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The Limits of Regulatory Capture: Explaining the UK Payment Protection Insurance Mis-Selling Scandal

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ABSTRACT

To what extent does regulatory agencies' failure to protect the public from harm result from undue industry influence? We argue that “regulatory capture” is invoked too easily to explain regulatory failure. To re-examine the relationship between regulatory capture and regulatory failure, we use process-tracing to study UK regulatory decision-making about payment protection insurance (PPI), a product synonymous with one of the largest financial mis-selling scandals of all time. We analyze the case through three different perspectives on regulatory decision-making: regulatory capture, organizational reputation, and organizational blind spots. The findings show that only the combination of all three theoretical lenses enables us to make sense of the Financial Services Authority's approach to PPI. We advance regulatory failure theory by showing how different external pressures on regulators and internal organizational constraints interact to result in failure, thus providing a comprehensive framework for the study of regulatory failure that future studies can apply.

1 | Introduction

When regulators fail to protect the public from harm, excessive industry influence—or regulatory capture—is often identified as the inevitable culprit (Carpenter and Moss 2014; Hutter and Lloyd-Bostock 2017). However, the prevalence of regulatory capture has been questioned (Heims and Moxon 2024; Yackee 2022), with greater significance attributed to deep-seated forms of industry influence on politics and policy-making (Browne 2020; Slayton and Clark-Ginsberg 2018). There is also a recognition of the need to distinguish clearly between industry influence used to create barriers to entry to an existing market, and industry influence used to water down regulation, so-called corrosive capture (Carpenter and Moss 2014). In either scenario, the relationship between capture and regulatory failure remains ambiguous (Donadelli and van der Heijden 2024). This article examines a notorious regulatory failure: the sale of payment

protection insurance (PPI) in the UK between the 1990s and 2010. The PPI scandal is synonymous with the most significant financial mis-selling scandal in the United Kingdom. Globally, it comes second in cost only to mis-selling of residential mortgage-backed securities in the US before the financial crisis of 2008.

PPI (known as credit insurance in the US) was sold alongside most secured and unsecured credit products, ranging from mortgages to personal loans, credit cards and car finance plans. PPI was designed to protect consumers if they could not make repayments on the money they borrowed, for example, due to becoming unemployed, by covering their repayments. PPI sales grew rapidly through the 1990s, peaking in 2004. Roughly 45 million policies were sold between 1990 and 2010 in the UK, worth £44bn in premiums (FCA 2014, 7). Sales declined sharply from 2009 when the regulator (the Financial Services Authority) negotiated a ban on some PPI products with the industry.

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Consumer groups and the media had warned since the early 2000s that financial service providers were mis-selling PPI (i.e., selling the product to customers for whom it was not suitable) on a large scale. Eventually, between 2011 and 2020 the industry paid out £38.3 billion to customers who had been mis-sold PPI. In 2013, the Parliamentary Commission on Banking Standards stated that “scandals relating to mis-selling by banks were allowed to assume vast proportions, in part because of the slowness and inadequacy of the regulatory response” (PCBS 2013, 12). How and why did the Financial Services Authority fail to limit the PPI mis-selling scandal? And to what extent was regulatory capture to blame for the regulator’s failure to limit mis-selling?

To critically examine the FSA’s approach to PPI and the role industry influence played in shaping it, this article uses process-tracing methodology to examine regulatory decision-making through three distinct yet interrelated perspectives: regulatory capture, organizational reputation, and organizational blind spots. While the regulatory capture perspective focuses on a regulator’s responsiveness to the regulated industry (Braun 2022; Rex 2020), the literature on organizational reputation argues that regulators try to safeguard specific reputations that they have carefully curated with key audiences beyond industry, such as the media, professional groups, government and advocacy groups (Bustos 2021; Carpenter 2010). The organizational blind spots perspective, in contrast, focuses on a regulator’s “inner life”, meaning how mandates and standard operating procedures shape its decisions (Bach and Wegrich 2019; Pidgeon and O’Leary 2000). Together, these approaches provide a comprehensive approach to studying regulatory behavior as they combine the most important external and internal pressures and constraints faced by regulators, but existing scholarship usually confines them to separate analyses. We operationalize each of the approaches through a series of observable manifestations to evaluate how far each of the three different forces mattered in decision-making on PPI.

Our process-tracing analysis provides evidence for the limits of regulatory capture as the sole explanation for corrosive capture. Regulators respond to many external and internal pressures, of which pressure from the regulated industry is usually but one. The FSA undoubtedly faced industry pressure, resulting in a lack of enforcement against large firms in the early years and delays in pushing through new rules governing fair complaints handling in later years of the saga. However, when conducting a comprehensive empirical analysis, we find the capture lens fails to shine a light on why the FSA devoted considerable attention to PPI (which the reputation approach elucidates), or why it approached the issue on a firm-by-firm basis and consequently underestimated the sector-wide problem (which the blind spots perspective uncovers). The study thus provides a hitherto missing explanation for why the regulator failed to limit the scale of mis-selling (Ashton and Hudson 2013; Ferran 2012).

Elsewhere, we have argued the case for more detailed testing of different mechanisms through which industry influence comes to bear on regulators (Heims and Moxon 2024). Here, we complement this analysis by comparing regulatory capture with other perspectives on decision-making because capture is too rarely exposed to alternative interpretations of (in-)action

by regulatory agencies. The article highlights the importance of studying decision-making cases through different theoretical approaches to gain a fuller understanding of a particularly important case, and to shed light on the limitations of different perspectives (Allison 1971; Beach and Pedersen 2019, 281). Our case study shows that examining regulatory failure through multiple perspectives is crucial as no one approach provides a full account as to why regulators failed to live up to their task. We need to expose regulatory capture to alternative or complementary explanations to avoid ascribing inadequate regulatory action to capture by default. By combining three theoretical perspectives, we advance regulatory failure theory by showing how different external pressures on regulators and internal organizational constraints interact to result in failure. The interaction between these factors limits the degree to which any one factor can become the dominant cause of failure, while the interaction equally has the potential to reinforce failure. A key contribution of the article is that it provides a more comprehensive framework of the drivers of regulatory failure, encompassing three sets of forces that are usually confined to separate analytical frameworks. Future studies of regulatory failure should aim to consider the combination of internal and external factors we bring together in this study.

