IDEAS FOR LEADERS | **SECOND QUARTER 2017**

banking insight

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AN EXCLUSIVE INTERVIEW WITH TAN SRI AZMAN HASHIM
CHAIRMAN, AICB
REIMAGINING BANKS THROUGH ETHICS & PROBITY

The Importance of Effective Corporate Governance
By William Coen
Secretary-General
Basel Committee on Banking Supervision
Bank for International Settlements

BREAKING BAD BEHAVIOUR: RESHAPING BANKING'S ETHOS

Recent findings indicate there's still some way to go in regaining public trust. Can recent strides to rein in misconduct help banks make the quantum leap?

CRO: NEW PRIORITIES

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Editor's Note

VALUES, VIRTUE AND VALIANCE: KEYS TO GOOD BEHAVIOUR

TEN YEARS ON AFTER SUBPRIME SCANDALS triggered a global financial crisis, the aftermath of pain and systemic shock still lingers. Unsurprisingly, banks and financial institutions remain under scrutiny; despite compliance with stricter and more voluminous regulations, the behaviour of many prime institutions hogging news headlines indicates that the punitive lessons against self-serving greed and short-term satisfaction versus long-term sustainability were not fully imbibed.

The Asian Institute of Chartered Bankers places intense emphasis on embedding ethical behaviour, values and standards of professionalism among bankers and institutions in the banking sector, in order to revitalise public trust for a sector that has been reviled and vilified for bad behaviour. As such, it is timely that this issue of *Banking Insight* focuses on the sector's efforts to break bad habits and reshape the ethos of banking in a more ethical and sustainable mode. Apart from taking a helicopter view of banks' behaviour and culture post-crisis, *Banking Insight* zooms in on regulators' efforts to enhance good governance and the sector's own initiatives to change their culture and DNA to encourage boards, management and employees to embody desired and upstanding values. We shine the spotlight on the drivers behind banking misconduct and how regulators and banks are implementing appropriate guidelines and safeguards to better manage banking conduct risk. At a more granular level, we also look at how banks are conducting employee screening and due diligence to spot the bad apples which spoil the barrel and expose institutions to reputational risk, and how the appointment of an independent and empowered CRO is directly linked to mitigating risks and driving shareholder value.

As always, *Banking Insight* strives to cover developments emerging in the frontiers of banking to keep our members updated as part of our commitment to continuing professional education. Check out how fintech is being mobilised to improve microfinance and financial inclusion solutions and create better outcomes for the unbanked and underbanked. Cryptocurrencies and blockchain are topics *du jour;* central banks are experimenting with the possibility of launching central bank-issued digital currency, which could overcome current problems with regulating independent non-fiat cryptocurrencies and stimulate greater acceptance of digital payments. Plus, find out how banks are applying blockchain technologies to potentially revolutionise KYC and eliminate duplication of work, data tampering and, most significantly, reduce compliance turnaround, resources and costs.

While new is tantalising, the wisdom of hindsight offers substantial lessons, such as those shared by Tan Sri Azman Hashim, a stalwart icon of the banking industry and champion of financial inclusion for social good in an exclusive interview with *Banking Insight*. With more than fifty years' experience in business and governance, Tan Sri Azman's most pertinent message is that institutions must innovate, while becoming more ethical and customer- and stakeholder-centric to achieve longevity and sustainability.

Tan Sri Azman echoes other leaders calling for systemic and genuine change, driven by valiance, virtue and values at the institutional and individual levels. As BoE Governor Mark Carney said in a February 2013 speech in Ontario, "Virtue cannot be regulated. Even the strongest supervision cannot guarantee good conduct. Essential will be the rediscovery of core values… living the right values will be the most important challenge." Ten years on, have bankers instilled the changes necessary to reclaim public trust and rebuild tattered reputations? The jury is still out, but banks' behaviour shows that we still have far to go to live up to the standards expected of us by the public and other stakeholders. ✱

Hope you have a fruitful read.

The Editor

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ASIAN INSTITUTE OF CHARTERED BANKERS

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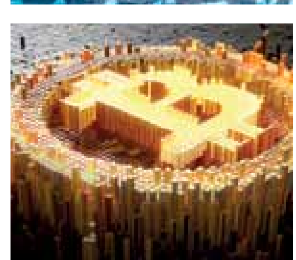

FRONTIER-ECONOMY BANKS TAKE CENTRESTAGE

The performance of Cambodian and Vietnamese banks stood out in The Banker's *2016 Top 100 Association of Southeast Asian Nations (ASEAN) Banks* ranking.

Although only two Cambodian banks – Acleda Bank (up 17 spots to No. 71) and Canadia Bank (debut at No. 94) – made the Top 100, the country's banking sector outpaced the region across the board in Tier 1 capital growth, total asset growth and pre-tax profits.

Bucking the trend in ASEAN jurisdictions, Cambodian and Vietnamese lenders registered year-on-year (y-o-y) pre-tax gains of 25.54% and 8.7% respectively. The two countries also led the tables with total asset growth of 23.03% and 13.36% respectively. Y-o-y aggregate Tier 1 capital growth in 2015, from which the banks are ranked, saw Cambodian banks securing top spot at 25.23% and Vietnamese banks at third place with 8.07%, behind Indonesia which clocked an increase of 9.36%. ✱

FINTECH
HACKS

Bank Negara Malaysia's Financial Technology Enabler Group (FTEG) launched its 'Fintech Hacks' initiative to actively engage with consumers to contribute ideas and improve the delivery of technology-based financial services in Malaysia.

The FTEG, established in 2016 to formulate and enhance regulatory policies for greater adoption of fintech in Malaysia, aims to identify pain points and aggregate public feedback to support innovations that will improve the quality, efficiency and accessibility of financial services in Malaysia via its website and using the social media hashtag *#fintechhacks*. ✱

28%

of CIOs and CSOs reported security compromises of mobile devices in 2016. **SECURING SMARTPHONES** is the No. 1 spending priority for authentication in 2017. – PwC 'Global State of Information Security® Survey 2017'.

USD678.5 BILLION OR AN 8.9% increase in 1Q2017 total deal value of global mergers & acquisitions (M&A) versus 1Q2016. Technology will drive M&A activity, with disruptive industries such as artificial intelligence, fintech and the Internet of things continuing to attract investor attention. – Katharine Dennys, EMEA research editor at Mergermarket.

GENDER MYTH BUSTER

Boston Consulting Group's latest research report, *Dispelling the Myths of the Gender "Ambition Gap,"* demolishes the myth that age and motherhood compel women to lower their career goals. Instead, the global survey comprising 200,000+ respondents, presents data to support findings that women's ambition levels vary based on corporate culture; when a positive corporate culture and attitude regarding gender diversity is cultivated, all women (including mothers) are eager to advance. Highlights from the report:

- **Ambition** is influenced by company culture. When both male and female employees feel that gender diversity at their organisation is improving, there is no ambition gap between genders.
- **Women** start their careers with as much ambition as men - or more.
- **Having children** does not make women less ambitious.

The firm recommends structural changes such as flexible work and building a gender-diverse leadership to promote greater participation and retention of women. ✱

REIMAGINING BANKS THROUGH **Ethics & Probity**

IN THIS EXCLUSIVE INTERVIEW, **TAN SRI AZMAN HASHIM, CHAIRMAN OF AMMB HOLDINGS BERHAD** AND THE ASIAN INSTITUTE OF CHARTERED BANKERS, SHARES INSIGHTS OF HIS JOURNEY AS A PIONEER IN MALAYSIAN BANKING AND HIS VISION ON HOW THE CHARTERED BANKING STATUS WILL ELEVATE STANDARDS IN FINANCE.

You are known as one of Malaysia's banking icons whose passion for the industry has contributed greatly to its development. What have been some of the highlights throughout your career?

I joined the banking fraternity in 1960 with Bank Negara Malaysia (BNM), which was established just two years prior, and am privileged to have interacted with all the BNM Governors – from the first Governor, Tan Sri W.H. Wilcock, to the current Dato' Muhammad Ibrahim, each with their own character and personality. It was Tun Ismail Ali, the longest serving Governor for 18 years, who brought me with him to an International Monetary Fund (IMF) Annual Meeting in Washington, on visits to major banks in Hong Kong, New York, Japan and sent me on a three-month high-level Bank of England course in 1963 in London.

In 1966, Tun Ismail gave me the opportunity to serve on the Board of Directors of Malayan Banking Bhd as an Independent Director during a difficult time in the bank, and later, as Executive Director, a role I was entrusted with for a decade.

My time with Malayan Banking was very exciting as we went all out to expand our footprint – increasing the number of branches, pioneering activities such as

computerisation, ATMs, and credit cards. I was involved in establishing the merchant bank, insurance company, setting up the Staff Training Centre in Bangi and together with the Chairman, Tan Sri Taib Andak, establishing Maybank's archetypal head office building in Kuala Lumpur, from acquiring the land from the Sultan of Selangor to commissioning its unique design by architect Hijjas Kasturi.

This period of my career was exciting and exposed me to the workings and intricacies of the finance sector.

The next phase of my journey was in 1982, when I acquired 100% of Arab-Malaysian Merchant Bank Berhad. As an owner and entrepreneur intent on building the merchant bank into a financial conglomerate, we acquired finance companies, insurance companies, a commercial bank and stockbroking firms through the open market, growing from a staff force of 200 to over 11,000 in 35 years.

The key to our success was talents at the helm such as the late Dato' Malek Merican as Managing Director, a top-class investment banker and contributor to the setting up of the Securities Commission (SC), the Real Estate Investment Trusts and the privatisation movement.

A significant and unforgettable event for me was the Asian Financial Crisis in 1997/98. The IMF formula of tight liquidity, high interest rate and no bailouts, created a lot of damage to our finance sector. The stock market collapsed as did the Ringgit. Fortunately, the Prime Minister's (Yang Amat Berhormat Tun Dr. Mahathir) moves, including releasing billions of Ringgit from the banks statutory reserves with BNM, brought down interest rates and provided liquidity to the system for banks to lend again. This was a painful time but I came through it with the support of my colleagues and the banking fraternity including Danaharta and local banks.

Such experiences have shaped my resolve on the critical role of education and training in professionalising the banking sector.

Since 2009, as the Chairman of the Institute of Bankers Malaysia, now known as the Asian Institute of Chartered Bankers (AICB), it is gratifying to see major events taking place to deepen the training and education of the financial services industry. AICB is currently constructing its building at a cost of about RM300 million with cutting-edge, world-class facilities. It will house the Asian Banking School (ABS), of which I am also the Chairman, and will be completed in early 2019.

As the founding Chairman of the Financial Services Professional Board (FSPB), an industry-led initiative by BNM and SC, it is crucial that we promote the highest standards of ethics, values and professionalism.

The trust and image of the banking profession worldwide have been badly impaired after the subprime mortgage crisis and financial crisis of 2008, and sorely needs improvement.

• As a pioneer member of the distinguished group of Fellow Chartered Bankers, in your opinion, what are the hallmarks of a Chartered Banker and why is it important for bankers today to consider attaining this qualification?

The last financial crisis highlighted the erosion of trust and confidence in banks and therefore, there is a great need to

elevate the state of professionalism in banking today. Bankers, just like lawyers and doctors, have an important role and responsibility to the public as they are intermediaries of public funds and must perform their duties in a professional and ethical manner to safeguard public interest. The Chartered Banker designation which is jointly awarded by AICB and the Chartered Banker Institute UK is not only recognised internationally as the gold standard in banking but also embodies the important aspects of being knowledgeable, skillful and professional. Professionalism is the cornerstone upon which being a Chartered Banker rests, as trustworthiness and integrity is imperative for a profession that ultimately serves society at large. Bankers who carry the Chartered Banker designation are also expected to play an important role as ambassadors in the banking community and inspire others to attain this gold standard in banking.

• **Since the global financial crisis, public trust in banks has taken a hit, undermining the credibility of the industry. What are your views on how professionalisation of the industry will change the current culture in banking, rebuild its reputation and restore public trust?**

There have been tremendous consequences on economies since 2008, with high profile scandals highlighting the critical importance and need for professional and ethical behaviour in banking globally. In some financial markets like the UK for instance, customers today want bankers who are professionally certified to do the job. In a UK-wide survey conducted by the Chartered Banker Institute UK in 2015, 88% of survey respondents who comprised customers of banks agreed that all bankers should pass professional exams and 84% would rather be a customer where all staff had passed banking exams. Though the Malaysian banking industry remained resilient during the crisis and bankers did not receive the same backlash as their counterparts in the UK and USA, there were many lessons to be learnt and professionalising the banking industry in Malaysia is definitely a step in the right direction. We need to ensure that the Malaysian banking industry is strengthened with a workforce that is equipped with the right skills, knowledge, and professional and ethical values that are vital in delivering high-quality service to the broader society. The banking industry needs to come together and embrace this in their institutional policies as it will further encourage the banking community to focus on not only the profitable aspects of banking but to also contribute and build a strong culture of ethics to further strengthen and secure long-term sustainability of the industry in addition to strengthening public trust. I would also like to add that as members of AICB, banking professionals will belong to a professional body which will not only provide a platform and opportunity to further enhance their professional education but members will also be bound by the institute's Professional Code of Conduct and must carry out 35 hours annually of continuous professional development which is crucial to maintaining ongoing competence.

• **Banks, overall, tend to emphasise and invest in the technical competence of its workforce. However, many of today's issues exist because of conduct risk.**

The last financial crisis highlighted the erosion of trust and confidence in banks and therefore, there is a great need to elevate the state of professionalism in banking today. Bankers, just like lawyers and doctors, have an important role and responsibility to the public as they are intermediaries of public funds and must perform their duties in a professional and ethical manner to safeguard public interest.

Post-crisis, conduct risk has emerged as one of the key challenges faced by banks and regulators. It is indeed a challenge to build a strong culture of "doing the right thing" and therefore, I strongly believe it is imperative to emphasise the importance of being ethical in tandem with technical competence when it comes to carrying out any duties that will impact public interest.

Where should abstract skills such as ethical decision-making and value-based judgements stand in banks' policymaking?

Regulators and standard-setters across the world continue to make significant progress in tightening and refining regulations in their efforts to strengthen global financial stability. However, there are still many instances of misconduct in banks that continue to come to light internationally which have shaken the cultural and reputational foundation of well-established financial institutions. Post-crisis, conduct risk has emerged as one of the key challenges faced by banks and regulators. It is indeed a challenge to build a strong culture of "doing the right thing" and therefore, I strongly believe it is imperative to emphasise the importance of being ethical in tandem with technical competence when it comes to carrying out any duties that will impact public interest. The world needs banking professionals who are not just highly competent, but also possess integrity and the right values to conduct a sustainable business. Setting the tone from the top is very important and will no doubt give an added impetus for the workforce to want to be professionally certified, competent and professional in delivering services.

The Governor of BNM, Dato' Muhammad, has also emphasised in his speeches the significant message of professionalising the banking industry and ethics as an inherent trait required of bankers as guardians of public funds. They have a duty to ensure good governance and guard against misconduct. Most recently, at AICB's 20th Graduation Ceremony in May this year, the Governor highlighted an important message on the need to improve leadership character and behaviour, and stressed that there needs to be a clear tone from the top that unethical behaviour will not be tolerated.

Further to this, he expounded the importance of bankers on attaining the Chartered Banker qualification. Additionally, to underscore the importance of ethics in banks' policymaking, BNM has continuously reinforced this objective through various initiatives including its upcoming publication of the five universal 'Principles of a Fair and Effective Financial Market', namely professionalism, integrity, transparency, competition and good internal governance, in consultation with the Malaysian banking industry. The BNM has also enhanced standards for corporate governance, strengthened requirements for KLIBOR rate-setting, introduced a Code of Conduct for the Malaysian Wholesale Financial Markets, and beginning 1 January 2018, a reinforced transparency framework for BNM's enforcement actions will be introduced as an added deterrent against misconduct. Therefore, setting the tone from the top is crucial to ensure good practices are emulated across the board, and with the support of BNM and AICB's Council Members, we hope to further strengthen industry's support in this national agenda.

• Malaysian banks are still facing a major shortage of skilled talent. In your opinion, as Chairman of AICB, how does your work with the Institute prepare bankers to meet this demand?

As Chairman of both AICB and ABS – AICB's exclusive training partner – there is a shared vision and commitment in elevating Malaysia's financial landscape by developing banking talent with both the right skills and values through our suite of professional certification and the various capability development programmes. AICB celebrates its 40th anniversary this year and I am pleased to share that it has produced over 18,000 certified banking

professionals to date, a showcase of the growing pool of banking professionals in Malaysia. AICB recognises the significance and need for continuous efforts to develop a pipeline of qualified banking professionals, both to support the expansion of the banking industry, as well as to ensure that existing players remain competitive in the highly regional banking sphere. To facilitate our efforts in creating a talent pool that is distinguished by its high standards of professional conduct, knowledge and competence, our Institute signed a Joint Declaration in November 2016 with 25 Member Banks of the Association of Banks in Malaysia, witnessed by BNM Governor Dato' Muhammad. I am pleased that this Joint Declaration makes our flagship programme, the Chartered Banker, the conduit with which to accomplish the aforementioned aims.

Furthermore, effective January 2017 all new graduates entering the banking industry are to complete a programme on professional ethics and become members of AICB. AICB has also signed a collaboration agreement with ACI–Financial Markets Association of Malaysia (FMAM) and ABS which significantly strengthens our relationship with FMAM and extends the reach of our educational and membership value to FMAM members. With these initiatives and support in place, we hope to increase the growing number of AICB members and banking professionals. The Institute is also committed to ensuring that our qualifications which are developed in close consultation with industry remain relevant and meet the needs of bankers today. At AICB, we continue our efforts to develop and contribute to a strong ecosystem of learning and professional development which is essential to building the professional standing of bankers in Malaysia and the world today.

• You've spoken about reimagining our banks and the finance sector through ethics and probity. Your work as past Chair of the FSPB and its recently-launched Code of Ethics underscores the practical measures taken to define good conduct, in addition to AICB's Professional Code of Conduct. What transformations do you foresee in Malaysia's banking sector arising from such initiatives to elevate professionalism and ethics?

AICB's mandate to professionalise the Malaysian banking industry and its Professional Code of Conduct is very much aligned to FSPB's Code of Ethics which includes the five principles – competence, integrity, fairness, confidentiality and objectivity. Together, AICB and FSPB strongly promote their respective codes and this further builds and strengthens the culture of professionalism which is anchored on a set of core ethical values. This is in itself an impactful start to highlight and create a greater awareness on how important the agenda on professionalism is for financial institutions in Malaysia and with its implementation, it is expected that financial institutions and individuals in the financial services adhere to these principles. With this, the FSPB Code of Ethics aims to enhance the overall reputation and public trust in the industry and it is hoped that it will be accepted not only in Malaysia but also internationally.

• With the rate of technological disruption, banking is currently undergoing a Renaissance. Bill Gates said: "The world needs banking but it does not need banks", indicative of the scepticism many people have about the future of banking and bankers. In your opinion, in the next 10 years, how will banking and the role of banks change to adapt to such an environment?

Rapid changes and developments in technology, regulatory requirements and customer behaviour are powerful forces that have reshaped and continue to reshape the global banking landscape. In my view, I still think customers will want physical banks in the next 10 years but I do believe that given the technological advancements in financial services, banks will certainly need to evolve and innovate in order to remain profitable and competitive. I also believe that in order to meet the future needs of banking, banks should steadily focus on being highly customer-centric – as customer behaviour and demands are changing rapidly – and simplify their business models and structures for greater agility. Additionally, banks also need to harness and use data intelligently to not only maximise profitability but provide greater insight into customer behaviour and identify trends which will assist them to create that greater customer experience for their customers. Most importantly, banks must continue to strengthen and build capacity and it is important for employees to update their knowledge base and skill sets so that they are able to foresee possible risks and challenges to operations going forward and remain in sync with the evolving business environment. ✱

BY ANGELA YAP

RECENT FINDINGS INDICATE THERE'S STILL SOME WAY TO GO IN REGAINING PUBLIC TRUST. CAN RECENT STRIDES TO REIN IN MISCONDUCT HELP BANKS MAKE THE QUANTUM LEAP?

BREAKING BAD BEHAVIOUR

RESHAPING BANKING'S ETHOS

Banking's major failures of the past decade are largely attributed to lapses in ethical behaviour. Whether the result of a single rogue trader or rate-fixing cartels, the effects have been devastating and long lasting. Despite an eight-point rise in global trust in financial services over the past five years, Edelman's *2016 Trust Barometer* indicates banking is still the world's least trusted sector for the fifth year running.

This view is reinforced in light of recent incidents that banking and the corresponding ecosystem that supports it continues to be beset by lapses in transparency, accountability and governance.

Take for instance the Bank of England (BoE) Deputy Governor Charlotte Hogg's voluntary resignation in March 2017 after it was revealed to members of Parliament that she had failed to disclose that her brother was the director of group strategy at Barclays Bank. The 46-year-old apologised and the BoE's Treasury Select Committee report stated: "The Committee considers that her professional competence falls short of the very high standards required to fulfil the additional responsibilities of Deputy Governor for Markets and Banking."

Public uproar also erupted in March when loss-making Royal Bank of Scotland announced its remuneration and compensation packages to top

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Public uproar also erupted in March when loss-making Royal Bank of Scotland announced its remuneration and compensation packages to top management. The bailed-out bank, of which the government owns up to 73%, announced it would award £16 million in shares to nine executives despite reporting losses of £8 billion in FY2016, its ninth consecutive year of losses totalling £58 billion.

management. The bailed-out bank, of which the government owns up to 73%, announced it would award £16 million in shares to nine executives despite reporting losses of £8 billion in FY2016, its ninth consecutive year of losses totalling £58 billion. The argument put forth by the current management team is that it should not be responsible for "legacy costs" and the approved bonuses reflect underlying profitability improvements in its operations.

There was also the tip-off that triggered official raids at Credit Suisse in five countries – the Netherlands, Germany, France, Britain and Australia – leading to scrutiny of thousands of accounts on alleged tax evasion and money laundering offences, at a time when Swiss banks have been aggressively trying to shed their reputation as a tax haven.

Then there was also scandal at professional service firms such as KPMG LLP's audit business in the US which ended with the firing of its top audit official Scott Marcello and four other partners over charges that they gave tips or advance word about which accounts its audit regulator, the Public Company Accounting Oversight Board, planned to scrutinise during annual inspections.

The question on everyone's mind is: Can banking truly reform?

'PREDILECTION TO CHEAT'

In April 2015, three economists at the University of Zurich published findings from their research on 'Business Culture and Dishonesty in the Banking Industry'. Recruiting 128 banking employees, each with about 11 years of experience in the sector (long enough to absorb the industry's norms), subjects were informed they would be rewarded USD20 each time the coin toss yielded the 'right' result, ushered into a private room, asked to flip a coin 10 times, and report the outcomes of each toss – heads or tails. In this first scenario, they reported the 'right' result 51.6% of the time – a statistically insignificant deviation from the norm of 50%.

However, the same group was then told to remember their profession as bankers, a social cue termed 'identity priming', and asked to repeat the experiment, after which 58.2% reported 'winning' tosses, an indication that over 25% had likely cheated in order to report wins. More worrying is the indication that this predilection to cheat is unique to the banking industry as repeated studies with non-bankers showed no deviation from the norm, pre- and post-identity priming.

