banking insight

IDEAS FOR LEADERS
DECEMBER 2014

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FUTURE FOR BANKERS: PROFESSIONAL DEVELOPMENT

MANAGING TALENT AND RISK: WHERE THOU SHALL PROSPER

BOLSTERING RISK MANAGEMENT

DOES BETTER GOVERNANCE MEAN SAFER BANKS?

BANKING IN THE SHADOWS

RIDING THE SILVER TSUNAMI

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RESPONDING TO THE RISK EMERGENCY

BANKING IS MIRED in an emergency risk situation, where risks seem to be emerging from every direction, in every shape and size. Indeed, dealing with risk could be likened to a hybrid between the labours of Hercules and Sisyphus – where bankers strive to manage seemingly impossible and difficult hazards on a daily basis.

The fact is that risk is ubiquitous and unceasing, but there is no option of sweeping risks under the carpet. Managing risk is a must-do agenda in this age of uncertainty where the only certainty is risk itself.

Aptly, this edition of *Banking Insight* is the 'Risk Issue', so-called because it examines a plethora of disruptive risks, ranging from talent risk, compliance and regulatory risks, and high household debt to GDP ratios, to ageing population risks, shadow banking or disintermediation risks, governance and structural risks, and sovereign risks.

Since these risks are so diverse, logically strategies for control too would differ. There is no one-size-fits-all solution. Rather, bankers should adopt best practices to shield against risk, such as clearly defining risk profiles and risk appetites, improving transparency and accountability, and establishing a worst-case scenario strategy for resolution in case of financial distress or crisis. Read more about this in the coverage of the AICB Risk Management Conference 2014, with the theme of 'Bolstering Risk Management Amidst a Challenging Landscape'.

Other recommendations to reduce enterprise risk would entail restructuring governance in banks. In 'Does Better Governance Mean Safer Banks?', Professor Jens Hagendorff argues that banks being 'unique beasts' demand atypical governance arrangements. For instance, given high leverage, banks' pay incentives should align managers more with creditors than shareholders. Dr. Raymond Madden, CEO of the Asian Institute of Finance comments that many financial institutions have failed to consider talent risk as part of their broader risk management strategy, and encourages better integration between human resources and risk management, especially in compensation, hiring, succession planning, professionalism and ethics. Meanwhile, corporate governance guru and author Datuk John Zinkin advises bankers to embrace ethical culture and values, a stance which resonates strongly with AICB. If banks continue with 'business as usual' and pay only lip service to culture and values, Malaysian banks will be faced with a 'perfect storm' when the next crisis hits.

Banks should also examine their defences against sovereign risk, which can be highly damaging as evident from the global financial crisis of 2007/2008. Donald R. van Deventer, Suresh Sankaran, and Clement Ooi of Kamakura, which offers a sovereign default service, recommend moving from legacy credit ratings to modern reduced form default probabilities to better assess sovereign risk.

No issue on risk can avoid discussing compliance and regulatory risks, such as those arising from Basel and IFRS. Professor Moorad Choudhry discusses the current challenges in liquidity risk posed by the requirements of the Basel III liquidity regime, specifically its liquidity coverage ratio and net stable funding ratio reporting metrics.

However, it is disheartening to note that the tsunami of regulations, along with the most sophisticated technical solutions, are not an iron-clad guarantee against risk. No regulator dares say that compliance can avert the next financial crisis – and by extension, a global meltdown. Rather, it is adherence to the principles underlying compliance that will create the desired outcomes – salvaging and restoring public trust and fortifying the industry against potential future crises. Ethics will be our salvation, not prescriptive rules. Bankers must revisit ethics and embed principles of good governance and enlightened behaviour, and this is precisely what AICB champions through the professional chartered banking offerings of our Asian Banking School.

It is AICB's hope that the bankers of today and tomorrow - from shop-floor to boardroom - will invest in quality learning and integrate professional standards and ethics into the banking culture. While this will require substantial focus and efforts, the creation of a strong risk culture will pay off when banks are able to strengthen financial performance, improve strategic management and realise a true competitive advantage. ✱

Hope you have a fruitful read.

