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Can Industry-Wide Self-Regulation in The UK Banking Sector Succeed? A Law and Economics Perspective.

Jan Linhart

Introduction

Eight years after the onset of the global financial crisis, the public trust in the UK banking sector is still eroded.¹ The crisis revealed that the industry is reckless and imprudent. The well-known post-crisis scandals, such as rigging of the LIBOR or manipulation of the FOREX market, revealed that the industry is also dishonest. These scandals, which happened despite significant post-crisis regulatory overhaul, demonstrate the limits of what formal regulation can achieve in the absence of cultural change across the industry. Indeed, the Parliamentary Committee on Banking Standards (PCBS) identified toxic corporate culture as the major cause of misconduct in the banking sector and called for an immediate change.² This change is crucial because formal regulation cannot cover all contingencies as the industry is constantly evolving.³ Regulatory gaps will always remain. To rebuild the trust in the sector, banks must go beyond the letter of regulation and focus on its spirit.

There are several regulatory models for bringing this cultural change about. This paper will focus on industry-wide self-regulation, a model which has received, in the context of banking, relatively little scholarly attention. The aim of this paper is to examine the factors that determine a functional self-regulation and to apply this analysis to evaluate a recent self-regulatory development in the UK, namely the establishment of the Banking Standards Board (BSB), which issued its first annual review in March 2016. This paper will not focus on the efficiency of self-regulation as compared to other regulatory models, but rather on what is necessary for a self-regulatory body to emerge and function, regardless of its substantive policies. Therefore, the BSB will not be evaluated for the efficiency of its policies, but rather for its ability to enforce its policies, which is the BSB's fundamental function. This paper is the first one to evaluate the BSB from this perspective.

In *Part I*, this paper will argue (*I.1*) that culture has been a problem for the UK banking sector because it suffers from the tragedy of the commons, a type of co-ordination problem where a resource is held in common among members of a group and each member exploits the resource at a level that is collectively inefficient.⁴ In the UK banking sector, the common resource is the collective industry reputation. It will be argued that because of this reputation commons problem, changing one's culture is not a rational strategy for banks to adopt. The paper will then (*I.2*) turn to the BSB, to explain how it works and what its main objectives are. While self-regulation is generally

¹ 'Edelman Trust Barometer 2016' (Edelman Worldwide, 2016) <<http://www.edelman.com/insights/intellectual-property/2016-edelman-trust-barometer/>> accessed 25 November 2016.

² Parliamentary Commission on Banking Standards, *Changing banking for good* (2013-14, HL 27-II, HC 175-II).

³ Saule Omarova, 'Wall Street as Community of Fate: Toward Financial Industry Self-regulation' (2011) 159 *University of Pennsylvania Law Review* 411.

⁴ Andrew King, Michael Lenox and Michael Barnett, 'Strategic Responses to the Reputations Commons Problem' in Andrew Hoffman, Marc Ventresca (eds), *Organizations, Policy, and the Natural Environment* (Stanford University Press 2002).

accepted as only one of the possible solutions to the commons problem, this paper will highlight its advantages over the other solutions to demonstrate its practical relevance and explain why the BSB was established. In **Part 2**, this paper will review (2.1) the Law and Economics scholarship on ‘Private Ordering’ and ‘Game Theory’ to identify the necessary conditions for the BSB to solve the reputation commons problem and thus successfully enforce its policies. It will be argued (2.2) that unlike the traditional tragedy of the commons, which can be rationalised as the ‘Prisoner’s Dilemma’, a type of non-cooperative game, the reputation commons problem in the UK banking sector resembles the ‘Stag Hunt’ game, a type of cooperative game, which can be solved relatively easily. Consequently, it will be argued that the BSB satisfies the necessary success conditions to be functional. In **Part 3**, it will be argued (3.1) that while the BSB can function if the ‘Stag Hunt’ game remains the underlying game for the BSB to solve, the underlying game can easily change and become less cooperative. This paper will conclude (3.2) by suggesting how the BSB can prevent this.

Part 1: Characteristics of the UK banking sector and the Banking Standards Board

1.1 The UK banking sector and the tragedy of the commons

Changing one’s culture is primarily motivated by self-interest: to regain reputation. Although no strict causal relationship between culture and reputation exists (for instance because reputation may get damaged by a single accident), empirical research demonstrates that negative culture is tightly correlated with negative reputation.⁵ Cultural change is therefore an effective tool for managing one’s reputation.⁶ In the UK banking sector, positive reputation is valuable, both for individual banks and the industry as a whole, as it leads to social and political legitimisation.⁷ This in turn enlarges growth opportunities, contributes to higher profits, and eases the access to resources.⁸ However, when one’s effort to improve or maintain one’s reputation makes no difference because it depends on others who do not cooperate, it may be rational to succumb to wrongdoing if it brings some short-term profits. In that case, improving one’s culture does not make economic sense. It is argued that this leads to the tragedy of the commons, often observed for natural resources⁹, but where the common resource is the industry’s reputation.

Traditional tragedy of the commons ensues when a resource is held in common among members of a group and each member exploits the resource at a level that is collectively inefficient.¹⁰ For each exploiter, the cost of exploiting the common resource is distributed among all the members, while the benefit accrues only to the exploiter.¹¹ Each member therefore maximises personal welfare at the

⁵ Rosella Care, ‘The Libor Case: A Focus on Barclays’ in Stefano Dell’Atti and Annarita Trotta (Eds.), *Managing Reputation in The Banking Industry: Theory and Practice* (Springer 2016).

⁶ Ibid.

