

# Getting Regulation Right

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By Martin Stanley

with Julia Wdowin

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## Preface

Regulation is a vitally important policy instrument, shaping everyone's lives every day, setting the rules of the game for businesses, making competition work effectively and ensuring consumer safety. And yet despite its crucial and positive role, it is often seen as an irritant and a source of restraint, widely labelled 'red tape'. At the same time, there have been manifest regulatory and enforcement failures, leading to tragedies such as the Grenfell Tower fire, or devastating economic events such as the financial crisis. In recent years the number and impact of regulatory failures seems to have increased, perhaps due to the greater potential for systemic impacts in our connected, complex world. New technologies are both increasing the potential for systemic harms from regulatory failure – the financial crisis is a good example – and also making regulation far more challenging. Not the least part of this is the need to ensure algorithmic decisions leave scope for human judgement in finding the right balance in the enforcement of regulatory powers. It may not be too much of an exaggeration to say that regulatory failure – in particular the inadequate policing of the behaviour of large banks, corporations and public organisations – has contributed to the pervasive decline in trust in such entities.

For all these reasons, we are delighted to publish this Policy Brief by Martin Stanley, formerly Chief Executive of the UK's Competition Commission and a distinguished senior civil servant. As well as authoring the well-known book *How to be a Civil Servant*, Martin now runs the *Understanding Regulation* and related websites [[https://www.regulation.org.uk/about\\_and\\_contact.html](https://www.regulation.org.uk/about_and_contact.html)]. There is nobody better placed to take a broad view of the challenges facing regulation today. This Policy Brief examines the recent history of regulation in the UK, but the lessons it draws are more widely applicable. Martin offers some powerful conclusions about the need for reform. He also points to gaps in the research agenda in this area, an issue we will be taking up here at the Bennett Institute.

Michael Kenny & Diane Coyle

## Introduction

The aims and outcomes of regulation do not always coincide. Regulation, at its core, seeks to protect – the vulnerable, the weak, the uninformed. On numerous occasions in recent years, from the financial crisis to the wrenching Grenfell Tower fire, it has failed in this core aim. However much it sets out to help citizens, in some respects it can also curtail or at least affect certain freedoms. So the importance of regulation cannot be overstated, considering the impact it has on citizens' lives. This policy brief sets out to explore regulation - its role in policy decisions and outcomes and its consequences, with the hope of working toward “getting regulation right.”

The series of recent high-profile failures of regulation, although nothing new, confirms that governments are certainly not always “getting regulation right.” However, the Centre for Analysis of Risk and Regulation (2016) points to another crisis, the shortcomings in academic research into regulation. Its authors noted that, “The question was not whether regulatory scholarship failed to predict these incidents, but whether the literature was pointing to the kind of vulnerabilities that were identified post-crises, and whether existing approaches and theories have proven sufficiently robust to analyse the aftermath of these various crises.” There is a gap between regulation theory and policy practice, between the academic approach and the reality.

This policy brief aims to contribute to closing this gap by discussing the difficulties associated with regulating, and the dilemmas that can arise surrounding the regulation of certain issues, meaning that decisions are often not clear-cut and that less regulation can sometimes have more effective impact than more. The following seven sections explore this by examining:

1. What trends in behaviour can we observe across regulators, and how do regulators subsequently approach their specified aims in view of certain behavioural tendencies? How do observed behavioural attitudes impede effective regulation?
2. Why can go wrong? Examples of regulatory failure.
3. Why regulation is necessary – the need for consumer protection.
4. Dilemmas arising from regulation of individuals and SMEs
5. Difficulties involved in regulating larger organisations
6. Where is there room for improvement in regulation procedures?
7. Preventative or curative; is ex ante or ex post regulation enforcement more effective?

The overwhelming conclusion is that sound regulation has a highly important role to play in current policy-making. The art is striking the right balance. Economic growth, well-being and progress depend on it. The numerous and striking examples of past and very recent regulatory failure, with sometimes tragic and disastrous outcomes, suggest not only that regulation is in need of reform, but also that the public attitude to regulation urgently needs to change. For on many occasions regulation has been in place, but its observance has been neglected or implemented inadequately. Often intentions become blurred, and regulation can lead to outcomes contrary to those intended. The design of appropriate regulation, in light of the psychological realities discussed below must be reviewed; but, perhaps more important, there needs to be urgent action on the implementation and enforcement of regulation.

For we should not assume that all citizens behave in one way, with similar motivations. In terms of maintaining an emphasis on “humanity” in regulatory enforcement, as discussed below, it is made clear that there cannot be a one-size-fits-all template; both in the context of organisation size (individual, SME or large organisation), and in the context of industry or sector. The negative consequences of the attempt

to do so are elaborated below. A turn to “humanity” and away from “one-size-fits-all” also applies to thinking about regulators themselves. Many obstacles to effective enforcement by regulators come from their fear of decisive action, which is rooted in the possible negative consequences arising from a blame culture. If regulators take action and something goes wrong, whether due to their decisions or not, they are often understandably apprehensive about the forthcoming media and political recriminations.

This Policy Brief reports on the rise of new economic thinking about regulation, and some signs of a will to change regulatory practice. Blueprint for Business, for example, argue that questions such as asking “what view of the person does the business have?” can be a “powerful agent of change.” A conclusion to be drawn from the discussion below is the need for a change in regulatory culture, both on the part of those regulated and those regulating. There is a need to influence the incentives of regulated entities to act in a socially responsible manner. When considering consumer protection, the discussion includes an ethical perspective: the difficult question of finding the boundary between acceptable and unacceptable behaviour, and regulation’s part in defining an appropriate balance.

In line with considering how regulation can improve outcomes, it is important to clarify the proper function of regulation. Regulation sometimes takes on the superfluous function of signalling action, despite it not being in the best interests of those it is supposed to protect. Regulation is sometimes undertaken for the sake of those responsible being seen to be doing something.

One result of the desire to be seen taking action is that enforcement can become a “box-ticking” exercise. Judgement and discretion become redundant in enforcement, and a “humanist” approach becomes unattainable. As concluded below, *“Knowing when to blow the whistle is the easy job of refereeing. The secret is knowing when not to blow it.”* The human judgement, in contrast to rigid or algorithmic judgment, in decisions risks being lost.

## 1. What is the role of a regulator? The behaviour of regulators

Modern regulators are typically large, complex and well-established organisations, largely unaware of the problems arising from their size and established ways of doing things. While many questions concerning regulation relate to the object to be regulated, the nature of regulators themselves, how they organise their activity and their behaviour are also important questions to understand how regulation might be more effective. In addition, because regulators have to follow complex legal and other processes, they typically devote little or no time to considering regulated organisations' likely responses to regulatory pressure. (In contrast, however, large regulated organisations do spend a lot of time and money considering how best to influence the behaviour of their regulators.) This first section seeks to explore some of the problems that can arise within regulators.

The first regulators of the privatized utilities in the UK had strong-minded individual Directors-General such as gas regulator James McKinnon, telecoms regulator Bryan Carsberg, and rail regulator Tom Winsor. Their clear independence of government and tough approach to their industries was initially welcomed by most observers – other than those they were regulating of course. But successive governments grew nervous that they were giving such individuals too much freedom, including the freedom to be weak regulators as well as strong ones. Over time, therefore, it became the norm to appoint Boards or Commissions rather than individuals.

It is almost impossible to tell whether this change has led to different regulatory outcomes. Strong Board members can in theory stiffen the resolve of their more timid colleagues. Alternatively, one nervous Board member can inhibit the activities of a Board that wants to proceed by consensus. The truth may be that the change did not often make much difference to regulatory practice because the full time Chief Executives generally control the flow of information and advice to their part time, non-executive and often somewhat amateur Boards. Indeed, Chief Executives' power is often strengthened by the appointment of a number of his/her direct reports to the supposedly supervisory Board.

Those regulators most often accused of having relatively weak Boards have in the past included Ofgem, which regulates the energy sector, and the Office of Fair Trading, now folded into the new competition regulator, the Competition and Markets Authority (CMA). Regulators at the other end of the spectrum include those like the competition regulator (now the CMA, previously the Competition Commission) whose constitution, modelled on Whitehall's split between Ministers and officials, provides for decisions to be taken by independent, non-staff Members advised by full-time staff. Another example of good practice was Postcomm which has now been assimilated by communications regulator Ofcom but whose constitution was modelled on both the Competition Commission (from where it recruited its first Chairman) and Whitehall (from where it recruited its first Chief Executive).

Apart from the pros and cons mentioned above, it is worth noting that strong regulatory boards tend to operate to a different rhythm from their Chief Executive-dominated counterparts. Significant decisions have to await the (often fortnightly or monthly) Board/Commission meetings. The advice presented to such demanding Boards tends to be well researched and argued and so the decisions tend to be more robust, thus permitting somewhat faster progress towards the regulatory objectives.

There is a significant and growing problem in that regulators are not well adapted to facilitating or even allowing innovation in the sectors they regulate. They are often under intense political and public

pressure to intervene when companies make good profits (even though there have been price controls), to get involved in all sorts of issues peripheral to their main remit, and also to become a complaints-handling body. Even though they may resist such pressure, they may not be keen to see their industry take the financial or performance risks associated with innovation.

Dieter Helm makes similar points in his Irresistible Urge to Meddle paper. Here is his summary:

*When the great utilities were being privatised, one of the key objectives was to establish a regulatory regime which would be credible to investors and fair to customers. The way it worked was that the companies would be given fixed contracts ex ante, and these would be reset on a periodic basis. Within the period, prices would be fixed by an RPI-X formula.*

*The logic was very clear: the only way in which the performance of the companies could be improved was to incentivise them to do so. Fixed-price, fixed-period contracts gave them the chance to outperform, and it was this outperformance which managers would chase after in the interests of their shareholders. The regulators would re-base the prices at the end of the period as the companies revealed what they could actually deliver, rather than what they told the regulators ex ante.*

*It was all very simple, and that was its attraction. But it never worked out as intended, for the very good reason that regulators and politicians could not resist the urge to intervene. Faced with the chance to curry favour with the customers, politicians kept up the pressure and most regulators eventually obliged. Indeed it is hard to think of many periods when there has not been some form of intervention, and the companies quickly learned that there was, in effect, a tolerable band of outperformance, beyond which the risk of intervention would be high.*

This “urge to meddle” is palpable in the vast majority of regulated areas, where regulation is widely and continuously extended. In line with this broadening of reach, politicians can load regulators with many or confusing extra objectives.

It was obviously reasonable to ask the postal services regulator “to have regard to the interests of

- *individuals who are disabled or chronically sick,*
- *individuals of pensionable age,*
- *individuals with low incomes, and*
- *individuals residing in rural areas.”<sup>1</sup>*

It was less obvious how it was in practice supposed to respond to “*the guidance [given] from time to time [by] The Secretary of State ... about the making by the Commission of a contribution towards the attainment of any social or environmental policies set out or referred to in the guidance*”.

Much more seriously, Ofgem’s multitudinous objectives - lower prices, protecting vulnerable customers, energy efficiency, climate change - require it to make political judgments for which it is not properly accountable at the ballot box.

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<sup>1</sup> Postal Services Act 2000, Section 54

In 2017, The Financial Conduct Authority was given *six considerations to take into account* to add to its *four objectives*, its *competition duty*, and its *eight regulatory principles*. The requirement that the FCA should have regard to the competitiveness of the City of London was particularly vague and troubling. Watchdogs should not also be cheer-leaders for the industries that they are supposed to be policing.

### *The Principal-Agent Problem and Regulatory Capture*

In discussing the behaviour of large regulated organisations below, the **principal-agent problem**, which leads to shareholders and senior managers not knowing what is really going on in the organisation, feature prominently. But it is just as important to remember that regulators are themselves agents, working for a principal, the government or legislature of the day. The principal-agent problem is accordingly present just as much in this structure, as it encourages regulators to enter into implicit understandings with the entities they are supposed to be supervising. Such relationships are described by the participants as 'sensible', 'pragmatic' and/or 'light touch'. Critics characterise such behaviour as **regulatory capture**, exacerbated in the case of economic and financial regulators by their almost total dependence on their industries for the often complex information and understanding they need to do their jobs.

Evidence of regulatory capture includes:

- (a) quality and safety regulators giving notice of inspection visits,
- (b) frequent staff interchange between regulator and industry,
- (c) the reluctance of either party to be strongly critical of the other, and
- (d) increasingly introverted consultation processes, baffling to the outside world.

A prominent example of (b), the revolving door, was ex-Financial Services Authority Hector Sants joining Barclays Bank in December 2012 only six months after leaving the FSA where he had been responsible for regulating the wholesale and institutional markets from 2004, and Chief Executive from 2007 to 2012 – that is, well before and then throughout the financial crisis. He was recruited to lead Barclays' compliance function. Barclays chief executive said "*Relationships with our regulators ... are obviously ... of critical importance to us. We must apply a renewed leadership focus on these to make them as constructive and productive as possible.*" In the short term, it seemed likely that Mr Sants would seek to improve Barclays very tarnished reputation with regulators by improving compliance (see examples of Barclays' and other banks' dreadful behaviour on this web page). In the longer term, however, he could only succeed if regulators begin to apply a less hostile, and then pragmatic and occasionally forgiving, attitude to Barclays, classic regulatory capture. And Mr Sants would have been less than human if he had not throughout his time at the FSA been aware that he would one day join a big financial institution, and consequently been anxious to avoid appearing over-reactive or over antagonistic in his dealing with the sector (which means being quite cautious when tempted to take strong action).

Eyebrows were also raised at the news that Tim Smith, the Chief Executive of the Food Standards Agency, was leaving that job in late 2012 to join Tesco, a huge supermarket chain which had for many years resisted the FSA's attempts to have the industry adopt traffic-light labelling for healthy and unhealthy foods. Mr Smith had previously joined the FSA from the food industry so, whilst leading an important regulator, he had in fact been dealing all the time with both his recent and future colleagues.



