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Understanding Risk in the Charity Sector: Regulating for Risk

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May 2015

Introduction

Risk is an everyday part of charitable activity. Charities operate in dynamic organisational, political and social environments. Consequently, charities and the institutions tasked with their oversight are under increasing pressure to demonstrate their legitimacy. One of the core challenges facing regulators of this sector is ensuring that their action is appropriate, targeted and proportionate, and that they balance enforcement of legislative requirements against placing an undue burden on charitable organisations. To that end, adopting what is termed a 'risk-based' approach to regulation is becoming increasingly common in this and other sectors throughout the UK.

What is risk-based regulation?

Uncertainty is inherent to most regulatory endeavours. It can stem from the sector subject to regulation, imperfect or incomplete information, and shifting public attitudes. As a response to this uncertainty, regulators in many sectors – such as nuclear power, road safety and occupational hazards – are increasingly adopting what is known as risk-based regulation. It is defined as a particular strategy or set of strategies that regulators use to **target their resources** at those sites and activities that present threats to their ability to achieve their objectives.[1] Risk-based regulation is championed as an 'apparently rational, objective, and transparent way of deploying limited regulatory resources.'[2]

What does it mean in practice?

Risk-based regulation encourages regulators to consider the costs and benefits – both in terms of the regulator and the regulatee – of a regulatory action prior to its implementation. This should enable them to be proportionate and targeted in discharging their function.

There is much variation in the implementation of risk-based approaches to regulation but a number of common practices when dealing with risk can be identified:

- Identification and selection of risks;
- Defining and describing risks;
- Measuring the risks using an appropriate methodology;
- Taking regulatory action in response to risks;
- Monitoring risks on a regular basis;
- Reporting the outcomes of regulatory interventions based on risk.[3]

What are the challenges associated with this approach?

Many of the challenges that are inherent to a risk-led regulatory approach are similar to those that plague the practice of risk analysis more generally. In order to successfully implement a risk-based approach, regulators have to address a number of issues:[45]

Defining and identifying risks – who decides what risks to focus on? What is the logic underpinning the identification and selection of risks? For example, should charities, the public or government be consulted on the identification of risks? Regulators should clearly define what regulatory concerns should be considered from a risk perspective.[67]

Developing indicators and measures – can risks be measured quantitatively? Does the regulator have sufficient data in order to measure a particular risk (for example, data relating to trustees in order to measure governance risks)?

Prioritising risks – what risks are more important from a regulatory perspective? Are risks relating to the misuse of charitable assets of more concern than damage to the charity 'brand'? This is a crucial process as appropriate regulatory responses are determined by the importance of the risk.

Selecting appropriate responses to risks - is it more productive to seek to reduce the probability of a risk occurring or focus on mitigating the impact of the risk? Ideally steps can be taken to address both but in practice resource constraints can force regulators to choose one.

Justifying their risk framework – does it help the regulator deliver their mandate and achieve their objectives?

Communicating their approach internally and externally – how is the regulator's concept of risk communicated to charities, government and the public? Is it easily understood? Will communicating the regulatory approach lead to positive or negative changes in practice in the sector?

What level of risk (or failure) they are willing to accept or tolerate – does a regulator accept a greater number of high probability/low impact risks occurring than low probability/high impact risks? For example, how many compliance and investigation cases are acceptable in a given year? In terms of income, is the failure of one large charity equivalent to the failure of many smaller ones in terms of its impact on public confidence?

Balancing institutional and sectoral risks – regulators should consider the relation between the risks they themselves face and the risks inherent in the sector they regulate.

What else is there to know?

Risk-based regulation requires regulators to adopt risk analysis as an organising principle for their organisation and activities.[8] The risk assessments conducted during the course of regulatory activity should be seen as repositories of information and a medium of communication; they can serve as a platform for the active discussion of risks and answer "what if" questions on an ad hoc basis.[9] Risk assessments are living documents and can help incrementally improve knowledge and decision making in an organisation; as a result, risk analysis can make the transition from strategic decision making to everyday operational procedures. Regulators should be mindful of the potential for new or additional burdens placed on charities as a result of risk-based regulation.[10] There is a risk that charities may become more accountable to the regulator at the expense of their donors and beneficiaries, and that charities may modify their behaviour or activities to meet reporting requirements.[11][12] Finally, risk-based regulation can temper emotional and subjective responses to events in the charity sector.

