Standards and efficiency in Regulators

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It is timely to discuss the topic of standards and efficiency in regulators, especially in the UK context. The new coalition government has recently announced that it will review many arm's length bodies and take powers to abolish those which it considers lack relevance and value. The onus is therefore on all regulators to demonstrate their unique contribution, efficiency and effectiveness. We can expect plenty of hard argument and evidence, but also some rhetoric and special pleading, from regulated sectors and industries in response. So I want to offer some reflections that might be useful in resolving those debates.

The need for high standards and efficiency is always on the regulatory agenda. Regulators do need to review their activities regularly and learn from their mistakes - whether at the level of an individual case, a lost legal action or what appears to be systemic failure. It is far from clear that the response to any such failure ought to be to sack the regulator. Responsibility for the underlying failure surely rests primarily with the firm or individual concerned. The regulator's primary task is to secure early redress and medium-term prevention of repetition. To shift to consideration of regulatory architecture as a kneejerk response may obscure the fundamental causes of the systemic problem and delay solutions.

But regulators **should** be held to account – and indeed hold themselves to account - for their own performance. The work of the Better Regulation Executive in the UK and its predecessors over many years has laid a firm benchmark here. Their

challenge is to keep their own processes aligned with the best regulatory practice and to ensure that evidence of regulatory effectiveness is considered in its full complexity.

I want today to talk about four incomplete ways of assessing regulatory effectiveness and then move on to four areas, which I would suggest, give a rather better framework. In doing that, I will draw on my experience in establishing the Legal Services Board in England and Wales, over the last two years. It will be interesting to debate how far you think any of these points are valid in your own contexts.

The first partial answer to what constitutes efficiency in regulators is the simple word "economy". Some hold that the only possible good government is small government. .And therefore that the only possible good regulation is small regulation.

If that is the key criterion of success, then my organisation passes with flying colours. We are 32 people, costing a little under £5m per annum, - and we have kept within the budget identified before we were set up. The other regulatory models which were in debate at the time of our creation were significantly more expensive –one model, an all-embracing legal service authority with over 1,000 staff, would probably have cost 20 or 25 fold than we do.

Our regulatory model is key to our economy. We regulate a number of what were previously purely self-regulatory bodies, rather than imposing our will directly. Indeed, the fact that those bodies have the same statutory objectives as we do means that we work primarily through influence, discussion and research rather than

direct regulatory diktat. That division of responsibility keeps us strategic, while ensuring that we remain close to the market.

But economy is not an end in itself. I say repeatedly that I can envisage my organisation, even in the current climate, trebling or even quadrupling in size over the next five years if the bodies we oversee fail to deliver on their side of the regulatory settlement. I can equally see us falling in size by one third or even two thirds over the same period if those bodies do rise to the regulatory challenge and transform the market and the customer's experience of legal services. We need to respond to their success or failure: value for money and effectiveness needs to drive the budgetary decision, not economy per se.

A closely related, but rather more broadly based, assertion is that regulatory effectiveness depends on minimising the financial impact on the firms or other organisations affected. That is more relevant than the cost of regulators themselves. The cost of my organisation equates to £35 per year for each lawyer in England and Wales – rather less than you have paid to hear me today. It is rather hard to argue that missing a conference is a great imposition on a system that gives protected access to a £25bn market.

There is now a good deal of work and experience in identifying the more relevant costs of regulation, those imposed on firms. That is clearly a key component in making policy decisions. But policy makers, both in regulators and central government, must recognise that it is usually far easier to identify the costs than the benefits of regulation.

Costing is not an exact science – one needs to look at the behavioural impact of regulation. Most notoriously, but probably far from uniquely, in health and safety regulation , those being regulated can over engineer solutions at a wildly disproportionate cost. But in most industries, there is usually some past cost data from which future projections can be extrapolated – or experience in other analogous sectors from which it can be derived.

It is usually far more difficult to identify benefits in financial terms. When looking at regulation of utilities and other forms of market opening, insisting on exact CBAs can be counter-productive. The evidence for the efficacy of market opening is plain in many sectors over many years in many countries – but that is not the same thing as saying that the *precise* effects of opening an individual market can be predicted with certainty.

This is an argument we constantly make in the context of the introduction of Alternative Business Structures within the England and Wales legal market. Alternative business structures are essentially law firms which can be owned by non-lawyers. They will be able to access external capital, strategic management expertise, accounting and IT skills and more flexible staffing models in a way that firms in the traditional partnership model find difficult. However, their creation overturns hundreds of years of what some would describe as professional independence and others professional parochialism. So, not surprisingly, some who worry about change, demand absolute certainty about how the new market will function.

Predictions are always difficult – particularly about the future – and even more particularly about liberalised markets. There is now a lot of evidence confirming that insight in the legal market, not least in work done for the Bar Standards Board by the consultancy Europe Economics, which graphically sets out the inherent unpredictability of such effects.