"Our results," conclude the researchers, "thus suggest that the prevailing business culture in the banking industry weakens and undermines the honesty norm", a view that also concurs with many other studies by consulting firms that the prevalent practice of rewarding bad behaviour is deeply entrenched in the psyche of banking culture. As Alain Cohn, lead author of the research, summed up the phenomena in an interview with The Atlantic, "the apples are good, but the barrel is bad".

BoE Governor Mark Carney said in a February 2013 speech in Ontario: "Virtue cannot be regulated. Even the strongest supervision cannot guarantee good conduct. Essential will be the rediscovery of core values, and ultimately this is a question of personal responsibility. More than mastering

An analysis of the Financial Conduct Authority's (FCA) latest annual business plan outlining priorities and agenda for 2017/18 points to an increased focus on conduct management issues including the treatment of existing and vulnerable consumers, culture and governance, financial crime and cybersecurity as well as financial technology (fintech).

options pricing, company valuation, or accounting, living the right values will be the most important challenge."

Instilling organisational culture to encourage employees to "live the right values" is a challenge that expresses itself repeatedly in all jurisdictions.

The answer for most institutions is to create a safe climate for employees to report incidences without punishment or retaliation. US-based non-profit Ethics Resource Center's *National Business Ethics Survey®*, the American benchmark on ethical behaviour at Fortune 500® companies, discovered companies that implemented effective ethics and compliance (E&C)-based programmes saw reporting rates soar to more than eight out of 10 staff reporting misconduct compared to three out of 10 staff in organisations with weak or non-existent E&C programmes. Other key findings include:

- 97% of observed misconduct is either reported or taken care of by employees themselves in firms with effective E&C programmes.
- The 'tone from the top' is essential in determining employees' confidence levels that alleged misconduct will be investigated. 71% report misdeeds when they believe top management is committed to ethics versus 56% otherwise.
- Only about one in 20 employees (approximately 5%) suffer from retaliation in firms with strong probity programmes compared to 50% retaliation rates otherwise.
- In turn, organisations with high reporting levels and low retaliation rates create a virtuous cycle, lowering the probability of misconduct and reinforcing a strong ethics culture.

Instilling organisational culture to encourage employees to "live the right values" is a challenge that expresses itself repeatedly in all jurisdictions.

VALUES AS COMPETITIVE DIFFERENTIATOR

Post 2008, the UK experience, with one of the more mature regulators in the ethics sphere, is regularly adopted as the preferred industry benchmark in probity regulations. An analysis of the Financial Conduct Authority's (FCA) latest annual business plan outlining priorities and agenda for 2017/18 points to an increased focus on conduct management issues including the treatment of existing and vulnerable consumers, culture and governance, financial crime and cybersecurity as well as financial technology (fintech).

Accenture's research titled 'The Ethics and Conduct Challenge for US Banks: Learning from the UK Experience' identified five broad themes in banking conduct that will shape its landscape, not just in terms of regulation but also leveraging ethics as a competitive differentiator to rebuild the sector:

+ Cultural Change

Financial institutions (FI) are moving away from a poor ethics culture, defined as one that merely fulfils the letter of the law but not its spirit. The former is a result of incentives focused on short-term benefits and growth rather than prioritising longer-term customer or public benefits. Firms that show the most progressive and successful probity programmes and change in employee mindsets are distinguished by undertaking proactive and concrete measures such as an overhaul in fee and commission structures to a values-driven screening of potential new hires by human resource. In all aspects of operations, values should be the driving force and strategic differentiator.

+ Personal Accountability

The emphasis by regulators on individual accountability and the role of senior

CASE STUDY:

UK POLICIES TO RESHAPE WHISTLEBLOWING

The UK's Financial Conduct Authority (FCA) was one of the first regulatory authorities to acknowledge that lapses in ethical behaviour resulted in the mis-selling of credit default swaps, one of the triggers of the financial meltdown. Acknowledging the lack of an ethical work culture at FIs forced it to move aggressively to change employee behaviour in banks.

Recognising that bank employees may be reluctant to voice concerns about noticeable bad practice for fear of personal and professional repercussions, the FCA and the Prudential Regulation Authority (PRA) took active steps to strengthen whistleblowing legislation in order to encourage a 'speak up' culture at FIs. The wisdom behind this move corroborates research findings by other professional bodies such as the Association of Chartered Certified Accountants that cultivating a 'speak up' culture and strengthening whistleblowing policies can significantly increase the levels of trust within firms and consequentially reduce the risk of misconduct.

In 2013, a UK parliamentary commission recommended that banks put in place mechanisms to support their employees in whistleblowing. By October 2015, the FCA and PRA had introduced new rules requiring banks and insurers to introduce whistleblowing procedures internally. This included requiring that whistleblowing channels be open to all, firms' obligations to tell employees about such whistleblowing services, and introducing a Whistleblower's Champion at a senior level within organisations.

After a series of industry consultations, on 3 May 2017, the FCA issued a Policy Statement extending whistleblowing protections to foreign banks' UK branches beginning 7 September 2017.

The programme has thus far had a net positive effect in public perception according to consulting firm Navex Global's most recent *UK Financial Services Whistleblowing Regulation Survey* assessing the impact of FCA/PRA whistleblowing rules. Among its key findings:

- A significant number of respondents shared positive outcomes as a direct result of the whistleblower regulations. 21% reported **improved employee behaviour and organisational culture**; 12% experienced an increase in trust and awareness of whistleblowing programmes.
- Although 46% stated that there has been **minimal or no impact following the regulations,** there was a 3% increase in the volume of whistleblowing reports received since the regulation came into effect.
- Board level **involvement with a firm's whistleblowing programme** increased dramatically, from 24% prior to the regulation to 62% post.
- Compared to other sectors, staff at FIs are more likely to file a report with a regulator on the second attempt to raise a concern, another incentive for firms to **build trust internally** by instituting proactive whistleblowing systems so that employees are not tempted to resort to external sources for action, avoiding not just stiffer penalties but also reputational damage.

management is coming to the fore. For instance, a central database listing code of conduct violations by traders has been proposed by the Federal Reserve Bank of New York and the UK's move to impose certification under the Senior Managers Regime – which commenced on 7 March 2016 – have put the onus of doing right squarely on the shoulders of individuals by clearly mapping who does what in the firm.

+ Mis-selling Scandals

This is the prime source of legal as well as reputational risk. Existing business models, strategies and operating models can lead to instances of conflict of interest. Key areas of focus cited by the FCA and the US' Financial Industry Regulatory Authority, Inc., include misconduct when selling to seniors and vulnerable people, embedded product features such as hidden fees or overly complex bundling beyond layman understanding, and a lack of transparency in sales and distribution practices. In the UK, a mixture of regulation, staff re-education programmes to include ethical modules, and adoption of technological innovations to identify and support vulnerable groups has been effective in raising public trust as well as driving shareholder value. The next priority for institutions on this front is to establish early warning systems or procedures to detect bad behaviour.

+ Market Conduct

Globally, regulators are addressing information leakages and conflicts of interest including cross-market and cross-product manipulation. The UK is stepping up measures to train and professionalise banking as a pathway to increased personal accountability, and also investing in fintech such as blockchains and roboanalytics for forward-looking conduct risk identification methods e.g. analysing high volumes of transaction data, conducting probability analyses and detection of false positives.

+ Information and Social Media

Designating the right communication channel for product promotion and securitisation of personal data are primary concerns. Regulators are reviewing legislation/policies that will put customers first, including how information is presented on all platforms – from mobile devices to paper contracts – including real-life customer testing for at-risk groups such as senior citizens, ensuring that critical information on risk is truthfully and appropriately conveyed.

Asia can significantly benefit from these lessons learnt in crafting its own conduct agenda for the region, applying this throughout the spectrum of regulatory and compliance-related activities. The end game is the implementation of successful probity programmes that can help banks reposition themselves and get back on track to profitable growth.

'LIGHT TOUCH' NO MORE

The *New York Times'* 14 March 2017 feature, 'Focus on Bank Culture is an Odd Regulatory Strategy", described the shift and priority of central banks to codify and enforce a set of living values for banking as "no easy proposition'.

Aside from the most obvious and challenging task of operationalising ethics, this shift in banking supervision to reshape banking culture implies that the 'light touch' regulatory approach of yesteryears – characterised by 'box ticking' and standardised reporting – will now make way to emphasise judgement-based decision-making and how the sector will incorporate processes and procedures to challenge dominant or established ways of thinking and doing in banking.

This is a unique challenge. Institutionalising ethics requires both a reequipping of skill sets and revisioning of what it means to be a banker.

Far from being complacent, the global agenda to professionalise the industry charts new territory, according it due recognition par with other guild professionals of accountancy, medicine and law, and shaping the ethos of next-generation bankers. ✱

■ *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.*

MANAGING CONDUCT RISK: ASIAN INSIGHTS

On the road to restoring public trust in financial institutions, Asia needed to carve its own path to tackle misconduct and restore public trust. How has it fared thus far?

Conduct risk – succinctly described by the European Systemic Risk Board as "risks attached to the way in which a firm and its staff conduct themselves" – is prevalent at every touch point in a financial institution (FI).

Due to its vast scope – ranging from the treatment of vulnerable customer segments to manipulative behaviour in the structuring of financial products – controlling this far-reaching risk class has posed practical challenges to FIs.

The Conduct Cost Project, an associated research project by CCP Research Foundation, reports that the financial consequences of misconduct at 20 major global banks clocked £252.25 billion in the 2011-15 period.

But more pressing is the opportunity cost this risk poses to the sector. Bank of England's Minouche Shafik in an October 2016 presentation titled "From 'Ethical Drift' to 'Ethical Lift': Reversing the Tide of Misconduct in Global Financial Markets" put the figure at £275 billion since 2008 which translates into more than £5 trillion in reduced lending capacity to the real economy. In similar vein, the European Systemic Risk Board's June 2015 reporting on misconduct risk in the banking sector pronounced lower Common Equity Tier 1 ratios of global systematically important banks due to fines.

Regulators in the US and Europe – markets directly

impacted by the global financial crisis – have charted the course for greater oversight of conduct through the establishment of dedicated agencies such as the UK's Financial Conduct Authority (FCA) and the US' Financial Industry Regulatory Authority, Inc. (FINRA).

Asia too has moved in a similar direction, though in a more contextualised manner with slightly different priorities. The end goal however is the same – to encourage banks to do the right thing by moving away from standardised reporting and embracing a judgement-based approach to address the underlying causes of misconduct.

REGIONAL PRIORITIES

In an interview with *Banking Insight,* Ei Leen Giam, Regulatory Advisory Leader at Deloitte Southeast Asia, weighs in on the regions' progress thus far: "Generally, banks in Southeast Asia are trailing behind their Western counterparts, particularly, the European banks in the wake of the scale of enforcement actions taken against these banks. The Dutch and UK regulators have instituted regulatory frameworks and tools laying ground for supervisory action in the area of conduct and culture."

Citing De Nederlandsche Bank, the Dutch central bank's comprehensive supervisory framework on behaviour and conduct and the FCA, these moves are representative of increased scrutiny and engagement by the regulators and the tightening regulatory environment and engagement with individual firms on issues of conduct and culture, pushing for enhanced rules on accountability, incentives, fair treatment of consumers and whistleblowing.

Although Asia is seemingly late to the game, this is best explained through regional patterns that evolved in response to the global financial crisis (GFC).

Though the crisis exposed severe shortcomings in the global financial architecture, these lapses arose out of the US subprime mortgages with a primary contagion effect to Europe. Studies have shown that systemic contagion to the rest of the world, including

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An OECD Economics Department Policy Note published in June 2012 titled 'Financial Contagion in the Era of Globalised Banking?' stated: "During the recent global financial crisis, all countries suffered from strong contagion, but the regional patterns were different from the earlier crises of the 1990s. This time, Latin American and Asian economies were among the least affected, whereas advanced economies and European emerging countries were those exposed to the strongest contagion shock."

This supports early-day findings of Asian regulators in the months following the GFC. Noted economist Dr. Rakesh Mohan, then Deputy Governor of the Reserve Bank of India, remarked at an IMF-FSF meeting in Washington D.C. on 9 October 2008 that Asian banks, having shaped up its financial institutions as lessons learnt from the Asian financial crisis in the late 1990s – including overhaul of its financial regulations, strengthening oversight of financial institutions which helped reduce risk-taking by households and firms – were already in better initial conditions than their Western counterparts at the onset of the GFC.

More recently, academicians such as Prof. Richard Pomfret, advisor to multilateral agencies such as the World Bank and Asian Development Bank and former professor of economics at Johns Hopkins University, affirmed the view that Asia did not experience significant financial crises and open economies in the region recovered relatively rapidly from the GFC.

Additionally, the same OECD Policy Note evidenced the trend that "higher banking sector capitalisation and larger reliance on deposits have reduced vulnerability to financial contagion" with countries where banks have funded credit to a larger degree through deposits having lowered risk of bank balance-sheet driven contagion leading to a banking crisis. Today, ASEAN banks like Malaysia have met and exceeded Basel III requirements for capital adequacy ratios, ahead of European and American banks.

Nonetheless, the need for concerted global action is necessary if the intention is to nip misconduct at the bud.

At the most recent Financial Stability Board Regional Consultative Group (FSB RCG) for Asia held on 9 June in Bangkok, the spotlight for regulators was on the restoration of public trust through the use of governance frameworks to address misconduct risk in the finance sector. The deliberations, among others, included the role of supervisors in influencing appropriate culture and the FSB's Working Group on Governance Frameworks which was established to explore the use of governance frameworks to mitigate misconduct risk with a view to potentially developing a supervisory toolkit or guidelines.

Thus, although the task of managing conduct risk in financial services in Asia has evolved at its own pace and in a different context from its Western counterparts, avoiding a recurrence of the lapses of the GFC is today a global priority. Risk misconduct directly impacts stability of the sector in toto and any meaningful toolkit or guidelines needs to comprehensively cover the spectrum of global experiences. The current stocktake on the state of affairs by the FSB will culminate in a March 2018 report on efforts by national authorities, firms, international bodies and industry associations to mitigate misconduct risks, including culture, Board membership and effectiveness, risk management and internal controls plus people management and incentives.

What is certain though is that by managing misconduct early on, financial institutions in the region have the potential advantage of improving overall profitability at significantly lower levels of regulation than currently imposed in the West.

Though the crisis exposed severe shortcomings in the global financial architecture, these lapses arose out of the US subprime mortgages with a primary contagion effect to Europe. Studies have shown that systemic contagion to the rest of the world, including Southeast Asia, was secondary.

COMMON THEMES IN MISCONDUCT

Giam described the progress of Southeast Asian firms as "largely compliant, with published actions

of gross misconduct being the rare exception rather than the norm". Nonetheless, Southeast Asian regulators have identified several areas of improvement given the climate of heightened focus by the Financial Stability Board on misconduct risks.

Most recently, Giam cited Bank Negara Malaysia's 13 April 2017 publication of two documents to enhance market conduct. The first concept paper on proposed Principles for a Fair and Effective Financial Market serves as an anchor for various codes of conduct and any activities related to promoting the fair and effective functioning of the financial market; the second is a new code of conduct for Malaysian Wholesale Financial Markets that sets out the principles and standards to be observed by market participants and the role of industry associations in preserving stability.

Overall, she predicts regulators in Southeast Asia will gradually introduce more reviews and initiatives to enhance compliance practices within the industry.

"Within Southeast Asia, we note that enforcement actions in relation to insider trading, false trading or unauthorised trading taken against individuals who are not employees of financial institutions are generally more common," Giam says.

In recent years, however, such high profile cases of misconduct by both financial institutions or employees of financial institutions have become more prevalent in the public eye. Referencing the eight drivers of misconduct model (see box story), Giam indicates the most common theme of lapses in Southeast Asian compliance culture are: (i) individuals and leadership are not responsible or held to account for misconduct; (ii) failure to identify and manage conflicts of interest; (iii) disparate subcultures or a problematic prevailing culture.

"It is difficult to pinpoint exactly the root causes underlying such misconduct in view that the eight drivers often overlap in a firm due to their intertwined nature," she says. "Nonetheless, from the examples of conduct failings above, we can see that financial institutions are more likely to be susceptible when there is a poor corporate compliance culture due to unpunished misbehaviour, failure to manage conflicts of interests and lapses in behaviour of supervisors and/or senior management."

"Notwithstanding, financial institutions should not disregard that the key drivers tend to work together to create an environment that incentivises and reinforces problematic behaviour, hence all eight areas should be considered when formulating their approach towards conduct risk management."

BULLISH ON ASEAN

Early signs point to growing trust in financial services (FS) globally. The latest *2016 Edelman Trust Barometer* clocked an eight-point rise in FS global trust over a five-year period.

This marks an opportune time as ASEAN is primed to be at the receiving end of global growth. The *2016 ASEAN Business Outlook Survey* indicates broad optimism of US companies in the region on the back of the ASEAN Economic Community (AEC), a turnaround from previous years of scepticism, with investors especially bullish about expansion prospects in Myanmar, Indonesia and Vietnam.

The AEC Blueprint paves the way for greater financial integration that includes, amongst others, liberalisation of capital account regimes, inter-linked capital markets, and harmonised payments and settlements systems. This underscores the urgency for banks in the region to strengthen integrity of the sector.

Embedding a risk culture is challenging – there is no 'one size fits all' solution and much of the work to be done is in uncharted territory. What is certain though is that banks that take control of organisational risk culture will eventually reap the rewards of improved relationships, business performance and financial profitability.

Notwithstanding, financial institutions should not disregard that the key drivers tend to work together to create an environment that incentivises and reinforces problematic behaviour, hence all eight areas should be considered when formulating their approach towards conduct risk management.

Ei Leen Giam
Regulatory Advisory Leader
Deloitte
Southeast Asia

08 DRIVERS OF MISCONDUCT

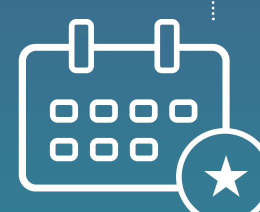
DELOITTE'S CENTRE FOR REGULATORY STRATEGY RELEASED ITS REPORT **'MANAGING CONDUCT RISK: ADDRESSING DRIVERS, RESTORING TRUST'** IN MARCH 2017, HIGHLIGHTING THE EIGHT DRIVERS OF MISCONDUCT THAT INCENTIVISES, REINFORCES AND SPREADS PROBLEMATIC BEHAVIOUR:

1 DISPARATE SUBCULTURES OR A PROBLEMATIC PREVAILING CULTURE

Deemed the "heart of ethical lapses within financial services", the disconnect occurs when the tone at the top – through explicit and implicit behaviour – is out of sync with expressed organisational aspirations. Improving the firm's culture is a central element in the restoration of trust in the financial system that, in many firms, is today being practically addressed through active change management programmes through retraining of its workforce and more regular discussions at the Board level with regard to risk, conduct and compliance. Sweeping regulatory reviews from regulators such as FINRA's targeted exams on how firms establish, communicate and implement cultural values and whether these are guiding appropriate business conduct, and the Hong Kong Monetary Authority's guidance on promoting sound culture in banks consistently emphasise the need to improve and maintain good firm culture.

2 CUSTOMER NEEDS AND SUITABILITY ARE NOT GUIDING PRODUCT LIFECYCLE PRACTICES

Various product governance and consumer protection obligations across jurisdictions mean that firms need to understand whether products are fit-for-purpose and actions are in the customer's best interest. For instance, in December 2016, the Australian government issued a proposal paper titled 'Design and Distribution Obligations and Product Intervention Power' that aims to subject issuers and distributors of financial products to supplemental disclosures as a form of enhanced consumer protection to reduce product failures and/or mis-selling of financial products that do not meet their needs.



3 FAILING TO HAVE A "BALANCED SCORECARD" FOR HUMAN RESOURCE DECISIONS

Recruitment, remuneration, promotion, professional development, and dismissal decisions that value short-term revenue generation over other important aspects of performance can incentivise misconduct. For instance, recruitment that consistently ranks a history of sales or trading success above other key factors such as customer satisfaction or management skills will tend to build a workforce whose behaviour mimics this ranking. An example is trading strategies that ignore market integrity rules and longer-term performance because an individual's bonus is based on short-term trading profit, an area which conduct guidelines such as the Bank of International Settlements' FX Global Code aims to address and rectify. The use of balanced scorecards – a performance metric designed to identify and improve various internal functions of a business and their resulting external outcomes – is employed to create a behavioural shift by rewarding good conduct.

4 INDIVIDUALS AND LEADERSHIP ARE NOT RESPONSIBLE OR HELD TO ACCOUNT FOR MISCONDUCT

It is required that all three lines of defence in a bank – frontliners who should "own" risk assessing and management; risk officers as second line of defence for monitoring; internal audit as the third line to test and escalate matters to the Board – work simultaneously to curb bad behaviour. This is effectively carried out by creating a "speak up" culture, strengthening complaints and whistleblowing processes to ensure provisions are in place to protect against potential retaliation.

5 FAILING TO IDENTIFY AND MANAGE CONFLICTS OF INTEREST

Non-action in instances of opportunism, ranging from internal processes such as insider trading and to more wide-ranging rate-fixing scandals, incentivise misconduct. In light of this, a stable of regulator-driven ethics rules such as the US' Volcker Rule, part of the Dodd-Frank Act, as well as enterprise-driven actions to build 'China Walls' between operations, are ongoing.

6 COMPLEX, DISCONNECTED OR "GROWTH AT ALL COST" BUSINESS MODELS

There may be a tendency to develop silos where different cultures, behaviours and operational practices incubate, leading to overlooking of early warning signs. Entities working across multiple jurisdictions have the additional vulnerability of "inharmonious and challenging state, national, and global regulation" resulting in incongruent interpretation of policies. In response, the industry has adopted a more holistic approach to good governance and supervision enforcement. For example, Japan Financial Services Agency advocates a "dynamic supervision" approach beyond minimum standard, moving from "a formality check of financial institutions compliance with rules and regulations" to one of best practice providing "better quality financial services to customers".

7 MANUAL AND COMPLICATED PROCESSES AND PROCEDURES

This includes lengthy and convoluted compliance policies, repetitive risk approval processes and frequent changes to process and procedures which have become endemic in many regulated businesses. In such instances, misconduct may be accidentally triggered due to a lack of understanding. Hostility may build around what individuals deem to be "bureaucratic roadblocks", undermining the integrity of risk and compliance procedures built to prevent such poor conduct in the first place. The result: a move by FS towards simpler, fewer but better rules, as well as automation through digital transformation projects to reduce human error.

