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## Regulation in context

Financial services regulation has matured considerably in the past 25 years. The current regulator, the Financial Services Authority (hereafter “FSA”), has developed a sophisticated, comprehensive and potentially far-reaching regulatory tool kit through which to implement its objectives.<sup>1</sup> This reflects the fact that the “art” of regulation is now understood to be far more diverse and intricate than when regulation first began to attract academic interest. While it operates within the statutory framework imposed by the Financial Services and Markets Act 2000 (hereafter “FSMA”), there are three aspects of this regulatory toolkit developed by the regulator that we believe are of particular importance and significance. These are the subject of this book, rather than the structure of the regulatory environment for financial services,<sup>2</sup> which needs little explanation and has been extensively described and analysed elsewhere.<sup>3</sup>

<sup>1</sup>See J Black, *Mapping the Contours of Financial Services Regulation* (Centre for Analysis of Risk and Regulation, LSE: London, 2003).

<sup>2</sup>This structure has undergone significant change since the 1980s – from one of little or no regulation of different sectors within financial services industry to “self-regulation under a statutory umbrella” – to full statutory regulation under one “super-regulator”.

<sup>3</sup>See, for example, G McMeel and J Virgo, *Financial Advice and Financial Products: Law and Liability* (Oxford University Press: Oxford, 2001); J Hamilton, *Financial Services*

The first aspect of central importance is the adoption by the FSA of risk-based regulation, and the concomitant development of its risk-based operating framework for supervision. This is of fundamental significance, and provides the context within which analysis and discussion of the two further aspects are carried out. The first of these two further aspects is the trend towards greater regulatory incursion into the internal business management processes and strategies of regulated firms through regulatory tools which address the role of senior managements of firms, and directly regulate individuals within firms, especially senior managers. The second further aspect is the change in regulatory rhetoric and action over the last 20 years to mirror the re-drawing of the boundary between collective and personal responsibility. This has led to an increasing emphasis on financial citizenship and personal financial autonomy.

The centrality of these aspects is in stark contrast to the situation in the early days of the precursor of the FSA, the Securities and Investment Board (hereafter "SIB"). At that time regulation was viewed simply in terms of command and control. Its effectiveness was judged against compliance with prescriptive and detailed rules, and regulators in the financial services sector were left to determine their own broad regulatory objectives.

## The rise of risk

In one sense the adoption of risk as the basis of regulation by the financial services regulator is neither particularly unique nor unusual. Discourses around risk have now become commonplace within executive government in the UK.<sup>4</sup> As Fisher<sup>5</sup> has commented:

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Regulation, in L Macgregor, T Prosser and C Villiers (eds) *Regulation and Markets Beyond 2000* (Ashgate: Aldershot, 2000), p 243; M Blair, L Minghella, M Taylor, M Threpland and G Walker, *Blackstone's Guide to the Financial Services and Markets Act 2000* (Blackstone Press: London, 2000).

<sup>4</sup>Although as Black identifies, risk-based regulation has two distinct meanings, one refers to the implementation of internal risk management systems, the other refers to risk-based regulation where sources of risk are regarded as external to the organisation – J Black, The Emergence of Risk-based Regulation and the New Public Risk Management in the UK, *Public Law*, 512–548.

<sup>5</sup>E Fisher, The Rise of the Risk Commonwealth and the Challenge for Administrative Law, *Public Law*, 2003, 455–478 at 455.

One of the central tasks of the UK executive state is now perceived to be the handling of risk... The task of public decision makers is increasingly characterised in terms of the identification and assessment and management of risk and the legitimacy of public decision-making is also being evaluated on such a basis.

Furthermore, risk has become the dominant concept across a range of regulatory spheres from environmental protection and health and safety to other diverse arenas such as health, penology, and child protection,<sup>6</sup> as well as public sector management and finance. It has become the dominant concept in the regulatory reform process itself where regulation has to be proportionate to the risks.<sup>7</sup> As Fisher notes, in some of these spheres a concern for risk has always been implicit, as, for example, in environmental protection, food safety and occupational health and safety. In other regulatory spheres a focus on the concept of risk is relatively recent. Increasingly, however, regulators are required to engage in formal risk assessment and risk management.<sup>8</sup> It is clear now that the language of risk has permeated most areas of executive government. This is so much so that HM Treasury's *Management of Risk: Principles and Concepts*<sup>9</sup> states that "it can now be presumed that all existing [government] organisations have basic risk management processes in place"<sup>10</sup> and further that "every organisation which wants to maximize its success in delivering its objectives needs to have a risk management strategy, led from the very top of the organisation, which is then implemented by managers at every level... and embedded in the normal working routines and activities of the organisation".<sup>11</sup>

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<sup>6</sup>See, e.g., J Braithwaite, *The New Regulatory State and the Transformation of Criminology*, in D Garland and R Sparks (eds) *Criminology and Social Theory* (OUP: Oxford, 2000), and P O'Malley, *Risk, Uncertainty and Government* (Glasshouse Press: London, 2004), M Power, *The Risk Management of Everything: Rethinking the Politics of Uncertainty* (Demos: London, 2004).

<sup>7</sup>Better Regulation Action Plan, 24 May 2005, available at [http://www.hm-treasury.gov.uk/newsroom\\_and\\_speeches/press/2005/press\\_50\\_05.cfm](http://www.hm-treasury.gov.uk/newsroom_and_speeches/press/2005/press_50_05.cfm). See also *Transforming the Regulatory Landscape – Launch of Consultation on Bill for Better Regulation*, Cabinet Office, 24 July 2005.

<sup>8</sup>E Fisher, *supra*, n 5.

<sup>9</sup>Consultation Draft, May 2004 (HMSO, 2004).

<sup>10</sup>*Ibid.*, para 1.3.

<sup>11</sup>*Supra*, n 9, para. 2.6.

As Fisher observes, however, the notion that risk is now embedded in public decision-making is not a simple case of rebranding past practices with new buzzwords. Instead, risk represents a new way of conceptualising what “public administration” and regulation do. She suggests it is not simply a tool for decision-making, but in fact represents a new way of governing, and adds that “the end result has seemingly been a dramatic evolution in what public administration does and what it is perceived that it should do”.<sup>12</sup> This evolution, she believes, has a number of fundamental implications for what is understood to be the role and the nature of the administrative state and the role of non-legal modes of regulating public administration, as well as how to identify good and bad public decision-making. It raises not only questions about the meaning of risk but also questions relating to the ways it is deployed by regulators and administrators, and its implications for citizens.

