#177: Delusions of certainty: Regulation through an ethical lens

VOICEOVER
Welcome to Up Close, the research talk show from the University of Melbourne, Australia.

JENNIFER COOK
I'm Jennifer Cook, thanks for joining us. Regulation, rules, boundaries control; to some these words signify order and safety, but to others they represent unwelcome constraints stifling the human drive to do better or to get richer. Regulations are put in place where there's risk and as we've witnessed over recent years an arena that has come to epitomise risk is the financial markets. But how do we measure risk and introduce balance controls? What is good regulation and how can it best be enforced? In this episode of Up Close we discuss The Paradox of Regulation with Associate Professor Fiona Haines, the author of a book by the same name, published by Edward Elgar in 2011. Dr Haines lectures in criminology, white-collar crime, globalisation and risk at the School of Social and Political Sciences, University of Melbourne. Joining Fiona is Professor Nancy Reichman, from the University of Denver's Department of Sociology and Criminology. Nancy will help us apply Fiona's framework of analysing regulation to gain insight into the global financial crisis, the collapse of American energy company Enron in 2001 and the insurance giant here in Australia HIH. Fiona, Nancy, thank you so much for joining us.

FIONA HAINES
Thanks very much.

NANCY REICHMAN
Thanks for having us.

JENNIFER COOK
Fiona, I'd like to begin by talking about this paradox of regulation. Can you explain to us briefly your framework?

FIONA HAINES
I'll start with a phrase that I used at the beginning of this research and the phrase was: never again. And what it seemed to me was that we had a system where
regulations were developed to prevent the next disaster in the wake of the disaster we just had. So the idea was that people would come out and politicians would come out and inquiries would say this must never happen again. This is a never again moment. But as somebody who's looked at a number of disasters what I found was that never again happened. So the paradox that I needed to explain was how never again becomes again. How the never gets lost.

JENNIFER COOK
How does the never get lost?

FIONA HAINES
Well the first part of the puzzle is to try to understand what regulation is. What happens is that it's conceived of as a set of rules, laws, regulations, codes in order to reduce risk and in order to reduce the kind of risk that's just been experienced. Okay, so you have a never again moment and you have a regulatory reform process that puts in place a set of regulations that is supposed to prevent the next disaster. But when you look at the debates around regulation both in the academic literature and in the policy literature, what becomes very clear is that regulation is as much political as it is a problem-solving issue.

JENNIFER COOK
Would you agree with that, Nancy?

NANCY REICHMAN
Yes for the most part but I think I would challenge Professor Haines to think differently about regulation. I'm not sure that regulation was ever intended to prevent disaster. That in fact regulation was about creating certainty and so there's a difference. That difference, I think, leads into Professor Haines' wonderful work on the paradox of regulation.

JENNIFER COOK
Fiona, talk to us about that because this idea that the politics comes into it seems very natural because we're all people with our own philosophical underpinnings and of course the people in power are from politics, they're going to bring that to it?

FIONA HAINES
So I started with this problem and I wanted to understand the problem on its own terms and the most straightforward it seemed to me was to look at an industrial disaster. Now I chose an industrial disaster in my home state of Victoria, Australia. It was the Longford disaster, but you could use any industrial disaster. You could use the gulf oil spill, you could use Chernobyl, you could use any number of disasters. The issue is what is the risk? And that risk to me was outside of society and outside of the self. In other words, it was the probability and the impact of another explosion at a chemical plant, another oil spill another nuclear meltdown. Right, so the first way of understanding the connection between risk and regulation in my frame is actuarial. In other words, it's preventing the next disaster. But, when you look at how risk and regulation are linked in political debate and even in scientific debate, it's clearly more
complex than that. So people talk about the way that this shouldn't happen again.
They talk about the way that the opposition doesn't understand the nature of the
problem. They talk about the nanny state, we're being over-regulated, we're being
stifled. So when you look at the way risk and regulation are mixed together, you say
okay it's not just about what I call actuarial risk. The second sort of risk really
emerges from the sociological literature. It's basic Sociology 101 and it's around who
we are. It's around us as human beings living in a social setting. We are herd
animals. None of us can live individually. None of us is independent, none of us is
self-sufficient, we live together, that makes us vulnerable. That means that we are
immersed in an environment where we have to be concerned about the we. We have
to be concerned about who we are as a group and our own identity as part of that
group. Now what I labelled that was socio-cultural risk. That risk however is equally
as real as the next explosion but it works differently. It works on an emotional logic. It
means that you talk about risk with an eye to what's happening in my society that I'm
a part of and, two, I belong here. So that was the second risk type that I talked about
and I talk about in the book. The third and what I call the master risk is really political
risk and that's a risk to political legitimacy. So the risk is in a shallow sense to the
government being voted out at the next election. In a deep sense it's a risk to political
legitimacy of the political regime as a whole. Now political risk has two components
that actually work in conflict with one another. The one is keeping the economy going
and it takes after a whole bunch of scholarship including people like Jurgen
Habermas who I use in the book and it's framed around keeping the economy going
and making people feel safe. Keeping the economy going and making people feel
safe. So politicians and governments gain legitimacy, by keeping the economy going
and making people feel safe. Now the paradox arises because you can retain
political legitimacy by keeping the economy going and reassuring people. You don't
have to deal with the actuarial risk. You don't have to deal with the problem that led
to the disaster except on rare occasions.

