Europe Economics

Cost Benefit Analysis of the New Regime for Individual Accountability and Remuneration

Final Report

28 July 2014

Europe Economics
Chancery House
53-64 Chancery Lane
London WC2A 1QU

Tel: (+44) (0) 20 7831 4717
Fax: (+44) (0) 20 7831 4515

www.europe-economics.com

Contents

Report Summary 1

Introduction 1

Compliance cost model 1

Indirect costs and wider impacts 3

Benefits 4

Conclusions 5

1 Our Approach 7

1.1 Introduction 7

1.2 Understanding and measuring compliance cost 7

1.3 Assessment of indirect costs and wider impacts 9

1.4 Assessment of benefits 9

1.5 Data gathering process 10

1.6 Counterfactual 12

1.7 Structure of the report 13

2 Overview of Policy Proposals 14

2.1 Introduction 14

2.2 Individual accountability proposals 14

2.3 Remuneration proposals 17

3 Compliance Costs 19

3.1 Introduction 19

3.2 Modelling approach adopted for each policy proposal 19

3.3 Banks and investment firms 25

3.4 Building societies 31

3.5 Credit unions 35

4 Indirect Costs and Wider Impacts 40

4.1 Introduction 40

4.2 Operational efficiencies 40

4.3 Labour market effects 47

4.4 Product innovation 51

4.5 Regulatory badging 55

4.6 Consumers 55

4.7 Competition 56

4.8 Summary of main findings 57

5 Benefits 59

5.1 Introduction 59

5.2 Summary of the underlying causes of failures and detriment 60

5.3 Reduced reward for non-compliance and excessive risk taking 62
5.4 Increased likelihood of incurring a sanction if misconduct identified 64
5.5 Increasing the likelihood of instances of misconduct being identified 68
5.6 Increased costs of sanction 70
5.7 Benefits to firms 72
5.8 Quantitative analysis of benefits to consumers 73
5.9 Quantification of benefits to firms 84
6 Summary and Conclusions 86
6.1 Introduction 86
6.2 Direct costs to firms of complying with the policies 86
6.3 Indirect costs to firms and wider impacts 87
6.4 Benefits of the policies 88
Appendices 91
7 Key Business Functions and Conduct Rules 92
7.1 Indicative list of key business functions 92
7.2 Draft conduct rules 93
8 Overview of the Main Failures 94
8.1 Introduction 94
8.2 Misconduct 94
8.3 Excessive risk-taking 96
8.4 Poor practice 99
9 Approach to Extrapolating Compliance Costs 102
9.1 Banks 102
9.2 Building societies 105
9.3 Credit unions 106

Report Summary

Introduction

This is Europe Economics' final report to the Financial Conduct Authority (FCA) for the cost benefit analysis of the policies to implement the new Individual Accountability regime and the policies for changes to the Remuneration Code.

The policies apply to banks, building societies, credit unions and the dual FCA/PRA regulated investment firms (although credit unions are not subject to the Remuneration Code policies). In order to conduct the cost benefit analysis the FCA provided us with a number of draft policy proposals, which have formed the basis of our cost modelling and analysis. In some areas the final proposals differ from the draft policies.

This study covers:

- Quantification of the direct costs to firms of complying with the individual accountability and remuneration policies.
- A qualitative assessment of the indirect costs and wider impacts that may arise.
- A qualitative assessment and indicative quantification of the likely benefits arising from the policies.

Our modelling and analysis draws on desk research and a structured in-depth interview programme of 20 firms covering large and small banks and investment firms, building societies and credit unions.

Compliance cost model

In modelling the compliance cost we have estimated both one-off and ongoing costs, defined as follows:

- One-off costs are those incurred once off in complying with the policy. Examples include developing guidance; setting up IT systems; or providing training on the migration.
- Ongoing costs are those incurred annually as a result of the policies, for example ongoing training obligations; or annual reviews of responsibilities.

This approach formed the basis of the cost questions included in our structured interviews.

The relative scale of the compliance costs vary across the different types of firms affected and are influenced by the extent to which firms already have similar processes in place to those required by the policies. In relation to the individual accountability policies, one-off set up costs are in general significantly greater than ongoing costs, driven by the costs involved in setting up the new accountability regime and training individuals, and by the fact that, for some firms at least, the ongoing processes required by the policies are often in line with current procedures which require limited adaptation.

Among smaller firms the impacts associated with the SMF policies account for the largest share of the costs; among large firms, whilst these costs are still substantial, they are outweighed by the costs associated with implementing the Rules of Conduct and Notifying of Breaches in misconduct, as the latter policies are driven to a large extent by employee numbers. Smaller firms are also more likely to be able to adapt flexibly to these policies (i.e. by simple updates or extensions to current procedures) compared with large firms which foresee significant investments in IT and training to implement the policies across their more complex organisational structures and systems.

The direct costs of the regime are relatively larger share for small firms compared to large.

Banks and investment firms

The direct costs across the sector are presented in the table below. These are shown for the three different options of Relevant Person to whom the policies around the Rules of Conduct and Notifying Breaches of Misconduct would apply. Option 1 (SMF + CP) includes only individuals in senior management function (SMF) and certified person (CP) roles; Option 2 (SMF+CP+MM) includes these and 'middle management' and above; and Option 3 ('everyone) includes all employees except ancillary staff.

Table 1: Total compliance cost impact on banks and investment firms across the three relevant person options (£ millions)

	Large	Small	Sector total
Individual accountability policies, one-off			
Option 1 (SMF + CP)	76.9	63.2	140.1
Option 2 (SMF + CP + MM)	123.7	64.5	188.2
Option 3 (everyone)	169.9	66.7	236.6
Remuneration policies, one-off	11.5	17.5	29.0
Individual accountability policies, ongoing			
Option 1 (SMF + CP)	7.6	11.8	19.4
Option 2 (SMF + CP + MM)	8.2	12.2	20.4
Option 3 (everyone)	9.8	12.8	22.6
Remuneration policies, ongoing	0.6	0.9	1.5

Source: Europe Economics.

The direct compliance cost of the individual accountability policies imply a sector-wide one-off cost of between 0.14 per cent and 0.23 per cent of sector income, and an ongoing costs of around 0.02 per cent of sector income. The remuneration polices will have a far smaller one-off impact of around 0.003 per cent of sector income and negligible ongoing direct costs. However, indirect costs and wider impacts of the policies are likely to be much greater.

Building societies

The direct costs across building societies are shown in the table below across the three options for Relevant Persons.

Table 2: Total compliance cost impact on building societies across the three relevant person options (£ millions)

	Large	Small	Sector total
Individual accountability policies, one-off			
Option 1 (SMF + CP)	5.65	1.60	7.25
Option 2 (SMF + CP + MM)	6.62	1.78	8.40
Option 3 (everyone)	17.14	2.11	19.25
Remuneration policies, one-off	0.13	Negligible	0.13
Individual accountability policies, ongoing			
Option 1 (SMF + CP)	0.30	0.29	0.59
Option 2 (SMF + CP + MM)	0.37	0.29	0.65
Option 3 (everyone)	2.62	0.29	2.91
Remuneration policies, ongoing	0.02	Negligible	0.02

Source: Europe Economics.

The direct compliance cost of the individual accountability policies imply a sector-wide one-off cost of between 0.2 per cent and 0.4 per cent of sector income, and an ongoing costs of between 0.01 percent and 0.07 per cent of sector income. The remuneration polices will have a far smaller one-off impact of 0.003 per cent of sector income and negligible ongoing costs. This is driven by the fact that building societies, in particular smaller ones, do not have extensive variable remuneration packages and thus are not greatly impacted by the policies.

Credit unions

The table below presents the costs to credit unions. Credit unions are not affected by the remuneration policies.

Table 3: Total compliance cost impact on credit unions across the three relevant person options (£ millions)

	Sector total
Individual accountability policies, one-off	
Option 1 (SMF + CP)	4.38
Option 2 (SMF + CP + MM)	4.67
Option 3 (everyone)	4.77
Individual accountability policies, ongoing	
Option 1 (SMF + CP)	1.03
Option 2 (SMF + CP + MM)	1.03
Option 3 (everyone)	1.24

Note: due to their small size and similar nature our model does not distinguish between small/large credit unions.
Source: Europe Economics.

The direct compliance cost of the individual accountability policies imply a sector-wide one-off cost of between 2.6 and 2.9 per cent of sector income, and an ongoing costs of between 0.6 per cent and 0.7 per cent of sector income. Compared with the other sectors the compliance costs represent a far greater share of sector income.

Indirect costs and wider impacts

The policies will also result in indirect costs to firms. Operational inefficiencies are likely to increase under the new regulatory regime, as firms, in particular large ones, increase internal monitoring and control procedures which could result in duplicated resources and increased costs. There may also be a move toward more collective decision making, with the decision process becoming more formalised and lengthy. This will increase operational inefficiencies and may cause delays to innovation and wider business development. These impacts would be driven by senior managers seeking to protect themselves against greater individual accountability, in particular the presumption of senior responsibility.

Most firms, credit unions aside, are likely to make adjustments to their wage structure to compensate individuals for the increased accountability and/or reduced present value of rewards under the new individual accountability and remuneration policies. Changes to wage structure could, to some extent, reduce the beneficial behavioural impacts of the remuneration policies by reducing the proportion of variable income subject to increased risk.

Labour market effects, i.e. the impact on firms' ability to hire and retain staff, are a key concern for firms. Credit unions, with largely voluntary boards used to taking collective responsibility, feel particularly vulnerable to retention issues given the significant increase in personal accountability for these individuals and the fact that they cannot compensate for this effect with more generous remuneration.

Large banks and investment firms, who are more exposed to international labour markets, are likely to be at a significant competitive disadvantage *vis-a-vis* non-UK based firms. This may further affect the competitive position of the City as a global financial centre in the long term. They may also suffer from an increasingly unlevel playing field *vis-a-vis* other UK sectors such as retail and industry and lose out on much-valued diversity among board members if candidates from non-financial sectors are deterred from taking up senior positions in the financial services sector. This is likely to be driven primarily by the remuneration policies, although the accountability policies would reinforce this. Detrimental impacts on staff hiring and retention could be most visible among non-executive directors and individuals in operational roles, as their skills are more readily applicable to other sectors.

There is also concern that increased accountability could mean that the regulatory changes have the perverse effect of attracting individuals more prepared to take risks, which would, to some degree, counteract the behavioural benefits.

Views on the impacts on product innovation are mixed. There is some evidence that firms may concentrate on less complex products, which could reduce consumer welfare through reduced choice, but a widespread increase in foregone innovation is not considered to be likely. However, delays to innovation are likely, due to regulatory uncertainty, more internal controls and a lengthier decision-making process. Whether such delay would benefit consumers (through more developed products) or reduce welfare (due to inefficiencies) is unclear.

Costs to consumers will depend on the degree of pass through, which will be determined by the relative price sensitivity of consumers and firms, the structure of the market, the degree of competition and the extent of product differentiation across firms.

Competition between firms subject to the regulation may be affected if the policies disadvantage smaller firms through a greater emphasis on fixed remuneration and/or a proportionately higher burden of complying with the policies being placed on them. Equally, firms that are subject to the policies may lose out to those that are not (e.g. international competitors) if it becomes more difficult for the former to attract and retain staff, and/or if the policies create delays to the delivery of new products. These factors may also affect new firms' decisions to enter the market.

Benefits

The individual accountability and remuneration policies are likely to bring about beneficial changes in behaviour and reduce non-compliance, misconduct and excessive risk taking, working through the following mechanisms:

- Reducing rewards for non-compliance and excessive risk taking.
- Increasing the likelihood of individuals being sanctioned in the event misconduct is identified.
- Increasing the likelihood of instances of misconduct being identified.
- Increasing the burden of sanctions imposed.

The remuneration policies, in particular the extension of the deferral period, will have the effect of reducing the present value of deferred remuneration, which will reduce the potential upside of a given variable remuneration package and, therefore, may reduce the incentives for excessive risk-taking behaviour (all else being equal – an increase in the amount of variable remuneration would dull this impact). The deferral policies also extend the period of time over which an individual's variable remuneration is subject to malus and clawback. This would increase the uncertainty of receiving the deferred remuneration and may increase the perceived likelihood that misconduct would be identified and the individual sanctioned. These effects may therefore lead to increased consideration of the longer-term consequences of potentially risky decisions, which is an aim of the policies.

These effects would be felt predominately by firms with extensive variable remuneration packages. A potential move by firms towards increased fixed pay as a proportion of total remuneration (which was cited in our fieldwork as a way of compensating individuals for an effectively lower value of deferred remuneration) would undermine these effects however. Further, evidence from our fieldwork suggests that individuals' *perceived* link between behaviour (particularly that related to risk-taking) and reward is limited, such that there would be few instances whereby behaviour would significantly alter in response to more uncertain variable remuneration.

The main mechanism through which the accountability policies may secure benefits is through increasing the likelihood that misconduct would be identified and attributed to individuals. This is driven by the statement of responsibilities and the presumption of senior responsibility. These policies also reinforce the impact of the remuneration policies on deferral, in that an individual's deferred remuneration is more likely to be subject to malus or clawback if they are more easily implicated in misconduct. Firms, in particular large firms, are likely to undertake additional monitoring and sign-off procedures among employees such that both intentional and unintentional misconduct and regulatory breaches can be identified and prevented. It is unclear the extent to which the policies will have a *direct* impact on individuals' actions and decisions, i.e. whether these will change significantly or whether simply the monitoring of them will increase.

Quantifying the benefits of the policies is not straightforward, given the uncertainty around the extent to which the policies will in fact change behaviour and the lack of clear evidence of the results of other, similar policy changes. We present an illustrative quantification whereby we estimate the harm caused by a series of mis-selling scandals and apply a percentage reduction in similar, future harm as a result of the policies. Benefits in the form of reduced harm range from £0.04 billion to £0.6 billion per year. We note that this illustration considers only harm which has been identified; there will be additional benefits of reducing unidentified harm, including structural harm.

Firms would benefit from the new individual accountability regime in that the processes around applications for Approved Persons would be limited to those in SMF roles. We estimate that this could save the affected firms just over £2 million each year. This would be limited to the larger firms which currently have substantial numbers of Approved Persons who would not be included in the SMF regime.

Conclusions

The individual accountability and remuneration policies are likely to result in beneficial behaviour changes as they effectively reduce the rewards of intentional and unintentional misconduct and regulatory breaches and increase the costs, through increasing the likelihood that non-compliance will be identified and attributed to an individual and increasing the cost of sanction. Behavioural changes are likely to be mainly in the form of more considered decision making processes and increased monitoring within firms. Direct changes in risk-taking behaviour are unclear, particularly as firms consider it difficult to identify all risks inherent in activities before these are undertaken given the often complex evolution of events. The remuneration policies are likely to have a more limited contribution to the benefits than the accountability policies. In particular, there may be risks around the implementation of the clawback policy, whereby firms are unable in practice to effectively apply clawback to deferred remuneration over the length of time implied by the policies (or at least the costs of doing so may far outweigh the amounts clawed back). The policies will provide the regulator with greater scope for discipline and enforcement which should improve how harm is dealt with, although the deterrent effect is less clear.

Firms will incur costs in complying with the policies; credit unions will be disproportionately affected with one-off costs at nearly three per cent of sector income. Indirect costs to firms may be significant, in particular negative labour market effects as firms are hindered in their ability to attract and retain employees. The application of the policies to some types of firm is unlikely to materially contribute to the benefits, i.e. to those firms less likely to be involved in in the types of misconduct and risk-taking identified as the justification for the new regimes.

1 Our Approach

1.1 Introduction

The banking industry in the UK has faced increasing public concerns on the corporate standards of conduct and the competency of individual following the financial crisis and the recent scandals of mis-selling and LIBOR manipulation. The widespread product mis-selling and loss to retail customers and shareholders has undermined trust in the industry and raised questions on the motivations and impact of the behaviour of banking professionals on the effective functioning of the industry.

The Parliamentary Commission on Banking Standards (PCBS)[1] conducted a fundamental review of the industry. In its report it identified a number of failures of the Approved Persons Regime which is the key framework for FCA to regulate individuals. The Financial Services (Banking Reform) Act 2013 (henceforth "the Act") sets out a new individual accountability regime to address these failings. The FCA has developed a number of proposals to implement this regime.

The proposed new individual accountability regime extends the scope of enforcement to cover a larger pool of relevant individuals, introduces a process to enable the FCA to effectively assess the fitness and propriety of the individuals covered by the regime on an ongoing basis, provides a clearer allocation of responsibility to senior managers, and provides the FCA with stronger powers to sanction senior managers if a firm fails. These features aim to improve the FCA regulatory framework and strengthen its enforcement power.

The PCBS report also identified a number of ways in which firms' provision of variable remuneration can contribute to excessive risk taking and misconduct. The FCA has therefore also developed proposals for changes to the current Remuneration Code to address these failings. The policy proposals include a longer deferral time period for variable remuneration combined with later vesting, a longer clawback period, and extensions to the applicably of the Remuneration Code to all forms of discretionary award in times of exceptional government intervention. These policies aim to align more closely the upside and downside risks of decision-making.

Europe Economics was commissioned by the FCA to assess the costs and benefits of the proposed new accountability and remuneration regimes. In this section we present our approach to conducting this assessment.

1.2 Understanding and measuring compliance cost

Compliance costs are "the costs to firms and individuals of those activities required by regulators that would not have been undertaken in the absence of regulation". Compliance costs would not therefore refer to those costs incurred by firms in activities which do contribute to meeting the requirements set out by the FCA and would have also been undertaken in the absence of regulation. This can also work the other way: for example, being FCA regulated can give firms a "badge" they may be able to use to reassure customers of the quality of their internal procedures. In the absence of regulation firms might have to engage in additional expenditure on quality systems or brand positioning advertising to sustain the same portfolio of products, or to hold additional capital.

---

[1] House of Lords, House of Commons, "Changing banking for good", Report of the parliamentary Commission on banking standards, 2013.

It is important to recognise that relevant changes are not simply incurred by compliance staff or what might be considered directly as compliance activity. Rather the costs of compliance also include those costs arising from the distortion of business practices not directly involved in compliance. A blunt example would be if certain products cease to be provided altogether then the profits from them are lost. More subtly, it may be that in order to comply with a certain regulation then more highly skilled non-compliance employees are required, increasing staff costs.

The objectives of this part of the study are to analyse, understand and describe:

- how firms expect to respond to the proposals;
- the incremental compliance cost arising from proposed regulatory changes; and
- how these incremental costs are derived and the main cost drivers for different types of firms.

We developed an analytical framework for our compliance cost model. This framework links the provisions of the proposed regimes with expected outcomes. In this way we identified the relevant costs to include in our model, and used this to create a data map linking specific questions in our data-gathering survey to the cost model.

The scale of incremental compliance costs of financial regulation is largely associated with firms having to address the challenges of ensuring any of the following:

- Any change or increase of regulations — forms, accounts to report, business plans to submit, training required — that firms now have to comply with.
- Any changes in the quality of the compliance expected or recorded by local regulators. The higher the expected compliance quality is, the higher the cost.
- A change in perception by firms as to the effectiveness of the monitoring of compliance.

All of these factors are likely to be relevant to the switch to the new regime.

There are two approaches that can be used to assess compliance costs: "bottom-up and "top-down."

1.2.1 "Bottom up"

There are two major components to estimating the compliance cost: the volume of the change and the unit cost.

In a bottom up approach, the volume effect is likely to be heterogeneous because the impact on particular business might be very business-specific. Moreover, the cost impact will be affected by the systems already in place within the organisation; some firms outperform against existing regulatory requirements (possibly as a result of synergies across business streams or possibly due to them being subject to stricter regulatory requirements in other jurisdictions which have been applied across the board).

The unit costs for most relevant inputs for our study (e.g. staff, IT system, marketing or informational publications, training, etc.) may vary less (on the one hand, (approximately) competitive supply of these inputs in the market should drive towards homogeneity. However, the specification of particular inputs — in particular, people — may be driven by firm-specific requirements). Our desk research is designed to check unit costs separately to any survey of firms.

Our main approach to our cost modelling is a bottom up approach.

1.2.2 "Top-down"

An alternative to the "bottom-up" approach is the "top-down" approach. This approach models the impact directly on the relevant population in aggregate. As such, it does not consider differences in the types of firms affected, merely the population of individuals affected and the average cost of compliance per proposal. This approach offers a useful tool for sense checking our bottom-up estimates.

1.3 Assessment of indirect costs and wider impacts

Several indirect costs and wider impacts must also be considered as part of the cost-benefit analysis. These may arise as a result of changes in behaviour at both the individual and firm level in response to the regulation, and may also include unintended consequences of the regulatory changes.

A reduction in risk-taking behaviour as a result of the policies may be seen as desirable in many cases, but there is a risk that individuals may reduce their level of risk taking to an inefficient level. This may have knock-on effects for profitability in financial institutions and could result in a reallocation of resources to areas where there is a greater scope to undertake risk in order to minimise the impact on profitability.

Changes in behaviour may also lead to negative impacts on innovation, as decision-making processes are slowed and individuals become reluctant to take decisions necessary for development.

Increased individual accountability may lead to changes in the structure of organisations to ensure that the correct checks are made before any significant decision is signed off. This may result in additional layers of management or duplication of individuals in similar roles, leading to inefficiencies, with decisions being required to be signed off by multiple individuals. An overly-conservative product sign-off could also have a negative impact on innovation.

The increased level of individual responsibility for senior managers may also have impacts on the labour market if individuals are reluctant to take on these new roles. Labour market effects would be exacerbated by the effective reductions in variable remuneration implied by the remuneration policies.

Equally, any mismatch between the personal risks being borne by senior managers (due to new regime and the presumption of senior responsibility) and the method and/or scale of remuneration may perversely deter more risk-averse people from seeking management responsibility. Demands for higher compensation to account for the additional responsibility to the regulator would not only increase the costs to the banks for senior managers, but also may undermine the value of the regulation itself (if the compensation is sufficient to offset the additional risk of punishment in the event that a breach occurs, the deterrent value of the enforcement regime and sanctions available is undermined).

To explore these effects we relied on a combination of desk research and feedback from firms gathered as part of the structured interviews.

1.4 Assessment of benefits

We now turn to our approach to assessing the benefits of the proposed regime. There are two elements of the assessment of the benefits:

- the extent to which any new policies will minimise instances of misconduct or poor performance and the associated impacts for consumers, the market, competition and the integrity of the financial system; and
- the potential for the new regime to bring about new benefits, rather than just minimising existing detriment. For example, increased trust in the banking sector or other benefits to firms.

We describe the mechanisms through which the benefits might arise from the policy proposals, as well as the interaction between the accountability proposals and remuneration proposals. The analysis of these "transmission mechanisms" enables us to clearly set out how the new regime would result in benefits. We then support this analysis with evidence from our fieldwork to form a judgement on the extent to which the benefits can be realised in practice.

1.4.1 Reduction in incidents of misconduct, poor practice or excessive risk taking

The aim of regulating individuals is to reduce incidences of failures in banking standards, creating a mechanism for identifying such failures when they do occur and addressing them promptly, and for holding those responsible for such failures to account. The ability to impose sanctions on individuals in such instances reinforces the system and creates incentives for good conduct.

Under the current Approved Person regime (APR) the regulators' ability to achieve the above is undermined primarily by:

- The limited scope of the regime.
- Difficulties in identifying the senior personnel accountable for failures in standards.
- Limited powers to monitor an individual's continued fitness and propriety.

In addressing these weaknesses of the current system the benefits of the new regime would focus on reducing the likelihood of failures occurring. Such failures can take numerous forms (as evidenced by recent scandals). These can be grouped into two overarching categories:

- Consumer focussed – behaviour that directly affects customers, primarily mis-selling, examples would include the recent PPI and IRHP incidents.
- Institutional or systems misconduct – behaviour that does not directly impact on consumers but rather indirectly through failures at a systems or institutional level, such as the recent LIBOR case and bank failures.

In assessing the benefits we consider the extent to which the new regime would effectively disincentivise such behaviours and (in so far as possible) quantify the value of reducing such incidents. Where quantification is not possible, we provide a detailed qualitative description of the benefits and a discussion of what evidence there is that might enable us to place some parameters on the likely scale of these benefits.

In a similar manner, the remuneration policies aim to better align the risks and rewards of decision making. Variable remuneration can distort incentives for risk-taking by providing short-term rewards that are not aligned with potential longer-term losses. Extending the time period over which malus and clawback applied would provide more time for misconduct and losses to be identified. The remuneration policies also reinforce the individual accountability regime by reducing the perceived rewards for non-compliance while the accountability policies increase the likelihood of non-compliance being discovered and sanctions being applied.

1.4.2 New benefits

Estimating the 'new' benefits arising from the new regime is less straightforward, and these benefits are discussed qualitatively, drawing on feedback from our fieldwork. We also estimate other benefits to firms of a slimmed-down individual accountability regime, for example savings from the reduced scope of pre-approval.

1.5 Data gathering process

Our analysis is based on two main sources of information:

- structured interviews with a sample of firms; and
- existing literature/research.

These are described briefly below.

1.5.1 Structured interviews

Our primary source of information and data for the compliance cost model is a series of structured interviews with a sample of firms from across the affected areas. The interviews also provided us with feedback as to the likelihood and nature of any wider effects of the policies, both in terms of indirect costs and benefits.

We have conducted 20 structured interviews for this final report. The new regime will apply primarily to deposit-accepting banks, building societies, credit unions and the nine dual PRA/FCA-regulated investment firms.

To ensure a balanced sample when selecting the firms to include in the sample we considered:

- The different types of companies affected (primarily banks, building societies, credit union, investment firms) — as this will affect the nature of risks that exist and the way in which harm may manifest.
- The range in size of affected companies (principally large versus small) — this will affect their ability to front load additional costs, benefit from scale economies and the nature of existing schemes in place. Size will also affect the complexity of management and feasibility of implementing the changes.
- The number of Approved Persons that currently exists within the organisation — this will impact the number of individuals likely to be affected and the existing structures in place (e.g. for fit and proper checks and conduct rules).

Our final interview sample was structured as follows:

Table 1.1: Interview sample

Type of institution	Small	Large	Total
Banks and investment firms	5	7	12
Building societies	2	2	4
Credit unions		4	4
Total			**20**

Note: Credit unions are not disaggregated into small/large.

We circulated a description of the policy proposals and the questions to be covered in the interview to interviewees in advance of the meeting. This allowed them time to confer with relevant colleagues where necessary and ensure that the appropriate people attended the interview. Alongside the questions we provided interviewees with an introduction to the study including, who we are, the aims of the study, and how the research is to be used.

1.5.2 Existing literature/research

To supplement the information gathered via the structured interviews, we conducted desk research to examine existing literature and data. This played a particularly important role in developing the mechanisms of effect for the indirect costs and benefits.

It also provided useful information to support the development of the compliance cost model. In particular using existing data on the costs of compliance to benchmark can play an important role in over-coming any bias in data collected via structured interviews. Specifically, we used:

- Price information — for example IT costs from IT vendors (with appropriate adjustment to offset potential bulk discount for big buyers) where there is a ready-made market place; and training cost from training providers (with appropriate adjustment to offset potential bulk discount for big buyers).

- Comparison to prior work — compliance costs have been considered by a number of consultants in various fields of financial services regulation — where relevant to the envisaged study we use these to compare the analysis of the survey responses to. We also use prior estimates of industry-standard salaries and other meta assumptions.

1.6 Counterfactual

Cost-benefit analysis needs to be conducted against an appropriate counterfactual. This is to avoid the potential for under or overestimating both the costs and benefits of any regulatory change. Normally the counterfactual takes the form of a structured tale of how the "market" would evolve in the absence of the intervention. In this case, careful consideration needs to be given to how developments in the market, regulatory changes and other factors may affect incentives and the behaviour of staff in the absence of the introduction of the new regime.

Of course, substantial change is ongoing at present in the light of the credit crunch and the associated economic slowdown and subsequent recovery as well as the more normal factors for consideration such as technological change (in the context of regulating individuals this might include streamlining processes for notifications and applications). Equally policy changes in other related areas may affect behaviour in the industry which would be relevant for the specific policy proposal under consideration here. In particular, regulation capping the ratio of bonuses to salary at one to one (or two to one with shareholder agreement) should reduce incentives for risk taking.[2] Separating out the effects of such policies from the new accountability regime for individuals and remuneration proposals would be difficult. This makes the task of identifying long-term trends away from short-term noise more challenging, but also potentially makes the benefit of considering a dynamic rather than static counterfactual all the greater.

There are a number of fundamental types of uncertainty here: uncertainty about how the market would develop, with unchanged practices; uncertainty about how practices are changing (i.e. what the response of market participants is to current market conditions — and also to past and current regulatory interventions); and uncertainty about how long current market conditions are likely to continue. There may also be additional factors which may affect the level of risk taking such as enforcement action taken against misconduct and failures.

Ultimately, since there is no clear direction in which risk taking is likely to progress and given the time constraints of the project, we have employed a static counterfactual. In this case we focus mainly on the current nature and scope of market participants and their relevant activities rather than on expected future developments. As such the baseline for our analysis is what firms currently do under the Approved Persons regime and the current Remuneration Code.

We do, however, need to account for any activities that have been undertaken in anticipation of the new regime being introduced. These should not be counted in the baseline since they have arisen in anticipation of the new policies being introduced and would not have occurred in the absence of the proposed policy changes.

Another consideration in developing the counterfactual was separating the impacts of the FCA proposals from the impact of the Act itself. The focus of this cost benefit analysis is the impact that the policies introduced by the FCA will have on firms. However, since the Act will only be implemented through the FCA's policies and, without these policies would effectively not be in place, we have taken the current status quo (i.e. the current Approved Person regime) as the counterfactual.

[2] Committees Committee on Economic and Monetary Affairs (2013), "MEPs cap bankers' bonuses and step up bank capital requirements", *European Parliament Press Release.*

1.7 Structure of the report

The remainder of the report is structured as follows:

- Section 2: Overview of policy proposals. This section presents the draft policy proposals upon which the study was conducted.
- Section 3: Compliance costs. This section provides our estimates of the incremental cost of complying with the proposed policies for the affected firms.
- Section 4: Indirect costs. This section sets out the main indirect costs and wider impacts that could arise as a result of the policy proposals.
- Section 5: Benefits. The final section provides our assessment of the benefits that could be associated with the policy proposals.
- Section 6 concludes.

Also attached are a number of appendices, these contain additional detail to support our analysis. This includes:

- Section 7: Key business functions and Conduct Rules. This provides a list of the key business functions and Conduct Rules that formed part of the material firms based their interview responses on.
- Section 8: Overview of the Main Failures. This provides more detail on the main failures identified in the PCBS.
- Section 9: Details about our cost extrapolation methodology.

2 Overview of Policy Proposals

2.1 Introduction

In order to conduct the cost benefit analysis the FCA provided us with a number of draft policy proposals. These were shared with the companies we interviewed in order to ascertain the implications of policy changes in this area on the affected firms. Our analysis has been used to inform the FCA's thinking on the most appropriate formulation of the policies, and as such the final policy proposals differ in some areas from the draft proposals. The draft proposals form the basis of the interviews and therefore our cost modelling and analysis.

2.2 Individual accountability proposals

The Act has introduced a new Individual Accountability regime. The relevant policy areas and proposals that we used for the basis of our analysis are summarised below.

2.2.1 Scope of the new individual accountability regime

The scope of the new regime covers potentially three groups of individuals. There are provisions and policies covering to each group. The FCA's proposed scope for each is as follows.

Senior management function (SMF)

The Act defines the SMF individual as:

- are responsible for managing aspects of a firm's affairs; and
- those aspects involve a risk of serious consequences for the firm or business or other interests in the UK.

This would cover all key decision makers i.e. board members and executive committee members (or equivalents).

In addition it could include individuals below this level where they have final responsibility (reporting only to the board) and oversight of 'key business functions'. A detailed list of example Key Business Functions is included in the Appendix at section 7.

The provisions in the Act that would apply to this group are:

- Criminal offence of reckless misconduct leading to bank failure.
- Presumption of senior management responsibility.
- Statement of responsibility.
- Pre-approval.
- Conditional approvals.
- Continuing fit and proper.
- Rules of conduct.
- Reporting suspected conduct rule breaches.

Certified persons (CP)

This would cover functions that involve or might involve a risk of significant harm to the firm itself or to any of its customers. The Act defines these functions as:

- a function requires the person performing it to be involved in one or more aspects of a firm's affairs; and
- those aspects involve, or might involve, a risk of significant harm to the firm or any of its customers.

The FCA proposes to include in this group:

- Those Significant Influence Function roles not captured in SMFs.
- CF30 and non-approved persons roles where there is a corresponding examination qualification standard (i.e. financial advisors, mortgage advisors).
- Line managers of the above (who are not themselves SMFs).
- Material Risk Takers (MRTs) as defined by the FCA/PRA Remuneration Code.
- Potentially others as identified by a firm itself – depending in the nature of its business.

The provisions set out in the Act that would apply to this group are:

- Continuing fit and proper.
- Annual certification of fitness and propriety.
- Rules of conduct.
- Reporting suspected conduct rule breaches.

