

**ZEW/AEI CONFERENCE
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**THE COSTS OF FINANCIAL
REGULATION**

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OVERVIEW

- Cost-benefit analysis at the FSA
- Costs of regulation
- Empirical evidence
- Regulatory capital requirements

COST BENEFIT ANALYSIS AT THE FSA



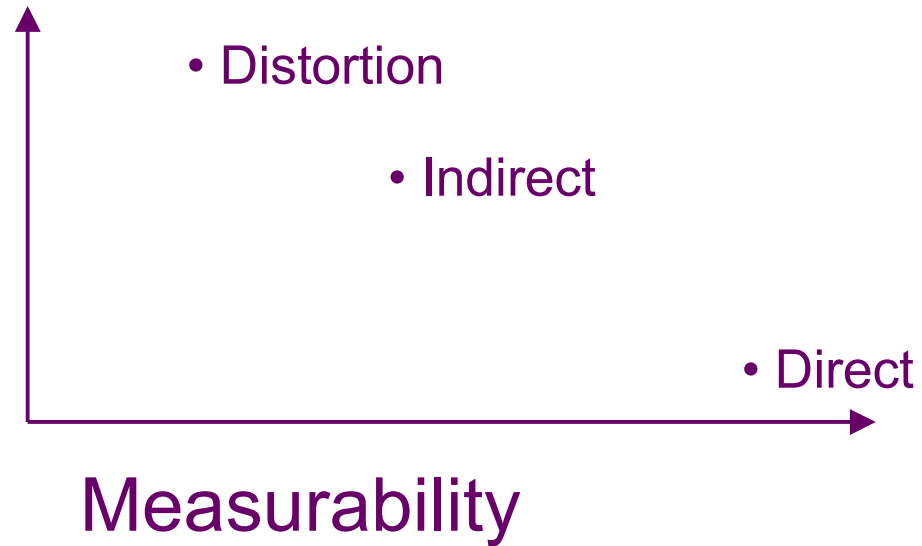
- Financial Services and Markets Act
- Publish, consult and feedback
- Wide interpretation of costs and benefits
- Use of external research

COSTS OF REGULATION

- Direct - financing the regulator
- Indirect - incremental compliance costs
- Distortion - how regulation changes markets

MAGNITUDE AND MEASURABILITY OF COSTS

Magnitude



ESTIMATION OF COSTS

- Surveys
- Case studies
- By analogy

EMPIRICAL RESULTS

- US studies
- Variation by type of regulation and by size of firm
- UK studies
 - the 4:1 “rule of thumb”

Table 1: Incremental Costs of FSA Compliance

| Percentage | Number of responses |
|-------------------|----------------------------|
| Negative or 0 | 2 |
| 0-2 per cent | 21 |
| 2-5 per cent | 9 |
| 5-10 per cent | 5 |
| 11-20 per cent | 5 |

Median : 1.6%

EUROPE ECONOMICS SURVEY (2)

Table 2: Incremental Compliance Costs by Firm Size

| | Number of firms | Mean (per cent) | Median (per cent) |
|--------|----------------------------|----------------------------|------------------------------|
| Small | 14 | 5 | 3 |
| Medium | 14 | 3 | 2 |
| Large | 14 | 2 | 1 |

EUROPE ECONOMICS SURVEY (3)

Table 3: Incremental Compliance Costs by Type of Firm

| Type of firm | Sample mean (per cent) | Sample median (per cent) |
|--------------------------------------|---------------------------|-----------------------------|
| Banking and credit | 2.6 | 0.9 |
| Managed investments | 3.4 | 1.1 |
| Retail | 5.6 | 2.6 |
| Insurance and pensions | 2.4 | 0.8 |
| Capital Market Operations | 4.7 | 2.0 |
| Exchanges, counterparties and others | 2.1 | 1.5 |