⁷ Nicholas Morris and David Vines, ‘Why Trustworthiness Is Important’ in *Capital Failure: Rebuilding Trust in Financial Services* (OUP 2014).

⁸ Ibid; Sylvia Flatt and Stanley Kowalczyk, ‘Corporate Reputation as a Mediating Variable between Corporate Culture and Financial Performance’ (Reputation Institute Conference, New York, 2006).

⁹ Garrett Hardin, ‘The Tragedy of the Commons’ (1968) 162 *Science* 1243.

¹⁰ King, Lenox and Barnett (*n4*).

¹¹ Ibid.

expense of collective welfare represented by the common resource.¹² To demonstrate that the UK banking sector suffers from a reputation commons problem, it must be true that stakeholders (public and politicians) cannot differentiate between the relative behavioural impact of each bank, and that the stakeholders can sanction the industry as a whole.

1.1.1 Reputation commons

If stakeholders were able to differentiate between the banks perfectly, they could determine the marginal behavioural impact of each bank and accordingly impose individual sanctions.¹³ Each bank would therefore possess a unique reputation and would be able to unilaterally control it. Individual wrong behaviour would therefore be a pure externality which could, depending on the transactions costs, be resolved by Coasian bargaining¹⁴. That is, stakeholders and each bank would try to negotiate to reach a deal which would maximise their collective welfare. Stakeholders would be willing to accept a ‘bribe’ from a bank in exchange for not triggering their sanctions, provided that the bribe would exceed their valuation of the negative externality imposed by the bank. This negotiation would continue until no further mutual net marginal gains could be realised.¹⁵

However, in the UK banking sector, this is not possible due to information asymmetry- caused by two factors. Firstly, the biggest banks are relatively homogeneous, because their products, employees, and management strategies are similar. This homogeneity is in itself empirically proven to attract strong reputation spill-over effects.¹⁶ Secondly, the nature of the banks’ work is very technical and their products are complex. Due to this complexity, the public cannot identify the causes of different problems or how the problems manifest in the products themselves.¹⁷ If they try to find out, the transaction costs are prohibitively large.¹⁸ Therefore, due to the homogeneity coupled with this lack of technical knowledge, the public cannot¹⁹ evaluate the relative behaviour of each bank. The public is also susceptible to various biases, such as availability heuristic²⁰, making it easier for extremes to be overestimated. Therefore, if one bank causes a scandal, the public becomes suspicious that the others also contributed or that they will cause a scandal in the future.²¹ Collective reputation thus suffers.

¹² Ibid.

¹³ Ibid.

¹⁴ Ronald Coase, ‘The Problem of Social Cost’ (1960) 3 J Law Econ 1.

¹⁵ Ibid; Cento Veljanovski, *Economic Principles of Law* (Cambridge University Press 2007).

¹⁶ Michael Barnett ‘Finding a Working Balance Between Competitive and Communal Strategies’ (2006) 43 Journal of Management Studies 1752.

¹⁷ David Llewellyn, ‘Reforming the Culture of Banking: Restoring Trust and Confidence in Banking’ (2014) 2 Journal of Financial Management, Markets and Institutions 211.

¹⁸ Ibid.

¹⁹ Michael Barnett and Andrew Hoffman, ‘Beyond Corporate Reputation: Managing Reputational Interdependence’ (2008) 11 Corporate Reputation Review 1.

²⁰ Amos Tversky and Daniel Kahneman, ‘Availability: A heuristic for judging frequency and probability’ in Amos Tversky, Daniel Kahneman, and Paul Slovic (Eds.), *Judgment Under Uncertainty: Heuristics and Biases* (Cambridge University Press 1982).

²¹ Lori Yue and Paul Ingram, ‘Industry Self-Regulation as a Solution to the Reputation Commons Problem: The Case of the New York Clearing House Association’ in *Oxford Handbook of Corporate Reputation* (OUP 2012).

1.1.2 Stakeholder-mediated sanctions

In the traditional commons problems, the cost of individual exploitation is distributed among all members of the group, because every such exploitation directly depletes the commons.²² In the UK banking sector, individual wrongdoing does not automatically deplete the commons and impose costs on other banks. The depletion is only caused by stakeholder-mediated sanctions²³, which are not always triggered by individual wrongdoing. To be sure, some wrongdoing may not transpire and this may incentivise some banks to act wrongfully. There is therefore asymmetry between the depletion and individual wrongdoing. However, this asymmetry gradually becomes smaller, because the UK banking sector is under increased scrutiny from regulators, and the probability of detection is very high²⁴. Therefore, since the asymmetry is not significant, the particular commons problem in the UK banking sector has similar mechanics to the traditional commons problems. The increased regulatory scrutiny also means that some banks have their reputation partially privatised, since regulators impose individual fines. While this may indicate a shift from the commons problem back to the possibility of Coasian bargaining, the primary stakeholders are the public and politicians, and for them, as explained in 1.1.1, individual detections only corroborate the need to sanction the industry as a whole.

In fact, it seems that the UK banking sector has reached a ‘tipping point’ where stakeholders react to individual wrongdoing more strongly than ever before. This is not only because the consequences of the financial crisis remain important today, but also because a large part of the public feel that they have been taken advantage of by providing safety nets to banks which, even post-crisis, still engage in wrongdoings.²⁵ This resentment forces the government to pursue more aggressive regulation.²⁶ Excessive regulation and enforcement has strong sanctioning effect on the industry as it reduces banks’ profitability²⁷ and opens up opportunities for new market players, such as alternative credit providers²⁸. In *Part 3*, it will be shown that this ‘tipping point’ is very conducive to successful self-

²² King, Lenox and Barnett (*n4*).