But it is recognised that the way risk has been embedded varies across public bodies and agencies.<sup>13</sup> Consequently, it cannot be analysed as if it were a uniform and unifying development across administrative and regulatory spheres. Rather each sphere needs to be examined for its specific implications. But in the call for more site specific examination of the embedding of risk it is important not to lose sight of the fact that this embedding is taking place within the context of an embedding of risk generally across a whole range of administrative and regulatory spheres. To ignore this wider context would be to overlook more subtle and broad-based implications of this development, and it is worth therefore analysing why risk has become so central in administrative and regulatory spheres generally. At the same time, risk is a concept that may be taken for granted by those involved in the everyday practices associated with it, and requires to be unpacked before looking at it further in the context of financial services regulation.

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<sup>12</sup>E Fisher, *supra*, p 2, n 5.

<sup>13</sup>See, for example, C Hood, H Rothstein and R Baldwin, *The Government of Risk: Understanding Risk Regulation Regimes* (Oxford University Press: Oxford, 2001), P O'Malley, *supra*, p 7, n 6.

## Why risk has become central

Very different explanations are given for why risk has come to be central across government and regulatory spheres.<sup>14</sup> These explanations are, in part, influenced by the different approaches to what risk is, discussed below.

In attempting to account for the emergence of risk as a strategic organising principle in the public sector some commentators have simply pointed towards the particular needs of government. They highlight the need to restore confidence in the aftermath of mismanaged crises (especially responding to particular stimuli such as the collapse of the Barings banking group and BSE), and the need to improve communication with the public, in order to better manage public expectations.<sup>15</sup>

Political scientists, however, convincingly suggest that the adoption of the language and practices of risk reflects a deeper, more complex process, that of “political isomorphism”.<sup>16</sup> This is a process of policy transmission such that bodies will adapt to or adopt governance strategies that have a common currency and will alter their practices so as to become more like those around them. In other words, as a strategy or operating principle risk becomes accepted and embedded in one organisation or institution, and so it acquires a currency within other organisations or institutions.

However, given that risk has been conceptualised and utilised in different ways across organisations and institutions, a process of policy

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<sup>14</sup>And the literature is extensive – see, for example, M Power, *supra*, n 6; D Vogel, *The New Politics of Risk Regulation in Europe*, Centre for Analysis of Risk and Regulation (LSE: London, 2001), and the references contained within.

<sup>15</sup>M Power, *supra*, n 6.

<sup>16</sup>P DiMaggio and W Powell, *The New Institutionalism in Organisational Analysis* (University of Chicago Press: Chicago, 1991). See also P Frumkin and J Galaskiewicz, Institutional Isomorphism and Public Sector Organisations, *Journal of Public Administration Research and Theory*, 2004, Issue 3, 283–307, M Lodge and K Wegrich, Control over Government: Institutional Isomorphism and Government Dynamics in Public Administration, *Policy Studies Journal*, 2005, Vol 33, No 2, 213, E Abrahamson, Managerial Fads and Fashions; The Diffusion and Rejection of Innovations, *Academy of Management Review*, 1991, 16, 586–612.

transmission cannot be the whole explanation.<sup>17</sup> Other explanations, primarily from within the socio-cultural disciplines, suggest that the centrality of risk stems from issues connected with control, accountability, responsibility and blame in late modern society. Two prominent theoretical perspectives that address these issues are broadly termed “risk society” theory and “governmentality” theory. The former draws on the work of the sociologists Beck and Giddens.<sup>18</sup> The latter draws on the work of the important French social thinker Foucault.<sup>19</sup>

At the risk of oversimplifying and caricaturing these important and extremely influential perspectives, the approach of “risk society” theorists such as Giddens and Beck is one that identifies what they believe to be broad socio-economic and political changes that have occurred in late modern societies. Among these changes they identify a loss of faith in institutions and authorities and a greater awareness of the limits and uncertainties associated with science and technology. This loss of faith, greater uncertainty and consequent anxiety about the future has arisen, they suggest, because of an increased awareness of the

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<sup>17</sup>Some suggest that in fact the politics of risk has a long genealogy in government and that in fact what has changed is the way in which it is being deployed – see, e.g., P O'Malley, 2004, *supra*, p 27, n 13.

<sup>18</sup>See, e.g., the work of Ulrich Beck, and Anthony Giddens: U Beck, *Risk Society* (Sage: London, 1992), U Beck, *Risk Society Revisited: Theory, Politics and Research Programmes*, in B Adam, U Beck and J Van Loon (eds) *The Risk Society and Beyond: Critical Issues for Social Theory* (Sage: London, 2000), U Beck, *The Reinvention of Politics*, in U Beck, A Giddens and S Lash, *Reflexive Modernisation: Politics, Tradition and Aesthetics in the Modern Social Order* (Polity Press: Cambridge, 1994), A Giddens, *Risk Society: The Context of British Politics*, in J Franklin (ed) *The Politics of the Risk Society* (Cambridge: Polity Press, 1998), A Giddens, *Risk and Responsibility*, *Modern Law Review*, 1999, 62, 1.

<sup>19</sup>See, e.g., G Burchell, C Gordon and P Miller, *The Foucault Effect: Studies in Governmentality*, (Chicago University Press: Chicago, 1991); N Rose, *Governing the Soul: The Shaping of the Private Self* (Routledge: London, 1990); N Rose, *Powers of Freedom: Reframing Political Thought* (CUP: Cambridge, 1999); M Dean, *Governmentality: Power and Rule in Modern Society* (Sage: London, 1999). The Chair Foucault held at the College de France was in “The History of Systems of Thought”. This connects with his general concern with the way human beings are sought to be controlled. For an introduction to his work, see P Rabinow, *The Foucault Reader* (Random House: London, 1984); B Smart, *Michael Foucault* (revised ed) (Routledge: London, 2002).

larger scale of risks faced in the 20th and 21st centuries (the period of “late modernity”<sup>20</sup>). This is encapsulated in what has been termed the “risk society” – a society in which most risk is “manufactured”, that is, generated by humans as part of the techno-economic development of industrialisation, modernisation and capitalism, rather than externally imposed by nature.

