# banking insight

IDEAS FOR LEADERS
JUNE 2012

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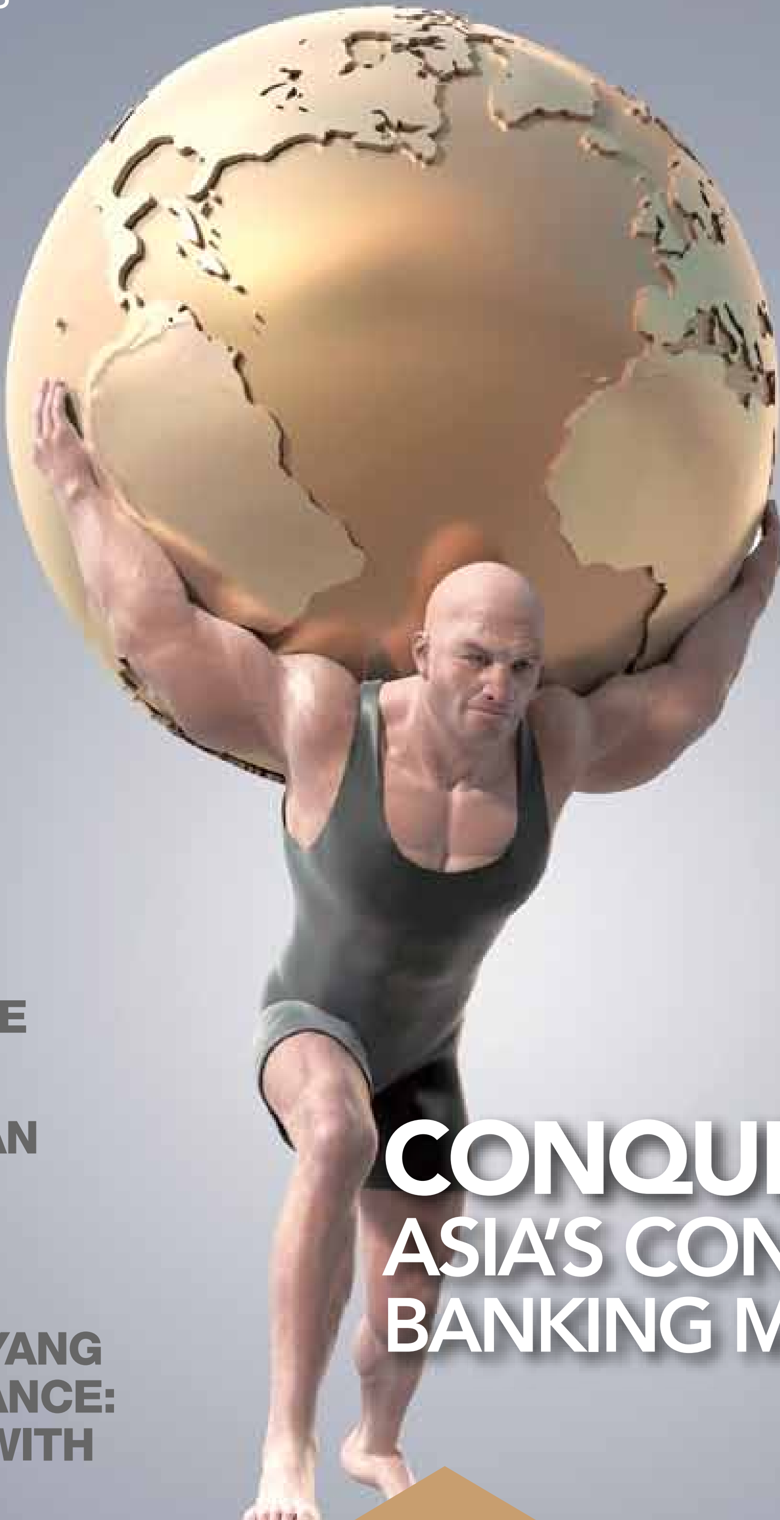

MILLENNIAL BANKING COMES OF AGE

A NEW BUSINESS PLAN

BANKING THE UNBANKED

THE YIN AND YANG OF PERFORMANCE: LEADERSHIP WITH GOVERNANCE

## CONQUERING ASIA'S CONSUMER BANKING MARKETS

DEFLATING MALAYSIA'S HOUSEHOLD DEBT BUBBLE

INTERNATIONALISING THE RENMINBI

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# BANKING ON DIVERSITY

**DIVERSITY** is poised to be a fundamental challenge for banks going forward, whether it is diversity of markets or customers. Recognising the urgency of the diversity issue, we have chosen to zoom in on diversity as the common thread in this third issue of *Banking Insight.*

As more and more financial institutions cross borders to pursue growth and economies of scale, there is no escaping market diversity. While Asia is a bright spot in the context of global economic malaise, Asia's markets and consumers are certainly not fungible or homogeneous, says our cover story on 'Consumer Banking Trade: Conquering Asia's Consumer Banking Markets.' Banks will have to fashion bespoke models that cater for each market's level of development; the sophisticated model that works like a dream in Hong Kong and Singapore would fall flat in Myanmar, which is just beginning to open up. Banks which aim to conquer Asia's consumers will thus need to be much more agile and flexible in responding to, connecting with and satisfying the changing needs and wants of these very different markets.

Apart from tackling market diversity, banks will have to tailor their models to accommodate customer diversity. Customers come in many different moulds, whether it is the digitally savvy Gen-Y, the expanding affluent and the middle-income classes in the multitudinous economies of China, India and ASEAN, and the unbanked and underbanked for which financial services and inclusion can be a means to break the vicious chains of poverty.

'Millennial Banking Comes of Age' frames the rise of Gen-Y as a pivotal business development and source of market disruption, innovation and transformation, and examines how companies are scrambling to dissect and cater to these digital consumers. Gen-Y will supplant Boomers and Gen-X as the largest customer segment by population by 2020, according to research by technology group Cisco. Banks will need to have digital strategies and channels firmly in place to win over Gen-Y to sustain business in the long run.

As disruptive as Gen-Y are the unbanked and underbanked, which comprise 2.5 billion or more consumers globally according to 'Banking the Unbanked'. Complying with regulatory goals on financial inclusivity and diversity targets would compel banks to cater to this underserved market segment. Understandably, regulators and development agencies are pushing for financial inclusion in order to ensure that no citizen is left behind as economies climb up the value chain; financial inclusion is a key plank in Bank Negara Malaysia's (BNM) policy. However, traditional banks may find that this segment does not fit their models – would financial inclusion be considered a CSR responsibility or a profit centre? Meanwhile, competing non-traditional providers are offering alternative solutions such as mobile banking and prepaid cards.

Regulators too will have to understand the implications of diversity if they want to perform better in oversight and regulation, and facilitate the growth of their jurisdiction's banks locally, regionally and globally. Diversity is a strategic imperative that is aligned with the Financial Sector Blueprint and Bank Negara Malaysia's New Business Plan 2012 – 2014, which was introduced early this year to enhance the central bank's performance and promote greater integration of Malaysia into a regional and global economic and financial system.

Ultimately, diversity is a tool for better business performance. Research has shown that diversity – like other strategies - works best when driven from the top by organisational leaders and accompanied by good governance. The most successful organisations, according to John Zinkin, Managing Director of Corporate Governance at Iclif in 'The Yin and Yang of Performance: Leadership with Governance', are those that reconcile leadership and governance to create sustainable long-term value for banks and their shareholders. On top of this, I would encourage banks to integrate the ideals and realities of diversity into their leadership and governance agendas in order to build robust models in this age of cross-border, interclass and intergenerational diversity.

I do hope that this issue will stimulate fresh trains of thought for our readers. Enjoy! ✱

*Hope you have a fruitful read.*

**THE EDITOR**

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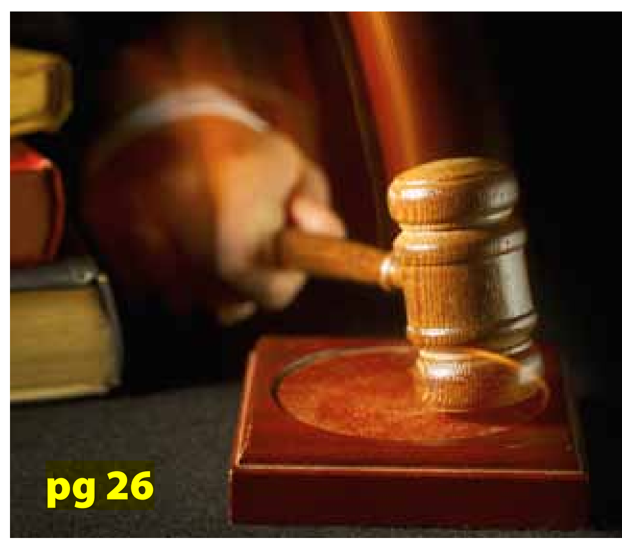


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**Growth**

**More banks in these countries are finding ways to overcome the traditional difficulties of reaching this market segment.**

# POTENTIAL IN MICRO-BANKING?

**OVER THE NEXT TEN YEARS,** an estimated 60% of the growth in global banking revenues will come from emerging markets, said a new McKinsey report, 'Micro-, Small and Medium-Sized Enterprises In Emerging Markets: How Banks Can Grasp A USD350bn Opportunity'. The research shows that a particularly attractive segment will be micro, small, and medium-sized enterprises: the revenues they generate for banks could jump from USD150bn in 2010 to more than USD350bn by 2015.

According to the report, the projected increase is being propelled by these countries' rising GDP levels, higher penetration of the formerly unbanked and underbanked, and new demand for advanced products, such as trade finance and cash management. In emerging markets, this customer segment will generate higher revenues over the next five years than those expected from sales and trading, asset management, and investment banking combined.

Of course, the scale and growth potential of micro, small, and medium-sized enterprises vary greatly from one emerging market to another. But more and more banks in these countries are finding ways to overcome the traditional difficulties of reaching this market segment. Innovations in technology and business models are making it easier to manage the inherent credit risks and lower the cost of distribution. ✱

# Household debt holds back recoveries but restructuring can help

**THE MORE HOUSEHOLDS ACCUMULATE DEBT** during a boom, the deeper the subsequent slump in the economy and the weaker the recovery, according to new IMF research.

'Dealing with Household Debt,' published in the April 2012 World Economic Outlook, finds that housing busts preceded by larger run-ups in gross household debt - mortgages, personal loans, and credit card debt - are associated with significantly larger contractions in economic activity.

Household consumption and real GDP fall substantially more, unemployment rises more, and the reduction in economic activity persists for at least five years. A similar pattern holds for recessions more generally: those preceded by larger increases in household debt are more severe, according to the study's statistical analysis.

This is sobering for economies today, such as Iceland, Ireland, Spain, the United Kingdom, the United States, and others, where house prices collapsed during the Great Recession and the substantial amount of debt racked up during the boom became a burden holding back the recovery.

The solution may lie in bold debt restructuring programmes which can reduce defaults and foreclosures. ✱

# IMPROVING CUSTOMER RETENTION

**THE NINTH ANNUAL WORLD RETAIL BANKING REPORT 2012** released by Capgemini and Efma found that while bank customers citing a "positive customer experience" increased modestly by 7% globally from last year, customer retention is in flux. According to the Report's Customer Experience Index (CEI), which surveyed over 18,000 bank customers across 35 countries, 9% of customers are likely to leave their banks in the next six months while 40% are unsure they'll stay long-term.

Banks have a significant opportunity to close the customer sentiment gap and address the factors that matter most to them to increase loyalty, said the report. Quality of service (53%), fees, (50%), ease of use (49%) and interest rates (49%) represent the biggest impact areas to keep customers from leaving. In terms of customer satisfaction, North American customers are most satisfied with their banks (80%), followed by Central Europe (71%), Latin America (69%), Western Europe (66%), and Asia-Pacific at (53%).

*A focused business model will allow retail banks to achieve a more positive customer experience and cultivate stronger, long-term customer relationships.*

The report found that banks that have opted to pursue end-to-end models or a traditional strategy of "do-everything" to improve customer experience need to consider differentiating on only one or two dimensions. This focus should enable them to evolve into one of three potential new business models: as a product leader (excelling in developing, bundling and pricing products), utility/processor (excelling in cost-effective transaction processing) or distributor (specialising in channel management). A focused business model will allow retail banks to achieve a more positive customer experience and cultivate stronger, long-term customer relationships. ✱

# REGULATIONS, COSTS PRESSURE PRIVATE BANKS

**THE LATEST STUDY ON PRIVATE BANKING** carried out by KPMG and the University of St. Gallen, 'Performance Through Focus – Seizing The Global Private Banking Opportunity,' showed that a high level of regulatory and cost pressure is forcing private banks to adopt new business models and clear client segmentation.

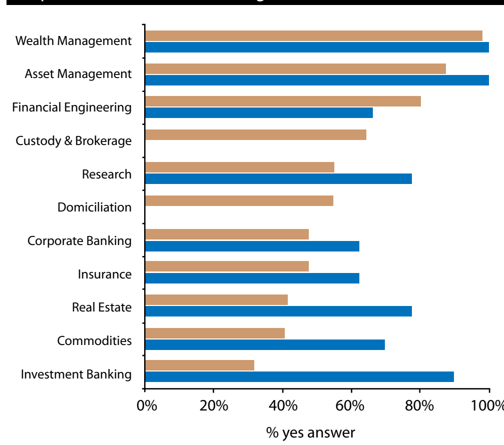
The private banks surveyed in Switzerland, Luxembourg, Austria, Hong Kong and Singapore consider political stability followed by client data confidentiality to be most important when it comes to location. At bank level, individual strengths are required as key differentiators. Very great value is placed on the specific banking culture, with Asian private banks attaching more weight to client advisory services and bank products. In Luxembourg, financial engineering comes next highest, with brand management and client advisory services occupying second place in Austria and Switzerland respectively. Some highlights of the research are:

**Increasing consolidation** - For European, and sometimes Asian private banks, M&A activities are an important way of strengthening their own positions as the size of the institution plays a central role in the face of high regulatory and IT costs.

**Regulations influence business models** - The private banks surveyed agreed that full tax compliance will be imperative in future. Political pressure from the USA, EU, OECD and G20 has become too strong. Markets in Financial Instruments Directive (MiFID), cross-border regulations and Foreign Account Tax Compliance Act (FATCA) are driving operating costs up and forcing banks to change their business models.

**Differences between Asia and Europe** - There are large variations between Asian and European private banks when it comes to products and services. 83% of Asian private banks see the range of services offered as an essential differentiator, compared to only 49% among European institutions. Asian clients also want integrated financial services covering wealth management as well as real estate, commodities and investment banking services.

Graph: Products and services regarded as critical success factors




Source: KPMG AG

European clients meanwhile demand an ever more detailed range of products and services. Swiss private banks thus focus primarily on wealth and asset management, and Luxembourg-based institutions on financial engineering closely related to tax issues. ✱


# CONSUMER BANKING TRADE

## *Conquering Asia's Consumer Banking Markets*

ASIA'S FRAGMENTED BANKING MARKETS REQUIRE DIVERSIFIED SOLUTIONS THAT RIDE ON TECHNOLOGY AND DELIVER PERSONALISED SERVICE, CONVENIENCE AND VALUE TO A MIXED BAG OF CONSUMERS.

AZIZA MASRI

**All of these studies have developed guidelines to improve bank corporate governance. In all of them the emphasis, not surprisingly, has been on risk governance.**


While much of the West is languishing amidst the fallout from the global financial crisis, Asian destinations remain among the most vibrant banking markets; partly as a result of the region's limited exposure to its western counterparts and partly due to its more prudent banking systems.

However, Asia's vibrancy has led to a separate conundrum for the region's banks especially in the consumer banking market, where markets range from saturated to underserved. The diversity of Asia's markets presents many challenges for the consumer banking business, especially with the emergence of exciting yet complex segments such as the Generation Y (Gen-Y) segment, Asia's new affluent class and the growing middle-income classes in the developing economies of China, India and Indonesia.

"There is the impact of reducing customer loyalty and the need for banks to be much more agile to respond to the changing needs, and more importantly, wants, of these client segments, as well as how we reach them and connect with them," remarked Renzo Viegas, Group Deputy Chief Executive Officer of CIMB Group and Head of Consumer Banking at CIMB Bank, a universal ASEAN bank.

## Diverse markets

With Asian economies at different stages of maturity, their consumer banking markets similarly reflect fragmented levels of development. In China, where the economy has grown rapidly but remains short of maturity, the consumer banking market is still emerging with opportunities abounding in the areas of credit cards, loans and private banking, noted Ernst & Young (EY) in its 'Global Banking Outlook 2012-2013'.

In Indonesia, where the economy has staged somewhat of a revival in recent years, banks are continuing to scramble for a slice of the underdeveloped consumer banking market mainly due to its lucrative potential. Nonetheless, Indonesian consumers have grown increasingly sophisticated, which provides banks with opportunities to deliver solutions in less traditional ways.

"The continued growth of the middle class and the increasing proliferation of smartphones will create new opportunities for consumer banking products, delivered via mobile technology to obviate the requirement for an extensive and costly branch infrastructure," EY said of the Indonesian market.

As with other parts of Asia and the Middle East, *Shariah*-compliant banking products present a growth opportunity – though unpredictable – in Indonesia, as the country's Muslim population grows richer. "However, the demand for these products to be provided by established global banks is difficult to predict and local and regional banks may enjoy more success in this market and elsewhere," says EY.

## Wealth of opportunity

Varying consumer segments and needs translate into a wealth of opportunity for the region's banks to tap into, provided they are able to adapt quickly to the dynamic environment. In the markets it operates in, the CIMB Group sees the high net worth individual private banking market, the aspiring affluent market, the Gen-Y and "first jobber" segment and Indonesia's middle-class and mass market as those showing

**"CONSEQUENTLY, BANKS NEED TO TARGET** AND ACQUIRE THESE CONSUMERS NOW TO LOCK IN THE FUTURE VALUE THAT WILL BE GENERATED BY THIS SEGMENT. A PWC RESEARCH SUGGESTS THAT THE EXTENT TO WHICH A BANK EXPLOITS THE NEW DIGITAL FEATURE SET WILL PLAY A VERY IMPORTANT PART IN THIS CUSTOMER GROUP'S DECISION-MAKING PROCESS, MUCH MORE SO THAN TRADITIONALLY IMPORTANT CRITERIA SUCH AS BRANCH LOCATION, OR EVEN BRAND."

among the highest potential for growth.

China, India and Indonesia's consumer banking markets also present the greatest growth potential due to its low banking branch penetration. Meanwhile, in the region as a whole, especially in South Asia and Southeast Asia, economic growth and a growing middle-class are driving demand for innovations in mobile banking, microfinance and insurance.

"In Indonesia specifically, we see potential in the middle-class and mass market (for the micro-lending business). We see a need to capture the middle-class segment as this segment will become the affluent segment in the near future, and capturing their banking needs now will translate into customer loyalty. In the mass segment, the key is getting the model right, as the high margin is compelling and credit risk modelling needs to be robust.

"The challenge for banks is to effectively make use of the findings from customer analysis and segmentation to deliver best-in-class products and services, as well as provide the best customer experience," said Viegas.

## Technology: Innovating for Asia

Consumers' reliance on technology is another common theme that has developed across the Asian markets. In a PwC report entitled 'The New Digital Tipping Point,' the firm noted the wide use of the Internet to purchase financial services products by all segments around the world; with more than 50% of the markets in countries such as India, China and Hong Kong falling under this category, while the percentage of users utilising mobile phones to purchase financial products is also growing rapidly. According to PwC research, 30% of Hong Kong's market currently uses mobiles for their financial needs, with around 45% of China's market doing so and India's market constituting the largest utilising mobile banking at around 55%.

"It is especially important for those customers who form part of Gen-Y now, at the point of choosing their main banking provider," commented PwC. "Consequently, banks need to target and acquire these consumers now to lock in the future value that will be generated by this segment. Our research suggests that the extent to which a bank exploits the new digital feature set will play a very important part in this customer group's decision-making process, much more so than traditionally important criteria such as branch location, or even brand," it added.

Viegas concurred, noting that technology has significantly altered consumer behaviour to the point that banks can no longer rely on the traditional above-the-line communication for brand building and information dissemination.

"Technology is having a major impact – both positive and negative – for banks. One common misconception is that technology reduces cost in banks, which is not necessarily the case. Over the longer term, it may lead to cost avoidance, but with customers demanding online real time banking and broader financial services anywhere and anytime, the cost for banks to build and sustain a leadership position is spiralling.

"That said, doing nothing or falling behind other industry players will be a major problem over the longer term," he cautioned.

## Regulatory reform

Another crucial trend faced by banks in Asia is growing regulatory reform, particularly as authorities have become increasingly prudent in the wake of the global financial crisis, which revived echoes of the 1997/98 Asian financial crisis. In Malaysia, the central bank, Bank Negara Malaysia, recently implemented measures to limit consumer debt, impacting trends in the personal financing and credit card segments.

"On the credit card front, the implementation of government service tax and responsible financing guidelines in Malaysia to ensure sustainable economic growth and financial stability has impacted card base and the issuance of credit cards. With the guidelines, financial institutions are to take responsible steps to establish that customers are offered financing products which are appropriate to their financial circumstances.

"The two-pronged strategy of full disclosure by customers and calculation of debt service ratio based on income after statutory deductions have contributed to the lower growth of the credit card industry," said Viegas.

Regulatory issues are also prominent in Australia, noted EY in its global banking outlook, where considerations on new laws cover global and local rules. "In response to a saturated local market and new regulations, banks will be focusing on improving customer satisfaction and loyalty and investing in targeted infrastructure projects, such as frontline and core systems replacement, distribution and sales capability," said EY.

Reforms in India have also impacted banking trends, with the nod for non-

financial local companies to establish banks and the deregulation of deposit interest rates leading to stiffer competition in the domestic space. EY added that measures by the Reserve Bank of India, India's central bank, to mandate financial inclusion will also continue to drive innovative low-cost services in rural markets; with mobile banking set to expand further and faster in the country than in developed markets.

## No one approach to Asia

Banks tackling the consumer markets in Asia must develop a diversified approach. "In saturated markets, the winning formula remains to be continually improving customer service across the board; selling more of your products and service to existing and new customers; offering products with a greater value proposition; providing fast, simple and convenient solutions to customers to fulfil their banking needs; reducing the cost to serve legacy channels and products; treating customers as customers and not individual product holders within the organisation; and continual innovation in products and services through technology or other means.

"In markets where penetration is low, it is imperative to build customer loyalty by establishing strong and lasting relationships with them and to encourage them to hold more products from the bank. The key is to identify how to reach out to them and provide them with the right solution," said Viegas. ✱

■ Aziza Masri is a freelance journalist based in Kuala Lumpur.

COST

**One common misconception** is that technology reduces cost in banks, which is not necessarily the case. Over the longer term, it may lead to cost avoidance, but with customers demanding online real time banking and broader financial services anywhere and anytime, the cost for banks to build and sustain a leadership position is spiralling.

# *Millennial Banking* COMES OF AGE

Call it banking for boomers, generation X, Y, Z and beyond. As the digital natives are growing up, banks are discovering that the generation gap is bigger than usual. Soon the baby boomers will no longer be the biggest customer group, meaning banks are facing the pressing challenge of catering to the unique tastes of the millennial generation.

JESSICA FURSETH

Rapid advancements in technology are changing the way we interact with each other. The more we can do over the internet and via mobile phones, the more we come to expect the same convenience when conducting business. For banks, this means heightened expectations for how people want to manage their money and interact with their financial advisors.

The banking industry has dealt with generational changes before, but the digital natives of Generation Y (Gen-Y) have brought about a unique set of challenges. In essence, the group of banking customers now aged between 18 and 30 are more different than usual, meaning banks have to step up their game.

