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'REMAPPING THE REGULATORY LANDSCAPE'

**UNDERSTANDING
THE PSYCHOLOGY OF REGULATION**

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*A Fresh Approach to Boardroom Review***

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My talk will be divided into two sections. In the first, I will describe the expectations and disappointments of the Walker Review of Corporate Governance in UK Banks and Other Financial Industry Entities (Walker, 2009) to which I and a colleague contributed an Annex on the psychological aspects of boardroom behaviour. In the second section, I will describe an experiment that examines the behavioural dynamics of regulators and the regulated.

The Walker Review of Corporate Governance in UK Banks and Other Financial Industry Entities asks the pivotal question: how can we address risk more strategically and sustainably? What must our minds and senses be alert to, especially when we need to overcome our own resistance to confront the uncertain and unexpected?

Risk concerns the future. It is an assessment of expected gain or loss. Whilst, technically, the value of those results may be positive or negative, in general, when we refer to risk management, we tend to focus more on the potential harm that may arise either from incurring a cost (human, financial or other) or by failing to attain some benefit.

Markets are said to be motivated by fear and greed. Fear is an emotional response to a perceived threat. Fear and risk are related as when risks are taken to demonstrate the conquest of fear. Greed is an inordinate desire to acquire or possess more than one needs or deserves.

No group of people assessing risk is immune to "groupthink" (Janis, 1972) – the unquestioning acceptance of obviously wrong answers simply because it is socially painful to disagree. One effective way to solve framing problems in risk assessment is to confront fears and other

negative emotions by having open and frank discussions. Wishful thinking is the formation of beliefs and making decisions according to what might be pleasing to imagine, instead of by appealing to evidence or rationality. It has consistently been shown that people will predict positive outcomes to be more likely than negative outcomes. Wishful thinking is emotionally appealing and leads commonly down blind alleys. (Josephs, et al.,1992).

The Walker Review has addressed behaviour that leads to consistent breaches of regulations. We have outlined how risk managers attempt to describe behaviour over which they have no control. They believe they can predict how actual human populations will behave when confronted with situations analogous to the game being studied. But this view can be criticised because the assumptions made by risk managers are often violated.

Walker has surfaced many issues about risk that won't go away simply with a report or a change of government. The dynamics of risk have to take account of powerful constituencies. Being a risk manager or board member of a financial institution has always been difficult, because of organisations' considerable size, global reach and their inherent complex nature. The size problem is compounded by the industry's fragmented and inherent contradictory nature. Like any other economic system, banking has to align and reconcile the conflicting interests and expectations of a number of constituents such as customers, finance professionals, government, regulators, voters and taxpayers, who all hold different and often discrepant priorities. At the same time, the anxiety-raising nature of economic threats and crises encourages the creation of institutional defences (Menzie Lyth, 1988; Miller, 1993), rigid

boundaries (Miller, op. cit.) and projective mechanisms (Hinshelwood, 2001) that significantly hamper any attempt to collaborate to accomplish a common task or to steer the banking industry at all. These conditions are further exacerbated because the nature, functioning and cost to the economy has become one of the most important issues in the UK political arena. The economy is one issue that substantially moves voter sympathy, and it was the one that probably decided the nature of the new British Government.

The Walker Review is the response to the highly controversial collapse of the Western market economy that has led to a rush by this Government towards a system based on a combination of regulatory organisations, regional co-ordination and centrally-monitored performance standards and cost control. Operating under the double scrutiny of the Government and the media, everyone expected Walker to come up with a major restructuring that would affect virtually every component in the economic sector. A complete redesign was expected to create a network of medium-sized banks, that are meant to be responsible for delivering sound economic judgement and overseen by the Financial Services Authority. It was hoped that the Government's intention would be to create a system of banking that is more UK-centred, that increases integration between banks and the rest of the economy, reduces 'risk', maximises the return of the bailout funding and produces tangible improvements for the public, manufacturing and commercial sectors.