²³ *Ibid.*

²⁴ Linklaters, ‘Regulatory Enforcement Trends - 2015’ (February 2015) <<http://www.linklaters.com/Insights/RI/Regulatory-Investigations-Update-February-2015/Pages/Index.aspx>> accessed 25 November 2016; EY, ‘Fines and prison sentences issued by UK regulators are increasing, EY’s Investigations Index reveals’ (30 November 2015) <<http://www.ey.com/UK/en/Newsroom/News-releases/15-11-30---Fines-and-prison-sentences-issued-by-UK-regulators-are-increasing>> accessed 25 November 2016.

²⁵ Sue Jaffer, Nicholas Morris, Edward Sawbridge and David Vines, ‘How Changes to the Financial Services Industry Eroded Trust’ in *Capital Failure: Rebuilding Trust in Financial Services* (OUP 2014); Parliamentary Commission on Banking Standards (*n2*).

²⁶ Stacey English and Susannah Hammond, ‘Cost of Compliance 2016’ (*Thomson Reuters*, 2016) <<https://risk.thomsonreuters.com/content/dam/openweb/documents/pdf/risk/report/cost-compliance-2016.pdf>> accessed 25 November 2016; Linklaters (*n24*); EY (*n24*).

²⁷ KPMG, ‘UK banks performance benchmarking report - Half year results 2014’ (2014) <<https://www.kpmg.com/UK/en/IssuesAndInsights/ArticlesPublications/Documents/PDF/Market%20Sector/Financial%20Services/uk-banks-performance-benchmarking-report.pdf>> accessed 25 November 2016; Laura Noonan and Emma Dunkley, ‘UK banks’ recovery from crisis lags behind European peers’ *Financial Times* (London, 2016) <<http://www.ft.com/intl/cms/s/0/62749460-06f0-11e6-a70d-4e39ac32c284.html#axzz47KmXTZ7k>> accessed 25 November 2016.

²⁸ Allen & Overy, ‘Funding European business: What’s the alternative?’ (November 2014) <<http://www.allenoverly.com/SiteCollectionDocuments/Funding-European-Business-Whats-the-alternative.pdf>> accessed 25 November 2016.

regulation, because self-regulation is more likely to work if the threat of collective sanctions is credible.

1.2 The BSB and the advantages of self-regulation

Firms are willing to develop a private legal system tasked with collective self-regulation (PLS) if it advances their shared economic interest.²⁹ Since the UK banking sector has reached a tipping point where misconduct leads to severe sanctions, this shared economic interest clearly lies in forestalling the sanctions. This is reflected by the establishment of the BSB. Before explaining how the BSB works and what its policies are, the general advantages of any PLS shall be explained. PLS is only one of the possible solutions to the tragedy of the commons,³⁰ the other solutions being privatisation or public regulation.³¹ While this paper does not argue that a PLS is the most efficient solution, its advantages over the other solutions will be highlighted to demonstrate its practical relevance and explain why the BSB was established.

1.2.1 Advantages of PLS over other solutions

Firstly, a PLS may be more efficient than privatisation because it is more neutral. Banks would be able to privatise their reputation if they could take unilateral action to differentiate themselves from others, such as by publicising information about their performance.³² However, if this information comes directly from the bank and not an independent body, there is a risk of empty propaganda, which the public is naturally aware of.³³ Further, the stakeholders would also need to know the relative performance of each bank to effectively compare them, meaning the information would have to be standardised across the industry. Because of the need for neutrality and standardisation, the aim of privatisation (which is essentially benchmarking), can be better facilitated³⁴ by PLS.

Secondly, the clearest benefit of a PLS over public regulation is its flexibility. Since the PLS's norms are developed by insiders who exactly know what behaviour is problematic, the norms can take many forms and will generally prevent wrongdoing more effectively than top-down rules constructed by outsiders.³⁵ Other major benefit of a PLS lies in compliance monitoring³⁶ since top-down monitoring by public regulators will inevitably be less effective than monitoring mediated by frequent business interactions among the PLS's members.

²⁹ Neil Gunningham and Joseph Rees, 'Industry Self-Regulation: An Institutional Perspective' (1997) 19 *Law & Policy* 363.

³⁰ Elinor Ostrom, 'Collective Action and the Evolution of Social Norms' (2000) 14 (3) *Journal of Economic Perspectives* 137. Elinor Ostrom, 'Coping with tragedies of the commons' (1999) 2 *Annual Review of Political Science* 493.

³¹ Hardin (*n9*); King, Lenox and Barnett (*n4*).

³² *Ibid.*

³³ *Ibid.*; Yue and Ingram (*n21*).

³⁴ Roger McCormick and Chris Stears, 'Banks: Conduct Costs, Cultural Issues and Steps Towards Professionalism' (2014) 8 *Law and Financial Markets Review* 134.

³⁵ Gunningham and Rees (*n29*). Saule Omarova, 'Rethinking the Future of Self-Regulation in the Financial Industry' (2010) 35 *Brooklyn Journal of International Law* 665.

³⁶ *Ibid.*

1.2.2 *The BSB*

Establishing the BSB in 2015 was specifically motivated by the problems with privatisation and public regulation, which failed to prevent many post-crisis scandals.³⁷ The shared interest among the banks to solve the reputation commons problem is evident from Sir Lambert's report, who was appointed by the PCBS to investigate whether the industry supports the establishment of the BSB. The report concluded that there was "a strong case for a collective effort to raise standards of behaviour and competence in the banking sector"³⁸.

