

Regulation, the Civil Service and the Coalition Government:

Regulation in Crisis?

These are Martin Stanley's speaking notes for a presentation made at a seminar organised by the Regulatory Policy Institute on Friday 10 December 2010.

Introduction

We are all paying for the greatest regulatory failure in history.

And yet there are also serious concerns about over-burdensome regulation.

And there is persistent criticism of a wide range of regulators, including not only the FSA but also Ofgem, OFT, Ofsted, the Audit Commission, and the Care Quality Commission. Not to mention BP's regulator's in the USA, and the SEC (Bernie Madoff).

My intention is briefly to review these concerns against the background of the new government and its official machine. And then consider how regulatory policy might develop over the next few years, including the proposed merger of OFT and CC.

Disclaimer: I am an observer, interested in long term trends. This presentation is about how regulators and regulation is perceived by outside observers. I do not claim that outsiders' views are necessarily well informed, but it is nevertheless important to be aware of them.

Let's start by defining our terms, and examining the relationship between civil servants and Ministers.

Election & Coalition

The financial crisis helped bring down the previous government, leading to an election that – some said - no sensible politician would want to win. The Whitehall mandarins appear to have handled the transition very well. As did politicians – coalition agreement within one week.

But some strains have inevitably become apparent - university fees, nuclear policy. And there will be tensions between politicians and their immediate civil service advisers. These too are inevitable given civil servant's constitutional role in the UK – to 'speak truth unto power'. Back in the 1800s, T H Green stressed that, as politicians are inevitably subject to short term and selfish pressures, there needs to be a unified administration in which officials ensure the common good or public interest. And Haldane, after the end of the First World War, said that the relationship between civil servants and Ministers should be one of mutual interdependence. Ministers provide authority and officials provide expertise.

Regulators have much the same relationship with those who write the legislation governing regulators' responsibilities, which leads me to consider:

Current Perceptions of Regulation

Some recent regulatory failures have been extraordinarily serious, and all have raised real concerns about the effectiveness of regulators and their staff. This is a list of some regulatory issues which have been of concern to politicians.

- Health care – esp. Stafford Hospital
 - “patients were left unwashed in their own filth for up to a month as nurses ignored their requests to use the toilet or change their sheets;
 - four members of one family, including a new-born baby girl, died within 18 months after blunders at the hospital; and
 - wards were left filthy with blood, discarded needles and used dressings while
 - bullying managers made whistleblowers too frightened to come forward.”
- Energy prices
 - Ofgem appear not to have the investigation powers necessary to tackle tacit collusion – esp. the power to gain information about prices paid for gas purchased overseas – and yet appear steadfastly determined not to refer the industry to the CC.
- Financial regulation
 - Say no more!
- The burden of regulation – especially on smaller firms and on individuals
 - Concerns on this front have not diminished, despite every effort by the Better Regulation Executive
- Cartels
 - The existence of Article 101/Chapter 1 no doubt has a huge deterrent effect. But, beyond that, OFT's huge investment in investigation and prosecution appears to have produced meagre results.
- Markets
 - Almost no Competition Commission (CC) references for several years.
- Cost
 - ‘Regulation’ is now a hugely expensive business, not only for industry, but also for government.
- Delay
 - Cartel and abuse of dominance investigations seem to take forever. And the results of the once reasonably efficient OFT/CC merger and market investigations are now routinely appealed to the CAT, adding hugely to overall timescales.
- Inter-regulator politics.

- Relations between the OFT and the CC became very poor once the OFT deployed its greatly increased (post-Enterprise Act) resources onto work previously regarded as CC territory.
- Separately, the utility regulators (and their industries) remain very reluctant to refer their issues to the CC.
- And the CC has remained somewhat insensitive to the concerns of regulators – especially the CAA, whose CC references are mandatory.

