Risk&Regulation

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Regulatory Creep

Risk&Regulation: CARR Review
No 8 Winter 2004

Editor: **Robert Kaye**
Assistant Editor: **Sabrina Fernandez**
Enquiries should be addressed to: Centre Manager
ESRC Centre for Analysis of Risk and Regulation
The London School of Economics and Political Science
Houghton Street, London WC2A 2AE
United Kingdom

Tel: +44 (0)20 7955 6577 Fax: +44 (0)20 7955 6578
Website: www.lse.ac.uk/Depts/carr/
Email: risk@lse.ac.uk
Published by the

There is little doubt that risk ideas and risk management are more prominent and more extensive than they used to be. And it could be said that CARR contributes to, and is part of, this general phenomenon. A risk industry has taken off and new connections between hitherto separate worlds are being made – IT security, business continuity, health and safety, financial solvency and so on. This process of connection involves the generation and formalisation of abstract levels of risk management thinking, a new risk management characterised by a variety of generic standards – beginning in 1995 with the document produced jointly by the Australian and New Zealand standards organisations and ending most recently with the publication of the final version of the COSO guidance on enterprise risk management in September 2004.

As organisational sociologists like John Meyer at Stanford remind us, this process of abstraction and standardisation supports the rapid diffusion of models of management practice which come to have the status of global blueprints. On this view, nation states and their regulatory organisations are adopters, rather than originators, of management knowledge. This seems particularly true in the case of risk management. As Michael Power argues in his recent publication by the UK think tank Demos, this ‘genericisation’ of risk management thinking enables the extension of its reach across more and more organisations and into more and more areas.* Indeed, the effect is that risk management and ideas of good governance are no longer clearly distinguishable; both are part of the social construction of a specific conception of the organisation as an actor.

Power also argues that this growth in the volume and scope of risk management is characterised by something else which is distinctive, namely the rise of *secondary* or reputational risk management. If more and more areas of practice can be regarded as having potential risks for an organisation’s reputation, then the rise of secondary risk management equates with the risk management of nearly everything. Organisations are becoming more preoccupied with how they appear, both to defend themselves in highly competitive markets and also in the face of potential complaint and litigation.

In recent years in the UK, there has been much interest and concern about the so-called compensation culture or litigation society, and how it might drive highly defensive and distracting risk management strategies for large corporations and public sector organisations. Complex internal processes may be documented less for reasons of operational efficiency and more for justificatory purposes. Actual litigation probably matters little in these settings; as the article by Francis Cairncross shows (p4), in the field of health and safety public organisations may prepare for the worst because sub-units and insurers have an interest in playing up the risks, a situation which results in daily absurdities. It is as if a growth in safety warnings in public places has less to do with protecting the public and more to do with protecting the organisation.

In other settings, multiple heavyweight regulatory initiatives – the Sarbanes Oxley Act, International Accounting Standards, Basel 2 – also reinforce the perception of a risky regulatory environment, and create considerable direct and indirect costs. However, as Clive Jones also suggests (p6), ‘regulatory creep’ may be self-inflicted by organisations.

All this raises the essential critical point of the risk management of everything: organisations may get safer because they simply transfer risk to those least able to transfer it themselves, namely the general public. This explains why there is no evidence to date, nor is there likely to be, that public trust in corporations is improved by the industry of certifications and disclosures they currently produce. The general public is smart and knows that this is all secondary risk management.

This general point applies particularly well to the predicament of professions and professionals at the current time. Founded on a principle of state support for the exercise of expert judgement with a strong public interest dimension, it is now almost impossible to get teachers, doctors and accountants to say anything sensible without lengthy and barely intelligible disclaimers in small print. These people know more than they can publicly say because honest mistakes are heavily punished. Consequently, society is denying itself a source of valuable expertise.

The critical problem of the risk management of everything is not therefore in the domain of a technical fix, of finding a new technique or organisational structure. It reaches into the macro-societal sphere, into the institutional environment in which organisations and experts operate. Even regulatory organisations operate in an environment of considerable political risk. The prescriptive challenge therefore has nothing to do with modifying guidelines, like COSO 2004; it can only be conducted at the level of a political and legal culture which supports the idea of an ‘honest mistake’ and which truly accepts and internalises the idea that risk implies: that things do go wrong sometimes, and no-one is to blame.

