

# **Regulatory risk**

## Trends and strategies for the CRO



**A report from the Economist Intelligence Unit**

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## Preface

*Regulatory risk: Trends and strategies for the CRO* is the second in a series of reports from the Economist Intelligence Unit's Global Risk Briefing, a research programme targeted at senior executives responsible for managing corporate risk. Alasdair Ross was the author of the report, and Gareth Lofthouse was the editor. The Global Risk Briefing is sponsored by ACE, Cisco Systems, Deutsche Bank, KPMG and IBM.

The research for this paper is based on a survey of 230 senior risk managers, as well as interviews with chief risk officers (CROs). The Economist Intelligence Unit bears sole responsibility for the content of this report.

Our thanks are due to everyone who shared their time and insights in the survey and interviews. We are also grateful to the Professional Risk Managers International Association (PRMIA) for their help in reaching CROs and other risk managers to support this research.

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## Executive summary

**R**egulatory risk, a term describing the problems arising from new or existing regulations, is now one of the greatest threats to business, according to a global survey of 230 senior risk managers by the Economist Intelligence Unit. In the eyes of many corporate leaders, regulatory risk is now a greater source of concern than country risk, market and credit risk, IT and people risks, or terrorism and natural disasters.

How did regulation, much of which is designed to reduce business risks, become a major source of risk in its own right? Most companies accept the need for rules to govern business, and are used to working within regulatory constraints. But a spate of new regulations in recent years has had major—and some would argue unforeseen—consequences for business. For companies with international operations, in particular, the cost and complexity of ensuring compliance have risen sharply. So have the penalties, direct and indirect, of non-compliance.

Anticipating how a patchwork of domestic and international regulations may be interpreted, changed and augmented has become a key challenge for senior risk managers. This report, written by the Economist Intelligence Unit and sponsored by ACE, Cisco Systems, Deutsche Bank, KPMG and IBM, focuses on the challenge of managing these regulatory risks. Drawing on a global survey of executives from a cross-section of industries, as well as interviews with several chief risk officers (CROs), this research sheds light on why regulation has become a major source of risk, and on what professional risk managers are doing about it. The report includes the following main findings:

- **The cost of regulation is rising.** Nearly 90% of companies believe that the cost of regulation will rise over the next three years; 36% of them believe it will

rise substantially. This is bad news for companies, but also for their customers who, according to almost two-thirds of executives in the survey, will ultimately foot the bill for compliance. Regulation has other, indirect consequences for business. Thirty-six percent of executives say that regulation has stifled innovation in their companies. Just under one-third fear their firms will become uncompetitive with companies operating in less regulated countries. Executives acknowledge the need for regulation, but the majority believe the benefits of recent regulations are outweighed by the problems.

- **Regulatory risks increase as firms expand overseas.** Increased complexity in the international regulatory environment is one of the biggest challenges facing companies, with regulations in one country potentially having an increased impact on firms' global operations. Only 17% of companies are very confident that they are compliant with regulation in their overseas markets, compared with 40% that are very confident of compliance in their home markets. Similarly, only one in five companies have high confidence that they are compliant with international regulations such as Basel II and International Accounting Standards.

- **Regulation is a significant deterrent to overseas investment.** Fully 57% of executives in the survey say that their perception of a country's regulatory burden has an important or very important impact on decisions to invest, compared with only 4% that believe it is of low importance. Over one-third of companies have been deterred from investing in a new market because of regulatory issues. The results have interesting implications for the US, which is seen by executives as the country where regulatory burdens are increasing most significantly.



● **Companies must seek to stay one step ahead of the regulators.** Executives believe the two best strategies for pre-empting regulatory change are to adopt best practice before it is mandated, and to maintain regular communications with domestic and international regulators. A proactive approach can help avert the need for regulation in the first place, and minimise the disruption caused by new regulation where it arises. With companies struggling to maintain compliance with regulations in multiple jurisdictions, recruiting expertise in different countries' regulatory environments is also seen as an important strategy. Direct lobbying of governments is deemed far less effective as a strategy for managing regulatory risk.