2 | The Essence of Regulatory Decision-Making: Capture, Reputation, and Blind Spots

There is no coherent literature on regulatory failure and there is no commonly agreed definition of the term (Donadelli and van der Heijden 2024; Lodge 2002). At the most basic level, regulatory failures are failures to manage risks (Hutter and Lloyd-Bostock 2017, 209). This means they challenge the *raison d’être* of a given regulator and expose the expectations placed on regulators by society. Inevitably, there may be different perceptions of acceptable risk and whether risk was or was not adequately managed by different actors or across different time periods, meaning the label of “regulatory failure” is ambiguous. When analyzed in hindsight, disparate facts and events are often linked together in a manner that gives the appearance that risk could have been adequately managed if different actions had been taken, which is not necessarily the case (ibid.).

Similarly, the relationship between capture and regulatory failure is unclear in the regulation literature. While capture is often suspected when regulatory outcomes are seen as a failure (Li 2023), this is usually not followed by a detailed empirical examination of the extent to which capture was at play (Hutter and Lloyd-Bostock 2017, 7), while capture is often mis-diagnosed (Carpenter and Moss 2014; Heims and Moxon 2024; Yackee 2022). This means we must be careful to delineate regulatory capture from regulators’ responsiveness to other pressures, for example, to government or public attention (Rex 2020). To avoid the pitfalls associated with analyzing a case of bad regulatory outcomes through the inevitable “capture lens”, we suggest using three different perspectives on regulatory decision-making for our analysis: regulatory capture, organizational reputation, and organizational blind spots. These approaches emphasize the importance of different pressures and processes on regulators’ decision-making; yet, they have usually been used in isolation of each other, meaning

that analyses are prone to overestimate the importance of one driver of behavior over others. Looking at one case of regulatory decision-making associated with failure through these three lenses opens the possibility of uncovering the extent to which industry influence, as opposed to other pressures, indeed matters in agency decision-making. At the same time, the literatures on these three perspectives overlap (Gilad 2008) and should not be seen as competing explanations. Our analysis highlights the limits of each approach and the complementarities between them. Taken together, the three perspectives encompass the most crucial external and internal pressures and constraints on regulators' decision-making. Below we discuss each approach in turn, focusing on high-level depictions of each literature. Table S1 provides a detailed overview of the operationalisation of process-tracing across the three theoretical frameworks.

2.1 | Regulatory Capture

Agency capture refers to regulatory decision-making processes significantly influenced by the regulated industry, resulting in a shift from public to private interests served by these decisions (Braun 2022; Carpenter and Moss 2014). The literature on capture spans numerous social sciences disciplines, using different methodologies and studying different levels of government (Chesterfield et al. 2025; Li 2023; Yackee 2022; for classic literature on capture, see Bernstein 1955; Laffont and Tirole 1991; Stigler 1971). There are several theoretical models of regulatory capture: they range from rational choice models (a regulatory favor in exchange for a well-paid job in the regulated industry) (Cohen 1986) over bounded rationality (regulators getting overwhelmed by industry information, thus basing their decisions on it) (Shapiro 2012; Wagner 2010), to normative pressure (close personal relationships and shared worldviews among the regulator and the regulated) (Chesterfield et al. 2025; Kwak 2014; Rilinger 2023). While the economic perspective on capture developed by Stigler and others focused on industry using regulation as a barrier to entry for new firms, the term is now most frequently used in relation to what Carpenter and Moss (2014) refers to as corrosive capture, namely the weakening of regulation to safeguard regulatees' interests. It is this form of capture that we are focusing on in this analysis. We use a wide-ranging conceptualization, which includes different modes and mechanisms of corrosive capture (cf. Heims and Moxon 2024). However, we focus on capture at the regulatory agency level and argue that capture is present if industry pressure results in agency decisions that favor the industry and harm the public interest (ibid.; Braun 2022; Carpenter and Moss 2014; Rex 2020). This differs from notions of business power (Culpepper 2012) or "deep" forms of capture (Hanson and Yosifon 2003; Browne 2020; Slayton and Clark-Ginsberg 2018; Weinkle 2020), which focus on the structural influence of industry because of its economic importance or deep-seated influence on the fabric of our societal and political systems. The view of capture we focus on in this analysis regards regulators as (relatively) passive recipients of pressure from the regulated industry. In this view, regulators do not actively manage these pressures or try to use them to their advantage. This means they regard external actors, specifically the regulated industry, as key in shaping organizational decisions.

The theoretical mechanism associated most closely with regulatory capture is a significant and sustained effort by the industry to influence regulatory decisions (though capture can also exist in the absence of this, for example, when cultural capture is concerned, see Kwak 2014; Li 2023; Rilinger 2023); likewise, capture can, more rarely, also happen through non-industry bodies (Dougherty and Phillips 2024) and a direct link between industry pressure and a pro-industry shift in decisions made by the regulator (Heims and Moxon 2024). This means for empirical analysis we focus on observable manifestations linked to industry pressure. Industry pressure may be overt, for example, in consultation procedures or through other agency committees or procedures in which industry stakeholders are formally represented. Industry may also exert influence through coordination among regulated entities (Rex 2020). On the other end of the scale, industry pressure may occur behind closed doors in confidential or informal interactions with regulators (Li 2023). We need to be able to observe an impact of this pressure on regulatory action, for example, the watering down of regulatory proposals, decisions not to act against the regulated in rule-making or enforcement, or the copying of specific wording or lines of reasoning from the regulated industry.

2.2 | Organizational Reputation

The organizational reputation perspective suggests that regulators' decision-making processes are significantly influenced by concerns about reputation among their key audiences (Carpenter 2010). Organizational reputation refers to a set of symbolic beliefs held by key audiences about a regulator's capacities, performance, role, and obligations (Carpenter 2001; Maor 2010). Such key audiences include, but go beyond the regulated industry, such as non-governmental organizations and pressure groups (e.g., consumer advocacy groups, patient groups, activist groups etc.), as well as the general public (e.g., Lee 2022). They also include the media, professional groups, parent ministries and elected government. A core argument is that regulators carefully curate an organizational image and reputation (e.g., for scientific excellence or agile decision-making) with key audiences, and empirical research has shown that regulators are particularly vulnerable to negative media attention compared to other government agencies (Verhoest et al. 2023). In building their reputation they remain responsive to their environment, such as what government is in power, views held by professional and academic communities and other regulators, the media, the public, and so on, thereby strategically prioritizing the most pressing threats to their reputation (Bach et al. 2022; Gilad, Maor, and Ben-Nun Bloom Gilad et al. 2013; Rimkutė and van der Voet 2024). Reputation-seeking behavior can result in organizations prioritizing some fields of work over others, contributing to bad outcomes (Gilad 2015).

