to prudential and conduct of business (COB) regulation. The estimates are not intended to be more precise than the discussion in the evidence base indicates.

Other key non-monetised costs by 'main affected groups'

There are no significant non-quantifiable costs.

BENEFITS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Benefit (Present Value)
Low	0		see text	**1,400**
High	0		see text	**11,000**
Best Estimate				

Description and scale of key monetised benefits by 'main affected groups'

Illustrative benefits only from reduction in frequency of severe financial crises in the UK - a benefit for the UK as a whole rather than for specific groups.

Other key non-monetised benefits by 'main affected groups'

A reduction in frequency of major incidents of consumer detriment in provision of financial services in the UK and benefits for consumers arising from increased competition between financial services firms - benefits for UK consumers, regulated firms and the regulators. These benefits are likely to be significantly smaller than the monetised benefits.

Key assumptions/sensitivities/risks — **Discount rate (%)**: 3.5

The key assumptions are those made for benefits and for the costs for regulators and affected firms. The main specific risks are: (1) that transitional costs are underestimated; (2) that there are significant additional costs for dual-regulated firms; and (3) that the benefit from the reduction in the frequency of severe financial crises is overestimated. The main overall risk is that the reforms make little or no difference to the incidence of financial crises.

BUSINESS ASSESSMENT (Option 1)

Direct impact on business (Equivalent Annual) £m:			In scope of OIOO?	Measure qualifies as
Costs: NA	**Benefits:** NA	**Net:** NA	No	NA

Evidence Base (for summary sheets)

Introduction

1. This assessment updates the impact assessment published in January 2012 in the policy document *A new approach to financial regulation: securing stability, protecting consumers* (Cm 8268) and accompanies the consultation on the main statutory instruments which are needed to complete the implementation of the reforms to the organisation of the UK's financial regulatory system as set out in the policy document and incorporated in the Financial Services Bill, now before Parliament. This section sets out the assumptions and analysis to support the assessment which have been refined where necessary to reflect further information from the Bank of England and the Financial Services Authority. It should be read in conjunction with the latest consultation document and previous documents regarding the Government's new approach to financial regulation. This impact assessment largely follows the structure of the impact assessments in those documents. As it updates previous assessments, the time periods covered and the base years for the calculations of present values of costs and benefits have not been changed.

2. The purpose of this assessment is to consider the package of measures as a whole. The statutory instruments now subject to consultation should be seen, therefore, as an integral part of the package of reforms and not as independent or separable measures. Accordingly, there are only two options: "do nothing" (the base case) and "proceed" (option 1). And this impact assessment does not include:
   a. an assessment of the costs and benefits of transferring consumer credit regulation to the FCA;
   b. an assessment of costs and benefits of other changes in FCA scope, including the conferring of certain competition powers and duties on the FCA.
   c. any other options or minor measures considered in previous impact assessments.

Objective

3. The tripartite system of financial regulation failed to ensure financial stability in the UK in 2007 and 2008. As a result there was the longest and deepest recession since the Second World War and a record budget deficit. The policy objective is to reduce the frequency and severity of financial crises.

4. The tripartite system failed in large part because of its inherent weaknesses and contradictions. It placed responsibility for financial regulation in the hands of a single authority which was expected to deal with all regulatory issues from the safety and soundness of large global banks to conduct of small financial advisers. The tripartite system also gave the Bank of England nominal responsibility for financial stability without the instruments to carry out that role or the regulatory relationship with the financial institutions whose activities could constitute the main threats to financial stability.

5. The Government's reforms will address these weaknesses by creating a system with properly focussed specialist regulators and institutions covering micro-prudential (firm-specific) regulation, conduct of business regulation and macro-prudential (systemic) regulation. The PRA (a subsidiary of the Bank of England) will be responsible for the prudential regulation of all deposit-taking firms, insurers and investment banks. The FCA will be a specialist regulator responsible for conduct of business regulation across the financial system covering the conduct of firms towards their retail customers as well as conduct in wholesale markets. A new Financial Policy Committee in the Bank of England will be responsible for identifying and addressing risks to the financial system as a whole while the Bank of England (rather than the PRA) will regulate systemically important financial infrastructure.

