

# Risk & Regulation

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PENSIONS  
MIS-SELLING

The  
BSE INQUIRY

SOOTHALL &  
LADBROKE GROVE  
JOINT INQUIRY INTO  
TRAIN PROTECTION SYSTEMS

Deirdre Hutton on  
consumer-driven  
regulation and  
Michael Spackman  
on regulatory  
populism

## **also**

Navigating the debate  
on corporate social  
responsibility

Regulating MP's conduct

Decentralising governance  
across the world

Lessons of Caribbean  
regulatory reform for  
developing countries

Is Japan on the brink of  
an audit explosion?





**C**reating innovative spaces for fruitful exchanges between academics and practitioners has proved to be one of CARR's most challenging objectives. The quality of our engagements with the worlds of practice depends on us creating forums where practitioners can debate





## Doctoral Programme Launch

Last term CARR welcomed nine affiliated research students from across the LSE to its new doctoral programme. The students are studying a diverse range of risk and regulation topics and have already started to play an active role in the life of the centre, as Michael Huber and George Gaskell report on page 11.

## Staff News

[CARR welcomes three new members of staff...](#)

**Claudio Ciborra**, Professor of Information Systems at LSE, has been appointed as PwC Chair in Risk Management. He is currently examining risks involved in building and managing global information technology infrastructures and their alternatives.

**Michael Barzelay**, Reader in Public Management at LSE, has recently joined CARR as PwC F8 6e La8 6e La8 omes thrfil2 Tcinnov6(es risks involved in building)]TJTppstarted achTc0o-0.0002 Tcfor weg0.0-2 .7(e0 Tgovctur)17.[(Replay anUni



'Westminster is one of the last bastions of gentle self-regulation', complained the *Sunday Times* last year, 'It's like the vampires being left in charge of the blood bank'. It is an irony that while parliament has presided over the creation of the 'regulatory state', its ability to retain control of its own members has been brought into question.

The case for tight controls on MPs' behaviour is hard to resist with the media running stories of MPs accepting cash for parliamentary questions, misleading ministers over links with lobbyists, or interfering with enquiries into the non-declaration of financial interests. But the recent story of claim and counter-claim over the fate of the first Parliamentary Commissioner for Standards suggests that regulating MPs is not an easy task. Some MPs felt the Commissioner was over-zealous and lacked a sense of proportion. Many outsiders, however, were of the opinion that she had been removed because she was too dedicated to her job.

### Do MPs Need Regulating?

There is a sporadic history of MPs abusing their positions, but whilst such behaviour needs to be controlled, it is not at all clear whether regulation is the way to do it. Some MPs claim that regulation is unnecessary and point to the relative lack of corruption in the UK. They conclude that regulation is at best unnecessary, and at worst could undermine the general good sense of MPs. But it is not clear that Britain is as free from corruption as these regulatory minimalists would like to believe. Certainly the UK generally ranks higher than many European partners in surveys of corrupt behaviour. But it consistently ranks below states such as Canada, New Zealand, Singapore and the Scandinavian countries.

More importantly, such an argument misses the point that regulation is not solely to control a handful of corrupt politicians. Without an ethical framework, under which standards are articulated and infractions punished, there is a real danger of a widening gulf between the practice of MPs and the expectations of voters. Research indicates that without an ethical framework, some MPs come to accept or rationalise behaviour that most would consider wholly improper. Ethical regulation is as much concerned with preventing the appearance of misconduct as misconduct itself.

### Leave it to the Ballot Box?

A more sophisticated objection to the regulation of MPs is to point to their democratic mandate. On this view, MPs are directly accountable to their electorate and not only is this held to be sufficient to deter misconduct, but any additional regulatory mechanism can only detract from the democratic right of the electorate to control their own representatives.

The argument fails for two reasons. Normatively it fails because the ballot box is wholly inadequate as a regulatory tool. Elections in the UK remain dominated by national parties and national issues. As politicians are wont to point out, 'ordinary people' are more concerned with the results of public service than with process. It is, for example, unclear whether Neil Hamilton would have lost his seat to the Independent candidate Martin Bell in 1997 if Labour and the Liberal Democrats had not stood their candidates down in Bell's favour.

Empirically the 'democratic' argument also fails because of other

factors governing MPs behaviour that need to be taken into account. Take the Whips, for example. Their weekly circular to MPs, indicating expected attendance and votes constitutes its own regulatory regime backed up with disciplinary sanctions ranging from loss of preferment to ostracism and, allegedly, even on occasion physical assault.