This approach conceives of regulators as rational actors, which, however, act under time, attention, and resource constraints (Maor 2010). It highlights that regulatory organizations act strategically in how they situate themselves and respond to the external environment. As in the capture perspective, external actors are key in shaping organizational responses. Unlike the capture perspective, however, it highlights that external actors beyond the regulated industry can affect regulatory decision-making.

Even more crucially, in this approach, government agencies are seen as proactive, rather than passive, actors, which respond to external pressures strategically. Such responses to and perceptions of external pressures do not exist in a vacuum but in relation to, for example, professional standards but also organizational solutions or regulatory approaches that are regarded as desirable in given contexts (e.g., whether more interventionist or “light touch” forms of regulation are regarded as most effective by key audiences of a regulator). Regulators are involved in the construction of their legitimacy in institutional contexts in this respect, meaning that strategic action is ultimately bound by their environments (Black 2008; Boon 2023).

The theoretical mechanism associated with this perspective is that reputational threats to the regulator emanating from external actors beyond the regulated industry (e.g., an advocacy group campaign against the regulator that appears in the media) result in changes in regulatory decisions and approach. Observable manifestations hence relate to pressure on the regulator exerted by third parties (e.g., NGOs and advocacy groups), elected government and the media. We would also need to find evidence of regulators being responsive to these pressures by shifting decisions or approach in response to it, for example, direct changes to the regulatory approach that follow a public campaign by advocacy groups and media attention that threatened the reputation of a regulator.

2.3 | Organizational Blind Spots

The organizational blind spots approach pinpoints that regulators' decision-making is significantly influenced by existing organizational processes and frameworks (Bach and Wegrich 2019; Lodge 2019; Gieve and Provost 2012; Pidgeon and O'Leary 2000). These define a range of options available to regulators and shape responses to problems and pressures exerted by external groups. This perspective highlights that formal mandates and standard operating procedures shape perceptions and information processing within organizations, but also informal frames of thinking and institutionalized norms (Barnett and Finnemore 1999; Egeberg 2012; Feduzi et al. 2022). For example, if a policy issue cuts across several public organizations' responsibilities, each agency is likely to interpret and act on the issue through the lens of its mandate (Bach and Wegrich 2019). In “crowded” policy spaces, agencies will also seek to delineate their domain from that of other government institutions in the field, compounding the “tunnel vision” created by specific mandates and domain perceptions (Gilad 2008; Wilson 1989).

The underlying theoretical assumptions of this approach focus on the importance of bounded rationality at the organizational level (Jones 2017; Gomes and Domingos 2025; Simon 1947), and the inherent dilemmas and problems attached to organizational life because of this (Hood 1974). However, the approach also has firm theoretical roots in institutional theories that focus on how values and norms become embedded in organizations over time (Christensen 2019). The perspective assumes that organizations have inherently limited capacity and attention and thus seek “short cuts” to handling problems by channeling them through existing (formal or informal) frameworks. As internal processes are key in shaping organizational responses, an

organization's internal life is regarded as at least as important, if not more important to decision-making, as external pressures. This means that regulatory organizations stick to existing patterns of processing information and making decisions, meaning that responses to external pressures are limited and shaped by these factors. This means that normal organizational behavior (as opposed to, for example, the deviant behavior of some officials) can result in failure and disasters (Bach and Wegrich 2019; McConnell and 't Hart 2022; Pidgeon and O'Leary 2000). In contrast to the organizational reputational approach, the blind spots perspective focuses on unintended consequences of institutionalization processes within organizations (Lodge 2019; Fligstein et al. 2017) rather than a purposive creation and maintenance of a distinct organizational reputation. Organizations are thus usually unaware of their own incomplete information processing (“not seeing that one is not seeing”) (Lodge 2019). At the same time, there is overlap between the two theoretical approaches since a focus on maintaining the organization's reputation can create or imbed blind spots (ibid.).

The theoretical mechanism associated with this approach is that a flawed framing or understanding of a regulatory problem or the solutions available (as a product of how the organization processes information) has a direct impact on the nature regulatory decisions. Observable manifestations of this mechanism are regulators focusing on a particular issue through the lens of its own objectives and mandates, even if the problem transcends the organizational mandate. Other key observable implications of blind spots (especially regarding the impact of informal institutions) include absence of information about a particular problem due to a lack of appropriate measuring tools, and an inability to identify the causes of a particular problem due to inadequate organizational processes, expertise or routines (Lodge 2019).

3 | Methodology

To study the relationship between excessive industry influence and inadequate (or failed) regulatory action, we use process-tracing methodology to understand what factors shape regulatory decision-making. Our analysis is based on a relatively unambiguous case of regulatory failure: a mis-selling scandal of enormous proportion, which caused financial detriment to consumers on a vast scale. We focus specifically on the regulatory approach of the UK Financial Services Authority (FSA) between 2005 and 2011, even though our analysis takes other regulatory bodies into account. The analytical focus on an individual regulator is necessary for an in-depth study of actions and motivations. The FSA's decision-making on PPI between 2005 and 2010 presents a “most likely” case to find capture, meaning it is a “crucial” case for studying capture (Gerring 2006). “Crucial” cases, in their strictest interpretation, should exhibit the causal relationship a theory is proposing. If they do not, this disconfirms the theory. We use a softer definition of a crucial case, suggesting it to be the most likely case to show a clear relationship between industry influence and regulatory failure (ibid. p. 115). If the capture perspective struggles to account for such a case, it is more likely to struggle to offer full explanations in other cases of regulatory failure. Hence, the case's generalisability extends to its ability to cast wider doubt about the relationship between capture and regulatory failure. It represents a “most

likely” case as financial regulators have been widely criticized for being too close to the industry they regulate, especially before the 2008 financial crisis, not least due to the large political influence of the financial industry, its economic importance, significant information asymmetries between the industry and the regulator, close relationships between regulators and the regulated, and shared frameworks of economic thinking across the industry–government divide (e.g., Baker 2010; Buitier 2012; Kwak 2014; Pagliari 2012). Indeed, some journalistic accounts have pointed to capture to explain regulators’ failure to act on PPI (e.g., Collinson 2009; Masters 2012; Inman 2007).

