banking insight

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EXCLUSIVE INTERVIEW WITH GOVERNOR MUHAMMAD BIN IBRAHIM, BANK NEGARA MALAYSIA

LAYING THE FOUNDATIONS OF TRUST

FINTECH: FINANCE'S NEW FRONTIER

From e-wallets to insurance, wealth management to peer-to-peer lending, robotics and the Internet of things, technology firms' shake-up of financial institutions is an exciting interplay between geeks in sneakers and Wall Street suits.

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Editor's Note

FINTECH: A FORCE TO RECKON WITH

OVER THE PAST DECADE, many influential trends have been gaining mass and traction, such as economic decentralisation, anti-globalisation sentiment, geopolitical power shifts, environmental protectionism, pressures for responsible business and sustainability, and digital disruptions, to name just a few. These developments have had tremendous impacts on business across all sectors, and banking and finance too are being pressured to adapt in order to become more relevant and sustainable in a rapidly evolving landscape.

Financial technology or fintech is perhaps the trend with the largest impact and disruption on banking and finance. Interestingly, although the trend originated in the tech-heavy developed economies, Asian economies are catching up fast. According to a *Forbes* report in January 2017 which cited new Citi research, the power shift to China is due to the rise of "Chinese dragons," an industry term for the biggest upstarts in Asia, such as Ant Financial, Lu.com, JD Finance, and Qufenqi. Citi found that China accounted for more than half of all fintech investments globally in the first nine months of last year, while US fintech investment dropped to 41% of the global total from 56% during the same period in 2015.

Meanwhile, around the region, fintech is taking off exponentially, judging by the wave of interest in fintech investment. In 2015 and the first half of 2016, investors channelled USD345 million representing 11% of total venture capital funding in Southeast Asia into fintech, as reported in the AICB-PwC Malaysia FinTech Report – 'Catching the FinTech Wave'.

Since fintech is gaining critical mass, it is opportune that this issue of *Banking Insight* focuses very strongly on fintech. We revisit the subject within the context of developments which are especially pertinent to ASEAN and the local landscape, as well as the impact fintech will have on markets and stakeholders. Judiciously, Islamic finance has also begun incorporating fintech as a digital strategy, and in our article on Fintech in Islamic Finance: The Journey Begins, we canvassed some of Malaysia's leading Islamic finance practitioners to get an idea of their strategies and movements.

This issue also highlights some of the key findings from the above-mentioned AICB-PwC joint survey. A key strategy within the fintech domain is that players must reframe their mindsets and embrace coopetition – a portmanteau of cooperation and competition – to succeed within an evolving digital economy. It's hence timely for banks to take a step back, and relook at their business models and consumer profiles to understand the 21st century zeitgeist of decentralisation, innovation and collaboration and how these affect business as usual.

+ Financial technology or fintech is perhaps the trend with the largest impact and disruption on banking and finance. Interestingly, although the trend originated in the tech-heavy developed economies, Asian economies are catching up fast.

Another perennial theme that runs throughout the publication is governance given the ongoing debate in recent years regarding the obligations of bankers to their stakeholders. We are delighted to publish a special commentary by Governor Muhammad bin Ibrahim of Bank Negara Malaysia, whose appointment took effect on 1 May 2016. Governor Muhammad offers his personal take on being a Fellow Chartered Banker and shares his views on the importance of professionalising the Malaysian banking industry to further enhance the quality of talent and good governance.

As we forge ahead into the future, it is our hope that *Banking Insight* continues to provide meaningful coverage of the issues and developments that matter to banking practitioners in Malaysia and the region. We wish you all the best for a prosperous 2017. ✱

Hope you have a fruitful read.

The Editor

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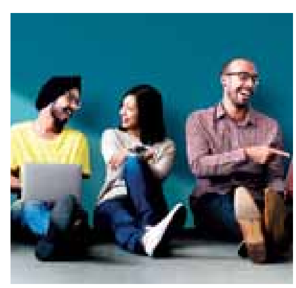

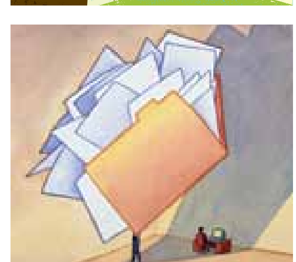

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DRIVING Financial Literacy

Bank Negara Malaysia has announced the establishment of a Financial Education Network (FE Network) to coordinate and drive a national financial education strategy in Malaysia.

The FE Network serves as an inter-agency platform to increase the impact of financial education initiatives and identify new opportunities for improving financial literacy among the Malaysian public through greater alignment, closer collaboration and a strong focus on impact assessments. Its initial members are Bank Negara Malaysia, Agensi Kaunseling dan Pengurusan Kredit, Suruhanjaya Sekuriti Malaysia, Perbadanan Insurans Deposit Malaysia and Kumpulan Wang Simpanan Pekerja. The FE Network will work with relevant government ministries, industry associations, consumer groups and other key stakeholders to deliver, monitor and measure financial education initiatives under a coordinated national strategy. ✱

ASIAN
GROWTH STABLE

Economic growth in developing Asia remains broadly stable, but a slight slowdown in India has trimmed the region's growth outlook for 2016, says the Asian Development Bank (ADB). In a supplement to its Asian

Development Outlook 2016 Update report, ADB has downgraded 2016 growth to 5.6%, below its previous projection of 5.7%. For 2017, growth remains unchanged at 5.7%.

In Southeast Asia, ADB growth forecasts remain unchanged at 4.5% in 2016 and 4.6% in 2017, with Malaysia and the Philippines expecting stronger growth due to a surge in domestic consumption and public and private investment, compared to lower growth forecasts in Brunei Darussalam, Myanmar, and Singapore. ✱

500 (USD7) AND 1,000 (USD15) RUPEE notes – the denominations withdrawn from circulation in India to tackle corruption and tax evasion, but caused banking chaos and badly affected many low-income Indians, traders and ordinary savers who rely on the cash economy. The two denominations accounted for about 85% of the cash in circulation.

USD14.6 BILLION - the level of funding attracted by 50 established companies in the Fintech 100 list, up

40%

from 2015.

TOP FINTECH INNOVATORS

Fintech Innovators, a collaboration between fintech investment firm, H2 Ventures and KPMG Fintech, recently announced its list of the world's leading fintech innovators, the 2016 Fintech 100. The list shows that China fintech continues to dominate, with four of the top five companies on the list. Global competition is expanding, with 17 countries represented in the top 50 established companies, up from 13 last year, and 22 countries in the full Fintech 100. New fintech subsectors have emerged, including regtech (regulatory technology), with nine companies on the list. Insurtech (insurance technology) continues its ascent, with 12 companies, almost double last year's total. ✱

PAYMENT SERVICES DIRECTIVE

Two new Payment Services Directive (PSD2) requirements are poised to trigger market developments and disruptions in Europe. One, third parties, such as fintechs, telecom providers, tech and data companies, will fall under the scope of regulation and will hence be officially recognised as participants in the payment services market. Two, banks will have to provide these third parties with access to account and payment data, allowing them to leverage client data for value adding services or to execute payments on behalf of customers once they have given their consent. As a result, more than two-thirds of Europe's banks fear losing the customer interface as a result of PSD2, according to PwC's *Strategy&* report Catalyst or Threat. ✱

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LAYING THE FOUNDATIONS OF TRUST

IN AN EXCLUSIVE WRITTEN INTERVIEW, **GOVERNOR MUHAMMAD BIN IBRAHIM OF BANK NEGARA MALAYSIA** OFFERS HIS PERSONAL TAKE ON THE IMPORTANCE OF THE CHARTERED BANKER QUALIFICATION TO THE FUTURE DEVELOPMENT OF THE BANKING SECTOR IN MALAYSIA. AS A MEMBER OF THE PIONEER GROUP OF CHARTERED BANKERS IN MALAYSIA, HE SHARES HIS VIEWS ON THE IMPORTANCE OF PROFESSIONALISING THE MALAYSIAN BANKING INDUSTRY TO FURTHER ENHANCE THE QUALITY OF TALENT AND GOOD GOVERNANCE.

Governor Muhammad bin Ibrahim

As a member of the pioneer group of Chartered Bankers in Malaysia and the region, what does being a Chartered Banker mean to you personally and professionally?

The Chartered Banker qualification reflects the aspirations of Bank Negara Malaysia and the industry to professionalise the banking workforce and hold it to standards of conduct that will inspire confidence in the financial system. In the aftermath of the financial crisis and indeed even today, such standards are important not only to ensure the proficiency of banking services, but also its integrity. This means that society can draw confidence from knowing that those working in the banking industry are competent in their roles, and subscribe to clear expectations set by the profession when they perform these roles.

I was privileged to be closely associated with this earlier vision which is now becoming a reality. The Chartered Banker designation was one of several recommendations that were made by a committee which I chaired back in 2013 to transform the banking education landscape in Malaysia. Other key recommendations which have also been implemented were the establishment of the Asian Institute of Chartered Bankers (AICB) as a professional membership organisation and the creation of the Asian Banking School as its accredited training partner. Today, both these organisations perform key functions that ensure the quality of standards observed by Chartered Bankers.

The Chartered Banker designation is by no means an end in itself. It is more importantly a commitment towards lifelong learning and professional development which are required to keep banking professionals at the top of their game in an industry that is changing very rapidly. To remain relevant, the Chartered Banker qualification must reflect an adherence to standards of professional and ethical conduct that are regularly refreshed to take into account new risks, expectations and industry settings. For it to be provided due recognition by the industry, the qualification must speak for itself. It must be self-evident that the banking industry places a high premium on those who have successfully attained the qualification. This must be assured through a robust curriculum, stringent assessment standards and a credible professional development programme that are not only consistent with its status as a professional qualification, but that will produce the type of talent that will be highly sought after by the industry.

The Chartered Banker qualification reflects the aspirations of Bank Negara Malaysia and the industry to professionalise the banking workforce and hold it to standards of conduct that will inspire confidence in the financial system.

The first group of Chartered Banker pioneers and those who follow have an important responsibility to serve as standard bearers and role models for the next generation of professional bankers who are starting their careers in the banking industry.

Following the 2008 crisis, the professional integrity of bankers was intensely scrutinised; subsequently, there was a strong renewed interest

in making the industry more professional. How can the agenda of professionalising bankers further protect the public trust in the banking industry?

The 2008 global financial crisis had a profound impact on the credibility and integrity of the global financial system. While many reasons have been given for the crisis, at its heart was a systemic breakdown in professional and ethical standards that should have guided the behaviours of bankers. Ultimately, this caused banks to fail the communities they exist to serve.

We clearly need better arrangements to ensure professional bankers - similar to those that exist in other professions such as medical practitioners, engineers and auditors - given the far-reaching consequences of negligent, reckless and criminal behaviour. The introduction of the Chartered Banker qualification and other professional programmes seeks to remedy this in several important ways:

By responding to demands from the public for higher standards of governance, integrity and professionalism in the banking sector;

By clarifying the values of the banking profession and what it expects of its members in terms of behaviours that are aligned with those values;

By holding out clear standards against which banking professionals can be measured by members of the public, and supporting members to meet such standards; and

By strengthening incentives for appropriate conduct through explicit and publicly transparent consequences for failing to observe the standards set by the profession.

▪ **There is an expectation that more individuals will qualify as Chartered Bankers in the future. How do you see this contributing towards raising the standards of talent development in the financial landscape? From your perspective as a central banker, what do you think will be the impact on banking culture and behaviour?**

It is imperative that the financial services sector takes concrete steps to elevate the professional standing of individuals employed in the industry. Growing the number of individuals in the industry who qualify as Chartered Bankers would certainly be a step in the right direction. But the desired impact on the quality of talent in the industry can only be sustained if the focus on professionalisation is firmly institutionalised within internal policies on recruitment, rewards and progression. There should be clear expectations within financial institutions of employees to possess and demonstrate the requisite technical and business knowledge, and to adhere to strict professional and ethical standards. For example, a bank staff performing credit evaluations or a compliance function should be appropriately certified to perform these roles. They should also be expected to commit to their own continuing professional development and to conform to a professional code of conduct through membership in relevant professional bodies. This is not new in the Malaysian banking environment. For several years now, forex and money market dealers employed by banks have been required to meet specific qualification and membership requirements, with notable improvements observed in their professional conduct. Similar efforts need to be replicated more broadly across the industry's workforce.

Attaining a professional qualification is an important way to shape culture and values. A strong body of professional Chartered Bankers should serve to refocus banking culture and behaviour on long-term (vs. short-term) horizons, and on delivering outcomes that are aligned

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with the interests of consumers and fair and efficient markets. In my mind, this will be supported and reinforced by two main factors: (i) the development over time of strong positive peer influences that professional membership provides; and (ii) the participation of qualified Chartered Bankers at different levels of a financial institution, in particular at the top management levels, which will accelerate behavioural and cultural change within organisations and amplify its impact.

▪ What changes would you like to see in the banking industry in Malaysia as possible impacts from the agenda of professionalising the bankers? Would ethics and professionalism be embedded as a must do both in practice and training?

Ethics and probity are integral aspects of professionalism. This is an important point. An observable lack of integrity, ethics and accountability precipitated the 2008 financial crisis and must never be allowed to recur with such devastating consequences.

In our regular engagements with bankers, insurers and many of Bank Negara Malaysia's affiliated training institutions including AICB and the Asian Banking School, we have encouraged the industry to ensure adequate coverage of ethical principles and professional conduct within the professional curriculum and internal training and development programmes. We have also conveyed our expectations that ethics, integrity and professional codes of conduct are firmly embedded in the workplace through a strong 'tone from the top', consistent policies and appropriate remuneration structures that are aligned with desired behaviours.

Promoting ethical and professional conduct in practice within financial institutions must be a deliberate endeavour and one that is pursued with diligent effort at an organisational level. We have seen bankers who are quick to showcase the best policies and frameworks, but show far less urgency in execution and implementation. Ethical and professional conduct has to start with a well-founded understanding of appropriate behaviour which is developed and shared across an organisation. This should be based on a careful examination of a wide range of factors, including the consideration of legal and professional obligations, wider impact on society, equity and fairness, and virtues such as honesty and compassion. Over time, these foundations also need to be reviewed to ensure that they remain reasonable. The focus should be on substance over form, leading to a demonstrable change in day-to-day practices and behaviours that are regularly monitored against the ethical and professional standards adopted by the organisation.

I believe a key reason why some institutions have not made more progress in embedding ethics and professionalism in practice is that this work is not currently done. This would be an important change that will need to happen across the industry.

▪ What advice would you like to give to professionals entering the banking sector, and what are your thoughts on the future of professional banking?

We have made great strides in our efforts to professionalise the banking sector. A somewhat understated but important milestone in this transformation journey is a requirement for all new graduates who join the banking industry after 1 January 2017 to complete a programme on professional ethics and conduct, and become members of AICB. This signifies a clear message that those aspiring to work in the industry must exemplify high ethical and professional standards, and they will be held accountable against these standards. As our economy expands and becomes more sophisticated, new entrants into the banking sector will have immense career opportunities but they will have to develop new technical and specialised skills. There will also be greater challenges that require agility and an adaptable mindset, but also a rock-solid foundation built on sound ethical and professional standards to guide behaviour and conduct. These values need to be nurtured early in their banking careers.

In Malaysia, we have laid the necessary foundation with the setting up of the Financial Services Professional Board (FSPB) to promote the convergence and harmonisation of professional and ethical standards. The FSPB is expected to complement the efforts of the professional bodies like AICB in raising the bar on professional standards and ethics.

The future banking environment would most likely be different from what it is now given the rapid emergence of disruptive technologies. It is imperative that professional bankers continuously reinvent themselves to meet and embrace these changes. But certain things about bankers should always remain, whether they are bankers of today or tomorrow, and this includes a clear moral compass for appropriate behaviour. ✱

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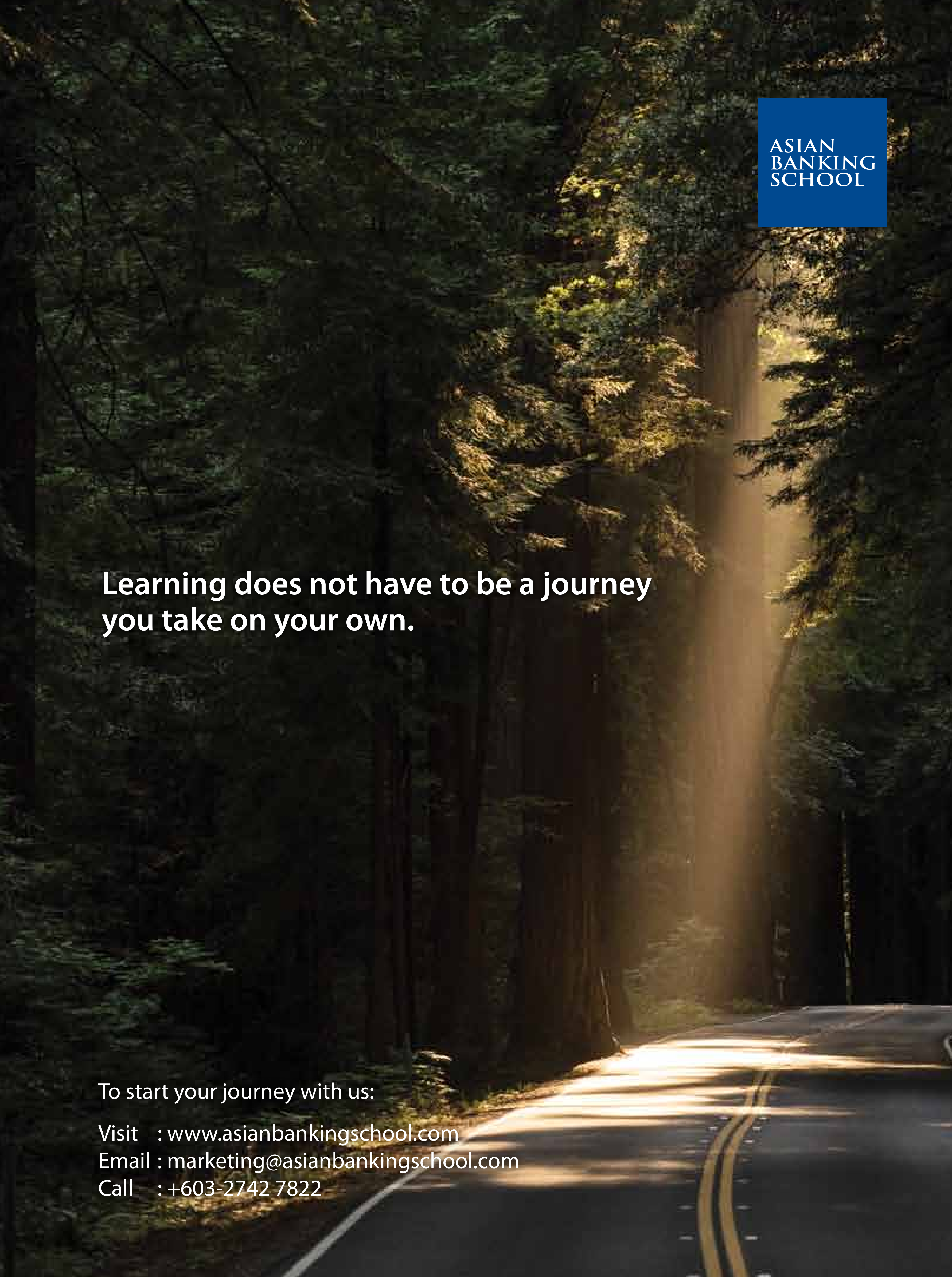
■ *Reporting by the Banking Insight Editorial Team*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FINTECH: FINANCE'S NEW FRONTIER

FROM E-WALLETS TO INSURANCE, WEALTH MANAGEMENT TO PEER-TO-PEER LENDING, ROBOTICS AND THE INTERNET OF THINGS, TECHNOLOGY FIRMS' SHAKE-UP OF FINANCIAL INSTITUTIONS IS AN EXCITING INTERPLAY BETWEEN GEEKS IN SNEAKERS AND WALL STREET SUITS. FROM DISRUPTION TO COLLABORATION, THESE STRANGE BEDFELLOWS HAVE CREATED A TRILLION-DOLLAR MARKET.

There has never been a better time to be a technology firm in finance. For this reason, some have dubbed this the Golden Age of Fintech, alluding to not just the quantum of monies invested but also the sky-high valuation of financial technology (fintech) firms, which has turned virtual start-ups into overnight giants.

Technology firms are no longer at the fringe of finance; they're in the thick of today's action and, by all accounts, the tipping point that will shape tomorrow's financial landscape. Goldman Sachs predicts that the fintech industry will hit the USD4.7 trillion mark and with billion-dollar valuations already achieved by unicorn fintechs, that may not be too far-fetched.

In various ways, technology has transformed finance many times throughout

+ In various ways, technology has transformed finance many times throughout history. But never at this rapid pace and at the risk of threatening the very existence of FIs (financial institutions).

Although the US and Europe have traditionally dominated the imagination and pockets of investors, we are seeing a rising trend within investor circles looking to Asia as the next big thing on the fintech frontier. From established fintech strongholds – Silicon Valley, London, New York – to emerging markets such as Mumbai, Tokyo, Hong Kong, Singapore and Malaysia, all are hungry to make their mark and beef up their respective fintech ecosystems.

history. But never at this rapid pace and at the risk of threatening the very existence of FIs (financial institutions). Disintermediation, robo-advisory, biometric know your clients: how did tech innovators rewrite the rules of engagement in finance?

First, the ability of fintechs to connect with consumers in a way which banks can't. The common descriptor for fintech is that it doesn't offer a product – it offers an experience for the consumer that is cheap, instant and works.

Second, improvements in technology, both hardware and software, has made it possible for agile, mobile and cloud systems to push the boundaries of greater tech. Barely ten years ago, few would have imagined the extent to which blockchains, distributed ledgers, application programme interface (API) and cloud computing would disrupt the business model of incumbent banks.

Third, post-2008 global financial crisis, the deficit of trust against FIs still lingers on, creating an incentive for consumers to look for alternatives to the status quo.

GLOBAL TRENDS

Against this backdrop, fintech firms and banks have been thrust together to develop unconventional solutions to solve big problems plaguing front-, back- and middle-office and transform the end-user experience.

Some overarching global trends have emerged over the past five years:

- **Deal flow has never been higher.** One global survey by Accenture valued global fintech investment for 2015 alone at USD22.3 billion, a 75% leap from 2014.

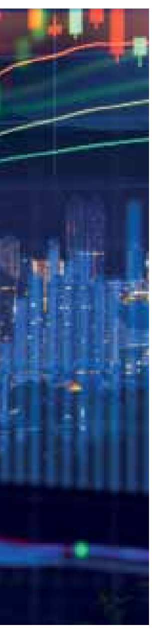
In the first quarter of 2016, the figure clocked in at USD5.3 billion invested in the sector, indicating that there is little sign of momentum tapering anytime soon.