Overview of costs and benefits

Benefits

6. The key assumption for this impact assessment is that creation of specialist financial regulators and the strengthening of the arrangements for coordination between the PRA and the Bank of England should result in a reduction in the frequency of severe financial crises in the UK, in addition to any such reduction that could be attributed to other measures (such as internationally agreed changes to regulatory requirements). If that assumption is correct, the benefits of the proposed reforms would be likely to be large but the actual quantification (discussed in detail below) can only be the result of the assumptions made, including those about economic growth and the impact of a single financial crisis. Since the severe financial crises are relatively infrequent (a reasonable assumption would be once every 20-25 years), it would probably not be possible to test the key assumptions for at least 30-40 years and even then, it would be difficult to isolate the effects of past regulatory reforms from other factors.

Costs

7. There will be both transitional costs to change the regulatory organisation and some additional ongoing costs. Some regulated firms may incur transitional costs in making arrangements to deal with two regulators rather than one and may also incur additional ongoing costs in dealing with two regulators on a regular basis. Public authorities (primarily the Bank of England and the FSA) will incur transitional costs in setting up the new regulators. The new regulators' ongoing costs in total may differ from the costs that the FSA would have incurred if the regulatory reforms were not implemented. As at present, regulators' costs will be recovered in fees or levies paid by regulated persons or by persons engaged in regulatory transactions apportioned, as they currently are, on the basis of size and other factors relevant to the type of business activity or concerned.

Costs for public authorities

8. These cost estimates have been provided by the Bank of England and the Financial Services Authority (FSA) and relate principally to the creation of the PRA, its integration with the Bank and subsequent operations, and the transformation of the FSA into the FCA. The cost estimates have been updated as estimating improves and must be seen as the latest available "snapshot" of an ongoing process. The cost estimates cover the transfer of about a third of the FSA's regulatory staff to the Bank and the transitional costs of making the FSA into the FCA. There are relatively small costs to the Bank in setting up the FPC.

9. The Bank's approach to creating the PRA is founded on an expectation that costs of prudential regulation will fall in the medium term. This will flow from improved quality of system support (flowing from the extension of Bank's more economical and secure IT framework to the new subsidiary), from eliminating duplication between the PRA and the Bank, and also from tight control of costs.

10. In the short run, however, the transition will involve significant expense to the Bank on premises and IT. Establishment of the PRA as part of the Bank involves substantially more than just splitting the FSA into two parts and putting one part under a Bank governance structure. The Bank's view is that to deliver the objectives of judgment-based regulation, integrated with the Bank's analytical capacity, the PRA will need to be physically located in or very close to the Bank, and given the likely staff numbers involved, a new building will be required. The Bank is also clear that in order to contain costs in the long run it would not wish to share in the existing IT systems at the FSA, which have relatively high running costs. So in order to reach a position in which it can both ensure integration and exercise a proper control over future costs, the Bank will need to invest in the transition.

11. The transitional costs therefore include the costs of preparing for and undertaking the transfer to the Bank of relevant FSA staff; acquiring and fitting out suitable accommodation for the PRA close to the Bank; delivery of Bank corporate IT to the PRA, with associated networks and data

centres; giving PRA access to selected FSA regulatory data and applications pending development of PRA-specific systems; and programme management and business change.

12. The FSA legal entity will become the FCA and retain the staff and systems not transferring to the PRA. As with the PRA, there will be some IT system development work, although the FSA would obviously have been incurring IT expenditure in order to make improvements or upgrades to its systems. Such expenditure should not be seen as part of the cost of transition. However, there will be costs in restacking the FSA's main site as the PRA staff move out and space becomes available for re-letting; and some HR and training costs. There will also be legal and programme management expenses.

13. The Bank and the FSA are committed to ensuring that the transitional costs are minimised and controlled, and to achieving long-run cost savings to offset the transition costs.

Costs for regulated firms

14. The Government has sought views on the transitional and ongoing costs for all types of regulated person in previous consultations. A small number of responses on these matters were received and the comments made have been taken into account in the assumptions made for the transitional and ongoing costs that firms would incur in making changes to their internal systems and processes.