It is also an “explaining the outcome” case due to the scale of mis-selling associated with PPI. An “explaining outcome” study using process-tracing methodology aims to offer a comprehensive explanation of a specifically interesting case, focusing on case-specific causal mechanisms (Beach and Pedersen 2019, 281ff). Our analysis of the case through three different theoretical perspectives provides a comprehensive explanation, with generalisability limited to casting doubt on regulatory capture as a “catch all explanation” for regulatory failure. Process-tracing uses specified theoretical mechanisms that link cause and effect, develops observable manifestations of these mechanisms and links them to empirical fingerprints (ibid.). In relation to the capture perspective, this means our empirical analysis focuses on observable manifestations linked to overt or covert, informal, industry pressure, also in relation to the degree of coordination between industry, which directly changes actions taken by the regulator. For reputational pressures, the analysis focuses on the responsiveness of the regulator to pressure from third parties (e.g., NGOs and advocacy groups), elected government and the media. To analyze the relevance of the organizational blind spots perspective, we focus on how and whether regulatory action is a result of the regulator’s perception of the regulatory problem and whether this is shaped by, for example, the regulator’s specific mandate, inadequate organizational processes, expertise, routines or measuring tools. Table S1 provides a systematic overview of observable manifestations and empirical fingerprints for each theoretical approach.

We studied the FSA’s approach to regulating PPI through a strictly chronological analysis of key sources to avoid interpreting empirical findings through the benefit of hindsight. This also means we avoided “fitting” our data to specific theoretical approaches, leaving space to interpret our findings through different theoretical lenses. Our data comprises the following sources: 2001 media articles (assembled via Nexis with the search terms “PPI and FSA”, and containing articles from 7 major UK newspapers), 266 FSA/FCA documents referencing PPI from the years 2000–2019 (the FCA, Financial Conduct Authority, is the successor of the FSA; the documents were identified via the UK government web archive using the search term “payment protection insurance”), 42 FSA consumer and practitioner panel annual reports, 69 documents of other government bodies (including the Competition Commission, Office for Fair Trading, Financial Ombudsman Service, and parliamentary Select Committees and parliamentary debates, identified through the UK government web archive, the Hansard, and Select Committee archives, using search term “payment protection authority”), 6 consumer body reports (identified through media articles), and secondary literature on PPI (six

studies identified through Google Scholar and search term “payment protection authority”). Documentary analysis was supplemented with five semi-structured interviews with former FSA Board members and staff members. Ethics approval for interviews was granted by the ELMPS Ethics Committee of the University of York. Interviews were conducted between July and December 2023. We took detailed notes during the interviews, and two of the interviewees agreed for notes to be deposited in the UK Data Service Re-Share Depository (Heims 2024). Our chronological case report of the FSA’s decision-making was then used to check for evidence aligning with observable manifestations of our three theoretical perspectives.

4 | Analysis: Payment Protection Insurance Revisited

The Financial Services Authority was created in 1997 and brought together numerous self-regulatory bodies which had hitherto overseen financial regulation in the UK. Insurance regulation, including provisions for fair treatment of consumers, remained under the remit of several self-regulatory bodies until 2005, when the FSA assumed responsibility for general insurance regulation due to a change in EU law. The regulator immediately started an investigation into PPI but did not restrict the sale of PPI until 2009. Mortgage payment protection insurance (MPPI) first emerged in the 1970s, with other PPI products following in the 1980s. Eventually, the market would come to be dominated by three PPI products: MPPI, personal loans PPI and credit card PPI. Initially it was regarded as a useful product as it was designed to protect people from becoming unable to make credit repayments (e.g., due to sickness, accidents or unemployment) (Ferran 2012). However, the first negative media attention to PPI emerged as early as 1989, with the *Guardian* reporting widespread inertia-selling (i.e., customers had to specifically opt out of buying the product, rather than opting in), a first indication that the persistent problems that would emerge were not a function of the products themselves but rather with how they were being sold (with sales mostly happening alongside the sale of the credit being insured, e.g., when taking out a personal loan). Meanwhile, the Consumer Association carried out a detailed study of the PPI market and the clauses and terms attached to PPI policies in 1990. At the same time, the government was actively promoting some PPI products (such as mortgage payment protection insurance) as alternatives for welfare benefits due to changes to government protection for people’s mortgages in case of unemployment or sickness. While mortgage PPI was never at the heart of the mis-selling scandal that developed over the next decade, the government’s active promotion of the product during the 1990s led to raised eyebrows, and harsh criticism on the part of Insurance Ombudsman Walter Merrick (ibid.). By the end of the 1990s, financial pages of the media were full of individuals recounting their stories of having been mis-sold PPI and consumer group activity on the issue picked up significantly. The penetration rates (used by businesses to calculate what percentage of people in a target market have bought a particular product) for personal loan PPI reached 62% in 2002 and 39% for credit card PPI in 2003 (Competition Commission 2009). These high rates fell after this peak, largely due to negative media coverage (Ferran 2012). Meanwhile, in its peak period, the PPI market was large with over 6.5 million policies purchased every year

