

# Regulation: Learning from Paradoxes and Failures

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# Outline

- The puzzle..
- Ways to fail
- Reasons for failure
- Analysing the dynamics of regulation: an elemental framework

# Regulatory 'disasters' – some recent examples

- NZ – leaky buildings
- NZ – Pike River mining tragedy
- Australia – failure of HIH insurance company
- US – Deep Water Horizon oil spill
- UK – Mid Staffordshire hospital
- UK, US, EU – global financial crisis
- 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
  - Produce negative endogenous effects from interactions 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

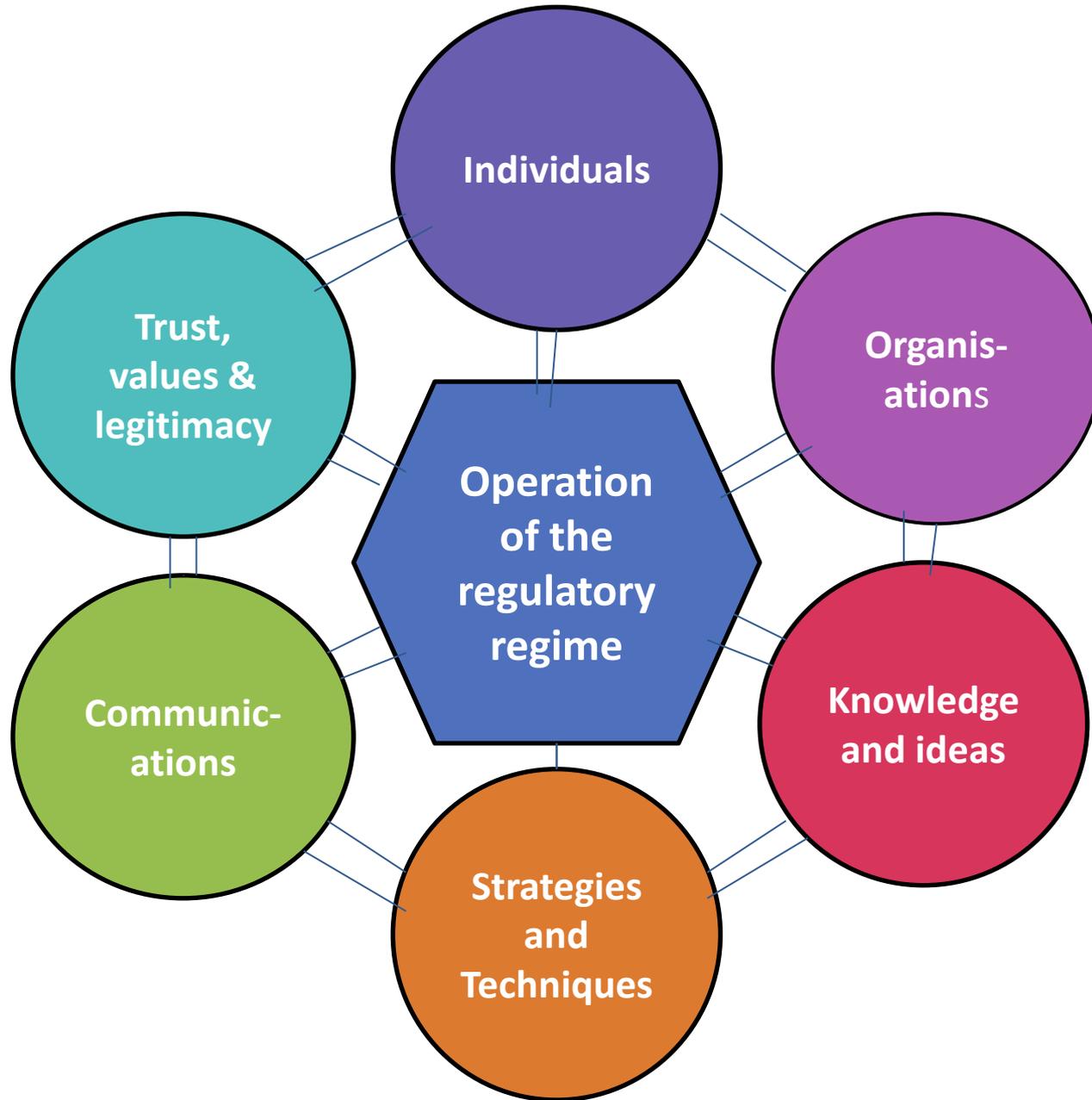
# The puzzle..

