banking insight

IDEAS FOR LEADERS
JUNE 2011

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MULTIPOLAR CHALLENGES

THE CHANGING SHAPE OF THE GLOBAL BANKING SYSTEM

Customer-Centric Banking Demystified

Basel III and the Implications for the Malaysian Banking System

IS THE PARTY OVER?
WILL ANYTHING REALLY CHANGE?

RISK AND REWARD

ISSN 2231-6247

A Publication of
Institut Bank-Bank Malaysia
Institute *of* Bankers Malaysia
35880 P





The Institute of Bankers Malaysia (Institut Bank-Bank Malaysia or IBBM) is devoted to providing world class education and learning services as part of its mission to develop talent in the banking and financial services industry. We aim to be at the forefront in the advancement of banking education and learning services; and are taking quantum leaps to reshape the banking education landscape through innovations in the delivery of our value propositions.

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THOUGHT LEADERSHIP FOR SENIOR BANKERS

THE INSTITUTE OF BANKERS MALAYSIA (Institut Bank-Bank Malaysia or IBBM) is on a mission – to develop premier talent in the banking and financial services industry through its mandate of providing world-class education and learning services. We believe that one means of achieving this is through provoking debate and sharing insights on current challenges and issues that are of interest to the banking and financial community, via innovative channels of influence.

One of these innovative channels of influence and knowledge dissemination is the publication you currently hold in your hand. As an instrument of thought leadership, *Banking Insight* was conceived and executed specifically to cater to the needs of decision-makers and senior management of financial institutions.

To facilitate strategic thinking and executive decision-making, the publication features an eclectic mix of exclusive contributions from authoritative experts and business commentators as well as original journalism on the issues and challenges that are shaping the financial landscape of today and the future.

Banking: Risky Business?

Risk is a key issue. The nature of banking is strongly related to managing and controlling risks; and risks come in various forms. It is the business of banks to know what these are and how best to manage them – for they cannot be totally eliminated!

In this issue, we offer coherent yet diverse coverage of the identification and management of risks that are bank-specific. Our cover story "Multipolar Challenges" looks specifically at the challenges and risks that face financial institutions in a multipolar and globalised environment. "Wanted: 21st Century Banking" discusses the risks of the current fractional-reserve model in use today, and proposes a shift to a less risky full-reserve banking model. Meanwhile, "Moving Towards Bank 2.0" highlights the risks of banks being behind the times in capitalising on emerging technologies – think twitter, facebook and tablet computing - and shifts in consumer behaviour.

The People Factor

It's clichéd but true that human capital presents yet another major risk. Banks are operated by humans like you and I. How well banks manage, motivate and reward their people could make the difference between stellar, middling or mediocre performance.

A focal aspect of bank performance, especially for retail banks, is customer service, which boils down to the behaviour of people in the front line. At the end of the day, a successful bank is one which is able to meet and satisfy customer demands and needs. Read about this in "Customer-Centric Banking Demystified".

Leadership is also critical for top performance. But are bank hierarchies populated by bosses, and void of leaders? See how banks can create better leaders in "Are Banks as Successful as They Can Be?"

Closely related to effective risk management is good governance and ethical behaviour. Indeed, ethics is at the root of good behaviour and essential to restoring trust in battered Western banks. "Rebuilding Trust in Banking" debates how to amend the erosion of trust that has affected several banking systems around the world and caused both financial and social damage.

Global Updates

Meanwhile, we should update ourselves on the latest global industry developments, which are addressed in our Technical section. This issue, we feature Basel III, which is a global regulatory framework which tackles bank capital adequacy and liquidity. Some believe that Basel III will lead to a stronger banking system with fewer risks of repeating the same mistakes of the past. Others argue that regulation will remain a major challenge and no one size fits all. The debate goes on.

Other issues covered in the Technical section are Islamic finance risks and accounting convergence risks for banks, specifically compliance with FRS139 and FRS7.

A Brand Premised on Thought Leadership

We hope this inaugural issue piques your interest and meets your need for timely and relevant discourse. With your support, we hope to nurture *Banking Insight* into a highly regarded and premier publication. Indeed, the unveiling of *Banking Insight* is part of the Institute's initiatives to differentiate itself in the marketplace with a brand that is crafted on the premise of thought leadership to complement its offerings of quality service and products.

In the meantime, we hope you enjoy this issue and please send any feedback you may have to the Editor of *Banking Insight*.

Hope you have a fruitful read.

THE EDITOR

We want to hear what you have to say on *Banking Insight*.

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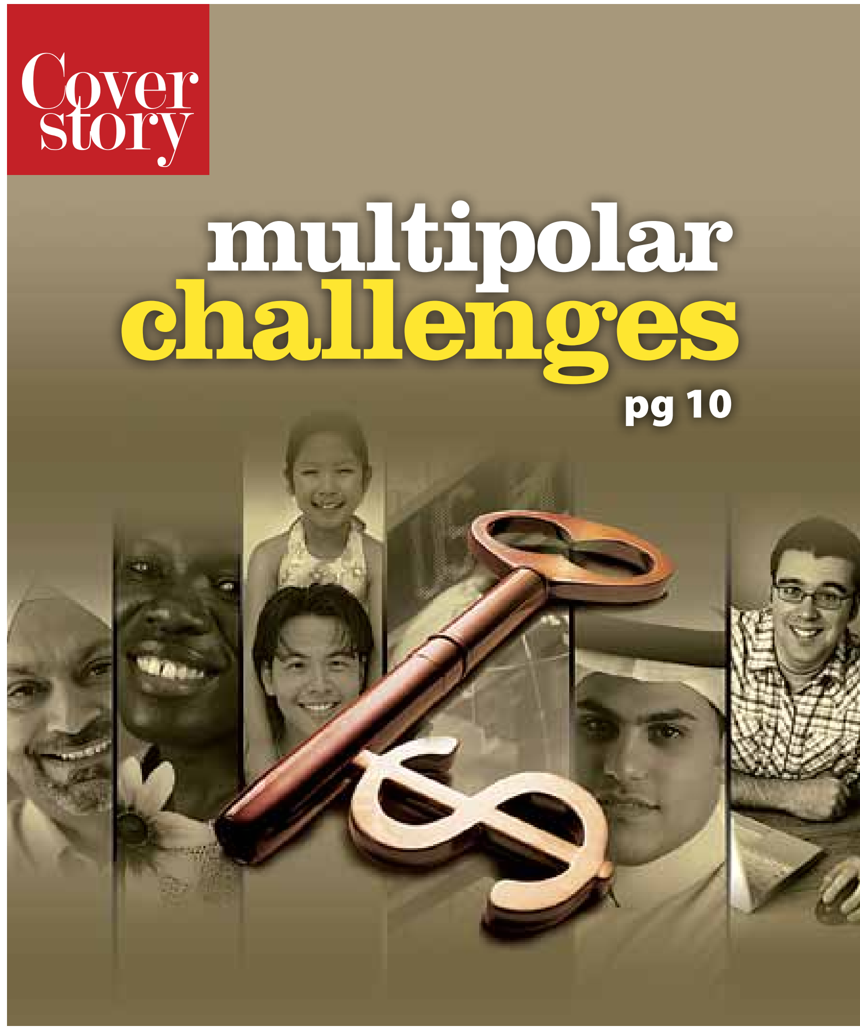

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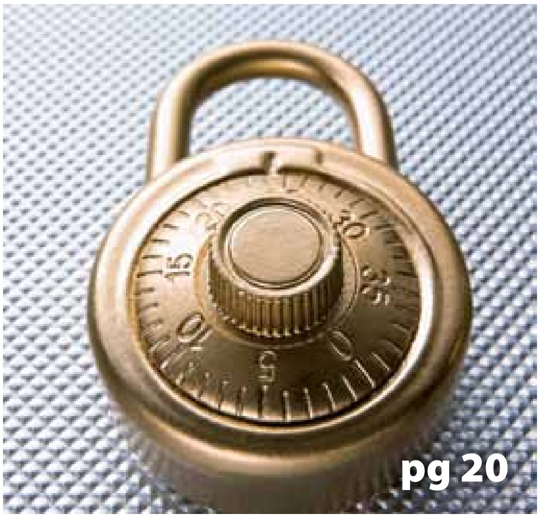
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RUSSIAN REVOLUTION

THE RUSSIAN BANKING market is set for dramatic changes over the next four years, driven by changing customer behaviour, intense competition and new banking models, according to an Accenture report based on a survey of 1,600 Russian bank customers and interviews with 30 senior bank executives at major state-owned and private banks.

The research argued that intense competition is "inevitable" over the next four years and will be driven primarily by reduced margins (cited by 90% of respondents), declining customer trust and loyalty (80%) and changing customer behaviour (80%).

"The banking market in Russia is growing, but more slowly than in the pre-crisis period – with revenue growth estimated at about 5 - 10% annually over the next three to four years," said Alexandre Gorine, Managing Director of Accenture in Russia. According to respondents, one of the three most important criteria for selecting a bank is "innovative products and services." The survey also showed rising demand for banking innovation among Russians -- with more than two-thirds of respondents (71%) reporting increasing expectations for multichannel access, 66% expecting greater simplicity and convenience from their banks and more than half (57%) saying they require faster service from their banks. ✱

ROOM FOR RUSSIAN GROWTH:

The average Russian bank customer currently uses three banks to provide an average of three banking products;

The most commonly used banking products are basic and transactional, with salary cards, debit cards, and bill payment and money transfer services, used by 63%, 42% and 39% of Russians.

Only 4% of Russian bank customers hold investment products, 7% hold mortgages and 10% hold car loans.

EMERGING MARKETS TO FEED GROWTH ASPIRATIONS

Financial services companies need to look far beyond their domestic markets if they are to achieve their ambitious growth aspirations. According to the 14th Annual PwC Global CEO Survey, CEOs of financial services companies believe emerging markets are more important than developed markets to their organisation's future. China tops the list of countries being actively targeted, followed closely by Brazil, India and the US.

But tapping into these markets may be more difficult than anticipated. Over a third (38%) of global financial services CEOs see the availability of key talent as a major threat to their plans. Plus, banking CEOs are adjusting to a new landscape. Over a third (36%) of those surveyed said they have fundamentally adapted their company's strategy in the past two years, driven primarily by changing attitudes to risk. In future, banks will need to adapt to the unprecedented rise in saving levels which is expected to become a permanent fixture. Western banks also face stronger competition from E7 emerging economies' banks, both within emerging markets and increasingly on their own turf. ✱

HOW MUCH DO SENIOR BANKERS MAKE IN MALAYSIA?

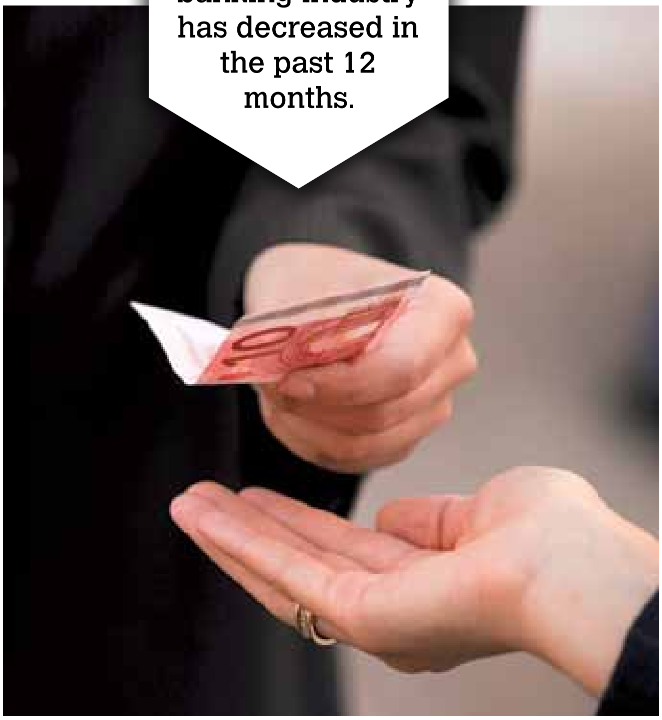
Benchmark your salary against the Malaysian banking salary guides listed in the Robert Walters Global Salary Survey 2011. And compare 2011 prospective salaries to 2010 figures. ✱

PERMANENT ROLE	SALARY PER ANNUM (RM)	
	2010	2011
Investment Banking	240k+	288k+
Private Banking	200k+	220k+
Corporate Banking	192k+	216k+
Commercial Banking	132k+	145k+
Compliance	190k+	212k+
Market Risk	210k+	241k+
Internal Audit	185k+	212k+
Credit Risk	192k+	198k+
Treasury Settlements	156k+	174k+
Cash Management	144k+	174k+
Finance Operations	130k+	156k+
Business Analysis	130k+	156k+

Source: *http://www.robertwalters.com/resources/salarysurvey2010/Malaysia_Salary_Survey_2011.pdf. Salaries stated are for Divisional Heads.*

44%

Customers worldwide say their confidence in the banking industry has decreased in the past 12 months.



CUSTOMER FOCUS KEY TO SUCCESS

TRUST IN BANKS FELL in the past 12 months in countries hit hard by the downturn, according to a new survey report, *A New Era of Customer Expectation*, from Ernst & Young which surveyed more than 20,500 global retail banking customers.

The survey found that 44% of customers worldwide say their confidence in the banking industry has decreased in the past 12 months. Levels of confidence are even lower in regions deeply affected by the financial crisis. In the US, 55% of customers now have less confidence in banks than they did a year ago. Within Europe, the UK has seen the largest drop in consumer trust (63%).

Finding a way to effectively deliver a personal service to customers will be a key success factor in the years ahead. While internet banking (83%), ATMs (79%) and branches (79%) are the touchpoints customers are most satisfied with today, satisfaction with call centres is consistently weaker (44%). Banks need to reconnect with their customer base by improving the customer experience across their operations. A number of banks are experimenting with new tools such as mobile banking but there is demand across all channels – including call centres and branches – for greater personalisation and attentiveness. ✱

MAJOR BANKING TRENDS

DELOITTE'S GLOBAL BANKING Industry Outlook 2011 identified five major trends to sweep across the banking industry this year. These are:

1. **Globalisation and consolidation.** Crumbling cross-investment barriers offer large banks the opportunity to expand abroad relatively freely by acquiring or merging with banks in other countries.
2. **Reconnecting with the customer.** Slow growth in many existing markets has pushed banks to reconnect with retail customers through a combination of technology and personal service. Forty two per cent of banks surveyed identified technology as a top driver of profits over the next three to five years as they rebuild their customer relationships.
3. **Promoting compliance.** Regulation is second only to globalisation as a transformative issue for banking over the next three to five years. Half of the banking industry survey respondents saw regulation as one of the top influences on profits.
4. **Better risk management.** Four out of ten respondents ranked risk among the top transformational issues over the next three to five years. Banks view operational and reputational risk to be greater concerns than market, credit and liquidity risk.
5. **Demographic shifts.** As the population gets older, the focus of target customers will be shifted from wealth accumulation to a lengthy retirement. At the same time, responsibility for retirement security in many markets is moving from the government and employers to the individual. ✱

DEVELOPING FINANCIAL INCLUSION

AS MALAYSIA MOVES TOWARDS a higher income economy, it is imperative that all groups enjoy the fruits of transition. Inclusive financial systems will not only catalyse progress for the poorest and marginalised segments of society, but also uplift those groups already in the financial mainstream but highly challenged by the environment.

Policymakers can contribute in five significant areas in advancing the financial inclusion agenda, said Bank Negara Malaysia Governor Tan Sri Dr. Zeti Akhtar Aziz at the recent Financial Inclusion Policymakers Forum as reported by *BERNAMA*:

- Give clarity to the financial inclusion agenda, in addition to driving the national commitment to financial inclusion. This includes defining the goals for financial inclusion that must be broad-based and comprehensive.
- Create the right incentives and competitive environment for financial institutions to respond to the opportunities in financial inclusion.
- Provide the enabling infrastructure to enhance the access to financial services. This includes making further use of IT, e.g. through mobile phone banking, to substantially reduce the costs of extending the outreach of financial services, and putting in place a sound payment and credit information system.
- Evolve a comprehensive approach to consumer protection to complement the role of prudential regulation in mitigating risks. This includes putting in place a conducive regulatory environment to protect consumers and ensure responsible behaviour by financial institutions.
- Develop a financial education programme to create empowered consumers who can make competent financial decisions.

In Malaysia, the commitment to the financial inclusion agenda is legislated under the new Central Bank of Malaysia Act 2009 which provides as one of its primary functions, the promotion and development of a sound, progressive and inclusive financial system. The blueprint for the development of the financial sector for the next decade gives special focus to financial inclusion and consumer protection. ✱

Roots

To move forward the Islamic finance industry would do well to go back to its roots.

RETURN TO RISK-SHARING

HSBC AMANAH GLOBAL Chief Executive Officer Mukhtar Hussain has argued that "To move forward the Islamic finance industry would do well to go back to its roots," reported *TradeArabia*.

'The main principles of Islamic finance are that of risk-sharing - taking on risks for possible rewards or losses and a requirement for financial transactions to be backed by assets such as properties or land. Going back to these principles will pave the way for what Mukhtar argued are the strongest opportunities for Islamic finance, which are *sukuk* project finance and Islamic real estate investment trusts (REITs).

Mukhtar said that with the global population forecast to reach 9.2 billion by 2050 from 7 billion currently, project finance *sukuk* can help raise more capital to build infrastructure in developing countries. Meanwhile, Islamic REIT is a new asset class that fund managers and private investors can consider, post financial crisis, as an alternative to traditional equities. Islamic REITs are asset-backed by a portfolio of properties. Although nascent, Mukhtar said that project finance *sukuk* and REITs are a natural fit with Islamic finance, "which is about building a stable future by investing in the real economy," reported *TradeArabia*. ✱

MULTIPOLAR *challenges*

ANDREW HARDING

THE CHANGING SHAPE OF THE GLOBAL BANKING SYSTEM

Despite the understandable caution that many countries, including Malaysia, are expressing about the return of economic confidence, there is growing optimism that the global economy is beginning to recover from the impact of the West's dramatic financial crisis. But whatever the future holds, there is no going back to the 'business as usual' scenario.

The financial world has changed permanently both in terms of the global balance of power and how banks will be allowed to operate in the future. And Malaysia is in a strong position to benefit. It's hardly surprising that everyone is looking towards the emerging markets and particularly those in the East. Banks in these regions are now comparatively well-capitalised and well-funded - and big enough to compete directly against their western counterparts. The dramatic shift in economic power is illustrated by the fact that the two largest banks by capitalisation are both Chinese – ICBC and China Construction Bank. British bank HSBC takes third place but it is a largely Asian operation. A league table compiled by *Bloomberg* in April last year shows that Citi, once the world's largest bank, now ranks fifth, while banks from the other BRIC countries, Brazil, Russia and India, are all in the top 25.

TOP BANKS

ICBC

中国建设银行 China Construction Bank

THE DRAMATIC shift in economic power is illustrated by the fact that the two largest banks by capitalisation are both Chinese – ICBC and China Construction Bank.

This potential for growth comes from the relatively immature development of domestic financial markets in emerging markets and their rapidly growing economies. Consultancy firm McKinsey & Company has estimated that 2.2 billion out of the 2.5 billion people globally who do not use a bank live in Africa, Asia, Latin America and the Middle East. This offers huge potential for expansion based on innovations such as mobile phone banking and microfinance lending. As Noel Gordon, a consultant at Accenture, told *The Economist*, western banks are 'fiddling with rocket-science finance' while emerging market banks are innovating more productively.

But sooner or later,

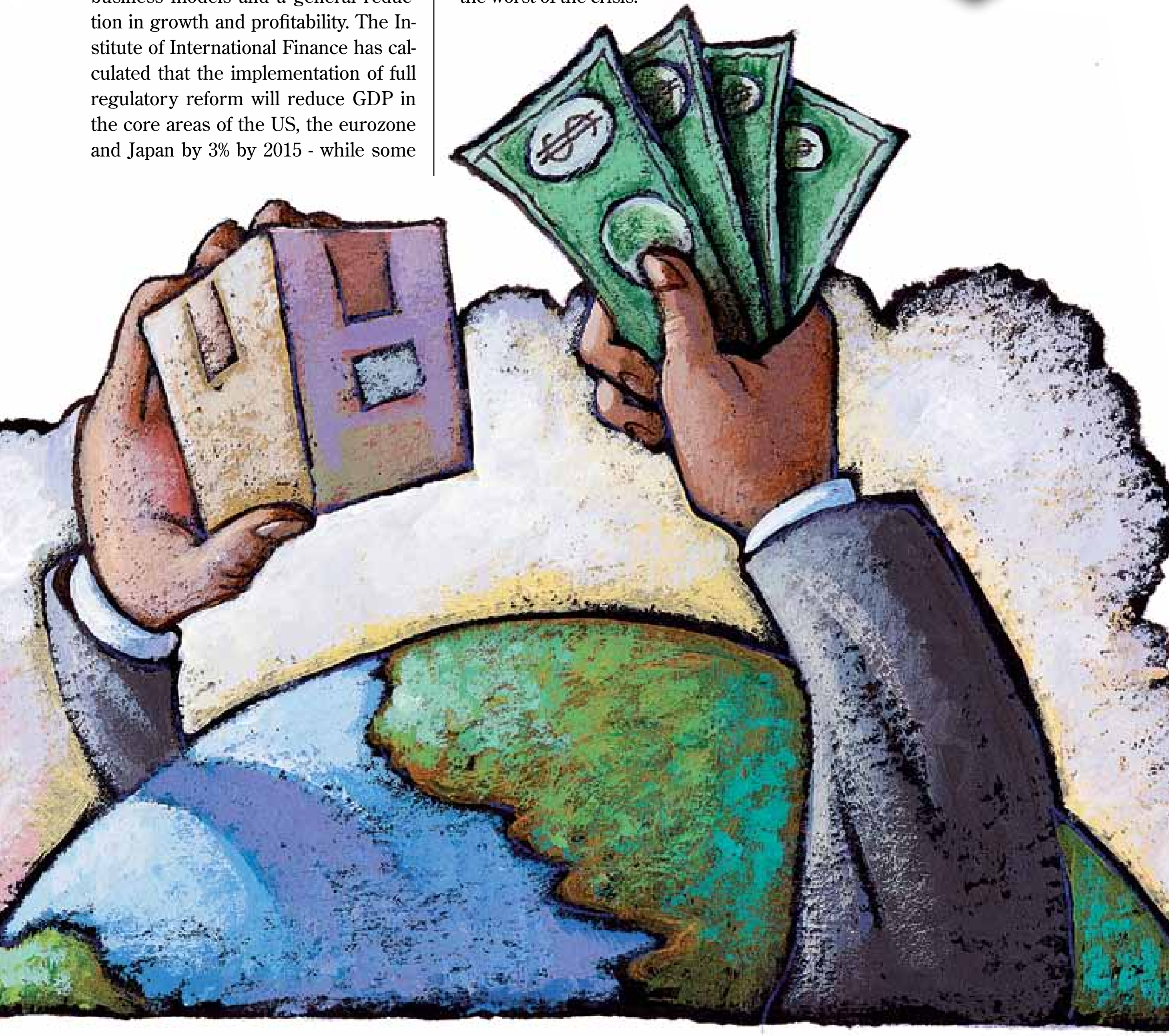
regulation will inevitably become an issue in these markets just as it has in the more established ones. Finance ministers of the G20 countries have called for a number of changes including stronger capital and liquidity standards, a 'fair and substantial' commitment by banks to pay back the cost of government intervention and tighter regulation to ensure greater supervision and transparency.

