

Regulation,
Regulators, and
the Crisis of Law
and Government

From Regulatory Capture to Regulatory Space?

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Policy Brief

The Foundation for Law, Justice and Society

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Regulation, Regulators, and the Crisis of Law and Government

This programme examines the regulatory system in the wake of the global financial crisis, assessing its current weaknesses, the role of legislative and judicial bodies, and identifying measures for future reform of both markets and regulatory regimes. It aims to shed light on the recent failures of regulators, often captive of the very industries they are meant to regulate, and examine ways to improve the accountability and effectiveness of the regulatory system.

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Executive Summary

- The run-up to the financial crisis saw a shift in the philosophy and practice of regulation. This involved greater dependence on market risk assessments and, frequently, less intrusive supervision. Monetary and fiscal regimes, which influence financial stability, assumed that markets are efficient and self-stabilizing.
- These changes were not simply the result of a 'capture' of regulators by the financial industry. The drivers included a sharp swing in ideas about the role of the state; changes in economics and technology; and political influences, including an addiction to boom-driven tax revenues. Faith in markets overshot, and the subsequent crisis triggered a long recession, with a rise in public debts unprecedented in peacetime.
- The main lessons of this experience concern the need for tougher financial regulation and supervision, and for macroeconomic policy regimes that help to dampen destabilizing swings in private sector financial behaviour.
- Moreover, there are also issues relevant to regulation in other industries. These include familiar dilemmas concerning consumer interests, political influence, and inherent problems in forestalling crises. And the experience also highlights emerging issues arising from complexity and interactivity in regulation.

From Regulatory Capture to Regulatory Space?

'...We must be struck at every turn by the importance of ideas. Regulation itself is such an idea; deregulation is another' (Wilson 1980)¹

The idea of regulatory capture

The capture of regulators by industry interests was once viewed as the dominant paradigm for failures of regulation. Subsequently, the analysis of experience in different industries in the United States dethroned this concept: richer models evolved, which involved a capture and warping of the public interest by various actors. The 'binary' capture of agencies by industries was put in perspective as only one among several influences on regulation.

Recently, the financial crisis has re-awoken interest in 'regulatory capture' — a term used by the Governor of the Bank of England Sir Mervyn King, among others. Indeed, it is striking how regulators adopted much of the toolbox of bankers in assessing risks, and outsourced important aspects of risk assessment to rating agencies, which were paid by debt issuers. In light of this, the literature on capture certainly offers one promising angle from which to consider the influences that came to bear on regulation in the run-up to the global and Euro area crises.

This policy brief takes the idea of capture as a starting point, as it explores the influences that changed financial sector regulation. Along the way, it finds that the term 'capture' may be too transitive and one-dimensional to characterize the dynamic process of change that occurred. The issues raised by this experience may be better framed in terms of influences that interact within the 'regulatory space' — a concept suggested by Hancher and Moran as early as 1989² and further developed recently by Vibert.³ Moreover, these complex and interactive features of regulatory change are found to be relevant in other industries also.

Influences that changed the philosophy of regulation

Among the factors that may trigger changes in regulation are new ideas; economic and technological changes; shifts in the power of interest groups; and incentives affecting legislators and regulators. These drivers may combine to catalyse change. The possibility that powerful interests might press ideas against a background of technological changes was already highlighted in 1999 by Baldwin and Cave.⁴ So the dynamics of change can be complex. How did this process play out in the period before the financial crisis?

Changes in ideas

There was a sea change in economic ideology in the decades preceding the global crisis. The new ideology stressed the economic and political virtues of private markets, which were seen as being dampened and distorted by government intervention. This intellectual movement had its roots in Hayek⁵ and von Mises,⁶ and it flourished particularly strongly in the US academic community.

In part, this was a reaction against a dominant view in the early post-war period, which had seen the state as a benign rule-setter and macroeconomic manager, but also as a planner, owner, and employer influencing major reaches of the economy. To borrow the vocabulary of Priestland,⁷ that post-war vision had seen the state as a 'sage', countering merchant interests which, left to play freely, would be destabilizing. By the end of the 1960s a neoliberal 'counter-reformation' was beginning to get under way, seeking to roll back the much expanded role of the state, after a period of tight regulation that began in the Depression.