After numerous high-profile failures in corporate governance in recent years, few would argue with the need for strong and effective regulation. But many business leaders are concerned that recent regulations have brought unintended consequences for business. As one CRO interviewed for this report puts it, "The main regulatory risk is that, failing to understand our business, the regulator does something that damages us." That makes it all the more imperative that companies work closely with regulators at home and abroad, helping them to set standards for good governance without the need for excessively onerous regulation.

## New face of an old challenge

The tension between private business and the public interest is as old as commerce. Back in the days, a century ago, when the Rockefellers, the Carnegies and the Schwabs dominated the US economy from the helm of virtual cartels known as business trusts, the state began to take direct action by introducing "anti-trust" mechanisms. Trust-busting became the model for a generation of legislation that curbed companies' ability to exploit an advantageous position in the marketplace. As the 20th century began, any scion of

America's great entrepreneurial families would have immediately grasped the meaning of the term regulatory risk.

Of course, regulation remains a hot topic for companies today. In the past decade, a succession of market failures put policymakers on the spot. Financial crises from Brazil to Thailand demanded more reliable mechanisms for steering international financial flows. Power shortages in California demonstrated the shortfalls in existing regulatory frameworks. Governance failures such as those at Enron and WorldCom focused attention on the complexities of the modern conglomerate, and the inequities in the share-out of risks and rewards between corporate officers and stakeholders.

The response of regulators to these developments has been energetic. Regulatory rules now cover every aspect of a business and its relationship with society, from business competition to financial management, from health and safety to conservation of the natural environment.

There is nothing new in companies being compelled to operate within regulatory constraints, and most executives recognise the need for rules to govern business. Recently, however, many executives have taken issue with the manner in which regulation is designed and implemented, and particularly with the trend in recent years towards a more intrusive, more comprehensive and more prescriptive approach. In a world of global brands and pervasive media, market abuses have the potential to elicit powerful public reactions, focusing pressure on governments and state agencies to respond with equally emphatic counter-measures.

The most powerful example is the US's Sarbanes-Oxley act of 2002, compelling company directors to provide evidence of probity on a range of issues on pain of imprisonment. Few question that legislation was needed, and the earliest versions of the bill were broadly supported by business, but what eventually emerged took regulation of corporate behaviour to new levels—



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perhaps unintentionally. Michael Oxley, one of the sponsors of the legislation, describes the post-WorldCom atmosphere in which the legislation was drafted as “a hothouse”, and now acknowledges that the legislation that bears his name is imperfect as a result.

Erwin Martens, CRO at TIAA-CREF, a New York-based financial institution, concurs. “Sarbanes-Oxley has hit both the bottom line and the business structure. Businesses are asking ‘Is this what you meant to do?’ and regulators are saying ‘Well no, but this is what happened’.”

There is a feeling among many executives that, in their haste to prevent another WorldCom or Enron, the regulators have rushed in far-reaching regulations without fully comprehending their impact on business. “The main regulatory risk is that, failing to understand our business, the regulator does something that damages us,” says Paul de Hoest, CRO for Egg Bank Plc in London. “So it is all about identifying and sharing our objectives.”

Mr Hoest is not alone in seeing regulation as a

significant source of risk in its own right. The Economist Intelligence Unit’s Risk Barometer (an index that tracks major business threats on a quarterly basis) now shows that regulatory risk is seen by executives as the most significant threat to business, ahead of country risk, market and credit risk, IT and people risks, or terrorism and natural disasters.