Giddens, for instance, suggests that concern with risk has become ubiquitous because of an increasing awareness of the potential scale of these “manufactured” risks, which are typically unseen, global and potentially catastrophic. There is increasing awareness, too, of the contingent nature of risk assessment and management techniques. Late modern society is not necessarily intrinsically more dangerous than before.<sup>21</sup> Indeed, we now live longer, have better health etc. But for every scientific “breakthrough” there are new uncertainties and new risks to be faced. There is now an awareness at all levels of the “inherent indeterminacies and uncertainties of risk diagnosis” associated with manufactured risk.<sup>22</sup> This contrasts with the position at an earlier period (which Beck calls “simple modernity”), where there was belief in the ability of experts to identify, measure and hence control risks, or at least a belief that with the advancement of science they would ultimately succeed in doing so.

In addition, attempts to try to confine and control these risks increases uncertainty and danger.<sup>23</sup> The near collapse in 1998 of Long Term Capital Management, an investment fund that traded in derivatives – the very instruments created to off-set modern risk – can be seen as a quintessential example of what Beck and Giddens would call modern manufactured risk. Had it not been for the bailout encouraged by US Federal Reserve Bank, its collapse had the potential to unravel the entire

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<sup>20</sup>Or what some would call “postmodernity”. See, for example, D Harvey, *The Condition of Postmodernity* (Blackwell: Oxford, 1989).

<sup>21</sup>Cf. Ulrich Beck – who believes society is facing potentially apocalyptic threats, see U Beck, *Risk Society* (Sage: London, 1992).

<sup>22</sup>U Beck, *Risk Society Revisited: Theory, Politics and Research Programmes*, in B Adam, U Beck and J Van Loon, 2000, *supra*, p 219, n 18.

<sup>23</sup>*Ibid.*, p 206.

banking system.<sup>24</sup> As a result, they suggest, we have entered a period of “reflexive modernisation” which involves questioning the outcomes of modernity, including the practices and procedures associated with industry and science.<sup>25</sup> “Risk society” theory suggests that the preoccupation with risk in government and regulatory circles is a response to a general recognition that there are limits to the ability to know or to control the uncertainties associated with late modernity, and to a public wanting to hold public decision-makers to account. Risk is now viewed as a political rather than a metaphysical phenomenon.<sup>26</sup> Giddens, who has been a formative intellectual influence on the development of Labour “third way” ideology, suggests that “[a] good deal of political decision-making is now about managing [these manufactured] risks – risks which do not originate in the political sphere, yet have to be politically managed”.<sup>27</sup> For the exponents of the “risk society” thesis, risk governance is not so much associated with control but with the absence of control. In Giddens’ phrase late modern society is a “runaway world”.<sup>28</sup>

An alternative perspective on the centrality of risk is offered by “governmentality theory”. The term “governmentality” is used to refer to

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<sup>24</sup>The study of the collapse has generated much paper and ink and different reasons put forward for its collapse. See, e.g., P Partnoy, *The Politics of Greed* (Profile Books: London, 2003); M Stein, Unbounded Rationality: Risk and Organizational Narcissism at LTCM, *Human Relations*, 2003, Vol 56(5), 523–540; D MacKenzie, Long-Term Capital Management and the Sociology of Arbitrage, *Economy and Society*, 2003, 32, 349–380; D MacKenzie, Fear in the Markets, *London Review of Books*, 2000, Vol 22, No 8, accessed on-line at [www.lrb.co.uk/v22/no8/mack01\\_.html](http://www.lrb.co.uk/v22/no8/mack01_.html)

<sup>25</sup>A Giddens, Risk and Responsibility, supra, p 6, n 18. Beck describes reflexive modernisation as “self-confrontation with the effects of risk society that cannot be dealt with and assimilated in the system of industrial society”: U Beck, in U Beck, A Giddens and S Lash, *Reflexive Modernisation* supra, p 6, n 18. For a discussion of the similarities and differences between Beck’s and Giddens’ concept of reflexive modernity, see S Lash, Reflexivity and its Doubles, also in U Beck, A Giddens and S Lash, *Reflexive Modernisation*.

<sup>26</sup>D Lupton and J Tulloch, Risk is Part of Your Life; Risk Epistemologies Among a Group of Australians, *Sociology*, 2002, Vol 36(2), 317–334.

<sup>27</sup>A Giddens, Risk and Responsibility, supra, p 5, n 18.

<sup>28</sup>A Giddens, *Runaway World: How Globalization is Reshaping our Lives* (Profile Books: London, 1999).

specific modes of government that have emerged in modern societies in line with liberalist and neo-liberalist discourses.<sup>29</sup> Governmentality theorists are interested in examining the ways in which power is constituted and exercised in liberal and neo-liberal societies. Their interest in risk does not focus on the nature and scale of risks in late modern society, nor does it centre around identifying macro-level transformations in society (transformations governmentality scholars do not necessarily accept in any case<sup>30</sup>). Rather it is centred around the exploration of how the identification of risks associated with certain behaviour or activities provide a means through which to exercise control over populations, groups or individuals in neo-liberal societies. In other words, governmentality theorists are interested in identifying how risk is used as a “tool of governance” to shape behaviours.<sup>31</sup> One of the clearest examples of the use of risk as a tool of governance is in insurance.

The technologies of insurance (statistics, classification and frequency observation) are tools used to make risk calculable and, in making it calculable, it can be used as the basis on which to promote responsible behaviour on the part of the insured, for which the clumsy but apt term “responsibilisation” has been coined. This can be seen, for example, in relation to smoking and other hazardous activities whereby smokers or those who engage in such activities are required to pay higher premiums or denied insurance altogether. This allocation of responsibility in turn enables norms of behaviour to be established, which are then used to encourage voluntary self-regulation,<sup>32</sup> such as, for instance, giving up

<sup>29</sup>D Hodgson, “Know your Consumer”: Marketing, Governmentality and the “New Consumer” of Financial Services, *Management Decision*, 2002, Vol 40, No 4, 318–328.