There was an interesting report in October 2015 of behaviour which appears to fall under (c) and (d) above - a regulator becoming far too close to the company that it is supposed to regulate. This example was the Driver and Vehicle Standards Agency (DVSA) which refused to disclose test results on Porsche cars. The tests allegedly showed that (in order to reduce fuel consumption at 30mph) the car failed to accelerate at that speed unless and until the accelerator had been pressed for 2.5 seconds – a long time if you are trying to pass a lorry in the face of oncoming traffic. DVSA argued that disclosing the results would reduce Porsche's '*proactive involvement*' in safety testing, a suggestion which the Information Tribunal understandably found '*disconcerting in the extreme*'.

It is interesting that principal-agent theory postulates the growth of a number of overlapping networks or cliques within any large organisation over time, and so predicts that organisations will become steadily more bureaucratic as they age. This is because senior executives will learn that a substantial proportion of their employees are bound by their previous personal commitments to each other, so it becomes imperative to overcome this by reducing the scope for personal discretion. It is also the case that organisations do learn the best way of carrying out certain tasks, and this too reduces discretion.

As noted above, the cliques and teams will often respond by ignoring the bureaucratic rules. Even worse, however, the gradual reduction in tolerance for initiative and discretion leads to recruitment and promotion policies which favour those who prefer to work in rule-bound environments, so reducing the organisation's ability to innovate or to cope with problems which are not in the rule book. This is one of the factors which underlie the growth of the 'box-ticking' culture so prevalent in many modern regulatory factories.

Resource constraints also lead to box ticking. Ngaire Woods of Oxford University's Blavatnik School of Government made this important point when interviewed by *Civil Service World* in June 2014: "*[Creating regulators as well skilled and equipped as the banks would demand] absolutely phenomenal resources. [One consequence is] government being seen to regulate by requiring lots of box-ticking, and business being seen to comply by ticking those boxes.*"

Further problems evolve from the rise in bureaucracy, though. No-one wants to disrupt the activities of essentially compliant organisations, so many regulators feel they should give at least a day or two's warning of a forthcoming inspection. It also helps in practical terms if a business has had time to gather together all the records that the visitors might want to inspect. In addition, of course, regulatory capture inexorably leads to regulators becoming rather too keen to respond to the concerns of their regulated sectors.

The result of the above pressures is that far too few regulators carry out effective unannounced inspections. The results are all too obvious in the education sector, for instance, and in the building industry.

Evidence of regulatory capture, the rise in box-ticking bureaucracy, may paradoxically be results of the tensions due to attempts to establish good governance. Such governance promotes effective accountability and strong consultation and transparency processes, but these activities, too, do not come without problems.

In his 2007 article, Oxford University's Professor Christopher Hood argues that the pervasive recommendation of transparency and accountability as a universal prescription for good governance

might lead to highly undesirable consequences when accompanied by blame avoidance by regulators and others in the public eye. The conventional assumption is that the management of political and reputational risk involves an upside of acquiring credit and a downside of attracting blame. But he and others are beginning to believe that there is a strong 'negativity bias' such that fear of attracting blame decisively outweighs the reputational attractions of bold and effective political or regulatory decision making.

The proposition is that negativity bias encourages regulators to avoid making contestable or appealable judgements with obvious losers. Negativity bias also encourages regulators to develop policies and bureaucratic routines that minimise the risk of institutional or individual liability and blame. And they introduce protocols and automaticity which minimise the exercise of individual discretion by both staff and senior officeholders.

Possibly the worst example of blame avoidance was the Financial Services Authority's behaviour before the 2008 financial crisis. Analyst Daniel Davies noted that '*... the defining weakness of the old FSA was a paralysing fear of doing something that might be criticised.*'

This is not to say that access to judicial review for those on the receiving end of regulation is not a good thing if it merely encourages regulators to follow due process. But it is a very bad thing if regulators worry about losing in court. Every court case carries risk, and every court setback leads to a PR attack from the company concerned, followed by easy headlines about regulatory incompetence. The fact is that good regulators are prepared - happy even - to defend their actions in court, although this may mean losing on occasions. Indeed, regulators who have near 100% records in court battles are almost certainly being too cautious in the way they carry out their duties. But fighting court battles is time-consuming and expensive, and this is itself a growing problem for resource-limited regulators.

Another obstacle that arises for regulators faced with limited resources is the sheer volume of complaints they receive, overwhelming their capacity to respond. Regulators typically receive many more expressions of concern than they can sensibly handle. They therefore need to sift them so as to investigate the most serious. This can lead to their discounting concerns emanating from outside the regulatory system, as the US Securities and Exchange Commission did when considering Harry Markopolos' submissions about Bernie Madoff's Ponzi scheme; Markopolos was an American fund manager who became suspicious about Madoff Investment Securities when asked to look into creating a product that could emulate the 'success' of Madoff. And it almost always leads to their commencing more investigations than they can efficiently handle, so investigations proceed at far too sluggish a pace. This was probably a factor in the FSA's willingness to allow the UK's mini-Madoff (Terry Freeman) to continue to trade despite their receiving complaints about him, and despite his having previous convictions and being disqualified as a director.

The number of complaints is a particular problem for larger regulators and there is no easy solution, although all regulators would be well advised to have systems in place which ensure that all potential leads are reviewed by staff who are (a) experienced, (b) sceptical, as long the scepticism is directed at the regulated entities, and not the complainants.

[Important to note is that a larger regulator will not necessarily be a stronger regulator.](#) Just as the Boards of large corporations lose touch with their businesses, so the Boards of large regulatory authorities often lose touch with much of what is done in their name, and are in practice unable to ensure that their staff

are as focussed, determined and sensible as they would no doubt wish. This was one reason for the FSA's failures in the period running up to the 2008 financial crisis.

## 2. Examples of regulatory failure

There have been significant regulatory failures in the case of the financial crisis, multiple banking and financial sector scandals, other large corporate disasters, and NHS hospitals. These examples point, however, to some common challenges in effective regulation.

### *The Financial Crisis*

A number of factors interacted to cause the financial crisis of 2007-8. In particular, there was clear evidence of the finance sector's willingness to exploit the vulnerability of their customers together with plenty of **herd behaviour**, **groupthink**, **cognitive dissonance** and **the MacWhirr syndrome** (all discussed below), as well as classic **principal-agent problems**.

It was fairly obvious even at the time, and subsequently it became crystal clear, that the individual financial institutions - in particular their Boards – either did not understand or did not care about:

- the riskiness of sub-prime lending (mainly in the US);
  - the riskiness of mortgages which represented a high proportion of asset value and/or of loans which were based on "self-certified" and hence exaggerated borrower income (in the UK);
  - the riskiness of some commercial lending by certain aggressive lenders;
  - the dangers posed by off-balance sheet borrowing (as particularly evidenced by Enron and Lehman Bros;<sup>2</sup>
  - the riskiness of relying on wholesale markets, instead of retail deposits, for their funding;
  - the dangerous short-term incentives that were built into bonus structures;
  - the fact that the apparent spreading of risk through novel derivatives in fact increased the total systemic risk undertaken by the financial institutions taken together;
  - the fact that between 1986 and 2006 the average annual return on banking rose from its historical norm of 2% to 16%, as a result of banks taking riskier bets, using borrowed funds.
- There was no skill, efficiency, intelligence or judgement involved.

Alistair Darling was Chancellor of the Exchequer during the 2008 financial crisis and tells the nice story that, the night after Royal Bank of Scotland went belly up, he was taken aside by the chairman of one of Britain's biggest banks and offered the reassurance that *'They had had a meeting last night and decided that, from now on, we will only take on risks that we understand.'*

The interesting thing about the incipient financial crisis was that there were plenty of hard indicators backing up the critics' warnings that something odd was going on. It was pretty obvious that senior appointments in major banks were made on the basis of 'who you knew' rather than any objective process. (For instance, four of Lehman's ten outside directors were over 74 years old.) Investment banks were leveraged to an unprecedented degree, or in other words investing borrowed funds with very little shareholder capital to cover losses. All large financial institutions earned very big profits year after year. And investment banks paid (and still pay) fantastically high salaries and bonuses, not just for genuine stars but for people who could never have earned anything like the same income in any other walk of life. It was far from clear why these profits and incomes were not competed away over time. Equally

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<sup>2</sup> See the Valukas report's reference to "actionable balance sheet manipulation."

worrying, the media was full of stories of institutions' unethical behaviour: retail customers receiving unfair treatment, high penalty charges, surreptitious reductions in interest rates on savings, and so on. And then there was the fantastic growth in the unregulated shadow banking system, the institutions that are banks in all but name.

Some banks (including Goldman Sachs, JP Morgan and Cantor Fitzgerald) did understand the risks and did take steps to reduce their exposure to them. But most of the major banks did not. As Margaret Heffernan says, in *Wilful Blindness*, 'As long as everyone was making money, many CEOs either didn't see a reason to change, or lacked the courage to do so'. The banks were benefitting, too, from the *implicit government subsidy* (and *the moral hazard*) associated with being 'too big to fail'. This not only cut their borrowing costs but also encouraged risk taking.

The deregulation and light touch regulation that preceded the crisis had been encouraged by the banks, which complained that the previous separation of investment and commercial banking - designed to protect the latter from the risks associated with the former - had led to their competing on an uneven playing field with a plethora of other, non-bank institutions not subject to the same rules. They were making a valid point about consistency of regulation, but the wrong way round. More regulation was needed - of those new non-bank financial institutions closely linked into the financial system.

## *The LIBOR Scandal*

It was well known in the City that LIBOR (the economically vital London Interbank Offered Rate) was being manipulated before the scandal became public. Writing in the FT in July 2012, Douglas Keenan said that:

*In 1991 I had live trading screens that showed the Libor rates. In September of that year, on the third Wednesday, at 11 o'clock, I watched those screens to see where the futures contract should settle. Shortly afterwards, Liffe announced the contract settlement rate. Its rate was different from what had been shown on my screens, by a few hundredths of a per cent. As a result, I lost money. The amount was insignificant for me, but I believed that I had been defrauded and I complained to Liffe. Liffe explained that the settlement rate was not determined by what rates were actually in the market. Instead, the British Bankers Association polled banks, asking them what the rates were. The highest and lowest quoted rates were discarded and the rest were averaged, giving the settlement rate. Liffe explained that, in doing this, they were adhering to the terms of the contract. I talked with some of my more experienced colleagues about this. They told me banks misreported the Libor rates in a way that would generally bring them profits. I had been unaware of that, as I was relatively new to financial trading. My naivety seemed to be humorous to my colleagues.*

LIBOR's 1960s inventor, Minos Zombakis, was reported in 2012 as confirming that LIBOR was originally built on honesty and trust: It was a matter of behaviour; you always assumed that you were dealing with gentlemen, and you assumed that people acted honourably because they couldn't afford to act otherwise. But the culture within Barclays in particular had become very aggressive. There is also some evidence that there was a culture of fear within the bank, although an alternative view is that no trader would 'rock the boat' for fear of both losing his very well paid job and being branded unemployable in the industry. Whatever the truth, Bob Diamond took the credit for Barclays' culture for many years, although he hesitated to take the blame when that culture was shown to have caused problems. It is less clear whether he knew what was going on within his organisation and if so whether he approved of it. He was certainly lauded by his peers and was one of the leaders of extensive herd behaviour.

But Mr Diamond's successor Martin Taylor (FT 8 July 2012) reported a somewhat similar serious failure of internal controls in Bob Diamond's part of Barclays in 1998. *'This breach was not made public, although the regulators were fully aware of it.'* Fast forward to April 2012 and the FSA was writing direct to Barclays' Chairman expressing concern that *'Barclays often seems to be seeking to gain advantage through the use of complex structures, or through arguing for regulatory approaches which are at the aggressive end of interpretation of the relevant rules and regulations'*. But managements who have come to pride and value their aggression will not change their behaviour as a result of a mere chastising letter, and Barclays' reply is far from contrite. Bob Diamond, appearing before a Parliamentary committee only three months later, hardly seemed to have remembered the exchange of letters. This is a classic case of a gentlemanly regulator not having a clue - over a period of at least 14 years - how to handle such a large and badly-behaved regulated entity.

This saga is reminiscent of the case of one of the 'big five' accountancy firms, Arthur Andersen, which had a Barclays-like reputation with the UK tax authorities as long ago as the 1970s. They supported the most aggressive tax avoidance schemes, and were the least helpful when challenged in correspondence or meetings. They accordingly attracted staff and clients who saw nothing wrong with this. Fast forward, in this case thirty years, and one of their biggest clients was Enron.

However, there appears to have been no serious attempt to hold senior staff to account. Facing criticism from the Upper Tribunal, which hears appeals against decisions by financial regulators, the Financial Conduct Authority said that "the documentation that is referred to as fingering senior people is not extensive. ... As is the way of these things, the senior people sometimes manage to keep their fingerprints off the relevant documents sometimes." There is little sign, however, that senior managers were subjected to rigorous interview and investigation.

## *HBOS*

The failure of Halifax Bank of Scotland (HBOS) (and its rescue by Lloyds Bank) was perhaps the biggest event of the UK experience of the financial crisis. Subsequent analysis, including two reports published jointly by the Financial Conduct Authority and the Prudential Regulation Authority in November 2015, make sad reading, noting for instance that the FCA's predecessor, the Financial Services Authority, was a *'deficient'* regulator which was *'too trusting of firms' management and insufficiently challenging'*. The general view within the regulator, one enforcement manager said, was that *'enforcement against big bankers had become virtually impossible'*.