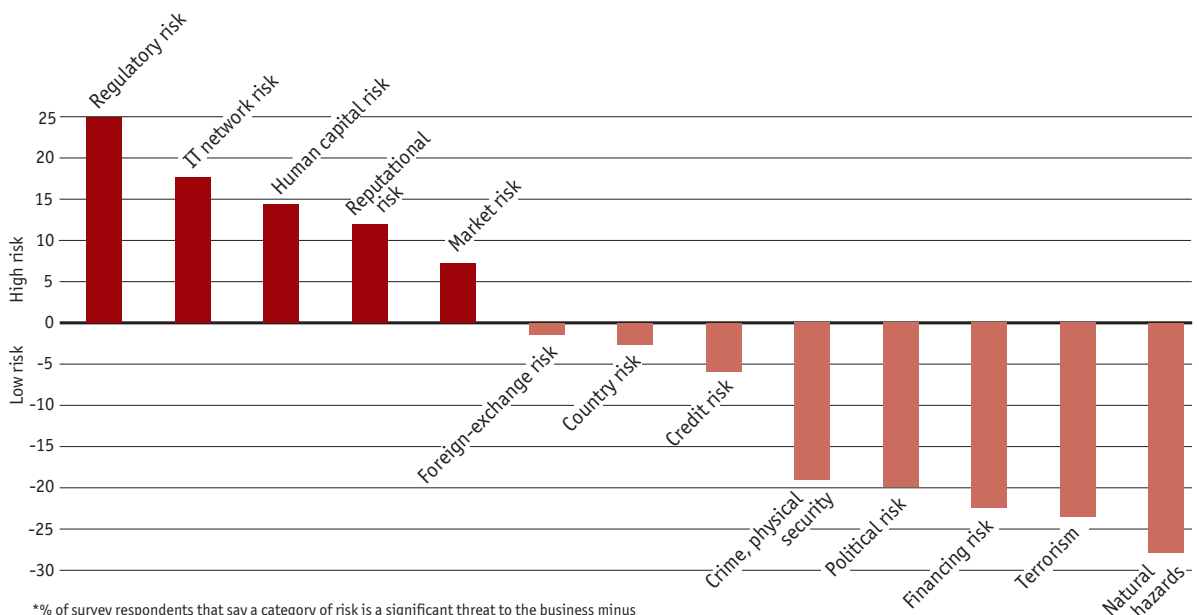
As to whether the regulators are achieving their stated aims, many CROs are sceptical. “Risk is like a balloon, you squeeze in one place and it just comes up somewhere else,” says Mr de Hoest. Certainly the majority of global executives surveyed for this report believe that the problems arising from recent regulations outweigh any benefits.

## Complexity equals cost

As we have seen, companies have had to come to terms with a raft of new regulations in recent years. But as much as the absolute level of regulation, it is the pace of change that causes managers headaches. “What’s

### Category risk barometer

Average % score for each category\*

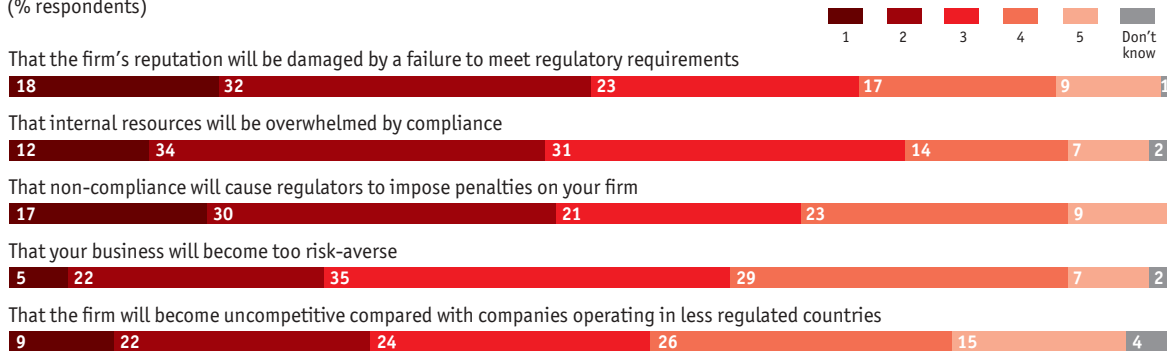


\*% of survey respondents that say a category of risk is a significant threat to the business minus % of respondents that say a category of risk is a low threat to the business

Source: Economist Intelligence Unit survey, June 2005



**How significant are the following regulatory risks to your business?**  
 Rate on a scale of 1 to 5, where 1=Very high risk and 5=Very low risk.  
 (% respondents)



Source: Economist Intelligence Unit survey, June 2005

unique at this time is the level of flux," observes Mr Martens.