"Gen-Y is so different from their predecessors that banks must understand their needs if they want them as their customers. Banks will need to use an approach distinctly different from anything they have been accustomed to in the past," concluded technology group Oracle in its report on Gen-Y banking, developed in collaboration with the European Financial Marketing Association. "The imperative is that as the economic power of Gen-Y expands, its members will change how financial transactions are conducted, together with patterns of spending, saving and investments."

Boomers, and their "silver generation" parents, currently make up the biggest segment of the banking population. Boomers are people born between 1945 and 1960, followed by Gen-X, born between 1960 and 1979. Gen-Y is the millennial generation, specifically those born between 1980 and 1992, and it is the gap between this group and its predecessors that has got banks worried; this is the first group of customers who were raised on the internet. And like it or not, Gen-Y will supplant the older generation as the largest customer segment by population by the end of this decade, according to research by technology group Cisco.

## What millennials want

"We live differently now. Together, technology and customer demand are driving a complete transformation of how banking is done. There is a growing global tribe of consumers who want anytime access to services and banking is no exception," said Steve Bertamini, Chief Executive Officer of Consumer Banking at Standard Chartered. A personalised experience sits at the heart of these expectations: Gen-Y wants to be treated as individuals.

Technology is the backbone of this change. Gen-Y is comfortable using online forums to communicate and solve problems, they like talking to customer services representatives in company chat rooms, they like receiving information via video, and they like to be able to access all these things on their own time, either on their computer or their mobile phone.

"Banks have a tremendous opportunity to provide Gen-Y and Gen-X consumers with personalised advice and value propositions. In fact, retail banks that execute correctly will become financial services providers of choice for these consumer categories," concluded Philip Farah at Cisco IBS, in his report on the next growth opportunity for banks.

Farah outlined three key elements for banks to meet the needs of Gen-Y customers: a mobile-enabled online interface for personal finance management emphasising a holistic view of the customers' needs; a video-centric advisory model that allows customers to interact with bank staff; and a bank-moderated community or social networking venue providing virtualised advice on demand.

While offering extensive online banking facilities will be a great start for banks to appeal to young customers, research from global professional services group PricewaterhouseCoopers (PwC) shows there are significant opportunities for those willing to take it a step further. The majority of respondents in an international survey were willing to pay up to £10 a month for digital banking services if they perceived them to offer both convenience and value. Features of particular appeal include social media notifications, and an electronic wallet for loyalty cards where accumulated points were converted into cash, according to PwC's report, 'The New Digital Tipping Point'. The future's digital features will, according to PwC, be focused on innovations in user experience; mobile devices and networks; social media and collaboration; customer analytics; and channel integration.

## A partnered approach

"The growth of digital has removed key barriers to market entry, including the need for large branch networks, customer inertia and brand trust," said Nicola Shield, Partner in the Northern retail and commercial banking group at PwC. "Because of this, banks need to consider strategic acquisitions or partnerships with digital innovators

to secure their long-term position and market share. Incumbents in developing markets, where there is a larger share of unbanked consumers, will experience the greatest threat from new players if they do not improve their digital offerings."

While many banks have already woken up to the fact that the up-and-coming generation of customers want a different experience, this is a far cry from being able to provide this in the manner expertly suited to meet their needs. Part of this is because it is not necessarily the most experienced bank executives who can best get into the heads of young adults.

"Engaging younger employees more actively may help provide the necessary reinforcements to accomplish this," said Steven Hatfield of global professional services group Deloitte. In his report on Gen-Y banking, Hatfield has recommended leveraging key qualities of Gen-Y employees such as innovation, tech-savvy, enthusiasm and creativity, in order to connect with younger customers. This view is echoed by PwC's report, which emphasised the importance of connecting with external experts in technology, telecoms and other non-traditional banking providers; "Identifying partners to acquire or help deliver the vision becomes of critical importance."

## Scratching the surface

Standard Chartered has done just this, by handing over the development of its mobile banking platform 'Breeze' to a small team of mobile and social media enthusiasts: "The best ideas will not necessarily come from the top, or even from bankers," explained Steve Bertamini. "It also means changing the approach to the consumer, offering financial services in ways that matter to people's lives." An example of this is how Standard Chartered's 'Wishlist', a savings feature within 'Breeze', has been integrated with Facebook and bulk discount aggregators, meaning people can share savings goals with friends and receive discounts from companies. Furthermore, 'Breeze Living' is Standard Chartered's augmented reality smartphone application where users can capture and share merchant discounts while on the move.

In Australia, UBank is using a Facebook-presence to launch new product ideas and source user opinions. Collaboration is encouraged via the 'Click to Chat' tool, with other features available on the social network including savings tips, discussions and links to instructional videos on YouTube. Japan's Jibun Bank is taking it even further by using the mobile channel as its primary means of contact with the consumer, allowing customers to open accounts using just their phone and its camera. "The point is that innovation is now about adding value to customers' lives, not about what products we can offer," said Bertamini. "In many ways, we have only just scratched the surface on how banking is going to change."

While their earning power is not as great as their parents yet, capturing the attention of Gen-Y, and the upcoming Gen-Z, is important as they are now at an age where they are forming banking relationships they may keep for the rest of their lives. But having said that, the younger generation is more likely than ever to change banks if they are not happy: 36% of Gen-Y customers are planning to change banks due to increased fees, while 33% will leave if another bank provides solutions that would improve the customer experience, according to a survey from business management solutions provider Intuit Financial Services.

Past generations have been reluctant to swap banks, but as this is changing with Gen-Y, financial groups will need to provide continually fresh offerings if they are to keep this demanding lot happy. Furthermore, Gen-Y's prolific use of social media platforms makes them extremely well connected, meaning they will quickly spread the word of a negative (or positive) experience. The good news is that customer service is also a major attraction for Gen-Y, a penchant they very much share with the Boomer generation.

## The power of Boomers

"The Boomer generation likes to have a relationship with their banks, to meet with a friendly face and to speak with people who use their names," said Suzie

Mitchell, founder of Mitchell PR, a US public relations agency specialising in understanding Boomers.

While preparing to meet the needs of Gen-Y, banks should not forget the influence the Boomers still have; they act as advisors both for their children as well as their ageing parents. And it is a mistake to think that Boomers are not technologically savvy, asserted Mitchell: "78% of Boomers are online, and out of these, 55% bank online. We have to remember that Boomers grew up with technology too; Apple computers were not even invented when they were in college, meaning they have been using this technology since the early days."

And teenagers are not the only ones eager to own a handy smartphone; as mobile devices and tablet computers become increasingly intuitive, Boomers are happy to download apps and use them for shopping. Ease of use is key to make the internet accessible for Boomers, especially smooth site navigation, logical placement of key information, uncluttered presentation and an overall sense of trustworthiness.

The main problem, however, is a concern over safety and privacy. While concerns about 'Big Brother' watching your internet activities will be a deterrent for some, the fear of online fraud remains the key fear for most Boomers. But Mitchell believes most older generation banking customers would be happy to use modern features if they were properly reassured they were safe: "Boomers are very adaptable."

Banks have become better at protecting people as online banking technology has matured, but equally important has been to teach people about safeguarding their details online. "Better public information about computer safety could save huge numbers of people the hassle of having their personal details stolen," said MP Andrew Miller, Chairman of the UK House of Commons Science and Technology Committee. While determined fraudsters will still find ways, the Committee concluded the internet is a "reasonably safe place" as long as people take "sensible precautions".

While Boomers still pack the biggest punch in terms of spending power, the global financial downturn has prompted changes in their spending patterns that mean banks have even more reasons to turn their attention to the upcoming generations.

"Although banks have invested heavily in meeting the financial needs of Boomers, this segment has seen its financial prospects dim with the recent collapse of asset values. Many Boomers are pushing out plans to retire, revisiting their portfolios and spending less," observed Cisco IBSG's Farah. "Although increasing restraint and financial anxiety on the part of Boomers do not necessarily denote trouble for banks, interest and fee income associated with older consumers is at greater risk than in the past due to a decreased appetite for new loans and the coming transfer of wealth to younger generations."

## Meeting the challenge

The question now is whether banks are adequately prepared to meet the expectations of Gen-Y. Not everyone is convinced that this is the case: "Industry leaders are generally misunderstanding the profundity of this generation gap," said Jim Van Dyke, President of research group Javelin Strategy & Research. Gen-Y and Gen-X will be tied in terms of income by 2020, on Javelin's estimates; "The mobile, payments and financial services generation gap will cause many banks, payments firms and technology vendors to play catch-up, or simply miss out altogether on crucial market opportunities."

Banks are facing a choice between the old, proven ways and the untested future, meaning new entrants who 'get it' could find this is their moment to undermine the incumbent providers. Some banks may view the Gen-Y trends as a distraction, risking alienation from the future customer base: "The victors will be those who recognise the changing ecosystem and set out on a clear digital vision for securing customers' relationship primacy," concluded the PwC report.

SAVVY

**"78% of Boomers are online,** and out of these, 55% bank online. We have to remember that Boomers grew up with technology too; Apple computers were not even invented when they were in college, meaning they have been using this technology since the early days."

There is however a gap between understanding that something needs to be done, and knowing what that something is. Choosing the right technology and the right partners will be a key challenge for banks, which are typically large, complex organisations not normally known for their innovation or speed-to-market.

"In the future, banks will have to become serial innovators, move with the urgency of start-ups and look for ideas everywhere. The task is not only to meet customers' needs but to capture their imagination," said Standard Chartered's Bertamini. "As I see it, the changes underway in technology and consumer demand represent not so much a threat but a great opportunity for banks to move to an unprecedented level of closeness with the customer. If we embrace it now, more than ever, we have the chance to make banking a true enabler in people's lives, helping to change the industry for good."✱

■ Jessica Furseth is a freelance journalist based in London.

# A NEW BUSINESS *plan*

*How will Bank Negara Malaysia's New Business Plan affect the Banking Sector? Notably, it is perceived by financial sector players that the New Business Plan will improve central bank performance while supporting banks' regionalisation initiatives and facilitating growth. Furthermore, the central bank's leadership roles may be diversified further as it functions substantially not only as a regulator, but also as a business facilitator, say respondents.*

Bank Negara's New Business Plan 2012 – 2014, which was introduced early this year, focuses on developing a more inclusive financial system that promotes greater integration of Malaysia into a regional and a global economic and financial system as well as sustaining the central bank's high performance. Indeed, it is perceived as an instrument that will improve the central bank's performance, and enable it to perform optimally in fulfilling the goals and aspirations of the overarching Financial Sector Blueprint, said chiefs of banks surveyed by the *Banking Insight* editorial team.

The New Business Plan is one of the key tools in ensuring the bank achieves its vision of being a progressive and high-performing central bank that is committed to the highest standards of excellence. It builds upon the Bank's Business Plan 2009 – 2011, which created the foundation to ensure organisational continuity and preparedness to better face the challenges going forward in achieving the Bank's desired outcomes.

In other words, the plan is aimed at ensuring the bank continues its path towards becoming a strategically-focused, outcome-driven and a sustainable organisation. As such, the plan sets the goals, outcomes and reporting structures against which performance will be assessed.

Key to the New Business Plan is talent management and upholding good corporate culture and values. In the management of human capital, a new framework is being introduced to recognise role specialisations through job, families and differentiated rewards. Targeted development will complement the current development framework to accelerate readiness of talent in Bank Negara.


Meanwhile, this year Bank Negara has upgraded its Code of Conduct and introduced the new Code of Ethics, given the significantly changing and more complex environment in which the Bank operates.

## Bringing the Financial Sector Blueprint's Goals to Fruition

Tengku Dato' Zafrul Tengku Abdul Aziz, Chief Executive Officer of Maybank Investment Bank Bhd believes that the central bank's New Business Plan is geared towards optimising its performance and thereby helping to attain the objectives set out in the Financial Sector Blueprint (FSB).

"One of the key objectives of the FSB is that the domestic financial system should achieve an annual growth rate of between 8% and 11% by 2020, while the depth of the financial system should increase to 6 times of Gross Domestic Product (GDP) by then. Contribution to nominal GDP is expected to rise to between 10% and 12% by 2020. Assets of the banking system, meanwhile, are expected to account for 3 times of GDP by 2020."

## Playing Across Borders

Another key thrust of the FSB is of strengthening regional and international financial integration and this implies that domestic banks will gradually have to venture abroad.

"Further liberalisation of the industry is one of the primary thrusts of the FSB and this means that there will be greater foreign participation and increased competition moving forward. For some domestic players, foreign equity participation could provide an avenue for further developing technical expertise while broadening skillsets. For the more well-capitalised players, there will be more opportunity to venture abroad with Bank Negara playing a more proactive role as a facilitator," commented Tengku Zafrul.

Diversification would also be a strategic imperative aligned with the FSB, which certain banks have already embraced. While retail banking continues to be Maybank's bread and butter, the contributions of other businesses such as corporate banking, global markets, investment banking, insurance and Islamic banking have grown. These businesses have been groomed to cater to a more diverse clientele base and to meet their ever more complex and varied needs.

Other efforts of the group include intensifying client coverage collaboration with its product partners, and rolling out the group's IT transformation programme while building a complete infrastructure and framework across multiple products and countries.

"Where regionalisation is concerned, overseas contributions now make up 27% of the group's pre-tax profit and this is set to grow as the Maybank-Kim Eng integration builds momentum. Expanding the group's presence in Asia remains a key objective," Tengku Zafrul explained.

Another bank with a regional footprint, the Export-Import Bank of Malaysia Bhd (EXIM Bank), also perceived the regionalisation of Malaysian banks as finance intermediaries to support the greater goals of economic expansion as a key tenet being championed by the central bank. Furthermore, Dato' Adissadikin Ali, Chief Executive Officer of Exim Bank said that the central bank's new business plan that takes into consideration the inclusion and integration of the regional financial system coincides with EXIM Bank's business focus.

Due to the considerable consumption power within the region, demand for capital would persist and it would be too taxing on EXIM Bank to keep up with such demand single-handedly, he said. "Thus, with Bank Negara's New Business Plan, which we believe will support the moves for Malaysian banks to expand their reach and operations within the region, EXIM Bank will be complemented by a larger number of Malaysian banks operating regionally. Together, we will be better able to support the needs of Malaysian companies that operate within the region," Adissadikin said.

EXIM Bank is considered a global player, he said, and the ASEAN region makes up about one-third of the bank's global exposure.

## Focus on Innovation, Service

Like it or not, banks would undoubtedly have to play a more effective intermediation role in the future, as Malaysia moves up the value-added chain and in step with the transformation into a high-income economy.

"This implies the need to be more product-innovative and more service-oriented in order to serve an ever-growing base of more sophisticated

clients and technologically advanced industries," remarked Tengku Zafrul. "There is an ever-growing need to enhance service quality, customer experience and satisfaction. More importantly, investment on human talent is crucial if the FSB goals are to be achieved," he said.

Moreover, banks need to become financially more secure and better capitalised to support the financing needs of large-scale projects to meet this demand. Banks should also possess sufficient expertise to provide risk capital financing.

## Emphasising Asset Quality

The emphasis on banks' asset quality and growth is another end being pursued by the New Business Plan, as perceived by the bank chiefs surveyed. "It's very important that when we grow our assets, we need to have a certain quality of assets. We need to reduce non-performing loans in the industry. Generally, it's at a manageable level now," said Datuk Mohamed Azahari Kamil, Chief Executive Officer, Asian Finance Bank (AFB).

Scaling up will be imperative and banks will need to penetrate regional markets to attain the desired volumes and economies of scale. "What's important is that Bank Negara is looking at the region as a whole, not talking about becoming a *jaguh kampung* (village hero) anymore. They are talking about consolidation, mergers and proposed acquisitions. You need to have size in order for you to compete globally," he added.

"The balance sheet is important, so through mergers and acquisitions (M&As), you can have a solid balance sheet, not only in terms of money but joint resources in terms of expertise."

Mohamed Azahari said that the New Business Plan augurs well for the bank as it is currently looking into mergers and acquisitions. "With our balance sheet, we know that we would not be able to grow. We are looking at M&As not through AFB, but our shareholder, Qatar Islamic Bank," Mohamed Azahari said.

"Bank Negara wants to ensure that all smaller banks consolidate to become stronger. The business plan focuses on this, gearing all the Malaysian banks to think of mega opportunities available in the market, and taking ASEAN with its 600 million population and Asia with its 3.9 billion people as a whole. There are a lot more opportunities especially in the Islamic finance sector, for us to develop," he added, referring to the central bank's vision of positioning Malaysia as global leader in Islamic finance.

## Talent Management

Talent is the achilles' heel of Malaysia's economy, and the story is no different in the banking sector. Solutions to the crunch include providing continuing training and development and putting facilitative frameworks in place to stem the brain drain; for example, Mohamed Azahari noted the shortage in the Islamic finance industry as these experts have moved to other regions. "Bank Negara provides training for the Islamic finance industry. The establishment of INCEIF (International Centre for Education in Islamic Finance) is a right move and direction by the central bank. Malaysia's infrastructure and legislation for Islamic finance are also better compared to other regions," he added.

## Effective Regulation

An Islamic bank CEO who requested anonymity said that any improvement on the effectiveness and efficiency of the regulator in regulating the Malaysian banking sector within and without the country's borders would always have a positive impact on the sector moving forward. "More so, when more and more Malaysian banks are becoming regional players," he said.

**_"With the New Business Plan, there is greater confidence that we are appropriately and effectively supported by our regulator continuously as we embark on our business growth in the country and abroad."_**

"With the New Business Plan, there is greater confidence that we are appropriately and effectively supported by our regulator continuously as we embark on our business growth in the country and abroad," he added.

Currently, he sees no risk or direct impact on banks with the implementation of the New Business Plan. "The risks are only in the non-implementation of the business plan as planned. If implemented well, the opportunities to the banks are limitless, as banks would have the right platform and support to do its business with certainty," he said.

Changing regulations put pressure on banks. Therefore, banks must always be prepared for changing regulation and for this they need to be agile, said the Islamic bank CEO. At the same time, he recommended that banks should be farsighted in anticipating changes and work with regulators for the right regulations to be put in place for any game change.✱

■ Reporting by the *Banking Insight* Editorial Team.

# ASEAN rising

AMIRA ABDULLAH

## HOW WILL THE PROSPECTIVE ESTABLISHMENT OF THE ASEAN ECONOMIC COMMUNITY IN 2015 AFFECT THE BANKING AND FINANCE SECTOR?

Is the concept of regional integration still viable? The grand experiment of the integrated Eurozone is in the doldrums today, dragged down by divisiveness, non-harmonisation of the individual EU economies and desperate attempts to settle a sovereign debt crisis whose end is not in sight yet.

Despite the emasculation of the EU, hopes run high for ASEAN integration, which aims to bring together Southeast Asia's buoyant economies for the sake of furthering economic expansion and social and community development.

Essentially, the ASEAN Economic Community (AEC) which is slated to take off in 2015 entails a single market and production base offering businesses a large space to market goods and services to consumers regardless of existing national (administrative) boundaries within the region. This implies the total removal of all trading barriers in goods, services and investment, as well as free

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Put another way, "regional economic integration means free flow of goods, services, investment, and freer flow of capital, equitable economic development, and reduced poverty and socio-economic disparities in year 2020," said Dato' Jamelah Jamaluddin, Chief Executive Officer of Kuwait Finance House (Malaysia) Bhd (KFH Malaysia), referencing 2020 as the year Malaysia aims to achieve high-income developed nation status via the ongoing Economic Transformation Programme (ETP).

In such a market, Jamelah envisioned investors would be able to trade in ASEAN capital market products freely in any ASEAN market at a competitive fee from a single access point, with capital market intermediaries being able to provide services throughout ASEAN.

In charting ASEAN integration to date, it could be said that progress has been for the most part, defined and characterised by the ASEAN Free Trade Area (AFTA) which has brought about significant reduction and elimination of tariffs on trade in goods, said Tengku Dato' Zafrul Tengku Abdul Aziz, Chief Executive Officer, Maybank Investment Bank Bhd. Now, the game needs to be stepped up to the next level. Since AEC's effectiveness revolves around liberalisation, the challenge now is to tackle a host of non-tariff barriers, which is a main barrier to entry and competition as far as trade in investment in services is concerned, urged Tengku Zafrul.

Other issues include the need to harmonise and standardise – there are significant differences in the levels of development of capital markets; the existence of capital controls and exchange restrictions in many jurisdictions; differences in withholding tax regimes and legal

DEVELOPMENT

**Other issues include the need to** harmonise and standardise – there are significant differences in the levels of development of capital markets; the existence of capital controls and exchange restrictions in many jurisdictions; differences in withholding tax regimes and legal standards, to name a few.

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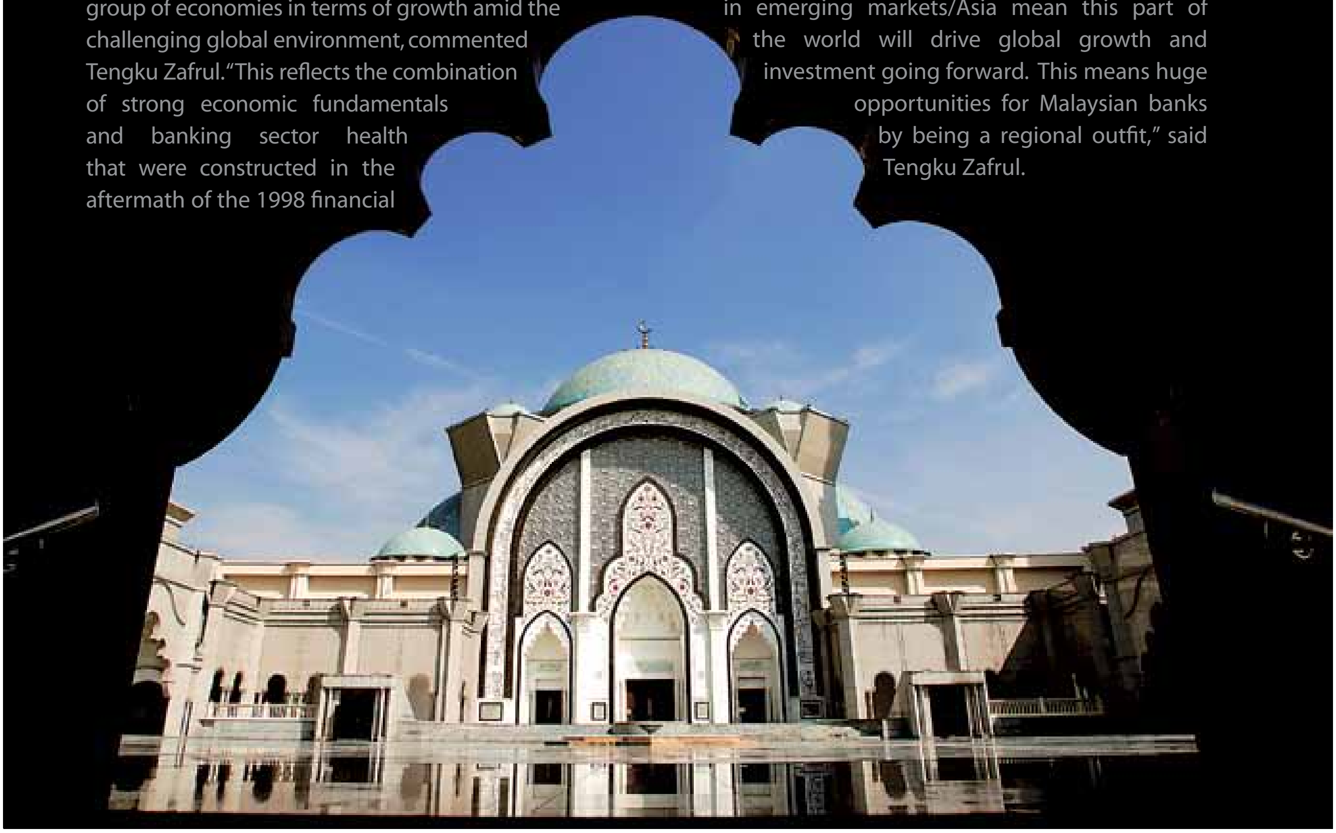
Jamelah concurred that the different levels of development within ASEAN would make integration a challenge. "There is a need to determine the exact form that the ASEAN Economic Community will take and address the challenge associated with the increasing number of Free Trade Agreements (FTAs) negotiated." ASEAN economies too have jumped on the bandwagon of signing bilateral agreements, which could derail integration goals by putting individual interests ahead of collective interests.

