Articles

What About Psychological Actors? Behavioral Analysis of Equator Principle Adoption and its Implications*

*By Matthew Chan***

A. Introduction

In 1976, MGM released *Network*, a satirical film about a news anchor (played by Peter Finch) so frustrated by the state of the television industry and by society in general that he couldn't stop himself from lashing out in the midst of an evening broadcast. He was "mad as hell", and it was with this impassioned rage and his everyman sensibilities that he was determined to move the television watching nation.[1] Nevertheless, for all his conviction, Finch's character was destined to fail. In the penultimate scene of the film, Finch is confronted by the television network's chairman of the board (played by Ned Beatty). In a classic soliloquy, Beatty sermonizes on the declining importance of sovereignty and national distinctions, and the rise of corporations as the new governing powers of the world:

> "You get up on your little twenty-one inch screen, and howl about America and democracy. There is no America. There is no democracy. There is only IBM and ITT and AT&T and DuPont, Dow, Union Carbide and Exxon. Those are the nations of the world today."[2]

Today, more than a quarter-century after its release, film critics still praise *Network* for being an extremely well preserved time capsule of sorts, a "supremely well-acted,

---

* This paper is based on a presentation made at the Fifth CLPE conference at Osgoode Hall Law School Toronto, 1-2 March 2012, entitled "Transnational Private Regulatory Governance: Regimes, Dialogue, Constitutionalization".

** JD (Cand. 2013), Osgoode Hall Law School. Email: MatthewChan@osgoode.yorku.ca.

[1] NETWORK (MGM 1976).

[2] *Id.*

https://doi.org/10.1017/S2071832200017892 Published online by Cambridge University Press

intelligent film that tries for too much, that attacks not only television but also most of the other ills of the 1970s."[3]

It is interesting, then, that for a film which quintessentially represents the zeitgeist of the American 1970s experience, the enduring message of the film seems to be so directly applicable to the modern day evolution of governance towards transnational regulation. This is particularly strange, given that in many ways, modern regulation is markedly distinct from the types of regulation which predominated in the late 20th century. For instance, Keynesian economics is no longer recognized as panacea for financial ills, nor did the term 'technocrat' carry the arguably pejorative connotation that it does today.

As Beatty's character so aptly predicted, modern transnational regulation is characterized by non-state regulators, and often lacks the backstop of legislative enforcement. Moreover, those who are regulated have no clear entitlement by which to compel transnational regulators to govern in a democratic and accountable manner. This is especially so in scenarios where the decision to adopt transnational regulation projects is itself entirely discretionary. Therefore, it would be an oversight to assume that the same forces which motivated regulators in the past still apply with equal impact in this new context. The intent of this paper is to contribute to the relatively nascent literature on the topic of why transnational regulators behave as they do. Specifically, this paper will explore this subject by examining the relationship between the regulatory program known as the Equator Principles (EPs) and the Equator Principle Financial Institutions (EPFIs), which govern it.

As an introductory premise, it should be obvious that the success of the EP program is directly linked to the EPFI's decision to adopt the program (*i.e.*, the "adoption decision"), and, subsequently, to its decision to adhere to the program's requirements (*i.e.*, the "compliance decision"). Yet, as Hardenbrook points out, such decisions appear inherently contrary to the EPFI's interests.[4] The EP project requires the EPFI to incorporate greater restrictive covenants into its loan agreements, which often forces the borrower to incur greater transaction costs. Such additional costs directly impact the borrower's ability to repay its project financed loan. It is perplexing, then, that any private institution with the manifest goal of maximizing shareholder profits (such as an EPFI) would ever choose to participate.

---

[3] Roger Ebert, *Review of Network*, CHICAGO SUN-TIMES, Jan. 1, 1976, *available at* http://rogerebert.suntimes.com/apps/pbcs.dll/article?AID=/19760101/REVIEWS/601010305/1023.

[4] Andrew Hardenbrook, *The Equator Principles: the Private Financial Sector's Attempt at Environmental Responsibility* (2007) 40 VAND. J. TRANSNAT'L L. 197 (2007).

https://doi.org/10.1017/S2071832200017892 Published online by Cambridge University Press

The existing literature on the subject of EP adoption largely addresses this conundrum by relying upon pure economic rationalizations of adoption. While not disputing the relevance of such theories, this paper purposely diverges from the conventional wisdom by arguing that EPFIs undergo a broader, more intuitive decision-making process. The divergence in principle represented by this paper may be simply justified as follows. Just as traditional forms of governance relied on assumptions about the importance of hard law and the accountability of state actors, traditional theories of adoption are based on standard economic assumptions, such as perfect rationality and perfect self-interest. Yet, as Hardenbrook suggested, these standard economic assumptions do not necessarily reflect all empirical scenarios. Certainly, it is not immediately obvious how they apply in the case of EP adoption. The economist Matthew Rabin once stated that "To many of us, comparative institutional analysis is the core goal of economics," by which he simply meant that the main thing economists teach the world is how markets *compare* to other allocation mechanisms.[5] Likewise, academics in the field of governance must remember that there is nothing manifestly "right" about a shift to transnational regulation. Therefore, to the extent that a more holistic understanding of the motives behind adoption of transnational regulatory programs – such as the EPs – may highlight the advantages and shortfalls of such programs, this line of behavioral research ought to be steadfastly pursued.

This paper will be presented in five parts. This introduction serves as Part A. Part B of this paper reviews the existing literature on the topic of EP adoption by providing a brief background on the pure economic rationales for acceptance of the adoption decision. Crucially, it also highlights the shortcomings of these economic rationalizations, thereby making room for the behavioral psychology based rationales discussed in the remainder of the paper. In Part C, this paper addresses the threshold issues of why pure economic models of decision making are inherently unsatisfactory in the context of regulatory decisions, as well as why it might not matter from a policymaking point of view whether or not EPFIs actually quantitatively outperform non-EPFIs. Next, the paper focuses on three classes of behavioral theories (heuristic decision making, framing effects, and prospect theory) and explains the impact of each behavioral effect on the adoption decision. Subsequently, Part D explores the implications of behavioral theories on the compliance decision by introducing evidence of inequity aversion, altruism, and social preference. Finally, Part E concludes this paper by returning to its initial observation that in the context of modern transnational regulation, the decision to assume the role of regulator cannot be adequately justified purely upon the mere convergence of regulatory goals and economic incentives. It is suggested that non-state entities which choose to adopt a regulatory role of their own volition ought to be driven, at least in part, by a sense of moral agency. As a

[5] Matthew Rabin, *A Perspective on Psychology and Economics* (UC Berkeley Econ. Working Paper No. E02-313, 2005).

https://doi.org/10.1017/S2071832200017892 Published online by Cambridge University Press

result, the rationalization of EP adoption on primarily economic grounds wrongly conceptualizes EPFIs as simple profit maximizing firms, when in reality, they are citizens of a transnational deliberative democracy.