Bridget Hutter and **Michael Power**
CARR Co-Directors

** The Risk Management of Everything is available at*
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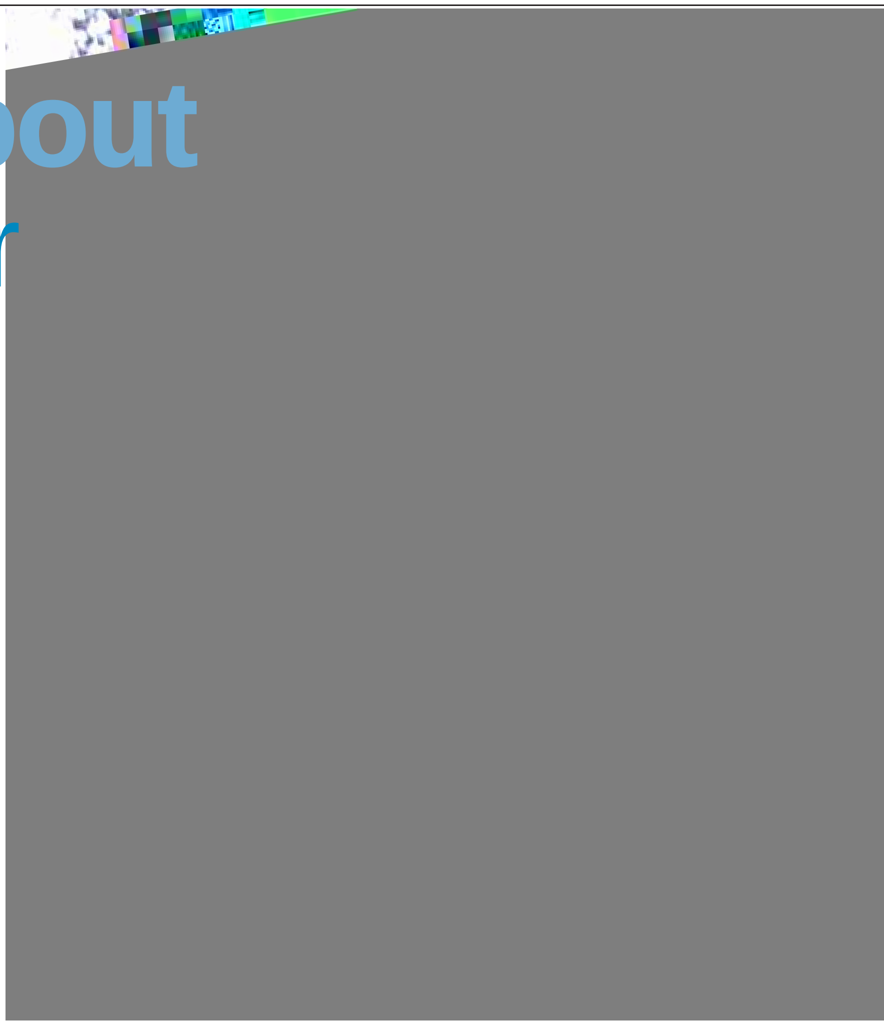
Messing about on the water



Frances Cairncross is Rector of Exeter College, Oxford, and chairs the Economic and Social Research Council (ESRC). She was formerly a senior editor on *The Economist* with special responsibility for management issues.

For the past few years, a couple of times a week, I have begun my day with a swim in Highgate Ladies' Pond. This lovely corner of Hampstead Heath is open all year, although as autumn progresses, the number of early morning swimmers declines until only a small group of hardy souls remains, swimming through the winter. Mad though it might sound, there is nothing more thrilling than plunging into icy water in the earliest light of dawn, while frost drifts from the trees. Nearby, the Men's Pond has an equally devoted group of swimmers.

Last year, the Corporation of London, which administers the pond, told winter swimmers that they could no longer swim when there was ice on the water and must wait until the sun was up to have their dip. The Corporation cited legal advice: if a lifeguard were to drown in the process of rescuing a swimmer, the Health and Safety Executive (HSE) might prosecute them. The swimmers were angry. Why should intelligent adults not be free to judge for themselves the level of risk they will accept?