The reports go on to reveal that the FSA's Chief Executive Hector Sants and its Director of Enforcement Margaret Cole would not take responsibility, or could not remember, or disagreed about why senior HBOS executives and Board Members had not been fined or banned from taking further City appointments. The minutes of crucial FSA meetings were unclear and no definite record was made of important decisions, still less who had made them. One perceptive commentator, Daniel Davies, added that *'If the defining cultural weakness of HBOS was arrogance and myopia, the defining weakness of the old FSA was a paralysing fear of doing something that might be criticised.'*

## *Other major banks in the UK*

There were plenty of other things going wrong within major banks. The following is far from a complete list.

Following persistent stories of unethical behaviour, Barclays was the first of the major banks operating in the UK to admit manipulating LIBOR both to inflate their own profits but also, probably, to avoid appearing financially stretched. They were fined £290m and many more banks were subsequently fined, and employees prosecuted, in the UK, US and elsewhere. UBS, for instance, paid fines totalling \$1,500m imposed by a number of regulators. At least 45 UBS traders, managers and senior managers were involved in, or aware of, the attempts at manipulation, and investigators found at least 2,000 requests for improper submissions. The misbehaviour spanned three continents and was widely discussed on group emails and in internal chat forums. UBS' internal compliance function failed to pick it up, despite making five audits of this part of the bank during the period.

Deutsche Bank was one of the leading culprits and angered the regulators even more by deliberately obstructing their investigation, including lying to them. The bank was fined a total of £1.7 billion in the US and UK and was ordered to fire seven staff (though one wonders why they had not done so on their own accord).

It was far from clear why regulators had not reacted much more quickly to the persistent rumours of serious problems. The FT's Gillian Tett ruefully reminded her readers that she had tried to expose the problems back in 2007, only to be accused, by the industry, of 'scaremongering'. But the generality of politicians (as distinct from a minority) at last turned on the industry, as did Sir Mervyn King (2012), the Governor of the Bank of England, who demanded immediate and far-reaching action to reform the structure and culture of the UK banking industry: *"That goes to both the culture in the banking industry and to the structure of the banking industry, from excessive levels of compensation, shoddy treatment of customers, to deceitful manipulation of one of the most important interest rates and now this morning to news of yet another mis-selling scandal."* But he, of course, appeared to have done little or nothing to address these cultural problems until they exploded in his face.

The LIBOR revelations described above came hard on the heels of admissions, by Barclays and many other banks, that they had mis-sold complex derivatives to very small firms.

All the major UK clearing banks had mis-sold huge amounts of PPI (payment protection insurance) to the wider public.

*Back in the UK "an employee of Zurich Advice Network received about £25,000 in commission after persuading ... a man in his late eighties who was suffering from cataracts, deafness and advancing dementia to make a series of wholly inappropriate investments ... the company denied any wrongdoing and forced the man's son to go through years of stress ... the ombudsman decided that the investments were clearly mis-sold ... you might imagine that Zurich would [then] apologise and and bend over backwards to right the wrong ... You would be wrong ... the pattern of mis-selling by Zurich suggests that the company is simply unfazed by occasional visits by the ombudsman ... there is little incentive for Zurich or any other company to rein in rogue salesman."* (Andrew Ellson, The Times 31 July 2010)

HSBC was fined £1,200m in December 2012 for allowing drug traffickers to launder billions in the US, and billions to be moved across international borders in the face of sanctions. Their whole compliance team had been totally ineffective despite receiving many warnings and seeing many rules being broken. One email, internal to the compliance team, read as follows: *'Please note that you can dress up the USD10 million to be paid ... to the US authorities as an 'economic penalty' if you wish but a fine is a fine is a fine, and a hefty one at that ... What is this, the School of Low Expectations Banking? ('We didn't go to jail! We merely*

*signed a settlement with the Feds for \$10 million!') ... We have seen this movie before, and it ends badly'. One wonders if the author would have done more if he had suspected that the fine would be 100 times larger - or did he know that, as alleged by US investigators, the bank's business interests were trumping its compliance obligations?*

HSBC was also heavily involved in facilitating tax avoidance. Somewhat surprisingly, its ex-Chief Executive and then ex-Chairman Stephen Green became a government minister in 2011, and previous non-exec director Rona Fairhead was deemed appropriate for appointment in 2014 as Chair of the BBC Trust.

The Royal Bank of Scotland was fined \$100m by New York regulators in December 2013 for hiding transactions that breached US sanctions against Iran and other countries. The regulators noted that RBS' group heads of anti-money laundering, operational risk, and global transaction services were fully aware of what was going on. Needless to say, none of them were dismissed.

Lloyds Bank was fined £28m in the same month - and will likely have to pay £100m in compensation - for putting staff under intense pressure to sell products that customers did not want - or face demotion and pay cuts.

It was revealed in December 2013 that Paul Flowers, the regulator-approved Chairman of troubled Cooperative Bank (assets £47 billion), had no relevant experience and was an expense-fiddler and habitual drug-taker and rent-boy-user - facts which were on the public record and known to his previous employers.

RBS confessed, in March 2015, that they had mis-sold Enterprise Finance Guarantees (taxpayer backed loans) to small businesses.

The 2015 collapse of Invexstar Capital Management led to losses probably approaching £100m for a number of banks. The company was only months old and yet was able to trade billions of pounds of government and corporate bonds.

Later that year Barclays was fined £72m for entering into a £1.9 billion transaction which might have been used to launder money or finance terrorism.

The National Audit Office, reporting in February 2016, concluded that the Financial Conduct Authority did not know whether its activities were in fact reducing the overall scale of mis-selling to customers, and banks' handling of complaints had been 'poor'.

If the problems were so pervasive and obvious, why did nobody do anything about it? One answer is that both regulators and their governments were to some extent caught up in the herd behaviour and groupthink, but were in particular the victims of cognitive dissonance and the MacWhirr syndrome (the latter being the concept of making a decision you know will end in failure or is risky, realizing that any alternative decision may end in success but will also result in delay and expense and, thus, outsider criticism.) Governments certainly appeared oblivious to the growing danger, and to the scale of the risks, despite all the warnings. They were also very keen to promote the virtues of 'light-touch' regulation, as a way of supporting an industry which appeared to be generating large profits, large tax revenues, and significant employment. No government or national regulator dared step out of line for fear of deterring



financial institutions from investing in their countries. But there was a clear (and with hindsight clearly dangerous) erosion of regulatory independence.

The UK government even failed to act on its own HM Treasury/FSA/Bank of England November 2006 'war game' which had showed that the UK government's investor compensation scheme was inadequate and could too easily cause panic, as indeed happened on 14-17 September 2007 when there was a run on Northern Rock. The Treasury's own March 2012 'lessons learned' report identified a number of causes of its own and the regulators' failure, including serious tensions between the Treasury, the Bank of England and the Financial Services Authority.

One must nevertheless acknowledge the difficulty of regulating large global banks which, as *The Economist* noted, 'have been a nightmare to run. ... Citi is in 101 countries, employs 241,000 people and has over 10,000 properties ... No boss but Jamie Dimon of JP Morgan Chase gives a convincing impression of being in full control - and even he suffered a \$6 billion trading loss in 2012.'

Incompetence or complacency surely played a part as well. It is not much of a defence to note that government and regulators did not appear to be aware that the credit rating agencies themselves did not understand the risks associated with the financial instruments such as SIVs (structured investment vehicles) and SPVs (special purpose vehicles) and others that they were rating, and/or were conflicted because they were being paid by those designing ever-more-complicated instruments rather than by those buying them. And financial regulators (the Bank of England and the FSA in the UK) also did not know or did not understand what risks the institutions were taking with these financial instruments or off-balance sheet vehicles. Nor did they seem at all concerned that financial deregulation, on both sides of the Atlantic and in Japan, allowed even the regulated banks to lend to a much wider (and riskier) range of borrowers, and failed to recognise the 'moral hazard' associated with such lending. The moral hazard means that the risk-taking borrower wins if his risk pays off, but the bank (and the state behind it) loses if it all goes catastrophically wrong. Finally, both regulators and investors did not seem to appreciate that the hedge funds' business models were bound to lead to eventual large losses, perhaps after many apparently good years, even though this had already occurred in 1998 with the collapse of Long Term Capital Management.

Further depressing evidence of the Bank of England's incompetence became available in January 2015 with the release of 500 pages of minutes of the meetings of its Court of Directors between June 2007 and May 2009. *The Financial Times* led its report on the documents by noting that Lord King, the Bank's Governor, had kept the Court (its governing body) 'in the dark on internal dissent, denied non-executive directors information about financial stability and fell out with them over alleged leaks'.

The underlying causes of the problems in the financial services are structural. Those who take the risks are not those who get stuck with the bill when it all goes wrong. The losers can be the shareholders, but many banks even became 'too big to fail' in which case risk-taking by City traders is like playing Russian roulette with someone else's head. Those traders who do not make money are soon fired, of course, but even that is counterproductive. "When you can be out of the door in five minutes, your horizon becomes five minutes", said one City worker.

More generally, though, financial regulators should be hanging their heads in shame at their failure to identify and tackle the failings summarised above. It is not good enough to come along with fines and

demands for compensation many years later. The economic damage - to individuals, companies and the wider economy - had already been done and could not be repaired.

But little has changed even now. Philip Stephens appears to have been pretty well spot-on when he wrote the following in the FT in January 2014:

*'It is time to admit defeat. The bankers have got away with it. They have seen off politicians, regulators and angry citizens alike to stroll triumphant from the ruins of the great crash. Some thought the shock of 2008 might change things. We were fools. Bankers are still collecting multi-million-dollar bonuses even as they shrug off multi billion-dollar fines. Countries and companies have gone bust, political leaders have fallen like skittles, and workers everywhere have been thrown out of jobs. We are all a lot poorer than we might have been. Yet on Wall Street and in the City of London, it is business as usual. Has the world been made safe for liberal financial capitalism? The short answer is No.*

*... This has been the story since 2008. True, laws have been changed and regulations have been tightened to curb the most egregious dice games. Capital requirements have been raised a tad, lowering slightly the insurance risk to governments and reducing by the same small amount the implicit taxpayer subsidies that pay for the bankers' bonuses. The Dodd-Frank legislation has increased compliance burdens on Wall Street. Welcome as they are, these represent changes at the margin. The basic structure of the system - with its perverse incentives, too-big-to-fail institutions and too-powerful-to-jail executives - remains untouched. The universal banks, combining straightforward commercial banking with high-risk trading, live on. The result is that the organising purpose of banking - to provide essential lubrication for the real economy - remains entangled with dangerous and socially useless speculation.*

## **BP**

An explosion at the Texas City Refinery in 2005 killed 15 workers and injured more than 150 others. The plant had been poorly maintained, was badly managed, had a strong blame culture, and had been subject to several rounds of cost-cutting whose safety implications were not understood. This was a clear example of BP's 'top brass' not having any understanding of what was happening deep down in their organisation:- the classic principal-agent problem.

The Deepwater Horizon disaster followed in 2010. Rather like the major financial institutions in the run-up to the financial crisis, it became clear that BP's Board and their US regulators were not aware of the risks being taken by BP's staff and contractors managing the Deepwater Horizon drilling activity, a classic example of the principal agent problem in action. Indeed, the root cause of the disaster may have lain with the difference between BP's culture and that of Amoco, the American oil company it had bought some years previously. BP preferred to delegate considerable responsibility to its operational managers, but expected them to behave responsibly and to be held accountable for their decisions. Amoco had a much more centralised and controlling management style. There are strengths and weaknesses in both approaches, but add the two together and the result might have been ex-Amoco teams whose behaviour was no longer closely monitored, and who had a good deal of freedom which they did not have the experience to handle. It is therefore interesting, though hardly surprising, that BP's board announced in late 2010 that it would tighten its oversight of the company's day-to-day operations.

The US Presidential investigation into the disaster announced in November 2010 that they had identified "a culture of complacency" on the Deepwater Horizon rig, though they did not believe this was driven by

over-enthusiasm for cost-cutting. This is consistent with what we know of the consequences of principal-agent interaction within a large organisation. And the US National Academy of Sciences had previously said that BP had demonstrated inability to learn from past near misses and "insufficient consideration of risk".

It is also worth noting that the Academy also made serious criticisms of the "education, training and personnel of [regulatory] personnel involved in the oversight ... of deepwater exploration operations" and expressed concern about the failure of any one of "the multiplicity of regulatory agencies and classification societies" to develop "an overall perspective of the exploratory operation" and their individual failure to understand the duties of the other bodies.

## *GlaxoSmithKline*

There was a particularly shocking failure of corporate ethics when several very senior GlaxoSmithKline executives ignored a whistle-blower's complaints in 2003 about contamination and mixed drug types and doses being put in the same bottles in GSK's Puerto Rico plant, probably because they feared the impact on US Food and Drug Administration approval of new products. GSK were seven years later fined \$750m, of which the whistle-blower received \$96m. The company made a pre-tax profit of £2.25 billion in the three months to December 31 2009, so the fine was hardly catastrophic; almost all the (very highly paid) executives remained in post; and neither the company nor its executives appeared to have suffered significant reputational damage.

Scepticism about the impact of the fine appeared to have been justified when GSK was fined \$3bn (£1.9bn) in July 2012 in the largest healthcare fraud settlement in US history. The company pleaded guilty to promoting two drugs for unapproved uses (an adult-only anti-depressant drug was promoted for use by children) and failing to report safety concerns about a diabetes drug Avandia.

## *News Corporation*

The News International phone hacking scandal, which culminated in the 2012 Leveson Inquiry, provided much fascinating evidence of real world relationships between senior executives, politicians, the police, and the regulator (the Press Complaints Commission). Even senior lawyers admitted that their professional standards could slip under pressure. The Times itself reported that the head of its legal team had instructed one of the newspaper's reporters to submit a witness statement to the High Court that was "*not entirely accurate*", *did not give the "full story" to the court and had been "oblique to an extent that is embarrassing"*.

