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Regulation, Regulators, and the Crisis of Law and Government

The Purposes, Organization, and Supervision of Regulators

Implications for Accountability and Liability

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Executive Summary

- The task of a modern regulator is unquestionably a difficult one. Regulators often make decisions in highly charged political environments and in contexts of significant uncertainty, and they are required to balance the views of vociferous and often powerful interest groups.

- At the same time, regulators are increasingly powerful institutions in many societies. As recent events in the financial sector have demonstrated, the action or inaction of regulators can profoundly affect lives and livelihoods. It follows that regulators must operate within well-designed frameworks of accountability and liability.

- The underlying purposes of regulators are diverse, reflecting the various reasons for which different regulators have been established. While some are focused on the potential exploitation of economic power, others are focused on safety, or the mitigation of future environmental risks. Some regulators are established with imprecise or overlapping, and potentially conflicting, objectives and purposes. This has implications for the complexity of decision-making, and therefore for issues of accountability and liability.

- The organization of regulators can impact on accountability and liability. Issues of accountability are complicated where different regulatory bodies share powers and responsibilities (a feature of the regulatory architecture that pertained to financial markets supervision prior to the 2008 financial collapse). In addition, the internal organization of an agency, in particular the organizational culture and internal working practices, can substantively affect regulatory decision-making.

- Various mechanisms of oversight of regulatory agencies exist in principle. These include general oversight by parliament, scrutiny through independent reviews, or through pressure applied by representative bodies. Accountability for specific decisions can involve the use of specialist review panels/tribunals, the court system, or, in matters involving a review of process, an ombudsman.

- The consequences of poor regulatory performance tend to be highly specific to the institutional and policy framework within which a regulator operates. In some cases of general poor performance, regulators have been abolished or amalgamated. Where a regulator errs in a specific decision, such as is established through a process of judicial review, the practice in many cases is for the original decision to be remitted back to the regulator to take a new decision.

- In this policy brief, it is argued that accountability and liability frameworks for regulators must be fit for purpose and provide the appropriate incentives for regulators. In this respect, it is argued that questions of regulatory accountability and liability cannot be separated from broader questions about the purposes of regulation (why we regulate); the external and internal organization of regulatory agencies (how we regulate); and regulatory oversight and supervision arrangements (who regulates the regulators).

The Purposes, Organization, and Supervision of Regulators

Implications for Accountability and Liability

Introduction

Regulators are increasingly powerful institutions in many societies, entrusted with significant responsibilities over aspects of social and economic life. They are often required to take decisions in highly charged political environments and in contexts of significant uncertainty, and, in doing so, they are required to balance the views of vociferous and often powerful interest groups (including political interests). The task of a modern regulator is unquestionably a difficult one.

However, as recent events in the financial sector have demonstrated, the action or inaction of regulators can have a profound effect on the lives, and livelihoods, of many citizens. It is therefore unsurprising that questions relating to the accountability and liability of regulators are now being asked in many jurisdictions. In the UK alone, the regulators and broader regulatory frameworks for areas such as financial services, antitrust/competition, water, and energy are all under current review. These reviews follow, in some cases, from perceived failures of regulation, but they also reflect a current political desire to 'pull back' the regulators; to reduce their functions to an irreducible core and to excise their policymaking functions.

The current interest in the accountability and liability of regulators also appears to reflect a number of broader factors, including:

- The age and size of many regulators. In the UK, for example, many of the economic regulators were established twenty to thirty years ago following the privatization and liberalization policies of the Thatcher era. Since that time, regulation has evolved from a small enterprise activity to a significant area of activity, and many regulatory agencies have grown into large undertakings, employing hundreds of people and attracting significant budgets. It is therefore unsurprising that questions are being asked as to whether regulators have become too big and too expensive.

- The philosophy underlying the current regulatory model is also being questioned in some quarters. This is most evident in discussions regarding the architecture for financial services regulation, but is also apparent in the emerging belief that the regulatory model has failed to provide the incentives for necessary investment in energy, transport, communication, and water infrastructure.