Relevant persons

Other relevant individuals would be subject to the following provisions:

- Rules of conduct.
- Reporting suspected conduct rule breaches.

The FCA is considering three options for the scope of this group:

- Option 1 – only those functions under the SMF and CP groups.
- Option 2 – all employees of the firm engaged in the financial services aspects of the firm, i.e. everyone except ancillary staff such as cleaners.
- Option 3 – The SMF and CP groups plus a narrower tier focussed around middle management, as defined by each firm.

We recognise that Option 3 is difficult to define because there will be different views as to what firms consider middle management; and furthermore, whether this be defined by remuneration, spans of control or by some other criteria.

2.2.2 Criminal offence and presumption of senior management responsibility

A new criminal offence, applicable to those in SMF roles, has been created by the Act. It applies where a senior manager is involved in taking a decision by the firm when he or she is aware that the decision may cause the failure of the firm. The senior manager may be prosecuted if the decision causes the firm to fail, and if his or her conduct fell far below what could reasonably be expected of a person in that position.

The Act also includes a separate provision for presumption of senior management responsibility in regulatory cases (sometimes referred to as the "reversed burden of proof"). SMFs would be held responsible for the firm's breaches of regulations in their area of responsibility, if they are unable to prove that they took such steps as they could reasonably have been expected to take to avoid such a breach.

2.2.3 Statement of responsibility (SoR)

This would apply to the SMF roles. The purpose of the SoRs is to ensure clear allocation of responsibilities, and that all key responsibilities will be assigned to individuals with Senior Management Functions. Individuals in the SMF roles can be held accountable for failures in areas of their responsibility.

The FCA proposes to issue guidance that there will be an expectation that *all* key responsibilities are assigned to individuals on the board or executive committees (or their equivalent) within a firm; and that SoRs should set out an individual's' responsibilities in full.

The exception would be those responsibilities which are, by their nature, the responsibility of a committee. For example, the board's ultimate collective responsibility for the business of the firm as whole; and the responsibilities of the various board sub-committees e.g. on audit, risk and remuneration.

The FCA proposes to require SMF holders to prepare handover certificates when changing roles.

The FCA proposes that firms must maintain a 'responsibilities map' in order to check that collectively the SoRs map to the financial services activities of that firm, i.e. there should be no accountability gaps between the individual SoRs when viewed as a whole.

2.2.4 Pre-approval

Individuals appointed to SMF roles must be pre-approved by the FCA. This process is likely to be similar to the current pre-approval process, with some additional requirements for example:

- Supplementary information provided by the firms including the SoR, job descriptions, organisational charts, responsibilities map.
- Confirmation by the firm that the individual is suitable for the role in the broader context of the skills mix of other board members.

2.2.5 Conditional approval

As a result of changes in the Act, the FCA will be able to grant approval of applicants for SMF roles subject to conditions or time limitations. The FCA's proposed conditions include:

- Time limited approvals – the approval of a candidate on an interim basis whilst the firm seek to appoint a permanent candidate.
- Competency related condition – approval granted on the condition that the applicant is required to undertake training or receive mentoring to compensate for a relative deficiency in a competency area.
- Role scale limited – approval so long as the role does not expand (e.g. after a planned merger).
- Enforcement action time limited – approval awaiting the outcome of an ongoing investigation

2.2.6 Continuing fit and proper

The Act puts a statutory duty on firms to satisfy themselves that all SMFs and CPs are fit and proper to perform the roles they are to be employed in. This must be done on appointment and also continuously (e.g. issuing a certificate of fitness and propriety on an annual basis).

The FCA is proposing to make rules on how it expects firms to apply the fitness and propriety requirements of the Act (i.e. in carrying out their own checks). It proposes that the provisions in the current FIT sourcebook would largely apply, with the following amendments:

- For board members the firm should carry out a broader assessment of how the candidate is fit and proper in the broader context of the skills mix of the board.

- Regular Disclosure and Barring Services ('DBS', previously the Criminal Record Bureau) checks on individuals in SMF roles.
- Mandatory 'regulatory references' obtained from previous FCA regulated employers when hiring all SMF and CP candidates. These should cover a period of five years and include information deemed necessary to assess fitness and propriety (e.g. instances of breaches of Conduct Rules or when a certificate of Fitness and Propriety could not be issued).

2.2.7 Rules of conduct

A new set of Conduct Rules will be applicable to individuals in the roles of SMF, CP and Relevant Persons.

The FCA proposes that the new Conduct Rules are similar in content, style and length to the existing Code of Practice for Approved Persons (APER). There are a small number of high level rules, generally applicable across the three groups, covering areas such as integrity, competence and diligence, and personal responsibility and judgement. A draft of the Conduct Rules is included in the Appendix at section 7. Note that the Act includes a requirement, at section 30, that firms ensure that persons subject to rules know that these rules apply to them, and that they take all reasonable steps to ensure that these staff understand the rules.

The FCA proposes that an additional set of more challenging rules only apply to SMFs. The rules are designed to be a short, clear statement of the standards expected of individuals covered by them. Where necessary the FCA proposes that the Conduct Rules will be supplemented by guidance.

2.2.8 Notifying breaches of misconduct

The Act provides for two obligations on firms to report misconduct by their employees, namely (a) if the firm suspects an individual has failed to comply with the Conduct Rules, and (b) if the firm takes formal disciplinary action for a particular reason specified by the FCA.

The FCA proposes that it would only require notification of disciplinary action under (b) where it leads the firm to know or suspect that the relevant person has failed to comply with any Conduct Rules.

The FCA also proposes that firms should have to notify it immediately of suspected breaches/disciplinary action by individuals in SMF roles, but on a periodic (i.e. quarterly) consolidated basis for certified persons and other relevant employees.

2.3 Remuneration proposals

The Parliamentary Committee on Banking Standards (PCBS) report recommended a number of changes to the Remuneration Code. The scope of the policies would apply to banks, building societies and the PRA regulated investment firms. It is assumed that many Material Risk Takers (MRTs) will be SMFs. The FCA is proposing that the remaining MRTs will become CPs. To note these would not be applicable to credit unions.

2.3.1 Deferral of variable remuneration

The FCA proposes to extend the period of time over which the pay-out of variable remuneration must be spread. During this time 'malus' may be applied by the firm. FCA proposes a two-tier approach. Its draft proposals included:

- SMF role: minimum 5 – 7 years deferral; awards vesting no faster than on a pro rata basis no earlier than year five.[3] [4]
- Other material risk takers (including CPs): minimum 3 - 5 years deferral; awards vesting no faster than on a pro rata basis no earlier than year three.

2.3.2 Clawback

The FCA proposes that the minimum clawback period for deferred awards should be calculated from award, rather than vesting, and this should depend on level of seniority:

- SMF roles: malus and clawback would apply for no less than ten years from award. Under the final proposals this means clawback of seven years from actual vesting.
- Other CPs/material risk-takers: malus and clawback would apply for no less than eight years from award. Under the final proposals this means clawback of eight years from vesting.

For non-deferred awards, six year clawback would apply.

Clawback should be allowed in a wider range of circumstances including employee material error; where the firm or relevant business unit suffers a material downturn in its financial performance; or where the firm or relevant business unit suffers a material failure of risk management. Clawback should also not be limited to employees directly culpable of malfeasance.

2.3.3 Exceptional government intervention

The draft FCA proposals state that the revised Remuneration Code should explicitly extend the current Code requirements on the payment of variable awards by firms in receipt of official support payments to all forms of discretionary award. This does not include unvested pension rights.[5]

[3] We note that the final remuneration proposals align with the PRA's definition of senior manager, which is likely to be narrower in scope than the SMF role (described in the individual accountability proposals) which formed the basis of the draft remuneration proposals. This may mean that the results of our cost modelling and analysis, which are based on the draft proposals, may slightly overstate the cost of the policies. That said, the majority of those costs are not variable, i.e. not significantly influenced by the number of people affected by the policies.

[4] The final proposals also change the minimum deferral period to 7 and 5 years for the SMF and other roles respectively (i.e. no range in the deferral period), with vesting from years 3 and 1 respectively.

[5] In the final policy proposals the FCA proposes that the Regulators would have an explicit power to render void or cancel all deferred compensation, in respect of all Senior Persons and other licensed staff. This does not include unvested pension rights. This change between the draft and final proposals is unlikely to materially affect our analysis.

3 Compliance Costs

3.1 Introduction

In this section we consider the impact of the policies described previously upon those banks and investment firms, building societies, and credit unions that would be affected by the policy changes.

For each group we quantify the incremental compliance cost impacts by proposal and in aggregate, and also show separately how these divide between one-off and ongoing costs. We describe the underlying assumptions of our analysis, and identify the key cost drivers. We present aggregate results for our sample as well as costs extrapolated to the sectors as a whole.

3.2 Modelling approach adopted for each policy proposal

In modelling the compliance cost we have estimated both one-off and ongoing costs, defined as follows:

- One-off costs are those incurred once off in complying with the policy. Examples include developing guidance; setting up IT systems; or providing training on the migration.
- Ongoing costs are those incurred annually as a result of the policies, for example ongoing training obligations; or annual reviews of responsibilities.

This approach formed the basis of the cost questions included in our structured interviews. Below we present the key cost drivers for both ongoing and one-off costs associated with the individual policy proposals. In each case, to construct the monetary value of the cost estimate we have multiplied the expected time involved in complying with the average remuneration of the individuals that would be involved (including overheads).[6] Where the cost is for a new system or infrastructure, or relates to outsourced activities, we have used the estimated cost of purchasing such inputs.

3.2.1 Migration to the Senior Management Function regime

The one-off costs to firms of migrating to the SMF regime may be incurred either internally and/or through third party costs (e.g. legal advice) and include:

- Understanding the regulation.
- Deciding, and developing guidance on, the definition of the SMF and who would be captured.
- Guidance for persons who will become SMF's to ensure they understand their duties and responsibilities under the new regime.
- Revision of the organisational structure of the firm.

3.2.2 Criminal offence and presumption of senior management responsibility

The costs associated with complying with this element of the SMF regime cover the costs of recording and retaining additional evidence to support the presumption of senior management responsibility (i.e. in the event than an individual in an SMF role is required to demonstrate proof that he/she took all reasonable steps to avoid a regulatory breach). We do not consider there to be any direct compliance costs of the new criminal offence.

[6] Remuneration figures are uplifted to include the total labour cost to the firm, for example property taxes and insurance payments.

The one-off costs here could include:

- Setting up systems to record additional information.
- Legal advice associated with recording and retaining evidence.

Ongoing costs could include:

- Annual costs of recording and storing additional information.

3.2.3 Statement of responsibility (SoR)

The one-off costs associated with this policy include:

- Developing an SoR for each individual in a SMF role.
- Developing a 'responsibilities matrix' including all important functions set out be the FCA.
- Developing guidance relating to handover certificates.

The days required would both be per SMF individual (i.e. training) or in aggregate (e.g. a project team).

In addition, ongoing costs would include:

- Maintaining the responsibilities matrix. This would be either a general annual review or a revision each time an individual left a role, in which case it is linked to the turnover of SMFs individuals.[7]
- Developing and retaining handover certificates.

3.2.4 Pre-approval

The one-off costs associated with this policy would include updating any policies or processes to provide additional information as part of the SMF pre-approval application. The ongoing costs would include additional time required for firms to submit an application for SMF pre-approval given the need for additional information.

3.2.5 Migration to the Certified Persons regime

The one-off costs associated with migrating individuals to the CP regime might include:

- Developing guidance/documentation on who is a CP.
- Changes to organisational structure.
- Migrating people/ functions to the new regime.

There may be some on-going costs associated with updating documentation if the CP population changes although these are likely to be limited.

3.2.6 Continuing fit and proper

If firms require a new system to ensure continual 'fitness and propriety checks', possibly through amendments to current appraisal processes this would represent a one-off cost.

Ongoing costs could include undertaking additional checks (e.g. request declarations from staff that there has been no change to their fitness and propriety).

[7] Based on our fieldwork SMF responsibilities are likely to the largely role based and therefore would not change when individuals left; therefore we adopted the former modelling approach.

These policies also propose DBS[8] checks for senior managers (either on an annual or periodic basis), which would impose ongoing costs of an update check (we assume that DBS checks are already conducted for senior managers upon hiring and therefore this implies no one-off costs).

Requesting regulatory references that go back five years could have one-off costs of setting up processes top request and provide this information, and ongoing costs of additional time spent in requesting and (more relevant) providing the information.

3.2.7 Rules of conduct

The costs of this policy will depend on the population included within the scope of 'relevant persons' and the extent to which firms already have a Code in place across some/all employees.

The one-off costs associated with this policy include:

- Developing or updating documentation/ guidance on conduct rules.
- Developing or updating any ongoing training material.
- Switching current staff over to new rules (both staff currently familiar with an existing code, and staff who are not currently subject to any code).

The ongoing costs would include:

- Where a firm does not currently have any Code in practice, time required to train staff in the new Code upon hiring. This cost would be related to staff turnover.
- Where a firm does not currently have any Code in place, annual revision training for all affected staff.
- Where a firm does currently have a Code in place, any additional time implied by adopting the new Code.

3.2.8 Notifying breaches of misconduct

The costs of this policy will also depend on the scope of 'relevant persons' and the extent to which firms already monitor and report conduct breaches. The one-off costs could include:

- Setting up / amending systems to record and report conduct breaches. This would include internal resources and external or IT costs.

Ongoing costs could include:

- New or additional reporting processes.

3.2.9 Deferral of variable remuneration

One-off costs could include changes to employment contracts and the development of guidance and rules, including legal advice. Ongoing costs would include the monitoring of deferred payments to ensure payment at the correct time.[9]

3.2.10 Clawback

The likely one-off costs of this policy are:

- Revision of contracts.

8 Disclosure and Barring Service.

9 The differences in the draft and final policy proposals are unlikely to result in a notable change in the direct costs as these are driven by the fact of a change in the Code rather than the exact metrics.

- Development of guidance and rules, including legal advice.

Ongoing costs of implementing clawback proceedings would be incurred if the new policies resulted in an increase in the occasions where clawback was implemented.

3.2.11 Exceptional government intervention

The costs related to this policy could include one-off costs of revising policies and the implications of applying the Code in the case of exceptional government intervention.

3.2.12 Summary of modelling approach

The table below summarises the above discussion of the modelling approach for each policy proposal.

Table 3.1: Summary of policies and modelling approach

Policy	One-off costs	Ongoing costs
Migration to the SMF regime	Understanding the regulation and defining SMF scope. Guidance for SMF roles. Revision of the organizational structure of the firm. External costs (e.g. legal).	N/A
Presumption of senior responsibility	Setting up systems to record additional information. Legal advice associated with recording and retaining evidence.	Annual costs of recording and storing additional information.
Statement of responsibilities	Developing an SoR for each individual in a SMF role. Developing a 'responsibilities matrix'. Developing guidance relating to handover certificates.	Maintaining the responsibilities matrix. Developing and retaining handover certificates.
Pre-approval	Updating any policies or processes to provide additional information.	Additional time required for firms to submit an application for SMF pre-approval.
Migration to Certified Persons regime	Developing guidance / documentation on who is a CP. Changes to organisational structure. Migrating people / functions to the new regime.	Updating documentation if the CP population changes.
Continuing fitness and propriety	Setting up systems and processes to annually assess fitness and propriety.	Undertaking annual checks and assessment. Time spent by individuals on declarations.
Regulatory references	Setting up processes to request and provide additional information.	Time spent providing additional information.
DBS checks	N/A	Costs of ongoing annual checks
Rules of conduct	Developing or updating documentation / guidance on conduct rules. Developing or updating ongoing training material. Switching current staff over to new rules.	Time required to train staff in the new Code upon hiring, related to staff turnover. Annual refresher training for all affected staff. Additional time implied by adopting the new Code.
Notifying breaches of conduct	Setting up / amending systems to record and report conduct breaches.	New or additional reporting processes.
Deferral of remuneration	Revisions to policies and guidance, including legal advice.	Monitoring of deferred payments.
Clawback	Revision of contracts. Development of guidance and rules, including legal advice.	Implementation of clawback proceedings.
Exceptional government intervention	Developing / revising policy and guidance.	N/A

Note: the results of all the SMF policies (migration to the regime; statement of responsibilities etc) are modelling together as firms often considered these costs together.

3.2.13 Modelling the costs across the sector

We have taken a bottom up modelling approach, using the quantitative results of our structured interviews to estimate the total costs per firm in our sample, and then extrapolating up across the industry. Where individual firm data were not provided, for example on salaries or legal fees, we have used benchmark data from pervious compliance cost research. Where firms have identified a cost but have not been able to provide quantitative estimates we have imputed costs based on the other firms in the sample, adjusting for scale differences.

The costs gathered from our sample firms are then extrapolated to construct a cost estimate for the industry as a whole. In order to account for differences in size among the firms in each sector, we separate the one-off and ongoing costs into fixed and variable costs. We separate out fixed and variable costs based on the compliance cost questions asked in the interviews, and define them as follows:

- Fixed costs relate to activities that would be undertaken largely regardless of firm size.[10] These include, for example, understanding the regulatory requirements; developing internal policies, guidance and other documentation; and setting up systems to record and report data.
- Variable costs are linked to the size of the firm (in particular the number of employees) and include time spent by individuals on training, reviewing documents, monitoring and reporting.

Fixed costs are multiplied up by the number of firms in the sector (with a distinction between large and small); variable costs are multiplied up as a proportion of turnover. As the extrapolation of fixed costs in particular is influenced by the number of firms classified as large or small, we conduct sensitivity tests using different thresholds.[11]

In some cases there is an element of uncertainty as to the extent to which a cost item is fixed or variable. For consistency and transparency (and to avoid making subjective judgements on the relative split) our approach is to consider cost items that are mainly fixed as ‘fixed’, and mainly variable as ‘variable’.

That said, there is a small number of cost items where there is a definite combination of fixed and variable elements. An example is the development of the Responsibilities Matrix. As a documentation activity this is largely a fixed cost, but it does depend on the size and complexity of the organisation which may vary even within the large or small categories. Another example is the development of training for the new Conduct Rules — again a largely fixed cost but depending on whether the training material needs to be differentiated across types of business unit there will be a variable element. For these cost items we apply an indicative 30:70 split across variable and fixed.

The classification of fixed and variable costs is largely similar across banks and investment firms and building societies. The classification of ‘variable’ is different for credit unions where costs are driven by the number of SMFs. This is due to the fact that the number of SMFs is not as linked to firm size as it is in the other sectors. All the credit unions in our sample stated that the senior management regime would apply almost exclusively to the board, and the firms all have a similar number of board members regardless of their turnover or number of employees (between 9 and 14). Therefore for those cost items relating to the number of SMFs and classified as wholly variable for the other sectors, we have applied a 50:50 split between fixed and variable.

Where firms’ responses *combined* a number of cost items (this was specifically the case for the SMF policies, where firms combined costs relating to migrating to the regime, developing the statement of responsibilities and accounting for the increased burden of proof) we used the responses from other firms to impute a

10 Some fixed costs are influenced by the complexity of the organisation (for example the number of different business units) which is arguably associated with size. However, for these cost items we assume that the level of complexity is adequately accounted for in the large / small divide, i.e. large firms are all assumed to have the same level of complexity, such that these costs remain fixed across large firms; and similarly for the small firms.

11 More details about our extrapolation are included in the Appendix, Section 9.

representative fixed/variable proportion. This was only necessary for three out of the eight banks, and one of the four building societies.

The average fixed costs across the large and small categories in our sample were then multiplied up by the total number of large and small firms in each sector. The variable costs were expressed as a percentage of turnover and then multiplied up by the total turnover across large and small firms in each sector. We present the data used in each sector when reporting the sector-wide compliance costs. More details on this process are included in the Appendix, Section 9.

3.3 Banks and investment firms

In this section we present the results of our compliance cost model for banks and investment firms. We first present the costs across the sample and describe the main cost drivers. We then present the costs for the sector as a whole.

3.3.1 Costs across the sample and summary of cost drivers

The tables below present the aggregated costs across our sample of banks and investment firms, which covers five large and five small firms.[12][13] We present the average costs per large and small firm across the various policy proposals in absolute values and as a proportion of annual income. We then present the total costs across the policy regimes. The total cost is provided for each of the three options for the Relevant Persons regime (relevant to the application of the Rules of Conduct and the Notifying of breaches).

Table 3.2: Average one-off per-policy compliance costs across banks and investment firms in sample (£000s)

One-off costs	Large	Small
Individual accountability policies		
SMF, statement of responsibility, presumption of senior responsibility and pre-approval	1,312.6	193.6
Certified persons regime - set up	37.8	30.5
Continuing fitness and propriety	512.5	7.7
Regulatory references	Negligible	0.9
Rules of conduct (SMF+CP)	3,559.0	15.4
Rules of conduct (SMF+CP+MM)	9,425.2	18.2
Rules of conduct (everyone)	13,468.7	22.7
Reporting breaches (SMF + CP)	812.5	4.3
Reporting breaches (SMF + CP + MM)	1,062.5	4.3
Reporting breaches (everyone)	2,612.5	4.3
Remuneration policies		
Deferral of remuneration	301.4	26.9
Clawback	759.2	37.0
Exceptional government intervention	Negligible	Negligible

Source: Europe Economics survey.

[12] Large firms have annual incomes greater than £1billion.

[13] Two large banks respondents were unable to provide adequate quantitative responses for inclusion in the model, but their responses have been incorporated into the qualitative analysis.

Table 3.3: Average ongoing per-policy compliance costs across banks and investment firms in sample (£000s)

Ongoing costs	Large	Small
Individual accountability policies		
SMF, statement of responsibility, presumption of senior responsibility and pre-approval	311.4	24.3
Certified persons regime - on-going	Negligible	Negligible
Continuing fitness and propriety	176.3	11.7
Regulatory references	Negligible	10.0
Triennial DBS Checks	0.3	0.1
Annual DBS Checks	1.0	0.2
Rules of conduct (SMF + CP)	4.5	Negligible
Rules of conduct (SMF + CP + MM)	4.5	Negligible
Rules of conduct (everyone)	32.0	Negligible
Reporting breaches (SMF + CP)	75.0	3.6
Reporting breaches (SMF + CP + MM)	225.0	5.0
Reporting breaches (everyone)	350.0	6.9
Remuneration policies		
Deferral of remuneration	33.1	11.9
Exceptional government intervention	Negligible	Negligible

Source: Europe Economics survey.

The tables below present the total costs across the three options for Relevant Persons definition (only SMFs and CPs; SMFs, CPs and middle management; all employees except ancillary staff).

Table 3.4: Average total compliance costs across banks and investment firms in sample (£000s)

	Large	Small
Individual accountability policies, one-off		
Option 1 (SMF + CP)	6,234.4	252.4
Option 2 (SMF + CP + MM)	12,350.6	255.1
Option 3 (everyone)	17,944.1	259.6
Remuneration policies, one-off	1,060.6	63.9
Individual accountability policies, ongoing		
Option 1 (SMF + CP)	567.5	49.8
Option 2 (SMF + CP + MM)	717.5	51.1
Option 3 (everyone)	870.0	53.0
Remuneration policies, ongoing	33.1	11.9

Source: Europe Economics survey.

Table 3.5: Average total compliance costs across banks and investment firms in sample (percentage of annual income)

	Large	Small
Individual accountability policies, one-off		
Option 1 (SMF + CP)	0.110%	0.471%
Option 2 (SMF + CP + MM)	0.155%	0.477%
Option 3 (everyone)	0.205%	0.488%
Remuneration policies, one-off	0.007%	0.077%
Individual accountability policies, ongoing		
Option 1 (SMF + CP)	0.015%	0.083%
Option 2 (SMF + CP + MM)	0.016%	0.085%
Option 3 (everyone)	0.018%	0.088%
Remuneration policies, ongoing	0.001%	0.004%

Source: Europe Economics survey.

SMF policies

The responses to our structured interviews identified the number of individuals who would be assigned SMF roles under the new regime in each firm. This was generally considered to include the current board and executive committees (ExCo). There was some variation in this across large and small respondents which appears to be linked to complexity of the firms' organisational structure, as reflected by its size. Larger firms considered it necessary to include a further layer of senior managers below the ExCo to cover multiple divisions, whilst smaller firms considered that ultimate responsibility for key business functions would remain with the board and the ExCo. It was highlighted that extending the scope of the SMF regime to include more individuals would not simply be a linear increase in associated costs. The further down the firm the regime goes the more complex the process of assigning responsibilities becomes, with an exponential increase in required resources.

The costs of migrating to the SMF regime combine the costs of reviewing the regulation and those associated with developing the statement of responsibilities and responsibilities map, as most firms considered these costs in a combined way. One-off costs include costs per SMF (agreeing their defined responsibilities, undertaking training etc.) as well as project team costs. Based on our responses we have assumed that significant changes to banks' organisational structure would not be necessary. However, respondents did raise a concern about the feasibility of assigning all key business functions to individuals (i.e. where there are currently a number of departments that feed into an overall function) and advocated a flexible approach to defining 'key business functions'.

A notable driver of the costs of migrating to the SMF regime is the involvement of employees beyond merely HR and compliance and the senior managers themselves. Each senior manager would have an associated business unit which would be involved in the deliberations around the allocations of responsibilities and ensuring that all affected individuals are adequately engaged in the process. Even seemingly straightforward exercises such as updating the responsibilities matrix could involve a number of different individuals and would be more than a documentation update.

This level of complexity is therefore also a driver of the ongoing costs of the new SMF regime. Large firms in particular would want to undertake an annual review of the allocation of responsibilities to ensure all areas continued to be covered, as well as undertaking quality assurance processes to ensure that senior managers are managing their responsibilities adequately, which may include requesting documented evidence from business units.

The one-off and ongoing direct costs associated with the presumption of senior management responsibility are considered to be relatively small, an increase in the level of detail of recorded decisions and a more formal decision-making process. The indirect costs of additional monitoring and sign-off are considered to be far more significant, and are discussed in our section on indirect impacts.

There was not considered to be any additional burden stemming from the extra requirements on pre-approval for SMFs.

Certified persons regime

The expected costs to banks and investment firms of implementing a certified persons (CP) regime include migration costs of updating IT systems (e.g. management software), developing guidance and policy documents and, to a more limited extent, engaging with individuals in the new CP roles. These set-up costs are largely fixed and there is not a great deal of variation across the large and small firms in the sample. The ongoing costs of applying the regulation are negligible.

The responses provided the potential number of CPs that would be captured by the policy. These generally included the management layer below the SMF roles as well as mortgage advisors, other customer advisors, material risk takers, and other roles considered to have the potential to cause harm to consumers. It was noted that the scope for the CP regime could be very wide if various back-office functions were included, and firms highlighted some regulatory risk associated with the definition.

Continuing fit and proper

The requirement for continuous checks of fitness and proprietary for SMFs and CPs are likely to have a moderate cost impact on firms. Whilst all firms in the sample already have a system of annual appraisal in place, many (particularly the large firms) felt that a more formal procedure would need to be added to this to incorporate a formal declaration of fitness and propriety from staff and sign off from designated managers. Smaller firms were more likely to adapt their existing processes.

The one-off costs include additional IT systems and some staff training, whilst the ongoing costs cover the additional resources spent on declaring and reviewing statements of fitness and propriety. As large firms are more likely to implement IT solutions, their one-off costs compared to ongoing are relatively greater than smaller firms'.

Firms highlighted that one-off and ongoing costs would be greater if a more rigorous approach was deemed necessary by the FCA (for example, the auditing of a greater proportion of self-declarations of fitness and propriety), or the collection and storage of evidence pertaining to individuals' fitness and propriety.

Regulatory references

The requirement to seek and provide regulatory references going back five years is not notably different to what banks currently do, in particular large banks, and any additional one-off and ongoing costs are considered to be negligible. Smaller banks did envisage some cost entailed in setting up processes to request and provide more detailed references.

DBS checks for SMFs

Banks in our sample all carried out DBS checks on potential SMF individuals, and thus the policy options would only imply an update check for all SMFs either every year or every three years (the periodic frequency agreed to by most firms in our sample), at £13 a check.

Rules of conduct

The responses to our quantitative questions provided the number of employees that would be captured under the three options, namely SMFs and CPs; SMFs, CPs and a concept of 'middle management'; and all employees except ancillary staff. In most cases the 'all employees' figure was aligned with the total number of employees reported by the firms, which is suggestive of the fact that many ancillary services are outsourced. We note that this figure as reported by firms does not include temporary employees or contractors as firms in general were unable to accurately predict these numbers. The costs associated with the 'all employee' option is therefore likely to be greater in reality if outsourced staff are included, although this is likely to vary significantly across firms.

All banks in the sample currently apply a Code of Conduct across all employees, with some initial and ongoing training. The additional one-off costs include updating documentation and guidance to include the new code (which is considered to be broadly similar in content to existing codes) and providing one-off training to all involved to familiarise them with the new code. One-off costs for the large banks are particularly significant as these represent a far larger number of employees captured under each option. Banks also highlighted the need to ensure that all employees understand and engage with the Rules to a sufficient extent, which would entail developing a number of different training programmes relevant to different types of employee. The IT costs of updating existing systems are particularly high among large firms; smaller firms relying relatively less on extensive IT systems.

The costs increase with the number of employees captured in the definition of 'Relevant Persons'. Given this, most firms would prefer the application of the Conduct Rules to the narrower definition of SMF, CP and middle management. A few firms, however, noted that defining a concept of 'middle management' could entail regulatory risk if certain groups of employees were missed out.

As the firms already have ongoing training in place, the additional ongoing costs of the policy are minimal, particularly for small firms with low employee numbers. These costs for small banks are considered to be negligible.

Reporting breaches in the rules of conduct

The policy for recording and reporting breaches in the rules of conduct will potentially incur significant costs for firms. Although firms already have in place systems for monitoring and recording general conduct breaches and disciplinary actions, these are generally not considered sufficient to record and report conduct breaches to the level implied by the policy (i.e. all suspected breaches in the conduct rules). This is more so the case for large firms than smaller firms, the latter being more flexible in terms of how they are able to implement this given small employee numbers.

One-off costs include setting up or updating systems to record breaches. Among large firms these are mainly IT systems; smaller firms suggest a mix of IT and manual processes. One-off costs also include training of individuals (e.g. HR, compliance and line managers) with respect to what would be considered a suspected breach.

Ongoing costs include monitoring and decision-making around whether an action constitutes a breach. The costs are increasing with the number of employees captured by the requirement — this is particularly the case for the large firms as there are significant differences in the size of the populations captured by the options.

Deferral policy

The costs of complying with the deferral policy largely consist of one-off costs of reviewing and updating guidance around the firms' deferral policy, including legal advice. There would also be one-off costs involved in communicating the changes to affected staff and dealing with queries etc. Nearly all banks said that they would not need to change individual contracts as variable remuneration was communicated to staff by means of an annual statement which could easily be altered.

Ongoing costs would also be incurred as a result of additional monitoring of deferred payments to ensure they are paid on time and to account for an increase in the complexity of deferral arrangements covering a wider population of employees.

The cost impacts of the remuneration policies in general were not felt to be significant by the small banks given the limited scope of variable remuneration payouts.

Clawback

The one-off costs here would most likely include a revision of contracts otherwise the enforcement of extended clawback would be very difficult. This cost varies across the firms according to the number of individuals likely to be relevant, but imply greater costs than the deferral policy. Again the small banks did not see this as a significant cost given the low scale of variable remuneration paid.

No specific ongoing costs of the clawback policies were quantified. A general comment was raised among firms that the legal costs associated with clawback could be significant, although these would vary on a case by case basis and it is unclear the extent to which these might increase as a direct result of the policies.

Exceptional government intervention

The banks in our sample did not foresee any notable costs in complying with this policy, with possibly negligible costs of documentation changes.

3.3.2 Costs across the sector

According to FCA data there are approximately 160 banks and investment firms subject to the new individual accountability regime and 240 subject to the Remuneration Code changes (the latter includes branches of non-EEA firms). Total sector income for these two populations is around £103 billion and £115 billion respectively.[14] In order to arrive at a large/small split we drew the threshold for large at 80 per cent of sector income, representing around the top 10 per cent of firms.[15] This equates to between 15 and 18 firms across the two populations.[16] Our compliance cost model reports an average cost per large and small firm across our sample of five large and five small banks, which are then extrapolated up to the sector.

The table below presents the total costs across the three options for Relevant Persons definition (only SMFs and CPs; SMFs, CPs and middle management; all employees except ancillary staff).

Table 3.6: Total compliance cost impact on banks and investment firms across the three relevant person options (£ millions)

	Large	Small	Sector total
Individual accountability policies, one-off			
Option 1 (SMF + CP)	76.9	63.2	140.1
Option 2 (SMF + CP + MM)	123.7	64.5	188.2
Option 3 (everyone)	169.9	66.7	236.6
Remuneration policies, one-off	11.5	17.5	29.0
Individual accountability policies, ongoing			
Option 1 (SMF + CP)	7.6	11.8	19.4
Option 2 (SMF + CP + MM)	8.2	12.2	20.4
Option 3 (everyone)	9.8	12.8	22.6
Remuneration policies, ongoing	0.6	0.9	1.5

Source: Europe Economics survey.