The BSB is a non-statutory body working with the industry but not representing it, and its board mainly consists of independent non-practitioners, with a minority of practitioners. The BSB's running costs are paid by its members. The founding members are six of the UK's largest banks and its largest building society.³⁹ The membership is voluntary for all the UK firms holding a banking licence, and as of November 2016, the BSB had 34 members. Among the leading investment banks, Goldman Sachs, JPMorgan, Credit Suisse and UBS have not joined.

1.2.3 *BSB's objectives*

The general aim of the BSB is to define and raise standards of behaviour and competence across the UK banking sector to re-build its trustworthiness.⁴⁰ This should be achieved by incentivising its members to improve their culture, go beyond mere regulatory compliance, and "recognise a shared responsibility for managing the standing, reputation and trustworthiness of the sector"⁴¹.

According to the BSB's first annual review⁴², the BSB will implement its general aim by, firstly, assessing the culture of its members annually. Based on this assessment, the BSB will develop minimum 'common standards' of good corporate culture, incorporating both professional and ethical principles. The common standards will particularly focus on: going beyond mere compliance, improving leadership, identifying adequate incentive and rewards structure, incentivising internal and industry-wide whistleblowing, and design of ethical training. Secondly, based on the individual assessments, the BSB will individually recommend to its members how to meet the common standards. Thirdly, the BSB will identify gaps in public regulation and will develop a mechanism for filling them.

³⁷ Parliamentary Commission on Banking Standards (n2).

³⁸ Richard Lambert, 'Banking Standards Review' (2014) <http://1984london.com/_banking-standards/pdf/banking-standards-review.pdf> accessed 25 November 2016.

³⁹ Barclays, HSBC, Lloyds Banking Group, Nationwide, RBS, Santander, Standard Chartered Bank.

⁴⁰ BSB, 'Banking Standards Board - Annual Review 2015/2016' (London, 2016) <<http://www.bankingstandardsboard.org.uk/wp-content/uploads/2016/03/BSB-Annual-Review-20152016.pdf>> accessed 25 November 2016.

⁴¹ Ibid.

⁴² Ibid.

Part 2: PLS as a solution to the reputation commons problem

2.1 Theory: conditions for a functional PLS

This part will identify the necessary conditions for the BSB to solve the reputation commons problem described in 1.1 and thus fulfil its fundamental norm-enforcing function. Before that, it is relevant to explain why this paper is concerned with this fundamental function. The majority of Law and Economics scholars⁴³ focus on the efficiency of the PLS's substantive norm. They assume that if the PLS's norm is more efficient than formal law, the PLS will emerge autonomously to replace the less-efficient formal law. However, Professor Aviram argues that the assumption is not warranted because one question logically precedes the efficiency analysis of the PLS's norm, and that is whether some contemplated PLS can in fact fulfil its most fundamental function, which is the enforcement of its norm, regardless of how efficient the norm is.⁴⁴ If this function cannot be fulfilled, the PLS will not autonomously emerge and function.⁴⁵ This prior question, on which this essay focuses, is therefore concerned with the costs in enforcing the PLS's (in this case the BSB's) substantive norm. The enforcement costs primarily depend on how adversarial the PLS's substantive norm is.⁴⁶ That is, whether complying with it is in one's self-interest. If it is in one's self-interest so that an individual will comply even if others do not, the enforcement costs are minimal. If compliance is against one's self-interest, more coercion is needed and enforcement is therefore more costly. Before examining more closely how to determine the adversariality of the substantive norm and what other factors affect the enforcement costs, how the enforcement costs affect the PLS's functionality will be explained.

2.1.1 How enforcement costs affect PLS's functionality

Aviram⁴⁷ argues that if the enforcement costs are high, as a result of the fact that the PLS's substantive norm is adversarial, a new PLS will not be able to fulfil its fundamental function. This is because the new PLS would have to incentivise its members to comply by conferring on them some benefit which makes compliance more valuable than defection. This benefit is the membership in the new functional PLS, from which the members can be excluded (if they defect), which will deprive them of the benefit (reputation, ability to mutually transact, etc.). But since the new PLS is not yet enforcing any compliance, the new members will significantly discount (or not derive at all) any benefits from this new PLS, because they must first be guaranteed that the new PLS will in fact be

⁴³ e.g. Lisa Bernstein, 'Opting out of the Legal System: Extralegal Contractual Relations in the Diamond Industry' (1992) 21 J Legal Stud 115.

⁴⁴ Amitai Aviram, 'Forces Shaping the Evolution of Private Legal Systems' in Peer Zumbansen and Graf Calliess (eds.), *Law, Economics and Evolutionary Theory* (Edward Elgar 2011); Amitai Aviram, 'Path Dependence in the Development of Private Ordering' (2014) Michigan State Law Review 29.

⁴⁵ Ibid.

⁴⁶ Ibid.

⁴⁷ Ibid.

able to enforce full compliance (as this is what provides the benefits).⁴⁸ Aviram calls this a “chicken and egg paradox”⁴⁹.

