Cost-benefit analysis and compliance culture

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ABSTRACT
The increasing use of cost-benefit analysis (CBA) in financial regulation is bringing a sharper focus on the benefits conferred by regulation. This paper addresses the impact of that sharper focus on the compliance culture of regulated firms. Why focus on the benefits of regulation? What does CBA have to offer to the compliance culture of authorised firms? How does the introduction of CBA fit in with other developments in the regulatory arena? This paper offers some tentative answers to these questions.

INTRODUCTION
The Securities and Investments Board (SIB) established, in early 1995, a cost-benefit analysis (CBA) department following the recommendations of the review conducted by its Chairman, Sir Andrew Large. A major aim of the CBA department is to act as internal advisors to those developing policy within the SIB by providing analysis of the impact (costs and benefits) of (de)regulatory proposals.

CBA is, therefore, regarded as an aid to policy formulation within the SIB. The purpose of this paper is to discuss CBA from an alternative perspective, that of regulated firms. Firms' perspectives on regulation are reflected in their compliance culture. Thus, the paper first discusses different views of firms' compliance cultures and then it presents Ruimsschetel's alternative framework for considering compliance cultures (which is better suited to the purposes of this paper).

The next section of the paper then discusses the practice of CBA by regulators and highlights its long-term implications for compliance culture. The paper shows that the practice of CBA can contribute to a better understanding of the rationale of regulation and can promote an improved compliance culture within regulated firms. The last section of the paper applies the compliance culture framework to explore other developments and policy discussions.

TYPE OF COMPLIANCE CULTURE
Firms authorised in the UK under the Financial Services Act (FSA) have to ensure that their behaviour accords with the relevant rules promulgated by their regulator. It is now accepted that firms' compliance culture is crucial for attaining a satisfactory level of compliance and, hence, of investor protection. The large number of papers addressing firms' compliance culture in journals such as Journal of Financial Regulation and Compliance supports this claim. This section analyses different views of compliance culture to set the scene for the subsequent discussion of the role of CBA.

There are two distinguishable strands in the literature on compliance culture. The first strand emphasises the impact of the organisational structure of the compliance function on the firm's compliance culture. It is argued
that the structure of the compliance function within a firm determines to a great extent its compliance culture. Two alternative approaches to structuring the compliance function are identified: a top-down approach which emphasises the role of a centralised compliance department and a bottom-up approach which integrates compliance with operational departments. It appears that the accumulation of experience, external factors (higher regulatory standards) and firms' resistance to increasing the size of the compliance department are creating a trend towards a bottom-up approach. It is then suggested that moving in this direction is more likely to generate a lasting compliance culture.

The second strand relates to the goal that firms associate with the compliance function. The overriding objective of this strand is to show that although the role of compliance may have been externally imposed, it is also beneficial to the firm itself. Compliance has been characterised as being motivated either by a goal of risk management in papers by Curtis and by Adams or by a goal of best practice in a paper by Clarke.

According to the risk management approach, compliance is the management of regulatory risk. This is the risk that a rule or regulation may be broken. It includes the risk of regulatory sanction, financial risk, litigation/legal risk, the risk of regulatory estrangement and reputational risk. The role of a firm's compliance function is therefore the management of that risk. This involves identifying and assessing significant risks and containing and managing them. Compliance, therefore, becomes very similar to the credit function within a bank.

The best practice goal, on the other hand, is guided by the industry's commitment to the principles of regulation. This is likely to result from the perception that regulation, in general, and its principles, in particular, are legitimate. The compliance culture then has a different basis and a diminished emphasis on the analysis of regulatory risk. Thus 'resort to the regulator for advice is then on a more assertive basis'. The presumption here is that by striving for good practice a firm may be more successful in the market. This might appear counterintuitive since this is likely to increase the firm's costs of providing the service. However, where there is more than one firm this decision could be part of the competitive strategy of the firm. Regulators generally impose uniform standards on the industry, thus allowing firms to limit their exposure to new regulations while gaining a competitive advantage over its competitors when new regulations are introduced.

Clarke's contribution also contains a framework to characterise compliance culture. The risk management approach is identified with negative compliance, an emphasis on rules and a tendency to legalism. On the other hand, the best practice approach is identified with positive compliance and a more proactive attitude to regulation. The usefulness of the framework is, however, limited, each type is characterised as the counterpart of the other. In addition, and as Clarke recognises, it is very unlikely that there would be firms with a compliance culture that fits in either of these extremes. The missing element in this framework is, therefore, a meaningful way of characterising the compliance culture of those firms that lie between the two polar cases.