JENNIFER COOK
That is the actual thing that caused the disaster is the thing that is expendable, that's
what you're saying?

FIONA HAINES
Yes.

NANCY REICHMAN
So, Fiona, can you explain in a little more detail what you mean by that risk being
expendable?

FIONA HAINES
What I mean is that dealing in a technical sense with rules and processes that will
actually reduce the next disaster is not essential for governments to retain political
legitimacy. That what they have to do is to make sure they keep the economy going
and make people feel safe.

NANCY REICHMAN
And in my language and my words what I would say is that the role of regulation in that context is to create certainty but not necessarily to eliminate risk. So the notion here is that there's a need to keep people engaging in behaviour dropping pipelines into the bottom of the sea. Creating more complex financial instruments - all those things that the capital sees as being important to sustaining and developing economies. Regulation is designed to make sure that folks play that game. That doesn't mean that it eliminates the risk of playing the game, it just creates certainty around the playing field. Is that consistent with your thinking?

FIONA HAINES
I think it is and it's consistent in particular with respect to political risk but not necessarily with actuarial risk, it is and it isn't. Actuarial risk when you look at it closely it's very complicated as you well know because science is premised on uncertainty. So when you are dealing with actuarial risk you actually are dealing with uncertainty because science understands itself as uncertain. So therefore it makes an assessment within the bounds of uncertainty about the best way to reduce that risk. The certainty that's needed is the certainty for economic investment, which I think, is exactly what you're saying?

NANCY REICHMAN
Yes economic investment, social investment to keep folks playing the game when sometimes it's even stacked against them.

FIONA HAINES
Absolutely, so in other words you're creating an environment of certainty where people feel that their everyday lives can continue and have some sense of security. That includes the security of people and the security that you need for investment.

NANCY REICHMAN
If I think about your work, I think about the way it reveals the technical, instrumental direction of regulation superseding any sort of normative value in terms of what social life should be.

FIONA HAINES
I think that's absolutely right and I think that it's the way that the politics around regulation tends to play out. I don't think that's a necessary consequence, although I think that's very complex. So what I mean by that is that governments in order to manage their political risk they listen to the way that businesses talk to them about what they need in order for certainty in the market. What they need in terms of certainty for their investments and so on. So they listen to that and in listening to that they shape their regulatory response. But there is the other side of it and that's the reassurance side of it. That's where the values should come in. That's where the conversations around what kind of a society we want should come in. But, in a sense they play a political game there. So instead of responding to values they create anxieties and fears and then say okay but we can resolve that fear for you, we can provide you security. So instead of engaging in values they engage in what you might call a political protection racket.
JENNIFER COOK
This is Up Close coming to you from the University of Melbourne, Australia. I'm Jennifer Cook, our guests today are Nancy Reichman and Fiona Haines and we're talking about the paradox of regulation. Perhaps if we could move to an example, perhaps the 1988 savings and loan crisis in the US?

NANCY REICHMAN
I think it's a good example in this way. That is there's an example of a crisis and a political response to that crisis which is some changes in regulation that created solvency for the savings and loans' industry at some level. But it's the kind of technical fix that Fiona talks about in her book. It fixes a very small problem without addressing sort of the larger issue of why savings and loans failed in the first place. So again it provides a procedural safety so that people can continue to play. But does it really engage some of the broader questions about social inequality, about the concentration of wealth that I think are very important to today's conversation?

JENNIFER COOK
So that never again of course can happen again. Fiona, what's your take on this?

FIONA HAINES
I think one of the points that Nancy mentioned there was very important in the sense that regulation as generally understood is supposed to be problem solving. It's actually supposed to intervene in a competitive market as little as possible. It's supposed to be light-handed. So when you see the response, what will happen is the problem becomes defined very narrowly and a fix is applied to that narrow conception of the problem. The difficulty with the financial situation is that in defining the problem narrowly you invite a gaming response. Because in a sense, the financial system and the financial markets gain, by pushing the limits, by pushing the rules. By hedging, by trying to create profit in the future and bring that back into the present. So in doing that, the savings and loans' responses and the savings and loans' crisis is not an expertise of mine. But as I understand it it created a temporary resting point for the games to start again.