## *Volkswagen - Vehicle Emissions*

It was revealed in 2015 that VW, and probably other manufacturers, had installed 'defeat device' software which manipulated vehicle emission levels under test conditions. There had been many previous allegations that emissions measured during formal tests bore little resemblance to the emissions that were made when vehicles were driven by regular drivers on normal roads. The fact that these allegations had not previously been thoroughly investigated, and that the vehicle manufacturers were allowed to choose their testing companies, were clear evidence of regulatory failure both in the US and the EU.

The origins of this scandal almost certainly lay in European (and particularly German) politicians using regulation as a substitute for industrial and trade policies with the aim of benefitting European vehicle manufacturers. Centre for Competition Policy (CCP) researchers have pointed out that European regulators have never been as concerned about NOx emissions as American authorities. As compared with petrol engines, diesel vehicles save fuel, improve mileage, and have lower greenhouse gas emissions (so Europeans could set greenhouse gas standards that were substantially tighter than their American counterparts). Given concerns about global warming, such a position was arguably sensible though it came at the cost of more localized pollution and health hazards. By focussing on the reduction of greenhouse emissions, and by enacting standards that they did not intend to enforce (unlike the USA), European legislators favoured production of diesel vehicles and strengthened their manufacturers' dominant position in the European automobile market. Indeed, CCP argue that Europe's emissions policies served to protect the European market by the equivalent of a 20% import tariff.

Within VW there had of course been what its chairman described as a "whole chain" of errors, and a mindset that tolerated rule-breaking.

### *NHS Hospitals*

The principal-agent problem was no doubt the main reason why the Mid Staffordshire Board and its regulators were not fully aware of the depth of the problems in Stafford Hospital where patients were left unwashed in their own filth for up to a month as nurses ignored their requests to use the toilet or change their sheets; four members of one family, including a new-born baby girl, died within 18 months after blunders at the hospital; and wards were left filthy with blood, discarded needles and used dressings while bullying managers made whistle-blowers too frightened to come forward.

Similar problems then came to light at Morecambe Bay NHS Foundation Trust, where 11 babies died as a result of a 'them and us' culture in which midwives at the Furness General Hospital - keen on natural birth - called themselves 'the musketeers' as they fought battles with doctors. Clinical records were destroyed and the Trust suppressed a critical report in order to get a clean bill of health from the regulators en route to achieving 'Foundation' status. Whistle-blowers alerted several regulators, all of whom failed to take effective action. The Trust's Chief Executive left with a £225,000 payoff and set up a consultancy, boasting of 'getting the best from teams'.

The Lessons Learned Report into the failings of the relevant regulator, the Nursing and Midwifery Council was compiled by the Professional Standards Authority whose Chief Executive made the obvious (though necessary) observation that "following the rules and being correct is not enough. You have also got to have humanity in the way in which you deal with people". As an aside, huge credit is due to James and Hoa Titcombe who fought for years to have the nursing regulator take seriously their concerns following the death of their new born son Joshua. The regulator, of course, began to see them as an annoyance.

These examples form quite a catalogue of failure, and it is by no means complete. It is worth pointing out, though, a number of striking cases of good regulation, of which the following are by no means an exhaustive list either.

One such was the response of the Civil Aviation Authority (CAA) following the eruption of the Eyjafjallajökull volcano in Iceland in in early 2010. There was very little hard information available about

the way in which aircraft engines respond to ash clouds of various densities etc., but it was certainly clear from numerous incidents that ash could bring down an aeroplane. The only existing guideline was "AVOID, AVOID, AVOID". The CAA therefore very wisely insisted on getting the aircraft and engine manufacturers to assess the dangers - a role with which they were very uncomfortable given the potential for legal liability if they were to get it wrong. The CAA also liaised very closely with all other relevant bodies, including the Department of Transport who were reasonably supportive. The CAA and its Chief Executive Andrew Haines were nevertheless unfairly pilloried by the industry. His response was perfect: "We will not listen to those who effectively say 'Let's suck it and see'". It was greatly to his and his colleagues credit that they withstood the pressure. It was good, too, that the CAA and many others, including vulcanologists and meteorologists, subsequently got together to establish safe thresholds and guidelines which will reduce the scale of future disruption following large eruptions.

Greatly improved water industry efficiency, and telecoms/broadband local loop unbundling, are generally regarded as significant successes in utility regulation.

And [Transport for London \(TfL\)](#) did a good job in standing up to Uber's bullying in 2017 and 2018.

### 3. Aims of regulation – Consumer protection

Regulators are under constant pressure to expand their scope, especially so as to protect consumers better. One UK utility regulator observed that his postbag was full of letters which could be summarised as '*This can be regulated, you are a regulator, let's regulate it!*'

Yet it is generally the case that consumers themselves are the best regulators. This is because – by threatening to move their custom elsewhere - customers can ensure that suppliers are efficient, innovative and customer-responsive. The principal activity of economic regulators should therefore be the encouragement of effective competition between suppliers or, if this is not possible, by applying similar pressures themselves through price controls, for instance. This *economic regulation* can conveniently be divided into competition policy and utility regulation.

But markets do too often fail to protect consumers so it sometimes makes sense for regulators to intervene in such markets to protect consumers and smaller firms.

Why do markets often fail to protect consumers? How, in a rational market, could a product like Payment Protection Insurance (PPI) - with premiums adding 20% to the cost of a loan yet a claims ratio (the cost of claims relative to income from premiums) of only 16% - have sold in the numbers it did, and to people who would never be able to claim successfully?

Let's begin by asking ourselves whether our own behaviour – or the behaviour of our employer – might need to be regulated.

Would we, when selling a car or a house, ensure that a prospective purchaser is aware of all its faults, such as:

- The oil leak that can only be seen when the car has stood for some time in one place?
- The noisy neighbours (who are the main reason we are selling the house)?
- The dry rot in that hard-to-access roof space?

Would we work for a business which:

- Pays attractive interest rates that disappear after 12 months, knowing that a significant proportion of investors will fail to switch to another investment?
- Sells a 'medicine' whose efficacy is questionable?
- Uses 'drip pricing' – such as
  - imposing e.g. surcharges, administration charges or debit card charges for internet transactions which (a) do not appear until the end of e.g. the booking process, and (b) are much higher than could be justified by the cost said to be associated with the charge, or
  - using well-hidden terms and conditions to get customers to sign up to automatic renewals, or
  - advertise low price offers with very restricted availability?
- Sells expensive product-linked insurance which lowers the cost of the linked product but which is not needed by the majority of those buying it?
- Enters into highly artificial arrangements so as to avoid UK tax?

- Sells gadgets based on ridiculous scientific claims?
- Sells products which are known to cause a range of serious illnesses and/or social problems?
- Sells investments which it believes to be very high risk to someone who does not appreciate the risk?
- Uses marketing techniques which use psychological tricks to take advantage of most customers' inability, for instance, to assess risk.

The fact is, of course, that many if not most of us would do these things. Indeed, we have almost certainly acted in one or more of these ways if we work in the financial services industry or for an airline. Why are we willing to behave in these ways?

First, we explicitly or implicitly believe in *caveat emptor* – 'let the buyer beware' – which is one of the key elements of UK and US law. Indeed, more generally, we (in the UK and USA) are generally free to do whatever is not explicitly prohibited. (The legal framework in many continental European countries and elsewhere is rather different.)

Second, it is well established – again in US/UK law – that corporate managers' primary duty is to generate profits for their shareholders, and this takes precedence over the consequences for the environment, for healthy and fair competition, for customers, for employees, and so on.

Yet 'buyer beware' and 'devil take the hindmost' can seem very harsh and unfair. Customers and consumer bodies often press for some or all of the above behaviours to be regulated or even prohibited. Their arguments fall into three broad groups: (a) economics, (b) limited information, and (c) the protection of disadvantaged customers.

## *Economics*

Economists and competition authorities keep a close eye on the behaviour of dominant companies such as Microsoft, Google and Apple as well as the big utility companies. In particular, such companies are not generally allowed to price discriminate – that is, to favour particular customers with lower prices than others. This is because such targeted discrimination can be used in an unfair way to stop customers switching to competitors. For similar reasons, dominant companies are generally expected to charge prices based on their costs.

This has led some to argue that price discrimination and non-cost reflective pricing are pretty well always undesirable. But this is an over-reaction. The modern fast-moving consumer market consists of lots of small-scale experiments which test customers' attitude to pricing and other models. There is therefore no objection in principle to phenomena such as:

- price discrimination which favours particular types of customers (e.g. early booking and Railcard discounts),
- surge pricing, as practised by Uber
- discounts for loyal and/or high volume customers,
- low price printers which need expensive inks,
- charging 'what the market will bear' - which may mean different prices in different countries,
- inexpensive smartphones paid for by expensive monthly rentals/call charges,
- free banking plus high overdraft charges, and

- cheap air fares or concert tickets + high surcharges and/or administration fees – perhaps for choosing a seat or paying by credit card.

However, such tempting offers are subject to more justifiable criticism if their negative attributes are hidden, unclear or presented in a confusing way.

### *Limited Information*

Politicians and regulators understand very well that most consumers cannot be expected have anything like as much product information as the person selling the product. (This is known as information asymmetry.) There is therefore a large number of regulations which protect those buying medicines, investment products and other items (such as cars) whose quality problems might not become apparent for some time, and whose failure might be seriously damaging to health or wealth. More generally, there is nowadays quite extensive consumer protection legislation such as requiring facts in advertisements to be broadly accurate, and so on.

There is little or no protection against many of the practices summarised at the beginning of this section, though. Drip pricing is generally allowed, as is the sale of medicines of dubious value and other dangerous or strange products. We are, for instance, all free to buy both cigarettes and ‘infoceticals’ which, we are told, ‘are not chemicals, herbs, nutrients or homeopathic remedies. Instead they contain micro quantities of colloidal minerals whose subatomic structure has been scientifically encoded with information needed to restore integrity to the human body field’ (Nutri-Energetics Systems). We are also free to pay whatever we like for houses and investment products even if the vendor is well aware that they are poor value for money. We often take advice if large amounts of money are at stake, but we are not required to do so.

It is debatable whether more should be done to protect us. As noted above, many otherwise reputable businesses are quite unscrupulous when it comes to deploying tactics such as drip pricing, or relying on our financial ignorance to sell us poor value products. (It is claimed, for instance, that 21% of UK adults cannot calculate 10% of £100. Surely the relevant regulator should intervene!)

The alternative argument is that regulators would then be taking on an impossible task, because there would always be an argument that the next new device or marketing claim should be banned. It is surely better that consumers should be expected to be on their guard. Maybe it is no bad thing that those customers who read appropriate newspaper columns and shop around should benefit from this activity as compared with those who do not. The banks were eventually forced to pay around £6bn compensation to those who were mis-sold payment protection insurance, but those who bothered to take an interest in such matters had known for many years that such insurance usually offered very bad value. Why should they (through their pension scheme investments in the banks) be forced to compensate the less aware?

In contrast, although much the same issue arises in the case of insurance on electrical and white goods, there has not as yet been any successful claim for compensation. It is interesting, too, that the courts have shown themselves unsympathetic to legal attacks on arguably excessive bank charges (such as for unauthorised overdrafts). The UK Supreme Court held that such charges are clear, well known, and part of the banking service, even though they bear little or no relation to the cost of providing the unauthorised overdraft.



Similar arguments apply in the case of energy pricing. Ministers, Ofgem, and consumer bodies such as Which? constantly promote the virtues of active switching e.g. between electricity suppliers. Indeed, Ministers are clearly tempted to do more and force suppliers to switch customers to more favourable tariffs. Yet it is perhaps hard to justify such a strong intervention in this market over others, especially as it is surely in the interest of electricity companies themselves to promote the advantages of their cheaper tariffs – at least to customers of other companies.<sup>3</sup>

## *Vulnerable Customers*

Here, finally, the arguments in favour of regulation are much more clear-cut. There is little dispute that regulators have a duty to ensure that young, poor, disabled, elderly, rural or otherwise disadvantaged customers need to be protected against exploitation along the lines summarised above or in other ways. Most if not all economic regulators ensure that their companies behave reasonably well when dealing with such customers.

Indeed, it was interesting to note that New York's Attorney General launched an investigation into hundreds of complaints of prices being increased in the aftermath of tropical storm Sandy in November 2012. The largest number of complaints concerned increased fuel prices, but other emergency supplies were also affected. "Price gouging" of essential consumer goods is forbidden under New York law. The term is similar to (legal) profiteering but can be distinguished by being short-term and localized, and by a restriction to essentials such as food, clothing, shelter, medicine and equipment needed to preserve life, limb and proper.

## *Ethics*

Maybe the underlying issue is ethical?

It is likely that most of us would, at one level, abhor the behaviours listed towards the beginning of this note. And yet most of us have behaved in at least some of those ways, as employees or when dealing with strangers. Where is the boundary? When does behaviour allowed by *caveat emptor* become unacceptable?

Politicians and other opinion-formers do not seem to believe that exhortation or shaming are generally effective in protecting the public. The City of London used to be very effectively regulated by the Governor of the Bank of England and his eyebrows. In short, if the Governor expressed concern about your behaviour by metaphorically raising his eyebrows then you very quickly got back into line. But that method did not, and perhaps could not, survive the 'Big Bang' and the arrival in London of the big American and other foreign-owned banks.

However, we have seen all too clearly that, if left to themselves, businesses will often engage in a 'race to the bottom', with pernicious effects not just for their customers but also for the efficiency of the wider economy.

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<sup>3</sup> A more detailed review of energy market regulation is [here](#).

