

# Risk & Regulation

Magazine of the ESRC Centre for Analysis of Risk and Regulation

No 7 Summer 2004

Risk management  
in the 21st century

Testing times:  
experiments and regulation

Consumer health  
and food regulation

Watching the watchers:  
new anti-terrorist legislation

Corporate social responsibility

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# The view from Davos

An important aspect of CARR's work is to engage users of risk and regulation research by disseminating our research findings and by engaging in discussions and debates with leading practitioners from government, business, and civil society. This magazine reaches out to a wide and diverse audience, prompting many enquiries and discussions; our workshops and seminars attract users of our research; and CARR increasingly engages in consultative forums with specialist practitioner groups around particular policy initiatives. The extent to which CARR's intellectual agenda is central to key corporate and political debates was also emphasised when risk and regulation issues took centre stage at the World Economic Forum Annual Meeting in Davos this year.

Managing New Risks was one of the main themes discussed by the 2,100 participants in this international meeting of world leaders. The broad-ranging programme focused on two main areas. The first was the issues that businesses face in identifying new risks, in risk assessment, and in risk perception. The second concerned more general global risks, such as climate change, terrorism, pandemics, and demographic changes. CARR's Co-Directors were involved in the design of the first of these themes prior to the event, and Bridget Hutter attended the meeting. She participated in a number of public and private discussions, ranging from broad debates about setting the agenda for risk through to more detailed talks about the dangers of risk aversion and litigation risks.

Discussion of the main contemporary risks that businesses face centred on political and economic uncertainty and the need for stable national and global business environments. Fears arising from major risk events were also of major concern. There was a suspicion amongst some participants in Davos that there are serious dangers of overreaction, in part brought about by the ease with which news can be transmitted and magnified around the world. Public anxiety about risks are a particular concern in some sectors, notably in the life sciences area where the necessity for businesses to appreciate different perceptions and fears has been learned in what one participant referred to as the 'School of Hard Knocks'.

Risk aversion emerged as a major concern with some participants in the Annual Meeting regarding it as the main risk facing businesses in 2004. The argument was that undue pessimism could lead firms to manage risk too tightly, thereby adversely affecting their business activities. In addition business may be forced to take a risk-averse role by others. The role of regulation and governments emerged as a key concern amongst the business audience, the contention being that governments force business to be too risk averse. The costs of government regulation were, perhaps unsurprisingly, attacked as too high, but there was also agreement that some regulation is necessary, and a willingness to recognise that business has, at any point in history, always been heard to complain about 'too much regulation'. This would doubtless be an interesting topic for future discussion.



PHOTO BY WEF/SWISS-IMAGE.CH

Litigation costs were identified as the other major risk for businesses in 2004. This was especially the case amongst the business audience from the United States, where class actions can result in multi-million dollar lawsuits. Participants spoke of 'a wealth transfer system created by the judiciary' and lawyers who made their living out of encouraging 'forum shopping' between states with differentially sympathetic courts. Once again the real issue here is one of balance. Clearly individuals and groups need the space to challenge corporate wrongdoing. The difficulty is caused, as with all law, by the more capricious cases and especially by those who opportunistically exploit the legal system. A balance needs to be struck between the just rights of individuals, groups, and companies; and systems must be devised which maintain this balance. This is, of course, as true for countries subject to corporate regulatory shopping as it is for companies subject to individual forum shopping.

A principal ambition of the Annual Meeting was to explore what could be constructively done to manage risks. Here a number of common themes emerged, notably the need for cooperation. Intergovernmental cooperation was advocated for large-scale global problems, especially those requiring stewardship for future generations. But the general consensus was that this alone is insufficient; we cannot be solely reliant on governments. Rather, the management of risk demands a more general cooperation between governments, civil society organisations, and business.

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

# Risk management in the 21st century



## Michael Osborne

has been at the Organisation for Economic Co-operation and Development (OECD) since 1980. He is presently Director of Multidisciplinary Issues and Director of the International Futures Programme. He is also responsible for the Global Science Forum. Currently, the International Futures Programme is working on projects focused on the commercialisation of space, the new security economy, monitoring and managing new systemic risks and the emerging bio-economy.

Risk has been a significant concern since the dawn of recorded history. Not only are there more risk situations today, but modern technological developments have brought a heightened awareness of risk: both of those risks that we knew about in the past, and of the emerging, new risks that are associated with the march of progress.

A key element in this heightened awareness is the fact that we now know a great deal more about the physical world than we did in the 19th and much of the 20th century; in addition, the mechanisation of much of daily life has brought human beings into contact with new risks. At the same time, technology has provided us with the tools to measure and to manage risk, and at times to avoid it altogether. The insights of behavioural psychology and economics have helped us to understand how risk is perceived and managed in everyday life. Yet the increasing complexity of modern life is going to require new and different ways to manage risk and to share its burden among citizens, collectivities, and governments.

The OECD's International Futures Programme (IFP) has recently produced a report which explores the implications of a number of deep-rooted changes for the management of risk in the 21st century.

One such force is demography. In one scenario, by 2050 the world population is set to increase to at least 9 billion from today's figure of 6 billion: virtually all of the additional 3 billion people will live in urban areas. As a consequence, a much larger fraction of the world population will be seriously exposed to well-known hazards such as natural disasters. Many megacities will, for example, be located in earthquake fault-zones, yet will be lacking adequate urban planning and construction norms.

Changes in the environment are a second driving force: the sheer speed of those changes may put our level of scientific knowledge to a severe test in dealing with the risks associated with phenomena such as climate change, water scarcity, and reduction in biodiversity.

Then there is technology. Will factors such as the connectedness brought about by communications networks ultimately prove more useful to terrorists, or to those fighting terrorism? What systemic vulnerabilities will emerge from this dependence on networks?

Finally, many questions arise that are linked to changing socioeconomic forces. Does greater economic concentration mean increased vulnerability? If government's role is shrinking, who is really in charge in an emergency? If the public's perception of risk is increasingly formed not by expert knowledge, but by media that seek to entertain, could a lack of awareness lead to over-reaction and misguided behaviour in the face of risk?

Building on case studies in five large risk clusters – natural disasters, technology-related risks, infectious diseases, food safety, and terrorism – the IFP's report on emerging risks focuses in particular on the possibility of major systems becoming more vulnerable in the future. Health services, transport, energy, food and water supplies, information and telecommunications, and safety and security are all examples of sectors with vital systems that can be severely damaged by a single catastrophic event or chain of events. The report identifies the challenges facing OECD countries, especially at international level, in assessing, preparing for, and responding to conventional and newly emerging hazards. It sets out five broad areas of action to

address those challenges:

- Re-examine the policy approach to risk management, with a particular view to improving policy consistency across risk areas, and to making a more coherent use of risk policy tool-kits.
- Develop synergies between the public and private sectors by getting the incentives right, by clarifying the legal frameworks, and by enhancing the role of the private sector in risk management.
- Inform and involve stakeholders and the general public: enhance dialogue, build trust, and develop a safety culture.
- Strengthen international cooperation, notably by improving the sharing of knowledge and technologies across countries, and by enhancing international systems of surveillance and monitoring.
- Make better use of technological potential and enhance research efforts to develop, for example, tools that reduce the vulnerability of systems and increase their resilience.

The report proposes a number of detailed recommendations for governments and the private sector as to how risk management might be improved by acting in these five directions.

The report is available at:  
[www1.oecd.org/sge/au/index.htm](http://www1.oecd.org/sge/au/index.htm)

## CARR at World Economic Forum

The CARR Directors advised the organisers of the World Economic Forum's Annual Meeting in Davos in January on this year's programme. **Bridget Hutter**, Co-Director of CARR, spoke at several sessions of the Annual Meeting which this year attracted an audience of over 2,100 participants from 94 countries, including 30 heads of state or government and 75 cabinet ministers.

## Award for Economics Professor

Our congratulations go to **Tim Besley** who has been awarded the Duncan Black Prize (jointly with Stephen Coate of Yale University) for his paper On the Public Choice Critique of Welfare Economics. The paper was published in the journal *Public Choice* in 2003.

## Tackling Research Ethics



CARR held an in-house session on research ethics in February. **Professor Henrietta Moore**, LSE Deputy Director, spoke about research ethics from LSE's point of view, and **Dr Patricia Spallone**, Associate Director, BIOS Centre, discussed the broader issues of research ethics, drawing on her experiences at The Wellcome Trust.

## Staff News

CARR welcomes **Tracy Cohen** who joins us as BP Postdoctoral Fellow. Tracy's current research examines the attempt by African governments to regulate, and in some cases prohibit, the adoption of Voice over Internet Protocol (VoIP).

We say farewell to **Michael Huber** who completes his three-year tenure at CARR as Aon Senior Research Fellow in Risk Management.

## Consultations and Debates

CARR regularly communicates its research findings to practitioners and participates in discussions and debates across the UK.