According to Deutsche Bank, this move towards tougher regulation will result in a return to more traditional business models and a general reduction in growth and profitability. The Institute of International Finance has calculated that the implementation of full regulatory reform will reduce GDP in the core areas of the US, the eurozone and Japan by 3% by 2015 - while some 9.7 million fewer jobs will be created.

However, it goes without saying that this new environment will differ greatly from one country to the next and regulators in Asia are still looking to the West to see how individual banks and governments rewrite the rules of corporate and banking governance. Whatever evolves in the future, the dynamics will be very different. Governments in emerging markets in Asia, Africa and Latin America are in a much stronger position because banks in their countries escaped the worst of the crisis.

2.2 BILLION *out of the* **2.5 BILLION**

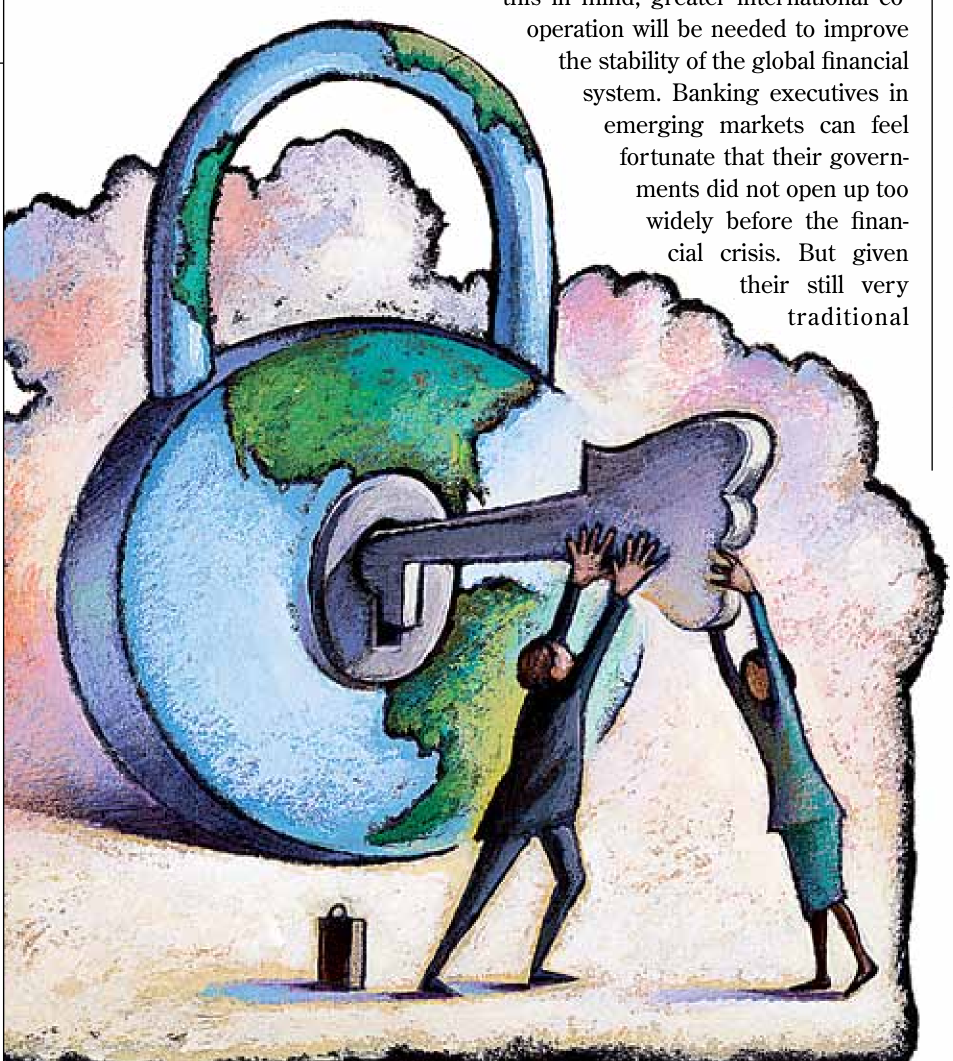
People globally who do not use a bank live in Africa, Asia, Latin America and the Middle East. This offers huge potential for expansion based on innovations such as mobile phone banking and microfinance lending.



Finance ministers of the G20 countries have called for a number of changes including stronger capital and liquidity standards, a 'fair and substantial' commitment by banks to pay back the cost of government intervention and tighter regulation to ensure greater supervision and transparency.

But the stronger role of national governments within banking means the future governance model is likely to be a hybrid of a regulated free market approach and so-called 'state capitalism.' Andrew Lockhard of the international law firm, Baker & McKenzie, provides a taste of things to come in his description of the situation in China. 'What we are seeing is pretty active control of the banks, particularly their liquidity ratios,' he says. 'This is being done on a micro-management basis for reasons related to the overall control of the economy as opposed to pure prudential regulation of the financial institutions themselves.'

Looking to the future, a key challenge lies in the fact that financial markets are increasingly global while regulators are predominantly national. With this in mind, greater international co-operation will be needed to improve the stability of the global financial system. Banking executives in emerging markets can feel fortunate that their governments did not open up too widely before the financial crisis. But given their still very traditional asset portfolio, the desire to understand how to respond to more complicated and complex financial products – the real money makers – is still very strong, and in many instances, government-led.



The China Banking Regulatory Commission is actively encouraging the development of a stronger derivatives market. Some may argue that it was these complex financial products that got banks into trouble in the first place and that the development of more complicated and diverse financial products clearly carries inherent danger.

To respond to this, emerging market banks and policymakers will be focussing on imposing strict rules to ensure that they avoid the West's mistakes. William Rhodes, Vice-Chairman of the Institute of International Finance and a senior advisor to Citi, has warned that the introduction of reforms needs to be determined with great care. He added that this should be the case not just in the mature industrial countries where it could slow economic recovery but also in emerging markets where banks are, 'the most important engines of development and growth'.

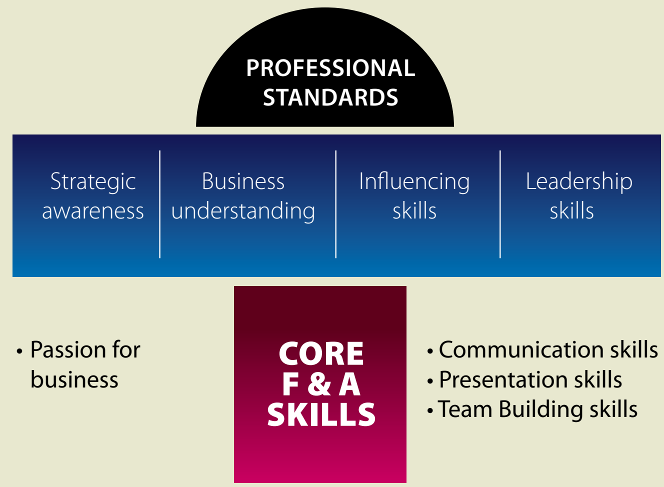
The dominant role of the US dollar and US banks is set to give way to a world where other countries, their currencies, their capital markets and their banks all play a greatly enhanced role. This structural shift will offer both opportunities and threats. As western banks go through painful restructuring, tackle the problems with toxic assets and - in the case of the nationalised banks - get ready for re-entry into the private sector, emerging market banks are likely to look to each other for new opportunities. ICBC's USD5.5bn acquisition of a 20% stake in Standard Bank of South Africa is

"The introduction of reforms needs to be determined with great care."

probably the clearest indicator of this.

Perhaps the biggest lesson from the crisis is that banks all around the world must co-operate more. Xiao Gang, Chairman of the Bank of China, has noted that, 'It is not about who should learn from whom. Instead, it is about learning from each other, strengthening co-operation and seeking development together.' It is this trend that is likely to shape the future of global banking in the post-financial crisis world. Malaysia has strong links with both mature and emerging economies and is in a good position to find new allies and new markets. Credit Suisse has described this development as a 'multipolar' global landscape - where the centres of power are more widely dispersed around the world. For the Malaysian economy to benefit from this new environment, its banking sector must make the most of finance professionals – and management accountants in particular. The financial crisis has demonstrated the need for banks to understand their business models together with the associated risks. Management accountants have a unique, business-based toolkit and they are ideally positioned to provide the clarity, innovation and integrity to help meet this need.

THE T-SHAPED ACCOUNTANTS:



Accountants' understanding of numbers, business processes and, especially, how to manage decisions through to impact is valued. (Source: CIMA, August 2008)

The challenge for banks, as for all organisations, is to create long-term, sustainable success. Once there is a clarity of vision in relation to the business model, banks also need to understand the role of performance indicators and executive incentives in driving the right, or wrong behaviours, as well as how good governance can make a difference. The financial crisis in the West has shown that some banks did not grasp these issues adequately.

By acting as forward-looking business partners, management accountants can support business success in a number of ways. This includes providing the high quality information needed to make the right decisions, ensuring the effective allocation of resources and developing a robust risk management strategy. To give an example, the tools and techniques used by management accountants such as activity-based-costing help banks to achieve cost leadership. They can also provide information to enhance understanding of customer, product and delivery channel profitability - key issues for retail banks.

In brief, management accountants have the knowledge and skills to plan out the business route and provide the information and key performance indicators to reach the desired destination and outcomes. Banks will need these skills as they move forward. Strong compliance regimes need to be linked with robust and sustainable business models. This relies on best-in-class management information and decision-making - and strong risk management. In other words, it is essential to always have a focus on the long term horizon. Caution may still be the word on many people's lips but with the right finance professionals playing a supporting role, the banking sector can move forward in the knowledge that sustainability is built into the heart of its business. ✱

■ Andrew Harding is Managing Director, Chartered Institute of Management Accountants (CIMA).

SKILLS

MANAGEMENT ACCOUNTANTS have the knowledge and skills to plan out the business route and provide the information and key performance indicators to reach the desired destination and outcomes. Banks will need these skills as they move forward.

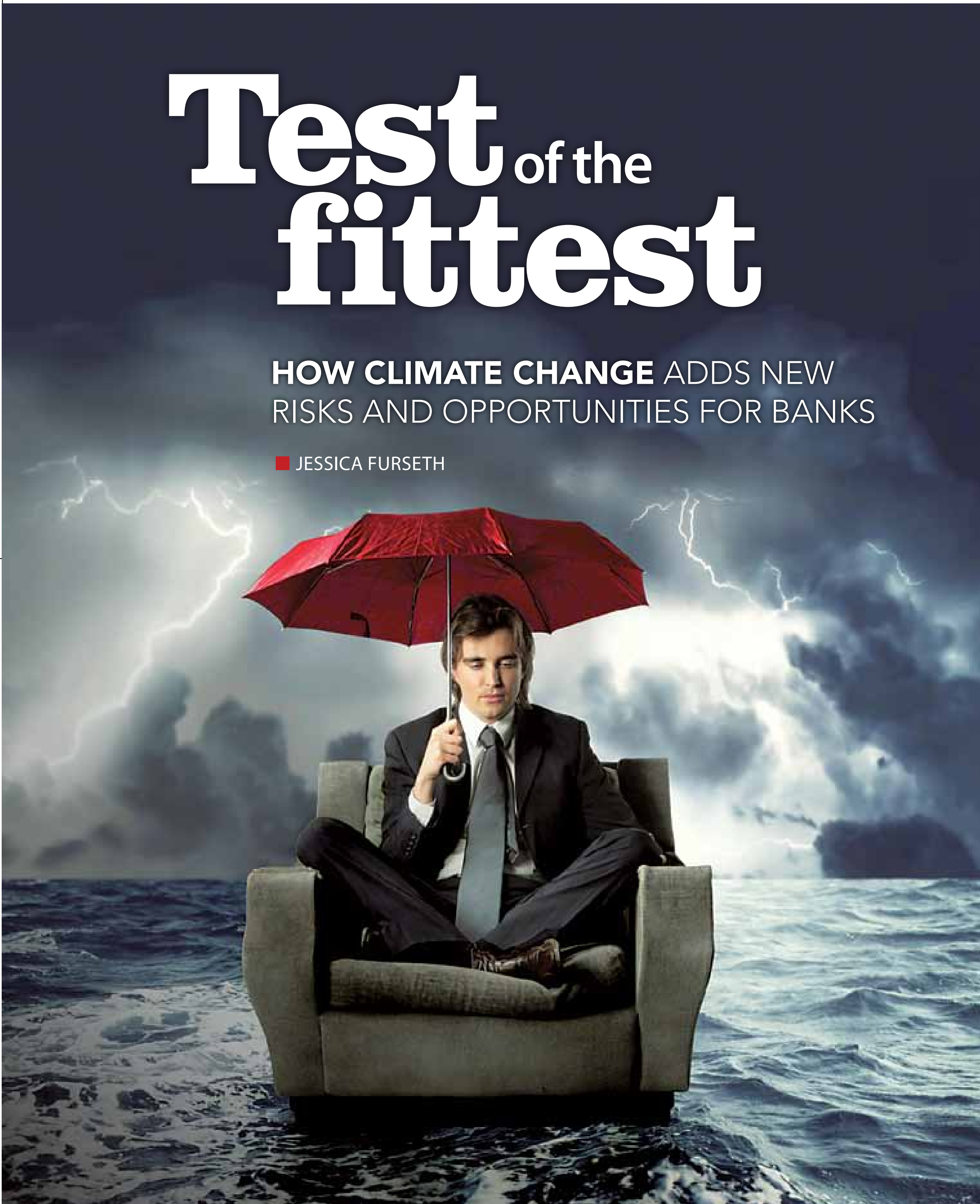
USD5.5bn

ICBC's acquisition of a 20% stake in Standard Bank of South Africa

Test of the fittest

HOW CLIMATE CHANGE ADDS NEW RISKS AND OPPORTUNITIES FOR BANKS

JESSICA FURSETH



Climate change is altering tried and tested rules for banking and business, meaning players must adapt or risk being left behind. This is also an opportunity to excel, as the changes are opening up new banking markets.

An uneasy mix of urgency and complacency surrounds the climate change debate, and this holds especially true in the financial arena. There is increasing acceptance of the severity of the problems caused by rising CO_2 levels, but this is the big picture view. While the financial sector has made progress incorporating climate concerns, the commitment to maximising profits still takes priority over the green agenda.

Corporate reputation is the main reason financial services executives take climate change into consideration, according to consultancy group McKinsey & Company. Findings presented in the global survey 'How companies think about climate change' show 57% of financial executives cite reputation as the key motivation. Forty one per cent acted mostly due to media attention, but 30% perceived climate change as an investment opportunity. As the problem grows in scale, the opportunity for banks to profit from investments into efforts to find solutions, should increase in kind.

There is however a significant amount of risk attached to the climate change investment proposition. Thirty three per cent of financial services leaders view climate change as an equal mix of risks and opportunity, according to McKinsey's. Twenty per cent of respondents see it as adding mostly risk, however an equal percentage see it as adding mostly opportunities. Only 16% thought climate change was irrelevant for their business.

NEW BANKING MARKETS

Reputational pressures aside, there are significant opportunities for the climate change agenda to also bring about financial reward.

New investment areas:

The climate change problem is leading to increasing investment by governments and private companies, and this means rising demand for new and existing financial products. Investment in clean energy asset classes has steadily increased since 2004, according to *Bloomberg New Energy Finance*. Banks will have a central role as providers of finance to green projects, as well as acting as dealmakers – on a business level as well as enabling homeowners to fund energy micro-generation.

€2,900bn in funding will be required to reduce European emissions to 83% of 1990 levels by 2020, according to Barclays and management consultants Accenture, in the report 'Carbon capital: Financing the low carbon economy'. The cost of climate change varies between studies, but there is little doubt it will be significant; by 2050 the cost of climate change adaptation will reach $70bn to $100bn per year, according to the World Bank report 'Economics of adaptation to climate change'.

Renewable energy and cleantech has the potential to attract $225bn of new investment every year by 2016, according to risk management consultants Oliver Wyman, in its report 'Climate change: Risks and opportunities for global financial services'. Up to $200bn will be required in coming decades to develop and renew key energy and transport infrastructure globally. For example, Britain is currently investing heavily into offshore wind power.

'The offshore wind industry is at the heart of the UK economy's shift to low carbon and could be worth £75bn and support up to 70,000 jobs by 2020,' said former UK Prime Minister Gordon Brown, as licenses for 25 gigawatt worth of wind power were distributed last year. This means high upfront investment into projects that will take many years to deliver revenues.

Renewable energy and cleantech has the potential to attract $225bn of new investment every year by 2016.

'A cautious approach persists amongst mainstream institutional investors,' says Graham Bell, Director of broking and advisory group Allenby Capital. 'Many have had their fingers burnt by getting involved at an early stage only to witness a decline in the value of their investment, as delays and cost overruns have impacted upon projects. All, bar the very high risk players in the market are insistent on either cash generation, or the prospect of near term cash generation.'

Regarding the risk of cleantech investment, Bell points out this often rests less on whether the technology is proven, but whether the targeted industries are willing to accept it. This is related to the cost and efficiency of the materials used; however, whereas the cost is often higher, the same usually holds true for efficiency.

Advisory and hedging:

Banks have the potential to step into an advisory role on climate change, as customers seek to protect themselves against increasing business risk. This includes rising energy prices and consequences of unpredictable weather, especially in emerging markets. As solutions are being developed, on the business-specific level there is considerable risk of failure. Wind power, fuel cells, solar and wave energy are all being developed now, and as with any young industry, there will be casualties.

Customer requests:

Consumers are increasingly conscious of corporations' stances on climate change, and are willing to pay a premium for an environmentally conscious financial product. A US survey by consulting group Deloitte found 36% were willing to pay 5% more for green energy. This willingness to 'do your bit' for the environment generates a market for banks to offer ethical consumer products, such as funds with a green mandate. Environmental awareness will set banks apart in the eye of the consumer; HSBC has been carbon neutral since 2005, a stance repeated by Barclays in 2009.

'From a lending perspective, Standard Chartered believes it has a role in the important transition to a low carbon economy. Our markets are frequently rich in renewable resources, but lacking in infrastructure and electricity generation capacity,' says a Standard Chartered spokesperson.

'Through a dedicated team within our wholesale banking group, we have the expertise to take a leading role in the financing of renewable and clean energy projects,' she adds, noting the bank has mobilised $4.9bn of project financing since 2007, as part of its commitments under the Clinton Global Initiative.

RISK CONSIDERATIONS

The inherent uncertainty brought about by the climate issue is the key risk for banks; the changing environment is altering business practices and investment behaviour because the rules are changing.

Credit quality:

Climate-related issues will affect the quality of credit, increasing the chance for defaults and asset value declines.

'The challenge for financial institutions will be to spot, in the absence of robust data, potential anomalies in achievable risk premium, and to establish those markets in which they should be competing aggressively and those in which they need to increase margin and collateral requirements,' says the Oliver Wyman report. Extreme weather could lead to insured losses rising to $150bn a year by 2030, according to Oliver Wyman, leading to rising insurance premiums to the point where regulators may step in to prevent prohibitive price increases. An extreme consequence of this could be an erosion of insurers' business models.

Regulatory intervention:

Government incentives remain the main drivers for the climate cause. On the upside, this means financial incentives to aid investment in new technologies, but investment will suffer if these are not perceived as reliable. For example, the German feed-in tariff for solar power was unexpectedly reduced last year; not only did this cut damage returns for solar installers, it also affected pricing along the whole industry supply chain.

Trading systems such as forest bonds and water trading rights have been introduced to create a market for environmental obligations. Carbon credits and emissions trading were introduced as a means to create economic incentives to cut pollution, but the persistently low price of carbon has damaged its efficiency. In March's budget, the UK government established a carbon 'floor' price, meaning British utility groups will have to pay a certain minimum for pollution permits even if the market price goes down. The floor will start at £16 a ton in 2013, rising to £30 by 2020. If UK utilities pass on this new cost to customers it would mean a 16% increase in energy bills by 2020, according to energy consultancy WSP. There is a chance the UK energy regulator would not allow this – adding further uncertainty.

Due to the scale of funding needed, 'a major portion of the financial backing necessary to tackle climate change will need to come from the private sector. There is not enough public funding available for governments to pay for the required volume of emissions reductions', management consultancy Booz & Co concluded in the report 'Climate change after the Kyoto protocol'.

This willingness to 'do your bit' for the environment generates a market for banks to offer ethical consumer products, such as funds with a green mandate.

The question of whether or not banks have an obligation to consider environmental matters in their investment decisions does however remain a highly sensitive issue, emphasises Allenby Capital's Bell:

'I would argue it is the duty of governments to regulate companies and industries that may impact upon the environment rather than provide investment banks with an "obligation" to consider the environment.'

There is however a downside to this approach, he concedes: 'Investors will generally tend to shy away from companies that suffer from too much government interference.'

THE LACK OF CERTAINTY

The strong lack of certainty surrounding the climate change problem is the main concern ahead of any action. Adding to changing regulations and technologies, the science of climate change is poorly understood, adding to the difficulty of predicting outcomes.

