

The Global Regulations Avalanche

Environmental & technological issues facing compliance risk management

A Report By

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1 Macro Environment of Regulatory Compliance

In 2008 the Economist Intelligence Unit (EIU) surveyed senior staff in large businesses with responsibility for risk management. In survey responses, audit and compliance risk were perceived as the biggest threats to their businesses, ahead of market risk and credit risk. It is intriguing, at the very least, that the processes purported to protect businesses and consumers are perceived as such a threat by experienced compliance and risk managers.

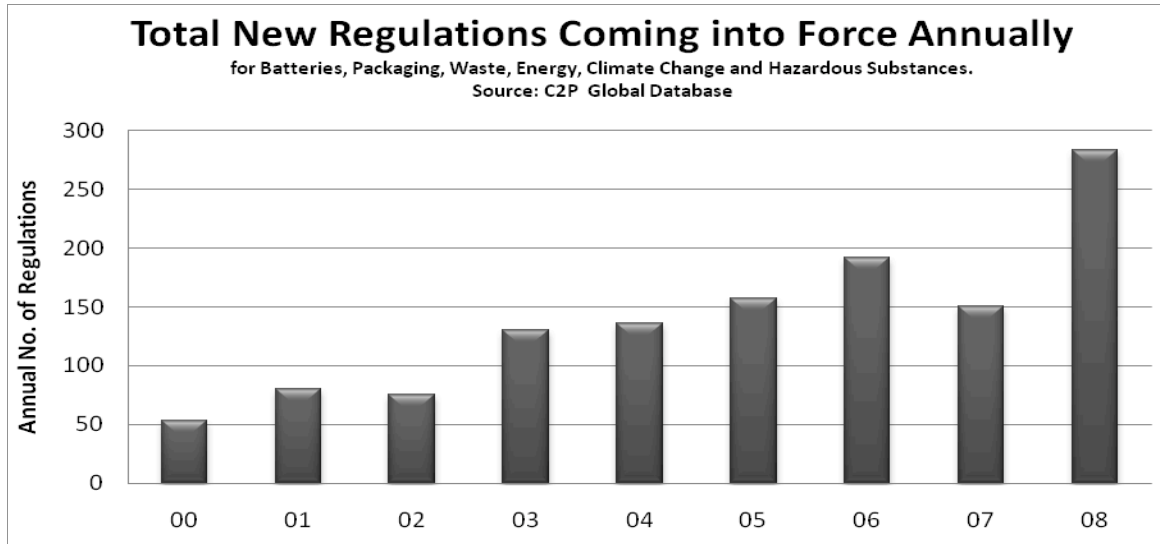
The survey identified two underlying reasons for this concern. One is the sheer volume of new regulatory legislation and industry standards, from Sarbanes-Oxley in the financial sector, to environmental and other global regulatory developments around such varied topics as take-back and recycling, toxic substances, chemicals (e.g. EU REACH, Registration Evaluation and Authorisation of Chemicals), packaging and labelling, batteries, energy efficiency, data protection, export controls, advertising, worker protection and climate change. Such new information must be identified and added to individuals' and companies' information stockpiles. The second is the complexity of new compliance rules, their interconnections, the potential for conflicting interpretations across different implementing measures, and the need not only for companies to comply in their own operations in relation to their buyers, but also to check the level of compliance of their suppliers. The EIU found that 66% of the problems associated with compliance were attributed to complexity.

Business complexity more generally refers to the increasing demands on personnel and functions within organisations to interpret new information, to learn from it and act upon it within the uncertain environment of business life. Regulatory compliance is clearly a domain that contributes to the generation of complexity for many modern organisations so that competencies in managing such complexity are becoming increasingly vital to maintain and improve market performance and organisational effectiveness. The essentially technical problem of coping with an increased regulatory burden in terms of both volume and complexity means that those companies that can address the matter strategically are likely to do better, not only in terms of compliance, but in terms of better and quicker decision making and collaboration all round, internally and with external stakeholders.

1.1 Volume

The rate of increase in the regulatory burden across the world is increasing at breakneck speed. Tim Ambler, Senior Fellow at London Business School, described it as "the torrential rate of new regulation." Based on data from the C2P Global Regulatory Database (in the areas of regulation for Batteries, Packaging, Waste, Energy, Climate Change, and Hazardous Substances), this view is supported by quantitative evidence as depicted in Figures 1.1 and 1.2. Verifiable quantitative data outside of these figures does not seem to exist publicly.