**Tim Besley** was invited to be a panel discussant at the launch of the Treasury's new publication: *Microeconomic Reform in Britain: Delivering Opportunities for All*. The event, at 11 Downing Street, was introduced by the Rt. Hon. Gordon Brown MP, Chancellor of the Exchequer, and was attended by an audience of over 70 academics, politicians, and senior civil servants.

An article by **Christopher Hood** about the Gershon review of the civil service appears in *The Guardian's* new monthly magazine, *Public*. The magazine addresses current challenges to public sector management, and is intended to appeal to senior managers working in health, local government, Whitehall, and the universities.

**Bridget Hutter**, **Martin Lodge**, and **Mark Thatcher** met with Trevor Bull from the Bangkok Ministry of Finance's State Enterprise Policy Office to discuss training needs for regulators, especially those in the regulated utilities.

**Bridget Hutter** and **Mike Power** explored the challenges facing insurers, including emerging issues involving re-insurance receivables, with the Donald McDonald Partnership, a new firm of consultants to the insurance industry. The CARR Directors also met with David Schofield, Senior Capital Governance Advisor, from BP to discuss issues in implementing a new internal controls framework.

**Joan O' Mahony** presented a paper at a one-day event on violence and civil societies. The event brought together social scientists from Germany, France, and the UK, and was hosted by the Maison Française D'Oxford in association with the French National Scientific Centre. Papers shortly available at [www.mfo.ac.uk](http://www.mfo.ac.uk)

In February, **Mike Power** presented a seminar on the theme of trust in the 'audit society' at the second of three Nationwide/Demos seminars on trust. James Strachan from the Audit Commission was the respondent at this event held at Nationwide's London offices.

## International Events

CARR members continue to be active in disseminating their research findings across the globe.

**Julia Black** contributed a paper on the democratisation of fragmented, state and non-state regulatory structures to a conference on Economic and Social Regulation, Accountability and Democracy in Sao Paolo, Brazil.



**Tracy Cohen** presented two papers at an event held by the Centre for Innovation Law and Policy and Bell University Laboratories at the University of Toronto, Canada. The papers examined the tension between privacy and increased surveillance requirements for telephone operators and international trade challenges to Canada's domestic regulatory framework for telecommunications and broadcasting.



**Javier Lezaun** attended two meetings organised by the European Commission to discuss the social and political implications of science: Interfaces Between Science and Society (Milan, 2003) and Modern Biology and Visions of Humanity (Genoa, 2004).

CARR has also recently been privileged to welcome four distinguished international scholars: **Dr Fiona Haines**, Deputy Head of the Criminology Department at the University of Melbourne; **Professor Steve Kelman**, Weatherhead Professor of Public Management at Harvard University's John F. Kennedy School of Government; **Professor Jerry Mashaw**, Sterling Professor of Law at Yale Law School; and **Professor Gunnar Folke Schuppert**, Chair for State and Administrative Science at the Social Science Research Centre (Wissenschaftszentrum), Berlin.

## Risk&Regulation 2004

**Research Student Conference**  
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'It gave me a great number of original ideas for my research.'  
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**Deadline for applications: 25 June 2004**

# Watching the Watchers

**Tracy Cohen** examines new questions of risk and regulation that are raised by recent anti-terrorist legislation.

**F**uturistic novels and Hollywood movies have long prophesied a 'surveillance society' as the norm. In a world post-2001, the prophecy is closer to reality than it ever was before.

The promulgation of anti-terrorism legislation world-wide is spawning innumerable related laws that are starting to have an impact on how travel, business, communication, shopping, and even charitable donations are conducted. Such laws predate the terrorist attacks on the World Trade Centre and those in Kenya and Morocco among others. Previously in most western democracies, public policy debates about the efficacy of such laws went hand-in-hand with debates about their possible dilution or protection of civil liberties and constitutional rights. Recent events, however, now raise broader questions related to the management of risk and regulation. What do these new systems of control look like? What new models of public-private regulation do they propose? And what challenges do they present for the regulatory state and civil society, both of which must negotiate the power preferences of multiple actors: local and foreign governments, international organisations, domestic activists, and ultimately, political constituencies?

Regulatory initiatives to combat terror take many forms, but some global patterns can be observed in the way that countries have responded to UN Resolution 1368 calling on increased cooperation between countries to prevent and suppress terrorism. Governments are introducing wider interception and monitoring powers, embodied for example in the *USA Patriot Act* or the lobby for a European arrest warrant. Due-process requirements are being eroded as demonstrated in the detention of suspected terrorists without trial for varying periods in the US and UK. More recently, there have been proposals to further identity control through national ID cards and biometric identity

procedures; the UK is one of the first countries to allow the use of face recognition technologies to monitor 'persons of interest'. New terrorist activities and crimes have been defined, including the funding of terrorist organisations or giving material support to these organisations. Recent Canadian and Australian legislation targets just such funding; New Zealand has fast-tracked law to provide for the freezing of the financial assets of suspected terrorist organisations, and the EU has ensured the passage of the Money Laundering Directive. France and Germany have seen a growth in data-sharing between law enforcement and national security agencies. Indeed, everywhere, data-sharing between domestic, regional, and international organisations has increased.

Doubtless some form of global Hobbesian compact is operating between citizen and state in an understandable desire to be safe from acts of terror. Yet, constitutional concerns aside, there are new questions emerging about the purpose and effectiveness of terrorist risk reduction and management. First, the question arises whether policy models proposed by the most active states are capable of universal application. Countries with scarce policing resources have adopted new anti-terrorism laws, often requiring institutions and regulatory enforcement well beyond their means. What some have called 'policy laundering' sees these countries, compelled to adopt new security measures, take examples from international 'best-practice' without the requisite institutions and resources to monitor or enforce such laws. For example, in 2002, the African Union passed an anti-terrorism convention that requires the implementation of complex technological border controls to minimise terrorist acts and provide mutual legal assistance to other countries.

Second, is the risk management of terrorism targeted at protecting national security or national economies and political credibility? National security

has long been used as a hackneyed justification for measures that are essentially about protectionism. Telecoms provides a good example where security arguments to resist foreign ownership of domestic telecommunications has already seen expression in the rejected attempt by Deutsche Telekom to acquire US Voicestream Wireless in 2001 and a similar rejection of Hutchison Whampoa's proposed investment in Global Crossing in 2003. In the surveillance society, this justification may well become the norm.

Third, current favoured regulatory models pose difficult problems if national security is to be tacked on. For example, in a mature and competitive market, co-regulation has certain advantages because it reduces unnecessary state regulation. However, in the surveillance context, this partnership converts many telecommunication companies and internet service providers into unwitting law-enforcement agencies. This raises concerns regarding both political accountability and consumer choice, leaving little option to select a service provider based on their approach to individual privacy. But the case of telecoms also highlights the question of how appropriate are the co-regulatory models between the state and the private sector for law enforcement activities associated with the surveillance of network communications.

Despite many questions, one clear issue that emerges is that the public policy discourse in this realm must urgently include real risk impact assessments and new and brave debates on terrorist regulation, its role, and on the design and effectiveness of the institutions required to implement such regulation.

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Tracy Cohen is BP Postdoctoral Fellow at CARR.

simple awareness-raising initiatives. The FSA, however, is faced with multiple challenges. The multi-level governance dimension of the food safety regime, for example, both limits the FSA's power to change EU rules and restricts its ability to change local authority behaviour. But these barriers can be overestimated. Arguably, member states could unilaterally introduce tougher controls given the risks to health presented by food allergens. No member states have yet gone down that route, which suggests that other factors are shaping policy.

First, scientific uncertainties about safety thresholds make it difficult to set legal standards for trace contaminants, though not for ingredients which are the cause of most deaths. Second, the catering lobby prefers voluntary to statutory controls and, with an annual turnover of between £30-£50bn, their views carry considerable weight. Third, whatever the law says, it is difficult to change entrenched business behaviour; getting staff just to wash their hands is hard enough. Fourth, there are skill constraints and poor targeting of scarce resources across the regime, including the FSA. Fifth, although polls suggest that just under a third of the population wants tougher controls on food allergens, regulation imposes an unequal distribution of costs and benefits on allergic and non-allergic consumers. Further controls that spawned ubiquitous 'may contain' warnings, or caused some foods to disappear from menus, might even result in a public opinion backlash.

Such problems, which are familiar in a range of regulatory contexts, help explain the FSA's preferred policy stance. But at the heart of the food allergens issue is an important clash in cultural perceptions of risk which the FSA is yet to resolve. Some, mainly caterers, view food allergen risks as a consumer health problem and, therefore, the responsibility of the consumer, not the supplier. On that view, food hygiene laws are inapplicable. Allergic consumers, in contrast, argue that allergens need to be treated as food safety risks if they are to have robust information on ingredients and contaminants. The European Commission has already stated that it considers food hygiene law to be fully applicable to allergens. The FSA, nonetheless, prefers the view that it is ultimately for the courts to decide. That clash in the experience and perception of risk leaves ambiguous the allocation of rights and responsibilities for food allergens; an issue that vitally needs to be resolved if consumers are to be adequately protected.