8 WEAK MONITORING AND SURVEILLANCE SYSTEMS

This inadequacy exposes the leadership to continued misconduct. Criticisms in this regard range from outdated control procedures to inaction upon detection and many banks have boosted monitoring and surveillance capabilities in light of greater regulatory oversight either by shoring up on compliance headcount or deploying financial technology such as integrated ledgers and roboanalytics. ✱

■ *Angela Yap is a multi-award-winning entrepreneur and founder of Akasaa, the social enterprise. An ex-corporate banker, she writes on issues of business, finance, ethics, human rights and social history. Julia Chong is a KL-based writer and researcher.*

REDESIGNING MICROFINANCE

SERVING THE UNDERBANKED

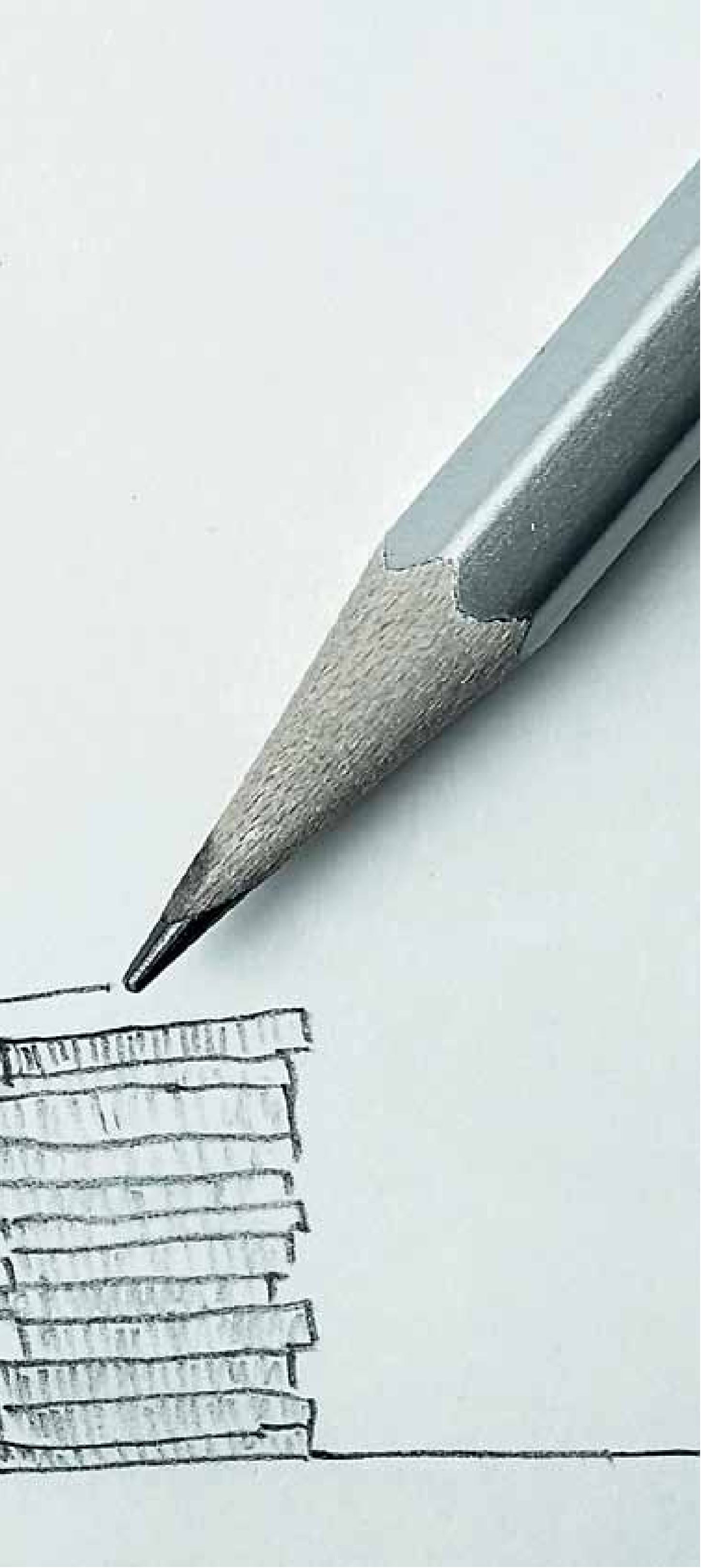
Despite being hailed as a miracle, microfinance has so far been plagued by systemic deficiencies. Now, coupled with financial inclusion, how can it be improved to help the poor escape poverty?

Over the years, many a solution has been proposed to eradicate poverty and economic inequality. Few have gained the same popularity as microfinance.

Developed in the 1970s by Nobel Prize winner Muhammad Yunus, microcredits would soon be complemented by a suite of financial instruments from microinsurance to savings accounts and fund transfers. Today, the World Bank estimates that the global microfinance industry is worth USD60 billion-USD100 billion and serves up to 200 million people worldwide. This constitutes only a fraction of the two billion people without financial accounts globally, 59% who cite lack of money or unaffordability as the main reason for being unbanked or underbanked. Almost 25% of the global unbanked reside in East Asia and the Pacific. In ASEAN alone, 50% of adults lack a financial account.

Unsurprisingly then, microfinance has increasingly been deployed with the concept of financial inclusion in recent years. "Financial inclusion," says Dato' Wan Mohd Fadzmi, Agrobank President/Chief Executive Officer via email, "is both a development imperative for the underserved community and a forward-thinking approach to unlocking economic potential in new and disenfranchised markets."

Where microfinance provides a capital boost, financial inclusion delivers the required services to save and grow that same capital. Through these twin silver bullets of accessible and inclusive finance, the unbanked and underbanked populations can be brought into the financial fold and onto the path out of poverty.



TWO SIDES

Devotees of microfinance and financial inclusion wax eloquence on its benefits. It provides the poor with the credit necessary to build businesses, improve incomes, and stretch savings. It boosts gender equality by empowering women with individual finances; generates macroeconomic growth by pulling money out of shadow banking systems or from under mattresses and into the light; and insulates the poor vulnerable to economic shocks by insuring their risk.

Yet data — specifically on the microloans constituting the bulk of microfinance — is mixed. For every anecdote of an individual touched by the hand of microfinance and climbing out of the pits of poverty, there are other stories of being cursed by the rampant indebtedness trailing in its wake. Overall, says David Roodman from the Centre for Global Development, "The best estimate of the average impact of microcredit on the poverty of clients is zero."

While some have been quick to lay blame on poor economics for these disappointing results, claiming that the unbanked squander capital and financial opportunities, the fault also lies in the design of the microfinance model and system. Microfinance and financial inclusion may be noble goals, but they are often subsumed by the commercialisation of poverty.

High administration costs and ensuing defaults hamper microfinance's success. Exorbitant interest rates — which can exceed 100% in countries like Mexico and India — charged to breakeven or profit off microloans can shackle entire communities to debt: Cycles of poverty perpetuate themselves when borrowers resort to taking out multiple loans to repay the original debt.

On the other hand, while microfinance is aimed at underserved communities, the IESE Business School notes that it still has trouble reaching those most in need. This includes rural, poor smallholder farmers with one acre of land who constitute 60% of the rural poor lacking financial services globally. Agricultural lending comes with its

+ Devotees of microfinance and financial inclusion wax eloquence on its benefits. It provides the poor with the credit necessary to build businesses, improve incomes, and stretch savings.

LAW AND ORDER
POOR VICTIMS UNIT

+ **In 2010, the commercialisation of microfinance caused a microloan debt crisis** in Andhra Pradesh (AP). A combination of rampant leveraging on captive and already-indebted clientele, exorbitant interest rates and coercive debt collection spurred many to commit suicide and precipitated a slew of losses for microfinance institutions (MFIs). When exiting AP, for instance, SKS Microfinance lost around 70% of its loan book. Given time and inaction, the high rate of default in a state constituting 25% of India's microfinance industry would have also instigated a national microfinance crisis. The government, however, then stepped in to regulate moneylending in the sector, implementing the Microfinance Ordinance 2010. Today, despite the smaller number of MFIs in AP[1], the industry loan book has grown by 130% from 2014-2015.

Now more evocative of Wall Street than a charitable cause, microfinance suffers from mission drift. The microfinance industry is becoming increasingly commercialised. It operates in a similar manner as larger financial industry, with stock-issuing MFIs behaving like profit-oriented banks. Plus, BFIs like HSBC and Deutsche Bank have also entered the microfinance game. Several MFIs are also transforming into for-profit organisations through initial public offers (IPO), accruing new profit-seeking responsibilities to shareholders. Banco Compartamos' IPO in 2007 is perhaps the most notorious example, but this was followed by SKS (2010), Ujjivan (2016), and Equitas Bank (2016)— all in India alone.

Globally, the trend towards profit-oriented institutions in microfinance has understandably raised some alarm bells. Critics question whether this new direction will further pervert microfinance's original noble cause. As in AP, however, regulation may be the way to get microfinance back on track, especially if the distinction between MFIs and BFIs are increasingly blurred. If targeted to promote justice, transparency, and consumer protection, microfinance regulation could engender a wealth of benefits, including improving the sustainability and outreach of MFIs. More importantly, it can bring microfinance closer to its original goal: Assisting the poor escape poverty.

[1] http://economictimes.indiatimes.com/news/industry/banking/finance/microfinance-industry-is-out-of-an-unprecedent-crisis-thanks-to-regulations-diligent-borrowers/articleshow/51886097.cms

concomitant risks, such as seasonality and irregular cash flows, risks that commercial banks are unwilling to take, leaving these farmers with little access to the credit necessary to invest in technology and other inputs that will improve their livelihoods.

In Southeast Asia, narrow targeting of microfinance products can also mean that overlooking populations like the urban poor in lieu of concentrating on the more lucrative Micro, Small and Medium Enterprise (MSME) market that constitutes 95%-99% of all businesses in ASEAN. Yet even MSMEs suffer from financial exclusion: small loan requirements, non-existent credit history, and higher perceived risk hinder their ability to qualify for and receive conventional loans. Even Islamic finance institutions, which have an inherent social bent due to their religious foundations, can struggle to provide credit due to shareholder aversion to microfinance's low profitability.

Financial inclusion has yet to garner the same swath of detractors. Nevertheless, while it appears a bulletproof concept, financial inclusion still operates on a transmission belt mechanism and transmission belts, no matter how well meaning, can be prone to breakdowns. Providing access to finance is only the tip of the iceberg. Without accompanying literacy and capability programmes, financial inclusion will not necessarily translate into the newly-banked using these services if they are not convenient, easy to use, or applicable to their daily lives. Nor should financial inclusion stop at bank enrolments, but should also encompass income and employment generation to be fully optimised.

LEMONADE OUT OF LEMONS

These stumbling blocks plague microfinance and financial inclusion efforts, whether by commercial banks and financial institutions (BFIs) or otherwise, across the globe. East Asia proves no different, though the landscape of microfinance and financial inclusion here varies. Countries like South Korea have achieved universal financial inclusion. While more than half of Singapore, Malaysia, and Thailand's population have access to financial services, the World Bank estimates that 264 million adults still lack financial accounts in ASEAN.

Undoubtedly then, Southeast Asian microfinance and financial inclusion prospects are ripe for the picking. responsAbility's *2017 Micro and SME Market Outlook Report* predicts the bulk of global microfinance industry's growth i.e. 25%-30% will be concentrated in Asia Pacific, driven by robust demand in Southeast and South Asia despite the maturity of MSME markets. *The Microfinance Barometer 2016 Report* further notes that banks and non-governmental organisations (NGOs) only service 27% of global borrowers; conversely, non-BFIs service a whopping 43.3%.

Moreover, microfinance in Southeast Asia — and to an extent Asia — has been traditionally dominated by state-run or NGO-pioneered initiatives for the past 20 years, according to Eric Duflos of the Consultative Group to Assist the Poor. This includes Bank Rakyat Indonesia with 40 million depositors and the Postal Bank of China with 400 million customers. On Malaysian shores, some of the biggest microfinance institutions are the government-funded TEKUN Nasional, Amanah Ikhtiar and Yayasan Usaha Maju. Development financial institutions like Agrobank have also stepped up efforts to reach underserved communities. Dato' Wan Mohd Fadzmi explains the bank "has put significant emphasis on developing more innovative products for targeted groups such as *Paddy-i* — financing that is designed to cater to paddy farmers who are usually seasonal income earners — and *AgroBakti,* special financing for people with disabilities".

Microfinance offerings in the commercial sphere, however, have been limited: a Bank Negara Malaysia comparative table shows that there are only eight commercial banks providing microfinance services, predominantly microloans for entrepreneurial purposes.

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BFIs can thus further expand their foothold in the microfinance sphere. As banks embrace the evolving role of economic agents working for fairer and more just societies, they will find a wealth of opportunities and support regionally.

ASEAN has increasingly attempted a welcoming and conducive environment for microfinance. *The 2016 Brookings Financial and Digital Inclusion Report Project* notes that the Philippines, Indonesia and Vietnam score highly in the areas of mobile phone penetration, country commitment and regulation. As the 2016 BASEL Consultative Group Workstream on Financial Inclusion co-chair, the Philippines accrued a perfect score for country commitment and regulation in financial inclusion. This has yet to translate into overwhelming success, however, and leaves ample avenue for commercial efforts in this space. The adoption rate of traditional or mobile financial services, reports Brookings, still stands at only 42%. According to Bangko Sentral Ng Pilipinas, an estimated 591 out of 1,634 cities and municipalities remain unbanked as of 2016.

Furthermore, as financial inclusion garners rising support from international financial institutions, so too does financial inclusion funding. The World Bank's Universal Financial Access goal has seen it cooperating with various private and public partners across ASEAN to improve and succour financial inclusion rates. Since 2012, the Asian Development Bank (ADB) has also run the Regional Microfinance Risk Participation and Guarantee Programme: By assuming 50% of default risk on loans to microfinance institutions, ADB hopes to promote local currency lending and nurture higher rates of private sector participation in the microfinance industry. In October 2016, Citibank partnered with ADB to avail USD100 million to microfinance institutions across Asia.

Albeit ASEAN has made inroads in microfinance and financial inclusion, there remains room to further explore public-private partnerships. Efforts to foster higher financial literacy and capability rates as well as awareness on available financial products would contribute to higher growth in BFIs. Within the private sector itself, instead of relying merely on bank branches, which are set for an overhaul in the digital age, BFIs can partner with other merchants to offer their services in retail stores and cast the financial inclusion net wider.

Those tasked with governing should also provide better technological infrastructure. This would herald a slew of benefits as mobile and digital services gain ground and significance in microfinance and financial inclusion. Providing facilities able to support backend-as-a-service (BaaS) platforms and application programming interfaces will be an appealing pull factor for financial technology (fintech) companies, especially in less developed Cambodia, Laos, Myanmar and Vietnam.

THE (CUTTING) EDGE OF TOMORROW

Turning microfinance from myth to miracle is far from impossible. Redesigning microloans to incorporate flexible repayment periods, grace periods and individual-liability contracts can make microfinance more effective and improve poverty eradication.

Yet as in other aspects of banking and finance, fintech may be one of the most significant game changer for microfinance and financial inclusion. Mobile and digital capacities are a boon to administrators and loan officers: It allows for lower costs and increased profitability, and consequently, lower interest rates and increased social welfare.

In front offices, fintech helps to facilitate data organisation, collection, and synchronisation. Better information systems engender better data analytics for improved loan access and tailoring in the back office as well as better compliance to Know Your Client regulation. Biometrics can also compensate for a lack of identification papers, while technology can enhance the processing system at points-of-service, enabling officers to skip copying information and generating documents by hand. As computer-generated documents are perceived to be more formal and official, this practice also inspires more trust in financial service providers.

In Asia, institutions trying to spread the seeds of microfinance and financial inclusion have already begun turning to fintech to revolutionise the landscape. Putting a new spin on agent banking, Bank Rakyat Indonesia equipped its officers with electronic data capture devices, eliminating the need for travelling to brick-and-mortar branches and expanding outreach into previously inaccessible localities — an innovation that won them the 2016 Microfinance Product of the Year award.

Myanmar, on the other hand, has just been crowned the first country to employ blockchain for microfinance; *Infoteria* uses Japanese data centres to support activity in Myanmar's nascent and still volatile cloud-computing environment. As blockchain costs a tenth of conventional data systems, this breakthrough could further slash administration prices in microfinance if scaled elsewhere. Meanwhile, Singapore has seen an uptick in peer-to-peer (P2P) and debt-lending platforms like *MoolahSense* and *CapitalMatch* aimed at filling the financing gap for microenterprises, SMEs, and the businesses that fall between the two ends of that spectrum.

Elsewhere in ASEAN, the Philippines'

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PayMaya capitalises on the country's high mobile subscription rate. The application outfits customers with a virtual Visa card upon registration and enables online shopping, P2P transfer and reloads for Manila's cashless Beep transport cards. Due to increased interoperability, customers on any mobile network can use the application. As Lotte Schou-Zibell puts it on the Asian Development Blog, bank accounts may soon be obsolete as "the user just needs to remember his/her mobile number". With rates of mobile phone ownership higher than those of account ownership, perhaps this will be the next revolution in financial inclusion.

Mobilising fintech in these fields does not come without its own challenges — identity theft, fraud and mobile corruption included. Technology as a tool should thus be used critically, with sufficient checks and balances such as more stringent quality controls embedded into mobile and digital applications.

CONCLUSION

At its inception, both microfinance and financial inclusion were considered holy grails: instruments powerful enough to bring real change, fixing poverty and delivering on ubiquitous promises of shared, inclusive wealth. Undoubtedly, both have the potential to improve economic realities. However, neither should be looked upon as the only saviours for the disenfranchised — as no financial instrument should. The world is complex, comprising many tangled webs of interests, ideas and institutions. There is no theory of everything despite the audacity of hope.

Just as microfinance and financial inclusion need to be viewed through a more nuanced lens, so too should poverty be approached in the same manner. Both microfinance and financial inclusion are predicated on the principles of capitalism: It proposes that the only thing barring the poor from economic ascension is a lack of capital and access to the financial system. Beyond that, everything else is supposedly a matter of gumption, savviness and luck.

Bill Gates once said, "If you're born poor, it's not your fault. But if you die poor, it is your fault." Yet buying into the myth of hard work also obscures the challenging material reality many of the poor face. As Reuben Summerlin noted at the 2014 Asia Microfinance Forum, in some parts of the world, "microfinance and microcredit are not the most perceived need". The destitute may require power, both electrical and otherwise, food security and access to education before capital. From the current microfinance perspective, moreover, problems like climate change, lack of political power, land grabs and austerity simply do not factor into the equation despite being instrumental in escaping poverty.

Though microfinance and financial inclusion may be a step in the right direction, there are still larger questions at hand: Will including the poor in the financial system be in their favour when the financial system itself does not favour the poor? And if conditional cash transfers, like those bringing entire generations out of poverty in South and Latin America, have better track records than microfinance, perhaps it may be time to retire the aversion to helping those in need without expecting anything in return. ✱

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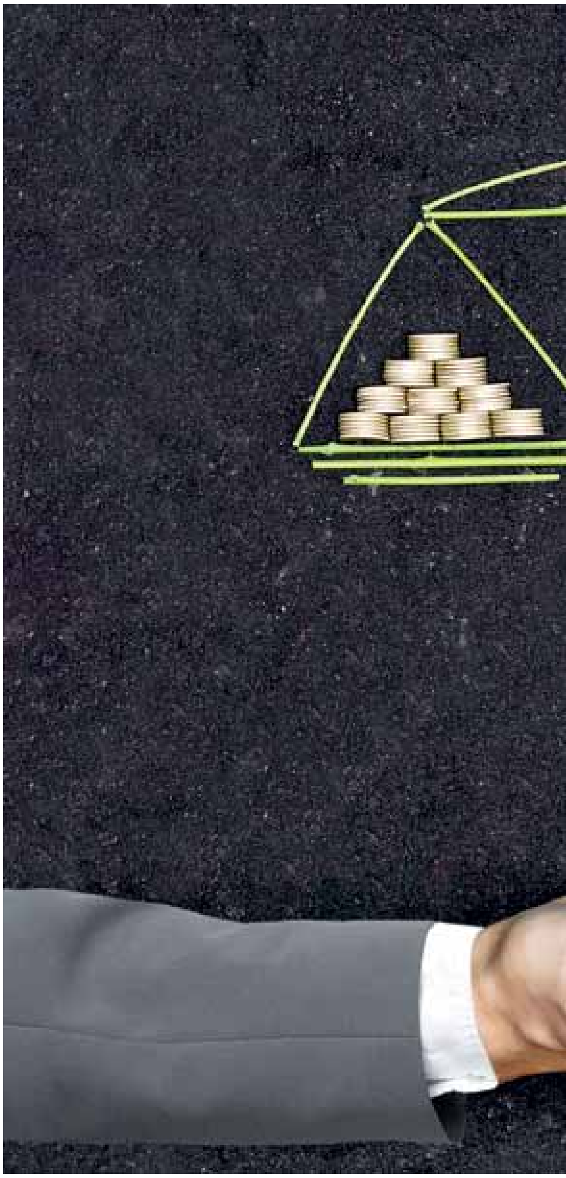
Mobilising fintech in these fields does not come without its own challenges — identity theft, fraud and mobile corruption included. Technology as a tool should thus be used critically, with sufficient checks and balances such as more stringent quality controls embedded into mobile and digital applications.

THE TANGIBILITY OF INTANGIBLES

WHAT DRIVES BANKS' SUSTAINABILITY DISCLOSURE IN THE EMERGING ECONOMIES?

MUCH OF THE PUSH FOR SUSTAINABILITY HAS BEEN DRIVEN BY DEVELOPED MARKETS. IS IT VIABLE FOR EMERGING MARKETS' FINANCE SECTOR TO FOLLOW SUIT?



At a time where the global economy is facing 'secular stagnation' due to a decline in investments and an ageing population, the emerging economies are among the fastest growing markets that could potentially offer viable solutions to global economic growth and sustainable development in the 21st century.

Over the next three decades, global economic power will continue to shift from developed economies in North America, Western Europe and Japan to existing and newly emerging economies. The economies of Mexico and Indonesia are projected to be larger than those of the UK and France by 2030 (in purchasing power parity terms) while Turkey's may become larger than Italy's. Malaysia has great potential for long-term sustainable growth while Nigeria could be the fast-growing large economy by 2050 (PwC 2015).

Relative to developed markets, emerging markets still lag behind in the disclosure of environmental, social and governance sustainability (ESG) in business and financing decisions. While faith-based sensitivities in the marketplace might align behaviour of banks towards sustainability, the presence of best-in-class sustainability banks in the emerging markets is hardly felt. Emerging market companies are less aware of and less prepared to manage ESG risks or optimise ESG opportunities.

+ Malaysia has great potential for long-term sustainable growth while Nigeria could be the fast-growing large economy by 2050 (PwC 2015).

A WWF report in 2015 finds an alarming gap between regional ASEAN banks and the ESG standards adopted by their international counterparts. For instance, only four out of 18 banks disclosed the use of ESG as a tool in their credit processes and only one out of four had a forest sector policy. There is also shortfall in regulations on responsible lending guidelines and corporate sustainability disclosure requirements between ASEAN and Brazil, China, South Africa and Hong Kong. Some of these markets may be more exposed to ESG risks due to the lack of robust regulations and enforcement; lower levels of external scrutiny (for example from civil society/media/non-governmental organisations (NGOs)); and lower awareness and capacity within banks, and from their clients, concerning ESG issues. There is a risk that minority shareholder interests are not sufficiently represented in countries dominated by family-owned and state-owned governance models. The gap in public disclosure of corporate corruption in emerging markets leaves investors uninformed of, and exposed to, the risks of bribery. These issues

pose reputational and material risks to investors and key stakeholders.

