

Learning from Regulatory Disasters

Professor Julia Black
London School of Economics and Political Science
Sir Frank Holmes Fellow, Victoria University of Wellington

Sir Frank Holmes Memorial Lecture
1st April 2014

Outline

- Regulatory disasters and other failures – some examples
- The puzzle..
- Ways to fail
- Reasons for failure
- Analysing the dynamics of regulation: an elemental framework

Regulatory 'disasters' – some recent examples

- Not every disaster is a regulatory disaster, but some disasters have significant regulatory elements
 - NZ – leaky buildings
 - NZ – Pike River mining tragedy
 - US – Deep Water Horizon oil spill
 - UK – Mid Staffordshire hospital
 - UK – Buncefield chemical explosion
 - UK, US, EU – financial supervision
 - and there have been many more..

But regulation can fail in less dramatic ways too..

- Regulation can:
 - Prompt displacement of the activity to an unregulated area
 - Lead to avoidance & ‘creative compliance’
 - Produce negative spill-over effects
 - Lead to over-deterrence
 - Create perverse incentives
 - Create moral hazard
 - Exacerbate what it is meant to ameliorate
 - Interact negatively with other regulatory regimes
 - Others..

How to avoid failures? There are some regulatory 'no-no's

There are some regulatory 'no-no's:

- Command and control regulation
 - Pervasive, but the 'better regulation' movement suggests a well known list of alternatives
 - Better
 - Smarter
 - 'right touch'
 - And governments demand less regulation (whilst creating more of it, often in the CAC mode)
 - Red tape challenges
 - One in, one (or two) out
 - etc

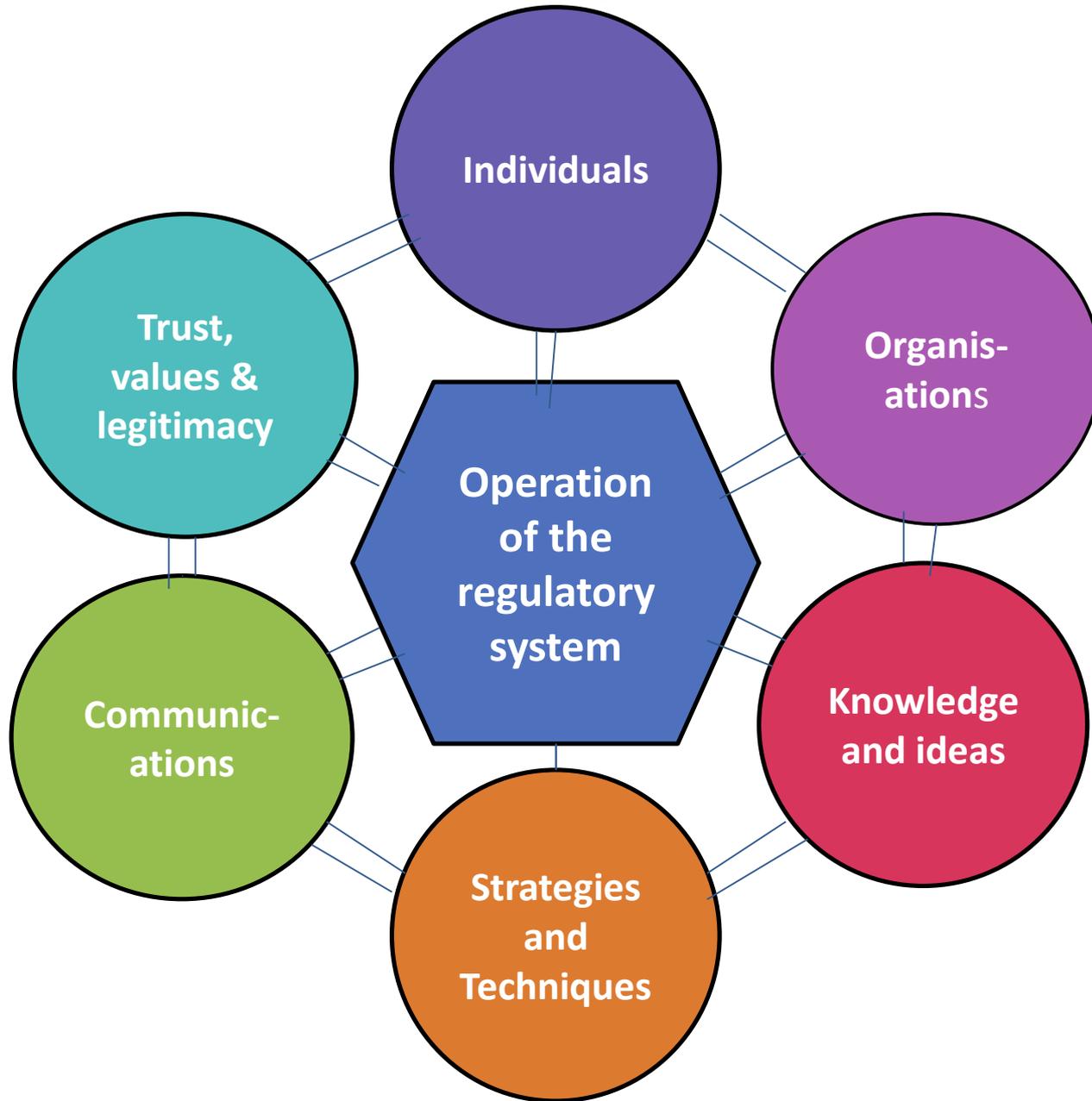
The puzzle..

- Even when regulation is trying by design to be ‘better’ or smarter’, it can still fail
 - Eg Many aspects of pre-crisis UK financial regulation, for example, fitted the text book model of ‘smart’ or ‘new governance’ regulatory techniques:
 - Principles based regulation
 - Management based regulation
 - Enrolment / co-regulation
 - Risk based regulation
- Why?

