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Managing regulation in a new era

As concern over global problems mounts, executives and regulators have everything to gain from building relationships based on trust, and developing solutions that benefit a wide range of stakeholders.

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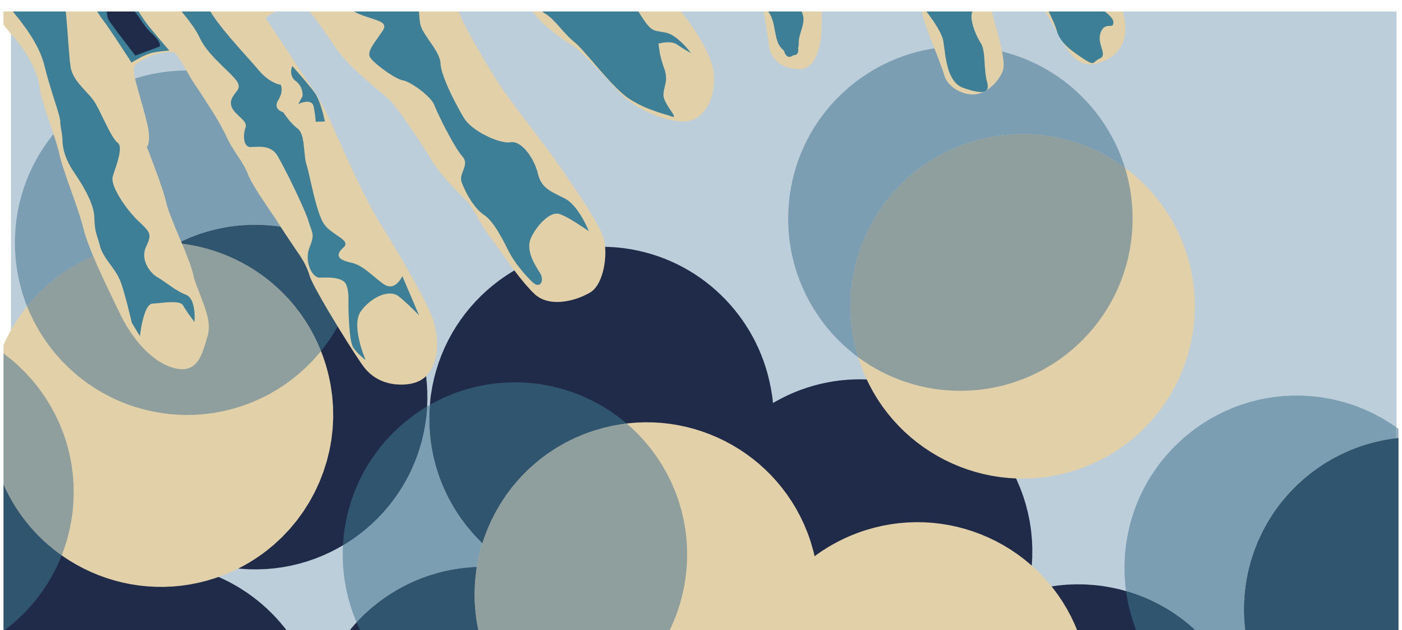

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The 2008 financial crisis may come to be seen as the demarcation between two regulatory eras. For the past generation, free markets have enjoyed a remarkable intellectual and political ascendancy, championed by academics and governments alike as the best way to promote continuing growth and stability. Now the world suddenly appears to think that some problems are too big and threatening to be solved by free-wheeling businesses. Politicians and commentators of every stripe are calling for greater regulation.

Like most big shifts in the intellectual and political climate, this one appears at first glance to have burst forth overnight. In fact, it's been bubbling beneath the surface far longer. There has been a gradual awareness that self-regulation and corporate social responsibility go only so far in solving big problems. On the day in September 2008 when Lehman Brothers collapsed and the financial crisis became a financial calamity, you may have missed a less prominent news item. Ian Cheshire, CEO of the UK retailer Kingfisher, told the BBC that "there are certain things that are too big, too long-term … to deal with incrementally. We need a government framework." Cheshire, a member of the UK Corporate Leaders Group on Climate Change, was speaking in support of a European effort to reduce greenhouse gas emissions.

A comment by Peter Brabeck-Letmathe, Nestlé's chairman, also failed to attract much attention: "Even though we have perhaps more impact than any other food company, we can only be a small part of the solution [to food and water problems]. The fact is that all our efforts, and those of other companies and consumers, will be in vain if governments throughout the world continue with their short-sighted policies instead of working towards solutions." He too was calling for more state intervention, not unfettered free markets.