- **Hotbeds of activity are shifting.** Although the US and Europe have traditionally dominated the imagination and pockets of investors, we are seeing a rising trend within investor circles looking to Asia as the next big thing on the fintech frontier. From established fintech strongholds – Silicon Valley, London, New York – to emerging markets such as Mumbai, Tokyo, Hong Kong, Singapore and Malaysia, all are hungry to make their mark and beef up their respective fintech ecosystems. It is not just the race for finding the best fintech idea, but also to attract the best talent pool to their shores.

- **Investment dollars are flowing into Asia.** In the same study, Accenture reported that out of the USD5.3 billion invested in 1Q2016, over 50% went towards funding Asia-Pacific fintech companies, including two Chinese unicorn deals. It estimates that Asia-Pacific's slice of the fintech investment pie grew four-fold to USD4.3 billion in 2015 and is the second largest region for fintech investment after the US. Financing activity in Asia-Pacific has more than tripled within five years to 19% from 6% in 2010.

- **Diversification points towards a maturing industry.** Today's fintech firms have evolved not just in terms of deal quantum but in the value chain they now operate in. Traditionally confined to the retail portion of the value chain, fintech's

What started out as disruptive innovation – a term first introduced in 1997 by Harvard Business School's Prof. Clayton Christensen in his book, 'The Innovator's Dilemma', a bible for business graduates – has morphed and shed much of its oppositional ideology. Fintech and banks today have moved from competing against incumbent banks to collaborating with them.



Today's fintech firms have evolved not just in terms of deal quantum but in the value chain they now operate in. Traditionally confined to the retail portion of the value chain, fintech's most promising innovations are now beginning to disrupt the capital markets.

most promising innovations are now beginning to disrupt the capital markets. Its reach has permeated beyond retail and moved into newer segments such as asset management, insurance technology (insurtech), risk technology (risktech) and regulatory technology (regtech).

▪ **Reality has also set in to temper expectations after 2015's acquisition spree.** The industry has had its share of hits and misses. Its casualties include some of tech's biggest and brightest, as overvaluation and investments go belly up, failing to live up to their promise. A case in point is Powa, a fintech focused on mobile payment products in the UK, which went into administration despite being valued at USD2.7 billion in 2015. Once upon a time, unicorn fintechs – firms which exceed the USD1 billion valuation mark – dominated tech headlines. Today's investors are more cautious of jumping on the bandwagon, a sentiment captured in a *Bloomberg* feature on 16 September 2016 titled 'Why Fintech Startups Might Not Want to Become Unicorns', which cites a weariness amongst early investors.

▪ **FIs are aware that fintechs pose a threat;** however, a poll placed 57% of FI respondents as being unsure how or unlikely to deal with the impending 'threat'. This was a key finding of PwC's 'Global Fintech Report 2016'. Furthermore, 95% of banks believed that their existing business is at risk due to developments on the fintech front, with the top four threats being pressure on margins (67%); loss of market share (59%); information security or privacy threat (56%); and increase of customer churn (53%). This 'paralysis' could be attributed to a fear of the unknown (as few in finance are conversant in tech) as well as a natural resistance to change.

▪ **Despite fears, mindsets and attitudes are changing.** What started out as disruptive innovation – a term first introduced in 1997 by Harvard Business School's Prof. Clayton Christensen in his book, 'The Innovator's Dilemma', a bible for business graduates – has morphed and shed much of its oppositional ideology. Fintech and banks today have moved from competing against incumbent banks to collaborating with them. One classic example is OnDeck, which began as an online lender for small businesses. Leveraging on its software to quickly calculate and underwrite small loans at a lower rate in the small business market segment that banks were retreating from, it looked to displace the role of banks by

Fintechs realise that in order to scale up, they need not just money, but also crucial know-how, someone who can show them how to manoeuvre within a regulated environment. For banks, investing in fintech is good business sense – they're investing in ideas, backing talents rather than developing them in-house in order to potentially derive solutions that could save them time, money and help rebuild margins. If it works, they also get to call themselves co-creators.

giving entrepreneurs quicker and cheaper access to small sums of credit. However, OnDeck today is listed on the NYSE and on-sells its tech and know-how to larger retail banks, giving these banks the power of tapping into a new market with the agility of an alternative lender.

- **Identifying points of convergence is key.** Data by Accenture showed a 138% jump in investments last year for fintechs wanting to collaborate with the FIs versus a mere 23% invested into fintechs looking to compete with and displace incumbent banks. Coopetition – a portmanteau of cooperation and competition – exemplifies the spirit behind this. Fintechs realise that in order to scale up, they need not just money, but also crucial know-how, someone who can show them how to manoeuvre within a regulated environment. For banks, investing in fintech is good business sense – they're investing in ideas, backing talents rather than developing them in-house in order to potentially derive solutions that could save them time, money and help rebuild margins. If it works, they also get to call themselves co-creators.

Although one can never tell what the future may bring, for now, it seems that fintech companies and FIs will remain steady bedfellows.

AN ASIAN IDENTITY

Is Asia's fintech ecosystem significantly different? Many market players say yes.

Fintech in Europe and the US evolved from the ground up, with innovators capitalising on the discontent and distrust of 'Too Big To Fail' by consumers. Their product offerings – from mobile payment options to electronic trading platforms – found a ready base of customers. In Asia though, the move has been top-down, led by governments and regulators seeking to develop an industry and spur their economies.

The adverse effects of the 2008 crisis also pushed Europe and the US to the brink. Under intense pressure to cut costs, increase efficiency and up supervisory controls, technology addressed all these concerns. It was what these markets needed, and it fulfilled what people wanted. However, in Asia, banks were largely insulated from the shocks and, generally, better capitalised than their Western counterparts. Innovation was not an imperative for their survival.

Finally, because of its organic growth, the US and Europe has allowed for grey areas to exist, whereas Asia has systematised the cultivation of innovators – regulatory sandboxes, digital economy incubators and by issuing clear guidelines in order to nurture market depth.

For many global fintech players, understanding these subtle differences between the landscape of Asian fintech versus the West informs their strategy.

In an interview with *Banking Insight,* Sylvain Thieullent, Chief Executive Officer of Paris-based Horizon Software, a leading technology provider for sophisticated electronic trading platform and investment management said the company leverages on the power of its local contacts in Asia – individuals familiar with the ecosystem and who can navigate the firm in implementation of its technology. With the company's connectivity to over 70 exchanges worldwide spanning North America to Asia, he said this is crucial because unlike Europe, "there is no mainstream fintech trend in Asia."

"Every country [in Asia] – Malaysia, Thailand, Hong Kong, Japan, Korea, Singapore – has its own dynamics. There is no regional trend as you see in Europe and in the US."

This is also a big part of its appeal.

Thieullent said: "It (the Asian market) is really attractive for companies like Horizon…because we can seize opportunities, give regional focus and bring some experience that we have gained overseas in terms of international standards…there is no one-size-fits-all."

Due to the wide range of markets they serve in Asia, their eyes are constantly on the regulatory ball. "Regulation is needed to keep the markets in good order and also to ensure the confidence of the investors. The question now is the balance you strike between regulation and innovation."

Balance is the operative word. And it is crucial that we get it right.

WHAT IS AT STAKE

The Millennial Disruption Index, a three-year study targeting millennials in the US, found that 73% said they would be more excited to get their financial services from the likes of PayPal, Amazon, Google, Facebook, Alibaba, than traditional entities that have provided these services. This puts banks in a precarious spot.

By 2025, McKinsey estimates that banks stand to lose as much as 10% to 40% of overall income to digital disruptors driving down margins and prices.

There are opinions amongst fintech players that close development proximity with regulator- or FI-driven endeavours will mean compromising on the disruptive qualities that set the industry apart in the first place, taking away much of its agility, leanness and intuition in creating market-forward solutions.

The balance is for the ecosystem to decide. Only time will tell where those lines will be drawn, and perhaps even redrawn, over the course of the industry's lifecycle.

DIG DEEPER

Although the ubiquitous influence of fintech is felt on both sides of the divide – incumbent banks and its fintech challengers – banks are far from being rendered obsolete. For every fintech service offered up to the market, at some point in the value chain, it will require a bank account to get the job done. This basic risk-bearing function of banks – which in turn, is tied-in with the availability of credit lines and judgement calls in response to market-breaking news – is a systemic burden that fintech cannot or will not shoulder.

For instance, robo-advisors that trawl news sites have been known to fall prey to hoaxes, encoding that resulted in automatic sell-down on portfolios on lapses in cybersecurity. Even in cryptocurrency, its closest risk mitigant for fraud or runaway inflation is to limit the creation of monies with every transaction logged in a public ledger, but it does not eliminate real-world risks where the majority of the population still relies on fiat currency instead of digital wallets, and the most popular cryptocurrency, Bitcoin, is still traded against fiat money.

Fintech, as it stands, has not supplanted the core reason for banks' existence. Its unique proposition is its tech prowess to drive down costs. Fintech of the future will most probably look like a morph of banking today, with tech tools becoming central in smart cities and greater efficiency in everyday living.

In this context, fintech is viewed as yet another financial tool to leverage on. Its advantage will thus accrue to those fastest to adapt and rethink legacy structures and decision rights to incorporate digital tools.

This means divesting varying levels of human power and control to technology, a continuing battleground between financial wizards and technologists with the former oftentimes reluctant to embrace the latter's message of change.

"The main challenge," Thieullent said, "is a people challenge. You need to change the mindset of some people. We speak to people who are not, and never have been, familiar with technology, and sometimes we fight against it (their reluctance to change) and with good reason."

Horizon's experience dictates that education of FI clients, especially those who are less exposed to technology, is critical in bringing them on the side of technology.

"[It requires] a change in organisation, how people should work with it, what you can expect from the software, and once the software is in place, you're going to have to think differently on how you're going to use your staff. These issues obviously go far beyond technology," he said.

"But that's what makes the job interesting." ✱

■ *Angela Yap is a multi-award-winning social entrepreneur and founder of Akasaa. She is an author and writer on business, finance and social history. She was previously a corporate banker, strategist with a Big Four firm, officer with the United Nations Development Programme, and served as the youngest governor on the Board of Amnesty International Malaysia.*

Regulation is needed to keep the markets in good order and also to ensure the confidence of the investors. The question now is the balance you strike between regulation and innovation.

 BY DALILA BAKAR AND NAZATUL IZMA

FINTECH IN ISLAMIC FINANCE
THE JOURNEY BEGINS

Fintech (financial technology) developments in the Islamic finance space are still very nascent, but key Islamic finance markets like Malaysia, UAE and Bahrain are seeking to support and grow Shariah-compliant fintech.

Islamic finance (IF) players are boarding the fintech train, but the application of fintech within the Islamic finance space is still extremely new.

"Fintech in Islamic finance is very far behind compared to fintech in the conventional finance space. Islamic finance fintech is still in its infancy and growing although not very rapidly. The number of fintech players specialising in IF is still considerably low," explained Othman Abdullah, Managing Director (Islamic Banking / Public Sector Solutions), Silverlake Group of Companies.

Whereas the fintech revolution in the conventional space emerged shortly after the 2007-2008 financial crisis, fintech in Islamic finance has only just begun testing the waters. In conventional finance, more than USD50 billion has been invested in almost 2,500 companies since 2010, according to the Accenture Fintech Evolving Landscape 2016, whereas no figures are directly available for Islamic finance.

Just like in conventional finance and banking, fintech solutions for Islamic finance aim to improve the customer experience and deliver better products and services.

"Fintech innovation seeks to bridge possible gaps between banks and the market by taking an 'out of the box' approach - the 'box,' in this case, being traditional banking methods," said Md Ali Abdul Aziz, Chief Technology Officer, Bank Kerjasama Rakyat Malaysia Bhd (Bank Rakyat).

At its most basic, the digital disruptors are usually associated with mobile functionality, simplicity, big data, accessibility, agility, cloud computing, contextuality, personalisation and

convenience, clarified Md Ali. "Most traditional banks have few of these qualities, but instead are associated with trust and security, significant capitalisation and customer indifference."

Marrying the two could thus result in a sweet spot for Islamic finance institutions. Similar to vanilla fintech, the emerging strategy is to co-operate and collaborate rather than to compete with fintech innovators. "When fintech first came up, most people thought that it was going to be a disruption to the banks." However, both realised that fintech is more complementary. "Now, most fintech firms are complementing the banks' operations to improve efficiency as well as enriching banks' offering to their customers. As of now, almost all banks treat fintech firms as potential collaboration partners; hence, you can see banks setting up specific units to work with fintech companies," explained Nazlee Khalifah, Chief Executive Officer, Affin Islamic Bank Bhd via e-mail.

Generally, the different types of fintech specialisations are Money Transfer, Mobile Payment, Trading Platforms, Wealth Management, Credit Scoring, Peer-to-Peer (P2P) Lending and Crowdfunding. "In Islamic finance, fintech innovations are mainly in the forms of Crowdfunding and P2P Financing platforms," said Othman.

Meanwhile, Mohamed Izam Mohamed Yusof, Chief Executive Officer, IAP Integrated Sdn Bhd observed different trends at play in the different segments of the financial sector. "In the Islamic capital markets, crowdfunding platforms such as equity crowdfunding and peer-to-peer lending platforms are making it more accessible for retail investors to fund small-scale financing or ventures. In the banking sector, there is an increasing usage of fintech to enhance efficiency in delivery and outreach, as well as to improve quality of customer experience."

LEADING MARKETS

"As of now, there are no Islamic banks or countries/markets that are really leading in Islamic fintech yet," surmised Othman. Meaning, leadership is anybody's game. However, Malaysia, UAE and Bahrain may potentially take the lead in IF fintech because they are striving to facilitate growth. Locally, the Regulatory Sandbox discussion paper issued by BNM in July 2016 included a

Othman Abdullah
Managing Director (Islamic Banking / Public Sector Solutions), Silverlake Group of Companies

Md Ali Abdul Aziz
Chief Technology Officer, Bank Kerjasama Rakyat Malaysia Bhd (Bank Rakyat)

Nazlee Khalifah
Chief Executive Officer, Affin Islamic Bank Bhd

Mohamed Izam Mohamed Yusof
Chief Executive Officer, IAP Integrated Sdn Bhd

Datuk Mohd Redza Shah Abdul Wahid
Chief Executive Officer, Bank Muamalat Malaysia Bhd

provision on Islamic finance. Abu Dhabi and Dubai are known to have been striving to support and develop their local technology start-ups. In Bahrain recently, Finocracy and CH9 announced their Future Finance 2030 initiative, which they claimed would position Bahrain as the first Global Islamic Fintech Hub and the Islamic Fintech Capital.

MARKET POTENTIAL

The consensus from the e-mail replies is that opportunities for fintech in IF are significant as the industry is very new and largely untapped.

Datuk Mohd Redza Shah Abdul Wahid, Chief Executive Officer, Bank Muamalat Malaysia Bhd cited recent World Bank statistics whereby more than two billion people around the world are unbanked and about half of them are in the Muslim world. "Fintech may be the answer to more inclusive banking whereby the new generation technologies will help break down economic and social barriers," he said.

Meanwhile, Othman surmised that: "From the consumer perspective, it is estimated that by 2020 two to three billion new consumers will be entering the digital finance space, and that 80% of these new consumers will be Muslims."

As a means to an end and a tool for efficiency and effectiveness, fintech is poised to drive IF's continuing maturity, while enabling lower costs and efficiency. Fintech offers a cost-efficient means for Islamic financial institutions (IFIs) to tap a wider consumer base and enhance their visibility in the market despite their smaller scale. "This enables IFIs to compete at a more level playing field with their conventional competitors," said Izam.

Fintech also enables IF to play catch-up, where IF institutions are beginning to explore risk-sharing modes of financing in addition to the traditional debt financing and evolving from being product-driven towards offering customised solutions to its customers, remarked Izam. "Stronger emphasis is increasingly seen on the quality of customer experience amongst the new generation of financial services clients. Similar to other financial institutions, fintech offers a competitive edge for IFIs in customising their offerings based on the preferences of their target customers."

Datuk Mohd Redza pointed out that certain fintechs offer product engineering solutions which would enable IF institutions to introduce new products and services in shorter turnaround time. "This could be a breakthrough to IF as the current process requires several layers of processes which can be lengthy."

The scope of IF would gain further from the advancement of technology and fintech, continued Datuk Mohd Redza. Emboldened by technology, IF institutions could potentially penetrate into newer growth areas including: green, ethical and environmentally-friendly development projects; international risk management through *Shariah*-compliant hedging instruments; funding the growing international halal trade business; funding international infrastructure projects; and enhancing liquidity management and capitalisation of Islamic financial institutions in line with newer regulatory requirements, for e.g., Basel III standards. Meanwhile, Affin's Nazlee singled out Islamic credit cards in the payments space as being ripe for innovation. "The concept of Islamic credit cards is rather limited. As such, banks should be able to work with fintech firms to broaden this area."

CHALLENGES SPECIFIC TO ISLAMIC FINANCE

But fintech in IF is not without its hurdles. Othman singled out paralysis in innovations and ignorance of *Shariah* guidelines and compliance as barriers to fintech in IF. "Lack of innovation is the same syndrome that has been faced by Islamic finance in general. Most of the Islamic finance products in the market today are the 'Islamised' version of conventional products."

While fintech is an agnostic tool, fintech start-ups also need to improve their familiarity with *Shariah* guidelines in developing financial services products for Islamic finance to ensure *Shariah* compliance. "Unlike traditional Islamic financial institutions where there are *Shariah* teams well-versed with *Shariah* requirements who participate in product development to ensure *Shariah* compliance, fintech start-ups do not have such a facility," remarked Othman.

GENERIC CHALLENGES

Given that fintech is a secular tool, deploying fintech in the IF space is subject to similar constraints on conventional fintech. For example, the reluctance of institutions to fund or invest in fintech initiatives without the certainty of being able to deliver returns could stunt growth, noted Izam.

Another heightened risk is cybersecurity. "Reliance on fintech in facilitating banking services would pose digital risk on IFIs in the form of potential cyber attacks on the banks' system or users. As customers' confidence is crucial for a bank to thrive, IFIs are cautious to grow in this area," added Izam.

Nazlee identified the "main challenge" as "integrating specific fintech capabilities within the existing bank operations." Md Ali cited "organisational culture - the ability to adopt a collaborative approach with new innovators and start-ups" as a challenge as well.

Harmonisation and compliance pose barriers too. "Based on our own experience in developing a shared infrastructure such as IAP, a significant challenge lies in the level of standardisation needed and incorporation of regulatory compliance required on the part of participating Islamic banks, to enhance ease of use by customers," said Izam.

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Othman Abdullah
Managing Director (Islamic Banking / Public Sector Solutions),
Silverlake Group of Companies.

THE NAMES TO KNOW

Which entities are leading the flight to fintech? Among the key start-ups in Islamic finance are Singapore-based EthisCrowd and Kapital Boost, US-based LaunchGood, Dubai-based Beehive, and Blossom Finance based in the USA and Indonesia. Beehive Finance and Blossom Finance both provide *Shariah*-compliant crowdfunding platforms which aim to provide low-cost alternative financing to small and medium enterprises.

Other IF fintech start-ups are Narwi, Easi-up, FundingLab, SkolaFund and Ata-plus.

Local examples of fintech start-ups that have been working with some major banks in Malaysia are Startupbootcamp and L337 Ventures, noted Datuk Mohd Redza.

"The most outstanding is probably EthisCrowd which received the Best Islamic Crowdfunding Platform Award at the 6th Global Islamic Finance Award 2016 held in Jakarta and the Islamic Economy Award at the Global Islamic Economy Summit 2016 held in Dubai recently," said Othman.

Datuk Mohd Redza singled out Malaysia's MarketplaceIF as an innovative Islamic finance e-market platform for those in search of Islamic finance solutions and services. The platform will pair customers with financial services providers who are able to match their requirements.

PLAYING IN THE SANDBOX

Currently, there are no specific regulations or laws governing fintech for IF. IF fintech should aim to comply with existing regulations and laws governing vanilla fintech. However, the consensus from the e-mail replies was that while fintech is an agnostic tool, IF fintech solutions must be *Shariah*-compliant in accordance with the prevailing *Shariah* rulings of the jurisdictions in which the IF fintech entity is operating.

Here in Malaysia, *Shariah* compliance looks set to be a tenet of any upcoming legislation for fintech in IF. Notably, Bank Negara Malaysia's proposed regulatory sandbox framework, which aims to stimulate fintech innovation in a controlled environment, stated that one of the intended outcomes was to ensure that innovative solutions for Islamic financial services are consistent with the prevailing *Shariah* standards. Bank Negara issued the Financial Technology Regulatory Sandbox Framework on 18 October 2016.

As one of the players that provided feedback for the regulatory sandbox framework, Othman proposed that the guidelines be made more specific, less general and less high-level to facilitate *Shariah* compliance, especially since smaller fintech players might not be well-versed with the *Shariah* requirements.

Moving on, it will be interesting to see what new products and services emerge from this controlled environment, and how fintech could do more to reshape the existing landscape of Islamic finance to scale it up and make it more competitive and sustainable.

IAP – A VEHICLE FOR FINTECH IN IF

When asked about fintech in the Malaysian Islamic finance scene, people invariably point to the IAP initiative. But what is IAP?

IAP is the abbreviation for Investment Account Platform, a *Shariah*-compliant fundraising and investing intermediary online platform owned by a consortium of Islamic financial institutions in Malaysia, Raeed Holdings Sdn Bhd. In the simplest terms, this is a crowdfunding platform, with the difference that the platform is bank-owned.

+ The IAP will benefit banks and improve liquidity and risk management by enabling the domestic Islamic banks to market investment accounts, which are a new product offering in the Islamic banking industry.

Initial members of the consortium were Bank Islam, Bank Muamalat, Affin Islamic and Maybank Islamic, and they were subsequently joined by Bank Rakyat and BSN. "IAP is currently owned by six shareholder banks and efforts are being made to increase the numbers of Islamic banks to join IAP and become sponsoring banks, which currently stands at four. The increase in the number of sponsoring banks that are allowed to list ventures on IAP is crucial to ensure the sustainability of the IAP business," said Mohamed Izam Mohamed Yusof, Chief Executive Officer, IAP Integrated Sdn Bhd via e-mail.

Launched on 17 February 2016, IAP will serve as a central marketplace to finance small and medium-sized enterprises. "The key difference is that IAP is the first bank-intermediated fintech platform. It is considered as fintech for Islamic finance because IAP is backed by Islamic financial institutions and both the fundraising and investment activities are in accordance to Islamic finance principles," clarified Othman Abdullah, Managing Director (Islamic Banking / Public Sector Solutions), Silverlake Group of Companies, via e-mail.

The IAP will benefit banks and improve liquidity and risk management by enabling the domestic Islamic banks to market investment accounts, which are a new product offering in the Islamic banking industry. "IAP could thus become an avenue for participating Islamic banks to fund their financing assets in the form of investment accounts (IA) opened by the investors, either individual, corporate or institutional," explained Mohamed Izam. More importantly, these investments entail the sharing of risks and returns from the identified assets between the sponsoring bank and also the investors, which is in line with the Islamic principle that rewards must commensurate with risks.

