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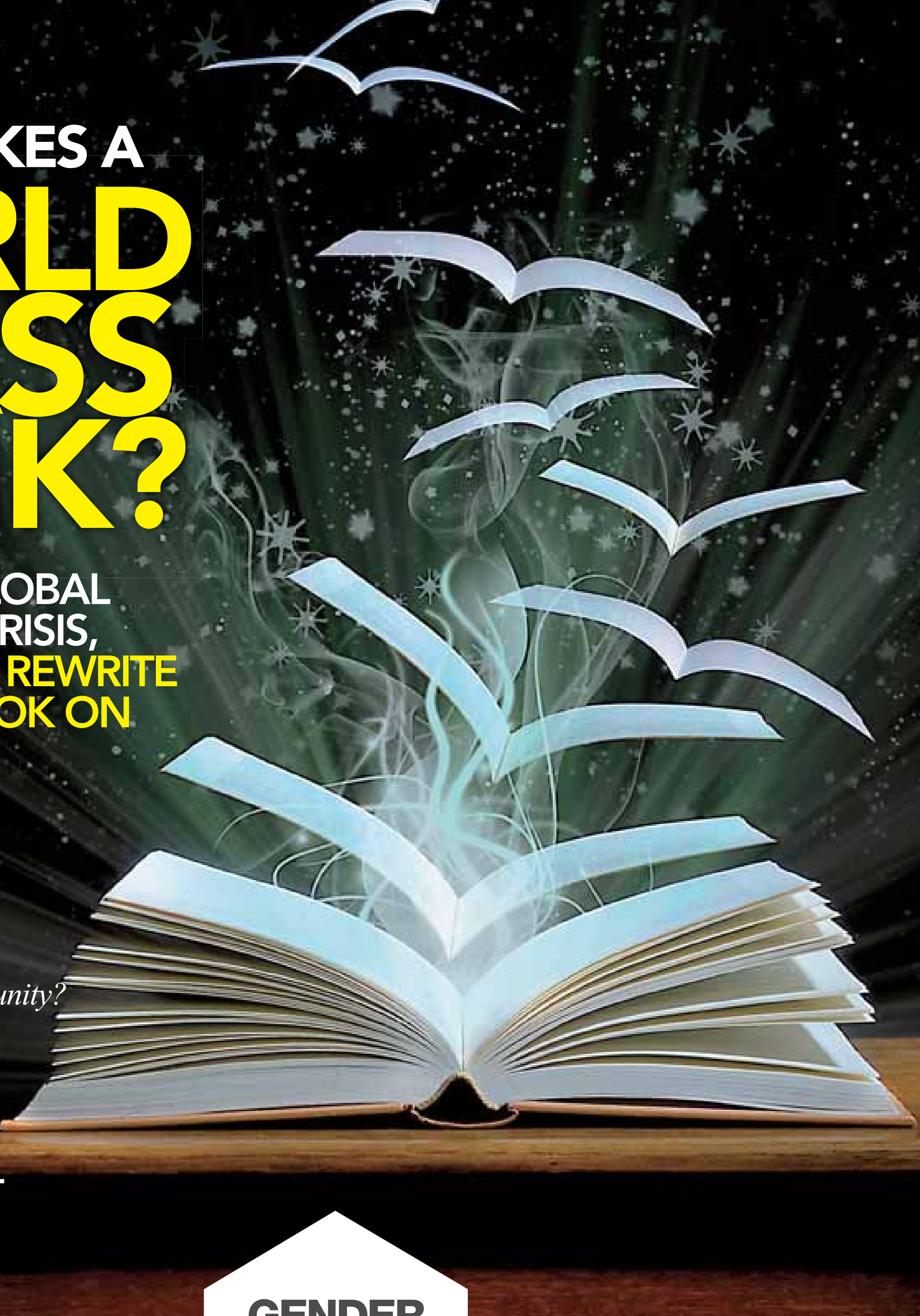

WHAT MAKES A WORLD CLASS BANK?

* POST THE GLOBAL FINANCIAL CRISIS, IT IS TIME TO REWRITE THE RULEBOOK ON BANKING

GREEN TECHNOLOGY FINANCING
The Next Big Opportunity?

RAMPING UP RISK MANAGEMENT

GENDER DIVERSITY AND CORPORATE LEADERSHIP

* BECOMING WORLD CLASS: 'CONCIERGE' BANKING

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Editor's Note

WHAT MAKES A WORLD-CLASS BANK?

THIS ISSUE, WE ADDRESS A THEME which resonates hauntingly in these perilous days when banking scandals involving venerated names and systemic financial risks threaten the economic wellbeing of the entire globe. How can we restore the reputations and performance of banks to heal and stabilise the global financial system? How can banks become world-class and respected as pillars of the financial system once again?

One lesson that has emerged from these years of crisis is that being world class is not defined by the sheer size of an institution, not by its global reach, and not even by how much profit it delivers at any particular point in time. And it is certainly not defined by what the CEO takes home, or by how well directors are remunerated. It is defined by, among other things, the robustness of the institution to external shocks, by the quality of its governance, and how well the interests of all stakeholders are taken into account. Read about all the numerous factors that constitute a world-class bank in our cover story on 'What Makes a World-Class Bank'.

No discussion on world-class banking would be complete without a discourse on optimising risk management. In our special coverage of the recent high-level Risk Management Conference 2012 organised by IBBM, we found consensus that world-class banks must learn from history to craft new and reenergised banking models. Risk management must also revamp their risk architecture to embed risk management in organisational culture, not operate in silo and enlist everybody as a risk manager.

We also consider several other dimensions of banking operations that contribute to banks becoming world class. In the Thought Leadership section, Lynn McLeod, Head of Professional Learning at the Chartered Banker Institute writes that developing talent is key to help enhance performance and integrity in banking and finance. Governance too is critical to top-performing banks to manage risks. In 'A Corporate Governance Agenda', ACCA's Executive Director – Brand, Neil Stevenson assesses existing regulatory frameworks and concludes that banks play a key role in enforcing global standards on lending and credit to manage the risks of the current financial environment.

World-class banks also incorporate the latest in management and technical thinking to move forward. We cover some of these pertinent topics, tackling gender diversity, the grooming of retail branch managers and the use of analytics and predictive tools to enhance performance. David Hovenden and Rafael Calderon of Booz & Company in Southeast Asia argue in 'Retail Banking's Secret Weapon' that banks need to develop and nurture talented branch managers to effectively compete in the retail banking arena. Meanwhile, an especially critical subject is customer-centricity, argues Professor Moorad Choudhry of Brunel University. World-class banks will eventually be concierge banks where each customer is treated like he, she or it is the only customer the bank possesses.

Last but not least, we also look at future trends and developments that are likely to gain importance in the years ahead. World-class practices in green technology finance are a high-potential area for banks, given the prominent attention being devoted to such technology. Also of growing importance is the rise of non-bank institutions as well as the expanding role that BRICs and MISTs are envisaged to play in the global economy. In fact, leading banking consultant Matthias Abold dares to voice a bold question: 'Do We Need Banks?' Might banks be replaced by shadow bankers or organisations offering pseudo-banking services? This is food for thought indeed that will shake up bankers' comfort zones.

Although this issue may seem somewhat disparate in coverage, the unifying thread is that banks must pay urgent attention to all these issues if they want to become world-class and survive and thrive in these challenging times. ✱

THE EDITOR

Hope you have a fruitful read.

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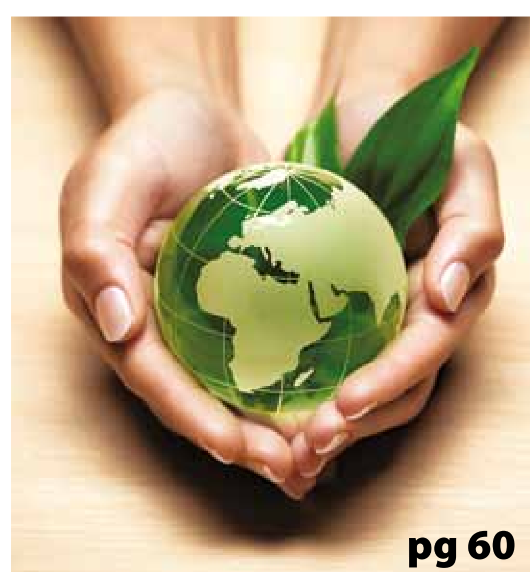

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Growth

MiFID II refers to the Market in Financial Instruments Directive, which is considered one of the most impactful reforms for European financial markets in decades.

Moving on MiFID II

JUST OVER HALF OF FIRMS within all financial services industry sectors are considering MiFID II within the context of wider regulatory change, noted a PwC European-wide survey and report entitled, 'Are You Taking Control of the MiFID II Agenda?'.

MiFID II refers to the Market in Financial Instruments Directive, which is considered one of the most impactful reforms for European financial markets in decades. MiFID II is a key part of Europe's response to the G20 post-crisis reform agenda and will fundamentally transform the way securities are traded, rendering obsolete current business models and creating new opportunities for the prepared.

Despite MiFID II deadlines being pushed back, it remains a key component of the changing regulatory landscape. PwC said that financial services firms are right to act sooner in order to set their future strategy and develop related systems and processes to prepare their business for MiFID II. Acting now on MiFID II in the context of wider regulatory reform will help prevent firms from reacting too late to the market changes that will arise, losing profitability and surrendering market share to competitors, concluded PwC. ✱

Making Microfinance More Effective in Asia

A GREATER FOCUS ON THE POOR is the key to effective microfinance in Asia and the Pacific.

Microfinance needs to reach more of the poor in Asia and the Pacific, but do so in a financially sustainable way, said a new study from Independent Evaluation at the Asian Development Bank (ADB) entitled 'Microfinance Development Strategy 2000: Sector Performance and Client Welfare'.

About 2.7 billion people worldwide, or 70% of the adult population in the world's developing countries, have no access to formal financial services, such as savings or checking accounts. They represent a key and still largely untapped market segment for financial inclusion.

The study said the penetration of microfinance among the poor in Asia and the Pacific remains low. As of end 2010, some 20% of the population living below the poverty level of USD1.25 per day had direct access to microfinance services in 21 developing countries receiving ADB microfinance support, below ADB's targets.

For microfinance to have a greater impact on reducing poverty in the region, it needs to better target the poor and focus more on educating them in using basic financial services, as well as more effectively link microfinance services to complementary pro-poor interventions, said the study.

According to the study, improvements in the policy environment and integrating microfinance in the formal financial sector do not automatically improve outreach to the poor.

However, certain areas showed promise. Combining access to financial services with livelihood programmes, food aid, skills training and asset transfers help people in extreme poverty to gradually move into sustainable livelihoods and become creditworthy for commercial microfinance.

Government-to-person payments also have the potential to become an effective means for financial inclusion, primarily through social transfers and wage and pension payments. These have already been implemented in Bangladesh, Cambodia, India, Indonesia, Pakistan and the Philippines.

Technology-based solutions such as mobile phone and internet banking, payment cards, and electronic money can help microfinance institutions reduce operating costs and expand the reach of their services. ✱

DEVELOPING ASIA FACES NEW ERA OF MODERATE GROWTH

THE ASIAN DEVELOPMENT BANK (ADB) is significantly scaling back 2012 and 2013 growth forecasts for developing Asia, saying that after years of rapid growth, the region must brace for a prolonged period of moderate expansion amidst an ongoing slump in global demand.

"Developing Asia must adapt to a moderate growth environment, and countries will need to do more to reduce their reliance on exports, rebalance their sources of growth, and increase their productivity and efficiency," said Changyong Rhee, ADB's Chief Economist. "These measures are critical if the region is to continue lifting its people out of poverty."

In its 'Asian Development Outlook 2012 Update', ADB projects the region's gross domestic product (GDP) growth dropping to 6.1% in 2012, and 6.7% in 2013, down significantly from 7.2% in 2011. The deceleration of the region's two giants – the People's Republic of China and India – in tandem with the global slowdown, is tempering earlier optimism. The ongoing sovereign debt crisis in the euro area and looming fiscal cliff in the US could have disastrous spillovers to the rest of the world, particularly developing Asia.

The projected slowdown is likely to ease price pressures, however, with inflation falling from 5.9% in 2011 to 4.2% for both 2012 and 2013, assuming there are no spikes in international food and fuel prices.

Closer to home, growth in Southeast Asia is expected to quicken to just over 5% in 2012, mainly due to Thailand's recovery from severe flooding in 2011. Higher levels of government spending have contributed to growth in Malaysia and the Philippines, while investment and private consumption in the sub-region are generally buoyant with inflationary pressures abating.

If an extreme shock were to materialise, most economies in the region have room to use fiscal and monetary tools to respond. However, there is currently no region-wide need to pursue aggressive demand management. Rather, efforts should focus on the medium-term issue of continued soft external demand.

Developing a vibrant service sector in the region can supplement growth, said ADB. ✱

Agent Banking

BANK NEGARA MALAYSIA has introduced the framework for agent banking towards achieving a more inclusive financial sector.

A recommendation in the Financial Sector Blueprint, this initiative allows financial institutions to reach out to the underserved segments of the population particularly in rural areas in a more cost-efficient manner through the use of non-bank retail outlets.

Authorised banking agents will provide basic banking services of accepting deposits and facilitating withdrawals. Other basic banking services that can be provided by the agents are fund transfers, bill payments and financing repayments. All transactions are conducted on a real-time basis to protect the interest of the public.

As at end July, during the pilot run of agent banking, more than one million transactions worth more than RM190 million had been conducted through 2,322 agents of three participating financial institutions.

To ensure that agent banking is conducted in a safe and reliable manner, Bank Negara Malaysia has issued the Guidelines on Agent Banking to financial institutions. The Guidelines outline the requirements to be observed by financial institutions in the areas of governance and oversight, management of agents, customer protection, awareness and education.

All authorised banking agents will display a national agent banking logo together with the logo of the financial institutions which will facilitate the public to identify the authorised agents and the availability of the basic banking services. ✱

TIME FOR A BANKERS' CODE?

TO RESTORE BATTERED CONFIDENCE and trust in the banking industry, KPMG's UK Head of Financial Services, Bill Michael has called for a Bankers' Code to be introduced. Ideally, the Code should be promulgated by bankers, overseen by an independent body and endorsed by regulators.

Michael outlined three core principles which should be enshrined in the Code:

- First, act in the best interests of the customer;
- Second, put reputation before profits; and
- Third, live by the principle of prudence. ✱

Cover story

WHAT MAKES A World-Class Bank?

Post the Global Financial Crisis (GFC) of 2008, what does it mean to be a world-class bank now? What yardsticks can we use? Size and global presence are not a failsafe gauge, as evidenced by the collapse of Lehman Brothers and the scandals surrounding the triumvirate of British banks – HSBC, Standard Chartered and Barclays. Meanwhile, regulators are putting in place a raft of regulations – such as Basel III – that will strengthen banks' resources and optimise risk management, among other measures. Despite the drive to expand, international reach may not always be a hallmark of excellence either, and could even be a source of risk, given the risk of contagion in our borderless world. Last but definitely not least, reputation and high ethical standards will be key benchmarks against which we measure world-class banks.

There is no one definition for what constitutes a world-class bank, and the term is relative and changeable. Asset growth, profitability, geographic reach, strategic relationships, new business development and product innovation were all key factors when *Global Finance* magazine drummed up the 2012 list of the world's best banks.

But the winners are not the biggest banks, as the ratings also take into account aspects such as effective risk management systems, service, and the opinions of equity and credit-rating analysts and other financial executives.

As public and regulatory expectations become even more demanding, violations of ethical codes cannot be discounted and weigh down heavily on perceptions of world-class behaviour. The accusations of manipulating London's interbank offering rate (Libor), and fines issued to banks accused of money laundering, tax evasion and misleading investors, are negative factors that cannot be ignored when classifying a bank as world class – or not.

Factors

Asset growth, profitability, geographic reach, strategic relationships, new business development and product innovation were all key factors when *Global Finance* magazine drummed up the 2012 list of the world's best banks.

Does Size Matter?

"Too big to fail" is a myth that was shattered by Lehman Brothers' collapse four years ago, among other banking failures. If size, and the vastly diversified financial activities that comes with it, will not protect a bank from failure, then what does it take to be a world-class bank?

It is not that size does not get you a long way there. With USD2.3 trillion in assets, J.P. Morgan is one of the tenth biggest banks in the world, according to the annual survey by international business publication *Global Finance.* Earlier this year the bank reported a USD2bn trading loss, and Chief Executive Officer (CEO) Jamie Dimon said this could grow by half this amount again i.e. USD1bn before improvement was seen. This does not actually pose a threat to the bank's overall financial stability, but has led to ponderings whether the bank is just too big to manage efficiently. J.P. Morgan had attempted to hedge its credit exposure, but, the CEO told *Reuters:* "In hindsight the new strategy was flawed, complex, poorly reviewed, poorly executed, and poorly monitored." US lawmakers are using the example of J.P. Morgan to argue for smaller banks, having proposed a 10% cap on any bank's share of the total amount of insured deposits.

"In hindsight the new strategy was flawed, complex, poorly reviewed, poorly executed, and poorly monitored." US lawmakers are using the example of J.P. Morgan to argue for smaller banks, having proposed a 10% cap on any bank's share of the total amount of insured deposits.

Changing cross-border patterns

Just as we are seeing a paradigm shift in economic heft away from developed nations to emerging economies, likewise might the weakness of Eurozone banks open up opportunities for banks from other sovereign nations to dominate global banking markets?

While the financial crisis has pushed banks like Banco Santander to focus away from its European core, other Eurozone banks have responded with pulling back from the Asian and US markets. "The reduced presence of euro-area banks is hardly surprising as the entire European banking market is under substantial pressure to deleverage and refocus on domestic markets." said Jan Schildbach, analyst at Deutsche Bank Research. "With US dollar funding conditions remaining tight for most European financial institutions, a further pull-back seems highly likely in the near future." US assets held by euro-area banks peaked at more than USD1.5 trillion in September 2007, but has since fallen to USD973bn.

This withdrawal of European banks from the Asian and American markets is creating opportunities for others. The US market has seen fresh initiatives from Canadian and Japanese banks, as well as successful inroads made by institutions from Brazil, India and China. "Even though their market shares are still very limited, the pace at which they have been catching up is remarkable," said Schildbach, adding that we may expect to see domestic US banks gain business at the expense of troubled European competitors in the next few years, either organically or via US portfolio acquisitions.

Building World-Class Banks Through Regulation

Post the global financial crisis of 2008, banks have been increasingly pressured by regulation, and held to increasingly stringent regulatory standards.

Coupled with the sovereign debt crises in Europe, and the ongoing weak interest rates following the downturn, costly new regulation is not popular among bankers right now. Still, looking at what happened with Lehman Brothers it is hard to argue against the need for change driven by regulation – perhaps extending even to guidelines on size and diversification.

"The bottom line is that [the banks] have to get smaller so they can manage better," Roy Smith, Finance Professor at New York University's Stern School of Business, told *Reuters* ahead of November's update from the Financial Stability Board on how much capital big banks should be required to hold. "They have to give up the idea of being a universal bank holding company that jams together businesses that have nothing to do with each other."

In the Eurozone and the US which were worst-affected by the global financial crisis, the EU and US governments continue to work on diverse regulatory efforts to safeguard their economies, as well as the financial institutions themselves, from future meltdowns. Still, the process is prone to delays: EU lawmakers have put off the 1 January 2013 deadline for implementing the latest 'Basel III' regulations for banks, which would more than triple the core capital that banks must hold as a buffer against insolvency. "What we are seeing here is an open recognition by the EU that there is a combination of forces at work making it unrealistic to expect full compliance with the Basel rules on the original timescale," Richard Reid, Research Director for the International Centre for Financial Regulation in London, told *Bloomberg.* "Some jurisdictions have already made it clear that this is no longer feasible, or perhaps even desirable."

Earlier this year, European Commission President José Manuel Barroso introduced the idea of an EU banking

union. This would provide significant new powers for the european Central Bank, including the authority to shut down Eurozone banks by withdrawing their banking licence, and creating a common EU bank resolution scheme. Bernhard Speyer, Head of Banking at Deutsche Bank Research, has called for caution against rushing the matter in his study on the banking union: "The path towards a banking union will be one that is saddled with substantial economic, legal, institutional and political issues. Hence, while there is undoubtedly some urgency to break the negative feedback cycle between sovereign and banking sector problems, banking union, which after all is designed to create a stable, trust-inspiring framework for Europe's financial markets, cannot be rushed."

The Dodd-Frank financial sector reform bill from 2010 plays a similar role in the US: providing regulators the tools to seize a collapsing bank and break it up in a controlled manner, and to make the financial markets more transparent in the hopes of better predicting an emerging crisis. The eight largest US banks stand to lose USD22-34bn in annual revenue as a result of Dodd-Frank, according to *Standard & Poor's* (S&P), and the American Bankers Association spent USD4.6 million to lobby on topics including Dodd-Frank in just the first half of 2012. But the necessity of some form of regulation is generally acknowledged, even though Wall Street wants to see changes to rules governing the swaps market, loosening of restrictions on bank investment in private equity and hedge funds, and a rebuttal of the rules preventing banks from trading with money from their own accounts, to name some.