Today a pattern is emerging. Tight credit; looming energy, food, and water shortages; and greenhouse gas emissions are high on the minds of business leaders as well as politicians. Consumers too are increasingly worried—and aware that an interconnected global economy means interconnected global problems. They hear about ice caps melting and banks collapsing in distant countries and know that all this matters to their lives, their jobs, their homes, their families. What's more, they expect companies to help alleviate these problems.[1] Such developments underscore the expansion of the "social contract" between business and society. The contract includes not only laws and regulations but also a growing obligation for companies to fulfill certain social responsibilities.

From antagonism to cooperation

Against this background of changing perceptions and priorities, regulation is set to assume fresh importance. As always, regulators should find the right ways to mitigate broader market failures—for example, to protect consumers and control environmental pollution—while also seeking to facilitate fair and intense competition among companies, for that will encourage larger increases in productivity, a faster-growing economy, and greater wealth for society to share.[2]

How should companies prepare? In the previous era, the answer would have been to hire more lawyers and lobbyists and send them off to do battle with regulators. Robert Reich, President Bill Clinton's first secretary of labor, describes in his 2007 book, *Supercapitalism*, the way intense competition has driven US companies in particular to dramatically increase their efforts to contest every regulatory decision affecting their profitability. Regulation has developed from a legal and political system that is structurally adversarial, so it is no surprise that adversarial attitudes and skills have set the tone in regulatory affairs. But an arms race of investment in legal and lobbying capacity makes less and less sense if governments, policy makers, and companies are to find optimal solutions to huge economic and sociopolitical challenges.

Our research shows that companies are beginning to recognize this truth. In a September 2008 *McKinsey Quarterly* survey of 1,500 executives,[3] the respondents saw regulators as the primary source of the political and social pressures facing companies around the world. But many of these executives were unsure how to respond. They saw lobbying as an overused tool. When we asked them which issues would gain companies little praise for getting things right and a lot of criticism for getting things wrong, "political engagement and influence" came second only to the top team's remuneration.

In practice, companies have three options when they seek to engage a regulator (exhibit). They can maintain arm's-length, often adversarial relationships—limiting communications, so far as possible, to answering requests and deploying legal instruments such as appeals and challenges. At the other extreme, they can seek to build collaborative partnerships with the regulator. Neither model is typically optimal from a company's point of view. The arm's-length approach makes it hard to achieve trade-offs with the regulator and therefore generates antagonism. The collaborative-partnership model is bound to fail, since the regulator is fundamentally a policeman, not a partner. A better approach—and not only in a time of economic crisis—is an open dialogue aiming for constructive engagement with the regulator.

Disagreement between the two parties is inevitable. Still, companies have a lot to gain, both for strategic and tactical reasons, from building trust and fostering long-term cooperation not only on small industry issues but also on large ones that may have sociopolitical dimensions.

EXHIBIT

Engaging the regulator

	Arm's length	Constructive engagement	Collaborative partnership
The regulator . . .	. . . protects consumers and promotes competition—but at the expense of industry efficiency and long-term sustainability.	. . . makes the industry function effectively and efficiently, balances multiple stakeholder interests, has a clear vision for the future of the industry.	. . . is a key partner in ensuring optimum industry outcomes.
Company lets the regulator see . . .	. . . the legal minimum.	. . . as much as it can, while maintaining a small "walled garden" to allow private internal company discussions.	. . . anything it wants to know. The company is open about problems with data.
The company communicates with the regulator . . .	. . . only through the regulatory department, in a limited and very controlled way.	. . . directly at senior levels across the organization—eg, quarterly board-to-board interactions.	. . . openly and informally at many levels of the organization, relying on the regulatory department as a source of expertise.
Conflict with the regulator . . .	. . . is frequent, public, and normal—including going to court.	. . . is something the company has processes in place to avoid if at all possible—especially going to court.	. . . is something the company goes out of its way to avoid—even to the extent of admitting fault preemptively.
Transparency with the regulator . . .	. . . is limited to responding to formal requests for information.	. . . involves proactively sharing models with it to establish common fact base.	. . . means the full, open-book approach.

One argument for the cooperative approach is that regulation is a game played over and over. In many cases, a company persuades a regulator that now is not the time to allow more competition, require reduced emissions, impose higher service obligations, or whatever—only to do much better than the regulator expected in the ensuing regulatory period. Regulators usually react to attempts to fool them by imposing a much harsher settlement in the next round. Trust can fall so far that regulators and companies must communicate through third parties.

This is not the first time we have shared such insights from our work helping companies with their regulatory strategies.[4] What's new is this: global economic and sociopolitical challenges have become more acute, and the contract between business and society is expanding, which makes it more important than ever for executives in a wide range of sectors to think hard about their approach to regulatory issues. Companies and regulators don't always have to be adversaries—where there is trust, regulation can become a mechanism for industry-wide, even global, cooperation on issues ranging from financial prudence to scientific innovation and climate change. The negotiation of formal competitive rules in heavily regulated industries is not the whole of regulation.