Description of options considered

"Do nothing" option

15. This option is the base case for this impact assessment. As the name implies, in this option the FSA would remain responsible for both the conduct of business regulation and the prudential regulation of all regulated financial services firms and carry out its other activities as now. The roles and responsibilities of other organisations would also continue as before.

16. "Do nothing" does not mean "no change in the regulatory environment". It only means that the reforms to the regulatory structure and organisation discussed in this consultation document would not be made. Other changes to the regulatory environment will continue to happen. These may include the implementation of changes to EU law or changes to domestic regulatory practice including the continuation of current FSA regulatory initiatives by the FCA or the PRA. Future changes to FCA or PRA rules will be subject to cost benefit analysis in essentially the same way as proposed changes to FSA rules currently are.

Preferred option – the proposed model of regulatory organisation

17. In this model:
    - a **Financial Policy Committee** in the Bank of England will have responsibility for considering the macro-economic and financial issues that may threaten financial stability;
    - the **Bank of England** will have responsibility for the regulation of settlement systems and central counterparty clearing houses to sit alongside its existing responsibilities for payment system oversight;
    - the **PRA**(a subsidiary of the Bank of England) will have responsibility for the prudential regulation of deposit-takers, insurers and certain investment firms;
    - the **FCA** will have responsibility for:
        - supervision (including prudential supervision) of all firms not regulated by the PRA, including most investment firms;
        - consumer protection in financial services (including through a stronger role in competition matters);
        - regulating conduct in financial services generally, including in relation to firms authorised and supervised by the PRA;

- regulating market conduct, including taking action to impose civil penalties for market abuse and pursuing criminal prosecutions;
- regulating investment exchanges and providers of trading facilities;
- primary market regulation (including listing).

Analysis of costs and benefits

Introduction

18. As explained above, the "do nothing" option provides the base case for this impact assessment and it is assumed that other changes to the regulatory environment – changes which would happen irrespective of changes to the regulatory structure or organisation - would increase or decrease the costs and benefits of each option by the same amounts on the same dates. The net present value (NPV) of each option would therefore be increased or decreased by the same amount and the ranking of the options and the differences between their NPVs would not be changed.

19. The costs and benefits of the "do nothing" option are therefore assumed to be zero and the costs and benefits of the preferred option are measured as differences from the amounts in the "do nothing" option. It would, of course, be double counting to treat something both as a cost (or benefit) of the "do nothing" option and as a benefit (or cost) in the preferred option.

Public authorities: transitional costs

20. The current estimate, taking account of the accommodation, IT and staff transfer expenses, the full cost to the Bank and the FSA of creating the PRA and transforming the FSA into the FCA, will be in the region of £135 million - £145 million. The range of transition costs has narrowed reflecting greater certainty about the costs for setting up the PRA. However, it will always be difficult to allocate precisely FSA costs between transitional costs for setting up the FCA and the ongoing costs of FSA/FCA operations.

Public authorities: ongoing administrative costs

21. The additional ongoing costs of the reforms will be mainly resource costs incurred by the new regulators less the ongoing administrative costs that the FSA would continue to incur in the "do nothing" option. However, it will always be difficult to attribute additional costs either to the regulatory reforms or to changes in regulatory practice or operations which might have occurred in any event.

Changes in supervisory practice etc.

22. The FSA has been taking steps to improve the rigour and credibility of its supervisory effort and the costs of this are reflected in the base case. The PRA is expected to take a more judgement-led style of prudential supervision which is likely to mean more intensive and demanding engagement between the regulator and the firms concerned. The Bank of England considers that these changes in supervisory practice will not result in higher ongoing costs for the PRA because of a more efficient approach to regulation and the ability to adopt more cost-effective IT solutions.

23. The FCA is also likely to make some changes to the operational model of the FSA in order to deliver improvements to consumer protection and market integrity. This reflects its role as a single, integrated conduct regulator with a more proactive approach to regulating conduct in financial services and financial markets and taking on a stronger role in competition matters. These changes will be in addition to changes already made by the FSA towards a more

interventionist and pre-emptive approach to retail conduct regulation which are included in the base case.