This shift in ideology had a pervasive effect on policy frameworks in advanced economies. It is no

coincidence that it was accompanied by a change in approaches to macroeconomic management. The new faith in private markets encouraged policy architects to believe that monetary and fiscal policy could be assigned simple and transparent targets (such as inflation targeting and debt sustainability), since imbalances in private markets could be regarded, over time, as reflecting fundamentals efficiently, and as being essentially self-stabilizing. Discretionary adjustments to policy were seen as largely misguided and destabilizing.

These medium-term macroeconomic policy frameworks seemed to insulate official agencies from capture by deficit- and inflation-biased politicians. But too simple a set of macroeconomic policy rules — and major failures in the field of macrofinancial risk assessment and policy coordination — eventually contributed to a policy disaster in terms of financial stability and levels of public debt. At the macroeconomic level, in terms of overall economic stability, these policy frameworks scored a massive own goal.

It was in financial regulation and supervision that, in some countries, theories of efficient markets and rational expectations had their most disturbing effect. They seemed to lend depth and intellectual credibility to a view that financial markets will deliver growth and stability, provided only that they are not intrusively regulated; and that instability largely reflects misconceived intervention by governments. This confidence flew in the face of experience with markets and their supervision over many decades, and it was misplaced.⁸

The swing towards deregulation was not confined to right-wing or neoconservative political groupings, and it did not begin with the Thatcher and Reagan administrations. In the United Kingdom, a shift away from state intervention and towards greater competition in the financial sector dates from the 'Competition and Credit Control' reforms of 1971. In the United States, it was the Carter administration at the end of the 1970s that initiated industrial and financial deregulation, and which saw the launch of the 'monetarist' revolution of former Chairman Volcker at the Federal Reserve.

Nonetheless, it was the period after 2000 that saw the most striking ideological claims made by some policymakers concerning private markets. The philosophy of former Federal Reserve Chairman Alan Greenspan showed great faith in markets, despite

some concerns about 'irrational exuberance'; featured a resistance to pre-emptive action in the face of possible bubbles; but stood ready to 'pick up the pieces' after market crises. Central banks in other advanced economies also failed to take policy action or sound alarm bells during credit and asset price booms, but stood ready with an official underwriting of failures — which set perverse incentives. More diffusely, approaches in the Basel supervisory community showed much increased dependency on the internal risk assessment processes of market firms and on rating agencies, and placed more reliance on this approach than was sensible.

This climate strongly influenced national practices in the regulation and supervision of banks in some countries. Among the leading 'crisis cases', Ireland, the United Kingdom, and the United States are clear examples in which regulation and supervision were not sufficiently intrusive, critical, or insistent — as indicated in the UK's various reviews of supervision, and in the reports on Ireland's crisis.⁹ These are somewhat extreme cases but, more generally, central banks and regulatory agencies in advanced economies bought into the idea of a much greater reliance on market ratings and methodology in performing risk assessment.

Changes in the economic habitat

The changes in regulation that were set in train in the United States and the United Kingdom in the 1970s also had economic roots. These lay mainly in fiscal imbalances and excessive monetary expansion. Stresses of this kind were evident in the United Kingdom from the late 1950s, and similar pressures emerged in the United States during the Vietnam War period, particularly from 1968 onwards. Such tensions spread more widely among advanced economies after the oil price shocks of the 1970s. The core feature was that governments sought to sustain economic activity in the private sector at levels that were unrealistically high, given prevailing conditions. This environment, coupled in some cases with rather rigid labour markets, bred accelerating inflation in a setting of weak growth.

Faced with volatile capital flows and pressure on public bond markets, governments in some cases responded initially by introducing or intensifying capital controls and/or wage and price restraints. This included the United States, with the Interest Equalization Tax, the Voluntary Restraint Programme on capital outflows, and a brief period of wage and price controls. But macroeconomic imbalances

eventually undermined such measures. Thus, economic pressures, and not just ideology, made it well-nigh impossible to persist with a financial system that was subject to comprehensive price and quantity regulation.