### Enter the Sleazebuster

Faced with ever more corruption scandals, parliaments are increasingly coming to rely on specialist committees and commissioners to deal with the numerous ethical dilemmas and conflicts of interests faced by legislators. Indeed, the regulatory framework within which British parliamentarians operate has changed considerably in the last seven years. Codes of Conduct have been introduced for both MPs and peers; the self-regulatory committees that oversee standards in the Commons and Lords have been formalised, and even the political parties have themselves introduced ethics bodies. The measure that has been the most publicly controversial, however, has been the introduction of a Parliamentary Commissioner for Standards to police the Code of Conduct.

As recent events have suggested, the theoretically independent Parliamentary Commissioner is seriously constrained by sitting at the centre of a self-regulatory web. This is not unusual: regulators can, after all, be regulated. But the insularity of Parliament creates self-replicating spirals: individual MPs are accountable to the Commissioner. But the Commissioner is appointed by MPs, reports to MPs and is also accountable to the Speaker, who is elected by - MPs. This may appear neatly symmetrical, but large parliamentary majorities can outplay Commissioners leaving them as regulators accountable only to the regulated.

The result is that in place of lines of accountability, we have regulatory spaghetti, with government at the centre and the electorate at the periphery armed only with the blunt tool of the ballot paper. With the electorate ill-placed to force change upon MPs, reform probably depends upon politicians giving up control over their own regulation. But experience suggests this may not happen until sleaze has brought the entire political system into disrepute.







Regulatory reform of network industries in developing countries presents many challenges, and none more so than the Caribbean telecommunications industry, report (a suntanned) **Martin Lodge** and **Lindsay Stirton**.

**R**egulatory reform in network industries presents many challenges. The organisation of the industry, the allocation of regulatory authority and the extent of liberalisation are just some of the key issues facing policy-makers. In the developing world such questions are even more problematic. Policy-makers in those countries have to contend with the inherently linked goals of economic and social development in conditions of high inequality, restricted access to network services and limited resources for infrastructure investment.

In order to understand the dynamics of regulatory reform in the developing world, we looked at telecommunications policy in three Caribbean countries, Jamaica, Trinidad and Tobago, and Barbados. Telecommunications is held to be a crucial factor for successful economic and industrial transition, but presents the three (small) island economies with four particular challenges.

First, basic universal service can only be an aspiration whilst technological standards are outdated and household access to basic telephone services remains relatively low. Second, none of the states have much home grown regulatory expertise. Third, all three states have to negotiate with one dominant

incumbent, Cable & Wireless, although the exact ownership pattern varies across states. And fourth, telecommunications, like other network industries, is highly politicised with politicians playing a key role in the selection of operators and in price-setting, and the use of cross-subsidisation to reduce domestic call charges and to expand networks.

Different national starting points have meant that the three states have responded differently to the common challenges of regulatory reform. Each island, however, teaches us some important lessons about regulatory reform in developing countries.

#### The advantages of phased liberalisation

Barbados followed Jamaica in adopting a phased transition to a fully liberalised market. Gradual liberalisation started with a limited opening of mobile and other non-core markets and is to conclude with the most profitable telecommunications market, international telephony (profits from which have historically cross-subsidised local rates) and possible rate-rebalancing. In contrast, Trinidad and Tobago adopted a strategy of immediate liberalisation allowing licensing of new entrants into all aspects of telecommunications services.

Phased liberalisation has often been accused of allowing the incumbent to shore up its position, but such an approach may very well be a necessary condition for an orderly transition towards liberalised markets. Even 'big bangs' usually lead to gradual competition, and 'big bangs' can turn into whimpers. Trinidad and Tobago's reforms have been bogged down for over a decade by legal challenges, delaying tactics on part of the incumbent, stop-go effects of domestic political instability and an uncertain agenda for liberalisation.

#### Capacity matters more than organisation

All three states have established free-standing regulatory authorities, but each have adopted different models. Jamaica adopted a British 'Of-type' regulator for telecommunications, water and electricity. In contrast, Trinidad and Tobago chose to separate telecommunications from existing departmental structures by creating a regulator headed by a politically appointed board for telecommunications sitting alongside the existing and similarly structured Regulated Industries Commission. Barbados, meanwhile, placed its faith in a Fair Trading Commission, similar to the Commerce Commission of New Zealand.

