

Impact Assessment Guidelines For EU Level 3 Committees

European Forum of Securities Associations ('EFSA')* Response to Consultation

August 2007

Introduction

EFSA strongly supports the development of these guidelines and welcomes the opportunity to comment on this draft. As co-signatories of the International Council of Securities' Associations' Principles for Better Regulation¹, we see the development of guidelines such as these as forming the core of a better regulation approach. In particular, they are a positive step towards the goal of ensuring that all regulatory initiatives are introduced only when clear evidence of a need has been established, and there is evidence that the regulation proposed is a proportionate response to this need.

Against a background of a growing and unprecedented regulatory burden in the EU there is a need for an approach to regulation that supports competition and consumer protection while at the same time avoiding unnecessary or excessive regulation. Well-judged regulation supports the proper functioning of markets and the appropriate protection of consumers, but regulators need to remember that since markets are the prime source of economic success, over regulation can all too easily undermine innovation and competition.

These guidelines help to deliver regulators' general commitment to Better Regulation, and are an indication of the Level 3 Committees' willingness to make this commitment. In that respect, we believe that the burden of proof is on them as regulators to show that regulation is necessary and proportionate, and not on the industry to show that it is not. This is the approach we support wherever regulation is being considered, particularly against the recent history of a plethora of regulatory initiatives.

Consequently, we welcome these Guidelines and the related Guidelines adopted by the Commission for Level 1 and Level 2. It is clear that substantial thought has gone into their

* The European Forum of Securities Associations (EFSA) comprises the French Association of Investment Firms ('AFEI'), the Italian Association of Financial Intermediaries ('ASSOSIM'), the London Investment Banking Association ('LIBA') and the Swedish Securities Dealers Association ('SSDA'). EFSA focuses on policy issues concerning European securities markets where working together adds value. See www.efsa-securities.eu

¹ The International Council of Securities Associations ('ICSA') – which is composed of trade associations and self-regulatory organizations active in the world's major financial markets – in 2006 published a set of best practice guidelines for improved regulation of the world's financial markets. These are available at http://www.icsa.bz/html/statements_and_letters.html, and are appended to this response.

development and if properly implemented we believe that they will support improved policy making by regulators. However, we do have comments on aspects of the Guidelines and these are set out below.

Governance.

1. In our experience, delivery of good IA in practice needs the support of a governance structure that:
 - Employs the use of expert IA advice that is (and is perceived to be) independent of the originators of any regulatory initiative. The purpose of this advice would be both to help policymakers with implementing IA and also to attest that key components of the IA process have been undertaken adequately;
 - Includes the use of an independent senior decision making body, separate from those initiating or responsible for the development of new policy, with the power to challenge decisions on whether or not to undertake IA or screening IAs, and prevent a policy initiative progressing where the IA or the approach taken to IA is inadequate.
2. Although the draft Guidelines set out 'working methods' for IA, these methods do not include a clear governance structure as above. This is an important matter for the final Guidelines to address.

Market Failure Analysis

3. We welcome the commitment to undertake market failure analysis ('MFA'), however we are not sure that the way in which MFA is communicated in the document is likely to be easily understood by non-economists, both in terms of what it is and how to do it. We are also concerned that the way in which MFA is defined (particularly with reference to perfectly efficient markets and the approach taken to information asymmetry) falls short of being a reasonable MFA test. In particular:
 - 'Perfect' markets do not exist in the real world, and the key MFA test for policy makers is not the existence or otherwise of the perfect market, but whether or not the relevant market is able to respond effectively to inefficiencies as they emerge;
 - Information asymmetries are not a market failure per se. There is a tendency amongst some to conclude that an information asymmetry is always a market failure and will lead to adverse consequences which require regulatory remedy. But some care needs to be taken on this point - a **wrong diagnosis and/or mistreatment of an information asymmetry could in fact create an externality market failure.** If information gathering is costly, or valuable knowledge arises as a consequence of undertaking a costly activity then information asymmetries may efficiently continue to exist if the person who might benefit from that information does not perceive the benefit as sufficient to compensate the person generating that information. In fact, information is only likely to be a source of market failure if it meets three criteria:
 - It is useful to users - e.g., it could change a decision to buy or sell;
 - These users are willing to pay for this information; and yet