'Climate change is a long-term trend which will affect the value of assets in the real economy,' Deutsche Bank senior investment analyst Bruce Kahn said in the research report 'Investing in climate change'. While Kahn says this will ensure investment opportunities, 'government policy volatility, or more obviously lack of policy, can result in short-term asset mispricing and a reluctance to deploy capital.' Diversification is a key defence against this added risk, as well as a focus on sustainable assets:

'Institutional investors must develop new tools to more effectively model systemic risks such as climate change. These tools require an expansion of the way we think about portfolio risk, looking beyond mere volatility,' consultancy group Mercer wrote in its report 'Climate change scenarios – impact for strategic asset allocation'.

A pro-active stance is also likely to be beneficial, according to Mercer, meaning active investment mandates, a bottom-up view on companies and geographies, as well as engagement with policymakers and researchers. While doing nothing is arguably the safer option in the shorter term, the longer-term cost rise exponentially as action on climate change is delayed. There is however a need for clear, co-ordinated efforts, and this is an area where banks have an opportunity to take a leading role. ✱

The murky science of green PR

In March, Britain's Royal Bank of Scotland (RBS) was targeted by green activists over its role in financing the coal industry. RBS provided nearly $8bn worth of finance to global coal miners in the past three years, according to a report from campaign group, Platform.

Last year RBS was accused of 'cashing in on blood oil' for its ties to the production of tar oil sand in Canada. RBS has rejected suggestions that it underwrote over $7.5bn of tar sand-related loans. However, the accusation resulted in 15 demonstrations throughout the UK.

RBS, which is 83%-owned by the UK government following the financial crisis, has re-focused its investment mandate following the bailout. However, when quizzed by *The Guardian* newspaper about the bank's involvement in the Canadian oil sands, RBS's Managing Director of energy and infrastructure Andrew Harrison responded by saying it was 'for government to decide what was legal and what was not'.

As a consumer, this response is nothing short of chilling, as it indicates that RBS does not really care. The bank includes specific reference to oil sands in its breakdown of energy financing:

'RBS has not provided direct finance to an oil sands project for at least three years. We do however provide general corporate finance to companies who have some oil sands extraction and production operations as part of their business.'

RBS's green credentials were boosted by its role as a sponsor for UK's recent Climate Week, but this has

not deterred critics from accusing RBS of paying lip service to the environmental cause. Whether the gap between the involvement in the oil sands and Climate Week is a PR issue, or symptomatic of a deeper problem, depends on one's attitude on how obliged is the bank to act ethically. Regardless, what customers are seeing is that RBS talks the green talk, but it does not seem to quite walk the green walk.

■ Jessica Furseth is a freelance journalist based in London.

REBUILDING TRUST IN BANKING

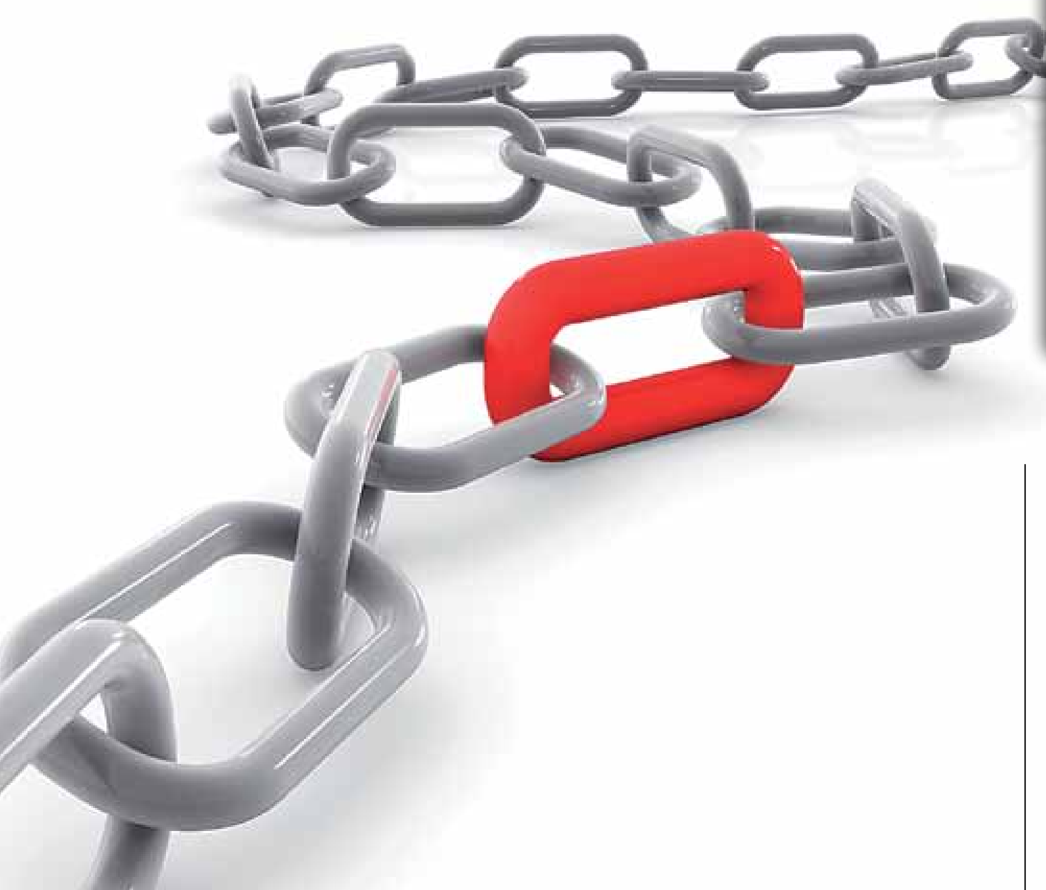
The following is an extract from the keynote address delivered at the 19th World Congress of Banking Institutes, hosted by the Bahamas Institute of Financial Services from19 to 21 March 2011.

SIMON THOMPSON

In many Western economies, there has been a well-documented – and deserved - collapse in trust in the banking industry. In 2009, just 19% of Americans trusted their financial system. Trust has risen slightly since then, but only to 26%, according to the most recent Chicago Booth Financial Trust Index. That's about the same in the UK, where about one quarter of the public say they trust banks – all banks, including those that had emerged relatively unscathed from the banking crisis of 2007/2008. Yet levels of trust in banks and bankers had been falling for many years before the banking crisis; in the UK this was caused by a combination of factors including a steady stream of stories of mis-sold financial products, the high overdraft fees charged to customers, and the increasing levels of executive remuneration. The "bonus culture" was eroding trust confidence long before the recent crisis struck.

By contrast, though, trust in banks in several emerging economies has actually increased in recent years. According to figures published by KPMG, the consulting firm, whilst trust in the banking industry dropped by 33 percentage points in the US between 2006 and 2009, in China trust rose from 72% to 84%, and in Brazil from 52% to 60% over the same period. The challenge in such economies is now maintaining these levels of trust – what will happen as asset prices flatten or fall, and credit is withdrawn, as is beginning to happen?

Trust matters in banking and financial services, as our industry is built on mutual trust between colleagues and



counterparties, and on customers' confidence that banks are safe places to deposit our savings, and to invest for our futures. When that confidence evaporates, we see panic as depositors and investors rush to retrieve funds, as happened in the UK with the run on Northern Rock – the first run on a UK bank since 1871. And, as we have seen, governments around the world are forced to step in to secure deposits, recapitalise banks and ensure the continued operation of the banking system.

When we lose trust in our banks and in our financial services industry, the costs are very high indeed. Andrew Haldane, a Director of the Bank of England, estimates the direct wealth transfer from the taxpayer to the banks in the UK at £20bn, and in the US at USD 100bn – approximately 1% of GDP in both cases. In terms of lost output, he estimates the cost to the UK at £140bn; USD4trn in the US. And a total loss of world output of between USD60trn and USD200trn. And these are just the financial costs – what about the social costs that lie behind such losses?

TRUST LEVELS

ACCORDING TO FIGURES published by KPMG, the consulting firm, whilst trust in the banking industry dropped by 33 percentage points in the US between 2006 and 2009, in China trust rose from 72% to 84%, and in Brazil from 52% to 60% over the same period. The challenge in such economies is now maintaining these levels of trust – what will happen as asset prices flatten or fall, and credit is withdrawn, as is beginning to happen?

CAUSE

IT WASN'T JUST LACK OF CAPITAL that caused problems; it was also poor lending, and poor management of risk and liquidity that lay behind these and other banks' problems.

19%

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It's an enormous bill that the banking industry has presented to society, and banks have only just begun to start paying this back. The Chief Executive of Barclays suggested earlier this year to the UK Treasury Select Committee that the "time for remorse" was over. In my view, it isn't. The time for remorse will only be over once trust and confidence in banks and bankers has been fully restored.

Rebuild Human Capital Alongside Financial Capital

International attention has focused on building confidence in the banking industry via prudential measures, in particular rebuilding banks' capital reserves, and on reforming the Basel regime. Of course increasing capital reserves is necessary. But increasing core capital to 7% or 8% and imposing additional countercyclical measures won't, in my view, do much to forestall future financial crises.

There are two reasons to be cautious about this. Firstly, the new capital requirements look steep – until we recall that Northern Rock, Lehman Brothers, the Belgian-French Dexia and many of the Spanish Caixa (savings banks) held significantly greater capital reserves than Basel III will require. It wasn't just lack of capital that caused problems; it was also poor lending, and poor management of risk and liquidity that lay behind these and other banks' problems.

Secondly, I believe we currently focus too much on financial capital issues, and not enough on human capital issues. We need to build (or, rather, re-build) a strong and sustainable banking culture based on high ethical, professional and technical standards. Banking is built both on financial capital and human capital; high quality financial capital provides the financial base the industry needs to support individuals and businesses; high quality human capital provides the stable cultural foundation on which the banking industry itself is built.

And this is where, I argue, governments and regulators should be focusing more attention. If we want to rebuild trust in financial services, we have to rebuild confidence and trust not only in our banking institutions, but also rebuild confidence and trust in individual bankers. The culture of our industry depends, ultimately, on the professional knowledge, skills and behaviours of the individuals who collectively comprise the organisation and our industry overall.

Customers and counterparties need to have confidence in the competence of individual bankers, and need to be able to trust their ethical and professional judgement. We need all bankers, therefore, to develop and demonstrate their ethical and professional competence – and this is where banking institutes around the world, and our partners, can and must play a key and ever-increasing role.

Ethics and Professionalism

Senior individuals in our industry understand this too. In September last year, the Chairmen of Barclays, Lloyds, RBS and another 14 senior figures in the UK financial services industry wrote to the *Financial Times* calling for the development of an "enlightened culture of professionalism and integrity" across the financial services industry. Yet policymakers and regulators seem curiously reluctant, at least in the UK, to act.

In a speech in June 2010, Hector Sants, Chief Executive of the UK's Financial Services Authority (FSA), shied away from calling for an "ethical culture" and "ethical leadership," claiming that "ethics carries too much baggage for regulators." Regulators don't like ethics, because it's hard to get to grips with and impossible to define in sets of precise rules. For me, though, it is the plethora of precise rules that led to many of the problems besetting the banking industry. For the most part, banks have been very good at complying with the rules, and have employed large numbers of staff and consultants to ensure compliance. Yet doing things by the rules hasn't meant that banks were necessarily doing the right things.

That's why we need to fix the bit the rules gloss over - the human capital on which banking depends - as well as rules for financial capital. That's why we need to build a strong and sustainable culture based on high ethical, technical and professional standards, in which we don't delegate responsibility for running our bank to the regulators, but where Boards and Directors – where bankers themselves - take responsibility. Ultimately, it's the responsibility of those managing the banks themselves to ensure they're well-run and adequately capitalised, whatever the rules say. And this requires those leading the banks to exercise their professional judgement – not simply to follow rules.

Regulators may struggle with "ethics" and "professional judgement", but at the Chartered Banker Institute we've understood them and embedded them in our educational programmes and Code of Professional Conduct for many years, as I know is the case in many other banking institutes around the world. Put simply, we regard being ethical and professional as a way of thinking and behaving which embodies honesty, integrity, high technical and professional standards, morality and a sense of fairness into everything a person does in their daily job. It is a mindset that should be encouraged and developed throughout all employees, irrespective of age or seniority in an organisation, and should be a constant feature of their ongoing development. It is underpinned by the "Scottish" values of stewardship, prudence and professionalism that were so successfully exported around the world for many years – it is no coincidence that two of the world's most successful and sustainable banks, HSBC and Standard Chartered, were proudly founded on these.

These general moral values, which drive appropriate behaviours, cannot be developed in isolation – it is not simply enough for bankers to be "good" people. These values must be underpinned by high levels of technical knowledge and skill. Without an in-depth understanding of banks' products and services, about what a bank does, about risk, and about the potential positive and negative impacts of a bank's actions on society, bankers at all levels cannot be confident about ensuring positive outcomes for consumers of those products and services. And without a detailed understanding of credit and risk, bankers cannot be sure their loans will be repaid. Yet in recent years, at least in some countries, technical knowledge and skills were valued less highly than sales and service skills. Both are important, of course. To me, though, a lack of technical knowledge and skill always implies a deficit of ethical and professional competence. For how can an individual make positive ethical choices without a good understanding of how their actions and decisions may lead to different outcomes?

Ethical, professional and technical competence. These are the foundations on which we must rebuild confidence and trust in banks and bankers. Yet we cannot wait for governments and regulators to take the initiative in these areas – the key role, in my view, will be played by banking institutes, educators and our partners around the world. For it is education, not regulation, that will, over time, rebuild the ethical and professional competence of bankers that, in turn, will help us rebuild confidence and trust in banking institutions and the industry overall. ✱

■ Simon Thompson is Chief Executive, Chartered Banker Institute, Scotland.

REBUILD

IF WE WANT TO REBUILD TRUST in financial services, we have to rebuild confidence and trust not only in our banking institutions, but also rebuild confidence and trust in individual bankers. The culture of our industry depends, ultimately, on the professional knowledge, skills and behaviours of the individuals who collectively comprise the organisation and our industry overall.

FOUNDATIONS

ETHICAL, PROFESSIONAL AND TECHNICAL COMPETENCE. These are the foundations on which we must rebuild confidence and trust in banks and bankers. Yet we cannot wait for governments and regulators to take the initiative in these areas – the key role, in my view, will be played by banking institutes, educators and our partners around the world.

Will overhaul restore Confidence?

VISHAL BALASINGHAM

IS AN OVERHAUL of global financial regulatory frameworks necessary to restore confidence in the banking sector? Vishal Balasingham, argues that it is not, as long as three necessary actions are taken. One, the banking sector needs to correctly assess, manage and distribute risk. Two, regulators restrict banks to pure banking activities, rather than enabling the riskier derivative and investment functions – the very issues that set off the crisis. Three, central bankers play a stronger role in governing banks. Taken together, these three factors should help the sector polish its reputation – without the need for a radical overhaul of financial systems and frameworks.

Western banks have been subject to public criticism since the global financial crisis four years ago exposed their high-risk activities and forced a major bailout of the distressed banking sector with public funds.

Apart from financial upheaval, the reputations of leading financial institutions were affected too. While UBS was the first top-flight bank to announce major losses of \$3.4bn, it was soon joined in the lengthening rollcall of red ink. By mid-2008, US financial authorities had stepped in to bailout America's two largest lenders, Fannie Mae and Freddie Mac. Later that year both Lehman Brothers and Washington Mutual Savings Bank filed for bankruptcy. The year ended with the government agreeing to rescue Citigroup by guaranteeing losses on \$306bn of Citi's assets and injecting \$20bn in fresh capital.

The existing banking model seemed to be broken: if it's broken, should it not be fixed? Ironically, although "destructuring" and "reforms" have become key industry themes across major swathes of the global economy, major industry players remain hesitant about calling for a complete overhaul of global financial regulatory frameworks.

Needed: Understanding of Risks and Proper Risk Management

Instead of an overhaul, the way forward for banks is to accurately assess, diversify and manage their risks.

In an INSEAD Knowledge report, Paul Tregidgo, Managing Director, Credit Suisse noted that an overhaul is a risk in itself and pointed out that while bad regulations can create crises, good ones don't necessarily prevent them. According to him the fundamental regulatory questions revolve around how risks are created, assessed, distributed and regulated.

"Do banks actually understand the risks that they are creating," he asked. "Are they assessing risk in a world of global connectivity? When we distribute risk, are we really distributing it?"

Instead, Tregidgo proposed closer regulatory oversight of how major financial intermediaries approach, assess and price risks. He added that it was time for a new regulatory contract which must balance the above mentioned issues.

"I suggest minimal regulation but one that is strong in letter and spirit because innovation must be encouraged to flourish," he said. "But innovation cannot be allowed to control the system."

Execution will be key to the effectiveness of central banks in managing regulation. A lot will depend on people and institutions on the ground. For instance, the European Central Bank will still depend on national regulators for information about specific firms and American bank supervisors will have to familiarise themselves with more stringent requirements for transparency of information.

Going Back to Basics

There is also no consensus on the ideal approach for balancing regulatory oversight and allowing room for financial innovation to boost economic growth. On one hand, some parties are calling for a return to basics and diminishing of complexities. Michael Gordon, Global Head of Institutional Investments at fund manager Fidelity International, argued in INSEAD Knowledge that regulation should aim to create a cleaner and simpler financial world.

"One where banks are more like banks as we used to know them, brokers more like brokers, corporate finance returns as a function of itself, asset managers being pure asset managers and the like," he said. "I think we will see a trend back to simplicity away from complexity. I think financial modelling will be less trusted."

Central Banks Injecting Confidence

Meanwhile, the expanded role of central banks could also help to restore confidence in banking and finance. Recently, central banks have been shouldering more responsibility for the supervision of banks and the stability of financial systems. Their new job scope involves regulating banks while keeping a lookout for any red flags that have the potential of weakening their respective economies.

This will have a direct impact on the banking and finance industry. According to Deloitte's Global Banking

It's a tall order. But if banks can do a better job in risk management and stick to pure banking, and central banks can pull off a better job in oversight compared to just four years ago, that should go a long way towards restoring confidence in banking and finance around the world.

Industry Outlook 2011, regulation will be second only to globalisation as a transformative issue for banking over the next three to five years.

Global developments would appear to bear this out. French and German central banks have already had their supervisory responsibilities increased while the Swiss National Bank will soon share supervision of Credit Suisse and UBS with the country's banking supervisor.

Central banks will also establish a financial policy committee which will identify threats to the financial system. These committees will be chaired by the governor and will encompass external experts and central bankers. But for now these strategies look better on paper than in practice.

Execution will be key to the effectiveness of central banks in managing regulation. A lot will depend on people and institutions on the ground. According to *Money Morning*, the European Central Bank will still depend on national regulators for information about specific firms and American bank supervisors will have to familiarise themselves with more stringent requirements for transparency of information. In an internal review of its supervisory record, the Federal Reserve Bank of New York admitted in *Money Morning* that the recommended reforms would require a "degree of sophistication, contrarian thinking and imagination beyond anything thought needed in the past."

It's a tall order. But if banks can do a better job in risk management and stick to pure banking, and central banks can pull off a better job in oversight compared to just four years ago, that should go a long way towards restoring confidence in banking and finance around the world. ✱

■ Vishal Balasingham is Head of Institutional Trading, Optiva Securities, London.


100
SLIPPERY
MARKET
CONDITIONS

Responsibility and ethics need to be placed at the heart of business thinking and behaviour.

A STABLE ECONOMIC FUTURE?

■ NEIL STEVENSON

Since the end of the Cold War, economies the world over experienced an almost inexorable march towards prosperity, led by innovative businesses and new approaches to regulation. Combining innovation with comparatively looser regulations and cheap credit, businesses, banks, and governments appeared to have stumbled upon a resilient recipe for growth.

Then it went wrong. The system stalled in spectacular fashion, undermined by an explosion of doubt and caution in the financial services industry that had once been in the vanguard of growth. Around the world the wrong kinds of records have been broken: 'biggest ever recession'; 'biggest ever bankruptcy', and more. Certainty turned out to have been complacency. We need to pick up the pieces and start again.

If we are going to move forward towards a more stable economic future then the causes of the crash need to be better understood.

One serious problem with the pre-crisis financial system was its regulation. The typical assumption about the regulation of the global economic system at the turn of the century is that such regulation was relaxed. The truth, however, is that the opposite was very much the case; for example, the financial services industry was one of the most tightly regulated industries in the world and was probably more tightly regulated than at any other time in its history.

Indeed, hiccups in the road to growth were routinely dealt with extra rules by the regulators. The Enron scandal for instance, resulted in the Sarbanes-Oxley Act in the US, a package of regulation later described as "excessive" by US Treasury Secretary Hank Paulson. Rather than occur due to a lack of regulation, the financial crisis occurred in spite of regulation.

Around the world the wrong kinds of records have been broken: 'biggest ever recession'; 'biggest ever bankruptcy', and more. Certainty turned out to have been complacency. We need to pick up the pieces and start again.

The ferrying around of bad debt served no one but punished everyone. If the global economy is to move on from the financial crisis, then we need to recalibrate financial services to fit more closely with the needs of society.

Broadly speaking, there are two traditional approaches to regulation: a principles-based approach and a rules-based approach. As shown by the Enron case, regulators favour a rules-based approach.

There is something comforting about rules for both the regulator and regulated. For the regulator, making new rules – rather than enforcing old ones – is an easy way of demonstrating that they are doing something in a crisis. For the regulated, rules provide clarity. They say exactly what is allowed, or rather, what isn't allowed. So, if a regulator closes off one means to an end with a piece of regulation, a business or individual can still try to achieve the same end by different, more innovative (and possibly more risky) means that have yet to be banned.

Worse, micro-managing regulators can sometimes take responsibility for sensible decision-making away from the regulated. The regulated don't need to consider what is right and what is wrong as this has already been done for them; a compliance mentality takes hold. Once businesses have ticked a box to confirm that what they are doing complies with a regulation, they are free to pursue whichever end they see fit, no matter how risky that end or means may be. Businesses aren't encouraged to think outside of short-term ends that they set themselves – such as year-end profit – leaving long-term sustainability or societal interests at risk of being neglected.

Other governance issues follow this pattern of confused risks and rewards, in particular the failure of self-regulation and the role of individuals. After all, the rules didn't bend themselves, it was the individuals working within the system that did. What were needed were strong, ethical corporate cultures that discouraged overly risky behaviour. Research by the UK's Institute of Business Ethics (2003, 2007), and research for ACCA (2006) has shown a positive correlation between ethical business behaviour and perceived financial performance.

