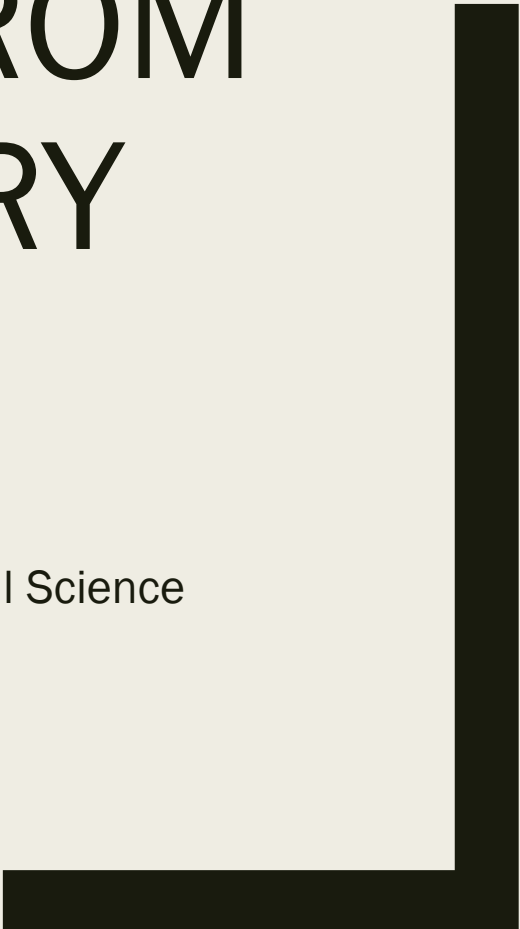


LEARNING FROM REGULATORY FAILURES

Professor Julia Black

London School of Economics and Political Science



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*

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 / inappropriate 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 – system blindness 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