Food allergens regulation holds wider lessons for risk regulation reform. The case highlights the range of obstacles that stand in the way of improving both policy and delivery; obstacles that go beyond simple institutional reform. The difficulty in allocating rights and responsibilities, however, also suggests that greater clarity is needed on what it means to put consumers first.

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Henry Rothstein is a CARR ESRC Research Fellow.



## Increasing concerns about food allergens highlight the difficulties the Food Standards Agency faces in protecting consumer health, argues **Henry Rothstein**.

Improving the way that governments manage risks to the public has been the subject of considerable contemporary debate. Policy prescriptions have commonly focused on such themes as transparency, independence, and stakeholder consultation. One test-bed for these ideas has been food safety regulation. Following the BSE debacle, the Food Standards Agency (FSA) was created in 2000 to pioneer a new approach to risk regulation; pledging, amongst other things, to 'put consumers first'. Recent polls suggest that the agency has started to win public trust, but the FSA has found it more difficult to actually improve food safety.

The problems posed by food allergens illustrate the difficulties confronting the FSA. Just over ten years ago food allergy was a rare condition, but today, for still unexplained reasons, almost 2 per cent of adults and between 5 and 8 per cent of children are allergic to a range of foods. One in 70 children has an allergy to peanuts alone. For a significant minority of the population, therefore, everyday activities such as food shopping or eating out can involve life-threatening decisions. Indeed, food allergens are responsible for at least ten deaths each year; over half of which are due to commercial catering.

Perhaps unsurprisingly, the FSA has made food allergens a priority. Amongst other things, the Agency is spending £1m a year on research, strengthening food labelling and raising awareness amongst businesses, inspectors and consumers. These initiatives may be helpful, but they fall short of what is needed to prevent further food allergy deaths. Allergic consumers need robust information about their food purchases in order to avoid foods that contain allergenic ingredients or contaminants. The current regulatory arrangements, however, fail to meet the information needs of consumers with food allergies.

Food allergy regulation is failing for at least three reasons. First, there are serious gaps in the law. The FSA has helped the EU tighten rules on labelling the ingredients of packaged food. Yet there are no equivalent rules for listing ingredients in catered and

loose foods, or indeed for allergenic contaminants of any food; 'may contain' warnings, which are familiar to shoppers, are entirely voluntary and do little to help if they are inconsistently applied. Instead, the *caveat emptor*, or 'buyer beware', legal framework puts the onus on consumers to question staff when purchasing loose or catered food. This absence of hard rules on information provision regularly leads to confusion and sometimes fatal incidents.

Second, there is wide variation in business and consumer behaviour. Many major businesses are streets ahead of the law in controlling food allergens, but smaller businesses face greater difficulties in meeting consumer needs. There are almost 400,000 small independent caterers, many of whom employ poorly trained, transient and sometimes non-English speaking staff. Kitchen culture works against accurate recipe following and contaminant control, and long supply chains make it hard for caterers to know the composition of foodstuffs. One study found that a fifth of takeaway meals that customers had requested to be peanut free, actually contained peanut protein. Such problems are compounded if consumers do not make their needs clearly known or take insufficient care about what they consume.

Third, existing regulatory controls are poorly enforced. Local government food safety inspectors have little expertise, there is no official guidance on managing allergen risks, and allergen control does not figure in local political priorities. On the rare occasions that inspectors analyse food samples, local authorities do not disclose results for fear of causing public panic and to protect commercial confidentiality. Enforcement is especially difficult for catered foods. In the absence of hard rules on information provision, inspectors are often unclear about compliance criteria. Even prosecutions following fatal incidents can be hampered by reliance on unwitnessed or contested dialogue between businesses and, sometimes deceased, customers. Consequently, many inspectors interpret the law leniently.

Overcoming these problems needs more than

# Testing times

What is the purpose of regulatory experiments?

**Javier Lezaun** and **Yuval Millo** look at two very different areas of experimentation: GMOs and options markets.

Regulators routinely conduct experiments. They run pilot programmes, create small-scale trials of future policies, and generally put their initiatives to test, before introducing them into the 'real world.' These regulatory experiments may take place prior to the announcement of a new policy, in the initial phase of policy implementation, or during moratoria – instances when government procedures are halted while a deeper investigation of their implications is carried out. Regardless of the timing of such experiments, what is common to all is that the course of traditional regulatory practice is altered, for a limited period, to allow authorities to assess the potential effects of their decisions under tightly monitored conditions. In what follows, we argue that regulatory experiments are an integral part of contemporary governance; they are increasingly used to bring certainty and resolution to complex governance issues. And yet, experiments, by their very nature, present the regulator with unanticipated dilemmas of validity and legitimacy.

We can draw a few preliminary lessons from the study of experimentation in the natural sciences. There, the ability of experiments to produce new information rests critically on the creation and maintenance of an 'experimental gap': materials and actors are isolated from their natural environment – their real world – so that they can be manipulated and closely observed, under conditions that would otherwise be absent. The separation from the real world that gives experiments their scientific value, however, also represents a political liability. Any experiment is open to validity challenges: to claims that it fails to replicate vital characteristics of the real world, and is therefore inapplicable. Experiments harbour thus an inherent tension: they need to be separated from the real world to produce valuable results, but their relevance depends on maintaining concrete connections with that world.

How then is experimental evidence translated into specific regulatory action? How is the separation between the experiment and the world bridged through concrete decisions in the domain

of rule-making? Let us look more closely at these dynamics with the help of two examples, one taken from the area of environmental regulation, the other from the governance of financial markets.

## **First Case: the experimental release of Genetically Modified Organisms (GMOs)**

In 1999, the British government established a number of experiments, known as the Farm Scale Evaluations (FSEs), designed to measure the effects of three herbicide-tolerant genetically modified (GM) crops (maize, oilseed rape, and beet) on farmland wildlife. In what it was claimed amounted to 'the largest scientific experiment of its type in the world,' plots of GM and conventional crops were planted side by side in hundreds of sites throughout Britain. The goal was to quantify the differential impact of the broad-spectrum herbicides used in combination with the new transgenic varieties. After four years of research, the experiment showed that the herbicides used in conjunction with the GM crops had detrimental effects on biodiversity in the case of oilseed rape and beet. The planting of GM maize appeared to be marginally beneficial.

As a purely technical exercise, the FSEs have been described as a rather expensive and time-consuming demonstration of the ability of herbicides to kill weeds. Yet, as a regulatory experiment, the FSEs have altered the contours of the public debate on GMOs, shaping the space of decision-making in which the regulator operates. They represent the most recent phase in a progressive scaling up of the experimental process to real-world dimensions, which began with the testing of GMOs in laboratories or greenhouses and continued to their planting in increasingly large fields.

Despite the growing approximation to a realistic scale, the experimental gap of the FSEs has become an obligatory point of reference for both critics and defenders of biotechnology. When the FSEs were still underway, environmentalists argued that the experiments would fail to analyse many key issues, such as gene flow and coexistence, and that the issues addressed would be framed

unrealistically, for example, by ignoring habitual patterns of crop rotation. At the same time, they complained that the process would release large quantities of possibly harmful organisms into the environment. When the results of the FSEs were published, environmentalists maintained this general critique, but were able to use the evidence of the FSEs on oilseed rape and beet to support their position. As a Friends of the Earth campaigner put it, 'these trials were never enough to give GM crops the green light, but they may provide enough information to give them the red one' (BBC News Online). In contrast to this interpretation of the 'experimental gap', advocates of biotechnology claimed that since the trials only measured the effects of herbicides, and not of the genetic modification of the crop, they could hardly prove any adverse effects of genetic engineering per se, and should therefore not be the basis of a regulatory decision on biotechnology.

Thus the gap between the experiment and the world became the space wherein the different sides of the debate articulated their arguments. But how did the experimental evidence affect the decision of the regulator? Certainly, the FSEs limited the number of potentially available options. A decision counter to or actively ignoring the evidence they had produced seemed unimaginable, particularly if the regulator chose to immediately authorise a crop shown to have a detrimental impact on biodiversity. Indeed, such an obvious contradiction of explicit experimental results did not take place. The environment secretary recently decided to allow the commercialisation of GM maize only, and with a number of restrictive conditions. Instead of justifying a blanket approval or a general ban, the regulator used the FSEs to disaggregate the category of 'Genetically Modified Organism' into individual crops, with disparate environmental impacts. In this context, the authorised GM maize became a regulatory bridgehead – a limited breach of the existing moratorium that may eventually lead to a permanent breakthrough in the regulatory stalemate. Rather than dispelling uncertainty and tracing a coherent long-term course of action, the





FSEs have served to justify the next step in a still uncertain regulatory terrain.