Open-air swimmers are caught by two separate restrictions – legislation to protect the safety of people (such as lifeguards) at work, and occupiers' liability, which makes landowners partly responsible for injuries sustained on their land. So often is 'health and safety' used as a reason to stop people swimming that the River and Lake Swimming Association has several exasperated pages devoted to the subject on its website. But increasingly, 'health and safety' has become the excuse for all sorts of changes that constrict freedom (and often add to costs).

On the face of it, this is odd. After all, very large risks such as the Flixborough disaster have become much less common; and accidents at work have also fallen dramatically, partly because it is more easy to sustain an injury from a piece of moving machinery than from a PC. Some of the health risks that now concern the HSE, the quango that administers the Health and Safety at Work Act, would once have seemed frivolous – such as stress at work.

The HSE is acutely aware of the tension between ensuring public safety and protecting people at work on the one hand, and allowing people to take reasonable risks on the other. On 12 October it held an open meeting in London, to try to launch a public debate on the issues. But there are several dilemmas. First, it is difficult to define what is an acceptable level of risk, and even harder to persuade the public to accept the concept. Most people, deep down, still think that zero risk is a worthwhile goal. Ordinary folk often find hard to accept the economist's approach, that the elimination of risk comes only in exchange for costs that rise ever faster, the nearer 'zero' approaches. Second, the public may object to nannying one moment – but then insist on pinning blame or demanding compensation in situations that would once have been regarded as acts of fate – a rail crash, say, or the death of a soldier on duty in Iraq.

The courts, on the whole, have taken quite a tough line on the development of a 'compensation culture' – much tougher than American courts. For example, the House of Lords last year threw out a claim from John Tomlinson, a young man seriously injured when he dived into a lake on public land. In a triumph for common sense, Lord Hoffman observed, 'I think it will be extremely rare for an occupier of land to be under a duty to prevent people from taking risks which are inherent in the activities they freely choose to undertake upon the land. If people want to climb mountains, go hang-gliding or swim or dive in ponds or lakes, that is their affair.'

So why are so many companies and public bodies still eager to remove potential risks? The reason, argues the HSE, is that people are more likely today to make claims for compensation when they suffer accidents, and insurers may be more willing to offer out-of-court settlements rather than undergo the uncertainty of a court case. If so, part of the burden may lie with insurers: perhaps they should be more willing to allow some people seeking compensation for risks to take the consequences. As long as there is perceived to be money in demanding compensation for accidents, people will claim it – and those who want to take more risks will suffer.

The Risk Management of Everything

In June, **Mike Power** gave the final lecture in the P D Leake Trust Series on 'The risk management of everything'. Mike examined the expansion of risk management since the mid-1990s, its centrality to agendas for corporate governance and regulation, and its emergence as a generic model of rational organisation which is increasingly formal and systematic.

The lecture was based on his Demos pamphlet published the same day (see editorial) and attracted an audience of over 200 at the Chartered Accountants' Hall, London.

Further information on this lecture, held in association with the Institute of Chartered Accountants in England and Wales, can be found at: www.icaew.co.uk/index.cfm?AUB=TB2I_66701,MNXI_66701

Roundtable on Regulatory Creep

The notion of regulation going beyond its original source of authority or intention was explored in this stakeholder forum, organised by **Bridget Hutter** and **Clive Jones** from CARR and the Better Regulation Task Force, in July. The high level discussion received contributions from the worlds of business, regulation, academia, consumer groups and the civil service, and contributed directly to a recent BRTF report. For more on this topic see page 6.

CARR in the Community

The Charity Law Association sought advice from **Julia Black** on the regulatory powers proposed in the Charity Bill for the Charity Commission, comparing them against selected UK regulators and the proposed charities regulator in Scotland. The paper formed part of the Charity Law Association's submission to the Joint Committee scrutinising the draft Charity Bill in July.

Bridget Hutter led a discussion on 'Can Regulation be a Social Good?' at the World Economic Forum Finance Industry Agenda Meeting 2004 in London. The meeting included senior industry representatives from Europe, USA and the Middle East. Bridget has also become a member of the Social Market Foundation Risk Commision.

