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1

Linking Regulatory Failures to Organizational Design

To prepare for the meeting of the conference committee which would ultimately result in the Dodd–Frank Wall Street Reform and Consumer Protection Act (Dodd–Frank Act), in March 2010, the House Committee on Financial Services held a hearing to examine the structure of the Federal Reserve in the wake of the worldwide financial crisis (Committee on Financial Services 2010). The discussion centered on two issues. The first was whether the Federal Reserve's core mission to formulate and implement monetary policy was aided or harmed by its concurrent role to regulate bank operations. The second revolved around the relative merits of separating the same banking regulatory function from the Federal Reserve's consumer protection responsibilities. During his opening remarks at the conference committee meeting, Congressman Spencer Bachus (R-AL) underscored the importance of these decisions, suggesting, "It is worth examining whether the Federal Reserve should conduct monetary policy at the same time it regulates and supervises banks. . . It is no exaggeration to say the health of our financial system depends on getting this answer right" (Committee on Financial Services 2010, p. 2).

Several others who testified at the hearing, including former chairs of the Federal Reserve Ben Bernanke and Paul Volcker, stressed that the institutional knowledge and expertise at the Federal Reserve made it uniquely qualified to oversee large banks and the financial system as a whole. Furthermore, proponents of the system's existing structure described the important role that close interaction with banks played in enhancing the Federal Reserve's ability to serve as the US central bank. Not only did its supervisory function allow the Federal Reserve to make more informed decisions as lender of last resort, direct interaction with banks also provided valuable data which could be used to appropriately set monetary policy.

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In contrast, opponents argued that the failures of several large banks under the Federal Reserve's supervision provided clear evidence of its inability or unwillingness to adequately regulate. As a case in point, despite having several officials on site, Congressman Bachus noted that the Lehman Brothers' bankruptcy examiner report revealed that neither the New York Federal Reserve Bank nor the Securities and Exchange Commission was able to keep Lehman Brothers from using "accounting gimmicks to hide its debt and mask its insolvency" (Committee on Financial Services 2010, p. 2). According to critics, the Federal Reserve's core focus on monetary policy diminished its ability to devote sufficient attention to its role as bank overseer. Worse still, combining the functions created "inherent conflicts of interest where the Fed might be tempted to conduct monetary policy in such a way that hides its mistakes by protecting the struggling banks it supervises" (Committee on Financial Services 2010, p. 3).

Ultimately, among its vast array of reforms, the Dodd–Frank Act did not include a provision to formally remove bank supervision from the Federal Reserve's set of responsibilities.[1] Even so, to elevate that mission within the organization, the legislation did create a vice chairman for supervision, a government official to be appointed to the Board of Governors by the president of the United States. The vice chairman would be responsible for "develop[ing] policy recommendations for the Board regarding supervision and regulation of depository institution holding companies and other financial firms supervised by the Board" and "oversee[ing] the supervision and regulation of such firms" (Dodd–Frank Wall Street Reform and Consumer Protection Act 2010, Section 1108).

In addition, notwithstanding efforts by the Federal Reserve to strengthen its consumer regulatory presence by revising rules for mortgage application disclosures and prohibiting certain lending practices prior to the law being passed (Carpenter 2010a; 2011; Engel and McCoy 2011; Immergluck 2011), the Dodd–Frank Act shifted the Federal Reserve's consumer financial protection functions into a newly created Consumer Financial Protection Bureau (CFPB) (Immergluck 2011). The Act further consolidated at CFPB the consumer protection responsibilities of a host of other agencies as well, including the Office of the Comptroller of the Currency,

[1] For detailed and insightful discussions considering both the contents of the Dodd–Frank Act, including the Obama administration's initial proposal drafted by the US Department of Treasury and its final provisions, as well as the political process that led to the Act, see Carpenter 2010a and 2011, Engel and McCoy 2011, and Immergluck 2011, among others.