World-class banks uphold their ethics and reputations

While regulation is being put into place to control the profit-seeking behaviour that played a significant part in creating the financial crisis, recent events have however demonstrated how leading banks can still do damage to their reputations in new and unexpected ways. HSBC faces a bill of at least USD700 million from the US Department of Justice in connection with money-laundering accusations, a matter separate from the bank's involvement in the Libor scandal. HSBC has been suspected of handling cash for Saudi Arabian banks with ties to terrorists; it has since strengthened controls to prevent money-laundering and sacked implicated staff. Standard Chartered stands accused of funding terrorism, according to the New York Department of Financial Services; the bank allegedly hid 60,000 transactions from regulators, involving at least USD250bn. Furthermore, reads the accusation document from the US regulator, the bank's activities "left the US financial system vulnerable to terrorists, weapons dealers, drug kingpins and corrupt regimes".

Barclays did more damage to its reputation following its entanglement in the United Kingdom (UK) Libor-fixing scandal than BP did after the 2010 oil rig blowout that killed 11 people, according to a recent poll by *YouGov.* The survey found that 70% of the British public thought banks were driven by greed, while half of respondents said British banks had lower ethical standards than other major UK businesses.

Demonstrating again that ethics trumps size, the small Co-Operative Bank emerged as the people's choice on the *YouGov* survey. The Co-Operative Bank, which has reported a surge in new customer accounts since the financial crisis, has a strict ethical investment policy which means it has turned away over £1bn in loans business since 1992. The group just bought 632 bank branches from Lloyds Banking Group, meaning it now has 7% of the UK banking market. Ed Mayo, Secretary-General of umbrella organisation Co-operatives UK, told the *Guardian:* "We have had a drip, drip, drip of scandals, characterised by a herd mentality. That is why there is such an interest in a co-operative, mutual model…[Mutuals] work to different incentives. If you are owned by your customers, you are not going to fleece them in the same way."

The UK's Co-Operative Bank may be a little on the small side to qualify as a world-class bank, but looking at *Global Finance's* list of the world's safest banks, smaller may well be better. You will find few multinational giants here: KfW in Germany, Bank Nederlandse Gemeenten in Holland, Zürcher Kantonalbank in Switzerland, Landwirtschaftliche Rentenbank in Germany, Caisse des Dépôts et Consignations in France are the top five.

Credit quality is also a benchmark for resilience. Several banks in the top positions are publicly owned, including KfW with €516.5bn in assets. The bank has a public-sector mandate, and the government guarantees all bank obligations, including loans extended, debt securities issued, fixed forward transactions or options, and other third-party lending activities. "Counterparty creditworthiness has seldom been of more concern to companies and investors worldwide," said *Global Finance* publisher Joseph Giarraputo. "Knowing how their counterparties are faring in the face of global economic uncertainty is key."

Alternative Measures of Excellence

Others will however come up with different definitions of what constitutes a great bank. A compilation by *Bloomberg Markets* saw the Oversea-Chinese Banking Corporation in Singapore take top position as the strongest bank, ahead of the National Bank of Canada and Sweden's Svenska Handelsbanken. The list especially considers Tier 1 capital compared with risk-weighted assets; nonperforming assets compared with total assets; and efficiency, a comparison of costs against revenues. David Conner, CEO of the Oversea-Chinese Banking Corporation, was hired in 2002 with a mandate for the lender to become a world-class bank, which Conner took to mean a focus on the customer, the establishment of a strong capital base, and the minimisation of risks. "The Monetary

Authority of Singapore has always required Singapore banks to keep more Tier 1 capital than other banks," said Conner, who is concerned about the impact of the newest Basel capital requirements: "Keeping the capital ratio high all the time makes it potentially difficult to expand…[But] this bank can meet all the Basel III requirements today, given our capital base, so we are ready."

Last word: the hunt for a sustainable banking model

It cannot be denied that banking today is in a state of flux as global banks work to stabilise themselves in the aftermath of the financial crisis. Much has also been written in the public domain on the need for a sustainable banking model that is driven less by seeking short-term reward and more by the quest for creating and adding long-term value.

The need for a new model is especially vital given that the return on equity for banks in the US and Europe have yet to recover to the point where it covers their cost of equity, according to a recent report from *McKinsey*, 'The State of Global Banking'. Without radical action to shrink balance sheets, cut costs, and increase revenues, banks will be unable to attract sufficient new capital from the investment community and to play their critical role in underpinning economic recovery and growth, the report concluded.

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"Increasing regulation is the single largest driver of post-crisis bank profitability in the US and Europe, and could have a significant impact on profitability in other markets too," said Stefano Visalli, *McKinsey* Director and report author. "A squeeze on capital and funding is driven by burgeoning investment and credit demand in the developing world. The sovereign credit crises could exacerbate this challenge in Europe by fragmenting Eurozone capital markets, thus increasing funding costs, particularly for banks from weaker countries. The funding squeeze could lead to consolidation among smaller banks, and pressure on deposit margins."

In the search for sustainable growth, another key area for banks to address is the gap between stagnant and growing markets. Asian banks especially are likely to achieve annual revenue growth of around 10% over the next decade, which is double the expected rate of developed markets.

"Finally," concluded Visalli, "banks will have to contend with shifts in consumer behaviour; none more significant than the rise of the digital consumer, accelerated by the mobile and tablet revolution. We expect branch density to fall, and average branch sizes to shrink. Banks will have to deliver superior customer experience to a generation with much greater choice."

Can the bank that delivers on all or most of these aspects be considered truly world class? ✱

■ Reporting by the *Banking Insight* Editorial Team.

WHAT DOES IT MEAN TO BE WORLD CLASS

Osman Morad, Managing Director & CEO of Standard Chartered Bank Malaysia Berhad, tells *Banking Insight* what it means to be world class.

AT THE OUTSET, we should answer the question can a local or regional bank be world class? Yes.

The top 25 banks in the world, based on market capitalisation or assets consist of several Asian Banks, especially from China and Japan. While there is not currently a Singaporean, Hong Kong, Indonesian, South Korean or Malaysian bank in the global top 50, this will not be the case 10 years from now.

But let us be clear what we mean by world class. Certainly we would agree that the days when physical size alone (as measured by a company's asset base, revenue, number of employees, etc.) was necessarily good are over. Events of the recent past and the impact on the global international banks are proof of this.

Nevertheless, traditional 'bigness' – that is, asset value, is important. When developed and managed properly, economies of scale can be extracted. To be a world-class financial institution, there are four things that count which are specialisation (differentiation), customer-centricity, strong liquidity and capital base, and brand value.

Specialisation is how you differentiate. It is the ability to deliver activities that add value better than anyone else. A bank can build a business on a much narrower speciality like focus on a particular segment, e.g. SME, emerging affluent or countries, e.g. markets in Asia. At Standard Chartered, our focus is on markets we know intimately and have been in a long time, in Asia, Africa and the Middle East. In remaining focussed on these regions which we have called home for more than 150 years, we are now among the top 25 largest banks worldwide and our growth prospects remain intact despite the increasing uncertainty in the West.

In the service sector, fulfilling customers' needs are paramount. Understanding and having long-term deep relationships with customers prove more productive. Long-term relationships allow the ability to better price for risk. It allows matching products to client needs, better service and ultimately superior returns and risk management. It is this (customer-centricity) that will form the foundation of the emerging model of banking.

Standard Chartered Bank's strategy is anchored on being customer-focused which is imperative to building our leadership. We have strengthened the different customer segments – for instance SME, Priority Banking - propositions and invested to improve our infrastructure, people and solutions to meet the changing needs of customers. For our wholesale business, we continue to deepen client relationships, making us their core bank and leveraging our massive network for cross-border transactions and global trade flows.

In the development of economies by re-cycling savings and facilitating business expansion, capital counts even more today, to enable better participation and organisational growth.

And finally the bank is represented by service excellence, superior people, deeper relationships and organisational strength which is a key differentiator. Building customer experience and meeting expectations are important. Financial solutions and services commoditise quickly; a brand that resonates with market expectations and aspirations ultimately does differentiate.

To be a world-class bank, what really matters is what a bank can do for the sustainability of economies and communities. At Standard Chartered, this is our mantra – being here for our customers and clients' long-term progress and being a force for good, contributing to the communities and societies in which we operate.

World-class banks: Case study

Considering the economic weakness in its Spanish home market, Banco Santander's strong performance over the past years is a testament to its quality. A significant factor to Santander being a world-class bank is its broad diversification, both in terms of banking operations and geographical footprint. This is backed up by the fact that the bank is well run by the management team.

Solid performance against gloomy backdrop

Spain's economy continues to feel the pressure following the financial downturn and the Eurozone struggles. Consequently Santander, as well as Banco Bilbao Vizcaya Argentaria (BBVA) and two others, were downgraded by *Standard & Poor's* (S&P) in October. Santander's long-term credit rating was lowered two levels to BBB, with a negative outlook, as S&P now classes Spain's credit rating at one level above junk status. This is because the government is believed to be considering a bailout which will affect the yields.

Santander, however only has a quarter of its assets in Spain, which represents a modest 12% of the bank's attributable profits. Today Santander generates over half its profits from Latin America, and its strong performance in that market has offset weakness in its operations in the Eurozone during its most recent reporting period. In Europe, its presence in non-Eurozone countries such as the UK and Poland has also aided performance, and the bank continues to make strategic acquisitions in its ten core markets.

Santander also achieved core capital requirements of 9% for 2012, as established by the European Banking Authority, six months ahead of schedule. The management's stated plan is to exceed the ratio by nearly a percentage point.

Santander is currently present in ten major markets: Brazil, Spain, UK, Mexico, Portugal, Germany, Chile, Argentina, Poland, and the US. The management team, led by Chairman Emilio Botín and Chief Executive Officer (CEO) Alfredo Sáenz, has spent several years directing the bank's operations towards the more profitable emerging markets. At last year's investor day, the management team stated how the bank's strategic focus would be moving towards 'balance sheet strength and stability' in reaction to the greater challenges emerging in the economy:

"Santander has given priority to balance sheet strengthening over short-term results, placing emphasis on capital, liquidity and provisions for real estate assets in Spain," said Sáenz as the bank reported results for 2011. Santander generated attributable profits of €7,021 million, 14.2% less than the year before, and profits were 34.6% down, to €5,351 million. "I would like to point out," said Sáenz, "the good performance of operating profit, which amounted to €24,373 million. Net interest income was up 5.5%; net fee income rose 7.6% and net operating income before provisions was 2.2% higher. Very few international banks have been able to generate growth in revenue and in net operating income. This reflects the good commercial performance of our businesses, and underlines our strong potential to generate future results."

International focus

Retail banking lies at the core of Santander's operations, representing 86% of revenues and 80% of profits. With 15,000 offices, Santander is the largest international banking network, and the leading Eurozone bank in terms of market capitalisation at €50bn. Founded in 1857, Santander oversees €1.4bn in managed funds, serves 102 million clients, and has 3.3 million shareholders, the most in the international sector.

Looking at the geographical breakdown, Santander carries out retail banking business in markets such as Spain, Portugal, Germany and Poland, and consumer finance in 13 countries. With 1,379 branches and 27 million customers, Santander is the third largest bank in the United Kingdom (UK) by retail deposits and mortgages. Latin America contributed 51% of the bank's profits in 2011, a percentage expected to grow. The bank holds leading market positions in Brazil, Mexico, Chile and Argentina, where it serves a total of 42 million customers.

Network

Retail banking lies at the core of Santander's operations, representing 86% of revenues and 80% of profits. With 15,000 offices, Santander is the largest international banking network, and the leading Eurozone bank in terms of market capitalisation at €50bn.

Santander Brazil is the country's third largest private sector bank in terms of assets, with 25.3 million customers. Last year, technology integration and brand unification was completed with Banco Real in Brazil. Santander merged its existing business with Banco Real in 2007 after the latter's purchase from ABN Amro, and Brazil has been a star performer for the group over the past few years.

Santander Mexico is the third largest bank in the country with more than 9 million customers.

Meanwhile Santander Chile is the country's main bank in terms of assets and profits. It has a market share of 19.7% in loans and 17.3% in savings.

In Argentina, Santander Río is the country's largest private sector bank in terms of assets and profits, tending to 2.5 million individual customers and more than 125,000 SME and company clients.

Beyond its retail banking focus, Santander provides a series of additional services. One of these is Insurance Santander, which serves 15 million clients; Santander Cards provides credit and debit cards as well as collection services and payment processing for merchants in 16 countries. Santander Asset Management provides savings and investment products to a global customer base, including mutual and pension funds, investment companies, discretionary portfolios, property investment portfolios and venture capitalists. Santander Global Banking & Markets provides banking services to large corporations, public entities and other clients whose size and complexity means they need customised services. Domestic private banking services can be found in Spain, Latin America, the UK, Italy and Portugal.

Looking at the geographical breakdown, SANTANDER CARRIES OUT RETAIL BANKING BUSINESS IN MARKETS SUCH AS SPAIN, PORTUGAL, GERMANY AND POLAND, AND CONSUMER FINANCE IN 13 COUNTRIES.

A six-pronged strategy

Key values lie at the core of Santander's operations. First is its focus on retail banking, where the aim is to foster valued customer relationships through an extensive branch network plus services via phone, web and mobile. 'Prudence in risk' remains a central value for the bank, which maintains its control functions separately from the rest of the business. This is part of the reason its default rate is lower than the sector average in several major geographical areas.

Santander's emphasis on efficiency is praised as a contributing factor. The bank has a cost-to-income ratio of 44.9%, a solid number which beats its international peers. This is achieved through recurring revenue growth and a culture of cost controls, supported by a global technological platform of operations and a commitment to ongoing improvements to all processes.

Santander emphasises capital discipline and financial strength and it prides itself on staying ahead of regulatory requirements on core capital ratios.

A split between developed and emerging economies ensures geographic diversification, while a subsidiary model offers the advantage of providing legally independent offshoot businesses with financing. The subsidiary system also reduces systemic risk in times of crisis by limiting the possibility of contagion. A central corporate function, coupled with flexibility in local markets, has helped Santander remain cohesive yet adaptable while continuing to expand. Local teams have the authority to make decisions on price, product and other issues according to their markets, while everyone looks to the central corporate core to deal with matters such as human resources, risk management and purchasing.

A global IT platform means all units can share information and knowledge, enabling efficient cross-selling through a vast distribution network and data centre.

Lastly, the bank's aim is for the Santander brand to convey its values and promote the business, to shareholders, customers, and the general public through advertising and corporate sponsorships.

Ongoing acquisitions are a feature of Santander's belief in the benefits of scale. In February Santander merged its Polish unit, Bank Zachodni WBK, with Kredyt Bank, a subsidiary of KBC. Santander will own about 76% of the combined bank, which will be the third-largest player in the Polish market with a 10% share following the merger. However, Santander has disposed of interests when required to do so to raise additional capital. In order to meet the European Banking Association's requirements for core capital, Santander sold 7.8% of its stake in Banco Santander Chile to raise USD950 million, boosting group core capital by 11 basis points. Additionally, Santander Colombia was sold for USD1.23bn, generating a capital gain of €615 million. Santander also raised €1.94bn in capital by exchanging preferred shares for new ordinary shares.

Santander's national expansion strategy stems back to 1986, first organically and then inorganically via the acquisition of Banesto and Central Hispano. The push into Latin America started in the mid-1990s, when Santander acquired over 10 banks in seven countries. Several large acquisitions have taken place in the UK, US and Latin America since 2004. In a report on cross-border banking, Accenture highlighted Santander for its record of improving profitability within the first year after an acquisition, as well as reaching a greater level of profitability in the vast majority of years following the deal.

A sustainability mandate

Santander's goal is for its business activity to contribute to the economic progress of the communities in which it operates, taking into account also how it affects the environment. In 2011, Santander invested €170 million in corporate social responsibility projects. This was a 15% increase on the year before, partially due to the bank increasing its contribution to higher education.

Three elements lie at the heart of Santander's sustainability focus. One is stable and lasting relations with its stakeholders. Another is its focus on higher education as the bank has pledged to support schooling to promote social and economic development via knowledge, innovation and entrepreneurship. Santander also emphasises its relationship with local communities, with a focus on environmental preservation through locally adapted corporate and social programmes.

Santander is committed to developing socially responsible investment products. Currently it has a range of products which meets financial, social and environmental criteria and up to recommended practices of corporate governance and transparency. One such product is 'Santander Solidario Dividendo Europa', a fund focusing on investments in companies committed to human, labour and social rights and respect for the environment. 21% of its management fee is passed on to one of 19 NGOs, as chosen by the investor.

Over 250,000 entrepreneurs in Argentina, Brazil, Chile and El Salvador have benefited from microcredit from Santander, which aims to help low income families undertake sustainable business activities. In Brazil, the volume of loan reached €77 million last year. Loans are mainly extended to informal micro companies which would otherwise be unable to get loans. The majority of these loans go to businesswomen, who, working in groups, receive €300-500 without the need for additional guarantees. Similarly, in El Salvador, Santander's €9 million microcredit programme is 85% extended to women who run their own businesses and support their families.

Environmental protection, as well as the fight against climate change, is amongst Santander's sustainability goals. The bank aims to measure its environmental footprint and follow an energy efficiency plan to reduce the impact of consumption and emissions from its own installations, while maintaining an element of social and environmental risk analysis in loans.

Santander also aims to develop and promote environmentally protective financial solutions, including the support and funding of renewable energy. Santander holds a leading position in this field, having financed the development of wind farms, solar power operations and hydraulic plants in Europe, the US and Latin America. ✱

■ Reporting by the *Banking Insight* Editorial Team.

WHAT REALLY MATTERS

Customer centricity through service and delivery, not size or a physical footprint, is what differentiates banks in today's environment.

BANKS DO NOT NEED to be large in size or have a global presence and expanded networks in order to be considered world-class, said Brett King, bestselling author, founder of the new 'dedicated mobile cardless bank' Movenbank and strategic advisor to many of the world's leading financial services organisations.

According to King, smaller banks who serve their customers well can do so in a targeted, competent manner that shows world-class skills. Some examples are UBank in Australia, Simple (simple.com), Knab.nl, Fidor.de, Movenbank and others.

"These banks or financial institutions are redefining best-in-class and best practice, especially from a user experience perspective," he said.

As for the locally-based medium-sized or small-sized banks, King said that these banks compete not on price, place or product but in service and delivery. "The only differentiation that counts in today's environment is service and delivery. The best delivery is banking when and where customers need it," he said.

King pointed out that branches are no longer a differentiation, adding that customer activity in-branch has plummeted 85% in the developed world in the last 20 years (measured according to average visits per customer per year). "So, you may actually have a distinct advantage without branch networks. Most customers choose a bank via online research and advocacy today," he said.

While operating a local service centre does offer the psychology of safety, with the success of brands like Simple, ING, RaboDirect and UBank, branches are no longer necessary to compete. "As there are no boundaries geographically to the web or mobile applications, these banks can compete anywhere their customers are," King added.

However, King noted that banks are not best-placed to cater to markets that are characterised by the need for diversity and financial inclusion for the poor and the small-medium enterprises. "Banks see underbanked and poor as bad investment decisions, which is why in markets like Kenya and the Philippines mobile phone companies are dominating basic banking services around the phone. It is also why in China and the United States, the fastest growing deposit products are prepaid debit cards not offered by the traditional banks," he said.

BRICs AND MISTs

JESSICA FURSETH

WHILE THE BRICs COUNTRIES ARE RISING TO GLOBAL FINANCIAL PROMINENCE, THE MATURATION OF THESE DEVELOPING MARKETS MEANS THE KEENEST PROFITS MAY BE FOUND FROM A NEW GROUP OF GROWTH NATIONS, **THE MISTs**.

China has officially broken into the top ten of the world's biggest banks, according to the annual survey by international business publication Global Finance. The Industrial & Commercial Bank of China now ranks ninth, and the country now has six banks among the world's 50 biggest financial groups by total assets. The growth of emerging markets, led by the BRICs – Brazil, Russia, India, China, and the more recent addition of South Africa – has long been hailed as a key focus area for international banks, but until now, league tables have been dominated by Western finance groups.

But not anymore. The list of the biggest banks in emerging markets shows an even more pronounced Chinese dominance: seven of the top ten banks are now Chinese, and the remaining three are Brazilian. South Korea, India, Taiwan and South Africa are also dominating nations: "As the developed world looks to emerging markets to help provide global economic stability, these banks are leading the way," said Joseph Giarraputo, publisher of Global Finance. "[They] provide not only their strong balance sheets, but also increasingly sophisticated products and services to clients that are the engines of growth, both regionally and globally."

While leading Western banks are making significant inroads into emerging markets, the local players who have been there from the early days have notable advantages. Standard Chartered focused on the Asia-Pacific region long before it sparked global interest, resulting in four decades of steady growth and 75% of profits now derived from Asia. Banco Santander may be the biggest bank by market value in the Eurozone, but growth has been strongly driven by its performance in

The MISTs countries take up three-quarters of the Goldman Sachs N-11 Equity Fund, which has risen by 12% this year and outperformed Goldman Sachs BRICs fund, up only 3.2%.