There are occasional public reactions – for instance in late 2012, against multinationals' tax avoidance – but the companies are pretty adept at riding out such storms including by making PR-driven placatory gestures. The fact remains that senior executives believe that their main duty is to further their shareholders' interests by increasing their profitability in any way they can, within the law. Loopholes, vagueness and subjectivity are there to be exploited.

Politicians and the media are responding by leaning more and more on regulators, but that means regulators are therefore forced to make difficult subjective decisions about where the line is to be drawn, knowing that any aggressive decisions on their part will certainly be challenged in court by a well-funded industry, whereas there is no counterbalancing legal pressure on behalf of customers.

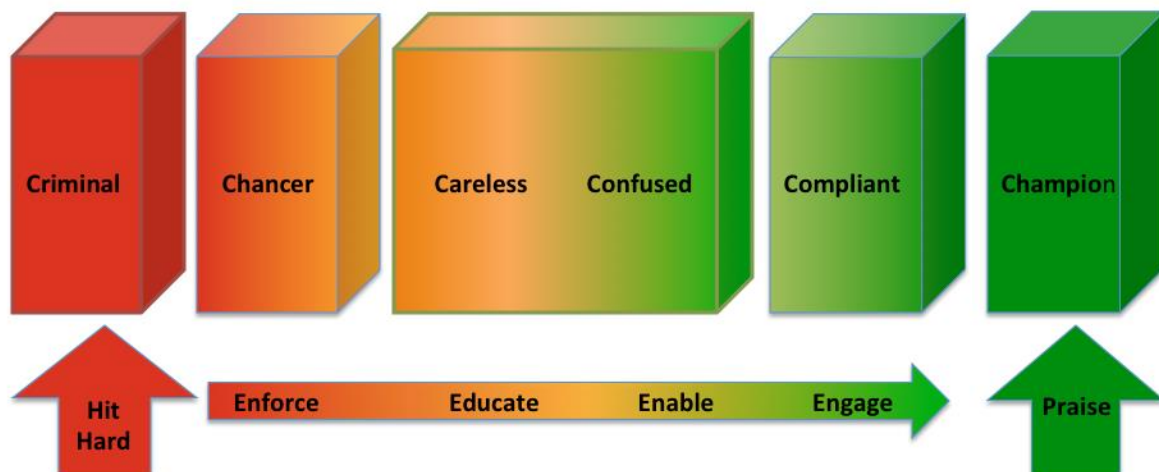
Maybe we need a totally new approach – a change in corporate culture? It takes a long time, of course, to change established norms. So maybe company directors should be put under a duty to operate with integrity? Maybe there is something to be said for requiring directors - and their advisers - to ensure that their businesses operate in good faith, so to speak? Deception of any form might be banned. One solution may therefore lie in company law. Another might be to strengthen the existing codes such as the code of banking practice.

## 4. Regulating individuals and SMEs

Many regulations govern the behaviour of large numbers of individuals (including specific groups such as health professionals) and/or small firms. This section discusses a number of choices that need to be made when deciding how to draft and enforce such regulations.

It is important to remember that - however justified they are - regulations interfere with our freedoms. They should therefore be designed intelligently, and enforced with humanity. Regulations need to include clear boundaries. Equally, it is not necessary to impose heavy penalties on inadvertent and/or minor transgressions.

It is certainly quite wrong to assume that everyone is likely to misbehave. It would be equally wrong to assume that there are no rogues amongst the regulated population. The vast majority will wish to comply with regulations, but may find it difficult to do so. The real world range has been beautifully summarised in this diagram by Campbell Gemmell of the Scottish Environment Protection Agency. The clear lesson is that 'one size does not fit all'.



Another important lesson is that it is vital to involve the target population in designing and publicising regulations that are intended to change the behaviour of those individuals. There is no point in designing elegant regulations that are likely to be ignored, or easily circumvented, on the ground. Members of the public will readily engage in exercises which are aimed at improving their situation, or which might impact their private or business behaviour. In addition, they will be realistic about what will work and what will not. It is absolutely wrong to take a condescending attitude which dismisses the views of the supposedly uneducated or ill-informed.

### *Small Firm Exemptions?*

There is clearly a lot to be said for reducing the burden of regulation by sometimes exempting smaller firms. On the other hand, is it a good idea to send the message that it is acceptable for smaller firms to, say, treat their employees less well than larger firms? Is it acceptable for smaller firms to damage the

environment, or take greater risks with health and safety, than their larger competitors? Is there not a risk of creating a somewhat unattractive small firms ghetto? It may also not be a good idea to tell the owners of small firms that a consequence of growing larger (and/or employing more people) will be that they will suddenly be subject to more intrusive regulation. The owners of British small firms all too often seem less ambitious than their overseas competitors – especially Americans – and all too willing to remain as niche players, or sell out to a bigger company. Why make their growth pains any worse? In general, therefore, it is better to *'think small first'* when designing regulations. If small firms will find it hard to understand and/or comply with a regulation, is the regulation really necessary?

As of November 2017, the small firms VAT exemption was £85,000 - more than five times the comparable German level of £15,600 - and it is seen by many as a significant impediment to growth. It is therefore being frozen at that level while the government decides what to do about it.

There is also much to be said for reducing the number of regulators that interact with smaller firms, yet this can be taken too far. Once a firm has got used to a new regulation, their questions tend to be quite specific, and about unusual situations. Such questions need expert answers, so staff in regulatory 'one stop shops' would either need to be very well trained and knowledgeable or they need to be very good at networking with relevant experts. Such staff may need to be paid good salaries, as are their private sector equivalents (lawyers and accountants, for instance). However, the public sector is unlikely to be willing to provide such staff. The best approach, therefore, is to ensure that smaller firms are given access to account managers or similar people who can deal with a limited range of regulatory issues in which they are reasonably experienced. Such advisers should not, for instance, attempt to be experts in all of tax, employment, and health and safety law and practice.

Frank Pasquale perceptively summarised regulators' *double bind* as follows:

1. Draft a simple rule >>> "That's far too blunt; we need nuance!"
2. Draft a nuanced rule >>> "Oh, the complexity and compliance costs are killing us!"

It is certainly true that smaller firms, and individuals, will never wade through lengthy legislation or guidance. Equally, they like certainty: clear (but therefore detailed and lengthy!) rules to which they can refer in complex or unusual situations. In the UK at least (and unlike elsewhere in Europe where officials are generally given much more discretion) it is probably best to veer on the side of certainty, but ensure that guidance is available online, clear, authoritative and easy to navigate.

### *What about the individualist?*

There are of course a number of individuals who hate to be regulated even if - in their quieter moments - they recognise the good intentions underlying the regulations that so incense them. And it is probably true that such individuals are more likely to be risk takers - including entrepreneurs and adventurers. It is generally recognised - at least in the UK - that society should not seek to protect such people from the consequences of their own behaviour, although it may need to seek to protect others.

Particularly striking was the 2016 official report into a powerboat accident on the Solent. The boat flipped over at speed - a well-known risk - but none of the occupants was wearing their safety harness or helmet. (There was no regulation mandating the use of such equipment, although it would have been compulsory had the boat been racing rather than just practising.) Three of the occupants escaped from

the overturned boat but one, the driver's son, was unconscious inside the cockpit and would have died if the driver had not dived back under the boat and brought his son to the surface. The more astonishing facts were that *'The driver held a commercially endorsed Royal Yachting Association (RYA) Yachtmasters' certificate of competency. He had over 30 years' experience as a powerboat driver and had extensive knowledge of the waters of the Solent. [He was also] a former offshore powerboat racing world champion and held 21 powerboat speed and endurance records. He was the former manager of the RYA's powerboat racing and motor boat department, a post he held for a number of years.'* Further comment would probably be superfluous.

## *Are Algorithms better than Humans?*

*New Scientist Magazine* (4 September 2013) carried an interesting article by Katia Moskvitch about the increasing use of cameras, facial and number-plate recognition software and intelligent computerised analysis to ensure that we comply with road traffic and other regulations. Many of the improvements in the algorithms underlying law enforcement are positive. Speed cameras, for instance, can pick out newcomers to an area and let them off a speeding fine if they are only a little over the speed limit. But these technologies also permit rigorous and unforgiving enforcement, facilitating the punishment of accidental transgressions, without any human involvement in the decision-making. For algorithms, all decisions are binary; a big contrast (in the UK at least) from our tradition of having law enforcement moderated by human police officers, jury-members and judges. As Ms Moskvitch notes, *'our society is built on a bit of contrition here, a bit of discretion there'*.

Reduced toleration of discretion may be leading to greater unwillingness to forgive certain minor criminality and youthful exuberance. Back in the late 1960s, Microsoft founder Bill Gates in effect stole discarded printouts of certain source code which was *'tightly held by the top engineers and off-limits to [Gates]'*. He and his friends then *'tried to beat the system by getting hold of an administrator's password, hacking into the internal accounting system file, and breaking the encryption code'*. (Note 1) He was caught but wasn't punished, leading one to wonder what would happen to a modern hacker in similar circumstances.

On the other hand, society's failure to punish certain dangerous behaviour if, as luck has it, little damage is caused is also striking. An assault will be punished much more severely if it leads to serious injury or to death. Ditto bad driving. Speeding through a red light will be much more severely punished if it causes an accident and injury. There is no logic to this. The person whose behaviour is being punished cannot and does not foresee the exact consequence of their action, and yet is punished as if they had clear foresight.

It is hard, however, to see a practical alternative. What is imperative is that regulators apply common sense to their enforcement activity, and be willing to stand up to those who would reduce all enforcement decision making to little more than numerical and box-ticking exercises.

## 4. Regulating large organisations

There have in recent years been a number of catastrophic failures involving large, heavily-regulated organisations, including the examples described above. Can any general lessons be learned?

It would be a great mistake to seek to avoid all regulatory failure. Although it is clearly necessary to regulate the behaviour of organisations that are in a position to do serious damage to society, we must not over-regulate such organisations and so impede their growth and innovation, in turn so important for employment and the wider economy. It is extraordinarily hard to get this balance right. Every significant regulatory failure is followed by calls for stronger regulation, inevitably followed some time later by equally strident calls for regulators to adopt a lighter touch, and be more pragmatic. But the catastrophes listed earlier in this Brief were surely so dreadful that they cannot be characterised as the result of risks worth taking.

It is a mistake to approach the regulation of large organisations as though they are merely supersized versions of smaller firms. Most senior managers do not know (and some do not want to know) what is going on outside their head offices, nor what risks (financial, environmental and other) being taken by their staff. Internal communications difficulties, compounded by the incentive to report good results, and senior executives' aversion to taking responsibility for errors, mean that senior managers are often the last to learn what is going wrong. Regulators therefore need to take account of organisations' internal communications problems; the existence of herd behaviour and groupthink; and the culture and tensions that are typical of most large organisations.

### *Principal and Agents*

It is particularly important to be aware of the principal-agent problem, already mentioned several times. As noted, this arises when a principal hires an agent to pursue their, the principal's, interests but the agent develops priorities of his/her own. The principal-agent problem is found in most large organisations, including in the way that shareholders and senior executives find it very difficult to ensure that middle managers or foremen work to the corporate agenda as seen from head office. There is a strong tendency for humans to align their goals and behaviour to that of the team or work group immediately around them. As a result, it often seems that corporations are run in the interests of the firm's managers, who have grown to regard their firm's economic interests as entirely coincident with their own.

It is for instance almost universally common for middle managers to focus on what they see as the long term good of their factory, office or other small part of the organisation. When asked to find efficiency savings they will fight hard to retain their budget and their staff numbers. They will often enter into an implicit bargain with their teams, allowing the use of material for personal ends, providing generous expense accounts, etc. so as to generate a better (non-confrontational) climate within the team, often characterised as 'high morale'. Such teams resist change, especially if it might lead to greater efficiency (working harder and/or job losses).

There are two consequences for regulators. *First*, it can be very hard to obtain reliable information from the intermediate levels in any hierarchy. *Second*, regulators need to be aware that agents and their teams often resist the introduction of (what they see as) tedious protocols aimed at improving quality or safety.

Rail and marine accident reports include many examples of such behaviour. It is quite common for teams to falsify data, including quality and safety data. New recruits are told by experienced colleagues that formal instructions - or things they learned in an induction program - can safely be ignored as out-of-date or impractical.

It can therefore be very hard for a regulator to find out what is really happening inside a regulated entity, not least because the entity's own senior executives probably do not themselves know what is happening and, if they do, will be very reluctant to admit their partial loss of control. Much the same applies to compliance officers, whose creation is too often regarded by their Board as a box which has been ticked, and so a good reason to ignore regulatory issues.

It is important to be aware that teams' failure to comply with safety, financial and other protocols does not necessarily mean that such teams are responding to pressure from above, such as to meet financial or other targets, complete work quickly, maintain production etc. Leaders of rule-bending teams may themselves be keen to work quickly, or to impress seniors with their achievements, or to get home on time, or to avoid a small amount of work running over into the next day. It is truly very difficult for regulators and company directors to know that this is happening unless there are robust and unpredictable inspection arrangements backed up by a strong compliance culture, and opportunities for whistle-blowing.

The principal-agent problem also means that regulators need to take into account how the middle and lower reaches of an organisation might react to regulatory pressure. The need for change and/or improvement may be accepted by senior executives, but this does not mean that the necessary changes will be accepted or implemented at the working level. The regulatory intervention needs to be designed with this problem in mind.

Here are some examples of the principal-agent problem.