- This information isn't available either at all, or at a price users are prepared to pay. (e.g. co-ordination problem or market power).
4. In general, we believe that non-economists reading the guidance on MFA in the draft Guidelines are likely to conclude, more often than they should, that a market failure is occurring. Moreover, given the statement on page 21 that '....regulation can only be justified by a market failure when it can improve on the market solution to that market failure. This is often but not always the case', they are likely further to reach an early conclusion, again more often than they should, that regulatory intervention will probably be justified.
 5. Hence we are concerned that the explanation of MFA in these Guidelines risks creating a bias in favour of regulatory intervention, and hence over-regulation. We attach, in the Annex to this response, a draft guide on MFA which EFSA Members are discussing with other Associations around the world, with a view to possible publication at a later date, as an example of the type of explanatory material that we feel is more accurate and accessible than the approach taken in the draft Guidelines. We would be happy to discuss this further with you.

Other points

6. Screening IAs will have an important role to play in helping the Level 3 Committees to prioritise discretionary projects, keeping them to a manageable number of matters of clear importance. We strongly support their inclusion in the IA process and are a little concerned that the language on whether or not to conduct them is too tentative – for example, the use on page 11 of 'may' instead of 'will' on such matters as whether to conduct a screening IA and informally consult with interested parties. On the latter point, we believe that significant further value can be gained by including informal pre-consultation with industry participants at this stage – not just for data gathering, but also to contribute views and research on the nature of the possible market or regulatory failure.²
7. It is important that a realistic time frame is set for IA. Where the Committees' work responds to a mandate from the Commission, the Committees will need to negotiate a realistic timetable with the Commission that allows for appropriate IA to take place.
8. Under the 'Limits of IA' on page 7, it is clearly appropriate to make the comment that IA should not become a substitute for decision making - that it is a tool for disciplined policy making but will not dictate the final outcome of a policy making process. However, we do think that the Level 3 Committees should commit to providing an explanation on those occasions, which we think would be rare, where the final decision (apparently) contrasts with the outcome of the IA in the consultation.
9. Notwithstanding a decision on whether or not screening / full IA's will be employed, we suggest that steps 1 and 2 as described in the IA process should always form part of the Level 3 Committees' decision making process as a matter of good policy practice – it is particularly critical to understand the nature of any market or regulatory failure that is being addressed in any regulatory action.

² Reference in the joint buy-sell-side research into European bond markets

10. Against a background of growing international awareness of the impact of regulation on competitiveness, the need that is addressed on page 56 for the IA process to consider the effect a proposed initiative may have on the competitiveness of the EU as a whole vis-à-vis non-EU jurisdictions, is particularly important, and could be brought more upfront in the Guidelines.
11. We fully support the 3L3 Committees' commitment to conducting CBA to ensure that regulatory action is only taken where there is a net benefit and that the least possible burden is placed on firms to achieve regulatory objectives. Care needs to be taken, however, with the assessment of costs, particularly in the prudential area, where the link between regulations and the price of financial services to consumers is very indirect. This same care needs to be exercised in section 1.4, which we think is a very important and helpful section of the Guidelines, but we would caution against too much emphasis being placed on the concept that increased costs flow directly into the prices offered to counterparties with consequent falls in the level of sales. Increased regulatory capital requirements will make business less economically attractive but prices will also be driven by a number of other factors such as level of competition in that segment of the market or interest rates. Hence assessing the impact of regulatory intervention is a challenging test
12. Finally, on the matter of costs, the consideration of implementation costs is particularly important and it would be useful for IAs explicitly to consider alternative implementation methods so as to improve the chances for these costs to be minimized. Also, with reference to the comment on page 7 that there is no need for an IA if the 'cost' is insignificant, it will be important for the definition of 'costs' to be universally accepted by the industry and regulators alike.
13. We may provide 3L3 with some further detailed observations on the Guidelines in the next few weeks in the light of our experience of CEBS's pilot market failure analysis in CP14 on large exposures

Annex – Draft Guide on Market Failure Analysis which EFSA Members are discussing with other Associations around the world.

Introduction

Market failure analysis is a type of economic analysis. It is important because it can indicate whether there is any prospect of a net benefit emerging from regulatory intervention. In particular, if regulatory intervention takes place when there is no market or regulatory failure, then that intervention will always impose net economic costs, no matter how carefully designed.

For this reason regulators are beginning to espouse market and regulatory failure analysis as a tool early in the policy formulation process to help them to determine whether there is a realistic prospect of a net economic benefit from regulatory action. We welcome these high-level commitments as marking clear progress in the broader cause of ‘better regulation’. However, much remains to be done to build clarity on what is meant by ‘market failure’ within the context of a proper burden of proof for intervention and the purpose of this note is to set out preliminary views on this question.