In this mood of public hysteria, it was no wonder that the Walker Review was received with so much disappointment. Now everyone wants to go back to the status quo ante and they were expecting that Walker would

do just that. It is now inconceivable for the banking industry to continue ignoring the regulators and political powers. The structure that banking organisations say they create and the ones they actually do create are two different entities. There is a gap between probity and organisational objectives. Real management happens in the corridors. Real transactions take place when the Board meeting is over. Boards' coping modes include running meaningless routines. The resistance side of banks is holding back on regulation. Walker does not address fraudulent marketing, nor the question of what happens when the principal people in banks have no authority. What are they expected to do when faced with an untenable proposition? They resort to what is called parallel cognition to deal with situations where they are expected to know what the future holds and they do not. They resort to the use of risk models that are presented as acclaimed reality. Risk models are no use since they make assumptions using numbers (Tett, 2009). Making judgment calls is risky. It is a human weakness to consider a number as a reality. Risk managers are parachuted into Boards to communicate a philosophy of risk. On the one hand, they are stripped of their authority because they are used as a veneer to support unlicensed risk appetite. On the other, when confronted by the risk experts, Board members might say I don't get it, can you explain? The risk experts explain, but use the same words and complex technical terms. To ask a second time for them to explain reduces the Board member's authority. The experts know that people won't dare to ask a third time because that will strip them of all authority. Therefore the experts are always ahead of the game. The group dynamic makes this happen.

Inevitably we are on the psychological and behavioural end of understanding structural power games in which the essential fact is that

the finance industry is more powerful than either the government or the regulator. Banking is fickle – it can take its business wherever it wishes. The threat of leaving is powerful. Banks are cold-hearted and have no loyalty. There is always conflict between government and finance, because the government needs the bank's money and its ethics therefore become compromised. To rein in banking, there has to be international regulation. Walker can only address local governance issues. The picture is much bigger and everyone is implicated and has responsibility for its solution.

At the heart of the Walker Review is a multi-disciplinary approach which commingles Board responsibility with the expertise of law, finance, psychology and social science. The coming together of such disciplines to consider Corporate Governance creates a mindset of learning from each other. It is the benefit of this learning mindset, rather than constantly looking for new solutions, that will improve governance.

In this section, I will describe an experiment I conducted with regulators a few years ago. A colleague, William Halton and I use a method of investigation that is designed to enable the regulators to understand in greater depth the forces behind the exercise of regulatory authority and how they understand and carry out their regulatory leadership functions, how they take up their roles as regulators and the results of their doing so. Thirty regulators spend a week in residence with the two experimenters - Halton and I. The regulators are drawn from a variety of sectors.

Over the course of the week, the regulators are charged with a number of tasks, two of which I will describe here:

1. The Regulation of Resources Event
2. The Regulation of the Market Event

Each event lasts three half-days and the regulators, after being given their instructions, are left very much to themselves to sort out how to achieve their tasks. The experimenters are on hand to offer comment on the group dynamics and collective behaviour as they unfold.

I will describe each event separately and then draw some common conclusions from both events about the psychology of regulation. The results of the experiment show that regulation as a process has a deep and profound psychology and regulators who do not take account of these lessons, are more likely to find themselves in conflict with the regulated.

In the “Regulation of Resources” event the experimenters authorize a small group of participants, called the regulator group, to work with the rest of the participants, the regulated, in planning a series of learning sessions based on the participants’ learning needs.

The overall aim of the Regulation of Resources event is to provide opportunities for all the participants to develop their understanding of processes that influence the psychological relationships and group dynamics between regulators and regulated, as they try to achieve a social and/or political goal.

In the briefing for the Regulation of Resources event the participants are told they have to help the regulators and those regulated to work more effectively within their roles and improve collaboration between them.

The regulators ask the resource groups, each composed of some subset of the participants, to plan and deliver learning sessions. The presenting challenge is for the regulators group to win the cooperation of the resource groups and for the resource groups to accept the authority of the regulators group. There is the risk that the resource groups would spin off as independent entities “doing their own thing.” Describing this experiment, Halton (2004) writes,

“Resource Group A members were upset that some of their needs had been left off the list by the regulators. At first they were frightened of the regulators and requested consultancy from Halton and Sher about whether it was safe to ask the regulators group to remedy this omission. Later, they came up with a plan that would solve the various dilemmas facing the regulators, but the regulators rejected the plan on the grounds that the resource group was too aggressive in the way they presented it. The group were then unwilling to allow the regulators into their room.”