<sup>30</sup>See P O’Malley, 2004, supra p 26, n 6.

<sup>31</sup>P O’Malley, Risk, Power and Crime Prevention, *Economy and Society*, 1992, 252, and P O’Malley, Imagining Insurance: Risk, Thrift, and Life Insurance in Britain, in T Baker and J Simon (eds) *Embracing Risk: The Changing Culture of Insurance and Responsibility* (Chicago University Press: Chicago, 2002).

<sup>32</sup>M Foucault, Governmentality, in G Burchell, C Gordon and P Miller (1991), supra, n 19, F Ewald, Insurance and Risk, in G Burchell C Gordon and P Miller, supra n 19; D Lupton, *Risk* (Routledge: London, 1999) at p 25, M Dean, *Sociology after Society*, in D Owen (ed) *Sociology after Postmodernism* (Sage: London, 1997), P O’Malley, supra, n 13; D Knights, Governmentality and Financial Services: Welfare Crises and the

smoking. Risk governance in this sense is about using the concept of risk as a means of governing individuals or groups in such a way as to (re)define responsibilities for the outcomes associated with particular phenomena or activities, consistent with an ethos of neo-liberalism which emphasises autonomy and self-help over state intervention.<sup>33</sup>

Examples of this emphasis are not confined to the area of insurance. They can be found across a broad spectrum of fields where the state utilises risks governance in this sense. As O'Malley illustrates, in some jurisdictions drug addicts have been

recast as "responsible risk takers" who must govern the effects of their risks on themselves and on others. This new governmental image of the drug user no longer represents them as "addicts" enslaved by the drug and cursed with impaired rationality. Rather . . . they are considered rational choice subjects, free to make choices and to take responsibilities, albeit having a "relationship of dependence" with a drug.<sup>34</sup>

In the context of environmental concerns on the other hand, the Australian government has sought to redefine drought to the category of "manageable risk" rather than a "natural disaster", the responsibility for which has been transferred away from the state and on to farmers on the basis of their failure to respond adequately to risk managing deteriorating land conditions.<sup>35</sup> Within the health field Ruhl<sup>36</sup> has drawn attention to how pregnant women are "statistically graded" for risk on the basis of lifestyle and increasingly assigned responsibility for the health of the foetus. Similarly, in the context of criminal behaviour in the UK Batchelor demonstrates that despite their difficult familial and social circumstances young women who offend tend to reject the label of "victim", preferring to focus instead on issues of personal choice and

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Financially Self Disciplined Subject, in G Morgan and D Knights, *Regulation and Deregulation in European Financial Services* (Macmillan: Basingstoke, 1997).

<sup>33</sup>D Lupton, *ibid.*, p 102.

<sup>34</sup>P O'Malley, 2004, *supra* p 8, n 6.

<sup>35</sup>V Higgins, Calculating Climate: "Advanced Liberalism" and the Governing of Risk in Australian Drought Policy, *Journal of Sociology*, 2001, 37, 299–316, referred to in P O'Malley, 2004, *supra*, p 9, n 6.

<sup>36</sup>L Ruhl, Liberal Governance and Prenatal Care: Risk and Regulation in Pregnancy, *Economics & Society*, 1999, 28, 95.

taking responsibility for their risky behaviour.<sup>37</sup> This internalisation of responsibility is a key objective of this form of governance.

It has been suggested that these risks are deliberately conceptualised by the state in ways which conform to neo-liberal ideas about the role of the individual and the role of the state, and in particular neo-liberal ideas about the responsibility of the individual to manage their own risks “free” from state interference.<sup>38</sup> These risks include the risks associated with ill-health, financial security, or personal security risks. Risk, through its ability to “responsibilise” citizens, is described as a form of “government at a distance”.<sup>39</sup> In other words, the ways in which risks are conceptualised enables responsibility for the management of behaviours or activities to be (re)allocated away from the state and onto the groups or individuals, in ways that conform to particular political ideologies.<sup>40</sup> The language and practices associated with risk provide an ostensibly neutral and objective basis on which to do so. Risk-governance, governmentality theorists would suggest, can provide a subtle but powerful strategy by which to reshape behaviours and expectations in order to achieve “political” objectives.

Dean<sup>41</sup> describes how this strategy is supplemented through the operation of “technologies of agency” and “technologies of performance”. Through technologies of agency such as contract and citizenship,

<sup>37</sup>S Batchelor, “Prove me the Bam,” Victimisation and Agency in the Lives of Young Women who Commit Violent Offences, *Probation Journal* (Special Edition on Violence), 2005, 52(4), 359–376. See also J Braithwaite, The New Regulatory State and the Transformation of Criminology, in D Garland and R Sparks (eds) *Criminology and Social Theory* (OUP: Oxford, 2000).

<sup>38</sup>See e.g., M Dean, Sociology after Society, in D Owen (ed) *Sociology after Post-modernism*, supra, n 32.

<sup>39</sup>On the importance of the twin concepts of freedom and self-governance in neo-liberalism see N Rose, *Powers of Freedom: Reframing Political Thought* (CUP: Cambridge, 1999).

<sup>40</sup>Governance theorists would not however suggest that risk governance is deployed in the same way in every setting but rather that the role to be played by risk will differ depending on the environment in which it is situated – see P O’Malley, 2004, supra, n 6.

<sup>41</sup>M Dean, 1999, supra, pp 167–170, n 19. See also D Hodgson, “Know your Customer”: Marketing, Governmentality and the “New Consumer” of Financial Services, *Management Decision*, 2002, 40/4, 318–328.

individuals, groups or organisations are encouraged to become responsible and autonomous. In the financial sector this has a certain resonance in relation to current government alerts over the risks associated with relying on the state pension to provide financial security after retirement, and the call for “responsible citizens” to make independent pension provision. This risk rhetoric suggests that responsibility for longer-term financial security no longer lies in any collective security provided by the state but lies primarily with the individual.<sup>42</sup>

Similarly, the adoption of a risk-based regulatory strategy by the FSA<sup>43</sup> constitutes a powerful rhetorical framework within which to embed enhanced concepts of senior management responsibility and so to redefine the roles and responsibilities of firms. Technologies of agency are generally accompanied by technologies of performance such as the establishment of, for example, performance standards through which to regulate that autonomy. This is demonstrated in the supervisory structure implemented by the FSA which includes an assessment of firms’ risk management systems and controls, supplemented by the various principles and standards designed to encourage the development of the responsible firm and responsible senior managers (the subject of Chapters 2 to 5).