Loss of economies of scale

24. Some loss of economies of scale due to duplication of fixed costs is inevitable but this is not expected to be significant for the FCA as it will remain a relatively large organisation. The PRA is likely to be a smaller organisation but it is expected to be able to share common services and overheads with the Bank of England.

Increased specialisation and efficiency gains

25. Increased specialisation may result in some efficiency gains. However, these are likely to be limited as the FSA is large enough to ensure that there is a critical mass of expertise in both areas relevant to the FCA and PRA. The FCA should also be large enough to support the specialisation needed for certain activities such as listing, infrastructure regulation and market conduct.

Other matters

26. There should be no significant additional ongoing costs in respect of functions transferred to the Bank of England or arising from the activities of the Financial Policy Committee (FPC).

Conclusion

27. It remains difficult to estimate the overall balance of the factors discussed above. The Bank expects there to be long-run cost savings in the PRA arising from a more efficient approach to operational support, and in particular IT provision. But it is less likely that such savings could be made in the FCA which will retain a broad and enhanced set of responsibilities. In the short term the FCA will be operating with a similar fixed cost base inherited from the FSA, further hampering its ability to achieve savings. Overall, therefore, this impact assessment assumes that the incremental running costs of the regulators attributable to the creation of the FCA and PRA (and excluding any changes in supervisory practice and scope e.g. the transfer of responsibilities for consumer credit and the giving of certain competition powers and obligations to the FCA) will be about £45 million a year (or £43m at 2011 base year prices). This is the sum of the proposed 2013-14 estimates of the marginal running costs of the PRA, plus the costs of the conduct regulator component of the FSA less a hypothetical 2013-14 budget for the FSA constructed on the assumption that the FSA continued in being and the regulatory reforms did not take place.

Regulated firms: transitional costs

28. The estimates of transitional costs for regulated firms have not been changed in this impact assessment. Previous assessments took account of the views of the small number of consultees who commented on this issue. However, considerable uncertainty must remain in relation to these estimates.

29. Most of the approximately 19,000 UK firms regulated under the Financial Services and Markets Act 2000 will be regulated solely by the FCA. These firms may face some transitional costs – for example updating websites and letterheads – but these costs seem unlikely to be important. All firms will need to replace stationery and update websites etc. on a regular basis and they will have had notice of the proposed change. The additional resources required specifically to take account of the transition from the FSA to FCA are, therefore, assumed to be negligible for the purposes of this assessment.

30. About 1,600 UK-authorised firms are likely to be prudentially supervised by the PRA while also subject to conduct of business regulation by the FCA ("dual-regulated firms"). These firms will have to make arrangements to deal with two regulators rather than one, including changes to IT systems and possibly to internal processes and organisation. There are also some groups containing both dual-regulated firms and FCA-only firms which may be affected in a similar way as dual-regulated firms.

31. Many dual-regulated firms will be large banks, insurance companies and investment banks and most groups which contain dual-regulated firms are likely to be large or to contain large firms of these types. These firms or groups seem more likely to incur transitional costs in setting up systems to deal with both regulators, largely a function of the size of the firm.

32. The PRA will also be responsible for prudentially supervising much smaller firms which take deposits or effect and carry out contracts of insurance. Almost all credit unions and some friendly societies and building societies would fall to be considered as small firms; many credit unions would be very small by any standard. Some investment firms regulated by the PRA may also be small firms although it is likely that they will be parts of groups that include a bank or insurance company. The transitional costs for these firms seem likely to be relatively less depending on the circumstances of the individual firm.