Moreover, the combination of economic stagnation, inflation, and financial volatility in the 1970s helped to undermine the view that Keynesianism and state planning could assure full employment. This experience also underscored the risks and limits of economic ‘fine-tuning’. Subsequently, the economic implosion of the Soviet Union at the end of the 1980s reinforced a neoliberal view of the state in so far as it discredited the opposite extreme — a vision of the state as a comprehensive, indispensable, and benign planner.

Technology and innovation

Changes in technology and innovations in capital markets also played an important role in triggering deregulation. Two examples illustrate this well. In the United States, technological changes made it possible to ‘sweep’ funds overnight into savings accounts from current accounts, which were not allowed to pay interest, thus undermining the impact of the regulation. In the United Kingdom, the regime of credit ceilings on established banks that existed until 1971 proved increasingly porous as new financial institutions sprang up to provide credit outside this framework. Hence the term ‘regulatory arbitrage’ entered the financial lexicon.

Indeed, as financial innovation expanded, the public sector often led the charge. Governments with large borrowing requirements experimented with innovative borrowing techniques. During the 1980s, for example, the Swedish National Debt Office led bond market innovations as it sought to contain public borrowing costs. The first mortgage securitization in the United States was effected by a US housing agency.

The wave of innovation that started to gather pace in the 1980s ended in the alphabet soup of securitized products whose mispricing was a key flaw in pre-crisis markets. Information technology played an essential role in the development of such products. The complexity of the transactions and financial linkages that grew up tended to obscure where ultimate risks had been passed to. It was possible to assert that the unbundling and re-packaging of risks, by spreading risks more widely, was diminishing systemic risk; but in key fields the reverse turned out

to be the case. As technology advanced over the following decades, indeed, it became more important for policymakers to anticipate future regulatory arbitrage, and markets, in turn, increasingly shaped their activities to regulation in an adaptive manner.

Changes in the effectiveness of interest groups

Advances in information technology, along with growing globalization, also reshaped the influence of different interest groups in society. It is not just that trade unions lost ground in the workplace. Households, firms, and other associations of individuals became connected — at falling prices — to a range of electronic media: the cost of access to the political process, which is known to be an important factor in the effectiveness of interest groups,¹⁰ was steeply reduced. The challenge is to disentangle the relevant ways in which these trends affected regulation.

First, where individuals or firms were dissatisfied with outputs of the financial sector, their ability to make their opinions effective increased. However, public concern before the crisis was not typically in the direction of reducing risk-taking. An illuminating example was discontent in Ireland with a lack of competition in banking, which included the levying of high charges and a failure to provide reasonably easy access to mortgages. One reflection of this was that the director for competition of the reformed financial services agency was made an *ex officio* board member of the agency, whereas the director for prudential supervision was not. The policy response overshot, and the climate it helped foster was one contributory factor to Ireland’s financial crisis.¹¹

Second, changes also took place in the power of interest groups in the labour market and in the culture surrounding pay: remuneration and incentives for risk-taking in the financial sector, while extreme, were an instance of a wider trend. It is clear that globalization and technology drove a gradual decline in the relative pay of low-skilled labour in advanced economies, and contributed to a decline in unionization. In the United States, official concern about distributional issues affected housing finance policy, and this was a significant contributing factor in lowering income and collateral standards for residential mortgages.¹²

As a third example of the role of interest groups, one may perhaps view rating agencies, for the purpose of this analysis, as such a group. They certainly provide an

example of the changing influence of industry bodies as a result of technology and innovation. As financial products became far more complex, regulators became dependent on rating agencies in evaluating the riskiness of portfolios. The rating agencies were also increasingly conflicted: they had always been paid by issuers, but now the securities they assessed were at times designed by banks with the active participation of the rating agencies themselves. This nexus was a factor in the mispricing of financial products that was a key source of the crisis.