Furthermore, the integration initiative may give rise to welfare losses if the "trade creation effect" is overshadowed by a "trade diversion effect", for example, if the elimination of barriers to trade among member countries causes trade with more efficient non-member countries to be diverted to the less efficient member-country, noted Jamelah. "It may lead to an 'investment diversion effect' where limited investment resources are diverted to the larger-scale integrated market. There are concerns about the 'noodle bowl effect,' referring to the potential problems that may arise as a result of lack of coherence among different overlapping agreements."

Despite such concerns, overall, ASEAN as a group is perceived to be resilient among the Asia ex-Japan group of economies in terms of growth amid the challenging global environment, commented Tengku Zafrul. "This reflects the combination of strong economic fundamentals and banking sector health that were constructed in the aftermath of the 1998 financial crisis; the secular – as opposed to cyclical – growth stories for the likes of Indonesia and Vietnam; as well as the supportive macroeconomic policies and strong domestic demand in Singapore, Thailand, Malaysia and the Philippines."

Adding to ASEAN's positive narratives are the new emerging economies within the region that are creating excitement in terms of new markets for businesses and investors, namely Myanmar and other Indo-China countries (Cambodia, Laos). AEC basically recognises and further harnesses the potential of ASEAN as a whole – rather than that of a single economy or few countries.

Where Tengku Zafrul is concerned, the key game-changing factor for ASEAN integration was the Global Financial Crisis and the Great Recession of 2008-2009. As a result, in the developed economies, both private and public sectors are under pressure to de-leverage amid socioeconomic issues like high structural unemployment and an ageing population. Malaise in developed economies, among other factors, subsequently led to the prospect of a shift in the global economic landscape such as towards emerging markets, especially Asia, in terms of growth and capital flows. "In contrast, the better macroeconomic fundamentals and social dynamics in emerging markets/Asia mean this part of the world will drive global growth and investment going forward. This means huge opportunities for Malaysian banks by being a regional outfit," said Tengku Zafrul.



## Impact on Banks

AEC carries grandiose expectations that will definitely affect the banking and finance institutions. It is projected that deeper ASEAN economic integration through AEC will open up a market worth USD2 trillion in terms of nominal Gross Domestic Product (GDP) and 600 million people involved in diverse activities ranging from agriculture and mining to manufacturing and financial and non-financial services.

AEC enjoys an enviable location that makes it the gateway to other markets as well. The region sits between two emerging economic powerhouses – China and India, and is at the heart of Asia, implying hub-and-spoke advantages for businesses and investors and presenting a scenario where banks can readily facilitate as intermediaries and serve their current and prospective consumers with holistic product and service offerings.

Viewed more narrowly, the AEC is expected to spur growth in Malaysian companies' offshore businesses and investments; it makes perfect sense for banks housed in Malaysia to accompany their clients and support the latter's regional growth through their own regionalisation initiatives.

In the spirit of easing cross-border banking business, ASEAN has committed to remove substantially most restrictions on trade in services through eleven packages of commitments under the ASEAN Framework Agreement on Services (AFAS). In financial services, members are working to progressively liberalise the insurance, banking and capital markets sectors. The aim is to provide financial institutions operating in ASEAN better access to the entire ASEAN customer base, and facilitate regional expansion, noted Jamelah.

Ultimately, the strong cross-border linkages created by an integrated ASEAN capital market provide vast business opportunities for countries – and banks - to capitalise on the diverse comparative advantages in this region. "An integrated ASEAN offers considerable investment opportunities, especially in infrastructure. The demand for infrastructure investment in the region is significant," she said. Banks as a major financier could benefit from booming investment demand as ASEAN pursues rapid growth and development.

## Challenges and Risks

While ASEAN economic integration provides tremendous opportunities for banks, institutions must be mindful of the other side of the coin – the anticipated challenges and risks.

If they don't want to lose out, banks must prepare themselves for this key milestone which is AEC. "AEC represents a watershed policy event and a major structural change in the ASEAN integration process, thus impacting the way banks operate in view of the resultant opportunities and challenges," commented Tengku Zafrul.

Key challenges for banks going regional include the need to strengthen internal capacity and capability to manage the increasing regionalisation of their operations and activities such as enhancing internal governance for a regional operation (via risk management and regulatory compliance) and investment in business infrastructure, human capital and talent management to support expansion, pointed out Tengku Zafrul.

On the positive side, Malaysian banks possess strong balance sheets, internal controls and governance systems (risk management, compliance etc.) and human capital to see through the regional expansion, he added. "These strengths essentially underline the official policy, as per Bank Negara Malaysia's Financial Sector Blueprint that among others envisages regionalisation of domestic financial institutions."

"Moreover, Malaysian banks are among the first movers when it comes to going regional," remarked Tengku Zafrul.

Regionalisation however shouldn't result in banks spreading themselves too thin, and jeopardising local financing needs. Jamelah stressed the need for Malaysian financial players to remain well positioned to provide a full suite of products and services to support the financial requirements of international and regional corporations that invest and expand their businesses in Malaysia.

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## Investing Abroad in ASEAN

Upcoming ASEAN integration presents the opportunity to cement the international linkages that are frequently touted by Bank Negara Malaysia to expand Malaysia's economic weight and heft. To date, the Malaysian financial sector has made significant strides in facilitating the country's cross-border linkages with other economies, said Jamelah.

The overseas expansion of Malaysian financial institutions over this recent decade has supported the increasing trend in investments abroad by Malaysian corporations pursuing new opportunities and markets, particularly in the energy, construction, plantation and services sectors.

Even if some banks aren't keen to expand their regional footprint yet, competition will definitely come knocking on the door. Domestic liberalisation policies welcoming greater foreign participation in the local banking sector likewise falls under the umbrella of building linkages and opening up capital markets, meanwhile growing the Malaysian financial sector through new investment sources. While domestic financial institutions have been encouraged to spread their wings abroad, greater operational flexibilities have been accorded to incumbent foreign institutions. More meaningful foreign participation in the financial system has occurred through the entry of new institutions to serve Malaysia's new growth areas and permitting higher foreign equity limits in domestic financial institutions.

Offshoring activities shouldn't be discounted in the battle for regional markets. Jamelah said Malaysia's international linkages would likewise be strengthened through the continued growth of the Malaysia International Islamic Financial Centre (MIFC) and the Labuan International Business and Financial Centre (Labuan IBFC).

## Strengthening Islamic Finance

Malaysia's drive to position itself as a global centre for Islamic finance could be boosted by ASEAN's integration ambitions, as Malaysia's Islamic finance players disseminate their services throughout the region.

Growing global interest in Islamic finance looks poised to bolster ASEAN demand for *Shariah*-backed services. "On the international front, the attention given to Islamic finance by the financial community has increased following the global financial crisis, with particular interest in the prospects, potential role and relevance of Islamic finance in contributing towards global financial stability and more sustainable economic growth. Its adoption of universal ethical values of fairness, transparency and risk sharing has enforced this trend," said Jamelah.

The demand for Islamic finance is expected to emanate not only from the Muslim population but also from those with an affinity for socially responsible objectives and those seeking ethical financial solutions where the central theme is a more equitable model that would foster sustainable growth, whilst preserving the environment and improving the overall socio-economic landscape. In other words, Islamic finance is compatible with the ideals of the growing global sustainability movement, which champions social and environmental concerns in addition to economic value, or the so-called triple bottom line.

**In other words, Islamic finance** is compatible with the ideals of the growing global sustainability movement, which champions social and environmental concerns in addition to economic value, or the so-called triple bottom line.

This is spurred by the growing significance of the global ethical consumer movement where Socially Responsible Investment (SRI) is expected to be an important mainstream asset class by 2015, she said. Islamic finance falls under the SRI category.

## Regional Business Models

The banks surveyed use different strategic models to capitalise on the potential of ASEAN's emerging markets.

For Maybank, there is no single formula that prescribes the bank's penetration and presence in ASEAN. "The Maybank Group now has a presence in all ASEAN countries – a position built steadily over five decades of our existence, and which has gained further momentum in recent years," said Tengku Zafrul.

"The key factor here is consistently and judiciously building from our starting points, for example, Malaysia and Singapore. Since then, the group's expansion in ASEAN involved acquisition of strategic partners in terms of financial institutions with strong local presence or regional footprints. This is the approach in penetrating the more developed or mature ASEAN economies where the banking or financial sector landscape is already competitive."

"For the 'frontier' markets like Myanmar and Indo-China (Cambodia, Laos) where the economic and financial sector development is still very much at the early stage but with strong long-term potential, the group looks at direct entry e.g. beginning with remittances services in Myanmar; acquiring an operating licence in Cambodia," Tengku Zafrul explained.

Meanwhile, KFH Malaysia has embarked on strategic partnerships with renowned international organisations to make cross-border forays and build the aforementioned linkages. For example, in July 2010, KFH Malaysia arranged and managed the issuance of Nomura Holdings Inc.'s USD100 million *Sukuk Al-Ijarah*. The *Sukuk*, which marked the first-of-its-kind for a Japanese corporate, was also the first United States dollar-denominated *Sukuk* for a Japanese multinational corporation issued out of Malaysia under the Framework of Issuance of Foreign Currency-Denominated Bonds and Sukuk in Malaysia.

## Issues and Concerns

Regulatory pressures that differ across the ASEAN jurisdictions continue to be at the forefront of banks' concerns. Banks have to be extra mindful of regulatory risk when operating externally. "In this context, a key issue is the need to bridge current financial sector (such as banking, capital market and insurance) regulatory gaps and supervisory differences between ASEAN countries towards a harmonised and standard framework," urged Tengku Zafrul.

Countries may differ significantly

in the extent to which their national financial sector development plans include the measures to enable and benefit from AEC. "Here lies the execution risk of AEC since it represents the first time where ASEAN commits to an Integration Blueprint which is essentially a master plan with roadmaps that direct member countries to achieve targets and outcomes, by carrying out deliverables, actions and policy measures on a scheduled timeframe or deadline," he said. "Traditionally, ASEAN's integration efforts in the past were somewhat process-driven, open-ended and non-binding, with tendencies to accommodate strategic national interests that contradicts and/or overrides ASEAN aspirations."

Licensing could be another stumbling block to smooth integration. "The licensing and regulation of banks is the natural and general barrier in any market," said the CEO of a leading Islamic bank.

He proposed that the region consider issuing single licences recognised across the different markets to smooth regionalisation and improve harmonisation and standardisation. "There is a need for all regulators in ASEAN to look into rationalising this so that there can be a true blue ASEAN banking industry – for example, a bank obtaining a certain category of licence in one ASEAN country can operate across all countries in ASEAN," he said.

Jamelah singled out fair competition, consumer protection and intellectual property rights protection as other concerns that regional banks should keep in mind with upcoming integration. As it matures, ASEAN is paying more attention to fostering a culture of fair competition in order to ensure competitiveness and fairness to stakeholders in line with international best practices. She noted that institutions and laws related to competition policy have recently been established in some member countries, while Malaysia too has enforced the Competition Act 2010 effective 1 January 2012.

Furthermore, the building of an integrated economic region with a people-centred approach has made ASEAN mindful that consumers cannot be precluded in all measures taken to achieve this integration. "Consumer protection measures are being developed in tandem with the proposed economic measures to address the already emerging consumer protection," remarked Jamelah.

She also cited intellectual property rights (IPR) as an important factor that can help incubate creativity and invention, and ensure more equitable access and benefit to all stakeholders.

"IPR can also influence both the volume and quality of external trade and investment and the transfer of advanced, proprietary technologies. Intellectual property creativity is a major determinant of local value added and external competitiveness," she said.

## Malaysia's Multicultural Advantage

How can Malaysia stand out as a business and investment beacon once ASEAN economic integration is rolled out?

Fortunately, Malaysian - originating banks have a natural advantage in their diversity and multiculturalism, which makes them adaptable, flexible and mobile. Malaysian banks could seize the opportunities from the integration to penetrate the region as they have the "better psyche and capacity to deal with different cultures, thus (they are) agile in dealing with the different ways business is done under different cultures," commented the Islamic bank CEO.

Malaysia also enjoys a talent bias which supports the ASEAN integration initiative. The Malaysian melting pot has been hailed as a perfect test case for diversity by researchers, producing talent with open mindsets. "As ASEAN becomes more integrated over time, banks would need talent whose outlook and expertise is regional but multi-local," said the CEO.

## Conclusion

Ultimately, it looks like Malaysia's banks could have the right x-factor to leverage the opportunities unfolding from ASEAN integration, and the chiefs of these surveyed banks sounded pretty optimistic. The trick will be to formulate and execute the correct strategy. "Banks need to have business models that allow them to have economies of scale and synergy across all countries that they operate in," advised the CEO.

Nevertheless, banks would have to pay close attention to the mobilisation of human resources cross-border as well as their ability to undertake the hubbing of businesses. "If banks cannot do this effectively we will lose the economies of scale and synergistic value of having a regional operation," he concluded. ✱

■ Amira Abdullah is a senior freelance journalist based in Kuala Lumpur.

## Comply

The enforcement of the Competition Act 2010 places Malaysian financial institutions under a greater onus to ensure compliance or risk formal punitive measures.

# Banking AND THE COMPETITION ACT

HOW WILL THE NEW **COMPETITION ACT** AFFECT THE BANKING LANDSCAPE IN MALAYSIA?

FONG MIN HUN

“People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices.”

*Adam Smith, The Wealth of Nations*

Tea time for Malaysian bankers will not quite be the same any more with a newly enforced competition law hanging over their heads. Although palling around with a rival bank’s officer, swapping banter and engaging in one-upmanship is part and parcel of being a banker, greater discretion is required as what was once merely bravado could turn into a costly transgression.

While the sharing of sensitive information between rival bankers is already frowned upon by convention, the enforcement of the Competition Act 2010 places Malaysian financial institutions under a greater onus to ensure compliance or risk formal punitive measures. And the punishment could be expensive.

A case in point is the large £28.6 million fine incurred by the United Kingdom’s Royal Bank of Scotland (RBS) after the Office of Fair Trading (OFT) found the lender to be in breach of competition law. In this particular case, two RBS employees had passed loan pricing information to their counterparts in Barclays Bank, which was subsequently used to price the latter’s own loans.

To be fair, the culprits in the RBS/Barclay’s case may not have deliberately intended to manipulate prices, but what is important here is that the breaches took place in non-work settings. In its official text of the January 2011 decision in the RBS/Barclay case, the OFT noted the following:

“The RBS individuals indicated to Barclays that they were concerned about the impact of the new capital adequacy rules (Basel II) on their profits for loans in that particular sector ... During the course of the conversations they indicated that margins on pricing were too low and that in future they intended to raise prices for the relevant products. The disclosure took place at various social, client and industry events, such as at a bowling event organised by an accountancy firm, a Managing Partners’ dinner, an industry seminar, over lunch at the pub and also through telephone conversations.”

Though there was no explicit collusion between the RBS and Barclays employees, the OFT adjudged that “the information was useful and of practical value to Barclays … (and) could therefore be regarded, by its very nature, as damaging to the proper functioning of normal competition.”

This case is also noteworthy because the transgressors were not from the upper echelons of senior management, which implies that there is a need for compliance to be thoroughgoing on all staffing levels.

## Competition Law in Malaysia

Malaysia recently joined the ranks of mature Asia-Pacific countries with competition laws in place to ensure that trade and business take place in a fair and non-collusive market. The Competition Act 2010, which came into force on 1 January 2012 after more than 15 years in the making, has far-reaching implications for almost every industry in the country, including the financial sector.

While the central bank, Bank Negara Malaysia (BNM), already holds a tight leash over many aspects of banking practice, this does not include market competitiveness. That role falls squarely on the shoulders of the recently appointed sheriff, the Malaysia Competition Commission (MyCC).

The chief objective of the Act is to protect the competitiveness of Malaysian markets, and it empowers the MyCC to implement and enforce the law's provisions for all industry sectors in the country. While still in its early days, the commission has already been granted powers to investigate and take action against anti-competitive agreements and abuses of dominant position.

Ensuring awareness of the new competition law from the top to bottom of an organisation has in fact been one of the most difficult challenges of its advocacy work, said Shila Dorai Raj, the Chief Executive Officer of the Malaysia Competition Commission's executive arm.

"We are only just reaching out to the top level of the members of the associations via our roadshows, and whether it cascades down or not to the other members, we're not so sure," she said, and this is where the education element plays an important role.

Malaysia, as with most emerging economies, is a place where networking and getting contacts in the right place is a vital component in all trade and business. This is not to say that networking isn't important in industrialised nations, but in countries where institutions and bureaucracies are still being put in place, who-you-know is a huge advantage.

Another point to note, Raj said, is that the Competition Act may at a later date include provisions for mergers and acquisitions as well. In its current form, the Act does not stipulate any merger control, unlike the majority of other Asia-Pacific laws which have those in place.

In a guidebook to Asia-Pacific competition law put together by international law firm Baker & McKenzie, Malaysia and Hong Kong are the only two countries within mature economies to not have merger control provisions in their competition laws. Raj says an earlier draft of the law did include those provisions, but these were taken out upon further consultation.

**In a guidebook to Asia-Pacific** competition law put together by international law firm Baker & McKenzie, Malaysia and Hong Kong are the only two countries within mature economies to not have merger control provisions in their competition laws.

"It was there in the original draft, but after consultation it was dropped though we might take it up later," she said. "The reason why it was dropped – well, the Securities Commission felt they are actively looking at those (competitive) issues so we just had to let it go."

As far as bank mergers are concerned, BNM also has a say in approving proposed mergers although their reasons to approve or reject a merger proposal may not have anything to do with competition.

### Yet another regulator

While BNM is directly responsible for the overall health of the financial sector – and they too are guided by a number of policies that promote competition in their substance, e.g. of maintaining financial inclusiveness – it does not, at least explicitly, regulate bank activities and their impact on market competitiveness.

Raj put a finer point on the distinction between the Commission and Bank Negara. "Sector regulation is very different from looking at the practices of an enterprise in a market economy," she says. "BNM does not look at market behaviour. They regulate the financial sector, they look at prudential issues but they do not look at the anti-competitive behaviours of financial players."

In the case of the RBS/Barclays competition law breach, the central bank does not explicitly bother with the question of how the loans were priced, as long the banks remain healthy and meet certain regulatory standards, such as the Basel III guideline on capital adequacy. Meanwhile, the how is exactly what competition agencies are interested in.

Sharon Tan, a partner and Competition Head for Zaid Ibrahim & Co, a Malaysian legal firm which advises on Competition Law amongst other areas, put it this way: "The Competition Act is mainly concerned about how business is conducted, and as for the Competition Commission, the question is not whether a bank lives or dies, for the Act protects the process of competition and not individual players in the market. Rather, it stops people getting together to basically collude and not compete," she says.

Tan, who was consulted during the drafting of the law, added that there may be some teething problems when competitive issues crop up in sectors where there is an existing regulator, such as the financial industry. Raj agreed and said there may be a small sense of a "turf war" between the Commission and regulators.

This is why the MyCC has set up a special committee comprising members from regulatory boards because cooperation between the Commission and regulators is really the best way forward, she added.

Even though the Act is barely months old, the Commission was tasked with looking at the high-profile case involving the share swap between Malaysian Airline System Bhd and AirAsia Bhd, which has since been called off at the time of writing. Although it was not a done deal, it was illustrative of competition issues; the problem is not

so much with the share swap itself but how having co-ownership of both airlines affects the way consumers fly.

"What is more interesting is not the shares exchanging hands, but how the two companies appear to be collaborating very closely. That is where the concern is coming from," said Tan.

"The problem of collusion comes when you own more than one operator in the same market space. If you did that, the question becomes: if the two companies operate in parallel – they do the same kind of activity, raise prices at the same time, operate as if they are talking to each other – is it because the directors sit on both companies and can influence the direction of both companies? Is this a classic case of collusion?"

### Competition Law: The way forward

In theory, competition law seems pretty straightforward – don't share commercially sensitive information that may lead to price fixing or manipulation of prices in the supply chain. In practice, this clear-cut picture becomes very murky because, as Adam Smith points out, there is a very human tendency to gravitate towards peers and discuss work. Where is the line drawn?

"It's difficult to prove that the (anti-competitive) actions come about because of an agreement; in this law, an anti-competitive agreement is not black and white – it's more the substance of the agreement as opposed to the form," said Raj, who describes the role of the law as a "protection of the competition process."

"We can't put a stop to it (sharing of information) but we can educate and advocate. I know it's something that the industry and associations are worrying about since associations are generally set up for members to get together to discuss work and prices."

Though proving collusion or price-fixing may be difficult, the important point here is that employees need to be aware that they run the risk of violating competition law when disclosing information, intentional or not.

"It is no defence if you sit around and listen and subsequently say that you didn't intend to follow or implement the agreement," said Tan. "The fact that you had been present and know of the substance of discussions will already have influenced your future business activities."

Tan said companies, including banks, need to take a hard look at their own practices to determine if existing practices transgress the Act. Tan added

**VIOLATION**

**Though proving collusion** or price-fixing may be difficult, the important point here is that employees need to be aware that they run the risk of violating competition law when disclosing information, intentional or not.

that some of the larger banks have already started compliance exercises in their various departments.

Behavioural and attitude modification can be difficult at the best of times, more so when the habits have been ingrained through decades of practice. While hard evidence of price fixing and collusion in the country is not immediately available, there is at least anecdotal evidence to suggest that those activities, which run contrary to the competition law, do exist.

"Price fixing is very prevalent," Raj says. "Bid-rigging, market sharing, limiting – these are the basic (transgressions). I think every association fixes or sets prices but what the association calls 'sets' is actually price fixing."

As with all new laws, one of the key problems is that of definition – when does information sharing become collusive, how is a market to be defined, etc. The MyCC is in the process of issuing a first set of three guidelines on market definition; Chapter 1 covers prohibitions and the complaints procedure. Guidelines on abuses of dominant position will be issued later in the year.

Raj says the Commission is presently taking a "soft approach" against companies that are presently in breach of the Competition Act as it is still early days. However, the Commission will likely take a more aggressive approach when the guidelines have been issued. ✱

■ Fong Min Hun is a freelance writer based in Kuala Lumpur.

# RISK MANAGEMENT, INTERNAL AUDIT AND HOW TO MAKE MONEY

## BANKS NEED TO CHANGE THEIR PERSPECTIVE ON RISK AND MAKE A PARADIGM SHIFT ON RISK MANAGEMENT.

DAVID BOBKER

### The race to riches

Imagine a bizarre race. Twenty or thirty tightropes are stretched across a canyon some 500m wide, about 200m above a raging torrent full of deadly sharp rocks. Traversing these tightropes are competitors in a race, the winners of which will share a large prize at the other side. Clearly the first thing an observer thinks about is how the competitors make sure they don't fall to certain death. However, the observer is surprised to learn (from the safety of terra firma) that the thought uppermost in the minds of the competitors is how to catch up to the man in front, or at least speed up to narrow the gap. Any suggestion that a missed step would result in disaster and that surely the first priority is to stay alive, is brushed off with the conviction that "that is not going to happen".

Perhaps this is a bit of an extreme metaphor for the race to succeed in financial services, yet the list of previously blue-chip, well-respected organisations that did unfortunately fall over the cliff is long and continually lengthening. What is more, in nearly every case a major contributor to the disaster is the over-confidence and excessive, unchecked power of the key decision-makers. On the other hand, it is certainly true that fortune favours the brave and there is another list of very successful people who at some time made a bold throw of the dice and won.