Mexico Indonesia South Korea Turkey

Latin America, representing 51% of last year's profits, with an intent from management to increase its overseas focus in the years to come.

BRICs: Relative growth

While the days of 20% growth in emerging markets are behind us, rapid-growth markets from Asia still represent the fastest-growing economic region in the world, with annual growth forecast at more than 6% a year, according to Ernst & Young. The International Monetary Fund (IMF) expects advanced economies to grow by just 2% in 2013.

When Jim O'Neill of Goldman Sachs coined the BRICs-term in 2001 it was to highlight the fastest-growing emerging economies. Now 11 years later, creating a stronghold in these up-and-coming markets is still a key challenge, but the competitive climate is getting tougher, both for international and local players.

"Established global players clearly possess considerable competitive advantages, with sophisticated distribution networks, product expertise and risk management capabilities. Today, emerging market rivals will struggle to match this," said Wei Min Chin, Asia-Pacific Capital Market Managing Director at Accenture, in a report on the top challenges for investment banks in 2012.

Non-local banks do however face barriers such as quota restrictions for foreign players, complex registration processes and bans on certain types of operations, not to mention the challenge that is a wide variety of local customs. For example, research by the Korn/Ferry Institute found that clients in China are less concerned with price and more focused on value-added services, such as corporate financing capabilities, assistance with their children's overseas education, property investment and immigration. In Hong Kong, on the other hand, price is key.

Noted Accenture's Chin: "We believe banks should be prepared for operations in emerging markets to take longer and to cost more than expected before they become mature. However high the expectations are for rapid and significant returns, banks need to undertake extensive due diligence supported by robust cost-benefit analysis before investing in significant market entry or expansion programmes."

Enter the MISTs

Growth-hungry investors are now turning their eyes towards a new acronym: the MISTs. Mexico, Indonesia, South Korea and Turkey are all countries with solid growth and favourable demographics, meaning investors are pulling money out of the BRICs to get in on this new growth story. Again the term was coined by Jim O'Neill, who is currently particularly excited about Turkey, which had its credit rating raised by Moody's earlier this year, and Mexico, which is becoming more competitive partly due to labour costs rising in China. The MISTs countries take up three-quarters of the Goldman Sachs N-11 Equity Fund, which has risen by 12% this year and outperformed Goldman Sachs BRICs fund, up only 3.2%.

USD67bn was invested in BRICs stocks between 2001 and 2010, according to research from EPFR Global, a provider of fund flows and asset allocation data to financial institutions around the world. During this period they beat the Standard & Poor's 500 index by 281 percentage points. Investors withdrew about USD15bn last year as those economies cooled, however, as excitement builds around the MISTs and a few other acronyms. Citigroup has launched the term CARBS: Canada, Australia, Russia, Brazil, South Africa; this group collectively produce between 25-50% of the world's commodities. BlackRock presented the CASSH acronym for particularly fiscally strong countries: Canada, Australia, Singapore, Switzerland, Hong Kong.

While the local MISTs financial groups may be facing good growth at home, that does not mean they are not also keen on international expansion: "Given the relatively slower growth rates for banks in Korea, they are now looking to expand outside Korea. For many, it is the Association of Southeast Asian Nations economies such as Indonesia and Vietnam that look like the best options," said Steve Ferguson, Asia-Pacific Sector Leader of Banking Capital Markets at Ernst & Young, in a country report. When it comes to cross-border expansion, emerging markets' banks face the same challenges as Western banks in terms of understanding the nuances of the local markets abroad. However Asian companies are often tightly controlled from the centre, found Ernst & Young: "This raises questions about the effectiveness and agility of their decision-making, particularly in markets that are distant and unfamiliar…Asian companies with a more diverse geographical footprint readily admit that their management teams need a better understanding of global markets and a more international outlook."

When it comes to cross-border expansion, emerging markets' banks face the same challenges as Western banks in terms of understanding the nuances of the local markets abroad.

Big versus small

"The fastest growing emerging markets have seen a surge in companies turning to capital markets financing, a trend we believe will lead to emerging markets' banks emulating the offerings of more established developed market banks," said James Sproule, Global Head of Capital Markets Research at Accenture, in a report on emerging market opportunities for investment banks. Emerging markets financing league tables continue to be dominated by Western banks: last year they underwrote 51% of equity financings and 45% of bond issues. Looking at the deals by number, however, international banks only funded 31% of the equity underwritings and 30% of debt underwritings in emerging markets. This is likely to be due to the deal sizes being too small to be of interest to the largest banks, however the rapid growth rate of these markets means this may not be the case for long.

In the meantime, local players are building customer relationships, partially with microfinance initiatives. Bank Rakyat Indonesia had USD7.4bn in microloans outstanding as of 2011; Bank Tabungan Pensiunan Nasional saw its microloan portfolio doubling in 2010, to USD500 million, representing 20% of its total loan book. The bank's total return on assets in 2010 was 4%, however microloans rewarded the group with a 14% net interest margin. Some Western players are also keen to get a slice of the microfinance pie, as seen when Progression Capital Africa launched its first fund in Nairobi earlier this year with backing from the UK, Germany, Norway and the European Investment Bank. The fund will invest USD40 million in microfinance initiatives in the region, aiming for gains between 10-15%. This is below the 30% usually sought from similar projects by private sector investors, however the fund has a social benefits agenda.

Technological advances

South Korea is currently among key focus areas for Standard Chartered, especially when it comes to lending to projects involving solar power, energy efficiency equipment manufacturing, energy storage and grid infrastructure. China and India remains core focus areas for cleantech investment, with Standard Chartered having led two finance deals worth over USD200 million to support wind power projects in India, as well as having invested USD50 million in the initial public offering of a Chinese wind farm operator. The bank will also get involved in projects beyond the financials, as demonstrated by Standard Chartered's structured finance solutions for farmers on the African continent. By using future crop yield as collateral, farmers can reach optimum production sooner, further aided by input from the bank's experts on crops, water and soil preservation.

Technological innovation in the banking industry itself is also ensuring local banks are getting in on the ground. Safaricom, part-owned by Vodafone, is now expanding internationally after turning mobile money transfers into a mainstream service in Kenya. A recent report from BRICs data found that a large unbanked population will be the fundamental driver for the growth of mobile-based financial services in Brazil, resulting in strategic business alliances being developed between banks and mobile operators.

"Asian companies with a more diverse geographical footprint readily admit that their management teams need a better understanding of global markets and a more international outlook."

BRICs united: A bank of one's own

Over 40% of the world's population belong to BRICs nations, however two-thirds of global growth is generated from these countries. Judging from March's 2012 BRICs summit in New Delhi, these countries are starting to demand more recognition for their financial heft, having accused Western banks of fuelling instability in the region with lax monetary policies. Consequently, the BRICs have requested the World Bank and the IMF to review their quota systems to help safeguard the interests of emerging nations. The BRICs are significant borrowers from the World Bank, having taken USD7bn in loans in 2011 alone, but their role in the Bank's decision-making remains marginal.

"We recognise the importance of the global financial architecture in maintaining the stability and integrity of the global monetary and financial system," the BRICs heads of state said in a joint statement, before going on to express concern over the slow pace of reforms at the IMF. Manmohan Singh, Prime Minister of India, elaborated: "Institutions of global political and economic governance created more than six decades ago have not kept pace with the changing world. While some progress has been made in international financial institutions, there is lack of movement on the political side."

The BRICs are currently working on an idea of setting up its own development bank to rival the role of the World Bank. This is a strongly proactive move from a group which was originally coined as an investment concept, but have gone on to make real-world alliances. There are numerous niches the new BRICs bank could delve into, such as green technologies for energy generation and countering of climate change. Still, critics are quick to point out that the five countries are far from cohesive in their interests: "India sees the BRICs as an economic proposition, while the Chinese see it as more political," said Jagannath Panda of the Institute for Defence Studies and Analyses, a New Delhi think-tank, to the *Financial Times*. "The Chinese are supporting heavily that the bank should be in South Africa, so they will have clout on that continent. India would still like to have the headquarters in India."

A BRICs bank would see the light of day no earlier than 2014, with numerous details needing to be worked out in the meantime. But the very idea signals that emerging economies are no longer just looking to the West to provide a model for finance, and that lending is increasingly happening between the emerging nations without including Western banks. Size-wise, banks in developed nations are still ahead, but there is little doubt as to where the growth is happening and as a result, emerging nations are gaining confidence. And there is every reason for them to do so, according to projections by PwC: the gross domestic product of the leading emerging economies, defined as China, India, Brazil, Russia, Indonesia, Mexico and Turkey, will be around 50% larger in dollar terms than the current G7 already in 2050. ✱

■ Jessica Furseth is a freelance journalist based in London.

DEVELOPMENT OF GLOBAL STANDARDS FOR BUSINESS

A CORPORATE GOVERNANCE AGENDA

As a central and key part of the global finance supply chain which facilitates business, leading global banks must show an interest in whether their clients and debtors are compliant with global standards to reduce lending risks and further their sustainability agenda; but equally banks need to show they are world class. Do we need to re-write the financial rules when it comes to ethics and corporate governance?

NEIL STEVENSON

There is no denying that banks have experienced a tough 2012. Some global reputations have been tarnished, with the likes of UK-headquartered giants such as Barclays, Standard Chartered and HSBC in the news for manipulating the LIBOR rate or facilitating money laundering.

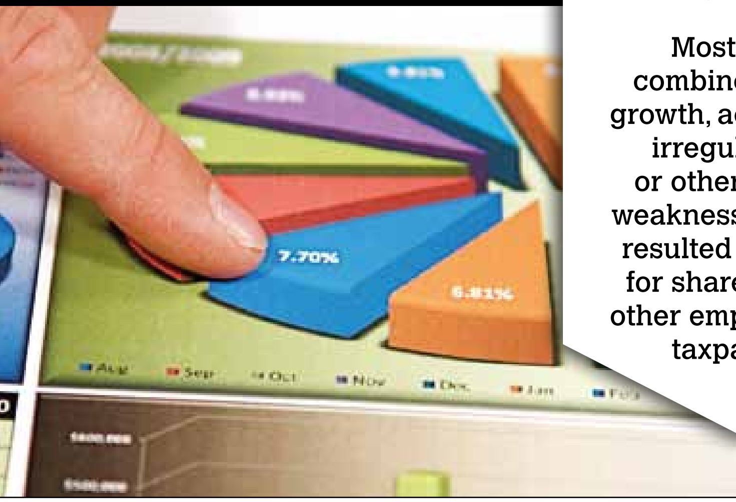
London, long established as the reputable home of global finance, took the brunt of the criticism. Indeed, the US Representative Carolyn Maloney told the House Financial Services Committee's investigation panel into J.P. Morgan Bank's trading losses that every big trading disaster (seems to) happens in London.

Of course, such 'disasters' are not confined to London. There has been a steady stream of corporate failings dating back to the 1980s, from savings and loans in the US, which involved over lending – to the serial collapses in 2007/8 of Northern Rock, Bear Sterns, UBS, Societe Generale, Lehman Brothers, RBS and HBOS – all of which involved quick expansion, coupled with risk management failures resulting in bankruptcy, massive financial losses and government bailouts.

These scandals have led to an unprecedented interest – and concern – about standards of corporate governance and business ethics in the financial sector.

This is perfectly understandable, given the wider economic repercussions of the crisis and the flaws which have come to light in its aftermath. But the corporate sector is not blameless in all this, and just as understandably, the banks are entitled to look to the corporate sector to improve its own standards of conduct and transparency and in the process help to reduce lending risk for the banks.

While some banks have received sustained criticism for their extreme focus on short-term lending practices, the same focus on unsustainable and short-term strategies and models has characterised too many companies in the corporate sector. The two sectors have a mutual interest in raising the level of trust and confidence in each other's motives and behaviours.



Result

Most have combined rapid growth, accounting irregularities or other control weaknesses, which resulted in losses for shareholders, other employees or taxpayers.

Regulation and Standards

Dispersed ownership and an increasingly globalised business environment have joined to raise shareholder and public awareness about how companies are managed and governed. Questions about corporate governance have arisen because business structures seem unsustainable, despite a plethora of rules, regulations and protocols.

The biggest expansion of rules and regulations stemmed from the Enron and WorldCom scandals – these led directly to the imposition of extensive and prescriptive controls on US corporations by the Sarbanes Oxley Act (SOX) in 2002.

SOX aimed to counter financial irregularities by regulating them out of existence. Despite its introduction, other major US firms with governance and accounting related problems, including Tyco, have come to light. Markets are concerned that profits are still being overstated or otherwise misrepresented, leading to a loss of trust in financial reporting and auditing.

While some banks have received sustained criticism for their extreme focus on short-term lending practices, the same focus on unsustainable and short-term strategies and models has characterised too many companies in the corporate sector. The two sectors have a mutual interest in raising the level of trust and confidence in each other's motives and behaviours.

What do these events have in common?

Most have combined rapid growth, accounting irregularities or other control weaknesses, which resulted in losses for shareholders, other employees or taxpayers. Many of these companies, however, ticked the governance boxes and so could claim high levels of literal compliance with regulatory demands and codes of best practice.

In many cases, problems have occurred not because of lack of compliance but because of failures to ensure a rigorous control of corporate risk and to exercise responsibility and self-discipline in the pursuit of short-term commercial objectives. Their models were unsustainable for those reasons.

The financial shocks created by the 2007 scandals have still not dissipated. While some have argued that ineffective accounting and auditing were in many cases responsible – and ACCA accepts that the profession can learn lessons and improve its work – there has been a general sense that the primary areas

where we need to focus, going forward, are people-related – we need to look at the quality of management, the way that businesses identify and apply values which are consistent with the idea of responsible and sustainable business models, the whole issue of business ethics, and how all these elements are embedded in corporates' structures and practices.

Capital markets and corporate governance - Promoting robust economic activity

Emerging capital markets are clearly an increasingly important source of finance for business, and ACCA recently looked into the relationship between the capital markets and economic growth in two reports – 'The Rise of Capital Markets in Emerging and Frontier Economies' and 'Making Capital Markets work in Emerging and Frontier Economies'.

The studies argue that broadening participation in company ownership, especially where the needs of minority shareholders are concerned, requires certain elements. These are clear corporate governance, responsiveness to investors' diverse needs, consideration of independent representation on the company board and transparency of decision-making in the interests of all investors and wider stakeholders. In short, capital markets drive up transparency by widening public ownership of companies.

This is precisely why developing capital markets need transparent corporate governance and ethical business approaches to encourage investor confidence.

An ethical and sustainable future

In 2008, ACCA published a discussion paper called 'Corporate Governance and the Credit Crunch', which considered what the accounting profession could do to enhance understanding of the issue, to learn lessons for the future and examine how sound corporate governance, risk management and accounting can help.

Until recently, one collective voice has been notably absent from the debate about corporate governance: that of investors. Some green shoots emerged earlier this year when investor action was notable in votes on executive remuneration. And ACCA's own research, for example international roundtables held jointly with Grant Thornton, highlight the desire by investors to be part of the debate.

As stated earlier, regulatory boxes may be being ticked, but fundamental principles of good governance are still being breached. The consequences were well foreshadowed by South Africa's Mervyn King, in his well-respected and acclaimed report on corporate governance – the King Report 2002, when he stated that: "Global market forces will sort out those companies that do not have sound corporate governance".

Learning lessons?

Looking back at past corporate scandals, it is clear that not only has corporate governance failed in many cases, but that lessons have not been learned.

As stated earlier, regulatory boxes may be being ticked, but fundamental principles of good governance are still being breached. The consequences were well foreshadowed by South Africa's Mervyn King, in his well-respected and acclaimed report on corporate governance – the King Report 2002, when he stated that: "Global market forces will sort out those companies that do not have sound corporate governance".

When governance structures fail, this impacts on risk management too – when one fails, both fail. The UK case of the whistleblower Paul Moore, Risk Manager at HBOS, is instructive.

A sustainable future with global standards?

ACCA's capital markets reports show that the perceived strength of accounting and auditing standards is a leading

Furthermore, it is important that global requirements do not create a straitjacket, preventing innovation and improvement in how organisations conduct themselves. This is perhaps the area where the biggest challenge lies. People and their conduct equal the sum of an organisation, so management principles may need to be re-written.

indicator of the health of capital markets and a strong predictor of their ability to drive economic growth. But what about global standards for ethics and corporate governance for the corporate world?

While there is currently no global standard for corporate governance or a global oversight body, the Organisation for Economic Co-operation and Development (OECD), seen as a global authority on corporate governance, has published the most authoritative international set of guidelines for corporate governance.

These principles have gained worldwide recognition as an international benchmark for good governance. They cover the protection of shareholder rights; strategic guidance of the company; timely and accurate disclosure on all material matters; recognition of stakeholder rights; equitable treatment of all shareholders; and the promotion of transparent and efficient markets.

ACCA strongly believes that the adoption of high standards of corporate governance by companies worldwide can help protect themselves and their stakeholders and in the process help to reduce their cost of capital by inspiring trust and confidence in the financial sector. We also believe that enhancing confidence and standards in governance will drive up confidence and standards in reporting and assurance: these aspects of the financial system are all inextricably linked.

We do not argue that one uniform code of conduct is possible, or even appropriate, given the variety of influences which impact on corporate structures and cultures: there should be flexibility in practices and structures. Furthermore, it is important that global requirements do not create a straitjacket, preventing innovation and improvement in how organisations conduct themselves. This is perhaps the area where the biggest challenge lies. People and their conduct equal the sum of an organisation, so management principles may need to be re-written. Business culture and tone, so often set at the top, need to change. Reward and how it drives behaviour will need re-examining. Visions and strategies will need to be re-created.

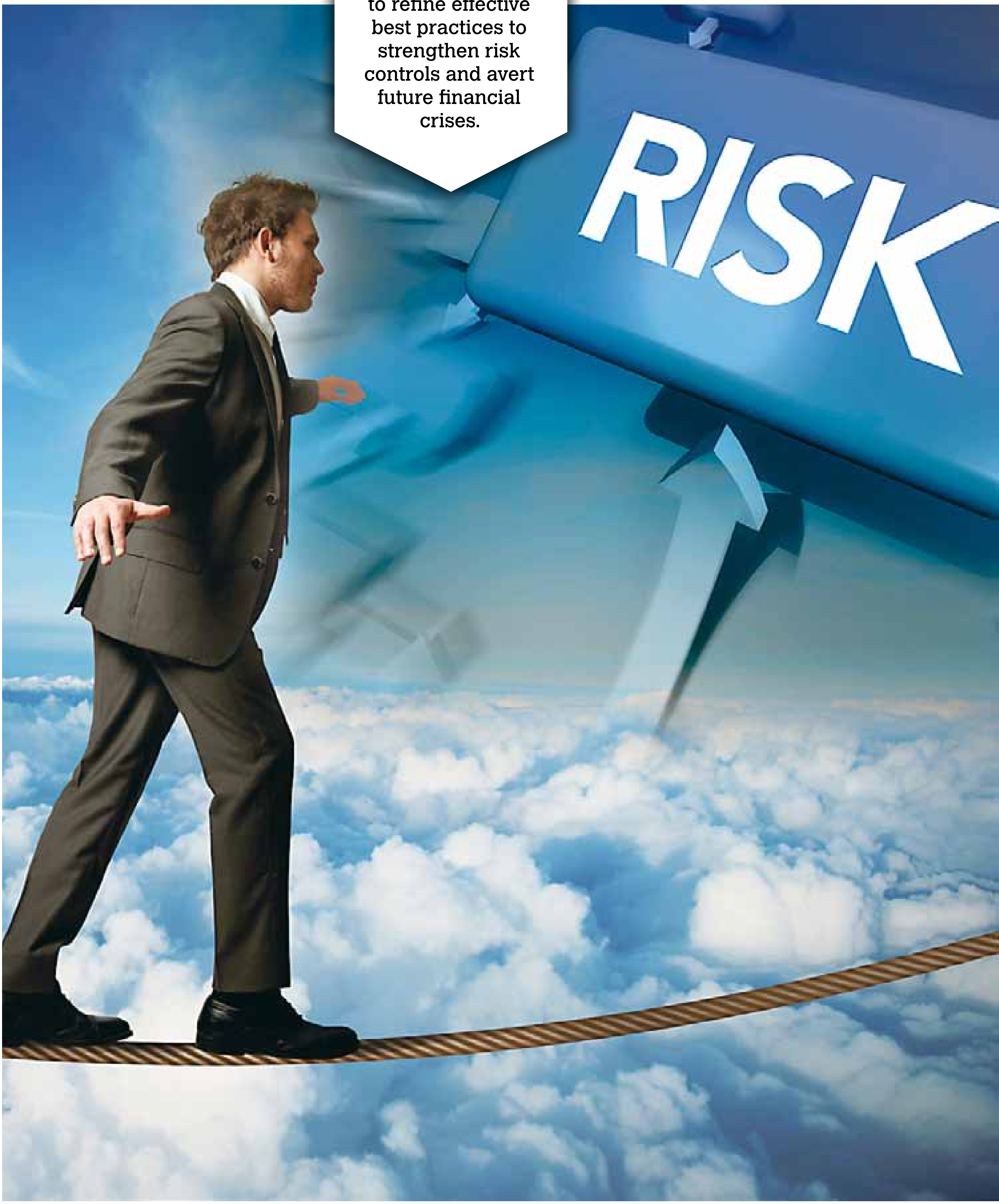
ACCA does not claim to have all the answers, but a debate is needed about 'better' corporate governance and how this can contribute to restoring equilibrium in the international financial system. Throughout the coming year, ACCA will be examining how to promote standards for business that are effective, enhance investor confidence, and bring public value. Please join the debate. ✱

■ Neil Stevenson is ACCA's Executive Director – Brand, with a remit covering marketing and communications, policy, technical issues and publishing. He is a member of ACCA's Executive Team.