Regulators should provide certainty where they can about impact and benefits – but not false certainty where it can't be attained. Regulation is not a wholly mechanistic exercise. At the end of the day, qualitative judgements may need to be made on imperfect evidence to achieve the regulator's public policy goals. Cost weighs heavily in that balance - but it should not be an absolute veto.

My third incomplete answer is related. Addressing cost too narrowly leads to a world where regulators may make incremental change, but basically have to assume that the status quo is the place to be in the absence of absolutely overwhelming and compelling evidence to the contrary.

I think that, in the vast majority of cases, this is profoundly wrong. Regulators do not exist to be academic talking shops, making marginal adjustments. Governments and Parliament create them to make change, sometimes rather dramatic change, happen.

Again, I refer to Alternative Business Structures. We have a statutory duty "to promote competition" and a clear legislative task to introduce ABS. That gives us not just the option, but a clear responsibility to challenge the status quo: in relation

to fundamentally anti-competitive market structures and in relation to the random historical structure of regulation, which lacks a clear public interest rationale for what is reserved to lawyers and what can be done by anybody.

Indeed, any presumption that the status quo does not need such scrutiny surely begs the fundamental challenge as to whether regulation is necessary in that particular market at all. In our case, a regulatory system designed for an era of deference needs to be measured against a clear set of statutory objectives and updated for a consumer market.

The final note of caution is on assessing regulators solely by a limited number of specific targets. Targets have their place – in terms of the regulator's own internal effectiveness and that of the organisations they oversee and, more broadly, in terms of the structure of the market or consumer outcomes which they seek to achieve.

But the behavioural effect of setting targets can be rather odd. Most regulators are dealing with complex multi-faceted sectors of the economy or patterns of experience. To reduce that to two or three simple numbers which are pursued at the expense of all other concerns makes regulators, at best somewhat one-eyed and blind to perverse incentives, at worst makes them ignore the important, but difficult to quantify, parts of their brief to pursue the easy ones.

It makes far more sense to think of regulation as a game of snooker rather than a game of football. There's not one ball to get into the net – there is, instead, a need to plan every shot by reference to its impact potentially unpredictable rebounds.

So, if economy, cost reduction, focussing only on incremental change and pursuing specific targets are incomplete, is it possible to develop a more rounded view ? I think that it is and I again put forward four possible areas for debate.

First, clarity of purpose. The statute which I administer, the Legal Services Act 2007 is over long, significantly over-prescriptive and, in some places, almost incomprehensible. But I forgive the legislators all that because of its marvellous opening section which sets out what we are here to achieve. It defines our regulatory objectives as

- Protecting and promoting the public interest
- Supporting the constitutional principle of the rule of law
- Improving access to justice
- Protecting and promoting the interest of consumers
- Promoting competition in the provision of services
- Encouraging an independent strong diverse and effective legal profession
- Increasing public understanding of the citizen's legal rights and duties
- Promoting and maintaining adherence to the professional principles (these cover things such as independence, integrity, duties to the court and confidentiality).

I find these objectives genuinely inspiring. We build them into the heart of everything we do at the Legal Services Board. Every effective regulator needs that sense of purpose – either in its statute or internal vision.

But a list is not enough. There needs to be clarity about what those objectives mean and how the regulator approaches them. We are today publishing a document which does just that. It makes clear, for example, that when we look at access to justice, we look not simply at the number of firms currently in the market, but also look at innovative ways of delivering services via telephone, online information services, online interactive services and so on.

Many of our objectives are qualitative in the extreme. Try reducing the constitutional principle of the rule of law, agonised over by philosophers and judges for many decades, even centuries, to a single performance indicator ! Of course, our document isn't the last word on that subject – but it is a clear statement about a key building block of our activity.

An effective regulator also needs to visibly link those objectives to its detailed activities. That is what we have done in our two business plans and in our Annual Report, due out next week. And it is increasingly what we will do in our research programme as we evaluate how the market is changing and what our own impact has been as part of that process. Can any regulator can be considered effective in the absence of that kind of discipline ? Without it, their programmes might appear to be a collection of rather random historical activities or stray initiatives, reflecting the political or professional whims of the moment, but never founded on clear policy intent or public interest.

The second area for effective regulation is identifying and aligning economic and commercial incentives with the broader public objectives which the regulator is there

to promote. This is fashionable at the moment as policy makers consider what behavioural economics has to offer them. “Nudge” is the new “black”.

It’s not always easy, as any utility regulator will tell you. Creating the right incentives means just that: it is not synonymous with creating an easy ride for new entrants or tying incumbents in knots. It’s usually about breaking down barriers to entry. But, as importantly, it’s then about putting all players, both new and old, on the proverbial level playing field where they have equal opportunity – and equal need – to review their own business models and behaviour.

Once again, this is particularly important for us in relation to Alternative Business Structures. We passionately believe that the legal market has much to gain by being open to ideas from elsewhere – but also that existing firms can only benefit by absorbing and then responding to that level of challenge. So, in the guidance we have given to those regulators who hope to regulate ABS firms, we have made clear that we will not tolerate the imposition of a very detailed “tick box” rule book. We are instead encouraging proper principles-based regulation – clear about outcomes, flexible about means.