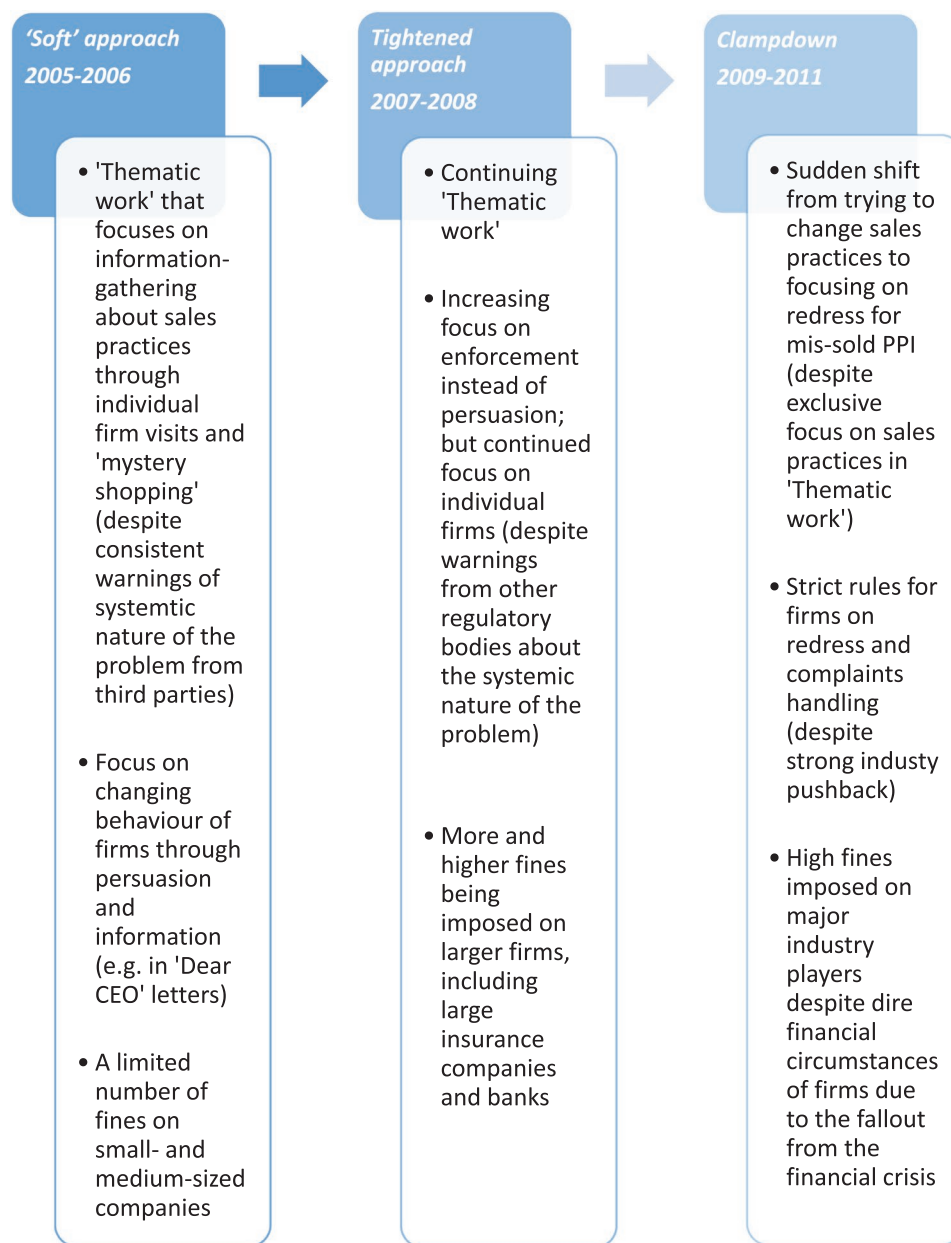


FIGURE 1 | FSA regulation of PPI—key regulatory approach in three phases. [Color figure can be viewed at wileyonlinelibrary.com]

worth over £5.5bn in 2005 (OFT 2007), the year in which the FSA gained responsibility over the insurance market.

The actions of the regulator in this respect can be separated into three distinct phases. Figure 1, represents the FSA's regulatory approach in each phase, moving from a soft to a tightened approach, followed by a clampdown (these three regulatory approach phases are distinct from the three theoretical approaches discussed above): while the FSA was aware of problems in the PPI market as soon as it assumed responsibility over the product type, it first assumed it could change industry behavior through “soft” means, that is, by gathering and disseminating information about problematic sales practices among offending firms and a limited number of small fines on smaller firms. This initial phase lasted from 2005 to 2006, when given the long-run warnings from consumer groups, the media and politicians, the FSA could, in theory,

have acted more decisively through more targeted enforcement procedures, and clearer consideration as to whether a focus on individual firms was appropriate. In the second phase (2007–2008), the FSA grew increasingly frustrated with a lack of change in PPI sales practices and subsequently tightened its approach to PPI, mainly by fining bigger industry players and imposing higher fines. Nevertheless, this approach remained focused on individual firms and only managed to scratch the surface in relation to the scale of mis-selling, even when other regulators and third parties were supplying clear information about the systemic nature of the problem to the FSA. The most fundamental change in the FSA's approach happened from 2009 when it shifted entirely from trying to assess if and how mis-selling was happening to redress for consumers that had been mis-sold. This shift was accompanied by immediate heavy-handed policy and enforcement against companies (including major high street banks) if they were refusing to

compensate mis-sold customers (as was often the case, which became clear through complaints from consumers to the Financial Ombudsman Service). Given that the regulator in previous years had not ever addressed the systemic nature of mis-selling in the first place, this was a sudden shift in focus and intensity. This was especially remarkable in the context of highly stretched financial institutions in the aftermath of the 2008 financial crisis, which were then being stretched further through significant pressure to pay redress to PPI customers, as well as increasingly high fines. Between 2011 and 2020, the industry then paid out £38.3 billion to customers mis-sold PPI by their financial service provider. Why did the regulator initially fail to limit mis-selling of this scale before moving to a more stringent approach towards PPI in 2009/2010? The analysis below answers this question using the three distinct theoretical approaches discussed in the previous section of the article. As the analysis will show, the three theorized drivers of regulatory decision-making were all present across all three different phases of regulatory approach, that is, each theoretical approach is needed to understand decision-making in every regulatory phase. This means that decision-making in every phase was more complex than, for example, the soft approach phase simply being a result of capture, or the clampdown being a result of reputational pressures.

4.1 | Regulatory Capture

Our detailed empirical analysis provides some evidence of industry influence thwarting effective regulatory intervention by the FSA. Industry stakeholders provided by far the most comments on the FSA's consultations on their PPI policies (FSA 2007b, 2009, 2010a, 2010e). They also had access to FSA decision-making via the FSA's Practitioner Panel and formal and informal settings, such as annual conferences organized for industry stakeholders by the FSA. In December 2005, the FSA met with 11 industry bodies to discuss the FSA's concerns with PPI and how the industry could address them (FSA 2006a), followed by a series of similar events (FSA 2006c). The FSA's initially timid approach to enforcement against firms that were mis-selling PPI also indicates behind-the-scenes industry pressure. Enforcement at first focused entirely on small or medium-sized firms, even though all large banks were mis-selling PPI, too. In 2005, the FSA's consumer panel raised concerns that the FSA appeared reluctant to take enforcement action and that the Regulatory Decisions Committee (RDC) seemed too influenced by the industry's views because of heavy industry involvement and lack of third-party involvement (FSCP 2005). Indeed, no large institutions were fined for mis-selling before 2008. While Lloyds was referred to the enforcement arm of the FSA for sanction in 2006, it was not fined after a two-year-long investigation, which struggled to gather evidence of institution-wide wrongdoing (PCBS 2013, 492), even though Lloyds eventually ended up paying out billions in redress to customers who had been mis-sold PPI. This feeble approach to taking on large players in the early years happened in a context in which the regulatory regime and informal political mandates for the FSA encouraged soft regulation to safeguard the competitiveness of the sector (Gilad 2015), also pointing to potentially deeper levels of capture.