Increasingly, we see that regulators and companies need to engage each other in an atmosphere characterized by fact-based analysis and trust: regulators can do so by understanding more fully the economics and long-term dynamics of the industries they oversee, and companies by looking for inherently sustainable solutions. Adversarial regulatory contests will no doubt continue, but executives are coming to realize that they must be flexible and ready to make trade-offs.

Network-based industries, such as telecommunications, power, and railroads, are a case in point. New infrastructure investments with very long payback periods (say, fiber networks for telecom services) won't be made unless operators are convinced they will yield satisfactory returns over a reasonable period of time. Regulators face a challenge in balancing the need for these investments with the imperative to reduce end-user prices by encouraging competition and opening up the infrastructure to all players. Rather than bargain hard in order to deny or delay access to competitors across a whole network, some incumbents make a nuanced and well-informed case that takes the interests of governments and consumers into account. This approach might, for example, involve accepting the principle of open access—where competitors are already present—while keeping access temporarily closed in less developed areas, so that investment will flow into them. Although such a compromise won't maximize an incumbent's short-term profits, it might include reasonably favorable terms that wouldn't be subject to constant change.

Building transparency and trust

Understanding regulatory issues in extreme detail is a prerequisite not only for anticipating risks and opportunities but also for building mutually beneficial relationships, based on trust and transparency, with regulators.

Regulatory issues are often extremely complex and interdependent. The process is no less complicated, commonly involving overlapping reviews by a number of agencies. Minor tariff revisions can have a major impact on corporate profits. Structural policy changes can reshape a whole industry. Executives will always be behind the curve unless they diagnose each issue in the current and long-term landscape of regulation and understand the economic, social, and strategic impact of different regulatory outcomes. Without such an understanding, companies often respond in an ineffective and desultory way to the opportunities and risks.

Consider, as a cautionary tale, the regulation of fees for cross-border payments after the euro's introduction, in 2002. It was no secret that the European Commission was eager to demonstrate the benefits of a single currency. Yet banks in the eurozone failed to anticipate, and therefore to influence, a new rule specifying that they could charge no more for cross-border transactions than for national ones. In many markets, national payments had been provided without fees, while cross-border transactions carried charges to cover the extra expense. Banks therefore ended up with costs they couldn't recoup from customers.

Typically, the quest for a detailed understanding should start with an exercise to shed light on the main regulatory issues that could affect a business, both today and within three to five years—and sometimes even within 10 to 20 years. The exercise should also examine the level of uncertainty for each issue, the positions of the major stakeholders (such as competitors, consumers, employees, unions, government agencies, and environmental groups), and the value at stake and other implications for the stakeholders as well as the company itself. These implications could involve, for instance, investment decisions, price and service levels, productivity, tax revenues, and employment levels. Potential disruptions, such as new technologies that might change the regulatory game, should be examined as well. In considering alternative regulations, there is no substitute for fact-based analysis to determine the trade-offs that will inevitably have to be made. The devil is in the details: seemingly minor ones can be worth billions and make all the difference between success and failure.

The key to a productive relationship between companies and regulators is a full understanding of the other side's perspectives and objectives—an understanding that makes it possible to craft solutions meeting the needs of both parties. In such relationships, companies and regulators might not show all of their cards, but they would discuss short- and long-term issues and share important, detailed information. An atmosphere of trust and transparency is critical for crafting balanced and sustainable regulations, since companies usually understand the economic challenges better than regulators do. A business, for example, has the best feel for how quickly (and to what extent) it can redesign products to reduce carbon emissions and is better placed to estimate how quickly new technologies can be rolled out to customers.

Transparency's virtues were evident when a regulator challenged a public utility to justify its decision to include the costs of its corporate parent in the profit-and-loss account. This company not only responded with a detailed and open explanation of its underlying assumptions and numbers but also signaled a willingness to consider alternative accounting approaches. The regulator accepted the arguments and did not change the company's tariffs.

An open, long-term relationship with regulators also gives companies a chance to shape regulation. While some auto manufacturers have lobbied governments to slow down carbon emission standards, for example, others are developing the technology to meet them. By informally discussing the progress of such efforts with the regulator, these front-runners can influence its expectations of how much of a reduction technical innovation can achieve. Such companies stand to gain the most in the heavily regulated markets of the future.

Going for win–win solutions

To shape regulation, companies will have to make it a core element of their strategies and move regulatory affairs from the exclusive domain of legal, technical, and public-relations experts to the agenda of the CEO and the top team. The leaders of every business should develop a vision of its industry's future—a vision incorporating sociopolitical issues, incremental changes in the industry, and structural changes, such as technological discontinuities—and build the organizational capability to support and shape it. The statements by Kingfisher's CEO and Nestlé's chairman reflect that kind of strategic, long-term approach to big sociopolitical issues and the resulting pressures for regulation.