At ACCA, he has developed the global brand strategy and related campaigns, established marketing and communications measurement, and overseen the development of enhanced approaches to publishing, public policy and technical research and insights. Neil has a particular interest in issues involving change and innovation in the global professions. He sits on the International Integrated Reporting Committee (IIRC) Engagement and Communications taskforce.

Controls

Bankers – backed by regulators – continue to refine effective best practices to strengthen risk controls and avert future financial crises.



RAMPING UP RISK MANAGEMENT

SPECIAL FOCUS ON RISK

Financial institutions need to ramp up their risk management practices to actively manage a plethora of risks ahead, including economic, regulatory, credit, structural and reputational risks. Although extensive regulation to mitigate risks is becoming the norm, banks too will have to proactively champion risk management, such as through embedding an organisational culture of risk which is driven from the top down. Below are some of the takeaways from senior bankers who shared their insights at the recent high-level Risk Management Conference 2012 organised by IBBM.

MAJELLA GOMES

The recent global financial crisis (GFC) left banks reeling and economies and markets roiling in their wake. Five years on, the banks' role as a catalyst for the GFC as well as their response to the crisis is still under discussion. Inevitably, the complex subject of risk management and controls continues to dominate global banking circles, and it is the focus of specialised high-level conferences such as IBBM's recent Risk Management Conference 2012, an annual affair. What can be gleaned from experts present at the Conference is that change for the better is still a work in progress. Bankers – backed by regulators – continue to refine effective best practices to strengthen risk controls and avert future financial crises.

Dissecting the Crisis

Without understanding the reasons behind the crisis, trying to formulate an effective response would be like blindly groping in the dark. Therefore, it is hardly surprising that much time is spent at risk seminars on understanding the reasons for crisis in order to justify the solutions in play.

"Today, we are still asking what went wrong. In order to understand what went wrong it is important to get a perspective of the events leading to the crisis," said senior banker and consultant Mushtaque Jindani.

Revisiting history, Jindani retraced the US subprime scenario which was a key to the GFC. Cutting a long story short, a drastic reduction in the US interest rates led to a housing boom. Deregulation breaking down the barriers between commercial banks, and relaxation of accounting standards enabled banks to come up with unique transactions structures using special purpose vehicles (SPVs) etc. By using complex mathematical models to lower the risk perception, banks started engaging in increasingly risky activity. These short-term gains were erased when in 2005 the Federal Reserve System raised interest rates from 1% to 5.35% as subprime borrowers were unable to service their loans leading to a widespread default.

But was the US situation entirely unexpected? For those not in the know, it is surprising to learn that banking crises are fairly ubiquitous. Equally surprising is the realisation that banks have not really managed to improve themselves based on these painful failures.

Banking crises are likely at least every 20 or 30 years, and anyone who has been through these situations will know that when a banking crisis happens, recession brings up the rear. "Five hundred banks have failed in the US since August 2007," said Tom Sandall, Standard Chartered Plc's Head of Group Portfolio Risk. "A number were regarded as too big to fail, and now we know that their failure was the result of many factors, such as misaligned incentives and failures in both market discipline and risk management."

Drawing parallels between how business was conducted today, and how it used to be done before, Christopher Robin Page, a Non-Executive Director of AmBank Group said that bankers were more rounded and used to have a philosophy that risk was everyone's responsibility, but today, this was not so. "We forget the lessons of history," he continued. "Banks keep losing money the same way – we keep repeating the same mistakes, and as time goes on, these mistakes keep getting bigger. Bad behaviour is not always punished. We are not drawing on the experiences we have had to improve the environment we have to operate in."

Improving Risk Management – Strengthening Capital Ratios...

Having identified the causes for the financial crises, regulators and industry have promulgated a range of responses to try and minimise risks going forward – and to salvage the tattered reputations and performance of the battered banking industry.

Responses have been complex – and are taking a lot of time and resources. So far, there have been at least 25 different initiatives applied to mitigate the situation, including greater loss absorbency and information disclosure, structural measures, better supervision, stricter accounting and increased risk management, among others, said Sandall.

"Basel III is the key proposal but it has benefits and implementation costs," Sandall added. "We are looking to reduce the frequency of crises, encourage the development of domestic capital and debt markets, and further develop institutions' risk infrastructure."

The demand for credit is as important as supply, and even if there is finance available, it may not be used, as overall economic activity has decreased in the wake of the global financial crisis. Furthermore, regulatory models must avoid a negative impact on key banking services, including providing trade finance, which usually demonstrates low default rates. Sandall recommended that capital ratios were a more direct way of targeting solvency than diluting the accuracy of risk models by adding in ever greater conservatism, and that institutions can collaborate with regulators to develop industry-wide standard regulatory models.

"Basel III is the key proposal BUT IT HAS BENEFITS AND IMPLEMENTATION COSTS," SANDALL ADDED. "WE ARE LOOKING TO REDUCE THE FREQUENCY OF CRISES, ENCOURAGE THE DEVELOPMENT OF DOMESTIC CAPITAL AND DEBT MARKETS, AND FURTHER DEVELOP INSTITUTIONS' RISK INFRASTRUCTURE."

... and Corporate Governance

However, capital is the last bastion. Boards and senior management need to be thinking of the causal factors that occasioned most of the losses. Often that was poor behaviour that should have been known by Senior Management and the Board. "There is a very important distinction here," remarked Tim L'Estrange, Chairman of L'Estrange Advisory and most recently the Group General Manager (Governance) at ANZ Bank. "It is not what Boards knew; it is what they should have known."

In hindsight, weak corporate governance especially at Board level coupled with complacent shareholders are just two interrelated factors that are frequently implicated in the recent banking crisis.

Stating that there were basically three kinds of investors, Jindani said that shareholders, whether of the individual, institutional or large family holding kind, invest in companies for returns, capital growth and preservation. Their interests are represented by Board members appointed by them. Consequently, "directors have a duty of care, loyalty and candour – fiduciary duties – to shareholders," said Jindani. "They must operate within the parameters of the law, and have responsibilities towards other stakeholders as well. The boards determine the corporate strategy, policies, risk appetite, select key management, and their compensation and reward structure."

Board composition was also an issue. "While most Boards comprised individuals of

high stature and leaders in their own industries, most of them did not have the technical competence to oversee these large financial institutions whose business was made increasingly complex. This however cannot absolve them from their responsibility. Where they failed is in their duty of candour, and the need to ask probing questions of the management. They should not have allowed management to proceed with transactions and businesses whose risks they did not fully comprehend."

Shareholders were at fault too for not policing their investments properly. Regulators have since embarked on improving shareholder awareness of the importance of good governance and market discipline. "Studies indicate that shareholders did not react to protect their interests, because they were benefiting from the returns in the early years. The institutional investors who are more sophisticated, and in the US control a very significant part of the equity market did not exercise their ownership rights to ensure they selected sound Board members to represent their interests," remarked Jindani.

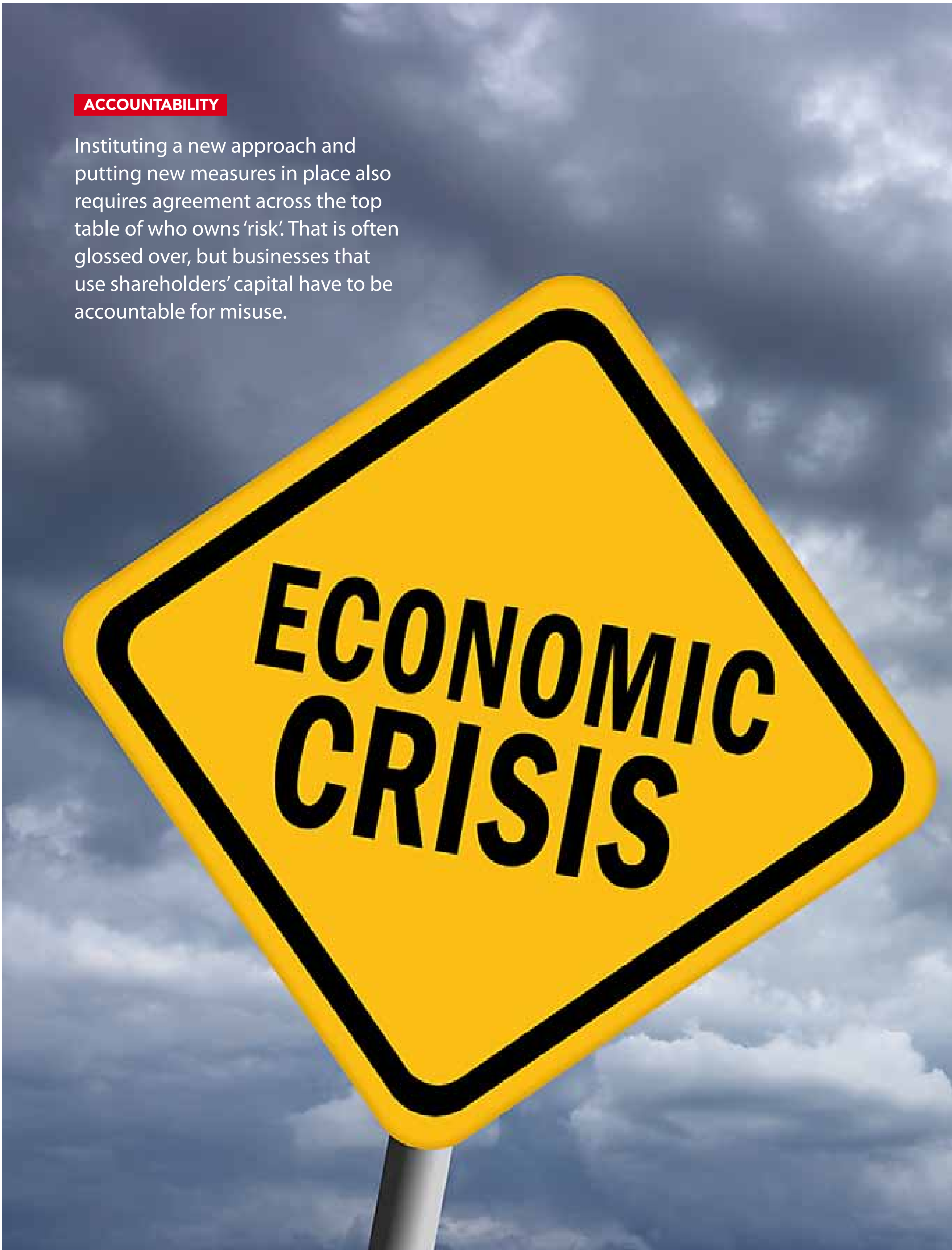
Today, corporate governance, especially tone at the top, continues to come under intense regulatory scrutiny. Fittingly, the global financial crisis has become a catalyst for a refocus on the composition of boards. "'Fit and proper criteria' has been expanded to include financial technical expertise; management remuneration is being seriously re-looked at; and Board members need to undergo training. Board members have greater responsibility and accountability, and in some cases personal liability," remarked Jindani.

As to Board composition, "There should be a balance. Boards should have members who come from different backgrounds," L'estrange suggested. "You do need people with technical expertise, as well as those who can bring a different perspective to the business. There must be some on the Board who understand banking – at least so they can ask the tough questions of management!"

Scrutinising Compensation Structures

Another area of risk centred on the unsustainable compensation structures for top banking positions, which the financial crisis inadvertently exposed. Compensation structures incentivised the pursuit of profit at the expense of corporate governance. "The management reward structure was too short-term focussed, and large bonuses were paid as the crisis was unfolding," Jindani said.

Before the crunch, top executives at some US banks and financial institutions negotiated remuneration packages that were not commensurate with the performance of their organisations. Their companies were legally constrained to pay them large bonuses even when the institution had to be bailed out by the government. This led to public outcry and of course, reputational risk. Today, compensation structures for senior management are being restructured, and 'clawback clauses' are being implemented so that remuneration can be tied to more responsible performance.



ACCOUNTABILITY

Instituting a new approach and putting new measures in place also requires agreement across the top table of who owns 'risk'. That is often glossed over, but businesses that use shareholders' capital have to be accountable for misuse.

New Structures for Assurance and Risk

Do banks require fresh and more effective structures for assurance and risk?

Having canvassed bankers, judges and industry players about what went wrong, L'Estrange noted that - there is a common theme - "that a new approach is needed today, one that requires a change in the way that Boards and Senior Management receive assurance about the governance structure and culture of the organisation."

L'Estrange said, "Good organisations have structures and processes to empower their people, who understand their roles and where proper information, moves upwards and downwards without fear. On the other hand, in poorly run organisations there are common traits of poor role clarity, poor accountability, and poor escalation of issues. Nobody wants to hear the bad news!" As a result, information which was perceived as negative was rarely escalated, so dangerous practices, products or relationships are implemented, developed and allowed to flourish.

"While culture is critical, so is a proper structure or governance architecture. Think of it as a building," L'Estrange said. "It would be absurd to have a building with nice interiors and aesthetics and no proper foundations, electrical or mechanical system."

As companies grow, particularly offshore, corporate governance becomes critical. L'Estrange says a good approach will establish a framework of rules, relationships and processes by which authority is exercised in the corporations. Good corporate governance facilitates the flow of information and communication, transparency and efficiency of operations. Corporate governance is inextricably linked to enterprise strategy, risk and ethical behaviour."

Ownership of Risk – No More Silos

Prevailing attitudes towards risk can also be hazardous to banks' health. Numerous studies found that risk managers and business managers were operating in silos. Risk was not being managed at the enterprise level. Many transactions were too complex for Boards to understand. Liquidity risk was ignored.

> While regulations have been PUT IN PLACE TO TRY AND ANTICIPATE, AND PREVENT FUTURE BREACHES OF THE SYSTEM, THEIR EFFICACY IS QUESTIONABLE IF BANKS DO NOT CHANGE THEIR CULTURE AND ATTITUDES TOWARDS RISK FROM A COMPLIANT MINDSET TO THE INNOVATION PARADIGM.

Evidently, change is desperately needed to manage risks effectively.

Instituting a new approach and putting new measures in place also requires agreement across the top table of who owns 'risk'. That is often glossed over, but businesses that use shareholders' capital have to be accountable for misuse. "So, if 'Risk' sits with the business, it cannot be passed off to a risk function," L'estrange stated flatly. "In a thoughtful risk structure, the risk function should be clear, as one of oversight of risk assessment and controls performed by the business. Internal and external audit become what is often termed the third line of assurance."

"While corporate governance principles are often seen as roadblocks, in truth they should act as enablers, allowing an organisation to be more agile in its decision-making, confident that it is allowing its people to get on with what needs to be done in a more transparent and accountable manner. Obviously, that should help clients and employees, and the organisation to execute its strategies," L'Estrange continued. "Organisational culture is critical to this; it will help bring governance to life."

How will an organisation know that its governance is working? Through constant communication, education and training. Open lines of communication will generate feedback for analysis and discussion. Most critical is the assurance that the governance is working. Better organisations are examining how they go about devising appropriate assurance. That will be a far cry from a tick the box approach! Central to this will be the very dynamic role of the Chief Risk Officer (CRO), who will be instrumental in the establishment of the governance architecture. There is also an opportunity for internal audit to play a more extensive role in assurance of culture.

Talent Challenge

A major challenge is a shortage of experienced and high-calibre talent to deal with the key issues beleaguering the industry today. As an example, AmBank's Page pointed to the last crisis that Australian bankers experienced in 1992. That was 20 years ago, and by the time the global financial crisis of 2008 erupted, the old guard had retired (or died) and their successors often had insufficient expertise to deal with the situation.

Rework banking models for sustainability

Banks may also need to tweak their business models to manage risks while focusing on services and customer centricity to become more relevant to markets. This will help mitigate the risk of obsolescence and internecine competition.

Page advised banks and financial institutions to determine what services they needed to put in place in order to serve customers. Customer centricity should be the key to new models. "The commercial banking model should be relooked at," he said. "We have to ensure that new product development is suitable for customer needs and fit for purpose."

These new models should also take the rise of new and unexpected sources of competition into account. "At the same time, the growth in shadow banking must be considered – which is something that has the potential to challenge traditional banking in many markets. One way of restricting shadow banking is through better supervision," said Page.

Systemic Integrity

Banks also need to invest in the appropriate intellectual capital and formulate new risk frameworks to ensure the integrity and robustness of their data, and the sustainability of their business models. "How good is your data, and how reliable is the platform you are pulling it from?" queried David Richard Thomas, Group Chief Risk Officer of CIMB Group Holdings Berhad. "It has to have integrity, and we have to have the focus to address shortcomings. Think about the kinds of issues banks face, and if your business model can hold up under the pressures of a more intense regulatory environment and/or macro-economic environment. Think in terms of capital, not revenue. The integrity of capital calculation depends on the integrity of the system and data that support the calculation. We don't know what the future holds, but we can formulate workable frameworks, and as long as we stick to our core markets, we will be able to progress. If we cannot do this, we deserve to fail."

Summing Up

The consensus was that there is no quick-fix solution for the ailing banking and financial system globally. Plus, banks need to urgently wake up and smell the roses. The global environment has changed irrevocably. There is scant tolerance for mistakes and failures in governance. Banks must contend with antipathy and even hostility from their stakeholders, especially a disgruntled public.

Ian Douglas Wilson, Vice-President of the Chartered Banker Institute described banks as still having their heads in the sand despite being battered mercilessly by the global financial crisis, and subsequently losing public confidence. Reputational risk remains one of the industry's greatest challenges but as Wilson said, "Bankers brought it on themselves."

The question now is: how can banks earn this confidence once again? To do this, a major change in culture – especially the culture of risk management – and even a major revamping of the prevailing business model may be necessary. Banks will also need to take cognisance of the fact that they are under threat in many areas. Solutions to these risks must be found if the banking and financial sector is to enjoy robust sustainability and claw back their formerly stellar reputations pre-2007.

While regulations have been put in place to try and anticipate, and prevent future breaches of the system, their efficacy is questionable if banks do not change their culture and attitudes towards risk from a compliant mindset to the innovation paradigm.

Even the efficacy of Basel III may be questionable as its guidelines could in the long term be inimical to the behaviour and functioning of local credit and capital markets. For example, the development of the bond market could be stifled by Basel III. Bond markets are generally not very mature, and a lack of liquidity will further retard them.

UNDERSTANDING

In these volatile times, regulators are constantly looking over the shoulders of industry. Hence, bankers need to have a better understanding of what is required of them, and improve their business models and risk controls for better governance and oversight.

Banks should also be alert to the readiness of regulators to intervene at any time. In these volatile times, regulators are constantly looking over the shoulders of industry. Hence, bankers need to have a better understanding of what is required of them, and improve their business models and risk controls for better governance and oversight. These business models and controls will need to be better thought through, better articulated, and better delivered. Wilson urged participants to use regulation as a defence and a chance to add value to business, rather than as yet more costly compliance that adds little value. ✱

■ Majella Gomes is a freelance reporter based in Kuala Lumpur.

Brave *new* world

WHAT RISKS DOES the global economy hold for banks? While developed economies tank along with their banks, Asian economies and banks may be the driving force for global growth in the years to come.

Economically and financially speaking, the world faces one of the most difficult economic eras ever in history. There is no sign of respite for the beleaguered banking industry given the looming American fiscal cliff and the turmoil in European markets, albeit there are bright spots in Asia and emerging markets.

Banks should be prepared for economic contagion and yet more challenges. Bart Van Ark, Executive Vice-President and Chief Economist of The Conference Board remarked, "The global economy is definitely not decoupled. All economies will experience more turbulence ahead."

He stated that the economic environment is changing, especially in Asia – and we have to change with it, whether we want to or not. To do this, there will have to be a major revamp of the way risk management is viewed within the structure of the banking and other financial systems the world over.

Currently, the changes can sometimes feel as if the world is just 'muddling through' but it is important to understand if it is going through a 'soft patch', adjusting the speed of its growth, or making structural adjustments. A 'soft patch' indicates a temporary drop in demand while growth recovery for some countries may well extend over another ten to 15 years, before they can be considered fully up and running again.

"However, this slow speed cannot go on indefinitely," said Van Ark. "We expect growth to slow overall in 2013, and some countries will see slow to no growth. The US economy is poised to slow even further. Europe is moving towards stability, but its path is unclear. Even emerging economies will see below-trend growth. 4% growth is achievable, but the global growth rate is more likely to be about 2.5%, tops. Global economic expansion will probably be zero, or at least, very, very small. China is not going to grow aggressively; it will not experience a full recession but its growth will slow."