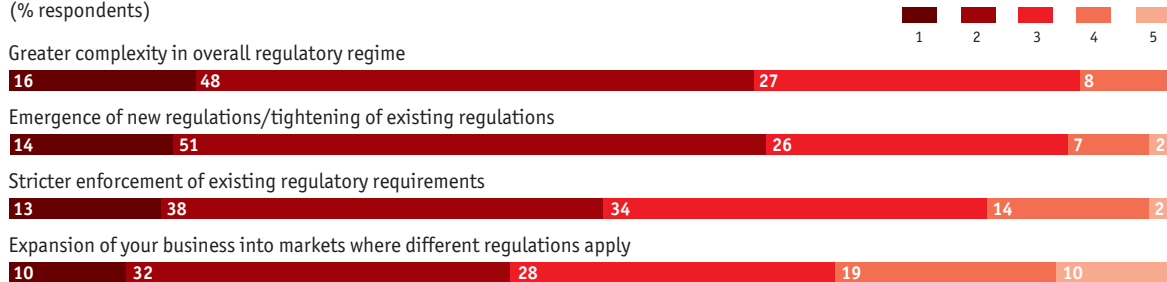
Many large companies have ended up juggling several compliance projects, and find it increasingly difficult just to keep pace with a fast-changing and unpredictable regulatory environment. Executives in the survey see rising complexity in the regulatory regime as the biggest source of regulatory risk, followed closely by the emergence of new regulations and the tightening of existing ones. Half the survey respondents also see stricter enforcement as another trend that will increase the burden of compliance over the coming years, while 42% see expansion into new markets as another likely source of compliance costs.

The survey indicates that regulatory compliance is by no means assured, particularly for companies with

global business operations. Only 17% of companies are very confident that they are compliant with regulation in their overseas markets, compared with 40% that are very confident that they are compliant with regulations in their home markets. Moreover, international regulations, such as International Accounting Standards and Basel II, add an extra layer of complexity. Although most companies feel broadly on track to meet the requirements of international regulation, only one in five companies are very confident in this regard.

Executives are keenly aware that a breach of regulatory rules could bring severe consequences that stretch far beyond any direct penalty imposed by the enforcement agencies. More than anything else, executives fear the impact that a failure to meet

**How significant an impact do you think each of the following will have on your business over the next three years?**  
 Rate on a scale of 1 to 5, where 1=Very high impact and 5=Very low impact.  
 (% respondents)



Source: Economist Intelligence Unit survey, June 2005



## Regulatory risks: a global perspective

In addition to shedding light on the costs and consequences of regulation, the survey also reveals the countries where regulatory tightening is having the greatest impact on business. Topping this list by a huge margin, the US stands out as the country creating the greatest source of regulatory risk for the majority of companies in the survey.

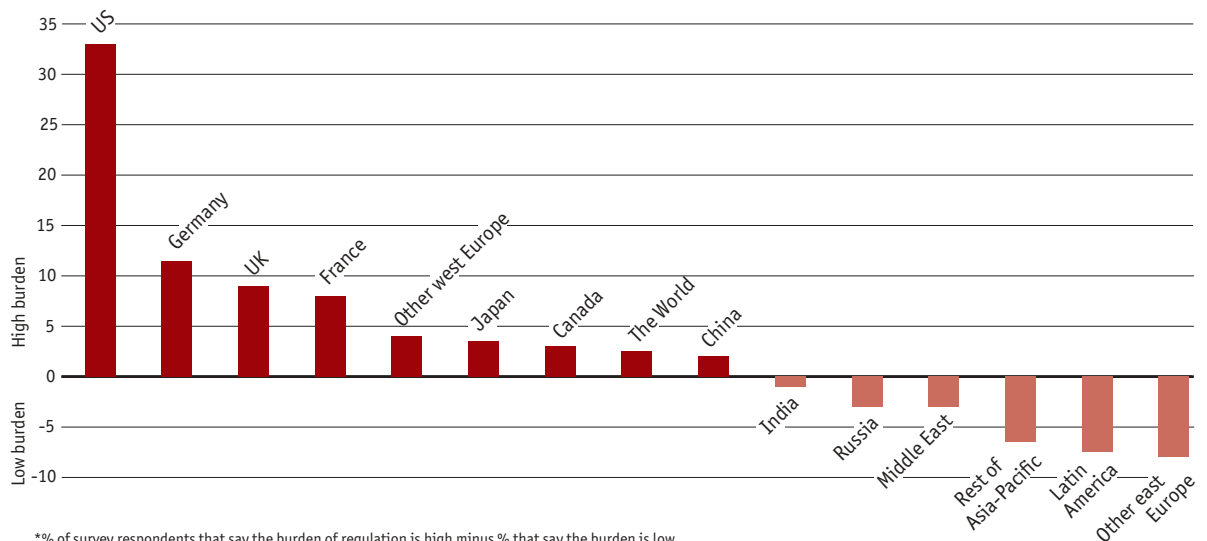
Given that historically business

regulation has been relatively light in the US, this result probably signifies a strong reaction to Sarbanes-Oxley, as well as the importance of the US market to companies in the survey. Sarbanes-Oxley has been in force for domestic corporations for a year; foreign-based firms will need to comply with the legislation by the end of 2006.

