Issue 1 - 2004

MARSH

# Risk management for an enlarged EU

In cooperation with The Economist Corporate Network and The Economist Intelligence Unit

## The challenge of change

**WELL DESIGNED** and implemented risk management programmes are a source of competitive advantage for businesses in the European Union. Operating costs can be reduced, product quality and reliability can be improved, employee productivity can be enhanced.

- EU membership is likely to increase the cost of risk for most organisations operating in accession countries.

- Much of this cost will result from the need to comply with harmonised national and EU legislation.
- Further cost will result from investor expectations of higher risk management standards.
- To help you manage your cost of risk, this paper introduces a series of reports exploring four key risk issues.

Since membership of the European Union is likely to increase costs and risks for most businesses operating in accession countries, sound risk management will become an increasingly important success factor.

This paper introduces a series of four reports to be published in 2004. Each report will explore the risk implications of enlargement of the European Union and discuss risk management options. The intention is to assist you in understanding which exposures will increase upon entering the EU and provide examples of how to manage these increased exposures.

These reports are brought to you by Marsh, the world's number one risk specialist. We hope the next few introductory pages will secure your interest in the discussions that will follow.

**EU ENLARGEMENT** is almost upon us. Ten new members are due to join the EU on 1 May 2004, eight of them from Central and Eastern Europe — the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia.

The business community has been one of enlargement's most enthusiastic supporters, enticed by the prospect of an integrated market with 450m customers, the potential for faster growth in the accession countries and the benefits of consistent legislation throughout the EU.

**ACCESSION FACTS**

| | |
|---|---|
| EU population | Increases by 20% reaching 447m |
| Territory | Increases by 25% |
| GDP | Rises by just 4.5% |
| Average GDP per head | Falls by 13% |
| Number of member countries | Increases from 15 to 25 |
| Candidate countries | 250+ EU directives to be implemented |

The opportunities associated with enlargement are significant but so too are the risks. There will be increased competition in both current EU member states and the new joiners. Complying with the new laws introduced to align national legislation with the *acquis communautaire*, the body of EU law, will be difficult and costly. The costs of non-compliance could be higher still. Labour costs in the accession countries could rise, eroding a key source of competitive advantage. Over the longer term, the path to euro membership may lead to appreciating currencies and slimmer export opportunities for companies in the CEE region.

These risks loom particularly large for local companies. Multinational companies are already largely cognisant of and compliant with EU legislation; most have risk management programmes in place and insurance profiles that match their level of risk. Central and Eastern European companies, and especially those that have not yet made inroads into the existing EU, face a far steeper learning curve.

"For all its benefits, EU enlargement could increase the total cost of risk for most local companies in Central and Eastern Europe. In particular, those companies which do not take the necessary steps to manage new and expanded risks arising out of their country's accession to the EU will face significant cost increases and an added threat of insolvency," says Jeffrey Manners, CEO Marsh Central and Eastern Europe/CIS.

So far, however, firms in the CEE region have displayed little sense of urgency in preparing for the potential downside of accession. A recent survey conducted by Eurochambres[1] found that only 10% of companies in the region say they are fully informed about new legislation that will affect their businesses. While 60% of companies are generally optimistic about their ability to exploit the opportunities created by enlargement, only 8% said company programmes to comply with EU legislation would be completed by 1 May 2004. Half of all respondents had not even started compliance preparations at the beginning of 2003.

**BUSINESS IMPACT:**
**THE LIKELY BENEFITS AND RISKS OF ENLARGEMENT**

**Benefits include:**
Easier access to EU markets
Enhanced transparency in business practices
Larger inflows of FDI
Greater macroeconomic stability
Faster long-term growth