What is meant by ‘market failure’?

In considering market failure from a regulatory perspective, it is important to draw a distinction between the theoretical notion of market failure, which is helpful as an analytical tool, and a persistent ‘welfare loss’ arising from significant market failures that market forces are unable to resolve.

At the extreme, market failures arise when there are departures from economists’ notion of a perfectly efficient market. In an efficient market firms produce goods and services at the lowest possible cost in terms of resources used and consumers buy the goods and services they want at the minimum possible price for a given quality. Moreover, at this price, supply and demand are in balance. To the extent that market failures arise, there is a waste of resources otherwise known as a ‘welfare loss’.

In reality, all markets at any point in time exhibit some departures from the perfect market. Indeed, these departures are an essential feature of all dynamic and growing markets – the welfare loss creates profit making opportunities for market participants and in the vast majority of cases market participants can be expected to respond accordingly.³ It is only when this doesn’t happen and the welfare loss is significant, persistent and unresolved that one has a potential ‘market failure case’ for regulatory intervention.

In other words, the fact that a perfect market is unlikely to exist should not be a cause for regulatory concern: short-term welfare loss is not in itself a candidate for regulatory intervention. It only becomes a candidate if this welfare loss persists - market solutions are absent or partially ineffective.

Even then, regulation is unjustified if it does not improve the market outcome:

‘...regulatory action should only be taken when there is a market failure. Now this is in fact a weak definition of the circumstances of when regulatory action is justified, since all realistic markets – that is all markets which exist

³ For example, where a firm does not produce goods and services at the lowest possible cost for a given quality, another firm could be expected to take advantage of this opportunity to profit through competing on price.

in practice – have some elements of market failure...It is an argument too often deployed by those who favour intervention that any market failure justifies intervention. The strong – and to me correct – test goes beyond that: there must be both market failure and the prospect that intervention will provide a net benefit. This involves recognizing that regulatory intervention has a cost and ...a probability of failure. Identification of a market failure should not lead to the assumption that regulatory failure is less likely, or less costly. It is an open and empirical question, which needs analysis on a case by case basis.’⁴

Types of market failure

Central to an analytical understanding of market failure is the point that when markets are working well the price of any good or service will equal both the marginal cost and the marginal benefit of that product.

For analytical purposes there are three types of market failure that matter most in the context of financial markets. All of which involve sustained departures from the price equals marginal cost equals marginal benefit paradigm:

- buyers (or sellers) are not able to form reasonably accurate estimates of actual marginal benefit (marginal cost) leading to ‘wrong’ consumption (or production) decisions – imperfect or asymmetric information;
- ‘social’ marginal benefit or cost differs from the ‘private’ marginal benefit or cost leading to under or over provision of a good or service - externalities;
- market power on the part of seller(s) (or buyer(s)) means that price exceeds marginal benefit (marginal cost), leading to ‘excess profits’ (‘excess consumer surplus’) and under-provision of a good or service – monopolies / oligopolies (monopsonies).

Imperfect and asymmetric information.

Individual decisions are affected by imperfect information about quality, price and the future. Information is a source of market failure if it is understandable by, useful to but not available to the buyer or seller, despite willingness on the part of the buyer or seller to pay for the costs of producing that information. Importantly, in this context ‘useful’ means information that could change selling or buying behaviour as distinct from information that is a nice ‘optional extra’.

Externalities.

A good or service generates externalities if its production or consumption affects the welfare of people or firms other than its original producers or consumers without prices reflecting such effects. Externalities may be negative or positive. They are ‘negative’ for those on whom they impose costs and ‘positive’ for those who gain from them. Negative externalities occur when production decisions do not take account of all the costs flowing from that decision because these are costs not borne by the firm. The classic non-financial sector example is pollution from factories. The classic example of a negative externality in financial services is systemic risk, where the failure of one bank may lead to runs on other banks and hence to problems for those other banks and their customers.