The next section suggests a more flexible framework to consider compliance culture which addresses the above issues and is based on Ruimschotel's 'table of eleven'. This is then used to relate compliance culture to the introduction of CBA and other developments.

A FLEXIBLE FRAMEWORK FOR COMPLIANCE CULTURE

An alternative perspective for characterising compliance culture is provided by the table of eleven. This is a framework designed to assess the extent and nature of compliant behaviour and, hence, the compliance culture. It is a flexible tool that can be applied in a variety of circumstances (for example, in respect of new regulations and in respect of existing regulations) and from a variety of perspectives (for example, regulator's perspective and firms' perspective).

The table of eleven identifies the key dimensions of compliance as a spontaneous compliance dimension and a forced compliance dimension. The spontaneous compliance
dimension refers to those determinants of compliance which are not dependent upon the existence of a system of formal supervision and enforcement. It has the following elements: quality of regulations, cost-benefit considerations, acceptability, non-conformity, informal control and spontaneous detection probability. The forced compliance dimension refers to those determinants of compliance which are dependent upon the existence of formal supervision and enforcement. It includes elements such as control density, detection probability, control selectivity, sanction probability and sanction severity. Appendix 1 contains a brief explanation of the different elements.

It should be noted that the essence of the forced compliance dimension is the risk management goal. That is, firms comply with proposed measures because there is a system of regulatory oversight and there is a risk of incurring penalties for noncompliance which needs to be taken into account. On the other hand, the essence of the spontaneous compliance dimension is the best practice goal. A firm’s compliance culture is therefore characterised as a combination of positive and negative elements rather than as being either positive or negative. A measure of compliance culture could result from the (weighted) sum of scores given to each element of the forced and spontaneous compliance dimension.

One by-product of this framework is that it explicitly relates the structural features of regulation to firms’ compliance culture. For example, one of the aspects in the design of a regulatory system is the reliance that is placed on coercion (the forced dimension); other elements may include the balance of the different coercive elements such as the relation between the probability of being caught and the penalties imposed. This framework suggests that a similar compliance culture may result from regulatory systems that emphasise different elements of the compliance culture. The framework is therefore more flexible and permits the rationalisation of several decisions about the form of regulation in the UK. For example, the government’s decision to maintain certain elements of self-regulation within the UK’s Financial Services Act framework can be seen as aiming to put in place an element conducive to spontaneous compliance. The next section discusses the introduction of CBA in the policy formulation process using this framework.

**COST-BENEFIT ANALYSIS**

Cost-benefit considerations are explicitly recognised in Ruimveld’s table of eleven as a determinant of the extent of spontaneous compliance. This section reviews the added value of CBA in this area by identifying the specific areas of CBA that may affect firms’ compliance culture.

CBA is a long-established discipline of applied economics; textbooks on this subject have been available in the UK since the early ‘seventies.’ It is, in essence, a conventional financial appraisal, such as those carried out by commercial organisations, adapted to the needs of decision making in a public policy context. CBA has been used by government departments in the UK as an appraisal tool for public investment since the early ‘sixties.’ Its application to policy formulation in the context of financial services regulation is, however, more novel. The key additions of CBA to previous discussions on financial services regulation in the UK include making explicit the benefits of regulation, improving firms’ understanding of regulators’ proportionality judgments, and the introduction of a non-confrontational approach. These are discussed below.

First, CBA makes explicit the benefits of regulation as a counterpoint to the costs of regulation. It is worth noting that the first assessment of the changes brought about by the FSA included a ballpark estimate of the cost of compliance expected at that time, £100m. This has become ever since a focal point for the assessment of financial regulation in the UK. This assessment did not include, however, any estimate (or indication of the likely order of magnitude) of the benefits of regulating financial services. These are therefore regarded as implicit.

Alternatively, the benefits may be regarded as ‘intangible’ and may simply be characterised in terms of ‘increased investor protection’. There are obvious difficulties of a conceptual and empirical nature in assessing the benefits of
financial regulation. However, neglecting the specific nature and extent of the benefits can have undesirable consequences. It may suggest to firms that the benefits are either small or nonexistent. This may then show regulation as having little purpose and might alienate firms' compliance functions from their colleagues. The alternative is not to define a benefit for each rule. The alternative is that the rationale and benefits of sets of rules, say, in respect of training and competence, are made explicit by regulators.