Before the crisis however, boards and non-executive directors should have stepped in to prevent some of the activity being carried out on their behalf but instead they stayed silent. The changing nature of shareholder ownership, from individual shareholders to large institutional shareholders, shifted the emphasis from long-term stability to short-term profit.

Financial services do not exist in a vacuum. They should exist to serve society; to provide safe sources of investment for the public and to provide capital to businesses. The ferrying around of bad debt served no one but punished everyone. If the global economy is to move on from the financial crisis, then we need to recalibrate financial services to fit more closely with the needs of society.

To achieve this, responsibility and ethics need to be placed at the heart of business thinking and behaviour. The scope for effective governance and regulatory changes is wide, with opportunities for change in company reporting, audit, shareholder engagement, and the nature of regulation.

Existing approaches to reporting are perhaps emblematic of compliance mentalities. Annual reports contain plenty of regulatory-compliant information, but the extent of the usefulness of that information is debatable. That's certainly the view of the International Integrated Reporting Committee (IIRC), which is seeking to set a new global standard in integrated reporting.

The problem, according to the IIRC,

is that current reporting standards fail to make a connection between financial performance and sustainability, whether environmental or strategic. Instead, reporting – in the form of a single report – should firmly relate governance and performance by showing that an "organisation's governing structure has applied its collective mind in identifying the environmental, social, economic and financial issues that impact on the organisation, and [has incorporated these issues] into the organisation's strategy." Integrated reporting is now mandatory in South Africa; the IIRC's discussion paper is out this June.

Linked to a more holistic approach to reporting is a wider role for audit. Audit can bring more value by expanding its scope to provide broader, more up-to-date assurance on matters such as risk management and the business model. Bolstering the role of the audit committee and encouraging deeper, much more frequent dialogue between audit committees and regulators would encourage more constructive approaches to regulation and clarify assumptions about responsibility for 'doing the right thing'. In a positive move, enhanced roles for audit and the audit committees have been recommended by a parliamentary committee in the UK.

Likewise, engendering a sense of responsibility, or providing the opportunity to take responsibility could help improve shareholder-business relations. As indicated above, the presence of aloof institutional shareholders can result in a focus on the short term above the long term. Efforts need to be made, as they are in the UK with a 'stewardship code' for investors, to encourage shareholders to use their rights and powers. Institutional investors must take an active interest; doing so benefits both society and the smaller investors they represent.

Finally, there is the issue of the kind of regulation we need for our global economy. The introduction of more principles-based regulation would be a good start. For instance, unlike rules-based systems, principles can rule out 'types' of activity rather than specific activities. This approach can give a clear steer to business behaviour, and actually also provides plenty of flexibility and opportunity for innovation within agreed parameters. Additionally, good regulation must be relevant to local needs with both the regulator and the regulated understanding its purpose and intent.

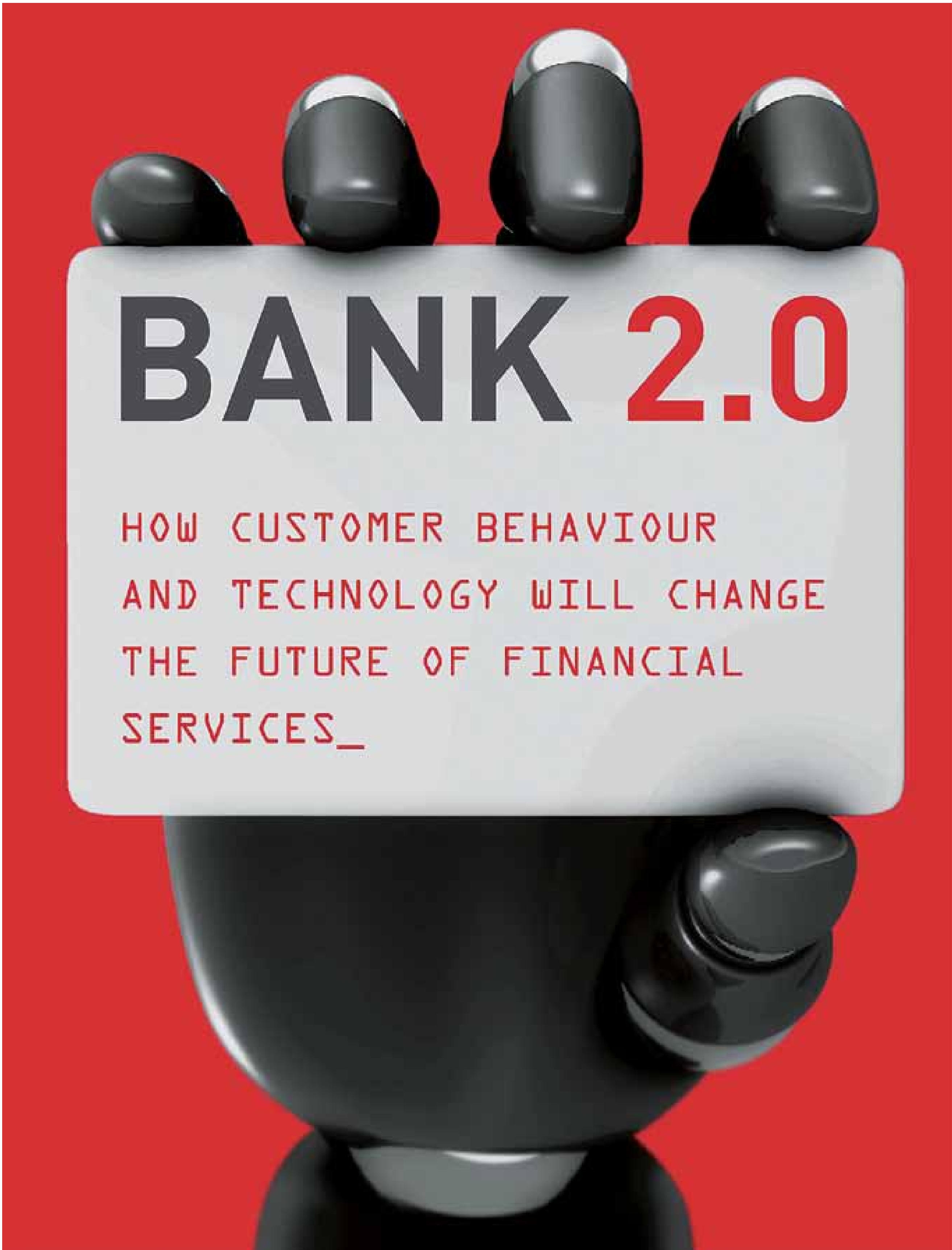
While not entirely principles-based – bans on charging interest are often flouted – Islamic finance offers some useful examples of what can be achieved with an expressly values-based regulatory framework.

It's important to note that the Islamic finance industry was hurt by the global financial crisis too and that the modern incarnation has perhaps not yet reached the same stage as conventional finance in terms of innovation or market structure. However, almost no industry was unaffected by the financial crisis given the pervasiveness of the conventional finance system; if anything, the risk-averse principles inherent in Islamic finance ameliorated the worse aspects of the crisis for Islamic Finance Institutions (IFIs).

The subprime mortgage disaster that kicked off the crisis was not repeated in the Islamic finance system: the debt-averse principles of Islamic finance would have required higher deposits before mortgages were paid. The trading of complex derivatives was not possible for IFIs, bound by the principle that stresses the importance of underlying assets to back transactions. Rampant speculation would not be possible in the Islamic finance system where you cannot sell what you do not own.

To protect the financial system from further shocks, policymakers need to learn and implement the lessons of past experience. For economies looking to develop their regulatory systems, there is an opportunity to learn from the mistakes of others. In particular, principles matter. The financial system will return to growth, but we need to ensure that growth is sustainable. We need to recognise that there are many good practices throughout the financial services sector, and apply a framework of governance which allows for a contemporary balance between risk and reward. ✱

■ Neil Stevenson is Executive Director, Brand, Association of Chartered Certified Accountants (ACCA).


BANK 2.0
HOW CUSTOMER BEHAVIOUR AND TECHNOLOGY WILL CHANGE THE FUTURE OF FINANCIAL SERVICES_

MOVING TOWARDS BANK 2.0

NAZATUL IZMA

How will technology and customer behaviour change banking? That is the billion-dollar question that Brett King, author, strategic consultant and long-time senior industry analyst in the finance sector attempts to answer in his best-selling book *Bank 2.0: How Customer Behaviour and Technology Will Change the Future of Financial Services.* According to King, 90 - 95% of bank transactions are executed electronically today. However, while the Internet, ATMs, call centres and smartphones have become mainstream for customers, banks still classify these as alternative channels and maintain an organisation structure where Branch dominates thinking, said King. He argues that continued technology innovations, Web 2.0, social networking, app phones and mobility are putting pressure on traditional banking models. In the following interview, King tells *Banking Insight* why and how he thinks banks should evolve to stay ahead in the era of the wired (and wireless) customer.

Q What are the hallmarks of the Bank 2.0 model? How does it differ from Bank 1.0? What are some examples of Bank 2.0 banks operating today?

BRETT KING (BK): Bank 2.0 is about banks having to reinvent the way they interact with customers, and the massive disruptive changes that come with both customer behavioural shift and technology adoption.

The biggest shift in Bank 1.0 to 2.0 is the erosion of the physicality of banking, that is physical artifacts like cheques, cash, plastic cards, and the decline in use of physical channels like branches. While this is often met with scepticism in the banking community the writing is already on the wall. In most developed economies for the last 10-15 years we've seen branch numbers fluctuating downwards, that trend is speeding up now – but, you only have to look at Travel Agents, Brokers, Blockbuster, Borders, and other businesses subject to the same modality disruption to know that banking is next. The same is happening with cheques and cash – these are in rapid decline in the west. While the debit card has overtaken cash usage, we're even going to see plastic disappear as NFC (Near-Field Contactless) payments and other such technologies quickly become ubiquitous. All of this attacks the 'physical' nature of banking in its 1.0 format, and it is completely unavoidable.

Q What are the best practices that Asian banks can adopt in migrating to a Bank 2.0 model? Conversely, what are the challenges? Are there any circumstances, e.g. legislation, market barriers, cultural factors etc., peculiar to Asian banking markets that would either promote or hinder Bank 2.0?

BK: In many ways, Asia is already leading the charge in terms of some aspects of the Bank 2.0 model. For example, Internet infrastructure in the developed economies of Asia is better than that of the US, Australia and other so-called developed markets. In Japan and South Korea, we see Asia has led the way in respect to mobile payments; China is rapidly ramping up in this area too. If I was looking at an area where Asia could develop a hub of expertise it would be in the arena of mobile payments integration and development.

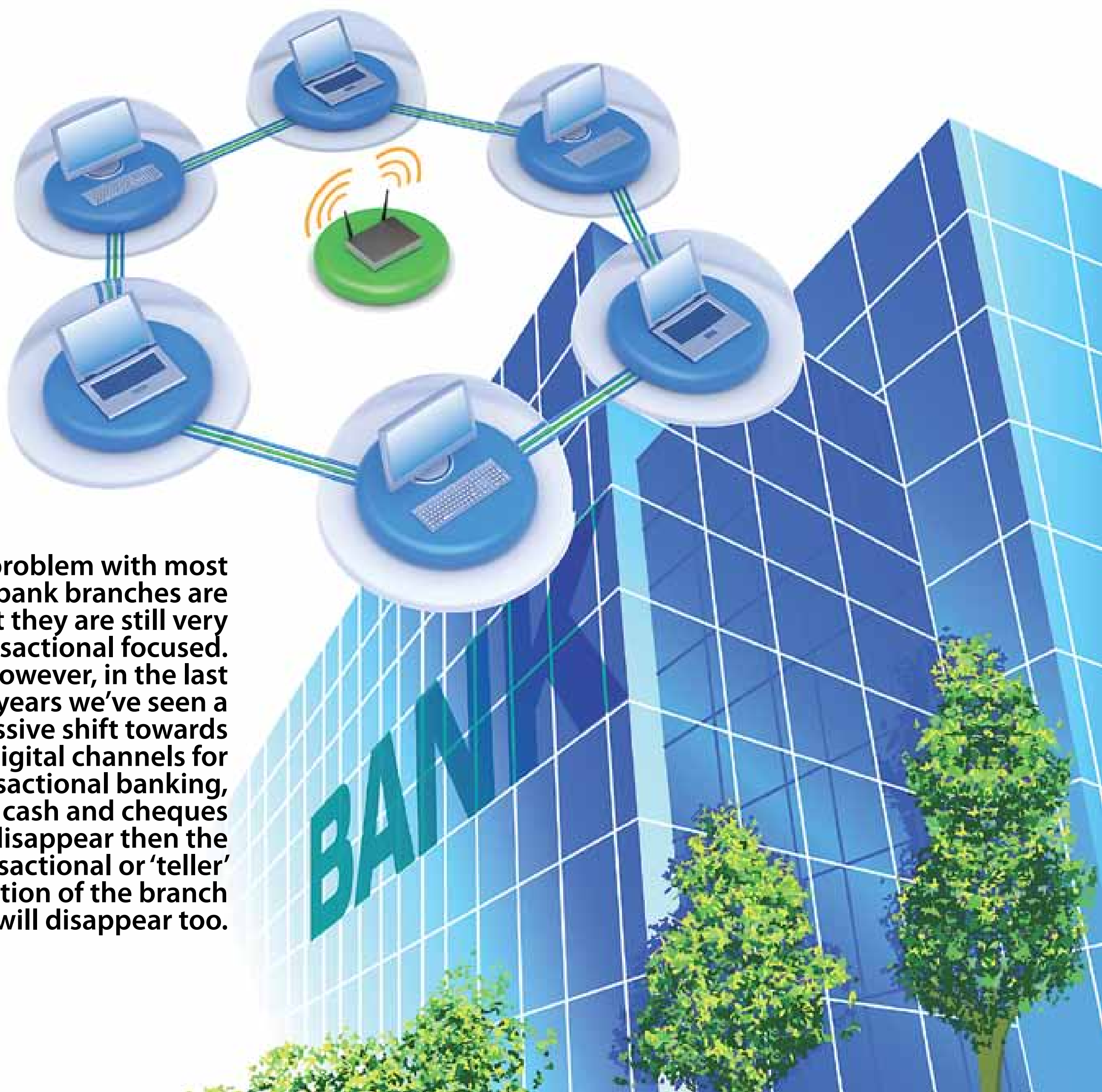
In respect to regulation, the Hong Kong Monetary Authority (HKMA), Monetary Authority of Singapore (MAS), and Chinese regulators, for example, have been very proactive and early in implementing measures like two-factor authentication for internet banking access, mobile payments guidelines, etc. However, the risk in Asia with regulation is that many of the banks are still looking to the regulators to define the 'standards' or building blocks for innovation – the problem with this is that regulators simply aren't innovators. Their role is to protect the market and consumers, not to define innovation. So I think many of the institutions in Asia need to stop waiting to see what the regulator's position is, or what is happening elsewhere and dive in!

Another key driver for regional success is that Asia has a very strong Gen-Y/Millennials population and their expectations of banks and service providers are very, very different. If you are a bank in Asia and you still require customers to come into a branch to open up an account, for example, then you're in trouble – these kids just don't see the need for physical processes like that – if you can't engage them on their phone you're dead! Asia can lead in this area potentially too…

Q You advocate a reformulation/refocusing of the bank branch. How exactly would this work; how do you envision this "refocused" branch? How would banks redeploy and retrain their branch banking staff? What services would a "refocused" brick-and-mortar branch offer under Bank 2.0?

BK: See the following blog post *http://www.banking4tomorrow.com/2011/03/if-your-bank-is-opening-branches-get-worried/*. The problem with most bank branches are that they are still very transactional-focused. However, in the last 10 years we've seen a massive shift towards digital channels for transactional banking, and as cash and cheques disappear then the transactional or 'teller' function of the branch will disappear too. Bankers may think that this is a 'generational change', but it isn't. By 2020 it is likely that there will be no tellers in any branches in any developed economies. That's not long to make a transition.

Some branches will survive by focusing on excellence in sales and service. The skill set is very different for a brand store that emphasises needs-based selling and rapid service delivery. We'll start to see branches more and more resemble coffee shops or



The problem with most bank branches are that they are still very transactional focused. However, in the last 10 years we've seen a massive shift towards digital channels for transactional banking, and as cash and cheques disappear then the transactional or 'teller' function of the branch will disappear too.

areas where interactions are friendly and personal. We'll see more technology coming into branches with iPads and tablets being used in discussions between the customer and the relationship manager, we'll see media walls with interactive engagement to stimulate customer journeys, and we'll see no paper. Gone will be the application forms of today. It will be about rapid and relevant service opportunities. We've been calling this 'engagement banking'.

Q Would a move away from brick-and-mortar branches as they exist today create a leaner workforce for banks; and do you anticipate a backlash in a post-recessionary environment where "traditional" jobs are under threat?

BK: I think you can ask Blockbuster and Borders the same question. Just because this is painful doesn't make it any less likely to happen to banks. The fact is many new jobs will be created in this environment, and it is more about re-skilling and re-tasking the bank than just destroying value or jobs. The concept, for example, that you can only provide good service to customers through a branch is erroneous. Banks need to really think about very strong service support through every channel. Right now today, if I email my bank, for example, it is hit and miss as to whether I would even get an answer. I certainly can't use Skype to contact my bank. These are just a few areas where we need to see massive investment in the creation of capability for the bank, and some of the staff that are currently in teller roles may end up moving behind the screen.

Branch networks will have to shrink though. Which does result in more profitable and leaner cost structures, because the most expensive component of a retail bank these days is physical real estate. So this is good news for investors because it means higher profitability and better stock prices!

Q You have pointed out that many banks lack a head of social media. Would this count as a key weakness in adopting the Bank 2.0 model? If a bank does hire a head of social media, where should he be placed in the management/reporting hierarchy for maximum effectiveness?

BK: Banks are struggling massively with social media while the world is ablaze with activity. Most banks today, for example, still don't have a coordinated presence on social media or an appointed VP who looks after this area – if there is anyone responsible it is likely a junior person within the IT or marketing area. Let me illustrate the issue here.

Imagine a customer walks out of a branch after having a very negative experience. In the old days he might pick up the phone and call the call centre to complain. Today, that same customer is just as likely to get on Facebook, Twitter, etc. and start talking about it and his message now goes out to 30-40,000 people instantly. The bank is sitting there not even involved in that conversation. It's like the customer calls the call centre and the bank hangs up on him in the middle of the call.

The problem with this is that right now people are using social networks to define which brands they work with based on the popularity or ranking of those brands amongst their network. So banks are spending millions of dollars on advertising telling customers how fantastic their bank is, but none of that works if my friends in my network tell me that your bank sucks. I will trust my friends every time over what you tell me in an ad. This is a massive transition. Banks just aren't used to having their brands subject to a dialogue or conversation, and the biggest problem right now is that they aren't even in the conversation.

Social media is about a conversation. The individual responsible for this will need to have the support of the entire organisation. It is a massive role and probably requires someone with a direct line to the CEO.

Q What are the best practices of banks that have successfully integrated social media into their business models? Are there any in Asia?

BK: For a complete coverage of the thousands of social media initiatives out there, I would recommend *www.visible-banking.com* as a great resource.

In respect to specific examples, we've seen ING Direct's CEO, for example, take direct ownership of social media within their brand – that's how important they consider it. We've seen TD create a Head of Digital Channels that reports to the CEO who is responsible for social media. Similar has happened over at brands like Ford, Coke, McDonalds, for example. So best practice would mean that social media starts at the top. With 600 million Facebook users globally, with more than 950 million users on social media networks in China alone – this is not a phenomenon that is going to disappear anytime soon. The thought that you can relegate this to a junior staffer is problematic. Right now today, the role of Head of Social Media is more important than your Head of Marketing and Head of Call Centres put together.

In terms of best practice in Asia, DBS Bank recently launched their 'I-designed-a-bank' contest for the Gen-Y segment in Singapore. This is a great example of what is called crowdsourcing. In September of last year, Standard Chartered launched a campaign on social media to 'hire the world's coolest intern'. Both were extraordinarily successful in respect to ROI and outcomes. So it surprises me that with such huge support for social media in Asia and with demonstrated success that someone like HSBC still doesn't have a Twitter presence.

Q Are there any banking trends or innovations originating in Asia that might benefit banks in developed markets? Or is Bank 2.0 a one-way street?

BK: Asia is leading the way in mobile enablement in many ways. I think the opportunities for mobile payments and financial inclusion in Asia through the use of the mobile as your bank, will be the biggest impact Asia has on the rest of the world. Bringing a billion people into the banking system via their mobile phones will be a massive shift in the way we see banking. Traditional brick-and-mortar banks would stay away from this market, but we've seen from the success of initiatives like M-PESA in Kenya and G-Cash in the Philippines that mobile banking changes peoples' lives.

The challenge with this is that actually companies like Apple, Google, Microsoft, Nokia and the telcos in the region, may actually be better placed to grab this business than the banks. So it is not just about Asia leading the way, but whether or not banks can be innovative enough with their business models in the face of such change to adapt.

We have so much inefficiency built into the banking system today.

Q Sustainability is a buzzword in business and banking circles. Does the Bank 2.0 model specifically address sustainability issues and environmental risks? Is it necessary to adopt green initiatives in order to become a Bank 2.0?

BK: Bank 2.0 is primarily about removing inefficiencies that have become embedded due to bank policy and process over many, many years. For example, I walk into my bank today, they've known me for 10 years – I ask for a credit card…what do they do? They pull out a blank application form and start to fill in all the details that they've already got. We have so much inefficiency built into the banking system today. By re-engineering customer journeys and simplifying interaction, by removing physical artifacts like cheques and cash we get improvements in sustainability. By not requiring people to drive down to the bank branch just to sign a piece of paper, and by helping customers when and where they need banking services in their daily life, we also reduce environmental impact.

While the primary goal of Bank 2.0 is to improve customer journeys by understanding behaviour and reducing complexity in interactions, the very positive side-effect is a massive improvement in sustainability and efficiency. ✱

■ Nazatul Izma is a freelance journalist based in Kuala Lumpur.

Wanted: 21st century banking

WOULD THE BANKING SYSTEM BE MORE STABLE AND ROBUST UNDER A FULL-RESERVE BANKING MODEL, AS OPPOSED TO FRACTIONAL-RESERVE BANKING, WHICH IS THE MODEL CURRENTLY IN USE?

