

# **The risks of risk-based regulation: the regulatory challenges of the higher education White Paper for England**

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## **Introduction**

1. The recent White Paper, 'Higher Education: Students At The Heart Of The System' (BIS, June 2011), proposes the introduction of risk-based regulation to English higher education, with the Higher Education Funding Council for England (HEFCE) as a lead regulator for the sector, in association with the Quality Assurance Agency (QAA), the Office For Fair Access (OFFA), and the Office of the Independent Adjudicator (OIA). The proposals for a new regulatory regime are backed up with a Technical Consultation document, entitled 'A New, Fit-For Purpose Regulatory Framework for the Higher Education Sector' (BIS, August 2011).

2. To date, external regulation in higher education has recognised that quality assurance should apply to all, and this was reflected in the adoption of scheduled, cyclical programmes of review that covered all institutions. Effectively, everyone was subject to the same processes of monitoring. Risk-based regulation is more discriminatory: it modulates levels of institutional audit on the basis of regulatory judgements concerning the variable risks posed by institutions to the sector and to the regulator. Rather than a consistent approach that applies the same levels of scrutiny to all providers, risk-based regulation varies the scope and intensity of monitoring against explicit calculations of risk.

3. As a result, risk-based regulation will provide a more selective monitoring of institutions, based particularly on considerations of established track records of regulatory compliance, financial soundness, and good internal (risk management) controls. A key feature will be that external quality assurance at the level of full institutional reviews will become less of a regular event for the great majority of higher education entities, and may even disappear for them entirely. This is in line with an important principle of risk-based regulation, that it focuses on the highest risk providers, thus reducing costs for those (perhaps the majority) that are deemed to provide little or no risk to regulatory objectives. As well as reducing administrative burdens and thereby 'freeing up' organizational enterprise and innovation, regulatory quality is also to be enhanced - by being proportionate, targeted, and explicit.

4. Risk-based regulation has become a significant organizing principle of government in a number of countries, including Australia, Canada and the USA, as well as the UK. Outside higher education it is well developed, and in 2010, the OECD issued case studies and guidance 'to assist OECD governments to develop coherent frameworks for the governance of risk in regulatory policy' (OECD 2010). Regulators, rather like the bodies they regulate, have come under increasing pressure to justify their activities and resources. A strong

deregulatory rhetoric has emerged internationally, centring on alleged over-regulation, exaggerated formalism and inflexibility, and rising regulatory costs.

5. Risk-based regulation in the public sector is an approach that borrows strongly from risk management practices in the private. Insurance is the classic example of private sector risk approaches, which justifies varying treatment of different risk categories and groups, and transfers risk (for a payment) to enable entrepreneurial behaviour to flourish. More broadly, within private sector organizations the approach is not that risk is to be avoided – that would result in diminished opportunity and entrepreneurialism – but that risk should be anticipated and controlled through coherent planning. Zero-risk outcomes in this approach are a chimera and, despite best efforts, failures should be expected, dealt with, and learnt from. For regulators, this translates into a warning to politicians, media, and the public to avoid ‘knee-jerk’ responses in cases of regulatory failure, such as calls for more draconian models, and to accept some ‘accidents’ as normal.

6. In competitive market-like systems, such as that proposed in the White Paper for higher education in England, risk is regarded as two-dimensional: it provides the basis for consumer protection on the one hand (protecting against risk), while encouraging enterprise on the other (encouraging and managing risk-taking). From this perspective risk loses its traditional negative connotations (of harm, hazard, and danger); rather it is to be embraced - as allowing uncertainty to be managed rationally within organizations, while recognizing that risk-taking also unlocks the route to added value.

7. The introduction of risk-based regulation is not simply a BIS initiative. For a decade or so in Whitehall, risk-based regulation has been strongly encouraged, not least by the Treasury, the Cabinet Office, the National Audit Office, two Prime Ministers, and various reports (the Hampton Review of 2005, commissioned by the Treasury, perhaps being the most influential). The government’s ‘Modernizing Government’ and ‘Better Regulation’ initiatives have viewed risk-based regulation as part of more transparent and accountable public administration arrangements. Relatedly, the Treasury has long regarded risk-based regulation as allowing UK companies to operate more effectively within increasingly globalized and competitive environments. Effectively, risk-based regulation has become mandatory across government departments and their agencies, and departments face their own monitoring within government to make sure that they comply.