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Office of Thrift Supervision, Federal Deposit Insurance Corporation, and Federal Trade Commission (US Senate Committee on Banking, Housing, and Urban Affairs 2010). Although formally still housed in the Federal Reserve, the CFPB was structured to operate independent of it. Not only would the director be appointed directly by the president, with confirmation by the Senate (Engel and McCoy 2011), its rules, enforcement actions, and budget (although funded through the interest and bank fees received by the Federal Reserve) would not be subjected to review by the Federal Reserve's Board of Governors (Carpenter 2010a; Dodd–Frank Wall Street Reform and Consumer Protection Act 2010, Sections 1011–1012; Engel and McCoy 2011). With its mission to focus solely on protecting consumers in financial markets, the CFPB became the first federal agency of its kind (Carpenter 2011; Dugas 2010).

While the deliberation over the structure of the Federal Reserve may seem exceptional considering the enormous impact of the associated housing meltdown and collapse of worldwide financial markets, the debate typified by the March 2010 hearing was far from the only example of regulatory reform triggered by failure around that same time. Just over one month later, in April 2010, the spill of several million barrels of oil into the Gulf of Mexico as a result of an explosion and subsequent fire on the BP-leased *Deepwater Horizon* drilling rig prompted a series of investigations and hearings. Many of these inquiries focused on the Minerals Management Service (MMS), the Department of the Interior's (Interior) regulator of offshore drilling at the time. A leading theory pinned MMS's "laissez-faire" (Waxman 2010) attitude toward regulating offshore drilling and production on initial decisions about how to structure the agency when it was created in 1982 (Flournoy et al. 2010; Honigsberg 2011). By combining oversight of offshore oil and gas drilling with both tax collection and development responsibilities in a single agency, Interior had allegedly laid the foundation for the Gulf disaster.

In reacting to this consensus view, approximately one month after the onset of the spill, Interior had already initiated the dissolution of MMS, announcing its intention to distribute MMS's functions among three separate agencies that were to be created within the department. In describing the restructuring, Secretary of the Interior Ken Salazar indicated that MMS "has three distinct and conflicting missions that – for the benefit of effective enforcement, energy development, and revenue collection – must be divided" (Office of the Secretary of the Interior 2010a). By the beginning of October 2010, the Office of Natural Resources Revenue had been created to manage MMS's tax collection responsibilities.

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In October 2011, the regulatory and development functions were officially split through the formation of the Bureau of Safety and Environmental Enforcement and the Bureau of Ocean Energy Management from the agency within Interior initially created to replace MMS, the Bureau of Ocean Energy Management, Regulation and Enforcement.

Six months after the BP well was permanently closed, the March 2011 earthquake and tsunami in northern Japan placed yet another regulator at the center of prominent policy reform discussions. While initially focused on the devastation from the tsunami itself, news coverage quickly turned to the impending nuclear meltdown at the Fukushima Daiichi power plant and, with it, questions about the effectiveness of the industry's regulator – the Nuclear and Industrial Safety Agency (NISA). In a policy debate eerily reminiscent of that associated with the Gulf oil disaster, by April, news agencies were already lamenting the "collusive ties that bind the nation's nuclear power companies, regulators and politicians" (Onishi and Belson 2011). According to critics, locating NISA within the Ministry of Economy, Trade and Industry sapped the agency's willingness to provide the necessary oversight of nuclear plants since the Ministry was also in charge of promoting nuclear power. This led to a call by Prime Minister Naoto Kan, among others, for the "separation of the current Nuclear and Industrial Safety Agency from the Ministry of Economy, Trade and Industry" (Japan Times 2011). By the middle of August, Goshi Hosono, the minister assigned to oversee the nuclear crisis, had already announced a restructuring of NISA. As a response to allegations that NISA was "too cozy with the nuclear industry in the years before the March disaster" (CNN 2011), the Nuclear Safety Agency was created through the merger of NISA and the Nuclear Safety Commission, which had previously been an advisory body in the Prime Minister's Cabinet Office (Japan Times 2011). Moreover, the new agency was positioned in the Environment Ministry, completely removing the Ministry of Economy, Trade and Industry from involvement in nuclear oversight.