B. Pure Economic Rationales for EP Adoption

I. Economic Theories and Applications

Since the foundation of the EPs in 2003, the majority of attempts to analyze and explain EP adoption behavior have focused on economic rationalization. Even where the theory of adoption was based on strictly non-financial variables (*e.g.*, firm reputation), the theory was typically construed in pure economic terms (*e.g.*, by reasoning that EPFIs were associating a dollar value to reputational gains or losses). Admittedly, such rationales have an almost instinctive appeal, found perhaps in the fact that EPFIs are, after all, private profit seeking entities. In general, these rationales can be classified according to the different types of risk which the EPFI is theoretically seeking to minimize through EP adoption. The three most common classes are financial risk, legislative risk, and reputational risk.

As Amalric proposed in 2005, the financial risk sub-category of pure economic rationales was borne out of the World Bank Group's decision to withdraw from project financing.[6] Although the withdrawal of the World Bank Group from the international project finance lending market created a huge opportunity for private banks to step in, this change in the project finance regime also presented a new risk. Historically, the World Bank Group had absorbed the costs of the environmental analysis required by the International Finance Corporation. As a result, private banks now faced the prospect of taking up this expensive task. The financial risk theory proposes that some EPFIs may have accepted the adoption decision as a convenient and coordinated means of shifting such due diligence costs back to the project finance borrowers. Similarly, other academics have also suggested that, because the EPs require borrowers to undergo mandatory social and environmental risk assessments, the EPs serve as a means for EPFIs to more accurately price the risk of project finance loans.[7] Such standardized tools are especially valuable in the context of the project finance lending market, where the international nature of the projects typically means that

[6] Franck Amalric, *The Equator Principles: A Step Towards Sustainability?* (Center for Corporate Responsibility and Sustainability Working Paper Series, No. 01(05), 2005).

[7] Christopher Wright, Setting Standards for Responsible Banking: Examining the Role of the International Finance Corporation in the Emergence of the Equator Principles, *in* INTERNATIONAL ORGANIZATIONS IN GLOBAL ENVIRONMENTAL GOVERNANCE (Frank Biermann, Bernd Siebenhüner & Anna Schreyögg eds., 2009), at 51.

https://doi.org/10.1017/S2071832200017892 Published online by Cambridge University Press

the diverse regulatory approaches taken by different countries results in little opportunity for direct comparison.[8]

Alternatively, it has also been proposed that EPFIs may accept the adoption decision in order to relieve a legislative risk. Essentially, the theory proposes that by adopting the EPs, EPFIs add credibility to the claim that social and environmental risks are already being adequately contained through self-regulation, and, therefore, no further government intervention is necessary. Such a claim attempts to pre-empt NGO lobbying for more restrictive regulations and the ossification of voluntary programs such as the EPs into "hard law".[9] Interestingly, there is anecdotal evidence that such legislative concerns do impact corporate decision making. For instance, in concluding a study on a multinational company's implementation of CSR initiatives in Argentina, Shever states that the initiative merely "shifts the terrain of struggle away from the formal judicial domain ... to the more pliable field of public opinion."[10]

However, notwithstanding the above discussion, the most common form of risk management associated with pure economic rationales for EP adoption is reputational risk. Hardenbrook's study indicates that as private financial institutions expanded their portfolios of project finance investments, the public became increasingly sensitive to the issue of responsible investing. NGOs are increasingly shifting the focus of their campaigns from project finance borrowers to lenders, and, as a consequence, scrutiny of investment practices has never been greater.[11] It has been suggested that EPFIs are accepting the adoption decision as a precautionary measure against the threat of negative media coverage and public criticism. Aizawa and Yang suggest that as more and more private financial institutions become EPFIs, the cumulative effect will be to create a "level playing field" with respect to the reputational risk of financing a potentially disastrous project, while simultaneously ensuring that no EPFI has to suffer the commercial disadvantage of foregoing profitable project finance investments.[12] Interestingly, although the EPs have

[8] Thomas Wotruba, *Industry Self-Regulation: A Review and Extension to a Global Setting*, 16 J. OF PUB. POL'Y & MARKETING 38 (1997).

[9] Amalric, s*upra* note 6.

[10] Elana Shever, *Engendering the Company: Corporate Personhood and the 'Face' of an Oil Company in Metropolitan Buenos Aires*, 33 POL. AND LEGAL ANTHROPOLOGY REV. 26 (2010).

[11] Hardenbrook, *supra* note 4.

[12] Motoko Aizawa & Chaofei Yang, *Green Credit, Green Stimulus, Green Revolution? China's Mobilization of Banks for Environmental Cleanup,* 19 J. OF ENV'T & DEV. 119 (2010).

https://doi.org/10.1017/S2071832200017892 Published online by Cambridge University Press

existed for less than a decade, there is already circumstantial evidence to this effect. Specifically, a corollary of the reputational risk based theory of EP adoption is that EP adoption should be positively correlated to direct institutional interaction between society and media. In fact, this was exactly the conclusion reached by Wright and Rwabizambuga in their 2006 study on why European and American banks represent the largest proportion of all EPFIs.[13] Finally, it has also been suggested that while some EPFIs may have accepted the adoption decision out of caution, still others may have adopted the EPs as a "differentiation-based strategy to achieve competitive advantage".[14] In this scenario, EP adoption is better conceptualized as capturing a potential reputational benefit, rather than avoiding a reputational loss.

II. Shortcomings

However, despite all the inherent appeal of pure economic rationales for EP adoption, it is suggested here that such theories all share one common shortcoming. Specifically, while they may adequately explain the motives underlying the initial adoption decision, they offer little, if any, explanation for why an EPFI would also accept the compliance decision. From a governance theory point of view, this is unsatisfactory because it should be obvious that initial acceptance of a regulatory role means little if the so-called regulator subsequently repudiates its obligations.

Unfortunately, mounting evidence suggests that EPFIs have in fact been shirking their duties. Based on recent studies, it appears that NGOs and at least some portion of the academic community have observed deteriorating EPFI engagement with the EPs.[15] In fact, in 2010 BankTrack stated unequivocally that the EPs were not making a difference.[16] There are a number of serious problems raised by the fact of empirically observed

[13] Christopher Wright & Alexis Rwabizambuga, *Institutional Pressures, Corporate Reputation, and Voluntary Codes of Conduct: An Examination of the Equator Principles*, 111 BUS. & SOC'Y REV. 89 (2006).

[14] Marc Allen Eisner, *Corporate Environmentalism, Regulatory Reform, and Industry Self Regulation: Toward Genuine Regulatory Reinvention in the United States*, 17 GOVERNANCE: AN INT'L J. OF POL'Y, ADMIN., & INSTITUTIONS 145 (2004).