Industry pressure on the FSA became acute in 2009 when the FSA published its Consultation Paper 09/23 on PPI complaints handling and redress (FSA 2009). The consultation paper set out clear rules on fair complaints handling and indicated that the FSA thought that rules on treating customers fairly applied to pre-2005 sales of PPI, given that the self-regulatory bodies had similar rules in place (*ibid.*). As this threatened to be hugely expensive to financial institutions, the industry applied pressure by any means, including legal action against the FSA. Due to the significant industry pushback, the FSA opened a revised version of the consultation paper for consultation in March 2010. Again, this consultation paper met significant resistance from the industry (FSA 2009, 2010a, 2010b, 2010c, 2010e). The FSA's final rules and guidelines on getting fair compensation for customers were only issued in August 2010 (FSA 2010a) and became subject to legal action by the British Bankers' Association (BBA). Consumer groups and the FSA's consumer panel voiced considerable frustration over the industry's influence on delaying the adoption of fair complaints handling rules, saying that the FSA "spent the past year battling against industry pressure to get their tough stance to be accepted" (FSCP 2010, 23). The real breakthrough in getting firms to start paying redress for PPI happened only after industry unity crumbled: the FSA won the High Court case against the BBA in April 2011, but the banks initially wanted to appeal the FSA's win. When Lloyds decided to withdraw from the appeal, other banks followed suit, which broke banks' resistance to the FSA's approach and ushered in the era of complaints handling and redress (notwithstanding major fines the FCA imposed for subpar complaints handling after 2010). In sum, the industry clearly tried to influence the FSA in consultations and private meetings, was likely able to do so in enforcement investigations, as well as holding significant power through coordination in a lawsuit against the FSA and in delaying regulatory action on redress for mis-sold products.

However, the capture perspective does not elucidate why the FSA began to act on PPI as soon as insurance came under its remit in 2005, and why its regulatory approach subsequently became increasingly demanding. The FSA consistently investigated PPI and continuously stepped up its efforts in response to insufficient change in the industry's behavior (FSA 2005a, 2005c, 2006d, 2007c, 2007d, 2009, 2010a). There was little direct industry pressure before 2009. Instead, the industry simply did not comply with the rules on treating customers fairly, leading to increasing frustration for the FSA. In its second PPI review in 2006, the FSA noted clear disappointment with the lack of progress by the industry, stating that it expected a "significant cultural and behavioural shift" from firms selling PPI (FSA 2006d, 5), with heightened threats of enforcement from 2007 (FSA 2007d, 2007e, 2007f), leading to a £7 million fine for Alliance and Leicester (FSA 2008) and eight further fines for PPI mis-selling in 2008. Moreover, in 2007, the FSA started to issue more restrictive rules applicable only to PPI, including refunds for customers who canceled their PPI and imposing specific reporting requirements for PPI because firms were too slow in complying with PPI sales rules (FSA 2007b). Prior to 2009, the industry responded mostly favorably to the suggested rules, and the FSA was not responsive to the limited criticisms that were raised. The gradual tightening of the FSA's regulatory approach amidst increasing industry pushback is not easily reconcilable with the regulatory capture approach. Neither is the

FSA's determination to take a tough approach to redress, which showed clear willingness to take on the industry despite the looming threat of legal action (FSA 2010b, 2010c). The regulator also withstood pressure from the largest high street banks to lower interest rates on redress to customers that had been mis-sold PPI. This means we cannot fully understand the FSA's regulatory approach and why it failed to act more effectively before 2009 when analyzing the case solely through the regulatory capture lens.

4.2 | Organizational Reputation

The FSA's quick take-up of PPI as a priority in 2005 is understandable if viewed through the lens of organizational reputation. The decision-making pattern on PPI by the regulator aligns with the perspective that the FSA was responsive to pressures from key external audiences beyond the regulated industry, especially consumer groups and the media, as well as political pressure. Most mainstream media outlets, including the *Guardian*, *The Times*, and the *Daily Mail*, had been reporting on the problems with PPI since the late 1990s. They frequently covered stories of individuals who had been mis-sold PPI (Morgan 2004) and regularly featured articles about consumer groups' work on the issue. Consumers' Association Which? and Citizens Advice published several reports about PPI in the 1990s and early 2000s, including analysis of the PPI market and results from mystery shopping of PPI products (Citizens Advice 2003). In September, Citizens Advice published a report on PPI called *Protection Racket* (Citizens Advice 2005) and raised a super-complaint with the Office of Fair Trading (OFT, a competition law enforcement and consumer protection agency), which, in turn, started to investigate PPI in April 2006. Consumer groups and media regarded the widespread mis-selling of PPI as a fact since at least 2003 and frequently criticized the FSA's lack of decisive action on PPI. This extensive criticism was also picked up by members of the government and parliament, who in turn requested more action from the FSA, with Ministers urging the FSA to act as early as 2003 (Atherton 2003) and the Treasury Select Committee asking the FSA to investigate PPI in 2005. These combined pressures had an impact on the FSA's decision to act on PPI and to continuously increase its efforts in this area (FSA 2005a, 1; FCA 2005b, 26; FSA 2010a, 24; FSA 2014, 7).