There is then a big gap between

the US and the second-placed country, Germany, which around one-third of respondents believe imposes a high regulatory burden. The UK and France follow closely. Other west European markets, Japan, Canada and China raise some concern and, at the bottom of the ranking, east European countries (excluding Russia) and Latin American ones are perceived as relatively light regulators.

**Do you view the current regulatory environment as placing a high or low burden on business in the following countries or regions?**  
Average % score by region\*



\*% of survey respondents that say the burden of regulation is high minus % that say the burden is low  
Source: Economist Intelligence Unit survey, June 2005



The US is also the only market where most respondents expect a high impact from regulatory change over the next three years. In all others, a majority expects the impact to be low. However, the breakdown by region and industry shows that the strongest reaction comes from those firms based in the US and those in the financial sector. Firms outside the US and from other sectors, although

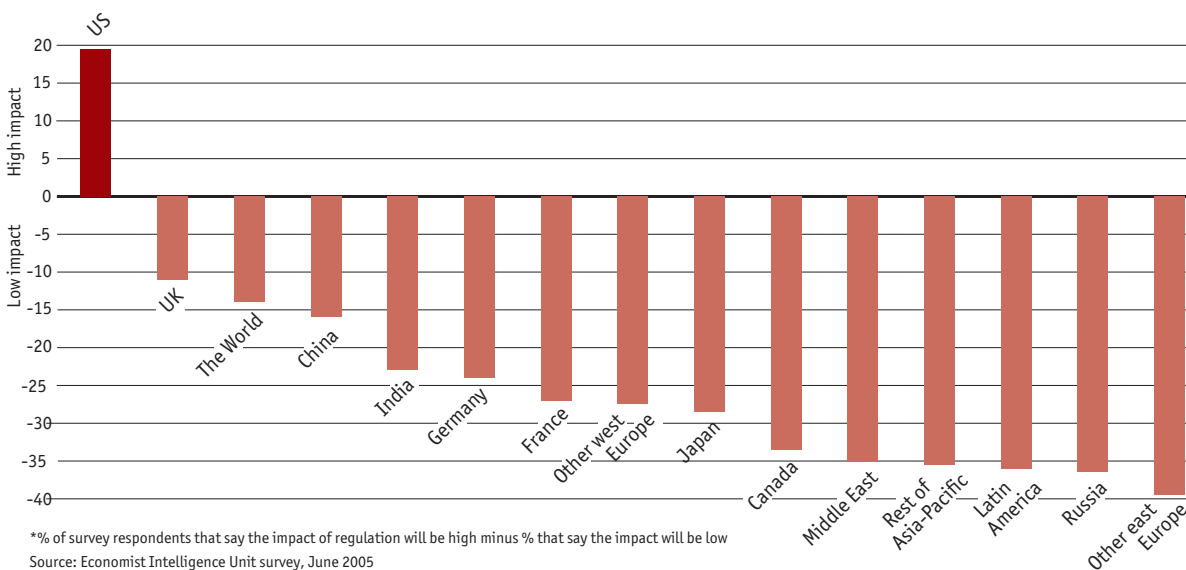
generally in agreement that the changing regulatory scene in the US will have a high impact, are less pronounced in this view.

These perceptions are of more than academic interest. For companies operating in the US, it is imperative to establish good lines of communication with the country's increasingly energetic regulators. But there are wider implications too. Over half of

executives in the survey say that their perception of a country's regulatory burden has an important or very important impact on decisions to invest, and over one-third say they have been deterred from investing in a new market because of regulatory issues. Policymakers in the US would do well to take these points on board when planning the next round of regulations.