[15] Niamh O'Sullivan & Brendan O'Dwyer, Stakeholder Perspectives on a Financial Sector Legitimation Process: The Case of NGOs and the Equator Principles, 22 ACCT., AUDITING & ACCOUNTABILITY J. 553 (2009).

[16] BANKTRACK, BOLD STEPS FORWARD: TOWARDS EQUATOR PRINCIPLES THAT DELIVER TO PEOPLE AND THE PLANET (2011), *available at*: http://www.banktrack.org/manage/ems_files/download/bold_steps_forward/100114_civil_society_call_equator_principles.pdf.

https://doi.org/10.1017/S2071832200017892 Published online by Cambridge University Press

disengagement, and it is suggested here that any proposed alternative rationale for the EP adoption and compliance decisions must at least make an attempt at resolving some subset of such problems. Therefore, a basic understanding of these problems is necessary. In general, obstacles to EPFI engagement may be classified within three broad categories: economic problems, political problems, and free-rider problems.

Of these categories, the economic problems are perhaps the simplest to conceptualize. For instance, it has been suggested that "environmentalism is a rich man's game", and that, as a result, it is highly unlikely that voluntary regulation targeting environmental issues will succeed in a weak global economy. As Conley and Williams point out, this problem may therefore be a major factor in present EP disengagement, especially given the current economic climate in Europe and the ensuing effects on global capital markets.[17] Alternatively, professional investment managers have also stated that disengagement may be due in part to a fundamental mismatch between incentive compensation and project finance investment horizons, a problem which plagues not only the EPs, but the entire "socially responsible investment" industry as well. Because socially responsible investment behavior such as EP adoption is likely to reap excess returns only in the long-term, most investment managers have no financial incentives for engagement owing to their short-term incentive compensation packages.[18] Essentially, the problem is that investment managers are evaluated based on their quarterly or annual performance, not their performance over multiple years. Fortunately, these economic problems are also among the easiest to resolve. Specifically, because economic fluctuations are largely cyclical, it is reasonable to assume that this particular obstacle to EP engagement will naturally be resolved given sufficient time. Similarly, the investment horizon problem can be addressed through more intelligently structured compensation structures.

In contrast, the political problems for EP engagement are relatively more nuanced. While European and American banks predominate amongst EPFIs, Russian and Chinese banks have little to no representation, potentially as a result of national policies which opt not to address social and environmental issues to the same extent as western nations. This under-inclusion is in itself the source of the political problems. As Aizawa and Yang explain, since banks from these nations do not typically accept the EP adoption decision, they present a "no-questions-asked alternative" for borrowers who are either unwilling or unable to accept the restrictive covenants imposed by EPFI lenders.[19] Fortunately, there is

[17] John Conley & Cynthia Williams, *Global Banks as Global Sustainability Regulators? The Equator Principles*, 33 L. & POL'Y 542 (2011).

[18] *Id.*

[19] Aizawa & Yang, *supra* note 12.

https://doi.org/10.1017/S2071832200017892 Published online by Cambridge University Press

some recent evidence to suggest that China and Russia have begun the process of altering their political stances on environmental and social issues, which, in turn, may alleviate these political obstacles to EP engagement. For instance, the most recent five-year plan released by the Chinese government reportedly sets out environmental targets.[20]

Nevertheless, by far the most pervasively cited concerns are related to free-rider problems. These take two closely related forms. The first is "green-washing", which consist of accepting the adoption decision in order to realize an immediate reputational benefit, and failing to do anything more. However, even where an EPFI appears to have complied with its obligations under the EPs, it may still be guilty of free-riding if it merely engaged in "rituals of verification" in order to satisfy the "institutional expectations" placed upon it by NGOs, as opposed to making a *bona fide* effort to prevent the commission of social and environmental harms by its borrowers.[21] This form of free-rider problem is known as the inculcation of "audit culture", a term borrowed from academic studies of self-governing behavior in the accounting profession. Both green-washing and audit cultures are threats to EP engagement because the reputational benefit gained by all EPFIs that legitimately participate in the EPs is undermined if public perception is that EPFIs are not accountable. As Conley and Williams explain, the issue presented by a deficit of accountability looms especially large in the context of voluntary regulatory programs such as the EPs, in which there are no clearly recognized legal sanctions against non-performers.[22]

Crucially, it must be noted here that because free-riding is motivated by self-interest, and is therefore considered rational behavior under traditional economic assumptions, purely economic rationales for EP adoption offer no simple resolution to this problem. In contrast, however, certain behavioral theories which can justify a departure from the assumption of self-interested actors can, and do, attempt explanations for why free-riding may not be as insurmountable a problem as it first appears. This paper will return to this topic in Part D.

[20] Aizawa & Yanga, *supra* note 12.

[21] *Christian Vannier*, Audit Culture and Grassroots Participation in Rural Haitian Development, 33 POL. & LEGAL ANTHROPOLOGY REV. 282 (2010).

[22] Conley & Williams, s*upra* note 17.

https://doi.org/10.1017/S2071832200017892 Published online by Cambridge University Press

C. Behavioral Rationales for EP Adoption

It has been argued that, historically, economists perceived the world as being essentially binary, in the sense that all behavior was thought to fall into two categories:

> A. Behavior that was perfectly rational, and therefore possible to formalize and explain, or
>
> B. Behavior that was *not* perfectly rational, and therefore *impossible* to formalize and explain.

In response to the realization that that the assumption of perfect rationality was more an academic crutch than an empirical truth, behavioral economists such as Kahneman and Tversky developed models of decision making based on so-called "bounded rationality" or, more simply put, an acceptance of the fact that people have a limited capacity for processing complex information. Interestingly, such boundedly rational models appeared to offer much more accurate descriptions of behavior than purely rational models.[23] It is argued here that purely economic rationales of EP adoption, which are founded upon similar assumptions of perfect rationality, are likewise flawed. If so, then the same behavioral phenomena which unconsciously operate on decision-makers in the field of economics may well also apply to firms facing the EP adoption decision.

I. Threshold Issues

The foregoing does not mean that governance decisions ought to be equated to pure economic decisions. In fact, behavioral economists such as Sunstein have proposed several very convincing arguments for the proposition that regulatory decisions (*i.e.*, policymaking) should not be predominantly concerned with economic models of decision making.

For instance, it is common knowledge that in most pure economic models of decision making, the determinant factor is ultimately a set of data representing aggregate individual consumption choices. The moral argument posits that it would be inherently unsatisfactory to make governance decisions based on economic decision-making models for scenarios in which the decision at hand has direct implications for human lives.[24] Because human lives

[23] Sendhil Mullainathan & Richard Thaler, *Behavioral Economics* (MIT Dept. of Econ. Working Paper No. 00-27, 2000).