Under a full-reserve banking model, the transaction function of banking – i.e. the payments system – is separated from the lending function. It is believed that a reform like this will create greater competition within the banking sector by hugely reducing the barriers to entry in the retail sector while supporting the development of a more diverse financial services sector.

WHAT'S THE DIFFERENCE?

A fractional-reserve banking system creates new money in the form of new bank deposits which it then lends out, whereas a full-reserve banking system is unaffected by the lending activities of banks. An economy based on full-reserve banking will therefore be less prone to pro-cyclical tendencies and inflation, compared to fractional-reserve banking. The separation of lending and creating money will ultimately lead to better stability in the financial sector. One of the most effective ways of achieving this is to ensure that safe deposits do not co-exist with risky assets.

The proposal is simple: banks should keep safe the money which customers wish to keep safe, and invest only the money that customers wish to be invested. It is believed that a few minor changes to the reserve account systems currently in use could ensure a stable money supply, regardless of the economic climate and the willingness of banks to lend. These changes will also provide a risk-free means of holding money regardless of the amount held, and remove the need for taxpayer-funded deposit insurance.

THE BENEFITS

Some of the advantages of full-reserve banking are:

- Stability: the banking system and wider economy will stabilise and not be affected by cycles.
- Less risk of recession.
- Enhancement of competition in the banking sector.
- The removal of deposit insurance, removing the risk to taxpayers and the government.
- Poorly-managed financial institutions which fail will not be a threat to the wider economic system.
- The payments system and money supply would be technically separate.
- No more bailouts.
- The public can store money without risk, regardless of quantity.
- Interest rates could be set by the market.
- Bank lending will be less likely to cause asset-price bubbles.

Simple & safe

The proposal is simple: banks should keep safe the money which customers wish to keep safe, and invest only the money that customers wish to be invested.

HOW WOULD IT WORK?

Firstly, the payments system needs to be separated from risky lending activity, so that failure of investments will not affect the payments system or other crucial parts of the financial infrastructure. Secondly, interest rates can be set by the market. This will directly influence the money supply through the creation of new money when necessary. To separate the payments system from lending activity, all accounts used by bank customers need to be classified into two types: Transaction Accounts and Investment Accounts.

Transaction Accounts, which collectively make up the risk-free payments system, will consist of payment services like cheques, debit cards, ATM cards, electronic fund transfers and receiving money. Holders of Transaction Accounts will have on-demand access to their funds at all times. The bank will no longer be able to use the money in Transaction Accounts for making loans or funding its own investments; this money will be held "off the balance sheet" – in fiduciary trust, and not be considered a liability of the bank. Because the bank will not use Transaction Account funds for investment, these Accounts will not pay interest, and incur a monthly or annual fee.

Investment Accounts, on the other hand, will replace present-day "savings accounts." Under full-reserve banking, the bank will have to attract funds for investment purposes; these funds will be provided by customers via their Investment Accounts. Customers will lose access to their money for a pre-arranged period of time, either agreeing to a "maturity date" or a "notice period." A maturity date will be a specific date on which the customer will be repaid the full amount of the investment; the notice period is an agreed number of days or weeks notice that the customer will give to the bank before demanding repayment. The Investment Account will not hold money that can be readily withdrawn. Any money here will be transferred to a central "Investment Pool" that will be used by the bank for making various investments.

REVAMPING THE SYSTEM

Currently, each large bank or banking group is required to hold a "reserves account" at the Central Bank. Extensive systems already exist to manage these accounts, and with slight adaptation, the revamped system will essentially encompass three new accounts: the Customer Funds Account (CFA), the Investment Pool and the Operational Accounts for individual banks.

The Customer Funds Account holds each bank's aggregate Transaction Account funds. While the funds in it belong to the relevant Transaction Account holders, the CFA is managed by the commercial bank. When a payment is made to a Transaction Account holder by someone at another bank, the balance of the Customer Funds Account will increase. When a Transaction Account holder makes a payment to someone who uses a different bank, the CFA balance will decrease.

The Investment Pool is the account that the bank uses to receive investments from customers, make loans to borrowers, receive loan repayments from borrowers and make payments back to Investment Account holders. The funds in this account will belong to the commercial bank. Where the bank can hold funds for its own purposes – retained profits, own capital, money for staff wages etc. – will be the Operational Accounts. The funds in this account will legally belong to the commercial bank also.

PROS AND CONS

A full-reserve banking system will stabilise money supply, and lead to a stable economy. Lending in a full-reserve banking model involves the transfer of real, risk-free central bank money from the investor to the borrower, thereby creating new, additional purchasing power. Banks will therefore become credit brokers rather than credit creators, with no power to swell or contract the broad money supply. This will also tend towards reducing the pro-cyclical tendencies within the current financial system, while increasing the stability of the banking sector and the wider economy.

Instability within fractional-reserve banks comes from the fact that customers can demand repayment at any time from any accounts that do not have maturity dates or notice periods. This could result in huge sums of money flowing out of the bank within a short period, making the bank insolvent. Although banks try to guard against this sudden outflow by having reserves, it is difficult to determine exactly how much should be held back, and how much can be utilised for giving loans etc. With established maturity dates and notice periods, the bank will be able to predict its cash flow and prepare accordingly. Full-reserve banks would therefore be more stable.

With full-reserve banking, the risk of any investment stays with the bank and the investor, not a third party.

Currently, a savings account is considered risk-free although the money is used for mortgage lending, personal loans or risky proprietary trading. Gains from such investments go to the bank and the saver or investor while the potential losses fall on the taxpayer. With full-reserve banking, the risk of any investment stays with the bank and the investor, not a third party. In the event of bank failure, Transaction Accounts, being fully funded with central bank money and not held on the balance sheet, can be transferred to other banks. Customers can nominate which bank they want to move to, and no taxpayer money will be spent on bailouts.

Full-reserve banking impacts positively on the government's fiscal position in three main ways. Besides reducing the risk of banking sector instability, it will also make taxpayer-funded deposit insurance unnecessary. There will be no need for taxpayer-funded bailouts – potentially saving billions for the government. Fractional-reserve banking encourages rising debt, creating an increasing money supply that generates a "credit-fuelled boom" which further encourages the taking on of more debt to the point of debt-servicing difficulties. Borrowers then begin to default on loans, triggering a recession. Lending under a full-reserve banking system, however, does not increase total purchasing power, and therefore will not provide a cyclical stimulus to the economy. In the long term, this "debt-free" money will help to reduce the overall level of household indebtedness, again impacting positively on economic growth.

Since full-reserve banks can be allowed to fail – their Transaction Accounts can be transferred to other banks – and not be bailed out with public funds, all banks will be exposed to free market discipline, leading to reduced market distortions, and removing moral hazards and misaligned incentives. A switch to full-reserve banking also has very little impact on capital markets. If banks realise that they will have to underwrite their own failed investments, they are likely to be more careful with the money they have.

Disadvantages of full-reserve banking are relatively few, compared to its advantages. The main one is that funds placed in Transaction Accounts will not earn any interest but will incur costs where providing payments services such as cheque books, ATM cards, cash handling, etc. is concerned. However, these fees will probably be low because of market competition. Full-reserve banking does reduce the liquidity for households, especially those looking to invest and earn returns because it requires savers/investors to give up access to their money for the period of investment. One way of mitigating this is to allow Investment Account holders to reduce a small proportion of their balance on demand.

FAR-REACHING CONSEQUENCES

A lack of understanding of the wider impacts of fractional-reserve banking will lead to an inadequate response to financial crises, as has already been seen in the past few years. Under fractional-reserve banking, the only way that households and businesses can get additional money is to borrow it from the banking sector. When banks lend, new money in the form of bank deposits is created and the economy grows. If they stop lending, the economy slows down and recession looms. The banking sector therefore has a monopoly on the supply of money to the public and the real economy.

If bank deposits are only created when an individual or company takes out a loan, then in order to have a growing money supply, the public must have a growing overall burden of debt. Therefore, as long as the real economy's money supply is issued by commercial banks via fractional reserve banking, a growing money supply must be accompanied by growing debt. Fractional-reserve banks are inherently unstable because of their fundamental business model, which is to lend out as much of their deposits as possible to maximise profits.

Every loan that they make creates more deposits that fund more loans. People's financial burdens increase as they take on more debt, but banks become increasingly willing to lend as this financial burden grows. Eventually, loans that are supposed to be repaid become unlikely to be repaid, creating a huge shortfall in the banks' income. Additionally, customers can demand repayment at any time from any account without a maturity date or notice period. Sometimes this means that banks have to pay back huge sums of money within a short time, which could drive them into insolvency.

FULL VS FRACTIONAL

With banks' monopoly on the supply of money to individuals, households and businesses, it means that the real economy does not have a stable money supply. Irresponsible lending will create an illusion of a booming economy, encouraging people to take on more debt. The cost of servicing this debt will eventually act as a brake on economic growth, leading to an economic downturn, with some debtors unable to service their debts. As it stands, the quantity of money in the economy depends on a banking sector that has huge incentives to over-issue credit and shareholders with limited liability, but is underwritten by public subsidy.

Full-reserve banking may see a new moral approach to banking and finance.

One argument against full-reserve banking is that it will lead to a shortage of credit. But fractional-reserve banking artificially inflates the need for credit whereas there is less need for credit in full-reserve banking. There are other arguments as well, such as full-reserve banks will tie up bank deposits rather than making them available to fund investments, and that short-term investments will no longer be transformed into long-term investments if this system were to be instituted.

Full-reserve banking will make it relatively more difficult for banks to pass on risk to savers or investors because they will be forced to use what is essentially their own – instead of other people's – money to make their investments. In recent years, finance professionals have demonstrated an innate inability at identifying possible trouble spots, particularly when they are in one. If a bank makes bad decisions and actually loses its investments, it will still need to repay the entire original sum to each of its investors – with no possibility of a government-sanctioned bailout with taxpayers' money. Perhaps more than anything else, full-reserve banking may see a new moral approach to banking and finance. ✱

This article is a summary of a report entitled **Towards a 21st Century Banking and Monetary System** written by Professor Richard A. Werner, the new economics foundation (nef) and Positive Money, and submitted to the UK Independent Commission on Banking. Professor Richard A. Werner, is Chair in International Banking and founding director of the Centre for Banking, Finance and Sustainable Development at the University of Southampton School of Management. nef is one of the UK's leading think tanks, developing research and campaigning for social justice, ecological sustainability and well-being. nef has a long track record of developing innovative proposals for financial reform. Positive Money was launched in 2010 to address the low level of understanding of fractional reserve banking among politicians, the media and the authorities. Positive Money works with think tanks, NGOs and universities to raise awareness and understanding of the flaws in the model of money and banking that underpins the global economy.

CUSTOMER-CENTRIC BANKING *demystified*

LANCE TAY

A STRATEGIC APPROACH FOR ATTRACTING AND RETAINING CUSTOMERS TO DRIVE PROFITABLE GROWTH

Meeting the rapidly changing needs of customers is at the heart of a successful bank. This increasing demand for customer-friendly services has put a great deal of pressure on banks. A customer-centric approach is the most effective way to increase revenue and profitability in the era of increasingly hard to please and vocal customers.

When talking about customer centricity as a strategy for attracting and retaining bank customers, there are the traditional 'Universal Truths,' and then there are the newer ones – thanks largely to the ubiquity of the Internet and social networks.

TRANSFORMATION STRATEGY

THERE ARE THREE TRANSFORMATION IMPERATIVES FOR BECOMING A CUSTOMER-CENTRIC BANK:

- A bank must be able to provide a seamless, unified customer experience for all customer interactions regardless of internal organisation.
- A bank must transform customer data into actionable information by providing the right information to the right person at the right time.
- A bank should extend customer understanding throughout the enterprise thus enabling all functional areas to make informed, customer-based decisions.

Truisms like 'good service earns the right to sell', 'customer word-of-mouth is powerful' and 'different customer segments have different definitions of good service and value' are supplemented by new universal truths for successful sales such as:

- **Mobile Internet word-of-mouth is ALL powerful;**
- **Customers DEMAND a consistent experience across all touch-points, 24x7; and**
- **A customer segment of ONE.**

Banks can only become a customer-centric enterprise by empowering BOTH the company and the customer. This is what good service is about in a nutshell. A customer-centric bank empowers employees with customer data and insight through end-to-end business processes to ensure the best decisions are made for both parties while providing a seamless customer experience.

Service

Banks can only become a customer-centric enterprise by empowering BOTH the company and the customer. This is what good service is about in a nutshell.

TECH

Data management enables banks to be more effective in knowing the customers, improving data quality, utilising customer insight for effective interactions, complying with privacy and regulatory requirements, and reducing data management costs.

REALISING THE STRATEGY

For the typical bank, this creates four operational requirements which information technology (IT) must fulfill:

1. Provide a single source of truth for customer data

Banks realise that knowing more about the customer can help them offer better service and grow the business. However, achieving this requires a single view of the customer across every channel and product. This information needs to be made available to all customer touch point channels. However, banks have traditionally organised data along product lines, and this has led to collection of customer data in multiple disparate transaction systems limiting the banks' ability to gain a single view of the customer.

Data management addresses the challenges of data quality and accuracy by consolidating information into one master repository from disparate systems or business lines. It helps organisations create, maintain, and distribute complete and accurate customer information across the enterprise – in a secure environment.

Data management enables banks to be more effective in knowing the customers, improving data quality, utilising customer insight for effective interactions, complying with privacy and regulatory requirements, and reducing data management costs.

2. Drive intelligent customer interactions

In the race to win and retain customers, understanding customer behaviour and buying patterns is a challenging task. In order to retain high value customers, it's a necessity to drive intelligent customer interactions.

Analytics applications enable institutions to seamlessly share information across teams, manage their sales pipeline, create quotes and proposals, configure products and services to meet customer needs, and provide an exceptional customer experience. A complete solution for an entire service lifecycle can give organisations a complete analysis of the call centre and field service business to understand the true cost to serve in a complex services business.

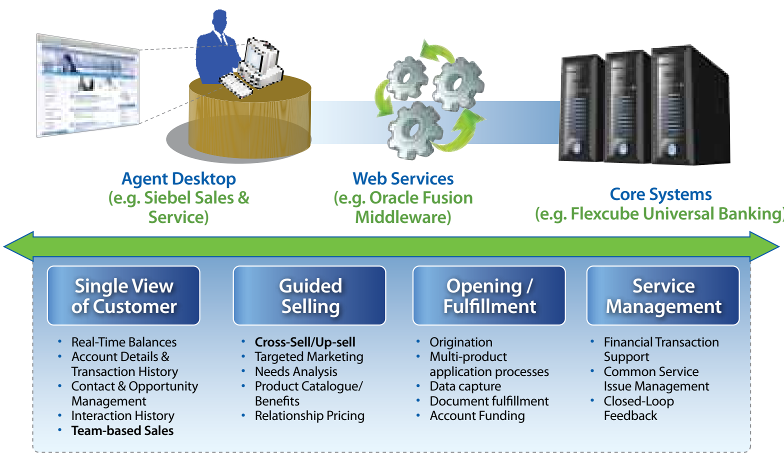
Imagine being able to measure and manage multi-channel contact centre operations, key business processes and activities by providing increased operational effectiveness through detailed staffing, headcount and scheduling analysis. Analytics also provide increased business value through complete campaign and sales performance insight by agent and across customer, product, service and region.

Marketing analytics can allow users ranging from marketing executives to marketing analysts to get up-to-the-moment, complete, and in-context marketing insight — personalised, relevant and actionable. The benefits from this include faster and more informed decisions that help to optimise resources, reduce costs, and improve effectiveness of marketing activities.

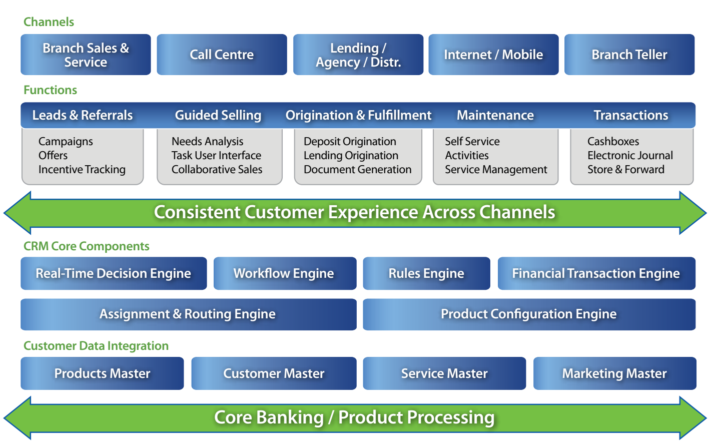
"In the race to win and retain customers, understanding customer behaviour and buying patterns is a challenging task.

360 Degree Customer View Through Integrated Banking Sales & Service

Show a Complete View of Customer to Customer Agent



Customer Centricity Strategy Requires Front, Middle, and Back-Office Solutions Working Together



3. Deliver multi-channel campaign and offer management (closed loop marketing)

With the proliferation of new channels there is the need to communicate marketing messages consistently across multiple customer touch points. Banks are constantly redefining their marketing practices to be able to improve the planning, execution, analysis and adjustment of all marketing activities.

Those who can successfully implement best practices in their marketing models will gain an edge over competitors. Solutions for closed loop marketing let organisations use a world-class Customer Relationship Management (CRM) application, including industry-specific capabilities to significantly improve marketing effectiveness.

A CRM tool should be able to complete the design, execution, and management of personalised, permission-based campaigns across all channels of a bank's customer interaction. At the core of this closed loop marketing capability is a single data repository that captures and stores all customer, partner, and employee interactions across all channels.

Institutions can also use this solution to leverage built-in analytic capabilities to create complex sales-target groupings, analyse campaign and marketing ROI, and create and execute the tactical components (such as programmes and campaign events) associated with a marketing plan.

SKILLS

Those who can successfully implement best practices in their marketing models will gain an edge over competitors. Solutions for closed loop marketing let organisations use a world-class Customer Relationship Management (CRM) application, including industry-specific capabilities to significantly improve marketing effectiveness.

4. Show a complete view of the customer to the customer agents

Last but not least, institutions that create long-lasting relationships with customers start with getting a deep understanding of the customers, including their needs, interactions, value, behaviour and relationships.

This enables bankers to be more effective in providing customer-centric service while increasing sales effectiveness. Integrating customer information with risk and profitability analysis tools gives banks a deeper understanding of customer relationships.

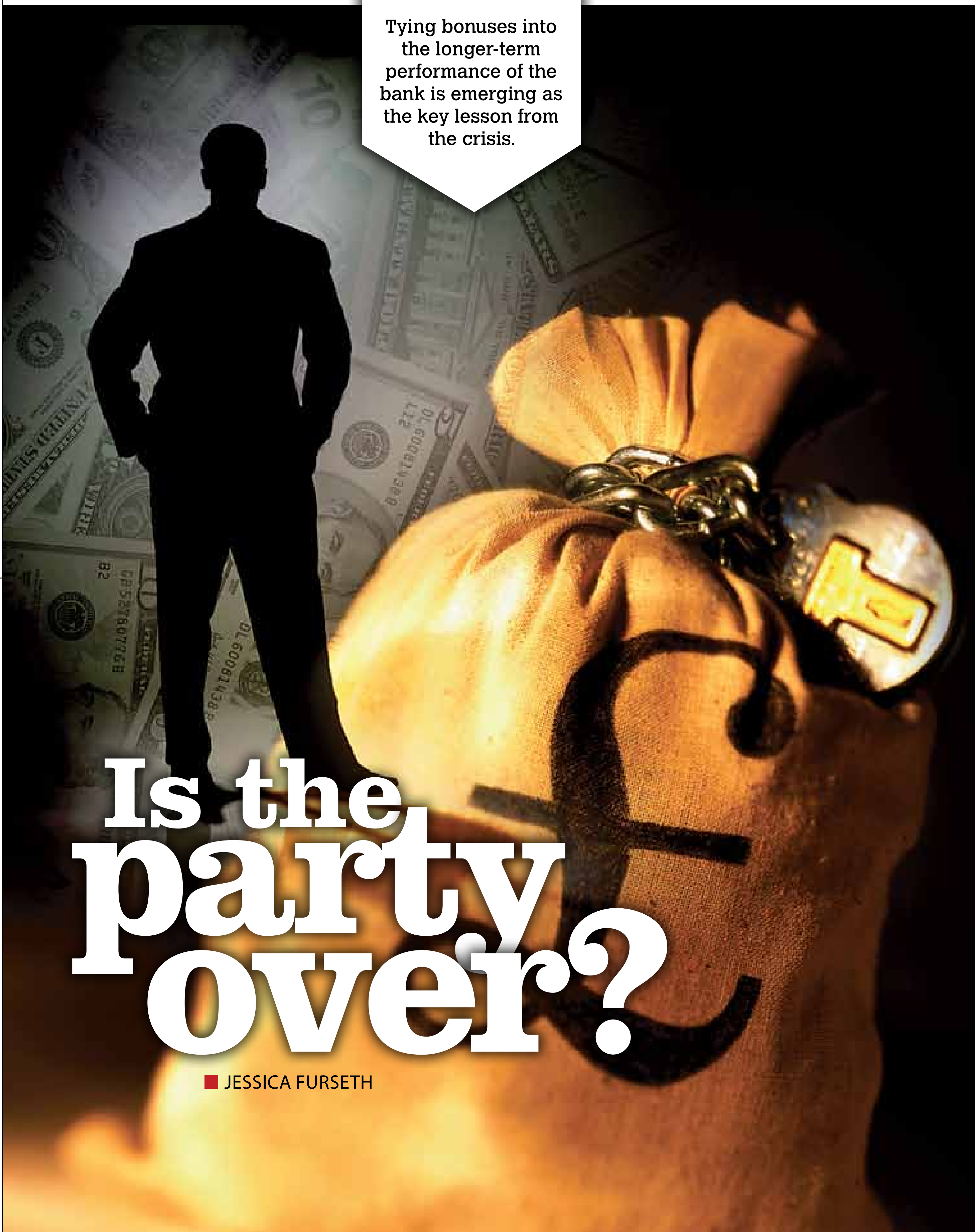
When this information is leveraged, institutions have a 360-degree view of customers, allowing them to identify the most profitable customers, meet their expectations for personalised services, and offer them products they're likely to accept based on past buying patterns.

To survive and prosper, banks must "wake up" and meet the rapidly changing needs from increasingly demanding customers. A Customer Centric strategy enables banks to deliver quality service for the customer while increasing revenue and profitability. ✱

■ Lance Tay is Senior Director, Financial Services, Global Business Unit, Oracle Corporation Asia Pacific.