**How significant an impact do you think changes in regulation in these countries or regions will have on your business over the next three years?**

Average % score by region\*



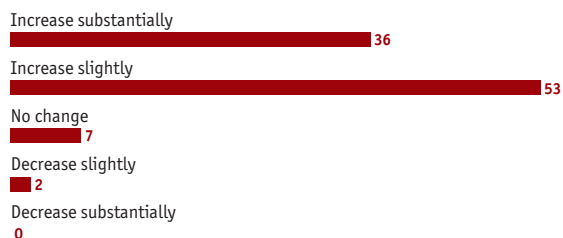
\*% of survey respondents that say the impact of regulation will be high minus % that say the impact will be low  
Source: Economist Intelligence Unit survey, June 2005



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### Do you expect the overall cost of regulation on your business to increase or decrease over the next three years?

(% respondents)



Source: Economist Intelligence Unit survey, June 2005

regulatory requirements would have on their companies' reputation. A large proportion of companies also worry that their internal resources will be overwhelmed by the burden of compliance. Some executives go further: a significant minority believe there is a danger that regulation will make their firms too risk-averse, or make them uncompetitive when compared with rivals operating in less regulated countries.

Although executives in all industries register similar fears in the survey, the level of concern varies between industries. For companies outside the financial services industry, the risk of resources being overwhelmed by regulatory compliance was a greater concern even than the risk of reputational damage. In general, executives in non-financial firms register lower levels of concern than those in financial services companies.

Few executives in the survey expect these regulatory burdens to diminish, at least in the short term. More than two-thirds believe that the trend towards tighter regulation will increase over the next three years. This is felt even more strongly in the financial services industry, where three-quarters of companies predict further regulatory tightening. An overwhelming 90% also expect the cost of regulatory compliance to rise over the same time period.

Executives are also concerned about the indirect costs of regulation, however, as resources are diverted

from value-creating activities into complying with red tape. For example, 36% of respondents are in broad agreement with the statement that regulation has stifled innovation, and a similar proportion say that regulatory issues have deterred their firms from investing in new markets. A large majority of firms (63%) expect the costs of regulation to be passed on to customers through higher prices. If these views are borne out, the recent raft of regulations will bring undesirable consequences for the very people they were meant to protect—shareholders and customers.

## Staying one step ahead

If regulation has become a major source of risk in its own right, what should risk managers be doing about it? For most executives in the survey, the key challenge is to predict and prepare for changes in the regulatory environment. But given the complexity and rapid pace of change in regulation, this is easier said than done.

In response to this challenge, most companies in the survey advocate two main strategies. The first involves adopting best practice whether required to by current regulation or not. This appears designed both to pre-empt regulation before it arises, and to deny the regulator a reason to introduce it in the first place.

Even where regulators feel compelled to act, early adoption of best practice can save money. "Sarbanes-Oxley was a huge issue for us, and we embraced it very early on," says John Wengler, CRO at Entergy Corp, a Texas-based energy producer and distributor with operations in seven south eastern states (see box). In Entergy's case, the new legislation was in tune with the existing management culture, and this lessened the burden of implementation.

"We had a good control environment to start with and we were able to leverage it," says Mr Wengler. "Adopting Sarbanes-Oxley was synergistic, not diversionary."

Other firms have found it more difficult to stay one



### Case study: Entergy

Energy provision in the US is perhaps the most heavily regulated business anywhere. The country's generating and distributing companies are subject not only to the general regulatory environment that all corporations face, but also to a tight framework of sectoral rules designed to ensure a smooth supply of power in return for a predictable and attractive return on investment. Even this strictly sectoral set of rules varies from region to region, and from product to product.

Entergy Corp, is a Texas-based energy producer and distributor with operations in seven south eastern states. It also owns the country's second-largest fleet of nuclear generation facilities.

Much of Entergy's conventional electricity generation and distribution business falls under state-level regulatory regimes that set the price at which power is sold. This part of the business is subject to the regulators of seven different states, each with its own approach to the industry. "Each state is truly different," says John Wengler, the company's CRO. "For instance, Louisiana's public service commissioners are elected, but in Texas they're appointed. There's a more public atmosphere in Louisiana."

