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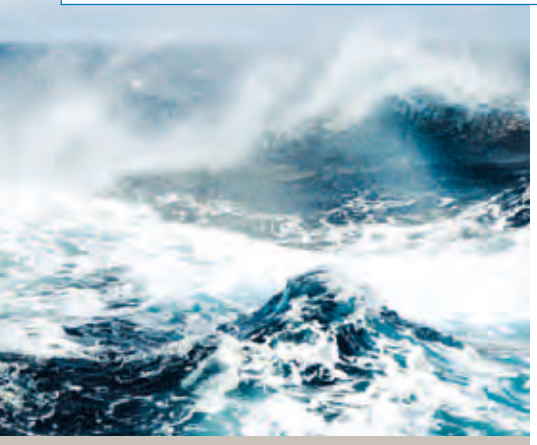

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Editorial

CARR Director **Mike Power** sketches the challenges of the Centre's new research project on risk culture in financial organizations.

CARR has been awarded funding under the Economic and Social Research Council's (ESRC) co-investment pilot scheme for a project on "risk culture in financial organizations". ESRC support is conditional on matched co-funding with other parties, and we have been successful in securing the further support needed from the Chartered Institute of Management Accountants (CIMA), the Chartered Insurance Institute (CII), and the Lighthill Risk Network. My thanks go to all these bodies and also to the Knowledge Transfer Network for Financial Services, which has acted as a broker for this research partnership. Future editions of *Risk & Regulation* will report on the results of our work.

There has been much talk of "risk culture" as one of the root causes of the financial crisis which began in 2008. It is widely accepted that there were cultural barriers to robust risk assessment in banks and a systematic failure to challenge high risk practices. Yet little in this diagnosis is genuinely new. For many years we have known that things rarely fail because of lack of information or knowledge (the exception being the lack of knowledge about systemic interconnectedness in credit markets). Rather, accidents and disasters are usually preceded by many smaller, less noticeable events and warnings which organizations find hard to process and make actionable.

These early warnings and missed opportunities for action have interested organization scholars for several decades. Barry Turner's work was pioneering in this respect. He coined the term "incubation period" to describe the timeframe over which disasters unfold; they are never truly sudden events, although actors are always surprised. In the context of "high reliability" organizations dealing with, for example, public transport and nuclear energy, scholars and practitioners have focused on the need to enhance "safety culture". And Diane Vaughan's classic study of the Challenger launch decision in 1986 added the powerful idea of "normalized deviance" to our analytical vocabulary. Applied to financial institutions prior to 2007, there is broad agreement that reckless and uncontrolled trading activity became normalized, not just for banks but also for their regulators. Those who, at the time, could see the underlying pathology of this normalized activity typically found themselves marginalized and deprived of authority.

This body of work provides the foundations for our future research into risk culture in financial organizations. However, the very category of "risk culture" poses methodological challenges. We don't really know precisely what "risk culture" is or refers to, and we should not presume to know in advance the very thing that is puzzling. Of course, many practitioners have views on what risk culture is, and we shall be seeking these views and looking for common themes. But it may be that the very idea of risk culture is more a symptom of other things than a clear object of management. So we need to find out more, focus on identifiable elements of organizational culture and seek to understand the ways in which they are relevant to, and intertwined with, risk management. Yes, incentives are likely to be crucial; yes, CEO leadership and "tone at the top" will also be important. But we also expect to find new factors and relationships which will be pertinent.

Another challenge for the risk culture project is that it is explicitly intended as a form of knowledge exchange. We must jump the high bar of our own scientific standards – there is no negotiation on this. But we also have a requirement to feed back our findings in a concrete way which is potentially useful for, say, Chief Risk Officers and regulators as they think about risk culture. Culture is typically not something that can be switched on and off, so the development of any kind of management instrument in this space is fraught with difficulties. In addition, we know that there are already several risk culture "dashboards" out there in the market place.

My co-travellers on this project – Simon Ashby at the University of Plymouth and Tommaso Palermo at LSE – and I are very excited by these challenges, but we are also cautious. We are looking forward to working closely with the large number of CROs who have expressed interest and support for the project, but we will also need to maintain our distance as analysts, since this is the best way to leverage real value from our efforts. To come up with something which has both scholarly and use value is a difficult balancing act. Furthermore, history shows that organizational failure is desirable provided that the externalities are not too great. So while we look forward to carrying out this research, we know that there may be better ways of mitigating those externalities than trying to manage something called "risk culture".

Mike Power
CARR Director

Hubris Risk

The European leaders establishing the euro, argues **Jon Danielsson**, were guilty of hubris risk, letting politics dominate the economic reality. Their successors now trying to resolve the sovereign debt crisis are repeating that mistake.

The European sovereign debt crisis is no different to most other crises. Of course, the specifics are different – just enough to bedevil the authorities. To complicate matters, it is really two crises in one: a sovereign debt crisis and a policy response crisis. Of the two, the latter is the one doing the damage.

The underlying direct causes are now quite familiar: political desire for strong ties between European countries acting as the driving force of the European common market and the monetary union. History tells us that the success of such unions hinges critically on several factors, most importantly on a common fiscal policy and a sense of single national identity. Both are lacking in Europe.

By ignoring the necessary conditions, the European leaders establishing the euro were guilty of what might be termed *hubris risk*. The dictionary defines hubris as excessive pride or self-confidence; the word itself comes from Greek tragedies. Hubris was a driving force in creating the euro. It is now the biggest threat to European integration.

Sovereign defaults and corporate defaults

Sovereign defaults are different from corporate defaults. A company goes broke when its debts exceed its assets, leading to restructuring or liquidation within a well defined legal framework. Countries don't go bankrupt nor are they usually liquidated – with the single exception discussed below.

A country defaults because the government wants it to default, presumably after a cost-benefit analysis has weighed the cost of debt service against the losses incurred due to default. This means that countries tend to default long before they stop being able to service debt.

This voluntary nature of sovereign debt defaults is one aspect ignored by the architects of the euro. If a country does not want to pay, creditors have to resort to extreme methods for enforcing sovereign debt.

Newfoundland

In the long history of sovereign debt crises, creditors have resorted to a variety of extreme measures. However, they have never used liquidation in the same way that a corporation is liquidated – except in the case of Newfoundland. We follow this story as told by Hale (2003).

Newfoundland is situated on the eastern extremity of Canada. It used to be a British Dominion, like Canada or Australia, and by 1933 its sovereign debt was about three times its GDP. The government asked the British government for help. The British government obliged by sending a Royal commission, which promptly declared: "No part of the British Empire has ever yet defaulted on its loan obligations." The commission proposal was that Newfoundland temporarily give up its independence to a UK appointed administration, which the locals agreed to.

Following World War II, the UK government felt compelled to resolve the issue, finding it most expedient to merge Newfoundland with Canada. Because of the threat of sovereign default, the British government abolished the second oldest parliament in the Empire, imposed a dictatorship on a country of 280,000 people with almost a century of direct democracy, and at the end of the process liquidated the country.

Vulture funds and extreme legal steps

While such extreme methods are not feasible today, vulture funds often buy heavily discounted government claims in secondary markets and pursue the impoverished debtors through courts internationally.

One of the clearest examples of this is the New York based investment fund Elliot Associates, which paid $11 million in 1996 for heavily discounted Peruvian debt and then threatened to action against the country unless they paid it $58 million. Peru was forced to pay because it had sent funds to Euroclear, a European settlement system, to pay bond holders participating in the restructuring. The Court of Appeals in Brussels enjoined Euroclear from making those payments because they violated the securities' *pari passu* clauses. Since that held up the restructuring process, Peru felt it had no choice but to pay up. In that case it was a Belgian court ruling on English law. If the case had been brought in the UK, the outcome might well have been different.

"All the best countries default nowadays..."

As one watches the European sovereign debt crisis unfold, a familiar theme emerges. When it comes to crises in other countries, governments find it quite easy to take a strong moralistic view, claiming that the crisis was caused by mistakes made in the crisis country and necessitates strong, often retributive reform so that the misbehaving country, or others, will not be tempted to make the same mistakes again. The attitude of the European creditor countries to their European debtors falls very much into this category.

When the shoe is on the other foot, attitudes are likely to be somewhat different. The British government might have found the moral high ground easy when it came to the Newfoundland default, but in discussing that resolution, the opposition Labour leader at the time, Clement

"When it comes to other countries, rules have to be followed, and bailouts are to be avoided lest they create moral hazard. If the problem is at home, rules are meant to be broken. The eurozone is a good example of this."

Attlee, suggested that default was preferable to giving up democracy, adding "All the best countries default nowadays" with reference to Britain's own default on wartime loans from the US. The same Attlee, then Prime Minister, eventually gave Newfoundland to Canada.

The attitude expressed by Clement Attlee demonstrates the often Janus-faced views of governments. When it comes to other countries, rules have to be followed, and bailouts are to be avoided lest they create moral hazard. If the problem is at home, rules are meant to be broken. The eurozone is a good example of this.

In setting up the euro, member states created both strict conditions for membership and the requirement of sensible conduct: the Maastricht criteria. If these had been adhered to, we would not have experienced the sovereign debt crisis. Countries like Greece, Portugal, and Italy would not have qualified for membership, and other countries would have had no choice but to keep their deficits under control. Admitting Greece, Portugal, and Italy meant that the euro was born with a handicap. It was, however, the deliberate violation of the Maastricht criteria ten years ago, first by Germany, and then by France, that signalled the end. Since these two most important countries felt they could break the rules at will, so did everybody else.