33. It is difficult, therefore, to estimate the transitional costs that dual-regulated firms will face. It would also be difficult to separate genuinely additional costs from expenditure that would have been incurred anyway. Unlike most regulatory changes which involve firms having to make specific changes to staffing, processes or systems used in their businesses in order to meet precise, identifiable regulatory requirements, the principal effect of the regulatory reforms considered here is that dual-regulated firms will have to deal with two regulators rather than one. The transitional costs for these firms are simply the costs of setting themselves up to be able to do this. These costs are likely to vary considerably depending on their size, individual circumstances and their existing internal organisations, systems and processes. The small number of respondents to previous consultations who commented on transitional costs mainly included large dual-regulated firms and they expected quite large transitional costs, partly reflecting experience with recent regulatory changes – although these would mainly include changes to regulatory requirements rather than to the regulatory organisation with which firms would have to deal. On the other hand, it seems unlikely that very small firms, which are not expected to have to make major adaptations to prepare for the PRA's more judgement-led approach to supervision, will incur significant transitional costs.

34. The Government sought views on the transitional for regulated persons in previous consultations and respondents' comments have been taken into account in the assumptions made for the transitional that firms are likely to incur in making changes to their internal systems and processes. However, the small number of responses received and the range of different sizes and circumstances of dual-regulated firms mean that it is not possible to produce more precise estimates of their transitional costs. The range of estimates is, therefore, unchanged at £50 million to £100 million.

Regulated firms: ongoing compliance costs

35. The estimates of ongoing compliance costs for regulated persons have not been changed in this impact assessment. Previous assessments took account of the comments received from a small number of consultees who commented on this issue. However, considerable uncertainty must remain in relation to these estimates.

36. Regulated firms and applicants for authorisation are only like to face significantly higher ongoing compliance costs if they have to deal with more than one regulator. The majority of FCA-only firms are unlikely, therefore, to face higher ongoing compliance costs. Some firms may be affected by the possible changes to the FCA operating model but that will depend on a range of factors and need not imply higher costs for firms; this is discussed in more detail in the section on benefits.

37. Dual-regulated firms (and applicants) will have to deal with two regulators and may need to respond to the changes in supervisory practice in the PRA. Respondents to previous consultations and those who commented on this issue in response to the June 2011 White paper have been concerned that dual-regulated firms would face significantly higher costs and that these would fall disproportionately on smaller dual-regulated firms.

38. In practice, it seems unlikely that very small dual-regulated firms would face significantly higher ongoing compliance costs. Changes in PRA supervisory practice will mainly affect larger firms as a result of the move towards more judgement-led supervision and greater emphasis on high-impact firms. It is likely, therefore, that the overall supervisory effort directed towards the smallest firms will not increase significantly as a result of the introduction of a second regulator. The smallest firms are unlikely, therefore, to have to incur extra compliance costs as a result of changes in supervisory practice. The smallest firms are also less likely to incur significant additional costs simply in dealing with two regulators rather than one. This reflects the fact that small firms will have fewer and less complex interactions with regulators and the introduction of a second regulator is unlikely to increase the burden of those interactions substantially.

39. The impact on larger dual-regulated firms seems likely to be relatively greater than for smaller dual-regulated firms but the amount of the impact would depend to a significant extent on the circumstances of individual firms and their existing internal systems and processes. The largest PRA firms are probably best placed to adapt to a move to more judgement-based supervision and other changes in supervisory practice and so may not face significantly higher compliance costs in comparison with the current position. Many of these firms are likely to be part of major international groups and so will already be dealing with a number of regulators internationally and they are unlikely therefore to face significant additional cost in interacting with on extra regulator in the UK.

40. However, it is much more difficult to gauge the effect on medium-sized PRA firms (which could include a broad range of smaller banks, building societies, insurers, friendly societies or proprietary trading firms). A great deal could depend on the complexity of their businesses and their individual circumstances and the nature of the business they undertake. Some medium-sized firms could be in a similar position to that of large firms (e.g. by being in a major international group). Others might be in a similar position to small firms. A wide range of possible cost impacts is likely.

41. The Government sought views on the ongoing compliance costs for regulated persons in previous consultations and respondents' comments have been taken into account in the assumptions made for additional ongoing compliance costs that firms would incur. However, the small number of responses received and the fact that firms can be expected to adapt over time to the new regulatory arrangements mean that additional ongoing compliance costs cannot be precisely estimated. This impact assessment therefore keeps the assumptions about additional ongoing compliance costs of between £25 million and £50 million a year used in previous assessments.