At the same time, there are more ESG-related business opportunities (such as energy efficiency or environmental protection project financing and microfinancing) given the greater need for social and environmental investment activity in these markets. The "Vision 2050: The New Agenda for Business" report notes that many of the opportunities that make businesses grow and prosper (to do more with less, to create value, to prosper, and to advance the human condition) will be in the emerging markets. An insightful meta-analysis of more than 2,000 empirical studies by Friede et al. (2015) reveals a considerably higher share of positive outcomes of relations between environmental and social performance on the one hand and corporate financial performance on the other hand in emerging markets (65.4%) than in developed markets (38%). More sustainability opportunities are present particularly in North America, emerging markets, and in non-equity asset classes.

With regard to banking regulation, authorities in Brazil, Bangladesh, China, Colombia, Indonesia, Kenya, Mongolia, Nigeria, Peru and Vietnam have issued sustainable banking guidelines for banks. Indonesia launched a Sustainable Finance Roadmap in December 2014 and is expected to announce additional regulations in 2016. This stands in contrast with most members of the Basel Committee (comprising the most advanced developed countries) which do not have a policy to coordinate environmental and banking regulation. Lessons on sustainable banking have been shared among emerging markets through a global knowledge-sharing network launched in 2012, the Sustainable Banking Network. Opportunities, therefore, exist within the current Basel framework for the incorporation of these emerging market regulatory practices into global best practices.

While extensive research has already been undertaken to examine the relationship between corporate social and environmental responsibility (CSR) and financial performance, extant studies offer limited and often conflicting evidence, particularly in the banking industry. Little attention has thus far been placed on seeking to understand why banks act in socially responsible ways.

A recent study on the impact of corporate governance on the quality of CSR disclosure in US-listed banks by Jizi et al. (2013) reveals that more independent Boards of Directors and larger Boards are the internal governance mechanisms that enhance both shareholders' and other stakeholders' interests. In the case of Spanish listed firms, Reverte (2009) finds that legitimacy theory, as reflected by those variables related to public or social visibility, is the most relevant theory for explaining CSR disclosure practices. Media exposure, followed by size and industry, is the most significant variable in explaining firms' variation in CSR ratings. In China, the disclosure of corporate social responsibility is positively associated with firm size, media exposure, share ownership concentration and institutional

Banks, particularly the smaller ones, should reassess the cost and benefit of using ESG as a strategic or competitiveness initiative in developing new or enhanced financial products, deeper client relationship, and leadership in certain ESG themes.

shareholding. Companies in high-profile environmentally sensitive sectors disclose more information than those in low-profile environmentally sensitive sectors.

Based on the analyses of 251 banks from 45 emerging countries over the period 2005-2014, we find that bank size is positively related to banks' overall ESG disclosure scores. On average, larger banks disclose 11 out of 12 environmental, 11 out of 13 social, and seven out of 11 governance policies and practices. Banks with lower liquidity risks are also more likely to disclose ESG policies and practices. However, banks' profitability, appear to have a mostly negative relationship with environmental and social disclosure. Other bank characteristics (capitalisation, management quality, asset quality and business model) have mixed effects on ESG disclosure. At the macro level, country ESG scores are mostly positively correlated with environmental and social indicators disclosure, but do not have a significant effect on any governance indicators. While banks in countries with higher economic freedom tend to focus on and value the importance of ESG, this is not the case with banks in countries with more economic growth and financial openness.

We also find that a financial crisis can reduce the probability of banks' disclosure. In the overall analysis, our estimation models can explain the disclosure of environmental and social indicators more than governance indicators.

CONCEPTUAL FRAMEWORK

Various theories explain why firms, particularly banks, are interested in ESG disclosure. Firms are moving the direction of business from maximising shareholder's wealth to maximising stakeholder's value. Although shareholders share financial wealth, stakeholders including employees, customers, the local communities are the ultimate risk owner who cares about the social impacts of business operation. Stakeholder theory indicates that banks disclose their ESG activities by not only considering their financial capital, but also human capital, natural capital and social and relationship capital to maximise their wellbeing.

Banks are particularly more interested in serving the social needs to build a strong local base for future sustainable business. This is because strong local presence, through environmental and social activity, will reduce the likelihood of bank failure. Further, signalling theory suggests that firms are more likely to disclose ESG activities in order to signal their social and environmental performance to stakeholders. As customers, employees and local communities are more concerned about wider impact on society and environment, ESG disclosure works as a signal of acknowledgement of their concern by the firm. It is also an effective way to signal to its stakeholders about its expected future financial performance. Banks also use ESG disclosure to signal the society that its internal operation and financing decision will not have an adverse impact on environment and society. This helps to increase investors' confidence and strengthens the local presence which, in turn, can reduce the impact of financial crisis on the local community according to Cornett, Erhemjamts, and Tehranian (2016).

Stewardship theory can also explain why banks are willing to disclose its ESG related activities. Stewardship is defined as "the extent to which an individual (management) willingly subjugates his or her personal interests to act in protection of others' (stakeholders) long-term welfare" (Hernandez 2012). This provides social benefits and fulfils the collective interest over a longer period.

Stewardship theory is particularly related to the bank's ESG related activities as the management invests in environmental and social activities to serve the shared value and interest of stakeholders despite incurring financial cost to shareholders. Banks employ its resources to improve environmental quality and to create a sustainable society, which in turn, can reinforce a strong social base in the society. Some researchers see motives of ESG disclosure from a sociopolitical view. Banks face social pressure to secure their legitimacy by fulfilling the "social contract" which are directly or indirectly demanded by stakeholders at large. Failure to comply with this demand may affect the bank's legitimacy and its future financial performance. Banking products and services should meet consumer's personal preference, and at the same time, fulfil social preferences to preserve the environment and society. This point is also related to institutional theory – organisations are embedded within broader social structures that exert influence on corporations' decision-making. Hence, firms in an environment of sound institutional quality are likely to make better corporate decisions that align with broader social interest.

Banks with larger asset size are more active in ESG disclosure. Environmental and social activities incur costs to the banks, and larger banks have relatively more resources to engage in and report these activities to stakeholders. Economies of scale play an important role in ESG engagement and reporting as it generally reduces the cost proportionately with respect to the size of banks. It indicates that larger banks typically incur lower cost for ESG related activities while smaller banks bear higher cost. This enables larger banks to be engaged in ESG activities.

More liquid banks are likely to be engaged in ESG activities. Investment into ESG activities are considered as long-term investment, with no immediate profit or payback in the short-term. Banks with higher amount of liquid or semi-liquid asset have enough resources to invest in long-term sustainability. Moreover, lower liquidity risk decreases the risk premium and borrowing cost of banks, thus reduces the probability of financial distress. This allows safer banks, with lower liquidity risks, an opportunity to focus on long-term sustainability by investing more on environmental and social policy and practices. It is probable that less profitable banks disclose ESG-related activities more to increase its social presence for greater acceptability by the society which may, in turn, increase its profitability.

CONCLUSION AND IMPLICATIONS

The internal and external communication of sustainability information contributes to an organisation's supply of key resources from various stakeholders. This contribution can be organically internalised and applied if the intangibility of ESG is driven by tangible factors. We find that (i) larger size, lower liquidity risk, longer years of establishment and higher market power positively influence banks' disclosure of ESG policies and practices; (ii) non-profitable banks have higher levels of ESG disclosures, probably to build their reputation and to attract more customers; (iii) banks require sound country-level institutional and ESG quality in order to thrive in embracing sustainability; and (iv) financial crises reduce the probability of banks' disclosures.

These findings have several policy and commercial implications. First, policymakers and regulators can use a differentiated incentive structure to help smaller banks to adopt more ESG disclosures, rather than giving the same incentives across the board. For example, some stock exchange authorities adopt a phased approach in requiring the disclosure of sustainability statement in the annual reporting according to the size of the corporations (e.g. Bursa Malaysia).

Second, given the effect of market power, banks, particularly the smaller ones, should reassess the cost and benefit of using ESG as a strategic or competitiveness initiative in developing new or enhanced financial products, deeper client relationship, and leadership in certain ESG themes.

Third, policymakers and regulators should strive to provide an enabling institutional environment conducive to sustainability practices in the banking industry. The banking sector can be a significant contributor to economies when it is allowed to operate in a reliable political and economic environment, supported by fair rules of the game and profit-making prospects. To minimise the unintended consequences of unhelpful regulation and to provide a more informed basis for policymaking, banks can adopt a proactive and collaborative approach with governments and regulators.

Fourth, investors and market analysts can now have better understanding of the motives of ESG disclosure by banks, and accord premium or discount to the bank's ESG and financial valuations. As a result, banks would be encouraged to move from altruism or greenwashing to strategic motive by integrating ESG into their business strategy, goals and financial performance.

Finally, since data availability is relatively limited in emerging markets, direct engagement with smaller banks can be helpful in addressing information gaps. Forming strategic alliances with domestic institutional investors, the use of local language, the understanding of cultural sensitivities, and the awareness of local business environment and ESG exposures are key ingredients in making such engagement productive. Further, responsible investors (banks) should reach out actively to investee (financed) companies to overcome data gaps and investment (financing) expectation gap. These push-pull factors would encourage improvement in both disclosure quantity and quality in emerging markets.

To play its role, business will still need to do what business does best: innovate, adapt, collaborate and execute. These activities will change along with the partnerships that we form with other businesses, governments, academia and NGOs in order to get it right for all. We believe there are tangible prospects for banks in the emerging markets to embrace sustainability from the inside out. ✱

This article is edited from the Global Economic Governance Working Paper 120 published in September 2016 by the University of Oxford. The full research paper can be accessed via http://www.geg.ox.ac.uk.

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A Sea Change in Payments?

COULD CENTRAL BANK-ISSUED DIGITAL CURRENCY SOON BECOME A REALITY, AND, IF SO, WHAT ARE THE BENEFITS FOR BANKS AND THEIR CUSTOMERS? **JAMIE GRAHAM** EXAMINES THE ISSUES AROUND THE FUTURE OF PAYMENTS.

Following a 40% reduction in the number of coins and notes in circulation in Sweden since 2009, the country's central bank, Sveriges Riksbank, plans to investigate the viability of issuing a digital currency.

Sweden is not alone: with physical currency use falling in countries such as Denmark, Canada and Norway, and plans to replace coins with a digital currency in South Korea by 2020, there is a growing appetite for exploring the possibilities.

Björn Segendorf, Financial Stability Advisor, Sveriges Riksbank, believes there are a number of factors behind falling traditional currency use in the country. "Young people are using less cash than other generations before them and the rise of e-commerce offers a convenient alternative where paying by cash simply isn't an option. In Sweden cards are accepted everywhere and there's one single infrastructure, making them convenient to use," he says.

"Young people are using less cash than other generations before them and the rise of e-commerce offers a convenient alternative where paying by cash simply isn't an option."

The Bank for International Settlements has a Committee on Payments and Market Infrastructures where influential figures from many of the world's central banks meet to discuss the future and implications of changes to the banking system, including digital currency.

According to Simon Taylor, Co-Founder and Director of Blockchain at 11:FS, we are technically already using a digital currency in the UK.

"Whenever you use your contactless card to pay for a coffee, you are using a digital currency. You pay bills with your internet bank, and currency is transferred across the banking payment rails digitally. In fact, physical pounds represent a small fraction of the total 'money' in circulation," he explains.

CENTRAL BANK-ISSUED DIGITAL CURRENCY

It's important to note the distinction between cryptocurrencies and central bank-issued digital currency (CBDC).

Cryptocurrencies are not created by banks, they are "agreed into existence by a large group of people" and an agreement is reached on the ownership of a collection of virtual coins.

"These coins are sold for other currencies, and so acquire a real-world value," Taylor points out.

There are a number of central banks across the world already looking into the implications of introducing digital currencies, to be issued alongside traditional notes and coins. These include the European Central Bank (ECB), People's Bank of China, Federal Reserve Bank of New York and the Bank of England (BoE). In a speech made by Victoria Cleland, Chief Cashier, BoE, in September 2016, she outlined the bank's position on digital currency. "We are undertaking more fundamental long-term research on the wide

“The question is what could the benefits and costs be of removing this layer and of allowing businesses and consumers to transact directly and instantaneously in central bank money.”

+ The Bank of England’s Primary CBDC Questions

What could be the economic impact of a CBDC?

What could be the impact on the financial system of a CBDC, and how could this affect financial stability?

How would a CBDC interact with monetary, financial stability and fiscal policy? How could it be used as a new policy tool?

How could CBDC be technically implemented? How could this be configured to meet the requirements of a CBDC?

+ Regulatory Considerations

Highlighting relevant risks to users and investors

Regulating specific types of firm

Adapting existing regulations to suit digital currency

Applying existing regulation to digital currencies

Prohibiting digital currency use by individual authorities.

range of questions posed by the potential of a central bank-issued digital currency (CBDC).”

There are a number of practical issues to be carefully considered around the volume and use of a digital currency, the structure of the financial system and how technology would be used to facilitate the changes. In fact, the BoE recently invited contributions to a set of research questions that it published on the opportunities and challenges that could arise from the introduction of a CBDC. Cleland highlighted an example: “If a CBDC provided competition for commercial bank deposits, one outcome could be a reduction in deposit funding available to commercial banks, undermining their ability to provide credit to consumers.”

THE BENEFITS FOR BANKS

Depending on the path digital currency takes in order to become a reality, there are benefits to banks, some of which are outlined in the Bank of England’s Staff Working Paper no. 605 entitled ‘The Macroeconomics of Central Bank-Issued Digital Currencies’.

One of these benefits is the reduction in cost of providing transaction services. There are many advocates of digital currencies suggesting there are significant cost savings to be made by the banks when it comes to distributed ledger technology (DLT) as a way of processing transactions in developed economies. This is a sentiment Taylor echoes, stating that the key for any executive is to understand what flavour of blockchain or DLT might be mature enough to solve a real business problem for them. “When you look at the Royal Mint, Euroclear and the Depository Trust & Clearing Corporation (DTCC), all now implementing DLT projects, there are clearly many who believe in these savings.”

Another potential benefit of introducing digital currency is the reduction of risk. A CBDC system would change the way settlements are made, allowing these to happen directly between the payer and the payee across the balance sheet of the central bank, thus avoiding counterparty risk completely. This would ensure significant sums could then be utilised for other purposes. Cleland feels there is a lot to consider before this becomes a reality: “The question is what could the benefits and costs be of removing this layer and of allowing businesses and consumers to transact directly and instantaneously in central bank money,” she opines.

IMPACT ON CUSTOMERS

The future benefits to customers of CBDC include a potential 24/7 settlement system, according to the BoE’s Staff Working Paper mentioned earlier. The status quo involves central banks having tiered payment systems which typically have maintenance ‘windows’ so it only operate at certain times of the day with overnight transactions limited to low-value settlements. In the advent of a decentralised setting, the fact that any given transaction verifier is not essential to the performance of the system means that the system can run without ever needing to stop.

Competition in the financial services marketplace for deposit accounts is expected to be another benefit of introducing digital currency. According to the BoE, CBDC would be “economically equivalent to the establishment of an online-only, reserve-backed, narrow bank alongside the existing commercial banking system. This should again lead to a more rapid adoption of innovative technologies and account offerings.”

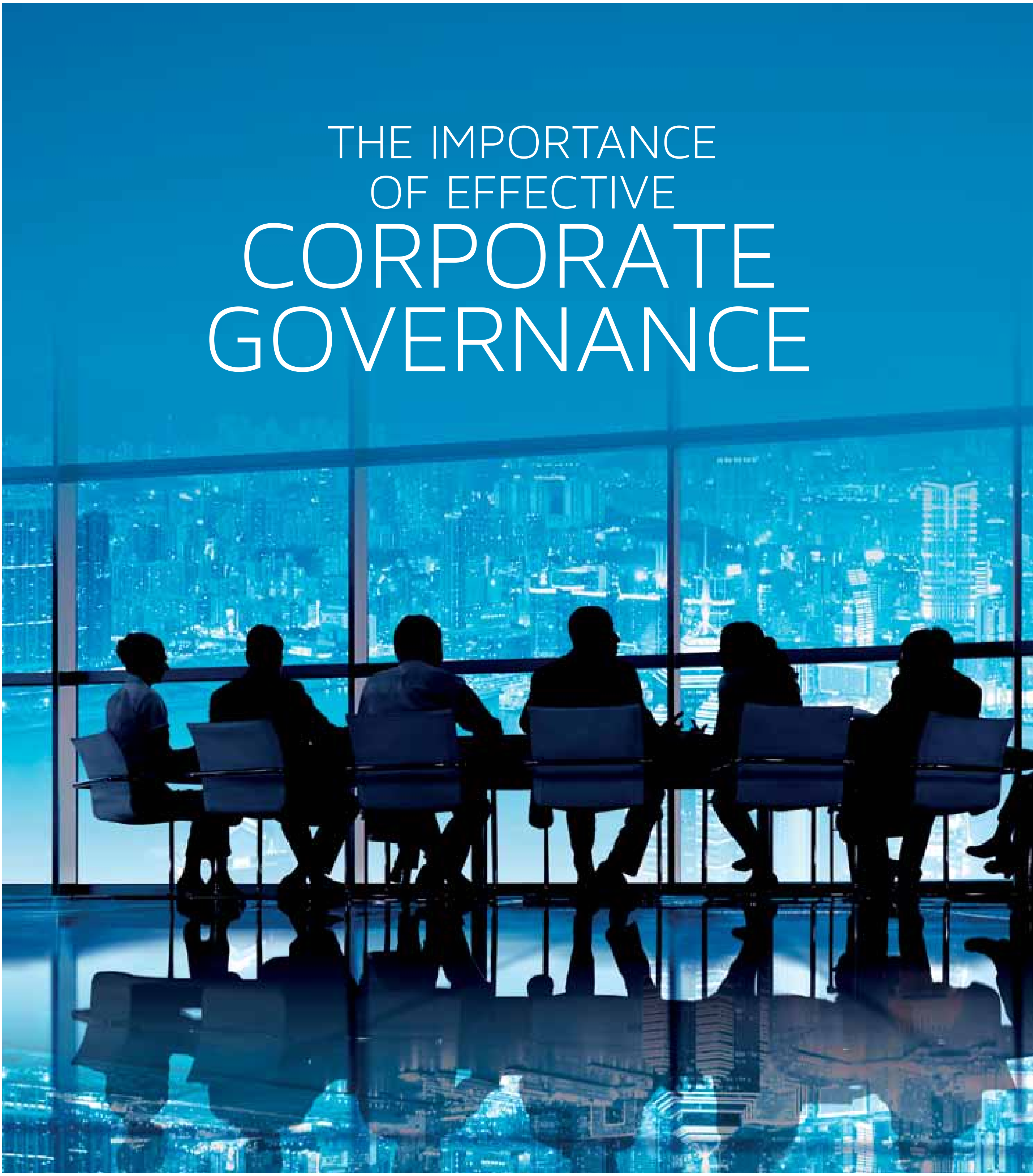
THE DIGITAL JOURNEY

Centralised digital currencies are coming, but we are only at the beginning of the journey from notes and coins to a digital payment future. The transformation will certainly not happen overnight and it remains to be seen how the first CBDCs will be introduced and used by the general public. It is up to the banking industry to play a pivotal role in helping to shape their future. ✱

■ *This article was previously published in the Chartered Banker Magazine, February/ March 2017.*

BY WILLIAM COEN

THE IMPORTANCE OF EFFECTIVE CORPORATE GOVERNANCE



The Basel Committee has a long-standing interest in helping banks to strengthen their corporate governance frameworks, and in supporting supervisors in their efforts to assess the quality of those frameworks. The Basel Committee first published guidance in 1999 to assist banking supervisors in promoting the adoption of sound corporate governance practices at banks in their countries. In 2006, the Committee enhanced this guidance, on the grounds that "issues related to corporate governance have continued to attract considerable national and international attention in the light of a number of high-profile breakdowns in corporate governance" as per its publication 'Enhancing Corporate Governance for Banking Organisations'.

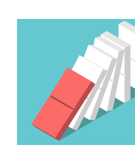
In addition, corporate governance has long been an important feature of the Basel Committee's Core Principles for effective banking supervision. Compliance with the Core Principles and, in particular, the principle on corporate governance is carefully evaluated under the IMF-World Bank financial sector assessment programme (FSAP). The Basel Core Principle 14 (Corporate Governance) states: "The supervisor determines that banks and banking groups have robust corporate governance policies and processes covering, for example, strategic direction, group and organisational structure, control environment, responsibilities of the banks' Boards and senior management, and compensation. These policies and processes are commensurate with the risk profile and systemic importance of the bank."

More than a decade later, the financial system and the global economy are still addressing the fallout of the Great Financial Crisis. Deficiencies in corporate governance were key contributors to the crisis, as the necessary safeguards to protect against excessive risk-taking at some financial services companies were weak or non-existent. To address these flaws, the Committee in 2010 issued a further set of principles for enhancing sound corporate governance practices at banks in its final document 'Principles for Enhancing Corporate Governance' in October 2010.

Despite official efforts to strengthen corporate governance practices, professional misbehaviour continues at financial institutions, as well as ethical lapses and compliance failures, resulting in large fines and settlements. The related costs incurred by banks in the period 2009–16 have amounted to an estimated USD321 billion according to the Boston Consulting Group in its March 2017 'Staying the Course in Banking' report, representing a significant and material source of losses for many global banks.

The costs of breakdowns in corporate governance erode the stability of both the banking sector and the real economy while misconduct-related legacy costs represent a significant drag on banks' profitability and capital ratios based on European Parliament figures issued in March 2017. The European Systemic Risk Board (ESRB) estimated that, absent past litigation costs and associated provisioning in anticipation of future litigation costs, the total accumulated profits of European global systemically important banks (G-SIBs) for the past five years would have been a third higher. Past fines and provisions for future misconduct have also erased all the capital issued by the European G-SIBs during the last five years, so that the Common Equity Tier 1 (CET1) ratios of these banks would be, on average, around 2 percentage points higher without such fines per the ESRB's 'Report on Misconduct Risk in the Banking Sector' in June 2015.

Misconduct fines and litigation-related costs also affect bank valuations, where uncertainty and the unpredictability of future costs are major barriers to a fundamental revaluation of the banking sector. The abovementioned ESRB report states that, since 2013, the equity prices



+ Deficiencies in corporate governance were key contributors to the crisis, as the necessary safeguards to protect against excessive risk-taking at some financial services companies were weak or non-existent.

of banks with substantial legacy problems have underperformed those of other banks, indicating the market prices in unsettled misconduct issues.

Effective corporate governance practices, on both a system-wide and individual bank basis, are therefore essential to achieving and maintaining public trust and confidence in the banking system. They are thus critical to the proper functioning of the banking sector and economy as a whole. As the financial crisis has shown, bank failures impose significant public costs and have broader macroeconomic implications. Post-crisis, failures in corporate governance practices continue to weigh on efforts to repair balance sheets and address legacy issues.

STRENGTHENING CORPORATE GOVERNANCE

Strong corporate governance is not only paramount for the proper functioning of banks and hence to broader financial stability; it also underpins the integrity of the Basel regulatory framework. Guidelines issued by the Basel Committee in recent years in particular place much greater emphasis on the roles of the Board of Directors and senior management in managing risk. They also underscore the need for banks to set strategies for their operations and establish accountability for executing these strategies.