- Increasing media and public interest in regulatory actions and decision-making, along with more robust political review, and judicial scrutiny through various appeals mechanisms.

In this policy brief, I address three aspects relevant to issues of regulatory accountability and liability. First, I consider the purposes of regulatory authorities and how these interact with questions of accountability and liability. Second, I identify some of the core organizational issues that can impact on accountability and liability, specifically those associated with division of regulatory powers between different authorities, and issues of organizational culture. Finally, I will consider issues associated with different forms of supervision and oversight for regulators.

All of these matters – regulatory purposes, regulatory organization, and regulatory supervision – are

relevant to determining whether the accountability and liability frameworks for regulators are fit for purpose, and provide regulators with the correct incentives in undertaking their tasks.

What is it that a regulator does, or should do?

A preliminary point should be made about the different types of regulators. A general distinction can be made between self-regulating bodies or organizations, and regulators who are established by the state or by statute. This latter type of regulator is typically given statutory powers and responsibilities to regulate in specific areas, which is intended to insulate it from the temptations of short-term political decision-making. Among these are the so-called 'economic' regulators, which are, generally speaking, tasked with ensuring that economic markets and activities operate effectively and that consumers are not exploited by firms who hold significant positions of economic power.

There are also various types of 'risk regulators' that focus on identifying and enforcing laws relating to different types of risks (such as environmental, health and safety etc.). In addition there are the 'rights' regulators, responsible for enforcing the rights of individuals, or ensuring that rights have been respected in various processes.

In practice, however, the distinctions between the different types of regulator tend not to be so rigid, with many regulatory agencies combining a number of these functions within a single organization. For example, water and energy regulators are often responsible for considering both environmental risks and economic aspects in those sectors, while civil aviation regulators are typically responsible for both the safety and economic aspects of the sector.

In addition, the responsibilities of regulators are not always narrowly delineated. The empowering legislation of many regulators provides a list of objectives to be fulfilled in the exercise of their powers. In some cases, this includes protecting or promoting the broader public interest or other strategic, social/distributive or environmental objectives. This means that some regulators are now explicitly required to consider, and balance, a range of economic, social, and environmental factors in their decisions. In the UK, for example, the Financial Services Authority has among its statutory duties a requirement to maintain the competitive position of the UK, while the communications regulator has a specific statutory duty to further the interests of citizens (as well as consumers). The recently created Legal Services Board in the UK has eight regulatory objectives, which encompass issues from competition to consumer protection; education to industry representation.

While the inclusion of a wide range of objectives and duties within the remit of regulators may be beneficial in so far as it prevents narrow, detached decision-making, in practice such multiple objectives require the regulator to make trade-offs between differing and potentially conflicting duties, a fact that has implications for regulatory accountability. In particular, multiple objectives may distract a regulator from the more central objectives that it has been established to fulfill, or create confusion as to 'regulatory purpose'.[1]

In this regard, it is important to recall that the work of regulators often affects interests differently: sometimes benefiting one set of interests at the expense of another. This can make regulators prime targets for political competition,[2] an issue that is exacerbated where there is potential conflict between objectives. In sum, the nature of regulatory responsibilities impacts substantively on the complexity of decision-making and accordingly on issues of accountability and liability.

1. Decker, C. (2010) 'The objectives of economic regulators: Old tensions and new challenges', *Network*, Issue 36, June 2010.
2. Joskow, P. (2010) 'Market imperfections versus regulatory imperfections', June 2010, CESifo DICE Report 8(3): 6.

Regulatory organization and accountability

Regulatory organization is relevant to questions of accountability particularly where different regulatory bodies share powers and responsibilities. A good example of such entanglements is the regulatory architecture that pertained to financial markets supervision in the period prior to the 2008 financial collapse (where oversight of the financial system was often divided between central banks, independent regulators/commissions, and self-regulatory bodies). However, the issue can also arise in federal systems where regulatory powers and responsibility are divided between state and federal regulatory bodies (or, in the case of the EU, between national regulatory authorities and the European Commission). The effects of these divisions, and potential overlaps of supervision and responsibility, are crucial to issues of accountability and liability.