THE EDITOR

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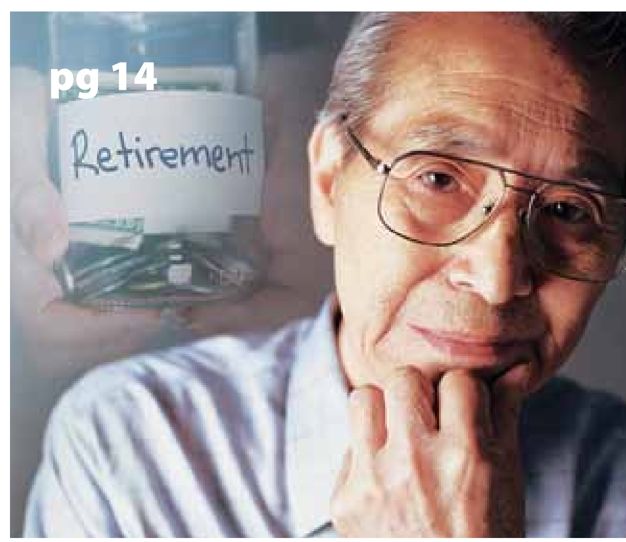

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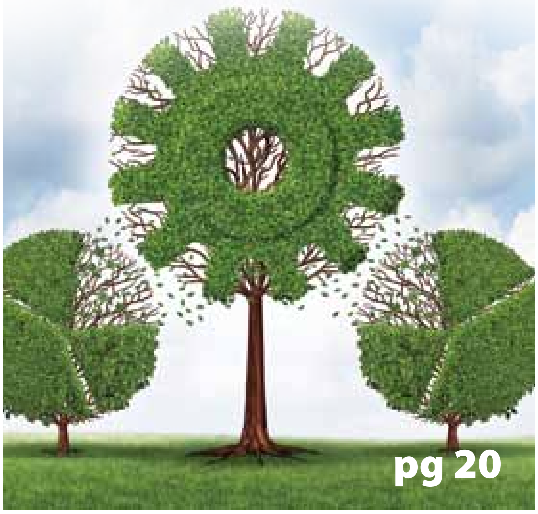
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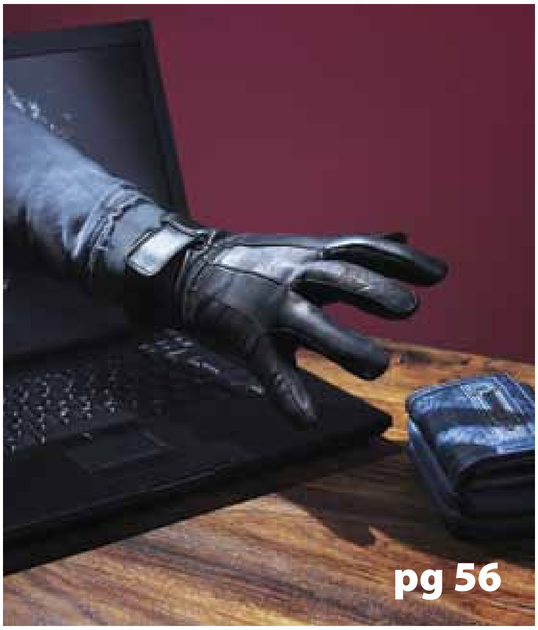
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RISK TAKES A FRONT SEAT

RISK CULTURE is at the forefront of banks' agenda as fines and remediation hit home, according to EY.

EY research has found that 50% of global systemically important banks (GSIBs) reported operational losses of more than USD500 million in the past five years. 47% of this is attributed to fines, and 93% of GSIBs agree that weak oversight and controls led to these failures.

As a result, 84% of GSIBs and 66% of banks are now changing their culture, noted EY in its annual risk management survey of major financial institutions, 'Shifting Focus: Risk Culture at the Forefront of Banking', in cooperation with the Institute of International Finance (IIF). The survey polled 53 IIF members across 27 countries.

Moreover, the survey reported a clear shift this year to general agreement that culture can be deliberately changed and effectively managed and enforced. Over two-thirds (68%) of those surveyed say they are strengthening accountability regarding risk roles and responsibilities, 58% are aligning compensation with risk-adjusted performance metrics and 86% state that severe control breaches will trigger serious disciplinary actions. ✱

MORE ACTION NEEDED, SAYS ECB

THE EUROPEAN CENTRAL BANK (ECB) recently published the results of a thorough year-long examination of the resilience and positions of the 130 largest banks in the Eurozone as of 31 December 2013, and concluded that much more action is needed.

The comprehensive assessment - which consisted of the asset quality review (AQR) and a forward-looking stress test of the banks - found a capital shortfall of €25bn at 25 banks. Twelve of the 25 banks have already covered their capital shortfall by increasing their capital by €15bn in 2014. Banks with shortfalls must prepare capital plans within two weeks of the announcement of the results. The banks will have up to nine months to cover the capital shortfall.

The AQR showed that as of end-2013 the carrying values - or book values - of banks' assets need to be adjusted by €48bn, which will be reflected in the banks' accounts or prudential requirements. Furthermore, using a standard definition for non-performing exposures (any obligations that are 90 days overdue, or that are impaired or in default), the review found that banks' non-performing exposures increased by €136bn to a total of €879bn.