Regulatory uncertainty is substantial in all areas of the business. For instance, Entergy's conventional operations in Texas are currently subject to regulated rates, but the state is talking about whether to allow utilities to compete on the open market. In the nuclear business, the company is monitoring developments on the proposed Yucca Mountain nuclear

waste disposal site in Nevada. If this is rejected, the company will need to build the costs of securing alternative storage facilities into its business plans.

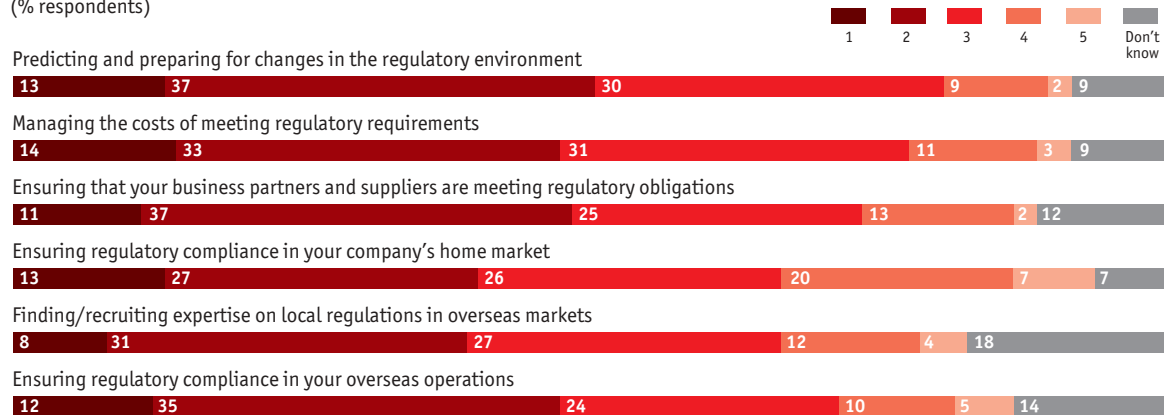
Cutting across this is the overriding issue in US energy regulation, the fate of the 1935 Federal Public Utility Holding Company Act (PUHCA), which places broad restrictions on where and how energy companies can invest. Proponents of reform say it would stimulate investment and improve efficiency. But a powerful array of critics believe it would encourage speculation and market abuse, as well as place the environment at risk.

"Regulatory risk is fundamentally different," reflects Mr Wengler. "You can't calculate value at risk (VAR) from regulatory sources. But there is a common denominator: dollars. More precisely, uncertainty attached to dollars."

step ahead of the regulators, however. In the financial services sector, for example, the introduction of the Basel II framework requires a fundamental re-think of risk assessment and control. This has been costly even for some institutions that had adopted its philosophy

at an early stage. "Lots of companies considered capital needs from the risk perspective, but not in the precise numerical terms of Basel II," says Mr de Hoest of Egg Bank. "Some had to re-invent systems they had already invested heavily in." Although Egg Bank has

**How significant for your company are the following challenges associated with managing regulatory risk on an international basis? Rate on a scale of 1 to 5, where 1=Major challenge and 5=Not a challenge.**  
(% respondents)



Source: Economist Intelligence Unit survey, June 2005

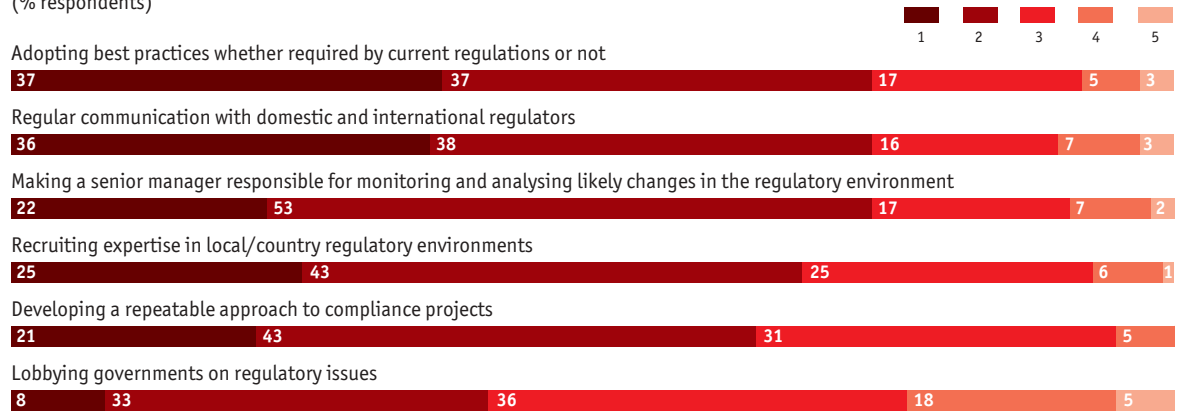


## Regulatory risk: Trends and strategies for the CRO

How effective do you believe the following strategies are for predicting and managing regulatory risk?