There is little consensus on the form regulatory structures should take, whether they be board vs. presidential leadership, or multi-sector vs. industry vs. sector-specific regulator. The Caribbean experience teaches us, however, that

the key issue is to establish and sustain sufficient domestic regulatory expertise to withstand the continuous pressures of well-resourced trans-national telecommunications operators and political interests. Unless regulatory authorities foster and sustain sufficient domestic regulatory expertise, they have to fall back on international 'best-in-world' expertise that may be ill-suited to country-specific issues. The history of regulatory reform in Trinidad and Tobago shows how imported expertise can fail where international donors provide technocratic 'leaders' with little understanding of the political circumstances. In contrast, the Jamaican case shows how the continuous 'import' of regulatory expertise on a medium-term basis at the non-executive level can have considerable positive effects. The latter strategy is also less likely to offend local sensitivities and can improve the overall capacity of the organisation.

#### Regulatory relationships need embedding

Network industries, such as telecommunications, remain highly politicised and governments and incumbents are continually tempted to resort to traditional informal ways of 'problem-solving', so undermining the credibility of the regulator and the viability of new entrants. On the one hand, new relationships must be embedded by paying crucial attention to greater formality in dealing with incumbents. On the other hand, political incentives to adopt an overly adversarial approach towards the (multinational) incumbents can frustrate joint development programmes and the introduction of new technologies.

These points illustrate some of the challenges facing policy-makers, not just in the three Caribbean states, but in developing countries more generally. It is unlikely that international 'off-the-shelf' solutions will provide an ideal way of transporting telecommunications regulation into the age of liberalised markets. Nor is liberalisation going to solve all the problems of regulatory control and political expectations. Developing regulatory capacity requires far less reliance on supposedly 'best-in-world' blueprints and short-termist 'leader-driven' programmes than we have so far seen. Instead, developing appropriate regulatory capacity requires far more sensitivity towards local environments and sustained support for the maintenance of domestic regulatory expertise.

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Martin Lodge is a CARR ESRC Senior Research Officer. Lindsay Stirton is a CARR Research Associate and Tutorial Fellow in Law.

The research was supported by a joint grant from the British Academy and the Association of Commonwealth Universities.

# Japan: Land of the rising audit?

Is Japan heading for a UK-style 'audit explosion' or will it take its own distinctive route to public and private sector reform? **Michael Power** considers the arguments on the eve of the translation of his book, *The Audit Society*, into Japanese.

Perhaps it is no coincidence that *The Audit Society* is being translated into Japanese at a time when Japan's economy and public administration are experiencing a profound transformation after a decade of difficulties. The Koizumi government is undertaking a widespread programme of structural economic reform, and job losses at major corporations, like Hitachi, make headlines in Western newspapers. There is much discussion about the changes needed within Japanese economic life in order to cope with global (particularly Chinese) competition in many sectors where Japan has previously dominated.

Such an environment, in which economies and their component organisations are suddenly 'poor', in which financial scandals rock the establishment, and in which pressures exist for de-regulation and public sector efficiency reforms, is ripe for an 'audit explosion'. Auditing, monitoring and evaluative activities come to be seen as a panacea for private and public sector organisations in search of more efficient use of resources, and in search of ideals of transparency and accountability. This is the so-called 'audit society hypothesis' and the question is whether it is an idiosyncratic British disease or a global phenomenon.

When information flows around relational networks and within closed policy communities, formal reporting and oversight mechanisms are not significant modes of control and form a low status part of the economic and political order. As Ronald Dore has observed, the delicate balance between audit and trust characterises the way a society operates and, historically, that balance in Japan has been slanted towards trust and mutuality. Whether this balance is now changing in Japan is the key issue.

In the name of greater competition and efficiency, the dominance of relational and informal contractual ties across supply chains, between borrowers and lenders, and between regulators and regulated, may be replaced by more distant and formal agency relationships supported by audit.

How and whether this happens will depend on the precise direction of institutional reform within Japan against the background of a culture of 'mutuality'. Despite having a well-known history of transplanting Western systems, Japan has generally subsumed imported ideas within a mutualist, anti-individualist cultural background. Accordingly, the question is whether this pre-modern consensus-building process will continue to provide the framework for 'new public management' style reforms in Japan, with their attendant emphasis on performance and audit.