There is a lot of psychology going on here, not least of which is the ability of a few people to put the possibility of catastrophe firmly to one side and boldly move forward. It is called "risk blindness" and affects some more than others. The psychologists tell us this is part of our animal heritage which, for example, allows a prey animal, such as a mouse, actually to leave its nest at all. Such a creature, if it spent all its time worrying it might be eaten at any moment, would be permanently locked in a sort of paralysis and probably starve to death. Therefore, boards are absolutely right not to hire over-timid, over-risk averse executives – they are patently unsuitable for the job. Where boards unfortunately may get it wrong however, is not following through on the next step which is to recognise

# Strategic

Risk management at the strategic level in an organisation is more than anything about people, about decision-making and then about the consequences of their decisions.

the obvious risk and put in place the necessary processes to mitigate it.

So the contradictions abound – between caution and bravery, between cold logic and emotion, between prudence and recklessness. These contradictions are at the heart of the issues of corporate governance, risk management and eventually, internal audit.

Risk management at the strategic level in an organisation is more than anything about people, about decision-making and then about the consequences of their decisions.

## Why banks are different

This brings us to a more specific consideration of banks. The real difference between banks taking risks and individuals being bold is that the former are doing it overwhelmingly with other people's money. People who are under the firm conviction that their money is at no risk at all in the bank. Of course, to a large extent, given the fact of deposit insurance, that is true but does not lessen the bank's obligations to them.

Secondly, of course, is the obvious fact that banks being full of money, there is the temptation for the managers (in the broadest sense – namely top management and the board) to utilise it to their own benefit rather than the shareholders generally. It is very rarely that the temptation simply to steal the money wins, but of course it has happened. Rather the real risk is the moral hazard of the managers playing heads I win, tails you lose. The loser in this case is the taxpayer who has to step in to bail out failed banks, but

CONSEQUENCE

**The first is this:** if the risk committee and the board do not give serious consideration to the possibility of catastrophic consequences, there is nobody else other than, of course the prudential authorities who will.

is generally unable to do much to prevent the accumulation of benefit to the managers, concurrent with the accumulation of risk.

A significant difference between the Asian and Western context here is the general existence of dominant shareholdings in many financial institutions in this part of the world where it is comparatively rare in the West. But the above considerations in fact are the same in both cases if we include the large shareholder in the management group so that the issue is more about the potential conflicts of interest between the majority and minority shareholders than between executive management and the shareholders.

This inherent potential conflict of interest, or "agency problem" as the economists call it, is precisely why there has been built, over many decades, a vast complex system of checks, balances and regulation to mitigate the risk. If every individual were both completely honest and also completely competent there would be little need for controls and regulation, which only serves to demonstrate that everyone has the normal human shortcomings to a greater or lesser extent.

## A new compact between the board and the executive

How then can the understandable and natural tendency of the best, most motivated and successful banking entrepreneurs to compete strongly and push forward with all due speed, sensibly be tempered so as to lessen the possibility of disaster? It is tempting to say that the first step is simply to recognise there is a possibility of disaster, but this may be difficult in the face of the five most dreaded words in risk management: "that's never going to happen." Because of this it is suggested that green indicators are red flags because all the risks marked green are those that someone is telling the board they need not worry about, when in fact they may well be precisely the ones the board should be worrying about most. Conversely, red-flagged risks may not be an issue for the board as they will have the full attention of management.

What is required then is a more explicit compact agreed between executive management and the board which runs along the lines of "you can do anything you want to make money except put the bank at serious risk of failing." And here is the rub. What does "serious risk of failing" mean?

Simply wheeling in risk managers and auditors at this point has been shown, almost conclusively not to work on its own. A CEO set on a course of action is very rarely, if ever, dissuaded by risk managers and auditors. They are generally regarded as naysayers, prophets of doom, killjoys, "the business prevention department", "the department for bayoneting the wounded" and so on and so on.

## Fundamentals for the board to think about

Therefore there needs to be much more input from above, namely the board of directors, explicitly through the Board Risk Committee who are strongly advised to take time out from the routine consideration of lengthy, complex reports to think about some fundamentals.

The first is this: if the risk committee and the board do not give serious consideration to the possibility of catastrophic consequences, there is nobody else other than, of course the prudential authorities who will. But it is a high risk, generally counter-productive strategy to delegate strategic risk management to the prudential authorities, or to deviate so far from their view of prudence as to suffer regulatory intervention.

The second key point is to understand that there are, very confusingly, two distinct types of risk. The first is the one which most business managers, due to their risk blindness condition, are reluctant to spend a lot of time and energy on, namely catastrophic risk or the risk of complete failure of the institution.

The second type of risk is that which figures in the risk/reward equation. This type of risk gets the universal, full attention of management. The calculations here are all aimed at optimising the business mix, or trading book, or investment portfolio, so as to maximise the return for the acceptable level of risk. Sophisticated institutions use "risk-adjusted performance measures" which allocate risk-based capital to profit centres so as to measure a more realistic risk adjusted return on capital, thus charging the true economic cost of capital to the P&L account.

This type of consideration of risk also includes the all important "risk-based pricing" of products to obtain the best chance of achieving a more realistic risk-adjusted positive return. If this can be done effectively, genuine competitive advantage may be obtained which is why banks are prepared to spend a lot on trying to achieve it.

Unfortunately, the problem is that the calculations (especially of probabilities) which are needed to do risk-adjusted pricing and risk-adjusted return on capital, give very little or zero information about the likelihood of complete disaster. This indeed was the fundamental error in Basel II (not yet corrected in Basel III). But this is emphatically not to say that the calculation of probabilities based on the statistical analysis of data (on customer defaults and market movements) are not however fundamental to effective, competitive bank management. For example, large-scale retail lending without robust scorecards is almost unthinkable, as is trading on any scale without rigorous VAR systems. But the cardinal error is to believe that such sensible management, on its own, will save the bank from disaster in extreme conditions. For that, the most careful consideration of stressed scenarios needs to take place and it is here that probability theory fails us.

### Where probability theory fails

Probabilities of extremely rare events cannot be calculated. Perhaps that is worth repeating: probabilities of extremely rare events cannot be calculated. The aftermath of the Fukushima nuclear reactor disaster in Japan has demonstrated this beyond all doubt. The truth is that a "probability" of one in a thousand or one in ten thousand is all but meaningless and to rely on such false assurance is extreme folly. During the market collapse of 2008-09, a leading market risk expert was quoted as saying "the real problem is that one in one million-year events have been happening every six months." The famed, Nobel Prize-winning leaders of Long Term Capital Management, the US hedge fund which spectacularly failed in 1998, believed their own calculations that the probability of failure of the company was no more than one in ten billion. The main point is the need for a clear distinction between the two types of risk.

The final basic consideration for boards is this: do we have the expertise to fulfil the role? In other words, does the board, collectively have the capability to understand fully the detail of the business plan and particularly the risks involved? The truth is that boards of once great institutions have failed lamentably either to understand what their organisations were getting into or do anything to prevent it. Yet frankly, a dozen or so, even highly qualified, competent and diligent people, meeting but once a month is going to be completely outgunned by a whole army of professionals working full time.

This is where the fundamental roles of risk and internal audit might be clarified. The role of risk management is to ensure that management and the board are able to appreciate fully the risks being run within the business, and the role of internal audit is to ensure they are doing it effectively. In the ideal bank, profit-motivated management would themselves genuinely consider carefully the potential catastrophic flaws in their plans and have credible risk early warning systems and contingency plans. Risk managers would support this by providing the heavy-duty analysis required in order to support the plans and report this analysis and the ongoing risk monitoring numbers to the board. Internal audit would review the frameworks and methodologies of risk management, and the detailed numbers, to ensure the board was given the unvarnished facts and assessments and was able to understand clearly what judgements (the risk appetite decisions) were required of it. Where the board felt it did not have the appropriate expertise to make the necessary judgements, it would not think twice in commissioning outside help to advise it and would have no fear of rejecting proposals on the grounds that it is not possible to manage what you do not understand.


Most organisations will know very well where they fall short of the ideal. To progress towards it requires one of those famous paradigm shifts, a change in approach and attitude of many, if not most of the actors in the governance and management drama. But the payback for getting it right would be the ability to take risk, perhaps venture even more boldly into uncharted territory, much more secure in the knowledge it really was unlikely to end in tears rather than blindly hoping for the best. ✱

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# THE YIN AND YANG OF PERFORMANCE: LEADERSHIP WITH GOVERNANCE

THE THREE PILLARS OF SUSTAINABLE LONG-TERM PERFORMANCE ARE: LEADERSHIP, THE DRIVING FORCE FOR PERFORMANCE; GOVERNANCE, "THE WISE RESTRAINTS THAT SET MEN FREE"; AND THE ABILITY TO RECONCILE THE DILEMMA POSED BY THE NEED FOR BOTH. TOO OFTEN WE FOCUS ONLY ON LEADERSHIP WITH DISASTROUS RESULTS; OR JUST ON THE COMPLIANCE ASPECTS OF GOVERNANCE LEADING TO MEDIOCRE RESULTS. THE TRICK IS TO RECONCILE BOTH TO CREATE SUPERIOR LONG-TERM VALUE.

JOHN ZINKIN

**LEADERSHIP – THE DRIVER OF PERFORMANCE**

Lao Tzu defined leadership as:

*"The wicked leader is he who the people despise. The good leader is he who the people revere. The great leader is he of whom the people say, "We did it ourselves".*

The 10th Asian Business Leaders Awards offered Vision, Character and Commitment to Excellence. These are the foundation of what leaders do to drive performance:

1. They seize the day. They spot the opportunity for change and act upon it by energising their followers to create a better future together.
2. They provide Purpose and Values. They recognise that the source of personal energy derives from personal values and are able to harness that energy to create a better future.
3. They define the mission. They explain the overriding purpose aligning it with the values and expectations of their stakeholders, ensuring collective energies are aligned to deliver their vision and mission.
4. They integrate the five key organisational drivers to deliver the vision and mission:
   a. *Purpose: by defining what business they are in and what difference it will make to the beneficiaries of their organisation and the returns to be achieved by satisfying them;*
   b. *Power: through the organisational design they establish to empower people through job descriptions and appropriate delegation of authorities;*
   c. *Principles: by defining what business they are in, and the values by which the business will be run and people will be assessed;*
   d. *People: by recruiting, retaining and promoting the right people with the right values, integrity and skills;*
   e. *Processes: by instituting policies and procedures to reinforce the principles and purpose of the organisation so desirable behaviours are rewarded and undesirable behaviours discouraged.*
5. Finally they monitor and improve the business by setting KPIs; allocating responsibilities and resources effectively; supervising implementation and execution; challenging followers to raise their game; and rewarding improvements.

LEADERSHIP

**They provide purpose and values.** They recognise that the source of personal energy derives from personal values and are able to harness that energy to create a better future.

LEADERSHIP

**They define the mission.** They explain the overriding purpose aligning it with the values and expectations of their stakeholders, ensuring collective energies are aligned to deliver their vision and mission.

However, leadership can be a force for both good and bad as Exhibit 1 below shows:

**Exhibit 1 :** Great Good and Great Bad Leaders Compared

### Great Good Leaders

1. Find the energy to create a better future;
2. Have a clear purpose at all times;
3. Lead with values and by example;
4. Know how to manage grief and learn from failure;
5. Forgive and move on;
6. Be willing to recruit co-leaders and share authority and responsibility;
7. Move from "I" to "We" thinking and create conditions for maximum collective success;
8. Create a lasting legacy.

### Great Bad Leaders

1. Find the energy to create change, though often not for the better;
2. Have a clear purpose at all times;
3. Lead through fear and force;
4. Ignore grief and punish the messenger;
5. Paranoiacs who punish failure;
6. Centralise control and authority; bottlenecks in decision-making;
7. *Après moi le dèluge*; manipulate their followers for self-serving agendas;
8. Fail to create a lasting legacy.

**The difference lies in their Governance.**

Governance – "The Wise Restraints That Set Men Free". Effective governance consists of three elements: self-discipline, market discipline and regulatory discipline.

Self-discipline is the foundation of good governance. It reflects the values and beliefs each of us has guiding us through life. If all leaders and top management teams followed their consciences, doing what is right regardless of the consequences, there would be little need for regulation. Unfortunately the world is not perfect and the Global Financial Crisis (GFC) demonstrated society cannot rely on top managers following their 'True North'.

If we cannot rely on all leaders having the integrity society needs to protect itself from bad behaviour, we can use market discipline to prevent malfeasance. This consists of two related elements: first, the reward and recognition systems for business leaders; second, the expectations of investors and their focus on corporate performance. If we reward leaders correctly they will not behave in irresponsible ways that destroy value and create systemic risk – they will be free to exercise their judgement to the benefit of all.

Unfortunately, the GFC showed we cannot rely on incentives for CEOs to deliver long-term sustainable value. The time horizons built into the reward systems for too many CEOs encouraged short-termism and risky behaviour. The capital market was supposed to provide strong signals regarding appropriate behaviour. The ultimate sanction for poor performance was supposed to be hostile takeovers with boards and senior management losing their jobs as a result. Unfortunately it has not really worked that way, even though the job-life expectancy of CEOs has been getting steadily shorter. Equally the quarterly earnings pressure put on boards and CEOs by investors who no longer act as owners, but as speculators instead, with no real interest in long-term value creation has meant the capital market has failed to encourage behaviour designed to deliver long-term value, rewarding increasingly risky behaviour instead.

Finally we come to regulatory discipline, the weakest of the three elements protecting society. Its role is to make good the deficits in self-discipline by creating sanctions that are enforced without fear or favour on leaders who misbehave. It is also to recognise how society feels about the behaviour of its leaders and their shortcomings. As a result, regulatory discipline almost always is one step behind. The fact people are always looking for ways to 'game the system' makes essential regulation not just rules-based, but principles-based. Rules-based systems have the merit of spelling out what is permitted and what is not, but are an invitation to lawyers to find ways round the wording so leaders can break the law legally. Principles-based regulation has the merit of making it difficult for lawyers to do this, but the disadvantage of not spelling out exactly what is forbidden. So some combination of the two is desirable.

There is something to be said for the argument regulation adds to the cost of doing business, especially if it results in box-ticking, compliance-based risk aversion. It may discourage the "animal spirits" Keynes identified as crucial to capitalism and encourages expensive reporting just to score well in governance indexes. It does not help that some of

GOVERNANCE

**"The Wise Restraints That Set Men Free"** Effective governance consists of three elements: self-discipline, market discipline and regulatory discipline.

# Dilemma

We need effective leaders to run our business, with appropriate checks and balances, lest they drive companies over the edge.

the poster children of formal corporate governance reporting have turned out to be frauds (Enron) or bankrupt failures (General Motors). However, whilst it is difficult to show causality between good governance and superior performance, there is little doubt failures of governance caused by powerful leaders have been incredibly expensive: Dick Fuld's leadership of Lehman cost USD691.1bn; Kerry Killinger's of Washington Mutual cost USD328.9bn; Bernie Ebbers' of WorldCom cost USD103.9bn and Ken Lay's of Enron cost USD63.4bn. To put this in context, recent estimates of the cost of the Tohoku earthquake and Fukushima disaster last year in Japan total around USD380bn.

**Dilemma Reconciliation**

Fons Trompenaars identified 10 strategic dilemmas, shown in Exhibit 2, in the upper column. The trick is to reconcile them by rephrasing the problem, shown in the lower column.

To these 10 dilemmas I add one more: we need effective leaders to run our business, with appropriate checks and balances, lest they drive companies over the edge. It is the role of the three elements of governance to provide such checks and balances and the role of the board to reconcile the need for the energising impact of great leaders with the governance restraints that set them free. ✱

**Exhibit 2 :** Reconciling Dilemmas

## 10 Dilemmas of Bipolar Thinking

1. "Develop our people" v. "Become more cost conscious";
2. "Reward our people for their mastery" v. "Reward our shareholders for their faith in us";
3. "Keep short-term cash flow" v. "Invest in long-term sustainability";
4. "Reputation in the wider community" v. "Serve our customers' wants";
5. "Global or standardised products" v. "Local or particular tastes";
6. "Customer is always right" v. "Anticipate customers' needs";
7. "Equal opportunities" v. "Positive discrimination";
8. "Operational agility" v. "Strategy clarity";
9. "Leverage intellectual capital" v. "Innovative projects";
10. "Satisfy our customers at all costs" v. "Shareholder value".

## Reconciling 10 Dilemmas

1. "Develop our people to reduce cost through greater productivity";
2. "Reward our people for their mastery so we can reward our shareholders for their faith in us";
3. "Keep sufficient short-term cash flow to invest in long-term sustainability";
4. "Enhance our reputation in the wider community by serving our customers' wants";
5. "Adapt local or particular tastes to create global or standardised products";
6. "Work with customers to anticipate their needs";
7. "Create equal opportunities through positive discrimination";
8. "Strategic clarity gives us operational agility";
9. "Leverage intellectual capital to create innovative projects";
10. "Reconcile satisfying customers at all costs with shareholder value".

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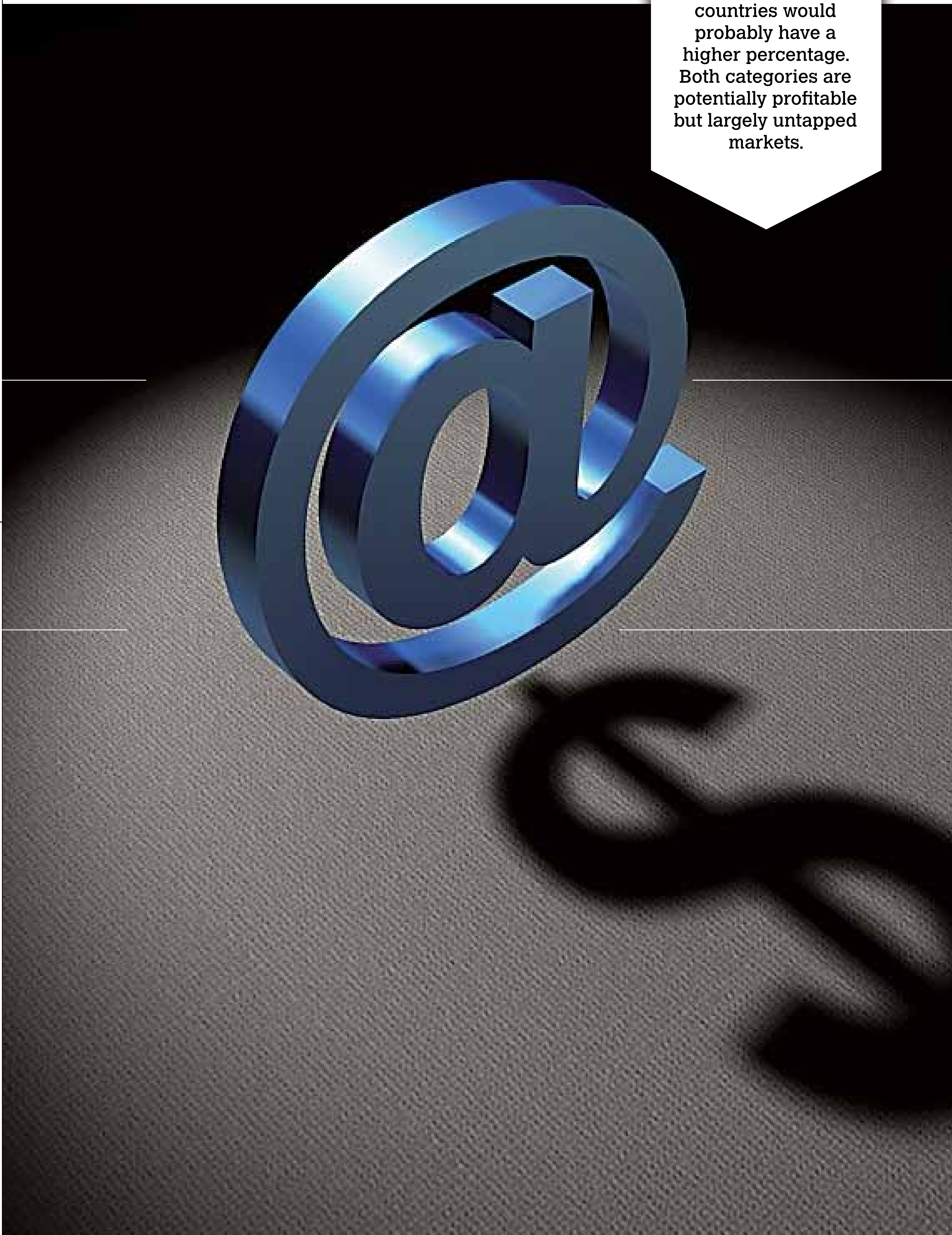
## untapped

Less developed countries would probably have a higher percentage. Both categories are potentially profitable but largely untapped markets.



# Banking *the* unbanked

Are traditional banks threatened by the rise of new payment infrastructures catering to the banked and unbanked? And is it viable for traditional banks to move into this highly-populated global market, in line with governments' financial inclusion goals? Could there be a new dilemma in the works for governments - protect the banking system, or be more financially inclusive? **Majella Gomes** summarises the highlights of the recent Deloitte report on **Banking the Unbanked: Prepaid Cards, Mobile Payments, and Global Opportunities in Retail Banking.**

What constitutes the "Unbanked"? They're the ones with no current, savings, credit or insurance accounts with traditional regulated financial institutions. The unbanked differ from the underbanked in that underbanked customers probably have at least one of these types of accounts but prefer to transact financially in other ways or with alternative service providers such as cheque-cashing services, moneylenders or pawnshops. The underbanked also tend to use cash for most of their transactions. Unbanked and underbanked sectors exist in both highly-developed and less-developed countries. It is estimated that in the US, approximately 60 million, or about a quarter of all households, fall into either the unbanked or underbanked categories, according to Deloitte's recent report on *Banking the Unbanked: Prepaid Cards, Mobile Payments, and Global Opportunities in Retail Banking.* Less developed countries would probably have a higher percentage. Both categories are potentially profitable but largely untapped markets.

## Innovation creates new customers...

In the developing world in particular, innovation has been central to the development of new payment infrastructures that rely less on the physical presence of branch offices and more on wireless telecommunications and the Internet. Unbanked and underbanked consumers in countries like India and Kenya are beginning to rely more on two relatively new payment channels: prepaid cards and mobile phones. General purpose reloadable (GPR) or prepaid cards are a medium of stored value and acceptable almost everywhere. They are proving to be cheaper, faster and more secure when it comes to transferring funds, and enable consumers to access online shopping and bill payment, among other more traditional banking functions. In addition, where graft is an issue, some governments have found that consumers receive funds more efficiently when payments are made through a direct, secure paperless channel, rather than by cash through indirect channels.

Payments made through mobile phones too are becoming increasingly common. With almost 5.9 billion mobile cellular subscribers worldwide, mobile phones are ubiquitous – making bill-paying and remitting cash possible without the facility of a traditional banking system. This is particularly widespread in Africa and Asia; prepaid products are becoming an alternative to bank accounts, which are more expensive to manage, and require

TRADITIONAL BANKING IS BEING DISRUPTED TODAY. IN THE US, IT IS ESTIMATED THAT ALMOST

detailed paperwork beyond the education of a semi-literate population.

### ...and Threats

While innovation and technology are making consumers' lives easier, they are also threatening to disrupt what has traditionally been the role – and the income stream – of banks, especially in the area of retail payments. Not only are innovation and technology offering more convenient alternatives, theirs are also less expensive. This has given rise to a government dilemma: protect the banking system, or be more financially inclusive? Indeed, in creating new, workable systems, technological innovation has raised the question of whether traditional banks will eventually need to provide basic financial services at all. In India, for example, mobile payment systems allow migrant agricultural workers, who live and work away from home for months at a time, to send regular remittances to their families, regardless of where they are working.