- Many aspects of pre-crisis UK financial regulation, for example, fitted the text book model of ‘smart’ or ‘new governance’ regulatory techniques, eg
  - Principles based regulation
  - Management based regulation
  - Enrolment / co-regulation
  - Risk based regulation
- Yet, they all failed in one way or another – why?

# Common sources of failure

- Individually and in their interaction these include:
  - 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

# Six Elements of Regulatory Regimes



# Individuals

- Focus
  - Actions of individuals shaped by 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 attitude to it is important
- Role in regulatory failures..
  - ‘Relational’ capture
  - Individual ‘mavericks’ or ‘rogues’
  - Decision making in situations of risk and uncertainty
  - Often complex interaction between individuals and the organisational context in which they are operating
- Developments in understanding
  - Behavioural economics
  - But also role of social factors eg status, social networks
  - Complex issues of culture and ethics

# Organisations

- Focus
  - Organisations' systems and processes as 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..
- Developments in understanding
  - Focus on structures and processes of both regulatee and regulator
  - Role of social dynamics and power relations in undercutting / overriding formal structures increasingly recognised but difficult to access from the outside
  - 'Culture' less tangible, harder to identify and to change, from the inside or the outside

# Knowledge, ideas and understandings

- Focus
  - 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)
  - Role of ideas (and fashions and fads) and ‘cognitive capture’ in the analysing problems and crafting solutions
- Developments in understanding
  - How often do crises prompt radical re-evaluations of knowledge, ideas and understandings?
    - Some evidence
  - Are these sustained once the effects of the crisis have been remedied / contained, and political & public attention has receded?

# Strategies and techniques

- Focus
  - ‘Technologies’ of regulation
    - Norms – rules, principles
    - Numbers – calculations, models
    - ‘Nuts and bolts’ – IT systems, software
- Role in regulatory failures
  - Mismatch in problem and solution, eg
    - Inappropriate models / bad science
    - Inappropriate processes and protocols
    - Mistargetted rules
  - Conflicting strategies adopted
    - ‘logics’ conflict
    - Interaction ‘on the ground’ produces negative effects
- Developments in understandings
  - Norms: oscillations through different regulatory approaches: PBR, OBR, judgement based; paradoxes and failures of different strategies
  - Numbers: construction of calculations – still trying to open the box; role of models – increase awareness of issues, but complex to address
  - ‘Nuts and bolts’ – as a focus and as a strategy of regulation – work in progress

# Communication

- Focus
  - 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
  - Lack of communication through rules, guidance or inter-personal conversations means standards, goals and expectations are not understood
- Developments in understandings
  - Modes and systems of communication – in progress
  - Clarity and consistency of messages – need for management on a 'macro' and 'micro' level throughout the organisations (regulator and regulated) and between them

# Trust, values and legitimacy

- Focus
  - Legitimacy as an endowment: regulators and firms need to earn legitimacy from multiple legitimacy communities with conflicting legitimacy demands
  - Strategies for building reputation, building trust
- Role in regulatory failures
  - Decision making with a view to maintaining reputation / legitimacy in the eyes of particular ‘legitimacy communities’ or key individuals
  - Lack of trust between regulator and regulatee
  - Too much trust between regulator and regulatee
- Developments in understandings
  - Attempts to shape understandings of politicians and the public as to what counts as success and what counts as failure are attempts to build reputation / legitimacy and trust
  - But trust and legitimacy are fragile at best

# So where to next?

- The six elements of regulation recalled:
  - Individuals
  - Organisations
  - Knowledge, ideas and understandings
  - Strategies and techniques
  - Communications
  - Trust, values and legitimacy
- Elements constitute and are constituted by activities and processes of each element and by the interactions with the other elements
- 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 through the potential operation of any changes within the regime
  - for breaking away from the 'toolbox' approach to 'fixing' regulatory problems
- Is changing the way we think about and 'do' regulation easy? No.
- Is it needed? Yes!