“Resource group B completed the inventory of their resources quite quickly and handed their list to the regulators. They then withdrew into themselves in an isolated self-congratulatory way in which they explored their own group identity and process. They failed to cooperate in creating the plan or in contributing to the resolution of the system’s problems.”

“Resource group C also contributed a list of their resources, but because a member of the regulatory group was rude to one of them, they went on strike and refused further cooperation.”

“The system fell apart. Crowds of observers gathered in the regulators’ room. Arguments proliferated; the time available for running the events diminished; ambitious schemes were progressively cut back; learning needs had to be curtailed amid further arguments.”

By contrast, in the Regulation of the Market event, sub-groups form spontaneously and are given the opportunity to plan a presentation for the other participants on any topic of their choosing and to be customers for the other groups’ presentations. One rule is that all members of a group have to be present when their group is giving its presentation. The initial feeling in response to the task is a manic one. There is excitement that stimulates thoughts about sexuality. For example, one group decides to offer an eau de Cologne scent that would improve a person’s sex life.

But more importantly, what can happen is that the unpredictability of the market itself, concerns about who will come to whose presentation and what will they think of it, leads the different groups to merge, so that now only one group, the participants as whole, is called upon to plan and deliver a series of scheduled events. Regulation turned into tight authoritarian rule by a dictator.

Describing the Regulation of the Market event Halton writes, *“The separate groups collapsed quickly into one organization with an authoritarian leader, who set up a corporate project of making a promotional film to attract tourists to their town. One group was to make the video, another the brochures, a third to plan distribution and so on.”*

“In the first fifteen minutes one member went round from group to group creating a coordinated time-table and arranging who would be customers for which event. These agreements were made before the products were created or the quality known or if customers even wanted them. The motto was, “If you buy from me, I’ll buy from you, no matter what we sell each other.”

These two outcomes lead Halton and I to a provocative formulation. In response to the Regulation of Resources event, the participants ignore the regulators and enact a Regulation of the Market event in which each group is independent and does its own thing, and, in response to the Regulation of the Market event, the groups respond by creating a Regulation of Resources event. They decide to allocate time and effort through a collective process.

Thus each event becomes a social defence against the other. In the Regulation of the Market event, the excitement gives way to anxiety about its unpredictable nature. This leads participants to combine forces and centrally plan their activities. This is not unlike companies who form surreptitious oligopolies or traders who try to corner a market. In the Regulation of Resources event, the authority of the regulators’, their impingement on the freedom and potential creativity of the resource groups, leads them to undermine the regulators’ authority and to strike out on their own as entrepreneurs.

Discussion

The tension between what psychologists call “the reality principle” and “the pleasure principle” (Freud, 1911) transforms the historic political

tension between markets and central planning (Hirschhorn, 2010). This tension grew out of, and was expressed by the “class-struggle.” Workers and their allies attacked markets because they resulted in low wages, adulterated food, and old people who lived in poverty. Their unions, and in Europe their political parties, aimed for a “social” democracy in which a citizen’s political rights, were matched by everyone’s right to a fair share of economic resources. At the same time, capitalists resisted government intrusions and defended their right to dispose of their property according to their own interests and objectives.

According to Hirschhorn, today this tension takes place on the psychological plane. Under the press of regulatory authority and the burdens of living with systemic risk, we project onto the state’s regulators the ‘reality principle’ and onto the market the ‘pleasure principle’. We split the two principles. This tension first lays a claim on our minds, on our emotions, before it results in an expression of some material or political interest.

This has two implications. First, we can use neither the market nor the state imaginatively. We deprive each side of the compensating principle it needs. Second, social conflicts result from the *projections outward* of this inwardly experienced tension. This is why political conflicts, for example, have an increasingly cultural cast. Political wars and culture wars converge. They are the projections outward of psychological forces as we saw in our experiments.

The financial crisis of 2008 exposed a serious tension between the pleasure and reality principals. Hirschhorn sums it up when he says that we need the former for creativity, the latter to manage and regulate

systemic risks. Each is in tension with the other. The cultural task is to integrate the two so that creativity takes place in a context in which legitimate authority can be exercised. But regression takes place readily, taking the form of the culture of narcissism and political correctness on the one side, or conformity and a devitalized organizational life on the other. We need to develop a new psycho-sociology to fully understand the implications of these developments and to create organizational and social systems that allow the imagination to flourish.

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