Benefits

Improvements in prudential regulation

42. The reforms are expected to deliver improvements to prudential regulation in two ways. First, the PRA will be a specialist prudential regulator able to focus exclusively on the safety and soundness of individual deposit-taking firms, insurers and investment banks – that is important proprietary trading firms that take significant risk on their own balance sheets. Second, the FPC will be able to take a better strategic overview of developments in the financial system and emerging systemic risks; as a result, it will be well-placed to anticipate potential problems and facilitate the taking of regulatory action by the PRA. The Financial Services Bill gives the FPC a power of direction to the PRA or FCA to take macro-prudential measures. (See separate consultation and impact assessment on macro-prudential tools.) The improvements in prudential regulation will deliver benefits in the form of a reduction in the likelihood of a financial crisis.

43. In principle, the these benefits can be estimated by calculating the change in the present value of the total expected welfare losses (represented by the reduction in output i.e. GDP) from financial crises due to the reduction in the frequency of financial crises. This is equivalent to estimating the change in the probability of a financial crisis occurring in a year multiplied by the very large

loss (the present value of the reduction in GDP in that years and several subsequent years) which would result from the financial crisis, and then discounting these annual amounts and summing them.

44. It is then necessary to deduct the amount of any benefits which could be expected to arise in the base case, including (i) the effects of the increased rigour and credibility of the FSA supervisory effort and (ii) the net effect of any changes to relevant regulatory requirements which would happen in any case (e.g. in bank capital and liquidity requirements made to implement recommendations of the Basel Committee on Banking Supervision to strengthen global capital and liquidity rules) or of other reform measures such as those to implement the ICB recommendations.

45. Of course, all such estimates are entirely dependent upon the assumptions made while isolating the net effects of other reforms or measures would be very difficult. The present values of benefits should be regarded as purely illustrative.

46. The Basel Committee on Banking Supervision has published estimates of the annual economic benefits and costs of tighter regulatory standards, including estimates of the effect of higher capital requirements on the probability of systemic banking crises. Their estimates of the annual benefits of reducing the probability of a financial crisis by 1 percentage point (e.g. reducing the incidence of financial crises from 4 per century to 3 per century) range from 0.19 per cent of output per year (assuming that financial crises have no permanent effect on output) to 1.58 per cent of output per year (assuming that financial crises have a large permanent effect on output).

47. The Basel Committee on Banking Supervision also considers that requiring banks to hold increased capital and liquidity will itself lead to significant reductions in the probability of financial crises and to significant net benefits in terms of reductions in output lost. It will always be difficult to assess how much of any benefits should be attributed to changes in capital and liquidity requirements rather than improvements in supervisory practice. The amount of capital and liquidity that a bank holds (and the amount of risk-weighted assets included in the denominator of a capital ratio calculation) can only be estimated on the basis of information from the bank's accounting systems and will depend on the quality of information in those systems. Clearly more intensive supervision could make a more important contribution to improving the stability of a bank if it led to the identification and correction of weaknesses in the bank's information systems. Increasing capital requirements would be more important for a bank which already had good systems.

48. It is impossible therefore to estimate the amount of any benefit that could be attributed to the preferred option but if it is assumed that the proposed regulatory reforms alone reduced the probability of a financial crisis by only 0.1 percentage points - equivalent to reducing the frequency of financial crises from (say) 5 a century to 4.9 a century or increasing the interval between financial crises from 20 years to 20 years 5 months. The Government considers that strengthening the regulatory system in the way proposed, allowing for more focussed and effective supervision of banks and similar financial institutions will result in significant changes in bank behaviour or allow the PRA to take appropriate supervisory action at an earlier stage to ensure that changes in bank behaviour take place. While it is not possible to give a definitive estimate of a change in probability of events of this kind, it is reasonable to conclude on this basis, that the proposed regulatory reforms will lead to a reduction in the probability of financial crises of at least the amount assumed in this impact assessment.

49. A reduction in the probability of financial crises of 0.1 percentage points would generate an annual benefit of between 0.02 per cent and 0.16 per cent of output. On this basis, for illustrative purposes, the annual benefit for the UK of the proposed regulatory reforms would be between about £250 million and £2,000 million a year. (This is estimated by assuming UK output (gross value added at basic prices) in 2010 to be about £1,300 billion. The estimates would be higher if GDP at market prices was used.)