NANCY REICHMAN
I think it's that gaming response is incredibly important to understanding Fiona's concept of political risk. That is the gaming response is when politics tries to manage that risk rather than dealing with it head on.

FIONA HAINES
Yes, if you're thinking about keeping the economy going, right? Keeping the economy going requires risk taking. So when you see in the media we need to reduce red tape, you see it as a request or a demand of business to reduce the costs of doing business. And in reducing the costs of doing business what is required is to get business to take risks, right? So you in a sense the political risk equation has a gaming element built into it. Keeping the economy going means creating an environment where people take risks. Making people feel safe means creating the regulations that reduce risk. So the political risk has this inherent tension built into it.
In the financial area what this means is that if we want the financial system to keep moving we actually have to encourage risk-taking.

NANCY REICHMAN
That's the certainty that I was trying to talk about at the very beginning. Our economy requires a certain amount of risk-taking. And so regulation in many ways creates the playing field around risk-taking. That's what I mean by creating a level of certainty. It doesn't truly eliminate the risk. It doesn't even contain the risk; it basically says we're just going to tell you how to manage. We're going to manage the risks that occur. In my work that I do in Denver, Colorado I'm looking at issues around fair labour. I'm looking at workplace standards. One of the things and I talk to businesses and I say, what's important to you in terms of creating a fair workplace? And the word that comes from them every single time is certainty. That is, we need certainty. That also often means no mandates. We want certainty but we don't want to be told what to do, we want to create the certainty for ourselves or we want the market to create certainty.

JENNIFER COOK
Which I think brings us back to Sociology 101 and why we're human, doesn't it?

NANCY REICHMAN
Yes.

JENNIFER COOK
Now, Fiona, you mentioned that the savings and loans' crisis wasn't your area of expertise. Would you like to talk us through one which is?

FIONA HAINES
The one that I looked at in the book was the collapse of HIH Insurance. That was the largest corporate collapse to date in Australia. It occurred in 2001 with losses calculated between $3 billion and $5 billion. What I saw in that financial collapse of that particular firm was an attempt at reforming both the accounting rules, the auditing rules and also the Insurance Act area. The difficulty with the collapse of HIH Insurance was that when I looked at the reforms and the reforms were around corporate governance. They were around things such as independence, independence of actuaries from auditors, independence of auditors from board members and so on. It was about transparency. It was about making sure that people had a very clear idea of what was in the accounts. It was around standardisation of the account rules. But the more I pushed in this area the more I asked the questions, transparency about what, independence from what. If you go into the financial literature and look at issues such as transparency, accountability and independence there is a very vibrant debate about whether any of these things are likely to prevent another corporate collapse. So then I asked the question, what was this response really about. I started thinking about the words transparency, accountability and independence. I realised that they're actually values that are inherent within contemporary Australian society about the way things should be done. We should be transparent. We should be accountable. There should be
independence in the sense that there shouldn't be a conflict of interest. So when I looked at the reforms to corporate governance and I looked at the reforms to accounting rules, what I saw was not the prevention of the next corporate collapse. To an extent that was there but what I saw was socio-cultural reassurance by drawing on particular elements within the society to say, corporations will be responsible from this point on.

NANCY REICHMAN
And if you look at many of the financial collapses over the last decade whether it is an Enron or even looking at the global financial crisis, and response tends to be to create more checks and balances. That is to make us more accountable in a technical sense for our actions.

JENNIFER COOK
Does this, Nancy, then create that sense of certainty that you were talking about?

NANCY REICHMAN
Yes, it creates a sense of certainty but what it doesn't do is impose any kind of value. I began thinking about the movie Wall Street and remember the character Gordon Gekko and he says, greed is good and we all snigger and laugh. But none of us say greed is bad or we don't say you can be greedy but only to this point. So getting back to questions about the concentrations of wealth, we don't put any value to that concentration of wealth. It just happens. We don't say as a society, only so far, you can only accumulate so much. We never impose any kind of standard at that level, we just say as long as you play by the rules it's fine.

JENNIFER COOK
You're listening to Up Close; we're coming to you from the University of Melbourne, Australia. I'm Jennifer Cook and we're talking about the ethical and philosophical underpinnings of regulation with Fiona Haines and Nancy Reichman. Now we've talked about this role of independence could we have a look at that now in terms of the global accounting firm Arthur Andersen? Now they were the accountants not only for HIH but also Enron. So Fiona, if I could ask you to explain what their role was? And also, Nancy, if you can come in as well on this and if we can talk about how that worked, because really that blew it all apart, didn't it, this notion of independence?