In terms of the mechanics, on a periodic basis, profits on the principal paid by the ventures to the sponsoring banks that act as investment intermediary are then shared with the investors under a contract of *mudharabah* (profit sharing) or *wakalah* (agency).

IAP is a step forward in an uncertain landscape, especially in the IF strongholds of the Gulf states and Malaysia which are suffering due to oil and commodity price volatility. "IAP signals the entry of several Malaysian Islamic banks and development financial institutions into the fintech market at a time where domestic banks in general are facing decreased margins, loan growth and profitability in view of the decline in world's major commodities and oil prices," commented Mohamed Izam.

IAP also telegraphs the growing dominance of the sharing economy, where cooperation rather than competition – coopetition - makes business more sustainable. "A single shared platform was therefore the best answer in times of uncertainty as costs can be shared among the players and more importantly,

more heads are better than one when it comes to workable ideas and solutions to develop IAP, " said Mohamed Izam.

The IAP enables cost savings and efficiency, by migrating functions online. For instance, functions that are traditionally done at the bank's premises – registration of users, suitability assessment, listing of ventures by bank as well as selection and booking of ventures by investors during the campaign period – are now available online on IAP.

Below, Mohamed Izam tells more about the IAP and its progress to date:

How are the ventures to be listed on IAP assessed? What are the criteria for listing? Who does the assessment?

The ventures will be assessed by the banks before the bank lists them on IAP to raise funds.

The assessment is primarily done on the payment capability of the venture that seeks financing facility from the bank either to: purchase new assets for its business (factory, machinery, vehicles, etc.), fund its working capital, refinance existing financing with other banks, or to fund a specific project the venture is currently undertaking.

Other criteria that are being assessed are the past financial performance of the venture and the main financial ratios, its future cash flow and assumptions, payment records with its other bankers and suppliers, past projects undertaken, the state of the industry the venture is in, the experience of the main directors/shareholders and key technical personnel, as well as whether there are any outstanding legal proceedings instituted against the venture or its directors.

The banks and their internal committee would have to be satisfied with all of the above criteria, including the factors that would mitigate all the inherent risks, before the proposed financing is approved and offered to the venture.

Before listing is finalised by the banks, the venture will have to undergo a rating process by a rating agency. In some cases, the banks may impose a minimum rating to be accorded to the venture (a rating of 'bbb' or above, for instance) as an additional listing criteria.

How has the response been from the consumers for this IAP account? How is IAP educating consumers on this new product?

The response has been quite encouraging.

Being new to the market where this marks the first time where banks (Islamic or conventional in Malaysia) are funding their financing / loan assets via investments from the public, a lot of awareness and educational activities need to be undertaken.

From the investors' point of view, IAP allows them (individual or corporate investors) to channel their investment into a chosen venture of their choice, which is also a first, based on the venture's risk-return profiles via a product called investment account. The returns on their investments are very competitive and are much higher than the returns from the normal term deposit products like Fixed Deposit (FD) that are currently offered by local Malaysian banks.

Awareness and education programmes are being planned to cover both investors and ventures.

Efforts are being undertaken to create awareness on IAP as a new asset class through talks and meetings with both retail and sophisticated investors, companies with excess cash and also corporate as well as institutional investors such as EPF and KWAP.

For the ventures, we prefer to plan our engagement activities through seminars, pocket talks, events and roadshows via government agencies that have access to SMEs such as SME Corp, MDEC, Biotech Corp, MTDC etc. as well as SME associations, either state or industry-based.

In addition, we are also working with the sponsoring banks to market IAP to their existing network of non-SME clients.

What is the estimated rate of return on the IAP account? Is there a benchmark in the broader market for returns on the IAP account?

Since the investment in IAP is made to fund the financing/loan assets of the sponsoring banks, returns are therefore benchmarked against the pricing of the facility approved by the bank.

To determine the pricing of the facility, banks will consider several factors such as type, tenure and payment structure of the facility, the venture's overall risk rating as per the bank's internal credit rating as well as the type of security(ies) offered for the facility.

For instance, if the facility is being priced at BFR (or base financing rate which is currently at 6.6% p.a.) plus a credit spread of 1.5% p.a., giving an all-in-rate of 8.1% p.a., the end return to the investors will then depend on the profit-sharing ratio (PSR) determined by the bank (assuming that the contact between the bank under the investment account is *mudharabah*).

If the PSR is set by the bank at 80:20 (investor:bank) and the investors are agreeable to it, then the investors will stand to receive around 6.4% p.a. from the investment in that venture.

If there is any benchmark in the broader market for IAP returns, then the closest one would be the term deposit product such as FD with similar tenure that is offered by the local banks. ✱

■ *Dalila Bakar and Nazatul Izma are freelance journalists based in Kuala Lumpur.*

CATCHING THE FINTECH WAVE

FINANCIAL INCUMBENTS CAN AUGMENT THEIR FINTECH STRATEGIES BASED ON THESE LATEST FINDINGS FROM THE JOINT AICB-PwC SURVEY ON FINTECH IN MALAYSIA.

A fit-for-digital business strategy will entail understanding the changing needs of customers, and developing operating models and capabilities to deliver products and services that can meet those needs. Financial technology (fintech) is a marriage of sorts between the financial services (FS) and technology sectors — a dynamic segment where technology-centric start-ups innovate in the market segments traditionally dominated by financial institutions (FIs) to offer the products and services which consumers expect.

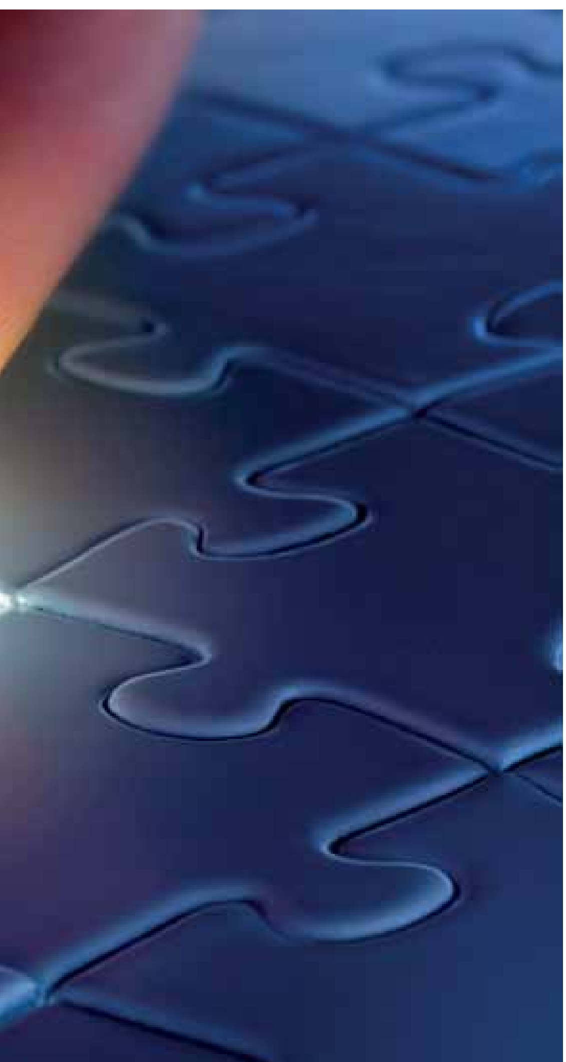
Around the region, fintech is taking off exponentially, judging by the wave

Attractive

Around the region, fintech is taking off exponentially, judging by the wave of interest in fintech investment. In 2015 and the first half of 2016, investors channelled USD345 million representing 11% of total venture capital funding in Southeast Asia into fintech. The region's growing economies and relatively large underbanked population make it an attractive target for new market entrants. Fintech is a threat that incumbents cannot afford to disregard.

of interest in fintech investment. In 2015 and the first half of 2016, investors channelled USD345 million representing 11% of total venture capital funding in Southeast Asia into fintech. The region's growing economies and relatively large underbanked population make it an attractive target for new market entrants. Fintech is a threat that incumbents cannot afford to disregard.

To help financial institutions and incumbents prepare for the fintech disruption, the Asian Institute of Chartered Bankers (AICB) and PwC Malaysia have collaborated to develop a Malaysia FinTech report – 'Catching the FinTech Wave', based on an online



Key Messages

The Concerns
82%
of FIs worry about losing to fintechs

Top Threats
- Regulatory uncertainty
- Pressure on margins
- IT security

Areas most likely to be disrupted
Fund transfer and payments
Consumer banking
General Insurance

The Prospects
59%
of FIs are currently dealing with fintechs

Top Opportunities
- Differentiation
- Cost reduction
- Customer retention

Areas FIs need to focus on
Boosting customer experience
Improving operations
Blockchain: unfamiliar and untapped

The Future
Act Now
There's no time left to wait-and-see

Challenge existing assumptions & **Embrace** the customer's perspective

Drive the creation of a holistic fintech ecosystem

survey and several interviews of top management from both the incumbents and newcomers.

Perhaps the overall key message of our findings is that incumbents must engage effectively with fintech as it reshapes the business landscape. Yes, there will be risks involved, but not embracing fintech wholeheartedly is a plan destined to fail. Incumbent industry players need to give their all when responding to the digital disruption, otherwise they risk losing their profit pool, or worse, becoming obsolete.

Below are some key takeaways from the survey to help financial institutions in developing and fine-tuning digital fintech strategies. Importantly, incumbents must bear in mind that fintech is a tool and enabler for strategy, and not the other way around.

+ Targets for Disruption

What are the top three financial services areas that are prime for disruption?

Fintech is most likely to disrupt fund transfers and payments. Increased adoption of biometric authentication, token services and global mobile payment services such as Apple Pay and Android Pay have the potential to redefine revenue distribution and profit pools across the payments value chain.

Consumer banking is the next sector most likely to see significant changes, as fintech can offer consumers simpler, faster and cheaper services, Information security and privacy risks are growing as cybersecurity events in recent years has thrown into question the adequacy of existing security standards and protocols. PwC's 'Global State of Information Security Survey 2016' found that on average there were 38% more security incidents detected globally in 2015 than the year before.

many conveniently available on mobile devices. Evolving consumer habits, especially amongst millennials – who value personalised service, experience and connectivity – are also redefining consumer banking.

Contrary to global responses, Malaysian respondents rated general insurance as being more likely to be disrupted compared to investment and wealth management. This is perhaps due to the threats posed by insurance-focused fintech (insurtech) to the existing agency underwriting and distribution models.

+ Consumer Readiness

42% of incumbents versus 78% of fintechs perceived consumers to be open to fintech-driven solutions. Financial institutions could be more conservative due to perceptions about digital adoption among local consumers. For example, the e-payment penetration rate in Malaysia is relatively low compared to more mature markets such as the UK. However, smartphone penetration in Malaysia is expected to exceed 100% by 2018, auguring well for consumers' digital exposure and readiness to accept new technology. Another positive sign is the growing number of people turning to electronic fund transfer services where the annual growth rate for Interbank GIRO grew from an average of 18.8% prior to 2013 to 34.1% in 2014 and 2015. Fintech acceptance could merely be a question of designing the right solution that meets consumers' needs.

+ Challenges…

Regulatory uncertainty slightly edges out pressure on margins (63% vs 62%)

as the number one threat. Information security marginally outranks loss of market share, making for a close third and fourth place with 56% and 54% of the respondents' votes respectively.

Regulatory uncertainty is likely rated as the top threat because survey respondents are concerned about how regulators are going to move from a highly-regulated financial services environment to a less regulated one for fintech. In the current early stages of regulatory development, there is a need for deep conversations and frequent engagement between regulators and stakeholders to build clarity and trust over the evolving regulatory environment.

Pressure on margins arises because most fintech companies have an edge over traditional FIs in terms of cost and scalability as they operate on asset-light, digital-centric business models.

Information security and privacy risks are growing as cybersecurity events in recent years has thrown into question the adequacy of existing

+ Pressure on margins arises because most fintech companies have an edge over traditional FIs in terms of cost and scalability as they operate on asset-light, digital-centric business models.

The top three fintech trends singled out by respondents as being the most disruptive for the banking sector revolved around customer experience. In order of disruptiveness, they are the move towards non-physical or virtual channels (including mobile channels), simplification and streamlining of product application processes, and the emergence of self-service tools.

security standards and protocols. PwC's 'Global State of Information Security Survey 2016' found that on average there were 38% more security incidents detected globally in 2015 than the year before.

Customer and proprietary information, key commodities in FI-fintech relationships, will become prime targets for cyber attacks. This leads to the elevated concern towards the threat of privacy and information security which we see in our survey results.

Loss of market share and increased customer churn rate are arising as fintech players aggressively offer solutions that allow a high degree of customisation, for example robo-advisors, and online-only solutions such as peer-to-peer lending platforms that are cheap, easy to use and available anytime and anywhere.

+ And Opportunities

Differentiation, cost reduction and improved customer retention are the main opportunities related to the rise of fintech, according to the survey.

Differentiation is seen as the top opportunity arising from fintech as selected by 87% of our Malaysian respondents. Such an advantage is particularly valuable in a competitive and mature FS market like Malaysia, where loan growth is expected to remain tepid.

As fintech is relatively new in Malaysia, there's a first-mover advantage to be had, where FS and fintech companies can strongly differentiate themselves from the competition through new innovative product offerings.

Fintech also offers opportunity for lower costs (76%) through new service offerings such as software-as-a-service (SaaS) solutions that foster the move away from physical channels towards digital and mobile delivery. Partnerships with fintech companies can help rationalise, improve and simplify FIs' operations. Furthermore, FIs can look to emulate fintech companies' asset-light business models to reap the benefits of cost reduction.

Incumbents also look to harness the potential for improved customer retention (49%) and additional revenues (39%) from fintech. Fintech solutions can offer better customer engagement, with multiple touchpoints and interactions to increase repeat patronage and inspire customer loyalty.

+ Some will invest, some won't

According to the survey, 55% of FIs plan to invest in fintech in the short term, while 33% plan to invest up to 10% of their total IT expenditure in response to fintech. Nevertheless, this means that 45% of the FIs and 41% of the banking industry participants surveyed either do not know or do not plan to invest in fintech, opening them up to the risk of being left behind.

+ Trends to note

The top three fintech trends singled out by respondents as being the most disruptive for the banking sector revolved around customer experience. In order of disruptiveness, they are the move towards non-physical or virtual channels (including mobile channels), simplification and streamlining of product application processes, and the emergence of self-service tools.

Correspondingly, these three trends were also the most likely areas that respondents will invest in. This makes sense because investing in a better-quality customer experience can create a differentiated and compelling service offering and enable FIs to adopt a customer-centric business model that will deliver to customers what they need when they need it as easily and autonomously as possible.

Surprisingly, respondents said that they were unlikely to invest in technologies that can improve compliance functions or regtech, even though regtech could offer considerable advantage since the FS sector is highly regulated, with substantial compliance costs. Regtech could also help banks address mounting regulatory pressures, for example, Basel III and know-your-customer (KYC) regulations.

The survey results also highlighted that local FIs could be underestimating the potential impact of blockchain, the distributed ledger technology. Respondents ranked blockchain as the second least disruptive of the fintech trends and 59% said that they are unsure or unlikely to respond to this trend, making it the least likely trend for them to invest in.

CONCLUSION

Ultimately, the message here is that fintech can be a tremendous source of risk and opportunities, and FIs will have to develop an appropriate strategy. At the very least, fintech can be a source of innovation and growth as FIs respond to competition from fintech start-ups. Certainly, to thrive, FIs will need to open their minds and learn how to act and behave more like a fintech outfit: unlearning and relearning how the finance function, value chain, distribution system and marketing channels work in this vast digital world. ✱

 BY ANGELA YAP

Banking 2017: Tough Road Ahead

BANKING INSIGHT ROUNDS UP CURRENT **RESEARCH, PREDICTIONS AND SOME ON-THE-GROUND INSIGHTS ON THE INDUSTRY** AND WHAT COULD HAPPEN IN 2017 TO SHAPE BANKING'S FUTURE.

With the prolonged low-rate, low-yield environment, coupled with increased regulatory oversight and compliance costs, research and experts alike project strong headwinds for banking interspersed with brief moments of sunshine in the year ahead. Few see signs the difficulties will end anytime soon, and the sector will be challenged to push the traditional boundaries for its operating model.

BATTLING THE SAME HEADWINDS

Here's a recap from 2016 and highlights from McKinsey's September analysis on trends in capital markets and investment banking:

The 'new mediocre' is here to stay.

Against a landscape of consistently flat economic growth and the limited future prospects facing most countries around the globe, the trend of a flat topline and growth for global banking is seen to persist.

2012's global economic recovery was expected to translate into pre-crisis revenues circa USD300+ billion. It didn't. In 2015, revenues continued to hover at the USD200+ billion level, with 2015 earnings standing at USD282 billion. Global industry ROE (return on equity) post tax was unchanged at 10% led by Asia-Pacific (16%), followed by the Americas (13%) and EMEA (12%). This is not expected to vary much in 2017.

Although the Asia-Pacific continued to be the engine of global banking growth, declining figures point toward a slowdown.

Propelled by the Chinese economy, the region's increased contributions to global banking profit in the 10-year lead-up to 2015 soared to 46% from 28%. The region's banks have clocked consistent growth in ROE, closing 2015 at 16%. Except in Japan, profit pools increased in all other countries in the region: an average 4% per annum for the developed economies of Hong Kong, New Zealand, Singapore, South Korea, Taiwan; and an average 15% per annum for others including Indonesia, Malaysia, Thailand, Vietnam.

Since the Global Financial Crisis (GFC), its contributions to the global profit pool (comprising consumer-driven banking activities, including retail and institutional asset management) consistently pushed the sector to exceed the USD1 trillion mark. In 2015, however, this marker dipped to USD538 billion from USD548 billion, its first turn down since 2009, signalling an impending slowdown.

Tougher regulations, proactive supervision.

The cost of compliance has pushed some banks to the point of non-profitability, forcing them to exit whole markets in some instances. This comes atop other more complex regulatory issues such as multi-jurisdictional reporting, dynamic risks, varying models and standards.

+ Here's a broad-brush look at what's on the regulatory horizon in 2017 and beyond, with each measure restraining ROE in varying degrees:

- **Fundamental Review of the Trading Book:** The overhaul will require some of the top banks to hold as much as USD65 billion more in additional capital to keep to current Common Equity Tier 1 ratios, and up to another USD150 million for implementation.
- **The regulation known as Basel IV:** Revisions generally include revisions or phasing out of models to allow for multi-jurisdictional reporting. This will include a revised IRB (internal ratings-based) credit risk model and phasing out of internal models to calculate operational risk, to be replaced instead with a proposed Standardised Measured Approach, currently in the consultation phase by the Basel Committee. RWA (risk-weighted asset) and leverage ratios will be phased in by 2019.
- **Derivative rules:** A streamlining of regulations to mirror the Dodd-Frank Act Title VII currently in place will emphasise central clearing for some over-the-counter products, changes in revenue model, products and sales trading processes and ban on inducements in retail and private banking. It's estimated that the top 10 investment banks will see an approximate 0.4 percentage points shaved off on ROE by 2020.
- **IFRS 9:** This standard requiring loan-loss provisions to be based on expected credit losses replaces IAS 39 and is due in 2018.
- **X-value adjustments (XVAs), or fair value adjustments** to the risk-neutral price of an OTC derivative, will mean organisational challenges of maintaining an XVA (all derivative valuation adjustments) function separate from trading and capital management functions, and incur calculation burdens on top of cost additions.

A low-rate, low-volume environment is seen to prevail in 2017. This follows higher operating costs and complexity, persistently low interest rates and slowing economic growth. Although cost control measures such as retrenchments, exits from unprofitable business sectors and markets, and attempts to leverage on advances in financial technology (fintech) are underway, there is only so much that cuts can do to enhance bottom line. Ultimately, increased capital levels must be matched against higher earnings in order for the industry to achieve sustainability.

Political uncertainties abound. Looming over the horizon are two of the biggest shake-ups in 2016.

Brexit

The Brexit bombshell continues to dominate headlines as legislative intricacies surround the de-coupling of the UK from the European Union.

In a 10 October 2016 interview with Le Figaro, François Villeroy de Galhau, Governor of Banque de la France

warned on the lasting effects of Brexit on Europe's growth outlook for 2017: "Relief over the impact of Brexit in 2016 must not mask the fact that it will have negative effects in the longer run, especially for the UK economy due to uncertainty surrounding investment. For 2017, the IMF has halved its growth forecast for the UK to 1.1%; the Bank of England is even a little more pessimistic."

The impact reverberates far into the future of the financial hub – over two million employees in limbo, £66 billion in tax contribution losses, and, a potential loss of financial services exports to the EU which generated a trade surplus of £18.5 billion in 2014, as noted by Grant Thornton.

The biggest risk is the potential ceasing of UK banks' passporting rights to sell its services into the EU. Despite multiple alternatives such as redesignating its footprint to minimise cross-border operations, or adoption of the Swiss banking model of operating *vis-à-vis* subsidiaries, all options under Brexit will see a significant reduction in financial services export to the EU. The region's stability will lessen as the UK and the EU will no longer follow a single rulebook for financial actors when the next crisis comes knocking.

As at the time of writing, Britain is still wrangling over Prime Minister Theresa May's triggering of Article 50 by end-March 2017, conditional upon her winning a Supreme Court appeal after pro-EU campaigners launched a legal challenge against Her Majesty's government, challenging the legality of Brexit without a parliamentary vote.

A Trump Presidency

In North America, President-elect Donald Trump's victory sent initial panic throughout the market. The morning after Trump's win was confirmed, stocks on the S&P 500 futures plummeted by as much as 5% at the opening bell, triggering the circuit breakers at the Chicago Mercantile Exchange. By 18 November the market had reversed its trend, rallying instead as the S&P 500 closed 1.5% higher than its election-eve level on news that the Republicans had

Across all banking segments, a clear vision, nerves of steel and prudence will be the greatest assets in navigating the impending storm. Those who thrive will take bold action where necessary and adapt wisely where they should.

wrested control of the presidency, the House and Senate of Congress, which lent an aura of stability.

Since then, the banking sector has rallied as a Trump administration looks poised to usher in a climate of deregulation, lower taxes, increased spending and higher interest rates. Although the Republicans recently re-established Glass-Steagall, an Act to separate commercial and investment banking entities, Trump's campaign reform included heavy emphasis on repealing the broader, more wide-ranging Frank-Dodd Act, the legislation crafted post-global financial crisis to rein in 'Too Big To Fail' by placing regulation of the financial industry under the purview of government.

The US is looking at possible interest rates hikes with Trump's incoming administration in January 2017, which will boost the economy especially the banking sector outlook, with a trickle-on effect on global markets. A stabilising factor is that Republicans have a clear mandate until mid-2018 to finalise these legislations, when the House and one-third of the Senate is up for re-election, although there are whispers in Washington that not all of Trump's policies will be backed *en masse* by a Republican-led congress.