[24] Cass Sunstein, *Cost-Benefit Analysis and the Environment* (U. of Chicago Law & Economics Working Paper No. 227, 2004).

https://doi.org/10.1017/S2071832200017892 Published online by Cambridge University Press

are not mere "costs", the idea that policy could be dictated by aggregate consumption data is repugnant to basic moral sensibilities.[25] Instead, it is suggested that policymaking in a democratic society must always follow the informed judgments of those who are governed (*i.e.*, the citizens). Likewise, certain environmental harms are also not mere costs because, once inflicted, they cannot be readily reversed by any means of monetary savings or accumulation. Yet, such environmental harms are likely to have a significant impact on the lives of future generations. Therefore, the application of pure economic models of decision making to adoption decisions respecting environmental policies ought to be seen as falling afoul of the same moral precept.

Conversely, consider so-called the "welfare argument". This argument suggests that pure economic models of decision making fail to take notice of important qualitative differences among quantitatively identical risks – also known as a welfare problem. To illustrate this problem, Sunstein raises an example of a hypothetical drinking water regulation in which the legally allowed arsenic content of drinking water would be reduced at the cost of $100 per person. Although aggregate consumption data indicates that beneficiaries of the regulation are only willing to pay $80 per person for the benefits of the regulation, the regulation could still be passed if only 70% of the cost is borne by the actual beneficiaries and the remaining 30% is paid by the water companies. From a purely economic point of view, the regulation should clearly be abandoned, because it will cost a combined $100 to achieve $80 worth of utility. However, as Sunstein indicates, such an adoption rule fails to consider that from a welfare perspective, the value of the increase in welfare to the beneficiaries may outweigh the value of the loss in welfare to the water companies.[26]

In the context of the EP adoption decision, Sunstein's notion that regulatory decisions ought not to be determined by a pure economic model of decision making simply implies that there are merits to considering diverse rationales for adopting any regulatory action. For instance, it may be used to support the proposition that the EPs ought not be rejected solely on the grounds that the costs of compliance outweigh the accrual of reputational benefits to the lender, if the social and environmental risks alleviated by the EPs would have a significant impact on less affluent people in countries where project-financed infrastructure would be implemented.

Finally, although economic considerations ought not predominate the adoption decision, one crucial threshold question with respect to economic considerations remains. Because potential EPFIs are typically private profit-seeking entities, this may suggest that the entire EP program and all behavioral analysis thereof would unfortunately be rendered moot by

[25] *Id.*

[26] Sunstein, *supra* note 24.

https://doi.org/10.1017/S2071832200017892 Published online by Cambridge University Press

evidence that EPFIs do not quantitatively out-perform non-EPFIs. If so, then what would be the point after all? Fortunately, no such evidence exists as yet. Interestingly, behavioral studies suggest that even if such evidence should eventually come to light, EPFIs that have already accepted the adoption decision may pay little attention to such quantitative measures. Research conducted by Barberis and Thaler points to the existence of "belief perseverance", or a tendency for people who have formed an opinion to "cling to it too tightly and for too long".[27] It has been suggested that such an effect is in reality the result of two more reflexive human behaviors. The first may be said to be a self-serving willful blindness, as a result of which individuals are reluctant to search for evidence contrary to one's own beliefs. Second, even where contrary evidence is found, the individual is likely to treat such evidence with excessive skepticism. However, quantitative proof *is likely* to have some effect on the adoption decisions of prospective EPFIs – a theory to which this paper shortly returns below.

II. Behavioral Theories and Applications

The field of behavioral psychology is extensive, and, as a result, this paper limits its focus to explaining the impact of behavioral theories falling within three major classifications: heuristic decision making, framing effects, and prospect theory.

Generally, heuristic theories of decision making encompass all decision-making strategies which consciously or unconsciously incorporate experience-based techniques for information processing. Studies on the topic of heuristic decision making generally conceive of it as being "dual processing", meaning that it is comprised of two discrete cognitive systems: System 1, which encompasses those thought processes which are rapid, automatic and effortless, and System 2, which consists of processes which are slow, reflective, and deductive. When faced with a decision, the two systems work in sequence such that System 1 provides a quick judgment, which judgment is eventually either confirmed or overridden by System 2.[28] In the context of the EP adoption decision, this two-stage theory of heuristic decision making suggests that while EPFIs may initially decide to accept adoption based largely on anecdotal notions of the benefits of doing so (or the costs of failing to do so), a subsequent, more reflective review of the initial decision triggered by the compliance decision may cause these same EPFIs to question their initial response.

[27] Nicholas Barberis & Richard Thaler, *A survey of behavioral finance*, *in* HANDBOOK OF THE ECONOMICS OF FINANCE, 1st ed. vol. 1 (Anthony Constantinides, Rene Stulz & Milton Harris eds., 2003), at 1053.

[28] Cass Sunstein, *Hazardous Heuristics* (U. of Chicago Law & Economics Working Paper No. 165, 2002), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=344620.

https://doi.org/10.1017/S2071832200017892 Published online by Cambridge University Press

It has been argued that the movement towards greater reliance on technical expertise in policymaking towards the end of the 20th century may be taken as "implicit recognition of the unreliability of ordinary intuitions" of the type which largely drives System 1.[29] Moreover, it has also been said that in recognition of this fact, quantitative risk analysis should have a more prominent role in regulatory decision making. For example, the greater continuous reporting requirements imposed by the 2006 amendments to the EPs can be seen as one form of institutionalizing this type of greater reliance on quantitative analysis. In turn, as the quantitative impact of EPFI status begins to emerge, prospective EPFIs are likely to re-evaluate their initial adoption decisions.

Another example of heuristic decision making is the so-called "affect heuristic", which posits that people have a tendency to assess questions of probability under the assumption that risk is somehow correlated to affect, ignoring the fact that in most real-life scenarios, risk and reward are entirely distinct concepts. As a result, it is further suggested that the use of the affect heuristic leads to predictable errors in judgment. Specifically, Sunstein reports that when people were asked to assess the risks and benefits associated with certain objects, individuals tended to respond by stating that "risky activities contain low benefits", and conversely, that "beneficial activities contain low risks".[30]

How does this assist in rationalizing the EP adoption decision? The affect heuristic would suggest that when people feel that a particular venture is low risk, the benefits of engagement are automatically higher. Therefore, since there is little initial cost associated with accepting the adoption decision, the affect heuristic suggests that EPFIs may tend to see inherent value in doing so, irrespective of whether any such benefit can be proven at the time. Conversely, if such benefits do not materialize in the long run, this same heuristic may incite a trend of rejecting the compliance decision as a result of the hypothesized affective association between the perceived risk of compliance costs and an automatic reduction in value. Such hypotheses generally appear to track with the empirical observations previously explored in Part B.