[14] Source: Bank of England Statistics Table B3.2 'Monetary financial institutions' annual profit and loss' http://www.bankofengland.co.uk/statistics/Pages/iadb/notesiadb/income_expenditure.aspx

[15] This threshold is based on a natural split in the distribution of income. See Appendix at Section 9.

[16] More detail on this is included in the Appendix at Section 9.

The direct compliance cost of the individual accountability policies imply a sector-wide one-off cost of between 0.14 per cent and 0.23 per cent of sector income, and an ongoing costs of around 0.02 per cent of sector income. The remuneration polices will have a far smaller one-off impact of around 0.003 per cent of sector income and negligible ongoing costs.

3.4 Building societies

3.4.1 Costs across the sample and summary of cost drivers

The tables below present the aggregated compliance costs across our sample, which covers two large and two small building societies.[17] The cost drivers for large and small building societies are similar to those of the banks in a number of areas. We discuss the key differences that would influence the costs.

Table 3.7: Average one-off per-policy compliance costs across building societies in sample (£000s)

One-off costs	Large	Small
Individual accountability policies		
SMF, statement of responsibility, presumption of senior responsibility and pre-approval	334.1	22.5
Certified persons regime - set up	182.3	1.4
Continuing fitness and propriety	112.1	Negligible
Regulatory references	Negligible	0.5
Rules of conduct (SMF+CP)	322.4	2.0
Rules of conduct (SMF+CP+MM)	606.0	4.5
Rules of conduct (everyone)	5,181.9	11.6
Reporting breaches (SMF + CP)	100.0	Negligible
Reporting breaches (SMF + CP + MM)	100.0	Negligible
Reporting breaches (everyone)	100.0	Negligible
Remuneration policies		
Deferral of remuneration	18.2	Negligible
Clawback	3.2	Negligible
Exceptional government intervention	Negligible	Negligible

Source: Europe Economics survey.

[17] Large firms have annual income greater than £50 million.

Table 3.8: Average ongoing per-policy compliance costs across building societies in sample (£000s)

Ongoing costs	Large	Small
Individual accountability policies		
SMF, statement of responsibility, presumption of senior responsibility and pre-approval	4.6	Negligible
Certified persons regime - on-going	Negligible	Negligible
Continuing fitness and propriety	15.5	2.1
Regulatory references	4.2	0.2
Triennial DBS Checks	0.1	0.0
Annual DBS Checks	0.2	0.1
Rules of conduct (SMF + CP)	17.2	Negligible
Rules of conduct (SMF + CP + MM)	37.2	Negligible
Rules of conduct (everyone)	358.8	Negligible
Reporting breaches (SMF + CP)	75.0	Negligible
Reporting breaches (SMF + CP + MM)	75.0	Negligible
Reporting breaches (everyone)	1,118.6	Negligible
Remuneration policies		
Deferral of remuneration	15.0	Negligible
Exceptional government intervention	Negligible	Negligible

Source: Europe Economics survey.

The tables below presents the total costs across the three options for Relevant Persons definition (only SMFs and CPs; SMFs, CPs and middle management; all employees except ancillary staff). Costs form a greater percentage of annual income for small firms compared to large, most notably for one-off costs. We also note that one-off costs form a greater percentage of income for small building societies compared with small banks. This is most likely driven by similar set-up costs, including those relating to the number of SMFs, but significantly higher incomes among small banks compared to small building societies.

Table 3.9: Average total compliance costs across building societies in sample (£000s)

	Large	Small
Individual accountability policies, one-off		
Option 1 (SMF + CP)	1,050.8	26.4
Option 2 (SMF + CP + MM)	1,334.4	28.9
Option 3 (everyone)	5,910.3	35.9
Remuneration policies, one-off	21.3	Negligible
Individual accountability policies, ongoing		
Option 1 (SMF + CP)	116.5	2.3
Option 2 (SMF + CP + MM)	136.5	2.3
Option 3 (everyone)	1,501.8	2.3
Remuneration policies, ongoing	15.0	Negligible

Note: the costs of the individual accountability proposals do not vary by the options for the scope the Relevant Persons as small building societies reported negligible ongoing costs for the Rules of Conduct and Notifying of Breaches policies; the ongoing costs are therefore driven by the costs of the SMF and CP regimes which do not vary across the options.
Source: Europe Economics survey.

Table 3.10: Average total compliance costs across building societies in sample (percentage of annual income)

	Large	Small
Individual accountability policies, one-off		
Option 1 (SMF + CP)	0.139%	0.677%
Option 2 (SMF + CP + MM)	0.162%	0.720%
Option 3 (everyone)	0.420%	0.798%
Remuneration policies, one-off	0.001%	Negligible
Individual accountability policies, ongoing		
Option 1 (SMF + CP)	0.007%	0.068%
Option 2 (SMF + CP + MM)	0.009%	0.068%
Option 3 (everyone)	0.064%	0.068%
Remuneration policies, ongoing	0.001%	Negligible

Source: Europe Economics survey.

SMF policies

The work required to migrate to the new SMF regime is more limited given the less complex organisational structure of many building societies and the more limited range of activities and functions compared to banks and investment firms; this is particularly the case for small building societies. This is likely to result in a relatively lower number of SMFs (largely consisting of the board and ExCo and not extending much beyond that). This influences the costs associated with individual SMFs (i.e. training and role familiarisation), as well as the costs of setting up the new regime. There would also be fewer people involved in the set-up of the new regime as, unlike banks and investment firms, building societies did not identify the need for business unit teams to be involved in the processes.

Ongoing costs of the SMF policies, including updating the responsibilities matrix and statements of responsibility, were also not considered to be large. Firms noted that as responsibilities would be assigned to roles rather than individuals, and given the relatively straightforward nature of these responsibilities, ongoing maintenance of responsibilities would be minimal.

In contrast to the bank sample the building societies in our sample did not foresee notable costs related to increased record keeping as a result of the presumption of senior management responsibility, compared to the recording keeping practices already in place. However, indirect costs of more collective decision making (involving sub-committees, more bureaucracy etc.) were highlighted as a risk of this element of the policy.

Certified persons policies

Large building societies are likely to have a large number of certified persons relative to the current number of approved persons and total employee population, given the large number of mortgage advisors. The one-off costs of migrating to the CP regime included IT costs and training. The firms in our sample generally all have a system for checking fitness and propriety for approved persons or mortgage advisors (as a result of MMR) (rather than, say, a fit for purpose appraisal system across all employees), and they would seek to update and extend this to the rest of the CP population. This should incur pro rata costs according to the size of the population unless it was deemed necessary to significantly increase the rigor of the systems. The smaller building societies envisaged using existing appraisal schemes which may incur small ongoing costs in terms of additional time spent on the process but negligible set-up costs.

Rules of conduct

The large building societies in our sample do not have a universal code of conduct which is applied to all staff. The closest thing is the application of the APER to approved persons. Whilst the content of the rules is not considered to differ greatly, applying them over a much larger population could incur significant one-off costs of introducing everyone to the rules and ongoing annual training and refreshing. The likely CP population would cover significantly more employees than are currently approved persons; a middle management population even more; and more so with the entire employee base (excluding ancillary staff). In addition to the pro rata costs, in order to ensure that all employees properly engaged with the rules, different training programmes would need to be developed to cater for the different sectors (i.e. mortgage advisors would need different training to back-office staff).

The large building societies in our sample felt that given the significant costs of rolling out Conduct Rules to all staff, and the potentially limited additional benefits, it would be far preferable to limit the application of these policies to CPs and SMFs, or a middle management option.

Smaller building societies with small numbers of employees would not incur this extent of cost and would most likely be able to communicate the conduct rules in a more flexible and lest costly way. The flexibility of smaller firms with regards to implementing the Rules of Conduct is a feature that it notable across sectors.

Breaches of conduct

Similar to extending the rule of conduct to wider populations, the requirement to record and report breaches of misconduct would also incur significant costs among large building societies. The firms in our sample already have systems to monitor and record errors and disciplinary actions (applicable to all employees) but these are not designed to flag *particular* breaches and operate at a higher level than what is implied by the policies. Set-up costs include additions to current compliance software, as well revisions to policies.

Ongoing recording and monitoring of breaches could be significant among the larger firms. One firm's current system was largely manual (disciplinary events entered into the system by an HR team in each division) and for many groups of employees this only happens once a year at appraisal. To increase this to, say quarterly recording and reporting implies a drastic increase in human resources; given the current structures automating this was not thought to be feasible.

Remuneration policies

The building societies in our sample had a relatively small number of Material Risk takers currently (indeed, the two small firms had none). The cost drivers for the large firms associated with the remuneration polices were broadly in line with those of the banks, although on a much smaller scale — updating scheme rules rather than amending contracts for the deferral policy; having some contract changes for the changes in clawback rules. External legal costs would be incurred as well. The remuneration policies would have no impact on the small firms in our sample as no variable remuneration is paid – we have assumed similarly low costs across all small building societies.

3.4.2 Costs across the sector

Data from the Building Society Association (BSA) indicates that 45 building societies would be subject to the new regime, with a sector income of around £4.5 billion in 2013. We apply a threshold of £100 million annual income, below which firms are considered small and above which they are considered large. This threshold is in line with a natural break in the size distribution of firms, and results in a split of six large firms (accounting for 90 per cent of sector income) and 39 small firms. We scale up the fixed costs by the number of firms in the small and large categories, and the variable costs as a proportion of annual income. The tables below show the results per policy and across the regimes as a whole.

The table below presents the total costs across the three options for Relevant Persons definition (only SMFs and CPs; SMFs, CPs and middle management; all employees except ancillary staff).

Table 3.11: Total compliance costs impact for building societies (£ millions)

	Large	Small	Sector total
Individual accountability policies, one-off			
Option 1 (SMF + CP)	5.65	1.60	7.25
Option 2 (SMF + CP + MM)	6.62	1.78	8.40
Option 3 (everyone)	17.14	2.11	19.25
Remuneration policies, one-off	0.13	Negligible	0.13
Individual accountability policies, ongoing			
Option 1 (SMF + CP)	0.30	0.29	0.59
Option 2 (SMF + CP + MM)	0.37	0.29	0.65
Option 3 (everyone)	2.62	0.29	2.91
Remuneration policies, ongoing	0.02	Negligible	0.02

Source: Europe Economics survey.

The direct compliance cost of the individual accountability policies imply a sector-wide one-off cost of between 0.2 per cent and 0.4 per cent of sector income, and an ongoing costs of between 0.01 percent and 0.07 per cent of sector income. The remuneration polices will have a far smaller one-off impact of 0.003 per cent of sector income and negligible ongoing costs.

3.5 Credit unions

3.5.1 Costs across the sample and summary of cost drivers

The tables below present the aggregated compliance costs across our sample of four credit unions. Given the small nature of credit unions, we have treated our sample firms as being indicative of the sector as a whole, and therefore have not made the small/large divide.

Our interviews highlighted a number of key features of credit unions that would affect the costs of complying with the individual accountability policies (they are not subject to the Remuneration Code).

Table 3.12: Average one-off per-policy compliance costs across credit unions in sample (£000s)

One-off costs	All firms
SMF, statement of responsibility, presumption of senior responsibility and pre-approval	6.2
Certified persons regime - set up	0.3
Continuing fitness and propriety	0.2
Regulatory references	Negligible
Rules of conduct (SMF+CP)	1.6
Rules of conduct (SMF+CP+MM)	2.1
Rules of conduct (everyone)	3.4
Reporting breaches (SMF + CP)	0.3
Reporting breaches (SMF + CP + MM)	0.3
Reporting breaches (everyone)	0.3

Source: Europe Economics survey.

Table 3.13: Average ongoing per-policy compliance costs across credit unions in sample (£000s)

Ongoing costs	All firms
SMF, statement of responsibility, presumption of senior responsibility and pre-approval	0.2
Certified persons regime - on-going	Negligible
Continuing fitness and propriety	0.7
Regulatory references	0.1
Triennial DBS Checks	0.1
Annual DBS Checks	0.2
Rules of conduct (SMF + CP)	1.4
Rules of conduct (SMF + CP + MM)	1.4
Rules of conduct (everyone)	2.3
Reporting breaches (SMF + CP)	Negligible
Reporting breaches (SMF + CP + MM)	Negligible
Reporting breaches (everyone)	Negligible

Source: Europe Economics survey.

The tables below presents the total costs across the three options for Relevant Persons definition (only SMFs and CPs; SMFs, CPs and middle management; all employees except ancillary staff).

Table 3.14: Average total compliance costs across credit unions in sample (£000s)

	All firms
Individual accountability policies, one-off	
Option 1 (SMF + CP)	8.6
Option 2 (SMF + CP + MM)	9.2
Option 3 (everyone)	10.4
Individual accountability policies, ongoing	
Option 1 (SMF + CP)	2.4
Option 2 (SMF + CP + MM)	2.4
Option 3 (everyone)	3.3

Source: Europe Economics survey.

Table 3.15: Average total compliance costs across credit unions in sample (percentage of annual turnover)

	All firms
Individual accountability policies, one-off	
Option 1 (SMF + CP)	0.601%
Option 2 (SMF + CP + MM)	0.659%
Option 3 (everyone)	0.751%
Individual accountability policies, ongoing	0.217%
Option 1 (SMF + CP)	0.217%
Option 2 (SMF + CP + MM)	0.217%
Option 3 (everyone)	0.298%

Source: Europe Economics survey.

SMF policies

Credit unions are generally small, and many very small, with low numbers of approved persons who tend to be all board members. Based on our interviews we have assumed that no one below board level would be captured within the SMF role. Given the simple firm structure the costs of migrating to the SMF regime are low, although the time spent reviewing the legislation and deciding on the allocation of responsibilities etc. will most likely be done by the board themselves and thus the relative costs compared to the use of more junior staff in larger organisations would be greater. Board members currently hold responsibility for all the main functions of the firm, and thus applying the new regime could be done flexibly. Credit unions would most likely look to trade associations for any training or understanding of the policies required.

Despite this, a key potential risk of the SMF regime, in particular assigning individual responsibilities, is that this may significantly undermine the principles of credit unions whereby all members are able to be voted onto the board and board members are often volunteers. Although the board holds all responsibly for the firm, this is generally held *collectively,* with all board members taking responsibility for all decisions. On the one hand, this does generate individual accountability and responsibility as each member would be held responsible in the event of a failure; on the other, separating out responsibilities to individuals for the purposes of the policies may not be feasible and would contravene the principle of a credit union, and there is a risk that individuals would be deterred from taking a place on the board. This would be particularly the case for volunteers who would not be remunerated for any increased personal accountability.

The costs associated with additional record keeping in relation to the presumption of senior management are considered to be low given that decisions are already recorded.

The relatively low compliance costs do however represent a non-trivial percentage of income in our sample.

Certified persons policies

The number of CPs in credit unions is likely to be very small. Given that most in our sample already have a system for annual appraisals, firms envisage that the fitness and propriety check could be included in this with little extra cost. Extrapolating this across the sector assumes a similar process across all firms which may have the risk of underestimating the costs.

Rules of conduct

Based on our sample we have assumed that credit unions are likely to apply some form of conduct code to their employees, and updating this to incorporate the new rules is unlikely to incur notable costs. That said, if the policies implied a more rigorous approach than envisaged by the firms in our sample (for example, dedicated training rather than reading through the Code manual) then this would imply greater costs. Given the small number of employees across most credit unions any pro rata costs would in aggregate be small. The differences between the options for Relevant Persons would have a small impact on the costs, with the greatest difference being the 'all employees' option; this stems from the fact that a concept of 'middle management' does not differ greatly from the population of SMFs and CPs.

Reporting of breaches of misconduct

Recording and reporting breaches incurred by the board members would not represent a diversion from current practice. Setting up systems to record and report breaches among staff is likely to require one-off costs — judging from our responses we have assumed this process would be done manually rather than investing in IT, and would build on existing recording processes. The existence of similar processes implies that ongoing costs would be negligible. Some firms in our sample noted that if they were to be obliged to record every small error or complaint involving a staff member then this could be very impractical and costly — the cost estimates reflect the reporting of more notable breaches in conduct rules.

3.5.2 Costs across the sector

Data from the FCA show that there are 523 credit unions that would be subject the policies, with a sector income of around £167 million in 2013.

Given the small, similar nature of credit unions, we have treated our sample of firms as being indicative of the sector as a whole. Differences in variable costs across firm size are captured as these are extrapolated up as a proportion of firm income. As the fixed costs are extrapolated across the number of credit unions with no adjustment for size this may overstate the costs to the very small credit unions. However, as explained in Section 3.2.13 many of the fixed cost drivers are related to the number of SMFs; this number is likely to be limited to the board and we consider it reasonable that the size of the board is relatively invariant to the size of the firm (this is certainly the case with our sample). Therefore the extent of the over-statement of costs may not be great.

Table 3.16: Total compliance costs impact for credit unions across the three relevant person options (£ millions)

	Sector total
Individual accountability policies, one-off	
Option 1 (SMF + CP)	4.38
Option 2 (SMF + CP + MM)	4.67
Option 3 (everyone)	4.77
Individual accountability policies, ongoing	
Option 1 (SMF + CP)	1.03
Option 2 (SMF + CP + MM)	1.03
Option 3 (everyone)	1.24

Source: Europe Economics survey.

The direct compliance cost of the individual accountability policies imply a sector-wide one-off cost of between 2.6 and 2.9 per cent of sector income, and an ongoing costs of between 0.6 per cent and 0.7 per cent of sector income. Compared with the other sectors the compliance costs represent a far greater share of sector income.

4 Indirect Costs and Wider Impacts

4.1 Introduction

In this section we consider the potential indirect cost of the FCA proposals on firms and the wider market. The indirect impacts discussed in this section are as follows:

- Operational efficiencies.
- Labour market effects.
- Product innovation.
- Regulatory badging.

We discuss why a change in regulatory regime could affect these areas, and how well (or not) the available evidence speaks to this. We consider the individual accountability and remuneration policies each as whole policy packages, but where relevant identify individual policies that are likely to have a particular impact. We also identify where we expect there to be significant interaction between the policy proposals and where this could have multiplicative effects on the indirect impacts.

A quantitative analysis of the indirect costs and wider impacts has not been undertaken as part of this exercise as it is not considered to be reasonably practicable to do so given the high degree of complexity and uncertainty surrounding the nature of such impacts.

4.2 Operational efficiencies

Operational efficiency is concerned with maximising the level of output for a given level of input. In other words, operational efficiency is achieved when resources are allocated such that, collectively, they are utilised in the most productive way possible. Regulatory proposals may change operational efficiencies by inducing firm and individual behavioural changes.

4.2.1 Monitoring costs

The individual accountability and remuneration policies could be perceived by firms to place an increased level of risk on individuals (indeed that is the aim), in particular on those in SMF roles. One of the benefits of this could be increased monitoring of staff and business activities. However, this also has the potential to increase operational inefficiencies.

Higher levels of internal staff monitoring could be characterised by increased reporting and sign-off processes, implemented by those in SMF roles to ensure they are more fully aware of – and approve – the actions of those for whom they are responsible. Additional monitoring could be beneficial if it improves the links between senior managers and the areas they are responsible for, and improves the behaviour of more junior staff. However, inefficiencies could arise if SMFs' incentives to monitor are over and above what is collectively rational at the firm level. Monitoring would exceed the optimal level if the costs of an additional unit of monitoring outweigh the benefits.

Internal controls can be detective or preventative in nature. Detective controls are designed to identify errors that may have occurred, while preventative controls are designed to keep the possibility of errors arising to a minimum. Increased employee monitoring could improve both forms of control. For example, more records of key decisions and actions taken by employees, and storing these records for a longer period, should increase employees' perceived accountability and, therefore, help to prevent deliberate errors from arising. The requirement for more senior employees to check and sign-off on key actions of junior staff should allow senior employees to detect both deliberate and non-deliberate errors at an earlier stage. Such monitoring measures may be more important where actions involve a greater element of uncertainty or risk, or are more directly customer-facing. Extra monitoring procedures like this are likely to increase the operational costs of firms, both in terms of the direct costs of monitoring and the opportunity cost of the time foregone on carrying out other (more productive) business functions.

In assessing the optimality of this increased monitoring, the additional costs of monitoring should be considered alongside the potential benefits and disbenefits of this extra monitoring. Martin and Freeman (2003) discuss what the potential impacts of increased monitoring could be.[18] The key impacts discussed are the impact of monitoring on employee productivity, employee creativity, organisational security, and employer liability. The impact of monitoring on employee productivity is widely debated. On the one hand, increased monitoring could make employees more focused and compliant, but increased monitoring could also lower employee morale (e.g. through increased anxiety) which would have the opposite effect. Optimality of monitoring (and operational efficiency) will depend on the extent to which these benefits and disbenefits arise and whether, or not, they outweigh the costs of additional monitoring.

Evidence from survey

Evidence from the survey highlights two elements of increased monitoring: internal monitoring of employees with increased reporting and sign-off processes; and more detailed documentation of decisions made by senior staff combined with more lengthy decision making processes.

Larger firms, in particular large banks and investment firms, foresee a greater need for the former type of monitoring than smaller firms. Some of the large firms surveyed believe that the impact on monitoring is likely to be the biggest behavioural impact of the regulatory changes, and in some cases it was said that this would reinforce the wider, top-down driven cultural changes that are already taking place or are expected to take place. Most of these firms also made specific reference to the presumption of senior management responsibility in accounting for the expected increase in internal monitoring.

Large firms often cited their complex organisational structure, and the inherent difficulty in unpicking the details of responsibility, as a key rationale for this increase in monitoring. In these large firms it is expected that the clear lines of responsibility would need to extend a significant way down the hierarchy in order to establish clearer lines of command for individual SMFs, and may even need to extend horizontally as well.[19] Thus any increase in monitoring would also need to be far-reaching. It is also clear from our fieldwork that it is not always possible to identify activities that may give rise to more risk ahead of time; increased monitoring would help in this identification process. In turn, the more risk averse senior individuals become as a result of the policies, the more likely increased monitoring will take place.

The indirect costs of increased monitoring could be substantial. Evidence from large firms suggests that a number of individuals from each business unit aligned with a senior manager would be involved in an ongoing process of developing and testing quality assurance and monitoring procedures; overseeing other supervisory arrangements within the units; evidencing due diligence of risks more robustly; and generally supporting the senior manager in complying with the processes deemed necessary in light of the increased level of individual accountability and the presumption of senior responsibility. To illustrate the possible scale, costs estimates received from a few large banks, with a range of between 20 and 30 SMFs, reach between £3million and £5million per year, covering ad hoc senior manager time and dedicated time of around two employees per business unit (including overheads).

---

[18] Martin, K. and Freeman, E. (2003), 'Some Problems with Employee Monitoring', *Journal of Business Ethics*, vol. 43, pp. 353-361.

[19] This is particularly the case for large firms with many business divisions, such as investment firms, where an individual with overall responsibility for a function (e.g. product development) is exposed across all divisions in which this function takes place.

Many of the smaller firms, in particular credit unions and building societies, do not perceive a significant change to internal monitoring, as board members are already accountable and take the necessary monitoring steps. In smaller, simpler organisations the oversight of employees is likely to be greater, and would not necessitate significant changes or new processes.

The second type of monitoring identified in the survey entails greater effort to collect and retain evidence of decision making to ensure that, should they need to, senior managers would be able to prove they took all necessary steps to prevent a breach from arising. Particular reference is made to higher frequency and elongation of sign-off procedures and increased documenting of decision-making, both in volume and the detail.[20] This could include recording greater detail of minutes and formalising all decision making processes. (An example of the latter would be the documenting of an informal discussion between two senior colleagues that may result in a decision being taken). There is a concern among firms that the presumption of senior management responsibility could create “no end” to the evidence SMFs might have to collect in order to prove they took all necessary steps to prevent a breach. Given this uncertainty it is likely that firms will overcompensate with inefficient levels of monitoring.

Indeed, many firms highlighted the danger that decision making would become very bureaucratic and slow as all individuals seek to document all processes as thoroughly as possible. Particular reference was made to the increase in collective decision making with referrals to ad hoc sub-committees, as individuals would be less willing to make independent judgements under the new regime.

There is general agreement amongst those firms who consider the implications of increased monitoring and bureaucracy that such changes are likely to increase operational inefficiencies. Responses have indicated that while there would be more awareness and focus on documenting decisions, the quality of decision-making itself would be unlikely to change. This suggests that additional monitoring would be suboptimal. Other firms simply note that sufficient monitoring was already in place, such that any additional delays imposed on decision-making would be inefficient. As well as delays to decision making, there is also a danger of more formulaic decision-making process, which could make firms less responsive to market challenges.

The impacts of more protracted decision making were felt by most firms in the sample, small and large alike. Several responses from small firms suggest that more lengthy decision-making processes would significantly reduce their competitive advantage against large firms which is dependent on their agility to react to changing market conditions and their ability to make quick decisions.

Overall, the survey responses suggest that increases in monitoring would be undertaken largely as a means of gathering sufficient evidence to protect senior managers, rather than as a way of identifying and pre-empting behaviour among staff that could lead to regulatory breaches. It is widely thought that such changes could increase operational inefficiencies by adding unnecessary delays to decision-making processes and using (often significant) additional resources to provide assurance to those in SMF roles.

4.2.2 Staff motivation/effort

The relationship between staff pay and staff motivation and effort has received much attention in the academic literature. Pepper, Gore and Crossman (2013)[21] conduct a two-part survey of senior executives

---

[20] Whilst the costs of additional record keeping have been included in the compliance cost model, it is not possible to quantify all the costs associated with the greater documentation of decisions and the increased length of decision-making processes.

[21] Pepper, A., Gore, J. and Crossman, A. (2013) ‘Are Long-Term Incentive Plans an Effective and Efficient Way of Motivating Senior Executives?’, *Human Resource Management Journal,* vol. 23, No. 1, pp. 36-51.

to analyse the relative importance of intrinsic and extrinsic motivation.[22] Their survey finds strong evidence of uncertainty aversion with regard to pay, as well as high discount rates on future earnings, among senior executives. As a result, they conclude that the perceived value of long-term incentive plans to senior executives is likely to be less than the financial cost to the firm of providing those plans.

Impacts on staff motivation should primarily stem from the proposed changes to remuneration policies. The key policies in this regard are:

- Deferral.
- Clawback.

A longer deferral period will mean that variable remuneration will be subject to greater time discounting and hence have a lower net present value, while tougher rules on clawback are likely to increase the uncertainty associated with the variable remuneration package. As Pepper *et. al.* find strong evidence of uncertainty aversion and high discount rates then, assuming there is no commensurate increase in the monetary reward to compensate for these changes, the extrinsic motivation of senior executives is likely to decrease significantly. This could be harmful for firms. Firms may decide to compensate for the policy changes by raising the basic monetary reward, in order to limit the impact on extrinsic motivation. However, this will impose additional variable costs on the firm, which could be passed on to consumers. Even if firms choose not to compensate for these policy changes, then consumers could still lose out, to some degree, as they may now be interacting with, on average, less motivated staff.

As these policies are likely to reduce extrinsic reward, executives of firms subject to these policies will see their returns fall relative to the executives of firms in other jurisdictions. In Pepper *et. al.*'s survey, the issue of fairness was brought up by a large proportion of executives. A key way in which executives assess the value of their remuneration packages is by comparing their value relative to other executives. If these compare unfavourably then this could negatively impact intrinsic motivations – what the article refers to as demoralisation costs. Because of the way in which lower extrinsic motivation can, in turn, reduce intrinsic motivation, Pepper *et. al.* predict a threshold below which motivation and effort fall off sharply for marginal decreases in pay. The key concern, therefore, is the likelihood that the remuneration proposals push individuals beyond this inflection point on the pay-effort curve. This could have further detrimental impacts in terms of firms' ability to attract and retain high quality staff, as well as for firm productivity and competitiveness. Lower productivity and competitiveness are likely to decrease profit margins to the detriment of the firm, which could also be of detriment to the consumer if firms respond by raising prices.

A less motivated workforce could potentially be of detriment to firm efficiency and productivity. If the decrease in motivation is sufficiently large it could increase staff turnover which, in turn, may incur additional costs of staff hiring and increase the exposure of firms to the labour market difficulties. The decrease in motivation could also reduce worker and, therefore, firm productivity, and higher staff turnover could reinforce this effect on firm productivity. However, given the impact on staff motivation is unlikely to be very large, these potential impacts should remain fairly minor.

Any adverse consequences for staff motivation and effort may be, to some extent, counteracted by adjustments to the firm's wage structure, as discussed in below.

Evidence from survey

Most firms do not anticipate a significant impact of the policies on staff motivation. This may suggest that individuals in these firms are unlikely to fall below the point of inflection on the pay-effort curve (after which effort drops off significantly for incremental decreases in pay) as a result of the remuneration policies. If individuals are significantly above this inflection point, then it may be intrinsic motivation that is

[22] Pepper *et. al.*'s study conducts a program of interviews of senior executives to establish key motivational factors. Intrinsic motivation is driven principally by achievement but also such factors as teamwork, power and status, while extrinsic motivation is driven by remuneration.

more important to staff effort than extrinsic reward. This would rationalise the limited impact of deferral and clawback policies on worker motivation and effort.

That said, a small number of firms did raise concerns that the ability to motivate staff would become increasingly difficult as the link between performance and pay diminished and/or became less transparent. This was primarily attributed to the longer deferral period and longer period before which vesting can begin, rather than the changes to clawback. In particular, some firms stressed that the longer period before vesting would be an influential change, as it would significantly disengage any link between pay and performance, with one firm saying that it would render the bonus scheme effectively pointless.[23] Respondents also said that the potentially detrimental effects to motivation (and staff hiring and retention, discussed in Section 4.3. may cause them to revise the current remuneration structure, both in terms of the absolute level of pay and in terms of the balance between fixed and variable pay.

Overall, in spite of a few firms raising this concern, the prevailing view from the survey is that the impact on staff motivation would be limited.

4.2.3 Wage structure

Firms may make adjustments to their remuneration packages in order to mitigate some of the effects of the proposed policies. In particular, firms may increase fixed pay in order to compensate for the perceived reduction in the value of variable pay. A PwC report[24] found that most executives would choose fixed pay over a high value bonus. Given the option between a certain sum of $41,250 and a 50 per cent chance of receiving a $90,000 bonus, only 15 per cent of executives in the UK opted for the latter. As the changes to remuneration policies are likely to introduce further uncertainty to variable remuneration packages, an even higher proportion of executives may prefer the lower sum with certainty.

The FCA's proposed changes to remuneration policies are likely to have a considerable impact on how individuals view variable remuneration packages, primarily through the following proposals;

- Deferral.
- Clawback.
- Exceptional government intervention.

The extended deferral period will lower the net present value of a given variable remuneration package, while the reforms to clawback and, to a lesser extent, the state aid impact on deferral, will place increased uncertainty on the reward being fully realised. The net effect is likely to be a significant reduction in the perceived value of variable remuneration. Therefore, in order to continue to attract the best possible staff and maintain the motivation and productivity of existing staff, regulated firms may choose to increase the fixed component of employees' remuneration packages. A higher fixed remuneration would, in part, compensate for the lower net present value of variable pay, while also acting, to some extent, as a certainty equivalent, i.e. a higher guaranteed pay to compensate for the increased riskiness of variable pay. In essence, a higher fixed rate of pay is likely to be the natural response of firms who are looking to add to and retain the quality of their workforce, and limit the risk of losing quality staff to other jurisdictions.

---

23 I.e. the time between when the individual performed well and when he/she actually received the bonus would be so long so as to remove any positive reinforcing effect. This argument is undermined somewhat by the fact that, after the first years after the policy change, individuals would begin to receive a rolling stream of income as bonuses from different time periods vest each year. Although linking particular payments to particular performances would be difficult, so long as their good performance remains steady and they continue to receive deferred remuneration, the length of time before vesting should eventually have little impact on their stream of income in this regard (although the concerns about greater discounting would remain). Further, the updated policy proposal of vesting after 3 years for SMF roles and 1 year for other roles would reduce this negative effect.

24 PwC (2012) 'Making Executive Pay Work – the Psychology of Incentives'.

However, this change in wage structure could be of detriment to firms because of the rigidities it imposes. Firms which place a larger emphasis on variable remuneration have greater flexibility to adjust their wage bill during an economic downturn. Rather than lay off employees, firms are able to make downward adjustments to variable remuneration to lower their total wage bill and, therefore, maintain profitability through a period of slow economic growth. Firms that offer a higher proportion of fixed pay, in response to the regulatory changes, would not have as much flexibility in adjusting to economic shocks. For these firms, downward adjustments to variable remuneration may not sufficiently reduce the wage bill, and so firms may also need to rely on worker layoffs during periods of slow economic growth. This would be a much less efficient process than simply making downward adjustments to variable remuneration packages. It also imposes the additional costs of staff turnover.

Furthermore, Burke and Terry (2004)[25] find that the potential shift in emphasis to fixed remuneration schemes could increase a firm's breakeven point, which they define as the ratio between total fixed cost, and price less variable cost. An increase in the breakeven point means that there will be an increase in the time taken for a firm to reach profitability, which could, in extremis, increase barriers to entry.