- 'Rogue trader' Kweku Adoboli nearly destroyed UBS in 2011, at one point exposing the bank to losses of £7.4bn. A colleague had reported Mr Adoboli's breach of financial trading limits in 2010 but found that this soured their relationship and so did not report him again when (a) the same thing happened in 2011, and (b) he learned that Mr Adoboli was hiding his losses. *"I felt as though I had stitched him up ... I think that maybe he didn't trust me as much [after he was reported] ... "I went to a school where people didn't grass."* said the colleague.
- Manhattan's prestigious Stuyvesant High School provided another good example in 2012 when caught up in what was described as a pervasive cheating scandal. [The New York Times](#) reported that *"Although students enter the school knowing they are among the best in the city, they must compete with hundreds just like them. ... They described teachers as being relatively sympathetic, discouraging cheating, but not always punishing it as severely as school policy dictates."* One consequence may have been that Stuyvesant's results became less trusted after this episode, thus damaging the academic and career chances of all its alumni.
- Investigations into the LIBOR scandal unearthed some juicy emails showing junior (but extremely well paid) staff's willingness to disregard ethical and other rules. *'It's just amazing how LIBOR fixing can make you that much money ... it's a cartel now in London'* wrote one trader. The Financial Services Authority subsequently concluded that some bankers had decided that the rules did not apply to them and [noted](#) that *'In March 2011, RBS attested to the FSA that its controls and systems were adequate. The attestation was inaccurate.'* It took another year before RBS

concluded that the bonuses of the back-room staff who submitted LIBOR figures should not have their bonuses linked to those of the traders who might make money out of manipulating those same LIBOR rates.

- There are inevitably lots of examples in formal accident reports. Here is a nice one, following a collision in the English Channel in which one ship's collision avoidance technology had been partly disabled: "The settings in the 'guard zone' and 'target alarms' areas ... were locked. The adjustment of these settings was password protected and [the] deck officers ... were unaware of the password. The crew considered the resulting absence of alarms to be beneficial."
- An HSE Inspector reported that a contributory factor to a serious roller-coaster accident at Alton Towers had been that the frequency of false alarms meant that staff tended to assume that all alarms were false, and so restarted the ride without carrying out proper checks.
- An investigation into an accident on a heritage railway, in which a child was nearly killed, found that there had never been an audit of the Safety Management System. "Had SDR [(the train operator) carried out this audit], it would have identified that the engineering staff within the carriage and wagon workshop had not been signing the *fitness to run* forms for some years. Although SDR staff conducting the fitness to run examinations were confident in their own ability and competence to identify if a fault required a carriage to be removed from service, they did not feel comfortable in signing and dating the forms to show that they had examined the condition of the carriages and were authorising that they were fit to run. They stated that this was due to the number of faults being identified, the 'fix and patch' culture, and the perceived possible personal implications for them of signing the form and an incident or accident occurring subsequently."
- Railway accident inspectors reported in 2018 that "Members of the [track maintenance] team told us that [their supervisor] neither fully briefed them on the safety arrangements, nor checked their track safety qualifications. Nevertheless, they all signed ... to acknowledge that they had received a briefing."

## *Herd Behaviour, Group-Think and Cognitive Dissonance*

*"Men, it has been well said, think in herds; it will be seen that they go mad in herds, while they only recover their senses slowly, and one by one."* (Charles Mackay)

It almost goes without saying that the majority in government, in regulation, and in the financial services industry were supported in their rosy view of the 1990s financial world by the fact that all 'the great and the good' shared their optimistic analysis of corporate behaviour and of the virtues of '*light touch regulation*'. This was despite the fact that there were nevertheless a good number of perceptive commentators who did their best to warn of the forthcoming catastrophe. This is a good example of two very common psychological behaviours, often called 'herd behaviour' or 'group-think'.

Herd behaviour is not necessarily irrational. Herds usually run together for a good reason, and there is nothing irrational about humans seeking to watch and learn from what others are doing. Rational investors in an efficient market will therefore produce frenzies and crashes from time to time - but regulators are surely responsible for ensuring that herds do not crash over cliffs and take lots of innocent (customer/taxpayer) victims with them.

Group-think is more pervasive but also highly undesirable, for it is essentially the unquestioning acceptance of obviously wrong answers simply because it is socially painful to disagree. Large



organisations require a good deal of conformity. You can't have every single person asking questions. Decisions have to be made and implemented. And if everyone you know, every newspaper you read, every person you once admired, are all saying the same thing, it takes a real effort of will, and real courage, to argue back. But someone has to do it - and yet it is uncomfortable to be a contrarian. Indeed, dissent can lead to the dissenter becoming the subject of personal and sometimes humiliating attack. Camilla Cavendish (who had run Prime Minister David Cameron's Policy Unit) told *the Today Programme* in December 2016 that some officials "became very, very, angry and took it viscerally personally" when it was suggested that there might have been a better way of negotiating with the rest of the EU in advance of the 2016 Brexit referendum. Questioning their strategy was perceived by them as questioning their commitment.

The British reluctance to offer overt challenge or criticism doesn't help. Industrialist Sir Denys Henderson was famed for his unforgiving tongue but appears to have had little impact as a non-exec of the Board of Barclays Bank. One scholarly director told him "You are essentially an *oratio recta* [direct talking] man but Barclays is essentially an *oratio obliqua* [indirect talking] company." No doubt this contributed to Barclays' subsequent troubles. (The Senior Civil Service, too, suffers from too much indirect talking.)

Margaret Heffernan offers an interesting - almost hilarious - analysis of group-think in her excellent book *Wilful Blindness*. "*I've even heard boards discuss how, and why, they are invulnerable to groupthink, oblivious to the irony inherent in their confidence. ... Dennis Stevenson, then chairman of HBOS, eulogised the outstanding board he chaired [at a time when] everyone knew the bank teetered on the edge of collapse. ... [Lord Stevenson cited as evidence] the fact that, even in this crisis, 'we are as one'. He seemed oblivious to the notion that the unity of his board may have been a contributory factor to the bank's mess in the first place.*"

The same book introduced me to the related concept of cognitive dissonance. This phrase refers to the stress that we all encounter if we try seriously to consider two incompatible views at the same time. We all therefore fiercely hold onto our preconceived beliefs even in response to intense external pressure. One result is that - as we almost all regard ourselves as good people, and essentially honest - we find it very hard to admit to ourselves that we or our organisation is behaving badly. Senior executives typically therefore push back very hard against any regulators or other suggestion that their actions maybe doing unnecessary harm, including risking their own business.

Cognitive dissonance almost certainly accounts for the failure of many, including Alan Greenspan - a deep believer in the power of the markets, and a fan of financial instruments such as derivatives - to react to all the warnings that something was going very badly wrong in the period before the 2008 financial crisis.

## *The MacWhirr Syndrome*

There is a separate though closely related syndrome, personified by Captain MacWhirr in Joseph Conrad's *Typhoon* who chose to sail straight through a devastating storm because he recognised that his employers would criticise him for delaying their cargo if he sought to sail round it. "*Suppose*", he says, "*I went swinging off my course and came in two days late, and they asked me 'where have you been?' 'Went round to dodge the bad weather,' I would say. 'It must have been dam' bad, they would say. 'Don't know,' I would have to say, 'I've dodged clear of it.'*"

The armed forces have often taken similar decisions. The classic case was perhaps the sinking of HMS Victoria in 1893 with the loss of 358 lives, following a collision which resulted from Admiral Markham following an order which he knew to be catastrophic. As another admiral wrote some time later: "*Admiral Markham might have refused to [obey the order but he would] have been tried by court martial, and no one would have sympathised with him as it would not have been realised that he had averted a catastrophe*".

Modern executives who mimic MacWhirr do so because company Boards and stakeholders are very likely to criticise delay and expense, even if the organisation eventually achieves its objective. Executives therefore prefer to take uncertain and dangerous risks rather than face certain (unjustified) criticism.

There was a classic example in late December 2012 when Shell chose to tow the Arctic drilling rig *Kulluk* through treacherous waters all the way from Alaska to Seattle in the middle of winter, at least in part to ensure that they avoided a \$6m Alaskan tax charge which would otherwise have fallen due on 1 January. The loss of the rig cost Shell around \$200m.

There were also a number of senior financiers who understood that they were running their companies into serious trouble in the years before the 2008 financial crisis, but felt they would face unacceptable criticism if they were to follow a less risky course. Citibank's Charles Prince famously told [\*the Financial Times\*](#) that "*As long as the music is playing, you've got to get up and dance. We're still dancing.*" This led the same paper's John Kay to conclude that "*The man who held the most powerful position in the financial services industry was the prisoner of his own organisation.*"

The MacWhirr syndrome is just as common in politics. US Congress Representative Barney Frank commented as follows, when talking about Hank Paulson's dilemma in the middle of the Lehman crisis: "*The problem in politics is this: You don't get any credit for disaster averted ... Going to the voters and saying, 'Boy, things really suck, but you know what? If it wasn't for me, they would suck even worse.' That is not a platform on which anybody has ever gotten elected in the history of the world*".

The implementation of the Brexit referendum strikes me as an excellent example of the syndrome, whatever you thought of the original decision. Ministers appeared much more concerned to avoid being criticised for delay in implementing the referendum result than interested in getting to a safe and sensible future relationship with the EU 27.

Nevertheless, there are some interesting examples of individuals and organisations refusing to succumb to the MacWhirr Syndrome, even though they were bound to be criticised for avoiding the likely disaster. A good naval example was Lord Jellicoe's caution throughout World War I, and in particular in the Battle of Jutland. He knew that he could have lost the war through one disastrous engagement with the German fleet. But his failure to take unnecessary risks was much criticised, especially by the British press. Various governments and most businesses were, for instance, to be congratulated for taking action to near-eliminate the Y2K 'Millennium Bug'. Subsequent evaluation has shown that the effort was very worthwhile, but the public and media reaction was that it had all been a waste of time and money because so few examples of the bug were discovered on 1 January 2000. This is a classic example of commentators not realising that disaster might well have ensued had no avoiding action been taken.

## *Diffuse Responsibility*

Knowledge of, and responsibility for, problems is often widely shared within large organisations, but it is then often the case that no-one feels responsible for addressing or even highlighting the problem. One example was the poor maintenance and terrible safety record at BP's Texas City Refinery, where the explosion in 2005 killed 15 and injured over 170 more. The problems were readily apparent to most employees and managers but - partly under pressure to save money - no-one felt responsible for doing anything about them.

Much the same was true of Bernie Madoff's Ponzi scheme where quite a few financial professionals had worked out that something fishy was going on, but saw no need to do anything more than avoid dealing with him.

Similarly, just about everyone in Westminster knew that Members of Parliament were receiving over-generous expenses payments as recompense for their low salaries, but hardly anyone saw much wrong with this until Heather Brooke and *the Daily Telegraph* published the expenses claims in 2009 - triggering immediate uproar outside Westminster, and a few prosecutions. Indeed, many MPs had previously supported an attempt to exclude their expenses claims from the Freedom of Information Act.

The diffusion of responsibility is exacerbated if there are frequent changes of management. This was part of the problem at Texas City as the over-worked men 'close to the valve' stayed put, whilst their managers generally moved on very rapidly, away from an old refinery which lacked the prestige of many of BP's other locations. Managers were not therefore in post long enough to both understand the issues and then have the time and inclination to do much about them.

## *Executives' Behaviour*

It can often be difficult to tell as a regulator whether your contacts within large organisations are truly speaking on behalf of their Board or other senior staff. Senior executives, senior partners, senior aircraft and ship captains, hospital consultants and so on are so powerful that they easily become isolated from ordinary people, and even more so from their front line staff and their concerns.

Some of them overcome the problem better than others. Crew Resource Management, mandatory protocols and generational change are making a big difference in hospitals and transport. But many other top executives have too much confidence in their own judgement and opinions, whilst the scale of their operations or responsibilities mean that they have to think in abstract terms where risks, and even death rates, become mere numbers that have to be managed. This can easily cause whole management teams to characterise as naive or unworldly anyone - and in particular a whistle blower or journalist - who expresses any concern about organisational culture. Lord Browne, BP's Chief Exec at the time of the Texas City disaster, was said by his executive assistant to show '*no passion, no curiosity [and] no interest*' in safety.

It can be worse if an organisation is highly focused on the power and influence of a single individual, often someone with a heroic leadership style. Their direct reports then spend all their time trying to second guess their hero's wishes, rather than think for themselves or commission analysis which might challenge their leader's views. This was certainly a problem at Toshiba where investigators into a huge

accounting scandal found "a corporate culture where it was impossible to go against one's bosses' wishes".

The wider the power gap, the more difficult it can be to communicate even urgent concerns. Junior doctor Rachel Clarke (2017) describes her distress when she failed to challenge the appalling behaviour of one senior consultant doctor:

*Mr Skipton ... stared up in trepidation as my boss, impatient to get to theatre as quickly as possible, alighted at the bedside. ... Without so much as an introduction, he broke the news to the patient of his terminal illness by turning away to the bedside entourage and muttering, perfectly audibly, "Get a palliative care nurse to come and see him." No one had even told 'him' he had cancer.*

*As panic began to rise in Mr Skipton's face, I remember catching the ward sister's eye to see her cringing alongside me. But trying to undo the damage would take so long and the ward round was already sweeping on. I had a moment to act decisively. I could have chosen to earn my consultant's wrath by remaining at my patient's bedside. Instead, to my shame, I scuttled dutifully after my boss, leaving someone else to pick up the pieces.*

Even if middle managers (the agents) are trying hard to achieve the aims set for them by their seniors (their principals), it is absolutely certain that their communications to their seniors will be less than totally honest or frank. Tim Harford puts it nicely in his book *Adapt*:

*'There is a limit to how much honest feedback most leaders really want to hear; and, because we know this, most of us sugar-coat our opinions whenever we speak to a powerful person. In a deep hierarchy, that process is repeated many times, until the truth is utterly concealed inside a thick layer of sweet-talk. There is some evidence that the more ambitious a person is, the more he will choose to be a yes-man - and with good reason because yes-men tend to be rewarded..... Actually telling the unvarnished truth is unlikely to be the best strategy in a bureaucratic hierarchy.*

At another level, the behaviour of large companies' senior executives has become quite fascinating. One begins to wonder whether big business has succeeded warfare as the most exciting form of competition between human organisations. Some modern boardrooms appear to attract those who would, in previous generations, have sought to command large armies. Instead of invasions, we nowadays have corporate takeovers; instead of gold braid and military honours, we have executive salaries. The leading actors therefore remain the odd combination of hugely ambitious, sometimes inspirational, but too often also highly self-absorbed and disastrously inept.