A long-term view is critical when companies confront many forces poised to reshape their industries. Regulatory decisions often create more value to be shared—bigger cakes, not just bigger slices—but sometimes only if an industry's leading players allow this to happen. The introduction of the GSM[5] standard for mobile telephony in Europe, for example, was accomplished through a joint effort of governments, regulators, and companies. GSM opened up an enormous market, with benefits for companies, governments, and consumers alike: mobile-telephony revenues rose sharply, governments presided over rising national productivity and tax revenues, and customers got ever-lower prices and wider coverage. New services flourished. Many younger

Europeans can hardly conceive of a world without text messages. In other parts of the world, the fragmentation of mobile standards held back growth for years.

The wisdom of looking for solutions that benefit such a wide range of stakeholders—especially consumers—is often apparent even when an individual company faces regulatory decisions. To succeed, its executives must understand the competing agendas of important stakeholders and work with them to build coalitions that translate corporate priorities into feasible compromises and sustainable outcomes.

Engaging stakeholders in this way can also be an investment in a company's reputation, and such investments are useful in dealing with customers and in future negotiations with regulators. Unilever, for example, decided to work directly with a prominent nongovernmental organization (NGO) to analyze in detail the impact on poverty of all the company's operations in a developing country. As part of this collaboration, Unilever granted the NGO unprecedented access to information and staff. The NGO came away from the project with a more positive view of this multinational corporation. Meanwhile, Unilever learned a great deal about how it could most cost-effectively have a positive influence in this country, in ways it hadn't previously considered. In addition, the company improved its reputation with the local authorities—an improvement that will undoubtedly serve it well in future negotiations with them—and showed customers that its commitment to alleviating poverty was more than PR.

In contrast, companies that take a short-term view, neglecting to base their positions on what might be sustainable in the eyes of regulators and other stakeholders, sometimes find themselves winning the battle but losing the war. Voluntary emission targets, for example, may help a business respond to environmental pressures on its own terms, but to gain traction these targets must be credible. Motor manufacturers in the European Union didn't heed that reality when they embraced voluntary standards later deemed insufficient by regulators, which imposed far more demanding ones.

The regulatory challenge

Regulation is about solving problems that society or businesses can't solve alone, as well as making trade-offs among different objectives and the interests of various stakeholders.

These tasks will not become any easier. Regulators face, among other challenges, the need to take fast-moving sociopolitical dynamics into account when they address issues that have no clear "right" answer. Consider energy: at a time when many fear that control of fossil fuels will be used for political purposes and many countries are pushing to cut their carbon emissions, policy makers must decide whether to facilitate or to go on blocking the expansion of climate-friendly but controversial nuclear and large-scale hydro power.

As the world looks for regulations that can address these acute social challenges (and seize opportunities linked to them), policy makers and businesses must have an open dialogue about what would constitute success. Many objectives are conflicting in nature—such as attracting large investments to reduce greenhouse gas emissions while maintaining the lowest possible electricity prices—and it is essential for the regulatory process to ascertain the facts. Such a dialogue won't necessarily come up with an abstractly right answer but will help illuminate the trade-offs among various alternatives.

Leaders must also consider the proper level for regulations. Many problems can best be solved by individual countries or even localities. Nonetheless, a growing number of worldwide sociopolitical challenges—carbon emissions, the future of the banking system and capital markets, and technology standards, to name but a few—require regulatory standards at a transnational level. Solving the very complex issues involved in creating them calls for a give-and-take dialogue among politicians, regulators, business leaders, and other stakeholders.

In the coming new era of regulation, executives and regulators need, more than ever, to learn from each other. Only then will leaders succeed in crafting practical resolutions to sociopolitical issues and burning industry problems, such as those created by the financial crisis. In short, companies should take a strategic view of regulation and strive for solutions that benefit a wide range of stakeholders. Q

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Notes

[1] See Sheila M. J. Bonini, Greg Hintz, and Lenny T. Mendonca, "Addressing consumer concerns about climate change," mckinseyquarterly.com, March 2008.

[2] See Scott C. Beardsley and Diana Farrell, "Regulation that's good for competition," mckinseyquarterly.com, May 2005.

[3] See “From risk to opportunity—How global executives view sociopolitical issues: McKinsey Global Survey Results,” mckinseyquarterly.com, October 2008.

[4] See Scott C. Beardsley, Denis Bugrov, and Luis Enriquez, “The role of regulation in strategy,” mckinseyquarterly.com, November 2005.

[5] Global System for Mobile communications, the global standard for mobile phones.

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