ASEAN VIGNETTES

One of the endeavours under the ASEAN Economic Community (AEC) is the integration of the region's banking sectors into a single market, leveraging on the third-largest economy in Asia with a regional GDP of USD2.47 trillion. The ASEAN Banking Integration Framework (ABIF), endorsed by member nations' finance ministers in 2014, is the guiding blueprint that aims to balance integration amidst varying circumstances in jurisdictions: common ground is the region-wide low non-performing loan (NPL) rate, which hovers within the 1.1%-2.6% band (2015: Singapore at 1.1%, Malaysia and the Philippines at 2.2%, Indonesia at 2.5% and Thailand at 2.6%), whilst other metrics such as cost-to-income saw greater variance (Indonesia 75.4% and the Philippines 64.5%, below Malaysia, Thailand, and Singapore at 50%).

The ABIF introduced the Qualified ASEAN Bank (QAB) status, a series of bilateral arrangements between two ASEAN central banks, giving qualifying banks full market access to the host country's banking sector and treatment on par with its domestic institutions. For instance, in August 2016, after lengthy negotiations, the Otoritas Jasa Keuangan (OJK), the Indonesian government agency regulating and supervising the country's financial services sector, signed a bilateral pact with Bank Negara Malaysia for three Malaysian banks to operate in Indonesia, including bank branches, ATMs, capital and fund guarantees, and vice versa.

However, the region is still bracing for an overall economic slowdown. The Oxford Business Group's Indonesia Report 2017 cites Kartika Wirjoatmodjo, President Director at Bank Mandiri's comments on what this means for countries like Indonesia, where the government is pushing for growth via infrastructure projects and investments amid low commodity prices:

"The NPL ratio in the banking sector is around 2.8%, but we still see three or four quarters of weakening in the quality of loans. The transition, in terms of how we see the manufacturing and services sectors replacing commodities income, will take slightly longer, around two to three years.

"Within the period of structural change," he said, "we will see a weakening in loan quality, but hopefully by the end of 2017, it will start to show some progress."

Overall, Asian sentiments reflect the

outlook of global counterparts where the industry is bracing for headwinds. Within a decade, the landscape for financial institutions has fundamentally changed. Across all banking segments, a clear vision, nerves of steel and prudence will be the greatest assets in navigating the impending storm. Those who thrive will take bold action where necessary and adapt wisely where they should.

DISRUPTIVE INNOVATIONS – BANKING'S SILVER BULLET?

The buzzword in finance today is fintech (financial technology).

Tech start-ups, once viewed with suspicion by banks for their disruption on traditional banks' market share as well as margins, are enjoying their revelatory moment in the spotlight with many considering it the sector's next frontier.

Banks and regulators are warming to the idea of collaboration with technology firms, and in many instances, bankrolling their innovations. Big corporates are hedging against disruption by investing in it. JP Morgan spends USD3 billion each year in funding fintech, Citi has sunk in over USD1.2 billion since 2009 and Goldman Sachs comes in third with investments in excess of USD800 million, including in 15 unicorn fintechs – firms with valuations in excess of USD1 billion – since 2008.

This has precipitated a new breed of digital challenger banks – smaller institutions with an online rather than physical presence – such as Atom, Fidor Bank, Mondo and Starling to rival established incumbents. With simpler business models, reduced or niche product offerings and functioning on a backbone of integrated technology, challenger banks have bucked almost all industry trends seen in traditional banking.

KPMG's May 2016 'Challenger Banking Annual Results' in the UK show their lending assets expanding by 31.5% versus a 4.9% decline for the Big Five UK retail banks, namely Barclays, HSBC, Lloyd's, RBS and Santander. Challengers are outperforming traditional banking with average ROEs ranging between 9.5% and 17%, plus lower average cost-to-income ratios of 59.6% compared with 80.6%.

But fintech is far from being banking's silver bullet. Challenger banks are not entirely immune to regulatory supervision and pressing macroeconomic concerns.

A case in point: First Global Trust Bank Plc (FGTB), which in May 2016 was announced as the UK's newest bank on the block, had been granted an "authorisation with restriction" licence by the authorities. Come November 2016, it announced its withdrawal due to "a difficult and fast-changing regulatory environment coupled with the difficulties of trying to innovate in the financial markets post the 2008 crisis."

FINTECH BUBBLE?

The FGTB incident and USD2.7 billion-dollar mobile payment provider Powa going belly-up in 2015 are sobering incidents in the nascent sector.

Addressing the elephant in the room, several voices on the ground, comprising experienced traders, investors as well as fintechs themselves, have drawn parallels of fintech's hype to the dotcom bubble, warning against possible systemic risk.

In a *Banking Insight* interview, an industry veteran with over 20 years in trading and fixed income instruments who wished to remain anonymous said that most banks in ASEAN are behind the curve when it comes to fintech. However, ASEAN's conservative history puts it in good stead and provides a shield against crisis. "Demand will create its own supply. If there is a demand for fintech, then the market will move to provide it."

But could the fintech revolution be overhyped? "Today, with the disparate level of Internet penetration in some parts [of the region], the low level of financial literacy, low adoption of technology by the older generation – those with the capacity to spend, I believe it is hyped up, much like the days preceding the dotcom crash in the late 90s."

"So, I don't think there's any harm in being behind the curve [in this area]."

This sentiment is echoed by some leading technology firms as well. Also wishing to remain anonymous, a global expert in legal entity identifiers (LEIs) – a universal 20-character identification code used to identify parties entering into financial transactions – concurred that one should not be in the rush for pole position. Ranking isn't everything; allowing an idea to mature from proof-of-concept to implementation to continuous improvement has its benefits.

Using the European experience as example, he said the push for LEIs arose in Europe out of the GFC to easily identify beneficial ownership, related parties and calculate single counterparty exposure thresholds. However, this was not immediately necessary in Asia; this slow rate of adoption has allowed Asia to inherit a far cleaner, more efficient system.

"Europe has had almost a decade of fine-tuning LEIs, ironing out a lot of the nitty-gritty difficulties in its implementation. Asia has benefited from the European experience, in waiting for the system to mature. We've gone through the pain process so that Asia doesn't have to." ✱

Are Banking Jobs at Risk?

Tumultuous change is **reshaping the landscape** of banking jobs.

Is the outlook really bleak for career bankers? The finance and banking industry won't be haemorrhaging jobs, but the World Economic Forum does note that up to 2020, the sector will experience flat employment growth worldwide.

One reason is the global economic slump straitening the finance sector. Another reason could be automation, a key innovative disruption that will impact traditional banking jobs; Citigroup predicts that nearly 30% of finance jobs will be automated by 2030.

With the rise of machines, jobs involving low-level processes and skills will be the first to go. In the finance and banking industry, this means eliminating jobs in administration and support function positions, for instance. With Big Data swooping into financial services, robo-advisors may also be replacing financial advisors and analysts, writes Murray Newlands in a *Forbes* article entitled '6 Disruptive Trends in Technology for 2017'.

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Every crisis, however, simultaneously presents an opportunity. Just as technology culls jobs, it also creates them. Businesses will be looking for candidates well versed in a plethora of digital skills. Robert Walters Malaysia Director of Financial Services, Legal and IT Sammie Sam says that digital marketing experts, SEM/SEO (search engine marketing/search engine optimisation) and UI/UX (user interface/user experience) specialists, and social media strategists will find many opportunities. Talent experienced in content management, systems integration, managing technological products, and digital-related business development roles will also thrive. Furthermore, with the issue of cybersecurity climbing up the list of priorities, IT security professionals will be in demand.

Thanks to technology also, banks and financial service providers (FSPs) are streamlining their retail banking sectors, investing in online versus over-the-counter banking. Due to this trend, the presence of retail banking branches is anticipated to dwindle even further, notes Tom Osborne, Regional Director of Hays Malaysia, reducing jobs for relationship managers and frontliners in retail banking.

Once banks downsize and shift to smaller brick-and-mortar branches, however, there will be room for the finance and banking industry to optimise their services. Remote working will be on the rise, and businesses can take this opportunity to save space and slash overhead costs. One strategy to do so, explains Sam, would be to pool and divert more resources into digital services and self-service machines. "Industry players," Sam says, "should focus more on enhancing digital transactions, self-service platforms for consumers, virtual interaction and consultation, along with online content and information on financial products."

EXPERTISE STILL WANTED

Subject matter experts capable of more specialised jobs will continue to be in demand. In Malaysia, for instance, Hays notes in its latest job market report that candidates knowledgeable in advisory structuring and credit appraisal will be marketable. Furthermore, despite the number of foreign financial service providers like ANZ closing down branches across Asia, bigger local banking groups will continue to expand in the region. As these FSPs further their reach into the ASEAN space, says Osborne, there will be "an organic growth of relationship managers, client coverage and credit professionals especially in the global and corporate banking spaces."

Compared to front office jobs, back and middle office jobs will see a stronger market. Sam says mid- to senior level candidates such as cash and treasury operatives will be in demand, along with credit risk modellers to implement new IFRS 9 Financial Instruments requirements. Heightened governance, tougher regulations and central bank compliance monitoring will see renewed calls for more risk management professionals with niche expertise, along with audit, legal, and compliance experts to deal with more stringent legislation. "Anti-money laundering and financial crime investigation functions in particular," Osborne notes, "are getting a lot of attention from regulators."

Over in the Islamic finance space, Malaysia's Islamic asset management industry will also be shopping for employees, specifically Islamic asset product developers and innovators in both fixed income and equity markets. "There will be demand for *Shariah*-compliant product specialists and institutional sales specialists in 2017," Sam adds. "Due to the limited talent pool for this area of expertise, experienced candidates can expect a minimum salary increment of 25%."

Employees need to hone skills like digital literacy, leadership, problem-solving and above all, an innate sense of adaptability and versatility to navigate and overcome the dynamic landscape of work.

EQUIPPING THE WORKFORCE OF THE FUTURE

Knowing how technology will encroach into more functions, the need to equip the workforce of the future with relevant skills is paramount. Employees need to hone skills like digital literacy, leadership, problem-solving and above all, an innate sense of adaptability and versatility to navigate and overcome the dynamic landscape of work.

Education plays a key role in upskilling talent, but current education systems may not be up to the task. In PwC's 'Tomorrow's Leaders Today' survey, 64% of young leaders viewed the education system as the best platform for developing a skilled, adaptable workforce. Almost 70% of them, however, believed that existing education systems fail to prepare the next generation for the digital age. Respondents cited the lack of emphasis on global experience, communication, ability to give and take constructive criticism, and ethics as the problem.

Collaboration will be vital to remedy the flaws of existing education systems. "Businesses and governments need to work more closely together to create policies that will train and develop skills for the future," explains Osborne. "Besides new digital skills, training programmes need to emphasise softer 'employability skills', including problem-solving, communication, and negotiation. Lastly, businesses need to tackle low productivity through better technology and employee engagement via open conversations."

Employees also need to take personal responsibility for learning, which has never been easier in a universe of e-learning and easy access to new experiences. Sam adds that employees are responsible for staying relevant in their job roles by broadening their scope - by participating in offered job rotations, overseas secondments, and mentorship programmes, for instance.

But machines and robots aren't the only threats that bankers must contend with. People and other markets are equally a threat, where the talent war has now gone global thanks to increased mobility and communications, leading to banks shedding jobs. "Though Malaysia is considered one of the relatively more cost-friendly and higher skilled employee environments in ASEAN," says Osborne, "we increasingly observe that operational banking roles are being outsourced to lower-cost countries such as the Philippines and India." ✱

 BY AMALINA ANUAR

Banking's Y-Factor

Millennials are changing the nature of work. How can the finance and banking industry attract and retain millennial talent?

There's no avoiding millennials. By 2020, millennials will constitute 50% of the global workforce, according to PriceWaterhouseCoopers (PwC). Ernst & Young (EY) predicts that number will grow to 75% by 2025. Power, influence, talent, and purchasing power, among others, will be increasingly concentrated in their hands. So how can financial institutions reengineer their talent ecosystems to attract and retain this cohort effectively?

Today, the banking and finance industry faces a drought of talent, where previously banking used to be a top career choice. Banks want to attract millennials, but fail because millennials either don't want to work for banks or find the bank's culture too stifling. In recent years, the *Financial Times'* Global MBA Ranking shows that graduates from prestigious business schools like Wharton increasingly shun the sector, and these findings are backed up by Deloitte's 'Talent in Banking 2015 Survey' and Compensation Advisor's 2016 'Bank Director Compensation Survey'. In countries like Japan, China, and India, the banking and finance industry continues to lose the best and brightest to the FMCG (fast-moving consumer goods) sector and the technology sector.

WHAT CAN I DO TO MAKE YOU LOVE ME?

So how can banks and financial institutions take back their talent? To appeal to millennials, various studies and on-the-ground research recommend that banks makeover their conservative image, adopt best practices in ethics and community, and tailor the workplace to millennials.

Perhaps more so than any other industry, finance and banking suffers from perception and image issues. As a generation, millennials are characterised as being on the cutting edge of technology, and poised on the brink of social transformation in a seemingly never-ending quest to upend the status quo. These digital natives stand for change, and banking with its traditions and legacy culture seems antithetical to that. Incoming hires do little to alleviate attenuating innovation. Banking-inclined students are often conservatives and not innovators, according to Deloitte's 'Talent in Banking 2015 Survey'. They represent the past and millennials prefer future-oriented industries. Legislative frameworks also stymie banks from being agile in reaching out to talent. Despite social media being a preferred channel of communication for Gen Y, notes Universum in its 'Talent Attraction in the Banking Industry' report, regulations and compliance requirements mean that firms cannot communicate much to prospective employees.

Keeping up with Gen Y requires banks to eschew not just tradition, but structure. Millennials demand enablement by technology for quick turnaround and chafe against arbitrary structures, preferring flatter hierarchies. Paring down company SOPs to the essentials, creating a company culture that demolishes power distances, and facilitating a friendly working environment will thus give banks an edge. Asian banks in particular have a comparative advantage: Mike Parsons, Universum's Marketing Director for the Asia-Pacific notes that local talent in the region perceives home-grown firms to be friendlier and have more inclusive working environments.

Perhaps more so than any other industry, finance and banking suffers from perception and image issues. As a generation, millennials are characterised as being on the cutting edge of technology, and poised on the brink of social transformation in a seemingly never-ending quest to upend the status quo. These digital natives stand for change, and banking with its traditions and legacy culture seems antithetical to that.

Finance and banking's less than stellar reputation also deters millennial talent. Edelman's 2016 Trust Barometer ranks finance last out of 25 industries. In Malaysia, Singapore, and Indonesia, levels of trust fall below 70%. Gen Y refuses to work for organisations which they don't trust. While millennials understand that businesses primarily aim to be profitable, Deloitte's '2015 Millennial Survey' shows that they want more emphasis on creating jobs, improving society, enabling innovation and generating progress. For Gen Y, these values are non-negotiable because they represent and reflect millennial values. 56% of millennials globally refuse to work for an organisation whose values and ethics contradict their own, reports Deloitte's '2016 Millennial Survey'.

Beyond compliance, banks and financial service providers (FSPs) should thus aspire to better ethical standards and principles to engage millennial talent. Start by initiating more CSR programmes, encourage philanthropy whether inside or outside the office, or enable prospective employees to make a difference in the world, while ensuring that ethics and integrity and sustainability become ingrained in corporate culture. Global banking brands such as Citigroup are starting to change to become more value-driven. In March 2016, Citigroup announced its 'Service Year' programme, where future employees can take a year off to pursue non-profit work before commencing their jobs. Citigroup will pay them 60% of their starting salary during that period. The programme also offers employees a chance to contribute to social transformation in Kenya, where they can work on microfinance initiatives for a month.

CARROTS AND STICKS

Banks also need to understand what motivates millennials. Though Deloitte's 2016 report mentions that "pay and financial benefits drive millennials' choice of organisation more than anything else," millennials are also drawn to better work-life balance and flexible working. To accommodate them, JP Morgan's 'Pencils Down' programme encourages young employees to take the weekend off if they've no live deals. Moelis & Company, on the other hand, offers employees a four-week paid sabbatical after five years.

But are these efforts too little, too late? Banks and FSPs still suffer a significant millennial talent attrition rate. Deloitte's '2016 Millennial Survey' indicates that 66% of millennials will likely leave their current job by 2020.

It turns out that millennials also want career development to induce them to stay. EY's '2015 Global Generations' study indicates that a paucity of career opportunities and platforms to hone leadership skills drives millennial frustration. Deloitte's '2016 Millennial Survey' notes that 63% of millennials globally and 70% in ASEAN countries like Malaysia, Singapore, and Thailand believe companies fail to develop their leadership skills.

One answer lies in adding value to millennials' careers to retain them, said Tom Osborne, Regional Director of Hays Malaysia via e-mail. "This includes mentoring, development and providing a work-life balance. Their work scope needs to be aligned with KPIs to encourage employees to achieve goals." Sammie Sam, Robert Walters Malaysia Director of Financial Services, Legal and IT concurred. "To engage millennials, supervisors should empower them to achieve their career goals."

Offer international placements and mentorship, which are high on millennials' wish list. Millennials abhor the mundane, and want to tackle challenging projects from the onset of their careers. "Being raised with fast-paced multimedia, millennials are accustomed to fast-paced results and would not consider spending years developing their career," explained Osborne. "They want immediate challenges and with it, recognition." Albeit banking is an industry founded on tradition, management can no longer expect employees to just keep their heads down and pay their dues, while waiting for their time to shine. Instead, banks and FSPs must distribute

+ Though Deloitte's 2016 report mentions that "pay and financial benefits drive millennials' choice of organisation more than anything else", millennials are also drawn to better work-life balance and flexible working.

projects to keep millennials interested and engaged, instead of concentrating substantive work in senior levels. Firms like Credit Suisse Group AG, for example, have "begun putting early-career bankers in front of clients soon after hiring," write Daniel Huang and Lindsay Gellman for the *Wall Street Journal,* "something that might have taken years in another era on Wall Street."

Furthermore, Accenture notes that millennials want a variety of professional experiences early on in their career. Giving employees opportunities to try out different functions within the organisation, or dividing work into small projects are some of the consulting firm's suggestions in their 'Workforce of the Future: Dealing with Change and the Millennial Challenge' report. The sector can also offer co-leadership opportunities, facilitating collaborations between senior experience and young innovators, which provides mentorship and upskilling. For example, Maybank's Transitioning Leaders to CEOs Programme or its Global Maybank Apprentice Programme, offers chosen candidates customised job rotations in Maybank's various international offices. Their efforts have paid off: at the launch of Maybank's GO Ahead Challenge in 2015, Maybank Group Chief Human Capital Officer Nora Abd Manaf declared that the firm had boosted millennial hiring by 17% over the past five years and retained 90% of Gen Y employees. Sam also suggests that banks allow Gen Y a degree of autonomy over their work, giving them a sense of ownership over their jobs. As a fiercely independent cohort, millennials want to feel in control of their career, and the more satisfied this generation is with their employers, the more likely they are to stay. Other incentives to attract and retain young talent include frequent feedback, collaborative and team-oriented environments, and a creative, inclusive working culture.

Admittedly, this seems a long laundry list of demands. However, millennials don't necessarily make these demands because they feel entitled but because millennials question why they shouldn't deserve them. This generation champions the deconstruction of arbitrary systems and traditions. If a junior executive excels while his senior struggles, why should ageism bar them from promotion? However, millennials should try to meet employers halfway and adjust their expectations. "While millennials are known to be more ambitious than previous generations," says Sam, "they need to be realistic and reasonably patient when it comes to opportunities for promotions or pay increments."

CAVEAT EMPTOR

Nevertheless, don't assume that millennials are a uniform demographic. Trends differ across markets, and employers must suit strategies to local context. PwC Malaysia's 2012 'Millennials at Work: Reshaping the Workforce' report listed flexible working hours, cash bonuses, and training and development as desired benefits. In 2016, on the other hand, Randstad Malaysia Country Director Ryan Carroll writes that Malaysian millennials prefer financial security over flexible working hours and work-life balance due to the economic slowdown. In the Randstad Award 2016 report, 45% of Malaysian millennials stated they prefer clocking in standard office hours and 28% prefer to work from the office instead of telecommuting. Globally, Gen Y may be accelerating rates of workplace transformation, but in more conservative markets like ASEAN, it looks like some aspects of the near future may well resemble the past.

Above all, be patient. Millennials are a generation in their adolescence, and age, rather than generational differences, causes some of this disruptive behaviour. Millennials could outgrow their quirks once they stabilise. Once millennials become parents, shows Deloitte's 2016 report, they stay at jobs longer.

Popular perception could also be wrong. Despite the brouhaha on millennial job-hopping, writes Gordon Tredgold in an article entitled '29 Facts that Might Make You See Millennials Differently', Gen Y stays at their jobs for one year longer than Gen X employees did at the same ages. Moreover, the talent crunch looks set to stay in a disruptive economy where lifetime employment is being phased out. The average tenure for a job is now only three years; regardless of the industry, job-hopping has become the norm. Even job-hopping has a silver lining. Boomerang employees – those who leave and return - are on the rise. When they return, explains Brendan Browne, LinkedIn's VP of Global Talent Acquisition, they are equipped with a wealth of newly acquired skills, experiences, connections and even potential customers.

MUCH ADO ABOUT NOTHING?

Finally, it's debatable whether this panic is justified. Every new generation disrupts the status quo; Millennials are no different. Perhaps the best strategy for bridging this great divide is to downplay the generation gap and stop fanning the flames of misunderstanding. In the past year, Accenture hired 90,000 millennials and its CEO Pierre Nanterme refrained from framing millennial desires as being abnormal: "Do you want an interesting job? Yes. Do you want a balanced life? Yes. And to make a contribution as well? Of course," said Nanterme in the Fortune article entitled 'Accenture Hired 90,000 millennials Last Year'. "So does everyone."

Albeit millennials prove a force to be reckoned with, business and financial institutions should not be myopic to other changes while focusing on Gen Y. Silver citizens will be an equally influential cohort. By 2050, the World Economic Forum predicts that older people will number two billion and the Asia-Pacific, already home to half of the people over 60 globally, will host 1.3 billion of them. Opportunities abound for FSPs in the region, including for "whealthcare", retirement funds, as well as new services and policies targeted at the elderly. And as we enter the 2020s, the rise of Gen Z and Generation Alpha – successors to the millennials – will pose a whole new set of challenges for finance and banking. Justly, millennial managers in that era will have to deal with them. ✱

■ *Amalina Anuar is a KL-based writer interested in political economy, international relations, and comparative integration between Europe and Asia.*

 | BY ROBERT SOUSTER

DETERMINING YOUR ETHICAL STANCE

Why is it that some businesses see their only role as maximising the returns to their shareholders, while others accept broader responsibilities to their stakeholders? Is the first, narrow objective wrong, and therefore the second, wider objective right? How should banking organisations position themselves in this respect?