Hubris risk

When the euro was envisioned, the challenges inherent in monetary unions were well known, even to the euro's designers. The strains of the only monetary union in the EU at the time, Belgium and Luxembourg, clearly illustrated this. They shared a common currency, managed by Belgium. When, in the mid 1980s, Belgium felt the need to devalue without consulting Luxembourg, the latter's government was not amused and resorted to setting up a parallel central bank with the ability to issue its own currency within 24 hours, just in case Belgium misbehaved again. If Belgium and Luxembourg found it difficult to live with the same currency, what were the prospects for a common currency for the entire European Union?

Most monetary unions fail as member countries drift apart over time and need very different monetary policies. To prevent failure, a strong binding force needs to be in place. This typically involves a common sense of national identity and a powerful central government harmonizing rules and regulations, with powers to transfer funds between regions. Even then strains do emerge. One only has to look at Spain to see the challenges in implementing a transfer union.

In the absence of these conditions, a monetary union is set up for failure. The EU leaders tried to address this problem by the Maastricht criteria, but then wasted no time in ignoring them.

This problem was compounded by the prevailing view that sovereign risk had somehow been eliminated – a view strongly encouraged by banking regulations stipulating that sovereign debt is risk free. This both acts as a tax on other creditors and also sends a powerful signal.

By ignoring all these issues the EU leaders at the time were guilty of hubris risk, the view that their political desire and ability to implement a monetary union was sufficient and that other considerations could be brushed away. It was just hubris.

Conclusion

Surprisingly, even after the EU's authorities were guilty of hubris risk in setting up the euro, the crisis resolution process shows the same familiar signs of further hubris risk. The direct financial cost of a Greek default is quite trivial in the European context. Total Greek debt is around €350 billion, but the EU's GDP is 15 trillion, so a total bailout of Greece would only cost the EU around 2.3 per cent of its annual GDP. The cost of not solving the problem is one order of magnitude higher, estimated by Danielsson and de Vries (2011) to be 22 per cent of European GDP.

It is hard to see the objective of the European authorities. Perhaps they want to make sure that anybody receiving bailouts will have to suffer so much that nobody else will be tempted to get into the same situation. Or perhaps they want to use this as a means to create a proper European central government – a transfer union. Regardless of the motivation, the costs not only to Europe but also to the world are too high. By letting political considerations triumph over economic reality, the EU's authorities are yet again guilty of hubris risk.

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INSECURITY AND UNCERTAINTY IN THE CONTEMPORARY ARAB WORLD

Kristian Coates Ulrichsen analyses emerging patterns of insecurity and uncertainty as the Arab uprisings enter a second year.

Since December 2010, a wave of popular protest has swept through the Middle East and North Africa, toppling longstanding authoritarian rulers in Tunisia, Egypt, and Libya and leaving the regimes in Syria and Yemen on the brink of collapse. Its size and contagious overspill has distinguished the civil uprisings from earlier expressions of discontent and demonstrated the magnitude of the socio-economic and political challenges facing the region. The uprisings dramatically revealed the narrow social base of support underpinning outwardly strong rulers and fundamentally challenged prevailing assumptions about their durability.

As the "Arab Spring" enters its second year, it raises a number of important – and unresolved – issues over the pace and direction of change. These include: the messy and uncertain pathways of transition in countries that have experienced regime change; a perilous stalemate between supporters of the status quo and advocates of change elsewhere; and a fiscally and politically unsustainable policy response to quieten participatory pressures in the oil-rich Gulf monarchies. Underpinning them is the magnitude of the economic challenges facing incumbent and successor governments alike. They portend a volatile future for regimes and their peoples as well as for an international community unsure of how, and with whom, to engage.

Uncertain transitions

The euphoria of regime change in Tunisia, Egypt, and Libya has given way to acknowledgment that challenging landscapes lie ahead. With the exception of Tunisia's election to a Constituent Assembly in October as the first step in a gradualist shift to democratic rule, the "day after" in Egypt and Libya has been messy, contested, and violent. In part, this reflects the fact that it is far easier to mobilize against a shared opponent than around a common platform. Thus, the mass opposition that forced out Mubarak and Gaddafi (the latter with external military assistance) rapidly splintered into groups with competing visions for change. This is evident both in the fragmented electoral results in Egypt and in the ongoing clashes between the dozens of city- and tribal-based militias in Libya.

A second cause of uncertainty is the unresolved tension between the elites and the street. In Egypt, in particular, the toppling of President Mubarak did not precipitate a sweeping replacement of the elite groups that sustained his regime for three

decades. Entrenched structures of military and economic power have so far proven impossible to dislodge, leading to repeated calls to renew the revolution, this time against the Supreme Council of the Armed Forces. Similarly, in Yemen the tribal and military elites that underpinned President Ali Abdullah Saleh's 33-year rule only crumbled after months of intensifying street demonstrations. The protest movement subsequently were shut out of the elite-driven deal that removed Saleh from office and – as in Egypt – merely reoriented the demonstrations towards a new target.

It is still far from clear, and also too early to tell, if the instances of regime change will transit towards democratization and the consolidation of democratic institutions and values. Significant obstacles remain in states weakened by the legacies of authoritarian rule, lacking autonomous civil society organizations and freely independent political parties, and unsure of the relationship between the citizen and the state inherent in concepts of citizenship. Moreover, any attempt to untangle the role of national armies hitherto deeply enmeshed in authoritarian political, economic, and social structures will certainly be divisive and quite likely contested.

Perilous stalemates

There are multiple countries where persistent protests have neither ended nor escalated into fully blown civil uprisings. Two cases in point – one violent and the other volatile – are Bahrain and Jordan. A rapidly escalating protest movement briefly threatened to topple Bahrain's ruling Al-Khalifa family in March 2011. This was averted by the arrival of military forces from Saudi Arabia and the United Arab Emirates and by a relentless crackdown on all forms of dissent. Yet widespread opposition has continued amid the emergence – on all sides – of new youth-led movements. These groups have undercut the hitherto dominant dialectic between the regime and traditional opposition groups. They have injected radicalizing new elements into the political equation as the moderate middle ground is being outflanked and the contours of conflict are solidifying into permanent fissures.

The result is the erosion of the tacit understanding of the legitimate boundaries that opposition groups could operate within. These have been contested throughout the region, as evidenced by the convergence of political opposition and popular mobilization that forced Kuwait's Prime Minister out of office in November 2011. King Abdullah of Jordan dismissed two prime ministers in 2011 in response to persistent weekly protests that occasionally escalated into violent clashes with security forces. His attempt to deflect public anger at endemic corruption and perceived abuses of privilege onto the technocratic elites nevertheless failed to quell calls for greater political freedoms and moves towards a constitutional monarchy.

In these "halfway houses" (which also include Morocco) a decisive tipping point has yet to occur whereby continuing demonstrations acquire a momentum and trajectory of their own. There is, however, a danger that stop-gap or partial measures leave unresolved the basic divergence of expectations between authoritarian regimes bent on limiting concessions and opposition movements advocating deep and meaningful shifts in the source and distribution of power. It remains to be seen whether (and how) these differing viewpoints can be reconciled into a consensual settlement for political reform.

Short-term responses

The economic dimension of the Arab Spring is as important as the political; indeed, the two are inextricably intertwined. This is especially the case in the redistributive political economies of the Gulf States. In these oil-producing states, the legacy of policy decisions taken in 2011 will reverberate in the years and decades ahead. Decisions focused overwhelmingly on short-term measures to blunt or preempt the social and economic roots of potential political tensions. Policies included hand-outs of cash (Kuwait and the UAE), creating jobs in already saturated public sectors (Saudi Arabia and Oman), and raising public sector workers' wages and benefits (Qatar, Saudi Arabia, and Oman).

The scale of the spending is enormous. Saudi Arabia announced two emergency welfare packages collectively worth $130 billion. This figure exceeded every annual government budget until 2007 and included a provision to employ 60,000 additional Saudis in the Ministry of Interior alone. It also contained stipulations for increasing the minimum wage of public sector employees (but not private sector workers), offering a one-time bonus of a month's pay to all public officials, and constructing 500,000 new homes to combat a crippling shortage of social housing. In Oman, Sultan Qaboos announced 35,000 new public sector jobs as well as a pay increase, while leaving the private sector largely untouched. Even Qatar, with little to no threat of domestic unrest, announced 60 per cent increases in basic salary, social allowance, and pensions for public officials and 120 per cent rises for military officers.

Yet the decision to intensify the politics of patronage by increasing the flow of unproductive payoffs to key sectors of society delivers damaging blows to the attempts in recent years to scale back the role of the state in the economy and boost the role of the private sector. Instead of strengthening the private sector and weaning citizens off public sector employment, the new packages expand government spending and widen an already large discrepancy between the public and private sectors. In addition, they create hostages to fortune as they lock in government spending at very high levels that depend on the price of oil remaining high. They considerably complicate the transition towards post-oil economies that must eventually take place.

Difficult next steps

The developments outlined above are not taking place in a vacuum. They are occurring against the backdrop of the deep-rooted socio-economic challenges that proved the catalyst for revolutionary change in the first place. While the waves of anger at regimes' perceived inability to address the economic stagnation produced the feelings of helplessness and rage that so galvanized the protests, the difficulty moving forward is that political change is not in itself sufficient. It is the first step in a larger process of transformation, but so many issues still have to be addressed.

Beyond the removal of the person of the autocrat and his immediate family, can the broader regime of "crony capitalists" and networks of patronage be removed? Is the military a part of the "old regime" and can it be trusted to oversee the move towards democracy? Can a counter elite emerge to challenge the existing elite, as happened (democratically and without a revolution) in Turkey after 2002? How will the successor regimes cope with the massive socio-economic challenges, such as unemployment and economic exclusion, and with the inevitable disillusionment when people's material situation fails to improve overnight? And will the international community support all countries in transition, rather than cherry picking support where it is in their interests (such as Libya) and condoning state repression where it is not (such as Bahrain)?

