

How does economic analysis help regulatory policy design? The FSA experience

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Overview



- **Some contextual remarks**
- **Our approach to impact assessment (IA)**
- **The FSA experience**
- **Concluding remarks**
- **Questions**

Some contextual remarks



- **In seeking to use economic analysis as an aid to better policy making we have made many mistakes and learned many lessons over the years**
- **What follows describes some of the most notable mistakes and lessons learned**
- **They relate to the use of economic analysis in a large national regulator**
- **But some of the most important messages apply equally to smaller regulators**
- **Personal observations**

Our approach to IA (1)



What do we mean by market failure?

“In the FSA's work, a principle we have enunciated...is that regulatory action should only be taken when there is market failure. Now this is in fact a weak definition of the circumstances of when regulatory action is justified, since all realistic markets – that is all markets which exist in practice – have some elements of market failure...It is an argument too often deployed by those who favour intervention that any market failure justifies intervention. The strong – and to me correct – test goes beyond that: there must be both market failure and the prospect that intervention will provide a net benefit. This involves recognising that regulatory intervention has a cost and...a probability of failure. Identification of a market failure should not lead to the assumption that regulatory failure is less likely, or less costly. It is an open and empirical question, which needs analysis on a case by case basis.” [Hence the need for CBA]

Callum McCarthy, Chairman, FSA

Our approach to IA (2)



What do we mean by regulatory failure?

- **Regulatory failure is, like market failure, an economic justification for further regulatory intervention (including deregulation)**
- **For our purposes, regulatory failure means an intervention whose economic costs were higher or economic benefits lower than was originally expected such that the net effect is harmful (or more harmful than it need have been)**

Our approach to IA (3)



- **MFA/RFA (to decide whether an intervention can produce net benefits):**
 - What is the relevant economic market or markets?
 - What are the material market failures and/or regulatory failures in the relevant market(s) now?
 - If no intervention or no further intervention takes place, will an improvement in welfare take place? will the market failures be corrected in the short term?

Our approach to IA (4)



- **High level CBA (to decide how to intervene):**
 - What broadly are the regulatory options?
 - What are the economic and other costs and benefits of the options, relative to doing nothing?
 - What is the plan for further CBA work?

Our approach to IA (5)



- **Sometimes MFA and HLCBA can tell us that a particular intervention is almost certain to produce net benefits**
- **In such cases full CBA becomes virtually redundant**
- **Nevertheless, FSMA requires us to publish a CBA (and compatibility statement) as part of formal consultation arrangements**
- **This is important for reasons of accountability**
- **And as a check on whether the decision makers got their facts right**

Our approach to IA (6)



- **IA conducted within redesigned institutional arrangements**
- **Independent sign off of MFA and HLCBA before policy papers go to decision making body**
- **Independent quality control process improves policy making**
- **European Commission's IA Board performs a similar role**

The FSA experience (1)



Issues

- 1. Organisational**
- 2. Resourcing**
- 3. Scope**
- 4. Technical considerations**
- 5. Integration**
- 6. Outputs**
- 7. Communication**

The FSA experience (2)



1. Organisational

Do

- A. Promote an evidence-based culture – consensual approach
- B. Get senior management buy-in
- C. Establish internal controls and incentives – challenge and assistance
- D. Set clear reporting lines and status – independence from policy area
- E. Clearly define division of responsibilities

The FSA experience (3)



1. Organisational

Don't

A. Practice apartheid

B. Pursue incompatible goals

The FSA experience (4)



2. Resourcing

Do

- A. Fully recognise constraints
- B. Focus on quality and seniority – influencing skills
- C. Employ policy-focussed and outcome-focussed economists – non-technical dialogue
- D. Use full range of inputs – firms, consumers, each national authority

The FSA experience (5)



2. Resourcing

Don't

- A. Free-ride – many markets are national or sub-national
- B. Outsource everything – need to build centre of expertise (subject to resource constraints)
- C. Rely on consultants whose interests may be more closely aligned with those of financial firms
- D. Skimp on project management skills

The FSA experience (6)



3. Scope

Do

- A. Clarify with Government/Commission what the goal/scope is – preferably narrow to avoid general equilibrium problems**
- B. Establish a proper market definition – product and national – crucial for reliable analysis**
- C. Set the right depth of analysis – proportionate use of resources – stop when appropriate degree of confidence achieved – recognise what is impossible**

The FSA experience (7)



3. Scope

Don't

- A. Try to explain the whole world – however interesting it may be: focus on what is policy-relevant
- B. Keep changing the scope of an IA exercise unless unavoidable
- C. Ignore overlapping policy initiatives

The FSA experience (8)



4. Technical considerations

Do

- A. Keep the framework for analysis rigorous but practical
- B. Be consistent in treatment of data/issues
- C. Exploit previous IAs and existing economic literature – empirical and theoretical

The FSA experience (9)



4. Technical considerations

Don't

- A. Simply assume that national research is/is not relevant across the EU
- B. Let the approach/methodology grow stale – continuous innovation (finding ways to solve problems drawing on work – other fields e.g. evolutionary biology, regulation of pig farms...)
- C. Give up just because a lack of data prevents use of ideal methodology

The FSA experience (10)



5. Integration

Do

- A. Embed IA in the culture of the organisation
- B. Integrate with research – already mentioned
- C. Integrate IA into the policy making and decision taking cycle

5. Integration

Don't

- A. Integrate legal considerations in a way that nullifies economic assessment
- Completely different mindset
 - Non – compliance is a fact of life: the set of incentives matters not just the legal incentive (to comply)
 - What we can do v what markets will do

6. Outputs

Do

- A. Use plain language
- B. Tailor outputs to objectives
- C. Tailor outputs to audience – relevance to decisions and the audience's value set
- D. Set economic material in sufficient context to make it intelligible
- E. Make uncertainties explicit

The FSA experience (13)



6. Outputs

Don't

- A. Try to show how clever you are
- B. Quote important economic papers that aren't really relevant to the issue/targeted audience
- C. Spurious accuracy

The FSA experience (14)



7. Communications

Do

- A. Consider partnerships with firms/their representative bodies
- B. Consider partnerships with consumer representatives
- C. Try to hear the voice of consumers themselves (e.g. behavioural studies/experiments)
- D. Provide clear feedback to stakeholders (to secure future co-operation)

The FSA experience (15)



7. Communications

Don't

- A. Necessarily believe what firms and consumer groups say
- B. Underestimate the efforts stakeholders have to make in order to help us

Concluding remarks (1)



- **MFA helps us to decide whether any intervention can produce net benefits**
- **It has materially affected policy within the FSA**
- **MFA and HLCBA together can sometimes remove the need for more detailed CBA work – helps overcome data problems**

Concluding remarks (2)



- **Organisational controls and incentives help give economic analysis traction**
- **Also critical to success are:**
 - **Effective stakeholder engagement**
 - **Proper planning (to deliver high quality outputs on time)**
 - **Early definition of policy options**
 - **Availability (or generation) of data**
 - **Availability of skills**
 - **Budget for academic/consultancy support as required**

Questions...



...are very welcome