As far as public sector auditing and inspection is concerned, much will depend on the evolving role of the Board of Audit (BOA)

and the newly created Administrative Evaluation Bureau (AEB). According to Takashi Nishio, a leading Japanese scholar of public administration, the BOA is weak because its constitutional independence removes it from the complex but high status processes of 'mutual adjustment'. As closed policy communities in government open up under the reform process, however, the BOA may have an opportunity to mirror other 'supreme audit institutions' around the world by extending its historical role beyond low level transaction vouching. The AEB represents the more established post war traditions of value for money and efficiency inspections, but suffers from the criticism that its embeddedness in mutual adjustment processes and, therefore, its lack of independence, leads to a dilution of its critical function. So the strengths and weakness of the two audit and inspection bodies in Japan are exact opposites.

A Japanese 'audit explosion' will have profound implications for traditional authority structures exposed to demands for 'auditable' rules and transparency, such as the 1998 ethics law for the civil service. Japan must also face the challenge of distinguishing between the productive and the technological dimensions of audit. The benefits for the beneficial effects of auditing are always undermined by the games that organisational agents play to create elaborate images of improvement and performance. So the emergence of auditing in reformist Japan could prove to be a symptom of crisis rather than a solution. Auditing empowers new experts in oversight and internal control, but these experts are not necessarily the right ones.



Details of forthcoming seminars can be found on the CARR website: <http://www.lse.ac.uk/Depts/carr/>

## **Regulation: a useful concept?**

Julia Black, CARR  
October 2001

Regulation is increasingly being seen as 'decentred' from the state. According to Dr Julia Black, a decentred perspective opens up the cognitive frame of 'regulation', enabling commentators to spot regulation in previously unsuspected places. Decentred accounts prompt policy thinkers to consider the delivery of public policy goals via a wide range of configurations of state, market, community, associations and networks. But decentred accounts also raise fundamental questions about regulation, the state and the law. What is it that is being 'decentred', what purpose does the concept of 'regulation' serve, and what are the implications of decentred accounts? Debate on these questions is sorely needed if we are to go beyond contemporary answers that are at best contested and at worst incoherent.

## **Governance, Risk and Modernising Government**

Joyce Tait, University of Edinburgh  
November 2001

Policy innovations within the Scottish, UK and EU 'Modernising Government' agendas relate primarily to education, health and social policy, but rarely focus on science, technology and innovation, regional development and environmental regulation. According to Professor Joyce Tait, the lack of 'joined up' policy goes largely unrecognised, but in the context of risk at least, this is an area that urgently needs policy integration. Using examples from chemical and biotechnology regulation, Professor Tait outlined the range of different approaches to policy-making, such as evidence-based, interest-based and ideologically-based styles and the consequent problems and conflicts that can arise. Professor Tait concluded by arguing that science and technology poses particular challenges that cannot afford to be sidelined in discussions of modernising government.

## **Traders and the Management of Risk in Financial Markets**

Paul Willman, University of Oxford  
December 2001

Professor Paul Willman's seminar examined the management of traders in financial markets from the perspectives of agency and prospect theory. Using interview data from a sample of traders

and managers in four investment banks, Professor Willman argued that the characteristics of managers and the nature of their role leads them to focus on avoiding losses rather than making gains. Professor Willman discussed the consequent policy issues for managers and the implications for agency and prospect theory.

## **Evidence Based Versus Value Based Policy: UK safety and environmental regulation**

Michael Spackman, National Economic Research Associates  
January 2002  
(*Serving the Public Interest?*, page 6)

## **Fuzzy Legality and National Styles of Regulation: government intervention in the Israeli downstream oil market**

Margit Cohn, Hebrew University of Jerusalem  
February 2002

In her seminar, Dr Margit Cohn examined the concept of 'fuzzy legality'. 'Fuzzy legality' serves as a collective title for six different regulatory techniques that are 'perfectly legal' but deviate in their operation from the ideal-type regulatory arrangement and may enable actors to accumulate covert and unaccountable gains. Drawing on the example of state intervention in the Israeli downstream oil (supply) market, Dr Cohn argued that 'fuzzy legality' allowed the industry, acting in concert with the government regulator, to retain a lucrative and practically non-accountable arrangement. Three central forces encouraged the continuation of fuzziness: a 'cloud' of state-security, institutional 'stickiness' that preserved colonial mandatory legal structures, and a prevalent national culture of non-legalism. Dr Cohn contrasted the Israeli regulatory style of 'adversarial non-legalism' with American 'adversarial legalism' and its opposite, 'consensual non-legalism', and argued that the Israeli style shows less promise for balance between market and public interests.