Related studies have also suggested two other ways that a decision-maker's affect may have an impact on his or her judgment. First, it appears that extreme affective states tend to impair cognitive processes of the System 2 type.[31] Thus, in theory, when decision

[29] *Id.*

[30] Sunstein, *Hazardous Heuristics*, *supra* note 28.

[31] *Id*.

https://doi.org/10.1017/S2071832200017892 Published online by Cambridge University Press

makers are feeling anxious or fearful, they are less likely to engage in a slower, more analytical process of overriding their intuitive tendencies. Second, it appears that extreme affective states also tend to increase susceptibility to social influence.[32] As Sunstein points out, these two propositions appear to follow intuitively from one another. Specifically, if it is true that anxiety or fear can persuade decision makers to accept faulty logic, then it is also likely that in the absence of more reliable analytical tools, the decision makers will feel greater pressure to conform to social standards. In the context of the EP adoption decision, these studies simply stand for the proposition that given the financing industry's emphasis on risk, and compounded by the fear of reprisal by aggressive NGOs, many decision makers likely eschewed a more systematic evaluation of the adoption decision in favour of a more affectively based decision-making process.

Similarly, research conducted by Kahneman and Frederick hints at the existence of an "outrage heuristic", which may be seen as a special case of the affect heuristic. This theory proposes that when decision makers are asked to respond to an initial action, but lack reliable evidence as to how they should react, the response is likely to reflect a measure of the decision maker's outrage at the initial action.[33] Kahneman and Frederick tested this theory by setting up jury experiments in which a hypothetical injury was described, and then the experimental subjects (*i.e.*, the jurors) were asked to provide their best estimate of the quantum of punitive damages justified. If an outrage heuristic did come into play, it was expected that the award of punitive damages would approximately track the severity of the injury and the maliciousness of the defendant, both of which were calculated to incite greater outrage. In fact, this is exactly what the experiment demonstrated. Kahneman and Frederick explained the observed results simply by reasoning that because the jurors had no sense of how to objectively set punitive damage awards, they compensated for this lack of analytical ability by substituting the more reflexive process of asking about the outrageousness of the defendant's conduct.[34] Likewise, it is reasonable to suppose that many potential EPFIs do not have a good sense of how, or indeed to what extent, they should go about contributing to various social agendas. Thus, in the absence of any other defined standard of behavior, leaders in banking who are driven by a sense of moral responsibility may allow their outrage at social injustices perpetrated by some project finance borrowers to color their decisions about adopting the EPs for themselves.

[32] *Id.*

[33] Sunstein, Hazardous Heuristics, *supra* note 28.

[34] *Id.*

https://doi.org/10.1017/S2071832200017892 Published online by Cambridge University Press

However, the suggestion that financial decisions may be driven by outrage seems to be *prima facie* at odds with the popular belief that private profit-seeking institutions are primarily dispassionate and calculating. This raises the interesting question of whether there is evidence to support the idea that moral attitudes govern the behavior of firms in a market. Again, the answer can be found in a review of behavioral studies. In a 1986 experiment, respondents were asked to evaluate the fairness of various unilateral actions a firm might take to set the terms of its transactions with customers, employees or tenants. Surprisingly, the results of the study showed that even where a company's actions are being assessed, people intuitively expect the actor to adopt the precept of "do no harm". Specifically, while respondents generally felt that actions taken by the firm to protect its profits from exogenous threats were normatively acceptable, actions which increased the firm's profits at someone else's expense typically incited moral outrage.[35] For instance, respondents felt that it was acceptable for a hardware store to raise its prices in response to an increase in wholesale costs, but that it would be unfair for a hardware store to raise the price of snow shovels in order to exploit an unexpected spring blizzard. Likewise, although some firms facing the EP adoption decision may choose to eschew the program in order to preserve their ability to dispassionately pursue all profitable investments irrespective of environmental or social considerations, this may incite outrage not only in the directly affected communities, but also in other potential EPFIs who may attempt to indirectly punish the offending lender through adopting the EPs themselves.

The second broad class of behavioral theories includes those which fall within the definition of 'framing effects'. This term is used to describe cognitive biases which may cause a decision maker to engage in inconsistent behavior, based solely on differences in the way the decision is presented. As with heuristic theories, framing effects also impact regulatory decision making with little to no conscious notice on the part of the decision maker. Indeed, to the extent that potential EPFIs have already considered the adoption decision within the context of a broad policy direction, psychological evidence suggests that framing effects may have had a large impact on their ultimate disposition. In fact, evidence of the framing effect supports the belief that such cognitive biases already have a tangible impact on policy development in such areas of law as valuation of injuries in tort, and whether or not to adopt restrictive environmental legislation. Without a proper understanding of the framing effects that may underlie a particular decision, it is easy to perceive the decision-making process as the cumulative result of incoherent and ad-hoc judgments by the decision makers. In light of this precautionary note, this paper will now explore two prominent examples of the framing effect.

[35] Daniel Kahneman & Cass Sunstein, *Indignation: Psychology, Politics, Law* (U. of Chicago Law & Economics Working Paper No. 346, 2007).

https://doi.org/10.1017/S2071832200017892 Published online by Cambridge University Press

In the field of tort litigation, the valuation of injuries to health is an omnipresent and contentious issue. As any attentive law student knows, the guiding principle is compensation for injury suffered to the extent that a pecuniary award can put the injured party back in the state that he or she would have been in but for the defendant's actions. However, in 1994, McCaffery, Kahneman and Spitzer were able to demonstrate in a jury experiment that even this elementary principle of tort recovery contained an inherent framing effect which unwittingly lowered awards of damages *vis-à-vis* alternative formations of the compensation principle.[36]

In the experiment, two groups of experimental subjects (*i.e.*, the jurors) were given slightly different jury instructions describing the thought experiment they should conduct to determine fair compensation for a tortious injury. The instructions to the first group were purposely framed as a "positive choice". In other words, fair compensation was to be set at an amount of money such that the hypothetical victim would be indifferent between accepting the money or an immediate cure of all injury suffered as a result of the defendant's actions. Instructions to the second group were purposely framed as a "decision to sell". For this group, fair compensation was to be set at the lowest amount that the victim would have accepted to sustain the specific injury actually suffered, had the victim been offered such a deal in an *ex ante* proposition.