One potential way the new PLS can provide the necessary guarantee is by relying on public regulatory enforcement, which would result in co-regulation. However, Aviram argues that no extra guarantee is needed if the new PLS can initially rely on pre-existing network which already confers benefits on its members, and from which they can therefore be excluded if they do not comply with the new PLS’s norm.⁵⁰ For example, Bernstein’s analysis⁵¹ of the New York diamond exchange can be rationalised as relying on a pre-existing network. The exchange is enforcing adversarial norm, which is the avoidance of opportunistic behaviour, but this norm initially relied on a cooperative norm, which was the compliance with the norms of one’s religious and ethnical community, as the exchange used to be, and still is, dominated by Orthodox Jews. If the early traders violated the exchange’s norm, they were deprived from participating in their religious and social community, which they valued more than free-riding on the exchange’s norm. Today, the exchange relies on its own network effects⁵², which reduce the adversariality of the norm: Since the exchange is the only place where the traders can conduct business, ruining their reputation by non-compliance would ruin them economically, as they risk to be excluded from the exchange. These network effects are further strengthened by the fact that it is very difficult for the traders, without using reputation as a proxy, to assess the counterparty’s reliability *ex ante*.⁵³ Therefore, traders are incentivised to constantly monitor each other.

2.1.2 Determining the enforcement costs

As was already explained, the primary factor affecting the enforcements costs is the adversariality of the PLS’s substantive norm, which depends on whether complying with it is in one’s self-interest. Whether complying with the norm is in one’s self-interest can be determined by simple game-theoretical models.⁵⁴

	H2 stag	H2 hare
H1 stag	<u>4; 4</u>	0; 2
H1 hare	2; 0	<u>2; 2</u>

Figure 1: Stag-Hunt Game

	P2 silent	P2 confess
P1 silent	-1, -1	-5, 0
P1 confess	0, -5	<u>-3, -3</u>

Figure 2: Prisoner’s Dilemma

Firstly, the ‘Stag Hunt’ game (SHG) represents the lower enforcement-cost norms. It is an allegory for two hunters who can either cooperate and hunt a stag, or defect and individually hunt a hare.

⁴⁸ Ibid.

⁴⁹ Ibid.

⁵⁰ Ibid.

⁵¹ Bernstein (n43).

⁵² Aviram (n44).

⁵³ Bernstein (n43).

⁵⁴ Richard McAdams, ‘Beyond the Prisoners’ Dilemma: Coordination, Game theory, and Law’ (2009) 82 Southern California Law Review 209; Amitai Aviram, ‘A Paradox of Spontaneous Formation: The Evolution of Private Legal Systems’ (2004) 22 Yale Law & Policy Review 1.

Sharing a stag is the best outcome, but hunting a stag is also riskier because the hunters must rely on each other, while hunting a hare is safe because hunters succeed on their own. There are thus two Nash Equilibria (a set of strategies, one for each player, where no player could do better by choosing a different strategy given the ones the others choose⁵⁵) in this game: either everyone hunts a stag or everyone hunts a hare. The important thing is that the cooperative outcome is the most preferred one. Therefore, a PLS only has to provide necessary assurance to *each* player that the others will cooperate. This can be simply achieved by information exchange. If this exchange is effective, everyone will happily cooperate. Free-riding on the efforts of cooperative players never makes sense, because full mutual cooperation is required to get the higher utility (to share a stag).

Secondly, the ‘Prisoner’s Dilemma’ game (PDG) represents the higher enforcement-cost norms. It is an allegory for two prisoners who can either cooperate to keep silent and face minimal sentence, mutually confess and face medium-term sentence, or confess while the other prisoner keeps silent, in which case the one who confesses will face no sentence. Unlike the SHG, the PDG has only one Nash Equilibrium, which is mutual confession: Each player will always confess regardless of what the other player does. This is because even if one player decides to keep silent and the other player knows this, the other player will gain more by confessing. This incentive to ‘free-ride’ on the cooperative efforts of others is in direct contrast to the SHG. For this reason, the enforcement costs of cooperation under the PDG are much higher: PLS must change the players’ incentives and commit them to something which is not in their immediate self-interest.

Besides the adversariality of the PLS’s norm, the enforcement costs also depend on how adversarial the environment in which the enforcement takes place is. This can be determined with the help of the competition law scholarship on the stability of cartels⁵⁶. A cartel, just like a PLS, is a form of collective self-regulation, and its success hinges on its ability to enforce its norm (price fixing, market allocation, etc.⁵⁷). Thus, enforcing mutual cooperation in a group of a large and fluctuating membership with heterogeneous preferences will be more difficult, and hence more costly, than enforcing cooperation in a smaller group of stable membership with homogenous preferences (this is where cartels survive).⁵⁸ The harsher the environment, the higher the costs of enforcing the PLS’s norm, and hence the lower the expected utility from cooperation. Therefore, even if the PLS’s norm is not particularly adversarial, changes in the harshness of the environment can change the expected payoffs and hence the type of the game.

2.2 Application to the UK banking sector

The enforcement costs of the BSB’s norm shall now be discussed. It will be argued that since the BSB’s norm is not adversarial, a pre-existing network is not necessary, and the BSB can therefore fulfil its fundamental norm-enforcing function. In *Part 3*, it will be argued that while a pre-existing

⁵⁵ Douglas Baird, Robert Gertner and Randal Picker, *Game Theory and the Law* (HUP 1994).

⁵⁶ George Stigler, ‘A Theory of Oligopoly’ (1964) 72 *Journal of Political Economy* 44; Andrew Dick, ‘When Are Cartels Stable Contracts?’ (1996) 39 *J Law Econ* 241; Aviram (*n54*).

⁵⁷ Dick, *ibid*.

⁵⁸ Aviram (*n44*) and (*n54*).

network is not necessary for the BSB nor even existent in the UK banking sector, a functional network may nevertheless help to prevent the BSB's norm from becoming more adversarial in the future. It will also be suggested how the BSB can develop this new network.