### **Second Case: the Options Pilot Programme**

Our second example of regulatory experimentation comes from financial regulation: the introduction of organised stock options trading in the US, which at the time, in the early 1970s, was a highly controversial decision. Stock options are leverage instruments: by selling options for a relatively low premium, market participants may take upon themselves disproportionately large future obligations. The financial regulator, the US Securities and Exchange Commission (SEC), viewed options and their impact on the economy with suspicion. Its main concern was that the approval would unleash forces they would not be able to regulate. The trading of options and the aggregated effect of obligation embedded in them might create pressures on the securities markets. In addition, the SEC feared that approving a standardised financial contract might open the floodgates: options would 'mutate' into a variety of assets and contracts, threatening the economic environment as a whole. The main proponents of options, on the other hand, the organised exchanges (which previously traded securities or commodities futures), claimed that the addition of options would help make the markets less risky and more efficient, contributing to a more stable economy.

In an attempt to resolve this dispute a regulatory experiment was set up in 1973. This experiment consisted of approving a pilot programme of options trading. In contrast to the genetically modified crops experiment discussed earlier, there could not be a separation between the 'laboratory' and the 'outside world'. While the FSEs involved an estimation of their effects on the environment by planting a number of well-demarcated experimental fields and comparing them with conventional counterparts, to appreciate the impact of options on the economy these new financial contracts had to be traded in actual markets. To assure that options could be studied, and that accurate information about them could be collected while

keeping their impact under control, the pilot programme included significant restrictions. The most important was that the SEC would have to approve each and every change in market procedures before they were implemented. The SEC would thus have authority to stop the operation of options markets, completely or partially, at any point.

The pilot programme was therefore a 'life size' regulatory experiment in which the 'laboratory' and the real world were one and the same. The crucial factor that turned it into an experiment was the SEC's ability to stop or alter any aspect of the trading. This restriction, the SEC hoped, would create a regulatory separation between options markets and the rest of the American financial system, but the restriction did not go uncontested. The exchanges that traded options, which did not want the development of the markets stifled by the duty to get approval for each change, challenged the validity of the pilot programme. They argued that the restrictions of the pilot programme (its experimental gap, in our analysis) invalidated the experiment's results: knowing that their behaviour would be scrutinised by the SEC, market participants would alter their decisions. 'Realistic' market behaviour would be substantially different from that of markets under the pilot programme.

The SEC terminated the pilot programme when the regulator realised that options markets were growing too fast for information about them to be collected and analysed properly. Following this decision, in 1976 the SEC and the exchanges agreed to place a moratorium on the addition of new options contracts, thereby freezing the growth of these markets.

Does the termination imply that the regulatory experiment had failed? Not necessarily. The experimental status attached to options proved to have a significant political value for the regulator. The exchanges were well aware that options trading was part of an experiment, and their agreement to the moratorium can be attributed, at least partially, to the experience of the pilot programme that preceded it. Without it, a decision

to impose a moratorium on options would likely have encountered much stronger resistance and would have carried with it a high political price. Although the regulatory experiment did not produce certain knowledge, it did help create an agreement between the regulator and regulated on the need for a temporal moratorium.

### **What do the two cases tell us about regulatory practice in contemporary society?**

The cases show that regulatory experiments rarely produce certainty. Not only does the evidence they generate admit multiple interpretations, the experimental gap itself becomes the subject of validity challenges. Sometimes, however, uncertainty is the most useful political outcome of an experiment, for it legitimises the regulator's decision to halt the regulatory process, or to act in a highly precautionary manner.

Experiments are difficult to ignore – they are designed to draw attention to specific variables and outcomes – and this framing function can be very relevant for the purposes of regulatory decision-making. As a result, experiments often redefine disagreements by directing the debate to the evidence produced in the tests. Regulators hope that experiments will form a commonly accepted point of reference, around which the public debate revolves.

In conclusion, experiments may not dispel uncertainty or produce the consensus necessary to chart a broad regulatory course, but they help define and legitimise specific decisions at important crossroads. This capacity to bring partial resolution to regulatory stalemates in times of intense controversy makes experiments a powerful political tool. Given their increasing centrality to strategies of techno-scientific governance, they deserve closer analytical scrutiny.

Javier Lezaun and Yuval Millo are ESRC Research Officers at CARR.



## The Stakeholder Route to Corporate Social Responsibility

**Joan O' Mahony** considers the long- and short-term causes of corporate stakeholding.

In its earliest expression, UK corporate social responsibility (CSR) was predominantly about charity. Victorian businessmen were often philanthropists, giving generously to the poor and providing health-care and educational opportunities for their workers. Contemporary CSR practice continues to be charitable: companies donate heavily to good causes and allow staff paid leave to work voluntarily in local communities. Yet, despite this apparent continuity, a major change has occurred. Individuals and organisations who are neither shareholder nor union member are demanding a say in how business defines, executes, and reports on responsibilities that are over and beyond those prescribed by law. With the rise of the idea of the 'stakeholder', companies are finding themselves with decreasing control over the civic practices with which they become engaged.

Why should such a change have taken place? There are three interrelated causes. First, modernisation and two world wars, for the UK in particular, has seen the decline of paternalism, the blurring of class boundaries, and a corresponding breakdown in deference to authority. As a result, it has become more acceptable to question the actions of organisations and to be suspicious of secrecy. Second, increased social complexity means that such willingness to question is accompanied by a greater anxiety or uncertainty about the answers received. There is a growing sense that no single person or agency can have all the answers, or all the solutions. There is then, a greater legitimacy in involving others in what was previously considered the domain of the expert. Finally, this growth in the willingness to question would have little impact if the beliefs and actions of individuals remained atomised. The third causal

factor in the rise of stakeholding is the huge increase in bodies, nationally and internationally, representing the interests of individuals: consumer associations, charities, single-interest groups, and NGOs.

These broad changes are behind the demand for a new type of corporate responsibility: a responsibility that not only accepts obligations, but which is also willing to enter into dialogue about them. Such broad changes are unlikely to be reversible. Thus, in one form or another, the 'stakeholder' and the demand for 'stakeholding' are here to stay.

The problem however is that we simply do not really know what stakeholding looks like, or what it should look like. According to most CSR company reports, stakeholding, in some sense, involves communication – with any group or individual likely to have an impact on business operations. The expected outcomes of such communicative initiatives are relationships of trust and goodwill: the very attitudes that produce cooperation among workers, that encourage innovation, and that secure the loyalty of customers and suppliers. These are the relationships that are necessary for companies to be able to take risks and to protect themselves from risk. Companies who can get it right, who can create permanent banks of trust and goodwill are, it is argued, more likely to increase lasting market value and to survive for longer.

But if communicative relationships, and their by-product trust, are key to success, there are few guidelines on how to build them. The UK Business in the Community (BiTC) has a 'tool-kit' for CSR beginners, but nowhere does it explain how stakeholding dialogue should proceed. The one-way conversations typical of the CSR annual report, company websites, or even the annual meeting,

often seem to be counter-productive for the building of trust. For example, a BiTC survey of financial journalists reported that most of them found CSR reports unhelpful and confusing. The lesson is that it is not simply communication that counts, but the quality of communication. Yet, while much research has been carried out on CSR in general – how to market it and measure it – there is little known about this most critical of areas: the intricacies of building long-lasting and meaningful dialogues between company and stakeholder.

The small amount of empirical research on such dialogues reveal the following. First, the type of communication most likely to foster trust is frequent, involves face-to-face interaction, and is two-way. Companies must be motivated to learn, not just to convince. Such communicative efforts are more likely to create the mutual awareness that is necessary in order to trust. Company and stakeholder are more likely to understand one another, even if they do not agree.

Second, all stakeholders matter, but they matter in different ways. Building good relationships with one group while ignoring another will not work. Stakeholders often exist in synergistic networks where reputation matters, and a poor relationship with one group may destroy the goodwill of another. Additionally, the synergistic relationships shared by a company and its multiple stakeholders are important, for they provide a check against the divide and rule strategies that are frequently the resort of managers engaged in stakeholding relationships.

Third, trusting in distrust is also important. Regulators and watchdog organisations must keep some distance from a company, and it is important that companies respect their professionalism. An NGO that gets too close to a company can lose the support of its own membership, and consequently its trust in a company becomes irrelevant.

Finally, stakeholding requires significant resources. Companies who cannot invest in it may be better served avoiding it, rather than risking more distrust from raising expectations that they cannot follow through on.

The stakeholding idea creates challenges for both business and academics. All involved recognise that there are limits to stakeholding's democratic potential. At some stage trade-offs appear between process and outcome, between for example, dialogue and company profits. For academics, much work needs to be done to find out where stakeholding can work and how relationships of trust can be built. For managers, the central challenge is how to negotiate the delicate balance of risks and benefits associated with the building of trusting relationships. These negotiations place the manager in a position similar to politicians who, as the sociologist Max Weber asserted, should meet the demands of both democracy and efficiency with imagination and courage, and with a recognition of values that are not reducible to the functions of the free market.