Rewards

Tying bonuses into the longer-term performance of the bank is emerging as the key lesson from the crisis.



Is the party over?

JESSICA FURSETH

The financial crisis has made

bank bonuses a public matter. Short-term thinking by bonus-chasing bankers has been given a large share of the blame for the financial crisis. Now banks are forced to scrutinise their executive compensation schemes, but the question remains:

Will anything really change?

FOR INDUSTRY ONLOOKERS, BANKERS' BONUSES HAVE ALWAYS SEEMED EXCESSIVE. However the bottom line remained: banks are private companies, and they create significant wealth and contribute large tax revenues. Then the financial crisis hit and everything changed - a problem emanating from the US subprime mortgage industry spread into the country's banking system, and from there across borders and into the homes of regular people all over the world. Bank collapses and bailouts followed, and as we are clawing back out of the mess there is strong appetite to curb some of the excess of the banking industry. The fact that the behaviours of a relatively small group of people had such extreme consequences proves that bank practices are no longer just a corporate matter – governments need to step in and ensure banks act responsibly.

A PUBLIC MATTER

Among the public, bankers' bonuses have become the symbol of a fundamental disconnect: the very system that caused us all so much pain is rewarding its people with large amounts of money. In the UK, Barclays's pre-tax profits were only £6bn in 2010, but still 231 key employees shared a bonus pot of £554M. The fact that bankers receive such amounts in a 'bad year' further demonstrates how finance operates with different rules than other industries. Before the crisis this was a concern for banks' shareholders, but now it has become a matter for us all.

Investment banking divisions will however see bonuses 10-15% below last year's levels, said executive recruiting group Korn/Ferry in the report 'Bank bonus outlook 2010/11'. This is due to reduced activity in fixed income and equities divisions, the key profit driver during 2005-07. On the other hand, asset managers will see bonuses rise by 5-10%, due to better year-over-year performance returns.

CARRY ON REGARDLESS?

Bank bonuses have become problematic because they encourage risk-taking behaviour, but the solution is far from straightforward. Bankers are understandably reluctant to give up this significant perk, but there are also arguments why banks should be left to carry on. Most of these are in the category of 'everyone else is doing it' – the best staff will leave if they do not get top-notch pay.

'It would be foolish not to recognise that banking is an international market, and these are companies with global footprints. There will always be a chase for the best talent, and that comes at a price,' says Patrick Long, banking and finance partner at UK law firm Pitmans. 'Public outcries such as these go in cycles, as we have seen in the past with the [UK] politicians' expenses scandal. Behaviours will usually change as a result, but only to a point; there is often a need for sanctions or incentives to drive change.'

There will always be a chase for the best talent, and that comes at a price.

From the banks themselves there is surprisingly little attempt at justification of the high bonus levels. 'We pay as little as we can get away with,' Barclays Chairman Marcus Agius said a few years back. Whether or not this is true, regulators have started drawing up guidelines to try and encourage a bonus system where the incentives are more aligned with the interests of the many.

Regulatory interference could backfire, however; speculation has it HSBC is considering leaving Britain if lawmakers interfere too much in business practices.

'In the light of possible regulatory changes and additional costs, such as the bank levy, we are being increasingly asked by shareholders and investors about the likely additional cost of being headquartered in the UK,' HSBC Chairman Douglas Flint and CEO Stuart Gulliver said in a joint statement. The duo added however that any talk of an actual move remains 'entirely speculative and presumptuous.'

'STATE-OWNED BANKS ARE DEFINITELY driven by the attitude from the public. The state-owned banks have to care about the criticism, but the others can pay lip service to it if they want,' argues Maana Ruia, supervisory analyst at Edison Investment Research. 'The others – they say they will try and change, but ultimately they will do what they want. They will say it is up to their shareholders to decide. Their priority is to retain top talent or their profits will go down.'

RISK CONTROL

Banks have responded to criticism by shifting their bonus incentives to emphasise longer-term growth. Maana Ruia, supervisory analyst at Edison Investment Research, says:

'Following two years of crisis, bonuses have shifted to consist of around one-third or two-thirds stock. This is locked in for between one and three years, so that means incentives have a greater long-term view.'

Still, risk-taking is part of the reality of running a bank. 'The move to lock in stock rewards is the key point here, but all investment banks have departments where employees are paid to take risk. The issue is to balance this. It would be wrong to remove risk altogether as that is banks' business,' says Ruia.

In the past, 'excessive short-term performance pressure on banks forced them to take a short-term view in markets that are long-term in nature, such as insurance, mortgage and corporate debt', management consultants Booz & Co wrote in its 'Rapid restructuring' report. This is why there is a need to control risk exposure, hence 'banks need to revisit their portfolio strategies and make bold decisions about which assets to divest, even if those assets are profitable'.

THE BAILED-OUT BANKS

The question remains: has executive compensation culture actually changed following the financial crisis? Yes and no, seems to be the answer. Pitman's Long says the changes have 'to an extent been cosmetic'; the public say it has not changed enough, while bankers may argue it has changed too much. This is however two separate issues depending on whether you are looking at independent banks, or those that received public money during the recession.

'State-owned banks are definitely driven by the attitude from the public. The state-owned banks have to care about the criticism, but the others can pay lip service to it if they want,' argues Ruia. 'The others – they say they will try and change, but ultimately they will do what they want. They will say it is up to their shareholders to decide. Their priority is to retain top talent or their profits will go down.'

Changes are happening, however; one out of every two organisations is planning new financial performance measures to their 2010 annual incentive programme, according to consultancy group Mercer's findings in its annual executive compensation and performance study.

'The demand from shareholders and legislators to tie pay to performance is not subsiding,' said Bruce Greenblatt, partner with Mercer's rewards consulting business. As the US Securities and Exchange Commission now requires more organisations to disclose risk related to compensation policies, 'companies will be validating whether their [incentive] programmes … leads to inappropriate risk-taking. This will provoke them to assess whether the design of their plans, performance measures and performance targets are aligned with the underlying business risks of the company'.

A LONGER-TERM VIEW

Tying bonuses into the longer-term performance of the bank is emerging as the key lesson from the crisis, and there is evidence this is starting to happen. A long-term view is however no guarantee to alter behaviour, according to PricewaterhouseCoopers's 2009 executive compensation review:

'The attempt to set long-term incentive targets over a three-year timeframe leads to complicated calibration and intensive negotiation between remuneration committees, executives and shareholders, none of whom can be certain how tough the targets will turn out to be,' argues the report. Because it is difficult to predict outcomes of actions years in advance, executives could see long-term incentives as 'largely out of control or unachievable almost as soon as they are granted,' resulting in them 'providing limited incentive effect until the few months before they vest'.

Neutralising the impact of executive incentives is a key element of introducing more long-term perspectives, IBM Research Director Jeremy Hope wrote in the paper 'How to break free from the short-term performance trap':

'The correlation [between incentives and results] is tenuous at best, and downright misleading at worst, says Hope, pointing to a study by McKinsey which actually suggests an inverse correlation between top executives' pay and innovation.

FOCUS ON TRANSPARENCY

Subsidiarisation is currently being debated as an option for the UK banking industry: the concept of creating separate capital structures for the retail and investment banking divisions, so the failure of one would not lead to a full collapse. Bankers have however been critical of whether this would be successful in the event of future problems:

'When was the last time a bank allowed a subsidiary to fail if it could rescue it? It's inconceivable that a bank could allow one part of its business to fail as that would immediately bring into question the rest,' one senior banker at a major UK bank told *The Daily Telegraph* newspaper. There is also the issue of cost; consultants Oliver Wyman estimates some forms of subsidiarisation could cost Britain's largest banks about £15bn each year in increased funding costs.

Transparency is hailed as a further key remedy – to force banks to disclose and justify how much they pay.

A third-party risk review has been suggested for implementation in the UK banking industry. The need to re-assess risk reports was among conclusions reached by the Korn/Ferry Institute's 'Calculated risk' study: 'Board members require more granular information, including less refined data. They also want more leading indicators, as well as opportunities for far-ranging discussions with relevant executives.' This includes bringing onboard new, finance-savvy directors to weed out habitual assumptions on risk.

Transparency is hailed as a further key remedy – to force banks to disclose and justify how much they pay. This could also be crucial as the industry attempts to rebuild trust following the crisis.

The executives presiding over the big financial institutions face the overwhelming task of restoring confidence following the downturn, and well-structured bonus schemes can play a role in ensuring this. There is however a need for a different type of leadership, one less focused on meeting quarterly targets and more in tune with business fundamentals such as accountability and risk. Banks' earnings have started creeping back up after a few dire years, but there is a distinct possibility the big bonus party may be over. ✱

The question of fair

The bank bonus debate touches upon a concept not usually prominent in capitalist circles: justice. In the post-recession world, people are angry at bankers' role in the financial crisis and see bonuses as 'reward for failure'.

HSBC is currently seeking shareholder approval to pay CEO Stuart Gulliver as much as £13.3M. This is slightly less than his predecessor, but considering the issue of what is 'fair', the question still remains: How can we justify paying any one individual this much money? Is it really impossible to find someone good who will do it for less?

'The principles underpinning the [pay] review include incentivising long-term sustainable performance linked to risk, and continued improvement of alignment with shareholders,' HSBC spokesman Robert Bailhache said as way of explanation.

Gulliver's base salary stands at £1.25M, and HSBC is seeking permission to grant a bonus of as much as three times the base salary. In addition, long-term incentive payment could be equal to six times base salary. This is an improvement from his predecessor's pay plan, whose long-term incentive payment was tied only to financial measures such as earnings-per-share growth and total shareholder return. Now, long-term incentive payment will vest after five years, and Gulliver would have to keep the awards until he retires from the financial services industry.

The Royal Bank of Scotland (RBS) and Lloyds TSB, the banks bailed out by the UK government during the recession, receive the most criticism across the internet, according to findings by market research specialist DigitalMR. This is likely an indicator that people hold the banks that took public money to higher standards of behaviour.

However RBS, which is 84% owned by the UK government, paid its top nine bankers a combined £28M last year. Its top team will share £9.6M in bonuses and can earn up to £18.4M under the long-term incentive plan if they hit performance targets over three years. An RBS spokesperson said:

'These awards follow exhaustive consultation with our shareholders and we believe they appropriately balance demonstrating restraint while remaining fully supportive of our leadership through the RBS turnaround plan.'

Looking at bonus packages, payments may be smaller and incentives may be more skewed towards the longer term – but still these multi-million figures fail to satisfy anyone concerned with what is 'fair'. In a nation dominated by political statements of 'belt tightening' and forced austerity it feels almost rude to pay someone this much. Not to mention how it looks slightly out of touch with the realities of the post-recession world.

■ Reporting by Jessica Furseth, a freelance journalist based in London.

Risk & reward

TWO OF THE TOP PEOPLE AT EXECUTIVE SEARCH FIRM ROBERT WALTERS DISCUSS TALENT AND COMPENSATION PATTERNS IN THE MALAYSIAN, ASIAN AND INTERNATIONAL BANKING MARKETS.

Sally Raj, Country Manager, Robert Walters Malaysia, has spent 20 years in the recruitment industry and has seen many and diverse faces of talent pass through her door.

When employment opportunities opened up in the banking industry last year, she combed through hundreds of resumes in search of the perfect match for her clients. So when she's asked about the quality of Malaysia's talent pool, her answer is unhesitatingly blunt.

"There is definitely a lack of skilled talent in this country as far as the banking sector is concerned," she said. "But it's not that we don't have any. Most of our good talent is residing outside the country in places like Singapore, Hong Kong and the UK."

It's an open secret that many of these talents have been flocking to foreign banks for fatter paychecks and better career growth prospects. Then the financial crisis hit and they suddenly found themselves knocking on Robert Walters' door.

Malaysian banks, which were fairly protected, had continued their hiring activity and were able to absorb these homeward bound talents. But that was the easy part. The challenge, according to Sally, is for banks to now retain their best and brightest.

And herein lies the perennial question; are banks willing to match their foreign counterparts in order to reclaim Malaysian talent? Sally believes so.

"When you have niche skills, like people management or driving transformation projects, the banks won't hesitate to pay what it takes to have you on their team," she affirmed. "Typically you see people moving in teams so if the head leaves the entire team goes with him or her."

"But the way banks operate today goes beyond just offering higher salaries. They are more creative and aggressive in coming up with retention strategies. Banks know that there is only so much money that they can throw at someone and that career progression is important to the experienced group who are looking for a different set of challenges."

The executive compensation debate

While there is truth in Sally's observation, remunerative power cannot be underestimated. Top management, while seeking fulfilment in non-monetary areas as well as intrinsic satisfaction, will rarely decline a healthy executive compensation package. These packages in turn will either function as a bone of contention or a carrot at the end of the stick for those in middle management and the rank and file.

The debate over executive compensation is a long-standing one. How much is too much? What are best practices? And should executive compensation be slashed in the eye of economic woes?

Pan Zaixian, Director of Financial Services and Legal Division, Robert Walters Singapore, attested that the financial crisis has indeed affected compensation strategies in international banks.

"From a profitability point of view, many banks have not done well in the second half of 2010 which has in turn affected the bonus pool," he said. "Another very considerable reason affecting bonuses this year is the socio-political pressures for banks to be seen to rein in on excesses as many banks have received some form of bailout whether from the government or private sector."

WHILE IT IS INEVITABLE THAT CHANGES HAVE TO BE MADE IN HOW BANKERS ARE REMUNERATED, IT IS ALSO MISLEADING TO VIEW BANKS' COMPENSATION POLICIES AS THE KEY REASON WHY BANKERS PUT THESE FINANCIAL INSTITUTIONS AT RISK.

But a recent cut back in bonuses hasn't prevented a backlash against banks which are seen to be breeding risky short-term behaviour through their attractive compensation packages and rewards system. Pan acknowledged public outrage over high bonuses in particular but reiterated that banks have looked at reducing bonus numbers as a percentage of overall compensation in a move to discourage bankers from participating in risky businesses.

"From a disclosure point of view, it is easier to represent to the public at large that action has been taken to rein in bonuses," he said. "However, as a compensating manoeuvre, international banks have instead significantly increased the base pay of front office bankers to offset the future lower bonus environment."

"Banks have also looked into paying bonuses over a three-year time line and installing a crawl back clause into bonuses should direct trades made by the bankers turn unprofitable after the usual year-end close."

However, Pan said that it remained to be seen whether a lower bonus environment actually discouraged bankers from taking risky positions. He added that while it is inevitable that changes have to be made in how bankers are remunerated, it is also misleading to view banks' compensation policies as the key reason why bankers put these financial institutions at risk.

Meanwhile, Sally noted that this issue has more to do with the compensation structure in investment banks rather than retail banks. She pointed out that compensation packages for executives would always be governed by industry standards.

"People may not want to pay out huge bonuses anymore but they may put it into stocks or back into salaries," she said. "But again this relates to foreign banks which are governed by a head office. Local banks haven't been impacted all that much as I do know a couple of larger investment banks in Malaysia that still pay out 15-month bonuses."

Pan Zaixian, Director of Financial Services and Legal Division, Robert Walters Singapore

According to Pan, subversion to the head office led to unhappiness in many local branches after the financial crisis. In an effort to get back on their feet, American and European banks ordered cut backs in remuneration following the non-performance of other international offices. The more resilient Asian markets found themselves forced to partake in these compensation slashes which stirred up much dismay and dissatisfaction.

"It was unavoidable as the large financial centres in Asia have to be seen to operate in an open international marketplace," Pan explained. "International banks will have to take the lead in remuneration policies imposed at the head office levels."

"But foreign and local banks reward and retain their people differently. Foreign banks are subversive to their head office but must also ensure that they are meeting the requirements of the local talent they are hiring. So a Malaysian branch may have to offer benefits that their other branches aren't offering or face losing good local talent."

"For example, many banking activities in Singapore and Hong Kong are global in nature whether it is back office staff catering to traders based in London or investment bankers advising on deals across the region. After all, many bankers within the Asian cities hail from all over the world."

"Our experience from the crisis shows that there are greater cut backs for bankers in cost-centric roles in areas such as operations in comparison with revenue-generating roles within the front office. Post-crisis there is also a greater inclination to save compensation in back office roles in preference for paying more for revenue-generating 'rain makers' in the front office."

Alarming as Pan's last observation is, Sally assured that the compensation gap between back-office roles and revenue-generating ones aren't wide enough to create a hue and cry. She put the difference at 15% at the most.

"This gap will vary among banks because each has their respective salary scales," she added. "Also banks are not all structured in the same way so job titles and terminologies will differ. In Bank A, a vice-president of a division may have a wider scope of work versus Bank B where the same title may not require the person to do very much."

When asked whether best practices are a two-way or one-way street between Asia and the West, Sally and Pan offered slightly differing opinions. Pan said that it was still a one-way street flowing from the West as many human resources practices and policies are being brought in by international banks which originate there. Sally, on the other hand, believed that Malaysia is a very unique market and shouldn't be lumped with the rest of Asia.

"I'd like to think that we are very much like a stand alone market where the fundamental question is what sort of compensation drives Malaysians," she said. "Compensation in banks is almost all the same and it is known that when it comes to the banking industry the benefits are untouchable. If you're talking about best practices in terms of benefits, there really isn't a bank here that is setting a precedent for providing super high ones."

■ Reporting by the *Banking Insight* Editorial Team.

ARE BANKS AS SUCCESSFUL AS THEY CAN BE?

RAJEEV PESHAWARIA

On moving to another country, I called American Express and asked for a local card. All I had to do was tell them that I have been a card member in the US for many years, and my new card arrived in 24 hours. Some years later I moved again, and this time my card took three weeks and several phone calls to arrive. The difference? The first time I called the American Express company itself whilst the second time I called another bank that also issued Amex cards.

In New York, I had a brokerage account with a bulge bracket investment banking firm. My financial advisor never visited or called even once after the initial sign up, but regularly helped me lose money. One day when I emailed him to get me some research on 2328.hk - a Hong Kong listing, he wrote back asking what the ticker symbol was. Instead of writing back to tell him that was indeed the ticker symbol, I closed my account.

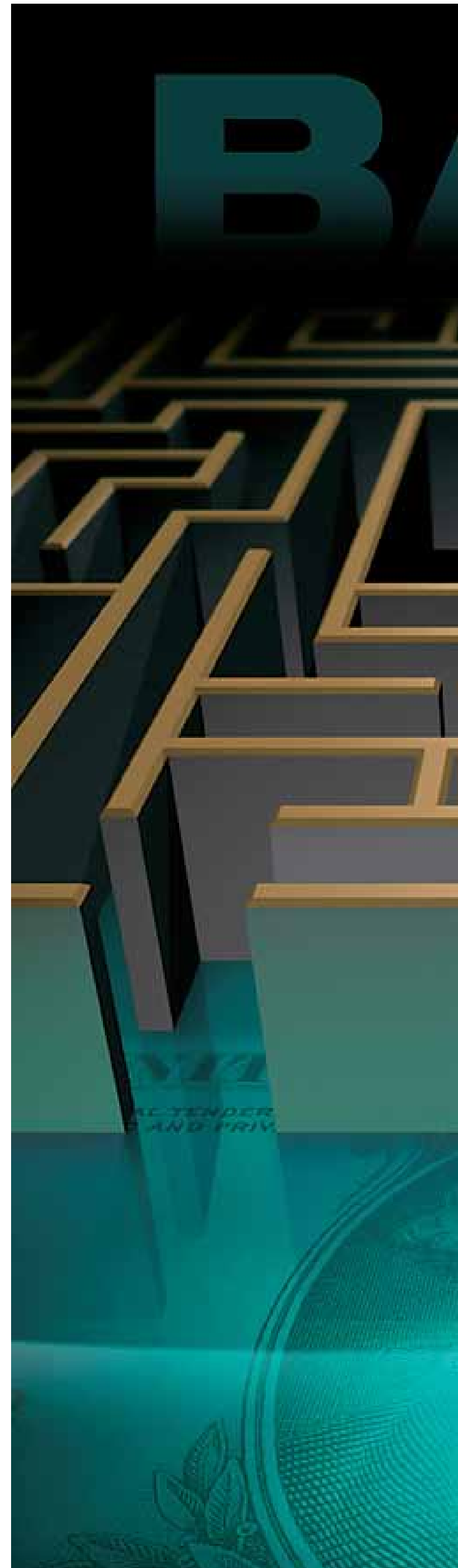
A friend of mine who took his company public in 2006 said this about two investment banks: "When I call Goldman Sachs, from equities to fixed income to advisory, I can usually get everything I want from one relationship banker. The banker himself does not have all the answers but he can get them from his colleagues to me in a seamless way. However, when I call Lehman Brothers, I have to call different people for different needs, and I don't have time for that."

In Europe, my private banker called me promptly whenever she saw a large balance in my account to suggest alternative investments. In my US bank, he never bothered.

When I asked the daughter of a friend of mine why she quit her job at a retail commercial bank recently, here's what she said: "My boss meant well, even tried all sorts of cute stuff to motivate us – like casual Fridays and family picnics – but I left because he did not have a clue on what motivates ME. He never stopped trying to motivate his staff with one-size-fits-all gimmicks, but it never occurred to him to ask us what really motivated each one of us individually."

THE ISSUE

RESEARCH TELLS US THAT when a customer or employee has a good experience, they seldom tell others about it. On the other hand, when they have a bad experience, on average they tell 16 people. You don't need to be a math wizard to figure out what this is costing banks in terms of lost opportunity.



Bad bank experience

In Europe my private banker called me promptly whenever she saw a large balance in my account to suggest alternative investments. In my US bank, he never bothered.

A couple of the above stories have to do with customer service or the lack of it. One is about tedious client interface, another about sheer incompetence, and the last one about losing top talent. What is common about them all? First, they are all from the banking sector, but more importantly, all of the banks mentioned here are under-achieving their potential. Since such incidents happen every day to a lot of customers, I assume the monetary value of this under-achievement must be significant. However, I am not sure if banks even care to calculate such loss of revenue and profit. Except in severe economic downturns, banks generally make huge profits. This "success" covers up the root cause of such under-achievement – poor leadership. Since there is no "burning platform" for change, no one really cares about this issue beyond a point. But they should, because research tells us that when a customer or employee has a good experience, they seldom tell others about it. On the other hand, when they have a bad experience, on average they tell 16 people. You don't need to be a math wizard to figure out what this is costing banks in terms of lost opportunity.