There has been much debate in recent years about the obligations of bankers to their shareholders, customers, employees, communities and the economy. One approach to considering this is to look at ethical stance.

Ethical stance refers to the extent to which an organisation is prepared to exceed its minimum legal obligations to stakeholders. The narrowest stance is portrayed by an organisation which defines its purpose as a profit maximiser and then looks to regulators and market forces to define the resources to be committed to compliance with those requirements. Yet there are many organisations that set out to define their purposes in terms of a whole array of broader ethical values, accepting responsibilities to be a 'good corporate citizen' and add value to society as a whole.

Strategy experts Johnson, Scholes and Whittington in their work 'Exploring Corporate Strategy' identified four typologies which demonstrate different approaches to ethical stance:

MAXIMISING SHORT-TERM SHAREHOLDER INTERESTS

This is the narrowest ethical stance and typical of an organisation that is prepared only to maximise shareholder value in the short-term. The focus is therefore on the generation of dividends and building shareholder wealth through increasing the value of equity in the company. This stance is consistent with the pure economic concept of a joint-stock company, which regards profits as the return to the entrepreneur.

Although a large, all-service banking organisation would find it difficult to justify not paying due regard to stakeholders other than the owners, the narrow stance is probably consistent with the public perception of some organisations, including some consumer finance companies and some credit card providers. It cannot be regarded as ethically wrong if the stance is consistent with stated objectives. However, it is less ethically acceptable if an organisation professes to be concerned with stakeholder needs but does not back this with its actions.

There are many examples of companies with a narrow ethical stance in the financial services marketplace. Several banks have sold their credit card portfolios to third party companies, which in most cases buy the debt at discounted value in order to profit from future cash flows from customers. These companies have minimal contact with customers, and in some cases even discourage customer interaction. There sole purpose is the primary economic objective of making a return from their investment.

LONG-TERM SHAREHOLDER INTERESTS

An organisation adopting this approach will accept broader obligations on the basis that it could be in the longer-term interests of shareholders to do so. For example, an organisation might introduce policies consistent with being 'green' and environmentally friendly because it believes customers will respect it more and buy more, thereby increasing revenues to the organisation.

This is essentially an instrumentalist approach to ethics, through which the organisation aligns some of its actions to perceptions of stakeholder values in the hope of enhancing reputation. The stance may also be adopted by organisations that believe it will reduce the risk of external laws or regulations being introduced.

Many banking organisations can be seen to align their stance with this typology. For example, many multinational banks are extensively involved in corporate sponsorship of the arts, sport and charitable causes, and this may be regarded as a legitimate extension of their marketing (or more narrowly, promotional) expenditure. It could be argued that many initiatives are instrumental, in that they increase brand awareness. A good example is offering credit card products as affinity cards, through which the card will be embossed with the logo of a famous football team or a charitable cause, and in the latter case, the card issuer will often commit to making a donation to the cause each time a transaction is made.

MULTIPLE STAKEHOLDER OBLIGATIONS

These organisations accept that their obligations extend to stakeholders other than their owners, and build these into their strategic plans. This approach may be reinforced by the adoption of corporate codes of conduct, which set out the minimum standards that the various stakeholder groups can expect from them.

Larger banking organisations are most likely to conform with the characteristics of this typology. Most directors and senior managers will accept that the reach of their fiduciary duty most certainly extends to customers, employees

+ Yet there are many organisations that set out to define their purposes in terms of a whole array of broader ethical values, accepting responsibilities to be a 'good corporate citizen' and add value to society as a whole.

Likewise, demonstrating a commitment to the community by keeping a large office open instead of moving it to a low wage cost economy benefits the community and employees, but the organisation will have a higher cost base. Arguably, this could be contrary to the interests of the shareholders and may make the organisation less attractive to new investors.

and the community. In order to be effective, the values that are advocated must be embedded in the culture of the organisation on a top-down basis.

However, this typology is most often demonstrated by financial services organisations with an in-built social dimension to their mission and objectives. For example, in the UK many of the regional building societies (mutual mortgage banks) align themselves strongly with the local community and some even restrict the geographical scope of their operations to ensure their activities are confined to their 'grass roots'.

This also presents the most difficult 'balancing act' of all the typologies, as in any organisation and at any point in time, the claims of stakeholders (the 'what's in it for me? question) will conflict. For example, maximising job security and the quality of working life for employees costs money and therefore inhibits profitability. Likewise, demonstrating a commitment to the community by keeping a large office open instead of moving it to a low wage cost economy benefits the community and employees, but the organisation will have a higher cost base. Arguably, this could be contrary to the interests of the shareholders and may make the organisation less attractive to new investors.

SHAPER OF SOCIETY

This is the broadest of the four typologies. It sees an organisation as accepting a high degree of commitment to all stakeholder groups. Johnson, Scholes and Whittington see this as typical of government departments, public sector organisations and most charities.

In the banking sector, few would claim to be true shapers of society, as their central role in creating wealth might be seen as incompatible with serving mainly society-driven or philanthropic purposes.

Some banking organisations lean toward the shaper of society by adopting overtly wide ethical stances. One of the earliest examples was the Co-operative Bank in the UK, which introduced an ethical business policy in 1992. The policy includes, *inter alia,* a commitment not to invest in companies involved in animal testing, blood sports (such as bullfighting and fox hunting), genetic engineering, labour abuses (such as child labour) and oppressive human rights. The extent to which this policy will survive was called into question when the bank had to enter into a rescue plan in 2014 through which the Co-operative Group became a minority shareholder.

Founded in 1980, the Netherlands-based Triodos Bank is another pioneer in ethical banking. The etymology of its name is derived from a Greek expression for 'three-way approach', representing people, planet and profit. Arguably, these three prongs allude to balancing profitability with stakeholder needs, suggesting that its stance is compatible with the multiple stakeholder typology.

DETERMINANTS OF ETHICAL STANCE

There are numerous factors that will determine the ethical stance that an organisation takes:

> **Founding values**
> Some financial institutions originate from efforts to address the interests of certain groups in society. Examples include credit unions, the building society movement in the UK and mutual life assurance companies. All of these have an explicit primary aim of maximising the interests of members.

> **Board policy**
> The drivers of strategy are the Board of directors, who will largely determine the reach of obligations accepted by the organisation.

> **Demands of society**
> The public is increasingly expecting organisations that it buys products from to respect certain values, including care for vulnerable customers, a sympathetic attitude to debt and appropriate concern for the environment.

> **Demands of government and regulators**
> In several countries, government and regulators have made it clear that if organisations do not take on board wider responsibilities, external laws and rules may be introduced to bring about forced change.

CONCLUSION

By determining the ethical stance that fits them best, banking organisations will be able to arrive at an approach that will enable them to clearly define their stakeholders and balance their obligations to their shareholders, customers, employees, communities and the economy. Hopefully, this will bring further clarity and accountability to the banking industry and help the sector strengthen its reputation and the public's trust. ✱

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Banking on Confidence

The age of **innovation and its impact** on depositors.

For many of us today, the digital and innovation era means that:

- Many of us cannot avoid holding money in banks especially in the electronic age. We receive our salaries in bank accounts. When we buy a house with a mortgage, the loan has to pass through our bank accounts. We receive our pensions in our bank accounts. At any one time, there can be significant sums of our money on deposit in banks.
- Today more than ever we live in an "always-on" world. People have easy access to others almost instantaneously. The speed at which communications can take place also means that, within a few short hours, rumours can spread like wildfire.

What does this mean for depositors? Should there be concerns about a bank's state of health, people might worry and consider withdrawing their money. If a significant number of depositors withdraw their deposits, this could in turn lead to bank liquidity issues and subsequently insolvency. As retail depositors, we do not in general have access to much information about banks that hold our deposits.

Some of the more recent events around the world inform us about how depositors and sometimes entire countries can be affected by banks in today's world. Take the example of the two bank runs in Bulgaria in 2014.

In June 2014, a large number of clients withdrew their deposits (bank run) from the fourth largest bank in Bulgaria, Corporate Commercial Bank (CCB). News reports about the shady dealings of one of its shareholders, and a public spat between him and another businessman holding deposits in the bank, led to Bulgarian depositors queueing to withdraw their deposits from this bank. After a withdrawal of more than 20% of the deposits, the authorities took control of CCB, suspending payments to its depositors. Eventually, CCB became not just illiquid but insolvent. CCB then closed its doors for about five months under the supervision of the Bulgarian central bank.

With CCB's closure in November 2014, depositors were deprived of access to their money to the total of USD4 billion, for a considerable time. Retail customers,

companies, hospitals, local authorities and schools alike suffered. Retirees were unable to pay for medical care and urgent treatments. Companies faced cash flow problems; their financial planning was disrupted; employees were not paid their salaries. The closure and subsequent events led to significant unemployment issues for many thousands. The guaranteed deposits in CCB, amounting to around 5% of the country's gross domestic product, were finally paid out – but only after a significant and prolonged delay, and after much suffering and losses.

Also in the same year, there was another bank run at the third largest bank in Bulgaria, the First Investment Bank, which seemed to have come about from an organised "cyber-attack". A company with a network of associates was thought to have spread an alert, alleging that the bank was suffering a liquidity shortage. The message also alleged that the country's deposit guarantee fund was underfunded and would not be able to meet possible repayments. Disseminated by texts, emails and Facebook, the news spread fast. Unnerved Bulgarian depositors, particularly those who had experienced a banking crisis in 1997, queued at the bank and withdrew about USD550 million in deposits in just one day.

+ These examples show us that:

First, it's important to be able to handle bank runs properly. The authorities' delayed actions and the flawed design of Bulgarian law meant that depositors did not have prompt access to much-needed money.

Bank runs can have devastating consequences on the country as a whole. Deposit insurers' experiences are that early action by authorities in dealing with a problematic bank will mitigate disruption and save losses than if there is a delay.

Bank runs today, like before, could well be rumour-driven. But rumours today, in our "always-on" world, can be propagated on social networks and other channels far quicker and with greater impact than ever before.

CONFIDENCE AMIDST UNCERTAINTY

To quote *Forbes*, the bank runs in Bulgaria are "… a fine example of how a rumour-driven run can bring down a bank." They demonstrated the dangers arising from a lack of confidence among depositors in an environment of uncertainty.

But Bulgaria isn't the only example. In September 2007, television viewers around the world witnessed depositors waiting in line outside the branch offices of Northern Rock, a United Kingdom bank, to withdraw their money. The last bank run in the UK before Northern Rock was some 150 years ago, in 1866. What we witnessed in the Northern Rock experience was that of anxious depositors, themselves galvanised by television images. Despite public statements of reassurance from the authorities, retail depositors remained unconvinced about the safety of their deposits and continued to queue for their money.

Several studies have been undertaken on this and other bank runs. Some of the key conclusions are these:

It is important to ensure public awareness about national financial compensation schemes, where they exist. In the Northern Rock case, little was known about the financial compensation scheme in the UK despite its existence. This is, as a matter of fact, one of the core principles of the International Association of Deposit Insurers (IADI) for effective deposit insurance systems.

Bank runs are not randomly fuelled events arising from irrational depositor fear. More often than not, runs are reactions to the reputation of a bank in an environment of deteriorating economic fundamentals.

In such circumstances, and in the absence of adequate information about banks, particularly for retail depositors, depositors must also have confidence in the credibility of government and government policies.

Depositors must have confidence and know the benefits and limitations of their national deposit insurance system.

Another key point to emphasise is that, as shown in the Bulgarian example,

the collective memory about past institutional failures will likely play on the minds of retail depositors in situations of uncertainty. Depositors who have experienced bank runs and failures of safety nets are more likely to run on a bank faced with similar circumstances.

CONCLUSION

Maintaining the ongoing credibility of financial safety net players is thus critical.

The examples highlighted underscore the need for a properly designed financial safety net, with appropriate governance and institutional accountability, including independence from political influence.

A financial safety net system involves prudential regulation and supervision; a lender of last resort facility; and an effective deposit insurance system. Having an explicit deposit insurance system is widely regarded today to be one of the pillars of modern financial safety nets. In 1974, there were 12 deposit insurers in the world. Today, 114 countries have explicit deposit insurance systems with many others considering setting up such a system. "In order to be credible," states the Basel Committee on Banking Supervision and the International Association of Deposit Insurers (IADI) in their joint publication, "… a deposit insurance system needs to be part of a well-constructed financial system safety net, properly designed and well implemented."

+ Deposit insurance systems help support confidence in the financial system in several ways:

by guaranteeing depositors that they will get their money back up to the insured limits in uncertain times should a bank fail;

by ensuring that depositors are aware that such a deposit insurance system exists and understand the benefits and limitations of such system;

by incentivising its member institutions to adopt sound risk management practices through the implementation of differential premium systems, i.e., by charging premiums according to the risk category in which the institution falls.

The mandate of the national deposit insurer in Malaysia, Perbadanan Insurans Deposit Malaysia (PIDM), specifically requires that it carry out all of those functions – i.e., to guarantee deposits in bank failures; to promote financial stability; and to provide incentives for sound risk management in the financial system. The legislation establishing PIDM also anticipates that PIDM must have powers "... to implement promptly the resolution actions... at minimum cost to the financial system." The PIDM Act thus provides it with a wide range of powers to promptly deal with a failing bank, and requires PIDM to protect depositors against the loss of part or all of their deposits in the event of a bank failure.

Insofar as PIDM's deposit insurance system and its effectiveness is concerned, in 2013, PIDM's system was independently assessed, within the International Monetary Fund / World Bank Financial Stability Assessment Programme, and was found to be in compliance with IADI's "Core Principles on Effective Deposit Insurance Systems".

Should public confidence in the financial safety net nevertheless fail for whatever reason, the financial safety net system must - as urged by the Basel Committee on Banking Supervision and IADI - be well implemented. The safety net must be in a position to deal promptly and credibly with the troubled institution. This is critical, as retail depositors do not just run on banks because they are worried about losing their money. They worry about losing access to their money. In Malaysia, PIDM is required to pay depositors up to the limit of RM250,000 per depositor per bank, in the event of a bank failure, and will do so promptly. Depositors will not therefore have to wait significant lengths of time before they will have access to their money up to that limit.

As we can see, the failure to respond quickly to a failing bank and depositors not having access to their money can leave profound and long-term mistrust among the public, and affect confidence in the financial system for many years to come. In Malaysia, depositors can remain confident that PIDM stands ready to meet its obligations should the need arise. ✱

■ *Perbadanan Insurans Deposit Malaysia (PIDM) is the national deposit insurer that was set up as an operationally independent statutory body in 2005.*

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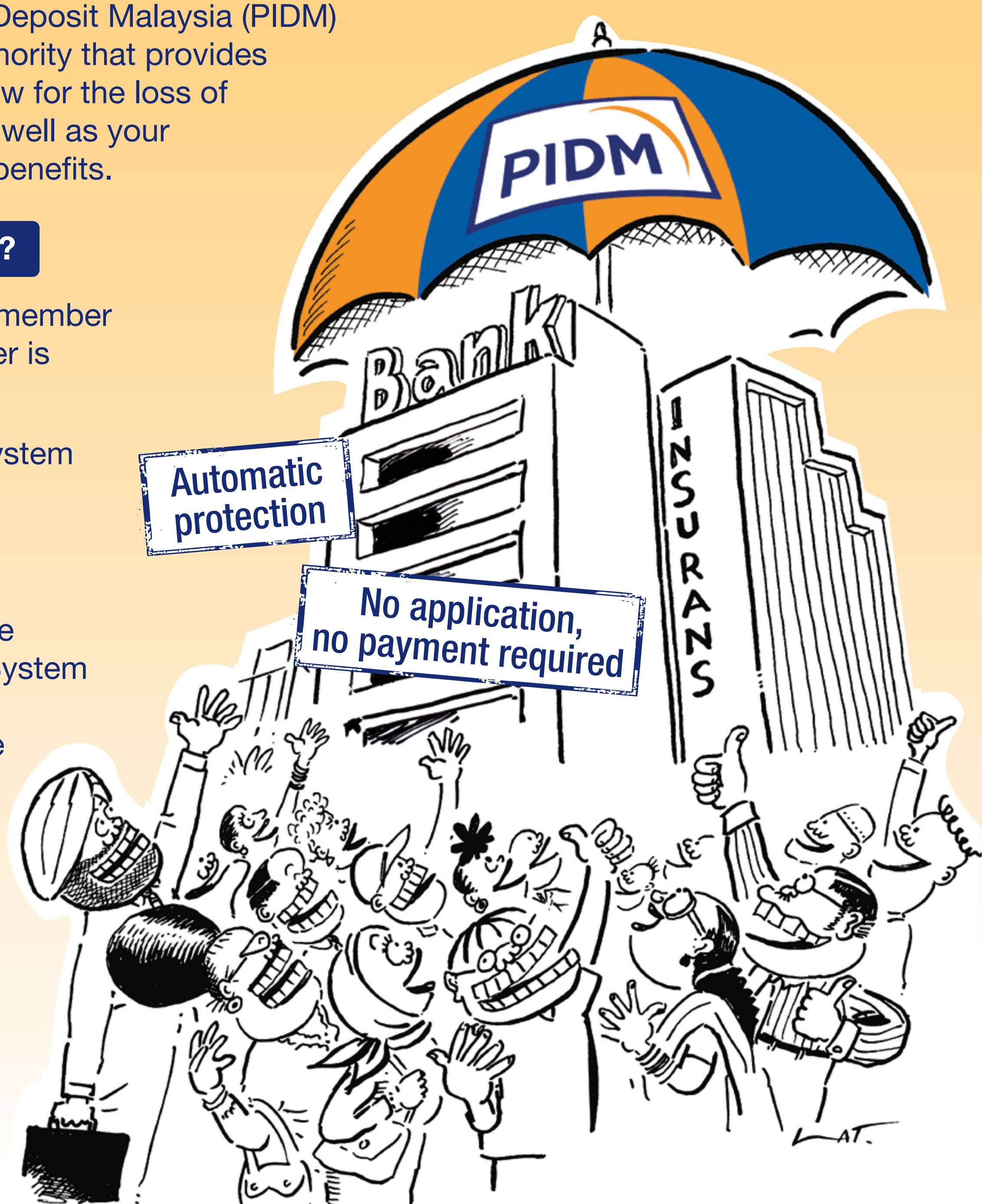

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OPTIMISING THE Three Lines of Defence

THE THREE LINES OF DEFENCE MODEL IS STILL VALID TODAY, BUT BANKING ORGANISATIONS **MUST PAY ATTENTION TO IMPLEMENTING A ROBUST RISK CULTURE** – WHICH IS FOUNDED ON ETHICS AND INTEGRITY - TO ENSURE THE EFFECTIVENESS OF THE THREE-LEGGED MODEL.

The emergence of new risks in the banking industry due to assorted disruptions and a volatile environment has spurred interest in revisiting the effectiveness of traditional methods of oversight to strengthen risk management and controls, such as the Three Lines of Defence.

Traditionally depicted as a three-legged stool, the Three Lines of Defence are management control (the first line), the various risk control and compliance oversight functions established by management (the second line), and independent assurance (the third line).

Below, we look at some key

+ One, two, three or more, the model is simply a tool for managing risk and enhancing governance. It is more important to better align the lines of defence to achieve robust governance and build a strong and unified compliance culture.

recommendations for managing risk using the Three Lines of Defence model, culled from experts speaking at the second AICB-Global Banking Conference (GBC) Discourse Series on *The Three Lines of Defence:*

THREE LINES – OR MORE?

Are three lines of defence really adequate? And is the model still valid in today's environment?

"In a perfect world, only one line of defence would be needed, but in the real world, any number could be necessary, and still not be enough!" said V. Maslamani, Chief Compliance Officer, Al Rajhi Banking & Investment Corporation.

One, two, three or more, the model is simply a tool for managing risk and enhancing governance. It is more important to better align the lines of defence to achieve robust governance and build a strong and unified compliance culture. "The Three Lines of Defence model should determine the ownership or division of compliance obligations," said Martin Tolar, General Manager of the Australian & New Zealand Red Flag Group.

REARRANGING THE LINES – ENSURING TONE FROM THE TOP

Importantly, directors should be taking the lead as the first line, and not the 'back-up' together with the C-Suite, or the model will fail. While organisational cultures differed between companies, the tone has to be set from the top. "The Board is an oversight body, not a management function, but it needs to understand the banking business," said Frankie Phua, Managing Director and Head of Credit & Country Risk Management, United Overseas Bank (UOB). "Risk culture is about escalating issues; the Board may need training to understand it."

The Board and senior management should be proactive to ensure that compliance weaknesses and issues are addressed and do not recur again and again. "We should be asking how serious the Board is, and if it has the capability or availability to address the problems. Is information being shared freely, or are things being held back? Is compliance and internal audit a permanent agenda item in Board and senior management committee meetings? There are multiple issues to be addressed for effective risk management," said Lim Tiang Siew, Group Chief Internal Auditor, CIMB Group.

The model should ideally include compliance managers to help the business team with its compliance efforts, recommended Tolar. Ideally, the second line (oversight, compliance and controls) should be coaching the first line (management), reviewing policies, issues and decision-making while ensuring obligations and accountability are aligned to organisational compliance KPIs. The third line (assurance) can then test the robustness of the framework.

RISK IS EVERYBODY'S BUSINESS; TAKE A HOLISTIC VIEW

Considered part of the Second Line of Defence, the risk management function developed in the 1990s after the Asian Financial Crisis and increased in importance in the wake of the Global Financial Crisis. However, the term "risk management function" is commonly misunderstood to mean that risk management responsibility and ownership sit within this function. This meant that what was an organisational responsibility may became siloed, cautioned Phua.

"As a process, risk management is really everybody's job. As a function, the risk management department performs the second line role," Phua clarified.

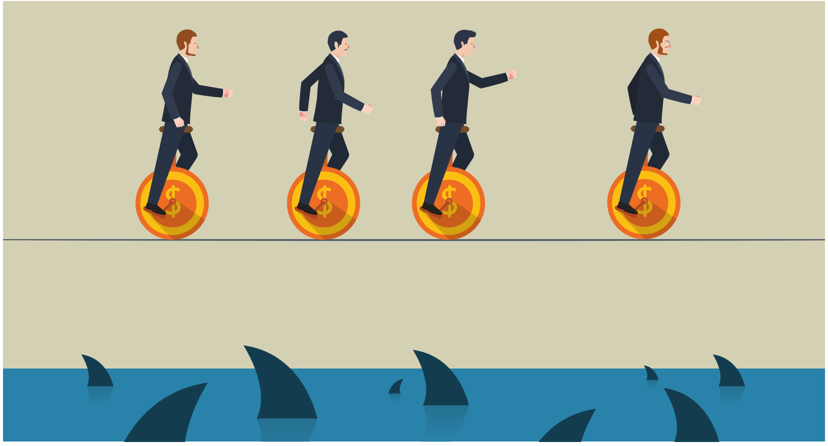
While the global financial crisis has enhanced the risk management function, this is still dependent upon the risk appetite of the respective firms. This appetite in turn is based on many factors: stress testing, governance and the risk management function itself, among others.