Answers to these questions will only become clearer in the longer term. The embedding of a genuine political transition is a long-term project and is intergenerational. The popular uprisings that sparked the Arab Spring are giving way to the next phase of struggle over the direction and depth of reform. However, the transformative effect of new media and methods of communication has enabled people across the Arab world to reclaim the public sphere and shape public discourse around demands for accountability, justice, and freedom. These are powerful forces that have decisively shattered the political status quo. There is, at least, no going back to what went before; the exact nature of the structures that replace it remains to be seen.

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"It is still far from clear…if the instances of regime change will transit towards democratization and the consolidation of democratic institutions and values."

Climate and Energy: Regulation and Governance

Neil Gunningham argues that the central challenge of climate change mitigation is energy regulation and governance.

Climate change is widely recognized as the greatest challenge confronting our generation and as one which, if not addressed, may have catastrophic consequences. Recent science reveals that the tipping points beyond which dangerous climate change becomes irreversible are close and that the window for effective mitigation is short.

As to how large cuts in carbon emissions might be achieved, attention has focused on the role of a global climate change agreement. However, although some progress was made at the Cancun and Durban Climate Change Conferences, agreement concerning an emissions trading scheme (widely seen as the key mechanism through which to drive emissions reductions) still seems distant.

But even if such a market mechanism were both agreed upon and implemented, it would be insufficient to resolve the global climate crisis. Carbon pricing does not address the large market failures that undermine R&D in climate mitigation, such as incompatibility with existing infrastructure and weak intellectual property rights protection. Nor would such a market mechanism sufficiently accelerate the development and dissemination of low carbon technologies.

In examining mitigation options "beyond the market", the single most important sector is energy. Energy production and consumption account for over 60 per cent of greenhouse gas emissions, and without achieving a drastic transformation in the energy sector, a transition to a low carbon economy is close to impossible.

This is every bit as complex a challenge as achieving a climate change agreement. How, for example, can resources be pooled to create a global technology development fund? How can intellectual property constraints on the use of new technology be minimized? And how can developing countries be integrated effectively into a global energy strategy? Such questions are about the appropriate allocation of scarce resources and about co-ordinating collective action. Thus they are all fundamentally questions of regulation and governance concerned with "societal steering".

Unfortunately, current regulatory frameworks for energy fall far short of what is needed to transition to a low carbon economy. At present, energy sector reform is addressed – to the extent that it is addressed at all – primarily at national level, but appropriate strategies differ markedly between developed and developing countries.

In the developed world, an increasing number of countries are beginning to explore strategies and tools that might be invoked to achieve a different energy mix. For example, there is growing interest in harnessing renewable energy, increasing energy efficiency, and removing fossil fuel subsidies (and dwindling commitment to carbon capture and storage).

But overall, energy sector reform within the nation state is currently modest in the extreme. This is perhaps understandable. State energy policy must be addressed at a time when, in many countries, key state assets have been privatized as a result of previous waves of market liberalization (and are therefore more difficult to influence), while in the developing world population growth is increasing pressure on existing resources and infrastructure (exacerbating energy security concerns).

However, the situation is gradually changing. When governments do act – whether driven by energy security considerations, climate change mitigation, or some combination of the two – economic incentives, regulation, and support for R&D are the central tools in the policy arsenal.

In terms of the first, a few countries and, at regional level, the European Union have sought to put a price on carbon via either an emissions trading scheme or a carbon tax. Other economic incentives to lower carbon emissions have been introduced, but these also suffer from significant limitations, not least imperfect information, principal-agent problems, and behavioural failures.

Accordingly, economic incentives are best seen as just one component of a broader mix of energy policy initiatives. For example, the International Energy Agency (2011) argues, with regard to energy efficiency, that a number of other policies – primarily regulatory – will be necessary in both residential appliance electricity use and buildings heating use, these being much better able to overcome the barriers described above. They include: energy performance standards, energy performance

labelling, consumer feedback tools, awareness-raising efforts, and contractual support for the construction of low energy buildings.

In the case of renewable energy, rapid growth again depends substantially on government policies, primarily in the form of regulatory policies, fiscal incentives, public finance mechanisms, and climate-led policies.

Most crucial of all will be the development and commercialization of new technologies (particularly "break-through technologies"). While some might argue that this can be left to the private sector, in reality technological innovation is typically a public good, with not all of the benefits of new knowledge capable of being "captured" by the innovator. Accordingly, technological innovation will require substantial public expenditure and the development of public-private partnerships.

In the developing world, the challenges are very different. The circumstances of Indonesia, the world's second largest thermal coal exporter, illustrate this. First, there is a tension between energy security (having a reliable and adequate supply of energy at reasonable prices) and climate change mitigation. With large coal reserves and a growing demand for electricity, building more coal fired power stations offers a relatively low cost and reliable means of increasing electricity production. But while this makes sense as a matter of political expediency, it runs counter to Indonesia's commitments to reduce its greenhouse gas emissions.

Second, there are perverse incentives. Fuel prices are heavily subsidized, and removing or even reducing these subsidies would put the government at serious political risk. This makes a transition to renewable energy extremely difficult.

Third, there is the tension between climate change mitigation, energy policy, and economic development. For example, Indonesia, along with Malaysia, produces about 90 per cent of the world's palm oil. Widespread deforestation is the price for this development, but with the Indonesian palm oil generating some $14 billion per year, further growth of, rather than constraints on, deforestation is anticipated. Here as elsewhere, climate change mitigation continues to be trumped by the demands of resource exploitation.

Fourth, no government can deliver on its climate and energy promises without harnessing state institutions to implement them. But the Indonesian bureaucracy lacks capacity, resources, and sufficient high quality staff to do so. Key energy policies are not well defined, nor is it clear how energy governance is handled within the state, with multiple agencies having some stake but none the authority or capacity to achieve change.

Of course, much depends upon an individual country's energy profile and capability. By way of contrast, South Korea, which imports more than 90 per cent of its energy, has a strong incentive both to increase energy efficiency and identify low carbon sources of energy (primarily nuclear power) to reduce supply risk and its energy bill.

But the central challenge of energy governance – meeting growing global energy needs while transitioning to a low carbon economy – must be engaged in globally and regionally, not just at the level of the individual nation state. This might include a global mechanism to ensure energy supplies in crises and emergencies, the development of global energy norms, international agreement on intellectual property laws that encourage innovation in low carbon technologies, co-ordinating and funding R&D and mechanisms for technology transfer, and support to developing countries.

In Asia, regional agreements such as the ASEAN Petroleum Security Agreement, which commits signatories to cooperate in times of shortage and oversupply, might also be expanded. The Trans-ASEAN Gas Pipeline project is already in train and will be important in terms of regional energy security. An ASEAN Power Grid project is also being contemplated.

But notwithstanding some modest individual achievements, acting collectively on matters of collective interest *on the scale that will be necessary* has so far proven an insurmountable challenge. States have jealously guarded their autonomy over energy issues, especially energy security, with the result that global and regional institutions, norms, and organizations are weak or absent.

In the case of the many developing countries that lack the economic and the technological capacity to bring about an internal energy transition, it is only with considerable assistance and support that change can be achieved. The degree of support currently provided by the World Bank, Asia Development Bank, and national aid agencies does not remotely approach this level. Whether a sufficient proportion of the $100 billion Green Climate Fund, the key outcome of Cancun, will be allocated to assist the transition to a low carbon economy in developing countries remains to be seen.

"…the central challenge of energy governance – meeting growing global energy needs while transitioning to a low carbon economy – must be engaged in globally and regionally, not just at the level of the individual nation state."

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CARRRESEARCH

RISKY REGULATION in HIGHER EDUCATION

Roger King argues that the UK government is introducing risk-based regulation to the higher education sector in England in a context where its funding policies will significantly increase system and institutional risk.

The idea of regulating by risk – rather than just the regulation of risk – has come to be regarded as a sign of good regulatory practice. Risk-based regulation generally provides for a more selective monitoring of organizations than standardized and all-encompassing programmes of inspection and audit for everyone. It is based particularly on considerations of organizations and their respective track records of regulatory compliance, financial soundness, maintenance of quality and standards, and the robustness or otherwise of internal (risk management) controls.

Risk-based regulation is an example of the "better regulation" movement across sectors and countries in regulatory practice in recent years. This is thought best reflected in regulatory decision making that is open, transparent, widely communicated, and, in the case of risk-based regulation, where regulatory attention is focused on organizations and practices where risk to the taxpayer and the consumer is argued to be highest. Cost-benefit analyses and regulatory impact assessments are examples of operational mechanisms that convey rationality of processes and accountability for "better" regulatory activity.

Higher education in England is the latest sector to be subject to risk-based regulation. The recent White Paper (and upcoming legislation) entitled *Higher education: students at the heart of the system* (Department of Business, Innovation and Skills 2011) proposes that the existing Higher Education Funding Council for England (HEFCE) becomes a risk-based regulator for the system, as a "lead" regulator in association with the Quality Assurance Agency (QAA), the Office For Fair Access (OFFA), and the Office of the Independent Adjudicator (OIA). This is particularly significant for external quality assurance and the role and perception of the QAA.

Currently QAA, although contracted by HEFCE to assure the standards of the programmes it funds, operates with high levels of autonomy, signified by the strong representation of independent members on its Board. It will in future, however, become subject to the "direction" of HEFCE as a "lead" regulator. HEFCE currently is largely perceived as an agent of government rather than as an independent regulator or a genuine "intermediary" in the sector.