Social theorists have also drawn attention to the powerful forensic function of risk. Douglas, for example, suggests that imputations of risk provide a modern, sanitised, and seemingly depoliticised way of attaching blame for particular outcomes on particular agencies, organisations or individuals. For Douglas

The idea of risk could have been custom-made. Its universalizing terminology, its abstractness, its power of condensation, its scientificity, its connection with objective analysis, make it perfect.<sup>44</sup>

As is argued later in this book, it is also a convenient tool for obfuscating and shifting downwards, onto the shoulders of the regulated, politically

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<sup>42</sup>The implications of this downward shifting of responsibility are discussed in Chapter 6.

<sup>43</sup>Discussed in Chapter 2.

<sup>44</sup>M Douglas, *Risk and Blame: Essays in Cultural Theory* (Routledge: London, 1992), p 15, quoted in *Lupton, supra*, p 48, n 32. See also C Hood, *The Risk Game and the Blame Game, Governments and Opposition*, 2002, 27, 15.

difficult conflicting policy agendas that drive overlapping risk-based regulatory regimes. These conflicts are sometimes unforeseen, but equally sometimes the result of issues not being fully thought through. Apparent depoliticisation through the use of 'risk' then, simply masks and obscures the political.

These theoretical perspectives are not uncontested. "Risk society" proponents in particular have been accused of "grand theorising" and for their tendency to overgeneralise and to perceive late modern risk as universalising in its effects.<sup>45</sup> However, there is now some empirical support for their view that individuals do sense a loss of control over the future; that risk is regarded as a pervasive and inevitable aspect of everyday life; and that there is a need to try to contain this loss of control through careful consideration of risks. However, the evidence also suggests that risk is not always perceived of in purely negative terms.<sup>46</sup>

These perspectives suggest that the increased focus on risk and risk management at the "political" level cannot simply be understood as a pragmatic response to mismanaged crises or to institutional isomorphism.<sup>47</sup> Rather, they reflect concerns emerging at a deeper level around issues of uncertainty and control in late modern societies. Governmentality theorists suggest that the accumulation of knowledge through information and statistics has enabled risk to be used as a mechanism of control. "Risk society" theorists on the other hand would suggest that the shift into risk-based governance reflects a desire to structure decision-making in the face of increased uncertainty, and, moreover, that the contingent nature of our ability to identify and control risks has resulted in a greater sensitivity to risk at both the individual and

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<sup>45</sup>See, for example, T Baker and J Simon, *Embracing Risk: The Changing Culture of Insurance and Responsibility* (University of Chicago Press: Chicago, 2002), p 21; P O'Malley, 2004, *supra*, p 176, n 6; A Scott, Risk Society or Angst Society?, in B Adam, U Beck and J Van Loon, *supra*, n 18; M Cohen, Science and Society in Historical Perspective: Implications for Social Theories of Risk, *Environmental Values – Special Issue: Risk*, 1999, Vol 8, No 2, 152–176.

<sup>46</sup>D Lupton and J. Tulloch, *supra*, n 26; P Taylor-Gooby, H Dean, M Munro and G Parker, Risk and the Welfare State, *British Journal of Sociology*, 2000, Vol 50, No 2, 177–194.

<sup>47</sup>For the meaning of this term see footnote 16 and accompanying text.

the political (governmental) level. These theoretical strands are not necessarily incompatible, for, as Steele argues, the failure to control manufactured risk does not require rejection of the role of risk as a decision-making resource. Risk as a decision-making resource is in fact extremely resilient and can be adapted to incorporate uncertainty and volatility, as the financial markets in particular demonstrate.<sup>48</sup>

Where these two theoretical strands appear to share common ground is in terms of their assessment of the implications for the relationship between the “state” and the “individual”. Giddens in his conception of the “risk society” suggests that the contingent nature of the risks associated with late modernity means that governments cannot automatically assume responsibility for them. Rather individuals have to adopt what he calls a reflexive and calculative attitude to the possibilities presented by modern society and to accept more responsibility for the outcomes flowing from the choices they make. One of the roles of government, he suggests, is to create the opportunity for individuals to engage with government and “experts” in order to better understand the limits of scientific or technical knowledge associated with those choices.<sup>49</sup>

Governmentality theorists on the other hand “look beneath the grand gaze of universal theories such as the risk society” and suggest risk governance is a neo-liberal mechanism of control in that identifying risks enables public decision-makers to allocate responsibility for outcomes in ways that conform with political objectives by, for example, encouraging groups and individuals to take steps to avoid or minimise the

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<sup>48</sup>J Steele, *Risks and Legal Theory* (Hart Publishing: Oxford, 2004), p 49, but see also S Green, *Negotiating with the Future: The Culture of Modern Risk in Global Financial Markets*, *Environment & Planning D: Society & Space*, Vol 18, 77–89 who argues that the resilience of risk expertise systems runs counter to Beck’s belief that science is beginning to question its rational foundations.

<sup>49</sup>A Giddens, *The Third Way: The Renewal of Social Democracy* (Polity Press: Cambridge, 1998). Beck makes a similar point about the need for reflexivity but whereas for Giddens reflexivity is mediated through expert systems, for Beck the authority of the individual supplants external, “expert” forms of authority. For a discussion of differences and similarities between Giddens’ and Beck’s concept of reflexive modernity see S Lash, *Reflexivity and its Doubles*, in U Beck, G Giddens and S Lash, *Reflexive Modernisation*, supra, pp 110–173, n 18.

risks to themselves.<sup>50</sup> It is argued in this book, however, that although regulatory rhetoric appears to bear out this intention to use risk as a governance tool through which to achieve certain political objectives (one of which, we suggest, is to manage and neutralise reputational risk to government), the way in which responsibility is allocated to firms and individuals buries and obfuscates conflicting political objectives once any particular responsibility framework is mapped onto the many others that now pervade social and economic life. Chapter 5 illustrates this obfuscation through the discussion of the various potentially conflicting responsibilities imposed on firms and on specific individuals within firms under FSMA and general company law and corporate governance requirements.