Finally, and related to this point on rating agencies, there is a more general issue about the impact of technical complexity on the supervisory process and the effectiveness of industry influence. The sheer difficulty for supervisors of understanding the techniques being used in the marketplace means that 'regulatory authorities are required to develop a constant and close interaction with the market participants they regulate in order to stay abreast of rapidly changing financial markets, to monitor the build-up of risks, and to understand the impact of their regulatory policies'.¹³ Such constant interaction may present heightened opportunities for market participants to influence regulators and (especially if the latter are poorly remunerated) may result in a form of skill dependency on the side of the agency.

New incentives facing legislators

A primary factor evident in the run-up to the crisis was that political parties in power in many countries benefited strongly from a surge in tax revenues during extended financial booms. In some cases, such as Ireland and Spain, they were alerted by international agencies to the fact that these revenues were transient, and also that their structure was increasingly vulnerable to an economic downturn. These warnings may have seemed inconvenient: they were certainly ignored. This is an important additional element in the 'political cycle' identified by Green, in which public support for tough regulation fluctuates over the business cycle, being weakest at the cyclical low point (when small firms complain about access to credit) and highest just after a crisis breaks.¹⁴

Second, in countries such as Ireland, the United Kingdom, and the United States, one can see the relevance of the suggestions by Grabosky and Braithwaite¹⁵ concerning the influence of a low 'relational distance' between agency officials and the regulated population in terms of experience, outlook, class, and frequency of contact.

Third, and more specifically, in the United States, and to a lesser degree in some other countries, there has been, over time, what is uncharitably termed a 'revolving door' between the financial services industry and senior government positions. Whether earlier or prospective employment in the financial sector influenced government officials unduly during their tenure is an issue on which there seems to be no hard evidence.

Fourth, there is clear and recent evidence from the United States that voting patterns in Congress on financial sector issues reflected the garnering of local votes.¹⁶

Fifth, countries with large financial industries found ways to allow them an expanding global role outside the scope of national controls. An interesting question in the case of the United Kingdom (and also in Ireland) is how far the 'light-touch' approach that was in fact adopted in financial regulation reflected considerations of regulatory competition with other centres. The creation of the Euro area may have intensified such concerns. The statutes of the Financial Services Authority obliged it to pay regard to the competitiveness of the UK's financial services industry; Briault cites the concession given in 2004 to US investment banks to operate in the UK even though they were not supervised as banks in their home country.¹⁷ The financial crisis in Cyprus in 2013 is adding a chapter to this branch of the literature.

The internal dynamics of regulatory agencies

Turning to the internal workings of regulatory agencies, a major theme in the literature, there is indeed some evidence that these proved dysfunctional, though in 'new' ways. Partly for ideological and partly for technological reasons, there was a trend in the advanced economies to separate bank regulation from central banking. This seemed desirable not only to insulate the 'pure' pursuit of monetary stability (often in the form of inflation targeting), but also because of the scope for arbitrage among instruments designed by different types of financial institutions, including insurance companies — some of which had typically never been among the entities regulated by central banks.

The divorce between central banking and regulation may have diminished the sensitivity of regulators to systemic risks — although there are

counter-examples, such as the Federal Reserve Board, which is a supervisor. The hybrid central banking/ supervisory structures created in some cases, such as Ireland and the Netherlands, did not show a good track record in diagnosing the emergence of risks.

A further organizational problem was that agencies with overlapping responsibilities, as in the United States and in Spain (for the *cajas*), also experienced problems in effective analysis and supervision.

The interplay of influences

The recent literature, and even anecdotal evidence, leaves some ambiguity about the extent to which pressures from the industry to 'capture' regulators actually *increased* during the period before the crisis. In a broad sense, all reports on the period suggest that regulators 'bought into' market risk assessments far too extensively, and failed to criticize systemic risks as they built up in banks. The large amounts spent on lobbying activities by Wall Street firms are also well documented.¹⁸ However, the drivers and influences described in this policy brief, along with evidence presented in the recent literature, do not in themselves substantiate a much greater vigour on the side of the industry in seeking and obtaining specific gains at the expense of the public interest.

