Risk Based Regulation

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Future of Legal Regulation Conference
14th June 2010

Outline

- What is risk based regulation?
- Examples of risk based regulation
- Main elements of a risk based framework
- Key issues in design
- Challenges of implementation
- Main lessons to be drawn from current experiences

What is risk based regulation?

- Range of meanings
  - (1) Regulation of risks to society
  - (2) Loose collection of approaches expressed terms of risk
  - (3) In banking and insurance regulation, the use of firm's own internal risk models to set capital requirements
  - (4) Systematised decision making frameworks and procedures to prioritise regulatory activities and deploy resources, principally relating to inspection and enforcement, based on an assessment of the risks that regulated firms pose to the regulator's objectives
- Definition (4) is that used here

Examples

- Risk based regulation has been adopted in a number of sectors and countries:
  - Legal services regulation (Queensland and New South Wales, Australia)
  - Food safety (England, Ireland)
  - Environmental protection (England & Wales, Ireland, Netherlands, Portugal)
  - Financial regulation (Australia, Netherlands, UK)
  - Occupational Health and Safety (UK)

Why have a risk based framework?

- Some reasons others have adopted RBFs are:
  - Stakeholders - attempt to develop a more justifiable or transparent approach to monitoring and enforcement
  - Resources - to enable resources to be directed where the agency thinks they are most needed; deal with resource constraints
  - Better regulation – help to develop regulatory framework which is more targetted and focuses on the main risks and objectives
  - Internal organisational reasons
    - Facilitate integration or coordination within and between agencies / local authorities
    - Provide internal mechanisms of control and performance evaluation
    - Improve organisational processes and decision making

Main elements of a risk based framework

- 'Setting' the risk tolerance
- Nature of the risks
- Risk categories
- Risk identification and risk assessment of firms / system wide risks
- Assigning scores and ranking firms or sites
- Linking supervisory resources and responses to the risk scores (in some frameworks only)
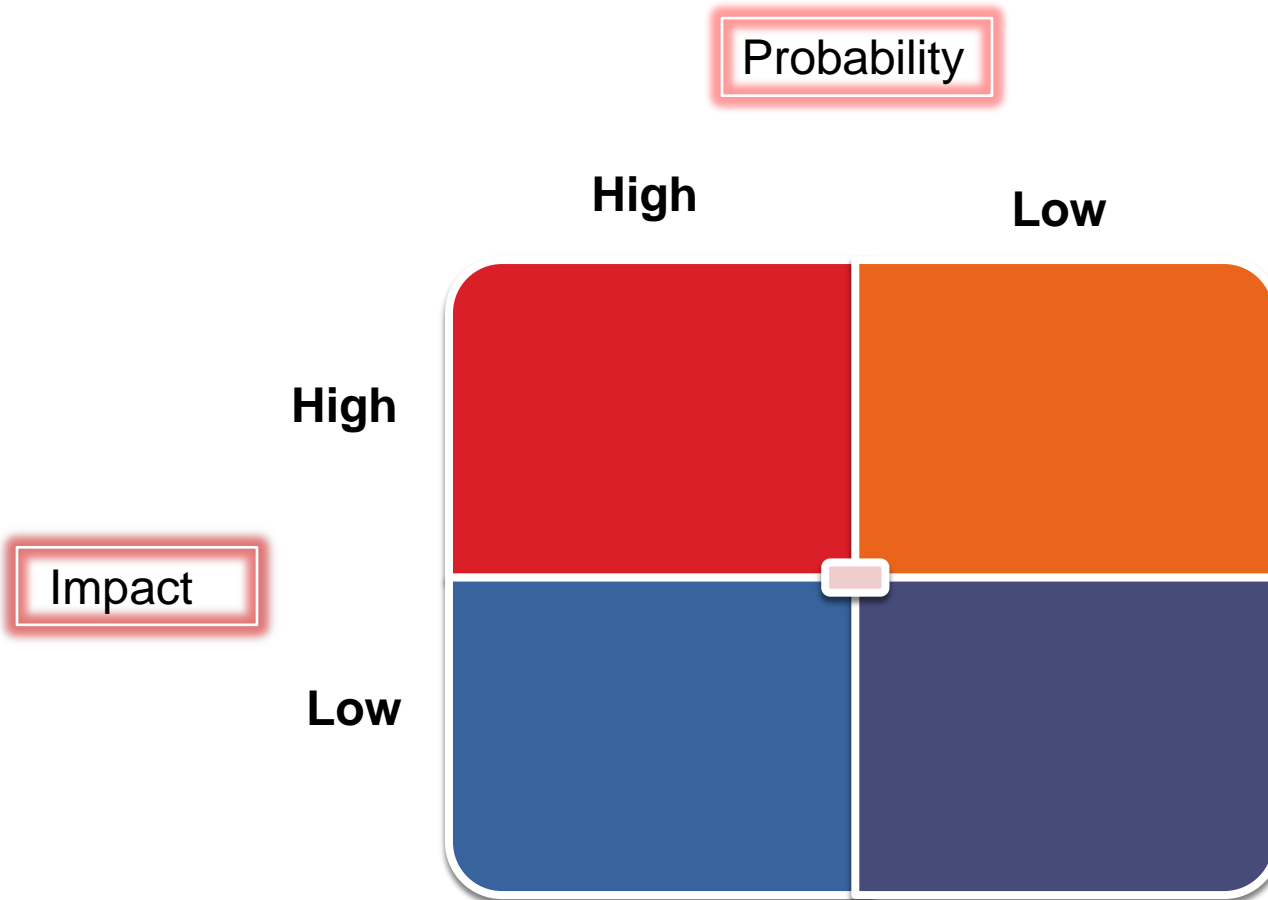
Key issues: 'Setting' the risk tolerance