It certainly seems to be the case that power changes the behaviour of previously decent men and women. It is perhaps inevitable that powerful CEOs' sense of right and wrong becomes aligned with the norms and expectations of others who are similarly rich and powerful. Neuroscientist and psychologist Ian Robertson goes further and draws attention to research which shows that power increases testosterone levels which in turn increases the uptake of dopamine in the brain, leading to increased egocentricity and reduced empathy ([New Scientist 7 July 2012](#)). Power also reduces anxiety and increases appetite for risk.

And yet, as the FT's Lucy Kellaway points out: "*Modern CEOs seem to have no [public] opinions, especially not negative ones. If they feel one coming on, they have been trained by their lawyers and PR advisers to*

*suppress it.*" It is certainly difficult these days for CEOs to correct the mistakes or improve the behaviour of their organisation without laying themselves open to the charge that previous behaviour was in some sense faulty and so worthy of criticism and/or claims for compensation.

Senior managers are certainly, all too often, very concerned to appear infallible (and un-sue-able). Organisations therefore get locked into defensive modes, from which they find it increasingly difficult to extricate themselves - and so the problems get worse. The reputation of BP's Tony Hayward was for instance badly damaged (yet further) when he failed to answer many of the questions put to him by US Congressmen in June 2010. Barclays' Bob Diamond also did himself no favours when responding so blandly to UK politicians' questions in July 2012.

Regulators, therefore, have become increasingly circumspect in the way in which they communicate with CEOs, their lawyers and their PR advisers. The financial services 'Big Bang' saw an end to the ability of "the [Bank of England] Governor's eyebrows' to terrify City of London financial services. And it is highly improbable that any regulator would nowadays get away with the following behaviour even if, like Sir Thomas Barlow, they were a business man brought into government during World War 2:-

'I chanced to be in Tommy Barlow's room when he had a question for a manufacturer who was suspected of rigging [wartime] restrictions to his firm's advantage. Tommy began his address ... "I wonder if you have any idea, Mr X, how I long to be relieved of this job [or] if you have any idea of the reason ... It is, Mr X, because I shall never have to meet a man like you again'. [Francis Meynell, *My Lives*]

## *Profits or Ethics?*

In the absence of strong regulation, many organisations are not incentivised to behave in a responsible manner. Some companies are certainly very good at filling their annual reports with information about their CSR (Corporate Social Responsibility), But most CSR activity is just a way of promoting the brand. *The Times'* Ian King enjoyed reporting on "a company that won six awards in only one year from the US Environmental Protection Agency. It won a "corporate conscience" award from the US Council on Economic Priorities. It published a *Corporate Responsibility Annual Report* solemnly detailing its philanthropic activities and its pursuit of "Respect, Integrity, Communication and Excellence" that would "integrate human health, social and environmental considerations into our internal management and value system." And it placed on the desk of every executive a framed copy of its corporate values. It sounds impressive, until you learn that the company was Enron, the American energy giant whose collapse in October 2001 was followed by revelations that it had been fiddling its figures for years."

Indeed, modern companies seem to exercise much less social responsibility than in previous decades. The US Business Roundtable in 1978 listed CSR as one of the four core functions of company Boards. It had disappeared from the list by 1990. To take just one recent example out of many, Pret a Manger hit the headlines in 2018 because it took advantage of a 'small firms' (locally baked produce) exemption to omit allergy advice from its sandwich labelling, leading to the death of a young woman. The company had built up a powerful wholesome image of serving handmade natural food. But its food contains many additives, and its baguettes were imported, frozen, before being cooked for a final few moments at the back of its shops. None of this might have mattered too much if it had reacted quickly and recognised that - as it is now a huge company - it should label its products properly. But it had become profit focussed under new investment fund owners. As Ritson (2018) put it:- "Pret ... in 1995 would have said sorry and worked out how to solve the problem. Pret in 2018 basically said it didn't care." So Pret took

the view - initially at least - that it would only improve its labelling when required to do so by amended regulation.

Corporate managers will often quickly remind you that their primary duty is to generate profits for their shareholders, and this responsibility in law, its fiduciary duty, often takes precedence over the consequences for the environment, for healthy and fair competition, for customers, for employees, and for wider society if their business were to fail - and some would say rightly so. Non-profits and public sector organisations have their own primary duties, and must also operate in a way which generates income and/or reduces expenditure. But all organisations ignore wider, longer term and societal benefits at their peril.

Equally, however, fiduciary duty is (or should be) a long term concept. It is easy enough to maximise short-term profits at the expense of customers and other stakeholders, but directors' and executives' duties are to maximise the value of the company in the longer term.

Farrer & Co (Solicitors)'s advice for the Tax Justice Network in September 2013 makes the point about directors' duty to consider the longer term success of the company very well indeed. Here is an extract:

*In circumstances where a director decides that the company will eschew tax avoidance, he or she may do so for reasons that he or she considers to be aligned with the long-term success of the company, including for example:*

- (i) the adverse risk profile of tax-structured transactions in the long term,*
- (ii) the desirability of investment in public health, education, infrastructure &c in the jurisdictions where the company's employees live and work,*
- (iii) the need to foster the company's relationship with tax authorities and with consumers,*
- (iv) the impact of tax avoidance on the wider community of taxpayers and users of public services, and*
- (v) the desirability of the company maintaining a reputation for high standards of business conduct.*

*...Our view that other kinds of impact may constitute a legitimate basis for a director's decision notwithstanding an adverse financial impact may be derived from the clear meaning of the [Companies Act] but it is also supported by the pre-existing case law on the corresponding common law duty.*

Blueprint for Business argues that UK company law permits a purpose led approach: "*Section 172 of the 2006 Act makes clear that the primary duty of the director is the success of the company, and that in discharging they have to take account of the Interests of shareholders (which may well vary between them) and have regard to a bunch of other stakeholders too. Although it is often interpreted as a duty to maximise shareholder value, our view (supported by legal opinion) is that they are not agents of shareholders but true fiduciaries, who have to set out what they think success means. The law is certainly not as clear as it could be but it is often narrowly interpreted and poorly understood. For us a key shift in thinking is where profit is not seen as the purpose but one outcome of living out a purpose that serves society.*"

Blueprint for Business also makes a strong second point about motivation. Their view is that "*organisations implicitly operate with a view of the human person, usually unstated, and typically that people are self-interested, motivated by money and status. A heuristic then operates to reinforce this as people respond accordingly. The diminishing returns to regulatory reform are one manifestation of this. What we are proposing, drawing on a strong multidisciplinary body of learning and everyday experience is a different view.*"

*This is that people are hard wired to seek meaning and fulfilment through work and that the quality of relationships is intrinsically important to us. The link to purpose is then that organisations with a pro-social purpose whose relationships are founded on respect and co-creation will 'crowd in' intrinsic motivation. People associated with it will lean in because they care. This is hard to introduce in large organisations but the conversations are fascinating because people are not used to being asked about what view of the person does the business have. This is a powerful agent of change."*

Separately, there is a well-established business principle that the buyer is responsible for assessing the value and suitability of the thing that they are buying (Caveat Emptor or Buyer Beware). It remains the case that many companies feel under no obligation to behave ethically, even when their customers are buying complex financial and other products about which they are inevitably badly informed. This applies big time in financial services.

Legally, an important case is Hedley Byrne v. Heller which held that all businesses have a general duty not to mislead their customers, but this does not extend to a duty to protect them from making a mistake, such as paying too much for a product, unless the customer is explicitly relying on the skill and judgment of the business's employees. But this principle does not protect those naive individuals who trust their suppliers to reward their loyalty, when others of us have learned that many such companies should not be trusted.

Lawyers may sometimes unnecessarily exacerbate the problem when advising corporate clients how to respond to regulatory inquiries. Most directors and senior managers should have little to fear if they make it clear that, if there is a problem somewhere in their organisation, they will address it. No regulator expects directors to know everything that is happening but they do expect them to deal openly and honestly with the regulator, and correct problems when they are identified.

## 6. Some ways to improve regulation

Following recent regulatory failures, many of which are described in this Brief, there are several ways in which regulation of key industries might be reformed and/or made more effective. Most obviously, there could be more emphasis on prevention rather than punishment.

Other improvements might include the following:

- a. Regulators should become more sceptical and tougher.
- b. Larger organisations might be placed under a duty to act with integrity.
- c. Regulation could be carried out by different people.
- d. Governments and Parliament could exercise much more effective oversight of regulators and regulated industries.
- e. Greater use might be made of Oversight Regulators.

I consider these in turn.

### *a. Tougher regulators*

The general conclusion of the political and regulatory establishment, following the financial crisis, was that they or their predecessors had been perfectly competent, but underpaid and simply not allowed to regulate large parts of the financial services industry, and so were taken by surprise by unprecedented turmoil. They concluded, therefore, that pretty much the same people - including regulators recruited from the industry itself - should carry on working broadly as before. I am not aware of a single UK regulator who suffered any form of penalty after the crash. It was particularly startling that the FSA's Hector Sants - its Chief Executive throughout the financial crisis - was made Sir Hector at the end of 2012. One Parliamentary committee had accused him of being 'asleep at the wheel'! He also got a very senior job at Barclays Bank after leaving the FSA at the end of 2012.

However, it was agreed that attempts should be made to strengthen the financial regulators by recruiting even more senior bankers. Perhaps the regulators' role should be expanded so as to provide much more effective regulation of the previously unregulated 'shadow' parts of the financial services industry? There should certainly be improved cross-border regulatory co-ordination. And maybe banks should be split into their 'more risky' and 'less risky' parts, rather than the half-hearted 'ring fencing' of ordinary retail banking that has occurred.

Lord (Adair) Turner, the incoming Chairman of the FSA, gave a very interesting interview to Prospect Magazine in August 2009, saying that:

*"The way that the tripartite system worked post-1997, and especially the relationship between the Bank of England and the FSA reflected a particular philosophy of the time, and in retrospect, I think everyone recognises that a different approach would have been better.... It is hard to distinguish between valuable financial innovation and non-valuable. Clearly, not all innovation should be treated in the same category as the innovation of either a new pharmaceutical drug or a new retail format. I think that some of it is socially useless activity. On the other hand, I don't know whether that means the world would have been better off without any credit default swaps, or simply some credit default swaps. I just think it's difficult to work out*



*where one can draw the line with this. And that leads me away from the idea that regulators should be saying: product X bad, product Y good, and more towards a set of mechanisms such as high capital requirements which create hurdles for new products, but do not stop those that are of obvious value."*

It was hardly surprising that the FSA then began to make a lot of noise about its new tough approach to the financial services industry, whilst politicians in parallel made a lot of noise about the need to cut bankers' bonuses. The FT reported on 29 December 2010 that *'Fines levied against companies and individuals by the UK markets watchdog nearly tripled this year as the regulator further stepped up its enforcement operations in the wake of the financial crisis. ...the regulator... also banned 60 people from working in the financial sector, raided high-profile City institutions and won its first overseas extradition request. In addition, it launched its first cross-border insider dealing case in conjunction with US authorities.'* But the scale of this activity remained tiny in comparison to the profits made by, and the numbers employed by, the industry and it was far from clear that the threat of this ex post activity had any significant deterrent effect. Nor was there any sign that other regulators were becoming more aggressive in their approach to other industries.

There were fewer signs that the FSA or other regulators had learned to employ staff who have the guts and determination to find out exactly what is going on in their sector, to understand the larger trends, and to act when they become concerned, whatever the howls of outrage from vested or complacent interests. There were occasional welcome signs that Martin Wheatley, the new head of the FSA's successor body, the Financial Conduct Authority, was gearing up to take a tough line with the banks etc. Asked in March 2013 why the banks disliked him so much, he said: *"I'm sorry they don't like me. I like them!"* But his tougher approach did not go down well [subsequent developments, including the sacking of Mr Wheatley are summarised at [https://www.regulation.org.uk/key\\_issues-accountability\\_and\\_independence.htm](https://www.regulation.org.uk/key_issues-accountability_and_independence.htm)].

More general lessons, from what we have learned about the psychology of large organisations are that:

- politicians and regulators need to discount very heavily the assurances given by Boards and senior managers unless they are backed up by hard independent evidence. Conversely, they need to give significant weight to evidence from junior staff, customers and whistle-blowers
- politicians and regulators need to be on constant guard against uncritically accepting an industry or institutional viewpoint. This is of course much easier said than done but the best defence against complacency is to take critics seriously, however annoying or self-serving their messages.

### *b. A duty to operate with integrity*

It is interesting that some informed commentators are beginning to wonder whether we might not need a totally new approach. Maybe company directors should be put under a duty to operate with integrity? Many senior business people have in the past thought it perfectly proper to pull the wool over the eyes of regulators (and to avoid taxes, exploit their less savvy customers and so on). There was a game to be played and, if the regulators did not have the wit and experience to ask the right questions, or spot misleading or incomplete answers, then that was their problem. So maybe there is something to be said for requiring directors - and their advisers - to ensure that their businesses operate in good faith. One solution may lie in embedding this in company law. Another might be to strengthen the existing codes of banking practice and the like. The public certainly seem astonished and angry when they learn about the

way in which many large corporations are allowed to behave, and yet be operating entirely within the law.

There are some straws in the wind.