In some countries, the commitment of regulators to an intrusive questioning of risk positions rather seems to have crumbled under the weight of these various, mutually reinforcing influences. In some cases, at least, it seems that the root of the problem was an intellectual or moral failure to identify, follow up, and contain concentrations of risk, with Northern Rock in the United Kingdom and certain major lenders in Ireland being clear cases in point. In Spain, reflecting local political factors, very risky property lending went unchallenged at the level of the *cajas*, although the major banks were successfully challenged on the potential use of 'special purpose vehicles' to acquire US debt instruments.

Rather than a quantum shift in 'capture energy' on the side of the banks, it seems more as if economics, technology, ideology, and politics reduced resistance to the risk assessments put up by the industry, and perhaps contributed to a failure of analytical diagnosis with regard to mounting systemic risks. This experience strikingly illustrates the general assertion by Baldwin and Cave cited earlier: that factors of different kinds may come together to trigger regulatory change; and, specifically, that powerful interests may be able to press home certain

ideas more effectively against a background of technological advances.¹⁹

The run-up to the crisis thus saw technology and economics interacting to change regulation of the financial sector, and it also saw these factors interacting with changes in ideology and with economic interests in a mutually reinforcing manner. The path of this process seems, in retrospect, steeped in irony. In essence, an exaggerated faith in private markets contributed to new macroeconomic policy and regulatory regimes that were designed to avoid government-induced distortions and to promote stable and non-inflationary growth. Yet the outcome has been a deep and enduring recession, and, in the advanced economies, an economic, financial, and public debt crisis of historic magnitude.

Wider issues in regulation emerging from experience in the financial sector

The aim of this policy brief has been to explore influences that affected regulatory philosophy and approaches in the run-up to the global and Euro area financial crises, taking as a starting point the insights of the literature on regulatory capture. The wider issues that emerge from this analysis can be grouped under three headings.

Is 'capture' the right framework?

The concept of regulatory capture arose from a binary relationship between industry actors and regulatory agencies. It was not proposed as a comprehensive framework within which to explore all changes in regulation. Subsequently, it was enriched by the notion of ideological capture. Further complexity was added by the consideration of other interest groups in society, and at times the term 'capture' has also been used to describe the self-interested behaviour of legislators and regulatory agencies.

As foreshadowed at the outset of this brief, there are problems in expanding the use of the term capture so broadly. Among other concerns, the term typically has a pejorative connotation (whereas the influence of ideas may be benign, as in the original consumerist example). It can also be confusing to say that a regulatory agency captures regulation for its own advantage, a phrase that could refer to many different aspects of agency behaviour and one that probably, therefore, generates more heat than light. More fundamentally, the notion of capture is one-

dimensional and transitive: it does not reflect the complexity and interactivity of various influences in the pre-crisis period.

The way in which actors and influences interacted in the run-up to the crisis points towards more subtle and dynamic interactions, which may best be explored in the 'regulatory space' featured by Hancher and Moran.²⁰ And the complex nature of interactions within that space deserves deeper study in its own right. At a minimum, one has to see the relations between actors and influences as everywhere growing in complexity; as a 'learning process', very far from a static concept of regulation or a linear process driven by agencies; at the extreme one might ask if they take on some features of a 'regulatory game'.

Continuing tensions in regulation

Experience in the run-up to the crisis highlighted a number of tensions in regulation that are not new, but have gained in importance; these issues have recently been prominent in other industries also.

A first issue is the difficulty in categorizing and channelling the 'consumer interest'. The Irish example cited above illustrates how immediate 'consumer' and longer term 'household' interests (including those of tax payers) can diverge over a medium-term time horizon. This experience also highlights the challenge in finding effective channels for consumer representation, an issue that has often been prominent in, for example, utilities regulation.