The experiment was designed such that the only difference between the two sets of instructions was that in the former, the jury is valuing the benefit of "re-gaining" physical faculties lost as a result of the injury, while in the latter, the jury is instructed to value the cost of "losing" those same physical faculties. Because the same physical faculties are being valued in either scenario, one would expect the damages awards of the two groups to be roughly equal. In fact, however, the experiment revealed that the average judgment of fair compensation was about twice as high when faced with the "losing" instructions versus the "re-gaining" instructions. This proved the existence of an "endowment effect", which unconsciously biases individuals to attach greater significance to losing something already owned versus acquiring that same thing.[37] In practice, the existence of this cognitive bias suggests that the way in which project finance lending institutions conceptualize the EP adoption decision can have a large impact on their final disposition. Specifically, if the benefits of adoption are framed as merely an opportunity to gain a degree of reputational benefit, then the value of adoption may be seen as significantly lower than if the EP program were pitched as a means of preventing the loss of reputation.

[36] *Id*.

[37] Kahneman & Sunstein, *supra* note 35.

https://doi.org/10.1017/S2071832200017892 Published online by Cambridge University Press

Similarly, framing effects are also present in policy decisions regarding whether or not to adopt restrictive environmental legislation. In fact, this example is arguably a better analogue to the EP adoption decision, because in both cases one of the ultimate goals is the institution of more responsible environmental practices. Also, the environmental benefits of the EPs and restrictive environmental legislation are both likely to be realized over time, and largely in respect of future generations. As Cropper demonstrated in 1994, policymakers are significantly affected by framing when disposing of environmental legislation adoption decisions.

In Cropper's experiment, respondents were presented with pairs of policy statements regarding the obligations of current policymakers to future generations, and asked which policy out of each pair they most preferred. In the first test, respondents were asked which of two environmental programs they would prefer. The first would save "100 lives now", while the second would save a substantially larger number of lives "100 years from now." In the second test, respondents were asked which of two alternative outcomes would be worse. In the first outcome pollution would cause a single death immediately, while in the second outcome, pollution would cause a single death 100 years from now.

In the first test, subjects were generally indifferent between the two alternative environmental programs. Yet, if the value of saving fewer lives immediately is approximately the same as saving more lives later, this strongly implies a preference for the current generation. On the other hand, when subjects faced the second test, they responded that both outcomes would be "equally bad", implying no bias towards the current generation. Cropper concluded that the experiments stood for the proposition that "people's moral intuitions about obligations to future generations are very much a product of framing effects."[38]

In practice, this suggests that even where potential EPFIs are motivated by moral, rather than merely monetary concerns, framing effects may still have a significant impact on the disposition of the adoption decision. For instance, Cropper's research suggests that NPOs which focus their campaigns towards highlighting the atrocities caused by irresponsible lending (*e.g.*, species extinction, lost jobs) may be more effective at encouraging EP adoption than those which merely focus on selling the advantages of responsible investment (*e.g.*, habitat preservation, sustainable businesses). Conversely, this research also suggests that to the extent that such framing effects can be said to incentivize baseless fear-mongering by NGOs, financial institutions aware of such effects can combat the threat of reputational loss by spreading awareness of the effects of framing.

[38] Kahneman & Sunstein, *supra* note 35.

https://doi.org/10.1017/S2071832200017892 Published online by Cambridge University Press

The final class of behavioral theories includes those which subscribe to prospect theory. Prospect theory is a model of economic decision making under conditions of uncertainty, in which the risk of particular outcomes is known by the decision maker (or may be approximated). As mentioned previously, one of the major contributions of this model was that it reflected empirically-observed behavioral traits inherent to bounded rationality, as opposed to adhering to traditional economic assumptions. These behavioral traits will now be explained and applied to the EP adoption decision.

In 1979, Kahneman and Tversky conducted a series of three experiments to test whether prospect theory could adequately explain the way economic actors actually made decisions with respect to money.[39] Specifically, respondents were presented with choices involving Israeli lira. In the first experiment, respondents were asked to assume that they had an initial endowment of 1000 lira. They were then asked whether they would prefer Option A (a 50% chance to gain 1000 more lira) or Option B (a 100% chance to gain 500 more lira). It was discovered that Option B was overwhelmingly the more popular choice. Next, the respondents were asked to assume that they had an initial endowment of 2000 lira. They were then asked whether they would prefer Option C (a 50% chance to lose 1000 lira) or Option D (a 100% chance to lose 500 lira). This time, Option C was the most popular.

Kahneman and Tversky concluded that these results illustrated two crucial descriptive principles of prospect theory. First, most decision makers are relative thinkers. This proposition is derived from the fact that the two decisions in the first experiment were identical in terms of their final wealth positions, but yet, the respondents chose differently. Therefore, it may be inferred that the respondents were focusing primarily on gains and losses.[40] According to some academics, this natural preoccupation with relative wealth effects may be caused by a tendency to exaggerate how long sensations associated with gains and losses will last. It has been posited that because people exaggerate such sensations of gains and losses, they naturally overreact to change.[41] Second, it is believed that this experiment also illustrates that most decision makers are risk averse over gains, and risk seeking over losses. This can be inferred from the fact that respondents chose a small certain gain over a larger risky gain in the first test, but opted for a large risky loss over a smaller certain loss in the second test. Kahneman and Tversky further posit that the reason for risk seeking over losses is that "a person who has not made peace with his losses is likely to accept gambles that would be unacceptable to him otherwise."[42] Support

[39] Barberis & Thaler, *supra* note 27.

[40] *Id*.

[41] Rabin, *supra* note 5.

https://doi.org/10.1017/S2071832200017892 Published online by Cambridge University Press

for this rationale can be found in the general observation that a gambler's tendency to bet on long shots generally increases as he or she loses more. Likewise, this aspect of prospect theory may be applied to explain the tendency for normally responsible people to under-insure against risks in poor economic times.

These results also offer crucial insights into the behavioral rationales that may underlie the EP adoption decision. For instance, the observation that most people focus primarily on changes offers a potential explanation as to why an EPFI would accept the adoption decision, but reject the compliance decision. Specifically, if concern over changes predominates decision-making, then the mere act of adopting the EPs may be sufficient to induce satisfaction in all parties concerned. In other words, it may be argued that an implication of prospect theory is that NGOs care more about a financial institution's initial acceptance or refusal of the EPs than any gradual attenuation in commitment which may eventually occur. Similarly, it may be stated that given the relatively certain gain in reputation associated with adoption, the principle of "risk aversion over gains" may explain why many potential EPFIs will accept the adoption decision. However, given that most EPFIs will perceive compliance as a loss, the principle of "risk-seeking over losses" may explain why many EPFIs will take the chance that the costs of non-compliance (such as they are) will not resolve, or that such costs will be outweighed by the gains. Moreover, just as the tendency to under-insure rises in poor economic times, prospect theory predicts that EPFIs will likewise be tempted to eschew compliance under adverse economic conditions.