This change raises at least three political issues. First, unless the character and function of HEFCE changes, external quality assurance for universities and other colleges will be subject more formally to governmental intrusion through QAA's "subservience" to HEFCE. Second, QAA is a UK-wide body; however, it will become constrained directly by the Funding Council for *England*. How this situation will play out in the wider politics of devolution will be interesting in its own right. Finally, QAA (and the UK government – as an original signatory) has signed up to the predominantly European-wide Bologna Agreement on tertiary education. This Agreement has a lot to say about external quality assurance, not the least important that it is conducted in a cyclical and regularly scheduled manner to provide protection for all students. It is not clear that risk-based regulation fits well with these provisions, and the likelihood is that it does not.

The introduction of risk-based regulation severely jolts QAA's existing methodology based on scheduled, cyclical programmes of review for all institutions. The White Paper muses, however, that a significant number of institutions might be spared such reviews altogether. That is, risk-based regulation will be more discriminatory to the point where only a minority of institutions may receive a full review. It will modulate levels of institutional audit on the basis of regulatory judgements concerning the variable risks posed by institutions to the sector and to the consumer (and to the regulator). Rather than a consistent approach that applies the same levels of scrutiny to all providers, risk-based regulation will vary the scope and intensity of monitoring against explicit calculations of risk.

Several criticisms may be levelled at such a selective approach to external quality review. First, institutions that received good review outcomes within the recently completed six-yearly cycle of visits conducted by the QAA might easily travel in the "wrong direction" (not least as the sector becomes more competitive), and weaknesses may not be picked up until too late. Second, should not all students receive the protections and benefits of regular external review of the institution at which they are studying? Why should some be "left uninsured"? Finally, the good practices found in high-performing institutions (those which are likely to be left out of future reviews or to receive more perfunctory monitoring) are much more difficult to disseminate throughout the sector as a whole; risk-based regulation can undermine notions and diffusions of good practice because many organizations which display such excellence, and which could be important exemplars of development for others, may be left out of the regulator's direct oversight.

One approach is for the QAA to adopt random inspections, albeit much lighter than full institutional reviews, for those deemed to pose least risk to the sector. The Hampton Review of 2005, which was a major influence on the UK government in its

"…random inspections may be the price that has to be paid for accepting the decreased bureaucratic intrusions of risk-based regulation in a way acceptable to the public, politicians, and the media…"

adoption of risk-based regulation more generally, was very much in favour of such an approach. Universities and colleges, however, dislike such visitations, particularly if the notice of the arrival of auditors is quite short. It suggests a more inspectorial and compliance approach to regulation than they feel is appropriate for the autonomies and necessary freedoms of, particularly, research-based universities. Yet random inspections may be the price that has to be paid for accepting the decreased bureaucratic intrusions of risk-based regulation in a way acceptable to the public, politicians, and the media and their notions of accountability.

Although much has been written on the risks of risk-based regulation for the regulator and the resultant organizational strategies for reputational defence – Black (2010), and Rothstein and Downer (2008), for example – these risks seem magnified when governmental policy aims at making a sector even riskier than before. Higher education in England is just such an example. This shows that it is difficult to come to a balanced view about risk-based regulation without taking full account of the wider context within which it is introduced.

The funding changes being proposed by the UK government for higher education in England arguably increase the level of risk in the system both overall and for many individual institutions. The allocations of student places to institutions are to be "freed up" by the introduction of a "core and margin" model to be administered by HEFCE. Around 20,000 students will be stripped from core institutional allocations for 2012–13 to form a "pool" which will then be bid for by universities and colleges with net overall fee levels of £7,500 or less on the basis of price (tuition fee levels) and quality. Moreover, the core "will reduce every year" with "the size of the margin growing steadily in future years", thus almost certainly and progressively introducing higher levels of instability, vulnerability, and uncertainty for many institutions (Department of Business, Innovation and Skills 2011: 5).

Some institutions are likely to become particularly vulnerable to the continual loss of student numbers and this may lead to riskier behaviour even by those deemed originally as "low risk". These will need to take action to accommodate the lower income that they will have as a result of lost student places and the lower fees that they will need to charge in order to be eligible to recover lost student places. Such action could take the form of significant cost cutting in budgets for the institutional assurance of standards and the provision of high quality learning environments.

Revenue seeking in such circumstances may lead some institutions to undertake risky entrepreneurial behaviour in high fee-earning (unregulated) international markets to replace lost domestic students. Particularly risky would be an extension of franchising and similar vehicles to expand provision abroad with untested partners. Failures in such activities are particularly prone to media scrutiny and scandalizing, and so not only pose greater risks to institutions, but also to the regulator (because everything that goes wrong can be interpreted as a failure of regulation, and if the "lighter touch" approach of risk-based regulation has exempted the institutions concerned from perceived adequate scrutiny, the regulators will be accused of failure to protect the public).

Moreover, the introduction of risk-based regulation may significantly and adversely impact on the reputation and attraction of English universities as a whole, if it is felt abroad that the vast majority of English higher education institutions are subject only to sparse external quality assurance. Foreign senders and funders of international students may feel that the quality of at least some provision cannot be guaranteed and may consequently look elsewhere, despite the obvious encouragement in UK government policy for institutions to become even more competitive globally. A perception abroad that a sizeable proportion of student places is being allocated to institutions on the basis of cost and price may also damage the English brand.

Introducing risk-based regulation to higher education follows its introduction over the last decade in other sectors in the UK, as part of the "Modernizing Government" agenda of the New Labour governments. However, its rather generalizing spread across government does not necessarily make it an appropriate model for all sectors in all circumstances. The higher education regulators nonetheless will require the capacity to learn the lessons from its earlier applications elsewhere in government, including those instances where risk-based regulation generates high risks for the regulators themselves.

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Responsibilizing Rights

Wrongful Life, Tay-Sachs Disease, and the Unfreedom of Choice

Shelley Z Reuter discusses malpractice lawsuits filed on behalf of children born with Tay-Sachs disease, exploring what these cases can tell us about how we have come to think about genetic risk.

Tay-Sachs disease (TSD) is a rare metabolic disorder caused by a genetic mutation on chromosome 15 that affects the body's production of the hexosaminidase A enzyme. Hex A's function is to regulate the level of lipids or fat in the brain and nervous system. When this enzyme is deficient, an excess of fat accumulates, leading to visual impairment, profound neurological deterioration, and, eventually, death. Tay-Sachs disease includes juvenile and late onset adult variations, but the most frequent (albeit still rare) form is classic infantile Tay-Sachs, which is normally fatal by age three or four. Commonly associated with Jews of Eastern European or Ashkenazi descent, TSD has also been found to a certain extent among some Mediterranean populations, including groups of heterogeneous Arab origin, as well as among some French-Canadian communities in eastern Quebec, the French-Americans of southwestern Louisiana, people of Irish/British descent, and, to a lesser degree, in the general population. The child of two carriers of the genetic mutation that leads to Tay-Sachs has a one in four chance of inheriting the mutation and developing the disease.

Since the means to screen for TSD was developed in the early 1970s, Jewish communities worldwide have willingly participated in reproductive counselling and Tay-Sachs blood screening programmes, the latter often carried out among school-age children. In fact, even though the disease is not exclusive to Ashkenazi Jews, this group in particular has most actively availed itself of the genetic test for TSD because of its strong prevalence among them. Their participation in screening programmes has had remarkable results: the frequency of TSD among American and Canadian Jewish communities, for instance, has been reduced by more than 90 per cent to rates even lower than those found in the general population (Kaback et al. 1993; Kaback 2000).

Some cases have still slipped through the net, however, and by the end of the 1970s several malpractice suits claiming "wrongful life" and/or "wrongful birth" had been brought before US courts by parents of children born with Tay-Sachs disease. Briefly, the defendants named in these proceedings – physicians, hospitals, and labs – were sued for having neglected to warn prospective parents at risk of giving birth to a child with Tay-Sachs and/or for having failed to tell them about available genetic tests or prenatal diagnosis. All the parents involved argued that, had they known they were at risk of giving birth to a child with TSD, they would have terminated their pregnancies.

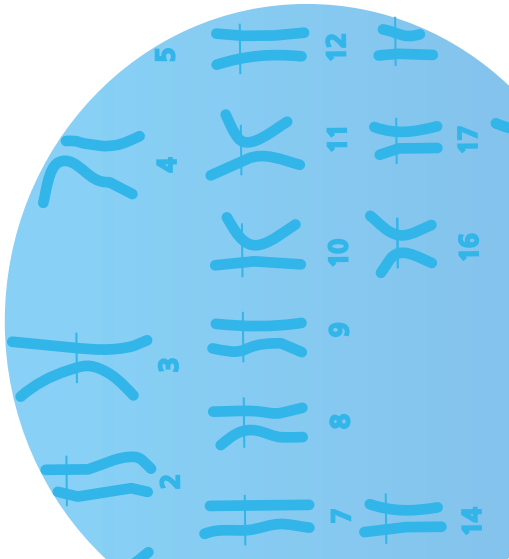
Of course, wrongful birth and wrongful life claims are not limited to cases of Tay-Sachs. A search in Westlaw turns up more than 150 lawsuits since 1974 claiming negligence related to a range of genetic or congenital diseases and abnormalities. The burgeoning preoccupation with seeking damages in such situations has been a significant element of the trend in recent decades towards what Canadian scholar Abby Lippman (1991: 19) has termed geneticization, where most disorders, behaviours, and physiological differences between individuals are defined at least in part as genetic in origin.