Common sources of failure

- Analysis of regulatory disasters suggests six frequent factors, operating individually or interacting:
 - the behaviour of individuals
 - the organisational dynamics of both the regulator and regulated firms, internally and in their inter-relationships
 - knowledge, ideas and understandings / assumptions about the problems and appropriate potential solutions
 - the internal tensions, ambiguities and contradictions of the strategy adopted to address the problem
 - failures in communication about what conduct is expected and permissible
 - lack of acceptance of the regulatory regime by regulatees / lack of trust between regulator and regulatees
- Analysing further – failures correspond to the six core elements which interact to produce regulatory regimes (for those who are watching closely – a slight re-configuration of the first 3 RRR elements)

Six Elements of Regulatory Regimes



Individuals

- Element
 - Actions of individuals (both regulators and regulatees) are shaped by the interplay of interests, values and social context (widely defined), and by inter-personal interactions
 - Their actions and interactions contribute to producing and sustaining regulation – so their behaviour and attitude to it is important
- Role in regulatory failures include:
 - Inappropriate / inadequate knowledge and skills
 - Linked to poor training and or low levels of education
 - Linked to comparative levels of pay and reward within public sector and between public and private sector
 - Individual ‘mavericks’ or ‘rogues’ – relatively rare
 - Decision making behaviours with respect to risk
 - Overriding safety procedures as seen as ‘nit picking’ or unnecessary
 - Often complex interaction between individuals and the organisational context in which they are operating
 - Role of cultures, systems and incentives

Organisations

- Element
 - Organisations' systems and processes are mechanisms which translate individual actions into collective action by enabling them to be sustained over time
 - Significance of internal dynamics of regulated organisation(s) AND regulatory organisation(s), AND interrelationships between the two
 - Significance of organisational power and powers (legal and in practice)
- Role in regulatory failures
 - Usually fundamental, in numerous ways – and evidenced in both regulators and firms
 - Priorities – related to market and political pressures
 - Conflicts of interest
 - Maturity of the individual business and familiarity with being regulated / maturity of the regulator

Organisations cont.

- Expertise and organisational capacity
 - Effectiveness of internal board oversight and governance
 - Culture and willingness to address failings
 - Responsiveness to internal or external criticism
-
- Within regulatory systems particular issues of
 - Coordination and managing system complexity
 - Information flows
 - ‘Ownership’ of responsibilities and problems
 - Legal powers and mandates
 - Business model
 - Implications of fees or structure of costs-recovery mechanisms

Knowledge, ideas and understandings

- Element
 - States of knowledge
 - Issues of legibility (how well do regulators know the market / context of the actors they are regulating?)
 - Risk and uncertainty
 - How is knowledge being produced?
 - What are the understandings / assumptions of the nature of the problem and ‘best fit’ solutions?
- Role in regulatory failures
 - Includes but goes well beyond lack of information to
 - inappropriate assumptions as to how firms & the market operate (eg rational actor and efficient market assumptions)
 - Failure either to see or to recognise significance of early warning signals
 - Understanding and prioritisation of risks – micro and macro

Strategies and techniques

- Element
 - ‘Technologies’ of regulation
 - Norms – rules, principles
 - Numbers – calculations, models
 - ‘Nuts and bolts’ + IT systems, software
 - Monitoring techniques
- Role in regulatory failures includes:
 - Mismatch in problem and solution, eg
 - Inappropriate models, product or technology specifications / bad science
 - Inappropriate processes and protocols
 - Rules - mis-targetted; wrong type (eg principles not supplemented with guidance / rules); confused - combining minimal with aspirational standards

- Conflicting strategies adopted
 - Interaction ‘on the ground’ produces negative effects
- Inappropriate / inadequate monitoring
 - Focusing either on on-site inspections or systems and processes reviews, but not joining them up
- Mismatch of strategy and context of implementation
 - ‘Cannot have principles based regulation for people who have no principles’
 - Degree of support that industry / types of firms need to know what to do
 - Implications for PBR, MBR and OBR strategies

Communication

- Element
 - Communicating standards of behaviour through regulatory norms and regulatory conversations
 - Signalling by both regulator and regulatee of their regulatory stance
 - Constructing identities
 - Managing regulators / managing regulatees
- Role in regulatory failures includes:
 - Lack of communication through rules, guidance or inter-personal conversations means standards, goals and expectations are not understood
 - Confused / inappropriate signalling
 - Eg emphasis on 'minimising costs'
 - Differences in communications at different levels of regulatory and regulated organisations

Trust, values and legitimacy

- Element
 - Goals and values
 - Legitimacy as acceptance of right to govern
 - Building trust
- Role in regulatory failures includes:
 - Prioritisation of goals or risks
 - Eg financial considerations over safety or quality
 - Occupational H&S over major hazards
 - Retail financial product misselling over prudential supervision
 - Lack of trust between regulator and regulatee
 - Too much trust between regulator and regulatee

So where to next?

- The six elements of regulation recalled:
 - Individuals
 - Organisations
 - Knowledge, ideas and understandings
 - Strategies and techniques
 - Communications
 - Trust, values and legitimacy
- Through their interactions they produce the dynamics of the regulatory regime, for both success and failure

Summary and conclusions

- The elemental analysis does not provide a menu of solutions but a framework:
 - for analysing deep rooted causes of failures
 - for analysing current regulatory dynamics
 - for thinking about what ‘success’ would look like
 - for thinking through the potential operation of any changes within the regime
 - for breaking away from the ‘architecture’ and ‘toolbox’ approaches to ‘fixing’ regulatory problems
- Is changing the way we think about and ‘do’ regulation easy? No.
- Is it needed? Yes!