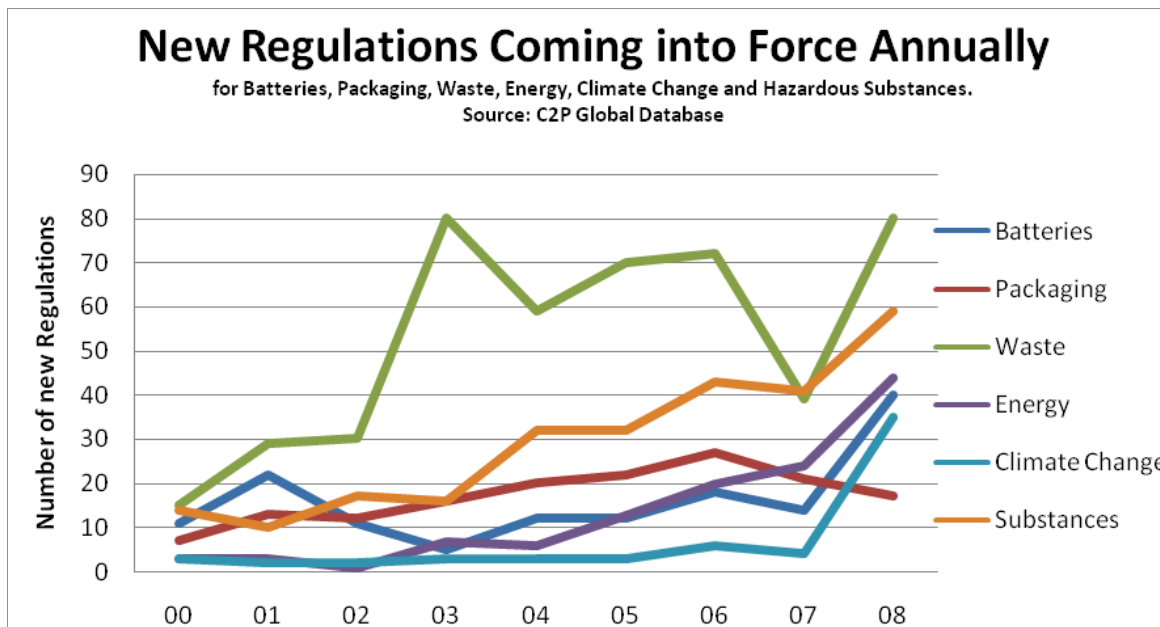
Figure 1.1 Total new regulations coming into force annually



Source: C2P Global Regulations Database

Figure 1.1 shows the substantial increases in the volume of new regulations each year since 2000. The average annual increase in regulation is 28%, but clearly the rate of increase is itself increasing, with an 88% increase in 2008 as opposed to 50% in 2001. There were over 4 times more regulations issued in 2008 than 2000, showing that the rate of growth in the volume of new regulations coming into force annually is substantial.

Figure 1.2 New regulations coming into force annually



Source: C2P Global Regulations Database

From the six compliance areas of Batteries, Packaging, Climate Change, Waste, Energy and Hazardous substances, it can be seen in Figure 1.2 that the increase is evident across all areas of regulation, so the aggregate figure is not being skewed by one particular area of compliance, although Waste and Hazardous Substances have experienced larger increases than the other four categories (particularly between 2002 and 2006).

The data collected on the volume of new regulations is a sample of only legal regulations in the six areas mentioned, and takes no account of other sources of increases. These would include legal regulations for areas other than the six sampled, for which this study was unable to source reliable estimates, but also self-imposed industry standards and internal company regulations that would have come into force during the period, which serves to emphasise Ambler's view that the increase in the volume of compliance has been "torrential".

1.2 Complexity

One of the main reasons proposed by the EIU for the relatively high level of threat associated with regulatory risk (relative to market and credit risk) is the increasing level of complexity of the regulatory environment. In a 2008 Deloitte report focussed on issues in banking compliance, the authors found that 90% of respondents agreed that compliance had become more complex, while 95% thought that it would become even more so over the next 5 years.

A major reason for this is the overlap, interrelationship, and conflict between regulations and the challenge of dealing with multiple regulatory environments, both domestically and internationally, as companies attempt to run projects and initiatives as efficiently as possible. In addition, it is necessary not only to ensure the compliance of the individual company's activities but of their suppliers', and to prove the compliance of products to a company's own buyers.