The comprehensive assessment also showed that a severe scenario would deplete the banks' top-quality, loss-absorbing Common Equity Tier 1 (CET1) capital - the measure of a bank's financial strength - by about €263bn. This would result in the banks' median CET1 ratio decreasing by 4 percentage points from 12.4% to 8.3%. This reduction is higher than in previous similar exercises and is a measure of the rigorous nature of the exercise.

Since the announcement of the exercise in July 2013, the largest 30 participating banks have undertaken various measures, including capital raising to an amount of €60bn, to strengthen their balance sheets by a total of more than €200bn. These frontloaded measures are part of the overall successful outcome of the exercise. Some of the measures taken in 2013 reduced the insufficiencies detected by the comprehensive assessment; some measures adopted in 2014 may count toward the coverage of the capital shortfall. ✱

UNDERSTANDING DIGITAL EVOLUTION

NO BANK CAN AFFORD to ignore the opportunities opening up from the digital economy. But which countries and markets offer the richest potential?

To enable businesses and governments to make sense of the evolving global digital landscape, reveal patterns and provide insights into current and future Internet users, MasterCard and The Fletcher School at Tufts University collaborated to create the Digital Evolution Index. According to the Index, Singapore, Sweden and Hong Kong occupy the top three spots on the list of countries primed to welcome the next billion Internet users thanks to their advanced, but still growing, digital economies. The UK and Switzerland round out the top five, while the US ranks sixth among the 50 countries measured. China, Malaysia and Thailand ranked as the top three fastest-moving digital economies, a result of their rapidly increasing Internet and smartphone population.

China, Malaysia and Thailand ranked as the top three fastest-moving digital economies.

The study identified four interdependent drivers – supply, demand, institutions and innovation – that define each country's digital evolution and can serve as strategic evaluation points for future growth. ✱

'TRADITIONAL' BANKS ON THE WAY OUT?

PwC'S REPORT on 'The Future Shape of Banking', suggests that by as soon as 2025 – 2030, a market economy could readily exist without banks of the traditional kind. The reason? As barriers to entry for non-banks to provide formerly 'core' banking services continue to decline, the business models of today's banks will be challenged.

However, banks retain some substantial advantages to help them prevent this from happening: although tarnished by the financial crisis, banks' brands and reputations remain powerful, shored up by familiarity, experience and regulation, said PwC. Trust and brand matter in financial transactions and some of the resistance to alternative banking providers results from a lack of trust in their security.

Among some key points of the PwC report:

- Banking services will move away from physical, tangible distribution into technology-enabled channels.
- As technology advances, it will become easier for customers to move between banks and other service providers.
- Brands could become central to banks' value – those which build a brand which represents trust, integrity, security and quality to customers will be more likely to solve the 'transaction cost' of choosing how and with whom to bank.
- Banks could become utilities focused on the management of deposits below insured limits and providing a narrow range of domestic credit products.
- Regulators and regulation also need to adapt their mindset and approach in order to deal with the changing banking landscape. ✱

Bolstering risk management

RISK IS OMNIPRESENT AND UNPREDICTABLE. WHILE BANKERS MUST BE PREPARED FOR THE WORST, THEY SHOULD ALSO BE STRATEGISING INNOVATIVELY TO OPTIMALLY MANAGE RISKS AND RETURNS, CONGRUENT WITH THEIR ORGANISATION'S RISK PROFILE AND APPETITE.

How should banks and financial institutions in Malaysia position themselves to manage the bewildering array of risks facing them currently and in the future?

Perhaps it is most imperative to be prepared for absolutely anything, kitchen sink notwithstanding. Understand that past patterns will not predict future crises. "The one thing we have learned over the years is that lessons learned will not enable us to plan for the future," said Tay Kay Luan, Chief Executive, Asian Institute of Chartered Bankers (AICB), at the AICB Risk Management Conference 2014, with the theme of 'Bolstering Risk Management Amidst a Challenging Landscape'. Concurring, Tan Sri Azman Hashim, Chairman, AICB, said in his keynote address that, "Risks are coming from all angles and sides, in all shapes and sizes. Don't be surprised if anything strange strikes us; we have to prepare ourselves."

All Sorts of Risks

Risks scrutinised at the conference ran the gamut from regulatory and compliance risks (Basel III liquidity and capital requirements and impairments risks under IFRS 9) to the hazards of talent, governance structures, and cybersecurity.

But the bleak reality is that compliance with a torrent of increasingly demanding regulations does not render banks immune to risk.