50. For the purposes of this impact assessment, it is assumed that these benefits would only accrue from 2014 to 2020, reflecting the 10 year cut-off for impact assessments. In practice, of course, the benefits should endure as long as the new regulatory structure is maintained. (The method of estimating the benefits implicitly assumes they are long-run effects; the effect of the reforms is essentially to increase the time between severe financial crises although the analysis accepts that much of this can be attributed to internationally agreed changes in regulatory requirements (which are in the base case).) On the assumptions made, these benefits should exceed any ongoing costs so the results of this assessment are not biased by working with the 10-year cut-off period.

Improvements in consumer protection

51. The benefits in terms of consumer protection from a more proactive approach with greater emphasis on transparency and disclosure, to regulating financial services and conduct can be estimated in essentially the same way by calculating the change in the NPV of the expected gains or losses for consumers, regulated firms and others (such as regulators) arising from adopting the new approach to consumer protection. This analysis will also be entirely dependent on the assumptions made.

52. There are potential resource benefits for consumers from a reduction in the frequency or severity of incidents of significant consumer detriment (e.g. major investment misselling cases). Consumers would not have to engage with firms, regulators or bodies such as the Financial Ombudsman Scheme (FOS) in order to obtain redress, or suffer any loss of interest because of the inevitable delay between suffering a loss and receiving compensation. They would also not suffer distress about potentially losing what may be large amounts of money or because of the uncertainty over whether they are able to obtain compensation; distress can be regarded as a resource loss for consumers although it is obviously more difficult to estimate.

53. The resource gains or losses for firms and regulatory bodies could also be large. Firms would not need to use resources to examine claims or complaints from customers or to deal with regulators or the FOS. Regulators, the FOS etc. and, if firms were in default and unable to pay claims, the Financial Services Compensation Scheme (FSCS) would not need to use resources to process claims. Both firms and regulators etc. can incur these costs whether or not the complaint is justified or compensation is payable. (Compensation paid or losses incurred because a customer is unable to obtain sufficient redress from a firm or from the FSCS (because the claim exceeds the limit in FSCS rules) are transfers rather than resource costs.)

54. There is no doubt that the quantifiable resource gains or losses involved could be large. The cost benefit analysis (CBA) included with an FSA consultation in 2009 on payment protection insurance (PPI) complaints indicates that there had been over 400,000 complaints since January 2005 about PPI while 63,000 cases were submitted to the FOS. The costs for firms and others in dealing with these complaints can differ significantly depending on how they are to be handled. The same FSA CBA assumed administrative costs for firms of £200 per complaint but indicated that this was lower because firms only had to review rejected complaints.

55. It is impossible, therefore, to estimate the amount of any benefit which could be attributable to the preferred option rather than the base case. However, assuming that numbers of customers affected by any one incident was of the order of 100,000 and that the resource costs were £5,000, the resource costs of any one incident would be £500 million. While the precise answer would depend on the assumed frequency of such incidents and the change in the frequency attributed to an improved operating model, this calculation suggests that benefits could not be of the same order as the benefits from the improvements to prudential regulation discussed above and would almost certainly be substantially lower. No amount has therefore been included in the illustrative benefits of the preferred option.

56. The benefits from the FCA having a stronger role in competition matters are also very difficult to quantify. Most of the effect of the elimination of monopoly rents in the supply of real goods and services (which would include the provision of investment advice but not the provision of financial investments themselves) takes the form of a transfer from suppliers to consumers and so does

not involve any resource cost or benefit. The benefits to consumers from the stronger FCA role in competition would therefore be found in any increase in the provision of financial services such as investment advice less the amount of any such benefits that might be expected to arise in the base case. There would also be some benefits in any reduction in resource costs incurred by other bodies such as the OFT. These benefits would be very difficult to estimate but there does not seem any reason for believing that they could be of the same order as the benefits from the improvements to prudential regulation. No amount has therefore been included in the illustrative benefits of the preferred option. (This is also consistent with the exclusion of the costs arising from conferring certain competition powers and duties on the FCA.)