A second issue is political influence. Here the experience with policy frameworks affecting the financial sector is troubling in several respects:

- In some countries, the effectiveness of financial regulation was impaired by political factors that official agencies internalized. Rajan²¹ reports this with reference to social goals of housing finance in the United States; political 'deference' is alleged in Ireland; and the fiscal benefits of boom revenues seems to have weakened political willingness to 'take away the punch bowl' in several countries. In the UK, the flagship industry statues of the financial sector may also have affected official attitudes to regulation.
- The macroeconomic frameworks and rules designed to safeguard fiscal, financial, and price stability were in some countries (including the UK) drawn quite narrowly. This is often a quid pro

quo for taking important time-consistency issues (inflation, debt sustainability) out of the political arena, where myopia is a risk. Narrow authority is the price of delegation. However, the lack of peripheral vision in monetary and fiscal policy, which were part of the framework which should have assured the stability of financial markets, resulted in the neglect of destabilizing trends in credit, asset prices, and capital flows. This was a regulatory failure in a broad sense.²²

- The failure in many countries to introduce pre-emptive policies that would have moderated their financial booms provides a striking example of a political economy hazard that is featured in the regulatory literature. The benefits would have been diffuse over time and over segments of the population. The costs would have fallen immediately on potentially vocal interest groups. This suggests an inherent problem in pursuing financial stability policies, and it may raise a question whether pre-emptive financial policies need to be subject to some sort of pre-agreed triggering mechanism.

New issues with relevance beyond the financial sector

There are probably few truly 'new' regulatory topics under the sun, but two issues deserve more attention in light of the crisis. Indeed, there have been reports (for example, at a recent FLJS workshop on Fundamental Issues in Regulation)²³ that they are gaining importance in other industries also:

- **Complexity:** It was suggested above that the complexity of financial products and transactions may have decreased the relational distance between regulators and the industry, reducing regulatory independence — and perhaps also credibility. It seems that this feature of growing complexity has been registered in other industries as well, including utilities. Possibly, it may tend to constrain market entry and other forms of competition. Innovation and technology no doubt account for this in part, but there is scope to wonder about an endogenous tendency for industries to increase complexity as a means of dominating the regulatory debate or shutting others out.
- **Interactivity:** Regulatory arbitrage emerged at an early stage in the liberalization of the financial sector. Subsequently, the interaction between regulators and adaptive financial markets seems

to have taken on some features of a *game*. With very severe capital and liquidity constraints in the financial sector, this has implications for 'shadow banking' — the migration of financial intermediation to channels that are less regulated and supervised. This experience may have relevance in other fields of regulation. The information and communication industry displays some of the same features of rapid adaptation; and utility companies are reported to 'game' the system by loading profits on non-regulated products, leading to a more intrusive (and complex) analysis of costing by regulators.

More broadly, the importance of addressing such dilemmas in regulation is increasing. A distinctive feature of the crisis, in many advanced economies, was the ensuing rise in public debts, which is unprecedented in peacetime. This has implications for the way governments may structure their activities in the future. Severe fiscal pressures mean that governments may choose to pursue economic and social goals through regulatory initiatives rather than spending programmes.

This turn of events is full of irony. It is scarcely too cruel to say that the economic legacy of major failures in the field of regulation may lead governments to rely even more on regulation to secure their policy goals. The most obvious concern in the financial sector is that contingent liabilities will develop which, over time, further increase the public debt. High vigilance will be required in this setting to safeguard the public interest. All fields of regulation — not just financial regulation — are potentially at issue here.

Notes

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19. Baldwin, R. and M. Cave, *Understanding Regulation*.
20. Hancher, L. and M. Moran, *Capitalism, Culture and Economic Regulation*.
21. Rajan, *Faultlines*.
22. 'Regulation' is, at times, used in such a sense. The US Congressional Budget Office noted that wide definitions 'would result in the definition of most federal actions as regulatory'. CBO (1976), cited in Mitnick, B. (1980) *The Political Economy of Regulation*. New York: Columbia University Press.
23. FLJS Workshop on Fundamental Issues in Regulation, March 2013 <www.fljs.org/content/former-central-bank-ireland-director-tackles-causes-financial-crisis>.



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