Burke and Terry also find that a greater use of variable remuneration should increase staff motivation (discussed in 4.2.2) and that firms using variable compensation tools should have more predictable and consistent monetary returns, which should lower investors' perceptions of risk and thereby improve investor financing. A shift towards a greater emphasis on fixed pay would undermine this.

A follow up study by Burke and Hsieh (2005)[26], finds evidence of an inverted-U relationship between firm value and the proportion of total pay that is variable. This is because firms placing too much emphasis on variable pay may find it difficult to attract or retain high quality staff who prefer a larger element of fixed pay. Therefore, the likely impact of the increase in fixed pay remuneration on firm value would depend on the firm's current position on this inverted-U (i.e. the existing balance between fixed and variable remuneration).

A higher proportion of fixed pay may also have the undesired consequence of increasing risk-taking, the very problem the proposals sought to address. Wiseman and Gomez-Mejia (1998)[27] develop a model of internal corporate governance and find that risk bearing is a function of future base pay and anticipated changes to that base pay. Therefore, an increase in future base pay means that a greater proportion of future pay is protected from the threat of loss. This reduces the risk borne by agents, such that agents are more prepared to pursue additional variable pay through riskier strategic decision-making.

Aside from the impact on the relative proportions of variable and fixed remuneration, the individual accountability policies may influence the total remuneration firms offer to their employees. In order to compensate individuals for their increased accountability under the new regime, firms may feel that an increase in total remuneration is necessary, or else they run the risk of staff relocating overseas or to other sectors domestically (as discussed in 4.3). The relevant policies in this regard are those discussed in 5.4 to 5.6, as these are the mechanisms which are likely to contribute to a perceived increase in individual accountability.

The extent to which firms may adjust remuneration packages, both in terms of total remuneration and the split between fixed and variable remuneration, is likely to depend on staff type, i.e. SMF, Certified Persons and other relevant persons.

[25] Burke, L. A. and Terry, B. (2004), 'At the Intersection of Economics and HRM: an Argument for Variable Pay Schemes', American Business Review, vol. XXII, pp. 88-92.

[26] Burke, L. A. and Hsieh, C. (2005), 'Optimizing Fixed and Variable Compensation Costs for Employee Productivity', *International Journal of Productivity and Performance Management*, vol. 55(2), pp. 155-162.

[27] Wiseman, R. M. and Gomez-Mejia, L. R. (1998), 'A Behavioural Agency Model of Managerial Risk Taking', *Academy of Management Review*, vol. 23(1), pp. 133-153.

Evidence from survey

There is a general consensus among firms that individuals would need to be compensated for the policy changes. This excludes credit unions for whom most of the board members are voluntary and, therefore, do not receive a remuneration package. That aside, most other firms attribute the additional need to compensate individuals to the extra accountability and liability these individuals are likely to face under the new policies. The increase in individual accountability is largely attributed to the presumption of senior management responsibility and the statement of responsibilities, as discussed in more detail in 5.4. A large building society also said that the Certified Persons regime could significantly increase remuneration expectations for those individuals who are now subject to a more formal (and annual) certification process.

A smaller portion of firms, emphasised the reduced value of deferred remuneration packages as the rationale for increased compensation. These firms attribute this reduced value of deferred compensation to the proposed changes to deferral or clawback, or a combination of the two, as discussed in more detail in 5.3.

So, whether firms accredit it to the increased accountability under the individual accountability policies or the reduced value of deferred pay under the remuneration policies, there is general agreement that changes to the wage structure would be necessary. One firm pointed out that changes to compensation could be either in the form of higher absolute levels of pay, either variable or fixed, or in the form of a higher proportion of fixed pay. Most firms make reference to increasing the levels of fixed pay, which would be a combination of these two possibilities.

Firm responses also raise the issue that the importance of increased compensation may vary across staff type. A common concern is that individuals in back office roles, such as operational risk, can more readily relocate and apply their skills in other non-financial sectors and, therefore, may have greater bargaining power to increase fixed pay. Another issue emerging from the survey is that if regulatory accountability cascades further down the firm than under the current regime, then less senior individuals may have to be remunerated accordingly. One small firm estimates that a mid-senior manager currently earning between £50,000 and £100,000 per annum would expect at least a £20,000 rise in pay to compensate for the increase in responsibility.

Of particular concern to the large banks and investment firms is their competitiveness in international labour markets, especially as the more senior staff at these firms tend to be very internationally mobile. To remain competitive, one of the large banks surveyed said that an increase in overall levels of remuneration or fixed pay remuneration is a necessity.

Some firms also mentioned that such a shift towards fixed remuneration would increase fixed costs to the industry and, therefore, could increase operational inefficiencies. One respondent said that this change would be beneficial to the extent that it reduces the administrative complexity and regulation associated with variable remuneration, but it would also be of detriment to the firm by making them far less flexible and introducing significant prudential risk. Evidence from our fieldwork suggests that this detriment is likely to outweigh any administrative benefits.

Of all the potential effects on operational efficiencies discussed in 4.2, wage structure received the most attention in the firm-level survey. Most firms, credit unions aside, see a shift towards higher fixed remuneration as a necessary response to the regulation, and there is cause to believe that the required magnitude of such increases may in fact be quite large. Several responses also recognised the trade-off between changes to staff remuneration packages and firms' ability to attract and retain staff. The latter is discussed in more details in 4.3.

4.2.4 Potential impacts of operational inefficiencies

The evidence suggests that operational inefficiencies are most likely to arise because of changes to firms' wage structure and due to more lengthy decision-making processes and, more specifically for large firms, increases in internal monitoring. Significant impacts on staff motivation are perceived as unlikely.

While the majority of small and large firms see a shift towards higher fixed remuneration as being necessary, large firms may be better placed to meet the demands for higher fixed wages. That said, large firms are also likely to be more exposed to the competitive pressures of international labour markets, as their employees are likely to be more mobile internationally. Credit unions could be particularly worse off as, by their very nature, their boards are made up largely of volunteers and so these firms cannot compensate the board for their increased accountability. This should make it harder for credit unions to attract and retain staff, as discussed in 4.3.

The shift to a more fixed wage structure should increase the operating leverage of the firm and, therefore, could make these firms more susceptible to macroeconomic shocks. This may be of particular concern for small firms, as they are less able to benefit from retained earnings and economies of scope, such as cross-subsidisation of product areas, in order to smooth out the impact of economic shocks. As a result, and depending on the extent to which fixed wages rise in response to the FCA's policies, there is a slight possibility that smaller regulated firms will find it more difficult to compete both with the larger firms and the firms not subject to FCA-regulation.

Survey responses suggest that more protracted decision-making processes, increased internal monitoring and other internal control costs are likely in large complex organisations, as individuals look to protect themselves in light of the higher individual accountability. Most firms believe that this would be suboptimal and, therefore, would increase operational inefficiencies. There is a very small possibility that these increased costs could be of detriment to the consumer if passed on as higher prices. It is also widely suggested that delays to the decision-making process could have impacts on innovation, as discussed in 4.4. Increased internal monitoring could, however, increase the likelihood of excessive risk-taking and other misconduct being identified and, in that way, reinforce the intended policy benefits discussed in 5.5.

4.3 Labour market effects

The individual accountability and remuneration policies may have undesirable labour market efforts for FCA-regulated firms. We have already discussed the potential detriment to the motivation and effort of existing staff in 4.2.2, but the proposals could also limit the ability of firms to attract and retain staff.

When analysing an individual's decision to leave (or to forego applying to) a role, the costs and benefits of this role must be considered. In this context, we focus on the benefits of the role as the remuneration received, and the costs of the role as the risks to which the employee becomes exposed.

4.3.1 Individual accountability policies

Individual accountability policies may reduce the ability of regulated firms to attract and retain staff because individuals may not want to bear the increased likelihood and costs of sanction under the new regime. The key policies in this regard are:

- Criminal offence.
- Presumption of senior management responsibility Statement of responsibilities.

Under the new proposals, individuals in SMF roles would be subject to criminal offence proceedings for reckless misconduct in the event of firm failure. Most individuals are likely to perceive the threat of imprisonment as a significantly more severe sanction than existing pecuniary sanctions, such as clawback and malus. For some individuals the risk of this sanction may not be sufficiently compensated for by their remuneration package and, therefore, it would not be rational for them to remain in (or apply for) SMF roles.

The presumption of senior management responsibility and the statement of responsibilities may have a similar impact, though it is likely to be to a lesser degree. The presumption of senior management responsibility means that SMFs are effectively 'guilty until proven innocent', as the onus is on these individuals to demonstrate that they took the necessary steps to prevent such misconduct arising. Individuals may, therefore, be concerned about their ability to absolve themselves of responsibility and escape the sanctions of the regulator. The statement of responsibilities directly relates to this, as it sets out the responsibilities for which the individual will be subject to this 'reverse burden of proof'.

4.3.2 Remuneration policies

Remuneration policies could also influence firms ability to hire, by reducing the attractiveness of a given variable remuneration package.

- Deferral.
- Clawback.

The reforms to deferral policy specify both a delay in vesting of at least three years and a longer deferral period once vesting has begun. This will decrease the net present value of variable remuneration. This is likely to have quite a substantial effect on the perceived value of a variable remuneration package, as a PwC report[28] found that individuals discount future earnings at a very high rate (20 per cent in the UK).

Proposals to extend the period over which clawback can be applied and to allow clawback to be applied to the individuals responsible for overseeing junior staff who have caused conduct failures, are likely to increase the uncertainty of the variable remuneration package. This too could have a significant impact on attracting staff, as the PwC report also found a high degree of risk aversion amongst executives (as discussed in 5.3). As the clawback proposals increase the risk of pay, individuals are likely to find the remuneration contracts on offer less attractive.

If we now revisit the idea at the start of 4.3 that a rational individual's employment decisions are based on that individual weighing up the perceived benefits and costs of the specific role, we can see that the proposed individual accountability and remuneration policies are likely to reinforce one another in making existing employment positions less attractive. The individual accountability policies influence the cost side, by increasing the exposure of employees in the event of misconduct, while the remuneration policies influence the benefit side, by limiting the perceived value of the remuneration package offered.

The potential loss of competitiveness for FCA-regulated firms in labour markets may be particularly problematic in the labour market for SMFs, as these individuals are more internationally mobile, such that FCA-regulated firms may struggle to compete with foreign firms in the financial services sector. Regulated firms may also be susceptible to losing staff in operational roles, e.g. legal and IT, whose skills are transferable to a wide range of other domestic sectors, such as retail and industry. There may also be a loss of competitiveness *vis a vis* branches of EEA firms operating in the UK which are not subject to the remuneration policy proposals. The un-level playing field created by the direct compliance costs is not likely to be significant, but the indirect costs in terms of potential changes to fixed and variable pay and difficulties in retaining staff may exacerbate these. Firms in our sample did not identify a loss of competition with EEA branches as a particular issue — though competitiveness in general with firms not under the scope of the proposals (including international firms and firms in other sectors) was noted.

28 PwC (2012) 'Making Executive Pay Work – the Psychology of Incentives'.

If firms perceive that such effects on staff hiring are likely then they may try to compensate by increasing the basic rate of pay to staff. In this regard, large firms may be better placed to the cope than smaller firms, as they will have greater flexibility to adjust the basic rate of pay upwards.

The mechanisms to this point have assumed homogeneity of individuals. However, as well as influencing the ability of firms to hire staff, the policies could also potentially influence the type of staff who are attracted to the roles. The increased regulatory risk could mean that, perversely, less risk-averse individuals are attracted to the roles. This is because less risk-averse individuals would be more willing to take on the increased accountability and uncertainty of reward that prevail under the new regime. If this did occur, it could somewhat blunt the intended effects of the regulatory changes.

4.3.3 Evidence from survey

Of the indirect impacts considered, the survey responses suggest that labour market effects are likely to impose the greatest indirect impacts on firms. Firms believe that they will find it more difficult to hire and retain staff under the new regulations. Indeed, one firm recalled that such an effect already occurred with the shift to regulate mortgage advisors, as some individuals were unprepared to take on the additional responsibility and so left the industry. Several of the survey responses emphasise how these labour market effects are dependent on the extent to which firms compensate with adjustments to their wage structures, (discussed in 4.2.3).

Some firms attribute this difficulty to hire and retain staff to the higher individual responsibility and accountability faced, while other firms emphasise the reduced value of deferred income due changes to deferral and clawback policy. Credit unions' primary concern is that the additional individual responsibility and accountability may deter board members, who are mostly unremunerated. Although board members take on responsibility for all business areas, this is done collectively. Due to the voluntary nature of the board, these firms cannot compensate for the additional responsibilities through higher pay, and therefore credit unions believe that volunteers will be fearful of accepting additional, personal responsibility. One credit union said that the new regime does not accommodate for board members who are there because of their local connections, rather than their financial skills or knowledge.

Large banks and investment firms, with international pools of potential employees, believe that they could be particularly vulnerable to the regulatory changes. The commonly held view amongst these firms is that retention and hiring would be hindered as the perceived value and certainty of their remuneration packages falls, given the tougher rules on clawback and the longer deferral period, and the combined 8-10 year period over which deferral and clawback could apply. Some firms also stressed that the individual accountability policies, and in particular the presumption of senior management responsibility, could hinder their ability to attract high calibre candidates to senior roles. One respondent said that their SMFs tend to have control over very large areas such that they cannot prevent all risks and, therefore, the threat of higher individual accountability could deter them from the role. These firms, therefore, believe that the regulatory changes will create an un-level playing field in international labour markets.

Several firms also note the importance of high international labour mobility in underpinning this mechanism. In addition, while firms admit that there could potentially be a reduced quantity of individuals applying to roles, a small number of respondents emphasise that this would not detract from the quality of hires due to the robust internal screening and selection processes.

As well as discussing the overall impact on staff hiring, many responses also cast light on which types of employees the above impacts may be most relevant to. Some firms are concerned about the retention of those employees who tend to be more risk averse (perhaps those in back office operations), because they would be less willing to take on the additional responsibility and, therefore, less attracted to the position. Furthermore, these individuals are often in professional support roles not specific to the finance sector, e.g.

accounting, legal and human resources and, therefore, may find it easier and more attractive to relocate to other UK sectors. This is a concern raised by several firms.

Some respondents also noted that it would be particularly difficult to retain existing non-executive directors, who are not remunerated in the same way as executive directors. As a result, they may not be sufficiently compensated for the additional responsibility, and so may choose to look for management roles, with similar skill requirements, outside the financial services sector. A small number of respondents raised the concern that employees in roles which inherently carry more risk (i.e. where a large proportion of risk is outside employee control) may be unwilling to accept the additional liability in light of their risk exposure and thus start to find the tenure less attractive. The more risk averse the individual, the more likely this is to be the case. Therefore, this could lead to the unintended consequence that positions are taken, on average, by less risk-averse individuals, as they are prepared to take on the additional responsibility. This evidence supports the hypothesis that there could be a potentially perverse impact on the type of individuals attracted.

Aside from staff hiring and retention, our fieldwork also shows a concern that individuals may rationally choose to forego internal promotion (e.g. from a Certified Person function to a Senior Management Function). Policies are expected to reduce the net present value of employee bonuses and increase individual accountability, with the net effect that the improved remuneration package on offer for promotion is unlikely to compensate for the increase in individual accountability in this role. So, not only may firms lose competitiveness in 'external' labour markets, but their 'internal' labour market may operate less efficiently too.

Overall, the survey evidence suggests that the detrimental labour market effects are a key indirect impact of the regulatory proposals. The increased accountability and/or reduced attractiveness of variable remuneration packages are likely to make it harder for firms to attract and retain staff, especially for those firms who are more internationally exposed. Of course, the magnitude of these labour market effects should be intimately linked to changes in the firm's wage structure (discussed in 4.2.3), as this could, to some degree, compensate for the policy impacts of increased accountability and reduced reward.

4.3.4 Potential impacts of decreased ability to attract and retain staff:

The decreased ability to attract and retain staff could create a more uneven playing field between FCA regulated firms and firms in other jurisdictions, both domestically and internationally. It seems that firms may find it particularly difficult to attract and retain staff who occupy professional support roles, non-executive director positions and roles with high-risk exposure. Individuals in these areas may be unprepared to accept the additional accountability and, therefore, may look for roles with similar skill requirements in other sectors domestically. There is also an increased possibility that those in executive Senior Management functions, who are more internationally mobile, may look to relocate to the financial services sector overseas. Therefore, to the extent that firms may find it harder to attract the best talent in these areas, it may affect firms' competitiveness with domestic non-regulated firms and international firms. Failure to attract and retain this talent, and the potential detriment to competitiveness that could arise, may, in the extreme case, hinder innovation.

Another possibility is that, due to the increased accountability, the average individual applying to the role is less risk-averse than under the old regime. This could, to some extent, blunt the intended behavioural benefits of the new regime, as discussed in section 5. This could be of particular concern if individuals with customer exposure are deterred by the extra accountability they must bear and are, therefore, replaced by individuals with lower risk aversion. If this effect is significant then it might subject customers to greater risk and greater likelihood of mis-selling, which would weaken the intended policy effects. That said, the extent to which this occurs should be very limited, as several firms said that, in spite of the potentially reduced pool of applicants, they have systems in place to ensure that the quality of staff hires is maintained.

4.4 Product innovation

There are two key dimensions to the impact on product innovation. Firstly, there is the potential for delays in innovation, both in the short-term due to increased regulatory risk associated with a regime change and in the long-term due to behavioural changes stemming from increased individual accountability. Secondly, there is the possibility of innovations being foregone entirely, due to impacts on individual incentives and behaviour. For example, Rothwell (1980)[29] finds evidence of both delays to and foregone innovation as a consequence of changes to regulation in US manufacturing and industry.

The proposals which are likely to have the most significant impacts on product innovation are:

- Statement of responsibilities (reinforced by the provision for the presumption of senior responsibility).
- Rules of conduct.
- Deferral.

The impacts of specific proposals will be referred to in the discussion of delays to and foregone innovation.

4.4.1 Delays to innovation

Delays to innovation occur when there is a time delay between when it is rational for a firm to bring an innovation to market and when the firm actually brings the innovation to market. Stewart (1981) argued that, in order to reduce the impact of regulatory change on market innovation, regulators should keep compliance costs and the associated delays as low as possible.[30]

Delays should be particularly common when the FCA proposals are first introduced due to the inherent regulatory risk.

In the short-term, delays may be characterised by risk-averse firms performing extra due diligence checks to minimise their risk of misconduct in the face of regulatory uncertainty. Specific examples of uncertainty under the new regime include the lack of case law precedence with regard to the criminal offence for reckless misconduct; uncertainty over how the regulator will treat reported breaches of the rules of conduct; uncertainty over the extent to which SMFs will be held accountable for failures of junior staff and the severity of sanction that will be applied; and uncertainty as to the level of evidence that is required to prove that senior managers took all reasonable steps to avoid a regulatory breach.

Under the current regime, firms have an idea of which due diligence checks would need to be performed in order to comply with the regulation. However, in the early stages of the new regime, additional due diligence checks may be undertaken in order to comply with several possible interpretations of the new proposals. Other firms, either those which are more risk averse and/or those who deem the extra due diligence costs too high, may instead postpone bringing new innovations to market, as they wait for greater regulatory certainty in the future. Ashford, Ayers and Stone (1985) found that the uncertainty associated with regulatory change was responsible for retarding product innovation, and the diffusion of these products, in a number of industries.[31] They argued that regulatory uncertainty can deter innovation, as there are risks that the technology may not ultimately be needed or may be too costly, and therefore firms will continue to rely on existing, low-risk technologies.

---

[29] Rothwell, R. (1980), 'The Impact of Regulation on Innovation: some US Data', *Technological Forecasting and Social Change*, vol. 17(1), pp. 7-34.

[30] Stewart, R. B. (1981), 'Regulation, Innovation, and Administrative Law: a Conceptual Framework', *California Law Review*, vol. 69(5), pp. 1256-1377.

[31] Ashford, N. A., Ayers, C., and Stone, R. F. (1985), 'Using Regulation to Change the Market for Innovation', *Harvard Environmental Law Review*, vol. 9(2), pp. 419-466.

Although delays to innovation should fall with time, as a result of legislative and regulatory precedent, delays may nevertheless persist at a higher long-run level than under the old regime (irrespective of regulatory risk). This may be attributable to both the SMF regime policies and the remuneration policies.

SMF regime policies may impose extra delays on innovation because of the greater accountability they place on individuals in SMF roles, both in terms of an increase in the perceived likelihood of sanction and an increase in the perceived cost of sanction. The key policies underpinning these mechanisms are the statement of responsibilities, presumption of senior management responsibility and criminal offence for reckless misconduct, and the interaction between these policies. The impact of these policies on perceived likelihood and costs of sanction is discussed further in 5.4 and 5.6. Greater accountability should give individuals in SMF roles greater incentives to perform additional, and/or more thorough due diligence checks.

The proposed remuneration policies could increase delays to innovation in the long-run, by more closely aligning individual reward with the long-run risks of a given innovation. The increased deferral period could be particularly significant in this regard. A delay in the vesting period until at least year three, and a longer deferral period thereafter, allows both the firm and the regulator a longer time period over which to assess the performance of innovations, and impose malus or clawback on variable remuneration if necessary. By extending the deferral period, the regulator can investigate a new product or service's performance over a longer portion of the financial cycle (although it will still fall short of the 16 year, or more, financial cycle estimated by Drehmann *et. al.* (2012)[32]).

As a result, SMFs will be more exposed to the potential downside risks of a given innovation, and should, in turn, be more cautious about which products they endorse. SMFs, therefore, may rationally incur additional costs and time delays before bringing innovations to market, in order to undertake a more thorough assessment of the long-term risks associated with the product. This could include additional and/or more thorough due diligence checks, referral to sub-committees and increased sign-off at various stages along the innovation process (as discussed in 4.2.1). In this sense, it is the impact on individual economic incentives that could delay innovations coming to market.

The clawback policy is also likely to work via a similar mechanism to deferral. If clawback is extended beyond the six years after initial vesting then individuals will, once again, be more exposed to the long-run implications of their innovations. As the deferral policy delays the start of the vesting period, and clawback could be applied for a longer period after the initial point of vesting, these policies should complement each other in increasing senior staffs' exposure to the potential downside risks of their innovations. Furthermore, as the tougher clawback rules may include not only those directly responsible for malfeasance, but also those in more senior roles who could be judged indirectly responsible, senior staff should be incentivised to conduct more thorough checks of new product risk assessments carried out by junior staff. This could also increase delays to innovation.

4.4.2 Foregone innovation

While delays to innovation can reduce consumer welfare temporarily, a more significant concern is the possibility of innovation being foregone entirely, provided that the innovation is considered to be beneficial to consumers.

If the behavioural changes induced by the increased likelihood and cost of sanctions and reduced reward for non-compliance under the new regulatory proposals are sufficiently large then there could be reason to believe that some innovations may be foregone entirely. These mechanisms of effect on individual

[32] Drehmann, M., Borio, C. E. V., and Tsatsaronis, K. (2012), 'Characterising the Financial Cycle: Don't Lose Sight of the Medium Term!', *BIS Working Paper No. 380*.

behaviour and the significance of specific policies in underpinning these mechanisms are discussed in greater detail in the Benefits section.

The FCA's individual accountability and remuneration proposals will reinforce one another in discouraging risky and potentially innovation-inducing behaviour, by increasing both the likelihood and cost of sanction and by decreasing the reward for non-compliance. Under these proposals, individuals, when assessing possible innovative opportunities, will be more concerned with the long-run profitability of such innovations, which are inherently more uncertain. Individuals may, therefore, believe that the increased risk exposure is not sufficiently compensated for by the expected reward, especially as the reward for such behaviour is now lower. As a result, they may no longer be incentivised to take risks that would have been rational to take under the old regime. This should be particularly true for product types where there is greater inherent uncertainty in the forecasts of future profitability. In this way, the policies may influence innovation in certain product areas, or activities, more so than others.

Foregone innovation may also be attributable to a reluctance for collaboration between different departments. Tsai (2001)[33] finds that a business unit's innovative capacity is dependent on the opportunities for shared learning, information exchange and knowledge transfer in intra-organisational networks. However, the greater individual accountability under the new regime may incentivise individuals to focus more on their own personal performance and the performance of their team, and show less interest in areas over which they do not have direct control. This concern is raised in the PCBS report[34], which says that individuals have often felt more loyalty to their small team than to the wider firm.

The statement of responsibilities could be particularly detrimental to collaboration as it sets out specific responsibilities for each SMF, against which sanctions can then be imposed. Therefore, the primary concern of SMFs is likely to be ensuring they meet their commitments as defined by the responsibilities map, so as to reduce their exposure to regulatory sanctions. Intra-organisational collaboration, networking and knowledge sharing are likely to suffer as a result.

In a follow up study[35] Tsai also finds that hierarchical structures, where the locus of decision-making is towards the top, has a significant negative effect on knowledge sharing, and by extension, although not explicitly stated, on innovation.

4.4.3 Evidence from the survey

There is some evidence from the survey to suggest that foregone product innovation could occur, although this is the view of a limited number of firms. Most responses do not foresee particular products or activities being more affected than others by the regime change, and that the impacts of increased accountability would be felt across the firm. This is true across the different types of firm, and for both small and large firms. However, a small number of firms suggested that the effect of the increased accountability (under the individual accountability proposals) and reduced reward (under the remuneration proposals) on SMFs could encourage a move towards more 'vanilla' product development and a more 'heads down, don't make mistakes' culture that may inhibit innovation. A similar concern raised was that the changes to remuneration policy may cause individuals to put personal interest ahead of firm interest, which could cause them to hold back on beneficial decision-making and so reduce innovation. In addition, a small firm noted that the changes may undermine their ability to develop bespoke products that allow them to compete against larger firms. However, this would only be the case if there was sufficient uncertainty within the firm about the nature of these products that would cause it to hold back on the development.

---

33 Tsai, W. (2001), 'Knowledge Transfer in Intraorganizational Networks: Effects of Network Position and Absorptive Capacity on Business Unit Innovation and Performance', *Academy of Management Journal*, vol. 44, pp. 996-1004.

34 'Changing banking for good', Report of the Parliamentary Commission on Banking Standards, Vol.1, p.49.

35 Tsai, W. (2002), 'Social Structure of 'Coopetition' Within a Multiunit Organization: Coordination, Competition, and Intraorganizational Knowledge Sharing', *Organization Science*, vol. 13, pp. 179-190.

An important point emerging from the survey is that some firms are undertaking a positive reduction in innovation anyway, independent of the FCA proposals. A large bank mentioned that it is already carrying out such a process in order to provide less complex products and avoid mis-selling to consumers. Therefore, decreases in product innovation, or in certain types of product coming to market, appears to be more dependent on firm's own initiative, rather than the regulatory policy changes.

As discussed in relation to operational inefficiencies, the increased length and detail of decision-making processes may delay and hinder innovation and business development more widely. This was considered to be a risk among the majority of firms in the sample. In this sense, operational inefficiencies and delays to innovation are closely linked.

4.4.4 Potential impacts of reduced product innovation

The survey evidence suggests that the policies could have some detrimental impact on innovation. Delays to innovation will probably incur additional costs for firms and, more importantly, may make it harder for them to capture temporary monopoly profits from first mover advantage in new products (as firms in other jurisdictions can act more quickly). This may be felt disproportionately by smaller firms whose agility has been a competitive advantage against larger firms. That said, increased delays may improve the quality of innovations that come to market, as more testing and product refinement are likely to have been carried out to help reduce potential product risks. As a result, consumers may benefit from safer, less complex products which reduces their exposure to risk, i.e. there is less probability of mis-selling. However, if delays are to some degree unnecessary (say, because a firm has excessive regulatory risk aversion), then this could create temporary losses in consumer welfare by delaying the arrival of beneficial products to market.

With regard to foregone innovation, the general view is that the impact of the FCA's policies will be limited, with some firms suggesting that there is already a trend towards focusing on less complex and safer products, irrespective of regulatory changes. However, some firms anticipate a product narrowing and move towards more vanilla products under the regime. This is because the increased internal monitoring and sign-off processes discussed in 4.2.1 may help those in senior roles to better understand new products and activities, and thereby identify those that may hold unacceptable levels of risk. Like delays to innovation, this too could reduce the probability of consumer harm which, in the past, often resulted from the sale of complex products for which customers did not fully appreciate the risks involved. A focus on less complex products should be beneficial to a large portion of consumers, who do not have the financial skills or knowledge, or simply the time, to evaluate the underlying risks of different products. However, for those customers who are better placed to assess such risks and try to shop around the market for the best deals, foregone innovation could be somewhat detrimental by narrowing the products on offer and so reducing consumer choice. Excessive product homogenisation can be undesirable, because consumers have different characteristics and different risk profiles and, therefore, are likely to desire different products to best suit their needs. Nevertheless, there is a general consensus in the survey that the policy changes are unlikely to affect certain product areas more than others and, hence, it seems unlikely that homogenisation will go so far as to be significantly detrimental to consumer choice. Therefore, the benefits to consumers of reduced product complexity and reduced mis-selling are likely to far outweigh any costs of homogenisation.

A broader concern is the impact of innovation on firm's ability to compete, both domestically and internationally. It is important to appreciate that causality can run in both directions and could be mutually reinforcing, i.e. lower innovation could reduce international competitiveness, which leads to lower retained profits and, therefore, a lack of resources with which to invest in further innovation. However, as the intended expected impacts on innovation are only marginal, such a self-reinforcing cycle is an unrealistic concern.

4.5 Regulatory badging

Firms subject to a new regime may benefit from the connotations this has in the eyes of consumers. While the regulatory badge effect is beneficial from a firm's viewpoint, it may paradoxically be detrimental to consumers as firms look to 'hide' behind the beneficial connotations that the badge provides. The extent to which firms can benefit from regulatory badging is dependent on the credibility and robustness of the new regulatory regime.

The new regulatory regime principally addresses issues of individual accountability and remuneration. These are issues which have been at the forefront of debate surrounding the banking crisis, and the subject of much public grievance. Therefore, the change in regulatory framework to address these key issues might significantly increase the value of the regulatory badge.

If the new regime is highly credible and robust, consumers can benefit from the regulatory badge, as they can forego the search costs of assessing firm quality independently. Furthermore, Atkeson, Hellwig and Ordoñez (2012)[36] find that if regulation is visible to consumers, then firms can benefit from regulatory compliance by increased long-run output. This may perhaps reflect the anti-competitive effects of the regulatory badge, whereby firms not included in the new regime could suffer at the expense of firms that are. Of particular importance in this regard are the continuing certificates of fitness and propriety that regulated firms must produce. This verifies that appropriate persons have the necessary qualifications, training, competence and personal characteristics to perform their functions to a required regulatory standard. Therefore, individuals in customer facing roles, such as investment and mortgage advisors, who are covered by the certificate of fitness and propriety policy, should be perceived as more credible than individuals who undertake similar roles either independently or in firms not subject to the regulation.

However, the regulatory badge effect can be risky if it significantly reduces consumer due diligence. This problem is exacerbated by the fact that firms are incentivised to 'hide' behind the status of the regulatory badge. Although the regulation solves an existing asymmetric information problem between consumers and firms, it creates a new problem of asymmetric information as the FCA-regulated firms can 'hide' behind the badge. As a result, regulated firms may be more lax about, and/or have less incentive to promote, high standards of conduct internally, as the very fact that they comply with FCA regulation could be what many consumers base their decision on.

4.5.1 Evidence from the survey

The consensus among firms is that a beneficial regulatory badge effect is unlikely. When asked to respond on the ways in which the policies may impact the sector more widely (e.g. the impacts on innovation and competitiveness), almost no firm identified the regulatory badge effect. This may be because firms do not see the changes to the existing regulatory regime as sufficient enough to have a large incremental impact on the benefits of being regulated. This may, in turn, give them little extra competitive advantage over non-regulated firms and independent advisors. However, although firms do not expect such benefits, this is not to say that such benefits will not arise, as consumers may now perceive those firms subject to the new regulation as more reliable and thus be more willing to use them. Indeed, some firms do expect public trust to improve as a result of the regime, although they expect this to materialise over a long time frame.

4.6 Consumers

The costs to consumers will depend on the extent to which the compliance costs firms incur are passed on to consumers as higher prices. The compliance costs encompass both fixed and variable cost elements.

[36] Atkeson, A., Hellwig, C., and Ordoñez, G. (2012), 'Optimal Regulation in the Presence of Reputation Concerns', NBER Working Paper No 17898.

Since, in theory, in a competitive market firms must set price equal to the marginal cost of providing the service, this implies that variable compliance costs can be passed on to consumers. Higher fixed compliance costs, on the other hand, must be absorbed by the firm in a competitive market setting.[37]

The pass through rate of variable compliance costs will be determined by the relative price sensitivity of consumers and firms. If consumers are very price sensitive (relative to firms), then a small increase in price could induce a significant reduction in demand. This reduction in demand is likely to offset any gain per unit from the price increase and, therefore, firms are likely to pass through a lower proportion of the variable cost increase. By the same logic, if consumers are less price sensitive than firms then it would be rational for firms to pass through a higher proportion of the variable compliance costs.