A regulatory agency's organizational culture and internal working practices can also impact on accountability and liability. Both economic theory and empirical studies have long recognized the potential for a particular form of partiality in regulatory decision-making. Generally, the potential is described in terms of (1) regulatory agencies being motivated by a collective self-interest (for example in the size and budget of the agency) rather than the 'public interest'; and (2) regulatory agencies being captured by sectional interest groups or ideologies (so-called 'capture theory'). These theories suggest that overt bias can sometimes enter into regulatory decision-making, and compromise the independence of the regulatory agency.

However, there are other less known, collective behavioural factors that can affect regulatory practice and decision-making. These behavioural factors may be particularly relevant as, in many contexts, a regulator's task involves decision-making under conditions of uncertainty, that is, decisions must be made which envisage or accommodate a range of possible outcomes (e.g., volcanoes erupting, credit drying up, climate change etc.). In such conditions an *unconscious* bias can emerge, known in psychological research as 'confirmation bias'. In general terms, confirmation bias involves the inappropriate bolstering of particular hypotheses or beliefs through *'unwitting selectivity in the acquisition and use of evidence'*.[3] Confirmation bias does not refer to purposive, deliberate, or conscious selectivity in the use of evidence. Rather, it captures a less conscious, less deliberate, and even non-intentional approach to information gathering and assessment, which is nevertheless 'one-sided' in its outlook.[4]

To take a concrete example of how confirmation bias can manifest, consider the widely held expectation of many in the financial community – including borrowers, banks, creditors, investors, central banks, and regulators – prior to the 2008 financial collapse that there would always be credit available somewhere in the financial system (albeit that such credit may have a high price in times of financial stress). This patently turned out not to be the case.

The critical point, however, is not whether this expectation was justified (and economic history suggests otherwise), but rather why the regulatory system did not explore the alternative possibility. This question is especially troubling given that one of the purposes of expert technical regulatory agencies, particularly those that have a risk focus, is to identify and examine a range of possibilities arising in the future, and to collect and assess evidence in such a way as to help it determine the likelihood of different outcomes occurring.

In short, to the extent to which confirmation bias is a real phenomenon (and in many regulatory contexts it is being suggested as such)[5] it can result in a culture in

3. Nickerson, R. S. (1998) 'Confirmation Bias: A Ubiquitous Phenomenon in Many Guises', *Review of General Psychology*, 2(2): 175-220.
4. While there are broad similarities between the effects of confirmation bias and those associated with 'group think' (another psychological/behavioural notion that has received much attention following the financial crisis and refers to a tendency to minimize conflict and bring about extreme concurrence among group members) the two notions are conceptually distinct.
5. See: Wils, W. P. J. (2004) 'The Combination of the Investigative and Prosecutorial Function and the Adjudicative Function in EC Antitrust Enforcement: A Legal and Economic Analysis', *World Competition*, 27(2): 201-24; Neven, D. J. (2006) 'Competition economics and antitrust in Europe', *Economic Policy*, 21(48): 1.

which regulators fail either (i) to identify the right questions, or (ii) to collect and assess evidence that may be relevant when considering the veracity of different hypotheses concerning the relative likelihood of possible outcomes. In short, it can result in systematic defective decision-making and actions. Accordingly, any accountability and liability framework must be capable of identifying and addressing such organizational risks.

Forms of accountability and oversight: accountable to whom?

Who are regulators accountable to when things go wrong, and what are the institutional and other mechanisms that provide oversight of the regulatory framework? In considering these points, a distinction can be made between general oversight of a regulator's conduct and performance, and the oversight or scrutiny of specific decisions or actions.

General accountability and oversight

A number of forms of general oversight of regulatory agencies are typically observed in practice. The first, political or executive oversight of the regulator, may include requirements for a regulator to periodically appear, and answer questions, at parliamentary select committees;[6] requirements for annual reports and accounts to be submitted to parliament or public accounts committees; parliamentary reviews of the performance of the regulator; independent reviews of the regulator; or reviews by bodies such as national audit offices.