But some regulators have been able to enhance their reputations. The current and former Information Commissioners come to mind, as does the CAA for its handling of problems caused by the Icelandic volcanic cloud, and its refusal to relax previous guidelines without clear advice from the airframe and engine manufacturers. The Authority and its Chief Executive Andrew Haines were nevertheless unfairly pilloried by some in the aviation industry. His response was perfect: "We will not listen to those who effectively say 'Let's suck it and see'"! If only there were more like him!

What are the causes of regulatory catastrophes?

Herd behaviour – regulators as well as regulated. This was most obvious in the run up to the current financial crisis. There were plenty of warnings – unprecedented leverage, huge growth in shadow banking system, November 2006 Treasury/FSA/Bank 'war game',

Ex post punishment seems ineffective – whether by regulators or the market. Note Greenspan's erroneous faith in self-correcting markets. It is only natural for business people to hope that consequences will arise on someone else's watch. And they usually regard their reputation as just as (or more) important than any potential financial cost.

What happens when Transparency meets Blame Avoidance?

Professor Christopher Hood argues that the pervasive prescription of transparency and accountability as a universal prescription for good governance might lead to highly undesirable consequences when accompanied by blame avoidance by regulators and others in the public eye. The suggestion is that there is a strong 'negativity bias' - so that fear of attracting blame way outweighs the attractions of bold and effective political or regulatory decision making. This encourages regulators to avoid making contestable or appealable judgements that create obvious losers. Negativity bias also encourages regulators to develop policies and bureaucratic routines that minimise the risk of institutional or individual liability and blame. And they introduce protocols and automaticity which minimise the exercise of individual discretion by both staff and senior officeholders.

And we should surely pay more attention to **regulatory psychology**. See <http://www.regulation.org.uk/psychologyofregulation.pdf> for a fascinating and very readable introduction to this subject by Mannie Sher.

Possible Responses

I can think of six ways in which politicians might conceivably respond if they perceive the above problems, and if regulators themselves fail to improve their performance. In no particular order ...

1. **Address the size and structure of regulators.** There has been a persistent, and in my view counterproductive, tendency for politicians to believe that 'bigger means better' regulators. This has led to the Boards and senior managers of the larger regulators losing touch with what is done in their name, and losing understanding of the subtleties and devilish detail inherent in their complex tasks.

But there is (perversely and unfortunately) much to be said for the proposed merger of the competition arm of the OFT and the CC to form a new Competition and Markets Authority (CMA). The two authorities worked very well together before the Enterprise Act, but its additional resources encouraged the OFT to increase the depth of its Phase 1 merger investigations and introduce its non-statutory market investigations, and so begin to take decisions based on much less analysis, information and consultation than if the matters had been referred to the CC. As Ministers and government officials felt it impossible to require the OFT to revert to its previous role, the only other way to tackle the problem was to merge the two bodies. But this decision raises a number of interesting questions which will be dealt with in a genuinely open consultation early in 2011:

- How can the new CMA maintain the CC's robust independence, free of confirmation bias, sunk cost bias, momentum bias and group think and avoid the accusation that it has been created prosecutor, judge, jury and executioner? (See <http://www.regulation.org.uk/philevansspeech.pdf> for Phil Evans' thought provoking review of this issue.)
- Should Phase 2 investigations continue to be controlled by independent CC 'Members' rather than professional staff?
- If so, how many Members should there be?
- Also if so, should Members oversee the later stages of cartel and abuse of dominance cases? Their independent views would be valuable, but it would be unfamiliar and arguably trickier territory.
- The legislation necessary to create the CMA might also be used to introduce pre-notification of larger mergers (thus avoiding the problems which occur when the CC has to unravel completed mergers), and/or
- abolish the very-hard-to use criminal cartel offence (though it is still said to have a strong deterrent effect) and/or
- remove the ability of the 'concurrent' utility regulators to investigate cartels and abuse of dominance, leaving this to the experts currently in OFT.