2.2.1 Enforcement costs

Firstly, applying the description of the BSB from 1.2.3, the BSB's norm is a mutual cooperation between its members to collectively restore public confidence in the UK banking sector. The key elements of the norm are: improving individual culture, sharing information with the BSB board, and not engaging in wrongful behaviour proscribed by the BSB.

Secondly, the adversariality of the norm. The starting point is the commons problem. Any commons problem requires competitors to cooperate with each other, and this may clash with their dominant strategies, which may be free-riding. This is why traditional commons problems are represented by the PDGs, because individual depletion of the commons (defection) is always more rational for each player than cooperation. However, in the UK banking sector, free-riding is not a rational strategy. Unlike in the traditional commons cases, where free-riding results in a direct gain for the free-rider, in the reputation commons problem, as argued in 1.1.2, a single free-riding attempt may prove disastrous both for the free-rider as well as the whole industry, and the probability of detection is high. All banks must therefore cooperate to forestall the stakeholder sanctions.

Thirdly, the harshness of the environment. While the membership in the BSB is open to all entities holding a banking licence, which covers a range of firms from building societies to investment banks, the membership will probably not fluctuate – it is only likely to increase. This is because once banks join the BSB, they “make a strong, positive and public affirmation of their commitment to achieving high standards of behaviour”⁵⁹, so leaving the BSB later would send negative PR signals and attract the attention of regulators. Further, the preferences of at least the key members, which are the largest UK banks, are relatively homogeneous: they want to forestall stakeholder sanctions.⁶⁰

2.2.2 Game-theoretical model

Hereafter, based on the discussion above, it will be shown that the UK banking sector and the BSB's enforcement costs result in the SHG scenario. To simplify, the discussion will be applied⁶¹ just to two players (banks). A complete model would have to involve all players, and the game would be much more extensive (*n*-player game).

⁵⁹ BSB (n40).

⁶⁰ Lambert (n38).

⁶¹ A similar model applied to different context is adopted in Simon Ashby, Swee Chuah and Robert Hoffman, ‘Industry Self-Regulation: A Game-Theoretic Typology of Strategic Voluntary Compliance’ (2004) 11 International Journal of the Economics of Business 91.

Utility from unilateral compliance: 0 – C	Firstly, since a single wrongdoing may trigger severe sanctions, a cooperative bank derives no utility if the other bank engages in wrongdoing, because reputation will be depleted, while the cooperative bank bears all the BSB’s enforcement costs (<i>C</i>).
Utility from imperfectly functioning PLS: 0	Secondly, the corollary of the first point is that utility for a non-cooperative bank from imperfectly functioning BSB (when only one bank complies), that is, the utility from free-riding, is also zero.
<i>B</i> : relatively high	Thirdly, the utility (<i>B</i>) from perfectly functioning BSB, which is derived from forestalling stakeholder sanctions, is very high.
<i>C</i> : relatively low	Fourthly, the BSB’s enforcement costs (<i>C</i>) are relatively low, because its norm is not adversarial and the environment not harsh.

Formal summary of the discussion from 2.2.1

Since the BSB’s norm is not adversarial as free-riding is not an option (utility from imperfectly functioning BSB is zero), the resulting game is likely to be the SHG (Fig.3). However, this is not necessarily the case if the individual share of the enforcement costs (*C*/2), despite being low due to the SHG, is still bigger than the utility (*B*) from the perfectly functioning BSB. Therefore, if $B > C/2$, the resulting game will be the SHG (Fig.4). If $B < C/2$, each bank’s dominant strategy will be to defect (Fig.5). Since *B* is high and *C* low, the resulting game is the SGH. Therefore, as long as the BSB’s norm remains non-adversarial so that the underlying game is close to the SGH, and *C* and *B* remain constant, the BSB can fulfil its fundamental norm-enforcing function. The BSB must only provide sufficient guidance for meeting the BSB’s common standards, must monitor compliance, and provide sufficient information to each bank about the relative progress of all the members.

	F2 comply	F2 defect
F1 comply	$\frac{B - C/2}{B - C/2}$	0 – <i>C</i> ; 0
F1 defect	0; 0 – <i>C</i>	<u>0</u> ; <u>0</u>

Figure 3: No free-riding => SHG

<i>B</i> (4), <i>C</i> (6)	F2 comply	F2 defect
F1 comply	<u>1</u> ; <u>1</u>	-6; 0
F1 defect	0; -6	<u>0</u> ; <u>0</u>

Figure 4: SHG if $B > C/2$

<i>B</i> (1), <i>C</i> (6)	F2 comply	F2 defect
F1 comply	-2; -2	-6; 0
F1 defect	0; -6	<u>0</u> ; <u>0</u>

Figure 5: Defection if $B < C/2$

Part 3: Challenges and recommendations for the BSB

3.1 Challenges for the BSB

3.1.1 Changes in the enforcement costs (*C*)

The BSB’s norm will become more adversarial if banks start to free-ride. While it was argued that this is unlikely because of the tipping-point situation and high probability of detection, if this changes and the asymmetry between individual wrongdoing and depletion of the commons (by stakeholder sanctions) increases, banks may be incentivised to free-ride. If free-riding happens, the utility for the free-riding bank is the same as the utility (*B*) from the perfectly functioning PLS (because stakeholder sanctions are still forestalled), without having to share the enforcement costs (*C*/2). Free-riding will inevitably change the pay-off structure of the SHG, as demonstrated by Fig. 6,

and the possible resulting games will be less cooperative than the SHG. Since C will increase as the PLS's norm becomes more adversarial, if $C > B$, the resulting game is the PDG (Fig. 7). Therefore, the BSB has to ensure that free-riding is not a rational strategy (the utility from imperfectly functioning PLS must be zero).