In such a context, these wrongful life and birth lawsuits have contributed to a complex, contradictory new way of thinking about and responding to genetic risk. Specifically, mitigation of genetic risk, at least in the West, has become a widespread cultural project. This project is especially resonant for those individuals who know or merely suspect they have inherited a genetic disorder. As health and disease are increasingly understood in genetic terms, these individuals or perhaps even all individuals are in turn responsibilized to be proactive – encouraged to accept responsibility for their own health and optimize their lives by making themselves better than they are.

In a general sense, the concept of responsibilization captures practices as mundane as getting regular exercise, avoiding junk foods, even taking one's daily multivitamin. In the context of geneticization and genetic disease, it usually means seeking out genetic testing; the idea is that everyone has a responsibility to know themselves genomically and prevent irresponsible lives – unoptimized lives – from being born. There is a certain sense of obligation in this, not just to oneself but also to others. The individual's genes have become something of a "public good", as Callon and Rabeharisoa (2004: 10) put it, such that the individual's existence and even her/his "biovalue" (Waldby 2002) are increasingly defined – at least in part – by how much of a drain on healthcare resources they represent. There is an expectation, then, that the individual will do for the collective good what ought to be done to prevent an unnecessary burdening of the healthcare system. Preventing genetic diseases – that is, irresponsible lives – follows naturally once the individual has become responsibilized to society in this way.

The parents in the lawsuits described above were aware of their obligations. Implicit in their arguments

"…where genetic risk is concerned even the most informed of choices is nonetheless constrained by a set of moral and regulative imperatives that responsibilize the individual to exercise their right to do the responsible thing."



was the notion that their doctors deprived them of the opportunity to be responsible when they failed to tell them about TSD and available tests. The parents saw themselves as deprived of the chance not only to optimize their lives through genetic testing, but also to prevent any further unoptimized or irresponsible life from coming into existence. We may question the extent to which these parents were really concerned about the collective good of society when they elected to bring suit against their physicians; nonetheless the parents' right to be responsible had allegedly been violated. Their claims against their physicians were informed by the new normative ethics and politics of genetic risk that make our submission to medical authority and control a fundamental individual right – a right central to our very personhood.

With the desire to know one's genetic status and the will to be tested on the one hand, and the obligation to do so on the other, the line between rights and responsibilities has indeed become quite precarious. Simultaneously, the notion of agency or freedom of choice in an age of geneticization has become something of an illusion. We need to rethink what we mean by "choice", complicating any straightforward ideas about agency or freedom at a time when choice is becoming increasingly bound up with individual responsibilization.

What we have at the heart of this public-cum-individualized politics of genetic risk is a conception of agency framed by rationalist interests that govern to serve the greater good yet present genetic testing as an opportunity for individuals to liberate themselves from the shackles of their genetic inheritance. This is a liberation ostensibly derived from the choice to be screened and the choice to take action on learning the results. Yet with these choices comes responsibility for their consequences. Making the wrong choice – choosing not to be tested – requires justification and explanation, because an individual's genetic choices are never relevant to her or him alone. The entire family, both existing and potential, has something at stake, as does society at large.

In the new dispensation, rational and responsible people have themselves genetically tested, while irrational and irresponsible people do not. With the boundary between coercion and consent so thoroughly blurred, it must be recognized that where genetic risk is concerned even the most informed of choices is nonetheless constrained by a set of moral and regulative imperatives that responsibilize the individual to exercise their right to do the responsible thing. We have the unfreedom to choose to be tested, the inalienable right to subject ourselves to medical control.

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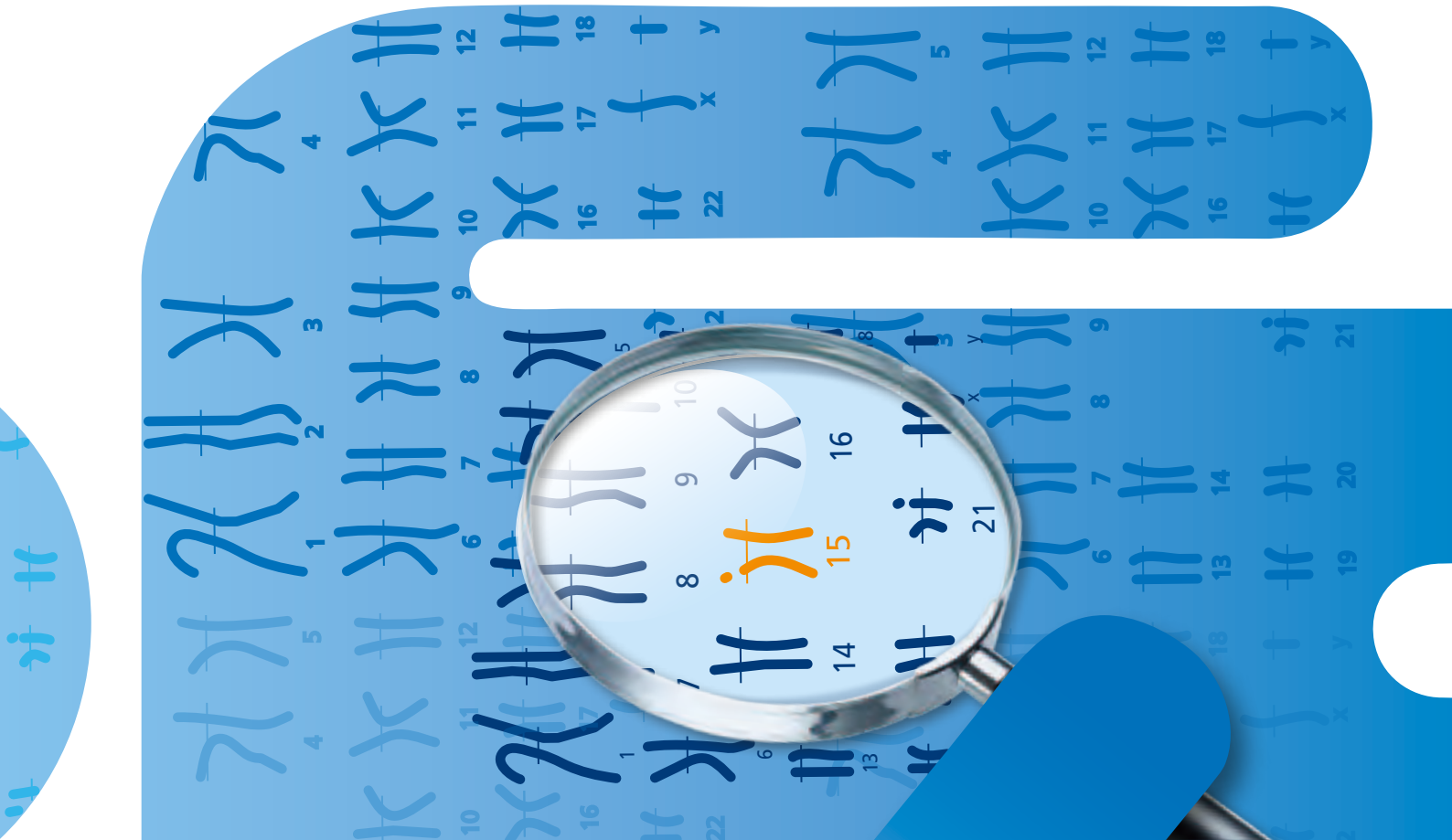

21ST CENTURY RISK AND SECURITY GOVERNANCE: NEO-LIBERAL, NEO-REPUBLICAN, OR ...?

Karen Lund Petersen and **Vibeke Schou Tjalve** examine homeland security as a form of public/private risk management which escapes the logics of neo-liberal "privatization".

Throughout the past decade, national security has come to be understood in terms of "risk", and the governance of such risk has been presented as a "shared responsibility". As a result, the rhetoric of "public-private partnerships", "public mobilization", "public awareness", "corporate patriotism", and "responsible citizenship" has become common parlance in the politics of protecting the *national* interest.

This blurring of the public-private divide has long been noted by risk scholars. It is often read as yet another instance of neo-liberal governance: privatized, individualized, marketized. Yet is that really what the emerging practices of civic duty signify? Or does the language of partnership, framed within tropes of fallibility and communality, somehow challenge the field of risk studies and the neo-liberal orthodoxy that has crystallized? In this brief commentary, we use the case of emerging national security governance to suggest that risk studies must abstain from knee-jerk assumptions about the monopoly of neo-liberalism and adopt a more empirically sensitive approach to emerging risk practices. Moreover, as the practice of governing risk eats its way into ever more aspects of our social and political world, we need to develop theoretical sensitivities capable of understanding complexities and variations, rather than simply identifying commonalities or reproductions.

"Homeland security starts with hometown security..."

Nowhere in current Western security governance is the language of civic duty and patriotic participation as overwhelming as in American counterterrorist strategies. Consider for instance the most recent metaphor from the Director of the Department for Homeland Security (DHS):

"As I said, it [homeland security] requires not just a 'whole of government', but a 'whole of nation' approach. In some respects, local law enforcement, community groups, citizens, and the private sector play as much of a role in homeland security as the federal government. That is why I like to say that 'homeland security starts with hometown security'" (Napolitano 2011).

Existing scholarship within or at the margins of governance studies has gone a long way in responding to the kind of "responsibilization" which Napolitano engages with here, theorizing the call for public "preparedness" and "resilience" as a technical and de-politicized risk management practice. It is not. At face value, the appeal to civil society (citizens, nurses, renovation workers, banks, transportation systems, insurance companies, airports) to share in anticipating and shouldering elusive security responsibilities may appear as the logical course of action in an increasingly uncertain threat environment. Yet to "rally the entire society", as the DHS puts it, is a fundamental break with basic principles of the modern (liberal) state, in which civic protection was always and wholly a state responsibility (DHS 2002: ii; Petersen 2012). Napolitano's appeal is thus part of a larger policy of patriotic mobilization that is neither a strategy of mere "technical efficiency" nor simply a "privatization of security".