The literature in this area suggests that the degree of pass through is likely to increase with the intensity of competition in a market. However, the extent of pass-through may vary by firm, particularly where product markets are more differentiated.[38]

4.7 Competition

Competition in the sector may also be affected by policy proposals. In particular, there may be aspects of the regulation that impose disproportionately large costs on small firms relative to large firms (or vice versa), or that will be of detriment to the firms subject to the regulations relative to firms that are not.

As discussed in section 4.2, the survey evidence suggests that firms are likely to respond to the proposed remuneration policies by increasing individuals' fixed remuneration packages. However, such a change is likely to be harder for small firms to undertake, because a higher fixed wage will increase a firm's operating leverage and, therefore, increase susceptibility to macroeconomic shocks. A large firm may be better placed to withstand these shocks through the use of retained earnings or the benefits of economies of scope. Therefore, the higher operating leverage and susceptibility to shocks that are an inherent feature of a larger fixed remuneration structure could disadvantage small firms and potentially act as a barrier to entry for small firms. These effects may be, to some extent, offset by the additional internal monitoring and other internal control costs that will predominantly fall on large firms helping to 'level the playing-field' among the firms subject to the regulation.

The results of the compliance cost chapter, specifically sections 3.3 to 3.5, show that compliance costs as a proportion of annual income are larger for small firms. Therefore, if a high proportion of these compliance costs are passed through to consumers (as discussed in 4.6), then small firms are likely to see a larger reduction in their price competitiveness relative to large firms.[39] Equally, if firms must bear the burden of these additional costs, and not pass them on to consumers, this could also disadvantage small firms compared to their larger competitors.

Section 4.3 discussed the labour market effects of the proposed regulatory changes. The higher individual accountability and lower certainty equivalent, net present value of variable remuneration are likely to make

37 While this is true in general, the distinction between costs and the extent to which they are passed on to consumers may vary. For example, the period of time frame over which pricing is considered will affect the categories of costs which would be passed through; the longer the relevant timeframe, the greater the proportion of costs which should be regarded as variable. Where prices refer to a long term contract, all costs that are associated with fulfilment of the contract will be variable costs and can be expected to affect contract pricing decisions, even if those costs will not subsequently vary with the units of output actually delivered under the contract. RBB Economics (2014), "Cost pass-through: theory, measurement, and potential policy implications", A Report prepared for the Office of Fair Trading, February 2014, p. 29.

38 For a review of the literature in this area see RBB Economics (2014), "Cost pass-through: theory, measurement, and potential policy implications", A Report prepared for the Office of Fair Trading, February 2014.

39 The extent to which such a loss of competitiveness occurs will depend on the rate of cost pass through, which in turn will depend on the type of compliance costs incurred. If a high proportion of the compliance costs are fixed, then the impact on consumer prices will be limited and, therefore, the competitive effects limited.

it more difficult for firms to attract and retain staff. The survey evidence suggests that this would be particularly true of certain types of employee, namely those who have more cross-transferable skills and those who are more internationally mobile. As a result, the regulatory changes are likely to reduce the labour market competitiveness of the firms subject to the regulations relative to firms that are not (including those in other sectors or overseas). This may be of particular concern for small firms, for whom adjustments to the fixed remuneration structure to help counteract this effect may be more difficult, and even more so for credit unions whose boards are predominantly voluntary.

This loss of competitiveness in labour markets may, to a limited extent, feed through into a loss of competitiveness in product markets, if the former limits firms' ability to attract an appropriate level of talent, or a particular type of employee (such as those who rationally prefer employment in other related sectors or overseas).

Delays to innovation, detailed in 4.4, could also be of detriment to the regulated firms relative to non-regulated firms. A more protracted decision-making process concerning possible innovative products would disadvantage regulated firms wishing to enter new product markets. This effect could be of particular detriment to small firms, who are more reliant on their agility in developing new products/services in order to achieve a competitive advantage.

4.8 Summary of main findings

We summarise below the key findings from our analysis of the indirect costs of the proposed new Individual Accountability and Remuneration regimes. This summary highlights the main likely impacts on individual and firm behaviour and provides a basis for the assessment of the benefits of the proposals.

- Operational inefficiencies are likely to increase under the new regulatory regime:
  - Large firms, with complex organisational structures, may increase internal monitoring and control procedures, which could duplicate resources and increase costs. This impact is unlikely to occur across all firms, in particular smaller and simpler organisations. Improvements to internal control procedures could increase the likelihood of risks and misconduct being identified by the firm.
  - Most firms are likely to increase the volume and detail of the records of decisions, and there may be a move towards more collective decision making. This will result in decision-making becoming more formalised, protracted and lengthy. This is will increase operational inefficiencies and may cause delays to innovation and wider business development.
  - Detrimental impacts on staff motivation are unlikely.
  - Most firms, credit unions aside, are likely to make adjustments to their wage structure to compensate individuals for the increased accountability and/or reduced reward under the new regime. Changes to wage structure could, to some extent, reduce the beneficial behavioural impacts of the remuneration policies.
- Labour market effects, i.e. the impact on firms' ability to hire and retain staff, are a key concern for firms:
  - Credit unions, with largely voluntary boards used to taking collective responsibility, feel particularly vulnerable to retention issues given the significant increase in personal accountability for these individuals and the fact that they cannot compensate for this effect with more generous remuneration.
  - Large banks and investment firms, who are more exposed to international labour markets, are likely to be at a significant competitive disadvantage *vis a vis* non-UK firms. They may also suffer from an increasingly unlevel playing field *vis a vis* other UK sectors such as retail and industry and lose out on much-valued diversity among board members.

  - Detrimental impacts on staff hiring and retention could be most visible among non-executive directors and individuals in operational roles, as their skills are more readily applicable to other sectors.
  - There is also concern that increased accountability could mean that the regulatory changes have the perverse effect of attracting individuals more prepared to take risks, which would, to some degree, counteract the behavioural benefits discussed in section 5 below.

- Views on the impacts on product innovation are mixed:

  - There is some evidence that firms may concentrate on less complex products, which could reduce consumer welfare through reduced choice, but a widespread increase in foregone innovation is not considered to be likely.
  - However, there may already be a process of product narrowing and a movement away from complex products in some retail firms, irrespective of regulatory change
  - Delays to innovation are likely, due to regulatory uncertainty, more internal controls and a lengthier decision-making process. This could benefit consumers if this results in a better understanding of the products, but reduce consumer welfare if such delays become excessive and product innovation becomes inefficient.

- A beneficial regulatory badge effect for firms subject to the new regime is unlikely (in the short to medium term at least).
- Costs to consumers will depend on the degree of pass through, which will be determined by the relative price sensitivity of consumers and firms, the structure of the market, the degree of competition and the extent of product differentiation across firms.
- There may also be an impact on firms' competitive position, both between large and small companies, and between firms affected by the regulation and those that are not:

  - Any shift to a greater emphasis on fixed remuneration resulting from the policies would be likely to disadvantage smaller firms, though this may be, to some extent, offset by the additional internal monitoring and other internal control costs that will predominantly fall on large firms.
  - The proportionately higher burden of complying with the policies for small firms may also place them at a disadvantage vis-à-vis their larger competitors.
  - Firms that are subject to the policies may also lose out to those that are not (e.g. international competitors) if it becomes more difficult for the former to attract and retain staff, in particular those who have more cross-transferable skills and are more internationally mobile.
  - Any delays to the delivery of new products that arise from the policies would also place firms subject to the regulations at a competitive disadvantage to those that are not. This is potentially of particular relevance to small firms, who are more reliant on their agility in developing new products/services in order to achieve a competitive advantage.

5 Benefits

5.1 Introduction

Firm-level non-compliance can be difficult to deter if the sanctions given are not sufficient to deter such behaviour. Evidence presented in the PCBS report shows that firms can include regulatory fines as a cost of business. Even total failure may not be a sufficient deterrent if the losses are diluted through public bailouts. More importantly, the sanctions are not often directed at those responsible for making the non-compliant decisions in the first place. Isolating individual responsibility ensures that those directly responsible for problems are sanctioned. It also provides for a wider range of possible sanctions (such as criminal convictions).

In this section we analyse how the FCA policies on individual accountability and remuneration might address the underlying failures identified in the PCBS to benefit consumers and the market as a whole. We discuss these benefits and the mechanisms through which they would be expected to arise. In each case we outline our hypothesis for each mechanism of effect then discuss the extent to which each mechanism is likely to function in reality based on feedback from our fieldwork.

5.1.1 Benefits for consumers

Benefits should arise both from reduced risk-taking behaviour and misconduct of employees in the FCA-regulated firms and by enabling the swifter identification and management of conduct breaches and failures.

Specifically, the FCA's policies are aimed at changing the behaviour of individuals and firms to reduce misconduct and excessive risk-taking by:

- Reducing rewards for non-compliance and excessive risk taking — through stronger provisions on deferrals and clawback.
- Increasing the likelihood of individuals being sanctioned in the event misconduct is identified — achieved by applying the rules of conduct across a wider range of individuals, identifying clear lines of responsibility for business activities, introducing a presumption of senior responsibility, increasing the reporting requirements on firms to the FCA in the event of any misconduct, and increasing the length of time on deferrals.
- Increasing the likelihood of instances of misconduct being identified — through increased accountability at senior level increasing monitoring of more junior staff, applying the rules of conduct to a broader set of staff, requirements to report regularly on instances of misconduct to the FCA (which increases the emphasis on monitoring), continued monitoring of fitness and propriety, and extended periods for deferrals, clawbacks and malus (which allow more time for misconduct to be identified).
- Increasing the burden of sanctions imposed — through longer periods for clawback to occur and malus, introducing a possible criminal offence for SMFs in the event of the failure of the institution, and applying the rules of conduct across a wider range of individuals (which allows the firm and the FCA to sanction these individuals).

The policies may also improve the performance of staff more generally by increasing knowledge about good standards.

We assume that the FCA would be able to implement and monitor the new provisions to the full extent envisaged in their design.

The scale of any benefits in each case will be influenced by the scope of the various provisions, which is dictated by the definition of SMFs, CPs and other relevant persons.

5.1.2 Benefits for firms

Aside from the benefits to consumers, firms may also benefit from the introduction of the conditional approval process which should help to facilitate the recruitment process of SMFs, and the restriction of the pre-approval process to the SMF regime which will result in cost savings on current Approved Person applications. Firms may also be expected to benefit more broadly from greater consumer trust in the industry that the new regime could create.

5.2 Summary of the underlying causes of failures and detriment

The evidence presented to the Parliamentary Committee on Banking Standards (PCBS) provides a detailed account of the main problems and market failures that the individual accountability and remuneration policies attempt to address. The table below summarises the main failures and problems identified in the report by the PCBS.[40]

Table 5.1: Summary of key failures and problems

Conduct failures in the banking standards, including poor practice	• Inadequate level of personal accountability attributed to individuals, especially senior managers. • Lack of understanding of senior managers of the 'front line' and ability to hide behind ignorance. • Poor internal governance with inadequate formal checks and balances on individuals' behaviour. • Poor regulatory approach with slow and inadequate responses to prevent or address failure and risks. • Incomplete and unclear application of the Statement of Principles and the associated codes of practice
Incentives for poor conduct and excessive risk-taking	• Remuneration package with bonuses awarded based heavily on short-term performance but not the potential long-term consequences. • Absence of a sense of collective responsibility against individual actions. • Ignorance about product risks and complexity and excessive faith by senior management and regulators in the precision of risk modelling. • Misaligned incentives driven by the performance-based culture and lack of sense of duty to customers

Source: PCBS report.

The failures identified above can be summarised broadly as 'misconduct', 'poor practice' and 'excessive risk-taking', although there will be overlapping driving factors across each.

The main driving factors behind these failures fall into two main areas:

- Inappropriate behaviour, both on the part of individuals and firms, either carried out deliberately or as a result of misaligned incentives.
- Inadequate identification and management of conduct breaches and failure, both on the part of firms and regulators.

---

[40] We provide a fuller discussion of these issues in the appendix (see section 7).

For the purposes of our analysis is it useful to examine in more detail the potential motivations of inappropriate behaviour and non-compliance, to enable a more focussed assessment of the benefits of the FCA's policies in addressing failures and detriment.

There is substantial literature on what motivates non-compliance (we use this term generically here to refer to non-compliance with FCA regulations, deliberate misconduct, poor practice and excessive risk-taking). According to this literature, reflected in the seminal work by Becker (1968)[41] intentional non-compliance implies a conscious and rational decision to breach specified regulations. At the most basic level the literature argues that the decision to be non-compliant is based on a trade-off between the potential benefits of non-compliance (or equally, the costs of complying) and the potential cost if caught being non-compliant, adjusted for some measure of the likelihood of being caught (essentially an assessment of the risk). This can be summarised as follows:

- The benefits of non-compliance: the value perceived of undertaking the behaviour, be it profits and remuneration; prestige; etc. An assessment of the likelihood of securing the gains from the non-compliant activity would also be factored into the consideration of the expected benefits. Benefits could also be thought of as forgoing the costs of complying, and could include the time, effort and monetary costs of compliance. The costs of complying would also include the effort required to understand the obligations, such that a more complicated regulatory scheme could be associated with a higher level of non-compliance.
- The likelihood of being caught: the extent to which behaviour is monitored and non-compliance detected.
- The punishment if caught: this could include financial penalties, removal from position or reputational impacts.

More recently, Buccirossi *et. al.* (2009) reinforced this idea of a trade-off arguing that the costs of not complying are greater if the probability of getting caught is high, if the losses on being caught are large and if the probability of errors is low, i.e. regulatory enforcement is robust. [42]

These theories of non-compliance can apply both at the individual and the firm level. At the individual level, for example, the decision might be whether to engage in misconduct such as rigging LIBOR or pushing a consumer to buy an unnecessary product, or excessively risky behaviour, such as authorising a deal or a product that has a high risk of failure (beyond that which the consumer or bank fully understands or accepts). At the more corporate level, non-compliance decisions are likely to be related to the implementation of systems and processes to enable and promote compliance.

It could be argued that the above theories do not apply where individuals are *unintentionally* non-compliant (for example, sales staff being genuinely ignorant of the risks inherent in products they recommend to customers). As no 'optimising' decisions have taken place, the threat of sanction is unlikely to be an effective deterrent.

However, unintentional *individual* non-compliance is likely to be driven by (intentional) firm-level non-compliance. For example, maintaining an appropriate monitoring system over sales staff and providing sufficient training on products to be sold to consumers would reduce the likelihood that unintentional individual non-compliance occurs. Similarly, a senior manager who makes it his business to know what junior staff are doing on the trading floor would limit the possibility of being genuinely unaware of conduct breaches.

The motivations for non-compliance, both clearly intentional and seemingly unintentional, provide a useful framework within which to assess the mechanisms through which the FCA's policies could be expected to

[41] See: Becker, G. (1968), 'Crime and Punishment: an Economic Approach', *Journal of Political* Economy, vol. 76, No. 2.

[42] Buccirossi, P., Ciari, L., Duso, T., Spagnolo, G., and Vitale, C. (2009), 'Deterrence in Competition Law', *Governance and the Efficiency of Economic Systems (GESY)*, Discussion Paper 285.

secure benefits through reducing non-compliant behaviour. We consider each of these elements in the following sections.

5.3 Reduced reward for non-compliance and excessive risk taking

The first mechanism of effect that could lead to a change in behaviour is a reduction in the perceived reward for non-compliance. This is likely to stem primarily from the proposed remuneration policies, in particular the policies on:

- Deferral.
- Clawback.

Assuming individuals are characterised by a positive rate of time preference and risk aversion, a longer minimum deferral period and tougher rules on clawback are likely to reduce the attractiveness of a given variable remuneration package. There is much evidence in the literature to suggest these assumptions are an accurate reflection of senior executive preferences. A recent PwC report[43] shows that the discount rates applied to uncertain future income streams are very large, and far in excess of economic discount rates. Using evidence collected from a cross-country survey of executives, the report finds that deferral of executive remuneration, in Europe, results in a 20 per cent reduction in its perceived value per annum. A study by Pepper, Gore and Crossman (2013)[44] used a series of survey questions to establish senior executives' time preference. They calculated a median annualised discount rate of 18-23 per cent, which they contrast with an annualised accounting discount rate of less than 5 per cent.

This evidence suggests that the policies on deferral could significantly lower the net present value of a given remuneration package. Engaging in high risk activities which could secure greater profits for the firm and higher levels of variable remuneration for the individual would be less attractive, as the reward to the individual has been eroded away. Using the PwC estimate of a 20 per cent discount rate, the longer minimum deferral period of 5-7 years could have a significant effect on the net present value of a given remuneration package. Under the existing deferral policies, which stipulate a deferral period of 3-5 years and no delay before vesting, the net present value of £1 remuneration, paid evenly across the period, would be in the range of £0.54 to £0.65. However, under the longer 5-7 year deferral period set out in the draft proposals, with vesting delayed until year five, the net present value falls to between £0.22 and £0.18. [45] This represents a significant reduction in an individual's value of the deferred variable remuneration.

The deferral policies reduce the potential upside of a given variable remuneration package and, therefore, may reduce the incentives for excessive risk-taking behaviour.[46]

The deferral policies also extend the period of time over which an individual's variable remuneration is subject to malus in the event that misconduct or failure is linked to the individual. This would increase the uncertainty of receiving the deferred remuneration. The introduction of tougher rules on clawback are also likely to increase senior managers' perceptions about the uncertainty of their variable remuneration.

The PwC report finds evidence of risk aversion among senior executives. Given the choice between a smaller guaranteed amount of money, and a 50 per cent chance of receiving a sum with a higher expected value, a majority of the respondents chose the former. Since these executives are willing to forego a higher

43 PwC (2012) 'Making Executive Pay Work – the Psychology of Incentives'.

44 Pepper, A., Gore, J. and Crossman, A. (2013) 'Are Long-Term Incentive Plans an Effective and Efficient Way of Motivating Senior Executives?', Human Resource Management Journal, vol. 23, No. 1, pp. 36-51.

45 The final proposals of a longer deferral period of seven years but vesting from year three would result in a net present value of around £0.29.

46 The impact of the deferral proposals may be somewhat blunted if individuals are able to leave their firm and receive a lump-sum payout of their deferred remuneration from the new firm, as this would effectively 'wipe the slate clean' and remove the incentive to consider risk-taking over a longer period of time.

expected payout to obtain a smaller payout with certainty, this suggests that executives place a value on foregoing risk. The increased uncertainty introduced by the policies could therefore significantly reduce the risk-taking behaviour of executives on a given remuneration package. This behavioural effect may be particularly marked in the UK as the PwC report, which surveys senior executives across 43 countries, found that UK (and Australian) executives are the most risk-averse.

The above dynamics suggest that, under the new policies, individuals should be incentivised to reduce excessive risk-taking and non-compliant behaviour; particularly those individuals who earn a significant portion of their income through variable remuneration. Therefore, these policies are likely to be most relevant to large banks and investment firms, as they tend to offer the larger variable remuneration packages. PwC's finding of high risk aversion among UK executives suggests that the policies could have a notable effect on executive risk-taking and compliance. This may not only be beneficial at the board level, because executive risk-aversion may feed down the levels of responsibility as executives look to reduce their risk exposure. So, as well as potentially having some influence on larger strategic decisions, such as product development, at the top of the firm, the changes may partially feed down to affect the actions of more junior staff, e.g. by reducing mis-selling.

5.3.1 Evidence from the survey

The perceived impact of the changes to remuneration policies on individual behaviour varies by firm type. For some firms variable remuneration is not a significant part of their remuneration packages (and deferred variable remuneration even less so) and therefore the proposed policies would have little impact on individual behaviour. This is particularly the case among building societies and smaller banks.[47] Amongst these firms the view was held that individuals do not place a great weight on their bonuses and so, even if these bonuses were reduced or removed, the behavioural impact is unlikely to be significant. Furthermore, variable remuneration is not sufficiently linked to performance or income earned to the extent that individuals would make an explicit link between risky behaviour and potential reward. Overall, therefore, it seems unlikely that the mechanisms discussed above would have much relevance to smaller or simpler banks and building societies.

The evidence among large banks and investment firms is more mixed. Many respondents maintain that the impacts on risk-taking behaviour could be limited, because existing internal remuneration structures already take account of performance criteria, including the level of risk-taking, both at an individual and firm level, when calculating bonuses, rather than simply basing it on the returns the individual generates. If an individual generates significant income but also has taken risks beyond his remit or those specified by the firm's wider risk appetite, then he would not be rewarded. This is linked to the importance of a non-formulaic approach to variable remuneration in incentivising good behaviour that ensures that behaviour is in line with the risk-bearing interests of the firm as a whole, and which does not just consider financial performance. Our fieldwork indicates that there is an industry-wide move towards this approach. It is likely, therefore that the regulatory changes may not add significantly to many firms' existing remuneration structure and so the beneficial impacts on individual incentives in terms of reducing rewards for non-compliance would be limited.

However, many of the large banks and investment firms do emphasise the negative impact the remuneration policies could have on individuals' perception of their variable remuneration, as discussed particularly in section 4.3 on labour market impacts. The policies on deferral and clawback were perceived to lower the value employees place on deferred rewards, which implies that the policies may in fact reduce the link between behaviour (including risky behaviour) and reward in practice even if the firms in the sample maintain that this effect would be unlikely.

[47] Credit Unions are not subject to the Remuneration Code and thus the policy proposals do not apply to them.

The impact of the extended clawback period may be undermined by the practical difficulties for firms in applying clawback. This was foreseen to be particularly difficult once an individual had left the company. Even when employees are still within the firm it may be difficult to identify the causes of misconduct or a regulatory breach after such a long period of time sufficiently to apply clawback. The individual accountability policies, in particular the statement of responsibilities, would help to identify the individuals involved, although given the complex evolution of many activities and decisions this may still not be possible in all cases. Firms foresee potentially complex legal processes being necessary to recover deferred remuneration, and costly to the point that they would outweigh the benefits of clawback.

Overall, it seems that the reduced reward for non-compliance and risk-taking will have most impact in large banks and investment firms who tend to offer the higher variable remuneration packages. Although their responses do not explicitly suggest an impact on individual compliance and risk-taking behaviour, they do expect the deferral and clawback policies to have a significant impact on the perceived value of deferred remuneration, and so we anticipate greater compliance and lower risk-taking to materialise through the mechanisms discussed above.

An important caveat to this discussion, however, is that this mechanism for reduced reward for non-compliance may be weakened by firms shifting emphasis from variable to fixed remuneration, as discussed in 4.2.3. A lower proportion of income from variable remuneration would mean that the changes to deferral and clawback would have less importance as they would affect a smaller proportion of individuals' remuneration which, in turn, could feed through to a less than expected reduction in non-compliance and excessive risk-taking behaviour. As the majority of firms interviewed said that changes to remuneration structure may be necessary, the effects of deferral and clawback are likely to be more muted than they would have been. That said, firms do place a high importance on deferred variable remuneration as a means of retaining staff. Particularly if firms remain able to cancel deferred remuneration when employees leave, they may still retain an element of variable remuneration even if the proportion of fixed remuneration increases, which should provide some scope for the impact of the remuneration policies to be realised.

5.4 Increased likelihood of incurring a sanction if misconduct identified

The increased likelihood of sanction, or the increased probability of being caught, is subjective, as agents may differ in the way that they assess risk. Some may underestimate the likelihood of being caught, while others may overestimate it. Therefore, the impact of an increasing likelihood of sanction on individual compliance depends not only on the actual probability of being caught, but also individuals' perceptions about the probability of being caught. Both the individual accountability and remuneration policies should influence the perceived and actual likelihood of sanction.

The policies likely to be most important in this regard are:

- Presumption of senior management responsibility.
- Statement of responsibilities.
- Rules of conduct.
- Notifying breaches of misconduct.
- Deferrals.

5.4.1 SMF regime polices

The presumption of senior management responsibility requires the manager responsible for the area of a firm in which there has been a breach of regulatory requirements to prove that he took reasonable steps to prevent the misconduct. This stance, with the onus placed on the SMFs to demonstrate that they undertook sufficient due diligence checks, could significantly increase their perceptions about the likelihood of sanction in the event of a failure or regulatory breach.

The statement of responsibilities is also likely to increase the perceived likelihood of sanction. This proposal requires a clear mapping of all key responsibilities to individual SMFs, with no gaps in these responsibilities, and the understanding that, even when responsibilities are delegated, overall responsibility for a key business function will remain with the designated individual. This will make the FCA better able to hold SMFs to account and impose relevant sanctions. In effect, the statement of responsibilities should reduce the informational asymmetries between firms and the regulator which had previously enabled individuals to claim ignorance and hide behind collective responsibility, such that individuals perceived the regulatory threat as much less credible. This increased likelihood of sanction should raise the expectation of incurring a sanction if misconduct is identified, reducing incentives to engage in non-compliant activities and increasing incentives to ensure that such activities do not occur.

5.4.2 Rules of conduct and notifying breaches of misconduct

The application of the rules of conduct to staff who currently are not subject to them creates the possibility for these individuals to be sanctioned in the event of misconduct or non-compliance in a way that is not possible currently. [48] The small number of high level rules should formalise responsibilities for all staff in an easy to understand way and create a universal, shared understanding in firms of what standards are expected of staff. The rules are relatively qualitative and high-level in nature and thus subject to interpretation and value judgements which should incentivise individuals to act in the spirit of the law. The high-level nature of the rules also enables the FCA to enforce a wider range of good conduct compared to a set of very detailed rules. This may strengthen the credibility of the enforcement deterrent.

This will affect those on those individuals in CP roles who are not currently Approved Persons and already subject to the APR and FCA enforcement, and all relevant persons. The scale of the impact would depend on who is included in these categories and would therefore be subject to the rules. The effect is likely to be weaker if only 'middle management' are classified as relevant persons unless they have specific and direct responsibility for more junior staff such that the application of the rules increases their accountability for non-compliance and misconduct and their responsibility for any misconduct by their staff.

In contrast applying the rules of conduct to all staff in the firm (except ancillary staff) would introduce the scope for all staff to be sanctioned in the event of misconduct.

The proposal to require firms to report breaches of the conduct rules may enforce the perception of credible enforcement. This policy will require firms to periodically report rules of conduct breaches by less senior staff to the FCA. The requirement to report all conduct breaches to the regulator should increase the perceived likelihood of sanction among less senior staff.

5.4.3 Remuneration policies

Remuneration proposals may also increase the perceived likelihood of sanction, in particular:

- Deferral.
- Clawback.

Deferral is an important feature of variable remuneration schemes because, while bonuses are usually paid to individuals on an annual basis, the profit implications of individual actions may take much longer to

[48] Although the rules of conduct and breaches of misconduct are likely to have some beneficial impacts on the behaviour of SMFs (i.e. any significant conduct failure involving junior staff would also involve more senior staff, at least through a failure to adequately supervise) and CPs these impacts are likely to be relatively small given that these groups are by and large already subject to rules of conduct under the Approved Person regime.

unravel. The PCBS report[49] considers a deferral period of only three years to be insufficient to take account of the timeframe over which detrimental impacts can arise and the timeframe over which regulators become aware of such misconduct. In addition, Drehmann *et. al.* (2012) undertake a statistical analysis of credit prices and other variables in order to assess the duration of financial cycles. They find evidence that the financial cycle is a medium-term phenomenon, with cycle lengths of 16 years or longer.

An extended deferral period for variable remuneration should allow the impact of senior decision making and risk-taking to be evaluated over a longer portion of the financial cycle. This would increase the probability of the regulator or firm identifying conduct failures and may also allow more time in which to collect evidence and determine the individual(s) responsible for misconduct. This, in turn, could increase individuals' perceived likelihood of sanction and better align the downside risk of their behaviour with the upside risk. Nevertheless, the proposed extension to the deferral period still falls a long way short of Drehmann's estimate of the financial cycle length, which may limit the regulator's ability to evaluate the longer term impacts of individual behaviour.

The impact of the above mechanism would be lessened if individuals' deferred remuneration is cancelled when they leave and they are able to receive a compensating buyout from the next firm. However, this is only likely to really negate the impact of the policy if individuals purposefully undertake risky behaviour with the view to receiving a large bonus which they would then convert into a lump sum by leaving, which does not seem plausible for the majority of individuals.

Changes to the rules on clawback could also increase the likelihood of sanction by increasing the grounds on which clawback can be used; by increasing the time period over which it can be applied; and by increasing the scope of employees who can be subject to it. Individuals who are subject to these rules will see their deferred remuneration package as more contingent on good long-run conduct, as there are a wider range of circumstances in which variable remuneration can be recouped.[50] This increased contingency of variable remuneration is likely to increase individuals' downside exposure to excessive risk-taking and thereby reduce the incentives for short-termism.

5.4.4 Evidence from the survey

The survey evidence on perceived increased accountability varies significantly. Several of the small firms across credit unions, banks and building societies, believe that the impact on perceived accountability would be limited, with no commensurate change in individual behaviour. This is because individuals already hold significant responsibility and accountability for specific business functions, and they do not expect a need to assign responsibility beyond those who already have it. That said, some of the smaller banks surveyed did expect a significant increase in perceived liability. The same is true of the large firms in our sample, who highlighted that increased personal accountability would affect how decisions were made as individuals would be increasingly cautious about making decisions which could later implicate them in non-compliant outcomes further down the line. This is further evidenced by the large firms' expectations of individual behavioural changes, including increased regulatory compliance, due diligence and monitoring (the latter discussed in 4.2.1.

Whilst, when asked directly, some firms said that individuals may not perceive much additional accountability, many of these firms later said that they would have difficulty in hiring, or promoting, people prepared to accept the level of accountability now associated with these roles. This implies that these firms do foresee an increase in perceived accountability. Such a concern was emphasised by the credit unions, who said that the predominantly voluntary boards and the emphasis on collective responsibility were not compatible with the increased individual accountability. Together this suggests that there could

[49] 'Changing banking for good', Report of the Parliamentary Commission on Banking Standards, Vol.1, p.50.
[50] 'Changing banking for good', Report of the Parliamentary Commission on Banking Standards, Vol.1, p.50.

be a disproportionately large impact on credit unions, with a largely unremunerated board, relative to large banks and investment firms, where large remuneration packages can be used to help compensate for such changes. Indeed, the evidence in 4.2.3 suggests that most firms, with the exception of credit unions, are likely to increase fixed remuneration as a result of the regulatory changes.

Our fieldwork highlighted that many firms, banks and investment firms in particular, have defined levels of acceptable risk-taking designated to each level of seniority, which are in line with the firm's overall risk appetite. Therefore individuals would only change their behaviour if their individual risk remit was adjusted by the firm. The increased accountability of senior managers may result in a reduction in firms' overall risk appetite which would flow down to individuals' risk remits, if senior managers collectively seek to reduce the scope for downside risks or potentially non-compliant behaviour to occur.

In terms of the most impactful provisions of the senior management regime, the majority of respondents, encompassing all types of firms, emphasised the presumption of senior management responsibility. One firm said that it constituted a significant departure from existing regulation, with another saying that it should focus the minds of those in SMF roles on risks and firm behaviour. This provision is then strongly reinforced by the statement of responsibilities and, to a lesser extent, the criminal offence for reckless misconduct.

There was general agreement among firms that, despite perhaps formalising existing practices, the rules of conduct and the requirement to report breaches would have limited impact on junior staff's perceived accountability. Some firms said that the cost of extending these conduct rules and their lack of proportionality may outweigh any potential benefit. The limited deterrent effect of these policies was, in some cases, attributed to the fact that for most junior staff the FCA is likely to be a rather abstract concept, with individuals having little awareness of regulatory oversight. Increased accountability of more junior staff is expected to largely stem from the discipline imposed by their managers, rather than the threat of regulatory enforcement. As a result, most firms said that perceived accountability among junior staff was more dependent on the quality of management staff and the emphasis they place on the rules of conduct, rather than the rules of conduct in isolation. Several large firms made reference to this, by saying that a wider cultural change would be a top-down driven process, from those in SMF roles to the other employees in the organisation. In some cases, such a cultural change is already said to be taking place, independent of the policies.

Some reference was made to the changes in perceived likelihood of sanction across different types of employee. In particular, a small bank mentioned that those in operations may perceive the changes as a large increase in accountability because they are not accustomed to such responsibility, and may tend to be more risk-averse on average. This idea is also borne out by the common concern among firms that it will be difficult to retain individuals in operations functions, such as legal and human resources, as they look for similar jobs in other sectors (as discussed in 4.3).

With so much variation in what firms currently do, it's not possible to make a clear judgement on the impact on perceived accountability from the survey responses alone. However, the responses do generally support the hypothesis of a perceived increase in individual accountability. Among SMFs, this is predominantly linked to the presumption of senior management responsibility and, to a lesser extent, the statement of responsibilities (although, we must appreciate that these two policies interact). The role of the rules of conduct and notifying breaches of misconduct are deemed to be rather limited, with the perceived accountability of more junior staff largely a product of the discipline imposed on them by their managers.

5.5 Increasing the likelihood of instances of misconduct being identified

As well as influencing individuals' behaviour, the FCA's proposals should also allow the FCA to regulate more efficiently, more pro-actively and with greater reach through the swifter identification and management of failures.