The Indian government, in its efforts to efficiently disburse federal programme subsidies, plans to deploy prepaid cards to manage an annual payroll of approximately USD2bn across labour-intensive projects in rural India. Prepaid cards usually do not require consumers to produce the detailed documentation required by bank accounts.

Kenya offers another example with M-PESA, a mobile-based branchless banking service which allows users to perform basic financial transactions without having to visit a physical bank branch. Launched in 2007, M-PESA covers about 14 million people in Kenya, and is one of the most popular financial services mechanisms in the country. In 2009, it had a larger market share than commercial banks, microfinance institutions and savings & credit cooperative societies.

Even in highly developed countries, GPR prepaid products seem to be gaining ground. In the US, these are being targeted as checking/debit alternatives to the unbanked and underbanked, as well as the banked. Prepaid cards appeal to younger consumers who are looking for cheaper, more convenient alternatives to banks, and parents who want to control their own or their children's spending. Online banking is taking off, with players offering more products, including savings and credit accounts to complement their prepaid products. In addition, several established non-bank players and large retailers have introduced prepaid cards with fewer fees, aimed at younger consumers and the cost-conscious market segment.

### Is there a problem?

Increased regulatory rules and compliance costs, among other pressures, are spurring major banks to steer unprofitable customers to other institutions like community banks, credit unions and online banks. Some of these customers may find that prepaid products are a viable alternative to basic checking accounts, and may decide to fulfil their other financial services through these as well. Migration of this kind may well disrupt an industry as established as banking – consider what the emergence of low-cost airlines did, to the detriment of big-name, more established carriers. According to disruption theory, for a product to disrupt an existing industry, it needs to fulfil four conditions: it meets the needs of a large, non-consuming market segment; it is readily available and cost-effective; it is in a segment that is

PROSPECTS

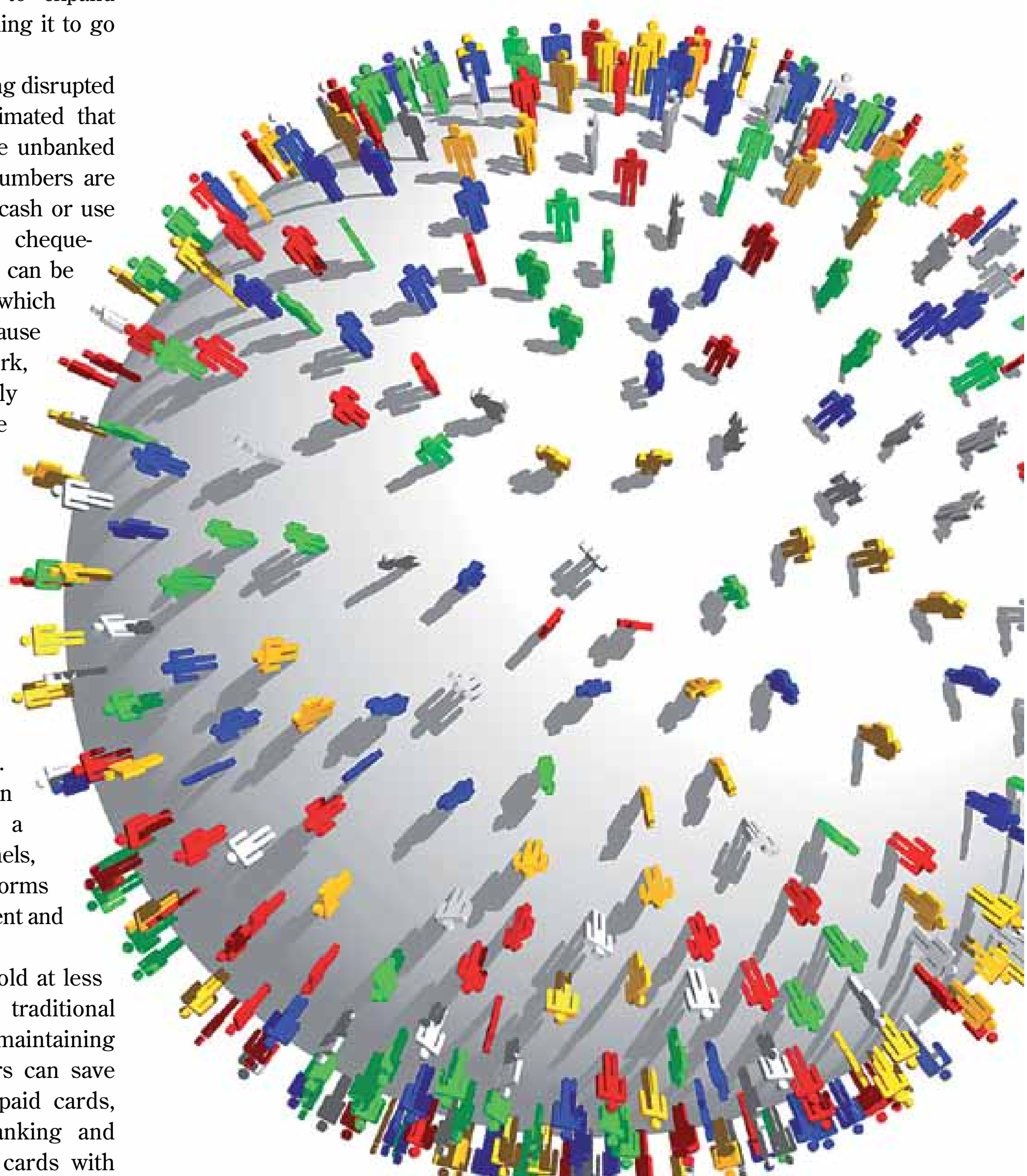
**According to disruption** theory, for a product to disrupt an existing industry, it needs to fulfil four conditions: it meets the needs of a large, non-consuming market segment; it is readily available and cost-effective; it is in a segment that is viewed as unattractive by entrenched competition; and it is supported by technology that allows it to expand features and benefits, enabling it to go beyond its initial foothold.

60 MILLION PEOPLE ARE UNBANKED OR UNDERBANKED, AND THE NUMBERS ARE GROWING.

viewed as unattractive by entrenched competition; and it is supported by technology that allows it to expand features and benefits, enabling it to go beyond its initial foothold.

Traditional banking is being disrupted today. In the US, it is estimated that almost 60 million people are unbanked or underbanked, and the numbers are growing. They have to pay cash or use high-cost alternatives like cheque-cashing services. This need can be met with prepaid cards, which are more attractive because they require no paperwork, are conveniently and easily obtained, and provide immediate access to funds, with no possibility of overdrawn accounts. Prepaid providers also increase product features over time; some cards are already offering remittances, bill payment, rewards, expanded reload networks, credit building and spending controls. Low-cost GPR products can be made available through a variety of distribution channels, and prepaid processing platforms are usually technology-efficient and scalable.

These products can be sold at less than half the price of a traditional bank account while maintaining profitability, and consumers can save money by using GPR prepaid cards, rather than traditional banking and finance methods. Prepaid cards with direct deposit features, especially, have been associated with greater spend, engagement and retention behaviours, which can allow programme managers to reduce fees. The same cost advantage exists in developing economies.



INDEED, SOME BANKS MAY CHOOSE TO CREATE AN ENTERPRISE-LEVEL FOCUS ON THE UNBANKED


The unbanked and underbanked sectors are largely viewed as unattractive because traditional banks find their serving costs are high when compared to more affluent segments, while income generated is low. Banks prefer to sell more products to those who can afford them, and the unbanked and underbanked don't usually fall into this category. Because of the high cost of service, some banks are even allowing – sometimes even encouraging – attrition among less affluent customers. Over time, this could be detrimental to the banks themselves as disruptive providers move in and target former or dissatisfied consumers.

## Technology, the Great Enabler

All this will not be possible without the enablement of technology. Many prepaid cards today are already full-featured, high-quality products that are as easy to use as traditional checking accounts or debit cards. They offer a range of possibilities, including direct deposit, person-to-person transfers, point-of-sale support and online purchasing, rewards, discounted merchant offers, online cheques and money orders and mobile alerts. Prepaid providers are also increasingly efficient, creating new technology platforms and distribution channels that lower operating costs, simultaneously making them cost-efficient and widening their outreach. These systems are flexible, agile, and scalable – characteristics that further enable them to reduce prices or add to their margins.

Even governments are moving into electronic channels and beginning to rely on prepaid products. This will have a ripple effect, as direct deposit of government payments will likely increase the awareness of and comfort level with prepaid cards among large segments of the population. It will also raise the awareness of GPR products among the banked population, and could drive up the adoption rate of prepaid products of this particular sector.

The "upward march" of product offerings may be most obvious in India and Africa, where their functionality in remittances especially, is helping to address the needs of the unbanked and underbanked sectors. In India, prepaid cards offer online payment capability; in Africa, they are designed to enable microcredit organisations to collect payments and allow remittances. What this may eventually result in is a migration of more users from traditional banking systems to the less conventional methods of technology-enabled banking. But what does this portend for the future of banking, not just in developing countries, but in those with entrenched financial systems, such as the US and most of Europe?

## The future is already here

If traditional banking services can be taken over by more expedient, less costly solutions, we can expect to see these new solutions gaining ground. Other retail financial services and products like individual or small business microloans and microinsurance may well see a revolution. The signs are already apparent. In India and Africa, prepaid cards are a much-utilised means of remitting payments for loans and insurance premiums, primarily because the ubiquitous mobile phone is an efficient distributor of services that is accessible to more people than established banking services – and infinitely less intimidating!

In the light of these ongoing developments, how should traditional banks respond? Obviously, a change of strategy is in order but there are options which they can consider. One is to stay the course but reduce operating costs. How this is to be achieved is best left to the respective banks; they have to work out where and how they can cut back without limiting their services, and hope that they will be able to maintain their market share. While this is the usual response of big players when faced with disruptors and may make the most sense for them, it will


AND UNDERBANKED, AND GEAR UP FOR NEW BANKING SOLUTIONS.

also mean that they will be forcing out unprofitable consumers, which in turn will shrink their customer base. Many banks, especially the large ones, have chosen this option, either to protect their profits or to focus strategically on their more affluent customers. Their shallow pool of existing prepaid customers has also been cited as a reason for this choice.

Banks will have to walk the fine line between reducing operating costs and maintaining a unit-cost advantage as their customer base shrinks, so this may not work for smaller financial institutions. There will also be the negative fallout from such moves, and banks may find themselves in the public eye for the wrong reasons as they start being perceived as being dismissive of less-profitable customers while being exploitative of the more affluent ones. This may lead to another challenge: finding customers in an increasingly crowded market. Banks will find themselves competing with each other for the same affluent customers.

Another option will be to offer prepaid products to unprofitable consumers while maintaining the traditional services for those who are likely to pay. Banks could migrate those customers they see as "unprofitable" or debit consumers, to a cheaper prepaid platform, or offer prepaid options to those who are less creditworthy. This approach may help protect the franchise by preserving its size and scale while offering the option of migration to interested or "qualified" consumers. While it will not alienate consumers completely from the banks' customer pool – thus saving them the trouble of fighting to regain these consumers at a later stage – it also gives the bank the opportunity to market more products to a segment with a potentially brightening future, such as cross-selling farming loans and crop insurance as customers become more financially literate. This option is being considered by banks which are trying to find a way to serve their middle-income and subprime customers, as well as regional institutions which are looking to grow aggressively, as they perceive it as less of a risk.

### Threats – and Opportunities

A third option will be to just embrace the disruption, and consider it another opportunity. Indeed, some banks may choose to create an enterprise-level focus on the unbanked and underbanked, and gear up for new banking solutions. This will be particularly appealing to banks in fast-developing markets where the non-

CONSUMERS

**Another option will be to offer prepaid** products to unprofitable consumers while maintaining the traditional services for those who are likely to pay. Banks could migrate those customers they see as "unprofitable" or debit consumers, to a cheaper prepaid platform, or offer prepaid options to those who are less creditworthy. This approach may help protect the franchise by preserving its size and scale while offering the option of migration to interested or "qualified" consumers.

consuming segment is 70% or more of the population. Traditional banks could acquire a prepaid specialist or create one of their own, and use it to meet the needs of their targeted sectors. However, this could be a difficult option to execute; many banks will perceive it as fraught with risk or requiring too many resources. They will also be going up against e-commerce businesses which facilitate online payments and large retailers, who are in better positions to offer this type of service.

While disruptions to traditional banking services are certainly a threat, traditional banks could be missing new opportunities to expand and increase revenue if they do not respond quickly to market dynamics. Banking revenue streams are increasingly under pressure from the global slowdown, regulatory actions and competition from alternative providers. The global marketplace of 2.5 billion – or more – of unbanked or underbanked consumers is evolving rapidly, and new technologies and non-traditional providers are already offering alternative solutions which can hardly be dismissed. If traditional banks do not rise to the challenge, they may well find themselves a relic of the past. ✱

■ Majella Gomes is a senior freelance journalist based in Kuala Lumpur.

# STUDY IN CONTRAST

## THE ASIA-PACIFIC CONSUMER CREDIT MARKET IS A REGION MARKED BY DIVERSITY AND CONTRASTS.

MICHAEL LAFFERTY





PROSPECTS

**...the two most** populated countries in the world and the two with potentially the strongest immediate prospects: China and India.

The consumer credit market in the Asia-Pacific region is marked by one overriding consistency: there is virtually nothing consistent about it.

Indeed, thanks to differences in market maturities, population sizes, economic conditions, and other cultural nuances, any consideration of the market becomes a fascinating study in contrasts and challenging generalities. What is clear, however, is that taken as a whole, it is one of the most dynamic – and attractive – regions in the world for consumer credit.

This diversity is perhaps best illustrated by the fact that, as a whole, the region has the lowest level of non-mortgage consumer indebtedness among the six global regions surveyed by Lafferty Group. However, if China, India, and Japan were removed, the region jumps to the top position with the highest level of indebtedness in the world. While this exemplifies the difficulty in generalising overall, it also highlights the potential attractiveness about many of the countries in the region.

The two most notable markets, of course, are the two most populated countries in the world and the two with potentially the strongest immediate prospects: China and India. With the fastest-growing economies in the region - averaging 10% and 8% annual GDP growth, respectively, between 2002 and 2011 – the two markets represent a boom that no global banking group could ignore.

At the other end of the scale is Japan - arguably the most developed country in the region and historically the second-largest economy in the world until losing that position recently to China. Its long economic stagnation can be seen directly in the country's consumer credit market.

Then there are the long-developed markets of Australia and New Zealand. Those countries' banking and consumer credit structures have more in common with London or New York than with Beijing or Tokyo. And unlike their counterparts in the English-speaking world, Australia's banking environment, and to a lesser extent that of New Zealand, avoided any savage hit by the financial crisis. As such, while many consumer credit markets in Europe and North America have been contracting and consolidating, Australia and New Zealand have maintained good growth and an outward focus.

Two of the most dynamic markets in the region are Singapore and Hong Kong where real GDP growth has averaged 6% and 5%, respectively, between 2002 and 2011. These services-led economies also enjoy financially literate populations and some of the most competitive banking landscapes found anywhere.

Among other economies, Vietnam and Indonesia also stand out as attractive and notable with large populations, fast-growing economies, and increasing demand for financial services. Malaysia and South Korea, too, feature strong financial and banking sectors. In fact, outside anglicised Australia and New Zealand, these two markets also have the highest ratio of consumer indebtedness in the region.

In particular, Malaysia, though its economy

# Asia

Thanks to differences in market maturities, population sizes, economic conditions, and other cultural nuances, any consideration of the market becomes a fascinating study in contrasts and challenging generalities.





DYNAMIC

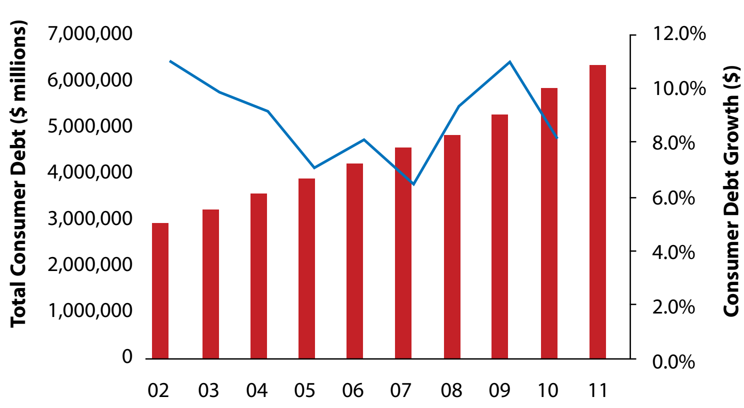
**What is clear,** however, is that taken as a whole, it is one of the most dynamic – and attractive – regions in the world for consumer credit.

is not as developed as South Korea, has a strong consumer acceptance of credit - a key challenge for many other markets in the region. Malaysia, together with a substantial conventional consumer banking environment, is also one of the pioneers and global centres for Islamic finance.

### Contrast in growth rates

Understanding the different characteristics of each market is vital then to helping understand the significance of the overall picture of consumer debt in the region. When examined, the data show strong upward progression in the amount of outstanding consumer debt, with a compound annual growth rate (CAGR) of 9% between 2002 and 2011. Lafferty Group research shows that all markets in the region had overall growth during this period. Even during the difficult period between 2008 and 2010, consumer debt in all regional markets, with the exception of Pakistan, continued to grow.

**Asia-Pacific Total Consumer Debt**




**In particular, Malaysia, though its economy is** NOT AS DEVELOPED AS SOUTH KOREA, HAS A STRONG CONSUMER ACCEPTANCE OF CREDIT - A KEY CHALLENGE FOR MANY OTHER MARKETS IN THE REGION.

Oi Li, we hightened the contrast by making the text bolder and background darker, so easier to read now.


GROWTH

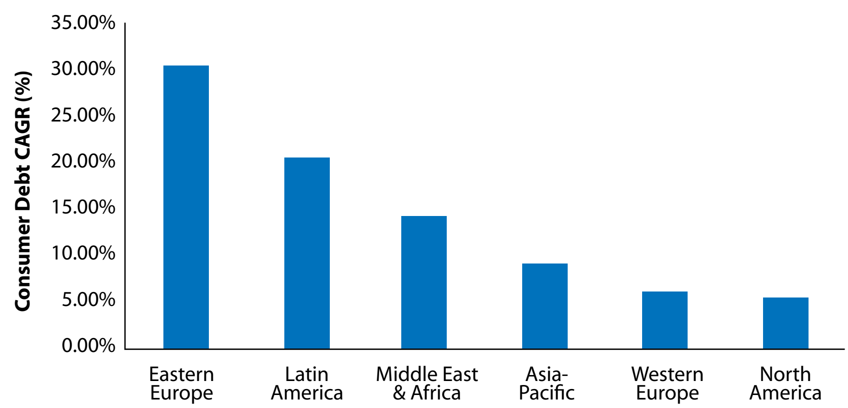
**However, the sluggishness** of Japan's consumer credit growth is relatively unique across such a sustained period. For example, while many developed markets had declining growth rates in outstanding consumer debt since 2008 because of the recent financial crisis, Japan saw its growth in the low single digits since 2003. This low growth can be partly explained by very low inflation and, for some years, deflation.

However, the variance in growth rates is considerable. In Japan, consumer debt CAGR between 2002 and 2011 was just 2.2%. This is compared with China and India, which had CAGR in the same period of 27% and 24.7%, respectively. At 47%, Vietnam had the largest growth rate in consumer debt between 2002 and 2011.

In general, high growth rates in China, India and Vietnam were indicative of the developmental stage of their respective markets. However, the sluggishness of Japan's consumer credit growth is relatively unique across such a sustained period. For example, while many developed markets had declining growth rates in outstanding consumer debt since 2008 because of the recent other regions – i.e., the comparatively lower growth rates in the developed markets offset some of the impact of the strong growth in the region's emerging markets. For example, when compared to Eastern Europe and Latin America, the Asia-Pacific region has less than half that average annual growth rate.

Almost all markets in Eastern Europe and Latin America can be described as developing. As a result, consumer credit throughout these regions is growing at high rates often from very low starting positions. Conversely, all the countries within Western Europe and North America have, for the most part, developed consumer credit markets and therefore growth rates are much lower.

**Global Consumer Debt CAGR - 2002 to 2011**




**Note: Middle East & Africa - 2004 to 2011**

financial crisis, Japan saw its growth in the low single digits since 2003. This low growth can be partly explained by very low inflation and, for some years, deflation. If we remove Japan from the overall summary, outstanding consumer debt CAGR across the Asia-Pacific region increased by 12.7%.

Outstandings are also highly concentrated in the region, with Japan, Australia and China accounting for just under 70% of total consumer debt in 2011.

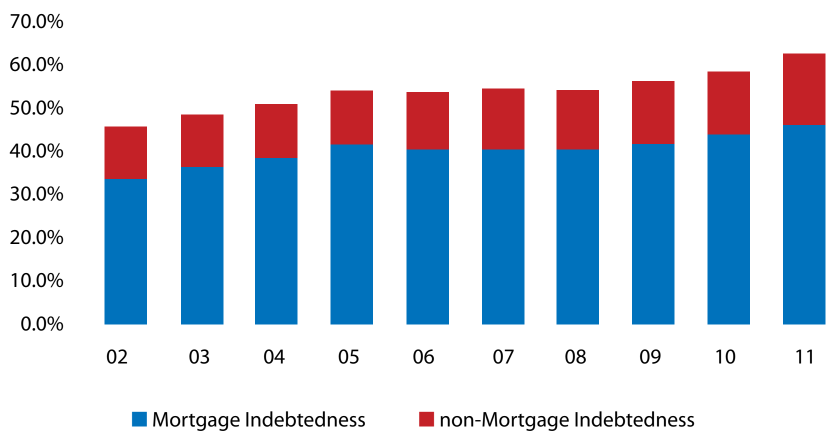
Asia-Pacific's mixture of fast-growing, developing markets and major developed economies can partially explain why overall annual growth rates of consumer outstandings are not as high as some

## Demographics and attitudes

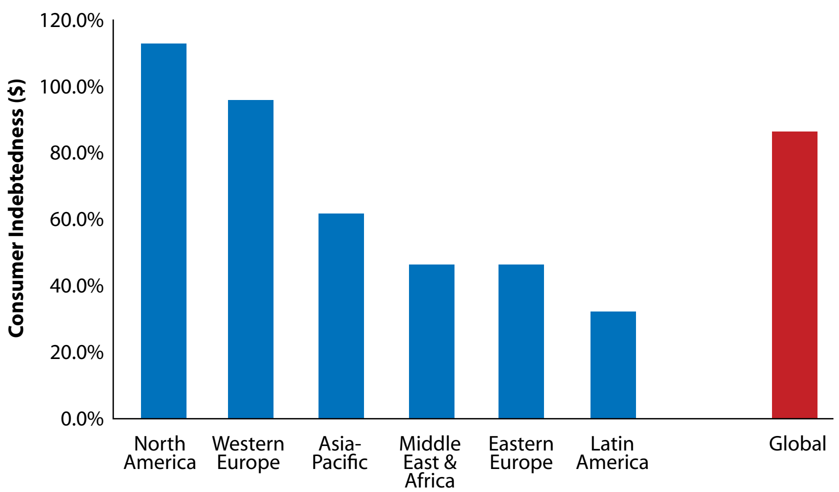
Consumer attitudes in the Asia-Pacific region also play an important role. While Australia, Malaysia, Singapore and New Zealand display clearly positive attitudes towards the role of personal credit, other markets such as China, India, and Vietnam have had to overcome largely conservative attitudes towards consumer borrowing. Growth in consumer credit in these countries has been supported by a changing demographic profile as a new generation of consumer emerges – one with growing wealth thanks to dynamic economies and with fewer inhibitions about borrowing.