In addition to its similarities to the controversy resulting in the termination of MMS, the policy discussion and reorganization of Japanese governmental nuclear functions closely paralleled the US political debate over regulation of nuclear power some thirty-five years earlier. After years of mounting allegations in the 1960s and early 1970s that its regulatory programs were not rigorous enough to prevent disaster and mitigate harm if a meltdown occurred, the Atomic Energy Commission (AEC) was split into two parts through the passage of the Energy Reorganization Act of 1974 (Hacker 1994; Rolph 1979; US Nuclear Regulatory Commission 2011). Again, the

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focus of the reorganization was the dual structure of AEC, which had been charged with both promoting nuclear power and ensuring its safety (Rolph 1979). By creating both the Nuclear Regulatory Commission to oversee industry operations as well as the Energy Research and Development Administration to aid expansion of nuclear power, Congress had "at least addressed one of the most serious long-standing complaints against the AEC" (Hacker 1994, p. 254). Not only had its dual structure apparently impeded its ability to regulate similar to Japan's NISA, but also, by separating the two functions in response, the enacted remedy for AEC's problems closely mirrored the response to the disaster at the Fukushima Daiichi power plant.

ORGANIZATIONAL REFORM FROM REGULATORY CRISIS

Along with the September 11, 2001 terrorist attacks, the financial meltdown, Gulf oil spill, and nuclear disaster in Japan represent some of the most pressing crises of the first one and a half decades of the twenty-first century. However, as the above descriptions have demonstrated, these calamities share commonalities that extend well beyond this observation. In focusing critical attention on the regulatory agencies charged with overseeing the associated industries, the policy debates following the onset of each crisis pointed to shortcomings in regulatory design to help explain why the failures occurred. These discussions focused attention on the multiple roles that the regulators in charge were asked to fulfill and the potential conflicts that such arrangements created. Because NISA was located in the Japanese ministry in charge of promoting the nuclear power industry, how could the agency be fully committed to ensuring that nuclear power plants were operating safely? Did the regulatory function not require the agency to restrict activity at the very same companies that the Ministry of Economy, Trade and Industry sought to support? Since the Federal Reserve sets monetary policy, would it not be tempted to downplay bank problems uncovered through its examinations if these revealed evidence that it made bad policy decisions? How could one expect MMS to adequately regulate offshore oil and gas operations when it was also facilitating exploration through its role in selling leases to the same oil companies? Moreover, since the amount of tax revenue collected is largely determined by how much oil and gas is produced, would not collecting taxes from these companies further compromise MMS's willingness to restrict production through stringent regulation?

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Beyond simply occupying pages of congressional testimony and popular newspapers, the belief that organizational structure was important in explaining each of these crises also played prominently in the resulting reforms. The notion that joining bank regulation and monetary policy had weakened the Federal Reserve's impetus to adequately perform the former function prompted the aforementioned decision to create an additional position on the Board of Governors, a presidentially appointed vice chairman in charge of bank supervision. The associated conclusion that the financial regulatory infrastructure, of which the Federal Reserve is a prominent part, collectively ignored their consumer protection functions in order to focus on their core roles was the impetus for the formation of a completely new agency, the CFPB, with an operating budget exceeding $350 million just over a year after its creation (Consumer Financial Protection Bureau 2012).

As for US offshore oil and gas and Japanese nuclear regulation, the reforms were arguably even more dramatic. In both cases, the perception that the agency's role in facilitating energy development impeded adequate oversight by encouraging close ties between the industry and the regulator prompted the complete restructuring of the regulatory agencies. In creating the Nuclear Safety Agency from both NISA and the Nuclear Safety Commission and positioning it in a different ministry, Japanese authorities completely overhauled the nuclear regulatory infrastructure just five months after the initial earthquake and tsunami. These changes were a response to the notion that NISA's compromised relationship with industry was prompted by its organizational design. Similarly, the announcement of a plan to dissolve MMS and reorganize government offshore oil and gas operations under three separate agencies came almost immediately after the initial oil rig explosion and was driven by the view that the combination had encouraged, in President Barack Obama's words, "a scandalously close relationship between oil companies and the agency regulates them" (2010c). Echoed in the remarks of Secretary Salazar, the solution then was to carve up the agency to eliminate the conflicts that had encouraged the regulatory decay.