The individual accountability policies that are likely to increase supervision and regulatory information are:

- Statement of responsibilities and the presumption of senior responsibility.
- Rules of conduct.
- Notification of breaches of misconduct.
- Remuneration policies.

5.5.1 Statement of responsibilities

As discussed above the introduction of the presumption of senior responsibility and the statement of responsibilities is likely to increase accountability of SMFs and thereby increase the likelihood of them being sanctioned in the event that misconduct in their area of responsibility is identified. An increase in the likelihood of sanction for SMFs may incentivise greater internal monitoring of junior staff and more formal decision-making processes as SMFs look to reduce their individual exposure to the actions of other employees. This may in turn increase the likelihood of potential and actual instances of misconduct or regulatory breaches being identified and prevented. It is important that the FCA proposals address individual risk-taking at these lower levels of seniority because past failures have shown that severe consumer detriment can be attributable to the excessive risk-taking behaviour of more junior staff, as in the LIBOR scandal.

This increased monitoring and more considered decision-making could, in turn, reduce the incentives for intentional non-compliance, but also help reduce the frequency of unintentional non-compliance.

The responsibilities map and the increased information to be made available at pre-approval of SMFs may also allow the FCA to pro-actively identify potential gaps in responsibility so that firms can make the necessary changes before a situation of misconduct and confused responsibility arises. Again this would increase the likelihood of misconduct being identified.

5.5.2 Rules of conduct and notification of breaches

The more extensive coverage of the rules of conduct would increase the scope of regulatory supervision and information, increasing the likelihood that misconduct by staff not currently under the Approved Person regime is identified. The requirement for firms to regularly report on breaches of misconduct to the FCA further increases the emphasis on monitoring.

5.5.3 Fitness and propriety

The requirement for firms to report annually on the fitness and propriety of SMFs and certified persons, in principle, increases the monitoring of these individuals. In turn this should improve the firm's ability to identify misconduct. However, since firms already are required to notify the FCA of any change in the fitness and propriety of Approved Persons the effect is likely to be relatively small, especially for those SMFs and certified persons who currently fall within the Approved Person regime.

5.5.4 Remuneration policies

The ability to regulate effectively and the credibility of this regulation are also dependent on the time the regulator has to identify misconduct and on the time necessary to establish who is responsible for this misconduct and hence impose the necessary sanctions. The extended minimum deferral period is likely to have this desired effect. This should allow the FCA more time to investigate potential misconduct and, if necessary, build up stronger, more evidence-backed cases which are more likely to hold up in court.

The individual accountability and remuneration proposals could reinforce one another. The individual accountability proposals will give the FCA access to greater information, while the remuneration proposals will give the regulator more time to use this information to identify conduct failures and ensure that the correct individuals are held to account.

There is also likely to be a positive feedback loop from increased supervision and regulatory information to an increase in the perceived likelihood of sanction. If individuals perceive the new regulatory regime as more credible (due to its improved efficacy, its more pro-active stance and/or its greater scope), this could be perceived as an increase in the likelihood of sanction and thereby reduce risk-taking and intentional non-compliance.

5.5.5 Evidence from the survey

There is little survey evidence which speaks directly to the impact of the SMF regime policies on the regulators' ability to identify misconduct. Instead the focus is on how individuals' perceptions of this influence their behaviour, as discussed in section 5.4. Reference to the ability of the regulator to identify misconduct was made by one large bank which said that the SMF regime policies would give the regulator more levers with which to enforce compliance.

An important issue arising from the survey is that the extent of any increase in the likelihood of identifying misconduct depends on the existing structures in place. Some of the smaller firms said that identifying regulatory failure or misconduct is already very straightforward because of their size, and therefore do not anticipate an increased capability to identify misconduct. Larger firms have noted that that while it can be easy to identify misconduct where roles are clearly defined (for example sales advisers), identifying those responsible at higher levels of the organisation can be very difficult as many decisions are made collectively by committees. This may suggest some room for improvement under the new regime, and perhaps more so for large firms with complex organisational structures.

As discussed in section 4 respondents to the survey note that it is not always possible to identify activities that may give rise to more risk ahead of time. Firms could reduce their risk-appetite as a whole in an attempt to avoid potentially non-compliant behaviours from occurring. Senior individuals could also engage in more monitoring to help in the identification of risks. Evidence from our survey shows that such increased monitoring of employees, with greater provisions for reporting and sign-off, is unlikely to occur across the board (the most widespread change in this regard was more detailed and protracted decision-making processes). That said, firms that indicated such an increase were the larger and more complex organisations where, arguably, this type of monitoring is more necessary and would be most beneficial.

Firms expect that the impact of the rules of conduct and notification of breaches will be largely insignificant, with most firms instead emphasising the importance of internal disciplinary pressure from managers (as discussed in 5.4.3. However, several firms related this to the fact that junior staff are not usually aware of the rules of conduct. Therefore, firms largely considered the impact of the rules of conduct and notification of breaches by their effect on the perceived likelihood of sanction, while not considering the potential impact on the regulator's ability to actually identify misconduct. Therefore there is still a possibility that such a mechanism of effect exists. In this regard, the (regular) reporting of small breaches could be useful if it helps the regulator shed light on potential endemic errors or poor ways of treating customers.

The common view among firms, both small and large, is that the certificate of continuous fitness and propriety is likely to have very little impact on individual behaviour in isolation. Nevertheless, some respondents thought that it may provide them with additional levers with which to enforce staff compliance internally. This view is largely consistent with the hypothesis of impacts above, as we expected relatively little impact from the policy, except for an increase in internal monitoring and hence the firm's ability to identify misconduct.

Firms also believe that the remuneration proposals, which will increase the time period the regulator has to identify misconduct, assign responsibility and impose sanctions, will have little impact on individual behaviour. This is largely seen in the survey responses of large banks for whom variable remuneration packages are most important. One large bank believes that individuals are unlikely to evaluate risky decisions on the basis of the number of years it could take to get found. Furthermore, they believe that the five year deferral period currently in place for senior employees provides a sufficient cycle over which to identify problems which could justify the application of malus (whilst many firms in the sample applied a five year deferral policy to the most senior individuals' variable remuneration, others did employ lower limits of four and three years. This view is echoed by another large bank which doubts that a deferral period beyond five years will have much effect on the regulator's ability to discover and attribute misconduct. With whistle-blowing and three-line of defence approach already in place, this firm does not anticipate much effect of an extended deferral period on the likelihood of discovering wrongdoing.[51] The effectiveness of this mechanism will depend on the ability of the regulator to identify conduct breaches over a longer period of time and effectively link them to responsible individuals. The deferral policy may be particularly excessive in the case of small firms for whom problems are likely to come to light much more quickly.

Overall, the evidence in support of the hypotheses of impact discussed above is somewhat limited. The consensus among firms is that neither individual accountability policies nor remuneration policies will have a significant additional impact on the regulator's ability to identify misconduct. That said, the policies are likely to increase the likelihood of identifying misconduct indirectly through the expected increase in internal monitoring and controls discussed in 4.2.1.

5.6 Increased costs of sanction

Increased costs of sanctions should reinforce any increase in the likelihood of sanctions being applied and any increase in the likelihood of misconduct being identified, and thereby add further incentive for individuals to behave in an appropriate way.

The proposals that are most likely to increase the perceived costs of sanction are:

- Criminal offence for reckless misconduct.
- Rules of conduct.
- Exceptional government intervention.

[51] According to a KPMG report (https://www.kpmg.com/RU/en/IssuesAndInsights/ArticlesPublications/Audit-Committee-Journal/Documents/The-three-lines-of-defence-en.pdf) the three lines of defence approach is used as a 'means to demonstrate and structure roles, responsibilities and accountabilities for decision making, risk and control to achieve effective governance risk management and assurance'. The three stages are; risk and control in business operations; oversight functions to implement policies and provide guidance and oversight over business processes and risk; and, internal audit and assurance providers to provide independent and objective assurance and consulting.

5.6.1 Criminal offence

Under the new regime, SMFs will be subject to criminal offence proceedings for reckless misconduct that results in the failure of the institution. SMFs' liability to criminal prosecution is a significant increase in their potential costs of sanction, over and above any pecuniary costs. This criminal offence provision, in conjunction with the statement of responsibilities which helps the regulator identify the individuals most responsible, should disincentivise excessive risk-taking and non-compliant behaviour by SMFs.

However, the effectiveness of this increased cost of sanction will depend on the extent to which it is possible to prove the various facts required to establish the offence. Its effectiveness is also limited by the fact it applies only to the failure of the institution. There may be many other instances of failures and misconduct that result in significant detriment but which do not amount to the failure of an institution.

5.6.2 Certified Person and Relevant Person regimes

The rules of conduct policy increases the sanction to which those individuals not currently under the AP regime would be subject. Under the new regime, the FCA would be able to apply its range of sanctions. However, the extent to which this represents an additional increase in the perceived cost of sanction would depend on the extent to which such individuals can currently be sanctioned by their firm for misconduct (e.g. disciplinary action or losing their job), and the extent to which FAC sanction is perceived to be greater.

5.6.3 Exceptional government intervention

The draft exceptional government intervention policy seeks to apply the Remuneration Code, i.e. the provisions on malus and clawback, to *all* discretionary compensation in the event that a FCA-regulated firm receives state aid. The Code would no longer apply only to variable remuneration or bonuses, in order to prevent regulated firms from undermining the policy by increasing other forms of discretionary pay.[52]

In the past, there was a large imbalance between individuals' downside incentives in worst case scenarios relative to their upside incentives in best case scenarios. The implicit taxpayer guarantee was a large contributing factor to this limited downside risk, as taxpayers money was used to bailout failing banks, while employees continued to receive reward for their behaviour in spite of the considerable detriment caused. The exceptional government intervention policy could help to correct for this by increasing individuals' downside liability. This increased contingency of pay could help to ensure that the variable remuneration structure is more closely aligned with the long-term interests of the firm, rather than providing incentives for short-termism. The PCBS believes this is particularly important where individuals predominantly operate as part of a smaller team within the firm, and thus may be more driven by the performance of the team, rather than the firm as a whole.[53]

However, the decrease in short-termism may be, to some extent, undermined by a 'free rider' style problem that may arise. The problem is that, by sanctioning all individuals for institutional failure, individuals could have less incentive to curtail their own risk-taking behaviour, as they may well suffer losses as a result of the misconduct or excessive risk-taking of their colleagues. Nevertheless, if other FCA remuneration proposals, such as deferral and clawback, are effective then the moral hazard problem should be limited because individuals will be more exposed to the costs of their own actions.

---

[52] In the final policy proposal the FCA proposes that the Regulators would have an explicit power to render void or cancel all deferred compensation, in respect of all Senior Persons and other licensed staff. This does not include unvested pension rights. This change between the draft and final proposals is unlikely to materially affect our analysis, as both imply a greater risk to individuals' variable remuneration in the event of government intervention.

[53] 'Changing banking for good', Report of the Parliamentary Commission on Banking Standards, Vol.1, p.49

5.6.4 Evidence from the survey

There is some evidence from the survey which emphasises the increased cost of sanction as a significant concern of firms.

Firms made little reference to this mechanism of effect on individual behaviour. Instead most emphasis was placed on the reduced reward for non-compliance and the increased likelihood of sanction, as discussed in 5.3 and 5.4 respectively. That said, some reference was made to the impact of the new criminal offence law for reckless misconduct on the costs of sanction and the behaviour of individuals in SMF roles, and in particular its interaction with the other SMF regime policies, i.e. the presumption of senior management responsibility and the statement of responsibilities. However, there was limited reaction from firms regarding the impact of the rules of conduct or exceptional government intervention on the costs of sanction.

Despite the absence of clear evidence from our fieldwork, the increased cost of sanction interacts closely with the increased likelihood of sanction, although the most significant increase — the criminal offence — would apply only in the most extreme of cases. The *additional* impact of the new regimes over and above the FCA's current powers of sanction is therefore likely to be limited.

5.7 Benefits to firms

Aside from the benefits to consumers, firms may also benefit from the introduction of the new regime. In particular, specific policies may, to some extent, influence the efficiency and costs of the staff hiring process. The costs of staff hiring are multifaceted, including the costs of recruitment processes, the costs of training new staff, the costs associated with lost productivity, and the administrative costs associated with new hires. These costs can be significant. Indeed, Bliss (2012)[54] finds that the costs of staff turnover can reach 150 per cent of the employee's annual salary, or as much as 250 per cent in the case of senior managers. Clearly, therefore, the impact on staff hiring costs should not be overlooked.

The impact on the costs of staff hiring should be largely attributable to the following individual accountability policies:

- Pre-approval.
- Conditional approval.

The new regime plans to limit pre-approval to SMFs, whereas under the Approved Persons Regime (APR) regime pre-approval was required for all APs, which approximately equates to all SMFs and Certified Persons in the new regime. This will, therefore, lead to a significant decrease in the number of individuals requiring pre-approval. The FCA discussion paper on the scope of the SMF and Certified Persons regimes says that the new pre-approval regime would cover 10,000 individuals – a two-thirds reduction from the 31,000 individuals covered by the APR regime. Pre-approval is a required regulatory vetting process that certain staff must go through before a firm can appoint them. This clearly adds time and costs to the staff hiring process. Therefore, a reduction in the number of individuals requiring pre-approval should significantly reduce the time and costs involved in the staff hiring process, specifically for the Certified Persons who were subject to pre-approval under the APR regime. The exclusion of Certified Persons from the pre-approval process is likely to reduce the downtime between outgoing and incoming staff, and thus could reduce the lost productivity costs of the staff hiring process identified by Bliss.

Conditional approval is a new policy area which will allow pre-approval to be granted subject to specific conditions being met in the future, e.g. training requirements, or subject to time limitations. Time limited approval could allow firms to take on interim staff to cover SMF roles temporarily, such that the firms have

[54] Bliss, W. G. (2004), 'Cost of employee turnover', The Advisor. http://www.isquare.com/turnover.cfm.

the necessary time to find the most suitable long-term candidate. Similarly, conditional approval subject to training or qualifications could allow firms to hire staff more quickly, without having to wait for them to meet all necessary regulatory requirements from the outset.

Conditional approval should help reduce some of the staff turnover costs identified by Bliss. By speeding up the process of staff turnover, conditional approval should decrease recruitment costs, including the costs of advertising and the costs of employing recruitment staff, and should also help limit the lost productivity costs, by minimising the downtime between outgoing and incoming staff. Furthermore, by reducing the probability of pre-approval not being granted, conditional approval would reduce the likelihood of the recruitment costs referred to above being duplicated.

More generally, firms will benefit from any increase in trust in the industry that arises as a result of the new regime. The regulatory changes undertaken may improve consumer trust in the regulated firms, if the consumers perceive the changes to be effective. In particular, consumers may be more trusting of certified advisors in regulated firms, if they believe that the certification process will reduce the likelihood of consumer mis-selling and excessive consumer risk exposure. This is linked to the regulatory badge effect discussed in 4.5.

5.7.1 Evidence from the survey

Very few firms flagged up potential benefits or disbenefits to the staff hiring process of the pre-approval or conditional approval regimes. Only a small number made specific reference to the potential benefits from the reduction in the number of staff subject to pre-approval. However, a small credit union is concerned by the extra requirement of pre-approval that the individual in question fits in with the wider skills of the board. The firm notes that the extent to which it could detrimentally impact on staff hiring will depend on how much the FCA scrutinises applications in line with these skill requirements and requests evidence of such skills.

A large bank mentioned that even under the existing regime pre-approval can take approximately 3 months. As a majority of appointments for this firm are internal hires, who are ready to start sooner than external hires, this delay is an even greater burden. Therefore, if the additional skills requirement further increases the time taken for pre-approval, then the burden for firms, especially those with a large proportion of internal staff hires, could be even greater. However, this firm also noted that the reduced scope of pre-approval, including only those in SMF roles, would generate savings for the firm.

With regard to conditional approval policy, firms cannot see many circumstances where someone who would previously have been refused approval would now be accepted. The implication is that conditional approval is unlikely to have a significant impact on the functioning of pre-approval and, therefore, on the ease with which firms can hire staff.

The small number of firms drawing attention to these mechanisms suggests that the impact of pre-approval and conditional approval will be very limited, especially in the case of the latter. The extent to which pre-approval could have small benefits for the staff hiring process is likely to depend on the benefits of reduced policy scope relative to the increased costs that may result from the additional skills requirement, with the former likely to outweigh the latter.

5.8 Quantitative analysis of benefits to consumers

5.8.1 Concepts of consumer harm

There are two overarching concepts of consumer harm:

- Ex post consumer loss refers to situations where individual consumers have experienced negative outcomes relative to some benchmark such as expectations or reasonable expectations.
- Structural consumer loss refers to loss of consumer welfare due to market failure or regulatory failure, typically measured as the loss of consumer surplus.

Both concepts of harm have advantages and disadvantages in estimating the actual harm created by misconduct or excessive risk-taking.

Structural harm represents the loss in expected consumer welfare as a result of market inefficiencies created by the misconduct. As such it recognises loss from transactions that would have been advantageous but never take place — which are ignored by approaches that focus on actual outcomes — and it covers the impact on all consumers, and thus automatically recognises that market or regulatory failures typically will not damage all consumers equally, but in fact may work to the advantage of certain people. Moreover, because it is an ex ante concept, it is well-suited to situations in which consumers knowingly take on risk, as it is not dependent on the outcome.

However, the estimation of this form of harm relies on comparing actual market transactions with those that might have arisen in a theoretical situation that by definition has not arisen. This means that it is intrinsically likely to be very difficult to measure with any precision, and estimates are likely to be subject to very wide margins of error.

In contrast, ex post consumer loss focuses on instances in which consumers experience negative outcomes (relative to their expectations or reasonable expectations) following a transaction. Such negative outcomes may take various forms, including financial loss, loss of time, and negative psychological effects. Thus this concept focuses on the "losers", in contrast to the structural concept which aggregates together outcomes for all consumers — losers and gainers alike. Therefore, even when consumers have been poorly advised, they might still benefit from the purchase. In this case, had matters turned out well, consumers would have gained ex post welfare. The ex post consumer loss concept takes no account of this feature — consumers that happen to do well out of bad advice do not appear in the aggregate calculation as "compensation".

Also, unlike the first approach, according to this ex post concept of consumer loss we focus on what actually happens after the transaction ("ex post") as opposed to the structural consumer loss concept which focuses on what is expected to happen at the time of the transaction ("ex ante") and thus (unlike ex post consumer loss) includes the fact that some valuable transactions may not occur at all.

It should now be clear that ex post consumer loss and structural consumer loss are fundamentally different concepts — neither is a subset of the other.

Quantifying the potential scale of any reduction in consumer harm resulting from the policies would require us to examine in detail the different types of behaviour and in each case estimate the harm that would have arisen. This is clearly not feasible. Rather, here, we consider recent examples of misconduct and estimate the harm associated with them. We then attempt to estimate the likelihood of such events occurring under the new regime. In this way we attempt to establish an approximate scale of the potential benefits of the proposals. We must emphasise, however, time and data limitations mean that this only offers a crude estimate of the scale of any benefits.

5.8.2 Types of behaviour trying to dis-incentivise/prevent

There are two main sources of harm to consumers in financial services markets:

- Mis-selling — this is when a consumer is sold a product on the basis of incorrect or mis-leading information, and can arise both from:
  - selling someone a product that they do not need; and/or
  - selling someone a product with a different risk profile than desired.

- Manipulation of market instruments.

The aim of the new policies on individual accountability and remuneration is to reduce the incentives for such behaviour and to enable managers and the authorities to identify and intervene more swiftly when such behaviour does occur.

5.8.3 Mis-selling

There have been a number of examples of such behaviour in recent years, including:

- Precipice bonds — thousands of precipice bonds were mis-sold, mainly to retired individuals, between 1999 and 2001.[55] The bonds are linked to a series of complicated financial instruments and very commonly dependent on the performance of the stock market.[56] However, many individuals were sold the bonds without adequate information on the risks of the investment. When the market value of shares dropped significantly, many have lost huge amount of money unexpectedly.
- Endowment mortgages — an endowment is a monthly saving plan, usually invested in shares and property, which was designed to pay off the loan taken out for the home (i.e. mortgage) and was sold to millions of consumers, peaking in the late 1980s. It was a non-transparent product and the associated risks were not made clear to many customers that purchased it.[57] According to the Consumers' Association, more than 5 million people were mis-sold an endowment mortgage without being properly informed on the risks of under-performance (i.e. that it would not cover the full value of their mortgage).[58]
- Card Protection and Identity theft insurances – this type of insurance aims to provide protection to consumers from potential loss due to fraud and identity theft.[59] There are around seven million people who were sold the insurance policy. However, poor practice has been found in which the insurance was packaged as compulsory to the credit products or was sold using high-pressure selling techniques to force consumers to buy the products which were unsuitable for them.
- NHFA investment products — between 2005 and 2010, NHFA (which was acquired by HSBC in 2005) was found to have mis-sold asset-backed investment products and provided inappropriate advice to its customers. The targeted customer group of NHFA was mainly elderly and was particularly vulnerable to poor practice. A third party audit of 421 NHFA customer records had revealed around 87 per cent of the customers were sold products that were not suitable to them.[60] A total of 2,485 or more customers could be the victims of this mis-selling.[61]
- Barclays investment funds — a total of 12,331 customers, many of whom were elderly people, were mis-sold the Aviva's Global Balance Income Fund and Global Cautious Fund by Barclays between 2006 and 2008. The customers often lacked the sophisticated knowledge to understand the risk involved in the investment. Some unsuitable sales were made which exposed customers to an unacceptable level of risks with potential significant impact on their investment.
- Payment protection insurance — Payment Protection Insurance (PPI) enables borrowers to insure the repayment of loans. They are commonly sold alongside credit products and paid through a single or a regular premium that could add up to 56 percent to the amount loaned. According to the Financial

---

55 http://www.telegraph.co.uk/finance/personalfinance/investing/2922915/FSA-draws-line-under-precipice-debacle.html.
56 http://www.theguardian.com/money/2004/jun/26/bonds.fundsbondstrusts.
57 http://www.moneysavingexpert.com/reclaim/endowments-miss-sold.
58 http://www.telegraph.co.uk/finance/personalfinance/borrowing/mortgages/2828940/Endowment-mis-selling-is-a-national-scandal.html.
59 http://www.telegraph.co.uk/finance/personalfinance/consumertips/banking/10258876/Are-you-one-of-7m-mis-sold-identity-insurance.html.
60 http://www.publications.parliament.uk/pa/jt201213/jtselect/jtpcbs/writev/misselling/sj015.htm.
61 http://www.bbc.co.uk/news/business-16095962.

Ombudsman Service estimates, there are around £50 billion of PPI policies sold over the past 10 to 15 years.[62] Consumer group CAB found evidence of high pressure selling of unsuitable PPI and unfair policies to consumers in their super-complaint in 2005.[63] In 2005 they found that PPI premiums are three times higher than cost of insurance cover and that the borrowers are overcharged £3 billion per year for PPIs.

- Interest rate swaps — interest rate swaps give the consumer certainty of borrowing cost and reduce the risk of being exposed to high interest rates. The products are complex and are being sold under poor-practice which makes it hard for consumers to understand the product and the risks associated with it. There has been poor disclosure of exit costs, inadequate information of risk, non-advisable sales and sales practices driven by monetary rewards or personal incentives. FSA carried out a further review of a sample of 173 sales to non-sophisticated customers and reported that over 90 per cent of the sales were not compliant with the regulatory requirements.[64] The majority of SMEs have faced great losses.

In each of the above cases, the mis-selling practices can be broadly categorised as follows:

- Poor product design: the nature of the product is mainly profit-driven with unnecessary features that do not promote consumer interests.
- Sale-driven culture: in most cases, consumers were mis-sold unsuitable products or given inappropriate advice in the sales that mis-led their understanding of the performance of the products and the risks involved. Which? has concluded the prevailing sales-based culture where salesmen often have the incentives to boost up short-term sales for bonus has led to a number of mis-selling practices.
- Inadequate corporate governance: various poor selling practices have been used, such as "high-pressure" tactics or force sales where consumers are often mis-led at the point of sale. However, the misleading sales processes had not been corrected or even identified by senior management which implied a serious failure in internal checks and reporting.

Manipulation of market instruments

Seemingly less common, but equally (if not more) detrimental, than mis-selling is the manipulation of market instruments. There have been recent cases:

- LIBOR fixing — in 2012 the FSA revealed a series of bank manipulations of LIBOR. Individual traders at several banks were able to rig the rate for the bank as a whole to give the wrong impression of the market. This caused trillions of dollars of financial investments being wrongly priced which in turn undermines the investors' confidence in the system. Regulators in the US, EU and the UK have imposed fines amounting up to more than £3.6 billion for the manipulations.
- Exchange rate (FOREX) fixing — several banks worldwide have been accused of manipulating the exchange rate market by artificially fixing exchange rates. At least 10 UK banks are under investigation and traders have been suspended in the meantime. They are accused of colluding to set benchmark rates at a daily basis over a number of years. This is a massive market where £3 trillion worth of currencies are traded globally each day; hence it could cause great losses to the economy.[65]

---

62 http://www.ft.com/cms/s/0/8310b6ec-8ced-11e3-ad57-00144feab7de.html#axzz33UhOvsOw.

63 Citizens Advice Bureau (2005), "Protection racket: CAB evidence on problems with payment protection insurance".

64 FSA update, "interest rate hedging products: information about our work and findings", http://www.fsa.gov.uk/static/pubs/other/interest-rate-hedging-products.pdf.

65 http://www.bbc.co.uk/news/business-26526905.

5.8.4 Cost associated with such behaviour

Mis-selling

In cases of mis-selling harm arises both as a result of the ex post loss to consumers mis-sold products which then did not deliver in line with the promises, and the structural loss arising from the impact on consumer confidence and trust in the market which reduces consumer demand for advice resulting in fewer transactions than would otherwise occur. Since it is inherently difficult to assess the loss due to forgone transactions we focus here on the ex post loss experienced by those consumers that were mis-sold the products.

In the case of mis-selling, however, the ex post concept of consumer loss can be seen as broadly capturing the risks that lead to the market distortion measured in the structural concept (though without correctly measuring the size of those market distortions). Thus we might expect that measures that limit the ex post loss caused by mis-selling without imposing too significant regulatory constraints on the market might reasonably be expected to reduce structural loss, also.

We rely on existing estimates of the ex post loss to consumers that has arisen as a result of mis-selling, as set out below:

- Precipice bonds: there was around £7.4 billion invested in the bonds between 1997 and 2004 and the FCA (FSA) has estimated investors could lose up to £5 billion due to mis-selling.[66]
- Endowment mortgages: millions of homeowners have been caught in the endowment mortgage scandal but it is difficult to estimate the total number of mis-sold mortgages as providers do not usually differentiate between endowment mortgages and savings endowments. According to the Association of British Insurers, a total of £450 million of compensation has been paid to over 300,000 people.[67]
- Card Protection and Identity theft insurances: the FCA has concluded that the mis-selling affected around 7 million people. Each of the victims would be compensated an average of £200 for the loss. The total compensation bill to the industry was around £1.3 billion.[68]
- NHFA investment products: HSBC is estimated to set aside £29 million to compensation the loss of the consumers.[69]
- Barclays investment funds: Barclays had been ordered to pay back £60 million to affected customers from the mis-selling of investment funds.[70]
- Payment protection insurance: based on total PPI premiums paid by consumers, Which? estimated that a total of over £40 billion of PPI has been sold to thousands of consumers since 1996.[71] The costs to consumers can arise from the PPI premium and the extra interest payment as result of the additional amount of loan taken to cover the premium. Taking into account all the cost elements, Which? suggested that the total costs to consumers could reach almost £50 billion.
  While many PPI policies were mis-sold, not all of them were. In the financial year of 2010/2011, the Financial Ombudsman Service received approximately 100,000 complaints and around 75 per cent of them were upheld in favour of the consumers.[72] We therefore apply an indicative 25 per cent reduction

---

66 http://www.theguardian.com/money/2004/jun/26/bonds.fundsbondstrusts.

67 http://www.telegraph.co.uk/finance/personalfinance/borrowing/mortgages/2828940/Endowment-mis-selling-is-a-national-scandal.html.

68 http://www.telegraph.co.uk/finance/personalfinance/consumertips/banking/10258876/Are-you-one-of-7m-mis-sold-identity-insurance.html.

69 http://www.bbc.co.uk/news/business-16095962.

70 http://www.dailymail.co.uk/news/article-1348405/Barclays-pays-60m-conned-customers-Daily-Mail-campaign-victory.html.

71 Written evidence from Which? To the Parliamentary Committee – http://www.publications.parliament.uk/pa/jt201213/jtselect/jtpcbs/writev/misselling/sj015.htm

72 BBC, "Payment Protection Insurance", http://www.bbc.co.uk/programmes/b006mg74/features/ppi-information

to the total cost estimated by Which? in order to account for PPI policies that were not mis-sold. This equates to an estimate of around £37.5 billion.

- Interest rate swaps: the FCA has reported that at least 60,000 swaps were mis-sold to SMEs.[73] By May 2014, a total of 6,726 claims were made with a total compensation of around £1 billion paid to affected customers.[74] Using the industry estimate on the average compensation of £152,500 per settlement, the total compensation bill can reach around £9.1 billion for all 60,000 mis-sold cases.[75]

We summarise the estimated costs of the mis-selling scandals in the table below.

Table 5.2: Cost of consumer harm caused by mis-selling practices

Mis-selling scandals	Estimated loss to consumers
Precipice bonds	£5 billion
Endowment mortgages	£450 million
Card Protection and Identity theft insurances	£1.3 billion
NHFA investment products	£29 million
Barclays investment funds	£60 million
Payment protection insurance	£37.5 billion
Interest rate swaps	£9.1 billion
Total	**£53.4 billion**

Source: Europe Economics analysis.

As shown in the table above, the total consumer detriment caused by seven major mis-selling scandals in the past 20 years was around £53.4 billion. Assuming the frequency of mis-selling practices is around 7 in every 20 years, this would imply one mis-selling activity every three years at an average cost of £7.6 billion. We estimate that the average costs to consumers would be around £2.5 billion per year. While mean estimation gives an equal weight to all events, it may generate an upward biased figure due to the PPI event which caused a relatively high level of consumer detriment than other events. In the presence of a possible outlier, it may be more suitable to use the median figure which place less emphasis on extreme values. Using the median of the estimated costs of the mis-selling scandals, the annual cost is estimated to be around £0.4 billion. In sum, we estimate that the average costs to consumers could be between £0.4 billion and £2.5 billion per year.

Due to lack of in-depth market information, our estimates are based on high-level assumptions and can only represent an indicative cost to consumer per year. The following factors would need to be considered when interpreting the estimation provided:

- Unreported consumer loss – our analysis focus mainly on compensation that had been paid back to consumers to cover their losses. It does not take into account the number of affected customers who did not claim and receive compensation either because they did not realise they had been mis-sold the products or because they did not suffer any negative outcome. Therefore, the actual consumer harm, including the unreported loss is likely to be higher than the reported amount of compensation.
- Sensitive to time period chosen – we examined the number of major poor selling practices in the past two decades which is an ideal period that allows for economic cycles. However, the frequency of mis-

73 http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/10527353/FCA-chief-warns-Treasury-swaps-scandal-could-be-significantly-bigger.html.

74 http://www.fca.org.uk/static/documents/aggregate-progress.pdf.

75 http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/10563361/Cost-of-swap-scandal-has-tripled-says-regulator.html.

selling practice is unlikely to follow a discernible trend and could vary from zero to more than 7 in any twenty years.

- Size of consumer detriment – our estimated annual cost represents an average loss to consumer based on the past 7 major mis-selling practices. As seen from the table above, the size of consumer detriments can be between £29 million and £37.5 billion. It is therefore possible that the average cost will change with the frequency and scale of the mis-selling practices.

Manipulation of market instruments

As in the case of mis-selling, behaviour that distorts the market will create losses both to individual consumers that purchase affected products, as well as a wider reduction in consumer welfare from distortions to prices and consumer demand for affected products. This welfare impact can reach further if demand and prices for complementary products are also affected. For example, if mortgages are affected, this may have a knock on effect on house prices. Given the nature of the effect on consumers, the structural loss measure is particularly relevant here, any estimate based on ex post consumer loss risks substantially underestimating the harm caused.

LIBOR fixing

In 2012, the FSA revealed a series of bank manipulations of LIBOR – the London Interbank Offered Rate – which is the average interest rate estimated by major banks for inter-bank borrowing between 2005 and 2009.[76] Disciplinary action has been taken against a number of major banks whose traders were involved in the rate rigging. The LIBOR has a global prevalence[77] and the rate manipulation has led to trillions of dollars' worth of financial instruments being incorrectly priced and has seriously undermined investors' confidence in the financial system. If the market is unable to rely on fundamental measurements to set loan values then this could have further significant impacts for the identification of financial crises.