In the second of the prospect theory experiments, respondents were asked whether they would accept a bet in which there was a 50% chance that they would win 110 lira, and a 50% chance that they would lose 100 lira. Most respondents opted to reject the bet. Kahneman and Tversky noted that such a decision was irrational because the expected value of the bet was still positive.[43] This observed tendency for decision makers to irrationally reject prospects involving a risk of loss is commonly known as "loss aversion". Given the rate of EP adoption since the introduction of the EPs in 2003, it seems reasonable that some potential EPFIs may have coded the EP adoption decision not as an opportunity to gain a reputational benefit, but as a chance to avoid losing reputation under the threat of hostile NGOs. Indeed, as discussed in Part B, there is at least anecdotal evidence of this.[44] In the context of the EP adoption decision, the theory of loss aversion

[42] Amos Tversky & Daniel Kahneman, *Prospect Theory: An Analysis of Decision under Risk* (Levine's Working Paper Archive 7656, 1979).

[43] Barberis & Thaler, s*upra* note 27.

[44] *Id*.

https://doi.org/10.1017/S2071832200017892 Published online by Cambridge University Press

essentially predicts that an otherwise uncertain decision maker will adopt the EPs as a precaution against the potential loss of reputation, which could potentially result from failing to do so.

In the final prospect theory experiment, respondents were once again presented with pairs of options and asked to indicate a preference for either one or the other. In the first test, respondents indicated that they preferred a 100% chance to gain 3000 lira over an 80% chance to gain 4000 lira. In the second test, respondents indicated that they preferred a 20% chance to gain 4000 lira over a 25% chance to gain 3000 lira. On the basis of these results, Kahneman and Tversky concluded that the 20% increase in probability from 80% to 100% in the first test had a larger impact on the decision-making process of the participants versus the 20% increase in probability from 20% to 25% in the second test.[45] This tendency for decision makers to place more emphasis on outcomes that are certain relative to outcomes that are merely probable is a feature of prospect theory sometimes referred to as the "certainty effect". Naturally, it is also quite likely that the certainty effect plays some role in the EP adoption and compliance decisions. Namely, it appears to suggest that potential EPFIs will place more weight on the relatively certain short-term reputational impact of adoption than the considerably more remote possibility that serious costs will resolve in the long-term in the form of ongoing obligations and restricted project selection. Thus, the certainty effect also assists in providing an alternative behavioral rationale for the EP adoption behavior empirically observed.

D. Behavioral Theories for EP Compliance

I. Why Behavioral Theories Matter in the Long Term

Within the past century, state regulation philosophy has changed dramatically, and with impressive frequency. Students of governance will remember that at various times throughout history, socialist, liberal, welfare, and neo-liberal state regulation have all been in vogue. As the normative role of a state regulator continues to evolve, the only constant is that each subsequent evolution is certain to trigger widespread change throughout all spheres of governance. By many academic accounts, state regulation now stands upon the precipice of such an evolutionary step. Bauman argues that, as is so often the case, the catalyst for this change is that "society currently faces a predicament because its political organs cannot match the vitality, intensity, and influence of economic organs and networks anymore."[46] Nevertheless, unlike in the past, new theories of state governance make

[45] *Id.*

[46] Ronen Shamir, *Corporate Social Responsibility: Towards a New Market-Embedded Morality?*, 9.2 Theoretical Inquiries in L. 371 (2008).

https://doi.org/10.1017/S2071832200017892 Published online by Cambridge University Press

certain radical departures from the historical formula. For instance, little focus is placed on retaining the basic division between public authority and private interests, nor is the primary task to implement attempts at restrictive correction of market forces.

Instead, academics such as Shamir appear to be suggesting that the new theme underlying modern movements in governance is indirect control of individuals through "responsibilizing them to self-manage and self-regulate social risks".[47] Additionally, this technique of responsibilization is being applied not only to individuals, but also towards those other "associations, institutions and other 'stakeholders' that comprise the terrain of governance."[48] Obviously, a connection can be drawn here between this new school of state governance and voluntary transnational regulatory programs such as the EPs. In both instances, the issue of self-regulation looms large because neither form of regulation purports to resort to the types of corrective direct intervention that formed the backbone of older governance regimes.

The answer to the shared self-regulation problem lies in determining whether responsibilization works, and if so, on what basis. This is because it stands to reason that if responsibilization can be successfully implemented in the context of state regulation, it should also be workable in the context of the EPs, and vice-versa. In unpacking the term "responsibilization", Shamir proposes that this concept is "fundamentally premised on the construction of moral agency as a necessary ontological condition for shifting the regulatory capacities of government to individuals and non-state entities".[49] Crucially, self-regulation is recognized as being distinct from externally-imposed regulation, because it "presupposes one's care for one's duties and one's non-coercive application of certain values as a root motivation for action."[50]

It is argued here that behavioral theories of decision making are indispensable for theoretically proving governance regimes based on self-governance, because unlike economic theories of decision making, behavioral theories can empirically demonstrate that decision makers do assume moral agency.

---

[47] *Id*.

[48] *Id*.

[49] Shamir, *supra* note 46.

[50] *Id*.

https://doi.org/10.1017/S2071832200017892 Published online by Cambridge University Press

II. Evidence of Moral Agency

It is widely recognized, and virtually undisputed, that economic actors are largely self-interested. Indeed, the standard assumption of selfishness, which pervades both the expected utility and prospect theories of economic decision making, would, *prima facie*, appear to preclude selflessly-motivated decisions. However, as economists throughout history have recognized, self-interest does not fully account for all human motivation. In fact, some decision makers exhibit clearly moral tendencies, such as a desire to impose just outcomes, even where the decision-makers' duties do not strictly oblige him or her to do so.

For instance, consider the behavioral theory of "inequity aversion." This theory simply posits that some economic actors have a preference for an equality of outcomes. Since the mid-90s, experiments conducted by various behavioral economists have empirically demonstrated the existence of inequity aversion using the "dictator game." Such experiments involve two players. Player 1 (the dictator) begins the game with an initial endowment of resources. The dictator must then decide what share of its resources to give to Player 2. The game is then concluded, and the player with the most resources is declared the winner. The game is purposely designed such that because Player 2 cannot respond, Player 1's decision is essentially without repercussion. This reflects the idea that the game models a decision under conditions of no coercion.

Obviously, due to the assumption of selfishness, ordinary models of economic behavior predict that the dictator will never share any of its resources. Surprisingly, in a study by Forsythe, Horowitz, Savin, and Sefton (1994), only 20% of dictators chose not to share their resources, 60% chose to give less than half, and 20% chose to give exactly half.[51] Although a single instance of such unexpected results might be cast off as an aberration or attributed to poor experimental technique, even more extreme results were obtained when the experiment was replicated in 1995 by Andreoni and Miller. This time, 40% of dictators chose not to share, 20% gave less than half, and 40% chose to give exactly half.[52]

In a similar type of experiment designed to empirically prove the existence of altruism, the respondent is asked to choose between two different allocations of resources to anonymous third parties called A and B. In the first allocation, A gains $7.50 and B gains $3.75, whereas in the second allocation A and B both receive $4.00. Findings in this type of experiment typically reveal that half of all respondents generally choose the first

[51] Ernst Fehr & Klaus Schmidt, *A Theory Of Fairness, Competition, And Cooperation*, 114(3) The Q. J. of Econ. 817 (1999).

