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 textbook 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 permissable
  – 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

- Trust, values & legitimacy
- Communications
- Strategies and Techniques
- Knowledge and ideas
- Organisations
- Operation of the regulatory regime

Individuals
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!