What both of these theoretical explanations agree on is that responsibility for confronting risks and uncertainty is increasingly being devolved downward and away from government. In the context of financial services regulation this is occurring through techniques described as meta regulation, enforced self-regulation or enrolment. It is the aim of the rest of this book to explore and critique this downward shifting more directly in the context of the discussion in Chapters 3, 4 and 5 of downward penetration of financial regulation into firms and within firms, and in Chapter 6 to examine the link between government objectives, financial regulation and the development of the concept of the “financial citizen”.

Risk regulation, it is suggested, is therefore about far more than using risk simply as a decision-making tool to, for example, determine the allocation of scarce resources within administrative or regulatory bodies. Risk regulation in general is about far more than the dry and technical implementation of risk assessment and risk management techniques. Rather it has the potential to reshape relationships between those who

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<sup>50</sup>P O'Malley, 2004, *supra*, p 9, n 6. Further he notes “[T]hese responsabilising processes seemingly *democratize* government through the mobilizing of risk and uncertainty. Individuals and communities are made free to choose how they will govern themselves in relation to a host of insecurities. Expertise in risk and uncertainty . . . appears in an advisory capacity, often available in a commodified form. We are all to be ‘empowered’ by the provision of information and skills about how to secure ourselves”, at p 175.

govern and those who are governed, to embed norms of behaviour, to attribute blame and to define and delimit both responsibility and accountability.

## What is risk?

The issue is one which, of course, is not peculiar to the context of financial services. It is not self-explanatory and has been the subject of considerable discussion and debate, particularly between the techno-scientific community on the one hand, and the socio-cultural community on the other. This debate is reflected, for instance, in the 1992 report for the Royal Society for the Prevention of Accidents.<sup>51</sup> The social scientists and physical scientists called upon to participate in the study of risk were simply unable to agree about the nature and meaning of the concept.<sup>52</sup>

For the techno-scientific community risk has an objective existence. It is, in principle, capable of being identified through measurement and calculation and hence controlled using this knowledge. Debates within this community tend to revolve around the accuracy of the science used to measure and calculate the risk and whether particular risk models are optimally constructed to identify all of the risks and understand how risks occur. The objective nature of risk itself is usually taken for granted.<sup>53</sup>

Socio-cultural theorists on the other hand suggest that far from being a purely objective fact risk is in reality socially constructed and

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<sup>51</sup>*Risk: Analysis, Perception and Management* (Royal Society: London, 1992).

<sup>52</sup>This led to the presentation of the report in effectively two parts: the first part (Chapters 1–4) representing the views of the physical scientists, the second part (Chapters 5–6) representing the views of the social scientists, and see the discussion in J Adams, *Risk* (UCL Press: London, 1995).

<sup>53</sup>D Lupton, *supra*, p 18, n 32. Lupton includes within the techno-scientific stream (which she labels the “realist perspective”) approaches emerging from fields such as engineering, statistics, actuarialism, psychology, epidemiology and economics (p 17). See also O Renn, *Concepts of Risk: A Classification*, in S Krimsky and D Golding (eds) *Social Theories of Risk* (Praeger: Westport CT, 1992) for a classification of the various “schools” of risk. See also R Baldwin (ed) *Law and Uncertainty, Risks and Legal Process* (Kluwer: London, 1997).

shaped by cultural belief patterns and societal influences.<sup>54</sup> For this community:

All knowledge about risk is bound to the socio-cultural contexts in which this knowledge is generated, whether in relation to scientists' and other experts' knowledges or lay people's knowledges. Scientific knowledge, or any other knowledge, is never value free but rather is always a product of a way of seeing. A risk, therefore, is not a static, objective phenomenon, but is constantly constructed and negotiated as part of the network of social interaction and the formation of meaning. "Expert" judgements of risk, rather than being the "objective" and "neutral" and therefore "unbiased" assessments . . . are regarded as being equally as constructed through implicit social and cultural processes as are lay people's judgements.<sup>55</sup>

Socio-cultural theorists, accordingly, emphasise that the very act of risk measurement itself involves value judgements. There are value judgements, shaped by the social and cultural environment, with respect to what to measure, how to measure and how to interpret the results produced.<sup>56</sup>

Furthermore, Young has drawn attention to the role of metaphor in shaping perceptions about risk and suggests that these metaphors help to conceptualise risk in a certain way. In the context of finance, she draws attention to the language used, which refers to risk as "liquid", as "concentrated", and as having varying "levels". All of these terms suggest that risk is a thing apart from the asset or entity to which it is connected, and can therefore be isolated, measured and packaged

<sup>54</sup>Within the socio-cultural literature Lupton in fact identifies a range of positions on the nature of risk: from strong social constructionist positions ("nothing in itself is a risk") associated with the "governmentality" perspectives, to the weak social constructionist perspectives associated with the "risk society" ("risk as an objective hazard . . . inevitably mediated through social and cultural processes"), supra, n 32, Chapter 2.

<sup>55</sup>D Lupton, supra, p 29, n 32.

<sup>56</sup>See N Rose, *Governing by Numbers: Figuring out Democracy, Accounting, Organisations and Society*, 1991, 673–692; S Jasanoff, *The Political Science of Risk Perception, Reliability Engineering and System Safety*, 1998, 59, 91–99. As Shrader-Frechette, notes, in the early 1990s cyclamates were permitted and saccharine banned in Canada, while across the border the US adopted exactly the reverse regime – saccharine permitted and cyclamates banned, both based on science. K Shrader-Frechette, *Risk and Rationality* (University of California Press: Berkeley, 1991), as referred to in C Hood, R Baldwin and H Rothstein, *The Government of Risk*, supra, p 5, n 13.