Following most crises and periods of stress, post-mortem exercises reveal that the corporate governance lapses laid bare by the events are neither unique nor surprising; they are largely similar to past deficiencies but have manifested themselves in different ways.

+ For example, drawing on the lessons learned during the Great Financial Crisis, the Committee's 2010 corporate governance guidance set out key areas of (renewed) focus that included the importance of:

- the role and composition of the Board;
- an independent risk management function, including a Chief Risk Officer (CRO) or equivalent;
- monitoring risks on an ongoing firm-wide and individual entity basis;
- the Board's oversight of the compensation systems; and
- the Board and senior management's understanding of the bank's operational structure and risks.

Improving and maintaining strong corporate governance is an ongoing and collective effort on the part of a firm's Board, management and staff. This is true also of the regulators and supervisory bodies responsible for that firm's oversight. In 2014–15, I chaired a Basel Committee task force that further strengthened the earlier Committee guidance. The revised guidelines – 'Corporate Governance Principles for Banks' issued in July 2015 – stress the importance of risk governance as part of a bank's overall corporate governance framework, as well as the key components of risk governance such as risk culture, risk appetite and their relationship to a bank's risk capacity. The revised guidance also delineates the specific roles of the Board, Board Risk Committees, senior management and the control functions, including the Chief Risk Officer (CRO) and internal audit.

Since the crisis, banks have strengthened their overall governance practices. There is now a much better understanding of the important elements of corporate governance such as effective Board oversight, rigorous risk management, strong internal controls, compliance and other related areas. In addition, many banks have made progress in assessing collective Board skills and qualifications, instituting standalone Board Risk Committees, establishing and elevating the role of the CRO, and integrating discussions between Board Audit and Risk Committees.

Industry surveys have also shown that financial institutions are steadily enhancing risk management systems and processes to meet regulatory and market demands for tightened controls that will help prevent or mitigate the impact of a future crisis. In particular, results from a recent survey reveal that some significant changes to risk governance practices are under way. Many firms were in the process of adding new Board and senior management committees to oversee and monitor ethics and conduct and were streamlining and integrating current committees to breakdown silos as found in EY's 2015 risk management survey of major financial institutions.

It is also encouraging to see that banks are making intensified efforts to consider how to proactively and effectively manage risk culture. The EY study also reports that 77% of survey respondents reported an increase in senior management attention to risk culture in the past 12 months, and 75% reported they are in the process of changing their culture. A key driver behind these changes is said to be efforts towards aligning and integrating all the elements that ultimately affect behaviour, including risk appetite, accountability, performance management, compensation, hiring and training.

Heightened attention to risk culture is an important recognition of its ultimate impact on effective risk management. Poor cultural foundations and weaknesses in risk culture are often cited as a root cause of the global financial crisis, and poorly embedded risk cultures are also considered a primary cause of misconduct cases. Improving culture in financial services and banking is therefore an imperative not only as a means to improving conduct, but also to safeguarding financial stability and restoring public trust in the financial system.

Addressing risk culture in the banking sector is, however, a very complex supervisory issue. It involves behaviours and attitudes, making it very difficult to define and measure. A commonly accepted view is that culture ultimately shapes conduct, and relates to the implicit norms that reflect prevailing attitudes and guide behaviours within a firm, as outlined in the Group of 30's 'Banking

Conduct and Culture: A Call for Sustained and Comprehensive Reform' in July 2015. Regulation is largely focused on quantitative measures of resilience, such as capital ratios, leverage and liquidity, as these are tangible and measurable. Culture on the other hand is unique to individual institutions and is influenced by intangible behavioural norms and expectations, as well as by governance and risk management frameworks as outlined in the Australian Prudential Regulation Authority's Information Paper – Risk Culture issued in October 2016.

The Basel Committee's Corporate Governance Principles do not attempt the impossible task of regulating culture. Instead, they recognise that it is ultimately the Board's responsibility to establish the bank's corporate culture and values. This includes overseeing management's role in fostering and maintaining a sound corporate and risk culture.

The Financial Stability Board's (FSB) 'Guidance on Supervisory Interaction with Financial Institutions on Risk Culture' issued in April 2014 similarly recognises that, while risk cultures vary across financial institutions, certain common foundational elements support a sound risk culture within an institution. These include tone from the top, accountability, effective communication and challenge and incentive structures to promote a financial institution's desired risk management behaviour. Nevertheless, the Guidance also recognises that these indicators do not represent a checklist for supervisory review of an institution's risk culture and should not be perceived and managed as a compliance-driven exercise.

A ROLE FOR SUPERVISORS AND IMPLEMENTATION

Supervisors are in a unique position to gain insights on risk culture at financial institutions, given their access to information and individuals across an institution (and indeed across peer groups of institutions), as well as the results of their supervisory efforts. However, risk culture and conduct still depend entirely on the success of efforts by senior leaders of banks to implement tangible and sustainable changes throughout their organisations. The challenge for supervisors is to strike the right balance between taking a more intensive, proactive approach and not unduly influencing the strategic decisions of the institution's management.

A core element of any supervisory review process is to assess banks' governance decision-making structures and processes. Supervisors should evaluate whether the Board and senior management have processes in place for the oversight of the bank's strategic objectives, including risk appetite, risk culture, controls, compensation practices, and management selection and evaluation. Supervisors need to exercise a considerable amount of judgement on whether a healthy culture is fostered by this oversight. They can also use peer analysis and benchmarking exercises to aggregate informal observations made about institutions and gain insights into better practice. Regular interaction between supervisors and Boards of Directors, individual Board members, senior managers and those responsible for the risk management, compliance and internal audit functions is seen as the best way for supervisors to gain insights on corporate governance and risk culture at financial institutions. At the same time, as institutions vary, supervisors should avoid supervisory methodologies that use indicators as a checklist.

The Committee also recognises that supervisory assessment of corporate governance should be commensurate with the size, complexity, structure, economic significance, risk profile and business model of the bank and the group (if any) to which it belongs. This means making reasonable adjustments where appropriate for banks with lower risk profiles, and being alert to the higher risks that may accompany more complex and publicly listed institutions. Systemically important banks are expected to have in place the corporate governance structure and practices commensurate with their potential impact on national and global financial stability.

Finally, the effective implementation of sound corporate governance requires relevant legal, regulatory and institutional foundations. That said, effective corporate governance and a strong risk culture cannot be legislated into practice. Banks' senior managers and Board members should constantly keep in mind the need to build and maintain a strong and effective corporate governance framework and structure, whether or not a jurisdiction has chosen to adopt the Committee's regulatory framework. Ultimately, it is the combined actions of Board members, senior managers, control function heads and supervisors that can lead to meaningful changes. ✱

■ *William Coen is Secretary-General of the Basel Committee on Banking Supervision, Bank for International Settlements.*

 BY ROBERT SOUSTER

UNDERSTANDING REPUTATIONAL RISK

Building and preserving a sound reputation goes beyond mere codes of conduct. It needs strategies that are measurable and standards that are enforceable. Here's how banks can improve and shore up against reputational risk.

The upheavals brought about by the financial crisis that started in 2007 increased the media exposure of financial institutions, and not all of it cast banks in a positive light. The once-popular saying 'any publicity is good publicity' proved to be very wrong indeed. After all, when giants such as Lehman Brothers (in the USA) and Royal Bank of Scotland (in the UK) run into trouble, it is bound to affect the lives of many thousands of people. Some of those affected did not even know that they would be. To these two companies, and many others, reputational risk became a very real strategic issue.

This article defines reputational risk and discusses its nature. It goes on to consider the drivers and consequences of reputational risk. It also explains some of the actions that banking institutions have taken, and proposes courses of action that will address such problems in the future.

A QUESTION OF ATTITUDE?

Lehman Brothers, a major investment bank in the USA, collapsed with an announced USD3.9 billion loss on 10 September 2008. This led to a sharp fall in its share price, which was then accelerated by rumours that the bank was looking for a buyer. Before the bank collapsed, the executives of Neuberger Berman, its investment management business, sent emails to Lehman Brothers executives suggesting that the top people in the firm should forego bonuses to send a strong signal to employees and investors that management was prepared to accept accountability for the poor performance. At a Board meeting, senior executive George Herbert Walker IV responded with: "Sorry, team. I am not sure what is in the water at Neuberger Berman. I'm embarrassed and I do apologise" (Fitzgerald, Wall Street Journal). It is quite likely that the executives of the bank were probably already very wealthy people.

Such attitudes gave birth to the popular notion that many bank executives were oblivious to the impact that perceptions of 'reward for failure' would have on the public's view of the banking industry. This experience was echoed in the rescue of Royal Bank of Scotland (RBS) by the UK government when it was revealed that the Chief Executive Officer would leave the bank with a lucrative exit payment and a substantial pension intact (though he subsequently accepted a reduced pension voluntarily).

The fall of Lehman Brothers, the bailout of RBS and the difficulties of several other financial institutions confirm that reputations are built over decades, sometimes centuries, but can be lost in seconds.

WHAT IS REPUTATIONAL RISK?

According to the Financial Times Lexicon:

Reputational risk is the possible loss of the organisation's reputational capital. Imagine that the company has an account similar to a bank account that they are either filling up or depleting. Every time the company does something good, its reputational capital account goes up; every time the company does something bad, or is accused of doing something bad, the account goes down.

This definition is quite enlightening but is somewhat tautological, in that it uses the word 'reputational' to define the term. Another way of defining reputational risk is to do so in terms of how an organisation is seen by others. It is the risk that arises from the adverse perceptions of stakeholders. However, it is important to note that

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Another way of defining reputational risk is to do so in terms of how an organisation is seen by others. It is the risk that arises from the adverse perceptions of stakeholders. However, it is important to note that perceptions are not always real; they may simply reflect how people see a situation, which may be backed by facts or may not. This is a crucially important factor.

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In 1971, the Rolls-Royce aero engines company (unrelated to the car manufacturer) became insolvent. Its main production facility was in Derby, UK. Reporting on the crash of the company, the local newspaper reported that the events must be of great concern to other businesses in Derby, including the Derbyshire Building Society (a mutual savings and mortgage bank), who are bound to have investments in the company. In fact, the Derbyshire Building Society had no investments in Rolls Royce at all, as at that time the building societies were forbidden by law from investing in commercial companies, but the comment in the newspaper created a public panic, with long queues forming the following day to withdraw money from branch offices.

IMPORTANCE OF REPUTATIONAL RISK TO FINANCIAL INSTITUTIONS

In the 1980s, Guinness, the famous beverage company, was embroiled in a scandal which eventually saw three senior executives, including its Chief Executive Officer, convicted of insider dealing offences. The scandal arose from the activities of the guilty individuals during the takeover of a company called Distillers. Today, the successor company, now called Diageo plc, is a profitable and thriving business. It survived one of the biggest 'hits' to reputation ever inflicted, or rather self-inflicted, by its own people. By contrast, Lehman Brothers has gone, and several other investment banks only survived by the skin of their teeth and a government who regarded them as 'too big to fail'. In the UK, RBS and Lloyds would also have gone without government support. Reputation counts for a lot in the world of financial services. Why? Here are some reasons:

> **Banking is built on trust:** Banks deal mostly with other people's money, and this implies that those who deposit funds with them have to have a strong conviction that their capital is safe. If you lend a friend a few hundred ringgit and they do not pay you back, what happens to your trust in your friend? Once integrity is lost, it is difficult to regain.

> **Banking products are intangible:** If a manufacturing company loses reputation due to bad products or workmanship, the reputation can be restored, because the quality of future products is easy to judge in terms of what they do or how they perform. By contrast, banking products cannot be seen or touched, and so once there is an assumption that the organisation is dysfunctional in some way, it is more difficult to overcome the lack of confidence that people feel.

> **Banking services are inter-connected:** The problems of American and UK banks were rooted in subprime lending and misplaced confidence in the financial system, based on an assumption that all was well. However, once the crisis started to bite, the costs of wholesale funding increased, which meant that lending became less profitable, which in turn meant that banks changed their risk appetite. Suddenly, the home buyer, the small business, the young person trying to buy their first car find it more difficult or impossible to borrow. As bankers, we clearly understand the economics and the reasons for this, but the end customer may not see it the same way. Many banking services are subject to derived demand; nobody actually wants a loan at all, but they do want what the loan will do for them.

> **In the finance industry, reputational risk is contagious:** Once perceptions take hold, they spread. As newspapers screamed about 'fat cats' and their lack of morality, customers often overlooked the fact that investment banking is fundamentally different to retail banking. For example, many counter assistants in UK bank branches actually earn about the same salary as checkout operators in supermarkets.

THE DRIVERS

Reputational risk is driven by many factors, some of which may be external, such as contagion arising from perceived association with other companies; and others internal, including deficiencies in management. The following contributory factors have been apparent to some extent in the banking industry:

Material decline in financial performance, such as losses, falling profits, reduction in capital.

Insufficient attention to emerging risks, and misalignment of risk appetite with market conditions.

Failure to respond sufficiently quickly to rapidly changing market conditions.

An over-emphasis on organic growth, in some cases brought about by aggressive sales policies, fuelled by lucrative performance-related rewards.

An inappropriate focus on short-term performance at the expense of long-term financial sustainability. This problem has been exacerbated by poorly structured remuneration systems, often characterised by annual bonuses and lack of attention to the need to deter inappropriate practices.

Exposure of unethical behaviour or illegal actions affecting the organisation or its core decision-makers.

Compliance failures resulting in fines, penalties, compensation demands or other sanctions.

THE IMPACT

For a company whose securities are listed on a recognised capital market, the immediate impact of reputational risk is on the share price, which in turn transmits an effect on the personal wealth of investors. It also potentially affects earnings per share, and this will have a negative effect on expectations of investors, both new and existing. This can lead, in extreme cases, to direct or indirect intervention by institutional shareholders, who will be keen to preserve the integrity of their portfolios.

When reputational risk has arisen from unethical practices or inappropriate behaviours, this results in a diminution of trust and confidence of customers, investors and regulators.

Some economists and management writers have also argued that reputational risk will drive up transaction costs. These can be analysed by resource dependence theory (Pfeffer and Salancik, 1978), which suggests that transaction costs will increase as reputation diminishes. For example, a company with a bad reputation may find it more difficult to attract good quality employees (or retain existing ones), more difficult to raise funding as their credit rating falls, and more expensive to recruit new customers. Furthermore, companies whose reputation has been affected by violations of laws, best practices in corporate governance or even universally accepted norms of society may find themselves paying out more in marketing, public relations, compliance, compensation or even fines and penalties.

MANAGING REPUTATIONAL RISK

Building and preserving a sound reputation is dependent on having sound strategies that are aligned to the demands of stakeholders. The primary aim of most financial institutions is to maximise shareholder value, but most contemporary commentators now believe that the concept of 'enlightened shareholder value' is an appropriate approach. This pursues the primary aim whilst also attempting to balance the conflicting demands of other stakeholders, including customers, employees, providers of finance, the community and the physical environment.

In the decade since the financial crisis, it has become apparent that to rebuild trust, banking organisations have to define their values in terms of professional standards, and then embed these at all levels of the business. This cannot be achieved simply by adopting a code of practice or code of ethics and hoping that this will achieve what is necessary. The organisation has to put systems and metrics in place to ensure adherence to the defined standards. For example, the success of a branch manager was once measured by sales, but to achieve a lasting positive change in culture it is necessary to introduce qualitative standards. Individuals should be judged not only by what they achieve but also how they achieve it.

Embedding the right culture transcends many areas of operations, including recruitment and selection, the core messages delivered and values communicated at induction, how people are targeted and rewarded, performance appraisal, product design and customer service standards.

Many of these actions focus on building proper standards and ethical behaviour, but are not exclusively about 'being nice'. To maintain secure adherence to the standards demanded, there should be enforcement mechanisms in place to ensure that divergence from these standards are addressed resolutely. ✱

■ *Robert (Bob) Souster is a Partner in Spruce Lodge Training, a consultancy firm based in Northampton, England. He lectures on economics, corporate and business law, management, corporate governance and ethics. He is the Module Director for 'Professionalism, Regulation and Ethics', a core module of the Chartered Banker MBA programme at Bangor University, Wales.*

CRO: New Priorities

With rapid digitisation, supply chain disruptions, security breaches and political shocks, sources of risk have evolved and are on the rise. **Enter the Chief Risk Officer.**

Risk, today, is multifaceted.

Prior to the global financial crisis (GFC), associations with the word 'risk' in banking would most often be equated to credit and/or lending risk.

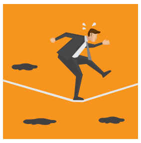
Now, the word elicits further questions: What type of risk are we dealing with: is it a quantifiable risk such as liquidity, operational, systemic; or qualitative like innovation, reputational risks or a moral hazard?

Mapping this into a cohesive enterprise risk framework is crucial for banking and failure to do so can lead to what Booz & Company ominously terms "significant value destruction".

The consequences are very real. In 2016, for the first time, the European Banking Authority included employee misconduct – known as operational risk – as a metric in its EU-wide stress test of 51 banks and projected the potential cost arising from this at 71 billion. This move exemplifies the industry's ever-evolving understanding of the interplay between risk and resilience.

Harvard Business Schools' Prof. Robert Kaplan and Anette Mikes, in a 2012 article, *Managing Risks: A New Framework,* highlighted the three criteria separating failed banks versus survivors of the GFC: "The failed companies had relegated risk management to a compliance function; their risk managers had limited access to senior management and their Boards of Directors. Further, executives routinely ignored risk managers' warnings about highly leveraged and concentrated positions."

Juxtaposed against other banks that managed to steer through the storm of the GFC, the crucial difference was these firms "had strong internal risk-management functions and leadership teams that understood and managed the companies' multiple risk exposures."



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SECOND-LINE DEFENCE

Business and lending units constitute the banks first line of defence. The urgency now is shoring up its second line – namely, risk governance and the CROs office – to enhance resilience when things turn critical.

FIGURE 1 Adapted from the IFCs 'CRO Role and Responsibility Assessment Tool' to guide banks on establishing best-in-class practice.

Responsibilities of the CRO – Best Practice	
Policy	**Implementation**
• Assists in developing policies and processes for identifying, classifying, assessing, monitoring and managing risks. • Assists in creating overall credit and market risk limits, as well as country risk limits for non-domestic exposures, and counterparty risk limits. • Reviews and recommends aggregate loss limit targets for various risk categories (e.g. loan losses, market losses, operational risk), paying special attention to capital adequacy and liquidity requirements. • Develops and recommends a comprehensive risk management programme including exception reporting mechanisms. • Reviews risk management infrastructure and control systems to ensure adequacy to enforce risk policies and business continuity planning. • Suggests appropriate levels of delegated authority to commit resources in each area of its business. • Address non-financial operational risks. • Recommends risk measurements and rating methodologies to be reported to regulators and used by the Board in evaluating corporate performance and risk appetite (e.g. value at risk, economic capital, internal measures, risk adjusted return on capital, credit ratings, etc.). • Moves risk policies towards an ERM approach (as defined by the Treadway Commission's Committee of Sponsoring Organizations of the Treadway Commission or similar). • Addresses strategic risks. • Stays abreast of "best practice" risk management practices and suggests modifications to policy based on new developments. • Suggests ways to instill risk culture, such as training, compensation, etc. • Works with the Board (Risk Committee) and CEO to implement.	• Implements risk policies and framework established by the Board (Risk Committee) to monitor and report risk exposures and assess how the changing risk profile affects need for capital. • Regularly reviews risk exposures and compares to approved limits. Serves as independent and objective check of the risk-taking activities. • Reviews risk management infrastructure to ensure adequacy, at least annually. • Documents risk measurement/ management programme. • Proposes CROs annual work plan to the Board (ordinarily the Risk Committee or, if not established, the Audit and Compliance Committee). • Supervises contingency (business continuity) planning. • Reviews exposures to major clients, counterparties, countries, and economic sectors. • Reviews assumptions used in risk measurement models. Considers whether model risk issues have been properly considered. • Conducts stress tests on credit, liquidity, market, and operational risks. • Examines and analyses risks over various time frames. • Supervises preparations and implementation of Basel II [Basel III] with respect to risk management and measurement issues. • Together with senior management, reviews adequacy of capital and allocation to business units. • Provides technical assistance to business unit managers. • Reviews new products to ensure they are consistent with the risk policies and risk management systems. • Works with senior management and the Board (Risk Committee) to establish an enterprise-wide risk management framework for all business units at all levels. • Responsible for instilling a risk culture.

SOURCE IFC Advanced Methodology for Financial Institutions.

Indeed, an independent and empowered CRO is directly linked to driving shareholder value. Both the Bank for International Settlements and Basel III advocate each bank have a CRO (for large and internationally active banks) and/or robust risk management functions (for smaller banks) in place.

Operationally, what was previously embedded as part of the Chief Executive Officer's (CEO) portfolio has now evolved into a specialisation of its own, with dedicated resources, independence from banks' operations and a reporting line that runs direct to the CEO's office and Board of Directors, the ultimate decision-makers.

CONSTRUCTIVE BUSINESS CHALLENGER

Tower Watson's (now Willis Tower Watson) *Eighth Biennial Global Insurance Enterprise Resource Management Survey* of over 400 tracked global players, outlined the moving trend towards empowering the CRO from compliance function to a strategic business partner, adding value to banks' operations.

"We believe that for this role to be truly effective in assisting the business to generate value, the CRO needs to be an equal player amongst the C-suite: participating actively at core decision-making forums, challenging the first line of defence and introducing healthy and creative tension.

"For example, [the] CRO's attendance at key strategic meetings is vital to ensure an adequate risk view on business decisions and to contribute to the CRO's job satisfaction. This could aid to reduce the observed high turnover of CROs in the industry. We believe that in order to generate value, CROs should act as a true business partner and constructive business challenger."

The report cites four key skills displayed by successful CROs:

+ **Leadership:** An effective CRO is a strategic thinker and catalyst of change, continuously driving innovation, looking for opportunities to achieve a profitable balance between risk and reward. Credibility within the organisation is also paramount and he/she must be viewed

"Active and cost-effective risk management requires managers to think systematically about the multiple categories of risks they face so that they can institute appropriate processes for each. These processes will neutralise their managerial bias of seeing the world as they would like it to be rather than as it actually is or could possibly become."

as a key player in the leadership team with a clear vision on how to deliver stakeholder value.

+ **Influence:** Whilst the CRO is not the owner of any specific area of risk, he/she is responsible for oversight of the entire risk framework and therefore, must persuade frontline management and risk owners to participate actively in the measurement, control and mitigation of risks. This includes educating the business on the value of risk management and securing buy-in by providing guidance and expert advice on risks related to new and major strategic decisions.

+ **Communication:** The ability to concisely convey complex risk information is crucial. As he/she is dealing with people at all levels in the organisation, using business language and avoiding technical jargon portrays the CRO as someone who is a trusted advisor and understands the issues for stakeholders of varying levels – frontline to Board – resulting in a pervasive positive risk culture.