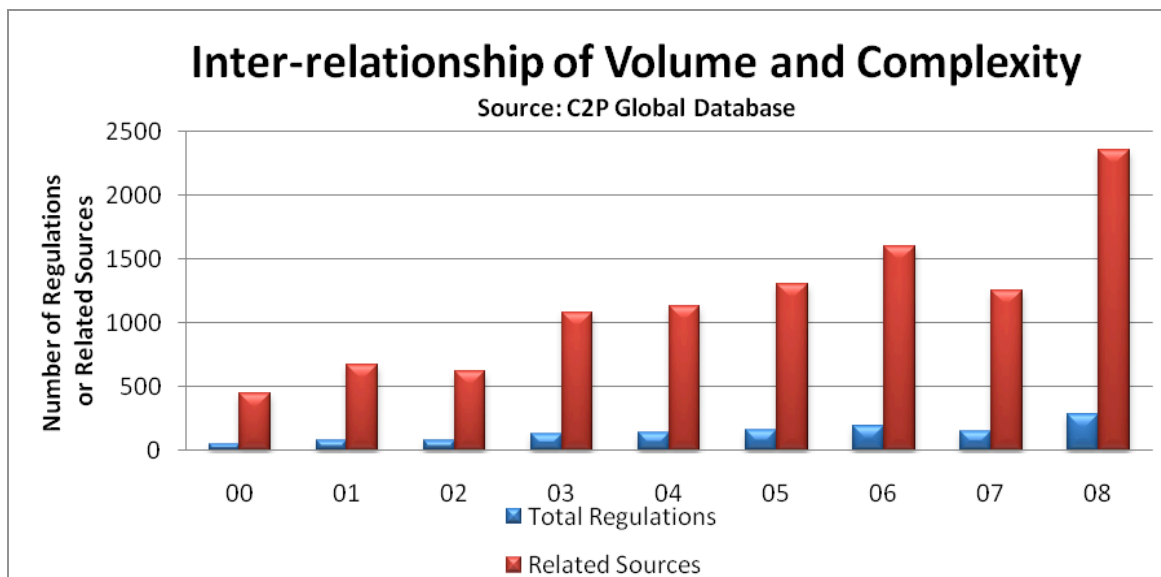
Figure 1.3 illustrates the amount of interrelation between legal and sundry documents that increases regulatory complexity. Related documents as defined by the C2P Global Regulatory Database include:

- Amendments (in force and pending)
- Documents providing clarification and interpretation
- Mentioned documents
- Implementing measures of various kinds
- Miscellaneous relevant documents

Understanding regulations requires analysis of terms and definitions, not only in the regulation itself but in related documents. The first requirement for a Regulatory Compliance Knowledge Management system is to save users time. It needs to organise scattered data (which requires more effort to find) into a cluster of quickly navigable, clearly

related documents, words, and meaning. Secondly, it must provide a mechanism for sensibly accumulating learning in such a way as to easily share insights, ideas, suggestions, and decisions. This saves everyone time in the analysis, communication, implementation, and audit phases of the compliance process. Again using the C2P Global Regulations Database, we identified an average of 8.33 Related Sources for each piece of legislation. In terms of the invisible complexity this is the tip of the iceberg, as it indicates nothing about the numerous points of difficulty within documents, all of which are potential stumbling blocks in terms of knowing what to do and communicating decisions in an auditable way, which itself saves more scarce organisational time.

Figure 1.3 Inter-relationship of volume and complexity



Source: C2P Global Regulations Database

Reports by both the EIU and Deloitte highlight the difficulty of juggling multiple compliance projects. Companies’ fears of the risk of non-compliance have led to a large scale duplication of activities, increasing the cost of compliance and revealing a preference for higher costs compared to the possible costs of non-compliance. Half of EIU respondents identify duplication as one of the main costs associated with regulatory risk. Just one quarter consider they are successful at minimising duplication in multiple environments. With the increasing prevalence of outsourcing, the pressure for such duplication can be expected to increase further.

Even with such duplication and increased spending to ensure compliance, regulatory risk management remains a key area of weakness in the EIU survey, with only 30% of those surveyed being happy that they are successful in relation to assessing compliance in their supply chain. The EIU reports that:

Few conduct frequent checks into the compliance of companies with which they work. Just 30% request formal details of compliance from key partners on a regular basis, while

the remainder seek this information only during the due diligence process, on an ad hoc basis or not at all (emphasis added).

This is in the context of 231,910 people employed in the US as Compliance Officers to counter such issues (a figure excluding employees in agriculture, construction, health and safety, and transportation) and an annual cost of \$12 billion on solely these personnel.

For the Financial Services Industry the problem of regulatory complexity is of particular relevance. As regulators prepare their response to the worst financial crisis in a generation, the sector will surely face a new set of regulatory constraints, possibly involving measures such as tighter liquidity requirements or higher capital ratios to take into account off-balance sheet vehicles.