Regulators are sometimes subject to an independent review of their performance and conduct. Typically, these reviews involve the appointment by a relevant Minister of an experienced, independent person to assess the performance of the regulator (or regulatory framework more generally) and make recommendations. In the UK, there are current reviews of the energy and water regulators. In addition, the Independent Commission on Banking was established following the financial collapse to provide recommendations about structural and non-structural measures to improve the banking system and promote competition.

The perceived advantages of this approach for accountability are the independence of the reviewer(s) and the ability to bring specialist knowledge to an assessment of a regulator's performance. The principal drawback of the approach in terms of regulatory accountability is that independent reviews can, in many cases, only present recommendations. The decision to implement any proposals typically lies with the relevant Minister.

There are current proposals in the UK for triennial reviews of all non-departmental public bodies (NDPBs), which would potentially include regulators. These reviews are designed to 'radically improve' transparency and accountability by: (i) providing a robust challenge to the continuing need for individual NDPBs (both their functions and their form); and (ii) reviewing the control and governance arrangements of such bodies to ensure compliance with recognized principles of good corporate governance.

A further mechanism by which regulators can be held to account is through consumer, user, or other representative bodies. Consumer representative bodies, in particular, are often perceived to address a risk that, absent this perspective, a regulator will have undue regard for the (often) more organized and better resourced industry interests. In practice, however, there can be limitations associated with relying on representative bodies to ensure accountability and supervision. Among these: the potential that the representative body is itself politicized; and that such bodies may focus only on influencing regulatory decisions over the short-term (e.g., in the case of consumer bodies, securing lower prices in the short-term, at the expense of longer term investment).

6. While periodic appearance before parliamentary select committees can, in principle, be a very effective means of oversight of regulators, one risk is that it can make regulators unduly concerned with headlines and political perceptions; an outcome that can compromise regulatory independence.

Reviews of specific decisions and actions

In principle, there are at least three potential avenues of accountability for specific regulatory decisions: (i) review of a regulatory decision by an expert or specialist tribunal; (ii) review of a decision by a generalist court; and (iii) review of regulatory process by an ombudsman.

Expert or specialist review panels are increasingly used to review decisions of regulators. In the UK, for example, an Environmental Tribunal has only recently been established to consider appeals against civil sanctions made by the environmental regulators. Similarly, the Competition Appeals Tribunal reviews the decisions of economic regulators and competition authorities. A principal advantage of this type of oversight arrangement is that the tribunal or panel is more specialized than a general court, and members of the panel can bring specific expertise to the review of a regulator's decision. In practice, however, while such forums are intended to be specialist and distinct from traditional court forums, the use of lawyers (including, in some cases, top silks) can make the tribunals legalistic in character and process. This can potentially have limitations where some of the panel members are not judges, and are not familiar with the tactics and techniques of the court process.

The general court process is the obvious alternative to the use of specialist panels or tribunals as a mechanism for accountability for specific regulatory decisions. Courts have in some cases been the forums for the judicial review of decisions of regulators, for example, in relation to Regulatory Impact Assessments. In addition, it is often the case that appeals of regulatory decisions from specialist tribunals (such as the Competition Appeal Tribunal in the UK) are heard by a general court.

Much has been written on the question of the relative advantages and disadvantages associated with the use of general courts as compared to specialist tribunals as a means of regulatory review. In a nutshell, among the perceived advantages of the general court system: courts and judges are familiar with complexity arising in a wide set of contexts; the adversarial nature of the court process results in the most persuasive arguments being presented; it avoids the problem of the same panel or set of tribunal members considering cases for which they may hold the same preconceptions or world-view. On the other hand, the perceived disadvantages of the court process as a means of regulatory accountability are: that in some contexts judges may not be adequately equipped to understand or appreciate highly specialized or technical arguments; and that the process can be very costly and time consuming.