	F2 comply	F2 defect
F1 comply	$B - C/2;$ $B - C/2$	$B - C; B$
F1 defect	$B; B - C$	0; 0

Figure 6: If the utility from imperfectly functioning PLS > 0

$B(4), C(6)$	F2 comply	F2 defect
F1 comply	1; 1	-2; 4
F1 defect	4; -2	0; 0

Figure 7: If $C > B > (C/2)$, then PDG

3.1.2 Changes in the utility (B) conferred by the BSB on its members

The importance of a low C was explained above: If $C/2 > B$, the BSB may fail (Fig. 5). But the failure can also happen because of a low B . This would happen if the stakeholder sanctions could not be forestalled even by perfectly functioning BSB, or if individual wrongdoing was still profitable despite the sanctions (e.g. when sanctions are very low). As explained in 2.1.1, to prevent $C/2 > B$, some PLS rely on pre-existing networks. Pre-existing network increases B because if members do not comply with the new norm, they are excluded from the pre-existing network, which confers benefits on them. The question is whether there is such pre-existing network to support the BSB.

It is argued that while such network based on reputational sanctions once existed in the UK banking sector, it does not exist anymore due modernisation and evolution. In the first half of the 20th century, banking was dominated by a small elite coming from the same social circle, and due to information asymmetry about the counterparties' reliability, reputation provided important informational function as it signalled this reliability.⁶² Ruining one's reputation would exclude that person or her family from their social circle and future business opportunities. Nowadays, there is neither the narrow social circle, nor does reputation fulfil the informational function. Firstly, in wholesale and investment banking, information about bank's reliability is reviewable by complex due diligence.⁶³ Also, banks are no longer family-run affairs and their employee base comes from varied social backgrounds and is highly fluctuating. Secondly, in retail banking, individual reputation is irrelevant due to reputation commons. However, even if the BSB cannot rely on a pre-existing network, it may develop a new network.

3.2 Recommendations for the BSB

3.2.1 Cooperation with statutory regulators

As explained in 3.1.1, in order for the SHG to remain the underlying game, free-riding must not be

⁶² Alan Morrison and William Wilhelm, 'Trust, Reputation, and Law: The Evolution of Commitment in Investment Banking' (2015) 7 Journal of Legal Analysis 363.

⁶³ Ibid.

rational, which means that the threat of detection must be credible and sanctions high. One way the BSB can achieve this is by cooperating more closely with statutory regulators (Financial Conduct Authority [FCA] and Prudential Regulation Authority [PRA]). While such co-regulatory approach may seem contradictory to the purpose of self-regulation, the main benefit of PLS, as explained in 1.2.1, lies in the nature of their substantive norms, which can be more efficient than top-down rules constructed by outsiders, and in more effective compliance monitoring. Co-regulation does not change this – it only builds on the potential synergies between the two regulatory models.⁶⁴ In particular, regulators can build on the BSB’s monitoring potential and generate an expectation of zero tolerance towards free-riding, so that if it transpires that banks do not comply with the BSB’s norm, regulators will intervene (in the form of fines and new regulatory initiatives). This threat can effectively deter free-riding⁶⁵, so that the SHG remains the underlying game. Also, since statutory intervention forms part of the sanctions which banks want to forestall, the threat will increase *B*, and this can prevent a further collapse of the SHG into unilateral defection (*Fig. 5*).

However, such co-regulatory cooperation is almost non-existent, and this has been seen as one of the BSB’s biggest problems since its establishment.⁶⁶ Also, while the government has been very active in some areas of banking regulation, the problem of culture has not received much attention since the PCBS’s report in 2013. In December 2015, the FCA dropped its own preparation of a new regulatory framework for addressing the cultural problem, because it did not want to duplicate the BSB’s work, but the BSB’s annual review did not provide any framework either. This approach must change or the BSB will be seen⁶⁷ as having lost its momentum and the government as too lax, which can precisely encourage free-riding.⁶⁸

One notable exception has been the BSB’s initiative in developing guidelines for complying with the new statutory Certification Regime (CR)⁶⁹, which came into force in March 2016. The BSB published a preliminary form of these guidelines⁷⁰, which were subject to further changes by June 2016. The CR applies to employees of banks (and other FCA and PRA-designated firms) who could pose a risk of significant harm to the bank or its customers. The CR requires banks to self-certify that these individuals, apart from senior managers who must be pre-approved by regulators under the Senior Managers Regime⁷¹, are fit and proper for their roles. While the primary aim of the CR is to strengthen the accountability of those working in the banking sector and to make regulatory

⁶⁴ Ibid; Anthony Ogus, ‘Rethinking Self-Regulation’ (1995) 15 OJLS 97; Iris H-Y Chiu, ‘Enhancing Responsibility in Financial Regulation – Critically Examining the Future of Public-Private Governance Part 1 and 2’ (2010) 4 Law and Financial Markets Review 170.

⁶⁵ Ashby, Chuah and Hoffman (*n61*).

⁶⁶ Lambert (*n38*).

⁶⁷ Martin Arnold, ‘Banking standards report has more questions than answers’ *Financial Times* (London, 8 March 2016) <<http://www.ft.com/intl/cms/s/0/61cb8166-e483-11e5-a09b-1f8b0d268c39.html#axzz47KmXTZ7k>> accessed 25 November 2016.

⁶⁸ Ashby, Chuah and Hoffman (*n61*).

⁶⁹ Financial Services (Banking Reform) Act 2013, s 29.