In Japan, a general reluctance among

## Asia-Pacific Consumer Indebtedness




## Regional Consumer Indebtedness




consumers to use credit, combined with strict lending regulations, has affected growth rates in the market. Under 2006 legislation, profit margins were squeezed because of a cap on interest rates and stricter screening criteria. The regulation has also raised the bar for new entrants with higher minimum requirements on a lender's net asset value. The conservative attitude among Japanese consumers towards credit has also been built on the experience of an economy that has stagnated since 1995.

In Indonesia, the country with the largest Muslim population in the world, religious rules against usury have played an important role in restricting demand for consumer credit. To address this problem, the Indonesian government began implementing the regulatory framework to encourage *Shariah* banking. For example, legislation passed in 2008 allows foreign-owned banks and Indonesian banks to spin off or convert their existing banking practices into *Shariah*-compliant lending operations.

The model for *Shariah* banking in Indonesia is Malaysia. Malaysia is one of the most indebted markets in the region and also has a dominant Muslim population. *Shariah*-compliant banking in Malaysia accounts for 12% of assets – though consumer credit is more widely distributed among non-Muslims. Nevertheless, the strength of Malaysia's *Shariah* banking meant the country has become a global financial centre for this type of finance. By contrast, Indonesia's Islamic banking is still in its infancy.

### Growing Indebtedness

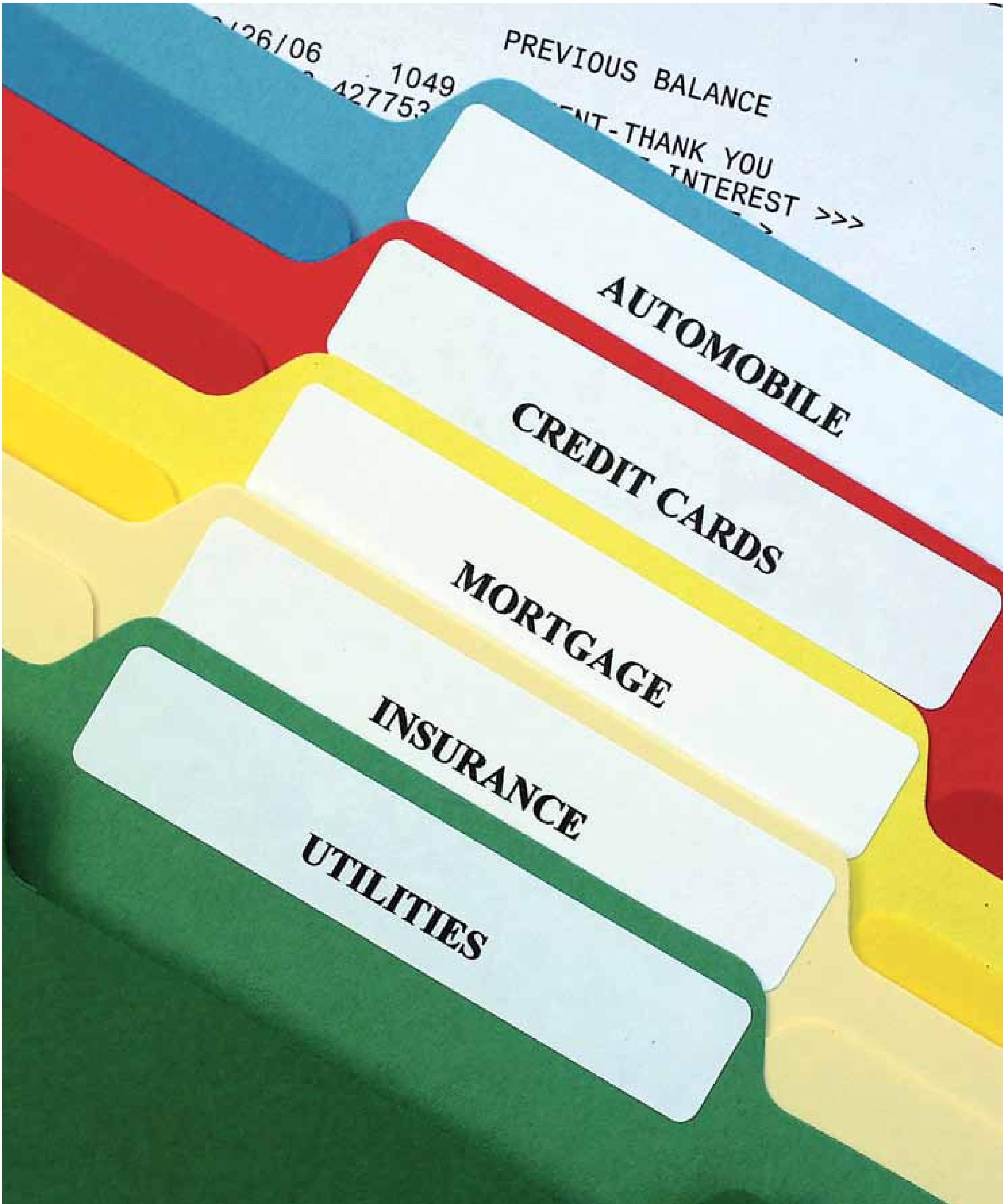
With the growth of overall consumer debt, consumer indebtedness in the Asia-Pacific region has also been steadily increasing since 2002, albeit with slight dips in 2006 and 2008.

Defined as a combination of total mortgage and non-mortgage debt as a proportion of personal disposable income, consumer indebtedness – like elsewhere in the world – is primarily attributable to mortgage loans.

In terms of overall indebtedness, though, Asia-Pacific lags well behind North America and Western Europe. This is perhaps unsurprising, especially considering the highly developed consumer credit markets in these regions. But whereas Asia-Pacific indebtedness is increasing, indebtedness in Western Europe and North America has been declining in recent years. Perhaps more indicative of the strength of Asia-Pacific is the comparison of it to regions with predominantly developing consumer credit markets, such as the Middle East & Africa, Eastern Europe, and Latin America. Asia-Pacific consumer indebtedness, for example, is almost double that of Latin America.

As mentioned above, the components of consumer indebtedness vary widely. While there has been steady growth in non-mortgage consumer indebtedness across the Asia-Pacific, it has the lowest level when compared across all six global regions, or 16.4% at the end of 2011. Low level non-mortgage indebtedness in the key regional markets of China, India and Japan are the principal reasons for this. For example, if we were to measure Asia-Pacific's non-mortgage consumer indebtedness without these three markets, the rate would increase significantly to 44.2% – considerably above the indebtedness levels in all other regions. ✱

■ Michael Lafferty is Chairman of Lafferty Group, the London-based retail banking education, research and publishing house.



PREVIOUS BALANCE
1049
THANK YOU
INTEREST >>>
AUTOMOBILE
CREDIT CARDS
MORTGAGE
INSURANCE
UTILITIES


# DEFLATING MALAYSIA'S HOUSEHOLD DEBT BUBBLE

'The problem is us. The problem is not the banks, greedy though they may be, overpaid though they may be. The problem is us... We've been living very high on the hog. Our living standard has been rising dramatically in the last 25 years. And we have been borrowing much of the money to make that prosperity happen.'

**Professor David Beim, Columbia University**

SARAVANAN RAMASAMY

As fiscal problems faced by certain countries around the world, especially in Europe, continue to dominate headlines, it comes as no surprise that concerns over Malaysia's high level of debts are mounting.

Based on the latest data released by Bank Negara Malaysia (BNM), the national debt level stood at RM456bn as at Q4 2011. This represents a 53.8% increase over 2007 when the national debt level was RM266bn. With a population of approximately 28 million, this would mean that every Malaysian had to bear RM16,000 of the national debt in 2011. If we were to take into account the debt guaranteed by the federal government, the total debt exposure of the federal government hit RM573bn in 2011, equivalent to 67% of the Gross Domestic Product (GDP).

BNM, in a separate report, was also quick to highlight that Malaysian household borrowing has been on a rising trend over the last 10 years, increasing at an annual rate of 12.5% as of December 2011. The household debt-to-GDP ratio stood at 77%, which roughly translates into household debt of RM662bn.

Thus, the combined debt(government debts and household debts)-to-GDP ratio as at end-2011 had easily surpassed the - 143% mark. Though this is an alarming number, how does Malaysia rank globally? Is Malaysia over-leveraged?

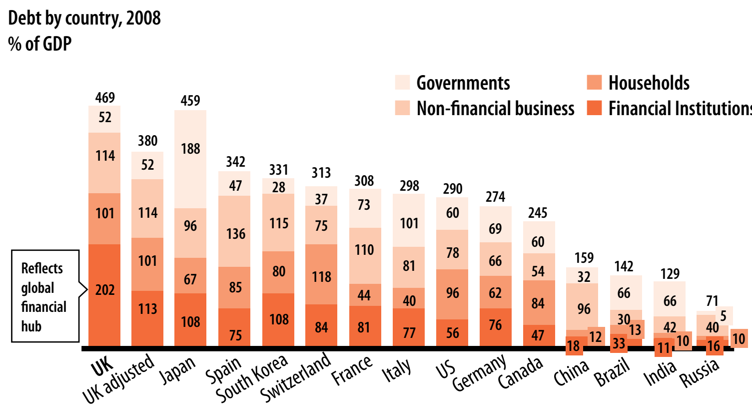
## GLOBAL DEBT TREND

Generally, the rise in debt level throughout the 1980s and 1990s was seen as a boon to the economy globally given that the rise was accompanied by what economists called the 'great moderation'. During this period, economic expansions became longer, recessions became shorter and inflation remained low, resulting in smoothened business cycles. With asset prices rising even faster, balance sheets looked healthy and debtors could afford to meet their interest payments without defaulting. However, from early 2007 onwards, there were signs that economies were reaching the limit of their ability to absorb more borrowing. The growth-boosting potential of debt seemed to recede.

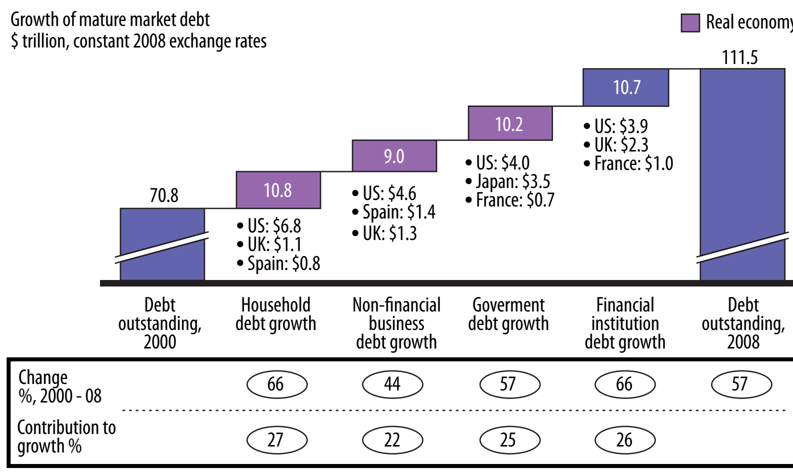
A closer look at debt levels across various countries shows that debt increased across every segment of the economy, ranging from consumers, companies and financial institutions. The effect varied from country to country, but a survey by the McKinsey Global Institute found that average total debt in 10 mature economies rose from an average of 200% of GDP in 1995 to 300% in 2008 *(see graph 1)*.

A closer examination of the sectorial composition of the 10 countries reveals that more than half of the growth in debt (i.e. 52%) was contributed by government and household borrowings *(see graph 2)*.

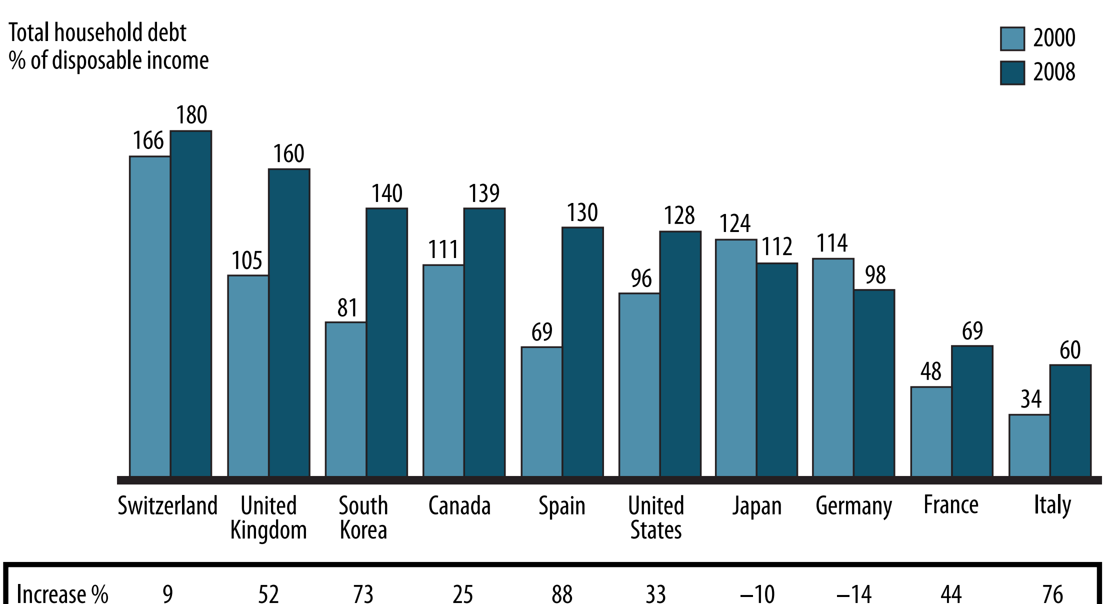
Taking a more granular view, households were found to have increased their borrowing substantially, particularly through housing and motor vehicle loans. With house prices on an upward trend, the ratio of household debt to assets appears stable. However, would red flags be raised if the ratio was worked out against disposable income? Graph 3 below illustrates the fact that households in almost all mature economies, with the exception of Japan and Germany, boosted their borrowing significantly relative to disposable income since 2000.



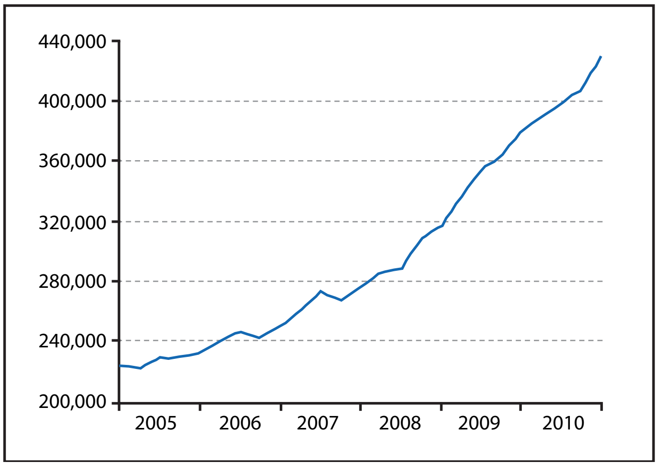

**Graph 1 -** The sectorial composition of debt across major countries
**Source:** McKinsey Global Institute



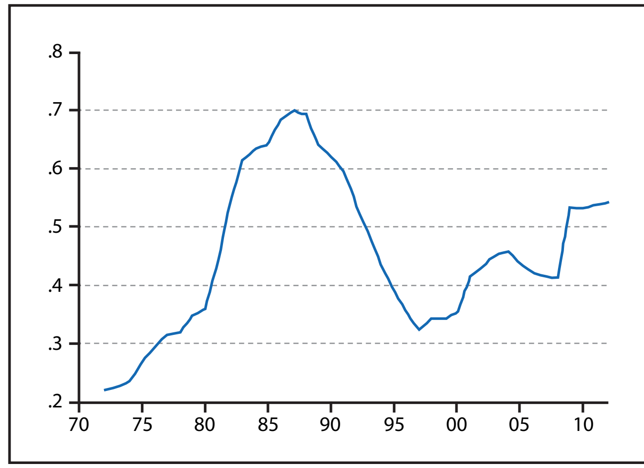

**Graph 2 -** The sectorial contribution of debt across major countries
**Source:** McKinsey Global Institute




**Graph 3 -** Household leverage measured as debt/income
**Source:** McKinsey Global Institute




**Graph 4 -** Government Debt
**Source:** *www.econsmalaysia*




**Graph 5 -** Government Debt Relative to GDP
**Source:** *www.econsmalaysia*

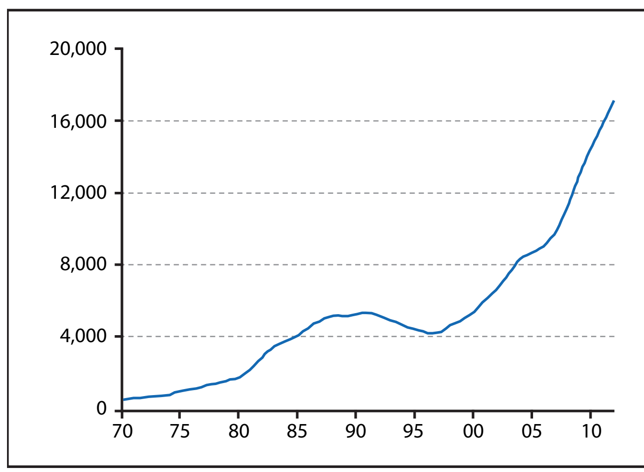
## THE MALAYSIAN SCENARIO

In the Malaysian context, both government debts and household debts have been on an upward trend, in line with the global trend as discussed above *(see graph 4)*.

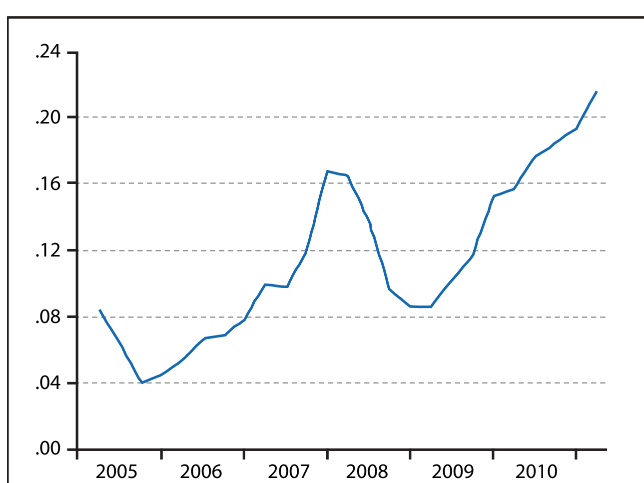
- Up to Q4 2011, government debt in total reached RM456bn, or approximately 53.5% of nominal GDP.
- As reported in *www.econsmalaysia*, based on Budget 2012 numbers, total government debt should reach just over RM495bn by the end of 2012.
- Up to Q4 2011, per capita debt is approximately RM16,000.
- As reported in *www.econsmalaysia*, based on 2012 numbers, the per capita debt should reach a little over RM17,000 per person by the end of that year.

By looking at the trends, one may quickly form an opinion that the level of government debt is no longer sustainable and Malaysia's economy is going down the same disastrous path as the economies of Portugal, Italy, Ireland, Greece and Spain (PIIGS).

However, a closer analysis of the foreign and domestic composition of government debt provides some comfort and soothes public concerns on Malaysia's high debt levels relative to GDP. Although the ratio of foreign holdings of government debt has been rising steadily since 2005, it is still at a fairly low level *(see graph 5)*.




**Graph 6 –** Debt per Capita
**Source:** *www.econsmalaysia*




**Graph 7 –** Foreign Holdings of Government Debt
**Source:** *www.econsmalaysia*

This is a sharp contrast to the PIIGS economies. For example, a large part of Greek public debt is owed to German creditors while French banks are exposed to Italy's debt. According to a recent article published in *www.econsmalaysia*, as long as a government's debt is denominated in its own currency and it retains control over issuance of that currency, government debt can always be paid off. This is entirely different in the Eurozone countries where they have no control over the issuance of their own money.

Having said the above, this does not mean that the Malaysian government can sit on its laurels when it comes to the growing level of government debt. The government must continue to manage the level of borrowings and ensure that it only borrows to finance development expenditure that will raise future capacity to produce.

## MALAYSIA'S HOUSEHOLD DEBT

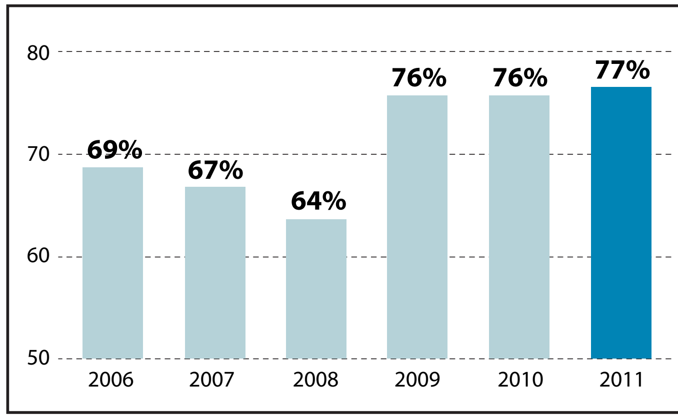
Having seen one side of the debt equation (i.e. government debt), a closer look at the other side of the equation (i.e. household debt) reveals that it is indeed a matter for concern. According to BNM, Malaysia's household debt at end-2011 was RM662bn or 77% of GDP *(see graph 8)*. One may claim that the household debt at this level is still manageable because of Malaysia's income growth, high levels of savings and favourable employment opportunities.

However, as the Consumer Association of Penang (CAP) rightly points out, if we look at household debt from the angle of the ratio of debt payments to household total income (i.e. the debt service ratio), then the picture painted is worrisome because it reveals that households are spending about half of their total income to pay off their debts *(see graph 9)*.

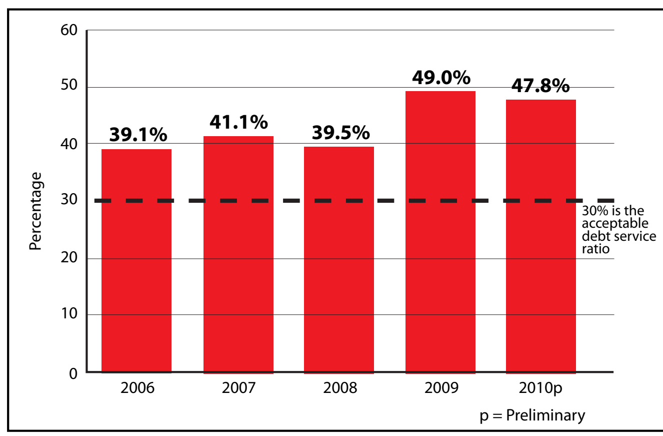
According to CAP, the general acceptable debt service ratio is 30%. In other words, one-third of a household income is used to pay off debt (principal and interest). The Malaysian household debt service ratio was 39.1% in 2006, rose to 49% in 2009 and dropped slightly to 47.8% in 2010.

As a matter of fact, when it comes to measuring the sustainability of household debt, the ratio of household debt to household disposable income is the accurate measure because the ability to service debt is directly related to disposable income.