Assumptions, risks and sensitivities

57. The principal assumptions are those relating to the benefits of avoiding a financial crisis (see above) and about the costs for public authorities and regulated firms.

58. The key assumption is that establishing two specialist financial regulators and the strengthening of the arrangements for coordination between the PRA and the Bank of England should result in a reduction in the frequency of severe financial crises in the UK, in addition to any such reduction that could be attributed to other measures (such as internationally agreed changes to regulatory requirements). There is a risk that this assumption is not correct and that the benefits assumed in the impact assessment are overstated.

59. In addition, the amount of the benefits is clearly dependent on the detailed assumptions made (including by the Basel Committee of Banking Supervision in its work). This can be seen in the difference between the high and low estimates of the benefits which reflects different assumptions about whether there are permanent effects on output from a crisis. These estimates will always be very sensitive to changes in economic assumptions (for example, the long-run trend in economic growth).

60. In relation to costs, the main risks are that (1) the transitional costs (i.e. development and implementation costs) for regulatory bodies or firms are materially underestimated (including the risk that implementation takes longer than anticipated); and (2) the ongoing costs for regulatory bodies and firms are materially underestimated.

Wider impacts

Statutory equality duties

61. The Government has considered the proposed reforms in relation to its public sector equality duties under the Sex Discrimination Act 1975, the Race Relations Act 1976, the Disability Discrimination Act 1995, section 75 of the Northern Ireland Act 1998 and the Equality Act 2010. It has concluded that no relevant issues arise. All UK residents would be affected to a greater or lesser extent by a financial crisis having a severe impact upon the UK economy.

Environmental, social and sustainable development impacts

62. The Government does not anticipate any impact upon greenhouse gases, wider environmental issues, health and well-being, human rights, the justice system, rural proofing and sustainable development. This assumes that the proposed reforms would not change the relationship between certain environmental phenomena and GDP.

Economic impacts

63. Apart from any effect arising from the stronger FCA role in competition matters, the principal effect on competition from financial services regulation is through the effect on barriers to entry into the industry. The Government does not envisage that the proposed reforms to regulatory structure will in themselves change the conditions which applicants have to satisfy to obtain authorisation from a regulator but there may be higher costs in obtaining authorisation for applicants to be dual-regulated firms as both the PRA and FCA will be involved in processing the

application. The Government does not expect these costs to be significant and there would in any event be no effect upon the ability of EEA firms to enter the UK market using a 'passport' from their home State regulator issued under the relevant EU Directives. The possible increase in compliance costs for dual-regulated firms does not appear large enough on its own to induce a dual-regulated firm to relocate elsewhere in the EEA and use an EU 'passport' to provide services in the UK. (Many dual-regulated firms such as credit unions and building societies could not relocate to another EEA state; the additional compliance costs arising from dual regulation will be only one of many UK and non-UK factors which would be considered in the location decisions of the largest dual-regulated firms.) The Government does not consider, therefore, that the proposed reforms will have any significant adverse effect on competition.

64. Small firms which take deposits or effect or carry out contracts of insurance, and certain small investment firms will be regulated by the PRA and FCA. The proposed reforms are likely to have some effect on their costs (see above). Most small firms in the financial services industry are not deposit-takers or insurers and will be regulated by the FCA in succession to the FSA. They are not likely to be disproportionately affected by the proposed reforms. Micro-businesses are not exempt but most micro-businesses will be regulated solely by the FCA in succession to the FSA and so will not be significantly affected by the reforms. Some micro-businesses will be regulated by both the FCA and the PRA but it is unlikely that these firms will face significantly higher compliance costs as the anticipated changes to supervisory practice will mainly affect much larger systemically important firms.

Summary and preferred option (with description of implementation plan)

65. The Government therefore proposes to proceed with the preferred option and to proceed therefore with the implementing secondary legislation covered by this consultation.

66. The main implementing measure will be primary legislation which is expected to be enacted in 2012. The secondary legislation is expected to be put in place in early 2013.