- Sensitive and challenging issue – requires Board engagement
- Unstable: non-zero risk can turn to zero-risk in times of crisis
- Whose risk tolerance is it anyway?
  - eg LSB, Law Society, SRA?

Key issues: Nature of the Risk

Static

Dynamic

Intrinsic

Net
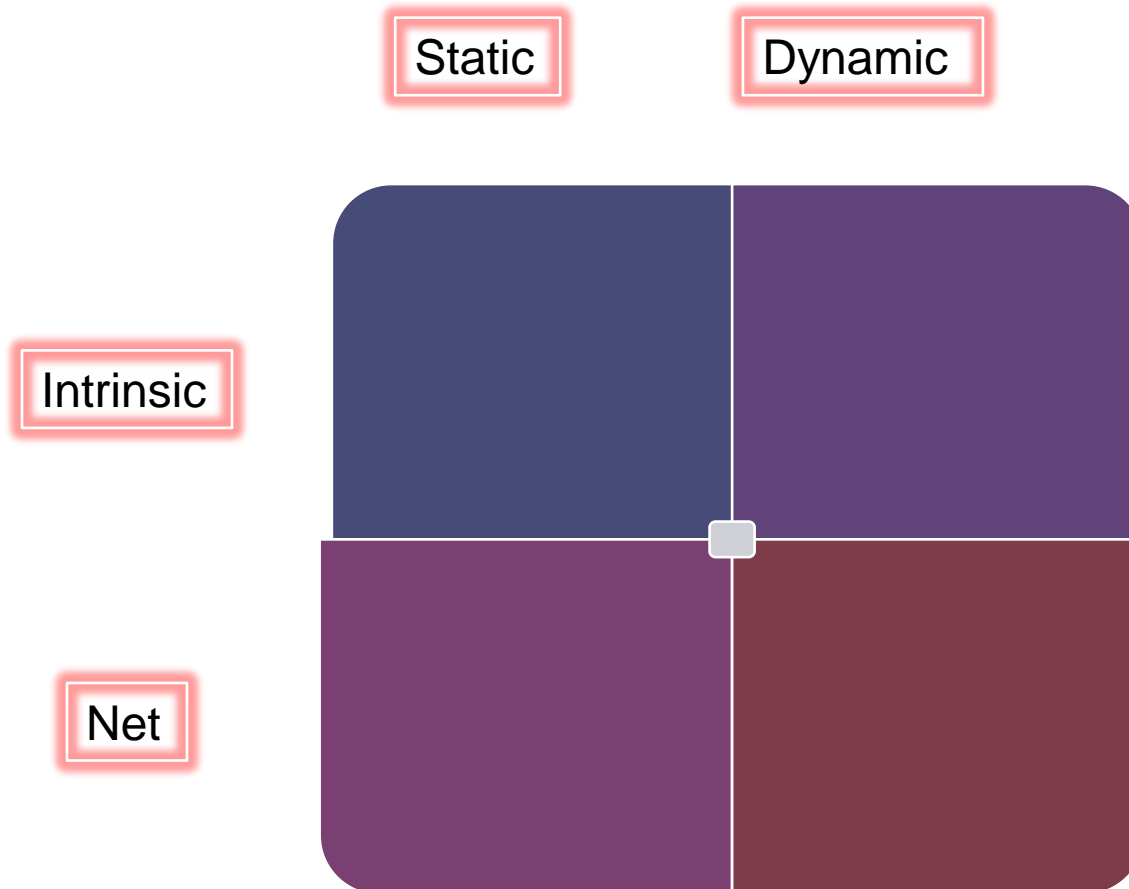
Key Issues: Risk categorisations

Probability

High   **Low**

High

Impact

Low

What drives the categorisations?

- Should impact be a measurement of size and / or vulnerability?
  - Size-based measures: eg turnover, numbers of clients
  - Vulnerability measures:
    - potential for physical harm - eg consumer credit: home debt collection
    - vulnerable clients - eg legal services: immigration applicants
    - susceptibility to infection – eg food: children, elderly people
- What are the relative weights of impact and probability in the categorisations?
  - Eg is a high probability but low impact event a high, medium-high, medium-low or low risk?
- What risks are being assessed?
  - Risks posed by individual firms?
  - Systemic risks posed by aggregate effects of individual firms' behaviour?

Key issues: Risk indicators

- Selecting risk indicators
  - Internal process
  - Identifying risks and outcomes
  - Relationship of indicators to risks and outcomes
  - Using proxy measures, eg complaints data
  - Objective or subjective / judgement based indicators?
    - Examples of objective indicators: environmental regulation
    - Examples of subjective, judgement based-indicators :food, financial regulation)
  - Data – making sure the indicators and the data match up
    - Frequent problem: having too much of the information you don't need and not enough of the data you do

Key issues: Risk assessment and internal governance of the RBF

- Lessons from the FSA and Northern Rock: the best designed system will fail if not implemented
- Design of the framework and internal governance
  - How much discretion to give to those performing the risk assessments?
    - Objective vs subjective indicators
    - Weighting indicators so they have greater influence on the overall assessment / score
  - Ensuring accuracy and consistency of assessments
    - Challenge panels