8. While at the level of abstract general principles it is hard to cavil with a regulatory approach that seeks to be selective, focused, and proportionate, and which promises to relieve a number of institutions of unnecessary central control and bureaucratic impositions, risk-based regulation can be a risky business, not least for the regulators. Risk-based regulation principles are set to provide major operational challenges, particularly for HEFCE and for QAA. Nor is it clear that the principles of commercial risk-based competitiveness sit easily with

established democratic beliefs of equality before the law and associated ideas of fair treatment and accountability, based on bureaucratic impersonality, the application of the same rules and processes to all, and standardization.

### **Risk-Based Regulatory Frameworks**

9. Risk-based regulation may be regarded as the application of a systematic and defensible framework that formally prioritizes or selects activities for regulatory focus, and then subsequently aligns regulatory resources accordingly. Although all regulators may implicitly have to do this to be effective, risk-based regulation explicitly (and publicly) uses an evidence-based assessment of the risk that regulated organizations pose to the achievement of the regulator's objectives. That is, it is a part of the broader movement to formalism, accountability, and transparency found in contemporary UK governance. It constitutes a move away from more uniform models to an approach selectively based on risk anticipation and control.

10. Herein, however, lies risk for the regulator. Risk-based regulation implies that some risks are tolerable and to be expected – but politicians, media, consumers, and even the public may have other ideas. Scandal or failure can quickly turn such stakeholders away from risk-based regulation and back towards more uniform and standardized compliance models.

11. In the past, the basis for evaluation and monitoring was less explicit and relied more on flexibility and the expertise of the regulators in the field, recognising that higher education cannot be regulated like other "products" and services. Although it has become fashionable to decry discretion-based public administration and regulatory governance as belonging to an older, clubbable world of insiders that has passed in the age of increased formal proceduralization and transparency, risk-based regulation, which can be formalised and encoded in a set of potentially inflexible risk assessments, in turn may be criticized for being too rigid for a fast-moving world (not least that of 24-hour rolling broadcast news). It may over-narrow and erroneously select a range of issues, leaving regulators prey to rapidly-changing and unforeseen circumstances because of an over-commitment to original risk assessments. Risk-based frameworks, and their apparent lack of discretion and flexibility, may solidify regulators into particular ways of assessing risk. The result of heightened transparency and formalism is increased risk to the regulator, and a subsequent continuing focus on blame avoidance strategies to ensure organizational longevity.

### **Why risk-based regulation is a risky business for HEFCE and QAA**

12. HEFCE and QAA face critical challenges in becoming risk-based regulators for higher education. There is no doubt that risk-based regulation has several advantages: potentially reducing compliance costs for most of those being regulated; providing clearer and explicit focus on important risk activities;

educating government and the public that all risks cannot be eliminated and some should be tolerated; and is broadly welcomed by most stakeholders for reducing burdens. Yet the experience of introducing risk-based regulation in other government sectors reveals major difficulties, too. For example, deciding which institutions fall into categories ranging from high to low risk, and then justifying such decisions openly and evidentially to both the institutions and the wider public, is not easy and may easily mire a regulator in prolonged controversy.

13. Moreover, dealing with the majority of institutions that fall within the 'trusted' and 'light-touch' category (and most should) poses the risk that regulators become disconnected from these organizations over time, especially if circumstances, or senior managers and their attitudes, change, resulting in danger signals (risk incubation) not being spotted until too late. Methods of overcoming such a disconnect, such as random, albeit light, inspections are never popular and run the risk of a withdrawal of sector cooperation which risk-based regulation aims to secure as a major objective. More thematic audits, or increased education and guidance programmes, are never fully trustworthy channels for gaining risk-based intelligence on particular institutions because of their cross-organizational focus.

14. There are other reasons why initial support for risk-based regulation from the majority of institutions may be short-lived. Experience elsewhere in government shows that the introduction of risk-based regulation generally results, at least initially, in more rather than less paperwork and data collection being required, either because existing data are unsuitable for risk-based regulation purposes, or are inadequate. Some regulators also seek more data than is initially justified, in part to allow for developing information needs as their risk models are modified as their regimes develop.

15. Risk-based regulation sets major organizational challenges. Apart from the difficulties in establishing their own risk appetites, and allocating the regulated organizations to relational categories - of trusted to least trusted - openly and with justificatory evidence, assessors have to become much more familiar with a broader range of governance issues than before. Research shows that assessors are especially poor in estimating the value of the internal control systems of the organizations they supervise and how much reliance to place on them for regulatory purposes.

