Of Brexit, regulation, tales and tails

Peter Bonisch and **Mustafa Cavus** advocate a fundamental rethink of the UK's regulatory regimes in the wake of Brexit

With Brexit bearing down on us, the issue of the repatriation of regulatory responsibilities from the European Union and European Commission has gained renewed salience. But, is the UK ready for their return? What will be required to rebuild a domestic regulatory capability? And, with a Government commitment to replicate the existing regulatory position – the EU legislative and regulatory *status quo ante* or *acquis communautaire* – at Brexit via the UK Repeal Bill, what, really, is at stake and over what horizon? Most importantly, who is thinking about the broader issues involved, and how well?

What we can observe gives little cause for optimism as Britain's recent history of regulatory intervention is somewhat patchy. Regulation across financial services, privatized utilities, corporate business, health and education, for example, has led to variable outcomes and considerable controversy about appropriate regulatory frameworks. In many contexts, recent UK regulation has been, more realistically, translation of (UK-informed) EU-defined rules into UK rulebooks and devising local supervisory regimes to oversee compliance and produce national reporting thereon. Much criticism has been levelled at the propensity of UK regulators to 'gold-plate' EU regulatory requirements, especially in financial services. Most significantly, for a couple of generations, UK regulators have not autonomously been responsible for defining regulatory principles, nor for evidence collection and analysis to specify regulatory problems or to formulate regulatory policy.

The UK's post-Brexit regulatory *oeuvre* must also adjust to new technological and resulting economic and social realities just as much as to Brexit. In other words, Brexit may delimit the timeframe for action; it does not and need not delimit the scope of attention.

Debates about requiring ministerial departments and regulators to plan for multiple post-Brexit scenarios are an indulgent distraction; such entities should perpetually plan across multiple scenarios. The current requirements could easily be cast as a sound discipline that should occur periodically anyway. What is far more troubling is the apparent lack of such work historically or maintenance of skill base or frameworks or the availability of meaningful data sources with which to do so.

The need for a substantial rethink of Britain's regulatory frameworks in the wake of Brexit offers an extraordinary opportunity: to reconceptualize regulation as an economic and social as well as political activity. The problem is that the options regulators now face are path-dependent; they are critically dependent on where they have been as well as where they might be going. That makes change all the more difficult and all the more necessary.

For example, with risk, most of the action is in the tail of the distribution of outcomes – extreme exposures or contingent events and thus impacts to which the response must cater. Too often, regulatory frameworks focus on more routine outcomes, distracting from their real purpose. A recent example is the long overdue initiative in 2014 by the Financial Reporting Council (FRC) to focus corporate attention to risk on potential threats to longer-term viability, encouraging firms to adopt scenario-based approaches and stochastic analysis to assess their long-term solvency; such methods have already proved useful in refocusing attention in operational risk in financial services firms. These methods can readily augment (and even substitute for) more traditional and bureaucratic risk-register type approaches; importantly, they have the potential to redirect executive and board attention to where it matters – the tail of the distribution of risk outcomes.

But, as ever, the devil is in the detail. Not only must a regulatory framework accommodate the significance of these tail risks; it should also address what regulation is and does, by whom and to whom (Koop and Lodge, 2017). Conceptually, it should represent (formally or otherwise) a theory of purposeful and goal-directed actors guided by interests, and their actions and interactions; in Coleman's (1986) phrase, 'connecting intentions of persons with macrosocial consequences'. It is also important that whatever approach the regulator adopts should not compound the problem it was designed to solve or create new problems along the way (Stiglitz, 1994). In the terminology of Merton (1949), the regulatory framework will fulfil a combination of *manifest* functions (intended or recognized impacts) and latent functions (unintended or unanticipated impacts); some of these functions will be positive, some negative ('dysfunctions'), some irrelevant ('non-functions').

A useful regulatory framework requires a set of cognitive or behavioural rules applying to humans and corporate agents (i.e. the subjects of the rules) and the social or organizational and technical rules the subjects must apply to their activities (or 'objects') (Dopfer and Potts, 2009). In addition, a framework will contain what these authors call 'orders of rules'. These are (i) the generic 'constitutive' rules applicable across all actors and actions (legal, political, social and cultural rules); (ii) the subject and object 'operational' rules as well as (iii) 'mechanism' rules about how to change frameworks and regulations.

Across a range of regulatory contexts (including extensively in financial services and recently at the FRC), considerable effort is being devoted to the vexed issue of culture. It is both right and proper for executives to attend to their organizations' cultures (plural, note) and how they manifest and interact as well as their latent impacts. Yet, most of this work seems divorced from the rigours of referring to any established discipline or body of knowledge. Executives should attend to the organizational practices (routines and rules, symbols, stories or 'tales') and values they demonstrate by their observable actions, that they communicate and then reinforce through pecuniary and non-pecuniary incentives and rewards; these may contrast their espoused values and any gaps their observed behaviours reveal. It is quite another thing for regulators to attempt to intervene therein or to suggest instrumental approaches to culture that will surely be overcome by latent dysfunction (Merton's actual term for 'unintended consequences'). Culture is a complex, emerging social phenomenon that is highly contested and not readily operationalized. Any existing psychometric methods are individual but culture is social; individuals' perceptions can be measured and contrasted but sociometric approaches to culture are problematic at sub-national levels. And few regulators or supervisors have invested in the anthropological or sociological skills or resources necessary to observe and opine meaningfully on culture. It is a difficult area not subject readily to instrumental or deterministic interventions.

Repatriation of regulatory functions as part of Brexit offers a remarkable opportunity to address Britain's regulatory architecture – both intellectually and organizationally – from first principles. Such an exercise should seek to design and implement a sustained programme to rationalize regulatory rules and to enhance the use of web technologies (usually referred to as 'RegTech') in order to reduce the burden on businesses and improve the efficiency of compliance validation and assurance. Doing so will require a recognition of the limits of current regulatory practice, efficacy and capacity and the need for a substantial enhancement of regulatory coordination as well as the economic, policy, technical and analytical skills effective coordination requires. Muddling through the process in superficial ways will only add costs and reduce businesses' competitiveness.

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AUTHORS

Peter Bonisch is chairman and co-managing partner and **Mustafa Cavus** is co-managing partner at Kage Strategy.