Joan O' Mahony is Leverhulme Special Research Fellow at CARR.

Ofcom is the new regulator for the UK communications industries. It recently published its Public Service Broadcasting Review (PSB). Here, **Ed Richards**, who led the review and is Senior Partner on Ofcom's Executive Board, talks to CARR.



**CARR: What are the two biggest obstacles Ofcom faces in fulfilling its functions?**

**ER:** The level of innovation is high, so the biggest obstacle is that we are constantly confronted by significant near-term challenges. The second difficulty is a much more mundane one: once you work inside a regulator, you discover how difficult it is to actually withdraw from regulation. We're trying to withdraw from direct regulation of broadcast advertising, and we've been castigated by the consumer bodies for doing so. It's also difficult with politicians: we were given about 200 new duties in the Communications Act compared to what the previous regulators had, and that was largely the result of the backbenches and the Lords adding new duties into the bill as it went through.

**CARR: Do you find the concept of 'risk' has any relevance in your work?**

**ER:** Yes, absolutely. We have to do cost of capital calculations, so risk is part of that in a very direct way. The other more general economic dimension is that how we regulate has an important impact on companies and investors' assessment of risk; we need to try to regulate in a way that reduces unnecessary regulatory risk. Another area where it comes into play is just organisational risk. We're a new organisation, merging five organisations. There are all sorts of risks associated with that, and we have to manage those organisational risks in a very careful way.

**CARR: Has Ofcom modelled itself upon, or emulated any other regulator?**

**ER:** We looked at the Financial Services Authority, particularly in relation to their consumer panel, and we've come out with a consumer panel that is pretty similar to theirs. Another comparison which we considered was the Bank of England. We thought about the extent to which we should publish minutes in the way they did, because there's an issue of accountability, an issue of transparency. On reflection, we decided we couldn't do that because so much of what was going through the Board was commercially sensitive. So we publish a note of what we've covered in the meetings, whereas the Bank of England publishes every word of the Monetary Policy Committee.

**CARR: What do you think are the benefits or perils of the new structure?**

**ER:** At the very least we will end up with a much more efficient regulator. The real benefit is that you get policy coherence between the communications sectors, particularly between spectrum use, telecoms, and broadcasting. Over time the relationship between broadcasting and telecoms is increasing, and it's very rare that you've got a public institution that is being created with a view to the future which, as a result, is slightly ahead of the curve. And I think that is of enormous benefit in such a heavily regulated area. The biggest peril is all the pressures of being new: when you're trying to merge five different organisations into one, it's a big management challenge.

**CARR: Under what circumstances would you like to see yourself cease to exist?**

**ER:** In the telecoms sector I definitely can envisage effective competition being established and regulatory withdrawal taking place. Broadcasting is more difficult, because you might have an

effective market for broadcasting and content, and that may address many of our concerns as consumers, but I don't think that it will address all our concerns as citizens. And I suspect there will still be a case for positive regulation in the sense of actual intervention to secure certain interests through what we've called public service broadcasting. It may not be on the same scale as it is today, but at the moment, I think the intellectual case for it is something that will endure 20 years from now.

**CARR: Were you taken aback by the reaction of the media to the PSB review?**

**ER:** The one thing that surprised me about the overall media reaction was the extent to which the media and the press media went hunting for anti-BBC stories. I knew they'd do that, but the intensity surprised me. What I underestimated was just how much, in a report of this breadth and scale and scope, many parts of the press would just go through it trying to find pieces of information or certain sentences that they could quote selectively in order to serve their particular interests. So we were taken out of context. It was alleged that the regulator attacked the BBC whereas that is not a fair representation of what we did at all.

**CARR: What happens to regulatory bodies under circumstances where rules are being fundamentally rewritten, when it's not just about implementation? For example, some of the discussions about top-slicing?**

[distributing a license fee to other broadcasters with public service requirements]

**ER:** Well, that's not an issue for us, that's an issue for the BBC. [But] if as a country we can't debate issues like top-slicing licence fees, or contestable funding, or the scale and scope of public service broadcasting in general, if we can't debate those things, the quality of our public debate is in a pretty parlous state. So, I am certainly against one thing: people being so defensive and paranoid that they try to close a debate of this kind down. These things need to be put on the table. It doesn't presuppose an answer and, to take that one example, we will weigh up very carefully the pros and cons of it in our second phase work.

**CARR: The term 'citizen-consumer' [in Ofcom's mandate] clearly reflects different preferences. How do you assess the consumer interest?**

**ER:** If you can establish effective competition, you are broadly speaking going to be serving the consumers' interest. I think the citizens' interest is much more difficult to assess. But in both areas what we try to do is to research it where we can. What do the public think about public service broadcasting? And which elements of it do they most value? That is in a sense, trying to unearth what the citizens interest is.

**CARR: What's your top tip to aspiring regulators?**

**ER:** People think of regulators as sort of necessary but bad – but it's an important public service. Good regulation is in the public interest, and that's a good thing to do. The second thing is that the communications sectors are just really interesting, fast moving, and fascinating. You couldn't find a better place to learn about them than in Ofcom, because we are in a position of being able to take a real overview.

**Ofcom**  
OFFICE OF COMMUNICATIONS

# Risk and Value Management



**Kieran Poynter**

Kieran Poynter has been Chairman of PricewaterhouseCoopers since the UK firm adopted LLP status on 1 January 2003. He has previously been Senior Partner and Managing Partner of the UK firm.

**M**anaging risk and ensuring security are critical for creating and sustaining shareholder value. Banks need to set about creating shareholder value in a way that fully recognises both the risks and the opportunities that are present in the markets in which they operate.

Most businesses arm themselves against risk with insurance, crisis management, and business recovery plans to thwart or cushion the impact of potential catastrophes. However, taking this traditional view of risk management leaves an organisation with a support function designed to reduce losses. In the long run this can lay the foundation for preparedness and security but it falls short on two counts. First, most risk management activities are developed and implemented at business unit level: they are very often not integrated into the core processes of the business. Second, businesses are prevented from harnessing the power of risks by matching them with opportunities, from converting risks into advantages that enhance shareholder value.

## Where does value come from?

One way that value is created is through informed and inspired management decisions in all spheres of commercial activity from strategy to operations; by necessity, these involve taking risks. Such management requires the continual reassessment of the future market and competitive environment, the continual re-deployment of precious resources, and the continual delivery of superior cost-competitive products and services to meet the changing needs of

customers. This is a little different from what many would describe as the source of value, since we are often more accustomed to thinking about value in terms of highly refined, and slightly abstract, business metrics such as Economic Profit (EP), Shareholder Value Added (SVA), or Risk Adjusted Return on Capital (RAROC). These are all valid in different ways, and share the basic feature that the cost of capital must be covered before value is created. The cost of capital is determined by (i) the volume of capital tied up in the business, and (ii) the rate at which that capital is charged. The rate at which capital is charged is partly a function of the risks borne by the providers of that capital. Accordingly, if managers can develop business plans and performance targets which strike an optimal balance between maximum returns, minimum capital, and minimum risk, they will maximise the value created.

But what if things don't turn out quite as planned? What if the competitive landscape changes? What if opportunities are missed because management is too busy executing a business plan that was devised nine months ago?

The reality is that we do not live in a deterministic world where it is always possible to plan and calculate your way to value creation. Rather, the challenge is to create and sustain shareholder value in a world of constant change, and of considerable uncertainty. This might sound like bad news. It will be for some, but for others – those who can embrace and make use of these phenomena – it is very good news indeed.

## The significance of change, uncertainty, and risk

Why do companies and investors need to understand risk? For many, risk is included in the model via a risk premium on the cost of capital. Simplistically, we need to know about a company's risk because it tells us what returns are required to compensate for risk. However, we would suggest that the significance of risk extends beyond the computation and manipulation of an economic performance adjustment factor: risk is there to be managed.

## Solvency

At one level, this is manifested in the question of solvency, and whether there is sufficient capital to bear extreme levels of loss. This is the preoccupation of regulators and rating agencies, whose primary interest is to protect the interests of creditors, customers, and the wider financial system. However, the question of solvency links to shareholder value through the determination of minimum capital levels (thereby limiting the scope for financial leverage) and credit ratings (thereby 'charging' equity holders for the risks borne by debt holders, customers and others).

## Variability in returns

At another level, variability in returns needs to be interpreted by managers and investors to determine whether their strategies are working, and whether expectations for future cashflows should be revised. If there is no sense of what constitutes a reasonable range of expectations, then there can be no context



within which to assess the significance of performance variations. Thus, managing the business to reduce earnings variability and managing internal and external expectations with respect to earnings variability have clear links to value.

**Impacting the numerator**

But there is a still more compelling aspect to this. An understanding of risk can help identify where opportunities exist to influence future expected outcomes through risk management. Traditional value-based management methods focus on pulling 'value levers' in a deterministic sense; linking risk and value management extends this concept to include factors over which management may not have absolute control, but over which they may be able to exert some degree of influence.

