LEARNING FROM REGULATORY FAILURES

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Outline

- Regulatory disasters and other failures – some examples
- Ways and whys of failure
- Where to next?
Regulatory failures – some examples

Deep Water Horizon, US

Leaky homes, NZ

Pike River mine, NZ

Financial crisis

Buncefield explosion, UK

Stafford Hospital, UK
Ways of failing: characteristics of regulatory failures

- Range from single events to systemic failures
- Range from low probability, high impact events, to events which are high probability and low impact per individual, but cumulatively have a high impact
What’s a failure, what’s a disaster?

- Regulatory disasters
  - *catastrophic events or series of events which have significantly harmful impacts on the life, health or financial wellbeing of individuals or the environment, caused, at least in part, by a failure in the design and/or operation of the regulatory regime put in place to prevent their occurrence*

- Regulatory failures have harmful effects of a lower magnitude and/or duration

- Neither includes political or reputational ‘disasters’: those events which are harmful to the reputation or continued existence in power for the politicians or regulators involved – these may be a side effect but are not integral to what constitutes a ‘regulatory disaster’
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
  - And more..
‘Why’s’ of failure: common sources of contributors to failure

- Organisational capacity and dynamics
- Inappropriate Strategy / Techniques
- Ideas and understandings
- Communication failures
- System design and operation
- Individual behaviours
Organisational capacities and dynamics

- **Element**
  - 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, but failure often starts at the top
  - 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
Organisational failures – micro to macro

■ Inadequate expertise of staff
  - *Eg Care Quality Commission in the UK*
  - *Financial Services Authority, UK*
  - *Mining inspectorate, Pike River*

■ Conflicting experts, or generalists vs specialists
  - *Eg Buncefield (environment vs health and safety)*
  - *Pike River (generalists vs specialists)*

■ Operational failures – pervasive
  - *Eg Poor inspection management*
  - *Data: inappropriate and inadequate data, inability to use data (eg scale, incompatible databases)*
  - *IT: inadequate IT systems*
  - *Information flows – information dissipates as issues move up the organisation*
Organisational failures cont.

- Organisational cultures and ‘soft’ power structures
  - Undercut mandates and formal processes; role of reward structures

- Conflicting frameworks
  - Multiple organising frameworks operating simultaneously

- Failures to manage risks strategically – problems crowd out risks
  - Favour the ‘here and now’ rather than the ‘possibility in the future’

- Weak / inadequate Board governance and oversight – in regulators, overseers and firms
  - Care Quality Commission, UK; Financial services, UK; Pike River, NZ
Strategies and techniques

■ Element
  - ‘Technologies’ of regulation
    ■ Norms – rules, principles
    ■ Numbers – calculations, models
    ■ ‘Nuts and bolts’ – IT systems, software

■ Role in regulatory failures includes:
  - *Mismatch in problem and solution, eg*
    ■ Inappropriate models / bad science
    ■ Inappropriate processes and protocols
    ■ Mistargetted rules
  - *Conflicting strategies adopted*
    ■ ‘logics’ conflict – eg tricky interplay of PBR and tough enforcement
    ■ Interaction ‘on the ground’ produces negative effects and trade-offs, eg profit vs safety
  - *Every technique has its Achilles heel..*
Weaknesses in technique - examples

- Prescriptive and mandated rules in statutes
  - Deep Water Horizon: so shifted to management based regulation
  - But in the case of NZ leaky buildings – rapid deregulation and removal of rules without any substitute left significant gaps in understandings as to what was an appropriate set of standards for safe and durable buildings

- Management based regulation
  - Advantages of flexibility, and express reliance on management
    - But disadvantage of reliance on management when incentives are not aligned (especially if regulator thinks they are aligned), eg financial services regulation, Pike River
    - Can produce over-reliance on auditing systems and processes – hence move to outcomes based regulation

- Principles based / Outcomes focused regulation
  - But need guidance on how to achieve outcomes (Pike River) and how they will be assessed (Care Quality Commission)
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)
- Role of ideas (and fashions and fads) and ‘cognitive capture’ in the analysing problems and crafting solutions

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Knowledge, ideas and understandings - examples

- Key issue in regulation of risk
  - Financial crisis – fundamental misapprehensions about the operation of markets: ‘collective failure of imagination’
  - What risks are recognised?
    - Buncefield – societal risks not recognised in the regulatory regime
  - What risks are known, known unknowns and unknown unknowns
  - What risks are tolerated?
    - High impact / low probability risks vs low impact / high probability risks
    - Regulatory regimes often operate politically on a zero-failure basis, eg health
      - Implications for design, resourcing and public expectations
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 / misappropriate signalling
  – Differences in communications at different levels of regulatory and regulated organisations
  – Mixed messages across the system
Communication failures - examples

- Operational communication failures within and between organisations
  - *Linked to operational failures, above*

- Macro-level: multiple players sending mixed messages:
  - *Contradictory messages from the ‘deregulation agenda’*
  - *Is the regulatory system setting minimum standards or aspirational standards to drive higher quality performance?*
    - NZ building regulations
    - Care Quality Commission & Mid Staffordshire Trust
  - *How to manage the relationship with regulated firms?*
    - Facilitate economic growth and reduce costs of compliance yet maintain high standards of performance to achieve regulatory objectives
    - Trade-offs in the ‘regulatory dividend’ approach
System failures

Failures are often connected to wider political and legal elements of the system as a whole, eg

- Legal mandate
  - *Too expansive for capacity of the organisation*
    - Care Quality Commission, UK
  - *Creates conflicts of interest / priorities*
    - Minerals Management Service, US: royalties from licences vs environmental protection
  - *Fragmented and / or inadequate scope – mandate of any one regulator does not cover all the risks that the activity poses*
    - Buncefield explosion, UK – systemblindness to societal risk
    - Pike River, NZ – licensing organisation not required to take health and safety into account
System failures cont.

- Resources and business model
  - *Minerals Management Service: safety regulation ‘on a starvation diet’*
  - *Pike River – inspection service merged with Dept of Labour and funding reduced*

- Complexity of the regulatory system, including accountability structures
  - *Political context influencing decisions*
  - *Dynamics of the ‘blame game’*
So where to next?

- Regulators (and risk & compliance folk) need to be aware and take account of respond to the key elements of regulatory systems:
  - Incentive effects on individuals in both regulators and regulatees
  - Organisational capacity and dynamics
  - Strengths and weaknesses of different regulatory techniques
  - Knowledge and understandings of risks and operating environment
  - Role of communication
  - System dynamics
  - Interactions and changes in all or any of these

- A challenging agenda, but a necessary one