**Risks include:**
Increased competition
Higher compliance burden
Threat of consolidation
Pressure on labour costs

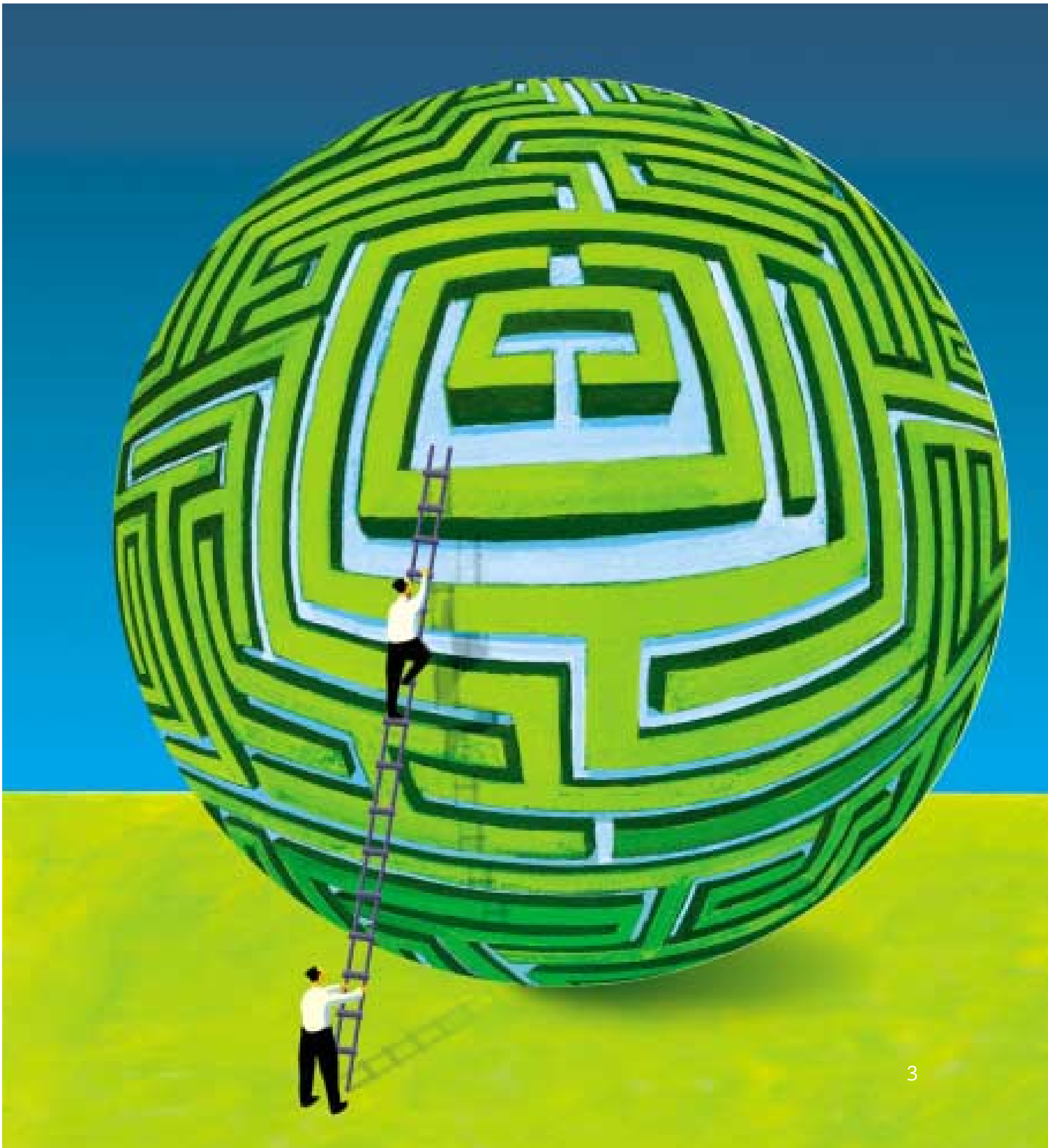
**Costs include:**
Investments to comply with EU regulations.
High costs in the areas of:
- Environment
- Health and safety at work
- Consumer protection/Product liabilities

Direct financial costs of non-compliance

[1] "Corporate Readiness for Enlargement in Central Europe. A company survey on the state of preparations for the single market 2003", Eurochambres and SBRA, May 2003.

*"For all its benefits, EU enlargement could increase the total cost of risk for most local companies in Central and Eastern Europe. In particular, those companies which do not take the necessary steps to manage new and expanded risks arising out of their country's accession to the EU will face significant cost increases and an added threat of insolvency."*

*Jeffrey Manners, CEO Marsh Central and Eastern Europe/CIS*



# Four critical areas of risk

**GIVEN THESE** low levels of awareness, Marsh is now working on a series of four reports in co-operation with The Economist Corporate Network and The Economist Intelligence Unit to illuminate the risk management challenges that companies in Central and Eastern Europe face. Each paper will address a different area of business risk. All are areas in which the challenges of aligning national and EU legislation are substantial and the potential costs of non-compliance or poor risk management are significant.

### Product liability and consumer protection (available February 2004)

EU law on consumer and health protection covers 14 directives ranging from product liability to advertising. None of the new member states will have transitional periods for implementing legislation.

Under these directives, manufacturers are liable for damages caused by any aspect of the product. If the manufacturer cannot be identified, each supplier of the product becomes liable.

A revised EU product safety directive is effective from 15 January 2004 and will also apply to acceding countries.

EU food legislation includes general rules for hygiene and control, labelling, additives and packaging that differ extensively from local rules in the new member states.