16. Internally, risk-based regulation raises major organizational and cultural challenges for regulators, not least for the control relationships between senior managers and field assessors. A study of DEFRA found that assessors experienced considerable difficulty in ascertaining the risks to be managed, and that major cultural differences and variations in risk appetite co-existed within the same government department (Rothstein and Downer 2008). Many assessors find it very difficult to move from longstanding and holistic relationships with 'their' regulatees to a position of accepting more central

direction of regulatory relationships and levels of resourcing and monitoring. Decisions on the extent of monitoring, visiting, and reviewing (that often previously had some element of local or field discretion) become determined strategically as part of overall regulatory prioritizing and are determined by criteria that are centrally set. QAA auditors, for example, have generally enjoyed quite high levels of autonomy from officer direction in carrying out their responsibilities (King, Griffiths, and Williams 2007).

17. Inevitably, risk-based regulators find that considerable training for their staff is required, not simply on the mechanics or detailed technicalities of the approach, but on the general principles that underpin risk-based regulation. Inspectors and assessors, used to more impersonal compliance models, find that risk-based models are often hard to accept in principle as well as in practice. Compliance models that apply to all equally appear more in tune with the temper of democratic ideas of equality and with methodologies of formal rationality than risk-discriminatory approaches. Moreover, assessors may not be confident that in undertaking the risks of risk-based regulation, they will always be backed up by their senior managers when an unanticipated risk crisis develops and a media and political storm ensues. Support from the highest levels of the regulator – and from politicians – for staff engaged in this risky business is essential if the approach is to become fully grounded and operationalized

18. Field assessors are critical agents, not least in the supply of local intelligence to the regulator, but their judgements and assessments become subject to wider considerations than before, including to the weighting factors generally constructed centrally that overlay more technical or probabilistic risk assessments. Decisions taken centrally that assess risk generally may not match the judgements of those in the field that take account of specific circumstances. Weightings reflect political and other risks to the regulator. Some risks and some organizations have a higher political salience than others and cannot be ignored. Institution-based risk analyses by assessors also require more explicit aggregation into evaluations of systemic risk to the sector as a whole.

19. Politicians generally have wider policy issues to promote, too, that impact on regulatory approaches. They may prefer the more globally-competitive entities, such as the most prestigious universities, to be 'lightly regulated' in the belief that this will enable them to compete more successfully on the international stage. Nonetheless, as was seen in the recent global financial crisis, such an approach may lead to a serious underestimation of the systemic risks involved. Nor is it at all clear that perceptions by those abroad of 'under-regulation' would help the English university system to be regarded as a safe investment, particularly if things go wrong, as they will from time to time.

20. Risk assessments are never simply technical and involve levels of qualitative judgement and even bias. Tacit knowledge and expertise remain important in assessing risk, despite increased formalization, and this is especially true when it comes to analyzing softer risks such as reputation or amenability to

compliance requirements. Often judgements may be made in a context of uncertainty where some degree of flexibility is required concerning the notion of risk, and where different methodologies need to be employed to assess it. Such vagueness may enable long-established equally applied bureaucratic practices to continue but disguised under the new rubric of risk, further adding to confusion and threatening failure in meeting communicated risk objectives.

### **Risks to the regulators**

21. Regulatory agencies that manage risk to consumers and the public themselves face risks. The idea of taking calculated risks is potentially precarious for them and not easily reconcilable with political imperatives. Although reliance on a risk-based approach may enable regulators initially to justify themselves more easily, it may also draw attention to their performance. If something goes wrong then that is interpreted as a failure of regulation rather than a natural consequence of a risk-based approach.

22. Risk-based regulators tend to become as preoccupied with risks to themselves as to society, and to managing the spaces between their assessments of risk based on probability and the pressures that crowd in from the wider political environment. Stratagems in response may be to involve a wider group of stakeholders in decision-making (although this runs the risk of considerably slowing the internal processes of regulators, which may drain confidence externally), and establishing tougher compliance criteria for those issues that are more visible and contentious in government and the media. The danger, however, is of focusing more on those risks that threaten the regulator than those that impact on the public.

23. Perhaps in higher education systems above all, where those who work in them retain considerable discretion over what they do and how they do it (they remain very largely 'loose-coupled' organizations), regulators have inherently limited capacities to control risks in the manner expected. This creates risks to their legitimacy and durability. Regulators are under constant pressure to justify their activities and resources. Risk-based regulation, and its commitment to transparency and openness, provides at least some prospect of an audit trail and justification for activities in the event of failure or the crystallization of unexpected risk. But, as explained above, such transparency carries its own risks and when a serious problem arises may not be sufficient to appease politicians, the media and the wider public.