Consider the effect of a business continuity plan. The value proposition here is that plans are developed in advance which have the effect of mitigating the potential negative cashflow and earnings impact of some sort of calamity. By reducing the likelihood of loss, the 'expected' outcome is enhanced. Assuming the costs of developing the plan are more than covered by this shift, the enterprise has a higher expected value as a result. This is an instantaneous outcome, and is independent of any presumption that calamity subsequently strikes.

On the upside, supposing there is uncertainty about whether a particular retail banking product will gain market acceptance. Should management simply accept that uncertainty and hope for the best? Or should they take measures to enhance the likelihood of its acceptance, for example by researching customer preferences and tailoring the product, or the marketing message, to appeal directly to those preferences? If this results in a higher expected probability of success, and the resulting shift in the distribution curve more than covers the costs of the programme, then intrinsic value is necessarily and instantaneously boosted.

**A comprehensive risk and value framework**

In promoting comprehensive integrated risk and value management, I would advocate the closer integration of risk and value management disciplines and processes. This involves developing a clearer understanding of the dynamics of risk and value in the business, and creating processes and structures to improve business management with the benefit of that understanding.

For example, in relation to the three

key dimensions of investment and management, financial risk engineering, and communication, the integrated risk and value management framework can help answer the following questions in the table below (figure 1).

What is the starting point for integrated risk and value management? One approach is to build considerations of change and uncertainty into existing management processes and metrics.

Take the business planning process for example.

The business plan formalises corporate strategy for a particular time-frame; there are three important principles to be followed.

**Plan for risk**

Business plans should be formulated in probabilistic rather than deterministic terms. Management and the Board should be comfortable not just with the expected outcome from following strategy, but also with potential outcomes which fall short of expectations to a defined level of confidence. This process can also alert management to the existence of further value creation opportunities: if risks involved in scenarios can be anticipated and either eliminated or mitigated at the planning stage, there will be an immediate beneficial shift in intrinsic value.

**Promote risk 'ownership' and accountability at all levels**

The process of anticipating and defining the distribution of future business outcomes should cascade up and down through the business. This is analogous to the regular budgeting process whereby business units and corporate functions are tasked with submitting

their draft budgets for consolidation and challenge at the corporate level. This forms the basis for the creation of a consolidated corporate plan which integrates risk funding into the value creation of the business.

**Be flexible to changing circumstances**

The business plan should not lock management into following a particular course of action for the duration of the planning period. Just as annual business plans are formulated in the context of a longer term strategic plan, so the management system should promote the continuous reformulation of strategy as circumstances dictate. In practice, this process may take the form of periodic restatements of the plan, with an emphasis on defining expectations and variations, and linking this into a revised management agenda at multiple levels in the organisation.

The definition of future business scenarios should combine both quantitative data analysis and qualitative expert judgement on the part of managers. These various inputs are iteratively consolidated and reconciled to the point where a comprehensive picture of risk and value emerges from both top-down and bottom-up perspectives. With successive iterations of this process, management will be able to create this

picture without much more additional effort than is anyway required for regular budgeting purposes.

Furthermore, the risk and value models which are developed as part of this can be used to support high level revisions of the business plan and changes in strategy as key assumptions vary and major uncertainties are resolved.



Figure 1: Integrated Risk and Value Management

<b>Investment and Management</b> <i>influencing business outcomes</i>	<b>Financial Risk Engineering</b> <i>taking risk to market</i>	<b>Communication</b> <i>informing market perceptions and expectations</i>
<ul style="list-style-type: none"> <li>• How should I incorporate risk into my strategic planning process?</li> <li>• Are my investment plans robust to changes in my business environment?</li> <li>• How should I select between alternative risky projects?</li> <li>• How should I allocate capital between diverse business units in a way that maximises value for the group?</li> <li>• Does my performance measurement and incentivisation system stimulate the right behaviour?</li> <li>• Can I create excess returns through portfolio management?</li> </ul>	<ul style="list-style-type: none"> <li>• How can I reduce my cost of capital?</li> <li>• Do I have sufficient capital in my business (or too much)?</li> <li>• What is the 'value' of reducing risk in my business?</li> <li>• What is the optimal capital structure and dividend policy to support my growth plans?</li> <li>• How should I structure my insurance programmes? Should I self insure?</li> <li>• Should I be targeting a particular credit rating?</li> <li>• How should I structure the financing of major projects?</li> </ul>	<ul style="list-style-type: none"> <li>• Why doesn't my share price reflect the intrinsic value of my business?</li> <li>• How should I 'read' market signals in relation to share price, debt margins and investor/analyst feedback?</li> <li>• How can I better manage market expectations in relation to risk and value outcomes?</li> <li>• How do I obtain a common language for discussing risk and value issues within my business?</li> <li>• What levels of disclosure are appropriate? How can I gain from greater disclosure, and how might I lose?</li> </ul>

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

### Soft Risks, Hard Lessons: using corporate governance to manage legal, ethical and reputational uncertainties

University of Cambridge, January 2004

A joint workshop organised by the Centre for Business Research, the Forum for Philosophy in Business and CARR.

This one-day event on corporate governance and related ethical issues featured keynote addresses by Onora O'Neill, Principal of Newnham College, Cambridge and 2002 Reith Lecturer, and Charles Fombrun, formerly professor of management at the Stern School, New York and currently executive director of the Reputation Institute.

Professor O'Neill gave a talk entitled 'Intelligent Trust and Intelligent Accountability'. She argued that the extensive use of managerial methods for accountability purposes has damaged and distracted professional cultures, and that defensiveness has come to dominate at the expense of informed judgement. Managerial conceptions of accountability have also deflected attention from the need to define the primary, substantive obligations of agents to right bearing principals. Defining accountability primarily as 'answerability', O'Neill suggested a form of more

intelligent accountability grounded primarily in dialogue with right holders.

In his talk on corporate reputation and risk, Professor Fombrun argued that it is not only our society that is obsessed with celebrity: 'the star system has also happened to our companies.' The era of deregulation and liberalisation of markets fostered enormous forces of competition between companies and products, and competition for money, talent, knowledge and attention. While this has generated significant wealth creation and business growth, the more negative consequence has been a 'winner takes all' mentality in both society and business, in which all the attention is focused on a few individuals. As a result a few companies are making huge incomes while many others are barely surviving.

This was the reason for the series of business scandals over the last two years that have engulfed corporates such as Enron, Tyco, Adelphia and WorldCom. Fombrun went on to consider how reputation could be used to regulate corporate misbehaviour. Companies' reputations, he said, were valued far more by the markets than by accountants; therefore companies put a lot of emphasis on branding and marketing themselves in order to gain the support of investors.

Amongst the participants were Adrian Cadbury, father of the modern corporate governance movement, and representatives from the Foundation for Independent Directors, Reuters, accountants BDO Stoy Hayward, and The Change Partnership.

### Business History and Regulation

University of Southampton, March 2004

CARR, in association with the University of Southampton's Centre for Research in Accounting, Accountability and Governance, held a workshop on 'Business History and Regulation' on 3 March 2004. This third and last of the business history interdisciplinary workshops was led by business historian Terry Gourvish; it brought together economists, political scientists, management

scientists, accountants and historians to debate regulatory processes.

Peter Casson, University of Southampton, opened the workshop with a paper on 'A Study of Institutional Change: the Finance Act 1989 and Employee Share Ownership Plans'. Examining experience in both the US and UK, Casson showed how the incentives offered by the institutional structure can lead to outcomes other than those intended by the legislators. Gerald Burke (University of Oregon), spoke on Organising Economic Diversity: Antitrust, Associations and Accounting in the United States, 1906-25. Burke was concerned with the efforts of Louis Brandeis and others to encourage 'associational antitrust' and improved methods of cost accounting in the United States in the name of 'regulated competition'. He offered some interesting data to support his contention that these interventions had a positive impact in terms of higher productivity.

Among several provocative issues was the question: does capitalism function more responsibly with high or low information flows? Tony Arnold (University of Exeter) and Sean McCartney (University of Essex) examined 'Regulation and Strategic Policy Formulation in the British Railway Industry, 1870-14'. In an innovative contribution that provided new data on railway profits and concentration levels, they examined the impact of the regulation of Britain's private railway companies before the First World War. Key themes were the fluctuations of public policy towards mergers, and the response of the private sector towards these fluctuations.

Finally, Forrest Capie (City University) offered a provocative interpretation of financial regulation in Britain over the last three centuries. Extensive regulation in the 18th century gave way, first to deregulation in the 19th century, and then to self-regulation in the 20th. Capie pointed out that the age of 'neo-liberalism' has seen extensive additions to the regulatory framework. He highlighted the role of financial crises in encouraging change.