In 2008, public pressure on the FSA again intensified. The media and consumer groups, especially Consumer Association Which? heavily criticized the FSA for acting too slowly on PPI after consumer groups had been warning about PPI for 10 years (Hanson 2008a). Which? emphasized that the FSA was doing too little to ensure that customers got compensated for mis-sold PPI products (Hanson 2008b). This was echoed in the PPI complaints to the Financial Ombudsman Service, which had seen an increase from 802 PPI complaints in 2003/4 to 31,066 in 2008/9 (FSO 2009). This triggered FSA involvement through a so-called "wider implications procedure", asking "the FSA to consider whether—in the light of the evidence available to us [the FOS], its own regulatory findings, and the findings of the Competition Commission—it should take wider regulatory action" (ibid.). Ombudsman Walter Merrick meanwhile publicly expressed frustration with the FSA's handling of PPI: "There may be very sound reasons why more fines are not happening ... but the fact

is we are continuing to get a very large number of complaints on issues that it should be clear to firms we would uphold, and the FSA is fully aware of the situation" (Cooper 2009). The FSA's own Consumer Panel also started to push the FSA to do more for consumers who had been mis-sold PPI (FSCP 2008, 31). When the FSA moved to a more aggressive regulatory approach focused largely on compensation for mis-sold products in 2009, it did so under a wave of public and political pressure (not least due to the fall-out from the 2008 financial crisis) and a fight for its survival in the run-up to the 2010 general election. In a speech by Chief Executive Hector Sants at Oxford University's Said Business School, he outlined the FSA's new regulatory approach that was meant to end mis-selling scandals by scrutinizing products at the design stage and intervening in the product cycle earlier. In this, he acknowledged that fines and past business reviews had not effectively prevented mis-selling (e.g., Treanor 2010; FSA 2010d). The speech was widely seen to mark the end of "light touch" regulation and to be a bid for survival by the FSA before the upcoming election and the Conservative party's pledge to dismantle the agency. Industry pressure on the regulator was thus counterbalanced by media and consumer groups and focused regulatory attention on consumer protection.

The FSA's approach to PPI is also consistent with the organizational image it cultivated. In its first decade, it successfully styled itself as an innovative, world-leading, light touch, "not enforcement led regulator", inspired by the responsive model of regulation (FSA 2010e; Gilad 2015). Its core regulatory strategy was a cooperative approach to get the industry to comply with regulatory rules (FSA 2006b). In the Chairman's words, the regulator regarded "informal encouragement" as the main strategy to change behavior (FSA 2007a, 6). This organizational image shines a light on why the FSA started with a "soft" approach to handling PPI. Indeed, the regulator initially believed that encouragement and eventually fines would change firms' behavior (Farrow 2012). When it became apparent that the industry was not changing its PPI sales practices in response to encouragement, the regulator announced a change of strategy: in autumn 2007, it moved to a "credible deterrence approach" (FSA 2010e), relying increasingly on fines for non-compliance with PPI guidelines (a general shift in regulatory approach not only related to PPI, see Ferran 2012).

The FSA acted on PPI as a direct response to external pressure and criticism of its (in)action. It crafted its step-by-step approach on PPI in its self-image as a responsive regulator. However, the regulator's initial approach was cautious in relation to the scathing attacks by the media and consumer groups. Its step-by-step approach aimed at visiting and enforcing against individual firms was fundamentally at odds with the clear argument made by consumer groups and the FOS that PPI mis-selling was systemic. This means that while reputational pressures help us to understand why the regulator sprang into action, they do not help us to fully comprehend the precise nature of *how* the regulator chose to deal with PPI.

4.3 | Organizational Blind Spots

Why did the FSA not take consumer advocacy groups' warning of the systemic scale of PPI mis-selling on board when it started

to work on the subject in 2005? And why did it take 4 years to conclude that PPI mis-selling had happened on a wide scale, and that redress needed to be paid out on an equally large scale? The regulatory capture and organizational reputation perspectives only partially answer these questions. Turning to the organizational blind spots approach helps us illuminate how the FSA interpreted the PPI problem. At first, the FSA expected that any problems with PPI mis-selling would be solved by insurance products coming under its umbrella in 2005 and hence being subject to statutory regulation for the first time (FCA 2014, 7). Moreover, the responsibility for detecting market-wide dynamics and dealing with mis-selling of financial consumer products overlapped with the tasks of the Competition Commission, the Office for Fair Trading, and the Financial Ombudsman Service. The overlapping mandates with the OFT and CC, and cooperation between the FSA and OFT on the issue blurred the lines of responsibility in the initial phase of the FSA's work (Treasury Committee 2011, 117, 119, 151). In 2005, Chairman Sir Callum McCarthy made clear that the FSA lacked clarity about the work that the OFT was doing on PPI at the time, and that the FSA would have to consider whether it should wait until the OFT and the Competition Commission had completed their work on the issue before moving forward (Treasury Committee 2005). From 2006, the OFT and FSA tried to cooperate actively on PPI, continuously trying to establish a clear boundary between each other's work (OFT and FSA 2006). The lack of a competition objective directed the FSA's analysis of the problem away from market-wide activities, while these fell within the remit of the Competition Commission. In direct response to pressure from the Treasury Select Committee, for example, the FSA emphasized that it would not consider competition dynamics when investigating PPI as this was beyond its remit and was already being investigated by the OFT (Croft 2005), which then referred the matter to the Competition Commission in February 2007. The lack of a competition objective and a need to delineate its mandate by focusing on consumer protection through the supervision of individual firms meant that the FSA relied on a firm-based, mystery shopping approach to analyze how particular firms were selling PPI. The Competition Commission, meanwhile, looked at the banking and insurance market overall to assess which role PPI played in it. The Competition Commission's two-year-long investigation showed that to make money from loss-leading products, such as consumer loans, banks needed to sell PPI as a package with these financial products to make profits (Competition Commission 2009; also see Ashton and Hudson 2014; PCBS 2013, 91). While the FSA knew about competition issues in the PPI market based on the OFT's and CC's work as early as 2006 (FSA 2006d), the high prices of PPI products were not something that the FSA regarded as mis-selling or falling within its remit (PCBS 2013, 92).

Focusing on the supervision of individual firms fundamentally shaped the FSA's interpretation of the problems surrounding PPI. The FSA published its first significant piece of work on PPI in November 2005, based on visits to 45 firms and 52 mystery shops. This "Thematic Work" showed that "PPI is a relatively complex insurance product and is often sold to vulnerable customers. As a result of this and the poor levels of compliance set out in this report, the sale of PPI poses a high risk to our consumer protection objective" (FSA 2005c, 2). The FSA concluded that there was a general compliance problem as firms

lacked adequate internal control processes to supervise PPI sales (FSA 2005a, 2005c, 2005d). As a result of the FSA's firm-by-firm approach, it thus interpreted and acted on PPI as a compliance problem, which could be sorted out through encouragement and cooperation, and, when this failed, through fines. The FSA lacked the capacity and expertise for market-wide and business model analysis and did not fully appreciate how profitable, and important for their business model, PPI was for some major high street banks (PCBS 2013, 92). It also only understood after 2009 that fines were seen as "a cost of doing business" for financial institutions (PCBS 2013, 493f; FCA 2014, 8).