That doesn’t give new entrants a free ride. The legislation rightly commits us to tight controls over ownership on the basis of the “fit and proper person” test with which those of you with a competition background will be familiar. There are requirements in respect of their internal governance. Where risks differ, requirements should. But where they do not, the aim should be the maximum commonality of regulatory framework to produce common incentives.

Effective incentive regulation right also needs effective risk management and enforcement. So, it is important both to design the rule book in a way that enables innovation and maintains essential protection AND to back that up with a clear supervisory process based on risk and strong intervention. Sometimes that intervention needs to be positively punitive, as in competition law or the unlimited fines we propose for ABS, to ensure that firms take outcomes seriously, rather than regard them as motherhood and apple pie.

This is particularly important in legal regulation, where we need to incentivise ethical professional behaviour rather than economically rational behaviour alone. Everything I have said about definition, outcomes, risk and enforcement is valid in relation to individual professional, as well as corporate economic, behaviour.

And it is as important to get the balance right here as well. To believe that professional ethics can be reduced to a tick box list of compliance is to profoundly insult the professionals I oversee – and indeed professionals in other sectors as well.

And, in fact, it not only insults the genuine professional, but it also gives licence to the small minority whose behaviour does give rise to genuine concerns. I worry when I hear of lawyers asking for absolute clarity and prescription on what regulatory outcomes enable them to do. Regulatory rules are no more riddled with mind-numbing uncertainties than is the legislation on which lawyers advise clients day in and day out. Regulatory outcomes need to clearly align with professional behaviours. But they do not need to be defined at the level of the number of angels

dancing on the head of the proverbial pin – that encourages compliance with the letter, not the spirit and leads to the wrong outcomes.

So, setting behavioural and economic incentives is key – and can be done with relative economy, as a large infrastructure is not necessarily essential. But how is that achievement to be assessed? This brings me to my final pointer about regulatory effectiveness.

I said earlier that targets could be at best incomplete and at worst positively harmful. But that's not a plea for a return to closed government. What I think above all characterises effective regulation is a culture of complete transparency and accountability. Regulators make incentives work best by being rigorous on the transparency requirements they impose.

To take another example, we have a duty to encourage a diverse workforce. We are therefore asking the regulators we oversee to find ways of getting the firms they regulate to publish information about the make-up of their workforce in terms of gender, ethnicity and possibly other markers of diversity such as social mobility as well. We are not interested in headline grabbing initiatives-in this area – not least to avoid the rather silly headline of "political correctness gone mad". But dispassionate investigations of the legal workforce all show a common pattern of a great deal of effort to attract a diverse workforce at entry level, but glass ceilings apparently kicking in harder and lower than in many other sectors.

Regulators have a role to hold up a mirror – to those they regulate, to consumers and to policy makers – so that everybody can see where any individual firm or group stands relative to the general picture. That discipline is as, if not more, powerful than any specific targets – not least because it gives the incentives to firms to find solutions themselves rather than pursue top-down initiatives forced on them by the regulator. And I'll take some persuading that the cost of such transparency is less than that of failing to attract and retain the most talented workforce.

If regulators expect this level of transparency from others, they should live by it themselves. That means obeying the spirit as well as the letter of requirements on consultation for example. It means finding innovative ways to engage those they oversee – and the other public and consumer stakeholders with an interest in it. It means seeking to stimulate and facilitate debate, rather than plonking semi-cooked propositions into the public domain and hoping for the best.

It also means, of course, following the proper disciplines of evidence-based policy making by being clear about sources of data and research – and also being honest about where decisions have to be made in the absence of that data but against an imperative at pursuing the public interest to achieve outcomes rapidly.

Indeed, many times regulators are in a position where the evidence is really rather helpful in telling them what not to do, rather than indicating where the solution lies. I do not regard this as a problem, provided that the regulator is honest about this and indicates how it will evaluate the decision, both for short-term fine-tuning and longer-term policy development.

To conclude. There are real dangers in taking a partial view of regulatory effectiveness by focussing on inputs, costs to the exclusion of benefits or a narrow set of targets or being insufficiently ambitious. Instead, we need a wider definition of regulatory effectiveness, starting with an assessment of the regulator's understanding of its own purpose, its effectiveness in getting the right incentives to influence commercial behaviour and, where appropriate, individual ethical behaviour as well and its ability to inspire and enable strong accountability within its marketplace and also about its own activities.

In short, we need holistic, self-aware and unafraid regulation to deliver real outcomes for consumers and citizens, often mystified by the market and professional relationships in which they find themselves. We do those consumers and citizens a grave disservice if we fetter ourselves by pursuing one-dimensional targets which prevent us doing the job we are set up to do with the rigour, drive, flexibility and creativity that our role demands. Thank you.