+ **Technical:** Three core areas of technical competence stand out – capital management allocation concepts and methodology, risk management techniques, regulation and compliance policies. This knowledge will be channelled towards creation of an enterprise risk management (ERM) framework where the CROs main priority is to identify risk areas, assess the banks' risk appetite and develop a strategy that applies risk metrics with clear limits. As these risk aspects vary for each bank due to regional, national and cultural differences – what is deemed "high risk" in one country may be "nominal" in another – the task demands a combination of technical skills as well as business acumen.

BEST PRACTICE

Yet, the survey highlights deficiencies in the understanding or risk functions. Risk officers found themselves inundated, sitting in on almost every meeting from treasury to human resource and admitted their role is challenging, demanding and, in some cases, not as clearly defined as they would like it to be.

To lend structure, the International Financial Corporation (IFC), a World Bank working group, has developed a CRO Role and Responsibility Assessment Tool for banks (see **Figure 1**) to delineate clearly the portfolio.

Kaplan and Mikes had this to add on the dynamic role CROs need to embrace to be valued as a true business partner and contributor to day-to-day operations: "Risk management is non-intuitive; it runs counter to many individual and organisational biases. Rules and compliance can mitigate some critical risks but not all of them.

"Active and cost-effective risk management requires managers to think systematically about the multiple categories of risks they face so that they can institute appropriate processes for each. These processes will neutralise their managerial bias of seeing the world as they would like it to be rather than as it actually is or could possibly become."

CRO 3.0

Already, risk experts anticipate that the oversight role of second-generation CRO functions, termed CRO 2.0, is facing its next wave of transformation into CRO 3.0, which includes, amongst others, frontline responsibilities (as and when required such as project-based rollouts) and whose performance will be benchmarked against missed opportunities as well as negative events.

This builds upon the current best practice of the CRO as a strategic and valued business partner, and will propel the second line of defence up front and centre to solidify a culture where every employee is a risk manager. ✱

SKILLS FOR SUCCESS

As the industry evolves to face new challenges, so too are the skill sets that its professionals need to thrive and secure a sustainable future for their firm.

We know that banking is evolving as it faces new challenges; it has to, not least because the regulators and politicians demand it. But the changes seen in the sector demand commensurate change in the skill sets that its personnel need to continue successful careers.

Technology, as one of the key determinants of banking evolution, has naturally had its focus squarely on cybersecurity. But the view that technology is an enabler for streamlining processes has gathered pace in recent years, driven in no small part by the need to manage costs.

The way customers interact with banks is increasingly through digital channels: knowing how customers want to bank and then finding a way of providing that service is the single biggest critical change in recent times, believes Carolyn Dickason, Director of Hays Finance and Technology.

The corollary of this is that it is much harder for banks to build relationships with customers if they're primarily transacting through smartphone or tablet. Finding ways to build that relationship through digital means is a core banking skill now, she notes.

HOW DID WE GET HERE?

"If we think back to before the crash, there was quite a strong focus on being entrepreneurial in growing revenue streams," recalls Francis Lake, Head of Organisational Development at Clydesdale and Yorkshire Banking Group.

"Banks are going to have to do a lot from the employee value proposition point of view to attract the necessary entry-level candidates."

- Carolyn Dickason
Director of Hays Finance and Technology.

"I think now it's about trying to have more balance and having more people who can run the balance between understanding risk and the right risks to take – and mitigating them."

In senior roles, there's much greater emphasis on individual accountability, so rather than getting on with your job and relying on someone else to provide the checks, people need to be able to think through the consequences and own their own actions, explains Lake. The almost simultaneous arrival of digital transformation has placed banking with an immediate need for people who can operate in the digital environment, understand the way in which customers

now interact with banks, and be subject to increasing accountability. This, he says, means being able to think about the customer, the opportunity and risk 'in the round' – and then have an acute sense of how to achieve this in a digital landscape.

"And for anyone in a management position, there's also now much more emphasis on being able to pay attention to the wellbeing of those around you and being able to support them in a way that wasn't really on the radar a couple of years ago," says Lake.

EVOLVING SKILL SETS

Banks today still look for people with a solid work ethic, notes Dickason. "But because of digital streamlining, the work ethic and the scope of requirement has broadened." It is no longer a matter of doing your job and that is all that is expected of you. Today, employees are shifted out of their comfort zone more often. "Organisations need and want flexibility," she says.

Banks have been siloed in the past too, and often ne'er the twain would meet. "We're increasingly looking for people who are able to bridge silos in the bank," says Lake. People with multiple specialisms are sought after. "The real opportunities today lie in being able to look across customer service and operations and risk, for example, to find the ways in which we can really optimise processes."

MIND THE GAP

Within the changing landscape, notable skills shortages are seen in architecture, solution design and automation, says Katrina Hutchinson-O'Neill, Head of Resourcing at Nationwide Building Society. With many institutions undergoing simplification programmes with legacy architecture, efficiency and channel strategy programmes, while deploying new approaches such as 'agile' and customer-led design, she feels the gap must be filled by new talent.

But risk and compliance has moved from merely partnering the business agenda pre-crash to becoming fundamental to its survival, she adds. "Both volume and depth of expertise in these areas has been at a constant premium in the market. We are seeing the current natural evolution of that demand now in risk and compliance '3.0'."

This, she explains, values individuals not only with great technical risk or compliance expertise and industry knowledge, but who are also "able to translate that seamlessly into a digital and agile environment, both shaping and leading on the strategic plans of their respective organisations".

SETTING PRIORITIES

As roles evolve, some banks will find they are recruiting for the first time for specific jobs. They will rely heavily on recruitment experts to advise on what other organisations have done or are doing. "Just a few years ago, the recruiters from the bank side knew what they wanted. Now they try to find out what their competitors are doing, how they can do things better and whether they're ahead of or behind the general trend," notes Dickason.

"There are a lot of organisations trying to jump three steps to get to where they need to get to very quickly," she adds. "Because these roles haven't existed for years or at all, the candidate pool in the UK can be quite small." This is why some banks are looking for candidates with an increasingly broad range of skills but finding that the skills that exist in the market are very niche. But there are also some organisations who are looking for candidates to do something very niche and narrow and the candidates want a much broader scope within their role so that they can learn more. "There is a mismatch that must be tackled."

WHAT WILL BE HOT?

Digital, innovation and design skills are 'hot' market areas across the sector. Alongside recruiting and building these skill sets into product and transformation teams, it is important that organisations recognise the need for leadership development. This, says Dickason, will ensure those acquired wellrounded skills become truly embedded within organisations.

"Banks are actually going to have to do a lot from the employee value proposition point of view to attract the necessary entry-level candidates," she warns. "They are definitely going to need the sharpest of the data scientists that are coming out of universities because I do think there is going to be a massive demand there in the next five to 10 years; security candidates as well."

Technology will lead the way, but project management skills will be valued too "because it's all about making sure the process is as efficient as possible", she says. "Human capital is going to naturally decrease in some capacity but the banking sector is still going to have to continue to be this premium brand."

The ability to accept that change is now the norm means candidates need to be able to roll with the punches. If candidates have that ability to bounce and maintain a positive outlook then they will do exceptionally well in the market, says Dickason. "This would translate in job descriptions as multi-skilled, able to diversify and keep an open mind'."

KEEP UP OR CLEAR OUT

Whereas larger institutions may still struggle to compete as an attractive proposition for millennials, Tier 2, challenger banks and FinTech organisations are "definitely there", says Dickason.

Lots of the international banks that are now operating in the UK are fantastic at this too, she advises. "They are really good at thinking outside the box and understanding what they're trying to achieve. They realise they can use something slightly different, with different skill sets that are transferable to potentially get a better result – and faster."

Banks need to be using social media to build awareness of their brand with potential employees. Otherwise, cautions Dickason, they will fall behind and not be in sight of the people they should be hiring. "It's a passive message that they have to start drip-feeding to the new generation that is coming through." ✱

■ *This article was previously published in the Chartered Banker Magazine, February/ March 2017.*

DEBUNKING THE MYTH

PROPERTY MEASURES HAVE LED TO HIGHER LOAN REJECTION RATES

HIGHLIGHTS

The overall housing loan approval rate remains high at 74.2% in 1Q2017.

First-time house buyers continue to have access to financing.

Rental as an alternative option to house-ownership.

MYTH 1 HOUSING LOAN REJECTION RATES ARE AS HIGH AS 60%

The overall housing loan approval rate remains high at 74.2%[1] (average 2012-2016: 74.1%). The approval rate is the ratio of the number of housing loan applications approved[2] by all banks in Malaysia to the number of housing loan applications received by the banks during the same period. In 1Q2017, banks approved a total of RM22.3 billion of house financing to 90,137 borrowers. Of these, more than half was for buyers of affordable housing units priced below RM500,000.

Generally, housing loan applications were rejected if the borrower was already highly leveraged with weak credit history and had insufficient documentation to support ability to repay loan obligation.

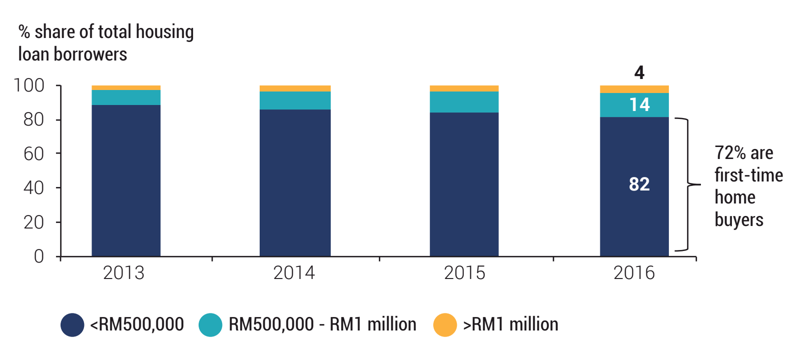
MYTH 2 FIRST-TIME BUYERS ARE UNABLE TO OBTAIN HOUSING LOANS BECAUSE OF THE IMPOSITION OF MACROPRUDENTIAL MEASURES

The measures introduced by Bank Negara Malaysia since 2010 were for two specific purposes: (i) curb excessive speculative activity in the housing market; and (ii) deter over-borrowing. The maximum loan-to-value ratio (LTV) of 70% introduced in 2010 is imposed only on borrowers with three or more outstanding housing loans. Therefore, this measure does not affect eligible first-time house buyers, who typically qualify for an LTV of up to 95% (including Mortgage Reducing/Decreasing Term Assurance). In fact, it improves the chances of first-time buyers getting a loan as it shifts financial institutions' focus away from the speculators. In 2016, about 72% of housing loan borrowers are first-time buyers of homes priced below RM500,000 **(Chart 1)**.

The maximum housing loan tenure of 35 years is more than sufficient for borrowers to settle their loans by

Chart 1: Housing Loan Borrowers by House Price Range

Eligible Borrowers Continue to Have Access to Financing for Affordable Houses



Source: Bank Negara Malaysia and internal computation

retirement. Increasing the housing loan tenure will further add to the total cost of financing and also would not significantly improve one's debt service ratio. To illustrate this point, assuming the tenure for a housing loan of RM500,000 is increased from 35 to 40 years, the total cost of financing will increase by 17.4% or RM97,428 while the monthly instalment will only reduce by 4.4% or RM112 **(Table 1)**.

Developer interest bearing schemes (DIBS) are similar to adjustable rate mortgages, one of the key causes of the subprime mortgage crisis. These schemes should not be allowed as they encourage excessive speculative activity in the property market and cause artificial increases in house prices.

Property valuers indicated that the price difference between houses with DIBS and without DIBS can be as high as 30%. Homebuyers generally were unaware of this fact due to lack of transparency and non-disclosure of material information.

Table 1: Comparison Table for Different Loan Tenures

Increasing Loan Tenure Will Further Add to the Total Financing Cost

	Loan tenure of 35 years	Loan tenure of 40 years	Difference
Loan amount (RM)	500,000	500,000	
Financing rate (%)	5	5	
Monthly instalment (RM)	2,523	2,411	112
Total cost of financing (RM)	559,844	657,272	**97,428**
Difference in total cost			17.40%

Source: Internal computation

Table 2: Illustration on Residual Income

Owning a Home is a Significant Commitment

	RM
Assumed household monthly income	**5,000**
Net monthly income after statutory deductions	**4,272**
Housing loan (RM300,000) monthly instalment*	1,283
Household monthly expenditures**	2,946
Residual monthly income for savings and emergencies	**43**

* Based on 35-year loan tenure, loan-to-value ratio of 90% and lending rate of 5%
** Based on Household Expenditure Survey 2014 (Department of Statistics Malaysia)

MYTH 3 ROOF OVER ONE'S HEAD = NEED TO OWN A HOUSE

Buying and owning a house is a long-term commitment and represents a significant financial obligation for an individual. Rigorous financial planning and the availability of sound financial buffers against unexpected events are critical. To illustrate this point, the **Table 2** above shows the monthly obligation associated with the purchase of a house priced at RM300,000. For a household earning RM5,000 a month, there is very little amount of money left for savings or emergencies after deducting the monthly instalment for the housing loan and monthly household expenditures.

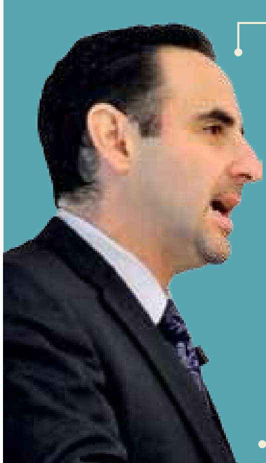
Measures to promote responsible lending and borrowing are intended to deter borrowers from incurring debts that could lead to financial hardship. It minimises the risk of borrowers having to carry an excessive debt burden, and losing their homes to foreclosure if they are unable to service the debt. ✱

■ *The article is written by Lim Le Sze and is a contribution from Bank Negara Malaysia. The complete quarterly bulletin is available at **www.bnm.gov.my***

[1] *This ratio is derived based on monthly data submissions from banks to Bank Negara Malaysia. BNM notes that other sources have quoted different estimates based on broad surveys extended to a limited sample of developers.*

[2] *Regardless of whether it is accepted or subsequently cancelled by the applicant.*

BY DR. THUN THAMRONGNAWASAWAT



> "If you've been doing the same thing for more than two years, then you might as well be in a coma."
>
> **Dr David Rock**, founder of the NeuroLeadership Institute, an integrated field that merges hard science with the soft skills of leadership, stated this one summer at the American Society of Training and Development (now known as the Association for Talent Development) in Florida.

What did he mean? Let me tell you a story about an intriguing experiment out of the University of Southern California, which was published in the *Personality and Social Psychology Bulletin* in 2011.

The experiment was about popcorn and the people who eat them. That's right, popcorn. The researchers focused on two groups of moviegoers: one who regularly enjoyed these delicious treats and the other who rarely ate them. Let us call these popcorn personalities 1) the 'Yes, please' and 2) the 'No, thanks'.

The groups were tagged and then offered some popcorn during their movie going experience. In the bucket, researchers put in two types of popcorn. One was freshly popped and another was about a week old. The mix was handed to both groups. And the organisers then sat back and waited to see what would happen.

WHAT DO YOU THINK?

From my own survey with participants in the room, most people think that the 'Yes, please' group would only go for the fresh popcorn. After all, these were 'professional' popcorn eaters so they should know what they were doing, right? Perhaps it was the same logic that an employee who has been doing a job for many years should know it more than anyone else?

That's what I had thought, too.

The results of this experiment however, showed otherwise. It turned out that people who were 'smart' about selecting fresh popcorn were instead the 'No, thanks' group. The 'Yes, please' were indifferent to new versus stale popcorn. They would eat them both!

Truly intriguing was when experimenters asked the 'Yes, please' group to repeat the task, only this time its members were asked to use their non-dominant hand. That's right, to use only their non-dominant hand. If they were right-handed, then they had to use their left hand to pick up the popcorn. If they were left-handed, like me, then it was the right hand.

Amazingly the results flipped. The 'Yes, please' group now exhibited selective behaviour for fresh popcorn just like the 'No, thanks' group. Forcing them to do what they were not accustomed to appeared to restore awareness. Their brain can now distinguish between what is good and what is bad.

What to make of these results?

Forcing them to do what they were not accustomed to appeared to restore awareness. Their brain can now distinguish between what is good and what is bad.

LEADERSHIP INSIGHTS

+ The brain operates in *'economy'* mode. In simple terms, our brain is frugal. The brain tries to find the most energy-efficient path to get its desired output. When the brain learns something for the first time, it uses a lot of energy. Basically, it needs to think. However, doing the same repetitive work for a while the brain discovers that it can save a lot of energy by merely carrying out the act. This is what we know as habits, like locking your car, driving home, or taking a shower in the morning.

+ The myth about experience. Given the implication, is it always true that people with a lot of experience know the most? Our understanding of the brain might suggest otherwise. The experienced popcorn eaters relied on their habit more than their forebrain. They were not 'thinking' about eating the popcorn. It was not until they were asked to use their non-dominant hand that their brain was subsequently forced into an active mode. So, don't just rely on the veterans in the team; bring in a fresh perspective – someone who asks 'stupid questions'. Listen to them and see if they saw something the experienced may have missed.

Quint Studer, author of *Hardwiring Excellence: Purpose, Worthwhile Work, Making a Difference,* wrote about a practice at his hospital called The-First-30-Days. After a month into the job, new employees are gathered to share what they have seen that seems 'strange'. It could be as complex as an MRI preparation procedure he/she used at a prior workplace, or as simple as "I was wondering why the microwave here took so long to heat up our food". The rule is everyone else can only listen. No explanations or rebuttal are allowed.

Studer explained that most organisations assume it is natural for seniors to mentor juniors. But valuable insights can be drawn from reversing the process as well – getting your house guests to see what your home has been missing. By the way, the microwave catch was an actual example. The hospital improved their staffs' return-to-work time after it placed a more powerful microwave in the pantry. This is an example of not becoming 'popcorned'.

+ Lead your brain. If we do something repetitive for a while (like writing that marketing plan using the same excel template for two to three years consecutively), our brain switches off and operates in 'economy' mode – no thinking required. What the experiment also taught us, fortunately, was that we can do something about it. Don't let your brain settle into repeating patterns. Come to work using different routes, disrupt the morning routines, allow ideas you disagree with to take shape, read different types of books, volunteer for unconventional tasks, rearrange the office, start with a fresh template – the possibilities are endless.

Intriguing, isn't it? This is yet another reason why organisations should actively develop leaders. Ask your people to experiment with their sense of urgency for change. Force their forebrain to look for 'cracks in the iceberg', as leadership guru Professor John P. Kotter would say.

A litmus test: Is the first thing your people think of when getting to the office in the morning: "Where to have lunch today?" If the answer is closer to 'yes', then it might be a red flag that everything else between breakfast and lunch has become habit. Your people may have become 'popcorned'!

Dr. Rock concluded his session with this gem:

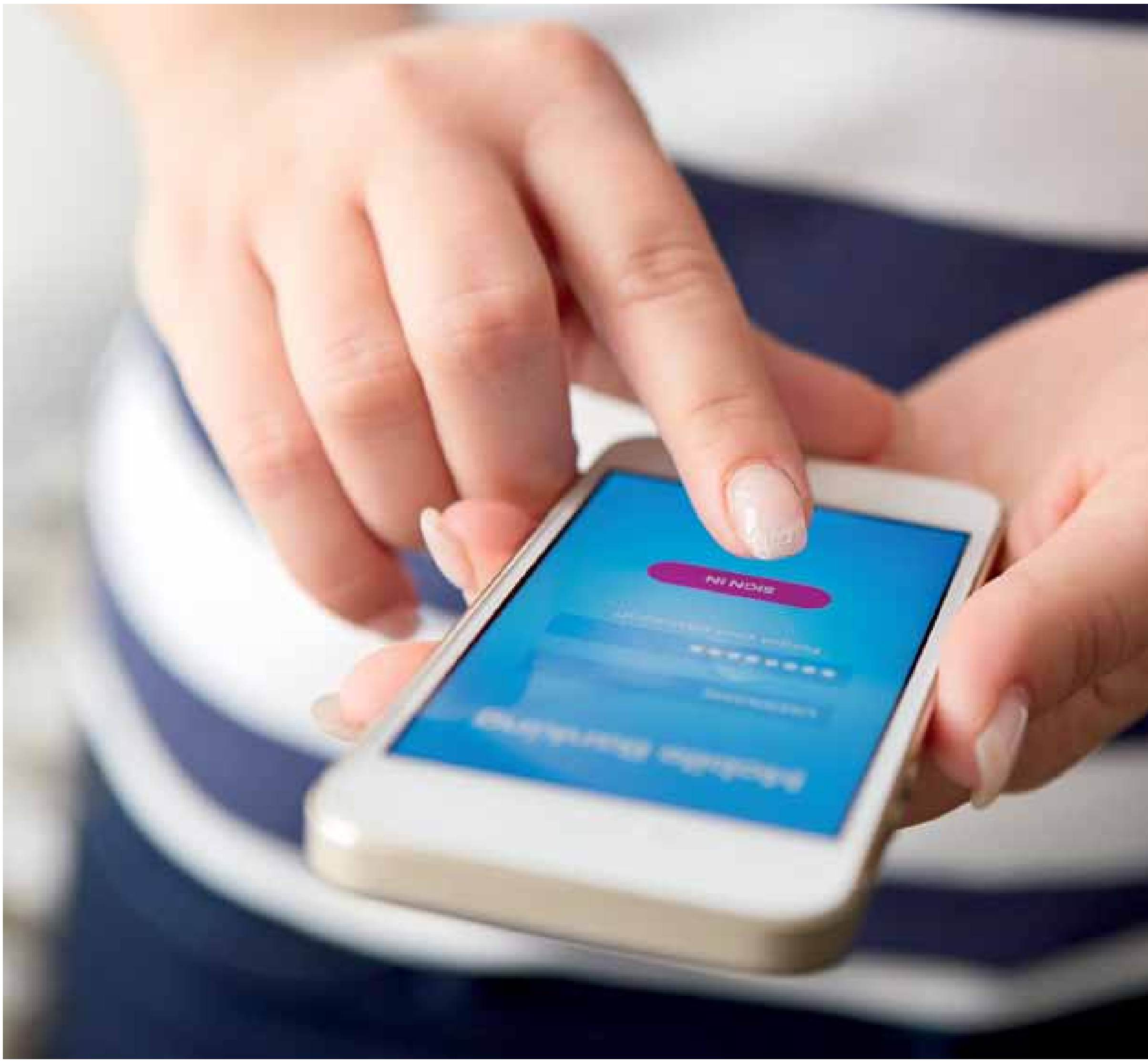
"Do your best people actually have 20 years of experience, or simply a two-year experience repeated ten times?" ✱

■ *Dr. Thun Thamrongnawasawat is Director of Research & Curriculum at the Iclif Leadership and Governance Centre.*

BY DUNCAN WOODS AND RITWIK GHOSH

Banking the Unbanked in Southeast Asia:

HOW CAN DIGITAL FINANCE HELP?



Promoting the use of formal financial services continues to be a challenge across developing economies (including a number of ASEAN markets) and the depth of engagement varies with different financial products.

WITH REGULATORY SUPPORT AND POLICY ACTION, **DIGITAL TECHNOLOGY CAN CLOSE THE FINANCING GAP** FOR MILLIONS CURRENTLY UNDERSERVED BY TRADITIONAL FINANCIAL SERVICES OFFERINGS.