Making a projection for advanced economies beyond 2013, he said that their recovery between 2013 and 2016 will be followed by slow growth from 2017 to 2025, driven largely by emerging economies. The risks to be aware of are the shocks that may come from the breakup of the Euro, a hard landing for emerging economies, among others, and the collapse in trust of the US dollar. Advanced markets may experience a Japan-type deflationary model. There may also be failure in attempts to rebalance the global economy and critical markets, which may give rise to protectionist activity which will further slow growth. "The choice will come down to applying offensive or defensive strategies," he concluded. "But strategies for growth must be more offensive, rather than defensive."

Asia Ascending

Going forward, the harsh reality is that Europe and the US will continue to face challenges in the banking and finance sector for some time to come. How they cope with these demands will shape their future. However, there is a bright spot on the horizon in the form of Asian banks, two-thirds of whom derive less than 10% of their income from offshore activities, said Christopher Robin Page, a Non-Executive Director of AmBank Group. This means they have considerable domestic capacity which will keep them healthy for a while. Asian banks are also considered the best-capitalised and most liquid banks in the world right now, and industry growth will likely be driven by Asian markets. Asian banks will need to collaborate with each other to handle cross-border business flows as there will be challenges and risks in developing a cross-border business model.

Positive growth factors which have to be taken into account include the phenomenon of increasing corporate cross-border expansion, and migration of labour in Asia. Both of these will spur the growth of banking and finance products and services. "Thirteen million Asians migrate annually across Asian borders while another 39 million migrate outside Asia," he said. "They all will have banking needs. The amount of Asian savings will grow, and the main challenge will be how to manage this liquidity – so this has to be managed safely and across borders which means there will have to be closer collaboration between Asian banks. Islamic banking will develop further. Either way you look at it, the opportunities for Asian banks in the years to come are significant, and we may see many domestic champions becoming more Asian regional players especially as global players retreat."

DO WE NEED BANKS?

DO WE NEED BANKS? OR IS THERE ACTUALLY HOPE FOR BANKS? LIKE OTHER INDUSTRIES, BANKING IS IN A STATE OF FLUX AND UNDER THREAT FROM NON-BANKS. THE REVENUE FOR BANKS GLOBALLY IS MASSIVELY SHRINKING AND ONLY THE BANKS WHICH ARE CLIENT-CENTRIC AND CAN PROVIDE ITS CHOSEN CLIENTS WITH A 'WOW' FEELING WILL STAY RELEVANT.

MATTHIAS ABOLD

Is a world without banks really inconceivable? Is it a natural law that mankind needs banks and Isaac Newton just was not aware of it? Or did many banks in the world, not necessarily ASEAN banks, screw up massively in any and every possible way and are now in danger of being remembered only in history classes?

There are many reasons why banks in the western world but eventually globally are in search of meaning, in existential fear without realising or wanting to realise it.

Take innovation, the single most important factor to remain relevant and stay in business. Former Federal Reserve Chief Paul Volcker said, "I wish somebody would give me some shred of evidence linking financial innovation with a benefit to the economy" and went on to mention the automatic teller machine (ATM) as the only financial invention in the past 25 years that benefited the consumer.

When was the last time a product or service innovation from a bank thrilled consumers? Conversely, products and services from companies unrelated to the financial industry have been wowing customers. There is the iPhone from Apple, the internet *per se*, new medicine and innovations from the car industry. While the principle of the car in itself has not changed much in the past 125 years, the latter deserves mention because one might be tempted to think modern banking is over 600 years old and nothing can be invented anymore.

But please, do not think about Asset Backed Securities (ABS), foreign exchange (F/X), the London Interbank Offer Rate (LIBOR) or Credit Default Swaps (CDS) as being helpful to the economy. These are but a few of the financial innovations or products originating from the banking industry; intrinsically they can be good products but without proper regulation or no regulations at all, some of these products such as ABS and CDS caused the present financial crisis. LIBOR is a reference point for over USD350,000bn in finance and most of the 'world class' banks are involved in manipulating it. F/X has a daily volume of USD4.3 trillion but only about 1% of this value has an underlying business transaction. The rest is speculation and proprietary trading, which is a euphemism for speculation. Of course, bankers never stop arguing that they provide liquidity to the markets – but is 99% liquidity necessary for 1% of underlying business?

There are about 7 billion people on this planet and slightly more than 2 billion have a bank account. On the contrary, about 6 billion mobile phones are in operation. If mobile services can innovate and capture markets, should it be difficult for bankers to come up with novel banking products?

Non-Bank Financial Innovations

There are many financial innovations which did not come from banks at all and actually do serve society. Look at the Grameen Bank founded by Muhammad Yunus; he was a professor before he invented Microfinance and became The Banker to the poor. Could a bank not have come up with this idea?

Currently, there are about 7 billion people on this planet and slightly more than 2 billion have a bank account. On the contrary, about 6 billion mobile phones are in operation. If mobile services can innovate and capture markets, should it be difficult for bankers to come up with novel banking products? Look at M-Pesa which started big in 2007 in Kenya and is growing international. Vodafone – which is not a bank – worked with a local partner to come up with this idea.

Banks need to also beware of 'disintermediation' or 'getting rid of the middleman'. The following are but a few

MUHAMMAD YUNUS WAS A PROFESSOR BEFORE HE INVENTED MICROFINANCE AND

Wow

When was the last time you had a 'wow' feeling about a product or service innovation from a bank?

financial products/services offered by non-banks cutting into the income cake of banks.

The Euro as a first example of disintermediation might not be too obvious. While the EU has its problems, it will overcome them similar to growing pains, teething problems or a childhood disease. Before the Euro was introduced, EU banks enjoyed over €20bn in foreign exchange income from the 16 local currencies being traded. Once the Euro was introduced this income vanished instantly and there was no longer a need for a middleman. Is ASEAN next?

Elsewhere, insurance companies, as institutional investors, have to find investing opportunities. That is quite difficult with the historic low interest rates. Instead of mandating banks, they invest money directly with the consumer in the form of mortgage loans which are cheaper than those offered by banks, which in turn makes the consumer happy. The insurance company also wins, as it receives a higher return than a bank would offer, hence cutting out the middleman!

BECAME THE BANKER TO THE POOR. COULD A BANK NOT HAVE COME UP WITH THIS IDEA?

THE AIRLINE INDUSTRY IS ALSO HEAVILY REGULATED AND PROTECTED. YET BY PROVIDING

PROSPECTS

Is it really technically impossible that Apple or Microsoft might open a worldwide clearing bank, which allows every owner of an iPhone or Windows to do all their cash management for next to nothing? Every company, which has a huge distribution channel (7-Eleven, mobile phone operators, supermarkets, etc.) could not only distribute financial products but also produce them!

A similar modus operandi can be seen in many industries. Almost all car manufacturers have their own captive bank which offers car finance at much lower interest rates than banks are prepared to offer. Because companies such as BMW, Mercedes and Audi are swimming in money, car finance is a supplementary income for them as they too receive higher interest income compared to depositing their cash with banks.

The dilemma here for banks is that they are banks. By virtue of their banking status, they are unable to diversify into other industries such as car manufacturing.

Meanwhile, new companies are offering alternative financial products with the help of technology. Peer to Peer (P2P) lending is a prominent example. A borrower who wants a loan of about €10,000, puts his or her profile on the P2P's website and others offer to chip in €100 or more until the desired amount has been reached. The money is paid out, the borrower makes one payment per month to the P2P company and the latter pays out the interest payments according to the lenders' share. The company gets a commission, the borrower gets the money cheaper and the lenders earn more compared to a bank. Default rates are similar to the banking industry and this risk can be mitigated by investing in many borrowers and buying insurance cover; this is pure disintermediation.

For companies, joining a trade exchange like BarterCard helps free working capital without borrowing money by creating a kind of artificial currency/point system. When thinking about company loans and disintermediation think also about bonds! Instead of asking for a loan from a bank the company asks for money directly from investors; this cuts out the bank too. Of course, this is part of investment banking but there is no law that the origination, distribution and underwriting of a bond has to be offered by a bank!

There are of course many more examples already available or products that could become available. Why does an AirAsia not exist yet in banking? Like banking, the airline industry is also heavily regulated and protected. Yet by providing a service invention, AirAsia is successful while others have to fight for survival.

Is it really technically impossible that Apple or Microsoft might open a worldwide clearing bank, which allows every owner of an iPhone or Windows to do all their cash management for next to nothing? Every company, which has a huge distribution channel (7-Eleven, mobile phone operators, supermarkets, etc.) could not only distribute financial products but also produce them!

As yet, these ingenious disintermediation products are not available in the market. Those already available are by no means a serious threat for banks as their market share is pathetic. But there could be parallels for banks in the utility business in Germany. Many years back, there were three gigantic power utility companies in Germany, financially and politically immensely powerful. Some 20 years ago, solar energy became known and quality improvement throughout the years, environment protection

A SERVICE INVENTION, AIRASIA IS SUCCESSFUL WHILE OTHERS HAVE TO FIGHT FOR SURVIVAL.

and global climate change helped raise its profile and popularity. Yet the electricity generated was still so much more expensive compared to the atomic power of the three giants that the solar industry remained a dwarf.

However, realising that alternative energy is the future, the government began subsidising the electricity generated by regenerative technology. Although Germany is not known for sunny weather, no other country in the world has more solar panels installed than Germany. Then came Fukushima; in its wake, the government phased out all atomic power reactors and the three gigantic utility companies lost tens of billions in market capitalisation. They are now a shadow of their former selves and alternative lending, sorry, alternative energy is suddenly mainstream.

As long as banks do not change and continuously reinvent themselves, a similar fate could strike them very quickly. Given one or two more global financial crises….

Become Client-centric

How can banks become pro-active, inventive institutions with products the client needs and clients that the bank needs?

Indeed, it is quite difficult to really invent new financial products so it might be better to concentrate on service innovation and make existing products better. For example, many banks in ASEAN do have a strategy to be or become client-centric. However, it is not enough to trail the client and reproduce the same logo in all countries where a bank operates. Being client-centric means being perceived by clients in the region as one bank operating in five countries instead of five banks in five countries but with the same name and logo.

To achieve this, banks need to start with people; future managers must be regionally attracted and continuously regionally posted. Client specialists need to be seconded to regional country desks, i.e. a Malaysian bank operating in Thailand needs to establish a Malaysian desk with Malaysian regional managers in Thailand and vice versa. This is not rocket science, but highly effective and instantly adds to the bottom line; how many banks in the region have this approach?

Being client-centric means being perceived by clients in the region as one bank operating in five countries instead of five banks in five countries but with the same name and logo. To achieve this, banks need to start with people; future managers must be regionally attracted and continuously regionally posted.

Client centricity also means knowing one's clients and the client's client. Please do not think of segmentation as being easy, many banks are just not there yet. Twenty years ago, there were only three Mercedes models: the C-Class, E-Class and S-Class. Now, the range of models has expanded tremendously. This is true for so many other industries. People want choice, the more the better. However, in banking it is as if time has stood still; within consumer banking a typical bank has three to four clusters (mass-market, affluent consumers, privileged consumers and private banking clients), and likewise in wholesale banking.

Client-centric business however means you would have 30, 40 or 100 clusters instead of three. For instance, ASEAN wants to be a hub for medical tourists; which local bank has a 'Health Desk' where bankers are former medical professionals? Malaysia and Singapore like Formula 1; which bank has a 'Sports Desk' where former well-known sports professionals are employees of the bank? Each bank has bank employees who are well paid; which bank has a dedicated employee desk offering tailored products relevant to the bank's employees? Malaysia has many migrant workers; which local bank offers them tailored products?

Which bank has already moved from doing boring cross selling – being reactive – towards offering clients a solution – being proactive? Being proactive includes offering a package of products but also means that banks need to know their client, their client's industry and the industry's drivers. This is what it means to be client-centric?

None of these examples are rocket science. They may even sound boring and basic but this is exactly what is lacking for banks to stay relevant for the long term. The revenue for banks globally is massively shrinking and only the banks which can provide their chosen clients with a 'wow' feeling will stay relevant. Why not start to pick low-hanging fruits first and develop further to become the AirAsia or Apple of banks? ✱

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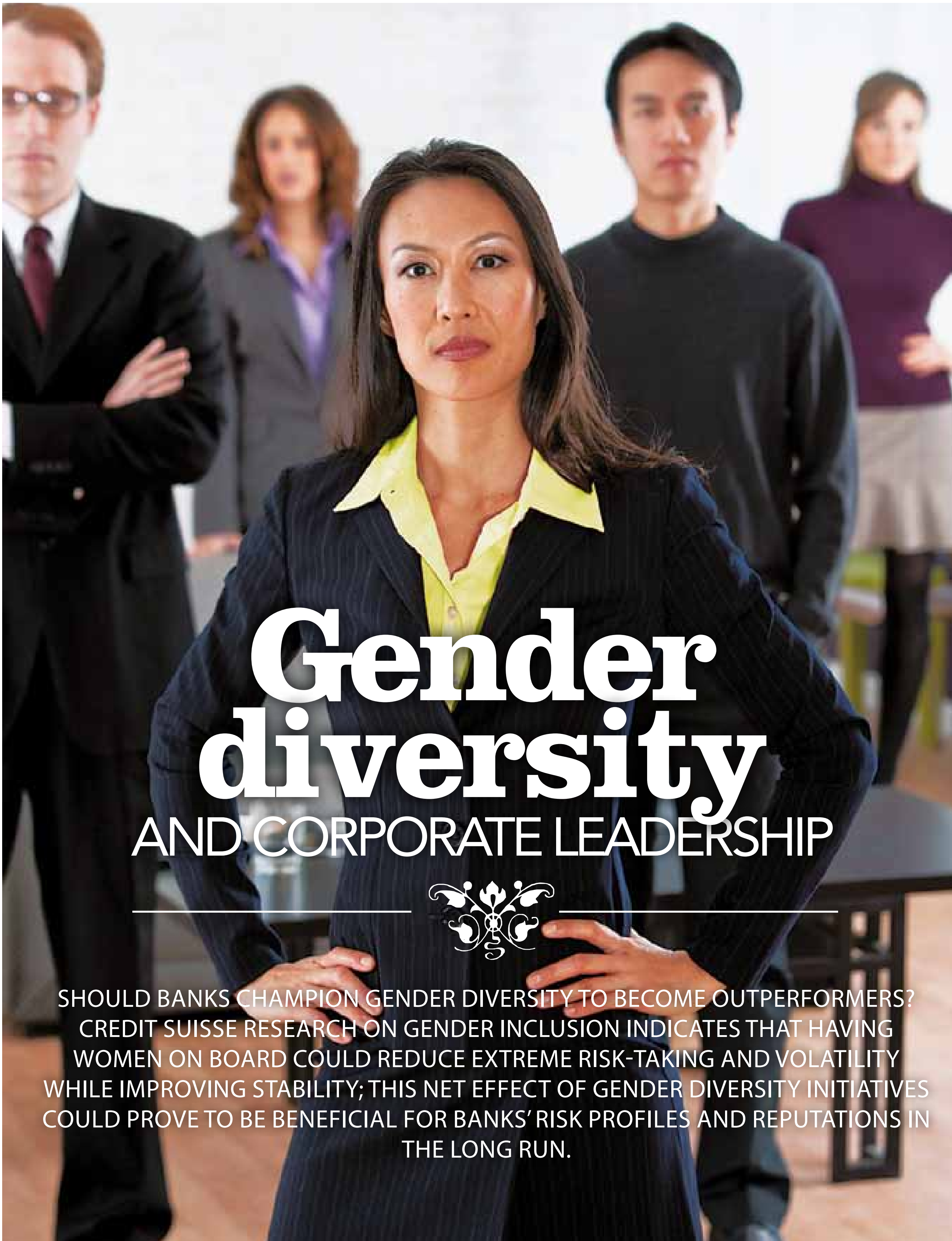

Gender diversity AND CORPORATE LEADERSHIP

SHOULD BANKS CHAMPION GENDER DIVERSITY TO BECOME OUTPERFORMERS? CREDIT SUISSE RESEARCH ON GENDER INCLUSION INDICATES THAT HAVING WOMEN ON BOARD COULD REDUCE EXTREME RISK-TAKING AND VOLATILITY WHILE IMPROVING STABILITY; THIS NET EFFECT OF GENDER DIVERSITY INITIATIVES COULD PROVE TO BE BENEFICIAL FOR BANKS' RISK PROFILES AND REPUTATIONS IN THE LONG RUN.

Equality

Government intervention in this area has increased; and it is not a matter solely of fairness and equality any more – it is now a question of superior performance.

Does gender diversity on corporate boards enhance corporate performance? An August 2012 report by Credit Suisse Research Institute entitled 'Gender Diversity and Corporate Performance' that tested the performance of 2,360 companies globally over six years, shows that companies with women on their boards delivered higher than average returns on equity, lower gearing, better average growth and higher price/book value multiples.

Diversity is Timely

The impact of gender diversity on corporate leadership has been widely debated for some time, and gender diversity within senior management has become an increasingly topical issue for three main reasons: the number of women at board level is generally low; government intervention in this area has increased; and it is not a matter solely of fairness and equality any more – it is now a question of superior performance.

Statistics show that the number of women on boards is growing. In 2005, only 41% of listed companies had women on their boards. This number had increased to 59% by 2011. Statistics also show that Fortune 500 companies with more women on their boards tend to be more profitable. They also exhibited a higher degree of organisation, above-average operating margins and higher valuations.

Asian companies with no women on their boards

72%

16%

North American companies with no women on their boards

On the other hand, some other studies have shown that there is no link between gender diversity and improved profitability. In some cases, appointment of women to the board seems to indicate that the company is already doing well.

So what incontrovertible evidence is there that women do indeed enhance a company's performance; and is there any difference between the financial performances of companies which have women on their boards, and those that do not? Does it make a difference to have gender diversity in company management, and what factors may inhibit companies from increasing female representation? While some answers may seem obvious, others have more serious underlying reasons – and implications.

For instance, in the middle of the decade (2005-07), economic growth was robust, and there was little difference in share price performance between companies with women on the board, and those without. Post-2008, however, the macro environment deteriorated and volatility increased. Stocks with greater gender diversity performed better when markets fell. What this says is that companies with women on the board do exhibit a certain level of inconsistency but evidence suggests that more balance on the board brings less volatility and more balance through the cycle.

Where are the Women?

Latest data and recent trends encompassing 2,360 companies as surveyed by Credit Suisse have been surprising. For instance, sectors that were considered closer to final consumer demand, such as consumer staples, had a higher proportion of women on the board. Sectors that were at the bottom of the supply chain, like energy and IT, had a much lower proportion of women on their boards.

Certain regions like Scandinavia and countries like Norway have a higher number of women on boards, while Asian countries tend to have relatively lower numbers. In emerging Asia, 72% of sampled companies did not have any women on their boards. In comparison, only 16% of the North American companies surveyed had no women on their boards.

Overall, however, the fastest rates of change in female board representation have come from European companies. Some European governments have set mandatory or non-mandatory targets for female board representation, which may account for the higher numbers.

Scandinavian markets have the highest degree of female representation. Compared to other European markets, Switzerland and Italy have low representation. In 2005, only 22% of Spanish companies had one or more women at board level but this improved and by 2011, this had increased to 89%. In Korea, Taiwan and Japan, female representation is low; it is higher in New Zealand, Australia and Thailand. Israel and South Africa really stand out in their respective regions; more than 90% of companies polled in the survey had at least one woman on the board, while China demonstrated some impressive figures. In 2005, only 6.5% of companies had any gender diversity at all. By the end of 2011, this had increased to 50%.

It is worth noting that the number of women on the board tends to rise with the size of the company; large-cap, higher-profile companies seem to have more women in senior management positions. On average, companies with three or more women on the board have a market capitalisation three times higher than that of companies with no women board members.

But this issue should not be oversimplified, as it is tied to industrial sector more than anything else. For instance, in the consumer staples sector, where female board representation is higher than anywhere else, share price performance has had little to do with board composition. Rather, share price performance here was due to the very stable and defensive nature of companies' earnings in an uncertain earnings environment.

Lessons learnt

For large-cap stocks greater than USD10bn, companies with women board members outperformed those without women board members by 26% over the past six years. Small to mid-cap stocks performed 17% better where women were on the board – but these figures are not consistent, and have to be read against the general market environment. Between 2005 and 2007, there was little differentiation in performance, but in the second half of 2008, the share price performance of companies with women on their boards really picked up because of the bear market, and has been strong ever since. However, it must be borne in mind that the companies surveyed were heavily skewed towards European-based ones.

Even so, two conclusions can be drawn from these survey results. Firstly, stocks with a greater degree of gender diversification appear to be defensive in nature. Secondly, this kind of stock performance may not continue if the world recovers from economic crisis, and the macro environment stabilises. But for the moment, the good news continues for companies with women on their boards. For instance, they experienced higher returns on equity (ROE), and better average growth. Companies with at least one woman on the board, over the past six years, saw an ROE of 16%, which was 4% higher than companies without; while companies with women on their boards grew an average of 14%, compared to 10% for companies without.