The analysis of the benefits of regulation is, however, an area in which a very limited amount of research has been carried out. Llewellyn's paper delivered to Autif's annual conference stands more as an exception than the rule. It may therefore be useful at this point to provide illustrations of the specific benefits of financial regulation:

— in wholesale markets, the knowledge that the counterparty is subject to a known degree of external supervision may have a beneficial effect on the transaction costs incurred by market participants
— in retail markets, firms benefit from a flow of customers who feel reassured that external supervision provides a minimum level of competence of providers of financial products; without this reassurance, consumers would limit their purchases and may not enter the marketplace.

Thus, making the benefits of regulation explicit at the point of introducing new regulations is crucial for a regulatory system which wishes to encourage spontaneous compliance. This should allow firms to see more clearly the rationale of proposed measures. It should therefore enhance firms' compliance with the spirit of regulation and improve further their compliance culture.

Second, by making explicit the benefits of regulation, CBA exposes the basis for the proportionality judgment about costs and benefits made by regulators in deciding to take specific courses of action. It is worth noting that CBA is not a substitute for the policy judgment but an aid to it and that this judgment is by no means trivial since it may need to take into account a variety of considerations such as distributional factors, either between types of firms or between types of investors. This improved understanding of regulatory decision making should lead firms to take a more favourable view of regulation and so enhance their compliance culture.

Finally, discussions on financial regulation may sometimes give the impression that regulation aims to take from some (firms) to give to others (consumers). This is far from being the intention and the economic foundations of CBA explicitly recognise that. CBA aims to maximise society's welfare by improving economic efficiency, that is by identifying whether regulatory measures will lead to an increase in the size of the pie to be shared between firms and consumers. It assesses therefore the benefits of regulatory measures against the cost of implementing them. For example, a market from which consumers are exiting (or refraining from entry) as a result of lack of confidence is not an efficient market. In this circumstance, firms would suffer a loss of profit opportunities and consumers would be worse off by giving up the purchase of products that would benefit them. Regulatory measures which would restore confidence in the market may bring costs, initially to be borne by firms, while clearly benefiting investors. However, these measures would also benefit firms by contributing to the materialisation of what were otherwise lost profit opportunities.

CBA can therefore contribute to the development of the spontaneous dimension of compliance by emphasising the role of the benefits of regulation. The combination of the three elements above should have a significant impact over time on regulated firms' compliance culture. Casual experience from the project work of the SIB's CBA department and from discussions with firms in various fora is so far encouraging. Firms do welcome, in general terms, a more rigorous approach to the assessment of (costs and) benefits, although there are still doubts as to the assessment of the benefits of regulation. In any event, it is worth emphasising that the long-term impact that CBA may have on firms' compliance culture also depends on firms' cooperation. This can
have a variety of forms: contributing to regulators' assessment of measures (such as responding to regulators' requests for information), carrying out assessments of the costs of regulation in a systematic manner, and disseminating within their own organisations the rationale and benefits of regulatory measures (in addition to information about rules and other requirements).

**SPONTANEOUS COMPLIANCE AND OTHER DEVELOPMENTS**

The concept of spontaneous compliance and compliance culture has been used above to highlight the implications of the introduction of CBA from the perspective of authorised firms. This section utilises these concepts to discuss very briefly the disclosure dividend and the rules versus discretion paradigm.

The prospect of a disclosure-dividend for the retail industry has been raised by the SIB's Chairman. He has argued that the introduction of disclosure and new training and competence requirements may allow a less prescriptive approach to regulation. A recent paper by Llewellyn elaborates on this theme and explicitly introduces the trade-off between rules and discretion in the design of a system of financial regulation. In Llewellyn's analysis, a certain level of investor protection can be provided by different combinations of rules and supervisory discretion. For example, the same level of investor protection could be provided either by combining a prescriptive rule book and a small degree of supervisory discretion, or by combining a set of general principles and a high degree of supervisory discretion.

An implicit requirement for an effective trade-off between rules and discretion is, however, a minimum level of compliance based to a great extent on spontaneous compliance. This is so because an effective application of supervisory discretion requires a degree of consistency. For a given level of regulators' resources, there is an amount of discretion that can be effectively exercised. If there is not a sufficient degree of spontaneous compliance, regulators would have to exercise their discretion in an increasing number of cases. It is almost inevitable that sooner or later concerns would arise as to the consistency with which regulators use their discretionary powers. It may then be argued that it is more cost-effective to increase the scope of rules and reduce the scope of discretion.