REGULATORY PERFORMANCE UNDER COMPETING MANDATES: OVERVIEW

In his celebrated book, *Bureaucracy*, James Q. Wilson tells us that, "Organization matters, even in government agencies. The key difference between more and less successful bureaucracies . . . has less to do

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with finances, client populations, or legal arrangements than with organizational systems" (1989, p. 23). Viewed through the lens of the Gulf oil spill, the financial crisis, and the Japanese nuclear meltdown, it is clear that when it comes to regulatory agencies, Wilson is correct that organization matters. For evidence, one has to look no further than the reforms that emerged from the crises, which were in large part efforts to improve existing organizational structures. Regardless of whether ill-conceived regulatory designs actually laid the foundation for any of these disasters, the responses of the policymakers in charge suggest they believed that they did. Or at least that these policymakers believed reorganization was a viable way to respond to the crises and ameliorate the discontent these events fostered. Even without investigating the factual bases for these claims, these episodes then suggest that regulatory structure is meaningful since the perception that it is can drive reactions to failures in regulated industries.

This book then is not so much focused on determining whether organization is important. Clearly, the organizational responses to the three aforementioned disasters indicate that it is. Rather, the focus is on the second part of Wilson's claim, that organizational systems are the key determinant of bureaucratic success or failure. The book is centrally concerned with ascertaining whether and how regulatory organizational design matters for regulatory agency behavior and performance rather than accepting that it matters merely because people believe that it does. In the context of the disasters described above, this aim means ascertaining the extent to which an organizational system which combines regulatory and non-regulatory functions in a single agency can help us explain failures such as the financial disaster, Gulf oil spill, and Japanese nuclear meltdown. But it also means determining whether organization impacts the performance of these types of agencies more generally as well.

Combining a statistical analysis of a large set of US agencies, a historical case study of the development of MMS prior to the Gulf oil spill, and a theoretical analysis built on the evidence uncovered in the statistical and case studies, I demonstrate that regulatory agencies that simultaneously balance important non-regulatory functions – agencies that I refer to throughout as multiple-purpose regulators – generally perform worse than those agencies that either solely regulate or do not oversee a significant regulatory mission. By revealing that multiple-purpose regulators are less apt to achieve their goals than other agencies, the findings are thus supportive of the popular criticisms of the Federal Reserve, MMS, and NISA.

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Further, this evidence also supports the conclusions of an influential literature in public administration and political science studying the effects on government organizations of what is known as "goal ambiguity." Among other reasons that the goals agencies try to achieve may be vague (Chun and Rainey 2005b), the literature studying goal ambiguity warns of the perils for agency performance of combining multiple goals in one agency, particularly in the extreme, when the goals actually conflict with each other (Lee et al. 1989; Rainey 2009). The empirical analysis simultaneously reveals that the mechanism by which these scholars often link goal ambiguity to poor performance – specifically the uncertainty that it fosters among employees in trying to make connections between their work and the organization's goals – helps explain why multiple-purpose regulators perform poorly. In demonstrating empirically the linkages between organizational design, employee behavior, and agency performance, this study substantially extends existing goal ambiguity scholarship.

However, this is not the end of the story. Although the analysis finds that academic theory and conventional wisdom hold some truth, stopping the analysis there overlooks an important additional finding. The evidence presented demonstrates that assimilating multiple and even conflicting goals in a single government agency can still be better than dividing them among multiple agencies. In fact, I show that emphasizing the role that competing organizational goals may play in impeding an agency's ability to develop a cohesive sense of purpose misses several important factors that explain both how multiple-purpose regulatory agencies respond to multiple mandates and why they continue to exist. These factors include: (1) the importance of collaboration in completing the tasks associated with the competing goals; (2) the capacity of a government organization to structure itself to mitigate goal ambiguity and conflicts; (3) the role that political as well as social preferences have in shaping agency priorities; and (4) the relative advantage regulators balancing multiple missions have in managing uncertainty in their environments in order to achieve competing missions concurrently.

Certainly, it is well established in economic theory that complementary tasks – where the performance of one assists completion of the other – are better off assigned to the same individual or organization (Dixit 2002; Holmstrom and Milgrom 1991). However, this insight has not been incorporated into studies of the effects of goal ambiguity, likely because tasks and goals are typically assumed to be synonymous.