Mike Power was invited by a joint working group of the Financial Reporting Council and the Institute of Chartered Accountants in England and Wales to advise on the process to review the Turnbull Report. He also advised the ICAEW on its recently published report on Sustainability.

Research alliance launched

CARR members took part in the 'Test Society' workshop in May at the Centre de Sociologie de l'Innovation in Paris, an event that launched a collaboration among researchers interested in the role of testing in modern society. Researchers from CARR, BIOS, the Saïd Business School, the CSI, the Institut National de la Recherche Agronomique and the CNRS discussed the role of testing and experimentation in their respective areas – genetics, medical imaging, financial markets, food control, focus group research, terrorism and policing, among others. For more information on the 'Test Society' group, contact **Javier Lezaun** or **Yuval Millo**.

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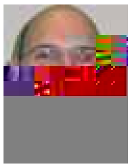
International events



In August **Javier Lezaun** (far left) and **Yuval Millo** (left) gave papers at the joint annual meeting of the Society for the Social Studies of Science (4S) and the European Association for Study of Science and Technology (EASST). In addition, along with Dr Fabian Muniesa (Ecole de Mines, Paris), they arranged a series of conference panels on: 'Economic Experiments'.

Robert Kaye presented a paper in Trento, Italy entitled 'Bribery, Conflict of Interest and Beyond' at a major conference of international scholars organised by the University of California, Berkeley on conflicts of interest in public life.

Mark Thatcher spoke on independent regulatory agencies at the New York University Centre for European Studies and at Columbia University in September. He also presented a talk on 'New regulatory institutions for markets' at the World Bank, Washington.

In December **Colin Scott** presented invited plenary papers on his research 'Governance Beyond the Regulatory State' at the Regulatory Institutions Network Annual International Conference (Canberra) and on 'The Regulatory State of Tomorrow' at the Institute of Public Administration Canada Workshop (Toronto).

Staff News

CARR welcomes **William Jennings** who joins us as ESRC/BP Postdoctoral Research Fellow. Will's research interests predominantly focus upon the regulation of government by public opinion (public policy and public opinion); blame avoidance; theories and analysis of policy implementation; and the politics and administration of governmental policies of public celebration.

Our congratulations go to **Michael Barzelay**, CARR Research Associate, who was awarded the Brownlow Book Award in November by the US National Academy of Public Administration for his book *Preparing for the Future: strategic planning in the US Air Force*. The award is given in recognition of outstanding contributions to public administration literature.

CARR has also been privileged to welcome two leading scholars as research visitors to the Centre: **Dr Reimund Schwarze**, Research Associate, German Institute for Economic Research (DIW) Berlin and **Professor Anthony Heyes**, Royal Holloway, University of London.

We extend our gratitude and appreciation to **Joan O' Mahony** for her hard work on *Risk&Regulation* over the last year. Congratulation also to Joan on the birth of her new baby. We welcome the new editor, **Robert Kaye**.

Have you moved or changed jobs recently? Please keep us informed of any changes in your contact details so you can continue receiving *Risk&Regulation*. **Email: risk@lse.ac.uk or Tel: +44 (0)20 7955 6577**

Regulatory Creep:
Myths and Misunderstandings

Have you heard the one about the factory owner who wanted to build a two-storey extension onto his factory to cater for 50 new employees, with a panoramic window on the second floor overlooking the river? The planning officer signed it off, the health and safety officer signed it off, but the fire officer said he had to lower the bottom of the window by three bricks. He did this, and fitted a new window with a new frame, but then the health and safety officer said he contravened another regulation. The owner wrote to the three officers and explained his situation and asked them to just tell him what to do. They each wrote back saying if you break this subsection of these regulations then we will prosecute.