An ombudsman can potentially also have a role in examining the actions and process of a regulator in reaching a decision. Specifically, where an ombudsman can examine issues of administrative practice and regulatory maladministration, this can act as a further mechanism for regulatory accountability. In the UK, the Parliamentary and Health Service Ombudsman undertakes independent investigations into complaints that government departments and regulatory agencies have not acted properly or fairly or have provided a poor service. In Europe, the European Ombudsman investigates complaints about maladministration in the institutions and bodies of the European Union. A recent decision by the European Ombudsman is instructive in highlighting this potential, and is particularly relevant in the context of points made earlier about confirmation bias.[7] In that case, the European Ombudsman determined that the European Commission had committed an instance of maladministration in failing to consider and take adequate account of information in its investigation that may have been exculpatory for the entity under investigation.

Some comments on liability

Questions of accountability bring us to the related issue of liability, and in particular what, if anything, are the consequences of general regulatory failure, or of a regulator erring in a specific decision. It is

7. Nikiforos, P. (2009) DIAMANDOUROS 'Decision of the European Ombudsman closing his inquiry into complaint 1935/2008/FOR against the European Commission'. 14 July 2009.

difficult to comment on this question at a general level, as the consequences of regulatory errors or general poor performance tend to be highly specific to the institutional and policy framework within which a regulator operates. Accordingly, the brief comments that follow are intended to be illustrative rather than comprehensive in scope, and to draw on recent examples from economic regulation in the UK.

When the performance of a regulator is perceived to be inadequate in general, the regulator may become the subject of an individual or sector-wide independent review. While the consequences resulting from such reviews can vary, the mere fact of being subject to review can itself act as spur to internal change within a regulator.

Alternatively, where a regulator, or a set of regulatory arrangements, are deemed inadequate, the regulator may be abolished or amalgamated with another regulatory agency. In the UK, it is proposed that the Financial Services Authority be abolished following what the Chancellor of the Exchequer described as its *'spectacular regulatory failure'*,[8] and replaced with a prudential regulatory authority and an independent consumer protection and markets authority. Similarly, the Strategic Rail Authority was abolished in 2005, in part, as a response to the poor performance of UK railways, and the perceived failure of that regulator to hold the train companies accountable.

Finally, in terms of the liability that arises when a regulator is found to have made an error in a specific decision (for instance, through a process of judicial review) the practice in many cases involves the original decision being remitted back to the regulator for review. However, in some recent judicial reviews, where the court has remitted decisions back to a regulator, the subsequent decision of the regulator has effectively been the same as the first.[9] Such outcomes have led some commentators to question the efficacy of judicial review as a mechanism of accountability, particularly in so far as the reviewing body may be limited in its ability to follow up on whether a regulator has adequately addressed any errors it has identified.

Conclusions

Recent decades have seen significant growth in the establishment of regulatory agencies in many areas of social and economic life and in many parts of the world. Correspondingly during this time the remits and powers of many regulators have increased, and regulators are often given substantial discretion to make decisions over central and critical features of an economy and society.

This policy brief has argued that the accountability and liability frameworks for regulators must be fit for purpose and provide the appropriate incentives for regulators. However, this brief has also argued that questions of accountability and liability cannot be separated from broader questions about the purposes of regulation; the external and internal organization of regulatory agencies; and regulatory oversight and supervision arrangements.

8. Parker, G. and Masters, B. 'Osborne abolishes FSA and boosts Bank', *Financial Times*, 16 June 2010.
9. These cases involved judicial review in the remedies proposed by the UK Competition Commission.

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Regulation, Regulators, and the Crisis of Law and Government

This programme will examine the regulatory system in the wake of the global financial crisis, assessing its current weaknesses, the role of legislative and judicial bodies, and identifying measures for future reform of both markets and regulatory regimes. It will aim to shed light on the recent failures of regulators, often captive of the very industries they are meant to regulate, and examine ways to improve the accountability and effectiveness of the regulatory system.

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