Neo-republican security governance?

The politics of shared responsibility cannot be unpacked by asking how much responsibility is "transferred" from public to private actors, or how much authority is retained by government. We need to consider seriously the notion of "shared", instead of reducing it to the idea of "transferred". Our studies suggest that the rhetoric of public mobilization appropriated to support the American counterterrorism policy reflects transformations of more profound ideological and organizational dimensions (Petersen and Tjalve forthcoming). Rather than disconnecting the public and the private, the policies of counterterrorism seek to strengthen the moral or ideational links between these two spheres, adopting an ideal of communal homogeneity.

If this strategy of "communality" is not neo-liberal, then what is it? Clearly, the language of "shared responsibility" accentuates an organicist and deeply moralist vein in the Western legacy of democratic security governance – one which, we suggest, is most appropriately termed "neo-republican": "republican", because its primary means of public responsibilization draws on the language of community, sacrifice, virtue, and civic *self-regulation*; "neo", because the state-society link is a more complex one, and the security policies it produces are potentially less democratically restrained (Petersen and Tjalve forthcoming).

The paradox of neo-republican responsibility sharing is that the state it reconfigures is both a strengthened and weakened one. On the one hand, it installs the state as the author of security politics – as a supervisor or coach of civic behaviour. On the other hand, the state does not *want* to script the story – it does not believe in the possibility of defining what needs to be done to reach the so-called political goal of eliminating terrorism. Contrary to neo-liberal security governance, which rests on the possibility of defining the "right" techniques and behaviours (eg risk management), the neo-republican language of elusiveness, uncertainty, and precaution can make no such prescriptions.

"...the political task of creating a resilient society becomes one of second order character formation, not of direct policy formulations: the government is to create the kind of society which will define and enact resilient behaviour on its own accord."

A recent example of such elusiveness is the Suspicious Activity Reporting (SAR) initiative spurred by the DHS in 2010. The purpose of SAR is to facilitate the process of information sharing by creating a reporting system for industries and the general public to use when they observe "suspicious activities" possibly related to terrorism. Going through the available material on SAR, the absence of explanations of what is meant by suspicious activity is striking. The closest one gets to an explanation is in a DHS report on the protection of privacy, where it is stated that: "All SARs are centered on activities, meaning that an event or action has occurred that has triggered some degree of suspicion" (DHS 2010: 2). A similar degree of vagueness characterizes the slogan "If you see something, say something", invented by the Metropolitan Transportation Authority (MTA). In an interview in 2010, the Security Director of MTA explained the meaning of the term "something": "It is a wide-open thing – don't be complacent, if you see anything that you feel and in your mind bothers you".[1]

In the name of resilience, citizens are asked to "be alert", "stay awake", "see something", and "say something", but the meaning of these terms is left to citizens themselves to create. In other words, acting "responsibly" is not scripted or defined. As such, the political task of creating a resilient society becomes one of second order character formation, not of direct policy formulations: the government is to create the kind of society which will define and enact resilient behaviour on its own accord. Neo-republican security governance thus involves the political creation of civic subjectivities able and willing to co-create, to define the "something".

Beyond the neo-liberal state

In bringing the case of American counterterrorist policies to debates on the nature of contemporary risk management, we do not dispute the extensive political influence of neo-liberal modes of thought or the critical value of neo-liberal governmentality studies. What we do want to suggest, though, is the need for empirical sensitivity: for approaching local practices of risk as part of complex historical, cultural, and often national governance traditions that do not simply fit the bill of "privatization".

As the case of American counterterrorist policies illustrates, neo-liberalism was not the only intellectual legacy that modernity brought into play in its dealings with uncertainty, insofar as rationalist, individualist scientism is not the only political philosophy on which the modern state was built. Neo-republicanism is but one of those "other" philosophies relevant to the contemporary governance of threats, risk, and security. In our opinion, to acknowledge that complexity and the rich historical, cultural, and often national patterns from which specific practices of risk and security management spring is the central theoretical as well as empirical challenge that risk scholars of the 21st century must face.

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[1] Interview with MTA's Deputy Executive Director/Director of Security William A. Morange conducted by Karen Lund Petersen, MTA office, New York City, 13 May 2010.

CORPORATE REPORTING REGULATION: Time to Recalibrate around Practice

Yasmine Chahed discusses why regulators should pay greater attention to the corporate reporting process when looking for solutions for symptoms of reporting "failure".

Corporate financial reporting appears to be a constantly failing endeavour. A seemingly endless stream of revision and reform has occupied national and international policy makers in the field. For more than 30 years, the common aim of regulatory activities has been to increase transparency and accountability of companies in a capital market setting.

Their success has been put into question by published corporate reports which are deemed increasingly long, complex, and fragmented. According to recent research by Deloitte (2011), the average length of the annual report of UK listed companies has increased by 123 per cent, from 44 pages in 1996 to 98 pages in 2011. Other studies highlight an alarming compartmentalization of the corporate reporting system into a set of disconnected disclosures (Tomorrow's Company 2011).

New initiatives have been launched in the UK and internationally to address these issues. While some maintain a traditional focus on the clarity, comparability, and understandability of company financial statements in the "back end" of the annual report (EC 2011), other projects aim for greater integration, standardization, and harmonization of narrative disclosures in the "front end" (eg EC 2010; IASB 2010; BIS 2011; IIRC 2011). They call upon companies to demonstrate – more explicitly – the links between their financial results, business models, long-term objectives, risks, remuneration, and a wide range of non-financial factors including social and environmental matters. The problem with the current and most recent reform programmes is that they treat corporate reporting as an outcome by focusing almost exclusively on formats and contents.

Outcome myopia

Those involved in corporate reporting may have a point when criticizing financial reporting regulators for living in "a parallel universe where academia and theory take over" (interviewee working in an FTSE 100 company). They refer to the development of the corporate report into an over-theorized and over-politicized object of regulatory intervention, while the more mundane processes of corporate reporting remain unobserved. The risk of ongoing reform is to trigger fatigue rather than progress by creating a complex system of ever expanding and overlapping requirements that are detached from the challenges of communicating a coherent "equity story" in practice. First, policy makers commonly speak of "the user" of published reports, but rarely consider *how* the annual report is actually used. Second, the entity concept of financial reporting suggests a unity of "the preparer" that is not necessarily reflected in the act of *preparing* the annual report. In other words, what remains overlooked in proposals for financial reporting reform are the people, processes, and institutions which constitute corporate reporting in action.

Who are "the users"?

Policy debates tend to portray the annual report as a key instrument of corporate governance. Spectacular corporate failures are often blamed on weaknesses in the corporate reporting system, as in the cases of Enron, Worldcom, or Parmalat in the early 2000s. The global financial crisis of 2008 rang new alarm bells about difficulties to discern the message about the long-term financial health of companies from published financial and other statements. Further enhancements to corporate reporting are demanded in order to help investors (shareholders being the primary users of published financial reports according to company law) and other report users in the future to make better informed decisions about their relationship with the company and to prevent similar crises of governance from recurring. However, there appears to be a great disparity between the reporting ideal in policy making and the practical use of corporate reports once they have been published. Anecdotal evidence from those involved in the corporate reporting process of UK listed companies suggests that we have reached a point where "no one" or at least "very few people" read the full version of the annual report (interviewees working in FTSE 100 companies). Over the past ten years or so, the increasing availability of topical information about the company through other channels has changed the ways in which the annual report is used. Technical developments have made it possible to communicate topical information about the company's strategy, governance, and performance through websites, webcasts, or interactive applications. The practice of releasing preliminary results contributes to an additional decrease of the incremental decision value of the information provided in some companies' final annual reports.

Professional investors are often quoted as saying that they prefer personal communication with the company. According to their own accounts, fund managers use the annual report selectively, at most, to check the consistency of the financial information on which their investment models are based. In that sense, the annual report may be understood as a "hygiene factor" that needs to be clear, consistent, and easy to understand, but that contributes little to managing the expectations of investors. The only exception seems to be published information on remuneration. The Directors' Remuneration Report is often the only element that constitutes "news" by the time the annual report is released.

The fragmented and overall limited use of the annual report by external parties raises fundamental questions about the emphasis on "the user" in corporate reporting regulation. Evidence is emerging that new policies should be defined alongside the ways in which annual reporting information

"…what remains overlooked in proposals for financial reporting reform are the people, processes, and institutions which constitute corporate reporting in action."

is implicated in the activities and decisions of preparer organizations themselves. While external communication increasingly takes place through other channels, the components of the annual report continue to provide important points of condensation around which internal perceptions of the organization and its performance materialize.

Who are "the preparers"?

Regulatory reform in corporate reporting also often seems to fail because the internal process and control challenges of preparing corporate reports in practice are not reflected in programmes for change.[1] Put simply, the corporate reporting process is not as clear-cut as the fundamental entity concept of corporate financial reporting suggests. In spite of the legal assumption that the formal responsibility for the preparation of the annual report rests with the board of directors and its committees, the production of the document that is eventually released to the public involves a range of organizational functions and extra-organizational knowledge. The dispersion of the reporting process within and across the boundaries of the reporting entity makes it more difficult to use the annual report as a means of telling a coherent "financial story" about the organization and to give management the opportunity to tell it in their own words.