‘Modernisation’ is the battle-cry for the current government in its attempts to encourage a further stage in the reform of public services. Few would question such a noble objective. Indeed, who could be against cooperation, flexibility and innovation, terms that form a central part of this new political lexicon? But, as researchers we need to look beyond the rhetoric. We need to examine the ways in which such dreams and schemes are put to work. We are interested in how they are given substance. We are interested in what helps them work as intended, and what hinders them. And we are particularly interested in the ways in which accounting and risk management practices are

Analyses of risk and regulation reveal the limits of knowledge and extent of uncertainty. Many perceived dangers are not readily calculable with respect to frequency of occurrence and severity of loss. Scholars curse.' Catastrophes that are unimaginable before a loss have two impacts after the loss. First, there is the cost of unexpected indemnity payments, estimated in this case at up to $55 billion. Second, in the effort to learn about the new catastrophe risk, uncertainty magnifies. Insurers experienced new problems with geographic risk spreading (terrorism insurance is difficult to limit geographically because terrorist activity can occur anywhere, anytime, repeatedly); aggregation risk (concentration of risk in commercial high-rise buildings, which were previously among the best insurance risks, but now became seen as high risk using total loss scenarios); correlation risks (correlation of exposure across several lines of insurance arising from the same event in ways not appreciated previously); and, enterprise risks (9/11 insurance exposure interacted with the capital markets downturn and low interest rate environment at the time to provide new understanding of how underwriting, investment and credit risks correlate in an actual case). Insurers made frantic efforts to devise models of terrorism risk and to form expert panels of

CARR: Why do the railways remain controversial?

Terry Gourvish: That's a good question. We seem to have an obsession about the railways that is out of proportion to the importance in the transport system that they have.

John Dodgson: There's a certain amount of

CARR: And the new regulator will also oversee health and safety…

JD: You might suppose that an economic regulator would be more concerned to compare costs and benefits.

TG: I think that in the industry there was a lot of disquiet about the Health and Safety Executive (HSE). There was certainly a fear more broadly that the HSE was imposing higher costs in terms of safety requirements.

JD: Such as making railway accident sites crime scenes. The time it took to clear up has been a big issue.

TG: It's helpful if practitioners have a say in the safety systems that are in place. If they have them imposed from above from a complete non-railway person there is a danger that they might not understand the operational realities of running a railway. As far as the health and safety authorities are concerned, railways are lumped together with nuclear power and oil installations as elements which required a considerable amount of regulation.

CARR: Why is safety such a big deal? Surely railways are the safest form of land transport?

TG: Safety is interesting. When you're in a car it's assumed you are the contarl5 0.12157 0.G0002 Tc0.0278 Tw[(Such as making r 0 0.0278 T77 Tw[(imposed r94 08JE8t77 Trt87.6(ements.)]TJET/GS1 gsBT/F5 1 s.)]TJET

Science: a puzzling profession?

Professor Robert Dingwall
University of Nottingham
9 November 2004

CARR sponsors risk and regulation conferences at LSE and at universities throughout the UK.

Are Risk Managers Dangerous?

Joint public debate with *The Economist*
CARR, LSE, October 2004

Opening the debate, Mike Power of CARR portrayed risk managers as 'cosmetic, legalistic and concerned with appearances'. In contrast, Reg Hinckley of BP thought the overall effect of risk managers was, on balance, positive. They had contributed to the quantification of risk, and had at least prompted the 'right sort' of boardroom discussions.

Avinash Persaud put the case differently: risk management wasn't working. Risk management should ensure that risks are distributed according to the ability to carry risks. In practice, risks are being transferred from those, such as banks, who can afford to take risks, to members of the public who cannot. Likewise, a 'one size fits all' mentality among risk managers had the perverse effect of destroying the diversity which successful risk management values, and increasing volatility.

A somewhat equivocal response was provided by Thierry Van Santen of Group Danone: the problem was the failure to distinguish between compliance and risk management. The job of the latter is to identify good and bad risks – since the company which takes no risks has no future.

A hand count of the audience suggested that the proponents had succeeding in convincing a majority that risk managers – the minority, perhaps? – were indeed dangerous.

More information on CARR events can be found on CARR's website, www.lse.ac.uk/Depts/carr

CARR publications can be viewed on the CARR website: www.lse.ac.uk/Depts/carr/

Selected Recent Publications

Competency, Bureaucracy

CARR research staff

ESRC Centre for Analysis of Risk and Regulation
The London School of Economics
and Political Science
Houghton Street
London WC2A 2AE
United Kingdom

Tel: +44 (0)20 7955 6577
Fax: +44 (0)20 7955 6578
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Email: risk@lse.ac.uk