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More information on CARR events can be found on CARR's website, [www.lse.ac.uk/Depts/carr](http://www.lse.ac.uk/Depts/carr)

# Auditing and Insurance



One of CARR's objectives is to establish links with practitioners and policy makers in risk management and regulation, both to communicate and disseminate research findings, and to gain access and insights into the worlds of practice. The inclusion of practitioners in workshops and seminars is part of this strategy. Two recent workshops were particularly successful in this regard: *Challenging Insurability, Flood Management and Insurance Regulation* in December and *Auditing in Action* in February.

The Aon workshop on *Challenging Insurability*, organised by Michael Huber, brought together an interesting mix of academics and practitioners to discuss historical and institutional aspects of flood insurance. The insurability of events is more problematic than ever before. On the one hand, the increased sophistication of risk management tools suggests that virtually all events can be insured; on the other hand, the growth of risks has been taken as an indicator of decreasing insurability. This tension has brought a political dimension to defining and clarifying the responsibilities and limitations of insurance, especially in the field of weather-induced risks. The conference was largely concerned with explicating such features and problems, and with indicating potentially viable solutions to them. The empirical focus was on flood insurance, a topic that is currently high on the public agenda in both developed and developing countries.

David Crichton (Middlesex University and UCL) compared the English, Scottish and Welsh institutional setting of flood insurance. Peter Zimmerli (Swiss Reinsurance Company, Zurich)

and Andrew Dlugolecki (Climate Research Unit, University of East Anglia) described the different institutional arrangements for flood insurance across the developed and developing world. Reimund Schwarze (Deutsches Institut für Wirtschaftsforschung, Berlin) presented the results of a consultancy project to introduce private flood insurance in Germany. The historical dimension of insurability was emphasised by Geoffrey Clark (State University of New York at Potsdam). And finally, Michael Huber (CARR) gave an account of how models of private-public flood insurance regimes are negotiated.

The ESRC workshop *Auditing in Action*, organised by Michael Power and Christopher Humphrey (University of Manchester), brought academics and practitioners together to discuss a range of issues about the audit process, particularly pertinent in the wake of the apparent failure to detect a large fraud at Parmalat. The papers presented were all field studies of auditing, and two contributions dealt specifically with the business risk audit (BRA) model. Christopher Humphrey (with Rihab Khalifa (LSE) and Keith Robson (UMIST) argued that BRA was much more than a technical innovation and was part of a repositioning of the professional identity of auditors as advisers and consultants; a process which was undermined by the collapse of Enron. Robert Knechel (University of Florida) traced the history of risk-based auditing, arguing that it was born in a climate of cost pressures on auditors. There was a lively panel session discussing the future of auditing, led by Jonathan Hayward (Independent Audit), Martyn Jones (Deloitte), and David York (ACCA). Auditing is an essential resource for

regulatory systems and in the wake of Enron and Parmalat pressures for the reform of auditing have been great. However, the technical dimension of auditing has always been relatively immune from these pressures, changing slowly, and often regarded as a 'black box' by regulators. It was argued that this was set to change with the development of new standards by the International Federation of Accountants. Some practitioners expressed concern that new regulatory arrangements could change the incentives to audit, leading to an undersupply of good auditing; but this market failure scenario was doubted by others. This discussion was followed by two detailed studies of the audit decision process in Scandinavia (Stig Westerdahl, Mid Sweden University; Peter Ohman and colleagues from Mid Sweden University, Lulea University of Technology and the University of Oslo). Finally, Jean Bedard (Laval University) presented empirical work on how audit committees construct themselves as effective and credible bodies in organisations.

These two workshops show that, in different ways, both insurance and auditing are critical risk management technologies operating at the base of many regulatory systems. Apparent failures in these practices, either because the limits of insurability are reached or because of frauds and corporate collapses (also suggesting limits to 'auditability'), tend to have far-reaching consequences, not least the increased regulation of these tools of risk management themselves.

Full abstracts and details of seminars can be found on the CARR website: [www.lse.ac.uk/Depts/carr](http://www.lse.ac.uk/Depts/carr)

## Regulation of the NHS in England

Gwyn Bevan, LSE  
11 November 2003

NHS organisations face two instruments of regulation: clinical governance and performance (star) ratings. Clinical governance is a system of steps and processes to ensure high quality patient care. Performance (star) ratings are based on key targets, a wider set of indicators, and results of clinical governance reviews. Both instruments are undertaken by the Commission for Health Improvement (CHI) which is soon to be replaced by a new inspectorate with wider powers: the Commission for Healthcare Audit and Inspection (CHAI). Prof Bevan explored the regulatory issues arising from this and new policies being introduced which emphasise patient choice and payment by results.

## Beyond National Styles of Regulation – GM food in Germany and the US

Astrid Epp, Bielefeld University  
25 November 2003

The transatlantic divide on biotechnology is exemplified by the varying public response over the introduction of GM food, and in the regulatory approaches to the issue. On the surface, legal regulations in the US seem to be less strict than in Europe. National differences in the legal regulation of similar issues are predominantly explained by reference to the particular regulatory style of a given country: the 'national styles approach'. Epp presented a comparison of German and US regulatory approaches to GM food, and argued that a focus on the interorganisational networks that emerge around an issue allows for a better understanding of the regulatory process.

## Decentralisation of European Economic Law

Dr Myriam Senn  
Swiss Federal Banking Commission  
9 December 2003

Interest in decentralising governance is increasing all over the world. In European economic law, the regulation of the implementation of competition rules introduces a decentralised enforcement system. In financial services law, the proposal for a new directive on investment services is to introduce a four-level regulatory approach which centralises rule-making while enforcement remains decentralised. Dr Senn examined these regulatory structures, taking into account that they raise different issues of coordination and the delegation of power and control.

## Rules and Discretion in the Design of a Procurement System

Dr Steve Kelman, Harvard University  
13 January 2004

Dr Kelman was responsible for an effort to deregulate the process by which the US government procured goods and services, part of the Clinton Administration's 'Reinventing Government' programme. He discussed conceptual, philosophical and jurisprudential arguments for greater reliance on rules versus greater room for discretion in the management of government procurement (and, by extension, in other areas of government regulation and/or public management). Kelman went on to discuss the specifics of de-regulation in the context of public procurement in the US, and finally drew a contrast between administrative law and public management approaches to the government's self-regulation.

## The Ensuring State and Modes of Regulation

Professor Gunnar Folke Schuppert  
Social Science Research Centre, Berlin  
10 February 2004

The concept of the 'ensuring state' develops upon the idea of the 'enabling state' by emphasising the responsibility of the state in areas where non-state agents play a dominant role in the provision of public services. Even if public goods or services are provided by external bodies, the state still has a major role in ensuring these public goods, whether it is by audit, regulation, or funding. Modern governance is centred around the business of regulation, because without the appropriate regulatory framework the ensuring state would not function. Prof Schuppert concluded that new forms of regulatory regimes, like 'co-regulation' at the European level, might facilitate this form of 'governance with society' to evolve.

## Law as a Last Resort

Professor Keith Hawkins, Oxford University  
9 March 2004

In almost all types of legal disputing, formalities are employed only as a last resort. Case attrition is a constant feature in the legal system, because pre-trial negotiations are employed to search for solutions that avoid the costs, risks, and delays of trial. Prof Hawkins outlined and applied a theory of legal decision-making in the context of the regulation of occupational health and safety. He focused on the forces acting on the creation, handling, and disposal of cases in a regulatory agency, addressing in particular the conditions under which legal officials deal with a problem by electing the public and consequential – but highly unusual – course of going to court.

## Getting to Grips with Regulatory Quality

Professor Claudio Radaelli, Bradford University  
16 March 2004

Recent European regulatory reforms have focused on 'good regulation' and 'regulatory quality'. Yet policy-makers who have sought to import specific instruments and 'new' approaches to law-making from their original Anglo-Saxon context to other European contexts have found it difficult to implement successful programmes. One reason for this is that the notions of quality that circulate in the current debate are insensitive to context. Another is that 'success' means different things to the politician, the bureaucrat, and the technocrat. This paper explains the diffusion of regulatory impact assessment (RIA) in continental European countries by using 'context' and the interaction between different logics in RIA as explanatory variables.

## Corporate Social Responsibility as a New Self Regulation

Ben Hunt, Author, *The Timid Corporation*  
27 April 2004

In 1995, Shell set a precedent for future behaviour when it decided to reverse its decision to dump Brent Spar into the sea. This early example of corporate social responsibility (CSR) illustrated how a moral duty to do 'the right thing' replaced more reasoned scientific criteria for making decisions. Nearly ten years on, we see that notions of corporate social responsibility are influencing business behaviour like never before. Yet is CSR a progressive development? Hunt argued that CSR is a response to a more insecure, mistrustful society that tends to see all industrial activity from the one-sided perspective of harm and risk. He noted that an inflexible dogma of social or moral responsibility is replacing pragmatism and commonsense in decision-making.