The rate was generally manipulated downward, as such some retail consumers with mortgages and other loans may have benefitted; on the other hand other hand the inappropriately low interest rates would have negatively impacted interest payments from residential mortgage-backed securities.[78]

Morgan Stanley has estimated that the scandal might impose a negative cost to the industry of between £15 billion and £20 billion, but an accurate figure on the scale of harm is difficult to model due to the complexity and inter-dependence nature of financial transactions.[79] This estimated cost includes the fines to the major banks and potential litigation costs but there could also be long-term impact on the industry. In terms of financial penalties, regulators in the U.S., UK, and EU have imposed fines of more than $6 billion (approximately £3.6 billion) for the manipulation and have taken criminal actions against several bankers and traders.[80]

However, given the high degree of complexity in assessing the costs to consumers of the LIBOR fixing it is difficult to quantify the loss. As such we do not include this in our estimate of the potential benefits to consumers from the introduction of the policy proposals on accountability and remuneration.

---

76 Report of the Parliamentary Commission on Banking Standards, "Changing banking for good", 2013.

77 For example, around 45 percent of adjustable-rate prime mortgages and 80 percent of adjustable-rate subprime mortgages are based on Libor, while half of variable-rate private student loans are set to Libor. See Alessi and Sergie (2013) 'Understanding the Libor Scandal', Council of Foreign Relations.

78 These products accounted for around £360 billion in the UK in 2008 alone. See The Guardian 'Does Barclays Libor scandal affect me?' 28 June 2012.

79 Jon Macaskill (2012), "Libor scandal: counting the cost of the fix", http://www.euromoney.com/Article/3067441/Libor-scandal-Counting-the-cost-of-the-fix.html.

80 http://www.cfr.org/united-kingdom/understanding-libor-scandal/p28729.

Exchange rate fixing

Similar to the LIBOR fixing, the manipulation of FOREX has caused a wide scale of distortion to the financial market. With the investigation still in progress, the level of the harm caused is unknown but it is predicted to be worse and to exceed the cost and severity of the LIBOR scandal. [81]

5.8.5 Effectiveness of disincentives created by policies

The policies aim to create disincentives for risk-taking behaviour and misconduct by:

- Reducing rewards for non-compliance and excessive risk taking.
- Increasing the likelihood of individuals being sanctioned in the event misconduct is identified.
- Increasing the likelihood of instances of misconduct being identified.
- Increasing the burden of sanctions imposed.

The effectiveness of the policies will depend on the extent to which they impact on these factors. To assess this we rely on feedback from the structured interviews.[82] Taking into consideration this information, we estimate the likely effectiveness of the proposed regime. We acknowledge that there is a high level of subjectivity in this process and the resulting estimates of the benefits should be considered as illustrative.

Individual accountability policies

The individual accountability policies will affect the likelihood of individuals being sanctioned, the likelihood of instances of misconduct being identified, and the burden of the sanctions imposed. In particular the increased accountability under the Senior Management Function is likely to be an important driver of the benefits.

Increasing the likelihood of individuals being sanctioned in the event misconduct is identified, and the cost of such sanction, effectively speaks to individuals' perceptions of individual accountability. The survey evidence on the perceived increased accountability varies a lot. Few firms considered it likely that individuals would *directly* change their behaviour in terms of the levels of risk they engaged with when undertaking activities or making decisions.[83] This was particularly the case for credit unions, which cited the simple, low-risk nature of their products and business models, and the fact that the scope of the SMF regime is unlikely to capture individuals beyond the current board, as reasons for limited behaviour changes relevant to the benefit mechanisms. However, large banks and investment firms did consider it likely that the policies would result in behavioural changes as senior managers sought to ensure they would be protected in the event that misconduct or a regulatory breach was discovered, driven by the statement of responsibilities and the presumption of senior responsibility. Such behaviour includes increased due diligence, monitoring and sign-off processes, as well as more formalised and considered decision-making. These actions are all likely to contribute to an increased likelihood that potential and actual regulatory breaches are identified and prevented.

---

81 http://www.globalreinsurance.com/how-forex-rigging-scandal-will-cause-a-wave-of-do-insurance-claims/1407604.article.

82 We explored the potential to use evidence on the effectiveness of similar policies as benchmarks to assess the likely effectiveness of these policies, principally the introduction of the AP regime and the remuneration code. However, in the absence of any existing analysis of their effectiveness, and the potential for complaints and disciplinary data to be distorted by a number of other factors, such as the financial crisis, other regulatory interventions that coincided with these policy initiatives, we did not feel that this was an appropriate approach to adopt here.

83 This would only be likely if the overall risk appetite of the firm were to decrease which would then flow down into the individuals' risk remits.

The impact of the policies beyond those related to the senior management function on the behaviour of employees is likely to be limited, with junior staff placing more weight on the disciplinary actions of their employers than of the regulator. However, the increased scope of the regulator over these individuals through the Rules of Conduct will increase the ability to sanction misconduct if it occurs which, over time, may have a deterrent effect on poor behaviour.

As the policies are likely to have the greatest impact on large banks and investment firms (as discussed above, behaviour changes are likely to be greatest among these firms), the overall effectiveness of the policies therefore will depend upon the extent to which the mis-selling activities identified earlier were conducted by large banks and investment firms compared with smaller businesses and credit unions. For the mis-selling scandals, it is not unfair to assume that majority of the harm stemmed from large banks since:

- they represent a large proportion of the market share in the credit market (harm generated by smaller firms, such as credit unions, with low market shares would be on a much smaller scale); and
- the majority of the fines issued targeted big banks (two particular scandals on mis-selling of investment products caused by Barclays and NHFA, which was acquired by HSBC).

Based on this and the fact that the accountability policies appear to be more likely to have an impact on behaviour in the larger banks and investment firms, we conclude that the proposals may reduce the likelihood of future mis-selling.[84]

Remuneration policies

The remuneration policies should reinforce the impact of the accountability policies by reducing the rewards for non-compliance and increasing the likelihood that misconduct is identified. In particular the deferral and clawback policies are likely to be important drivers of the benefits.

Evidence from our fieldwork suggests that the remuneration policies are unlikely to have a significant impact on reducing rewards for non-compliance and excessive risk taking for small firms (and credit unions which are not included in the scope). In contrast the impact for large banks and investment firms is likely to be much stronger.[85] This is driven by the longer deferral periods and stricter rules around clawback and, to a lesser extent, the provisions around exceptional government intervention. That said, the effectiveness of the policies may be blunted somewhat if firms move towards greater proportions of fixed versus variable remuneration, as less of individuals' remuneration would be at risk in the event of poor behaviour. Given that firms place a great deal of value on variable remuneration as a means of staff retention it is unlikely that this would be completely done away with and thus the muted effect on the policies may be limited.

The strength of the policies in terms of increasing the likelihood that misconduct is identified by providing longer deferral periods is unlikely to be great, given the difficulties in proving all necessary facts to hold individuals accountable after so many years. Firms do however consider that the policies will increase the likelihood of *sanction* where misconduct is identified.

As the remuneration policies are likely to have the greatest impact on large banks and investment firms, the overall effectiveness again will depend upon the extent to which the mis-selling activities identified earlier were conducted by large banks and investment firms, which we have established in the discussion above.

[84] We note that the examples of mis-selling illustrated here have already been identified and to some extent dealt with through compensation schemes. This raises the natural question of the benefit of the new policies over and above the existing mechanisms to identify and address such misconduct. However, we assume that the policies would reduce *future* instances of such misconduct.

[85] See section 5.3 - Evidence from survey.

Effectiveness of the policies

In order to quantify the reduction in consumer harm, and thus the benefits, it is necessary to assign a value to the potential effectiveness of the policies in changing the detrimental behaviour identified in the sections above. This is not straightforward for a number of reasons, notably the uncertainty around the extent to which the policies will in fact change behaviour and the lack of clear evidence of the results of other, similar policy changes.

We reviewed a range of sources to identify comparable interventions associated with improving compliance, focussing where possible on individual compliance where the intervention was aimed at one or more of the elements in our theoretical compliance model (i.e. addressing the reward for non-compliance, the likelihood of sanction and/or the cost of sanction).

The Public Company Accounting Reform and Investor Protection Act (otherwise known as the Sarbanes-Oxley Act), was enacted in 2002 in the USA after a series of high-profile corporate scandals involving companies such as Enron and Worldcom. In effect, the Sarbanes-Oxley Act places high level executives (most specifically the CEO and CFO) personally accountable for financials submitted to auditors, investors, and regulators. Each officer must personally sign documents to verify the integrity and ethics of regulatory filings. Executives found with wrongdoing can be tried in criminal courts, introducing a large downside and significant personal responsibility. The Sarbanes-Oxley Act increased criminal penalties for various kinds of financial fraud — maximum prison terms for mail fraud, for example, jumped to 20 years from five years. The Sarbanes-Oxley Act also created a new auditor watchdog, the Public Company Accounting Oversight Board (PCAOB). The Sarbanes-Oxley Act led to a number of changes in affected businesses, including implementing new accounting and reporting systems, increased auditing activity including independent audit committees, and strengthened internal controls. In a survey of affected businesses, 48 per cent noted a positive impact of the Sarbanes-Oxley Act in detecting and preventing fraud.[86] In the aftermath of the Sarbanes-Oxley Act there have been significantly fewer corporate fallouts and it is widely held that the legislation created a sharp deterrent effect on criminal behaviour by public companies.[87] [88]

This example provides for increased individual accountability, increased costs of sanction, and increased likelihood of sanction (through the new regulatory board). Key differences to the FCA's regimes considered here are:

- The introduction of a whole new regulatory regime, including a new watchdog organisation.
- A focus on accounting error and fraud, which are arguably easier to measure against a baseline of 'good practice' and thus detect and prevent compared to the more subjective and varied concept of banking risk and misconduct.
- A greater range of new sanctions (i.e. criminal offences for misconduct at a number of levels below outright firm failure).

We therefore consider this example to represent a level of effectiveness significantly beyond that implied by the new regime represented by the FCA's individual accountability policies. That said, the above intervention did not specifically address the reward received for non-compliance which we would expect to increase the relative effectiveness of the combined regimes. Using the results of the business survey quoted above as an indication of effectiveness of the Sarbanes-Oxley Act, we assume a level of effectiveness equal to half that could be applicable to the new regimes represented by the FCA's policies, i.e. that these could result in a *maximum* reduction in harm of around 25 per cent.

---

[86] United States Securities and Exchange Commission (2009) 'Study of the Sarbanes-Oxley Act of 2002 Section 404 Internal Control over Financial Reporting Requirements' http://www.sec.gov/news/studies/2009/sox-404_study.pdf

[87] Drawbaugh, K and Aubin, D 'Analysis: A decade on, is Sarbanes-Oxley working?', Reuters July 30 2012 http://www.reuters.com/article/2012/07/30/us-financial-sarbox-idUSBRE86Q1BY20120730

[88] Public Company Accounting Oversight Board 'Remarks on The Sarbanes-Oxley Act of 2002: Ten Years Later', 24 September 2012 http://pcaobus.org/News/Speech/Pages/09242012_NYU.aspx

Economic models of individual tax compliance highlight the link between enforcement and compliance. For example, Witte and Woodbury (1985) find a significant positive relationship between the probability of auditing (i.e. the likelihood of non-compliance being detected) and individuals' compliance with personal tax laws.[89] Their empirical results find that for a one per cent increase in the probability of audit, voluntary compliance increases by up to 0.2 per cent. Dubin and Wilde (1988) also find deterrent effects of auditing on tax non-compliance.[90]

It is not possible to directly link these estimates to a potential reduction in misconduct and poor performance in the banking sector as a result of the FCAs policies, but they do serve as evidence that an increase in the likelihood of sanction can increase individual compliance.

Using the sources described above and the overall perception of effectiveness from the surveys, we apply an indicative maximum effectiveness of the FCA policies in terms of a reduction in the instances of mis-selling of 25 per cent. Given the lack of quantitative estimates of the effect of similar policies on consumer harm, and the uncertainties surrounding the effectiveness of these policies, this estimate effectiveness should be viewed as purely illustrative. We also apply a more conservative lower bound of 10 per cent, and present the quantitative results below.[91]

5.8.6 Expected reduction in consumer harm

To estimate the expected reduction in consumer harm we consider both the cost to consumers from mis-selling activities, and the expected effectiveness of the new regime. This can be represented as follows:

$$\text{Expected benefit} = C \times (E_L; E_U)$$

Where C is the average annual cost to consumers from mis-selling, E_L is the lower bound percentage reduction in mis-selling and E_U is the upper bound percentage reduction in mis-selling that would be expected to occur as a result of the new individual accountability and remuneration policies.

Based on our estimate that the average costs to consumers could be between £0.4 billion and £2.5 billion per year, this implies a reduction in loss of between £0.1 billion and £0.6 billion per year at the upper bound of effectiveness, and a reduction of between £0.04 billion and £0.25 billion per year at the lower bound of effectiveness.

Table 5.3: Indicative benefits stemming from the individual accountability and remuneration policies

Estimated effectiveness (%)	**Expected reduction in annual loss (£ bn)**		
	Low	*High*	*Mid-point*
Upper bound - 25%	0.10	0.63	0.36
Lower bound - 10%	0.04	0.25	0.15

Source: Europe Economics estimates.

The quantified benefits are intended to provide a reasonable illustration of the possible effects of the FCA's policies. The uncertainties around the exact impact of the policies on individuals' behaviour and firm outcomes and the lack of quantitative information about the effect of similar policies prevents a more definitive estimation of the benefits.

[89] Witte, A and Woodbury, D., 'The effect of tax laws and tax administration on tax compliance: the case of the U.S. Individual Income Tax, *National Tax Journal,* 38(1), 1985.

[90] Dubin, J and Wilde, L 'An empirical analysis of Federal income tax auditing and compliance', *National Tax Journal,* 41(1) March 1988.

[91] This lower bound of 5 per cent is the same as the lower bound of the effectiveness of the Individual Accountability policies in isolation reported in Europe Economics' CBA on Individual Accountability only. This is because we do not consider that Remuneration policies will have a very material impact in addition to the Accountability policies, and only at the upper bound.

If the benefit is sufficiently high we might also expect the policies to improve confidence and trust in the industry which would reduce the structural harm caused by mis-selling.

5.9 Quantification of benefits to firms

The proposed individual accountability regime has removed the pre-approval requirement for approved persons that are not performing senior management functions (SMFs). It has also introduced the possibility of conditional approvals for SMFs. These policies may have the following benefits to firms:

- Direct cost saving from the reduction in pre-approval applications – this is costs saved from making an application to the FCA.
- Indirect cost saving from the reduction in pre-approval applications – this refers to the saving in opportunity costs which a firm would incur from the "waiting period" to transfer an employee to an approved function.
- Direct and indirect savings from the conditional approval – whereby firms can reduce duplication of applications for SMFs who may previously have been refused approval under the current regime, and reduce the opportunity cost of potentially having a role unfilled.

Direct cost savings from the reduction in pre-approval applications

Between April and September 2013, there were 12,945 applications for approved persons received by the FCA.[92] As this number refers to *all* applications and not just those from firms within the scope of the new RAP[93] regime, we apply the ratio of the total number of approved persons within and without RAP firms as a broad approximation of the proportion of these new applications that would be made by Rap firms (34 per cent).[94]

Approximately 25 per cent of them were for Significant Influence Functions, which we assume would broadly be included under the SMF regime. We therefore assume that 75 per cent of the RAP applications would be eliminated under the new regime.

Based on our desk-based research and findings from the interviews, an application for an Approved Person takes on average around 1.5 days of a compliance officer's time.[95] The average salary, including overheads, of a compliance officer is around £233 per day. As such, the estimated cost per application is around £350.

This produces an estimated annual saving to firms within new authorised persons regime of approximately £2.3 million.

This saving will not be spread equally across all affected firms. Based on our fieldwork, for many small firms, in particular credit unions, the roles that would be included in the SMF regime (e.g. the board and executive directors) account for all the approved persons in the firm. In this case these firms would not benefit from such savings under the new regime. The savings could be substantial for the larger firms with large populations of Approved Persons who would not be included in the SMF regime.

---

[92] We are waiting application numbers for the second half of the year; for the purposes of this analysis we have doubled this 6-monthly figure. See http://www.fca.org.uk/firms/being-regulated/approved/approved-persons/volumes

[93] Regime for Authorised Persons.

[94] The total number of unique approved persons is approximately 150,000, and the number of approved persons employed by the RAP firms is approximately 50,000 based on FCA data.

[95] This differs from previous estimates of half a day used in our Consumer Credit work and previous FCA consultations. However, in this case we are measuring a reduction in all activities associated with pre-approval of an Approved Person, not simply the filling out of an application form.

Indirect savings from the reduction in pre-approval applications

These savings are likely to apply mainly to internal candidates waiting to move into an authorised person role, as externally hired candidates are likely to have a natural notice period which would cover a delay in processing the application. Quantifying these potential savings is not feasible for a number of reasons. As the individual would already be working for the firm the correct measure of the opportunity cost should be the wage differential between the two roles, which is infeasible to estimate across the board given the variety of salaries of approved person roles and of the vast range of other non-authorised roles. It is also unlikely that the delay in processing non-SIF applications would be significant. We therefore do not consider it of value to attempt such an estimation.

Saving from conditional approval

The policy on conditional approvals is unlikely to result on any notable savings to firms. The hypothesis is that some individuals in SMF roles who might have been refused approval by the FCA due to, say, a lack of qualifications, could be granted conditional approval until such qualifications were achieved. The firm would therefore save on having to re-apply at a later stage. However, feedback from our fieldwork suggests that the number of withdrawn applications is very low across firms and, more importantly, firms do not foresee any clear circumstances where those withdrawn under the current regime could be granted conditional approval under the proposed regime. It is therefore unlikely that this policy would bring notable benefits to firms.

6 Summary and Conclusions

6.1 Introduction

The Individual Accountability and Remuneration policies proposed by the FCA are intended to address key failings in the banking sector identified by the Parliamentary Committee on Banking Standards.

The policies in relation to individual accountability implement various provisions set out in the Act. The new individual accountability regime provides a clearer allocation of responsibility to senior managers and provides the FCA with stronger powers to sanction senior managers in event of a regulatory breach or bank failure. The regime also extends the scope of regulatory enforcement to cover a larger pool of relevant individuals and introduces formal processes among firms to assess the fitness and propriety of the individuals covered by the regime on an ongoing basis. These features aim to improve the FCA regulatory framework and strengthen its enforcement power.

The FCA has developed policy proposals for changes to the current Remuneration Code to address identified ways in which firms' provision of variable remuneration can contribute to excessive risk taking and misconduct. The policy proposals include a longer deferral time period for variable remuneration combined with later vesting, a longer clawback period, and extensions to the applicably of the Remuneration Code to all forms of discretionary award in times of exceptional government intervention. These policies aim to align more closely the upside and downside risks of decision-making.

The policies on individual accountability apply to deposit-accepting banks, building societies, credit unions and the nine dual PRA/FCA-regulated investment firms. The policies on remuneration apply to the above scope with the exception of credit unions, which are not currently subject to the Remuneration Code.

In this report we estimate the direct costs to firms of complying with the policies and discuss the likely indirect costs arising from the policies. We analyse the way in which the policies may bring about benefits in the form of reducing behaviour associated with misconduct and excessive risk taking, and present an illustrative range of quantified benefits in the form of reductions in harm.

Our analysis is informed by desk-research and a programme of structured interviews with 20 firms across banks and investment firms, building societies and credit unions.

6.2 Direct costs to firms of complying with the policies

The policies will result in firms incurring direct compliance costs. These costs vary across the different types of firms affected and are influenced by the extent to which firms already have similar processes in place to those required by the policies. In relation to the individual accountability policies, one-off set up costs are in general significantly greater than ongoing costs, driven by the costs involved in setting up the new accountability regime and training individuals and by the fact that, for some firms at least, the ongoing processes required by the policies are often in line with current procedures which require limited adaption costs.

Among smaller firms the costs associated with the SMF policies account for the largest share; among large firms these costs are substantial but are outweighed by the costs associated with implementing the Rules of Conduct and Notifying of Breaches in misconduct, as the latter policies are driven to a large extent by employee numbers. Smaller firms are also more likely to be able to adapt flexibly to these policies (i.e. by simple updates or extensions to current procedures) compared with large firms which foresee significant investments in IT and training to implement the policies across their more complex and arguably rigid organisational structures and systems.

The direct costs of the regime represent a larger share of income for small firms compared to large. Credit unions are particularly impacted, with one-off costs reaching nearly three per cent of sector income.

The remuneration polices are only likely to result in noticeable costs for large banks, investment firms and building societies, as the smaller firms do not have significant variable remuneration provisions in place. The costs will be largely one-off, consisting of updating guidance and policies (including obtaining legal advice).

6.3 Indirect costs to firms and wider impacts

The policies will also result in indirect costs to firms.

Operational inefficiencies are likely to increase under the new regulatory regime.

- Large firms, with complex organisational structures, may increase internal monitoring and control procedures, which could duplicate resources and increase costs. This impact is unlikely to occur across all firms, in particular smaller and simpler organisations. Improvements to internal control procedures could increase the likelihood of risks and misconduct being identified by the firm.
- Most firms are likely to increase the volume and detail of the records of decisions, and there may be a move towards more collective decision making. This will result in decision-making becoming more formalised, protracted and lengthy. This is will increase operational inefficiencies and may cause delays to innovation and wider business development.
- Detrimental impacts on staff motivation are unlikely.
- Most firms, credit unions aside, are likely to make adjustments to their wage structure to compensate individuals for the increased accountability and/or reduced reward under the new regime. Changes to wage structure could, to some extent, reduce the beneficial behavioural impacts of the remuneration policies.

Labour market effects, i.e. the impact on firms' ability to hire and retain staff, are a key concern for firms.

- Credit unions, with largely voluntary boards used to taking collective responsibility, feel particularly vulnerable to retention issues given the significant increase in personal accountability for these individuals and the fact that they cannot compensate for this effect with more generous remuneration.
- Large banks and investment firms, who are more exposed to international labour markets, are likely to be at a significant competitive disadvantage *vis a vis* non-UK firms. There may also be a loss of competitiveness *vis a vis* branches of EEA firms operating in the UK which are not subject to the remuneration policy proposals. Firms may also suffer from an increasingly unlevel playing field *vis a vis* other UK sectors such as retail and industry and lose out on much-valued diversity among board members.
- Detrimental impacts on staff hiring and retention could be most visible among non-executive directors and individuals in operational roles, as their skills are more readily applicable to other sectors.
- There is also concern that increased accountability could mean that the regulatory changes have the perverse effect of attracting individuals more prepared to take risks, which would, to some degree, counteract the behavioural benefits.
- Views on the impacts on product innovation are mixed:
    - There is some evidence that firms may concentrate on less complex products, which could reduce consumer welfare through reduced choice, but a widespread increase in foregone innovation is not considered to be likely.

    - However, there may already be a process of product narrowing and a movement away from complex products in some retail firms, irrespective of regulatory change
    - Delays to innovation are likely, due to regulatory uncertainty, more internal controls and a lengthier decision-making process. This could benefit consumers if this results in a better understanding of the products, but reduce consumer welfare if such delays become excessive and product innovation becomes inefficient.

- A beneficial regulatory badge effect for firms subject to the new regime is unlikely (in the short to medium term at least).
- Costs to consumers will depend on the degree of pass through, which will be determined by the relative price sensitivity of consumers and firms, the structure of the market, the degree of competition and the extent of product differentiation across firms.
- There may also be an impact on firms' competitive position, both between large and small companies, and between firms affected by the regulation and those that are not:
    - Any shift to a greater emphasis on fixed remuneration resulting from the policies would be likely to disadvantage smaller firms, though this may be, to some extent, offset by the additional internal monitoring and other internal control costs that will predominantly fall on large firms.
    - The proportionately higher burden of complying with the policies for small firms may also place them at a disadvantage vis-à-vis their larger competitors.
    - Firms that are subject to the policies may also lose out to those that are not (e.g. international competitors) if it becomes more difficult for the former to attract and retain staff, in particular those who have more cross-transferable skills and are more internationally mobile.
    - Any delays to the delivery of new products that arise from the policies would also place firms subject to the regulations at a competitive disadvantage to those that are not. This is potentially of particular relevance to small firms, who are more reliant on their agility in developing new products/services in order to achieve a competitive advantage.

6.4 Benefits of the policies

The individual accountability and remuneration policies are likely to bring about beneficial changes in behaviour and reduce non-compliance, misconduct and excessive risk taking, working through the following mechanisms:

- Reducing rewards for non-compliance and excessive risk taking.
- Increasing the likelihood of individuals being sanctioned in the event misconduct is identified.
- Increasing the likelihood of instances of misconduct being identified.
- Increasing the burden of sanctions imposed.

Increasing the likelihood of individuals being sanctioned in the event misconduct is identified, and the cost of such sanction, effectively speaks to individuals' perceptions of individual accountability. The survey evidence on the perceived increased accountability varies a lot. Few firms considered it likely that individuals would *directly* change their behaviour in terms of the levels of risk they engaged with when undertaking activities or making decisions.[96] However, large banks and investment firms did consider it likely that the policies would result in behavioural changes as senior managers sought to ensure they would be protected in the event that misconduct or a regulatory breach was discovered, driven by the statement of responsibilities and the presumption of senior responsibility. Such behaviour includes increased due diligence, monitoring and sign-off processes, as well as more formalised and considered decision-making.

[96] This would only be likely if the overall risk appetite of the firm were to decrease which would then flow down into the individuals' risk remits.

These actions are all likely to contribute to an increased likelihood that potential and actual regulatory breaches are identified and prevented.

The impact of the policies beyond those related to the senior management function on the behaviour of employees is likely to be limited, with junior staff placing more weight on the disciplinary actions of their employers than of the regulator. However, the increased scope of the regulator over these individuals through the Rules of Conduct will increase the ability to sanction misconduct if it occurs which, over time, may have a deterrent effect on poor behaviour.

The remuneration policies should reinforce the impact of the accountability policies by reducing the rewards for non-compliance and increasing the likelihood that misconduct is identified.

Evidence from our fieldwork suggests that the remuneration policies are unlikely to have a significant impact on reducing rewards for non-compliance and excessive risk taking for small firms (and credit unions which are not included in the scope). In contrast the impact for large banks and investment firms is likely to be much stronger.[97] This is driven by the longer deferral periods and stricter rules around clawback and, to a lesser extent, the provisions around exceptional government intervention. That said, the effectiveness of the policies may be blunted somewhat if firms move towards greater proportions of fixed versus variable remuneration, as less of individuals' remuneration would be at risk in the event of poor behaviour. Given that firms place a great deal of value on variable remuneration as a means of staff retention it is unlikely that this would be completely done away with and thus the muted effect on the policies may be limited.

The strength of the policies in terms of increasing the likelihood that misconduct is identified by providing longer deferral periods is unlikely to be great, given the difficulties in proving all necessary facts to hold individuals accountable after so many years. Firms do however consider that the policies will increase the likelihood of *sanction* where misconduct is identified.

As the remuneration policies are likely to have the greatest impact on large banks and investment firms, the overall effectiveness again will depend upon the extent to which the mis-selling activities identified earlier were conducted by large banks and investment firms, which we have established in the discussion above. Given the strength of the evidence on both the remuneration and the accountability proposals, we consider that the accountability proposals will have a greater impact on individuals' behaviour than the remuneration policies, but that the latter reinforce the former and together the two regimes will positively influence behaviour and outcomes.

Quantifying the benefits of the policies is not straightforward, given uncertainty around the extent to which the policies will in fact change behaviour and the lack of clear evidence of the results of other, similar policy changes. We present an illustrative quantification whereby we estimate the harm caused by a series of mis-selling scandals and apply a percentage reduction in similar, future harm as a result of the policies. Benefits in the form of reduced harm range from £0.04 billion to £0.6 billion per year.

Firms would benefit from the new individual accountability regime in that the processes around applications for Approved Persons would be limited to those in SMF roles. We estimate that this could save the affected firms just over £2 million each year. This would be limited to the larger firms which currently have substantial numbers of Approved Persons who would not be included in the SMF regime.

The share of the wider benefits of the policies is unlikely to be equal across the affected sectors. In particular, the evidence of the role of credit unions in the mis-selling scandals and systemic bank failures which characterise much of the harm referred to in the PCBS report is extremely limited; the same might be said of building societies. The costs of the policies will affect credit unions disproportionately (in terms of a share of annual income). The high compliance costs, combined with the likelihood that credit union

[97] See section 5.3 - Evidence from survey.

board members may be particularly unwilling to take on the additional personal accountability implied by the regime, may have an impact on the feasibility of some firms to remain in the market.

Appendices

Europe Economics

7 Key Business Functions and Conduct Rules

We include here for completeness the indicative list of key business functions and the draft Conduct Rules that were circulated to firms as background material to the structured interviews.

7.1 Indicative list of key business functions

Key Business Functions[98]
Financial crime (e.g. fraud)
Client Assets
Sales
Marketing (PCBS said that "Those who … market products should be held responsible should those products be mis-sold to consumers)
Product development (i.e. creation of new financial products) (PCBS said that "Those who design … products should be held responsible should those products be mis-sold to consumers.")
Customer service (i.e. dealing with customers or clients after the point of sale, including queries and fulfilment of customer requests)
Customer Complaints Handling (PCBS said that banks need to be "…motivated to deal with complaints appropriately the first time around.")
First line quality assurance of sales
Managing customers' investments (including fund management, advisory or discretionary portfolio management)
Collections and dealing with customers in arrears
Proprietary trading (trading on the firm's own account, including Treasury management functions)
Financial/investment advice
Trading on behalf of clients
Information Technology
Human Resources/Personnel (e.g. recruitment, training and competence, performance monitoring)
Incentive Schemes – not limited to sales (PCBS said that "…poorly constructed incentive schemes in retail banking have also hugely distorted behaviour.")
Disaster Recovery
Underwriting loans
Wholesale activities (e.g. settlement, sponsoring/listings, custody, other middle/back office or non-trading activities)
Market making
Day to day retail banking activities (e.g. payment services, provision of payment cards, person current accounts)
Secured and unsecured credit
Firms specific risks and associated business functions (where not covered above)

[98] These functions are based on the likely functions undertaken in a large bank. Smaller firms or credit unions may not have all of these functions, they may also have additional functions that we need to consider.

7.2 Draft conduct rules

Expectations of all Relevant Persons	
1	You must act with integrity.
2	You must pay due regard to the interests of customers and treat them fairly.
3	You must observe proper standards of market conduct.
4	You must act with due skill, care and diligence.
5	You must be open and cooperative with the FCA, the PRA and other regulators.
Expectations of Senior Managers	
	You must take reasonable steps to ensure that the business of the firm for which you are responsible …
SM1	…is controlled effectively.
SM2	…complies with the relevant requirements and standards of the regulatory system.
SM3	You must take reasonable steps to ensure that any delegation of your responsibilities is to an appropriate person and that you oversee this effectively.
SM4	You must take reasonable steps to ensure that any breach of the firm's regulatory obligations of which you are aware is being appropriately addressed.
SM5	You must disclose appropriately any information of which the FCA or PRA would reasonably expect notice.

8 Overview of the Main Failures

8.1 Introduction

The evidence presented to the Parliamentary Committee on Banking Standards (PCBS) provides a detailed account of the main problems and market failures that the individual accountability and remuneration policies attempt to address. The table below summarises the main failures and problems identified in the report by the PCBS.

Table 8.1: Summary of key failures and problems

Conduct failures in the banking standards, including poor practice	• Inadequate level of personal accountability attributed to individuals, especially senior managers. • Lack of understanding of senior managers of the 'front line' and ability to hide behind ignorance. • Poor internal governance with inadequate formal checks and balances on individuals' behaviour. • Poor regulatory approach with slow and inadequate responses to prevent or address failure and risks. • Incomplete and unclear application of the Statement of Principles and the associated codes of practice
Incentives for poor conduct and excessive risk-taking	• Remuneration package with bonuses awarded based heavily on short-term performance but not the potential long-term consequences. • Absence of a sense of collective responsibility against individual actions. • Ignorance about product risks and complexity and excessive faith by senior management and regulators in the precision of risk modelling. • Misaligned incentives driven by the performance-based culture and lack of sense of duty to customers

Source: PCBS report.

The main driving factors identified above fall into two main areas:

- Inappropriate behaviour, both on the part of individuals and firms, either carried out deliberately or as a result of misaligned incentives.
- Inadequate identification and management of conduct breaches and failure, both on the part of firms and regulators.

We now assess in more detail the mechanisms of effect through which the driving factors outlined in the table above lead to different types of failures. These failures can be summarised broadly as 'misconduct', 'poor practice' and 'excessive risk-taking', although there will be overlapping driving factors across each. We draw out how each main failure might result in structural detriment and personal consumer loss. Examples of different types of problems are presented as case studies.

8.2 Misconduct

Professional misconduct refers to improper and unacceptable behaviours which can be driven by personal greed or other personal rewards rather than the interests of customers. This includes reckless behaviours, dishonest actions and manipulation of information.

Misconduct can potentially be carried out by all types of staff. Although it is characterised by *deliberate* poor behaviour, the effects of misconduct can be exacerbated, perhaps unintentionally, by poor governance and a lack of individual accountability.[99] For example, evidence received by the PCBS highlighted that the complex organisational structure of large banks often means than senior executives are unable to effectively supervise actions made further down the chain of delegation, and that this leads to confusion around the lines of responsibility and a dilution of accountability. The Centre for the Study of Financial Innovation raised concerns to the PCBS that even formal risk management frameworks, such as the 'three lines of defence', were being adopted as a "box-ticking" exercise in which each line completed the check based on assumption of compliance of the risk takers without adequate judgement.