1.3 Integrating Compliance into Enterprise Systems

A study by the Aberdeen Group in 2006 revealed that nearly 80% of electrical and electronic manufacturing companies, including high-tech and IT manufacturers, lacked cohesive information systems to track, audit, and manage product compliance despite a spend of \$33 billion by US electronics companies in 2007. The Aberdeen Group indicates that most companies relied on a variety of solutions that were insufficiently integrated, and which did not provide the information needed to manage product compliance with global environmental regulations. They concluded that:

Inefficiencies in processes will continue to distract companies from innovation and add unreasonable costs without better, more automated approaches to product compliance.

According to the EIU, creating a unified approach to manage regulatory risk must be a long term objective to deal with this problem. The Deloitte survey found that top compliance managers considered that compliance and risk management functions should be brought together as one part of the solution.

However, even with this realisation, and as evident to both academics and compliance professionals, many companies still rely on spreadsheet-based solutions to manage compliance risks, rather than a purpose built system providing structured data on compliance and a system to track the product over its life-cycle. Matt Kelly reported in *Compliance Week* (August 23rd 2005) that numerous business enterprises reported spreadsheet compliance deficiencies that were only detected by third parties. Studies such as Baxter 2005 found serious deficiencies in using spreadsheets to manage compliance risk in relation to Sarbanes-Oxley.

As spreadsheets have been shown to be inadequate for financial reporting regarding relatively straightforward regulations like Sarbanes-Oxley and Basel II, their use by governance, risk and compliance officers, product stewards, and other compliance professionals facing increasingly complex and vast regulation leaves companies exposed to significantly increased compliance risks. The Aberdeen Group Report states that:

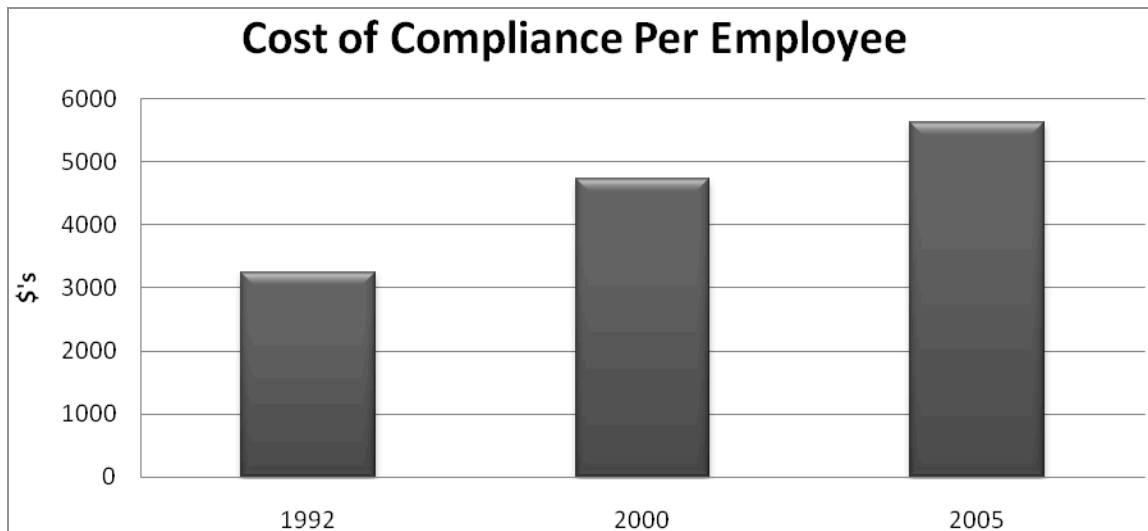
Best in class companies, however, are more than twice as likely to have fully automated, enterprise-wide systems as other companies.

Significantly, the report indicates that 'laggards' are more likely to be using spreadsheet solutions, as they continue to try and plough the compliance field with a spoon.

1.4 Direct Costs of Compliance

An offshoot of trying to deal with the rapidly increasing volume and complexity of compliance issues are the knock-on increases in the costs of compliance for business. Crain (2005), Hopkins and Crain (2000) and Hopkins (1995a) carried out studies in the regulatory burden across the United States for The Office of Advocacy, U.S. Small Business Administration. Figure 1.4 below graphs the average regulatory costs per employee estimated from their studies.