Worldwide bank account ownership rocketed by 700 million between 2011 and 2014, and as of 2014, 62% adults globally reported having a bank account with a formal financial institution. This represents significant success in extending access to formal financial services.

However, promoting the use of formal financial services continues to be a challenge across developing economies (including a number of ASEAN markets) and the depth of engagement varies with different financial products.

For example, only 18% adults use a bank account to receive wages or pay utility bills and only 11% borrow from formal sources.

A recent Oliver Wyman study jointly published with the Asian Development Bank and financial inclusion focused consulting firm *MicroSave*, finds that digital financial solutions can play a significant role in closing these gaps in financial inclusion promoting regular use of various financial services products moving beyond basic access. The study, which assesses the impact of digital finance in Cambodia, Indonesia, Myanmar, and the Philippines, estimates that digital applications can enable 40% of the volume of unmet demand for payment services and 20% of unmet credit needs in the 'Base of Pyramid' and the Micro, Small and Medium Enterprise (MSME) segments.

BANKING ON TECHNOLOGY

The effect of leveraging digital technology to bank the unbanked could boost gross domestic product (GDP) by 2%-3% in markets such as Indonesia and the Philippines, and by 6% in Cambodia.

Making the most of this opportunity could also help influence the financial services industry, particularly in smaller markets such as Cambodia and Myanmar, where only a small percentage of the current needs for financial services are met by formal providers.

Digital financial solutions will have the most significant impact on financial inclusion in five key areas:

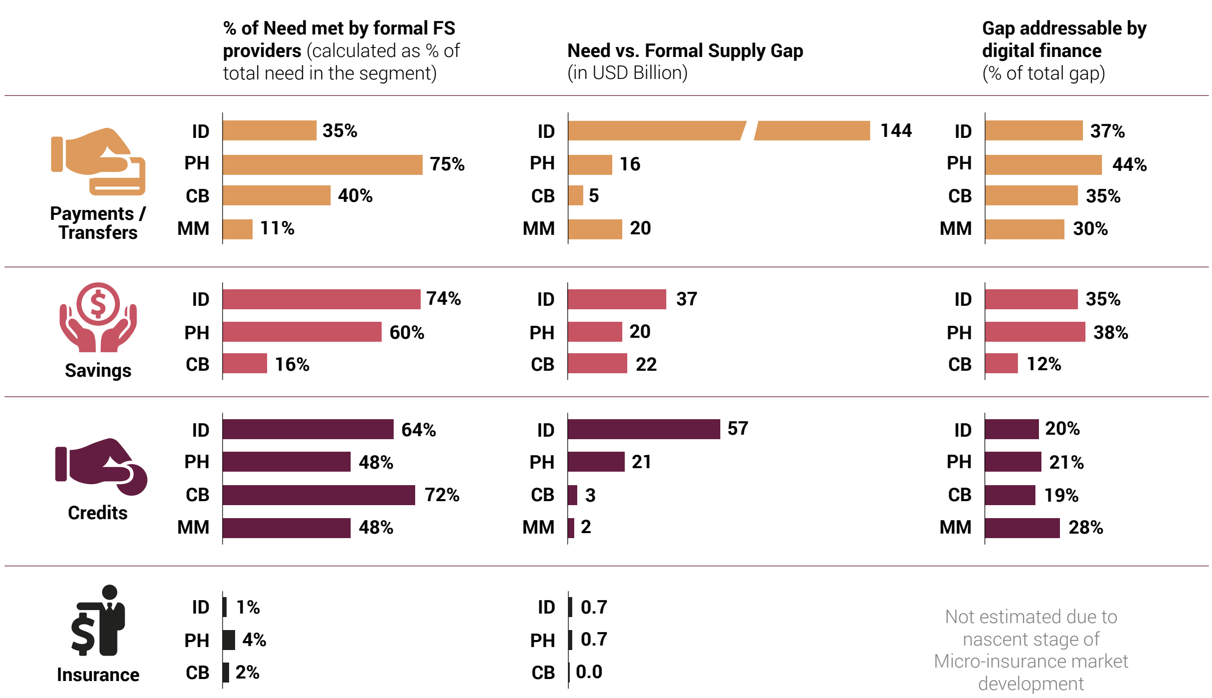
1 They can enable fast, low-cost and convenient customer identification and verification processes — especially when powered by unique national identification numbers, a real-time verification infrastructure and supporting regulatory frameworks such as tiered know your customer (KYC) schemes.

2 They can meaningfully alter the economics of the supply side by addressing last-mile distribution and servicing issues through low-cost, widespread, digitally-enabled points of physical access such as mobile phones and point-of-sale devices.

3 They are prevalent throughout the payments value chain and ecosystem. Digital government-to-person payments — such as employee payments (wages and pensions) and social transfers — and remittance flows can create the initial momentum for electronic payments, thereby supporting the development of viable supply-side business cases. These can be sustained and further developed through person-to-all payments (which include all payments made by individuals, including

The study, which assesses the impact of digital finance in Cambodia, Indonesia, Myanmar, and the Philippines, estimates that digital applications can enable 40% of the volume of unmet demand for payment services and 20% of unmet credit needs in the 'Base of Pyramid' and the Micro, Small and Medium Enterprise (MSME) segments.

Exhibit 1: **Gap between demand and formal supply, and impact of digital applications**



Source: Oliver Wyman Analysis
Note: We were not able to reliably estimate formal savings and insurance supply in Myanmar that targets financial inclusion sub-segments

to businesses or the government) systems, combined with interoperable networks and open application programming interface platforms.

4 They can significantly enhance access to credit by using alternative sources of data, such as payment transactions and telecoms data, as well as analytics. These improve customer profiling, credit risk assessment and fraud detection.

5 Savings can be mobilised digitally through alternative, lower-cost origination and distribution channels and more convenient product designs, such as mobile wallets connected to savings accounts and intuitive goal-based savings products. An easy KYC and onboarding process can also contribute to savings.

The table above provides an assessment of the financial inclusion gap across four focus markets and the potential impact of digital finance across different need categories.

THE NEED FOR REGULATORY SUPPORT

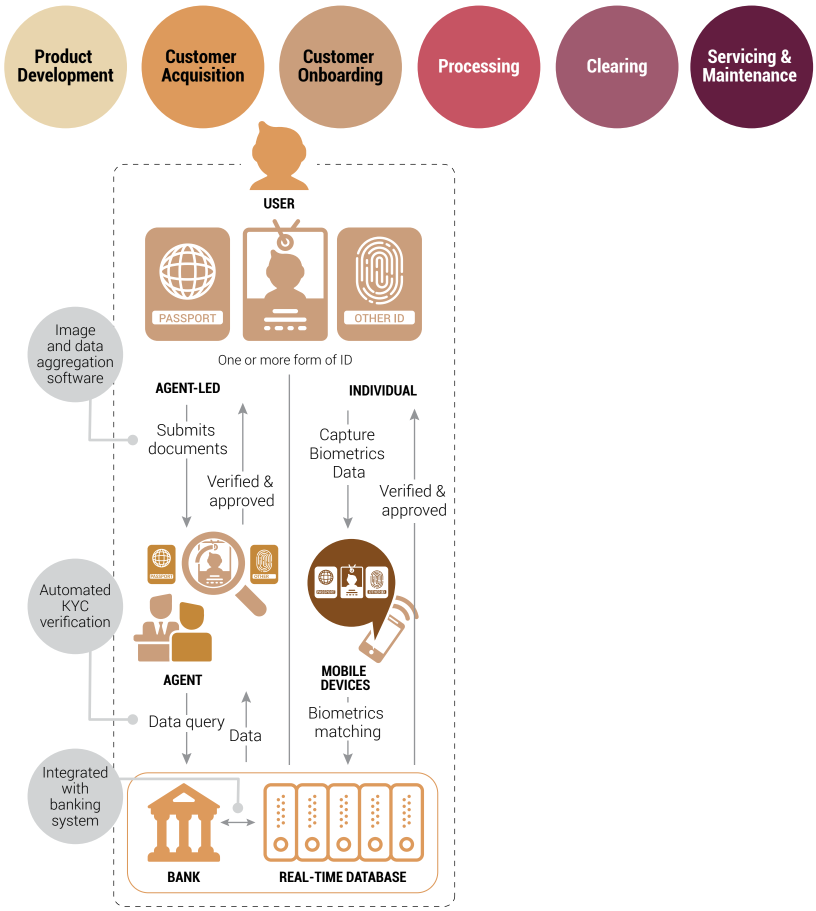
Since much of the digital enablement will be driven by the supply side, regulatory and public policy actions will play a significant role in creating a favourable environment.

+ There is a need for action in three areas:

Supply-side entry barriers. Create a level playing field by allowing collaboration and competition between traditional financial services players and new types of supply-side participants such as mobile network operators.

Suitable solution design and delivery. Develop a 'safe space' for businesses to test new ideas in a live environment with a more permissive regulatory environment that provides clear guidance on the development and role of agent networks, and allows different supply-side operators to use these alternative channels; and promote low cost and more convenient payment channels and network infrastructure, for example by advocating and mandating transfer of money between mobile money platforms.

Shared vision. Produce a unified roadmap for financial inclusion in order to focus the efforts of various stakeholders; and put in place a governance mechanism to facilitate coordination and ensure accountability for action in all relevant government departments.



A DIGITAL FUTURE?

When all of these elements fall in place in a mutually re-enforcing manner, rapid change in the level of financial access and usage can be achieved. The graphic on the right illustrates how such a digitally enabled solution can take shape in customer identification and verification. The user possesses a universal unique identification (ID) that is verifiable with biometric information stored in a public utility database. This is accessed real-time by various service providers via different channels ranging from agents to fully digital customer initiated requests. The end result is to be able to extend access to the unbanked/underbanked population by significantly reducing the cost of KYC, customer due diligence and onboarding processes.

This is not a pipe dream of a digital future. India is a case in point where much of this is now being realised on the back of a universal national ID project (called *Aadhaar*). Indonesia's national ID programme (e-KTP) is also being developed to enable a similar end-state solution.

TRANSFORMATIVE IMPACT ON MSME SEGMENT

The combined impact of digital finance can be transformative for specific customer segments, particularly those underserved by traditional financial services offerings. MSME businesses typically employ the vast majority of working adults in an economy and contribute a significant share of its

GDP. For Asia Pacific, it is estimated that they employ 96% of working adults and contribute 42% of GDP. Spreading credit access to MSMEs has been a cornerstone of financial sector development policy in most emerging economies. For example, Indonesia initiated a public credit guarantee scheme for MSMEs called People's Business Credit in 2007, which guarantees between 70% and 80% of credit granted.

Despite such efforts, MSMEs continue to be held back by a significant gap between their financing needs and the available supply. An Indonesia-wide survey conducted by Oliver Wyman in 2014 revealed that 44% of transitioning microenterprises located in rural Indonesia do not currently have any outstanding loan. Of these, 35% said they needed a loan but did not have access to one, while another 30% said they were likely to need to borrow in the foreseeable future.

We have identified a set of digital applications and related regulatory initiatives that could help address the MSME financing gap. These are listed in the table below.

While the MSME financing gap has been the subject of much public policy debate and economic analysis, the revenue opportunities MSMEs offer in funding and payments have often been overlooked. We estimate that about 700,000 SMEs in Indonesia together take up more than 40% of the total low-cost retail and SME funding available in the market. While a majority of MSMEs in Indonesia (94%) have a savings account, 23% do not use it and 42% use it once a month. This is rapidly changing as an increasing number of MSMEs are starting to participate in digital platforms (for example, e-commerce) and/or using digital solutions (for example, online accounting software).

As more businesses go online, they will realise a greater need for banking solutions (such as making/receiving electronic payments in e-commerce) and benefit more from such integration (such as online software with banking platform, which can help accelerate payments receipts). A number of financial services players have started addressing this opportunity by developing tailored SME solutions focused on specific sub-segments (sectors) and/or digital ecosystems (such as digital commerce platforms). They are often partnering with financial technology and other non-banking players in order to enable such solutions.

For example, PNC Bank in the US is partnering with OB10 to offer an e-invoicing solution targeting global supply chains with US-based SMEs as suppliers.

The opportunity to accelerate financial inclusion through digital finance is clear, and the impact will be very significant on both the lives of financially excluded people and the broader economy.

That said, regulators and policymakers have critical roles to play in supporting and enabling this digital innovation. ✱

An abridged version of this article first appeared on BRINK Asia (www.brinknews.com/asia).

■ *Duncan Woods is Partner, Retail & Business Banking Practice, Asia Pacific, and Ritwik Ghosh is Principal for Retail and Business Banking Practice, Asia Pacific at Oliver Wyman.*

Solution Areas	Digital Enablement	Regulatory and Public Policy Enablement	Applicability to MSME Segments
Use of Electronic Accounting Platforms	• Ensure that records are kept up-to-date, are accurate, and are digitally available, hence reducing audit time and expenses • Share digitally-captured accounting data with financial services providers to support their underwriting decisions	Advocate the use of electronic accounting platforms and encourage financial services providers to conduct training sessions for MSMEs	• Micro • Missing middle
Data Sharing	Data sharing (for example of credit history and collateral) to create a rich depository of data that enables providers to ascertain the creditworthiness of a business	• Define data sharing guidelines and advocate the sharing of credit data between providers • Mandate reporting of data to credit bureau	Missing middle
Leverage Alternative Data in Lieu of Banking Records	Use of payment histories (such as mobile wallet and transactional accounts) for credit scoring	Support the establishment and development of alternative credit-scoring methodologies	• Micro • Missing middle
Alternative Lending Platforms	Online or offline platforms extending credit to MSME clients largely for operational use (such as working capital loans)	Develop clear guidelines (including regulatory sandboxes) to define the fintech operating space	All segments
Digitisation of the Credit Process	Automation of credit decision engines to increase the efficiency of the credit process and reduce credit risk through enhanced risk analytics	Advocate the digitisation of providers' credit processes (for example through pilot projects)	All segments

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Employment Screening

MUST BE DONE THROUGHOUT THE COURSE OF EMPLOYMENT

Let's start with a scenario: Adam has been a trusted Vice-President for a number of years. One day, however, his employer discovers funds being diverted from the company's accounts to an unknown account. Further investigations reveal Adam to be the culprit, and after much interrogation, he confesses to abusing company funds for private gains.

Let's look at another scenario: Sam has been a top-performing, high-flying Sales Manager for three years. Recently, however, he's become careless, unable to deliver on his KPIs and generally found to be lacking in focus and drive. Questioned about his tardy performance, Sam reveals that he's been facing marital and personal problems.

Based on these scenarios, as an employer, the hard truth is that we sometimes don't know which employee to trust. This is the reason why many, if not all reputable organisations carry out pre-employment screening to help mitigate recruiting risks. In Adam's case, however, he passed all his pre-employment screening trials and proved to be a model employee for five years.

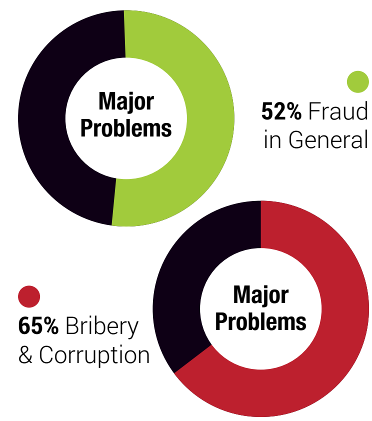
Then again, any employee might start their career with a clean background. There is no guarantee, however, that this will remain the case as time goes by. From drug abuse to racking up gambling debts or even quietly starting a company to compete with the current employer, the list of unfavourable activities can range from the simple to the complex. Such activities are also no longer confined or limited to certain industries and professions.

The answer to strengthening employment risk management lies not only in the past, but also in the present. While pre-employment screening is commonplace, regular post-employment screening on existing staff is one aspect of HR that many employers take lightly. This type of screening, conducted at regular intervals throughout an employee's term of employment, is very important in protecting a company's reputation, assets, customers and workforce.

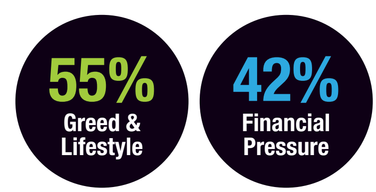
WORRYING STATISTICS

Data revealed in the KPMG Malaysia Fraud, Bribery and Corruption Survey 2013 show a worrying trend. For example, 68% of reported fraud experienced by companies were perpetrated internally by management and non-management employees. More than half of the respondents also admitted to fraud in general (52%) and bribery and corruption (65%) being a major problem in their organisation.

+ More than half of the respondents admit to these being a major problem in their organisation:



+ The most common motivators for fraud, bribery and corruption are:

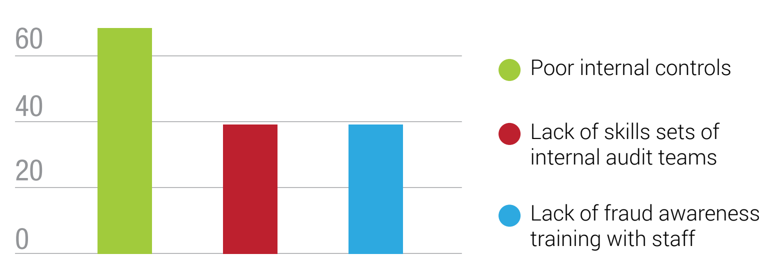


WHY AND WHEN TO CONDUCT POST-EMPLOYMENT SCREENING

While pre-employment screening is a valuable tool to manage recruitment risks, it only provides a snapshot of details possible at a given time. Post-employment screening, on the other hand, allows a company to manage any risk posed by existing employees, who had no criminal intent when coming on board but whose loyalty may have changed at a later date.

Some other valid reasons to conduct annual post-employment background

+ The three most prominent contributing factors in recognising glaring "red flags" or early warning signals of fraud are (in %):



checks include:

+ **Employee due diligence** - Screening employees can expose threats or vulnerabilities and pre-empt a company to security issues and corporate crimes. This can save a business from potential losses and any damage to its reputation.

+ **Protecting your business from liability** - Failure to spot a potentially dangerous employee through negligent monitoring or a lack of ongoing screening can have serious financial, legal and reputational consequences for an employer.

+ **Security** - Regular, updated post-employment screenings may determine if there is criminal activity inside or outside the workplace. Employers also have a duty to ensure that employees meet the required job standards and don't pose a danger to themselves or others.

Post-employment screening works best when done on a regular basis. It's recommended that every employee is screened based on their job's risk exposure - the higher the risk, the more relevant checks need to be conducted. In order to maximise cost efficiency, identify the various risk levels and type of checks before screening everyone. You should always conduct post-employment screening every 12 months.

Post-employment screening should also be a priority when an employee moves from a low-risk role to a high-risk one. This is because screening requirements of the new position may differ from the tasks the employee was originally hired for.

MAKE IT A POSITIVE EMPLOYEE EXPERIENCE

While post-employment screening is crucial for your organisation, it's equally important that these initiatives make for a positive employee experience. For example, long-time staff may not expect or even frown upon a post-employment check. As an employer, however, keep in mind that even one bad apple can affect other staff, jeopardise positions and even bring down an entire company.

There is a need to emphasise that such programmes are not intended to find fault, if any, with all employees, but only to weed out the ones with something to hide. The best way to allay any fears or misconceptions about post-employment screenings is to be transparent and upfront about your intentions.

For starters, explain your reason for such a programme and inform employees that any information obtained from the screening will be kept strictly confidential. Stress that post-employment screening not only protects the organisation and customers from wayward employees, but also secures the financial and personal safety of all other staff. This will allow for a smoother post-employment screening process.

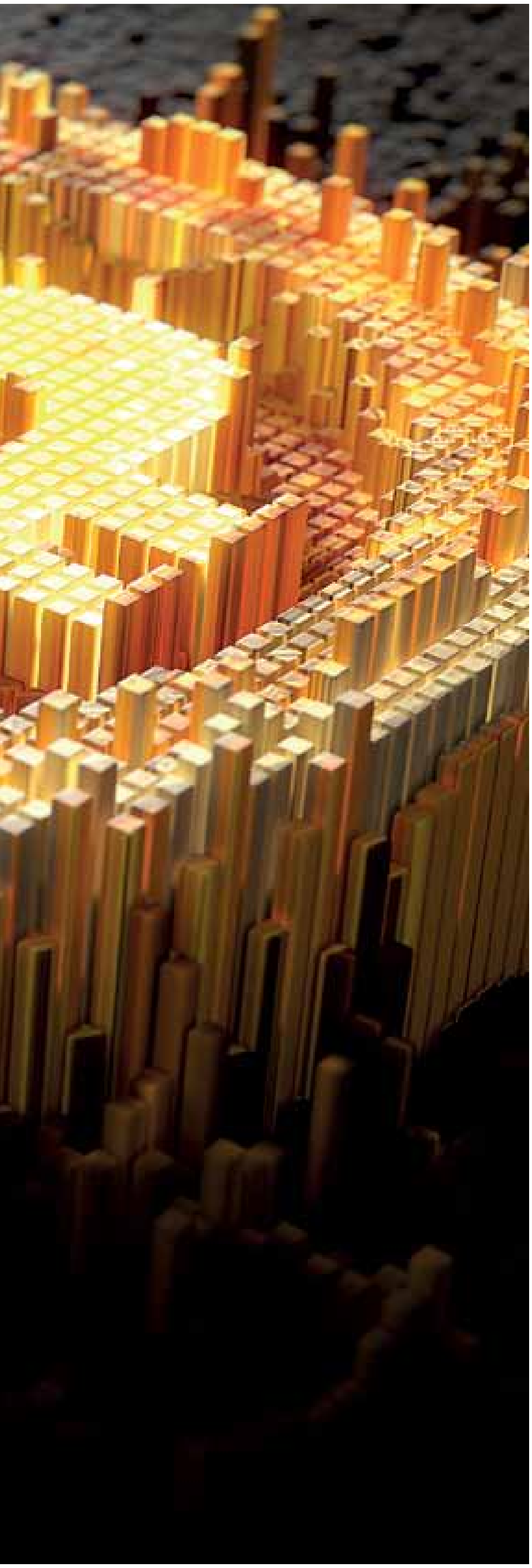
If you're a firm believer in pre-employment screening, then post-employment screening is something you should equally believe in. Not only does it have all the benefits of a pre-employment screening exercise, but is also offers you a means to continuously safeguard your organisation, staff and customers as your business evolves. ✱

 | BY ANGELA YAP & JULIA CHONG

How Blockchain

IS SHAPING KYC'S FUTURE

Described as one of the **most enabling and disruptive technologies** thus far, distributed ledger technology is set to revolutionise identity information exchange and client onboarding.



As global vigilance to detect and prevent financial crime hits an all-time high, so too has the cost of compliance at financial institutions (FIs). On 28 May 2015, the *Financial Times* reported that additional outlay for this at some banks totalled up to USD4 billion annually and senior management is under increasing pressure to rein this in.

In the hopes of restoring bottom line numbers, FIs are now leveraging on the power of blockchains. Accenture's latest 17 January 2017 report, *Banking on Blockchain: A Value Analysis for Investment Banks,* projected that the technology could potentially reduce infrastructure cost at the world's top eight investment banks between USD8-12 billion annually by 2025.