[52] *Id.*

https://doi.org/10.1017/S2071832200017892 Published online by Cambridge University Press

allocation, and half choose the second allocation. Academics have interpreted these mixed results to mean that under non-coercive conditions, nearly half of all decision makers have a "social preference" for equitable outcomes rather than pure economic efficiency, and, therefore, choose the second allocation over the first.[53]

In practice, the results from experiments have obvious positive implications when applied to the EP compliance decision and to self-regulatory regimes in general. Specifically, these experimental results suggest that even if EP compliance is viewed purely as a cost, EPFIs lead by individuals with a strong affinity for equitable outcomes may nonetheless make *bona fide* efforts to uphold EP obligations based solely on perceived environmental or social inequity in the parts of the world where project financing is most prevalent. Likewise, even where the net benefits of accepting the compliance decision do not accrue to the EPFI in the long term, the above results suggest that some portion of EPFIs may nonetheless continue to comply with obligations under the EPs out of a sense of inherent altruism.

As an alternate proof of moral agency, consider Fehr and Schmidt's "public good game" experiments, in which the theory of inequity aversion was applied to demonstrate that as long as *some* decision makers share a preference for equitable outcomes, cooperation can be achieved even in the face of the potential for free riding.[54]

In all public good games, each respondent (a player) is given an initial endowment of resources, and then presented with a single "contribution decision" in which they must determine how much of their resources they would like to contribute to the "public good". All players make their contributions simultaneously, and then all players are paid out an equal return (*i.e.*, profit) based on some function of the aggregate contributions. At the end of the game, the player with the highest total resources is declared the winner. To simulate contributions towards real life "public goods" (*e.g.*, environmental sustainability, public safety), the game is designed such that the greater the aggregate of contributions, the greater the equal return paid out to each player. Thus, the efficient equilibrium solution to the contribution decision is always for all players to contribute all of their resources. However, because players are entitled to share amongst the return irrespective of how much (or, indeed, whether) they contributed, the threat of free riding is always present. Then, in a second test, Fehr and Schmidt modify the traditional public good game by adding a second step. The game is played normally, but after the return is distributed amongst the players, each player is then presented with a "punishment decision" in which they may impose a cost upon any other player by paying a portion of their own resources.

[53] Rabin, s*upra* note 5.

[54] Fehr & Schmidt, *supra* note 49.

https://doi.org/10.1017/S2071832200017892 Published online by Cambridge University Press

In multiple instances of the first test, the results indicated that in the majority of games, the players contributed close to 0% of their individual resources towards the "public good", thereby indicating a strong tendency to engage in free riding. Fehr and Schmidt concluded that this is a rational result, given the threat of competition and the self-interest of each player.[55] Interestingly, however, in multiple instances of the second test, the results indicated that in the majority of games, the experimental subjects contributed close to 100% of their individual resources towards the "public good", thereby indicating a strong tendency to engage in cooperative behavior. The distinction was, of course, attributed to the impact of the punishment decision, which allowed players adverse to the inequity of free riding to curtail such behavior by choosing to accept a small personal cost. From this, Fehr and Schmidt concluded that even in situations where competition and self-interest are taken for granted, cooperative behavior can still be the efficient equilibrium state, as long as some subset of players are adverse to inequity.[56]

In practice, such "public good" games serve as an accurate analogue for the EP compliance decision, because while the positive impacts ostensibly achieved by the EP project are theoretically shared by everyone (or at least, everyone local to the financed infrastructure), the decision to accept the costs of EP implementation and compliance are completely voluntary. The results of the Fehr and Schmidt study effectively provide a rationale for why EPFIs may not shirk compliance with EP obligations in the long-term. First, merely by complying with EP reporting requirements and upholding standards of public accountability with respect to EP obligations, compliant EPFIs can effectively "punish" free riders by redirecting the harsh public scrutiny of NGOs towards these non-compliant EPFIs. Second, although these results contemplate that a sufficiently large number of equity-adverse players could effectively defeat the punishment mechanism by collusively agreeing not to punish free riding, such collusion is a less realistic threat in the context of EP compliance due to the presence of NGOs. This group of entities occupies a role with no direct analogue in the Fehr and Schmidt experiment, because while they share amongst the returns from the public good, they are under no obligation to make any contributions. Additionally, while they cannot be punished by the EPFIs, they retain the ability to institute punishment. By occupying this unique role, the NGOs serve as the ultimate enforcers of equality, thereby greatly increasing the chances that EP compliance will never move to an equilibrium state in which free riding pervades.

[55] *Id*.

[56] Fehr & Schmidt, *supra* note 49.

https://doi.org/10.1017/S2071832200017892 Published online by Cambridge University Press

E. Conclusion

In revisiting this paper's major themes, the paper now returns to its opening allusion. In the film *Network*, the central struggle is derived from Finch's frustration with the television industry, and to a larger extent, with the state of society in the 1970s in general. His limited ability to re-conceptualize the world through the lens of his own traditional sensibilities was fundamentally incompatible with a version of the world that had changed dramatically without him taking notice. As a result, Finch is completely caught off-guard by Beatty's casual revelation that private corporations had effectively assumed the role historically reserved for states.

Likewise, the major theme of this paper is the proposition that in the context of modern transnational regulation, purely economic justifications of the decision to assume a regulatory role leave much to be desired. Just as Beatty's soliloquy upset established expectations, this position stands in contrast to the economic justifications championed by traditional wisdom. Although this paper found that economic justifications can, in fact, explain the adoption decision by reference to self-interested risk mitigation, it was ultimately forced to reject such justifications because they admitted various economic, political, and free-rider problems which made justification of continued compliance impossible.

On a more abstract level, this paper argued that regulatory decisions in the transnational context are fundamentally unlike pure economic decisions, and, therefore, an exploration of a more holistic approach to justifications of such decisions might be worthwhile. The paper also argued that economic models of regulatory decisions fail to account for welfare effects, and also seem to be inherently unsatisfactory due to treating human lives as mere costs.

Finally, the paper also explored behavioral theories of decision making as an alternative to traditional economic rationales, and demonstrated that such theories could adequately account for both the adoption and compliance decisions. Through reviews of several behavioral experiments, it was demonstrated that such behavioral theories are able to provide justifications for continued compliance with EP obligations precisely because they departed from assumptions inherent in purely economic models of decision-making.