Organisations should hence take a step back and look at the big picture to see how all these factors work together. Importantly, risk must be assessed by looking at an organisation's entire risk framework, because compliance and risk extend beyond operational risk. Neither is there a one-size-fits-all model. Risk models should be carefully tailored to each organisation's unique circumstances.

across the board.

To effectively manage risks, organisations must build a risk culture. "Without a robust risk culture, the lines of defence are ineffective," warned Phua. In practice, this is easier said than done. "The first line of defence (management) has a long way to go; 70%-80% of the current issues are people issues. Staff are often not properly supervised or trained," said Lim.

Other issues include setting unrealistic key performance indicators (KPIs) which can lead to unethical behaviours by employees in order to meet the KPIs. There is an over-dependence by the first line of defence on the second (control and compliance) and third (assurance) lines, and a lack of understanding of their dual roles as first (management) and second (control and compliance) lines in risk management by some functions like finance.



Customise lines of defences to the organisation's needs and define these by activities rather than functions, recommended Phua.

ADDRESS HUMAN SHORTCOMINGS

How well a risk management framework works depends on people. Thus, the efficiency and effectiveness of the Three Lines of Defence model relies largely on the quality of the talent manning the lines of defence. As such, organisations are advised to invest judiciously in training and education

Organisations also need to ensure an adequate budget for people and systems deployed in risk management, especially as threats and disruptions evolve and become more sophisticated.

Encourage feedback and implement feedback mechanisms. Staff may be reluctant to raise issues, primarily because of the perceived lack of top management support. However, it is important that staff be courageous in reporting breaches, as this is integral to implementing an organisation-wide culture of taking responsibility for risk management.

There is also a need to reframe internal audit, the Third Line of Defence, as a sustainable career path in order to ensure consistency and continuity of governance and risk management processes. Internal audit is sometimes considered a training ground or stepping stone to a better position, so some people tend not to stay in the job for long, noted Lim.

BUILD A RISK CULTURE

Good governance and the efficacy of the Three Lines of Defence depends largely on developing an ethical organisational culture, but the real challenge will be to embed desirable risk culture throughout the organisation and ensure uniform good practice.

"No measures will work unless the culture drives it. The people who work in the Three Lines of Defence are not working independently of the firm; they are all responsible," said Tolar. All must shoulder the tasks of keeping an eye out for risks and reporting infractions without fear or favour. "There needs to be a culture of effective challenge, driven by internal motivation," agreed Phua.

Ethics and integrity must be a bedrock and people in the lines of defence must be able to assess ethical risks and exercise ethical judgement. "If they prioritise profits and personal gain over everything else, the lines of defence will not be effective," Lim stated. "Maximisation of profits is important, but not at the expense of ignoring risks."

Finally, organisations must be aware that new hazards emerge everyday as the environment changes, especially in light of massive disruptions such as technology and regulatory change. It is imperative that risk cultures and frameworks become agile and adaptable, while never sidelining ethics and integrity. At the end of the day, concluded V. Maslamani, "The challenge of aligning the responsibilities of the Three Lines of Defence will always be there. There will always be a need to evolve and be aware of the change in operating environment, and bankers must continuously be ready to manage the emerging risks." ✱

■ *Reporting by the Banking Insight Editorial Team*

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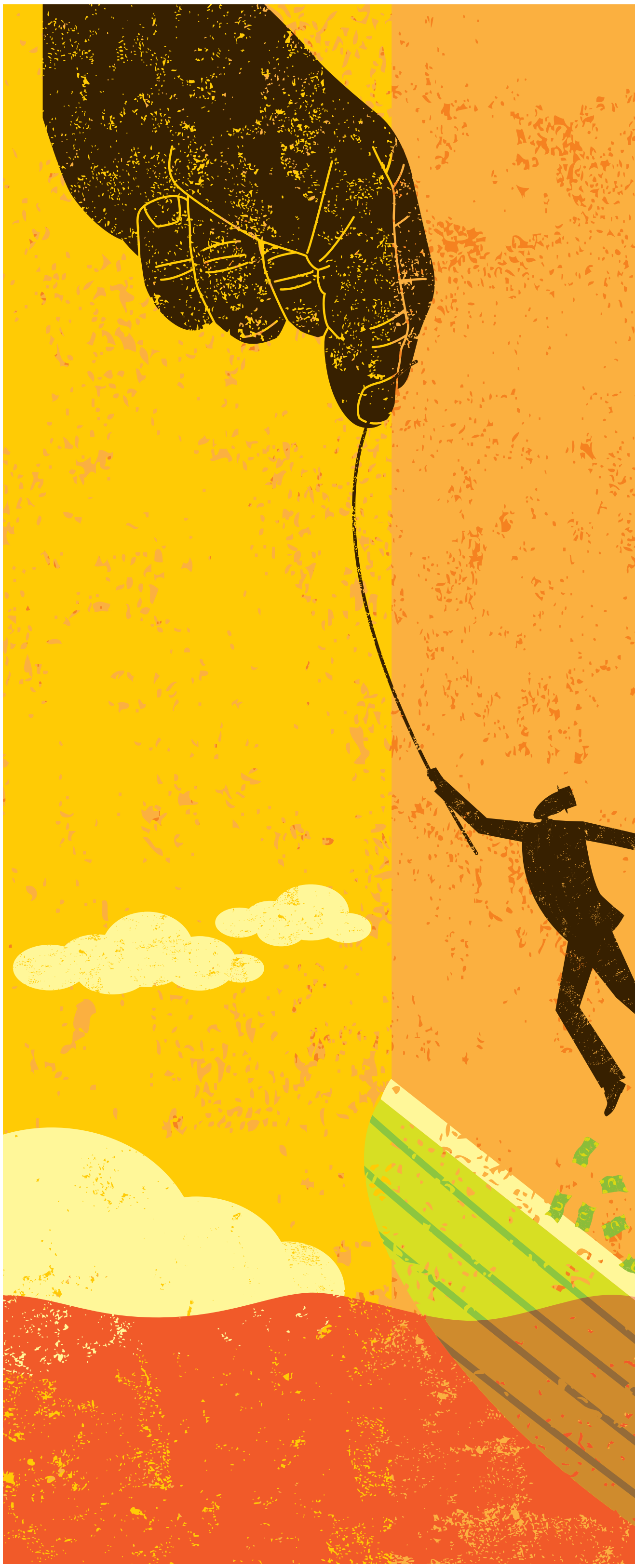


Lifting All Boats

With increasing competition among International Financial Institutions (IFIs), is there a place for the World Bank?

The wave of prosperity heralded by global economic linkages has seen an increasing number of countries and regions pool their resources into building more and more International Financial Institutions (IFIs). Despite the proliferation of new institutions, however, few can match the rich history and prominence of the International Monetary Fund (IMF) and World Bank. Conceived in 1944 at the Bretton Woods Conference, the two sister organisations are some of the oldest fixtures in the global finance scene. Whereas the former acts as an international lender of last resort for crisis financing, the latter focuses on a more humanitarian goal. "Our dream," goes the World Bank mission, "is a world without poverty."

The World Bank's original *raison d'être* was to finance the reconstruction of a Europe devastated by war. Over the years, however, it shifted gears to address the issue of poverty both relative and absolute. The world has been flooded with prosperity in recent years, but this abundance has not always been shared. Advocates of liberalism argued that capitalism is a rising tide to lift all boats, whether countries or segments of society. It

+ To achieve the twin goals of reduced poverty and shared prosperity, the World Bank has made several efforts to boost the productivity and economic growth that acts as the pathway to national and shared wealth.

"There is a pressing need to improve education and health outcomes, and match those with private and public investments to create employment opportunities."

Faris H. Hadad-Zervos, Country Manager for Malaysia, World Bank Group Global Knowledge and Research Hub

has become apparent, however, that surging prosperity has also resulted in economic inequality: only some boats have left the port. Others are shipwrecked on the rocks of corruption and faulty economic policy. Others still have yet to be built in a global economy that keeps giving to winners and taking from its losers. To that end, the World Bank focuses on creating a fairer economic landscape by eradicating poverty and boosting shared prosperity — a legacy the World Bank Group Global Knowledge and Research Hub in Malaysia seeks to continue.

BRINGING EVERYONE INTO THE FOLD

To achieve the twin goals of reduced poverty and shared prosperity, the World Bank has made several efforts to boost the productivity and economic growth that acts as the pathway to national and shared wealth. In the Asia-Pacific, the World Bank's strategy concentrates on "inclusion and empowerment, jobs and private sector–led growth, governance and institutions, infrastructure and urbanisation, and climate change and disaster risk management," according to its official website.

In regards to infra-financing, for instance, the Asian Development Bank estimates that Asia will require USD8 trillion in funds up to 2020 to shore up on infrastructure. The World Bank has contributed USD7.5 billion to the region for the 2016 fiscal year, on top of funding in previous decades. However, recent efforts to bolster financial inclusion in the region have increasingly taken centre stage. The issue of financial inclusion has less impact on Malaysia, which has already achieved near universal financial inclusion. Indeed, Faris H. Hadad-Zervos, Country Manager for Malaysia, World Bank Group Global Knowledge and Research Hub lauded Malaysia's efforts in the area. "Between 2011 and 2014," he said, "the percentage of adults in Malaysia having an account at a licensed financial

The world has been flooded with prosperity in recent years, but this abundance has not always been shared. Advocates of liberalism argued that capitalism is a rising tide to lift all boats, whether countries or segments of society. It has become apparent, however, that surging prosperity has also resulted in economic inequality: only some boats have left the port.

institution increased from 66% to 81%. Moreover, the percentage of sub-districts — areas with a population of more than 2,000 people — without access to financial services declined from 54% to 3% between 2011 and 2015."

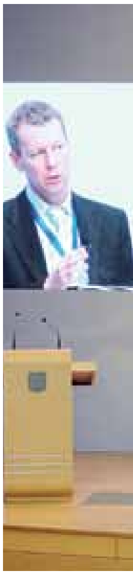
Malaysia's challenge thus lies elsewhere: in improving socioeconomic conditions and constructing buffers for the poor who are economically vulnerable. "Malaysia has been very successful at nearly eradicating extreme poverty based on the international extreme poverty line of USD1.90 (RM8.44) per person per day," noted Hadad-Zervos. Regardless, as in other countries, relative poverty has yet to be eliminated. As such, the World Bank aims to improve the socioeconomic status and incomes of the bottom 40% of the income distribution (B40). Its efforts include closing education gaps and upskilling the population to capture higher-skilled jobs, fine-tuning and streamlining social assistance systems and public transfers to the population, as well as boosting low savings rates to erect a buffer to economic shocks.

While Malaysia is fortunate in the field of financial inclusion, however, others do not fare as well. "Two billion people worldwide still lack access to regulated financial services," explained Hadad-Zervos. In ASEAN alone, a market set to be the fourth largest economy by 2050, 264 million adults are unbanked, wrote José de Luna-Martínez on a World Bank blog. Rates of financial inclusion across ASEAN are far from homogenous. Instead, they form as complex and diverse a mosaic as the political, economic, and sociocultural landscape in Southeast Asia. While Malaysia joins the ranks of Singapore, Thailand, and Brunei in achieving universal financial inclusion, the challenges — and opportunities — for the remaining six members loom large.

Rates of financial inclusion are stymied by abysmal levels of financial literacy, financial services that do not target women and the rural poor, as well as lack of valid ID or complex identification processes that encumber people who want to open accounts. Consumer protection and regulation prove another key hurdle, with Hadad-Zervos underscoring the importance of providing secure and reliable services along with protecting data privacy and funds. Transaction accounts must also be useful, he added, and act as a gateway to other financial services like savings and credit. This will be especially important in order to transition the ASEAN region into the digital age, creating future parallel progress with the cashless movements seen elsewhere in the world. "Some 355 million adults in developing countries who report having an account still remit money in cash or over-the-counter," Hadad-Zervos mentioned. "Governments and the private sector can play a key role in accelerating usage by depositing wages into accounts versus paying cash."

With fintech becoming a juggernaut, governments and financial service providers (FSPs) adept at harnessing technology will be poised to capture unbanked populations. "Mobile-based financial services bring convenient access even to remote areas," Hadad-Zervos remarked, "and the greater availability of customer data allows providers to design digital financial products that better fit the needs of unbanked individuals."

FSPs will further stand to gain from the World Bank's current initiatives for financial inclusion. Amongst them are plans to modernise retail payment systems and government payments by promoting electronic payment systems to phase out cash and paper-based instruments — a move that increases financial inclusion, boosts cost savings for governments, and reduces leakages related to corruption and fraud. Additionally, the World Bank seeks to diversify financial services for individuals, create enabling environments for fintech to thrive, as well as strengthen competition by supporting reforms to open up and level playing fields between traditional and non-traditional FSPs. Moreover, the World Bank essays good governance, since, as the Global Financial Crisis shows, being included in and expanding the system can be detrimental when a lack of oversight permeates its inner workings. As such, the institution's Financial Sector Assessment Programme will also facilitate stronger and reinforced national financial systems and sectors through reports and recommendations made by the World Bank's and the IMF's technical experts. Thus, for banks ready to take on the digital age and contribute to a sustainable and equitable society, the World Bank will encourage a conducive environment in which they can flourish.



Faris H. Hadad-Zervos (right) moderating a panel discussion at the Financial Reform for Economic Development in Asia-Public Sector Forum 2016 in Kuala Lumpur in May 2016.

As a pre-eminent IFI formed under the US leadership, it has been accused of spreading America's influence and agenda. The organisation's internal structure also leaves much to be desired. Though voting reforms have taken place, the US voting power remains unchanged.

STORMS AND RAINBOWS

The World Bank Group Global Knowledge and Research Hub in Malaysia represents the healthy and continued expansion of an organisation seeking to accomplish a noble goal. Nonetheless, some may find the augmentation of the IFI's reach, presence, and influence troubling: even if the new Hub does stay in the lane of research and knowledge for capacity building, it remains the extension of an organisation with specific agendas and practices — all of which have come under fierce criticism and intense scrutiny over the years.

As a pre-eminent IFI formed under the US leadership, it has been accused of spreading America's influence and agenda. The organisation's internal structure also leaves much to be desired. Though voting reforms have taken place, the US voting power remains unchanged. In a fixed pie model, this means that the voting power of other countries must be reduced in order to redistribute voting powers without attenuating the US chokehold over the organisation's administration, activities and funding. Even with the new voting reforms, China, India and Brazil combined only have 2.7% advantage over the Benelux (Belgium, Netherlands, and Luxembourg) countries, according to LSE (London School of Economics) Professor Robert Wade in a European Parliament briefing entitled 'The World Bank: Serving Ambitious Goals, but in Need of Reform'. This, despite the BIC tripartite accounting for a predominant amount of global growth, stands in stark contrast to Europe's stagnating economic presence.

The institution's credibility has also been questioned, especially when some of its policies have hurt rather than helped the poor constituting their target demographic. In 2015, the International Consortium of Investigative Journalists reported that north of three million people worldwide have been displaced by World Bank projects such as dams and power plants, threatening their livelihoods and ways of life. Weak compliance mechanisms and enforcement could also spell trouble for the organisation's work and integrity. Despite the World Bank Group's commitment to environmental protection and sustainability, IFC-funded banks and businesses have powered an Asian coal boom. Though the World Bank itself declined the project, Inclusive Development International's 2016 report shows that funds provided by the IFC to for-profit FIs have flown in the face of the World Bank's goals for a green future, undermining the institution's work.

Perhaps the biggest obstacle for the World Bank, however, is its diminishing relevance. Over the years, it has been accused of 'mission creep', wherein its projects have expanded beyond its original goals to include everything under the sun — like crisis lending to economies hit by commodity slumps, a task traditionally left to the IMF. The World Bank keeps veering from its mandate — a sign that its path may be less clear-cut to its top strategists and thus, even more obscure to the rest of the world. Various new IFIs and bilateral financial assistance programmes offer countries more and more options to pursue development. Today's mantra is 'evolve or perish', but the World Bank has yet to find the *je ne sais quoi* qualities setting it apart from the pack in this dynamic and ever-changing global landscape. Finding a new differentiating factor will thus prove paramount for the World Bank, according to the *Financial Times* article 'The Case for Reform at the World Bank', in light of "[World Bank President] Mr. (Jim Yong) Kim's failure to redefine the World Bank's mission, and restore its relevance in a world where middle-income countries, traditionally its biggest clients, can raise finance in global capital markets or go to nimbler regional development banks."

One of the many panel discussions at the Global Symposium on Innovative Financial Inclusion held at Sasana Kijang, Bank Negara Malaysia in September 2016.

A Malaysian Perspective

THE WORLD BANK GROUP GLOBAL KNOWLEDGE AND RESEARCH HUB IN MALAYSIA SEEKS TO SHARE MALAYSIA'S UNIQUE EXPERIENCES TO SHAPE BEST PRACTICE.

Launched in March 2016, the Hub will present Malaysia's development experience, knowledge and expertise in matters like reducing poverty and developing a competitive trade regime to other South countries. In his opening remarks, World Bank Vice-President of Development Finance Axel van Trotsenberg noted, "Malaysia's knowledge of Islamic finance could be very useful to many of the World Bank's member countries." Moreover, the Hub will provide analysis and advice to the host government, as well as conduct globally competitive research in relevant fields such as development economics.

The Malaysian branch will also coordinate efforts in eradicating poverty and redistributing prosperity with other World Bank offices across ASEAN. Though Malaysia can be considered a success story, some of its neighbours have struggled. "Extreme poverty remains a significant issue in countries such as Cambodia, Laos and Myanmar," said Faris H. Hadad-Zervos, Country Manager for Malaysia, World Bank Group Global Knowledge and Research Hub in Malaysia via email. "There is a pressing need to improve education and health outcomes, and match those with private and public investments to create employment opportunities."

As poverty isn't specifically a public sector problem, the region may also see the growing presence of the World Bank's other sibling organisations. As the private arm of the World Bank Group and the largest global development agency focused on building the private sector of developing countries, the International Finance Corporation's (IFC) expanded role could bring even more growth into the region through sustainable development and equitable growth businesses and practices. Workshops jointly held by the hub and Bank Negara Malaysia have already exposed Malaysian businesses to the range of services provided by the IFC, including asset management, investment and advisory aid. "In Malaysia, the IFC plans to ramp up its activities and leverage on the country's burgeoning economy as it transitions into a regional economic powerhouse," explained Hadad-Zervos. "Moving forward, the IFC will remain focused on its portfolio in infrastructure, renewable energy, manufacturing and financial sectors. With the new Hub in Malaysia, we certainly see more collaborations between the World Bank and its member organisations such as the IFC and the Multilateral Investment Guarantee Agency in the future."

NO PLACE IN THE WORLD?

Like any behemoth, the World Bank has been relatively slow to adapt; the sheer number of stakeholders and interests make it difficult for it to change and change rapidly. That does not mean, however, that it has not tried or that it is not trying still to institute reforms. The organisation has taken initiatives to improve justice and order within its ranks and structure through inspection panels and voting reform. Its staff has also looked towards working in post-Washington Consensus development programmes, as the GFC evidenced that policies like excessive deregulation and attenuated governance can make neoliberalism a recipe for disaster.

As for the World Bank's relevance, it must be remembered that mandates can change. Rates of poverty have dwindled significantly over the decades, and many countries have outgrown dependency on IFI financing to become lenders themselves — an achievement that should be celebrated. Plus, even an experimental attitude can be a sign of forthcoming innovation. At the very least, it means the organisation is well aware of the pressing need to change, as Andrew Rice's interview with Jim Yong Kim for *the Guardian* highlighted. "What is the relevance of the World Bank?" Kim asked. "I think that is an entirely legitimate question." As such, the diversification of World Bank

Like any behemoth, the World Bank has been relatively slow to adapt; the sheer number of stakeholders and interests make it difficult for it to change and change rapidly.

Prime Minister Dato' Sri Mohd Najib Abdul Razak (fourth from left) with other senior officials from the World Bank Group and the Malaysian government at the official launch of the World Bank Group Global Knowledge and Research Hub in Malaysia in March 2016.

interests may well be a step forward in crystallising the organisation's future direction.

Moreover, as countries turn inwards, even protectionist, the importance of an institution like the World Bank reminding global population of the benefits of international economic cooperation and globalisation — something it must promote according to its Articles of Agreement — cannot be understated. Its role as defender of globalisation can encourage the growth of a more robust and augmented financial regime, since new trade deals generally usher in more advantages for finance. "International trade is essential to support growth, development and poverty reduction," said Hadad-Zervos. "There is a backlash in some (advanced) countries against trade agreements and more broadly, globalisation, which needs to be taken seriously and merits a response." Recommending that authorities remain open to legitimate concerns like short-term adjustment costs and to be proactive in proposing solutions, he further advised the relevant entities to engage the population. "One must also recognise that there is a lot of irrationality in the public discourse," he noted. "The fact is that trade agreements are needed to manage increased interdependencies and can lead to welfare gains. Policymakers need to share evidence and educate the wider audience, while tackling head-on some of the unfounded arguments being made."

Even with the mushrooming of new IFIs globally and regionally, the World Bank sees the stage being set for cooperation instead of competition. The organisation is secure in the knowledge that it is "the only development institution that works on a global scale," as Hadad-Zervos puts it. "There is a call to rethink priorities of the World Bank in light of changes in the multilateral system, that now includes more than six other large and politically significant regional banks," he acknowledged. "The banks as a group need to be better equipped to tackle the urgent transnational problems of our time: for example, the risk of antibiotic resistance and forced migration." Nevertheless, the Country Manager for Malaysia urged people to view this as an opportunity for even greater collaboration. "Shareholders ought to think of these banks not as individual institutions competing for scarce resources but as a system of complementary actors. They should build on the key role of the World Bank as the only truly global bank in addressing transnational problems, while looking to the full potential of the regional banks to address their borrowing members' growing investment needs, particularly but not only in infrastructure."