## FORTHCOMING LUNCHE TIME SEMINARS

22 June 2004

### Catastrophic Risk, Insurance and Terrorism

Professor Richard Ericson  
University of Oxford

12 October 2004

### New Social Risks in Europe

Professor Peter Taylor-Gooby  
University of Kent

9 November 2004

### Science: A puzzling profession?

Professor Robert Dingwall  
University of Nottingham

Further seminars for Autumn Term 2004 to be arranged.



**CARR Books and Special Journal Editions**



**New**  
**Regulating Law**  
 Christine Parker, John Braithwaite, Nicola Lacey and Colin Scott  
 Oxford University Press 2004



**Preparing for the Future: Strategic Planning in the U.S. Air Force**  
 Michael Barzelay and Colin Campbell



**Business and Politics in Europe, 1900 – 1970: Essays in Honour of Alice Teichova**  
 Terry Gourvish, ed



**On Different Tracks: Designing Railway Regulation in Britain and Germany**  
 Martin Lodge  
 Greenwood Press 2002



**British Rail 1974-97: From Integration to Privatisation**  
 Terence Gourvish  
 Oxford University Press 2002



**The Labyrinths of Information – Challenging the Wisdom of Systems**  
 Claudio Ciborra, Oxford University Press 2002  
*'a series of highly literate jewel-like essays that are*

*intellectually fascinating but could also change the life of any practitioner.'*  
 Shoshana Zuboff, Harvard Business School



**Environmental Policy in Europe: Assessing the Costs of Compliance**  
 Andrew Gouldson and Evan Williams (Eds)  
*European Environment* 12 (5) 2002



**The Politics of Delegation: Non-Majoritarian Institutions in Europe**  
 Mark Thatcher and Alec Stone Sweet (Eds)  
*West European Politics* 25 (1) 2002



**Biotechnology 1996-2000: The Years of Controversy**  
 George Gaskell and Martin Bauer  
 London: Science Museum Press and Michigan State University Press 2001



**From Control to Drift: The Dynamics of Corporate Information Infrastructures**  
 Claudio Ciborra and associates  
 Oxford University Press 2001



**The Government of Risk: Understanding Risk Regulation Regimes**  
 Christopher Hood, Henry Rothstein and Robert Baldwin  
 Oxford University Press 2001  
*'...a significant contribution to the existing literature on risk regulation.'*  
*West European Politics*



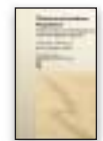
**Regulation and Risk: Occupational Health and Safety on the Railways**  
 Bridget Hutter  
 Oxford University Press 2001  
*'...a classic and deft piece of socio-legal scholarship ... sure to have an enduring impact on the debate.'*  
*Public Law*



**Cranston's Consumers and the Law (3rd ed.)**  
 Colin Scott and Julia Black  
 Butterworths 2000



**Regulation Inside Government: Wastewatchers, Quality Police and Sleaze-busters**  
 Christopher Hood, Colin Scott, Oliver James, George Jones and Tony Travers  
 Oxford University Press 1999



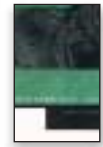
**Telecoms Regulation: Culture, Chaos and Interdependence Inside the Regulatory Process**  
 Clare Hall, Colin Scott and Christopher Hood  
 Routledge 1999



**The Politics of Telecommunications**  
 Mark Thatcher  
 Oxford University Press 1999  
*'an excellent comparative study, rich in empirical findings, given analytical focus by an explicit theoretical framework.'*  
*Government and Opposition*



**The Audit Society: Rituals of Verification**  
 Michael Power  
 Oxford University Press 1999  
*'A book like this – so rich in ideas, observations and interpretations – has to be taken seriously.'*  
*European Accounting Review*



**A Reader in Environmental Law**  
 Bridget Hutter (Ed.)  
 Oxford University Press 1999  
*'a timely and useful bringing together of major socio-legal statements on the law.'*  
*Environmental Law Review*



**Rules and Regulators**  
 Julia Black  
 Oxford University Press 1999  
*'a refreshing book that addresses the question of 'self-regulation' in a new way.'*  
*Modern Law Review*

## CARR Discussion Papers

### COMING SOON

**DP24 The Battle for Hearts and Minds? Evolutions in organisational approaches to environmental risk communication**  
Andy Gouldson, Rolf Lidskog and Misse Wester-Herber

**DP23 Creation of a market network: the regulatory approval of Chicago Board Options Exchange (CBOE)**  
Yuval Millo

**DP22 The Interaction of 'Civil' and Public International Regulation: lessons from the Energy and Biodiversity Initiative**  
Stephen Tully

**DP21 Access to Justice within the Sustainable Development Self-Governance Model**  
Stephen Tully

### AVAILABLE NOW

**DP20 Justifying Non-Compliance. A Case Study of a Norwegian Biotech Firm**  
Filippa Corneliusson

**DP19 The Impact of Regulations on Firms. A Study of the Biotech Industry**  
Filippa Corneliusson

**DP18 Reforming the UK Flood Insurance Regime. The Breakdown of a Gentlemen's Agreement**  
Michael Huber

**DP17 Mapping the Contours of Contemporary Financial Services Regulation**  
Julia Black

**DP16 The Invention of Operational Risk**  
Michael Power

**DP15 Precautionary Bans or Sacrificial Lambs? Participative Risk Regulation and the Reform of the UK Food Safety Regime**  
Henry Rothstein

**DP14 Incentives, Choice and Accountability in the Provision of Public Services**  
Timothy Besley and Maitreesh Ghatak

**DP13 Regulating Parliament: the regulatory state within Westminster**  
Robert Kaye

**DP12 Business History and Risk**  
Terry Gourvish

**Business Risk and Antitrust: comparative perspectives**  
Tony Freyer

**The Risks of Working and the Risks of Not Working: historical perspectives on employers, workers, and occupational illness**  
Joseph Melling

**DP11 Strategies, Methods and Reactions: questioning the open method of co-ordination**  
Martin Lodge

**DP10 Drivers and Drawbacks: regulation and environmental risk management systems**  
Marius Aalders

**DP9 Conceptualising Insurance: risk management under conditions of solvency**  
Michael Huber

**DP8 Social Licence and Environmental Protection: why businesses go beyond compliance**  
Neil Gunningham, Robert Kagan and Dorothy Thornton

**DP7 Neglected Risk Regulation: the institutional attenuation phenomenon**  
Henry Rothstein

**DP6 Mass Media and Political Accountability**  
Timothy Besley, Robin Burgess and Andrea Pratt

**DP5 Embedding Regulatory Autonomy: the reform of Jamaican telecommunications regulation 1988-2001**  
Lindsay Stirton and Martin Lodge

**DP4 Critical Reflections on Regulation**  
Julia Black

**DP3 The New Politics of Risk Regulation in Europe**  
David Vogel

**DP2 The EU Commission and National Governments as Partners: EC regulatory expansion in telecommunications 1979-2000**  
Mark Thatcher

**DP1 Regulating Government in a 'Managerial' Age: towards a cross-national perspective**  
Christopher Hood and Colin Scott

**DP0 Is Regulation Right?**  
Robert Baldwin

**Business Risk Management in Government: pitfalls and possibilities**  
Christopher Hood and Henry Rothstein

**Risk Management and Business Regulation**  
Bridget Hutter and Michael Power

## Selected Recent Publications

**Give Chance a Chance: Random Reflections on Targets, Inspections and Transparency**

Gwyn Bevan and Christopher Hood  
*British Medical Journal* 328 (7440)  
2004: 598.

**Regulating Law – the case of finance**

Julia Black  
In C Parker, J Braithwaite, N Lacey and C Scott (eds.) *Regulating Law*, Oxford University Press, 2004.

**Patents and Pollution**

Javier Lezaun  
In N Stehr (ed.) *Biotechnology: Between Commerce and Civil Society*, Transaction Books 2004.

**Constructing a Market, Performing Theory: The Historical Sociology of a Financial Derivatives Exchange**

Yuval Millo and Donald MacKenzie  
In R Swedberg (ed.) *New Developments in Economic Sociology*, Edward Elgar, 2004.

**Regulation in the Age of Governance: the rise of the post regulatory state**

Colin Scott  
In J Jordana and D Levi-Faur (eds.) *The Politics of Regulation*, Edward Elgar, 2004 (also published as National Europe Centre Working Paper no 100, Canberra: Australian National University).

**Winners and losers in Europeanization: reforming the national regulation of telecommunications**

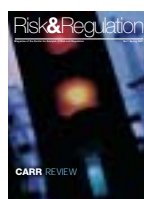
Mark Thatcher  
*West European Politics*, April 2004.

**Now available in paperback**

**The Government of Risk: understanding risk regulation regimes**

Christopher Hood, Henry Rothstein and Robert Baldwin  
Priced £18.99 and also available online through Oxford Scholarship  
Online: [www.oxfordscholarship.com](http://www.oxfordscholarship.com)

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