  - Balancing need for accuracy and consistency with speed and responsiveness where risks are dynamic

Key issues: Internal culture

- Implementing a RBF requires more than training staff about the IT

- Role of organisational culture critical

- Support of senior staff essential

- Can meet resistance from staff who feel they can no longer use their own judgements / are pressed now into making judgements

- Takes several years

Key Issues: Making resources follow risks

- Good principle and can be achieved on a 'more or less' basis, but harder than it sounds
  - Risk assessments can become tools for internal bidding of resources between divisions
  - In dynamic settings, risks tend to change more quickly than resources can follow
  - Non-substitutability of internal resources can make shifting resources difficult –eg requirement for particular skill or knowledge sets
- Making assessments forward looking – very difficult to move from 'point in time' assessment to forward looking
  - Role of design, eg requiring staff to indicate 'direction of travel' over a specified period of time

Key issues: Making resources follow risks (2)

- How low can you go?
  - Dealing with 'bulge' – the low risk firms which are usually the majority of the regulated population
    - Using strategies other than inspections to educate and inform – some examples
      - Role of professional bodies
      - Use of trade press for information campaigns
      - Use of marketing tools more broadly for education purposes
    - Using strategies other than inspections to assess risk / monitor compliance – some examples
      - Self-certification with validation on a risk based / themed / random basis
      - Use of proxy measures: eg complaints data
      - Themed inspections

Managing the risks of risk based regulation

- Issues in implementation
  - Model
    - Getting the design right
    - Ensuring responsiveness to change
    - Can require a number of versions
  - Implementation challenges
    - Combining simplicity of use with complexity of design
    - Ensuring 'buy in' across the organisation
  - Political challenges
    - Risk based regulation means not doing things
    - But do politicians and the public agree with the regulators' choices of what not to do?