### **The Higher Education White Paper in England**

24. The White Paper seeks to establish HEFCE as lead regulator for the sector. It also envisages HEFCE – working with QAA, OFFA and the OIA – as taking on a new role as 'a consumer champion' with 'an explicit remit to protect the interests of students', and as a 'promoter of a competitive system'. The aim is to have 'less centralised control' but with more accountability to students as well as the

taxpayer. It is a system that 'focuses regulatory effort where it will have most impact', with less data collection 'to reduce the regulatory burden'. The regulatory barriers for new market entrants will be reduced while the regimes for obtaining and renewing degree-awarding powers and university title will be 'easier and proportionate'. However, new private providers seeking approval for their students to be eligible for the student financial support system, or wishing to bid for student numbers and HEFCE grants, will face increased regulatory requirements to bring them into line with the obligations laid upon traditional providers.

25. On funding, HEFCE will control the financial exposure of taxpayers and will assure students and the public on the financial strength of institutions by maintaining and enhancing a risk-based monitoring role, and working with those institutions at risk of financial difficulties, addressing signs of failure, and agreeing recovery arrangements. A key objective for the transition to the new regime will be for HEFCE 'to continue to take a risk-based approach to assessing and maintaining the sustainability of institutions and the sector as a whole' (HEFCE 2011: 14).

26. On quality and standards, 'a risk-based approach to quality assurance' is proposed that aims 'to cut back the burden of institutional review for high performing institutions'. Although all institutions will be monitored through a common framework, the frequency of (even 'the need for') scheduled institutional audits 'will depend on an objective set of criteria and triggers, including student satisfaction, and the recent track record of each institution'.

27. Thus, for those providers 'with a sustained, demonstrable track record of high quality provision, we would expect to see significantly less use of full institutional review'; for new providers inevitably lacking such claims, 'a more regular and in-depth review as appropriate than has been applied previously' is required. Consequently, although for the majority of institutions that will be able to demonstrate low risk the purpose is largely deregulatory, the aim predominantly is more regulation for new providers. HEFCE is being asked to consult on the criteria against which overall risk should be assessed and the frequency of review.

28. It is difficult to analyze these risk-based regulatory proposals without considering the funding and other contexts set out in the White Paper, which arguably increase the level of risk in the system both overall and for many individual institutions. The allocations of student places are to be 'freed up' by around 85,000 students by 2012-13 by two processes: by leaving out of the calculations 'high performing students' (defined currently as scoring the equivalent of AAB or above at A-level, but with this definition likely to be widened in the future), which are estimated as comprising around 65,000 students; and by the introduction of a 'core and margin' model to be administered by HEFCE. Around 20,000 student places will be stripped from core allocations which will then be bid for by institutions with net overall fee levels of

£7,500 or less on the basis of price ('value-for-money') 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.

29. A key objective is increased student choice, informed by more and better course and related information, reflecting the establishment of student tuition fees as the primary funding driver of undergraduate learning and teaching. The government endorses the notion that each institution should have a student charter – 'to set out the mutual expectations of universities and students' – and is contemplating an increased regulatory requirement that they should be made mandatory.

### **Challenges for HEFCE-led risk-based regulation**

30. Outlined in earlier sections are some of the difficulties that regulators in other domains have faced in introducing risk-based regulation and which are likely to confront HEFCE and QAA, too. In addition, however, the White Paper poses some specific dilemmas for the two regulators.

31. The trade-offs between the regulatory objectives envisaged by the government may make it difficult to maintain a consistent risk-based approach, and it is not clear which of the regulatory objectives outlined is perceived as primary. For example, the championing of the consumer/student and the increased accountability of institutions to the taxpayer sits uneasily with the 'light touch' approach to quality and standards for the majority of institutions. The danger is of failing to capture risk incubation, or deterioration in the 'direction of travel' by the institution, on standards, and a potential complacency in the institution as the result of weak monitoring that leads to a regulatory failure. The benefit of a more regular, consistent, approach to compliance around scheduled institutional review is that, at least formally, all students are equally protected by external assurance arrangements. The Bologna Process (to which the UK government is a founding signatory), in its agreed statements on quality assurance, emphasises regular, cyclical review of institutions and programmes. This appears out of kilter with the approach now being proposed for England.