In addition, Fortune 500 companies with female board members outperformed their rivals, so these results tend to support the hypothesis that more women on boards equals better performance. In the wake of the European debt crisis, the best market performers have been those with stronger balance sheets, higher average ROEs and less volatility in their earnings cycle – characteristics associated with having women on the board. Even so, the question remains: would having a woman at board level make a difference to the structure of the business, and would that business have delivered the same result, regardless? The following are some of the factors to consider on both sides of the argument.

> **16%** *Companies with at least one woman on the board, over the past six years, saw an ROE of 16%*

Gender diversity = better performance?

What does having a woman (or women) on the board of a company say for the company itself? For the most part, it is a positive signal that indicates a stronger focus on corporate governance and that the company is doing well. There is even evidence that gender diversity can lead to better performance and a better mix of leadership skills. It is mostly the larger companies, which are already doing well, that tend to appoint women to their boards, so there may be other facets to this relationship. Research has found that greater gender diversity can lead to better performance – but it is not necessarily the performance of the individuals that produce results. However, group interaction has shown that collective group intelligence increases when there are more women in the group.

It is also worth considering leadership styles in the argument for greater gender diversity at board level. Men and women have different leadership styles. Women tend to be good at defining responsibilities clearly, mentoring and coaching, while men are better at making individual decisions and corrective action when things go wrong. A NASA study on mixed-gender crews showed that women's leadership styles were task-oriented, focused on mentoring and exhibited concern for others whereas on all-male expeditions, there was little sharing and lots of competitiveness. NASA crews also reported 'calmer missions' with women on board, and male crew members noted a reduction in rude behaviour and improved cleanliness.

With women accounting for a greater proportion of graduates today, any company that achieves greater gender diversity will, in effect, be tapping into the widest possible talent pool. According to UNESCO, male and female tertiary graduation rates for North America and Western Europe were about equal in the early 1980s, but by 2000, 51% of graduates the world over were female, increasing to 54% in 2010. School retention rates in the West also show that more girls than boys are staying in school. Women are likely to be responsible for household spending; thus it could follow that a corporate board with female representation may enhance the understanding of customer preferences. Unsurprisingly, consumer-facing industries have a greater proportion of women on their boards.

Improved corporate governance

Academic research points very strongly to a greater number of women on boards being instrumental in improving corporate and social governance. It found, besides, that gender-diverse boards were more likely to focus on clear communication with employees, prioritise customer satisfaction, and consider diversity and corporate social responsibility. The flipside? Gender diversity may improve the performance of firms with weak governance, but where governance is already strong, greater gender diversity may lead to 'over-monitoring' which interferes with efficient management and could lead to reduced profits and adverse stock price movements. It is a matter of achieving the correct balance.

Another factor that may drive better corporate governance is women's general aversion to risk. It has been found that overly-optimistic men added to investment volatility, making their portfolio performances fluctuate; whereas women, whether optimistic or not, did not go to extremes in their portfolio management. Research by Professor Nick Wilson at Leeds University Business School actually showed that having at least one female director on the board appears to reduce a company's likelihood of becoming bankrupt by 20%. Having two or three female directors lowered this likelihood even further. Companies with women at board level are also likely to have lower gearing, helping them perform better. The inverse correlation between female management and risk aversion is notable.

51% → 54%

By 2000, 51% of graduates the world over were female, increasing to 54% in 2010

It is often assumed that the main benefit of diversity comes from the different perspective brought by the minority group but this is not the only benefit. Research by Professor Katherine Phillips, Columbia Business School's Professor of Leadership and Ethics, says that diversity really changes the experience of all the people in the group. "In a diverse environment, individuals expect differences in perspectives," she said. "They recognise that those perspectives should exist, and they work harder to assimilate different ideas." But there is a downside to diversity: greater conflict and tension sometimes undermines the confidence of diverse teams, and assimilating conflicting viewpoints can be an uncomfortable experience.

Women on Boards: future scenario

Phillips said that although diverse groups might initially underperform, they will probably outperform homogenous groups over time. Her research has shown that firms run by female CEOs have lower leverage, less volatile earnings and a higher chance of survival than firms run by male CEOs. On average, momentum seems to be building in favour of greater gender diversity – but the macro implications outweigh the micro ones; greater female inclusion in the workplace can potentially reduce the growing skill shortages faced by industry as working-age populations decline. Public and private policies to raise the profile of women on boards have become more widespread over the last five years. Demographic concerns, and renewed focus on corporate governance have opened more board positions to women.

Norway has taken coercive action; the US and Canada encourage voluntary commitments, and the UK urges collaboration. Scandinavian markets have significantly higher female board representation, but southern European markets have yet to see progress in the area. Even in China, the profile of women in leadership roles is probably on the ascendancy. However, barriers – the 'double burden' of women, social typecasting, appointment processes and character traits – still remain. Women still spend twice as much time doing domestic chores as men, and childbearing inevitably involves some kind of break from the workplace.

When women choose to have a family rather than a career, this reduces the talent pool and limits the number of women available for board positions. The potential solution is to offer a working environment compatible with family life. Perceptions of men being better leaders than women still exist – but female leaders were more likely to be accepted within a community if their appointment came after other female leaders, which means that establishing role models may change stereotypical perceptions. Many board positions are not advertised, and are filled through informal networking systems. If these networks are dominated by men, it becomes a self-perpetuating cycle. Recruitment processes need to change, and networks need to be widened and more balanced.

But what of the women themselves? What do they want? Women appear to have lower professional ambitions than men; they aspire less to lead and manage. Employers therefore should tailor training and development according to the different traits of male and female managers, with special emphasis on coaching and mentoring, as these have proved to be effective methods. In the long run, it is the corporations and shareholders that ultimately stand to gain, as they reap the rewards of reduced volatility and enhanced stability in corporate performance. ✱

■ Reporting by the *Banking Insight* Editorial Team.

Developing world-class *talent*

DEVELOPING WORLD-CLASS TALENT IN THE BANKING SECTOR IS ALSO ABOUT DEVELOPING PROFESSIONAL BANKING PRACTITIONERS, REGARDLESS OF THEIR SENIORITY IN THE ORGANISATION.

LYNN McLEOD

Potential

Talent can be defined as a superior performing employee who has potential to contribute significantly more by developing his or her skills, knowledge and experience and who is motivated to do so.

A recent survey conducted by the Chartered Institute of Personnel and Development (2012) found that less than three-fifths of organisations who conduct talent management activities believe they are effective, and that most focus on developing high potential employees and growing future leaders. In this article, I suggest that developing world-class talent in the banking sector is also about developing professional banking practitioners, regardless of their level in the organisation.

First though, what is talent? And how do we know it when we see it? The term 'talent' is often used to refer to people who possess natural aptitude or skill. In a corporate context, it is more often used to describe those who perform well in their role and who have potential to fulfil more senior roles.

Clutterbuck (2012, p.65) suggests that talent can be defined as "a superior performing employee who has potential to contribute significantly more by developing his or her skills, knowledge and experience and who is motivated to do so." He also maintains that such an employee would be regarded as difficult to replace and that they would "contribute significantly to the development of other talented individuals." Talent management is therefore just as relevant for those who could grow and contribute to others' development through lateral movement across the organisation as it is for those who aspire to a more senior position.

If we were to observe superior performing employees in action, what would they do and how would they do it? What values and beliefs would drive their behaviour? What knowledge and skills would they demonstrate? Further, what would differentiate them as world class? As 'world class' suggests international standards of excellence, would the same individual be regarded as a superior performer regardless of the bank or country they worked in, or might cultural differences affect how they are perceived? Interesting though these questions might be, it is the answers that will help clarify what is meant by talent, how it can be measured, and how individuals can be assessed against these measures so that effective talent management solutions can be implemented to develop professional banking practitioners throughout the organisation.

Being a professional practitioner presupposes that an individual has evidenced achievement of professional standards, whether through accreditation against these standards or by completing a professional qualification. As a professional body, the Chartered Banker Institute develops professional standards and provides qualifications for bankers in the UK and internationally. In 2011, the Institute launched the Chartered Banker Professional Standards Board to enhance and sustain professionalism in banking and has published its first standard: The Foundation Standard for Professional Bankers. In doing so, banks are starting to define the knowledge, skills and behaviours required to be a professional banking practitioner and insisting on adherence to a Code of Professional Conduct underpinned by key values that drive customer-focused and ethical behaviour.

Central to the concept of professionalism is that a professional has a specialist knowledge base that underpins their professional judgement and decisions; exercises a high degree of autonomy; and provides a service based on the needs of their clients (Eraut, 1994). Professionalism involves: the understanding and application of knowledge; competence in relevant skills; reflective practice, using critical thought and informed, ethical judgement to make decisions in a range of contexts; responsibility and accountability to others; and engaging in lifelong learning to develop as a professional, and develop the profession itself (Katz, 2000).

To support the development of specialist knowledge and skills, the Chartered Banker Institute, and the Institute of Bankers Malaysia (IBBM) offer a range of professional education programmes and membership designations for bankers at different stages in their careers. Our entry-level qualifications for those new to banking offer the first step on a 'ladder of professionalism' leading to the prestigious Chartered Banker qualification, with 'Chartered' status providing the badge of professionalism that customers demand. For those seeking a Masters level qualification, the Chartered Banker MBA is a popular choice for managers, executives and other professionals with an interest in global banking.

As well as developing specialist knowledge and skills, an effective learning programme that prepares banking students for professional practice should also aim to develop the skills and qualities required to be a professional practitioner; one who is self-aware, self-directed, and who takes responsibility for their own actions. Therefore, learning materials and assessment methodologies are increasingly being designed to support development of these crucial skills from an early stage in the journey to professionalism.

To conclude, developing world-class talent starts with a belief that talent management applies to individuals at all levels in the organisation and that its purpose is not only to grow future leaders but also to focus on developing professional banking practitioners at all levels. The next stage is to define what is meant by talent and use this to create international standards of professional excellence against which individuals can be assessed. The outcome of these assessments can then inform the design of talent management activities and education programmes that are effective in their development of world-class talent and professional banking practitioners.

For further information about the Chartered Banker Institute's education programmes, visit *www.charteredbanker.com*. To keep up-to-date with the development of professional standards, visit *www.cbpsb.org*.

IBBM is collaborating with the Chartered Banker Institute to provide Malaysian bankers with an opportunity to study the Chartered Banker curriculum adapted to the Malaysian environment. This initiative is in line with the objective to develop banking talent and elevate professional standards through completion of professional qualifications. In addition to the Chartered Banker education programme, IBBM offers professional certification in several technical areas such as credit, financial markets, investor protection, anti-money laundering and counter financing of terrorism, internal audit. Please visit IBBM's website, *www.ibbm.org.my*, for further information.

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The next stage is to DEFINE WHAT IS MEANT BY TALENT AND USE THIS TO CREATE INTERNATIONAL STANDARDS OF PROFESSIONAL EXCELLENCE AGAINST WHICH INDIVIDUALS CAN BE ASSESSED.

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BECOMING WORLD CLASS: 'Concierge' Banking

Banks will need to focus on customer centricity, customer service and customer engagement if they want to win in a competitive and challenging landscape. Concierge banking could be invaluable in winning the war for customers' minds and hearts.

MOORAD CHOUDHRY

The market environment for banks remains competitive. While circumstances differ in detail across individual jurisdictions, there is no doubt that banks face severe challenges as they seek to meet the requirements of Basel III and maintain customer focus and engagement.

That last word is the key to future viability and a sustainable operating model: becoming world class means becoming Number One for customer service. All the other requisites – a sound liquidity and funding model, sufficient capital base, rigorous asset-liability management (ALM) discipline – are necessary but not sufficient. Given all the pressures banks face over the next several years, an ability to maintain top quality customer service will prove crucial.

Multi-faceted challenges

The most significant challenges of course are the regulatory ones, those pertinent to both Basel III and specific national jurisdictions. It is a given that these will result in the need for higher capital bases and, in some cases, more expensive funding structures. With the intense market competition in place, it will be difficult in many cases to reprice assets and liabilities; all else being equal, the more onerous regulatory requirements will drive down expected, and actual, return on equity (ROE) numbers.

Banks face additional cost pressures in an effort to maintain competitive advantage. This is particularly prevalent where the macroeconomic environment is one of slow or negative growth. However, perhaps the biggest challenge lies in the field of data quality, and the need to ensure an ability to produce real-time risk reporting that is accurate and representative of balance sheet risks. This will require significant investment in IT and systems infrastructure. The new regulatory regime makes particularly onerous demands of bank's management information (MI); for example, the metrics described in the current Basel Committee consultative paper on intraday liquidity will require considerably more granular data reporting. Another impact of the financial crash, the move to 'credit value adjustment' (CVA) and 'funding value adjustment' (FVA) in the derivatives market, again makes significant extra demands in the data quality and modelling arena.

The impact of these challenges is going to manifest itself in higher costs and lower returns for many banks, within an intensely competitive market. It becomes an imperative for banks to respond swiftly to these issues, perhaps via a 'regulatory and strategy roadmap' that outlines a specific approach in response to these pressures.

Concierge banking

The expression 'engagement banking' refers to engaging with the customer, and should be above all else the primary strategic focus of a bank. My own term for it is 'concierge banking', treating each customer as though he/she/it is the only customer the bank possesses. In other words, a tailored bespoke service for each client. But this is not simply a marketing slogan, it requires a coherent, integrated approach to customer engagement that works seamlessly from origination to processing, and on to ongoing service.

Conclusion

The model we describe as concierge banking is one in which a bank engages with customers across all media and presents the appearance of a tailored service for every individual customer, be they retail or corporate or wholesale. Given the considerable challenges banks face in all areas of their operations in the medium term, across regulation, capital, liquidity and competition, such an approach will help to ensure a bank retains brand value. In the post-Basel III environment, size matters less than customer engagement, which suggests niche players will also thrive. ✱

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ENGAGE

The expression 'engagement banking' refers to engaging with the customer, and should be above all else the primary strategic focus of a bank.

WE CAN CONSIDER THE FOLLOWING **SIX STRANDS** AS PART OF SUCH AN APPROACH :

- **Aim to be the primary banker:** in other words, concentrate on acquiring and maintaining customers with whom one has the primary banking relationship across all products;
- **Engage with the customer** in an integrated manner across all media (branch, phone, mobile, internet, call centre and ATM machine);
- **Present genuine bespoke marketing and communications,** tailored to the long term. This requires a bank to truly 'know your customer'. Efficient IT systems are vital to this strategy;
- **Customer engagement to be as accessible** as possible, ensuring easy understanding. This calls for a simplified and straightforward product range;
- **The management style should not focus solely on P&L** (profit and loss). Customer satisfaction must be inherent in the firm's culture;
- **Risk management:** this is not just the responsibility of the CRO (chief risk officer). In fact it must be a '3 lines of defence' approach: at business unit level, from front end; to define and set risk tolerance levels, which are closely monitored; and then only latterly by the CRO's office.

The key here is to be customer-focused. Ideally one would instil genuine customer satisfaction into the bank's ethos: customer viewpoint must be the No.1 factor in bank culture, strategy and operations, and also drive the main part of staff incentives.

RETAIL BANKING'S SECRET WEAPON

DESPITE THE ADVENT OF WEB 2.0 TECHNOLOGIES, THE RETAIL BRANCH IS STILL AN ESSENTIAL WEAPON IN THE ARSENAL OF WORLD-CLASS BANKS.

DAVID HOVENDEN AND RAFAEL CALDERON

Although we live in the connected age of the internet, email and social media, the branch is still the epicentre of the retail banking business. Many customers value the human interaction a branch provides, evidenced by the primacy of the branch for many important interactions as shown in **Figure 1.** In developed markets even a pure internet retail banking player like ING Direct decided to complement its online operations with the deployment of branches in key locations across particular European countries. In Southeast Asia the role of the branch can be even more prominent in countries where there is a preponderance of cash and absence of alternative channel infrastructure.

World-class banks – aware of the strategic importance of the branch network – are investing heavily to maximise its value creation potential. These banks recognise that success depends on two pillars: branch managers and analytical marketing tools.

Identify

Much of the conundrum lies in the fact that banks often do not understand what makes branch managers tick, and so they treat all managers alike. Instead, banks need to identify and develop the key traits shared by successful branch managers.

Figure 1: Branches are still a privileged sales location (% responded affirmative)

Product	Branch		Phone		Internet	
	Info	Sale	Info	Sale	Info	Sale
Deposits and Savings	13%	71%	10%	7%	18%	7%
Home Loan	18%	49%	35%	9%	12%	3%
Personal Loan	19%	49%	49%	11%	23%	8%
Credit Card	14%	45%	40%	5%	20%	13%
Managed Fund	9%	24%	31%	11%	23%	13%

Source: Booz & Company survey of banking customers in a developed market

The Branch Manager

Exceptional branch managers can have a huge impact on the performance of branches as drivers of the operating and sales processes. In a Booz & Company analysis of more than 4,000 branches in a developed market, only 5-10% of branch managers demonstrated consistent top-quartile performance over a sustained period. Importantly, those branch managers delivered three times the growth of their local competitors.

Most banks fail to recognise the impact a branch manager can have in building a successful local operation. Churn is usually high and few employees aspire to the position. Much of the conundrum lies in the fact that banks often do not understand what makes branch managers tick, and so they treat all managers alike.

Instead, banks need to identify and develop the key traits shared by successful branch managers:

- *Willingness* to be held accountable for both their successes and failures: "I'll find a way to hit our numbers one way or another…That's my job."
- *Pride* in their bank and their branch; they take pride in developing staff and seeing them improve and progress: "I believe in my heart that competitors are not as good and that this branch is the best."
- *Creativity* in developing innovative ideas to bring business to the bank: "If I know a customer has a tendency to overdraw their account, I call them when I see their balance is getting low."
- *Driven* by their branch success not just their own compensation package: "I look at the goals and add 25% above the target as a stretch."
- *Confidence* in meeting their targets and knowing what they need to do to succeed: "I walk to 15-20 new businesses a week and know I will get at least one new account."

In essence, the top-performing branch managers run their branches as if they were their own businesses, with an integrated view of all aspects: sales, service, people and core operations.

Critically, banks also need to differentiate between the two types of successful branch manager:

- *'Town mayors'*, who identify more with their branches than with the overall organisation. They usually have few ambitions to move beyond their current position.
- *'Find the next challenge'* types, who are curious to learn new aspects of the business and run bigger or more complex branches.

Understanding these differences in both ambition and talent is vital to

Figure 2: Approaches to Managing Top Performers

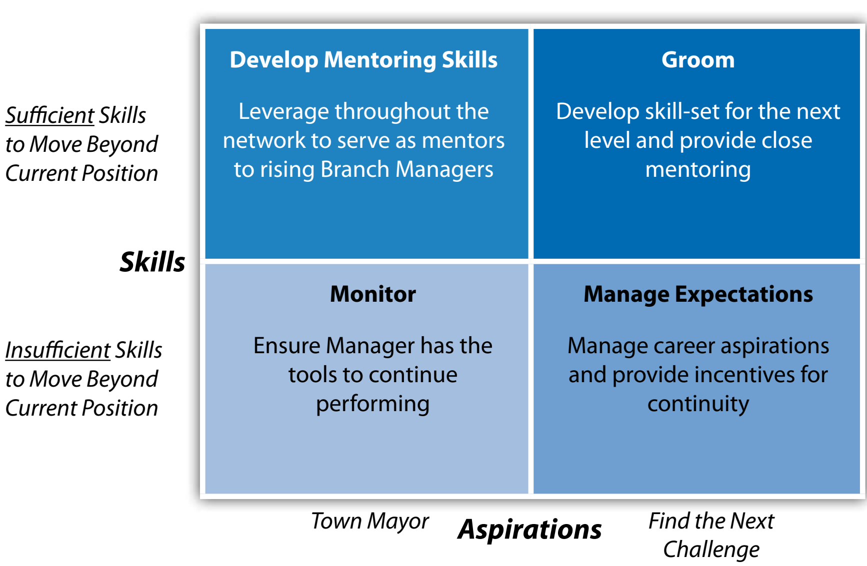
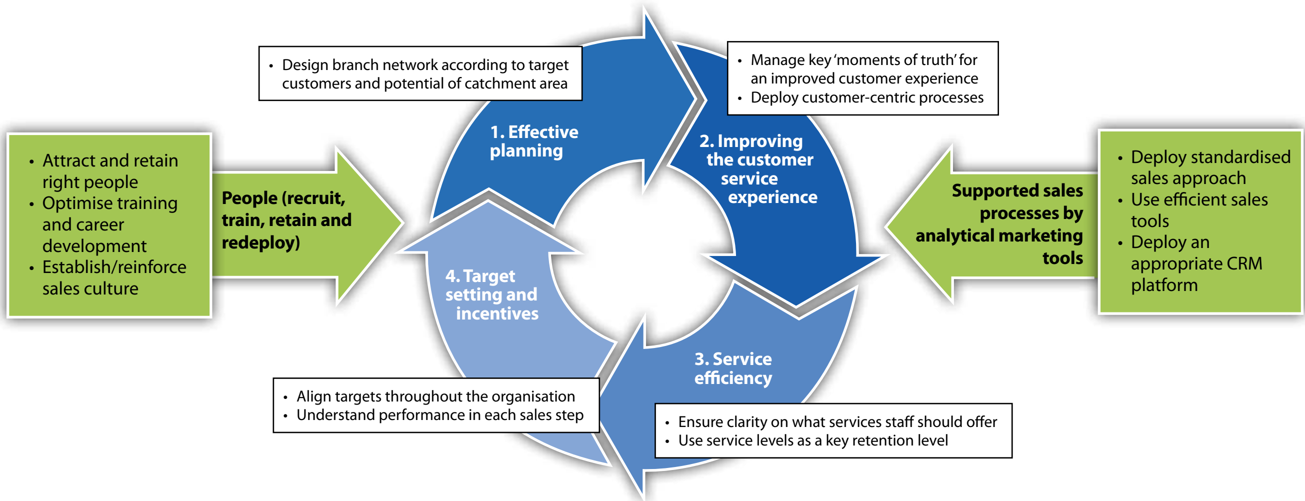


Figure 3: Best-practice branch management model



PERFORMANCE

Industry benchmarking proves that sustained training efforts can make a difference to both staff retention and performance. Performance should be assessed objectively with consistent and clearly defined criteria tied to financial metrics as much as possible.

effectively manage the career path of branch managers. 'Town mayors' can increase their value by acting as mentors of young stars in the organisation. 'Next challenge' managers should be groomed for their next job at a larger branch. And where managers lack the talent but not the ambition to progress, rewards should be geared towards their ongoing success and loyalty. **Figure 2** illustrates the approaches to managing top performers.