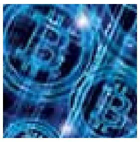
The disruptive nature of blockchains or distributed ledger technology in capital markets, part of the Big Data revolution sweeping the finance sector, is deployed in various forms, from validating cryptocurrency transactions to enabling smart contracts. Where the technology is still nascent is its application in the Know Your Client (KYC) compliance sphere.

BLOCKCHAIN 101

A blockchain is a shared digital ledger of interconnected computers that records all transactions in a public or private network. Each validated transaction by members of the network is permanently recorded in the ledger in blocks, and each block is linked to form a chain from the very earliest to the most current hence the term 'blockchain', which is the technology at the heart of distributed ledgers.

The efficiency of a blockchain is multifold. Using distributed ledger technology, members of the blockchain can share sensitive data more securely as other members are only allowed to view transactions relevant to them, thus adhering to personal data protection laws whilst the blockchain continuously culls and updates data into a golden source of identity information. Its decentralised means of aggregating and verifying information – the raison d'être of blockchain is the absence of any 'central authority' to vet or approve information – prevents any one participant or groups of participants from compromising the integrity of the system or output.

This level of encrypted security is achieved through several features which, theoretically, give distributed ledger technology its advantage over existing KYC information registries:



+ The disruptive nature of blockchains or distributed ledger technology in capital markets, part of the Big Data revolution sweeping the finance sector, is deployed in various forms, from validating cryptocurrency transactions to enabling smart contracts.

In light of this, many see the underlying potential of blockchain technology to revolutionise KYC and do for it what its done for payments, settlements and smart contracts – eliminating duplication of work, data tampering and, most significantly, to bring compliance turnaround and costs down to acceptable levels.

- **Consensus protocol**
  This is the essential feature which keeps the blockchain or distributed ledger system working even if one or several members fail to function. Maintained by a network of computers or nodes, members – state actors, financial institutions, corporations – agree on a set of rules and procedures in order to be part of this shared golden source of information with no centralised authority in charge.
- **Cryptographic hashes**
  Applied algorithms ensure that any alteration to input data can be traced back to its source, raising a 'red flag' through use of an assigned identifier to indicate to members that the input data has been altered and may potentially be compromised data.
- **Digital signatures:**
  Private assigned keys ensure tracking to a single source is possible and the transactions originated from the sender and not an imposter.

The above are the basics behind existing blockchain/distributed ledger systems containing transactional data for settlements and payments.

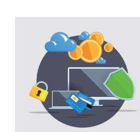
In light of this, many see the underlying potential of blockchain technology to revolutionise KYC and do for it what its done for payments, settlements and smart contracts – eliminating duplication of work, data tampering and, most significantly, to bring compliance turnaround and costs down to acceptable levels.

BREAKING INFORMATION SILOS

Accurate and timely KYC reporting are the foundations of a strong anti-money laundering and counter financing of terrorism (AML/CFT) programme, and in recent years, numerous KYC solutions have come to the fore, including SWIFT's KYC Registry, one of the industry's largest with over 3,500 banks globally. However, these existing solutions have not significantly solved the biggest issues plaguing the industry – shortfalls in accuracy and timeliness.

The jointly-produced Dow Jones–Association of Certified AML Specialists' *2016 Global Anti-Money Laundering Survey* reported that in adopting technology-based solutions, 47% of compliance officers cited excessive false positives as one of its top concerns; 14% reported timeliness as another crucial issue affecting confidence in client-screening data accuracy, prompting them to review their existing solutions. This indicates that although most banks have turned to Software-as-a-Service (SaaS) firms to manage aspects of KYC compliance, none have been wholly successful in unlocking true value.

On top of this, each FI stores its AML information in organisational silos behind confidential



+ But things are changing. Blockchain-enabled distributed ledgers are currently being tested to address the twin problems of accuracy and timeliness in customer due diligence (CDD) investigations.

In a bit of 'Wisdom of Crowds' philosophy, the progenitors of blockchain see it as more than just shared data – it is shared control, but unlike the simple aggregation of transaction data, applying blockchain technology in compliance is a far more complicated and risky affair.

information barriers, spurring the need for centralised intermediaries/agencies to gain efficiencies across the market, none of which are currently based on the blockchain/distributed ledger technology.

But things are changing. Blockchain-enabled distributed ledgers are currently being tested to address the twin problems of accuracy and timeliness in customer due diligence (CDD) investigations.

UNLOCKING VALUE

On 10 November 2016, the proof-of-concept for a KYC registry was announced comprising 10 major banks and the New York-based R3 blockchain consortium, a research and development group of over 70 global FIs. Over three months, using data simulated on R3's Corda platform, participants created and managed both individual and legal entities with relevant documentation. Members used distributed ledger technology to simulate onboarding procedures fulfilling KYC requirements on a single, unified interface, demonstrating the technology's potential to streamline and simplify compliance monitoring and reporting.

More recently, the National Stock Exchange of India, the nation's biggest stock exchange, together with five other FI players trialled the country's first KYC blockchain collaboration using a platform provided by financial technology start-up Elemential.

Through these collaborations, software developers and banks seek automation and increase operational efficiency in KYC compliance through:

> **Identity management**
Every FI performing the KYC process would share its validated information and documents by uploading to a central registry, tagging each customer to a commonly agreed unique identification number such as a Legal Entity Identifier (LEI) which are now common in Europe but have yet to gain ground in Asia. This digitised warehouse of information – which includes data such as source of funding, shareholding, credit history, politically exposed persons, progress updates – can be accessed by other members in the network in order to perform its own CDD.

> **Reductions in cost, duplication of work**
According to Thomson Reuters' Cost of Compliance 2016 report, over 33% of firms spend at least a day each week tracking and analysing regulatory change. Automated execution of KYC/AML investigations combining the analysis of both internal and external data sources would lower enterprise-wide operational compliance costs as well as overall headcount.

> **Enhanced security**
Higher data integrity through identity encryption, allowing banks to scan customer documents and generating private assigned keys to seal the information before sending it to the blockchain. Only authorised entities with the private assigned keys can thus view the information, giving members the convenience of a centralised database without having to relinquish power to a third party.

> **Transparent, near real-time updates**
Once the document is uploaded to a distributed ledger system, it is almost instantaneously available to other members.

> **Historical overview**
The ledger would be the most comprehensive source containing all shared documents and compliance activities conducted on any one client, which also works to justify to regulators that the bank has complied with existing onboarding regulations as well as detect any potential AML/CFT activity upon annual account review.

These efficiencies would shave precious time and cost, allowing banks to reallocate resources from compliance to its core business of lending.

CRACKING THE CODE

Adoption of blockchain in KYC also opens up possibilities of integration with other blockchain applications currently used in settlements, payments and smart contracts. This could signify the next level of interoperability merging compliance, transactions and operations. For instance, using integrated blockchains, banks could automatically permit contract settlements for clients who turn up negative KYC checks.

In a bit of 'Wisdom of Crowds' philosophy, the progenitors of blockchain see it as more than just shared data – it is shared control, but unlike the simple aggregation of transaction data, applying blockchain technology in compliance is a far more complicated and risky affair.

If done right, SaaS firms that crack the code can expect immense returns and FI players may finally see a scalable method to significantly control compliance costs. ✱

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DATA MANAGEMENT IN THE RISK WORLD CAN BE OVERWHELMING. HERE ARE GUIDELINES ON HOW BANKS SHOULD TACKLE THE MOST COMMON CHALLENGES EN ROUTE TO BECOMING A DATA-DRIVEN ORGANISATION.

6 ways to combat data management hurdles

Firms have acknowledged the need for a strong data management practice and although much has been done to usher banks into a new era of data-driven reporting, many are drowning in a sea of information overload and under pressure to report speedily with high-quality data.

New standards such as IFRS 9 Financial Instrument, Basel Committee on Banking Supervision regulation No. 239 (BCBS 239) Principles for Effective Risk Data Aggregation and Risk Reporting; and processes such as recovery and resolution planning, and stress testing; and ad hoc requests by regulators, have directed the type and granularity of information banks must now collate as well as its management. Current risk management practices are far from sufficient to meet increasing regulatory demands.

Risk reporting today extends beyond traditional financial risk metrics. As risk information starts to shed light onto the management and performance of firms, the concomitant requirement and disclosure to senior management and regulators on other business-related information becomes crucial for assessment and business decision-making. Beyond regulator-driven standards

for improved governance, consistency and integrity, it is crucial that banks themselves understand how a transformation in its data mining architecture can unlock real business value.

Below are ways in which banks can overcome common hurdles and institute in its place a good data compliance programme:

❶ **Active data quality management.** A critical component of good data compliance is managing data quality. The saying 'rubbish in, rubbish out' rings true in every sense in this perspective. Erroneous data renders even the most sophisticated of systems and models pointless. Cleaning up data is a necessary effort to which banks must commit time and effort. Eliminating inefficiencies through data reconciliation, patching of information and re-checking contributes significantly to the ability of firms to generate the required results and analysis with both accuracy and speed. A common pain point is the crunch of reporting season, as inconsistencies and off-the-mark results are generated as a consequence of poor data and/or incomplete information, resulting in gaps in the data stream. Simple features such as rule-based error messages, background checks, and periodic data tests should be performed to continuously resolve any data issues arising. More important is to have in place continuous process improvement to ensure good data quality can be achieved.

❷ **Standardised data.** This is a forward-thinking move that calls for subject matter experts with a thorough understanding of data requirements throughout banks' back-, middle- and front-office functions in order to achieve a consistent definition of data sets. From format irregularities, varying definitions and competing system architectures, these issues become tenuous to align but are necessary. Many banks find that various reconciliations need to be performed when information is extracted from multiple sources, thus compromising data integrity. By adopting financial technology or outsourcing data reconciliation tasks, banks can begin to break down the silo operations to converge risk, finance, operations and business data.

❸ **Strive for a single source of information.** Be it a single data mart for data extraction, analysis and reporting or maintaining multiple systems that are linked to a robust risk analytics engine, information should be accessible and leveraged from one system to another. Achieving this also enables higher efficiency. For example, in analysing a customer's credit risk profile, most banks typically maintain identity information in its customer management system, repayment behaviour and data in a separate credit management system while the credit risk team hosts a separate set of information which may be linked to the accounting general ledger system but not to the overarching credit risk management system (CRMS). The gap may occur where certain information that is maintained in the CRMS, could be an input in the credit risk profiling, but is not available in the credit risk system, thereby requiring either a separate manual feed, resulting in potential data integrity issues. Should a consistent definition be employed and a flow-through of information be maintained from a single source, a single point of entry in one system could feed the data for various purposes, thereby achieving efficiency, consistency and optimisation.

❹ **Understanding sources and drivers of risk.** This is essential in order to understand the risk tolerance levels and therefore risk appetite of the firm as risk information is increasingly crucial in the development of business strategy. The response to questions such as: "What are the risk adjusted returns of a business? How much capital is being used? Is there sufficient liquid asset to withstand illiquidity should a financial crisis occur? Is there sufficient capital coverage for high-risk asset growth? Is this where we should strategically take the business?" need to be revisited periodically to create a robust data reporting that responds in step with fast-changing business environments.

❺ **Data transparency.** Any model developed should be made editable under the right governance process, instead of being hosted in a black box that is not visible to anyone or locked away for future refinement. Financial risk or financial models are critical information for banks, in particular the risk management function. The understanding of inputs and sources of information to the respective models are as important as having the right data.

❻ **System flexibility.** While many banks work towards maintaining a risk data mart to house all risk-related information, focus must be accorded to the ever-expanding universe of risk data. As regulatory requirements such as BCBS 239 suggest, the required reporting covers risk and non-risk data, therefore the definition of risk data will continuously evolve with the change in regulatory requirement. Banks need to consider the flexibility built into their risk tools and systems to respond to current as well as future risk environments.

The transformation of banks into data-driven organisations requires significant planning in terms of infrastructure investment and talent acquisition. The payoff is flexibility, agility and accuracy in its response to evolving changes in the risk world.✱

■ *Reporting by the Banking Insight Editorial Team.*

STRESS TESTING: A STRATEGIC TOOL FOR CAPITAL PLANNING

A SHIFT IN PERSPECTIVE CAN ELEVATE STRESS TESTING FROM MUNDANE, ONEROUS REPORTING TO DYNAMIC STRATEGIC TOOL FOR ENHANCED CAPITAL PLANNING. THE OBJECTIVE? TO BOLSTER BOTTOM LINE AND EXPLORE NEW OPPORTUNITIES FOR GROWTH.

One of the most far-reaching consequences after 2008 is the requirement for more stringent capital stress testing for financial institutions, a process which many banks continue to struggle with not least because it is an added task to increased regulatory reporting. However, with a shift in perspective, banks can leverage the results of capital stress testing as a strategic tool to unearth and address organisational inefficiencies.

Capital stress testing is a process of simulating hypothetical events in order to determine the vulnerability of a bank's portfolio under multiple scenarios such as a global liquidity or price shocks, fire sale, wholesale creditors – all plausible occurrences judging from historical trends – and whether your bank's financial position is sturdy enough to continue trading through the crisis.

The approach at most banks is to view it as an onerous regulatory obligation. Indeed, the Dodd-Frank Act's Comprehensive Capital Analysis and Review (CCAR), the most forward and stringent of mandatory stress tests with proscribed data sets and scenarios for testing to which banks in excess of USD10 billion in assets must apply and report its findings to the Federal Reserve (Fed), has been a roller-coaster ride for many. Not least is Banco Santander that had the dubious honour last year as the first bank to fail the Fed's CCAR three years in a row. Stress tests mandated by the European Banking Authority and the UK's Prudential Regulation Authority are also on similar but less stringent metrics.

However, stress tests such as CCAR can be extremely beneficial if a bank's systems, processes and procedures are geared in the right direction, allowing these hypothetical, simulated events or scenarios to unearth organisational inefficiencies.

MATHEMATICS & MECHANICS

When leveraged well, stress tests can become not just integral to strategic planning but a potentially beneficial way to manage capital for banks both big and small. At some smaller community banks, when furnishing evidence of stress tests that meet sound capital planning requirements, regulators have been open to reducing their leverage ratios.

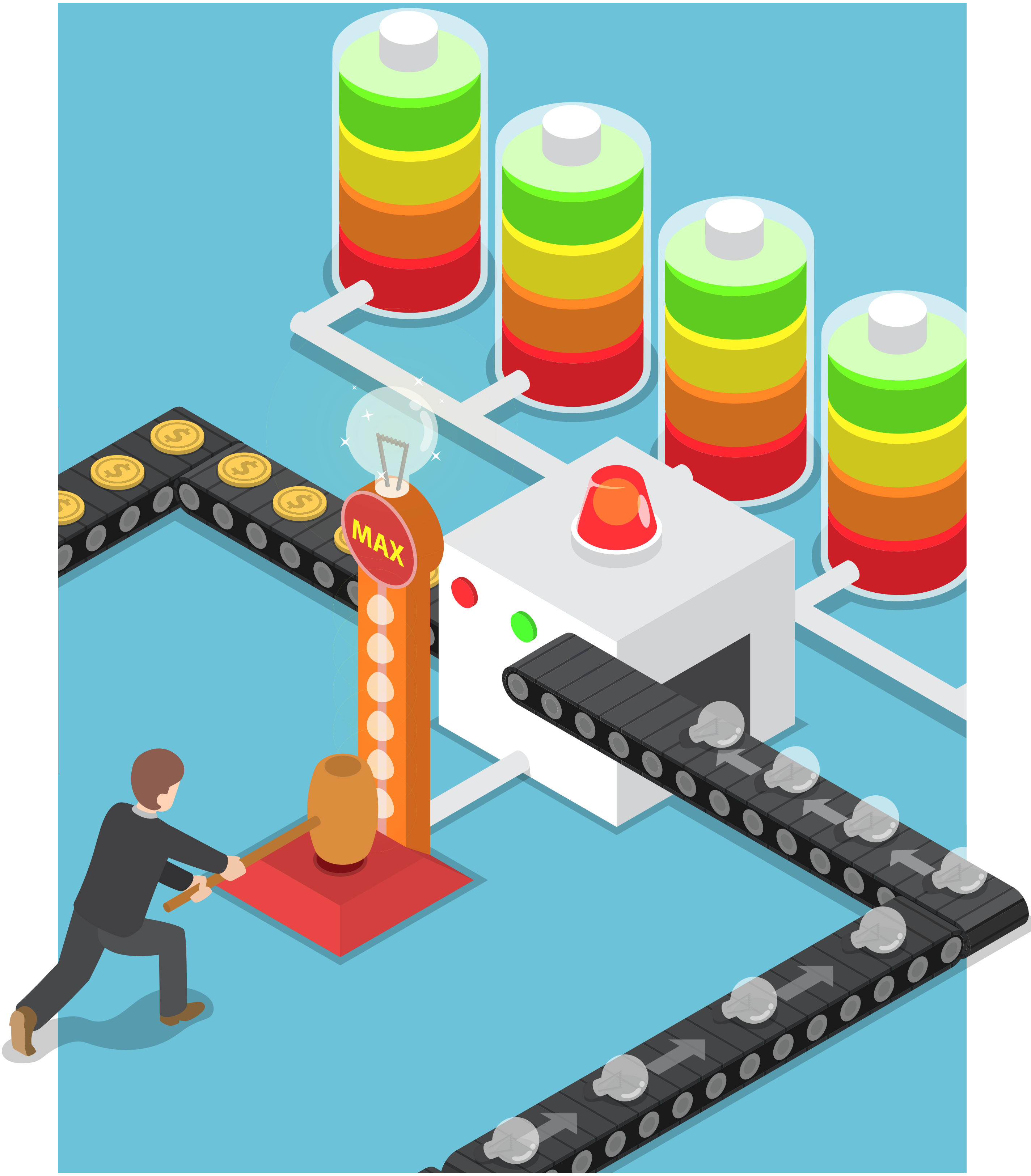
To illustrate the business case for stress testing, a mere 0.5% reduction in leverage ratio at a small bank with USD5 billion in assets implies a 'saving' of USD25 million in assets which can be re-deployed and used for other purposes, creating real capital that increases return on capital and competitiveness.

Essentially, the stress test is used to assess a bank's capital adequacy, which then translates to a leverage ratio. When run multiple times under various levels of 'stressed' scenarios, it determines its regulatory capital needs. This is where the line of thought ends for most banks, but to elevate it from a mere reporting metric to a strategic tool requires an extension of its logical application.

Banks needs to take this exercise from cost to profit centre. In a 'top down' approach, stress testing consists of applying estimated stress loss rates under various scenarios. The 'bottom up' approach using internal data modelling aggregates the results at the transactional level, then apply the stress tests under a similar set of scenarios and include routine performing of 'What if' analysis. Choosing which approach to use is based on the purpose of the stress test.

Most regulators impose a 'top down' approach such as CCAR for internal data modelling in order to gauge the financial health of a bank, whilst the 'bottom up'

However, stress tests such as CCAR can be extremely beneficial if a bank's systems, processes and procedures are geared in the right direction, allowing these hypothetical, simulated events or scenarios to unearth organisational inefficiencies.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approach is generally applied by banks in business decision-making and determining operational direction.

Several types of scenario analysis such as a recession (liquidity risk), loss of a major client (concentration risk), or localised economic downturn (credit risk) are initially outlined then applied into the bank's internal model, which in turn churns results used to evaluate loan portfolio risk and potential impact on earnings and capital based on its risk profile.

The most common types of stress testing listed by the US Treasury Department's Office of the Comptroller of the Currency are:

+ **Transaction stress testing.**

This estimates potential loan-loss levels by assessing the impact of economic conditions on the borrower's ability to service debt. This "bottom up" analysis lends insight into the borrower's vulnerability to default and loss and is used by lending units as predictors of potential loan default, allowing them to mitigate the risk of default using a range of options from safeguards such as a designated escrow account to channel all sources of repayment or exiting an account as a pre-emptive measure to predicted default.

+ **Portfolio stress testing.**

This identifies current and emerging risks and vulnerabilities of the collective loan portfolio based on different asset classes. It assesses the impact of changing economic conditions, identifies credit concentrations, measures the resulting change in overall portfolio credit quality, and the resultant financial impact on earnings and capital. The results from this pooling or segmenting of loans based on shared characteristics such as geography, security, industry risk profiles lend insight into how banks should mitigate potential portfolio deterioration. Options can be a mix of strategic actions including, but not limited to, re-designating internal loan limits in cases of over-exposure to a particular sector or increasing regulatory capital-at-risk if the portfolio indicates higher-than-preferred risk. Due to the inter-connectedness and complexity of operations, larger banks may require additional loan migration analysis before setting its course based on the results of portfolio stress tests. The analysis will require mapping how a change in internal loan ratings could affect other incomes, capital, and business considerations currently at play.

+ **Enterprise-level stress testing.**

This maps the multiple types of risk, its inter-related effects and the resultant financial impact to the bank as a whole. In its most basic form, it is an aggregation of portfolio stress tests that is then coupled with the related impacts arising from interest rate risk and liquidity risk.

+ **Reverse stress testing.**

In this forward-looking analysis, a bank begins by posing a scenario that could cause it critical damage and works its way backward by narrowing its root cause to a handful of potential triggers in its current environment. Also known as "Break the Bank" scenario, it is a powerful new way to look at risk mitigation by challenging the prevailing assumptions held by top management and could uncover very surprising or previously hidden vulnerabilities to help break the fallacy of 'groupthink' in organisations.

INTEGRATED STRESS TESTING (IST)

In recent times, IST has come to the fore as a more structured discipline for banks to apply when combining stress testing with business strategic planning. This relatively new and still-evolving framework is gaining significant ground as many risk practitioners admit that the prevailing risk management models may no longer be valid. IST goes beyond focusing on traditional risks such as liquidity, interest rate, credit, market, geopolitical, operational and includes a comprehensive inclusion of data from a bank's risk, treasury and finance divisions to cover data management, governance structures, IT architecture and delivery systems/dashboards when developing a dynamic risk framework.

The intended result is to realise savings in infrastructure costs and develop a more scalable stress testing framework – prerequisites for any bank looking to institute more robust and forward-looking capital planning to see them through future instances of economic or geopolitical distress.

CHALLENGES

Yet, few banks are adequately primed or equipped to perform IST. In an article for the US' Center for Financial Professionals, Rajib Chakravorty, Lead Risk Programme Data Architect at Lloyds Banking Group, lists the following challenges to greater adoption of integrated stress testing at banks:

Lack of involvement from senior management.

Risk data is not reconciled with business areas, finance and treasury.

Stress testing results are not embedded into business decision-making and planning processes.

Fragmented and inconsistent data stores across divisions.

Scenarios constrained by historical data with few forward-looking elements.

Stress impact is often evaluated by risk type in isolation and only in terms of risk measures, with a lack of a comprehensive view across risk types.

At the core of all quantitative efforts is how we elevate what we do to an art. Asset and liability management's preoccupation with stress testing and proclivity towards a more dynamic IST-driven approach reiterates this. Moreover, the industry recognises that there is both room and need for stress testing to expand beyond its current applications in financial services.

The challenge, as with many other aspects of compliance in banks, is multifaceted. However, banks that do this right can expect to be placed ahead of the pack and benefit from leaner operations, deploying resources in the most profitable areas and in its most efficient mix. ✱

■ *Reporting by the Banking Insight Editorial Team.*

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