The problem is, there are too many bosses, but too few leaders at most banks.

The problem is, there are too many bosses, but too few leaders at most banks. The distinction between the two is simple – leaders do whatever they need to maximise their organisation's success, while bosses just want to enjoy the privileges of their position. While most banks train their people on leadership, most of the training tends to be formulaic and theoretical, and is often based on look-back competency models and copy-cat role plays. Programme after programme looks at what made someone successful in a particular job over the past 10 years, and teaches formulas to emulate such past performance. To turn bosses into leaders, banks must re-think their investments in leadership development. To begin with, let's take a closer look at the differences between the two.

■ Leaders find limitless energy within themselves to create a better future

Bosses cling to the past and cope with the present

Leadership involves first envisioning a better future, then striving hard for as long as it takes to create it. The problem with articulating a better future is that it meets resistance the moment words of change come out of the mouth of the speaker. People tell you in a million ways why you will not succeed. To stay the course despite such resistance, you need limitless energy. Most bosses find it more comfortable to cope with the present instead of striving to create a better future.

LEADERSHIP

PROGRAMME AFTER programme looks at what made someone successful in a particular job over the past 10 years, and teaches formulas to emulate such past performance. To turn bosses into leaders, banks must re-think their investments in leadership development.

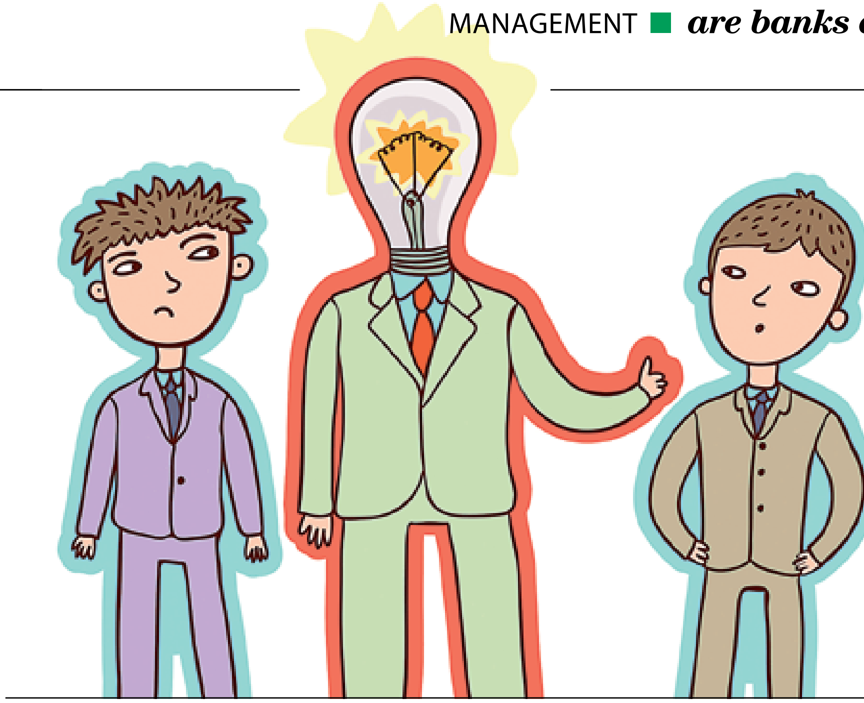
■ Leaders are clear about their purpose at all times

Bosses seldom have a purpose and live a reactive existence

Lasting energy comes from clarity of purpose, not from artificial incentives. When you know where you're headed, you feel energised and walk at a brisk pace. When you don't have a destination in mind, you wander about slowly. The problem is, most people are unable to answer the question: what is your purpose? If you hold a senior position, it is unacceptable if you haven't asked yourself this question yet.

VISION

LEADERSHIP INVOLVES first envisioning a better future, then striving hard for as long as it takes to create it. The problem with articulating a better future is that it meets resistance the moment words of change come out of the mouth of the speaker.



LEADERS

Together with a clear sense of purpose, values tell people what to do and how to behave when there are no ready answers. Leaders set the example with their own values-based behaviour in order to influence others.

■ Leaders lead with values
Bosses command with position power

The second source of lasting energy is clarity on personal values. Together with a clear sense of purpose, values tell people what to do and how to behave when there are no ready answers. Leaders set the example with their own values-based behaviour in order to influence others.

■ Leaders know how to manage grief and have learned from failure
Bosses usually hold some unresolved grief and haven't learned from failure

A big part of leadership is the ability to build genuine bonds with others. To be able to build such bonds, one must understand grief. Unless you have suffered pain, you don't know what it feels like. Unless you have fallen a few times, you have no idea what it takes to stand up again. Topics such as grief, sorrow and failure are considered too soft and touchy-feely (and therefore taboos) in most organisations even while they form the bedrock of authentic leadership.

■ Leaders forgive and move on
Bosses hold grudges, anger and jealousy

Life is full of disappointments. Whatever you do, people will disappoint you from time to time. The big difference between a real leader and a mere boss is that the former has discovered the magic of forgiveness. Holding grudges or remaining angry only hurts the holder. Learning to forgive is the best gift you can give yourself.

■ Leaders willingly recruit co-leaders and share both authority and responsibility
Bosses assign responsibility but do not share authority

Today's world is too complex for any one person to have all the answers. To succeed today, one must be willing to share leadership. Leadership is something that grows with sharing – the more you share it, the greater and more powerful it becomes. Mere bosses do not understand this.

■ Leaders successfully move from "I" to "We" and create conditions for collective success
Bosses stay fixated on "I" and create conditions to maximise personal success

Instead of worrying about how to maximise their personal power, or to create great results themselves, authentic leaders make it their full time job to pro-actively shape the three pillars of sustainable success:

1. **Setting Direction**
   (The BRAIN of a business)
2. **Designing the Organisation**
   (The BONES of a business)
3. **Creating a Culture of Excellence**
   (The NERVES of a business)

At the end of the day, leadership is the art of harnessing human energy towards the creation of a better future. By first finding their own energy through clarity of purpose and values; then aligning the energy of a few co-leaders towards a shared purpose; and finally galvanising the energy of an entire organisation by shaping the three growth pillars, leaders help their organisations be more successful. Personally, they also live more fulfilling lives. It is a win-win situation for both parties. Banks that wish to achieve their full potential should rethink how they develop their leaders. Instead of investing in formulaic and bookish models of leadership, instead of encouraging employees to copy others' behaviour in the name of best practice, and instead of administering a battery of psychometric tests to determine personality types, they will be much better off creating programmes that encourage authentic leadership behaviours as described above. ✱

■ Rajeev Peshawaria is CEO, ICLIF Leadership and Governance Centre and author of the book "Too Many Bosses, Too Few Leaders."

BASEL III AND THE IMPLICATIONS

FOR THE MALAYSIAN BANKING SYSTEM

ANITA MENON

There has been much concern on the sweeping changes that are being introduced as a result of the global crisis not least of which is the concern over Basel III. After some deliberation, the latest version of Basel requires that by 2019, all banks in Malaysia should aim to be fully compliant with the full list of standards set by the international institution. The changes will not be made in one swoop, but will be implemented over a phased schedule starting in 2013, which will vary in exact detail from nation to nation. The aims of Basel III are to strengthen the global capital and liquidity regulations and improve the banking sector's ability to absorb shocks from financial stresses. These are to be achieved through capital reforms (quality and quantity of capital amongst other items), liquidity reforms (ratios) and other general improvements which aid the stability of the overall financial system.

THE FOLLOWING is a quick run-down of the major requirements that Basel III entails:

A) Minimum common equity requirement (core tier 1 ratio) will rise to 4.5% from its current level of 2% by 2015.

B) Banks will also have to possess a common equity conservation buffer equivalent to 2.5% by 2019.

C) An additional buffer for going concerns regarding tier 1 set at 1.5% by 2014.

D) Tier 2 equity ratio set at 2.0% by 2015.

Basel III

The changes will not be made in one swoop, but will be implemented over a phased schedule starting in 2013, which will vary in exact detail from nation to nation.

ASSUMING THAT BASEL III AWARENESS becomes an issue when selecting a bank for an account or for loan purposes, choosing a bank that is already fully compliant at an early stage may prove to be a key factor in the competition amongst banks.

The result of these regulations is that in the future, banks must hold a total capital ratio requirement of minimum 10.5% by the time Basel III is scheduled to be fully implemented in 2019.

What does this mean for Malaysian banks? Analysis performed suggests that the majority of Malaysia's major banks should have sufficient ratios to meet the ratio requirements of 10.5%. Initial analysis shows that Malaysia should in theory be less affected by the requirement that other Asian nations such as South Korea and China. Malaysian banks have been fortunate that this latest round of amendments to Basel III in July 2010 has allowed for partial inclusion of such items as deferred tax, investments and minority interests as Tier 1 capital as these were not permitted under the original proposals.

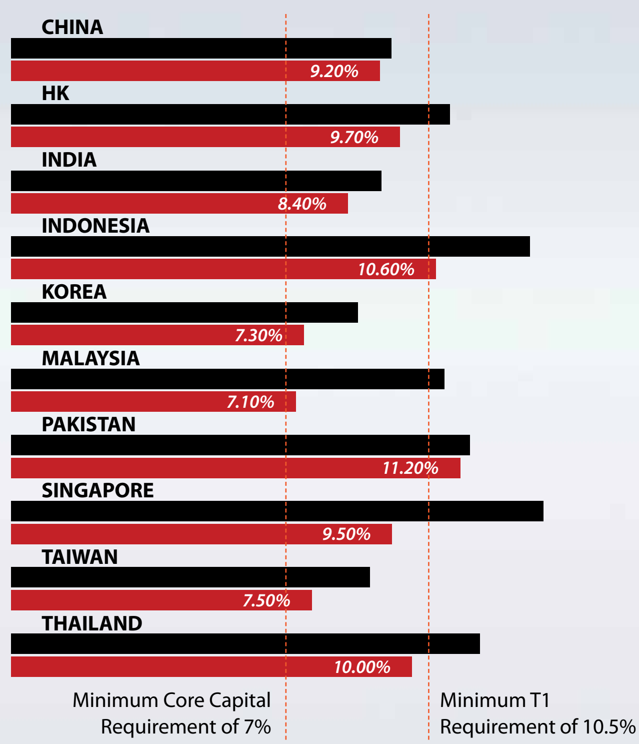
Even though Malaysia finds itself in a relatively stronger position than some other nations in adapting to Basel III's requirements, local banks which are currently able to meet the required ratios may still find themselves with plenty to do in preparation of 2013. The requirements of what can be considered Tier 1 capital have been redefined and many Malaysian banks which are relatively equity light in this category may still have to look at restructuring their existing Tier 1 capital. Items such as goodwill must be fully phased out as Tier 1 capital by 2019. This may mean returning to shareholders for increased equity or raising totally new capital. This restructuring involves costs that will ultimately be passed down to the consumers either corporate or personal, in the form of higher fees for services performed or worse the overall tightening on the availability of credit.

Liquidity ratio coverage being increased from a seven day basis to 30 days under the new framework may prove to be the major issue for Malaysian banks. The 100% ratio for net cash outflows to high quality liquid assets may be somewhat difficult to achieve as the Malaysian banking sector is somewhat thin on easily mobilised deposits due to EPF and other long term savings deposits making up a large proportion of Malaysian personal savings. This area is currently being closely monitored by Bank Negara who is aware of this issue and its potential implications for the banking system.

Another far-reaching consequence is the impact on banks' business models and governing structure that would have to change. The focus on a longer term model as opposed to the short term has been emphasised as the route to stability and this may cause a fundamental shift in the way banks conduct their daily business. Remuneration for senior executives in the industry may shift from being on an annual basis to a staged scheme in which bonuses are spread out over a 3-5 year period thereby impacting on banks' ability to attract and retain talent.

Public perception of banks which are early adopters may also prove to be an important factor. Late adoption may come across from a PR perspective that the bank is struggling to meet the requirements and is

BASEL III IMPACT IN ASIAN COUNTRIES



■ Basel II T1 CAPITAL RATIO ■ Basel III T1 CAPITAL RATIO

Source: Citigroup Global Markets. 22 January 2010

DESPITE THE INITIAL outward appearance of being well equipped to match the new requirements, it looks like there is still much work to do for Malaysian banks before 2019. It will be a period of transition and change and we can expect several transformations to occur not only in Malaysia but also globally on an individual bank level.

in financial difficulty. Assuming that Basel III awareness becomes an issue when selecting a bank for an account or for loan purposes, choosing a bank that is already fully compliant at an early stage may prove to be a key factor in the competition amongst banks.

Islamic banking is a harder sector to predict due to its lack of straight comparability to conventional banking and relative immaturity. Islamic banking worldwide is still generally coping with the challenge of adoption of Basel II due to the lack of framework and precedents required to calculate the capital adequacy ratios and other similar items. This can be felt much more at the smaller Islamic banks as opposed to the larger institutions across the world. Malaysia's Islamic banks however, have very much benefited from the Capital Adequacy Frameworks for Islamic Banks (CAFIB) issued by Bank Negara which has clearly defined recommendations providing suitable governance. Despite the problems faced by Islamic banks globally, the very underlying basic foundations of Islamic banking could be said to be very much in the spirit of the Basel III framework and Islamic banks are in general conservative with already high levels of capitalisation. For Basel III to be adopted successfully, the actual work to be done and how to adapt it for this different banking model will be a harder task than the actual raising of capital that may need to be done.

Despite the initial outward appearance of being well equipped to match the new requirements, it looks like there is still much work to be done for Malaysian banks before 2019. It will be a period of transition and change and we can expect several transformations to occur not only in Malaysia but also globally on an individual bank level. In a publication recently released by KPMG UK entitled "Basel 3, Pressure is building", the following additional points were put forward:

Weaker banks crowded out: Tougher regulatory influence will mean that smaller banks will find it more difficult to stay afloat and raise the required capital and funding. This may also lead to M&A activity in the sector as smaller banks become vulnerable targets and willingly or unwillingly merge with others.

Greater focus on short-term financing: The introduction of liquidity ratios to address the short and long-term nature of funding may cause a shift in banks to focus more on short term financing. This is due to long-term assets having to be equalised with corresponding liabilities under the net stable funding ratio. Longer-term funding in the future may be harder to obtain with higher rates than currently seen.

Legal entity reorganisation: The increased supervisory focus on local capitalisation and local funding matched with treatment of minority investments and investments in financial institutions is likely to drive group reorganisations to better fit these more stringent requirements. This may involve portfolio disposal and disposal of whole entities.

On the financial system level both globally and in Malaysia, the same KPMG UK research work also revealed that we may expect the following transformations:

Reduced risk of banking crises: Should the aims of Basel III be fulfilled this should lead to a systematic reduction in the risk of bank failure across territories that adopt the regulations. The strengthened capital and liquidity buffer along with the enhanced risk management standards should all work to bring a more stable and better equipped banking system worldwide. This however may not totally come to fruition if implementation is inconsistent across different jurisdictions and may in fact lead to overall disruption as early adopters of regulations struggle with late adopters.

Reduced lending capacity: There may be a decrease in lending capacity across the board as institutions have a reduced capacity to provide loans in an effort to maintain their capital liquidity ratios.

Reduced investor appetite for bank debt and equity: The onerous regulatory framework and requirements for the banking sector may prove unattractive for investors who are scared off by what may seem like ever-increasing restrictions in the way banks do business and also by the possible reduction in dividends in an effort to maintain liquidity ratios.

The years leading up to 2019 will be a testing period for all banks which are striving for compliance with Basel III. The amount of work left to be done cannot be overlooked or underestimated, even for those institutions that on paper seem to be able to meet the more stringent ratio requirements. There is still much to be done in terms of raising new capital and we may start to see a fundamental shift in the way that banks operate, as they progress from a short-term focus to a predominantly longer-term focus in their business models. With so much left to be done, it may become hard to remember that the Basel III regulations are protecting the banking industry rather than hindering it. The final outcome when the dust settles should be a stronger overall banking system with less chance of repeating the mistakes of before and increased confidence not only in the industry but also ultimately for the consumers. ✱

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APPLYING FRS 139 AND FRS 7

THE CHALLENGES CONTINUE…

CHAN HOOI LAM, MEGAT SHAH, LUKMAN MUSA AND NG YEE YEE

FRS 139 Financial Instruments: Recognition and Measurement (the Malaysian equivalent of IAS 39) has been effective in Malaysia since 1 January 2010. Much has been studied, analysed and debated about the standard, including whether to defer the standard, before its effective date. Nevertheless, companies in Malaysia, including banking institutions have finally implemented and applied FRS 139. Whilst the banks are getting more comfortable with the standard, certain challenges remain. The banks are also mindful of the incoming new standard, i.e. IFRS 9 that will ultimately replace IAS 39 or FRS 139, when making longer-term decisions on automation of processes and data collection.

FRS 139 challenges remain for key areas

The banks have done extensive work in the following three key areas with regard to implementing and applying FRS 139: loan and financing impairment assessment; the use of effective interest/profit/yield rate in income and expense recognition; and hedge accounting. Whilst hedge accounting is optional, the FRS 139 rules for impairment assessment and income/expense recognition are mandatory.

Collective impairment assessment

The banks were relieved from the most complex FRS 139 area, i.e. collective impairment assessment when the 2010-2012 transitional provision was made available by Bank Negara Malaysia. Most banks have applied the transitional provision, and maintained at least 1.5% collective impairment allowance. Otherwise, extensive analysis of sufficient historical loss experience would have been required for these banks to determine the level of allowance required under FRS 139. This is similar to the minimum 1% collective impairment allowance required by the Monetary Authority of Singapore under its transitional arrangement since 2005.

The common methods used include flow rates and migration analysis (e.g. for consumer and SME loans and financing), emergence periods, and vintage analysis (e.g. for business and corporate portfolios).

Many banks have made use of this relief period to get themselves ready for the full application of the FRS 139 collective impairment assessment in 2012. Various methods have been considered in measuring the credit losses. The common methods used include flow rates and migration analysis (e.g. for consumer and SME loans and financing), emergence periods, and vintage analysis (e.g. for business and corporate portfolios).

The internal ratings-based (IRB) banks, including those who are not now, but intend to move into IRB, have started to leverage on Basel II parameters for FRS 139 impairment measurement purposes. The probabilities of default (PD) and losses given default (LGD) derived from the FRS 139 methods have been compared to Basel II PDs and LGDs for better understanding of the credit risk profile and as a quality-check for reasonableness of these numbers generated. Some banks have even planned to use Basel II PDs and LGDs for FRS 139 provisioning purposes after appropriate adjustments to the emergence period or loss identification period (to adjust from the Basel II 12-month horizon into the emergence periods determined for each major type of loans and financing), and to the discount factors (to adjust from the Basel II weighted average cost of capital [WACC] to original effective interest/profit/yield rates of the loans and financing).

As an incurred loss model that stresses point-in-time estimation, FRS 139 impairment numbers are more sensitive to collection and recovery efforts, and macro-economic development. Any improvement in these efforts and factors are readily reflected in the PDs and LGDs, and thus the provisioning levels.

IFRS 9

A key concern is the potential volatility if there are changes in these factors, particularly the macro economic factors which are beyond the banks' control. This challenge may be mitigated when the banks move to the expected loss model under the new standard, i.e. IFRS 9.

The effects from the recent better outlook should have been reflected in the results of the banks, particularly the banks that have either fully adopted FRS 139, or those that have closely aligned themselves to FRS 139 when moving closer towards full FRS 139 in 2012. A key concern is the potential volatility if there are changes in these factors, particularly the macro-economic factors which are beyond the banks' control. This challenge may be mitigated when the banks move to the expected loss model under the new standard, i.e. IFRS 9 (see next page) in future. For this reason, some banks have applied model risk and/or macro-economic adjustments in determining the appropriate level of loan loss allowances to reduce the risk of under-provision.

Effective interest rate or effective profit/yield rate?

Interest income or profit and expense are recognised based on a constant yield throughout the expected life of the asset or liability under FRS 139. This has mainly affected the income recognised from mortgage loans and financing with multi-tier rate structure (those with different contractual rates at different points of time during the financing period), and auto loan and financing (the sum-of-digit method recognises income faster than the FRS 139 effective interest method). The interest or income is recomputed using effective interest method and adjustments are made as necessary. Generally, for relatively young portfolios with the types of facilities offered in Malaysia, the adjustment for mortgage loans or financing would have a positive impact to profit or loss, whilst for auto loan or financing, the impact of the adjustment is the reverse.

As the computation is voluminous in nature, the operational risks involved are high, including human error in manual inputs, e.g. expected loan life, timing of loan disbursement, revised timing of repayment etc. Some banks compute the impacts on a portfolio basis, e.g. by loan types, years of origination etc. Others quantify the impact on a loan-by-loan basis, or a combination of portfolio and individual basis, e.g. applying the portfolio level assumptions when computing the impact for each individual loan. Whichever method that has been applied, a sensible next step seems to be automating the processes as much as possible to reduce operational risks and shorten the lead time to produce the results.

As judgement is involved in quantifying the effective interest/profit/yield impact, 'catch-up' adjustments will be required whenever there is revision to the parameters (expected loan life, timing of loan disbursement, revised timing of repayment etc.). These 'catch-up' adjustments can cause volatility to the profit or loss. It has posted challenges to predictability of periodic results, including during the budgeting process. Some banks have thus started to develop tools to enhance prediction capability by enhancing the ability to analyse the impacts in sufficient level of detail.

Hedge accounting

Some banks, particularly the larger ones, have started to build hedge accounting capability since 2005, when derivatives were first required to be carried at fair value through profit or loss through the revised guidelines issued by Bank Negara Malaysia then, i.e. the then-revised BNM/GP8. This capability has proven valuable in managing profit or loss volatility from the fair value fluctuation of derivative hedging instruments and in explaining the impacts to stakeholders. It has been observed that hedge accounting has been applied by banks in Malaysia in their managing of interest rate and foreign exchange risks.

The need for hedge accounting is even higher now under FRS 139 as more items, e.g. embedded derivatives and financial guarantees are carried on-balance sheet. The more sophisticated banks have started to explore the possibility of applying hedge accounting when managing equity and credit risks. At least one bank in Malaysia has successfully applied macro or portfolio hedge, a much more complex but effective hedge accounting technique compared to the usual one-to-one and group hedges.