This approach places a critical emphasis on training and development, combined with effective performance assessment. Employees across the branch network should be assessed on key capabilities, and specific training and development opportunities should be provided. Additionally, assignment of a manager to a branch should take into account the different nature of branches to maximise learning potential. Industry benchmarking proves that sustained training efforts can make a difference to both staff retention and performance. Performance should be assessed objectively with consistent and clearly defined criteria tied to financial metrics as much as possible.

Analytical Marketing Tools

A well-designed analytical marketing platform can boost the performance of branch managers. On average, successful implementation of such a platform brings an increase of 10% in business volume when compared to the control group and raises the success rate of commercial actions three-fold.

Analytical marketing uses advanced quantitative techniques on banks' databases and external information in order to generate and integrate new and useful knowledge in the commercial process. In our experience, leading banks deploy these analytical marketing tools to help branches and branch managers with eight major issues: client segmentation, commercial alerts, cross selling, pricing optimisation, client retention, credit recovery, optimal use of channels and branch segmentation.

Client segmentation defines clear criteria to segment customers by age, income and financial profile, enabling identification of best practices in managing customers and estimation of business potential. The branch manager can develop an accurate and targeted commercial plan customised to the profile of his current customers and potential customers living in the branch's catchment area.

Commercial alerts determine the most beneficial commercial offer for each client (product, amount to capture, deposit, sales pitch). This tool can significantly enhance the branch manager's performance by triggering automatic alerts to branch employees to help them capture additional business.

Cross selling uses internal and external information to quantify the potential market for product placement based on the development of cross-selling (and up-selling) propensity models. This tool helps optimise the design of targeted commercial campaigns.

Pricing optimisation identifies client sensitivity to price changes and defines customised price ranges per product for each client. The branch manager can differentiate price to maximise profitability by defining a clear exemption granting policy and negotiation brackets for key products.

Client retention facilitates a deep understanding of risk factors for client attrition and identifies clients most likely to leave. Targeted, tailored commercial offers can then be developed for high attrition risk and high value clients.

Credit recovery offers client segmentation relative to debt recovery risk in terms of amount and duration, which helps define an effective debt recovery strategy by prioritising clients, increasing efficiency and minimising provisions.

Optimal use of channels identifies customer transactional profiles and drafts a client migration plan to automatic channels. The branch manager can define a migration plan to automatic channels for certain transactions and increase branch efficiency.

Branch segmentation typifies branches according to representative data on the internal and external environments, aiming at differentiation of branch features to increase proximity to client. This helps the branch manager redefine branch layout, re-allocate human resources and define sales targets.

Client retention facilitates a deep understanding of risk factors for client attrition and identifies clients most likely to leave. Targeted, tailored commercial offers can then be developed for high attrition risk and high value clients.

In addition, retail banks can unleash the power of Web 2.0 technologies. The power of social networking and other digital platforms can improve marketing efforts targeted to younger more internet-savvy customers, particularly relevant in Southeast Asia given the demographics in the region. The key to success will be integrating these technologies into a seamless customer experience.

Successful Implementation

To effectively compete in the retail banking arena banks need to develop and nurture talented branch managers, and provide them with the analytical tools to facilitate their success as illustrated in **Figure 3**. These key elements are intertwined. A Roman emperor would never send his best legion of warriors into a decisive and tough battle without proper swords and shields. Neither would he appoint an untrained army unit with the finest weapon-craft. In the same fashion, banks need to train promising branch managers and equip them with the appropriate tools to win the daily battle for retail banking business.

Deploying this secret weapon is ultimately more of a change management challenge than a technical challenge. Expectations must be managed from the very beginning. Often these efforts begin with a 'big bang' orientation that misstates the nature of the change required to capture the benefits of the transformation programme. Leaders have to layout the business case for change and deliver clear messages to the organisation by:

- *Aligning the new strategy* with the organisation's vision and purpose. The bank should develop a simple and clear statement of intent that links into its vision and purpose, together with a defined roadmap clearly outlining the transformation journey.
- *Defining executable actions.* The bank should develop granular and comprehensive actions for branch managers and stakeholders, embedding the new strategy into business plans and budgets.
- *Engaging branch managers.* Initiatives should be led and owned by branch managers; communication and feedback tools should be used throughout the transformation programme to find the right level of two-way engagement.
- *Sustaining focus on measurable results.* It is critical to set measurable and realistic targets and embed key success factors in business scorecards and performance measures.

Banks that effectively deploy this secret weapon will have a substantial advantage in strengthening their retail banking operations and enhancing customer experience at the branch, making customer centricity more than just a slogan. ✱

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INCREASING THE CHANCES FOR SUCCESS

DATA COLLECTION AND DATA SHARING CAN BE UTILISED AS RISK MANAGEMENT AND PREDICTIVE TOOLS TO INCREASE OUR CHANCES FOR SUCCESS.

HANSRUEDI SCHÜTTER

In our fast-paced world, decisions need to be made on a daily basis. Some of these decisions affect our daily work, and some have a much broader effect on the long-term sustainability of our activities. How are decisions made? Is it experience or gut feeling, is it assumptions or data that give the ultimate impulse and add enough weight to either yes or no?

It is part of human nature to make decisions which seem regrettable later on. Were these decisions made because they seemed right at the time or were they based on solid arguments? Was the decision made based on all the facts or was some crucial information missing? Is not one of the most unethical sales tricks to put time pressure on the prospective buyer, thus preventing him from checking out alternatives and making a comparison?

Obviously, information is an advantage, it is power. Information allows the decision maker to act and exploit opportunities before anyone else does. Therefore ultimately, information is worth money. For a business, managing based on the right information is one of the most crucial elements to ensure success, but it is also one of the biggest challenges to deal with.

COMMON LANGUAGE

According to the Book of Genesis, a united humanity of the generations following the Great Flood, speaking a single language, started building the Tower of Babel. Good progress was made until God confounded their speech and they were unable to understand each other. As a result, they were forced to abandon the project.

A similar pattern can be observed in modern-day projects. 'Misunderstandings' lead to planning or implementation mistakes, delays and cost overruns. Whereas everybody is aware of and accepts different human languages and deals with them in one way or another, many firms ignore the problem of company internal language barriers, where terminology is applied differently by different departments or business lines. Or as a client lamented once: "We lose so much time trying to figure out the meaning of the data we receive because trading and finance departments speak a different language."

DATA COLLECTION

As time progresses, more and more banks, insurers and, to some extent, corporates invest in building loss event databases, storage and reporting capabilities to satisfy regulatory requirements without thinking much about the way they could utilise these data to better manage their business, products, or services offered

Crucial

For a business, managing based on the right information is one of the most crucial elements to ensure success, but it is also one of the biggest challenges it needs to deal with.

and/or to support decisions through which risks could be transferred or insured.

At the same time, whenever a firm suffers a loss, it is often faced with a significant dilemma in how to classify the event. Take, for example, the recent case of UBS and Kweku Adoboli – in many instances, the resulting loss is automatically classified as the consequence of a 'rogue trader' – however, an in-depth analysis of the event will show that many things went wrong before Mr. Adoboli entered into any unauthorised trades or positions. How then can any firm, often operating in multiple and distant centres ensure that each loss event it experiences is consistently and correctly classified? To make things worse, ambiguous definitions and multiple possible correct classifications often cause loss events to fall into potential 'gaps' or 'puddles' between different event categories.

This is then further compounded by the fact that often firms use a classification that makes sense to its business and facilitates good risk management, but need to report or disclose information to the regulator in a totally different, non-business oriented, structure.

PERFORMANCE

It is possible to live with a quick formulation early on. Yet, in the long term, a programme with an ill-designed taxonomy is likely to fare little better in practice than an athlete entering the Olympics with a strong set of muscles but soft bones.

TAXONOMY

Solid information is based on timely, accurate and complete data. But this is not enough. The data must be properly structured, allowing the analyst to unambiguously identify the underlying issue. This is the only chance to collect data from various sources and ensure a correct aggregation without undue distortions.

The way about this requires the use of a well-designed and proven taxonomy. The word "taxonomy" finds its roots in the Greek ***τάξις*** (taxis), meaning 'order', 'arrangement', and ***νόμος*** (nomos), meaning 'law' or 'science'. Taxonomy can thus be defined as the science of arrangement or ordering of data according to specific laws or rules for classification – vital for good record-keeping and risk management.

Firms vary in the extent to which they have focused on taxonomy as a key element of value generation. Many use unmodified, high-level Basel II categories, while some have adopted different hierarchies for specific initiatives. It is possible to live with a quick formulation early on. Yet, in the long term, a programme with an ill-designed taxonomy is likely to fare little better in practice than an athlete entering the Olympics with a strong set of muscles but soft bones.

An effective taxonomy framework may contain a variety of specific data elements. The ideal number and composition of these elements depends on the organisation's specific business needs and its management culture. Some components are core data elements, likely to be included by virtually all organisations (risk category, line of business, etc.). Others are best described as supplemental, or specialised variables that a firm may use to its advantage, but only if suitable.

DATA AS A MANAGEMENT TOOL

With properly classified and reliable data it is now possible to make informed decisions. Sources of such data may be loss events, as used in the example above, but ideally include data collected through performance and/or risk indicators. If regularly analysed, such data may show the first signs of undesirable developments, providing the organisation with an opportunity to make a corrective move at an early stage.

Clients often ask about predictive indicators. It must be stressed that data requires a brain to do the rest of the job. Indicators are not the solution, they are merely objective data that need to be interpreted and worked with. Often enough it is difficult to see beyond the trees that make up the forest, or beyond the data which in combination describe a situation. Successful analysts therefore try to identify things that belong together, that influence each other. Combining such data in an index is a smart way of being alerted of problems where the individual components may not have provided sufficient reason to worry. Nevertheless, not many organisations have gone beyond the individual indicator monitoring stage.

DATA SHARING

An important element in a comprehensive decision-making structure is the ability to benchmark an organisation's data against peers data. Once a client recorded a fair amount of internal fraud. Management was concerned but for lack of better knowledge accepted the numbers as a cost of doing business. Only after they joined a loss data consortium and got hold of their anonymous peers' respective numbers did they realise that their concerns were more than justified. Losses due to internal fraud were way above everybody else's.

As nicely proven in this example, external data can be vital to the overall picture. Since Basel II, external data analysis is requirement to qualify for the Advanced Measurement Approaches to calibrate operational risk capital. The Basel Committee on Banking Supervision supports the idea of loss data sharing but wants to see such activities as private sector initiatives.

Following the Basel suggestion and supporting their banks in their need to obtain external data, a loss data consortium was recently established in Indonesia under the auspices of Lembaga Pengembangan Perbankan Indonesia (LPPI). Participating Indonesian banks will forthwith be able to read up on descriptions of loss events that happened to another bank in Indonesia, but without knowing the bank or the client. They can then use the amounts involved for inclusion in their own scenarios or capital models.

All too often, data sharing initiatives fail because someone internally refuses permission to anonymously contribute the firm's own data. Indonesia's success to establish the Konsorsium Data Kerugian Eksternal (KDKE) is largely attributable to member banks' senior management's embracing of a fresh idea, with encouragement from Bank Indonesia's publicly stated support for the initiative. Malaysian banks, unfortunately, have not passed that support hurdle yet, despite years of contemplating the establishment of such a consortium. ✱

CONCLUSION

As the KDKE example shows, success is the result of a number of factors:

1. *Determination* – the will to do something
2. *Planning* – preparation for an accurate budget and internal sales campaign
3. *Courage* – proposing an initiative with initially unlikely approval chances
4. *Management support* – senior managers taking the time to look at initiatives with an open mind
5. *Discipline* – implementation as per plan
6. *Data quality* – timely, accurate, complete and well structured data
7. *Follow-up* – applying one's know-how to professionally and sometimes inquisitively work with data
8. *External data* – benchmarking and learning from/getting warned by peer data

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GREEN TECHNOLOGY FINANCING - *the next big opportunity?*

JON MALCOLM AND JEAN-FRANCOIS LOWES

Green technology is a global growth area. For example, according to the International Monetary Fund (IMF) between 2000 and 2010, investment in renewable energy - solar, wind, biofuels, biomass and geothermal (but excluding hydropower) - increased from USD7bn a year to USD154bn. Most of this growth occurred after 2004 with only a slight dip during the recession. And it is not just renewable energy; energy efficiency, green buildings, water conservation, waste recycling are among many areas now benefiting from innovation and commercial interest. But will green technology continue to boom?

To answer this question it is worth looking at some of the changes over the last 20 years and considering what is likely to happen in the future.

Since 1992, globalisation has led to a tripling of international trade and foreign investment with a six-fold increase in the trade of natural resources. Low interest rates, cheap commodities and low labour costs have produced significant economic growth in many countries. The world's population has grown from 5.4 billion in 1992 to 7.0 billion today, with more people enjoying a higher standard of living than ever before. This has led to accelerated consumption with the result that resource usage is growing by more than the population. As this data becomes better quantified and validated, an increasing number of academics, business leaders and policy-makers are concluding that we are on an unsustainable trajectory. At current rates of growth and consumption, by 2050 we will need three planets worth of resources to support our lifestyles[1].

One organisation that has looked into the future is the international accountancy firm, KPMG. In its publication 'Expect The Unexpected'[2] it identifies a number of global mega-forces which include material scarcity, ecosystem decline, population growth, increasing wealth, energy and water scarcity. Topping the list is climate change, which KPMG considers to be "the one global mega-force that directly impacts all others".

These mega-forces are creating numerous disturbing pressures. In particular there is increasing global demand for resources, mainly due to a rapidly rising world population and a growing resource-hungry middle class. Also, we have falling stocks of natural resources, which in some cases will be increasingly difficult to exploit.

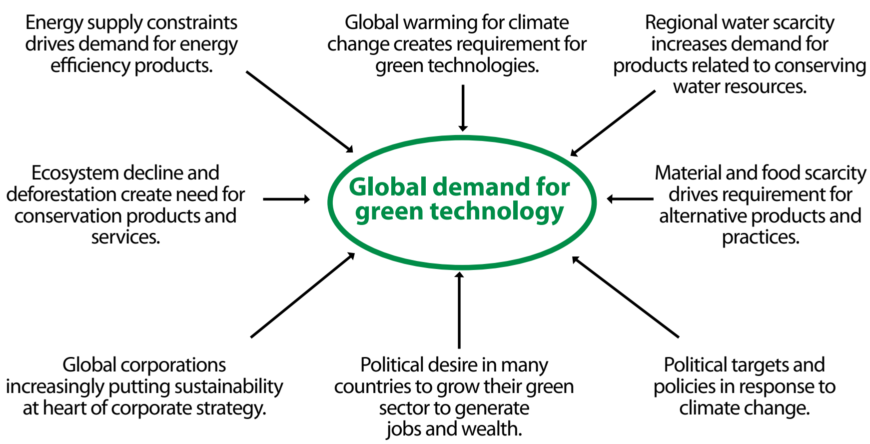
Therefore any product or service that ameliorates the situation will be highly prized, a point not lost on many companies, both large and small. Politicians also see opportunities for job creation and increasing the living standards of their constituents. Fundamentally, global demand for green technologies looks set to grow and grow *(see Figure 1)*.

However, there are some barriers.

Resource

At current rates of growth and consumption, by 2050 we will need three planets worth of resources to support our lifestyles.

Figure 1: Growing green technology



EXPAND

Since the green sector is relatively new and certainly fast developing, another barrier is the lack of knowledge by potential buyers as to the possibilities. This can also extend to organisations that might provide the finance for green technology projects.

For instance, in a number of countries, the cost of fossil fuels (generally oil, natural gas and coal) is subsidised by the government, which extends the payback on renewable energy projects and so acts as a disincentive. This is in sharp contrast to many countries which apply taxes to fossil fuelled energy usage, so-called 'brown' taxes, and this serves to stimulate energy efficiency related products.

Since the green sector is relatively new and certainly fast developing, another barrier is the lack of knowledge by potential buyers as to the possibilities. This can also extend to organisations that might provide the finance for green technology projects.

In Malaysia, the government has sought to facilitate the growth of the green sector by introducing the Green Technology Financing Scheme (GTFS)[3]. This 'soft loan' scheme is designed to benefit Malaysian companies that are either producers or end-users of green technologies. The government will bear 2% of the total interest rate and will guarantee 60% of the financing amount, with only 40% of the financing risk borne by the participating financial institutions. The original scheme started in 2010 and has now been extended to 31 December 2015.

Four sectors have been targeted, namely:

- Energy
- Buildings and township
- Transport
- Water and waste management

According to the scheme administrator, GreenTech Malaysia, as at July 2012, 48 companies had received loans totalling RM800 million.

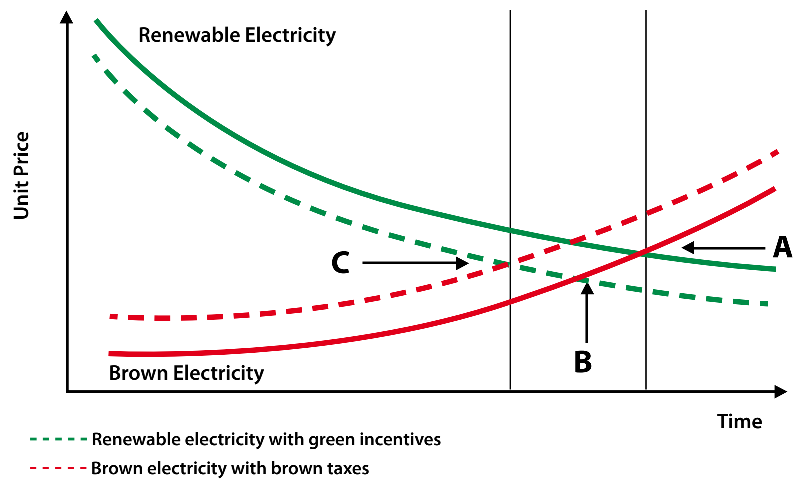
Another measure introduced by the government is a range of feed-in tariffs (FiTs)[4], a policy which has been adopted in over 50 countries. Where an eligible renewable energy technology has been implemented (i.e. biogas, biomass, small hydro or solar photovoltaic) the owner can receive regular payments for the electricity fed into the grid. The actual rate or tariff received will depend on a number of factors including:

- Type of renewable resource used
- Installed capacity
- Date the installation was completed, connected to the grid and ready to produce renewable electricity for sale

Additional bonus rates can be available if certain criteria are met, for example, if the solar photovoltaic modules are manufactured or assembled in Malaysia or in the case of a biogas project, landfill gas or sewage gas is the fuel source.

The cost of electricity from renewable energy has been falling due to factors such as advances in technology and production economies of scale. This trend is likely to continue but probably at a diminishing rate. Conversely, electricity generated from fossil fuels, also known as 'brown electricity', is likely to increase as global demand climbs and more easily extractable reserves become depleted. In simple terms, when the unit costs of renewable electricity and brown electricity are the same, 'grid parity' is said to have been reached *(Point A in Figure 2)*. The feed-in tariff system in Malaysia has been designed with the main objective of achieving grid parity and through its introduction this should be accomplished earlier than would otherwise have been the case *(Point B in Figure 2)*. Grid parity could be

Figure 2: Grid parity - Green Incentives and brown taxes



reached even sooner, if subsidies on fossil fuels were removed and brown taxes implemented *(Point C in Figure 2)*, which would certainly shorten the payback periods of renewable energy related projects and thereby hasten the uptake of these green technologies.

Grid parity for any particular project will of course vary due to a number of factors, not least the type of renewable energy technology used. Importantly, once grid parity has been reached for a particular technology in a particular location or region then simple economics should drive a strong trend away from 'dirty brown' fossil fuels to 'clean green' renewable fuels – that is good for the economy and good for the environment.