## **Extreme Risks and the New Capital Allocation Charge for Operational Risks**

Elena Medova, University of Cambridge  
February 2002

Operational risk is a consequence of critical contingencies, which are varied in nature and can lead to extreme losses. According to Dr Elena Medova, however, the current Basel

proposal for economic capital allocation for operational risk has a number of flaws. Instead Dr Medova argued for a formalised definition of operational risk linked to the evaluation of economic capital provision for market and credit

## CONFERENCE NEWS

### **New Crafts for an Old Machine? Civil service competence in economic policy-making**

Anglo-German Foundation, London  
October 2001

The aim of the workshop was to bring together central government officials and other observers from Germany and the UK to discuss challenges to civil service competence in economic policy-making. The discussions broadly focused on demands on individual as well as organisational competencies in three aspects of policy capacity and activity, namely: Consultation; Subject Expertise and the New Public Administration; and, the State as Risk Manager. By drawing on officials from different policy settings, the seminar generated a wider cross-national discussion of the role, necessary skills and wider competencies of civil servants in particular and public administration in general. For full conference report visit: <http://www.agf.org.uk/pubs/pdfs/e1361web.pdf>

### **Business History and Risk**

University of Leeds  
February 2002

CARR, in association with the Centre for Business History, University of Leeds held a successful workshop aimed at examining the various ways in which business historians have explored issues of risk in their work. Tony Freyer (University of Alabama) surveyed national patterns of antitrust and risk regulation, focusing on divergent national consciousnesses of accountability and competition. Oliver Westall (University of Lancaster) focused on the insurance industry as a bearer of risk and highlighted the historical lack of systematic risk assessment in most traditional insurance businesses and the rather narrow fronts on which statistical risk evaluation had advanced. Jo Melling (University of Exeter) examined the risks borne by employees in industrial employment, focusing on the history of industrial silicosis. He challenged the view that trade unions, by campaigning for compensation, have hindered prevention and regulation. Finally, Philip Augar (author of *The Death of Gentlemanly Capitalism*), discussed the City of London and the management and changing cultures of risk before and after the 'Big Bang'.

The workshop, attended by historians, economists, accountants and risk analysts from 11 institutions, highlighted the fact that although 'risk' is a recurrent issue in business



## CARR research staff

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### Michael Barzelay

PwC Fellow in Risk Management

Reader in Public Management

*Executive leadership in government; Managing government operations; Internal regulation of government (public management policies); Case study research methodology.*

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### Tim Besley

Director of Suntory and Toyota International Centres for Economics and Related Disciplines (STICERD)

Professor of Economics

*Public economics; Development economics; Political economy.*

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### Julia Black

Senior Lecturer in Law

*Regulatory techniques and processes; Interpretive and discourse based approaches to regulation; Rule making; Financial services regulation.*

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### Claudio Ciborra

PwC Professor of Risk Management

Professor of Information Systems

*Global information technology infrastructures; Business risk strategy in relation to building and managing integrated infrastructures.*

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### George Gaskell

CARR Programme Director:  
Organisations and Risk Management

Professor of Social Psychology

*Organisational management of technological risks; Public opinion and public policy; Expert and lay understandings of risk and uncertainty; Public perceptions of biotechnology.*

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### Andrew Gouldson

Lecturer in Environmental Policy

*Science, technology and environment; Environmental risk assessment and management; Corporate governance and stakeholder relations.*

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### Terence Gourvish

Director, Business History Unit

*Business and corporate history in the 19th and 20th Centuries; Comparative study of state-owned enterprises; Mergers and industrial concentration.*

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### Christopher Hood

CARR Programme Director: Regulation of Government and Governance

Gladstone Professor of Government and Fellow of All Souls College, University of Oxford

*Regulation of public-sector bodies; International comparative analysis of risk*

*regulation regimes; Institutional factors in shaping regulation; Transparency and 'better regulation'.*

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### Michael Huber

Aon Fellow in Risk Management

*Environmental regulation; Risk regulation; Organisation theories and social theory.*

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### Bridget Hutter

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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: <http://www.lse.ac.uk/Depts/carr/>

Email: [risk@lse.ac.uk](mailto:risk@lse.ac.uk)