In March 2010 the FSA announced it would in future intervene in order to stop risky products being sold to the public, rather than merely requiring the industry to pay compensation after things had gone wrong. This change of style (which stopped short of requiring products to be vetted before they went on sale) did not immediately apply to the regulation of financial institutions themselves (as distinct from their retail products) but it showed that the regulator was at long last willing to consider taking firm action. But it remains to be seen whether these good intentions will ever in practice be implemented on behalf of the public.

Lord (Adair) Turner, then Chairman of the Financial Services Authority, writing in the FT on 7 December 2010, raised the possibility that senior bankers might be required to operate in a more risk-averse way than their counterparts in other industries:

*"[RBS Executives were] doing what executives and boards in other sectors of the economy do: sometimes getting judgments right and sometimes wrong. But banking is not like other sectors. The fact that many banks made decisions in the same way as other companies was itself a key driver of the crisis, a big problem, but not one that regulators had adequately identified. In some other sectors we want bold risk-taking, which might sometimes result in failure, shareholder loss or even the danger of bankruptcy. But banking is different. Failure in banking, or even the threat of failure offset by public intervention, carries huge economic costs quite different from non-banks. .... The question is should we reflect these fundamental differences in a more explicit recognition that the attitude of bank boards and executives towards risk-return trade-offs should be different from other sectors, and should we create incentives to adopt this different attitude? ... Investigations focused on whether individual executives breached rules have a role and the FSA has successfully brought some enforcement cases relating to breaches revealed by the banking crisis. But achieving a general shift in attitudes to risk and return may require that bank directors and executives are made subject to quite different incentives than those that are appropriate in other sectors of the economy."*

Outside the financial sector, Ofgem, the energy regulator, announced, in March 2009 that they were minded to require that energy suppliers must:

- not sell a customer a product or service they do not fully understand or that is inappropriate for their needs and circumstances
- not change anything about a customer's product or service without clearly explaining why
- not prevent a customer from switching product or supplier without good reason
- not offer products that are unnecessarily complex or confusing
- must make it easy for customers to contact their supplier
- must act promptly and courteously to put things right when the supplier makes a mistake.

Martin Wolf addressed the responsibilities of large corporations in general, arguing:

*The core institution of contemporary capitalism is the limited liability corporation. It is a brilliant social invention. But it has inherent failings, the most important of which are that companies are not effectively owned. That makes them vulnerable to looting. Incentives allegedly provided to align the interests of top*

*employees with those of shareholders, such as share options, create incentives to manipulate corporate earnings, at the expense of the long-term health of the company. ... What is the answer? Unfortunately, no simple remedy exists. The corporation is the best institution we know of for running large, complex and dynamic businesses. It is surely important to ensure that taxation and regulation do not obstruct other forms of ownership, including partnerships and mutuals. It is vital to encourage the creation of genuinely independent, diverse and well-informed boards. It is sensible to ensure that pay packages are transparent and any incentives for destructive forms of remuneration are removed.*

It is often argued that current law (and in particular the law pertaining to directors' fiduciary duties) requires companies to maximise profits at the expense of behaving ethically. But this is a mis-reading of the law (as seen in the discussion above drawing on Farrer & Co Solicitors' advice.)

### *c. Different regulators*

Maybe part of the answer is fewer experts in financial and other regulation. It is after all very hard for anyone to seriously and energetically challenge their ex-colleagues, people who are very likely to be their friends and their future colleagues and bosses. And it is very difficult to discard group-think. If everyone - absolutely everyone - is behaving in a certain way, how can a member of that circle possibly challenge it? And how do they withstand the contemptuous suggestion that they must be too stupid, or inexperienced, to understand why everything is just fine. It takes a brave regulator to press for an explanation that they can understand when faced by a very senior person, or renowned expert, who is baffling them with complex and incomprehensible explanations. There are many circumstances in which outsiders ask better questions, and see things more clearly, than supposed experts.

Another way of improving the financial regulator's gene pool might be to aim to raise its status, and the status of other regulators. This is not the same as paying them more. Indeed, high salaries may be counterproductive. The culture of regulation seems to be more ingrained, and less resented, in the American psyche; bright US lawyers and economists see working for a US regulator as a key career stepping stone; and, though far from perfect, US regulators are generally more willing to 'kick doors down' than their UK counterparts.

We certainly need to employ regulators who don't just focus on their KPIs, budgets and business plans. John Braithwaite (2017) made this telling point:

[An] excellent regulator [would] have seen in 2001 the huge opportunities to make America safer and stronger by responding to suspicious flight training ... [An excellent regulator would have taken] the opportunity an Australian environmental regulator had in 2009 to respond to an oil spill caused by Halliburton's cementing of a drilling rig that spilled oil into the Timor Sea for 74 days ... an opportunity that could have prevented the Deepwater Horizon spill for 86 days in the Gulf of Mexico a year later".

### *d. More effective Governments and Parliamentary oversight of regulators and regulated industries*

Surely, too, governments and parliaments are going to have to put much more effort into overseeing regulatory structures and practices. The buck must, after all, stop with our elected

representatives. However, the relationship between regulators and government representatives must be nurtured in such a way that true independence of the regulator is maintained.

### *e. Oversight regulators*

A welcome development has been the creation of two new regulators to oversee the activities of certain (to some extent self-regulating) professional bodies. The first of these was the *Council for Healthcare Regulatory Excellence (CHRE)* which was set up in 2003 to keep an eye on healthcare regulators such as *the General Medical Council* and *the Nursing and Midwifery Council*. This was followed in 2008 by the creation of *the Legal Services Board* (modelled on the CHRE) to oversee the legal professions. Both of these bodies are themselves quite small, thus allowing them to consider a wide range of regulatory and consumer issues without suffering the disadvantages of super-regulation, such as being over-large, over-bearing, out of touch, over-expensive and employing front-line staff who are unfamiliar with the full breadth of the organisation's regulatory remit, or suffering from the demolition of the principle of self-regulation.

## 7. Ex Ante vs. Ex Post Enforcement

Regulators often hit the headlines as they impose apparently eye-watering fines on errant companies. A flurry of fines in early 2017 included £20m for Thames Water, £42m for BT and £129m for Tesco. But are they an effective deterrent?

Should regulators intervene in advance (*ex ante*) to prohibit what they perceive as excessively risky or undesirable behaviour, or is it better to ensure that companies and their managers are suitably punished, after the event (*ex post*) if things go badly wrong. In economic regulation, this is the debate that divides the Chicago and Harvard Schools of economists, the former favouring the *ex post* approach and vice versa. The question is essentially one of psychology and politics.

Take psychology first. Many (most?) of us are naturally law-abiding and anxious to comply with reasonable regulations. Others of us comply for fear of getting caught. These two groups probably make up those who design regulatory systems and they will naturally assume that decency or the risk of punishment will keep most other people on the straight and narrow. They typically argue that fines deter bad behaviour because of the fear of getting caught, prevent further transgressions, especially if the Chief Executive loses his/her job, and can be accompanied by compensation paid to those injured by the regulatory failure.

The contrary argument is that a proportion of the population are not naturally compliant; nor do they spend much time worrying about being held to account. Senior executives, in particular, have big egos, and don't expect to get caught. And they are just as likely to be the victim of Group-Think and the MacWhirr Syndrome as the rest of us - or maybe more so. They will therefore only comply with (to them over-restrictive) regulations if they are subject to firm and effective prior enforcement regimes.

There is also the point that the consequences of getting caught are seldom cause of serious concern. Although a Chief Executive may know they may eventually lose their jobs, they also know that they would then receive very generous compensation for loss of office to add to all the millions they have acquired while in that office. And they are almost never held legally responsible for even the most dramatic misjudgements. This is particularly the case in the USA where 50% of public companies are incorporated in Delaware - the second smallest state but a notable corporate haven with very CEO-friendly 'business judgement rules'. Even Delaware's own Senator Ted Kaufman noted somewhat despairingly in September 2010 that "*We have seen very little in the way of senior ... level prosecutions of the people ... who brought this country to the brink of financial ruin.*"

The company may suffer reputational damage, of course, but this is seldom of great concern. The early 2017 fines on Thames water, BT and Tesco did not do much to affect their reputation with the general public or their business revenues. Indeed, most likely hardly anyone took much notice of the fines when they were imposed, let alone remembering them months later.

Overall do the fines hurt the companies or their shareholders? No. Thames Water's £20m fine was pretty small beer compared with its annual profits of around £750m.

In conclusion, therefore, fines and other *ex post* regulatory penalties have relatively little deterrent effect on those who are not naturally inclined to comply in the first place. It is vital, then, that important

regulations are backed up by effective quality management - and strong inspection and enforcement regimes. This is often the case, of course, as in the nuclear and aviation industries. But there are plenty of areas where powerful lobbies have persuaded politicians to 'reduce red tape' and introduce 'light touch' regulation. There is something to be said for this, as a balance is needed. But it can be taken far too far - and was a major factor in the development of the 2008 financial crisis.

Recent regulatory failures of the kind described earlier certainly seem to support the need for *ex ante* intervention rather than *ex post* punishment in many contexts.

Alan Greenspan famously put too much faith in the self-correcting power of free markets. Joseph Stiglitz, writing in the FT in August 2010, said "*Alan Greenspan ... express[ed] surprise that banks did not do a better job at risk management. The real surprise was his surprise: even a cursory look at the incentives confronting banks and their managers would have predicted short-sighted behaviour with excessive risk-taking.*"

Much the same point can be made about the Gulf of Mexico oil spill. The New Scientist (July 2010) reported that conservationist Sylvia Earle had earlier pleaded for stiffer penalties for oil companies - after the 1989 Exxon Valdez disaster - to prevent anything similar happening again. Sadly, it would have made much more sense if she had argued for stronger *ex ante* regulatory activity, for neither the fear of penalties nor the fear of other financial damage seems to have affected the behaviour of BP and its contractors. Indeed, the apparently huge \$4.5bn fine imposed on BP in November 2012 was met with relief in financial markets, who compared it with BP's annual profits of \$26bn. This reaction also serves to make the point that penalties hurt only shareholders, not directors or managers. Shareholders are of course quite incapable of (and uninterested in) altering company culture.

Martin Wheatley, the new head of the Financial Conduct Authority, seemed to have got the point when he said, in March 2013, that big fines don't change the behaviour of the big banks, not least because "*... a financial penalty ... simply gets passed on to shareholders through lower dividends ... you could put [up the level of fines] three or five times, but it would not make much difference unless individuals are held to account.*" He went on to say that his goal was to change the culture of bank boards.

Nonetheless, Chancellor of the Exchequer George Osborne chose the crowd-pleasing *ex post* route when he introduced a new criminal offence of so-called reckless banking with effect from March 2016. Senior managers in UK financial institutions will have committed a criminal offence if:

- he or she agrees to the taking of a decision which causes the institution to fail,
- at the time of the decision, she or he was aware of the risk that the decision could cause the institution to fail; and
- his or her conduct in relation to the decision fell far below what could reasonably be expected of a senior manager in that position.

However, this law will have negligible impact. It is notoriously hard to prosecute white collar crime and to prove reckless or criminal behaviour. As financial journalist Dominic O'Connell put it: '*Was Fred Goodwin reckless in buying ABN Amro, the deal that helped make Royal Bank of Scotland a basket case? Only in hindsight; at the time he was cheered by the City. Did the management of HBOS set out deliberately to ruin the bank? I doubt it.*'

## Conclusions

The potential for regulation to contribute to better policy outcomes is clear. As described above, inadequate regulation or enforcement can have devastating consequences. This Policy Brief has set out some of the challenges but also some of the options for regulating more effectively.

In particular, the discussion points to the urgent need for better enforcement as opposed to new regulations, although these may be needed too. Tragic cases of regulatory failure, such as the Grenfell Tower fire or the serious problems in the Mid-Staffordshire Hospitals, have in common a failure to comply with existing regulation. These, along with other scandals, including those from the corporate and financial worlds, indicate that the current approach to regulation is deeply flawed.

The ways in which citizens, policy-makers and regulators tend to approach regulation and its enforcement, in light of the psychological and behavioural characteristics described above, are in need of significant change. Indeed, there is a case for a cultural transformation to shift our approach to regulation itself, as well as to the operation of businesses or large organisations such as hospitals. Examples of such a shift include the allocation of greater prestige (though not necessarily financial reward) for the regulatory profession, greater recognising in public debate about complexities that are not readily obvious, and the granting of credit to regulatory expertise amid the pressure of a crisis. In the case of the regulated entities, possible cultural changes include providing stronger incentives for organisations to act with integrity, as opposed to having in place a system of punishment for misconduct *ex post*.

Regulation, however well-meaning, affects people's freedoms, so establishing the extent and reach of regulation, and especially its enforcement, requires a sensitive and intelligent handling. The scope for such judgement is potentially threatened or undermined by growth rise in the use of artificial intelligence and big data sources. Humanity in enforcement is required along with the deployment of new methods. Discretion in enforcement decisions is a necessity for well-functioning regulation. Striking an appropriate balance in relation to the reach of regulation is important (although difficult) in order to avoid stifling growth, innovation, and creativity, which are fundamental for employment, and for the wider economy.

Among the other conclusions offered here is the idea that regulation design must include the more active involvement, or at least serious engagement with, citizens. The benefits of this also extend to gaining a more realistic idea of what will and will not work. And finally, *ex post* regulatory intervention is inadequate, especially in the case of large organisations. Tougher *ex ante* intervention is necessary.

However, these answers do not form a complete agenda for the reform of regulation. In complex economies and societies, where there are many competing interests and a loss of trust in many forms of authority, new approaches will be required. This is a challenge both for regulators and other policy makers, and indeed for researchers who need to engage with new insights from psychology and other social sciences, address the new challenges posed by AI, and respond to the manifest failures of so much regulation as it is implemented today.

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