Green technologies that qualify for the GTFS

Solar energy offers a lot of potential, particularly solar photovoltaic panels. Electricity generated from these panels can earn up to RM1.75 per kilowatt hour of electricity generated and fed into the grid. The FiTs are guaranteed for 21 years.

Mini hydro is another area which benefits from a feed-in tariff and has the additional benefit of being able to generate electricity for 24 hours a day. The technology is well tested, long lasting and robust.

Biomass is eligible for the GTFS and is plentiful in Malaysia with significant sources being empty fruit bunches, palm kernel shells and palm frond prunings. The technology for generating electricity from biomass is well proven and relatively inexpensive. These projects also qualify for FiTs. The key issue for the success of these projects is a reliable long-term source of feedstock.

Biogas is a product of anaerobic digestion, where agricultural wastes are converted into gases and digestates inside a sealed tank. The gas can be burnt in a gas engine to generate electricity and the digestate can be used as crop fertiliser. Again the technology is well tested and reliable as well as being eligible for FiTs. As with biomass, the key issue for these projects is a long-term supply of feedstock.

Demand side technologies are those that reduce energy consumption in the organisation; they can be financed under the GTFS and the main benefit is a reduction in energy consumption and therefore costs. Low energy lighting is an example as is variable speed drives for industrial machinery.

Some elements of building and construction are eligible for the GTFS, such as energy-efficient fixtures and fittings, roofs and windows that generate power from the sun and water-efficient plumbing systems. Solar photovoltaic roof tiles and solar glass are examples of construction projects that can be financed under the GTFS.

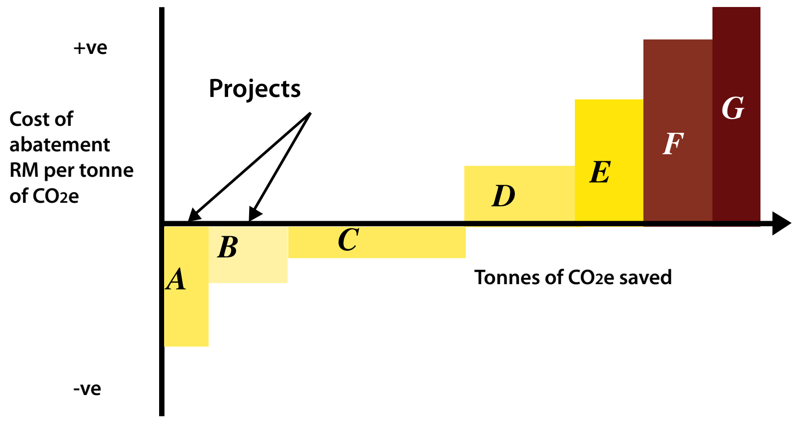
Waste management is included in the scheme and largely comprises waste recycling and waste to energy. Capturing landfill gas and using it to generate electricity is eligible for the feed-in tariff.

The role of banks

The role of banks in sustainable development is threefold. Firstly, their role is to incorporate environmental and social responsibility into their own operations, for example improving their own energy efficiency and waste recycling rates. Secondly, it is to integrate environmental and social responsibility into their products and lending strategy; for instance, by supporting green technology financing. Thirdly, banks have an important role to play in raising awareness and in providing finance to support the National Green Technology Policy Objective of the government, of which the GTFS is a part.

In terms of the GTFS there are significant advantages in a bank having a specialist team to evaluate green loan applications. They will develop expertise in the different technologies and understand the underlying

Figure 3: Marginal abatement cost curve



dynamics of each technology, for example solar photovoltaic and grid parity. Advice from a major UK bank that has a large green loan portfolio is to focus on just two technologies at the start so that the specialist team builds up understanding and experience of these technologies which will improve their confidence and the quality of the loans they make.

When evaluating sustainable projects it is useful to split them into four types:

- **Revenue earning**
  Such as generating electricity from renewable sources
- **Cost saving**
  Reducing energy costs for the organisation
- **Greenhouse gas reducing**
  Powering emissions for the organisation
- **Pollution avoiding**
  Reducing environmental degradation

The costs and benefits of the project should be evaluated using a financial model (usually a spreadsheet) to provide a consistent approach and allow comparison of different projects. Net present value (NPV) and payback are the normal techniques adopted for financial evaluation.

Forecasts of the annual costs and benefits for the project are used to calculate the annual cash flows. These are then discounted back to the present day using a weighted average cost of capital. This net present value (NPV) is an important factor in the decision whether to invest in the project or not.

Usually the project is subjected to risk analysis, both qualitatively and by adjusting the key assumptions in the model. For example, reducing the revenues by various percentages to see how sensitive the NPV for the project is to changes in revenue. The debt service coverage ratio and the loan life coverage ratio are also useful measures of project loan risk.

One way of prioritising greenhouse gas (GHG) saving projects is by using a marginal abatement cost curve (MACC). This uses a formula combining the NPV of the project with the amount of carbon dioxide equivalent (CO_2e) saved over the life of the project, to rank projects in a sequence that optimises the GHG emissions reductions and the NPVs of a series of projects (Figure 3). There is also a version that works with project paybacks.

In conclusion, driving forces such as climate change, energy security of supply and water scarcity are creating a long lasting demand for green technology products and services. Clearly it makes sense for companies and banks to build up their expertise and get involved sooner rather than later, so as to take as much market share as they can, before their competitors make a name for themselves and become the dominant players in this fast growing sector. ✱

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■ Jon Malcolm and Jean-Francois Lowes have been consulting and training in the area of sustainability and green technology for six years. They are directors of Xcarbon Limited, a consultancy based in the UK.

Jon Malcolm has a background in geochemistry and an MBA. Jean-Francois Lowes is a qualified accountant (CIMA), has an MBA and a background in management accounting. In 2012, in partnership with the BPP School of Business, they developed and delivered a two-day course in Kuala Lumpur entitled 'Green Technology Financing', for the Institute of Bankers Malaysia.

GROWING MALAYSIAN Greentech Finance

HOW CAN MALAYSIA BUILD CAPACITY IN THE GREEN TECHNOLOGY FINANCING (GTF) SECTOR IN LINE WITH WORLD-CLASS BENCHMARKS? INTERNATIONAL EXPERTS SHARE THEIR INSIGHTS AND SUGGESTIONS FOR EXPANDING MALAYSIA'S GTF SECTOR.

FONG MIN HUN

Malaysia's depleting stock of domestic fossil fuel and the continuing volatility of external fuel prices is driving the growth of its renewable energy and green technology sectors but the lack of an adequate financing structure may hamper development of local green industries.

Like many other economies, Malaysia faces a potential energy security issue if its dependence on fossil fuels for power generation continues unabated. According to national power producer Tenaga Nasional Bhd (TNB), peak demand for electricity in Malaysia presently stands at about 15,000 megawatts (MW), with 93% of the country's generating capacity coming from gas, coal or distillate. Their energy demand is projected to increase to over 20,000MW by 2020.

A good illustration of the tenuous relationship between the supply of fossil fuel and power generation in Malaysia is the mini-crisis experienced by national power producer TNB in 2011. The company said at its investor briefings that an interruption to its gas supply from domestic sources soured its profits for three consecutive quarters after it was forced to purchase fuel from the open market to meet its energy obligations.

The gas disruption, which occurred when several production platforms were taken offline for maintenance, forced TNB to purchase coal from the open market at a time when the price of the commodity had hit multi-year highs. The event revealed significant weaknesses in the country's energy policy – its dependence on subsidised gas, the country's stretched production capacity – and signalled the need for the development of a robust alternative energy policy.

The global movement towards sustainability and initiatives by global agencies such as the United Nations' Millennium Development Goals also suggest that taking measures to promote renewable energy is the politically correct strategy in this era of climate change and ever-expanding carbon footprints.

But in this country where renewable energy has yet to take off on a significant scale, new ventures into the sector are constrained by a paucity of willing financiers. The sector is plagued by the 'chicken or egg' dilemma: financiers are reluctant to fund projects on a large scale because there is no proven track record, and project owners cannot develop track records because of a lack of financing.

However, there is no denying that banks and financial institutions could be a key catalyst for initiatives relating to green technology and sustainability. Carey Bohjanen, Managing Director of Sustainable Finance Advisory, a multinational firm specialising in emerging markets, noted that banks are exposed to every industry in the economy – from agriculture to manufacturing to exports – and hence can potentially play important 'levers' for the expansion of green technology. The idea here, she says, is to leverage on the dependence of industry on financing to get green technology off the ground.

For example, in the case of manufacturing, banks could insist that manufacturers adopt sustainable practices before they would release financing. Thus if the manufacturer needs financing, not only does it need to convince the bank of its commercial viability and its ability to repay the loan, but it must also show that it fulfils certain environmental standards.

There is no denying that banks and financial institutions could be a key catalyst for initiatives relating to green technology and sustainability.

PROMOTE

The global movement towards sustainability and initiatives by global agencies such as the United Nations' Millennium Development Goals also suggest that taking measures to promote renewable energy is the politically correct strategy in this era of climate change and ever-expanding carbon footprints.

Bohjanen noted that while adoption of new principles such as sustainability usually works best when they are driven by a business need, in a market like Malaysia, mandatory regulations and enforcement may have to be implemented before mindsets shift and significant change takes place.

Indeed, global agencies have already recognised the role of banks in driving sustainability and resource conservation. The United Nations Environment Programme (UNEP) embarked on a Finance Initiative to get commercial banks involved in sustainability and environmental issues as early as 1991. This initiative was further developed down the decades and now involves over 200 member institutions from 40 countries, though no institution from Malaysia is listed as a participating member.

According to the UNEP Financial Initiative Statement, some of the key ideas behind the initiative are:

- Identification of sustainable development as an aspect of sound business management,
- Financial institutions are important contributors to sustainable development through their interaction with other economic sectors, consumers and their own activities,
- Sustainable development is integral in the pursuit of good corporate citizenship and sound business practice.

Are local banks too conservative?

Local banks are understandably reluctant to invest substantial amounts into unproven technology and projects with unknown historical returns, given the limited track record of local GTF projects and banks' commitment to optimising shareholder returns. Another challenge is that Malaysian banks and businesses currently lack the qualified human capital, knowledge and expertise to successfully manage GTF initiatives. Tight governmental control over the power generation sector may also impede the development of a robust market for GTF.

Might the conventional adherence to profit motives and shareholder returns be hindering the more widespread adoption of GTF? Ken Furukawa, Mizuho Corporate Bank Ltd's Senior Vice-President and Head of Renewable Energy and Carbon Business Team remarked that banks retain a fiduciary duty to their shareholders to have reasonable profitability, despite the moral and sustainable imperatives to pursue GTF financing.

"This is a business," Furukawa said at the sidelines of the Green Technology Conference held in Kuala Lumpur in October 2012. "We are seeking our own profitability and improving customer relationships. In order for us to look at a particular deal, we need to be comfortable with its financial capacity or commercial viability."

Gregory Liu, the Senior Vice-President of Project Finance Investment Banking Asia for Sumitomo Mitsui Banking Corporation concurred with Furukawa's assessment. "They (local banks) cannot take risks that they cannot understand. That is the truth for every banker," he said.

But GTF financing and profitability need not be mutually exclusive. On the contrary, Bohjanen said, it is about changing the way banks think about sustainability risk and opportunity, and to convince them that the operating environment is changing quickly.

The consequences of not doing so, particularly in this day and age of social media and online distribution channels, can be devastating for the non-compliant financier. A case in point is Citigroup's run-in with the Rainforest Action Network in the early 2000s.

Though Citigroup was not itself directly responsible for the destruction of the Brazilian rainforest, the fact that its financing helped companies do so became a public relations nightmare for them. The Rainforest Action Network held a massive campaign getting people to destroy their Citi credit cards, and was backed by Hollywood celebrities such as Susan Sarandon and Ed Asner. The campaign forced Citi to concede some ground and agree to adopt more

responsible social and environmental policies in deciding what projects to finance.

"Sustainability is better business in a number of ways," Bohjanen said. "The benefits for banks include improved risk management – not just financial risk but non-financial risk considerations – as well as cutting costs, avoiding potential legal issues or unexpected payouts and helping build deeper and more enhanced client relationships."

"Banks need to make money. We are not telling business, no, stop what they are doing, but make sure it is environmentally sound and socially relevant in addition to being economically profitable."

Due Diligence and Good Risk Management

Meanwhile, adapting and adopting best practices and conducting stringent due diligence could help smooth the learning curve for GTF. In the initial stages of its GTF business, Mizuho worked together with other foreign banks that had experience in financing renewable energy in order to build its own track record and expertise. This collaborative framework helps build capacity, and Mizuho would be more than happy to do the same with local Malaysian banks, said Furukawa.

Banks may also be reluctant to support GTF unless they can demonstrate satisfactory returns on investment or the initiative fits into their sustainability agenda. "Supporting greentech finance should not be seen as a charity. If banks lend, they want to see it as a performing loan," remarked Liu.

Risk management takes a front seat for banks despite a project's purported environment benefits. "If the project is not completely sound in our assessment, we have to be careful even if we have a strong view on its environmental contributions. About four to five years ago, when we had our first solar PV (photovoltaics) transaction we had to do really careful due diligence (before we signed the deal),"said Furukawa.

Lack of competition could be another factor dragging down the GTF sector. Liu's colleague from Japan, Kenji Baba, Head of Environment and New Business at Sumitomo Mitsui Banking Corporation argued that one reason for the local industry's reluctance to take on more risk could be due to a dearth of intense competition.

"Compared to the Japanese, high competition among local banks is limited and that is one reason why they do not want to take on more risk," Baba said. "Without implementing compulsory rules or mandating greentech financing, it may be difficult for the bank to move ahead. Having the right policies in place – such as some kind of guarantee or support from the government – may be helpful."

Furukawa said he too judged that local banks are conservative in their unwillingness

COMPETITION

"Compared to the Japanese, high competition among local banks is limited and that's one reason why they don't want to take on more risk," Baba said. "Without implementing compulsory rules or mandating greentech financing, it may be difficult for the bank to move ahead. Having the right policies in place – such as some kind of guarantee or support from the government – may be helpful."

to take on some risk with respect to the renewable energy sector. "Obviously, we have to maximise the structure to minimise risk from the sponsor but local banks should be more confident. They are really good banks but when we look at our experience, if the projects are owned by and run by reliable and strong sponsors, we have managed the risk to some extent."

Furukawa added that Mizuho did not presently have any exposure to the green technology sector in Malaysia, but was actively looking for deals. Mizuho is heartened by the support of the Malaysian government and the central bank in developing this sector, which is a key advantage for Malaysian industry. Meanwhile, Sumitomo is involved in a rooftop solar project involving a local and Japanese company that will generate up to a megawatt of power for the national grid.

Developing and Supporting GTF in Malaysia

Further regulations may still need to be developed to support greentech financing and encourage local banks to build the required capacity and talent to take on greentech projects successfully.

Bohjanen noted that while adoption of new principles such as sustainability usually works best when they are driven by a business need, in a market like Malaysia, mandatory regulations and enforcement may have to be implemented before mindsets shift and significant change takes place.

As a developing market that still holds a reserve of natural resources, Malaysia's further growth and development could be impacted if environmental and social considerations are not part of the economic development equation, said Bohjanen.

She cited Nigeria as a good example. As with other agriculture-based emerging economies, Nigeria was, prior to the discovery of oil, a net exporter of food, but with oil came quick profits and a new economic focus.

As a result of the paradigm shift, Nigeria became a net importer of food, with marginal bank financing being directed towards agriculture. Despite plentiful arable land and sound reasons – such as food security and job creation – to place greater focus on agriculture, the comparatively lower returns meant that oil production became Nigeria's central focus.

Currently, together with the Nigerian central bank and its financial institutions, Bohjanen is helping to create a new model for the market that will encourage development in agriculture as well as other economic sectors. "Part of it is environmental and social risk management but part of it is saying, in a Nigerian context, what are the specific needs that we have around economic growth and development where the financial sector has a role to play," she said.

She conceded that Malaysia as a sovereign nation and the banking sector will likely need to change from the top-down to nurture sustainability and GTF, and that the government and Bank Negara Malaysia can play strategic and transformative roles. One approach would be to ensure that all financial institutions make the same demands of their clients *vis-a-vis* sustainability, for instance implementing financing criteria requiring certain projects to comply with environmental and social standards.

Undoubtedly, the Malaysian government is cognisant of its role in supporting the sector's development, and is similarly aware of the financing limitations constraining the nascent industry. In response, the government created the Green Technology Financing Scheme (GTFS) in 2010, which offered RM1.5bn in soft loans for sector players.

EXPAND

"The government has put in place the necessary support, incentives and infrastructure. Therefore the banking industry must reciprocate in kind, by allocating more resources and putting in place the required ecosystem to expand financing into this exciting new era of new financing."

The scheme was further enhanced in the recently tabled Budget 2013, which added another RM2bn into its coffers for disbursement. Meanwhile, Prime Minister Dato' Sri Mohd Najib Tun Abdul Razak was quoted in the media recently as saying that the Malaysian Green Technology industry was valued at RM67bn and grew 6% from 2010 to 2011.

The call for greater participation by the local banking industry was echoed by Bank Negara Malaysia's Deputy Governor Dato' Muhammad bin Ibrahim in his opening remarks at the Green Technology Conference. "It is in the financial industry's interest to be involved and engaged in its rapid development," he said. "The government has put in place the necessary support, incentives and infrastructure. Therefore the banking industry must reciprocate in kind, by allocating more resources and putting in place the required ecosystem to expand financing into this exciting new era of new financing."

In addition to financing, Muhammad said, the financial sector must also be prepared to provide advisory support as well as develop capacities to assess the viability of projects.

Despite the push from the government, Sumitomo's Liu feels that Malaysia needs more time to mature and build up capacity before it can implement its renewable energy plans on a large-scale basis.

"It is moving towards the right direction but maybe we need to be more realistic," he said. "I personally think that there should be continued effort over two or three years to build up a knowledge base among the practitioners." Optimistically, Malaysia is starting from such a low base for GTF that there is ample room for growth. ✱

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GTF: The Business Perspective

Despite the government's commitment to the Green Technology cause, Malaysian green technology promoters claim to find the road forward difficult.

Nasir Adnan, Vice-President for Core Competencies Sdn Bhd, is one of the early adopters of greentech. Core Competencies owns the country's first waste-to-energy plant, Recycle Energy Sdn Bhd, in Semenyih, Selangor. Recycle Energy essentially accepts incoming waste and sorts and recycles what it can, while turning the remainder into engineered fuel that produces clean, green energy.

Set up in 2004, Recycle Energy presently generates a total of about 9MW per hour, of which 5.5MW is sold to Tenaga. The rest is used to power the plant's facilities including its recycling and processing components making the plant a completely self-subsisting entity. It receives between 500 to 700 tons of municipal solid waste daily and is operating at full capacity.

From the promoter's perspective, Nasir says that there are a number of issues with the provision of financing for the sector. Among them are:

i) A lack of knowledge and expertise on technologies on the part of both government and banking officers
ii) Rigid evaluations of business viability that do not adequately reflect differences between green technology and conventional businesses
iii) Bureaucracy in the form of many overlapping agencies that hinder promoter efforts.

Despite the clarion call for innovation, "There is no clear support for local developers who have come out with their own home-grown technology," Nasir said in an email interview. "We are one of the examples. Rather than receiving support, we got more of a run-around…and more providers out there have voiced their frustrations to us."

Insufficient Funding, Poor Administration

On the bright side, Nasir said the Green Technology Financing Scheme (GTFS) introduced by the government was a step in the right direction though, again, he said the way it was managed could have been handled better. The amount made available through the government is also comparatively less than that of other developed economies, which makes getting off on the right foot all the more difficult.

"It was a good start when the government announced the Green Tech Financing Scheme of RM1.5bn earlier in 2010, but it kicked off badly owing to poor implementation by the authorities and member financial institutions involved," he remarked.

"Now with the additional RM2bn announced in the recent budget speech and also an additional RM300 million by Malaysia Debt Ventures Berhad (MDV), the amount is a boost for greentech participants (be it developers or users), but, compared to other developed countries, this amount is pittance."

TO BE EFFECTIVE, GREEN TECHNOLOGY NEEDS TO BE TAILORED TO THE REQUIREMENTS AND CONDITIONS OF THE LOCAL MARKET.

Engaging the Experienced

A key challenge, judging from the picture painted by Nasir, is the lack of a coordinated effort on the part of not just the financiers, but all stakeholders involved in the project. Getting the right people to the table, including the operational people, is vitally important for projects such as these, but may require that the government take a more streamlined approach to the sector.

To be effective, green technology needs to be tailored to the requirements and conditions of the local market. Unfortunately in Malaysia, the perception is that the people with on-deck experience who can provide greater insight into the challenges and issues are not being sufficiently tapped by the relevant authorities.

"People like us (who are on the ground in the technical, operational, financial management) are not being called upon to participate either by the IBBM, Bank Negara, or the ministries concerned," he said. "As practitioners, we are deemed to be on 'the other side of the table' in funding exercises. Operators and practitioners who get their hands dirty to do things right and the people with most exposure in real life are being left out despite their knowledge and experience."

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