separately from that entity. Risk “exposure” and risk “appetite”, on the other hand imply that risk is within our control and simply a matter of personal choice.<sup>57</sup> The power of these metaphors lies in their ability both to help construct and to reinforce a belief in the objectivity and certainty of risk within the financial community. As Knights and Vurdubakis reiterate in the context of discussing risk and insurance that to recognise

that risk is a construct is not to suggest that risk is a fiction, it is to recognise the need to examine the discursive and practical operations through which the concept becomes attached to the events it purports to describe . . . [I]n itself nothing is a risk. Conversely anything (from a lawsuit to the birth of a child . . . ) can be said to be a risk depending on how the event is viewed and analysed.<sup>58</sup>

For socio-cultural theorists risk perceptions are “shared, cultural and symbolic”.<sup>59</sup> Membership of groups (such as specialist risk assessment and management teams) and social networks (such as professional organisations) are important for the construction of risk. However, it is possible that even within tightly structured organisations, different shared interpretational frameworks can exist within organisations. Consequently different groups can appear to approach the issue of risk from quite different perspectives.<sup>60</sup>

What these debates draw attention to is not simply the need to be aware of the contested meaning and nature of risk. They also have implications for the way in which the existence of different perceptions of risk are interpreted. For example, different perceptions are often portrayed in the public arena as the result of faulty cognition on the part of one group, for example individual investors as opposed to another, such as financial experts. In this way one group, inevitably the “lay” group, is

<sup>57</sup>J J Young, Risk(ing) Metaphors, *Critical Perspectives on Accounting*, 2001, 12, 607–625.

<sup>58</sup>D Knights and T Vurdubakis, Calculations of Risk: Towards an Understanding of Insurance as a Moral and Political Technology, *Accounting, Organizations and Society*, 1993, 18(7/8), 729–764.

<sup>59</sup>D Lupton, *supra* p 56, n 32.

<sup>60</sup>For empirical research drawing attention to the relationship between risk and “culture”, see B Hutter, *Regulation and Risk: Occupational Health and Safety on the Railways* (OUP: Oxford, 2001). On culture and regulation see C Hood, *The Art of the State: Culture, Rhetoric and Public Management* (Clarendon Press: Oxford, 1998).

seen to under- or overestimate or ignore “real” risks. Socio-cultural theorists suggest, however, that these different perceptions may not stem from lack of understanding, ignorance or a refusal to take “real” risk seriously. Rather they stem from the fact that risk is not a homogeneous concept and different perceptions of it arise through the existence of different interpretive frameworks. It is necessary, therefore, for an appreciation of this to inform our understanding of how different individuals or groups (including “experts”) construct, interpret and respond to different risks.

Moreover, there is also a need to be aware of the different values that can be attached to risk. Whereas risk for some is simply a technical and neutral term referring to the outcome of a probability calculation, risk for others has come to be associated with the potential for harm, whether calculable or not.<sup>61</sup> This is the sense in which most regulators use the concept of risk, concerned as they are to minimise the dangers from excessive risk-taking. But risk-taking can also be valued as positive. It can be associated with self-fulfilment through, for example, promotion, or industry recognition or commercial success. Hence it is often valorised. Business enterprise and risk-taking have been inextricably intertwined throughout history. The encouragement of risk capital formation and promotion of an enterprising, risk-taking culture in business and individuals continues to occupy policymakers. In the financial markets, in particular, risk is not seen as a negative concept. On the contrary, it is associated primarily with a “good”, namely commercial opportunity and profit-making, and risk-taking is often rewarded handsomely. This “entrepreneurial” meaning of risk is also evident in current political ideology, which increasingly links entrepreneurship with risk-taking. For example, the reforms to bankruptcy law introduced under the Enterprise Act 2002 were designed to encourage entrepreneurship through risk-taking and to reduce the stigma attached to those who fail.<sup>62</sup>

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<sup>61</sup>Whether it be, for example, the risks associated with nuclear power; MMR vaccinations; genetically modified food; or the risks associated with failing to make proper provision for long-term individual financial security.

<sup>62</sup>See DTI Productivity and Enterprise, *Insolvency: A Second Chance*, CM 5234, July 2001 para 1.1.

Tensions associated with the different values attached to risk may exist not just between different actors, such as regulators and firms. They may also exist within a particular entity, as, for example, between trading arms and compliance sections within firms. In other words, even if different individuals or groups perceive risk similarly, it is possible they will value it differently. Again, in the regulatory context, the existence of these different cultures and values can help to explain why some might be more, or less, receptive to attempts to regulate risk.

Finally, for the purposes of this Introduction, it is important to acknowledge the distinction often drawn between risk and uncertainty<sup>63</sup> (a distinction that arguably lies at the heart of the concept of the ‘risk society’). Risk is traditionally associated with probability calculations. That approach to risk is to suggest that an event can be calculated mathematically in terms of probability and so can be predicted and therefore controlled. Uncertainty on the other hand is not capable of measurement and is concerned, therefore, with mere possibilities incapable of calculation but only guesswork or judgement. Uncertainty cannot be controlled because its outcomes are unknown and unknowable.<sup>64</sup> While the term “risk” is often used to refer to risk or uncertainty, one important implication of this distinction relates to the way in which issues are presented for public consumption. Although the distinction between risk and uncertainty is not commonly maintained in the practice of investment and finance (perhaps deliberately so), it points to the need to be aware of the possibility that uncertainty may masquerade in the language of risk in order that “expert” judgements benefit from a greater

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<sup>63</sup>For a discussion of the distinction between risk and uncertainty see e.g. P O’Malley, 2004, *supra*, n 6; F Knight, *Risk, Uncertainty and Profit* (Harper & Row: New York, 1965 (1921)) E G McGoun, *The History of Risk Management, Critical Perspectives on Accounting*, 1995, Vol 6, 511–532.

<sup>64</sup>Some would reject any hard and fast division, suggesting that risk and uncertainty are often configured together in varied and complex ways – as in the case of financial products such as catastrophe insurance and exotic derivatives – Ericson and Doyle, *Catastrophe Risk, Insurance and Terrorism, Economy and Society*, 2004, 33(2), 135–173; P O’Malley, 2004, *supra* p 13 and 24, n 6. O’Malley further suggests that there is no binary divide between risk and uncertainty, rather it is better to regard them as related along multiple axes, at p 19.

appearance of certainty and objectivity. To call something a “risk” suggests the odds are known; to call it an “uncertainty” is to admit to guesswork.