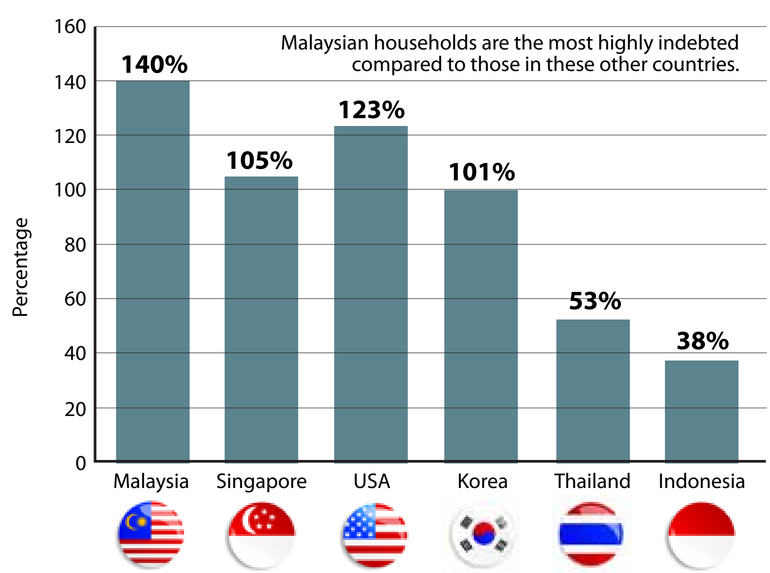
Looking at the problem from the ratio of household debt to disposable income, Malaysia




**Graph 8 –** Household Debt-to-GDP ratio
**Source:** BNM data, quoted by RAM Rating




**Graph 9 –** Ratio of Debt Payments to Income (Debt Service Ratio)
**Source:** Financial Stability and Payment Systems Report 2010, quoted by CAP




**Graph 10 –** Comparison of Household Debt to Household Disposable Income
**Source:** The Edge, 22 November 2010

recorded a ratio of 140%, being one of the highest in the world. Malaysia ranked above Singapore at 105%, USA at 123% and Thailand at 53% *(see graph 10)*.

According to BNM, home loans remained the largest component, contributing to 53% of total household debt. This was followed by vehicle financing at 19% and unsecured financing in the form of personal loans and credit cards accounting for about 15% and 5% of total household debt *(see graph 11)*.

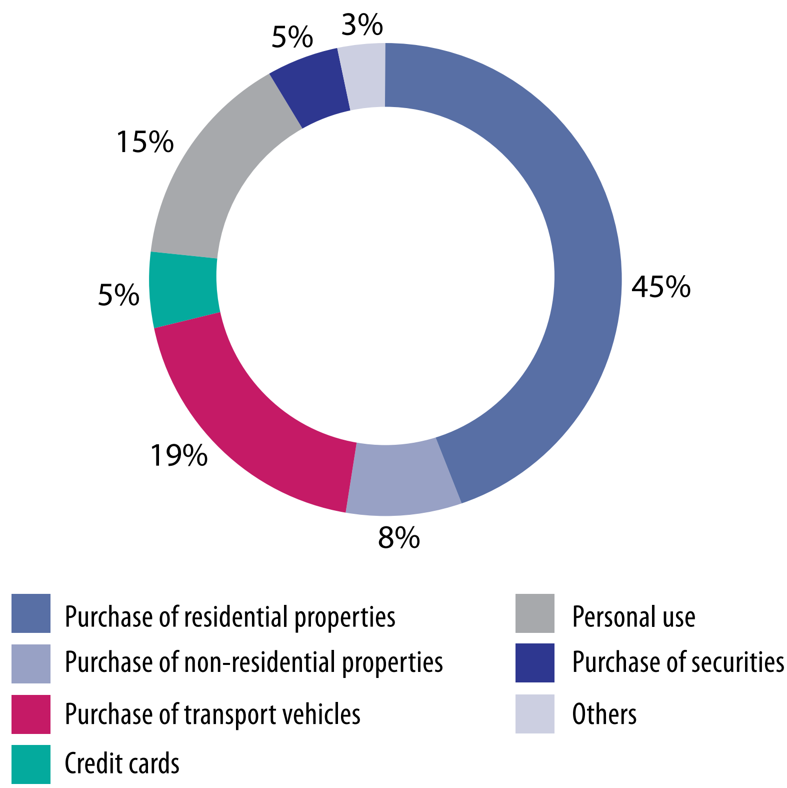
Are we comfortable with huge household debt that is tied mostly to vehicles that have hardly any value after a few years and an unpredictable property market? Can our salaries be increased correspondingly to support the rise in the cost of living? Ultimately, can the public cope with their debt obligation, which is vital in ensuring the banking sector's stability?

## THE NEED FOR COORDINATED RESPONSE

It is evident that during the last decade, Malaysian household debt has been on the rise as consumers continue to borrow more to spend more. While the banking system remains the primary lender to households, we are witnessing the increased level of activity by non-bank lenders in recent periods. This warrants a set of coordinated and coherent measures designed to rein in the growth in household debt.

Echoing this need, BNM has put in place a comprehensive range of pre-emptive measures, which among others includes the issuance of the Guidelines on Responsible Financing (GRF).

According to BNM, GRF in essence is aimed at promoting prudent, responsible and transparent retail financing practices. Knowing that consumers will seek alternate sources of borrowing (other than financial institutions under the surveillance of BNM), GRF requires all key providers of financing to the household sector to observe similar responsible financing practices. For example, GRF requires the Cooperatives Commission to impose requirements on responsible financing practices on credit cooperatives.




**Graph 11** – Composition of Household Debt
**Source:** BNM, Financial Stability and Payment Systems Report 2011

The following are other prudential measures introduced by BNM in an effort to rein in the growth in household debt:

- Loan-to-Value (LTV) ratio of 70% applied to third housing loans onwards
- Increased risk-weights for housing loans with LTV ratios of more than 90% and personal financing with tenure of more than 5 years
- New credit card guidelines
- Higher income eligibility - from RM18,000 to RM24,000 per annum
- Limit number of cards and credit limit for cardholders earning less than RM36,000 per annum
- Use of net income instead of gross income to calculate the debt service ratio for loans

Despite the noise surrounding the pre-emptive measures introduced by BNM, many feel the introduction of the guidelines is timely and justifiable. While the guidelines will strengthen the overall ability to lend prudently, developments in the level and profile of household debt will need to be closely monitored. As stated in the 'Financial Stability and Payment Systems Report 2011,' BNM is confident that the measures put in place should continue to improve the resilience of the household sector, albeit the highly dynamic domestic and external environment does not provide any room for complacency.

As the saying goes 'debt is the worst poverty'. Malaysia will have to control its household debt levels so that our financial security and economic stability are not compromised. ✱

■ Saravanan Ramasamy holds a Masters Degree in Economics from the National University of Singapore.

# Following the money:

## NURTURING SUSTAINABLE BANKING

**Sustainable banking is no longer a charity or CSR project, but increasingly a cold, hard economic advantage. In a rapidly changing world, a sustainability bias is proving vital to protecting the bottom line.**

JESSICA REE



To conduct banking with an overarching principle of serving the greater good has traditionally come at the expense of collecting the biggest returns. That is, until now: the world is changing and the case for keeping an eye on the social and environmental aspects of a transaction is not just for the bleeding hearts anymore. The threat of climate change means a new way of thinking is required, while the global financial crisis has provided a boost for the sustainable camp by demonstrating that single-mindedly chasing profits without thinking of the risks has its downsides.

"While public discussion continues about how to address the challenge of 'too-big-to-fail' banks and cajole or regulate them into expanding the amount of capital they make available to the real economy, a subset of banks have been pursuing business models with sustainable, community-focused finance at their core," said David Korslund of the Global Alliance for Banking on Values (GABV), a network of front-running sustainable banks, in a report on the impact metrics of its industry. "The vital role that these banks play in true economic development is increasingly recognised in the debate over how to restructure local and global finance."

### THE ECONOMIC CASE

Sustainable banks generally have significantly greater exposure to loans and deposit customers, GABV's research found, as well as having relatively higher and better quality capital. Significantly, the study showed that the 17 sustainable banks polled had better returns on assets than standard banks, with comparable returns on equity. Specifically, sustainable banks had an average of 7.07% return on equity compared to a 6.06% average at 29 big global banks, the Rockefeller Foundation-sponsored study found. Interestingly, the difference between the parties was even wider during the economic downturn, when in 2008 the sustainable banks returned 7.17% and the others suffered a 1.53% loss.

This suggests the case for sustainable banking is no longer about charity but finance. Especially during economically

***Had they conducted stress tests, some lenders might have seen how exposed they were to changes in market conditions or to an interruption of steady economic growth.***

# Profits

**The threat of climate change means a new way of thinking is required, while the global financial crisis has provided a boost for the sustainable camp by demonstrating that single-mindedly chasing profits without thinking of the risks has its downsides.**

rocky times, banking practices that take into account more than just the profit line may fare better.

"There is an increasingly compelling business case for sustainable banking, based on its track record over several decades. In general, these banks have offered stable returns, financing enterprises working in the real economy," said James Niven, Programme Manager for the GABV, and Head of Public Affairs at Triodos Bank, the sustainable retail and investment bank. "Some sustainable funds have also outperformed mainstream funds, attracting investors looking for solid, stable returns. … Our experience across the GABV network is that the financial crisis, in some countries, prompted large numbers of people to think more about the role of banks and how they use the money they entrust with them."

**LESSONS FROM THE FINANCIAL CRISIS**

As mainstream banks are experiencing an ongoing squeeze on capital and pressure on profits, a radical approach may be necessary to find new growth opportunities. One option is to extend the practice of derivatives and other types of 'shadow banking'. The other option is change. "The alternative for US and European banks will be to focus on transforming their business models. It will have to be intensified to deliver the level of improvement required for sustainable long-term returns," said Stefano Visalli, a Director with McKinsey & Co. in the sustainable banking report from global management consultancy McKinsey & Co.

McKinsey estimates that US banks will need to grow net profits from USD121bn in 2010 to USD312bn in 2015 if they are to achieve 12% return on equity on new capital, which is available despite the squeeze. European banks face a similarly steep challenge, needing to increase profits from USD166bn in 2010 to USD328bn in 2015. While there are different ways to potentially achieve this, the severity of the shift is indicative of just how far 'outside the box' the solution has to be.

"The recession has brought renewed attention to how financial institutions understand risk," said Richard Burrett, Co-Chair at the UNEP Finance Initiative. This global partnership between the UN Environmental Programme and the financial sector works with over 200 financial institutions to understand the environmental and social impacts of financial performance. "Leading up to the downturn, the financial industry did not see the crisis building up in its own sector. What transpired has helped us understand the risks going forward."

A study by restructuring advisory group AlixPartners showed a 35% increase in customer distrust of banks following the financial crisis, resulting in 33% of those surveyed planning to change their investment behaviour and 31% intending to change their banks.

### RECOVERING TRUST

"Financial institutions face growing challenges in rebuilding stakeholder confidence and restoring customer loyalty," said Bill Murphy, advisory partner in the climate change and sustainability services group at KPMG, the global professional services network. "Today, investors and customers expect more comprehensive management of, and broader disclosure of results related to, a full range of both economic and sustainability-related issues including ethics, corporate governance, risk management and environmental performance."

A commitment to sustainable business practices will typically find the rewards outweigh the risks and costs, as it awards access to new, often underserved, markets, stressed Murphy in his report on the strategic value of sustainability. "Sustainable business practices also improve risk management by broadening regulatory compliance and ensuring business partners and suppliers adhere to minimum environmental and safety standards. A competitive advantage can be realised by incorporating ethical and sustainable evaluation criteria into investment analysis and decision-making processes."

### DEFINING SUSTAINABLE BANKING

Technically, any non-exploitative banking venture could be described as sustainable; financial services consulting group Mercer defines sustainability as investments that seek to support sustainable economic development, enhance quality of life and safeguard the environment.

***"There is a risk that the terminology becomes devalued by overuse. For the banks in the GABV, sustainable banking means starting with a focus on the needs of people and the environment and finding financial ways to address them."***

"There is a risk that the terminology becomes devalued by overuse. For the banks in the GABV, sustainable banking means starting with a focus on the needs of people and the environment and finding financial ways to address them," explained GABV's Niven. He outlined six key ways in which sustainable banks are different from mainstream banks:

"They have a triple bottom line approach at the heart of their business model: balancing people, planet and profit in all that they do. They are grounded in communities, serving the real economy and enabling new business models to meet the needs of both. They are focused on long-term relationships with clients and a direct understanding of their economic activities and the risks involved," said Niven. Furthermore, sustainable banks are long-term, self-sustaining, and resilient to outside disruptions, and use transparent and inclusive governance.

In practice, sustainability tends to include the funding of local community businesses, as well as green ventures. Islamic finance has the potential to be included in this definition when it follows *Shariah* law to the letter, but according to Associate Professor Dr. Asyraf Wajdi Dusuki who is currently the Head of Research Affairs, International *Shariah* Research Academy for Islamic Finance (ISRA), this is not necessarily a given: "The orientation of Islamic banking and finance has somehow become dominated by the profit-maximisation doctrine, vying for countless billions of Arab petrodollars."

Just like Islamic finance is not necessarily synonymous with sustainability, sustainable banking also does not necessarily have to be green or low-impact. "We have a sustainable matrix system that allows us to invest in high-impact sectors like oil only if the company is exceptionally sustainable," Joachim Straehle, Chief Executive Officer of Bank Sarasin, the Swiss sustainable bank, told the *Financial Times*. Consequently, Bank Sarasin will invest in Statoil of Norway, due to its broad renewables focus.


Bank
Deposits
Loans
Credit



FUNDAMENTALS

**Lloyds Banking Group** has pledged to deliver at least £12bn in gross lending to small and medium-sized businesses in 2012, following the delivery of £12.5bn last year.

### BROAD-BASED SUSTAINABILITY IN PRACTICE

*Sustainable banking is nothing if not diversified.*

Itau Unibanco of Brazil was 2011's big winner at the *Financial Times'* annual Sustainable Banking Awards, after having stated two years ago an intent to become the leading bank in sustainable performance. Itau Unibanco aims that by 2013, 80% of assets under active strategy management should be compliant with environment, social and government criteria.

Other banks to receive awards for their sustainability efforts include Access Bank of Nigeria, which has an initiative to encourage women entrepreneurs and financing of renewable energy projects. YES Bank of India recently launched a sustainable investment bank for environmental and social business funding, while the UK's Co-operative Financial Services has integrated sustainability targets into its three-year business plan, including the 35% reduction of $CO_2$ emissions and £1bn in funding for clean energy solutions.

Lloyds Banking Group has pledged to deliver at least £12bn in gross lending to small and medium-sized businesses in 2012, following the delivery of £12.5bn last year. This means the group beat its targets as set by the Merlin agreement, set up between the UK government and the four biggest banks in 2011 to provide light regulation of lending and bonuses. Barclays and HSBC also beat their Merlin targets for lending to small businesses last year, however the Royal Bank of Scotland (RBS) came up slightly short.

### THE ENVIRONMENTAL CASE

While sustainable banking need not be green, environmental changes remain a significant driver for sustainability. "This is hard economics: the resources we depend on for growth are starting to run out," said UNEP Finance Initiative's Burrett. "Some organisations engage in sustainable investing as part of their Socially Responsible Investment requirements, but I think that is a very limited way to look at it. Others understand there will be future opportunities here, and consequently they are developing products to meet them."

Banks can become a part of the low-carbon economy by directing their investment capital towards business propositions and technologies that support it. This includes the development of smart grids for electricity distribution, biofuel vehicles, infrastructure for new transport initiatives such as electric cars, and the development of new renewable energy sources. In addition to the environmental benefits of these efforts, energy security is a primary concern for governments; the EU imported 94% of its crude oil in 2007, according to Barclays's carbon capital report. Consequently, many incentives to improve this balance receive development subsidies and other support, adding security for banks looking for new business opportunities. "In addition to decreasing reliance on foreign energy sources, governments are using the transition to a 'green economy' as an opportunity for economic growth," wrote Simon Whitehouse of consultancy group Accenture, which co-authored the report with Barclays. Whitehouse pointed to how London's proposed carbon mitigation activities are estimated to deliver 14,000 jobs per year, as well as an annual £600 million in value-added opportunities.

***"For some it may be a more commercial decision; entrepreneurs in developing countries may borrow from a values-based bank because, for example, they value the direct relationship with the bank and it provides access to finance."***

On a retail banking level, environmentally and socially-minded customers looking for a bank that reflects their values are a core target group for sustainable banks. "Many people who choose to bank sustainably do so because they are attracted by a combination of social, environmental and financial returns," said GABV's Niven. "For some it may be a more commercial decision; entrepreneurs in developing countries may borrow from a values-based bank because, for example, they value the direct relationship with the bank and it provides access to finance."

### SUSTAINABILITY FOR RISK, REPUTATION MANAGEMENT

In a similar vein, Burrett pointed out how banks are starting to look to more sustainable practices as part of their risk management. This is true in terms of the risk of business failure, but it is also a public relations issue. A key example of the latter is how RBS is one of the UK's largest investors in renewable energy, but this is all but blotted out by the bank's links to the Canadian tar sands; "As people become more aware, banks need to consider how they operate and what effect it has on their reputation."

As a former employee of ABN Amro, Burrett was instrumental in setting up the Equator Principles, a voluntary framework for banks to manage environmental and social issues in project finance, and related reputational risks. This includes a social and environmental assessment of each project, plus a plan for mitigation or corrections to counter any ill effects, all with an overarching principle of transparency.

The Equator Principle currently has approximately 80 members, many of which take the set-up very seriously; Standard Chartered applies the rules to even its smallest project finance deals, while HSBC has extended the principles to corporate loans and export credit loans in certain cases. The framework is being considered for expansion beyond the project finance arena, confirmed Burrett.

### A CHANGING WORLD

While banks will have different drivers motivating them towards sustainable banking, the changing world means the issue is becoming increasingly linked in with future profits. Climate change and energy security are two aspects of sustainable banking, but equally important is the growth in emerging markets, emphasised Karen Ward, an economist with HSBC in HSBC's report on what the world will look like in 2050: "By 2050, the collective size of the economies we currently deem 'emerging' will have increased five-fold and will be larger than the developed world. Nineteen of the 30 largest economies will be from the emerging world. At the same time, there will be a marked decline in the economic might, and potentially the political clout, of many small population, ageing, rich economies in Europe."

A new approach is necessary if we are to maintain sustainable long-term economic growth, and sustainable banks are starting to prove they can pack an economic punch. Especially in volatile circumstances such as those we have experienced over the past few years, there is an increasingly compelling case for keeping in mind a broader perspective. Whereas sustainability might have started out as a charity, today the picture looks very different: in order to follow the money, it pays to be good. ✱

■ Jessica Ree is a freelance journalist based in London.

# *The Treasury Concept:* ORIGIN AND APPLICATIONS

PROFESSOR DR.hc HEINZ RIEHL

Treasury Departments, which combine the key financial activities of a company under one manager, always have been a part of the organisational structure of non-financial institutions. All activities associated with finance are the job of the Treasurer, including the borrowing or investing of local or foreign currencies to satisfy a company's liquidity needs.

Until 1960, financial institutions and banks did not have a Treasury Department. Instead, the key treasury functions were separated, and each one was headed by an independent manager. This article describes the advantages of a centralised Treasury.

**Background**

The centralised organisation of "Treasury" in a bank is combined under one manager, the Treasurer, who supervises trading in the:

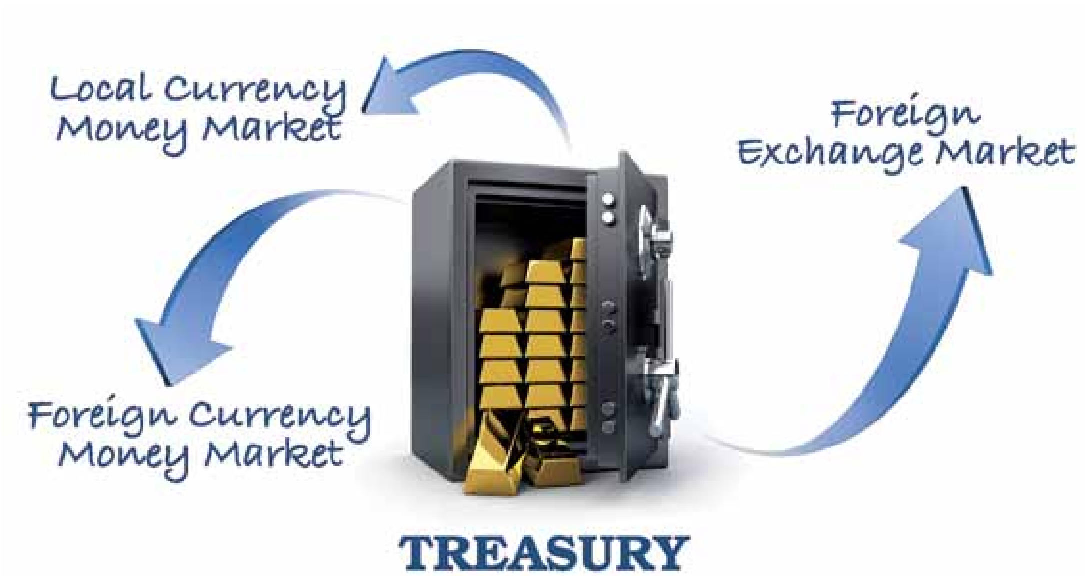
- Local Currency Money Market
- Foreign Currency Money Market
- Foreign Exchange Market

**Local Currency Money Market (LCMM)**

The management of the LCMM is very important in any bank. Most deposits have relatively short tenures and mature within six months, but the bank's business is to lend a large percentage of that money for much longer periods, often for several years. Due to this, the Funding Liquidity of a bank is critical. Therefore, it must be made sure that money is available at the lowest possible cost when obligations are contractually due.

**Foreign Currency Money Market (FCMM)**

Many customers wish to borrow and make deposits in foreign currencies. For borrowings, it means the bank must find deposits denominated in



# Treasury

**Until 1960, financial institutions and banks did not have a Treasury Department. Instead, the key treasury functions were separated, and each one was headed by an independent manager.**


those currencies so that deposits and loans are matched by currency. For deposits, the bank has to pay interest and invest them to earn back the interest plus a profit. In addition to matching all the different currencies, the maturities of foreign currency assets and liabilities must be matched or consciously managed so there is adequate Funding Liquidity in the bank's foreign currency book.

**Foreign Exchange (FX)**

This department is responsible for maintaining working balances in accounts with correspondent banks around the world. The accounts are denominated in the local currencies of the respective foreign countries and are used to handle a bank's incoming and outgoing payments in the respective currencies of these countries. The balances in the accounts must be kept at levels commensurate with the daily turnover in the accounts.

Foreign Exchange contracts are closed for spot value dates and various forward value dates. Value spot means that the currencies sold and purchased are delivered and received two business days after the contract or transaction date. Forward value dates are usually for a number of months into the future. This means that the exchange of currencies purchased and sold might take place 1, 2, 3, 6 or 12 months after the contract date.

How transactions work in each department will now be described, followed by how the separate departments are brought together under one manager, the Treasurer.

## FORWARD FX RATES

Trading in forward exchange rates is based on the fact that the premiums and discounts of forward exchange rates are equal to the interest rate differential between the two currencies involved. This can be illustrated with an example.

***Assume the following:***
- Spot FX rate for the dollar is 7.00 local currency.
- One year interest rates are 5% for dollars and 3% for local currency.
- The interest rate differential is 2%. As a result, the one year forward FX rate for dollars against local currency must be 2% lower than 7.00 or 6.86 local currency (LCY) per US dollar.*

| | | |
|---|---|---|
| **Spot rate** | **7.00** | |
| **less 2% of 7.00 =** | **0.14** | **swap rate** |
| | **6.86** | **forward FX rate for dollars against local currency.** |

* *All interest rates are 'per annum' rates. The annual flat swap rate of 0.14 will be different for shorter or longer periods, such as 0.07 flat for six months or 0.28 flat for two years.*

A holder of dollars could swap dollars into LCY at a 2% discount income and invest the resultant LCY at 3% for a total return of 5%, which is equal to the 5% he could have earned on his dollars on a direct dollar investment. The same logic applies to a holder of LCY.

### Trading in the Local Currency Money Market (LCMM)

This example illustrates how a bank can operate profitably in the LCMM.

As Germany's economy boomed, Citibank's many branches the world over opened accounts with its new German branch as they were all speculating on a revaluation of the German mark and, because of that, maintained slightly higher balances in their mark accounts with the Frankfurt Citibank branch. This resulted in the German branch accumulating more than 200 million marks (USD50 million) in its non-interest bearing checking account with Deutsche Bank.