A few years into the 21st century, it may still have been accurate to assume that the finance function in most large corporations owned and controlled the production of the annual report in its entirety. Today, the responsibility for formally overseeing and coordinating the reporting process rests in many cases with the company secretary. The secretary holds a senior administrative function and acts as the advisor to the board and the chairman on compliance and corporate governance related matters. As part of their work, the secretarial team often draft all or parts of the governance sections in published reports, which are formally signed off by the respective board committees. The narrative sections on strategy and business models tend to be drafted by investor relations or corporate communications departments. This often leaves finance teams with the task of preparing the financial statements and supplying any financial numbers that are presented in other parts of the report. At the same time, the market for external corporate reporting advisors is growing. Traditionally, the involvement of corporate communications agencies and public relations experts in the reporting process centred on the visual and textual design and the coordination of the printing stage. Their services have shifted towards helping companies develop coherent reporting strategies, the supply of benchmarking data on reporting "best practice", and the drafting of skeleton reports. A wide range of expert advisors also provide specialized inputs into the content of reports on pensions or remuneration. During the finishing stage, legal experts may be called in to perform compliance checks.

Addressing the challenges

Breaking the cycle of financial reporting "failure" and reform will require much greater attention to the challenges of corporate reporting in action. Current ambitions to promote the quality and integration of information in corporate reports are met by an increasing fragmentation of the processes of preparing and using the published reports and accounts in their present form. To prevent corporate reporting from dissolving into the space of box-ticking and compliance, policy makers need to rethink conventional categories. An outcome centred view on "the corporate report" as a means of connecting "the reporting entity" with its wider environment fails to acknowledge the complexity of the social processes by which it facilitates communication and action within and beyond organizational boundaries. In particular, a company level view of "the preparer" risks masking the multitude of functions and areas of expertise that need to be managed internally in order to ensure compliance and integrity of information. Research on corporate reporting as a social practice can help demonstrate how such reports in the 21st century are implicated in diverse economic as well as social and political relationships.

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[1] The agenda of corporate reporting reform is typically driven by a broad stakeholder community, including preparers and investors as well as political parties, trade unions, NGOs, academia, professional membership bodies, and professional service firms.

CARRRESEARCH

RESPONSIBILITY IN FINANCIAL INNOVATION
RETOOLING NEW PRODUCT COMMITTEES

Fabian Muniesa considers the potential contributions of New Product Committees to the development of responsible innovation in finance.

How practicable would be a reform of financial innovation that could lead to the development of a genuine culture of responsibility? Debates on responsible and irresponsible innovation in finance are attracting ever more attention. This is partly a result of the global financial crisis of the late 2000s. The need for change is widely acknowledged in policy circles as well as by some members of the financial services community. But regulatory oversight often fails to cope with the sophistication of practice, and measures of accountability rarely count on banking culture as a natural ally. Investment banks, however, possess organizational features which, once conveniently retooled, can make substantial contributions to the development of responsible innovation in finance. An interdisciplinary working group sponsored by the Observatory for Responsible Innovation, an independent think tank established at Mines ParisTech, has been looking in that direction. Its focus has been on New Product Committees (see Armstrong et al. 2012).

In the financial services industry, the notion of New Product Committee or New Product Approval refers to the organizational structures and group meetings inside an investment bank in which the development and launch of a new product or service are discussed. Within these spaces, risks and opportunities are assessed, decisions are validated, and tasks and responsibilities are attributed. Product approval processes have been in operation for quite a long time, for instance in the form of project development groups. But the institutionalization of New Product Committees as such is a quite recent phenomenon. Traces of their emergence can be found in the framework of the Basel II Accords. Regulators have since been introducing the idea of a mandatory approval for new products. The form this may take inside each investment bank is still dependent on organizational idiosyncrasies.

In short, New Product Committees are meant to be spaces in which responsibility for the consequences of innovation – including the negative ones – is (or can be) collectively taken. But is that really the case? It is up to bankers and regulators to look into this as a serious potential.

Where are we today? New Product Committees in the financial services industry are generally open to a multiplicity of concerned parties, but limited to the internal perimeter of the credit institution or the investment firm. Participants are members of the teams in charge of financial engineering and trading, risk analysis, legal compliance, accounting, and clearing and settlement. There is no widespread practice of extending the perimeter of New Product Committees and inviting participants from outside the firm. There are no industry-wide guidelines for the governance of New Product Committees, which is defined internally. Worries and concerns can generally be expressed by relevant departments within these spaces, yet sometimes a marked sense of hierarchy, an over-emphasis on competition, or a harsh climate of professional progress may lead to situations in which some actors refrain from expressing concerns or are simply not heard. In principle, New Product Committees can also assess the evolution and effects of a service or product which has already been released into the market. The innovation is thus open to a cyclical revision process or to preventive steps that can be implemented before the innovation is too widely disseminated, and hence difficult to restrain. Moreover, New Product Committees are instruments for tracing decisions and responsibilities. Decision making results in the production of signed documents which thereby certify that signatory parties are accountable. But New Product Committees are sometimes also seen as an administrative burden, impairing the unleashing of financial imagination (traders and financial engineers generally hold this view), and the organizational measures are not always popular among bank employees. The fact that New Product Committees somehow produce legitimacy and allow new products to join the chain of existing products may not be sufficient to make

"…as part of the organizational culture of the investment bank, New Product Committees strengthen the penetration of responsibility into professional habits, and they could strengthen it further through their role in career development."

these committees attractive. Compliance officers and other actors in charge of regulatory verification inside the financial firm play an important role in New Product Committees. Yet they are often caught between contradictory commitments: towards the firm on the one hand, towards the regulator on the other hand.

What can be done? As pointed out by Armstrong et al. (2012), once conveniently retooled, New Product Committees can be made appropriate hubs for the development of responsible innovation in finance. Firstly, the New Product Committee is a place in which the function of the product can be discussed and made explicit – an environment in which the purpose of the financial innovation could be publicly articulated and justified. Secondly, the role of the compliance officer could be strengthened and improved. It need not remain limited to warranting regulatory verification (ie restrained to a "box-ticking" view), but could instead be more oriented towards raising questions and moral issues. This would help transform the New Product Committee into a robust relay towards regulators. Thirdly, as part of the organizational culture of the investment bank, New Product Committees strengthen the penetration of responsibility into professional habits, and they could strengthen it further through their role in career development. For example, valid experience within New Product Committees could be considered as a requisite for accessing high responsibility positions in the organization. Fourthly, the New Product Committee is the space in which the limitations of modelling and forecasting can be acknowledged. This makes possible their compensation by discussions about qualitative considerations and through a commitment to revising and reassessing the innovation and its behaviour once it has been introduced into the market. Fifthly, membership to New Product Committees is already a form of personal accountability. This can be improved through a long-term commitment of participants (taking into account staff turnover), which would involve the recalibration of their economic incentives in light of their ability to commit to the long-run assessment of the innovation. Sixthly, the New Product Committee can be the place where issues of calibration and dissemination of innovation are systematically raised. This clinical perspective can be connected to an industry-wide initiative for setting indicative precautionary thresholds for the size and scope of an innovation, preventing full mass marketing before a testing period. Finally, New Product Committees allow for an informal deliberative process in which the voicing of concerns could be improved by procedures and codes of conduct that ensure that each participant has an equal say and this can include inviting external observers.

The conclusions of the Observatory for Responsible Innovation are quite promising: both regulatory measures and industry initiatives could find in New Product Committees a space conducive to the advancement of responsible innovation in finance. In his remarks at the *Conference on Debating Responsible Innovation in Finance*, held on 30 November 2011 at Mines ParisTech, CARR Director Michael Power observed the extent to which the organization of innovation in the financial services industry lacks proper understanding of how laboratories work in other areas (such as nanotechnology, biotechnology, biomedicine, telecommunications, and energy). New Product Committees can be effectively retooled to enhance that understanding.

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More information on the work discussed in this article can be found at: www.debatinginnovation.org

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THE ROOTS OF RISKS IN AUTOMATED FINANCIAL MARKETS

Daniel Beunza, **Donald MacKenzie**, **Yuval Millo**, and **Juan Pablo Pardo-Guerra** analyse the history of automated financial markets, trace the impact of economists and regulators on the shaping of these markets, and discuss some of the risks that may emerge as a result.

Automated financial markets dominate today's financial activity. Most of the trading done on a daily basis is generated through automatic algorithms and much of the orders in exchanges are matched by automatic computer programs. Automated trading is commonly regarded as a straightforward outcome of technological advancement. The usual argument is that information and communication technology became affordable and available and thus made trading in financial markets cheaper, quicker, and easier to trace and audit. This argument, however, is partial. It does not account for how automated markets came about, what actors took part in shaping them, and, crucially, how these historical processes affect today's financial markets and the potential risks they impose.

In a recent report for the UK Treasury and the Department of Business, Innovation and Skills, we examined the history of automated markets. We found that in the US and the UK, regulators and economists played important roles in shaping these markets and that this history introduced certain risks to the structure of financial markets. We found that regulators and economists, each motivated by a different worldview, advocated and actively took part in the design of a market without human intermediaries and that this quest contributed to the creation of today's financial markets and their unique set of risks.

In the US, regulatory attempts to improve the market by targeting intermediaries (such as market makers or specialists) go back to the 1960s. At the time, the Securities and Exchange Commission (SEC) became dissatisfied with the wide spreads quoted by dealers in the over-the-counter market and concluded that a market based on a loose network of dealers connected by telephones and restrained by self-regulation was too difficult to supervise. The SEC favoured replacing the dealers with information technology, requiring electronic quote dissemination at the new market, the NASDAQ, in 1971.