A lack of understanding of senior managers of the front line, coupled with little individual accountability, can also mean that managers do not ensure that they are aware of the actions of other employees and that misconduct goes unnoticed and unaddressed.

Poor internal governance in firms can be considered as another driving factor behind problems arising from misconduct. There are examples of misconduct that had lasted for many years, causing wide-scale detriment, before they were identified and corrected. As reported by the PCBS, for example, three major banks, Barclays, UBS and RBS have been implicated in the LIBOR manipulations but the senior management in all three cases claimed to be unaware of the misconduct of its junior staff.[100] The prolonged absence of adequate internal governance could lead to unnecessary consumer detriment that could have been corrected if the misconduct was addressed at an earlier stage.

Complex structures and a lack of clear lines of responsibility can also hamper the adequate and effective use of the enforcement powers (e.g. fines and penalties, public censure, banning from the industry) in cases of misconduct as it can be difficult to identify those holding final responsibility for the behaviour or for identifying and addressing the behaviour.[101] This in turn can result in limited incentives for senior managers to enforce high standards of conduct and compliance among staff, and ensure that they themselves are aware of and understand what happens at the 'front line'.

Misconduct can lead to a number of problems for consumers and the market such as fraud, market manipulation and mis-selling (to the extent that it is deliberate). Both personal loss and structural detriment could arise, depending on the scale and nature of the misconduct. For instance, market manipulations are likely to be characterised to a greater extent by structural detriment, as these impair the operation and structure of the market and result in sub-optimal market outcomes and losses from gains from trade. For example, as shown in the case study below, the LIBOR fixing scandal resulted in the mispricing of financial instruments on a vast scale, which led to huge losses and had wider implications for market confidence. In this case personal consumer loss could be relatively low, as the rate was often manipulated downwards and thus retail consumers may have benefited from cheaper mortgages (particularly sub-prime and buy-to-let mortgages), and credit cards and other loans. This highlights the importance of considering both structural detriment and personal consumer loss when assessing the harm caused by market failures.

Case study: the LIBOR fixing scandal

In 2012, the FSA revealed a series of bank manipulations of LIBOR – the London Interbank Offered Rate – which is the average interest rate estimated by major banks for inter-bank borrowing between 2005 and 2009.[102] Disciplinary action has been taken against a number of major banks whose traders were involved

[99] F. Burns (2003), "U.S. corporate governance: What went wrong and can it be fixed?".
[100] Report of the Parliamentary Commission on Banking Standards, "Changing banking for good", 2013.
[101] For example, the consumer group Which? observed to the PCBS that no enforcement action had been taken against individual senior executives of the PPI mis-selling scandal.
[102] Report of the Parliamentary Commission on Banking Standards, "Changing banking for good", 2013.

in the rate rigging. The LIBOR has a global prevalence[103] and the rate manipulation has led to trillions of dollars' worth of financial instruments being incorrectly priced and has seriously undermined investors' confidence in the financial system. If the market is unable to rely on fundamental measurements to set loan values then this could have further significant impacts for the identification of financial crises. The scandal has revealed the failures in banking control structures against misconduct and poor conduct of practices.

Personal consumer loss is difficult to measure: as the rate was generally manipulated downward some retail consumers with mortgages and other loans may have benefitted; on the other hand other hand the inappropriately low interest rates would have negatively impacted interest payments from residential mortgage-backed securities.[104] Aggregate estimates of the impact on economies may include a consideration of structural detriment, for example if compensation and fines demanded of implicated banks are based on an indication of total harm caused. Morgan Stanley has estimated that the scandal might impose a negative cost to the economy of between £15 billion and £20 billion, but an accurate figure on the scale of harm is difficult to model due to the complexity and inter-dependence nature of financial transactions.[105] This estimated cost includes the fines to the major banks and potential litigation costs but there could also be long-term impact on the industry. In terms of financial penalties, regulators in the U.S., UK, and EU have imposed fines of more than $6 billion (approximately £3.6 billion) for the manipulation and have taken criminal actions against several bankers and traders.[106]

Associated driving factors

The LIBOR scandal has been identified as a case of serious collective misconduct in the banking industry. Individuals used false LIBOR submissions for personal gains and in most cases have been held to account. However, such actions were not identified by corporate governance and allowed to last for a number of years. Individuals responsible for *these* failures have not been held to account. As highlighted in the PCBS report, the senior executives of three major banks that have been fined by FCA denied knowledge of the actions of their staff. This ignorance and collective decision-making shows a lack of individual accountability to address conduct failures.

8.3 Excessive risk-taking

Firms in the banking sector face a wide variety of risks both in terms of the nature of the risk and its level. For example, there are risks associated with the development of products, with investment decisions and with the growth of the business. Risk-taking can be beneficial to the development of the industry and can promote innovation. However, excessive risk taking can result in financial losses to consumers[107] and losses to banks that destabilise the financial system. Whilst there is no absolute definition of 'excessive' or 'improper' risk, we consider this to reflect decisions where the potential benefits of the risk are not accurately or sufficiently weighed up against the potential costs. Excessive risk-taking where consumers are concerned would also cover instances where the firm understands the risk (of, say, a certain product) but this is not adequately communicated to the consumers to enable him to make his own assessment of the costs and benefits of taking on that risk.

---

[103] For example, around 45 percent of adjustable-rate prime mortgages and 80 percent of adjustable-rate subprime mortgages are based on Libor, while half of variable-rate private student loans are set to Libor. See Alessi and Sergie (2013) 'Understanding the Libor Scandal', Council of Foreign Relations.

[104] These products accounted for around £360 billion in the UK in 2008 alone. See The Guardian 'Does Barclays Libor scandal affect me?' 28 June 2012.

[105] Jon Macaskill (2012), "Libor scandal: counting the cost of the fix", http://www.euromoney.com/Article/3067441/Libor-scandal-Counting-the-cost-of-the-fix.html

[106] http://www.cfr.org/united-kingdom/understanding-libor-scandal/p28729

[107] It is important to note that it is appropriate for consumers to face risks that they understand, as risk is associated with higher returns. However, excessive risk-taking by firms whereby consumers are not aware of nor compensated for risks is not appropriate and can lead to consumer harm.

Misaligned incentives can result in an individual or group placing more weight on the potential benefits of a risky decision than on the costs. Such misaligned incentives could arise from remuneration that is focussed too much on upside risk and not enough on downside risk; or from externalities compounded by a lack of individual accountability where those taking a decision will not suffer the (full) potential negative consequences of that decision.

In particular, the compensation structures employed in major banks have been highlighted as failing to combat incentives to take on excessive risks. Remuneration packages with bonuses based heavily on short-term performance but not the potential long-term consequences has led to asymmetry between rewards for short-term success and costs of long-term failure for individuals, contributing to poor prudential standards.[108]

Individuals and firms may also not be aware of the extent of risk or of the potential negative consequences. A driving factor in this regard is the complexity of models used in banks which has led to misplaced confidence in the performance and risks of investment activities. This is supported by a study by Kregel (2008) that argues that the statistical methods used in credit assessment has dramatically undervalued and mispriced risks.[109] The PCBS report highlighted that senior management can have "excessive faith" in the application of such models, without adequate checks or understanding of the accuracy and limitation of the models. This ignorance is exacerbated by an overreliance on mathematical models, and a lack of individual accountability that might incentivise individuals to reduce their levels of ignorance (e.g. by trying to understand the models and other important activities).

Improper risk taking can lead to a range of problems and implications for consumer detriment. *Ex post* personal loss is likely to represent a significant element of detriment arising from excessive risk taking. For example personal loss may be experienced by consumers if the returns from a product are subject to a greater level of downside risk than they were led to understand by the seller and willing to accept. Personal loss may also arise from bank failures or losses that are driven by poorly understood downside risk and involve consumer funds. Detriment may also be structural in nature if excessive risk-taking behaviour distorts the normal functioning of the market.

The example of the mis-selling of interest rate swaps speaks largely to *ex post* consumer loss, as discussed in more detail below.

Case study: interest rate swap mis-selling

An interest rate swap is a financial derivative instrument designed to manage potential risk exposure to interest rates movements. The two parties of the contract agree to exchange interest rate cash flows against the fixed base rate, i.e. if interest rates go up, the buyer would be compensated. A swap can be sold in conjunction with a floating rate loan which would in turn give a business a fixed rate of interest. A swap contract can protect consumers from an increase in interest rates and give them greater degree of certainty over their borrowing costs; but can also expose consumers to potential payment in the event that interest rates fall below the base rate. There are different types of interest rate swaps and the complexity of the product varies subject to different terms and conditions, such as termination and duration of the contract.[110]

Interest-rate swaps were often combined with loans to small and medium-sized enterprises (SMEs). This cross-selling practice was very common and has accounted for the majority of transactions with SMEs. The PCBS found that these financial products were sold without sufficient explanation to customers of the risks

[108] S.Bhattacharyya et al. (2011), "Risk-taking by banks: what did we know and when did we know it?", AFA 2012 Chicago Meetings paper.

[109] J.Kregel (2008), "Minsky's cushions of safety: systemic risk and the crisis in the U.S. subprime mortgage market.".

[110] Report of the Parliamentary Commission on Banking Standards, "Changing banking for good", 2013

involved if interest rates fell below the base rate. With the economic downturn and record low interest rates, SMEs suffered significant losses as a result of having to make extra payments on the swaps.

As with many examples of problems in the banking sector, the mis-selling of interest rate swaps covers a range of failures including what we identify as misconduct and poor practice, as well as excessive risk taking. In addition to the complexity of the products and lack of information which made it difficult for SMEs to understand the risks inherent in purchasing these products, the FSA identified other poor sales practices, including:[111]

- Poor disclosure of exit costs.
- Non-advised sales (in which consumers are given objective information to make their own decision) had strayed into advice.
- Unsuitable products being sold to customers that did not match the underlying loans.
- Sale practices that were driven by monetary rewards or personal incentives rather than the interests of the customers.

FSA carried out a further review of a sample of 173 sales to non-sophisticated customers and reported that over 90 per cent of the sales were not compliant with the regulatory requirements. The FSA has taken steps to address the consumer detriment caused by the mis-selling of swaps. This includes establishing fundamental principle of redress assessment which must be fair and reasonable for individual customers. According to FCA data, a total of 1,040 mis-selling cases had been reported by January 2014 and the average size of settlement was around £152,500 per claim (a significant increase from £50,000 in 2013).[112] The number total number of mis-sold interest rate swap agreements could stand at around 28,000.[113] A number of major bankshave already put aside around £3 billion to cover the cost of paying compensation and the administrative cost associated with the redress process.

Associated driving factors

The failure of corporate governance in addressing poor practice and non-compliance is considered by the PCBS as a primary driving factor of this failure. The remuneration of individuals and levels of senior accountability have also failed to correct the misaligned incentives in cross-selling the interest-rate swaps products to SMEs.

The failure could also have been exacerbated by a lack of understanding and undervaluing on the part of firms of the risks associated with the products. Interest rate swaps are complicated hedging products which require sophisticated knowledge to manage but senior managers who may lack such knowledge may be persuaded by employees within their chain of command that the products are “customer friendly”.[114]

As highlighted in the U.S Financial Crisis Inquiry Commission’s report, the breakdown in corporate governance and failures in financial regulation can be concluded as the key driving factors that caused the financial crisis of 2007/2008.[115] The report found a fundamental change in the banking model – one that was based increasingly on risky activities that produced large profits, but accompanied by governance breakdowns and irresponsibility. A number of examples have been provided to show the ignorance of senior executives in monitoring the risk of their activities effectively. For instance, the senior management of AIG failed to conduct adequate risk assessment of the company’s $79 billion derivatives exposure to mortgage-related securities which eventually led to substantial losses. There have also been evidences

---

[111] FSA update, “interest rate hedging products: information about our work and findings”, http://www.fsa.gov.uk/static/pubs/other/interest-rate-hedging-products.pdf

[112] http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/10563361/Cost-of-swap-scandal-has-tripled-says-regulator.html

[113] http://www.stephensons.co.uk/site/businesses/srvdefending/interest_rate_swap_hedging/

[114] http://www.telegraph.co.uk/finance/rate-swap-scandal/9283247/Major-failures-surround-banks-interest-rate-swap-scandal.html

[115] Financial Crisis Inquiry Commission, “The financial crisis inquiry report”, 2011.

found on poor internal governance with inadequate formal checks and balances on individual decisions in the EU banking industry. As quoted from the PCBS report, the banking culture has often been characterised by a lack of collective responsibility to protect the reputation of the industry and consumers' interests.

8.4 Poor practice

For the purposes of this analysis we define poor practice as commercial activities that do not protect and promote consumer welfare but are driven by other interests. We apply this concept more broadly than deliberate misconduct as described above to cover behaviour that, although it may be deliberate, is not necessarily intended to cause harm. Poor practice can arise from poor standards of internal activities like a lack of adequate internal controls, failures in risk assessment or risk management, or insufficient conduct training for staff which can affect the quality of services offered to consumers. Where individuals responsible for these failures are not held to account and systems changed accordingly, instances of poor practice can continue from one case to another.

Poor practice can also be driven by mis-aligned incentives. Evidence presented to the PCBS found that the remuneration of bankers can be closely linked their financial performance for the firm rather than their compliant behaviour or long-term interests of their customers. For instance, salesmen at major banks could be rewarded six times as much personal commission for selling a loan with PPI as compared to selling a loan without PPI. It has been argued by Citizen Advice that incentives to mis-sell PPI products were promoted in return for profits for the firm.

The mis-selling of products which are not suitable for consumers is a key example of poor practice, although we acknowledge that the mis-selling of certain products can also be driven by excessive risk taking and even deliberate misconduct. The case study below on the mis-selling of payment protection insurance (PPI) provides an example of poor practice, although as noted there are overlaps in terms of other driving factors.

Personal consumer loss is likely to be a significant type of detriment rising from mis-selling, particularly if consumers expend time and resources complaining and seeking redress. Personal consumer loss could also arise from consumers paying more than they would have had they fully understood the product they were sold (e.g. if they had fully understood the risks associated with the product or the value/necessity of the product). Structural detriment would occur if, for example, demand for such products fell as a result of consumers taking account of the risk of being mis-sold to (indeed, this lack of trust could affect demand for other products resulting in even wider structural detriment). Both the price paid and the quantity consumed could fall, reducing consumer surplus and producer surplus compared to a situation with no mis-selling.

Case study: mis-selling of PPI

Payment protection insurance (PPI), also known as credit insurance, is an insurance product that enables borrowers to insure their repayment of loans in the event that their financial and personal circumstances deteriorating. PPI was commonly sold alongside credit products and this cross-selling practice helped to make up for loss-leading credit product sales or deliver further profits to the banks. Consumers usually paid for PPI through either a single or a regular premium which could add up to 56 per cent of the loan amount. According to the Financial Ombudsman Service estimates, around £50 billion of PPI policies were sold over the past 10 to 15 years.[116]

However, evidence has been found of wide-spread mis-selling practices of PPI products. The Citizen's Advice Bureau presented a super-complaint in 2005 in which it reported that high-pressure selling

[116] http://www.ft.com/cms/s/0/8310b6ec-8ced-11e3-ad57-00144feab7de.html#axzz33UhOvsOw

techniques and unfair practices were used to force consumers to buy the products which were unsuitable for them and at times even unaffordable.[117] Subsequent market reviews conducted by the FSA and other regulators confirmed widespread poor sales practices and inadequate compliance standards.

Common mis-selling practices found by Which? included misleading consumers to purchase PPI products on the incorrect basis that it was compulsory, and selling products that did not suit the consumers' circumstances.[118] Consumers were also told that the approval rate of their loan would be affected if they were not covered by PPI products. In other poor practices, PPI was packaged as a product associated with the main credit product and consumers may not have even noticed that they were paying for it.

In addition to PPI being sold to consumers who did not need it, the mis-selling included a lack of information on the nature of the product itself. Although PPI can be a useful product in protecting consumers from a risk of indebtedness, the high rejection rate of claims has failed many consumers. Like any other insurance product PPI has exclusion policies and does not cover all types of circumstances and vulnerable borrowers. A survey by the Citizen's Advice Bureau in 2001 found that the percentage of unsuccessful claims was around 85 per cent which was in sharp contrast to the 85 per cent success rate claimed by the industry. Further, the high cost of PPI which is often paid in the form of a one-off premium has increased the financial burden of consumers. Lenders would also treat this as an additional opportunity to advise consumers to take out extra loan to cover the costs.

As estimated by the Citizen's Advice Bureau in 2005, PPI premiums were about three times higher than the costs to firms of providing the insurance cover, which suggested that borrowers could have been over-charged by as much as £3 billion per year for PPI products.[119] The mis-selling of PPI has developed into the biggest financial mis-selling scandal in recent years and has resulted in extensive losses to consumers and has significantly damaged public confidence in the banking industry.

The mis-selling of PPI demonstrates how banks can exploit information asymmetries between them and their customers to their advantages.[120] Consumers are often not fully aware of the costs and implications of the products that are sold to them. Even if information is provided, they can be in the form of small print and consumers can be bombarded with information which may be as detrimental as not providing enough information to them.

To address the consumer detriment caused by the mis-selling, FSA took over regulation of PPI in 2005 and the Competition Commission recommended a ban on single premium PPI and a prohibition on banks selling PPI alongside credit products which were came into force in April 2012.[121] The FSA also published Policy Statement 10/12 which formally states the approach which firms should take to assess the PPI complaints with adequate redress. Various major banks have made a large number of payments to consumers affected by the mis-selling of PPI. By February 2014, the total industry compensation bill had reached around £20 billion.[122]

Key underlying driving factors

One of the key driving factors of the mis-selling scandal identified was the inadequate internal governance of banks involved which has failed to combat misaligned incentives in PPI selling and to address the poor practices. According to the PCBS report, despite large volumes of complaints made by individual consumers and consumer groups, the limited number of whistle-blowing by internal employees reflect the

[117] Citizens Advice Bureau (2005), "Protection racket: CAB evidence on problems with payment protection insurance".
[118] http://www.which.co.uk/news/2011/05/top-five-ppi-mis-selling-tactics-253105/
[119] Citizens Advice Bureau (2005), "Protection racket: CAB evidence on problems with payment protection insurance".
[120] Report of the Parliamentary Commission on Banking Standards, "Changing banking for good", 2013.
[121] Report of the Parliamentary Commission on Banking Standards, "Changing banking for good", 2013.
[122] http://www.ft.com/cms/s/0/8310b6ec-8ced-11e3-ad57-00144feab7de.html#axzz33UhOvsOw#

ineffective reporting and checks procedure in the banking industry. Senior executives were found to have failed to provide adequate supervision of the actions of more junior staff but also provided incentives for them to sell products that were not in the interests of consumers.

9 Approach to Extrapolating Compliance Costs

In this section we describe in more detail our approach to extrapolating the costs estimated in our compliance cost model to the wider sectors.

To recap, average fixed costs across the large and small firms in our sample are multiplied up by the number of large / small firms in the sector. Variable costs for large and small firms, as a percentage of annual income, are multiplied up by the share of sector income implied by the large / small split.

9.1 Banks

Data from the FCA indicate that around 160 banks and investment firms would be affected by the new individual accountability regime. This excludes non-EEA firms operating in the UK. The remuneration policies include non-EEA branches and therefore the number of firms in scope is around 240.

We use data from the Bank of England (BoE) to estimate the annual income of the firms covered by the new regimes. [123] (Some income data was available to us from the FCA but at the time of writing details regarding the exact components and coverage of the data were not available. We have used this data as a cross-check to inform our distribution analysis). The BoE data includes the total annual income for monetary financial institutions operating in the UK (i.e. contributing to UK national accounts).[124] Total income for 2013 is just under £120 billion. This includes income from non-EEA branches and building societies.

We subtracted the annual income of building societies from the BoE figure to arrive at the total income for banks operating in the UK. This was just under £115 billion in 2013.

We then subtracted 11 per cent of this to exclude the income attributable to non-EEA branches.[125] This results in a total income figure of around £103 billion relevant to the accountability regime.

The table below summarises the estimates across the two populations.

Table 9.1: Population statistics for banks and investment firms

	Individual accountability regime	Remuneration regime
Number of firms	160	240
Total sector income, 2013	£103bn	£115bn

Source: FCA and Bank of England.

9.1.1 Distribution of income

In order to arrive at a large/small split for banks and investment firms, a distribution of income across firms is required. Given the uncertainty in relation to the FCA income data we cross-checked the distribution

[123] Bank of England Statistics Table B3.2 'Monetary financial institutions' annual profit and loss' http://www.bankofengland.co.uk/statistics/Pages/iadb/notesiadb/income_expenditure.aspx

[124] The BoE data represents around 240 firms (including building societies and non-EEA branches).

[125] This proportion of total income is based on the sample from the FCA which includes non-EEA branches.

implied by the FCA data using the BoE estimates distributed across a Zipf distribution, which we explain below.

Analyses of firm size using historical data have strongly indicated that the distribution of firms can be described by a form of lognormal distribution.[126] Similarly, research carried out on the distribution of U.S. firm size indicated a particular form of power law distribution, a Zipf distribution.[127] Technically this means that the probability of a firm being larger than a given size, S, is inversely proportional to S. In other words, firm sizes are highly skewed such that there are a large number of small firms and a small number of large firms. Heuristics like the 80:20 "rule" draw upon this research.

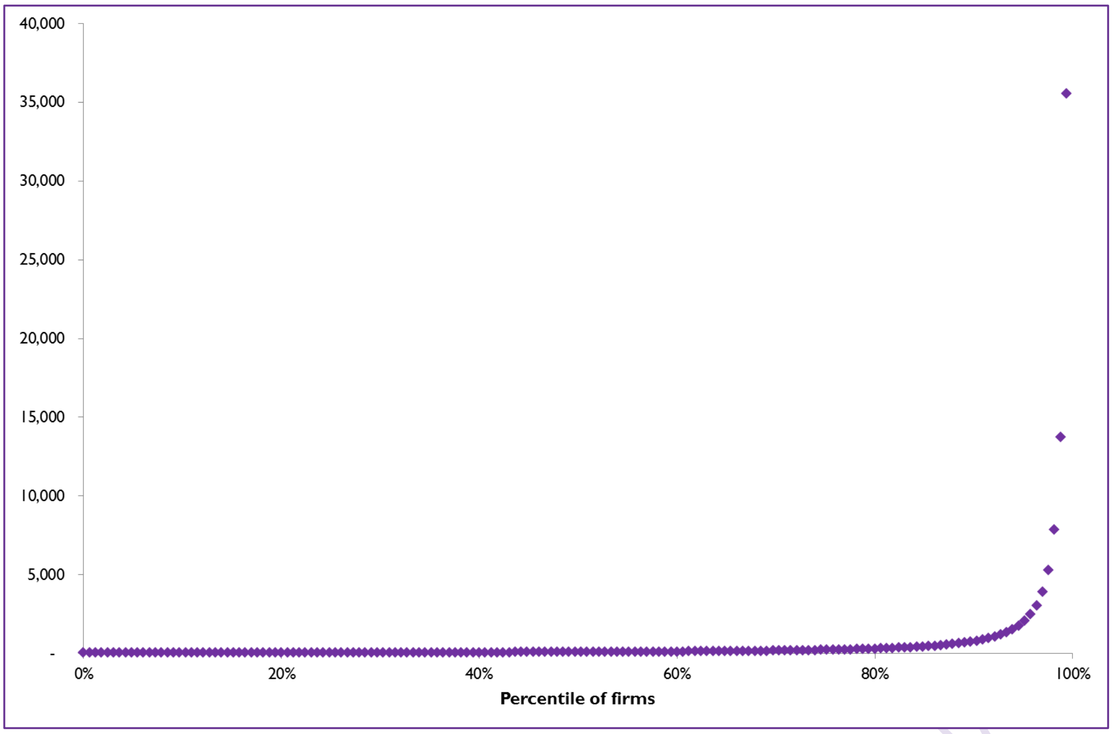
For a discrete pareto-distributed random variable, X, the distribution of firm size (by turnover) is drawn from the following cumulative distribution function (CDF):

$$P(X \leq x) = \left\{1 - (\frac{k}{x})^{\alpha} \quad for\ x \geq k, o\ if\ otherwise\right\}$$

where k is the minimum firm size and α defines the curve, and which, in effect, captures the degree of market concentration.

Using the BoE income data for the sector and the total number of firms we generated a distribution of income which enabled us to assess the firm numbers applicable to different proportions of total income. The results are shown in the chart below.

Figure 9.1: Distribution of income across firms



Source: BoE income data and Europe Economics analysis.

A clear change in firm size in this distribution occurs around the 90th percentile of firms, i.e. approximately the top 10 per cent of firms can be considered the largest — around 15 or 16 firms out of the 160 relevant to the accountability policies. These firms account for around 80 per cent of sector income. We cross-checked these results with the distribution of the FCA income data, which indicates that the top 15 firms in

[126] R.Perex, et al. (2005), 'Company size distribution for developing countries', see http://esfm.ipn.mx/~richp/papers/developingcountries_PhysA_359_2006.pdf

[127] R. Axtell, et al. (2001), 'Zipf distribution of U.S. Firm Sizes', http://www.swarmagents.cn/thesis/doc/jake_204.pdf

the sample account for around 80 per cent of income. A similar distribution analysis of the BoE data was undertaken for the income and firm numbers relevant to the remuneration policies scope — here a natural break occurred just under the top 10 per cent of firms – around 18 – which also account for around 80 per cent of sector turnover in both the BoE income data and the FCA income data.

We therefore set a threshold at 80 per cent of sector income above which firms are considered large. This captures 15 firms in the sector relevant to the accountability policies and 18 firms in the sector relevant to the remuneration policies.

9.1.2 Sensitivity analysis

As the cost extrapolation is dependent on the split between large and small we conduct a sensitivity using a large natural split in the FCA data as the threshold (where the difference between the income of the firms on either side of the divide is 30 per cent) — this captures 8 firms as 'large' in both the accountability- and remuneration-relevant sectors.

This results in a reduction in the costs for 'large' firms and an increase in the costs for 'small' firms (which is unsurprising as the number of large firms has decreased). The decrease in the one-off costs for large firms slightly outweighs the increase for small firms, — total sector costs from the accountability policies are around four per cent lower, and costs for the remuneration policies around 17 per cent lower. Ongoing costs are higher across the sector by around 16 per cent for the accountability policies; the change in ongoing costs from the remuneration policies is negligible.

9.1.3 Detailed costs across the sector

The table below provides a breakdown of the sector costs per policy. This is in addition to the tables in Section 3 that show the total costs to the sector for the accountability and remuneration policies.

Table 9.2: One-off compliance costs for banks and investment firms (£million)

One-off costs	Large	Small
SMF, statement of responsibility, presumption of senior responsibility and pre-approval	19.6	50.4
Certified persons regime - set up	2.5	4.6
Continuing fitness and propriety	6.2	1.2
Regulatory references	0.2	0.1
Rules of conduct (SMF+CP)	38.7	6.3
Rules of conduct (SMF+CP+MM)	82.5	7.6
Rules of conduct (everyone)	110.1	9.8
Reporting breaches (SMF + CP)	9.8	0.6
Reporting breaches (SMF + CP + MM)	12.8	0.6
Reporting breaches (everyone)	31.4	0.6
Remuneration policies		
Deferral of remuneration	4.8	6.0
Clawback	6.7	11.5
Exceptional government intervention	Negligible	Negligible

Table 9.3: On-going compliance costs for banks and investment firms (£million)

Ongoing costs	**Large**	**Small**
SMF, statement of responsibility, presumption of senior responsibility and pre-approval	2.8	5.1
Certified persons regime - on-going	Negligible	Negligible
Continuing fitness and propriety	4.0	2.3
Regulatory references	Negligible	3.1
Triennial DBS Checks	0.0	0.1
Annual DBS Checks	0.0	0.2
Rules of conduct (SMF + CP)	0.0	Negligible
Rules of conduct (SMF + CP + MM)	0.0	Negligible
Rules of conduct (everyone)	0.6	Negligible
Reporting breaches (SMF + CP)	0.8	1.2
Reporting breaches (SMF + CP + MM)	1.4	1.7
Reporting breaches (everyone)	2.4	2.3
Remuneration policies		
Deferral of remuneration	0.6	0.9
Exceptional government intervention	Negligible	Negligible

9.2 Building societies

Data from the Building Society Association (BSA) indicates that 45 building societies would be subject to the new regime, with a sector income of around £4.5 billion in 2013. We apply a threshold of £100 million annual income, below which firms are considered small and above which they are considered large. This threshold is in line with a natural break in the size distribution of firms, whereby the next firm below the threshold has annual income of only 30 per cent of the income of the firm above the threshold. This results in a split of six large firms (accounting for 90 per cent of sector income) and 39 small firms. We scale up the fixed costs by the number of firms in the small and large categories, and the variable costs as a proportion of annual income.

As the cost extrapolation is dependent on the split between large and small we conduct a sensitivity using another break in the data at annual income of £20 million. This results in an overall increase in one-off costs across the sector of around 25 per cent, and a decrease in variable costs of around 11 per cent. However, given the significant break in the data around the £100 million mark we consider this to be the most appropriate threshold.

9.2.1 Detailed costs across the sector

The table below provides a breakdown of the sector costs per policy. This is in addition to the tables in Section 3 that show the total costs to the sector for the accountability and remuneration policies.

Table 9.4: One-off compliance costs for building societies (£million)

One-off costs	Large	Small
SMF, statement of responsibility, presumption of senior responsibility and pre-approval	2.08	0.93
Certified persons regime - set up	1.03	0.46
Continuing fitness and propriety	0.67	Negligible
Regulatory references	Negligible	0.02
Rules of conduct (SMF+CP)	1.27	0.18
Rules of conduct (SMF+CP+MM)	2.24	0.37
Rules of conduct (everyone)	12.76	0.69
Reporting breaches (SMF + CP)	0.60	Negligible
Reporting breaches (SMF + CP + MM)	0.60	Negligible
Reporting breaches (everyone)	0.60	Negligible
Remuneration policies		
Deferral of remuneration	0.11	Negligible
Clawback	0.02	Negligible
Exceptional government intervention	Negligible	Negligible

Table 9.5: Ongoing compliance costs for building societies (£million)

Ongoing costs	Large	Small
SMF, statement of responsibility, presumption of senior responsibility and pre-approval	0.03	Negligible
Certified persons regime - on-going	Negligible	Negligible
Continuing fitness and propriety	0.07	0.21
Regulatory references	0.03	0.08
Triennial DBS Checks	Negligible	Negligible
Annual DBS Checks	Negligible	0.01
Rules of conduct (SMF + CP)	0.06	Negligible
Rules of conduct (SMF + CP + MM)	0.12	Negligible
Rules of conduct (everyone)	0.84	Negligible
Reporting breaches (SMF + CP)	0.11	Negligible
Reporting breaches (SMF + CP + MM)	0.11	Negligible
Reporting breaches (everyone)	1.65	Negligible
Remuneration policies		
Deferral of remuneration	0.02	Negligible
Exceptional government intervention	Negligible	Negligible

9.3 Credit unions

Data from the FCA show that there are 523 credit unions that would be subject the policies, with a sector income of around £167 million in 2013.

Given the overall small nature of credit unions and similar features across all sizes (in particular, the likelihood that the number of SMFs would be limited to the board, the size of which is less variant across the size of the firm) we do not create a large/small divide. We extrapolate the average fixed costs from our sample across all firms in the sector, and extrapolate the variable costs as a proportion of income.

9.3.1 Detailed costs across the sector

The table below provides a breakdown of the sector costs per policy. This is in addition to the tables in Section 3 that show the total costs to the sector for the accountability and remuneration policies.

Table 9.6: One-off compliance costs for credit unions (£million)

One-off costs	All firms
Individual accountability policies, one-off	
SMF, statement of responsibility, presumption of senior responsibility and pre-approval	3.179
Certified persons regime - set up	0.123
Continuing fitness and propriety	0.118
Regulatory references	Negligible
Rules of conduct (SMF+CP)	0.828
Rules of conduct (SMF+CP+MM)	1.124
Rules of conduct (everyone)	1.219
Reporting breaches (SMF + CP)	0.131
Reporting breaches (SMF + CP + MM)	0.131
Reporting breaches (everyone)	0.131

Table 9.7: Ongoing compliance costs for credit unions (£million)

Ongoing costs	All firms
SMF, statement of responsibility, presumption of senior responsibility and pre-approval	0.020
Certified persons regime - on-going	0.059
Continuing fitness and propriety	0.735
Regulatory references	0.735
Triennial DBS Checks	0.941
Annual DBS Checks	Negligible
Rules of conduct (SMF + CP)	Negligible
Rules of conduct (SMF + CP + MM)	Negligible
Rules of conduct (everyone)	Negligible
Reporting breaches (SMF + CP)	Negligible
Reporting breaches (SMF + CP + MM)	Negligible
Reporting breaches (everyone)	Negligible