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Yet, in fact, it is important to separate the two in order to understand how tasks associated with different goals can support each other, despite the goals themselves being in tension. Explicitly considering this distinction brings to the fore the friction that can exist between the goal ambiguity introduced by combining multiple goals and the need for collaboration to ensure that personnel have the resources required to successfully complete the underlying tasks supporting the competing goals.

The evidence uncovered further reveals how regulators can mitigate ambiguity and conflicts through organizational features embedded in an agency's creation or development which separate groups working to fulfill the competing goals. These features may include divisions created by reporting relationships as defined in the agency's organizational chart or simply by the geographical spread of the conflicted groups. Alternatively, these divisions can arise informally given, for example, differences in the backgrounds and core skills of the civil servants assigned to fulfill the regulatory and non-regulatory goals or agency processes and information systems that are intentionally or unintentionally decoupled.

However, while intra-organizational divisions may allay the effects of goal ambiguity and conflict, they may also simultaneously inhibit efforts to realize synergies between the underlying tasks, which is likely one reason why the agency was created as a multiple-purpose regulator initially. Thus, while a preference for either achieving goal clarity or facilitating task coordination and information sharing can drive the decision to divide or create a multiple-purpose regulator, that same preference will likely impede efforts to achieve the end that is relatively ignored by the decision. The existence of this tension explains why, in the analysis of a broad set of US federal agencies presented in Chapters 2 and 3, multiple-purpose regulators still perform significantly worse (in both statistical and practical terms) than other agencies, even holding constant the effects of goal ambiguity on performance. In erecting informal and formal divisions to mimic the goal clarity achieved by their single-mandate counterparts, multiple-purpose regulators' effectiveness will still suffer because their abilities to realize synergies through collaboration will be undermined by those same divisions. Thus, correcting one problem introduces another.

Further, even when the affected missions are pursued in close contact, such that the conditions for goal ambiguity and conflict are present, how the regulatory agency prioritizes among the competing goals is impacted

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by forces that extend beyond simply the preferences of those in the organization. It is not a foregone conclusion that the regulatory mission will end up relatively neglected either. Rather, political and public pressure can largely shape whether the agency emphasizes its regulatory or non-regulatory missions. As with most regulators, interest groups can certainly influence decision-making at multiple-purpose regulators. Yet, notwithstanding the views of some who assert that special interests will normally get their way in regulatory arenas (see, e.g., Stigler 1971), because multiple-purpose regulators balance additional missions, a broad set of politicians as well as the general public may exert more influence over whether the regulatory function is relatively overlooked.

Furthermore, these political forces will not be working in isolation. Rather, ecological, societal, and industry developments – which might include the discovery of a new technology, the emergence of a crisis, or the founding of a social movement – affect the likelihood of success in achieving both the regulatory and non-regulatory goals. Although often beyond the multiple-purpose regulator's control, the extent to which such events, dramatic or mundane, can be expected to impact the agency's ability to achieve its goals describes the degree of congruence between them, ranging from being relatively harmonious to completely conflicted. How external conditions impact goals in similar or dissimilar ways will also drive how much is gained by coordinating the tasks and how much is lost through goal ambiguity. Because the tension between coordination and ambiguity has real consequences for performance, understanding how the probability of achieving the goals is affected by activities outside of the agency in analogous or divergent ways is central for deciding whether to separate or combine regulatory and non-regulatory objectives.

These results point to a much greater role for multiple-purpose regulators in achieving social goals than is acknowledged in academic research or popular accounts, which typically offer few reasons to combine regulatory and non-regulatory missions. Particularly when outward evidence points to a regulatory agency struggling to manage goal ambiguity, a narrowly focused perspective misses the hidden benefits that merging missions can provide, and which offer good reasons to consider keeping them together. A broader perspective which recognizes the tension that exists in structuring regulatory agencies between stemming goal ambiguity while promoting synergistic collaboration can also help curb the harmful cycles described in the book whereby, over time, multiple-purpose regulators are created, disbanded, and later created again.

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