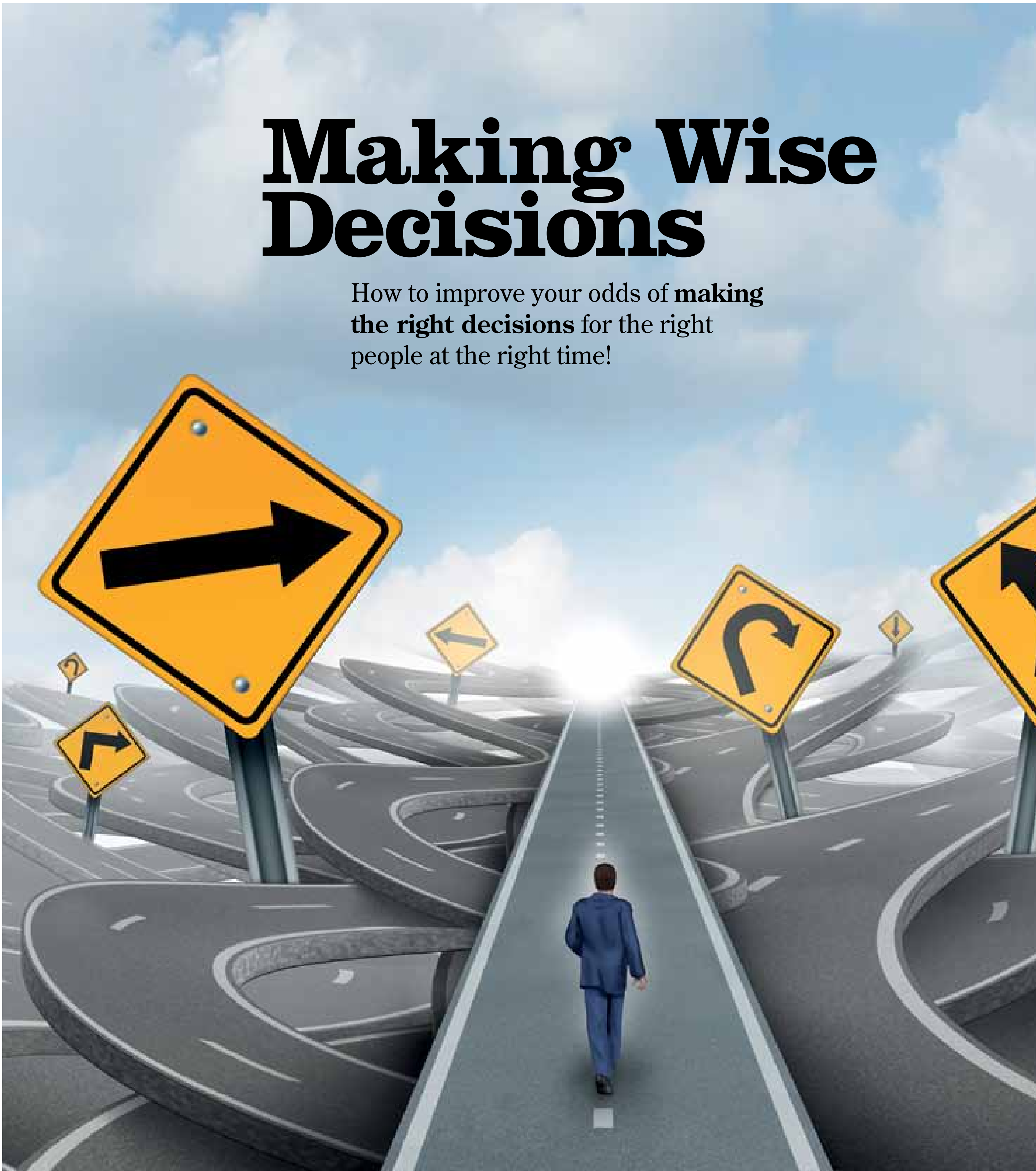
CONCLUSION

It is hard to say that the World Bank has no place in the world. The repository of knowledge and technical expertise it has cultivated and subsequently offers through its offices like the Global Knowledge and Research Hub in Malaysia, along with the credibility and legitimacy accrued throughout history make it a formidable player in global finance — one that cannot so easily be replaced. Undoubtedly, it will remain a fixture in international finance, especially when one realises that development is not a destination. It is a constant journey, long and hard and one that the World Bank will continue to help global society make well into the future. ✱

 | BY PETER WEBB

Making Wise Decisions

How to improve your odds of **making the right decisions** for the right people at the right time!



THINK ABOUT YOUR THINKING

Making decisions is a bit like driving a car. You think you're pretty good at it until you experience an accident or a near-miss. In that moment, you realise you're not so skilled after all. In the same way, we make hundreds of decisions every day, big and small, and we seem to manage without too much trouble. Yet, it turns out that most of our decision-making is unconscious, as David Eagleman wrote in 'Incognito: The Secret Lives of the Brain.' We think we're in control but actually we're on autopilot. Our brains are very good at learning patterns and following routines to conserve energy, which means we're more likely to make the same decisions over and over even if the circumstances are different.

The reason why we find it hard to change our minds is that it's easier to accept whatever we hear. To reject what we hear requires an extra step of thinking, and thinking is hard work! So, we typically follow the line of least resistance and that means our decision-making is easily biased. Here are the top four biases that cloud our judgement:

- **Self-serving bias:** We tend to attribute success to something inherent in us, "I was successful because of who I am". And we blame failure on the external situation, "I failed because of something or someone else out of my control". It's important to maintain strong self-esteem but we need to be vulnerable enough to learn from our mistakes.
- **Cognitive fluency:** The easier it is to process and understand an idea, the more likely we are to unconsciously trust it. Yet, whether something is easy to process has nothing to do with truth and can lead to an "illusion of truth". When you hear something that "sounds about right", that is exactly when you should question it!
- **Sunk cost fallacy**: We have an intense aversion to loss and so if we have invested time, money, or effort in a movie, a stock, or even a relationship, we're reluctant to walk away from the investment even when it's clearly a lost cause. It's better to focus on the future costs and benefits and not let your past losses influence your decision.

MAKING A WISE DECISION

Intuitive
"What am I feeling about this decision?"
"What does my experience tell me?"

Deliberative
"What do I know (and what don't I know) and what can I find out?"
"What is the best way to analyse this?".

Considerative
"Who will be affected by this decision?"
"What are the likely consequences of the decision for them, in the short-term and the long-term?"

Lifespan Contextualism
"How does my own life and the lived example of others help me in making this decision?"

Values Relativism
"What personal values are critical for me to uphold?"
"What cultural values or significant others' values might be implicated?"

Common Good
"What is the best possible outcome for everyone involved, and for society?"
"What is the wisest thing to do?"

Compassion
"What do I feel inspired to do to make a meaningful difference in the lives of others?"

Mindfulness
"What am I aware of when I take the time to relax and bring my mind to a place of stillness?"

***Source:** The Iclif Leadership and Governance Centre.*

The reason why we find it hard to change our minds is that it's easier to accept whatever we hear. To reject what we hear requires an extra step of thinking, and thinking is hard work! So, we typically follow the line of least resistance and that means our decision-making is easily biased.

- **Confirmation bias:** We have a tendency to only search for evidence that confirms our beliefs, since it requires far less cognitive effort to stick with what we know. However, it helps to actively search for contradictory evidence.

To avoid these flaws in decision-making, it helps to think about our thinking. We think fast and slow, as the economist and Nobel Laureate Daniel Kahneman showed in 'Thinking, Fast and Slow'. The fast, intuitive information-processing mode operates automatically and stems from what we know based on our experience. We get a 'gut feeling' of what to do, even if we can't explain it. The slower information-processing mode tends to be more deliberative, more logical, and to operate in a more rational way. Both modes have been found to operate simultaneously in the solving of complex problems.

Yet this doesn't explain why smart people can make foolish decisions! Recent research confirms a third mode used in our processing of information – the considerative mode as shown by Barry Partridge and Peter Webb in 'The Decision Processing Survey'. This is a slower, more reflective process, taking into consideration competing interests, moral and ethical dimensions, and potential long and short-term consequences. Without this mode, we may make calculated, intuitive decisions but fail to fully comprehend how our decisions affect others and even how we might cause a net negative social benefit.

Here is a framework to help you think about your thinking (see **Table 1**).

THINK ABOUT OUTCOMES

Making a wise decision means fully utilising all three modes of information processing. It should also be evident in the way we act when we are faced with a complex, poorly-defined problem in business or in life. How do we make a decision when there are no clear guidelines or procedures and where the outcome is uncertain or unknown (i.e., it might be viewed as the wrong decision now but the right decision in the long term, or vice versa)? A wise decision ought to be recognised by general consensus to be wise, and by implication to bring about the most benefit to self, others, and more broadly the common social good.

Wisdom is perhaps best defined by the Berlin Wisdom Paradigm as "deep knowledge and sound judgement about

+ The fast, intuitive information-processing mode operates automatically and stems from what we know based on our experience. We get a 'gut feeling' of what to do, even if we can't explain it.

Table 1

INFORMATION PROCESSING MODE	SELF-QUESTIONS
Intuitive Use your innate or gut feel to quickly arrive at a decision that "feels right"	1. "What am I feeling about this decision?" 2. "What does my experience tell me?"
Deliberative Draw on your knowledge to analyse the information and deduce a solution.	3. "What do I know (and what don't I know) and what can I find out?" 4. "What is the best way to analyse this?"
Considerative Think about how to balance the various interests in the short and long-term	5. " Who will be affected by this decision?" 6. "What are the likely consequences of the decision for them, in the short-term and the long-term?"

the essence of the human condition and the ways and means of planning, managing, and understanding a good life", as expounded by Ursula M. Staudinger, Jessica Dörner, and Charlotte Mickler in 'Wisdom and Personality' in 'A Handbook of Wisdom: Psychological Perspectives'.

Do you have to be smart to be wise? Well, it helps. And it also helps to have experienced life and to know stuff. These things are necessary but by no means sufficient. Being "the smartest guys in the room" is certainly no guarantee of making the right decisions for the right people at the right time for the greatest common social good, as Bethany McLean and Peter Elkind noted in 'The Smartest Guys in the Room: The Amazing Rise and Scandalous Fall of Enron'.

The Berlin Wisdom Paradigm, through the measurement of "wisdom-related performance", has discovered that relatively simple social interventions can enhance wise decision-making performance. For example, asking participants to focus attention on cultural relativism and tolerance caused them to express higher levels of wisdom-related knowledge. Discussing the problem with another person, or engaging in inner dialogue with a person of their choice also resulted in improved performance. Even asking participants to address the question, "what is the wisest thing to do?" significantly boosted wisdom-related performance.

Here is how to use the Berlin Wisdom Paradigm to think about your decision outcomes (see **Table 2**).

Table 2

WISDOM-RELATED KNOWLEDGE	SELF-QUESTIONS
Lifespan Contextualism Draw on your experience and understanding of human development to achieve a good life	7. "How does my own life and the lived example of others help me in making this decision?"
Values Relativism Uphold your deepest values yet recognise the cultural differences of others in relation to the decision	8. "What personal values are critical for me to uphold?" 9. "What cultural values or significant others' values might be implicated?"
Common Good Imagine the greatest common good that may be derived from the decision	10. "What is the best possible outcome for everyone involved, and for society?" 11. "What is the wisest thing to do?"

Table 3

WISDOM PRACTICE	SELF-QUESTIONS
Compassion Act on the deep wish for everyone affected by the decision to know happiness and the causes of happiness.	12. "What do I feel inspired to do to make a meaningful difference in the lives of others?".
Mindfulness Develop sustained, focused attention, with deep awareness, and relaxation	13. "What am I aware of when I take the time to relax and bring my mind to a place of stillness?"

THINK ABOUT WISDOM

What makes a decision truly wise? The intention behind our decision counts, and how well we have thought about and considered the outcomes of the decision for all concerned definitely counts. But perhaps what counts at an even deeper level is the mindful expression and practice of compassion for all people everywhere, and a sincere desire to bring our lives to a place of meaning and service. We can't know whether this or that action will really matter in the end, but we can seek to imbue every decision, in business or in life, with compassion.

Here are two important practices to help you think about wisdom (see **Table 3**).

Making wise decisions takes practice, and courage. It takes years of developing self-awareness, experiencing life lessons and learning from them, thinking about our thinking and seeking to overcome biases and error, fully appreciating the different contexts, values and motivations of people across the lifespan, and seeking to make a contribution to human flourishing with compassion. Yet, it is possible to enhance our wisdom-related performance through thinking about our thinking, thinking about outcomes, and finally thinking about wisdom itself.

So, when you're faced with a really big decision or a dilemma for which there are no right or wrong answers, stop and think. Ask yourself, "what does it mean to make a wise decision here?" ✱

■ *Peter Webb is Director, Research & Curriculum at the Iclif Leadership and Governance Centre in Kuala Lumpur, Malaysia. Author of 'Coaching for Wisdom: Enabling Wise Decisions' in 'The Philosophy and Practice of Coaching' (2008), Peter has more than 20 years' experience facilitating conscious and long-lasting change in business leaders, teams and organisations across the Asia-Pacific region.*

BY ANGELA YAP

LEAN THROUGH LAYOFFS

ACHIEVING STRATEGIC AND SUSTAINABLE COST REDUCTION HAS PROVEN TO BE ELUSIVE AS THE BANKING INDUSTRY BATTLES A BARRAGE OF CHALLENGES ON THE COST AND REVENUE FRONTS. UNDERSTANDABLY, BANKS TEND TO RESORT TO COST-CUTTING, ESPECIALLY HEADCOUNTS, TO MEET SHORT-TERM PERFORMANCE TARGETS. *BANKING INSIGHT* EXAMINES IF THERE IS ANOTHER LESS DISRUPTIVE AND MORE HUMANE ROUTE TO COST-CUTTING FOR SUSTAINABLE GROWTH. IN OTHER WORDS, CAN BANKS LAY OFF ON THE LAYOFFS?

After a decade of growth wherein the banking sector in Asia accounted for over 50% of global profits, the region now faces what McKinsey & Co terms a "triple threat": macroeconomic slowdown on the back of what the IMF considers to be China's economic "rebalancing"; technological disruption arising from the onslaught of financial technology (fintech) firms; and weakening balance sheets with nearly USD400 billion worth of non-performing loans in Asia, an increase of nearly 7% over the past four years.

In response, financial institutions have embarked on waves of layoffs in order to cut costs. In Asia, industry benchmarking firm McLagan reported that eight of the world's biggest foreign banks have culled up to 15% of their Asian investment banks' front office headcount since 2012, with Hong Kong being the hardest hit. This follows a separate report by Dealogic that the gap between M&A fees paid by Asian and western clients widened to its highest level in over a decade, which the *Financial Times* reported was a strong impetus for deep cuts in the region.

One-off

Layoff, retrenchment, separation scheme, downsizing, rightsizing, and in recent literature, "junior-sizing" – whatever name one gives it, the objective is to use these one-off cost-reduction events to bring back or enhance profitability.

THE TRIUMPH OF SHORT-TERMISM

Layoff, retrenchment, separation scheme, downsizing, rightsizing, and in recent literature, "junior-sizing" – whatever name one gives it, the objective is to use these one-off cost-reduction events to bring back or enhance profitability.

Companies often use layoffs as proof of their responsiveness, evidence that they are in control in even the worst of times. But experts who have studied layoffs for decades have shown it to be a flawed strategy.

We don't have to look far.

Even in the latest round of cuts that began in 2015, there's ample evidence to show that layoffs have not translated to improved profits in the long run.

Take the top 10 global banks. McKinsey's 'Capital Markets and Investment Banking 2016' reports that the world's Top 10 investment banks' average cost-to-income ratios hit an approximate 76% in 2015, up from 61% in 2010, despite average front office full-time equivalents (FTEs) dropping from 6,100 to 4,900 FTEs.

But this has not been a deterrent in the street's thinking. Pink slips continue to be at the ready whenever the economy signals a downturn. Wharton Business School management professor Adam Cobb, in an April 2016 interview with *Knowledge@Wharton* magazine, calls this the triumph of short-termism, pegging such behaviour to changes in today's social norms.

"For most firms, labour represents a fairly significant cost. So, if you think profit is not where you want it to be, you say, 'I can pull this lever and the costs will go down. There was a time when social norms around laying off workers when the firm is performing relatively well would have made it harder," he said. "Now it's fairly normal activity."

This is corroborated by global leadership professor Wayne F. Cascio at the University of Colorado Denver, who said layoffs "have been pretty constant over the years, and it seems to happen no matter how the economy is doing."

A case in point: In April 2015, media reports were far from glowing when Toronto-Dominion Bank CEO Bharat Masrani approved cost-cutting measures despite declaring a profit of over USD2 billion just months prior at a February quarterly results conference call.

Masrani said the banks' move "is simply a reality of today's slower-growth world".

Another source interviewed by this writer and who wished to remain anonymous gave this brutal assessment: "If you disagree with retrenchments, don't work in finance."

"When the economy is down, it's always the argument that we've got to cut costs, and when it's doing well we often hear we need

to improve profitability because it's the best time to do it. The tune hasn't changed," said Cascio.

However, some are suggesting that change is imperative. With decades of data and research to prove that layoffs are blunt tools that don't properly do the job of boosting profits in the long-term, advocates are suggesting strategies that may just do the job better and change the dynamics of how retrenchment strategies are devised.

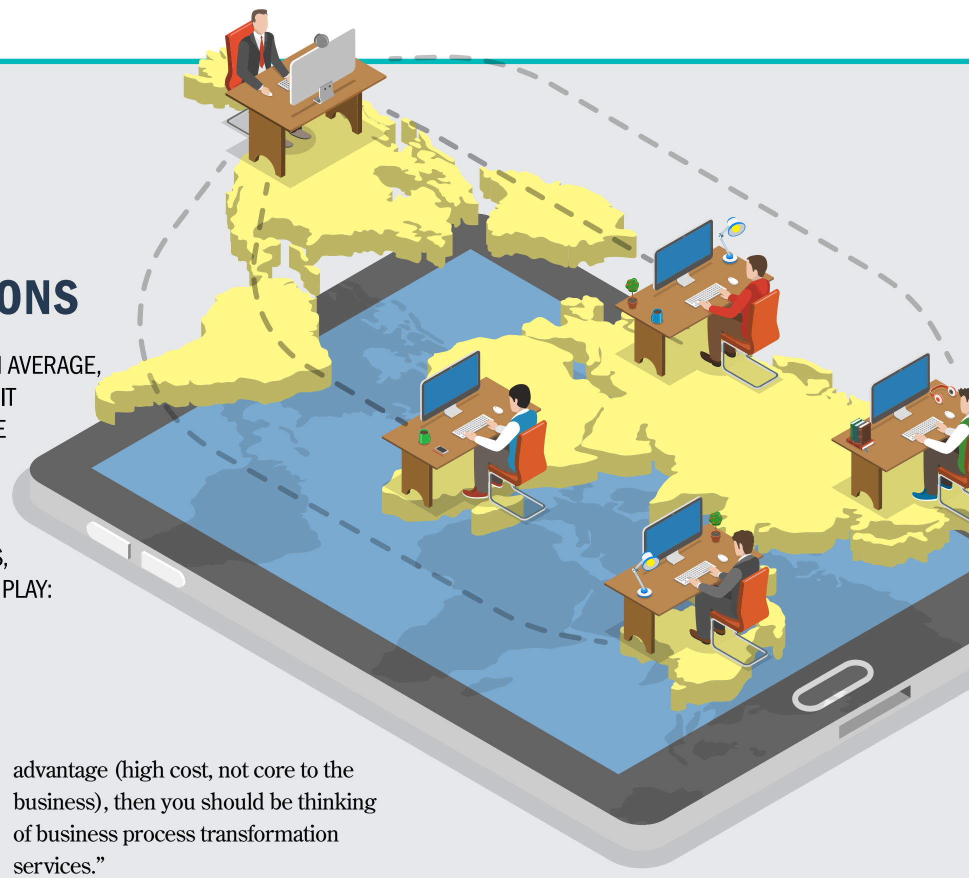
It won't be easy. According to Cobb: "The challenge is how do we get back to a more socially responsible way of handling employment, given the influence of financial markets on corporate decision-making?"

THE REAL COST OF DOWNSIZING

On 15 April 2016, American Express saw its stock price fall by 25% after it announced its "restructuring changes throughout the year" in a bid to shed USD1 billion off its cost base by 2017. It planned to achieve its 8% revenue growth target through corporate-wide cost cuts of a further 4,000 employees on top of its initial first cut of 7,000 in headcount in October 2015. The announcement came on the heels of a 63% drop in profit in 1Q2016 results that saw its stock price plummet by 25%.

Although its shares have somewhat recovered today, Fitch has maintained its negative outlook on the company, which "reflects continued execution risk as the company engages in strategic initiatives aimed at addressing the challenges related to its profitability and business model."

Such "execution risks" are rarely



REBALANCING OPTIONS

DESPITE A LESS-THAN-ROSY OUTLOOK, ON AVERAGE, BANKS ARE STILL TARGETING DOUBLE-DIGIT RESULTS. A LATEST SURVEY BY ACCENTURE STRATEGY REPORTS THAT THEY ARE AIMING FOR A RETURN ON EQUITY OF 11% AND AN AMBITIOUS COST-INCOME RATIO OF 35%-45%. OTHER THAN LAYOFFS, HERE ARE SOME STRATEGIES THAT ARE AT PLAY:

+ **Outsourcing, offshoring and strategic sourcing:** From build versus buy to outsourcing or strategic sourcing, Michael Blum, IBM lead banking partner for business performance services, in an interview with *Banking Systems & Technology* magazine, typified the process as breaking the business down into functional components where bankers can value the relative benefits for each and determine which way it needs to go.

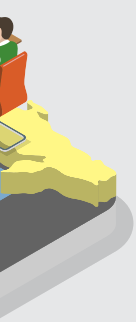
"For example, if you see a component that can create market advantage – account opening, perhaps – but (which) does not do so today, it more than likely will need to be replaced with packaged solutions," Blum said.

"If, on the other hand, you have components that will not gain you any market advantage but will continue to sustain operations in a cost-effective manner, then you may want to consider improving on those by making a minimum investment in custom development. If you see components that take away from your market advantage (high cost, not core to the business), then you should be thinking of business process transformation services."

+ **Simplifying the product proposition:** The most sophisticated banks oftentimes get caught up in the complexity of product offerings. Not long after RBS CEO Ross McEwan took over the helm from Stephen Hester in 2013, he streamlined the ailing banks' 109 credit card offerings, 36 savings products, and five mortgage platforms into a streamlined product set, simpler processes and fewer platforms. At the time, RBS only had 30% of staff facing customers daily. Bringing down the product mix options made it an easier sell and freed-up time for more face-to-face marketing activities with the client.

+ **Repurposing the workforce:** The disruptive effects of technology are undeniable, but banking is far from being in an apocalyptic Man versus Machine situation. Technology will not substitute but complement human skills. As banks move to reduce costs through electronic onboarding, KYC (Know Your Customer), e-CRM tools and financial technology (fintech) such as distributed ledgers and cloud computing, retraining current staff for higher-skilled jobs such as active client management and strategic decision-making will reallocate resources without the cost of future rehiring. The idea is to leverage the use of technology to put analytics at the fingertips of front line sales and trading staff.

+ **Leverage on competitive advantage:** Now more than ever is the need to fully capitalise on core competencies. For instance, at a 21 September 2016 conference, Moody's Investors Services reiterated its "stable" outlook for Malaysia's banking system on strong capital levels and liquidity profiles, with the agency's Islamic Finance Group



Global Head Khalid Ferdous Howladar projecting an increase in retail demand for Islamic financial products and services. Citing Malaysia's deep and mature Islamic financial market, he cited opportunities in the increasing issuance of international *Sukuk* with USD360 billion outstanding of the almost USD900 billion of *Sukuk* issuance since 2001 and pension fund participation as bright spots in the sector.