**Key questions**

- **What new requirements will producers in Central and Eastern Europe face on 1 May 2004?**
- **How will companies in the new member states cope with unfamiliar product recall obligations?**
- **How should companies monitor and manage product liability risk?**
- **What investments are needed to upgrade local food-processing plants to meet EU standards?**

### Your guide to better risk management in an enlarged EU

Based on interviews with EU officials, international executives and local business leaders, the four reports will help you better understand and manage each of the risks in question. Each report will:

- Explain the impact of EU laws and how they will be enforced
- Discuss the costs of compliance and non-compliance
- Look at upcoming changes in EU law that may further change risk profiles
- Describe best practice for risk management in the existing EU member states
- Showcase examples of how local companies and multinational subsidiaries in the new member states are managing risk
- Provide a checklist of recommended actions to deal with risk in your business
- Give sources of further information
- Illustrate how sound risk management can be an advantage to businesses.

### Health and safety/Employee protection (available April 2004)

The acquis sets out a very complex legal framework comprising over 40 directives for all industries and services.

National judicial and administrative bodies will be established to monitor and register employee complaints. Liability of employers will rise to the levels of EU member states.

A 2001 survey by the European Foundation for Improvement of Living and Working Conditions found that there are major differences between EU members and accession countries in this area. 40% of workers in accession countries consider their health and safety to be at risk in the workplace, for example, compared with just 17% of workers in the EU.

**Key questions**

- **How will enlargement change the rights and obligations of employers and employees in the accession countries?**
- **Will local producers' cost advantages be eroded by more robust health and safety requirements?**
- **What transitional periods, if any, will apply for rules on work equipment, working time and workplace conditions?**
- **What approach should companies follow to develop effective safety systems?**

### Environmental liabilities (available June 2004)

Compliance with the environmental acquis will require an estimated investment of up to €120bn for the accession countries and the future candidate countries of Bulgaria and Romania.

The acquis will, in many cases, impose stricter standards on emissions of hazardous substances and waste management practice regarding the handling and final disposal route of all types of waste materials.

Heavy industries such as chemicals, energy and metals will have to deal with stringent licensing requirements for pollution control specified in the Integrated Pollution Prevention and Control Directive. Costs of compliance will be high.

Environmental legislation is a moving target. Upcoming changes to the rules include the Environmental Liability Directive, to be adopted by spring 2004, which could significantly increase liability for contaminating activity and natural resource damage after the directive's implementation and a proposed Chemicals Directive that foresees registration processes and safety evaluations for enterprises trading more than 1 tonne of a chemical substance annually.

**Key questions**

- **What levels of investment will companies have to make to comply with current and future environmental rules?**
- **Which industries and which countries face the greatest environmental compliance challenge?**
- **How can investors be confident that acquisition targets do not have hidden environmental liabilities?**
- **What options are available for managing possible liabilities?**

### Directors' and officers' (D&O) liability (available September 2004)

Awareness of senior managers' liability for their company's actions has risen sharply following a raft of corporate scandals in 2002 and 2003.

The EU's Financial Services Action Plan aims to create an integrated EU capital market by 2005, which is also the deadline for the introduction of International Financial Reporting Standards. The EU is also mulling over corporate governance guidelines. More intensive shareholder scrutiny and regulatory oversight of directors of listed companies in Central and Eastern Europe can be expected.

Failure to comply with EU legislation will leave company directors in the CEE region more vulnerable to litigation and enforcement action. Heightened awareness of consumer and employee rights will further reinforce this trend.

**Key questions**

- **Will D&O insurance premiums surge in the CEE region?**
- **What impact will the application of EU corporate governance standards have on the running of Central and Eastern European firms?**
- **Are managers of local firms vulnerable to legal action from anywhere in the EU?**
- **What precautions can be taken to manage potentially increasing exposures?**

### Insurance Implications

On the face of things, membership of the EU will not bring any radical, short-term change to insurance markets in Central and Eastern Europe. Insurance reforms began in the 1990s and international insurers such as Allianz, AIG, Generali and QBE already have a presence in the region.

Over time, however, increasing competition is likely to bring significant change to the structure of Central and Eastern European markets. Insurance buyers will gain direct access to insurance products available in all 25 EU countries for the first time. Outside insurance providers will be able to attack the market share of local operations, without the expense of setting up and registering new entities.

Having said that, international insurers will take time to establish their reputations locally and are likely to be cautious in their underwriting approach in the short to medium term. Besides, they do not have the local infrastructures as yet to be able to deal with high volumes of policies. In practice, this means that outside insurers will be drawn first to larger corporate businesses in the region, for whom an international presence, specific industry expertise and niche insurance products will be most attractive.