There was an inter-bank money market in Germany where the marks could be invested. It included an overnight money market in which funds could be invested as call money at 3%. That is, they could be recalled at any time. The German branch invested its 200 million marks in that market and netted itself a profit which it would not have achieved if funds had been kept in its non-interest bearing checking account with Deutsche Bank.

### Trading in the Foreign Currency Money Market

Foreign currency trading works as illustrated in the following example for a German bank:

Say on Monday, it wants to sell USD500k for value Tuesday. However, the standard spot value date is Wednesday (two days after the transaction date as mentioned above). This means that, for one day, a bank could be left in a cash position short or overdrawn in USD, but long or with excess German Marks.

It could sell the dollars for value Tuesday at the same standard offered rate for value Wednesday, provided that the interest rate for dollars and marks for the Tuesday to Wednesday period was the same.

If the interest rate for marks was higher than the interest rate for dollars, the bank would earn that differential, because it could invest the marks at a higher rate than the rate at which it would borrow the dollars from the US branch. Then it could offer the dollars for value Tuesday at a slightly lower FX rate than the standard offered rate for value Wednesday. And vice versa if the interest rate for marks was lower than the dollar interest rate.

### Treasurers in Banks

Prior to 1960, the Treasury function was not centralised in most banks as mentioned above.

The consequences were that few if any FX traders understood the interrelationship between interest rate differentials on one side and premiums and discounts in the forward FX market on the other side. Instead, they thought that those premiums or discounts were indicators for the expected trend of the respective spot rates: When the spot exchange rate of a currency is expected to move lower, then the forward exchange rate is already at a discount. And likewise, when the spot exchange rate of a currency is expected to move higher, then the forward exchange rate is already at a premium. Their thinking, however, was wrong.

In addition to the misconception about forward exchange rates, at other banks the three managers heading the three different departments did not cooperate much with each other. This lack of cooperation in other banks worked to the advantage of banks which had the organisational structure of a Treasury.

### Expansion of the Treasury Concept

The Treasury concept had two major advantages. First, it was immensely profitable, because it allowed the Treasurer to take advantage of imperfections and disparities in the international marketplace. Second,


Imagine that a bank in Germany was quoting a discount of 0.20 for a one year swap, i.e. offering one year forward dollars at 6.80, which is equal to a discount of 2.86%. In that case:

- Dollars could be borrowed for one year at **5.00%**
- minus the discount or swap gain of **2.86% (0.20 as % of the FX rate of 7.00 per $)**
- and create fully hedged LCY for one year at **2.14%** or **0.86% lower than the 3% market rate**

the ability to create fully-hedged local currency by swapping dollars and other foreign currencies into those miscellaneous local currencies augmented the local currency deposit base in all those countries.

The global market gradually recognised the advantages of the Treasury organisational structure and the concept became an industry standard.

**Applications of the Treasury Concept**

*Below Market Rate Local Currency Funding*

Because the German mark (DM) was a revaluation-prone currency, the US dollar (USD) was always under downward pressure. As a result, the discount quoted in the market for forward USD against DM was larger than it should have been based on the interest rate differential *(as illustrated above)*.

A slightly different but basically similar technique involved the commercial FX business with customers. Instead of entering into a natural swap with a bank, very competitive forward outright bid rates could be quoted to exporters who wished to sell forward dollars in order to hedge their dollar-denominated export receivables. After buying the forward dollars outright from the customer, spot dollars could be sold in the inter-bank market and create the same cash flows as those for a natural swap with another bank. This is called an engineered (pieced together) swap, because forward purchase from a customer and spot sale of dollars against LCY to another bank was done with two different counterparties.

FX MARKETS

**When the spot exchange** rate of a currency is expected to move lower, then the forward exchange rate is already at a discount. And likewise, when the spot exchange rate of a currency is expected to move higher, then the forward exchange rate is already at a premium. Their thinking, however, was wrong.


INVESTMENTS

**Likewise, investors invest in** instruments and currencies and at types of interest rates that are popular with borrowers. Once the investment has been made, the investors will use the aforementioned derivatives to turn their investment into the type of currency and interest rate (fixed or floating) which they originally wanted.

**Broad Global Application in the International Financial Market**

It can be said that the forward exchange contract was the first financial derivative contract. Together with derivatives for interest rates, equities and credit, it allowed sophisticated borrowers and investors to increase liquidity and lower borrowing costs on the borrowing side, and increase investment yields on the investment side.

Borrowers offer debt instruments at interest rates and in currencies that are popular with investors. Once borrowers have the money, they will use the aforementioned derivatives to create the kind of currency at the type of interest rate (fixed or floating) they really want.

Likewise, investors invest in instruments and currencies and at types of interest rates that are popular with borrowers. Once the investment has been made, the investors will use the aforementioned derivatives to turn their investment into the type of currency and interest rate (fixed or floating) which they originally wanted.

The World Bank was one of the first financial institutions to apply this philosophy. They wanted to borrow fixed-rate dollars. However, the world gradually got tired of investing in that type of paper. The dollar's value began to go down, and the world's Central Banks held reserves not only in dollars but also in yen, marks and Swiss francs. The World Bank realised that and began to issue its debt in various currencies and at floating as well as fixed interest rates.

Those modified debt instruments were more popular with investors. The World Bank debt was easier to place and their liquidity was improved. The World Bank used miscellaneous derivatives to turn the proceeds of their borrowings into fixed interest rate dollars, which is what they wanted in the first place. Their effort and their willingness to cater to their customer needs were rewarded with improved liquidity and a borrowing cost that was below prevailing market rates.

**Risks in Trading and Financial Engineering**

Borrowing and investing is only limited by the imagination of market participants. It can lead to quite complex operations and instruments which sometimes even the participants themselves can no longer understand.

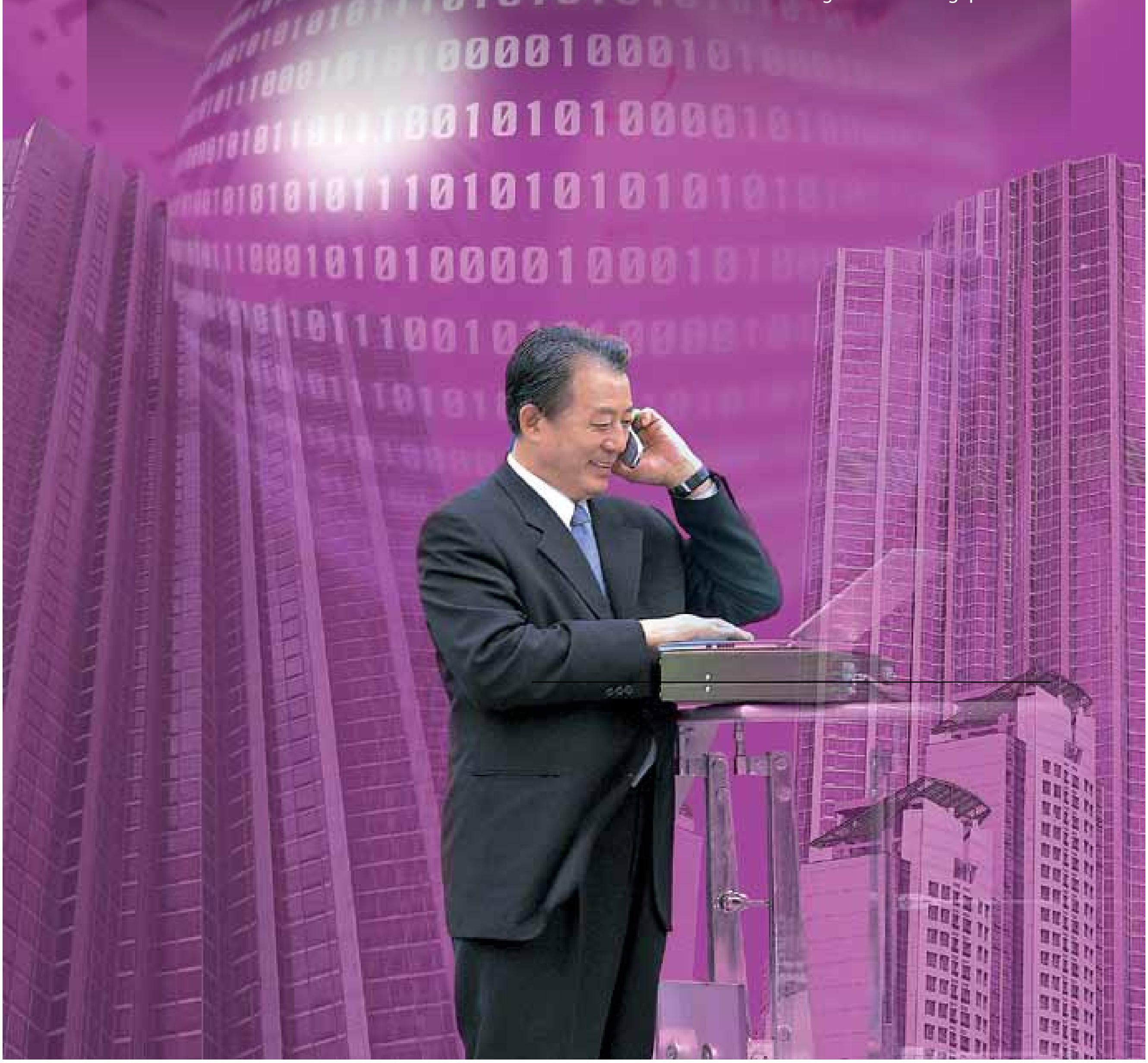
In 1990 Alan Greenspan, then-Chairman of the Federal Reserve Board warned that we should guard against a situation where the designers of financial strategies (traders) and their senior managers lack the experience to evaluate the attendant risk.

Exactly what Greenspan wanted to avoid has happened almost continuously over the last 20 years. It is therefore imperative for participants in this market to focus on treasury-related risk management, operations and

internal controls as much as on the business itself.

In the late 1980s, volatility-based techniques for controlling risks associated with financial trading were pioneered. These techniques include the concept of 'Value-at-Risk' (VAR) for the control of price risk and 'Loan Equivalents' for the control of pre-settlement counterparty credit risk in trading. These two concepts allowed a meaningful "risk versus return" analysis for the first time. In other words, how much equity capital was tied up in order to earn those profits, and what were those profits expressed as a percentage of this tied-up equity (Return on Equity or ROE). ✱

■ Professor Dr.hc Heinz Riehl advises globally on financial risk management and wrote 'Managing Risk in the Foreign Exchange, Money and Derivative Markets'. He is Professor of Finance at New York University's Stern School of Business, and has been conducting seminars at IBBM since 1985. Earlier, Heinz spent 36 years at Citibank New York, where he formulated Market Risk Policy, including the concept of Value-at-Risk to manage Price Risk. He was also multi-year Chairman of New York Federal Reserve Bank's FX Committee. Heinz is Director of Hedge Funds and provided litigation support in disputes about financial investments, testifying at the International Court of Justice, The Hague, Federal Court New York and the High Court of Singapore.




# Internationalising the Renminbi

Is China's currency internationalisation and domestic capital market protectionism a contradiction in terms?

A multipolar monetary system must emerge, whether negotiated or not and this necessarily implies the internationalisation of the renminbi.

*Ge Huayong, Director at the Bank of China*

It is against this backdrop that the Chinese government started a policy of using its own currency in international trade, vis-à-vis reducing its dependence on the US dollar.

The move to internationalise the renminbi probably has its origins in the global financial crisis (GFC) of 2007 – 2008.

One outcome of the GFC was to show policymakers in China how overly dependent their export industry is on the US dollar as the currency of settlement in international transactions. The financial crisis, chiefly triggered by the subprime mortgage market, gave rise to the credit crunch which consequently resulted in devastating spillover effects for Chinese exporters. Borrowing conditions all over the world worsened as banks were reluctant to lend for fear of bankruptcies or defaults. As a result of liquidity constraints, the external demand for Chinese goods witnessed a sudden plunge and this triggered the consequent lay-off of millions of Chinese workers.

It is against this backdrop that the Chinese government started a policy of using its own currency in international trade, *vis-à-vis* reducing its dependence on the US dollar. This marks the basis of internationalisation for the Renminbi (RMB), also known popularly as the yuan.

**Currency internationalisation defined**

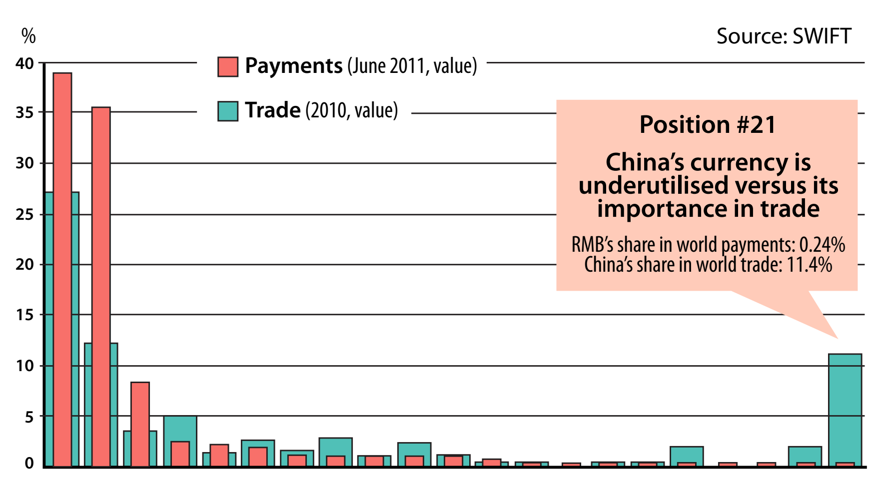
Although widely used, the term 'currency internationalisation' is not well defined in economic literature. Can we claim a currency to be 'internationalised' when it plays the role of money outside the country where it is issued? Alternatively, can a currency be considered internationalised when it is used in invoicing exports and imports of goods and services?

According to a 2009 research paper entitled 'Currency Internationalisation: Analytical and Policy Issues', Hans Genberg of the Hong Kong Monetary Authority claimed that if a national currency is used globally as a unit of account, a medium of exchange and a store of value without any restrictions other than those imposed on domestic residents, it qualifies as an international currency. National currencies may be fully convertible and freely floating but they may not qualify as international currencies as long as they do not serve as trade and reserve currencies. Therefore, the actual degree of its usage should be the most critical criterion for qualifying an international currency. The degree of internationalisation of a currency is often measured by its share in the denomination of international trade in goods, services and financial assets and in holding foreign exchange reserves.

**The phased approach of internationalisation**

RMB is not a world currency yet. At the international level, analyses of market shares in international payments and in foreign exchange markets reveal that the RMB is currently underutilised. According to a SWIFT white paper entitled 'RMB internationalisation: Implications for the global financial industry', in 2011, the RMB ranked 21st as a world payment currency, with 0.24% share in payments value, while China's share in world trade was 11.4% in 2010 *(see graph below)*. These figures show a clear underutilisation of the RMB in relation to China's economy.

While there is no roadmap with predefined timeframes for the internationalisation of the RMB, China has embarked on a phased approach, as depicted in the diagram below. China remains fairly conservative in its liberalisation efforts. It continues to follow the approach embodied in Deng Xiaoping's phrase 'crossing the river by



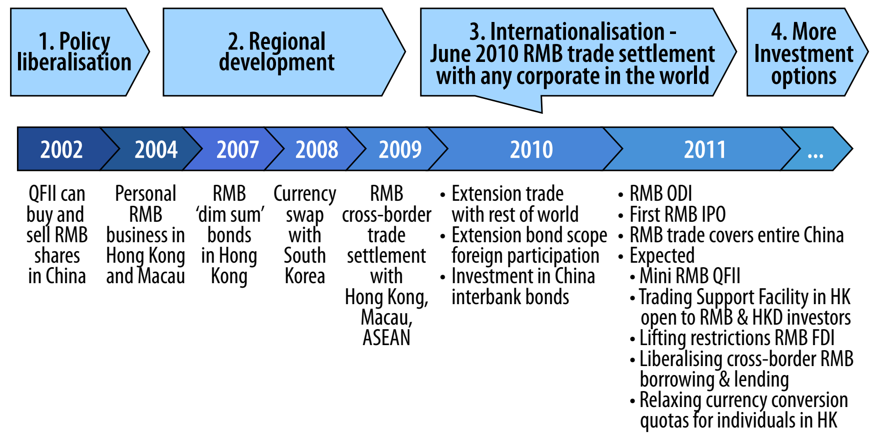
feeling the stones'.

China's currency policy liberalisation started in 2002, when for the first time qualified foreign institutional investors were allowed to invest in China's domestic stock market. Since then, China has implemented three phases towards the internationalisation of the RMB.

The first phase is to make the RMB an international trade settlement currency based on the convertibility of RMB on the current accounts. In April 2004, China allowed eligible enterprises in China to settle trade payments in RMB with their corresponding enterprises in Hong Kong and other countries. This allows for the invoice of exports and imports from and to selected countries in RMB. According to a recent report in *The Jakarta Post*, by the end of 2010 more than 67,000 exporters in 20 provinces in China were licensed to invoice in RMB. The value of this trade settlement expanded rapidly from a modest beginning at RMB5bn in the first quarter of 2010 to more than RMB100bn at end-2011.

The second phase is to turn the RMB into an investment currency by allowing certified investors at home and abroad to jointly promote the two-way flows of the RMB. In 2007, China allowed for the issuance of RMB-denominated bonds in offshore markets. The issuance of RMB-denominated bonds in Hong Kong (also known as 'dim sum' bonds) started when the Asian Bond Fund, an initiative of the ASEAN+3 Group (South Korea, China and Japan), started to encourage the issuance of bonds in local currencies. This issuance is now not only limited to mainland China's financial institutions but also extended to international banks and private companies. International banks such Deutsche Bank, Citigroup, JP Morgan Chase, Standard Chartered and HSBC and private companies such as Caterpillar, McDonalds, Ikea and Nokia have also started gradually to issue this type of RMB-denominated bonds. More recently, China removed restrictions to create more investment options in RMB. Indeed, for the first time in April 2011, the equity market witnessed an RMB-denominated Initial

Source: SWIFT




Public Offering (IPO) in Hong Kong.

The third phase is to achieve the internationalisation of the RMB and turn the RMB into an international reserve currency. This entails the use of the RMB for trade settlement via bilateral currency swap agreements, which allow China to receive payments in RMB for its exports to participating countries. According to a recent report entitled 'The Internationalisation of the Renminbi: Prospects and Risks', these agreements, put together as of end-2010, account for a little over RMB800bn (approximately USD120bn, see table below).

| COUNTRY | DATE | AMOUNT |
|---|---|---|
| South Korea | 12 December 2008 | RMB 180bn |
| Hong Kong | 20 January 2009 | RMB 200bn |
| Malaysia | 8 February 2009 | RMB 80bn |
| Belarus | 11 March 2009 | RMB 20bn |
| Indonesia | 23 March 2009 | RMB 100bn |
| Argentina | 29 March 2009 | RMB 70bn |
| Iceland | 9 June 2010 | RMB 3.5bn |
| Singapore | 23 July 2010 | RMB 150bn |

***Note:*** *China's Bilateral Currency Swap Agreements since the collapse of Lehman Brothers.* ***Source:*** *Miguel Otero-Iglesias - The Internationalisation of the Renminbi: Prospects and Risks*

**Early stage but with clear objectives**

Although the international usage of the RMB is in its early days, the Chinese government has successfully started a step-by-step campaign to promote its currency as a means of settlement in international trade. With this in mind, the following section attempts to analyse what China's main objectives are with this strategy of RMB internationalisation.

In this context, Anwar Nasution, a professor of monetary economics at the University of Indonesia and also a former senior deputy governor of Bank Indonesia claims that there are primarily two economic objectives of the RMB internationalisation.

According to Anwar, first and foremost, trade invoicing in the RMB reduces China's US dollar dependence. The same opinion is also echoed by Miguel Otero-Iglesias of Oxford Brookes University who stated that Chinese policymakers have realised that they are in a 'dollar-trap' and they want to come out of it as soon as possible. One way to do so is to internationalise the RMB. This would reduce the transaction costs for Chinese importers and exporters and more importantly, if the RMB becomes an international currency equivalent to the US dollar and the euro, China will be able to gradually exchange its huge US dollar reserves into RMB without having to suffer heavy losses. The elevation of RMB to a reserve currency status reduces the need for China to accumulate large external reserves in other major currencies, including the US dollar. It is worthwhile to note that the export-led development strategy adopted by China since the 1980s has produced surpluses both in its current account and capital account that has allowed the country to accumulate huge foreign exchange reserves amounting to more than USD3 trillion as at end-2011. Nearly two-thirds of China's external reserves are held in US Treasury bills and sovereign bonds.

Secondly, internalisation of the RMB would provide an avenue for China to gain alternative external demand. Anwar further elaborated that China hopes to increase foreign demand for its products, especially from emerging economies. While these markets will certainly not substitute for the demand pull from the US and Europe in the short term, China hopes that it can slowly reduce its export dependence on the developed world and increase its trade with the emerging markets, especially with the other BRIC countries: Brazil, Russia and India. It is important to note that Chinese banks are increasingly offering loans in RMB all over the world. According to a recent SWIFT report, China has actually provided more loans in 2010 than the World Bank. The loans will be used to buy Chinese products

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**The path ahead**

The internationalisation of the RMB has begun and will gather pace in the years to come. It is indeed a major change not only for China but for the world at large.

The main question is whether China can have it both ways, namely; a currency that is internationally accepted and able to compete with the US dollar and the euro and a domestic capital market that is heavily regulated.

Professor Yung Chul Park and Professor Kwanho Shin, both of Korea University, recently argued that emerging economies should push forward to develop domestic financial markets that are broad and liquid enough to absorb external shocks before proceeding with currency internationalisation. The same opinion was also echoed by Rizal Djaafara, Director of the Center for Banking Education and Studies of Bank Indonesia. Rizal argued that such domestic financial instability risk is one of the primary considerations for Indonesia not to internationalise the rupiah. The domestic foreign exchange market in Indonesia is not yet mature and is vulnerable to speculation. Although pressures in the domestic foreign exchange market are not fully isolated, restricting currency internationalisation has helped to minimise the fluctuations of the rupiah.

On the domestic front, reflecting on Singapore's experience, Tan Sri Dr. Zeti Akhtar Aziz recently stated that Bank Negara is aware of the risks associated with ringgit internationalisation and would review the situation every six months to assess its feasibility, with a view to phased implementation.

Realising the fact that internationalisation of RMB and at the same time maintaining a highly-regulated domestic capital market is indeed a contradiction of terms, the Chinese government is seen to be willing to open up the domestic market very gradually, but the reality is that


China has a long way to go before its domestic markets can be opened up to foreign inflows without being hugely destabilising.

However, investors are already betting on the prospects of gains from RMB internationalisation. Hong Kong is starting to be flooded with RMB ready to jump to mainland China in search of higher yields. Investors are currently very eager to pile more and more into RMB-denominated assets because they believe that the RMB will appreciate in the future, making the whole process a one-way bet. As Miguel Otero-Iglesias states, Hong Kong will be able to perform its laboratory role up to a point, but at a certain stage its RMB absorption capacity will be overstretched, provoking destabilising asset-price bubbles and instability. Miguel Otero-Iglesias claims that cases of illegal RMB smuggling into the mainland markets are widespread. While inflation is already a problem in China, the illegal inflows will make the situation even worse.

So far the internationalisation process has progressed smoothly because the waters of the river were relatively shallow, but once the waters deepen proportionally to the amount of RMBs that are in circulation overseas, China might not be able to control the process optimally. In the long run, the journey might not be so easy and 'one might not be able to feel the stones while crossing the river'. ✱

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■ Reporting by the *Banking Insight* Editorial Team.