In the same year, the economist Fischer Black argued for replacing financial intermediaries (in this case, the specialists at the New York Stock Exchange) with a central computer. Unlike the SEC, which saw human intermediaries as a problem for regulation, Black believed that markets were fundamentally large price-discovery systems and as such could be reduced to electronic networks of participants linked by cables, leading to a "thinking whole". In 1972, following public hearings in the US Congress where Black and other economists gave testimonies, the SEC published a statement in support of automatic markets and appointed an advisory committee to develop a detailed policy proposal; the committee included several of the notable supporters of electronic trading. The general motivation for the SEC's initiative was the concentration of power that human market intermediaries accumulated and the biases that this structural characteristic introduced. The suggested solution to this problem was a central market (known as the National Market System) where, it was hoped, the sheer number and diversity of intermediaries would prevent any of them from becoming too powerful.

As the committee operated, the influence of economics in the SEC grew. In 1975, the SEC established the Office of Economic Analysis within the organization and, a year later, the National Market Advisory Board (NMAB), another committee that was responsible for assessing the changes necessary as a result of the amendments. Following the recommendations from these bodies, a set of regulatory steps was put in place that tied together the various American exchanges in a system of communications.

In the following ten years, more regulations were implemented, increasing the informational connectivity among markets. Human intermediaries, however, were not removed from the market, but were "surrounded" by an ever deeper and more complex set of technological devices. A chain of scandals beginning in the late 1980s gradually eroded the trust in market intermediaries. In the wake of the October 1987 market crash, market makers at the NASDAQ were accused of opportunistic behaviour because they did not fulfil their obligations. In 1994, it was found again that NASDAQ market makers colluded to set stock prices. In August 2003, Richard Grasso, the powerful CEO of the New York Stock Exchange (NYSE), who was a staunch supporter of human market intermediaries, was embroiled in a scandal and had to resign. In October of that year, five of the NYSE's leading specialists' firms were found to have abused their positions and fined.

Following these scandals, the SEC implemented its most ambitious move towards an automation of markets. New rules connected all exchanges to a fast network of communications and market orders, leaving human intermediaries a reaction time of one second. As a direct result, activity in US financial exchanges was transferred mostly to automatic execution. The connectivity among exchanges meant that orders that were not executed quickly were routed automatically to another exchange and a race for speed began. The automation of execution also affected the generation of orders. Using the fast connectivity, investors split their orders into increasingly smaller parts, which were sent anonymously to different exchanges, thus hiding the overall size of the trade and avoiding having an impact on market prices. By 2008, most human intermediaries had disappeared from US exchanges and financial markets were dominated by automation.

A similar picture emerges from the historical developments in the UK. The London Stock Exchange (LSE), which had employed a system of human intermediaries and dominated financial trading until the 1970s, saw a challenge in 1973, when merchant banks were successful in abolishing the fixed commissions the exchange charged, an act that led to the development of an independent electronic trading platform. In 1986, in what is often referred to as Big Bang, the UK financial system witnessed the introduction of an electronic dealing system, SEAQ, which emulated the operation of the trading floor through a network of screens and phones.

In the UK, we also see that the regulatory environment began to incorporate economic theory. From the late 1980s onwards, the Office of Fair Trading (OFT) and other government bodies increasingly sought advice from economists. Researchers from City University and the Financial Markets Group of the London School of Economics were particularly active in conducting studies of the stock market which reverberated with the views of the OFT. To a considerable extent, market regulation policies forged ahead and after 1990 were informed by the economic theory that necessitated transparency for maintaining fairness and efficiency in the market.

These ideas and the regulatory motivation preceded the introduction of Tradepoint in the mid 1990s. Tradepoint was the first complete automatic alternative to the LSE, as it automated the process of collecting and matching orders from investors and offered anonymous direct market access. From the economists' perspective, Tradepoint provided an intermediary-free mechanism of exchange for institutions because it allowed direct access to the exchange's matching procedure instead of intermediation over the phone. The British regulators

"The specific form taken by market automation has undermined the social mechanisms of norm enforcement traditionally deployed by human intermediaries."

also saw Tradepoint as a positive development and encouraged its developers to register the system as an exchange. As in the US case, the developments in the UK market, leading to the introduction of Tradepoint, triggered increased competition, reduced spreads in the most active shares, and, consequently, lowered the intermediaries' returns per trade. These factors paved the way to financial markets where human intermediaries were marginalized and automation became dominant.

What are the implications of these historical events for the behaviour of automated markets? In particular, what potential risks were created along with the evolvement of automated trading systems? From our analysis, we identify three types of risks.

First, the risk of a *weak norms* market. The specific form taken by market automation has undermined the social mechanisms of norm enforcement traditionally deployed by human intermediaries. In many markets, such as the NYSE, for example, human intermediaries lost much of their clout because they were no longer the exclusive source of order for other traders. Furthermore, connectivity and the rise of anonymous orders diminished the ability of exchanges to impose desired behaviours through their procedures. The growing technological component of markets also increased the distance between the innovators and the users of the systems. Whilst in the past the designers of trading rules came from among traders themselves, in automated markets innovation was spearheaded by engineers and computer communication experts. The latter were less familiar with the informal norms and codes of behaviour that affected trading practices and, consequently, did not embed these into the automated trading systems they developed. Hence markets typified by weak norms may include adequate rules, but lack effective social and technological infrastructure through which such rules may be implemented and employed.

Second, the risk of *toxic transparency*. This risk can be understood on the basis of Steve Wunch's insight that pursuing transparency through a system where trading orders are openly visible to all other market participants and where orders can be immediately acted upon by others may have the perverse effect of deterring investors from participating in the market and thus lowering liquidity in the markets. An indication of the significance of this risk comes from the recent proliferation of dark pools – non-exchange trading venues where relative anonymity is maintained. While offering a solution to the traders, dark pools also increase the fragmentation of orders and further exacerbate the negative impact of toxic transparency on liquidity.

Third, the risk of *fragmented innovation*. Automation of financial markets motivated innovators to focus primarily on improving speeds. This focus, in turn, increased secrecy in the field and has narrowed the scope that any single actor may have. As a result, market participants make decisions about the design and development of systems as well as operational day-to-day activities while being, in effect, ignorant of their potential systemic implications.

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CARRNEWS

CARR News

Mike Power has joined the Advisory Panel of the Office of the Rail Regulator and has become a member of the Advisory Board for the Public Private Relations Platform at Copenhagen Business School. In March, Mike presented a paper on "Accounting for the impact of research" at the Birkbeck and Institute for Voluntary Action Research seminar.

Bridget Hutter chaired the British Library and Strategic Society Centre joint debate "From the other side: social scientists inside government" (November) and presented the paper "Governing food risks: the role of the state and non-state influences" at the Forschungswerkstatt of the Freie Universität Berlin (December). In March, Bridget chaired "Myths and realities 13 security and surveillance: has it gone too far?", a public lecture organized and supported by the Academy of Social Sciences and the British Library, and spoke on "Managing food safety and hygiene" in a Food Standards Agency seminar.

In November, **Peter Miller** presented the paper "Democratising failure: the making of a calculative infrastructure for forgiving and forecasting failure" at the Workshop on Strategy, Organization and Society at Copenhagen Business School. In the same month, Peter, together with **Irvine Lapsley** (University of Edinburgh), organized the workshop Accountants in the Risk Society – sponsored by the Institute of Public Sector Accounting Research – at the University of Edinburgh Business School. The keynote speakers were **Barbara Czarniawska** (Gothenburg University) and **Mike Power**, who presented a paper on "Fraud risk: an archaeological analysis".

Christopher Sampson, a CARR PhD student in LSE's Government Department, conducted research at Peking University for his dissertation on "Industrial reform and the dynamics of government-enterprise relations in China's water and electricity supply". During his research trip, he attended the 6th China International Water Business Summit and participated in a discussion panel on China's energy legislation at an Energy Review Academic Salon. Christopher also took part in a number of Beijing Energy & Environment Roundtables, conducted pilot interviews with senior representatives of water supply firms, and evaluated Chinese industry and media reports on the water and power sectors. A visiting scholar to the PKU School of Government and the Leo Ko-Guan Institute of Business and Government between September and December 2011, Christopher was supported by CARR and the LSE PhD Mobility Bursary Fund. He is scheduled to return to Beijing for further research in mid 2012.

CARR Seminars 2011/12

6 December 2011
Dr Javier Lezaun
Oxford University
The Transitional Objects of the Law

31 January 2012
Dr David Demortain
IFRIS, Paris-Est University
Ideals of Governability in Risk Regulation. Or Where Do Risk-Based Decision-Making Frameworks Come From?

6 March 2012
Professor Preben Lindøe
Stavanger University
Robust Regulation in the Offshore Petroleum Industry – An Assessment of Different Approaches

Recent CARR Discussion Papers

lse.ac.uk/researchAndExpertise/units/CARR/publications/discussionPapers.aspx

DP 70 How Firms Translate Regulatory Messages
Sharon Gilad, March 2012

Publication

The Managerialization of Security
Mike Power in *Securitization, Accountability and Risk Management: Transforming the Public Security Domain* by Karin Svedberg Helgesson and Ulrika Mörth (eds), Routledge 2012.

CARR Discussion Groups

CARR's three discussion groups on Financial Advice, Risk Indicators, and Failure-Resilience have continued. They have provided a useful forum for discussing the risk culture project (see editorial above) and other initiatives.

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

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Frank Vibert - Founder Director, European Policy Forum

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Jeremy Lonsdale – Visiting Senior Fellow National Audit Office

CARR Administration

Yvonne Guthrie – Centre Manager and Discussion Papers

Justin Adams – Seminars

Lynsey Dickson – Web and Publications

Elizabeth Venning – Reception

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