⁷⁰ BSB, ‘Banking Standards Board Consultation Paper – Certification Regime: Fitness and Propriety’ (London, 2016) <<http://www.bankingsstandardsboard.org.uk/wp-content/uploads/2016/06/FP-Consultation-Paper-BSB-June-2016.pdf>> accessed 25 November 2016.

⁷¹ Financial Services (Banking Reform) Act 2013, s 24 and s 30.

enforcement more effective, the second aim is to raise standards across the industry.⁷² Thus, according to the BSB, the CR might be “a catalyst for a positive change in levels of ethical behaviour”.⁷³ It is suggested that the CR and the BSB’s guidelines present a good opportunity for co-regulatory cooperation. Since regulators can deploy severe fines for not complying with the CR requirements, the BSB and the regulators should work together to make this threat more credible. The BSB would have to make the guidelines mandatory for all its members and build on its assessment capabilities, described in 2.1.3, to develop a mechanism for active monitoring of compliance with these guidelines. The regulators would in turn have to accept that compliance with the BSB’s guidelines is a prima facie proof that the CR has been complied with. This co-regulation would thus build both on the BSB’s monitoring potential and its realistic and insider’s understanding of the UK banking sector (reflected in the guidelines), as well as the regulators’ strong enforcement and sanctioning ability.

3.2.2 *Developing network*

As explained in 3.1.2, another way of preventing the collapse of the SHG into less cooperative games is for the BSB to increase the utility (B) which it confers onto its members. While there is no pre-existing network the BSB can rely on, one option is for the BSB to develop a new network. The BSB’s annual review suggests that this can be achieved by coordinating the various professional bodies in the UK banking sector to collectively raise barriers to enter the banking profession, thus strengthening a notional professional network, similarly to other professional networks such as those of lawyers or accountants.⁷⁴ Individuals would have to invest more (being required to undertake further qualifications for instance) to enter this network, which will in turn provide them with higher B , and they will be less likely to engage in misconduct. The potential to raise levels of ethical behaviour by strengthening the professional network is further confirmed by a new research⁷⁵ commissioned by the BSB, released in October 2016. Some commentators⁷⁶ also suggested that the UK should follow the Dutch example and require bankers to take a ‘Bankers Oath’ to assume a special duty of care.

It is argued that while these proposals may generate a sense of professional network and thus increase B for some individuals, the proposals lack teeth because they do not provide an effective mechanism for monitoring and excluding the individuals from this network if they behave wrongfully. Therefore, rather than focusing on individuals, which is the domain of the various professional bodies, the BSB should focus on establishing the exclusion mechanism for the banks as a whole. If exclusion looms over the bank as a whole, its leadership will be more committed to

⁷² BSB (n70).

⁷³ BSB, Jim Baxter and Chris Megone, ‘Exploring the role of professional bodies and professional qualifications in the UK banking sector’ (London, 2016) < <http://www.bankingstandardsboard.org.uk/wp-content/uploads/2016/10/160928-Professionalism-in-banking-publication-FINAL-WEB.pdf> > accessed 25 November 2016.

⁷⁴ BSB (n40).

⁷⁵ BSB, Jim Baxter and Chris Megone (n73).

⁷⁶ David Llewellyn, Roger Steare and Jessica Trelvellick, *Virtuous Banking: Placing Ethos and Purpose at the Heart of Finance* (London, ResPublica, 2014).

cultural change because such exclusion can have severe consequences.⁷⁷ This exclusion mechanism can be facilitated by converting the BSB's annual assessments of its members to comprehensive comparison tables⁷⁸ and publicising them, which would publicly shame the less-compliant banks. This would increase the banks' *B* from complying with the BSB's norm. This 'public shaming' is essentially a privatisation facilitated by a PLS, as described in 1.2.1. Furthermore, this is another area where the BSB can cooperate with regulators, which can deploy numerous sanctions, including revocations of banking licences. Therefore, while currently the biggest benefit of the BSB is its potential to forestall stakeholder sanctions against the industry as a whole, the BSB can increase this benefit by using its potential to forestall (and attract) stakeholder sanctions against its individual member banks.

Conclusion

When considering how to solve the cultural problem in the UK banking sector, academics and regulators primarily compare the efficiency of different regulatory models. While these models considerably differ, they have one thing in common – regardless of which one is adopted, there is no doubt that each of them is potentially functional, and the main question therefore is which model will work the best. This paper applied Law and Economics scholarship to consider whether self-regulation administered by the BSB is a model which deserves to be compared with the other models in this way. To qualify for this privilege, the BSB must be able to fulfil its fundamental function, which is enforcement of its policies. Otherwise, it would be functionally useless, regardless of how efficient the policies are. It was argued that to fulfil this function, the BSB must first overcome a reputation commons problem, from which the UK banking industry suffers. Since this commons problem can be rationalised as the SHG, it was shown that it should be relatively easy for the BSB to overcome it. However, it was also argued that the SHG may not be stable, and that the BSB should aim to prevent the SHG from collapsing into less cooperative games, especially by ensuring that free-riding is not a rational strategy for banks to adopt. It was suggested that the BSB can achieve this by cooperating more closely with statutory regulators to create a co-regulatory system which builds on the synergies between the two regulatory models and by facilitating a partial privatisation of its member banks' reputations.

⁷⁷ Dan Awrey and David Kershaw, 'Toward a More Ethical Culture in Finance: Regulatory and Governance Strategies' in *Capital Failure: Rebuilding Trust in Financial Services* (OUP 2014).

⁷⁸ A specific type of such benchmarking is suggested by McCormick and Stears (*n34*).