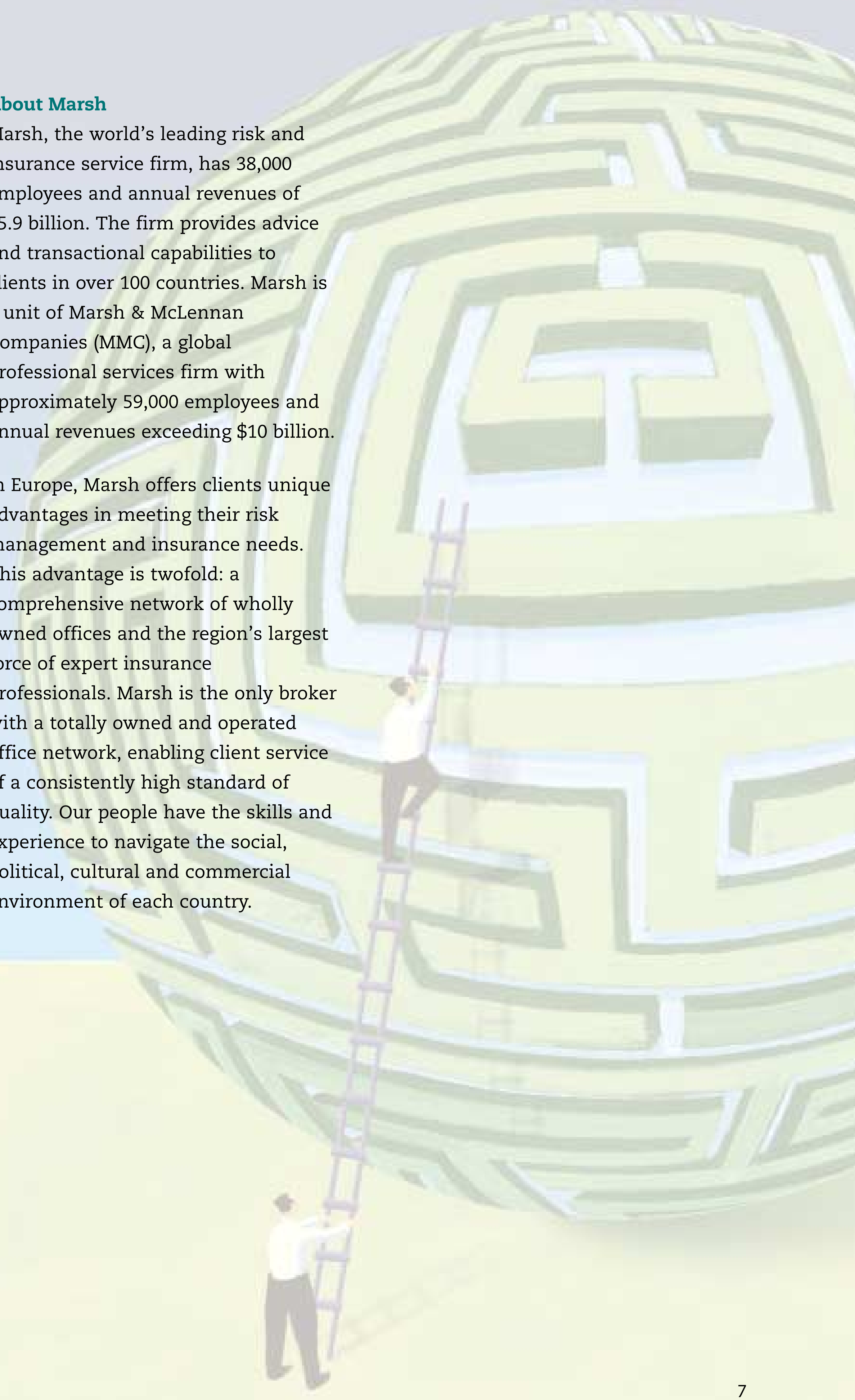
## Why are these issues important?

Understanding and addressing the four areas of risk highlighted in this series of papers is critical if enterprises are to safeguard themselves against the risk of non-compliance and minimise the impact of further regulatory changes. But proper risk management is not just about fending off disaster – it can also be a source of competitive advantage. Firms with sound risk management are more attractive candidates for investment and for acquisition, and companies with a clear understanding of risk-adjusted returns are more likely to create sustainable value. Among the benefits that enlargement brings, better risk management may yet turn out to be among the most important.

## About Marsh

Marsh, the world's leading risk and insurance service firm, has 38,000 employees and annual revenues of $5.9 billion. The firm provides advice and transactional capabilities to clients in over 100 countries. Marsh is a unit of Marsh & McLennan Companies (MMC), a global professional services firm with approximately 59,000 employees and annual revenues exceeding $10 billion.

In Europe, Marsh offers clients unique advantages in meeting their risk management and insurance needs. This advantage is twofold: a comprehensive network of wholly owned offices and the region's largest force of expert insurance professionals. Marsh is the only broker with a totally owned and operated office network, enabling client service of a consistently high standard of quality. Our people have the skills and experience to navigate the social, political, cultural and commercial environment of each country.



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