## Conclusion

In summary, risk-based regulation is in fact a highly politicised act in which risk is used as a normative tool to delineate accountability, establish norms of behaviour and embed particular conceptions of responsibility. In particular the literature persuasively argues that risk is a tool that can be used to redefine relationships between those doing the regulating and “others”, to effect a shift from collective to more individualised responsibility, and also to define the sites and boundaries of that responsibility. At the same time, however, the contested nature of risk, the values attached to it, and the potential existence of different interpretive frameworks inevitably raise questions about the ability of risk to carry the weight of expectations attached to it as a regulatory tool. These same questions are raised, too, given the interpretive frameworks relating to the understanding of the meaning of risk and the approach to it. This book, in its examination of the ways in which the FSA’s conception of risk and devolved responsibility is driving and shaping regulatory standards, processes and practice, aims to illustrate both this essential insight *and* this essential critique of its implications in the context of the regulatory environment for UK financial services.

## The structure of the book

Chapter 2 takes as its starting point the theoretical perspectives on risk outlined above in order to analyse the risk-to-objectives regulatory framework introduced by the FSA. Although the FSA has published information about this regulatory framework, there has as yet been little independent consideration of it in the light of these perspectives. The chapter explores more closely the reasons for the introduction of risk-based supervision and its design (including how risk is constructed and implemented as a regulatory tool) and asks whose purposes are being

served, and how, by its adoption. In doing so it will consider the extent to which it employs a process described as “meta-risk regulation” as a means to harness firms’ own risk assessment and management tools into the service of the FSA to reduce the perceived risks to its own statutory objectives. It will also consider the implications of risk-based supervision for the private investor “consumer” of financial services and the way in which these consumers are expected to engage with risk.

Chapters 3, 4 and 5 then move on to focus on the trend towards greater regulatory incursion within the internal business management processes and strategies of regulated firms, through direct regulation of individuals within financial services firms, and in particular of senior managers. Although this direct regulation is set against the backdrop of a risk-based supervisory regime that has the potential to reshape and redefine responsibilities in the name of risk reduction, this trend has its origins in earlier regulatory developments. These developments can be seen against theoretical work specifically relating to the way in which law and regulation have come to attribute responsibility to and within a business organisation. Chapter 3 therefore moves beyond considerations of risk-based supervision. Instead, it looks specifically at the way in which financial regulation has extended its reach “downwards” into the level of the regulated entity to impose specific responsibilities on firms in relation to issues of business organisation, governance and strategy (which might traditionally have been seen as outside the sphere of a regulator’s direct concern), and on individuals within those firms, particularly senior managers. It explains the genesis and structure of the FSA Handbook rules and guidance on senior management arrangements, systems and controls (SYSC) as well as the regime for approval, regulation and sanction of people performing what are known as “controlled functions”, i.e. key roles, within and on behalf of the firm. It concludes by considering some of the theoretical literature on regulation and compliance, as well as on the notion of “responsibility” within complex organisations and asks how initiatives such as SYSC can be seen in the light of the insights provided by some of that work.

Chapter 4 looks at the evidence about how these new arrangements are being received and implemented into firms. In doing so it draws on

both the outcome of FSA disciplinary action since “N2” (1 December 2001), and the results of a small-scale survey of firms undertaken 18 months after N2 into the reception and implementation of the new arrangements. It draws attention to the link between the FSA’s ex ante risk assessment of firms, which includes assessment of the control risk components of a firms’ “relationship with regulators” and “cultural and business ethics” on the one hand, and ex post assessment of these systems as part of FSA disciplinary outcomes on the other. These provide clear examples of the FSA’s view that senior management and its influence on firm culture is the key route into effective regulation within firms.

Chapter 5 then turns to consider the FSA’s regime of regulatory senior management responsibilities against both the existing duties owed in company law by the board of directors of a company, and by individual members of it. It will also identify the broader trends in the wider corporate governance arena that shape the appropriate responsibilities of both the board as whole, and of its individual company directors (such as, for example, under the Higgs Report as to Role of Non-Executive Directors, the recent reformulation of the UK Combined Code on Corporate Governance, and, in the US context, the Sarbanes-Oxley Act 2002). It draws attention to a number of potential areas of tension and conflict between these regimes and asks whether the vogueish concepts of “compliance culture” and “compliance ethos” are useful aids in understanding the overlap between regulatory expectations; a theme to which Chapter 7 returns.

While Chapters 3, 4 and 5 focus on regulation and the firm, Chapter 6 returns to the discussion introduced in Chapter 2 of the redrawing of the boundary between collective and personal responsibility in the context of the political desire to downshift the responsibility for long-term financial security from the government to the individual citizen. It examines the implementation of the regulatory objectives of “consumer protection” and “public awareness”, and in particular the role of information disclosure in developing the model of the “financial citizen”. In doing so it considers the potential effectiveness of what is predominantly process, rather than product-based regulation, drawing upon the growing body of literature challenging the model of the rational

decision-maker implicit in process-based regulation. It also discusses the extent to which it is possible to align consumer and adviser interests, and considers whether the rhetoric around the risks of consumer savings gaps and the promotion of the financial citizen has negated the opportunity for open political debate on collective versus privatised and individualised responsibility for longer-term financial security.

Chapter 7 returns to and draws together some of the themes addressed earlier in the book to consider more broadly the way in which the FSA, in the context of its risk-based regulatory framework, is seeking to achieve its regulatory goals as set out in its statutory objectives, by effecting cultural and organisational shifts within the financial services industry itself, as well as individual firms and individual managers, to transform them into better, more responsive and open citizens. This chapter considers whether these initiatives, broadly labelled as techniques of “meta regulation”, of “regulatory enrolement” or as “enforced self-regulation”, are capable of bringing about the results intended or whether they will have unintended effects leading, for example, to a decline of trust and a culture of caution and risk aversion. It also considers the extent to which such techniques gloss over the problem of conflicts in regulatory objectives between different regulatory regimes with different public policy goals to which firms are subject; the resolution of which is being shifted downwards away from politicians and government and onto firms and individuals within firms. It concludes that questions must be asked about the extent to which risk-based supervision and regulatory techniques such as meta-regulation in fact reflect a shortfall in our wider democratic culture.