Figure 1.4 Cost of compliance per employee



Source: Crain (2005), Hopkins and Crain (2000), and Hopkins (1995a)

The average cost of regulation per employee increased over 70% in the short period between 1992 and 1995, in real terms. In the UK the picture is much the same with the cost of compliance topping £10 billion per annum in 2008, according to the British Chamber of Commerce (based on a quite limited definition of compliance). Compliance costs represented approximately 0.6% of GDP in 2008 (using IMF figures of UK GDP).

The rate of increase in compliance costs has been just as rapid in the Banking sector. While the Deloitte report revealed an increase of 159% in compliance spending between 2002 and 2006, based on responses from Chief Compliance Officers and other officers responsible for compliance, three institutions reported spectacular annual growth rates in spending on compliance of between 1,100% and 3,200% over this five-year period.

The Deloitte report examines why expenditures have increased so much. While the volume and complexity of regulation have both increased through new legal requirements, as mentioned above, Deloitte believes that over-reliance on manpower to solve the increased workload and complexity is the chief cause of ballooning costs. Technology-supported solutions that could leverage the skills of already employed compliance staff by providing a system that lets them access information sooner, process it faster, and maintain it easily, could in principle address cost issues and facilitate the ongoing and increasing demands of managing complexity.

1.5 Non-Financial Costs

According to Andy Baynes, Senior Manager Environmental Technologies at Apple Inc:

The problem with compliance issues is that the data, which has been shown to be vast and complex, is also 'unstructured data'. For example, at any given moment a single product may be impacted by as many as 200 requirements across 50 markets. Each requirement may be buried in lengthy laws that are riddled with ambiguity that can only be deciphered by external counsel or other disassociated sources such as official guidance notes or technical standards. Today's engineer or compliance manager has to be able to navigate these requirements quickly. If there is no way to organize the requirements that impact your business from those that don't, and relate them to technical and legal clarification as it happens in 'real time', then the task of managing compliance and risk becomes unfathomable.

There is an increasing acknowledgement in industry publications and academic literature that a compliance software package designed to track regulations in real time and manage compliance risk using structured data linking global regulations to internal product specifications could potentially fill the gaps outlined here. The challenge in outperforming technical solutions—such as spreadsheet-type solutions—rests in expertise that focuses on complexity rather than quantity issues. This requires a knowledge management system built specifically for compliance information and sophisticated and comprehensive enough to address the compliance tasks of contemporary businesses that operate across varied input, output, and financial markets.

As outlined in the literature, the risks of failing to comply with relevant regulations include:

- Banned or delayed shipments of products
- Product Recall
- Regulatory Fines
- Litigation Costs
- Exclusion from some markets
- Damage to Brand Image

In addition to these, companies may well miss out on opportunities to gain first-mover advantage by not putting in place a more comprehensive compliance framework that allows them to deal with compliance issues in a timelier manner than competitors.

1.6 The Future Regulatory Burden

A final issue is whether the trend to more and increasingly complex regulation is expected to continue. In financial services it has already been noted that in the current financial crisis it is certain that increased regulation will unfold. On the 22 February 2009 leaders of the EU's largest economies met in Berlin and called for more regulation in the sector.

Global warming implies that further environmental regulation is a necessity, and the election of a new, more environmentally conscious president in the US who has set aside large sums of the economics stimulus plan for environmental initiatives is a clear indication that there is a commitment to take the regulatory steps necessary to protect the environment from further damage. This implicates directly and indirectly not only US companies, but also businesses trading with them or selling in or through the US.

In Europe the drive for a single market across the EU necessitates the continued harmonization of the 27 economies of the member states through increased regulatory compliance measures. This increased regulation of all parts of economic life in the EU will mean that other major economies, such as the US and China, will either regulate in line with the EU or attempt to create different economic structures for their economies, thereby further increasing the cost and complexity of the international regulatory environment.

For a number of reasons, however, the current global recession will not necessarily result in a reduction in regulation or a halt in new regulation. In response to a direct request for information from the European Commission when writing this report, the Commission indicated that there was no plan to decelerate or reduce the amount of regulatory legislation due to the current economic difficulties in Europe. There are still as many officials employed in regulating the world economy, and they will either be producing new regulation or amending previous legislation as before. In addition, some take the view that the current crisis came about through poor regulation in the banking and financial sector. This can only increase governments' prerogative and willingness to regulate.

As recently as April 2009, ANEC¹ and Orgalime² issued a position paper in which they called for more effective pan European Market Surveillance, calling on Member States to strengthen their criminal laws on the placing of dangerous or non-compliant products onto the EU market. ■

¹ ANEC defends European consumer interests in the process of standardisation and certification.

² Orgalime represents the interests of EU mechanical, electrical, electronic & metal articles industries.