FIONA HAINES
Well it did but it also speaks to Nancy's point about the increasing concentration of capital. So there was a very close relationship between Andersen and HIH in the sense that there had been an auditor who'd been auditing HIH's books for a long period of time. Also there was a kind of a revolving door between leaving as an auditor with Andersen's and being appointed to the board of HIH. So there was definitely all sorts of what you might term incestuous type behaviour. Andersen had also itself done a risk analysis of HIH before the collapse and had determined that HIH was a very high-risk client. Yet at the same time signed off on the accounts to say these were a fair and accurate account of the company. So you can look at that and say this is clearly problematic, we have to clear it up. So you try and put through
the independence provisions, but what you find is in a small market like Australia having this rotation of audit companies becomes very difficult because actually with the collapse of Andersen you have not the Big Five accounting firms but the Big Four accounting firms. So you have a real difficulty with independence. You also have a difficulty because people can be nominally independent in the sense that they can look on paper like they have a significant amount of independence, but actually they don't have the strength of character to turn up and say that's wrong. Also independence can mean disinterest. So if you look at private firms as opposed to public firms, the argument there is they are more profitable because their oversight is not independent. It's dependent on the outcomes of what they are doing. So you look at something like independence, it turns out that it can be possibly a good thing but it requires strength of character as well as independence on paper. Independence on paper is problematic because you have increasing concentration in the market and independence itself may be a problem because dependence on the outcomes may actually be a more effective way to go. So if you put all these elements together you start saying there's something more to the demand for independence than just independence. The demand for independence is because it speaks to us as human beings that independence is a good thing. When you technically analyse independence then it becomes a bit more messy and complicated.

NANCY REICHMAN
I'm not sure I have much more to add to that other than to say that I think the crux of this is that we rely on independence rather than direct oversight in order to regulate. Somebody else can say it's okay, it's fine there's an independent third party. We rely on that a lot when in fact sometimes the best kind of regulation occurs when people are dependent and not independent and then they can kind of monitor each other's behaviour.

JENNIFER COOK
It seems to me it becomes a value again, Fiona, independence is a value of society, we want that?

FIONA HAINES
It's a value; it's like motherhood and apple pie. It's something that people say independence is good. Now that's not that independence automatically becomes bad, it's just that it's more complicated than that.

NANCY REICHMAN
Or it's not enough.

FIONA HAINES
Or it's not enough.

NANCY REICHMAN
It's not enough.

JENNIFER COOK
I'd like to end now just by asking the question can regulation really solve anything? I'm talking in the context of won't there always be that big risk that is absolutely out of left field unanticipated too big for anyone to see coming? How can you make rules to stop them?

FIONA HAINES
The answer is yes and no. In the work that I did you could have regulatory reform that was effective but you had to so in the context where political risk and sociocultural risk were also managed. So in other words where you have an environment where political risk can be managed as well as the actuarial as well as the sociocultural you can have good reform. So after the industrial disaster that I looked at, after that context you had a unique environment where the three could be resolved. Similarly, in the case of HIH the reforms to the insurance law but not to accounting and corporate governance, there was also a window where those reforms were actually quite effective. But it's time bound, it never remains static. So as we continue down the track and as the political process is in train and as the economy moves, then you have, if you like, disintegration of the regulatory framework that you've developed. It was great for a time but things move and particularly as we were talking earlier with the gaming around finance, it will inevitably be rendered sort of ineffective at a later point in time.

NANCY REICHMAN
I think I agree entirely. My only add-on would be that I don't know whether we have the political will to constrain capital. We won't prevent every disaster. We can't regulate ourselves to absolute safety but the question is do we have the political will to create some constraints? That to me is the ultimate question.

JENNIFER COOK
I think that's the ultimate place to leave our discussion today. Fiona, and Nancy, thank you so much for joining us.

FIONA HAINES
Thanks very much indeed.

NANCY REICHMAN
Thanks for having us.

JENNIFER COOK
That was Associate Professor Fiona Haines from the School of Social and Political Sciences at Melbourne University and Professor Nancy Reichman from the University of Denver's Department of Sociology and Criminology. We've been talking about the ethical and the philosophical underpinnings of regulation. Relevant links, a full transcript and more information on this episode can be found at our website at upclose.unimelb.edu.au. Up Close is a production of the University of Melbourne, Australia. This episode was recorded on Tuesday, 6 December 2011 and our producers were Kelvin Param, Eric van Bemmel, audio engineering by Kelvin Param. Up Close is created by Eric van Bemmel and Kelvin Param. I'm Jennifer Cook, until
next time, goodbye.

VOICEOVER
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