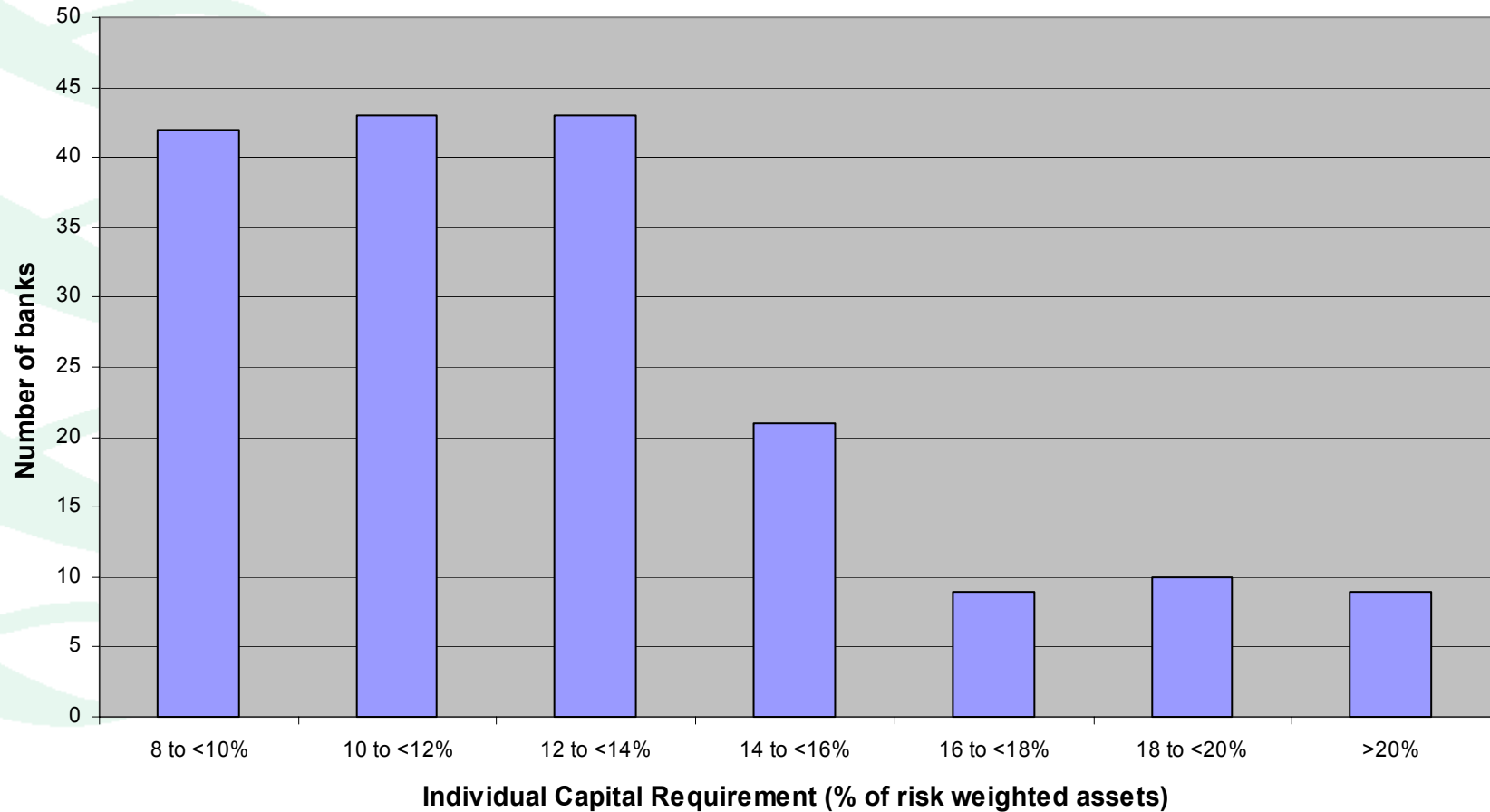
REGULATORY CAPITAL REQUIREMENTS



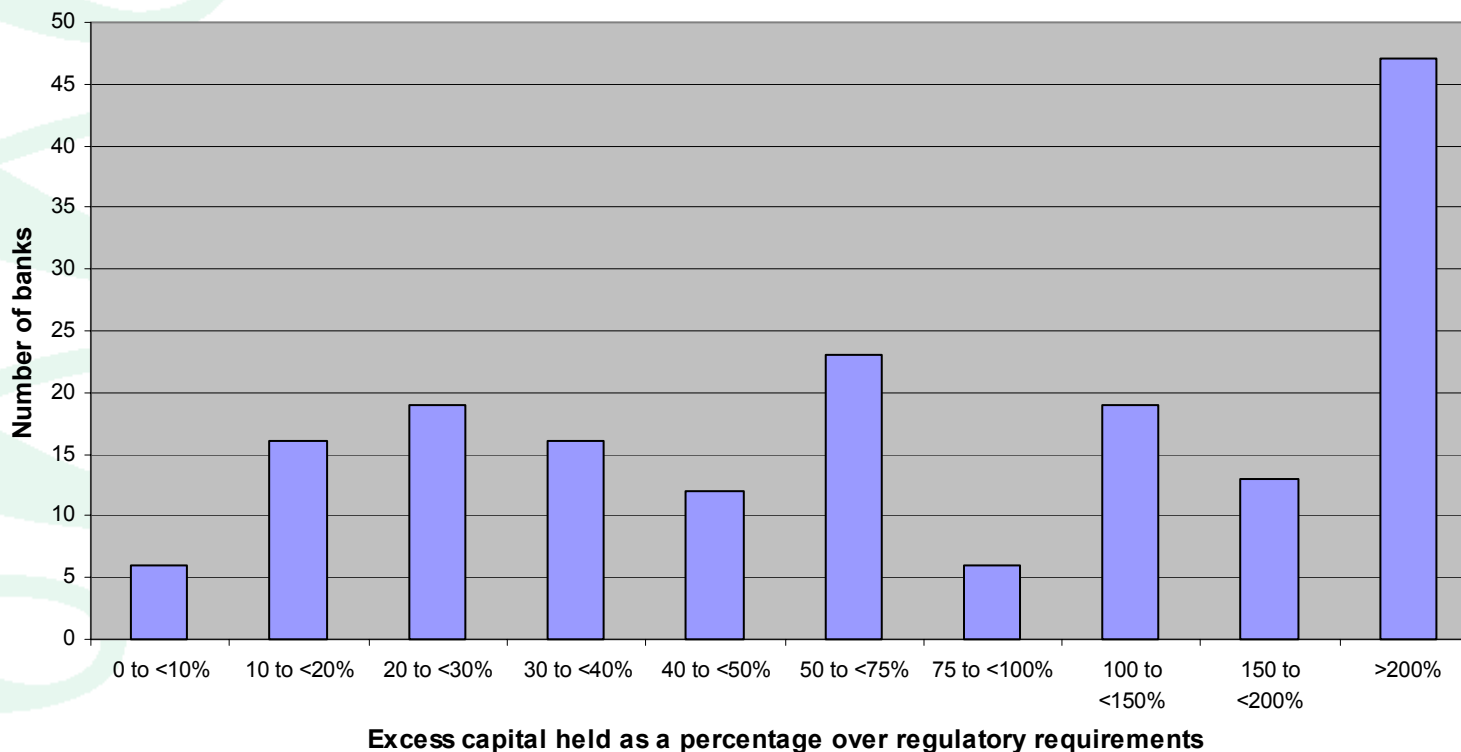
FSA

- Increase in UK and US banks' capital ratios during the 1990s
- Impact of first Basel Accord
- Impact of market forces

INDIVIDUAL CAPITAL RATIOS IMPOSED BY THE FSA



“EXCESS” CAPITAL HELD BY UK BANKS



WHY THE EXCESS?

- Ratings
- Cost of funding
- Peer group pressure
- Capital planning

REGULATORY REQUIREMENTS STILL MATTER



- Buffer
- Empirical evidence
- Signalling
- Major impact when regulatory capital requirements bite
- Cost of holding incremental capital

CONCLUSIONS

- Measurement difficulties
- But important to consider the costs of regulation
- They are large and should not be ignored