The FOS's work played a more prominent role in shaping the FSA's response to PPI than the work of the Competition Commission. The FOS was a body funded and supervised by the FSA, providing for a closer relationship between the two bodies. More importantly, evidence of a lack of fair complaints handling by banks fitted more neatly into the FSA's firm-centred approach to supervision than focusing on which role PPI played in their business models. Thus, the fundamental realization that it had underestimated the scale of PPI mis-selling resulted from the FOS's warning that it was being overwhelmed by PPI complaints. It was the number of rejections of customer complaints by financial institutions that the FOS was overturning (47% of complaints were upheld by the ombudsman in 2008, rising to 89% in 2009) (FSO 2010), and detailed exchanges with the FOS, that triggered the view within the FSA that PPI mis-selling had been much more common than it had assumed (FSA 2009, 2010a, 22ff; FSA 2010e). A key industry complaint against the FSA's approach to PPI redress was that the agency's work had always focused on PPI sales and not on complaint handling. Indeed, firms argued that the FSA did not have sufficient evidence and was basing its PPI redress approach too much on arguments put forward by the FOS (FSA 2010e).

The FSA approached PPI in line with its specific mandate and associated procedures and expertise that it defined in relation to other regulators' work in the area: while the OFT and Competition Commission oversaw market-wide dynamics and competition issues, the FOS focused on individual consumer complaints and redress. The FSA's niche in this crowded regulatory space was to focus on consumer protection through the supervision of sales practices on a firm-by-firm basis. This resulted in a flawed interpretation of the scale of the problem, and thus an inadequate regulatory response. The blind spots approach does not help us understand why the FSA initially started to act on PPI or why it backed down from action in certain moments (such as in key enforcement cases). However, it illuminates key aspects of the FSA's decision-making that stay hidden if we focus exclusively on regulatory capture and reputational pressures, namely why the FSA approached the problem through the lens of looking at individual firms' sales practices and how this shaped its response.

5 | Discussion and Conclusion

This article advances regulatory failure theory by showing how different external pressures on regulators and internal organizational constraints interact to result in failure. We show that industry influence can be limited by reputational pressures on

regulators to restrict industry excess, but a lack of flexibility in organizational routines can still lead to failure to protect the public. The approach developed here highlights that the behavior of regulators is shaped by external and internal factors at the same time, thus bridging literature that privileges one set of factors over others. The interaction between these factors limits the degree to which any one factor can become the dominant cause of failure, while the interaction equally has the potential to reinforce failure. Future studies of feeble or failed action by regulators can apply the three-pronged approach to uncover the interaction of different factors that lead to—or limit—failure to provide a more comprehensive account of regulatory failure.

The article challenges the widespread notion that bad regulatory decisions and outcomes are usually caused by regulatory capture. Unless agencies are very well insulated from other pressures, they are likely to respond to a multitude of audiences and demands (Ayres and Braithwaite 1992) beyond the regulated industry. As outlined in the methodology section, financial regulation in this era was widely regarded as being “captured”. If the relationship between industry influence and regulatory failure is more complex than usually suspected in this case, this is also likely to be the case in other instances of failed regulatory action. At the same time, external pressures always interact with internal organizational dynamics. Analyses focused on one set of pressures or constraints overlook important drivers of organizational behavior. We would expect internal dynamics within a regulator to matter in other cases of regulatory failure too, especially in “crowded” regulatory regimes, where regulators are trying to delineate their mandate from the work of other agencies in their sector. To build on our analysis, future research should focus on cases of regulatory failure in which external pressures on the regulator’s reputation were less pronounced. We would expect capture and organizational blind spots to compound each other to produce significant degrees of failure in such cases. It would also enhance our knowledge to apply our approach to a case of regulatory failure resulting from barrier-to-entry capture, in which industry exerts pressures on regulators to maintain a high regulatory burden to make it more difficult for new companies to enter the market. In such a case regulators do not act feebly yet regulation fails by limiting competition. It is possible that reputational pressures reinforce, rather than limit capture, in a barrier-to-entry scenario if stringent regulatory action is (mistakenly) regarded as protecting the public. In conjunction with organizational blind spots, this may be a scenario in which particularly pronounced cases of failure are likely to happen.

Theorists that emphasize capture at the systemic level may argue that the mandates, frames, and standard operating procedures that the blind spot approach relies on are in fact a result of captured processes and frameworks (Hanson and Yosifon 2003; Kwak 2014; Li 2023; Rilinger 2023). Our analysis, in contrast to this literature, highlights the value of separating these two levels of analysis in relation to advancing our understanding of how regulatory failures happen and what role regulatory agencies play in producing them. While our analysis does not preclude regulatory capture at different levels of decision-making, ‘deep’ capture, or industry influence on the creation of regulatory regimes, we focus on the limited wriggle room regulators have in these wider settings. This matters because regulatory agencies easily become scapegoats for regulatory capture that happened

at other levels of decision-making, resulting in agency reforms that do little to tackle the source of undue industry influence on regulatory regimes.

What lessons for minimizing regulatory failure, then, can be drawn from our analysis? In theory, bringing in more checks and balances to regulatory decision-making is key to solving any biases in decision-making, ranging from industry pressure to reputational concerns and existing institutional processes. The blind spots perspective, however, focuses on organizational life’s inherent weaknesses: any solution to a blind spot creates its own blind spot (Lodge 2019), and failure is a consequence of normal organizational life. Responses to failure all too often assume that the next disaster will look like the last one, thus failing to imagine a different route to catastrophe (McLean and Johnes 2000). This implies that it is wise for regulators to be receptive to external interpretations of a problem, as external viewpoints can sometimes expose organizational blind spots where internal processes fail.

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Ethics Statement

The interview data collection were approved by the Economics, Law, Management, Politics and Sociology Ethics Committee of the University of York on 26 July, 2022.

Consent

The author has nothing to report.

Conflicts of Interest

The author declares no conflicts of interest.

Data Availability Statement

The documentary data that support the findings of this study are available on request from the author. The documentary data are available in the public domain but cannot be shared via a data repository scheme since the authors do not hold the copyright to the material. Two interviewees agreed for the interview notes to be deposited in the UK Data Service Re-Share depository and can be found under the following reference: Heims (2024). The remaining interview notes are held confidentially by the author to comply with participants’ informed consent.

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Supporting Information

Additional supporting information can be found online in the Supporting Information section. **Data S1:** Supporting Information.