2. Legislation might be introduced which ensures **Better Case Management** undertaken by tougher staff, backed up by a CAT which reaches speedier decisions and recognises that Parliament wants regulators to make many economic judgements (e.g. about the likely effect of a merger, or a new market structure) which cannot be proved to traditional legal standards.

[A participant in the RPI seminar pointed out that Ofcom have already argued that the communications industry should no longer be allowed to appeal to the CAT 'on the merits' of their decisions. Challenges should instead be restricted to judicial reviews of process and reasonableness. This would be a major departure and possibly contrary to human rights legislation which generally requires governments to ensure that decisions can be appealed, on their merits, to a higher tribunal or court.]

3. **Get industry to pay a greater share of the cost of regulation?** This must be very tempting given the current economic and political climate. Interestingly, the Food Standards Agency has recently announced that it would like slaughterhouses to pay the Agency's full costs of ensuring meat hygiene and welfare, even though such regulation is mainly for the public good. This has in turn led the industry to criticise the Agency's cost base and suggest that its role should be reduced to the minimum necessary to maintain its status as an EU 'competent authority', letting contracts through which private sector companies would compete to enforce regulation.

We can surely expect to see further such debates in future.

4. **More effective intervention and punishment?** Should there be more 'ex ante' intervention in the regulation of certain industries, and/or much more scary retribution for those executives and companies that misbehave?

5. **More effective political oversight?** Despite pressure from the House of Lords, there is no one Parliamentary committee nor one government department responsible for looking at regulation in the round – i.e. looking at the sort of issues covered in this presentation. (See <http://www.regulation.org.uk/regaccountability.shtml> for further detail.)

6. **A Different Approach to the Regulation of Large Organisations?** Cranfield's David Parker was perhaps the first to suggest that, rather than invest in yet more detailed and intrusive regulation, there might be a lot to be said for introducing a (Company Law?) requirement that larger companies should behave ethically and responsibly. This would raise some interesting drafting challenges but it is interesting that Ofgem has already introduced a 'marketing licence condition' into some of its licences, stipulating that energy suppliers must:

- not sell a customer a product or service that they do not fully understand or that is inappropriate for their needs and circumstances, and ...
- not offer products that are unnecessarily complex or confusing, but must ...
- make it easy for customers to contact their supplier, and ...
- act promptly and courteously to put things right when the supplier makes a mistake.

[One participant in the RPI seminar called this 'spirit of licence regulation'!]

And FSA Chairman Lord (Adair) Turner, wrote this in the FT on 7 December 2010:

[RBS Executives were] doing what executives and boards in other sectors of the economy do: sometimes getting judgments right and sometimes wrong. But banking is not like other sectors. The fact that many banks made decisions in the same way as other companies was itself a key driver of the crisis, a big problem, but not one that regulators had adequately identified. In some other sectors we want bold risk-taking, which might sometimes result in failure, shareholder loss or even the danger of bankruptcy. But banking is different.

Failure in banking, or even the threat of failure offset by public intervention, carries huge economic costs quite different from non-banks. The question is should we reflect these fundamental differences in a more explicit recognition that the attitude of bank boards and executives towards risk-return trade-offs should be different from other sectors, and should we create incentives to adopt this different attitude? It would, for instance, be possible to set a rule that no board member or senior executive of a failing bank will be allowed to perform a similar function at a bank unless they can positively demonstrate to the regulator that they warned against and sought to reduce the risk-taking that led to failure.

But achieving a general shift in attitudes to risk and return may require that bank directors and executives are made subject to quite different incentives than those that are appropriate in other sectors of the economy.

Such an approach – if it could be implemented more widely than just the financial services industry - would make the directors of certain regulated companies behave much more ethically than now, would lower regulatory costs and would in effect be policed by the company's lawyers and other advisers. Who could possibly object?!

For further discussion of the issues raised in this talk, please see <http://www.regulation.org.uk> and <http://www.civilservant.org.uk>.

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