Positive externalities arise when the decision to consume does not take account of all of the costs of production. If this market failure is sustained, production is too low. The classic non-

⁴ Callum McCarthy , ‘Delivering more transparent and better informed financial markets,’ 30 September 2004.

financial example is the production of television signals which, in theory, can be enjoyed freely by any consumer with a television set.⁵ Financial sector examples can in practice be those induced by regulation (leading to regulatory failure -more on this below). For example, in the bond market transparency debate a wrong diagnosis and/or mistreatment of an information asymmetry could in fact create externalities that lead to market shrinkage:

*'If information gathering is costly, or valuable knowledge arises as a consequence of undertaking a costly activity (e.g. taking an own account position) then differences in trading information may efficiently continue to exist if the person who might benefit from that information does not perceive the benefit as sufficient to compensate the person generating that information. Part of the analysis that underlies the potential for a negative relationship between mandated transparency and loss of liquidity relates to this point. In particular, mandated transparency in the above situation, without appropriate compensation, will remove the incentive to generate information, which in this case might be the incentive to maintain the provision of quotes in particular markets.'*⁶

Market power

Market power on the sell-side refers to the situation where revenues above the marginal cost of all production inputs, including the cost of capital, ('excess profits'), can persist rather than be eroded by competitive pressures. 'Excess profits' are also an expected outcome of the market failure of information asymmetry, in that an information asymmetry reduces the buy-side ability to put effective competitive pressure on sell-side.

A good example of how this analysis can aid 'market failure' decisions is found in the EU bond market transparency debate. An important observation in the analysis of the relevant European markets⁷ is the tightness of the bid-ask spreads (both quotes and actual trades). This finding suggests that the relevant markets are working well – neither the market failure of 'market power'/'excess profit' nor the market failure of persistent information asymmetries (warranting transparency regulation)⁸ would appear to be consistent with this finding.

The causes of sell-side market power can be either natural or induced. A natural monopoly / oligopoly will arise where the magnitude of the sunk costs acts as a barrier to entry, so reducing the degree of competition. Classic examples are the provision of clean water and railways. Artificial monopolies can result from public sector intervention, either in the form of raising entry hurdles for particular competitors (protectionism) or all potential competitors equally (e.g. 'fit and proper' conduct of business requirements).

Regulatory Failure

⁵ Obviously the potential for under-production in this case has been solved. It is a matter for separate debate as to whether the role played by the public sector was ever necessary given the plethora of market-led solutions to this market failure.

⁶ 13 Trade Associations' 15 September 2006 joint response to the EU Commission's call for Evidence on pre- and post-trade transparency provisions of the markets in Financial Instruments Directive (MiFID) in relation to transactions in classes of financial instruments other than shares. Available on the LIBA website: www.liba.org.uk

⁷ Centre for Economic Policy Research, 'European Corporate Bond Markets: transparency, liquidity, efficiency', May 2006.

⁸ More fundamentally, it is arguable that the markets covered by this research come close to the 'perfect market' requirements that price equals marginal cost equals marginal benefit.

‘Regulatory failure’ itself is used as an economic justification for intervention. For example, the economic justification for MiFID was the prevalence of public policy barriers preventing the emergence of a single market for financial services.

More generally, market failure and regulatory failure are closely related considerations. Regulatory interventions generally do increase the cost of producing financial services and often, through conduct of business and prudential requirements, create barriers to entry which reduce competition, increase costs to consumers and lead to under production. Consequently, any regulatory intervention which does not respond to a market failure or does not respond proportionately to a market failure, or ‘crowds out’ a market forces response to a market failure will impose net economic costs.

Approach to using Market Failure Analysis to determine the case for intervention

In order to avoid an intervention whose economic costs are higher than expected, or whose benefits are lower than expected, it is important to ensure that the market failure analysis includes the following two stages:

- assessment of the nature and magnitude of the market failure, using data wherever possible; and
- analysis of whether or not market failures are likely to be corrected by market forces.

Evidence of significant market failures might include:

- a wide dispersion of market prices for essentially the same product (including risk profile);
- persistent ‘excess profits’; and
- persistent mis-match between risk and return.

Even when there is a significant market failure, factors weighing in favour of no intervention include:

- evidence that the market failure has arisen only recently;
- the recent introduction of other regulation likely to mitigate the market failure; and
- evidence that the market is able to discern and respond to the market failure – for example new entrants, products, and technology.

Conclusion

Market failure analysis is a useful tool to help regulators deliver effective regulation. In particular, it encourages regulators to put forward proposals for regulatory intervention only where these can be accompanied by credible economic evidence pointing to:

- The presence of significant market problems that are unlikely to be mitigated by market forces over a reasonable period of time; and
- A strong likelihood of a net economic benefit from any regulatory action.