Rate on a scale of 1 to 5, where 1=Very effective and 5=Ineffective.

(% respondents)



Source: Economist Intelligence Unit survey, June 2005

been able to integrate the Basel II requirements into its existing processes, Mr de Hoest says it won't get back its investment pound-for-pound.

This leads us to the second strategy, which entails building as close a relationship as possible with domestic and international regulators. This is a two-way process. It allows firms to keep abreast of the way regulators are thinking, and the issues that are giving them concern. It also gives firms the opportunity to ensure that regulators are familiar with the realities of the business world, and to reassure them that management is on top of issues that might otherwise require regulation.

Managing regulatory risk "is based on early warning," says Mr de Hoest. This means keeping abreast of "what's coming out of regulators' consultation papers and so on, what's coming down the track."

For firms outside the US, and for those in the financial sector, communication with the regulator is seen as more important than adopting best practice. For firms outside the financial sector, best practice comes top, but other procedural issues such as developing a repeatable approach to compliance projects and recruiting expertise in the local regulatory environment are considered more important than maintaining close relations with the regulator.

Although all respondents gave a high priority to staying in touch with the regulatory agencies, direct lobbying of governments on regulatory issues was identified as an effective strategy by relatively few firms. Indeed, in the financial sector responses were equally divided between those who saw this as an effective strategy and those who considered it ineffective.



## Conclusion

The tension between corporate self-discipline and state regulation is as active as ever. In a globalised economy awash with financial flows and dominated by multinational conglomerates, the stakes are also extremely high. For risk managers, navigating through this period of change is a formidable challenge, and one that must be achieved without detracting from the task of monitoring and mitigating a multitude of other

risks that fall under the remit of the CRO.

In this regard, an integrated approach to risk management is especially crucial. "The trick is getting everybody working together, because it's the cracks in the system that catch you out," says Mr Martens of TIAA-CREF. In a world where risks are increasingly inter-dependent, it's a lesson that is as relevant to policymakers and regulators as it is to corporations.

### Survey and ranking methodology

The findings in this press release are based on a survey of 230 senior executives. Forty-four percent of the participants were based in the US, 32% were based in Europe, and 15% were based in Asia Pacific. All survey findings in this report and press release are drawn from a survey conducted in June 2005.

Thirty-nine percent of the companies participating in the survey were from the financial services sector.

Respondents from 17 other industries participated in the survey, including professional services, energy sector companies, IT and telecoms firms, and pharmaceutical and healthcare companies.

The survey questions asked respondents to rate options from strongly positive to strongly negative, with neutral in the middle. Results were weighted (strong positives and negatives were doubled, moderate positives and negatives were unchanged, and neutrals were discarded) and combined to produce an average % score, and ranked accordingly.

Whilst every effort has been taken to verify the accuracy of this information, neither The Economist Intelligence Unit Ltd. nor the sponsor of this report can accept any responsibility or liability for reliance by any person on this white paper or any of the information, opinions or conclusions set out in the white paper.

LONDON  
15 Regent Street  
London  
SW1Y 4LR  
United Kingdom  
Tel: (44.20) 7830 1000  
Fax: (44.20) 7499 9767  
E-mail: london@eiu.com

NEW YORK  
111 West 57th Street  
New York  
NY 10019  
United States  
Tel: (1.212) 554 0600  
Fax: (1.212) 586 1181/2  
E-mail: newyork@eiu.com

HONG KONG  
60/F, Central Plaza  
18 Harbour Road  
Wanchai  
Hong Kong  
Tel: (852) 2585 3888  
Fax: (852) 2802 7638  
E-mail: hongkong@eiu.com