32. It is arguable too, that benefits to students and taxpayers may be best served by a broader review of institutions that aims to capture a range of low-to-medium risks across the sector, rather than an exclusive focus on perceived high risk providers. A larger net regulatory benefit to society may then ensue.

33. Rather than the introduction of risk-based regulation for the purposes of institutional review – what we might call 'detection' – it may be better to apply a risk-based regulation approach to enforcement. That is, initial trusting approaches to enforcement would escalate up a 'regulatory pyramid' to more punitive approaches in the event of non-compliance, dependent on the



responsiveness of the institution concerned to the need to take action and the effectiveness of actions taken to remedy problems that have arisen.

34. Some institutions may become particularly vulnerable to the continual loss of student numbers and this may lead to riskier behaviour 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, and such action could take the form of significant cost cutting in budgets for the institutional assurance of standards.

35. Revenue seeking in such circumstances may lead to 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 regulators (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 scrutiny, the regulators will be accused of failure to protect the public). The duality of control and enterprise found in risk-based regulation requires careful balancing and ongoing review, and it is not clear if the alignment proposed in the White Paper is correctly judged.

36. 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 government policy for institutions to become even more competitive globally. Moreover, a perception abroad that many student places are being allocated to institutions on the basis of cost and price may also damage the English brand.

37. It is not clear what arrangements HEFCE will establish for considering bids from institutions for the margin students in the pool, and the extent to which such decision making will be risk-based, in the sense of protecting primarily from institutional or systemic risk. Will HEFCE grant more students to an institution because if it does not then that institution will be at risk of financial failure? Or will it have regard only to the wider policy considerations of expanding the sector and increasing student choice? The extent to which such bureaucratically-determined decisions will match those of the market (defined as student preferences) is not clear (Thompson and Bekhradnia 2011). Moreover, such a system has the potential to impose significant data and paperwork burdens on many of the so-called 'lightly-regulated' institutions as they bid to recapture lost numbers.

38. With respect to AAB students and their exemption from reduced allocations, as Thompson and Bekhradnia note, 'establishing a threshold defining high achievement is, in effect, introducing Government regulation to admissions'. Effectively, an elite of universities with high levels of recruited AAB students (plus established research funding and high status) will remain largely free from the competitive pressures introduced for others in the new system (although they will be subject to potentially high competition between each other and, of course, globally). The White Paper proposals will increase the risks faced by many institutions, as the sector becomes even more competitive and high risk for those not able to compete effectively for such students. Yet it is not clear whether these varying risk and reputation categories stemming from the reforms in the White Paper will match the risk categories constituted by HEFCE and QAA for regulatory purposes. It is essential that they do so. It is not evident that risk-based regulation will necessarily mean a reduction in supervision for a large part of the sector, which will face greater risks as a result of government decisions.

39. The proposal to use student satisfaction as a guide to the necessity of regulatory intervention or otherwise is unwise. An example from the Financial Services Authority (FSA) illustrates (see Baldwin and Black 2010: 202). The FSA's 'Treating Customers Fairly' initiative required financial institutions to establish means of assessing their own performance. Firms responded by using customer surveys to demonstrate compliance with the rule that they were selling investment products that were in alignment with customers' risk appetites and financial objectives. However, this was unacceptable to the FSA as investment products from financial institutions can be very difficult for customers to fathom. As Baldwin and Black note, 'Customers could be very satisfied with the advice received but their limited ability to assess that advice might mean that such satisfaction was ill-founded'.

## **Conclusion**

40. Introducing risk-based regulation to higher education follows its introduction over the last decade in other sectors, as part of the Modernizing Government' agenda of the Blair and Brown governments. Its rather generalizing spread across government does not necessarily make it an appropriate model for all sectors in all circumstances. As is outlined above, risk-based regulation poses significant challenges as well as opportunities for regulators. However, its introduction in the context of the funding and other reforms being proposed are likely to make such challenges even more testing. A capacity to learn the lessons from its earlier applications elsewhere in government will be a necessary step for the regulators.

41. So two principal problems arise out of the application of risk-based regulation to the higher education sector:

- First, there is a danger that politicians, opinion formers and regulators themselves will not be able to accept the consequences that are implied by such an approach: that there will be failures as a result of institutions and activities that have slipped through the risk-based approach.
- The reforms of the White Paper actually increase the risks that will be faced by a large number perhaps the majority - of institutions. The regulatory burden will increase - logically it certainly should increase - for these institutions as a result of a risk-based approach

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