Conclusion

Risk-based regulation offers an objective, rational, and balanced approach to the regulation of charities. It can offer insulation from claims of subjective or emotional responses to events in the charity sector. It entails weighing up the costs and benefits of regulatory intervention, and applying regulatory powers in a proportionate, targeted manner. Regulators should be consistent in their implementation and application of risk-based regulation; regulatory interventions can, indeed should vary but the decision-making logic should remain the same. There are many challenges inherent to a risk-based approach to regulation and regulators should consider each one in detail. Most importantly, risk-based regulation should take into account the burden placed on charities as a result of this approach.

Further resources

The Society for Risk Analysis

http://www.sra.org/

Centre for Analysis of Risk and Regulation

http://www.lse.ac.uk/researchAndExpertise/units/CARR/home.aspx

risk and regulation magazine

http://www.lse.ac.uk/researchAndExpertise/units/CARR/publications/Risk&Regulation -Magazine.aspx

[1] Black, J. and Baldwin, R. (2012) 'When risk-based regulation aims low: Approaches and challenges' *Regulation & Governance*, volume 6, issue 1: pp. 2–22.

[2] Hutter, B. (2006) 'Risk, Regulation, and Management' in P. Taylor-Gooby and J. O. Zinn (eds) *Risk in Social Science*, Oxford: Oxford University Press (pp. 216-7).

[3] Sparrow, M. (2000) *The Regulatory Craft*, Washington, DC: Brookings.

[4] Black & Baldwin, 2012.

[5] Rothstein, H., Huber, M. and Gaskell, G. (2006) 'A theory of risk colonization: The spiralling regulatory logics of societal and institutional risk' *Economy and Society*, volume 35, issue 1: pp. 91–112.

[6] Power, M. (2004) *The Risk Management of Everything*, London: Demos.

[7] Power, M. (2009) 'The risk management of nothing' *Accounting, Organizations and Society*, volume 34, issue 6: pp. 849–55.

[8] Rothstein et al, 2006.

[9] Goble, R. and Bier, V. M. (2013) 'Risk Assessment Can Be a Game-Changing Information Technology – But Too Often It Isn't' *Risk Analysis*, volume 33, issue 11: pp. 1942–51.

[10] Corry, O. (2010) 'Defining and Theorising the Third Sector' in R. Taylor (ed.) *Third Sector Research*, London: Springer.

[11] Szper, R. and Prakash, A. (2011) 'Charity Watchdogs and the Limits of Information-Based Regulation' *Voluntas*, volume 22, issue : pp. 112–41.

[12] Hyndman, N. and McDonnell, P. (2009) 'Governance and Charities: An Exploration of Key Themes and the Development of a Research Agenda' *Financial Accountability & Management*, volume 25, issue 1: pp. 5–31.

The first in a series of four on the topic of risk in the charity sector, this research briefing will outline the core features of risk-based regulation and identify some of the challenges associated with this approach. This work is one of the outputs of a collaborative research project between the University of Stirling and the Scottish Charity Regulator (OSCR). This PhD project examines how risk is operationalized by the regulator, and experienced by charities. It will explore the extent to which existing (or new) charity data could be used to measure risk and it will test whether these measures are an accurate reflection of the qualitative risk within charities.

If you would like to learn more about the project then please contact Diarmuid McDonnell, University of Stirling, diarmuid.mcdonnell@stir.ac.uk.

To cite this paper: McDonnell, D. (2015) *Understanding Risk in the Charity Sector: Regulating for Risk*, Stirling: Scottish Network for Third Sector Data.

Scottish Network for Third Sector Data

The Scottish Network for Third Sector Data exists to link third sector organisations and researchers interested in the collection, analysis and use of data on the third sector in Scotland.

Run by Dr Alasdair Rutherford at the University of Stirling and Dr Eleanor Burt at the University of St Andrews, it provides details of relevant events, training, research and data for the third sector in Scotland.

Membership is free, and third sector organisations, public sector bodies, academics and students interested in third sector data are encouraged to join.

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