\+ **Adopting zero-based budgeting to unlock savings:** Cost reduction opportunities are typically identified by examining operating expenses in the aggregate. This is too general to unlock any clear indicators towards realistic and lasting savings, making the cost-saving initiative subject to blunt arbitrary cuts. A more sustainable alternative is zero-based budgeting (ZBB), quite literally "a technique for building a budget from zero", which has seen significant results in some industries such as consumer goods and retail. Accenture Strategy reported that by comparing the key performance indicators of ZBB clients against its peers (the respective industry's control group), on average, the ZBB clients reportedly clocked an increase in revenue of 28% versus its peer group's 22%, and increases in EBITDA as much as 50% versus 39%, respectively. Moreover, the report also found that in seven years, its ZBB clients in the consumer packaged goods (CPG) segment saw revenue increase by 42% versus the CPG peer group's 26%, and EBITDA by 52% versus 33%. Although banks mostly adopt the activity-based costing (ABC) method, ZBB has a compelling narrative for boosting top line.

accounted for when layoff strategies are drawn up. Undoubtedly, headcount reduction will give immediate relief to both balance sheet and profit and loss. But findings of a working paper by Zeynep Ton, an adjunct associate professor at the MIT Sloan School of Management, indicates that a reduction in staff strength leads to firms' reduction in profits over the long-run – short-termism at play again, with companies cutting payroll expense in order to meet short-term performance targets.

Layoffs create a string of other intangible losses along the way – low morale, loss of talent and the cost for big firms of employing and training new hires once business ramps up – which again are never reflected in balance sheets and profit and loss.

There will also be staff who opt-in for separation schemes, including senior personnel who may not be so easily replaced. The long-term costs of rehiring and retraining – which recruitment firms put at 18 months or less – may just wipe out any headway made from short-term cost savings. Top it off with costs of severance, compensation allocations, potential lawsuits, and loss of innovation, and these can add up to more than the annual salary of new hires.

BATTLE SCARS

Globally, Goldman Sachs, whose approach is to cut in gradual small numbers, has already reduced headcount by at least 2,000 – more if you include junior new hires to offset older staff, including 25% of its Asian investment banking headcount. This is the firm's deepest reduction since 2008. The cuts are considered normal course of business, as explained by its CFO Harvey Schwartz, who said in November, "You just have to run the business, and if the revenue environment is such that you're in a period of decline, you just need to take those actions."

With layoffs in Singapore last year, and its involvement in underwriting the billion-dollar 1MDB bonds, the bank has felt the pain of the Southeast Asian slowdown more keenly.

Total employees, including consultants and part-time workers, fell 5.4% to 34,900. The cuts mean that the investment banking stalwart expects to cut costs by allocating USD350 million to severance payments, an average compensation of USD134,000 each, although moving forward, it expects cost savings amounting to USD700 million per annum.

But history shows that struggles have been followed by a pick-up in a region which the International Monetary Fund (IMF) still projects to be the engine of global growth, accounting for over two-thirds of global growth to 2017 at a rate of 5.3%. Banks may find themselves hiring sooner than expected – resulting in another round of incurred recruiting costs, screening and orientation – and at a premium for valuable replacements.

Commenting on Goldman's repeated headcount cuts, Nisha Gopalan's 26 September opinion piece on *Bloomberg Gadfly* pointed out: "Rebounds in emerging markets show just how quickly an out-of-favour business area can become compelling again. Goldman is known for measured hiring when times are good. The bank may find its cuts were short-sighted when things pick up."

This alludes to the pockets of growth that are still exciting in Asia: the large unbanked and underbanked segments which McKinsey predicts could be up to one billion consumers, servicing small- and medium-sized enterprises with digital strategies and new collaborative fintech business models which banks are beginning to invest in, and the burgeoning wealthy middle-class in Asia that is anticipated to surpass that of North America.

Ultimately, Cobbs suggests that avoiding the pitfalls of short-termism would entail a world where long-term qualitative metrics are built into the judgement call banks make. "In that world, short-term pressures to boost profits and meet earnings targets are balanced by longer-term interests, and layoffs might, once again, be a practice employed as a last resort." ✱

BY DAVID GODES

AVOIDING A BUMPY RIDE ALONG THE ROAD TO DATA-DRIVEN DECISION-MAKING

ORGANISATIONS THAT WANT TO BECOME TRULY DATA-DRIVEN **MUST BE OPEN TO DIFFERENT ANSWERS** DERIVED FROM THE GENERATION, COLLECTION AND ANALYSIS OF DATA. IT'S ALL ABOUT THE DATA.

+ While the promise of improved decision-making across a range of departments and disciplines has attracted attention, it's also the case that just as many have found the implementation of these ideas to be somewhat more challenging than they had initially expected.

Among the topics of interest to managers today, few occupy as much mindspace as, take your pick, Analytics or Big Data or Data-Driven Decision-Making. While the promise of improved decision-making across a range of departments and disciplines has attracted attention, it's also the case that just as many have found the implementation of these ideas to be somewhat more challenging than they had initially expected. While no single book, article or real-world experience can channel the breadth of expertise needed to succeed in this new world, I have tried to identify the common mistakes that many organisations have made along the way in the hopes that we can learn from them and, at the very least, avoid them while perhaps making other ones.

Consider the following common and realistic example. Imagine that a bank has engaged in telemarketing for its home mortgage products. They've used two different scripts – "A" and "B" over the course of six months. It turns out that, by the end of this period, an analysis reveals that 12% of homeowners who heard script A applied for a mortgage while only 4% of those who heard script B did so. The focal question is, of course, what can the bank learn from this exercise and what can they do with the learning?

MISTAKE #1: MANY MANAGERS DO NOT UNDERSTAND THE DIFFERENCE BETWEEN DESCRIPTIVE, PREDICTIVE AND PRESCRIPTIVE ANALYSIS

As with the successful completion of any task, one must always be clear as to the desired objective: what am I trying to accomplish? In the realm of data-driven decision-making, specifically, one must clarify first whether the exercise of data analysis is meant to be descriptive, predictive or prescriptive. This is a commonly-skipped step of the process that can easily lead to the application of incorrect analytical techniques and possibly the wrong inference and insight. That is, this is more than simply a semantic distinction. It is one that can have important substantive implications.

Descriptive Analytics usually refers to an attempt to summarise or describe an event that occurred in the past. For example, in addition to the recognition that 12% and 4% of targeted customers applied following scripts A and B, respectively, the bank may also want to look at the extent to which these application rates varied as a function of other factors. These might include, for example, the respondents' affluence or gender or location. The descriptive analytical techniques used to accomplish this presentation of the data can vary from simple bar charts created in Excel to regression analysis to rich data visualisation rendered in a dedicated software application like Tableau. One must simply be clear that this is meant only to paint a picture of past events. Nothing more. Nothing less.

Implementing Predictive Analytics implies an attempt to generalise from a past set of observations in order to forecast what will happen in the future. For example, the bank may be tempted to conclude that the use of script A will compel, on average, about 12% of people to apply while script B will deliver 4%. Of course, there are many reasons why this may not be the case. Fundamentally, the assumption the analyst makes in drawing such a conclusion is that the other elements of the environment remain *ceteris paribus.* That is, all else remains exactly the same as was the case during the initial six-month testing phase of the two scripts. Of course, this is rarely going to hold strictly true. Therefore, a typical approach is to build a formal forecasting model that "controls for" – that is, reflects in the model – the various environmental factors that may have varied throughout the period and beyond: weather, economic conditions, interest rates, etc. This way, a forecasting model can be built that allows one to predict the success rate of each script in a specific context in the future conditional, again, on the assumption that the context will remain the same.

Finally, we implement Prescriptive Analytics when we're hoping to use the results of the analysis in order to select the optimal "intervention," or set of actions. It is critical for managers to recognise the difference between this approach and predictive analytics. Returning to the telemarketing example, the key question one might ask is whether we should adopt for all calls telemarketing script A, since it appears to have performed better? Indeed, consistent with our predictive analysis, assuming that the exact same conditions hold in the future as held during the six months of the test, it would seem that it garnered a higher response rate. However, does this mean that we should use script A always?

Absolutely not.

The reason is that, based on what we know, script A was used sometimes and script B was used other times but we don't know how they were chosen. Imagine, for example, if the following (very realistic) scenario is what actually transpired. Imagine that there are two types of customers: type A customers are easier to sell to and like the product. They respond to script A but not at all to script B. Type B customers are harder to sell to and respond to script B (albeit at a lower rate than A customers respond to script A) but not script A. Imagine further that the salespeople were skilled at identifying which type of customer they were facing before choosing the script. Then adopting script A for all telemarketing calls would actually lower the response rate, not increase it. Why? Because the skilled salesperson essentially had chosen the correct script for the given customer. By adopting script A for all customers, we would be losing all sales to type B customers.

We live in a time when more and more organisations are moving from a focus on intuition to a more data-driven approach to decision-making. While the idea of managing a large analytics group may appear somewhat daunting, starting from scratch is no less so.

MISTAKE #2: IGNORING THE DATA-GENERATING PROCESS

This leads to the second common mistake, which is to ignore what we'll call the "data-generating process." That is, what sequence of actions or decisions led to the dataset that we are able to observe. Why is this important? Because in deciding whether (and perhaps when) script A or script B should be chosen, one needs to be able to infer that there is a causal – not just correlational – relationship between the script and the response rate.

The best – and in many cases the only – way to ascertain cleanly the existence of a causal relationship is via an experimental data-generating process. While a detailed description of experiments is beyond the scope of this article, the main element that ensures a causal interpretation – absolutely

necessary for prescriptive analytics – is random assignment. That is, had we known that the data were generated via a random adoption of either script A or script B –perhaps via a new "coin flip" for each new call – then the 12% response versus the 4% would be enough for us to conclude that script A should be adopted over script B. To reiterate, the main point being made is that, in order to do prescriptive analytics, the "gold standard" approach is to implement clean experiments with random assignment.

Of course, such experiments may be difficult to do for a variety of reasons. They take time. They may be costly, in the sense that one may need to forego sales in the short run in order to learn which approach is best. Random assignment may be difficult to integrate into the business process flow. For these reasons, one may want to seek out "quasi-experiments" in the observational (i.e., non-experimental) data that has been collected. That is, the data-generating process may be "experimental enough" to infer causality and thus make prescriptions. For example, even if the organisation didn't formally randomly choose which script was presented to each customer, perhaps they can convince themselves that the choice was random enough. What is "random enough?" The critical test is that whatever factors that may have gone into the decision to choose A or B for a given customer is not related to the measure of interest which, in this case, is whether a customer applies for the mortgage or not.

At the end of the day, the main principle to keep in mind is that, even though we commonly think about complicated fancy models as being the core to data-driven decision-making, it's all about the data. If you're able to collect high-quality data – meaning a true experiment or a good quasi-experiment – then there's no need for any complicated analysis. However, if one is faced with purely observational data and it is clear from one's knowledge of the data-generating process that there are many factors making this non-experimental, then one needs to build a statistical model in order to make prescriptions for policy. The question, of course, is how to go about building these models and incorporating them into the business in order to guide decisions.

MISTAKE #3: HIRING A STATS GEEK AS AN "ANALYTICS RESOURCE"

We live in a time when more and more organisations are moving from a focus on intuition to a more data-driven approach to decision-making. While the idea of managing a large analytics group may appear somewhat daunting, starting from scratch is no less so. A reasonable approach may appear to be the acquisition of those analytic or statistical skills that your organisation may appear to lack most dearly. However, this may be the worst way to start. The reasoning behind this approach is that we understand the business side, we just need someone who understands model building and statistics. However, the true value of data-driven decision-making lies at the boundary of data and models, on one hand, and the business, on the other. In order to capture that value, the organisation needs to make a commitment to integrate these two pieces.

A critical component of this integration is the creation of an environment in which data speaks louder than intuition. This is driven in large part by the culture of the organisation. How "open" are employees? Do they value each other's ideas? It is also a function of the skills and perceived value of the analytics group. Positioning them as a quantitative "resource" for the rest of the organisation all but ensures that they will lose in any tug-of-war between intuition and data. The "knockout blow" will come via the claim that, "we understand the business, you don't." The immediate implication of this is simply that the analytics function needs to be built with individuals that live in both "worlds," with an understanding of both the business and the methods. They shouldn't necessarily be "stats geeks." They should be generalists, supported where necessary by technical specialists.

More and more empirical research has demonstrated the superior results that can be achieved when one admits that experience and intuition can only get you so far and is open to different answers derived from the generation, collection and analysis of data.

I hope this article has been of some help as your organisation begins, or perhaps continues, along the journey toward a truly data-driven organisation. More and more empirical research has demonstrated the superior results that can be achieved when one admits that experience and intuition can only get you so far and is open to different answers derived from the generation, collection and analysis of data. As Mark Twain put it best: "It's not what you don't know that gets you into trouble. It's what you know for sure and that just isn't so." ✱

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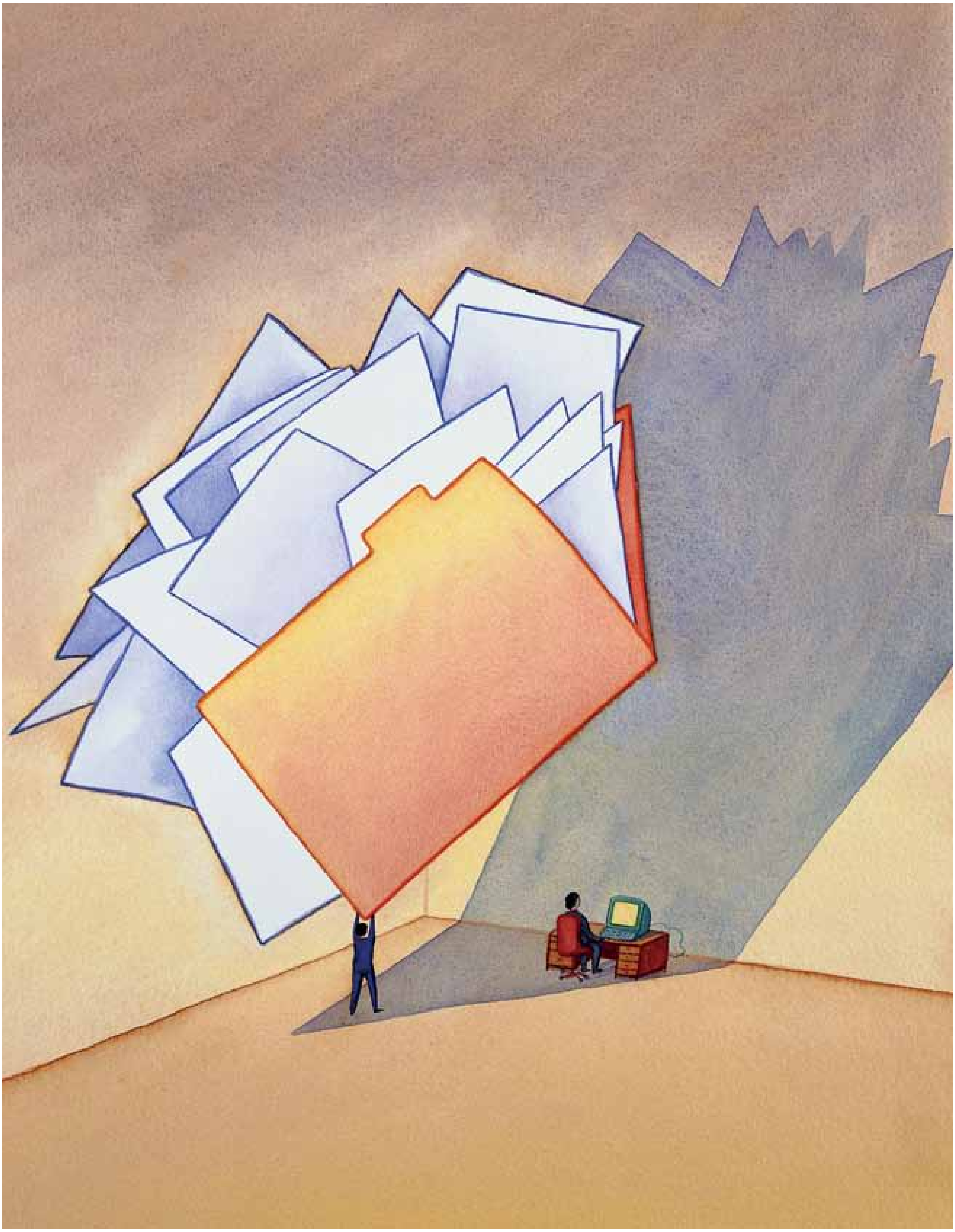
His work has appeared in top journals like Marketing Science, Management Science and Quantitative Marketing & Economics and he has authored numerous case studies on leading global firms. His research and opinions have been cited in a wide range of popular press outlets including The New York Times, Forbes, The Economist and The Boston Globe. David has also been the recipient of numerous teaching and research awards including the Krowe Award for teaching excellence at the University of Maryland and the INFORMS Society for Marketing Science's Long-Term Impact Award.

BY ANKIT KHANDELWAL



IFRS 9 – Too much, too soon or timely and responsive?

HAS THE PENDULUM ON RECOGNITION OF FINANCIAL IMPAIRMENT SWUNG FROM "TOO LITTLE, TOO LATE" TO "TOO MUCH, TOO SOON", ADDING UNNECESSARY VOLATILITY?

One of the most common warnings about the impact of impairment accounting under IFRS 9 is that impairment levels will be much more volatile. But is this always true?

First, let's distinguish between "volatile" and "responsive". IFRS 9 impairment models are intended to be more responsive to expected changes in both macro conditions and micro behaviour as compared to IAS 39.

One of the perceived failures of IAS 39 impairment models was that the recognition of impairment was "too little, too late". This delayed recognition is actually codified into IAS 39:

"Losses expected as a result of future events, no matter how likely, are not recognised." (IAS 39, paragraph 59)

So even if you could reliably estimate that a certain percentage of your "good" accounts would become "bad" in the next 12 months, you would not recognise any impairment against them today. Even "incurred but not recognised" (IBNR) provisions adhere to the principle that the loss events have already happened, even if the individual affected accounts cannot be identified.

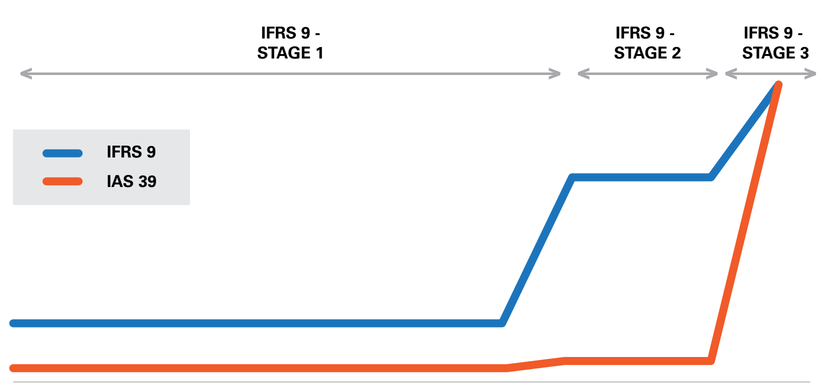
In contrast, IFRS 9 accounting recognises at least 12-month expected credit losses against even the best quality exposures, including newly originated accounts. For revolving credit products this includes off-balance sheet exposures. So not only does IFRS 9 anticipate future loss events and future macroeconomic conditions, it also anticipates future drawdown of unused credit lines.

So does the new approach create inappropriate volatility? Has the pendulum swung from "too little, too late" to "too much, too soon"?

Consider the following stylised example. Assume that Bank A holds only a trivial amount of IBNR provision against non-impaired accounts, and that IAS 39 impaired accounts map perfectly to IFRS 9 Stage 3 accounts, and that the chart below tracks one deteriorating account over time:

+ So not only does IFRS 9 anticipate future loss events and future macroeconomic conditions, it also anticipates future drawdown of unused credit lines.

IAS 39 vs IFRS 9 Impairment



The account attracts more impairment under IFRS 9 until it finally becomes impaired, at which point the two methodologies theoretically align. So which impairment calculation is more volatile? Arguably the IAS 39 approach creates more volatility because the major increase only occurs when the account becomes impaired, whereas the IFRS 9 approach reaches the same level in several material "steps".

In fact there are some ways in which IFRS 9 is actually intrinsically more stable than IAS 39 e.g.:

- Impairing against exposure rather than balance reduces large provision increases as both balance and risk increase
- Impairing against lifetime losses reduces artificial seasonality impacts
- A sound stage allocation methodology will more gradually build impairment against higher risk in order accounts

These models provide valuable early warning systems to enable more time to take mitigating actions. Surely we can be more prepared when we can see storm clouds in the distance, rather than waiting for the rain.

It is true that individual account provisions under IFRS 9 may be volatile as accounts move between Stage 1 (12-month expected credit loss provision) and Stage 2 (lifetime expected credit loss provision). But couldn't the same be said under IAS 39 as accounts move between "impaired" and "non-impaired" states, with greater consequences?

Moreover there are several ways to manage volatility under IFRS 9, including:

Adopting asymmetric stage definitions – define stage allocation rules to prevent large movements between Stage 1 and Stage 2. For example, if an account enters Stage 2 due to delinquency then introducing a minimum cure period before it can return to Stage 1 will improve stability

Managing unused credit lines carefully – large differences between current balance and exposures at default will amplify the impact of moving from 12-month to lifetime expected loss calculations

Balancing financial volatility across the portfolio – robust IFRS 9 impairment calculations will reflect actual portfolio dynamics so managing the asset (and exposure) mix in anticipation of the change will naturally reduce volatility and encourage active asset allocation strategies

Managing volatility of macroeconomic forecasts – enforce strong governance over updates to macroeconomic forecasts, including the frequency of updates and the probability-weighting of scenarios, in order to manage input volatility

Ensuring model stability – provisions will be based on expected loss models, often themselves derived from individual Probability of Default, Exposure at Default and Loss Given Default models. Following a rigorous and robust model design and development process will ensure these models are appropriately responsive without being inappropriately volatile

Optimising product design – the gap between lifetime losses and 12-month losses will naturally lessen where remaining contractual life is shorter, amortisation is more rapid and/or interest (discount) rates are higher

We shouldn't fear highly responsive expected credit loss models if they are accurate. These models provide valuable early warning systems to enable more time to take mitigating actions. Surely we can be more prepared when we can see storm clouds in the distance, rather than waiting for the rain. Earlier signs of credit deterioration enable more effective line management strategies for revolving products. Pricing and underwriting strategies can be adapted to anticipated changes in the economy. Collections and pre-collections activities can be prioritised based on a longer-term view of account health.

The distinction between responsiveness and volatility is not simply semantic. IFRS 9 models are supposed to react quickly to a range of expected changes but not be overly punitive. Taking a holistic approach to the end-to-end IFRS 9 implementation process will ensure that provisions respond appropriately to actual and realistically anticipated changes in portfolio mix, customer behaviour and macroeconomic conditions. ✱

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