In addition, system solutions have been considered in dealing with the volume of documentation and effectiveness tests required for applying hedge accounting. Compared to three to five years ago, the vendors seem to be able to provide workable solutions now to the satisfaction of the banks in Malaysia. As hedge accounting is relatively more consistent in terms of hedging strategies and specifications of the financial instruments used among the banks globally, the system solutions used by banks in other countries can be more readily customised for use by Malaysian banks here.

What about FRS 7 Financial Instruments: Disclosures?

FRS 7 relates to disclosure requirements on financial instruments. It replaces the previous requirements included under FRS 132. FRS 7 goes hand-in-hand with FRS 139 requirements and in addition, introduces more detailed disclosures both from qualitative and quantitative aspects. While FRS 139 requirements have taken effect from the first day of the financial period post-January 2010, FRS 7 is applicable to annual financial statements that are prepared at the end of the financial period. Among others, FRS 7 introduces new disclosures on the processes of managing financial risks, credit concentration and credit quality, fair value of certain collaterals held in hand, and sensitivity analysis of the effects of market risks (including interest rate risk, foreign exchange risk, equity price risk and commodity price risk) on profit or loss and equity.

A number of Malaysian banks have implemented both FRS 139 and FRS 7 together. Some other banks have implemented FRS 7 independently from FRS 139, after they are FRS 139-ready, for practical reasons, i.e. resources constraint and the belief that FRS 7 is less complex. Many of them have taken the pragmatic approach of taking direct reference from the banks that have published the annual financial statements first, instead of going through sufficient internal due processes of finding an appropriate mix of disclosures that best suit their business models and governance practices. Thus, it is expected that more effort will be invested in future in the preparation of the second set of financial statements under FRS 7 next year. There are also new amendments to FRS 7 that have been effective only from 1 January 2011.

Similar to FRS 139 challenges, many banks have worked hard to automate the data and information compilation processes for FRS 7 purposes to reduce operational risks. While waiting for the automation solutions to be in place, additional manual controls are relied upon to ensure accuracy of the disclosures made in the financial statements.

What's next?

Gearing up for the next change: FRS 139 replacement, IFRS 9

Following the call by G20 leaders since 2009 to address the flaws of IAS 39 (FRS 139 in Malaysia) and to simplify the standard, IFRS 9 has been developed in three main phases. IFRS 9 has been replacing IAS 39 requirements progressively since November 2009. The new standard will ultimately replace IAS 39 when its full version is ready by June 2011 (a delay from the earlier deadline in December 2010). IFRS 9 could take effect as soon as January 2013 in Malaysia although there have been discussions among the accounting standard setters globally to defer the date.

Phase 1 of IFRS 9 was completed in stages in November 2009 (Classification and Measurement of Financial Assets) and October 2010 (Classification and Measurement of Financial Liabilities). Similar to other countries, e.g. Singapore, Malaysia has not adopted Phase 1 of IFRS 9 (it will be known as FRS 9 if adopted in Malaysia). Malaysia has indicated that it prefers to have the chance to analyse the impacts of the full standard before its adoption for use in Malaysia.

Phase 2 (amortise cost and impairment) and Phase 3 (hedge accounting) have been issued as exposure drafts for comments globally. The Malaysian Accounting Standards Board (MASB) and the banks have had rounds of discussions to solicit views and consensus from Malaysia to be conveyed to the International Accounting Standards Board (IASB).

Phase 2 (amortise cost and impairment) includes a proposal to change from the current incurred loss to expected loss model. Credit loss of financial assets carried at amortised cost would be determined and provided for from the first day the asset is recognised. The latest proposal from IASB in January 2011 has alleviated many operational concerns in the earlier version, e.g. the decoupling of impairment from revenue recognition and no specific method mandated in developing loss estimate.

In Phase 3 (hedge accounting), IASB proposes to simplify hedge accounting rules, with the alignment closer to risk management activities. Hedge accounting could now be applied to more hedging relationships, including to non-financial items (e.g. oil and other commodities). Hedge effectiveness testing has also been made easier (e.g. with the abolishment of the bright-line threshold 80%-125%) under the proposal.

Tasked to take on the next change...

The banking industry in Malaysia has started to develop its own FRS 139 and FRS 7 practices since both standards became effective in 2010. But the good work done so far needs to continue. The invaluable experience acquired and the disciplines inculcated when implementing FRS 139 and FRS 7 should be the foundation for a smoother transition into IFRS 9. ✱

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Concept of Risk in Islamic Finance

DR. ASYRAF WAJDI DUSUKI

The global financial environment characterised by unstable financial markets, increasing episodes of financial distress and structural financial imbalances has brought the Islamic financial industry into the limelight. Indeed, the Islamic financial industry is ascending to prominence in the wake of the financial crisis as there have been several reports suggesting that the crisis which started to unfold in 2008, had a limited impact on Islamic banks, although it did not emerge entirely unscathed.

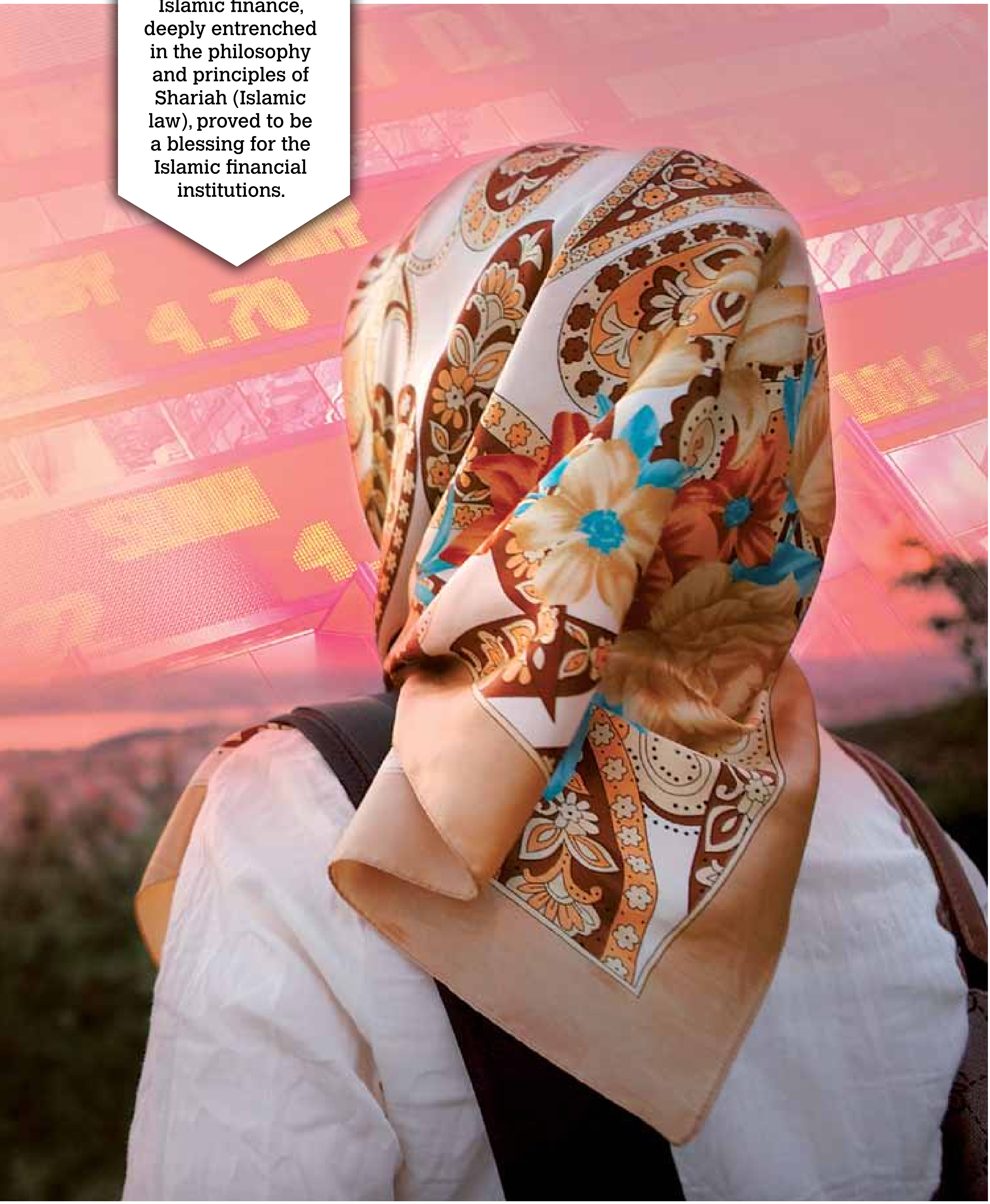
The recently published International Monetary Fund (IMF) working paper entitled "The Effect of the Global Crisis on Islamic and Conventional Banks: A Comparative Study" by Maher Hasan and Jemma Dridi confirm that in general Islamic banks fared better than their conventional counterparts during the global financial crisis.

The underlying principles of Islamic finance, deeply entrenched in the philosophy and principles of *Shariah* (Islamic law), proved to be a blessing for the Islamic financial institutions. While many have attributed the crisis to the overwhelming appetite of financial market participants in innovating derivative instruments such as credit default obligations (CDOs), Islamic banks on the other hand were not allowed to participate in these transactions as they violate the fundamentals of *Shariah*.

Having mentioned this, Islamic banking is not immune from exposure to issues related to risk management. In fact, it is a matter of general understanding that banks are intimately involved in the issue of risk management, for the concepts of asset and liability management - each with its own respective features and characteristics which are the opposite of each other - are central to the banking system.

Shariah

The underlying principles of Islamic finance, deeply entrenched in the philosophy and principles of Shariah (Islamic law), proved to be a blessing for the Islamic financial institutions.



For example, the deposits that banks take from depositors are highly liquid and short-term. The depositors can withdraw their money at any time, while at the same time they expect to get some profit or returns. On the asset side, banks will utilise the funds obtained through various deposit products by channelling them into various forms of financing activities, investment and other financial operations, which are more long-term and illiquid. The difference between the profit rates of assets and liabilities has an effect on the flow of funds and a bank's liquidity level.

This certainly exposes the bank to liquidity risks and other risks stemming from the structural nature of the banking operation. If the bank fails to manage its risks effectively, it will certainly face a liquidity problem, leading to various larger problems. The bank may end up being unable to fulfill a financing demand, or worse yet, to fulfill customers' demands to get their money back.

Islam recognises the concept of risk management particularly with respect to managing risk to protect wealth. This is in line with the spirit and direction of Divine Guidance, the Quran and the tradition of the Prophet Muhammad (peace be upon him), which among others advocates the concept of preservation of wealth as one of the most important objectives of *Shariah*. In the Quran for example, Allah directs human beings to record debts and business dealings and to take witnesses (Al-Quran: 2:282-283). This prevents the possibility of a party denying his obligation towards another party, which could lead to a loss of capital. The verse also stresses that if the dealing takes place during a journey, Allah allows collateral to be taken for the debt, if no record is made. Such actions are suggested so that the debtor is aware and is responsible in fulfilling his respective obligation.

The concept of risk management also has a strong basis in the tradition of the Prophet PBUH (Sunnah). For example, the following *hadith* (Prophet's saying) strongly illustrates the importance of taking steps to minimise loss.

A companion of the Prophet (peace be upon him), Anas bin Malik (may Allah be pleased with him) narrated that a man asked the Prophet: "O Messenger of Allah, should I tie [my camel] and place my trust [in Allah], or should I leave it untied and trust [in Allah]?" The Prophet answered: "Tie it and trust [in Allah]." (Hadith Narrated by al-Tirmidhi and al-Bayhaqi.)

The above *hadith* clearly indicates that the companion was encouraged to prevent the loss of the camel by taking steps to ensure its security by tying it up. The companion was advised to believe in God and at the same time take steps to prevent loss to property. This is a real example of hedging or managing one's risk. The sources from the Quran and *hadith* shows that as long as it is done through *Shariah*-acceptable means, risk avoidance and hedging strategies should be pursued.

In addition to these strong justifications from the Quran and *Sunnah* on management and minimisation of risks, the jurists of both the past and the present have consistently supported this concept. A major basis for that is the *SharÊÑah* concepts of *Maqasid al-Shariah* (Objectives of *Shariah*), which emphasise the development of wealth and its preservation from loss or damage.

Indeed, the preservation of wealth is one of the basic

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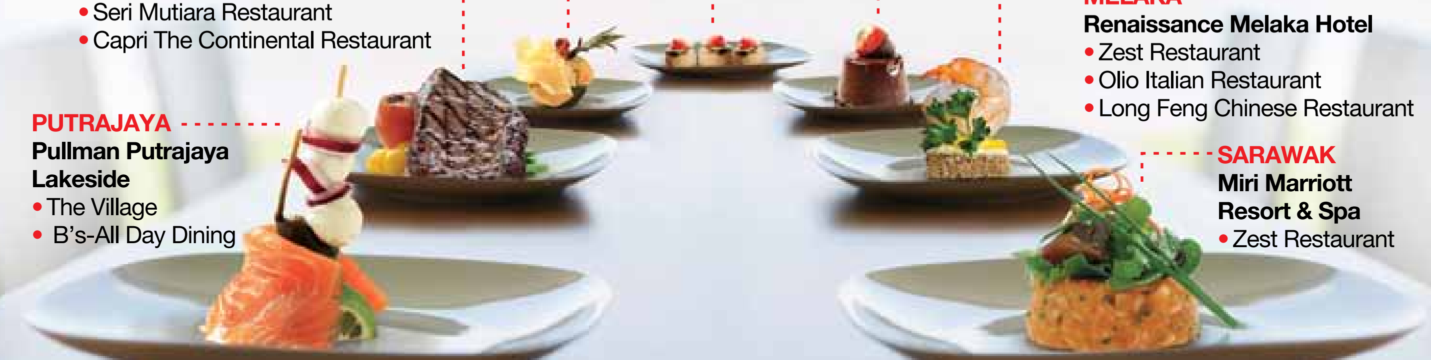

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objectives of *Shariah*. This is made very clear in a *hadith* which states that if one dies protecting his family and property, his death is considered martyrdom. That is why Islam has promulgated a variety of rules related to the preservation of property and wealth; it has prohibited misappropriating the property of others by acts such as stealing and devouring the wealth of orphans. It also interdicts incompetent people from handling financial matters. This would include the mentally impaired, children, and those who demonstrate imprudence and wastefulness in managing property. Islam also provides guidelines for ways to develop and use wealth, such as in business and investment activities.

All this demonstrates the emphasis Islam places on the process of acquiring and maintaining assets in ways that are both *halal* and safe. Islamic law also gives attention to types of persons and their level of competencies when conducting trade because disregarding this may result in loss of wealth, a risk that should be best avoided. Thus, there are eligibility requirements for every contract, and it is acknowledged that one's expertise can influence the profit and loss in any investment.

In fact, the Muslim is required to avoid harm, based on a number of Islamic legal maxims, among them:

'Harm should neither be initiated nor reciprocated.'
'Harm must be eliminated.'
'Harm must be eliminated as much as possible.'
'Repelling harm takes priority over seeking benefit.'

There are many more Islamic legal maxims which support efforts to manage risks and avoid harm to religion, lives, property or other objectives of the *Shariah*.

It can be understood from the discussion on risk from the perspective of Objectives of *Shariah* that any harm or risk to property must be resolved or efficiently curbed. From this perspective, any prospective business or investment issue must go through a comprehensive analysis process to determine the benefits and risk or harm contained in it before it is executed. If it is likely to bring about major harm or loss, it should be proposed that the transaction be cancelled.

As much as Islam recognises that risk is something which is inevitable in business, it also acknowledges that it can be managed and minimised if strategic steps are taken. Hence, Islam condemns two extremes of behaviour with regard to risk. The first is total risk avoidance by obtaining profits without assuming any risk, which is the case with *riba*. The second is excessive risk-taking in activities that have elements of gambling. Islam encourages taking calculated risk to obtain profits. Among several risk management methods that have been discussed and that jurists consider permissible are limiting the scope and level of risk to be taken in any investment, diversifying investment instruments, and obtaining a third-party guarantee. There are others as well.

To better understand the approach to be adopted in dealing with risk, it is pertinent to comprehend the various types of risk in Islamic finance. In general, Muslim jurists divide risk into three main components, each of which needs to be addressed differently.

Essential risk

This is the type of risk that is inevitable; in fact, it must be borne because it is part of the demands and norms of *Shariah*-compliant contracts and transactions. This is based on the above mentioned fundamental legal maxim *"al-ghunm bil-ghurm"* which means "entitlement to profit is accompanied by responsibility for attendant expenses and possible loss." For example, in a sale contract, the seller must bear all risks related to the commodity sold, such as the risk of defects, loss, value depreciation, etc., until the goods are sold and delivered to the buyer. It is only after the buyer takes possession of the goods

For example, in a sale contract, the seller must bear all risks related to the commodity sold, such as the risk of defects, loss, value depreciation, etc., until the goods are sold and delivered to the buyer. It is only after the buyer takes possession of the goods that the risks of loss, defects, or value depreciation in the goods sold can be transferred from the seller to the buyer.

that the risks of loss, defects, or value depreciation in the goods sold can be transferred from the seller to the buyer. These responsibilities are features of complete ownership *(milkiyyah tammah)*. Any conditions imposed at variance with this rule will result in the contract becoming void.

Forbidden risk

This category includes risk that can cause any trading or transaction to become void, according to the *SharÊÑah*. Jurists link this risk to the element of excessive ambiguity, known in Arabic as *gharar jaseem* or *gharar fahish.* Included in this category is *gharar* caused by elements of gambling *(maysir)*, which is a zero-sum game[1] forbidden by the *Shariah*. The Arabic term *gharar* also connotes risk *(khatar)*. *Shaykh al-Suwailem* discusses the meaning of *gharar* in the zero-sum game context. What is meant by a zero-sum game is a situation where one party wins and gets benefits from the losses of the second party. Because both sides compete to get profit and not to do charity, this transaction is more referred to getting wealth in the harmful way, which is strongly condemned in the Quran. It is also seen as a form of gambling which will foster a feeling of hatred, as is mentioned in the Quran. Islamic Jurisprudence *(fiqh)* books identify a number of aspects in which excessive risk or ambiguity *(gharar fahish)* may occur:

a. **Uncertainty or risk related to existence** – buying or selling something that is not present *(bayÑ al-maÑdËm),* as in the purchase or sale of something which does not yet exist. This prohibition affects the validity of modern-day commodity forward transactions, whereby the trading contract is executed upfront whereas the delivery and settlement only happen in future.
b. **Uncertainty or risk related to taking ownership** – the purchase or sale of something which is not yet in one's ownership or possession. For example, in short selling, the broker sells shares which are actually borrowed from the market and yet to be fully owned by the seller.
c. **Uncertainty or risk related to quantity** – for example, a sale contract in which the sale price is not known or a rental contract where the rental value is unknown.
d. **Uncertainty or risk related to quality** – for example, uncertainty about the type or specifications of the goods which are the subject of a contract.
e. **Uncertainty or risk related to the time of payment** – for example, a sale for deferred payment when the date is not fixed.

The jurists are unanimous that the existence of any of the risk elements mentioned above in a sale or exchange contract *(uqud muawadat)* will result in the contract becoming void. The majority of Maliki jurists are of the view that the same rule does not apply to a contract of gift or contribution *(uqud tabarruat)*. According to the Maliki jurists, the presence of substantial risk or uncertainty in a charitable-based contract will not affect the contract status. It is on this factor that contemporary jurists permit *Takaful* (Islamic insurance), even though it contains certain degree of uncertainty elements, as discussed above.

Tolerable risk to be avoided

Apart from the risk categories discussed above, there is yet another type of risk, one that is tolerable but avoidable. At times, it becomes necessary to protect against this type of risk. For example, in cross-border transactions, naturally institutions are exposed to the potential fluctuation in the value of currencies albeit the underlying transaction is *Shariah*-compliant. The volatility of the currency market has become a serious threat to investors. In fact, relying on a natural or basic risk management strategy, such as the use of diversification and concentration, is not sufficient to mitigate such a risk since the risk can only be managed and minimised with special hedging instruments.

However, the jurists of both the past and the present have consistently asserted that the instruments and mechanisms used to manage this type of risk must not

1 See Sami Ibrahim al-Suwailem, al-TaÍawwuÏ fÊ al-TamwÊl al-IslamÊ, pp. 81-89.

in any way violate a *Shariah* ruling. This assertion is strongly entrenched in the *Shariah* principle that 'the end does not justify the means'. This was explained in detail in the 28th Barakah Symposium in Jeddah on 16 September 2007, which specifically discussed the issue of hedging (*tahawwut*). The resolution issued was as follows:

In Islamic financial activities, the pre-condition is that investors bear the risks. This is based on the principle of '*al-ghunmu bi al-ghurmi*' which means that entitlement to profit is accompanied by responsibility for attendant expenses and possible loss. This is backed by the *Hadith 'Inna al-Kharaj Bi al-Dhaman'* which means the entitlement to profit from something is dependent on responsibility for attendant expenses and possible loss and defects (*Hadith* narrated by *al-Tirmizi, Abu Dawud, Ibn Majah* and *Ahmad*). Therefore, any investment activities based on the separation between "*al-ghunm*" (profit) and "*al-ghurm*" (losses), where investors are qualified to receive profits without bearing "*daman*" (responsibility for losses or risks), are not allowed. Any contracts or contractual terms which are meant to guarantee investment capital and profit are contradictory to the *Shariah*.

Minimising and avoiding risks are permissible if managed in line with *Shariah* mechanisms, contracts and instruments, as long as they do not bring about matters that contravene *Shariah* principles (Resolution No. 2:28).

Since the *Shariah* acknowledges the concept of risk management and its importance, the instruments and steps taken to achieve this are encouraged as long as they do not violate a *Shariah* ruling. Among the scholars who have discussed financial hedging, evaluated conventional hedging instruments, and made efforts to develop *Shariah*-compliant alternatives are Dr. Sami al-Suwailem, Dr. Mohamed Ali Elgari, Dr. Abdul Sattar Abu Ghuddah, the International Islamic Fiqh Academy, the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI), the Dallah al-Barakah Shariah Advisory Council, the *Shariah* committees of other Islamic financial institutions, and many others. Most of them do not reject the concept of financial risk management. They admit its importance in Islamic financial markets; however, they differ as to what *Shariah*-compliant hedging mechanisms can be developed. They agree that hedging is valid, but it cannot be thought of as a tool to totally eliminate risks. ✱

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