Thus, discussions about the disclosure dividend (and about rules versus discretion) and the type of compliance culture (spontaneous versus forced compliance) refer to the same issue: how to achieve a given level of investor protection. They do so, however, from two different perspectives: regulators and regulated firms. It is only by shifting towards a culture of compliance where the spontaneous dimension prevails that the disclosure dividend and the attendant trade-offs are possible. The increased focus on the costs and benefits of regulation can be seen as one step aiming to encourage spontaneous compliance in order to set (and to maintain) the appropriate environment for the disclosure dividend.

**CONCLUSIONS**

This paper has discussed the impact of the introduction of CBA in financial regulation from the perspective of regulated firms. Firms' approach to regulation is reflected in their compliance culture. This is crucial for attaining a satisfactory level of investor protection and has been the subject of numerous discussions. Compliance culture has been characterised according to the goal that firms relate to it as either positive (best practice) or negative (management of regulatory risk). This is unsatisfactory since it does not characterise in a meaningful way the culture of the great majority of firms. This problem is explicitly recognised in Ruimschotel's table of eleven where compliance is characterised as a combination of spontaneous and forced compliance elements. The essence of the former is the best practice goal whereas the essence of the latter is the management of regulatory risk.

CBA has been used as an aid for decision making in the public sector for many years. Its application to financial regulation is more novel. Its practice brings a sharper focus on the benefits of regulation by making these explicit. Therefore CBA also makes explicit the basis of regulators' proportionality judgments. In addition, CBA encapsulates a non-
confrontational approach to regulation. Thus, the introduction of CBA emphasises the spontaneous compliance dimension which should have a beneficial long-term effect on firms' compliance culture. The assumption about a satisfactory compliance culture based on spontaneous compliance lies behind policy initiatives such as the disclosure dividend.

To sum up, while not claiming to provide a definite solution to the assessment of the benefits of financial regulation, this paper has shown that the introduction of a more systematic assessment of benefits should have an effect not only on policy formulation but also on the compliance culture of firms.

APPENDIX 1: TABLE OF ELEVEN
A. Elements of the spontaneous compliance dimension:

— quality of regulations: for example, whether the complexity of regulations may give an opportunity for noncompliant behaviour
— cost-benefit considerations: for example, the extent to which these are explicitly taken into account in the design of regulatory measures
— acceptability of regulations: for example, the seriousness of the loss that may be caused to investors
— norm conformity: for example, the habit of the target group to act according to prescribed norms
— informal control: for example, the degree of self-regulation and professional control
— spontaneous detection probability: for example, the probability that non-compliant behaviour would be uncovered without exercising formal controls.

B. Elements of the forced compliance dimension:

— control density: for example, the probability of being subject to some control
— detection probability: the probability of uncovering noncompliant behaviour when some kind of control is applied
— control selectivity: the relation between the number of events of noncompliant beha-

viour discovered when controls are exercised and the evidence in a control group
— sanction probability: for example, the difficulty of demonstrating noncompliant behaviour because of legal complexities
— sanction severity: for example, the severity of punishment.

REFERENCES
(2) This paper has been written in a personal capacity. The views expressed herein are the author's and should not be seen as reflecting the views of the Securities and Investment Board, of any of its members or of its staff.
(7) An example of this view, albeit in a different field, is the support of the ban on CFCs in 1990 by ICI and Dupont which are major producers of them. This support has been explained by the fact that these firms had already sunk large amounts in the search for alternatives (Barrett, S. (1991) 'Environmental Regulation for Competitive Advantage', *Business Strategy Review*, Spring, pp. 1–15).
University Press, Oxford, which relates CBA to financial appraisal.


(14) This characterisation of consumers’ behaviour is known in the field of economics as the ‘theory of the lemons’ (low quality second-hand cars in the US) and was initially developed by Akerlof in a seminal paper (Akerlof, G. (1970) ‘The Market for Lemons: Qualitative Uncertainty and the Market Mechanism’, Quarterly Journal of Economics, pp. 488–500). Its relation to regulation of financial markets is due to a paper by Llewellyn (Llewellyn, D. T. (1994) ‘Consumer Protection in Retail Investment Services: Protection Against What?’, Mimeo). Akerlof’s model shows that the asymmetries of information between sellers and buyers, the inability of buyers to distinguish between good cars and lemons, together with the inability of sellers to communicate in a credible manner the quality of the car can contribute to a reduction of the size of the market.