"Is there too much regulation or too little regulation? Obviously, the crisis of 2007/2008 gives us the leverage to push the reform agenda to make the system more resilient. Of course, a lot of these rules are being set when the dust has already settled. With all these rules, whether we can avoid the next crisis is difficult to predict, but the aim is to ensure that any crisis can be well-managed and the shock can be absorbed," remarked Mohamed Rezwan Abdullah Ismail, Deputy Director, Financial Conglomerate Supervision Department, Bank Negara Malaysia.

While there is no guarantee that regulations can stave off crisis, the proposed changes will have significant impacts internationally on banks' business models, the competitive landscape, the financial sector infrastructure and the extension of credit, to name a few.

A-Z of Risks

LIQUIDITY RISKS. More demanding capital and liquidity requirements pose a severe challenge for banks going forward. According to Suresh Sankaran, Senior Vice-President and Managing Director, Global

Strikes

Risks are coming from all angles and sides, in all shapes and sizes. Don't be surprised if anything strange strikes us; we have to prepare ourselves.

Advisory Services, Kamakura Corporation, in the future, banks will be asked to hold six to eight times more capital for their trading activities, and higher capital and refinancing costs will structurally reduce profitability. Higher costs, and lower margins will be the by-products of regulation and increased scrutiny, and standardisation and price transparency will be the unavoidable consequence of 'one size fits all' regulation.

CYBER RISKS. In a world of data, cybersecurity is critical. While cybersecurity would seem to be a technical issue hinging on the quality of systems, people are a major risk factor. Douglas Brown, Executive Director, BDO urged banks to take steps to counter cyber risks arising from 'internal enemies', such as discontented or 'rogue employees'. Brown singled out systems support as the 'most dangerous' people in an organisation because they have access to create, edit, delete and change data and systems. Organisations usually segregate functions as much as possible; hence, why is the IT helpdesk allowed open access? "Take that same segregation of duties and apply it in IT as well."

GOVERNANCE RISKS. Best practice holds that highly independent boards, which comprise key numbers of independent and non-executive directors, can diminish the risk of corporate misconduct. "The problem is how do we measure board independence?" asked Professor Jens Hagendorff, Professor of Finance and Investment, University of Edinburgh. "We seem to be confusing independence of functionality with independence of judgement." He pointed out that currently very little is known about bank boards and misconduct, but what is known is that the more the interests of board members are aligned with those of shareholders, the higher the risk.

A better measure of independence would be if most of the directors were appointed before the appointment of the present CEO. "If the board members were appointed by the current CEO, then this undermines the judgement of the board. You're seeing personal loyalties, you're seeing a sense of being beholden to the CEO. So the ideal board is one where the directors were appointed before the present CEO arrives," said Hagendorff.

Risk managers need to position themselves as business partners to undertake **informed risk** and pursue steady growth which befits the organisation's risk appetite.

The Route Forward

While compliance and regulatory risks are probably top of mind for risk managers currently, it is equally critical to focus on the big picture of external risks and opportunities arising from global developments within the banking sector and beyond. Christopher Loh, Group Chief Strategy and Transformation Officer/Deputy Group Chief Risk Officer, RHB Banking Group said, "Regulatory liberalisation has opened up cross-border growth opportunities for regional expansion but at the same time increased competitiveness in local markets."

Loh sees Islamic banking as an area where Malaysia could shine. "The continuous development of Islamic banking globally has positioned Islamic banks in Asia well to penetrate into the international business and undertake

Continuous development is key in order for risk managers to be able to advise the business effectively. Prepare for the worst-case scenarios by formulating capital and liquidity plans based on well-designed stress tests.

cross-border investment activities." Feasibly, he thinks that Malaysia could excel in the Islamic space and that Malaysian Islamic banks could emerge among the global top players.

Competitive risks could escalate as European banks return to Asia, especially with the prospects of regional integration through the launch of the ASEAN Economic Community in 2015. Recent high passing rates for the European Central Bank stress tests could encourage European banks to flock back to trade finance and syndicated loans in Asia.

How should risk managers respond to these new threats and conversely, bright opportunities? At the end of the day, bank risk managers need to rethink their roles and equip themselves to navigate a dynamic and volatile environment. Do not become entrenched in silos; risk managers need to position themselves as business partners to undertake informed risk and pursue steady growth which befits the organisation's risk appetite. There is also a need to empower chief risk officers and risk managers, which would better enable risk to be integrated into strategic planning. Continuous development is key in order for risk managers to be able to advise the business effectively. Prepare for the worst-case scenarios by formulating capital and liquidity plans based on well-designed stress tests.

Importantly, there is a need to effectively communicate messages on risk appetite and risk tolerance. Align strategic and tactical decisions with risk management capacity, set a clear mandate on the amount and type of risk to assume or avoid, and ensure realistic expectations on the part of investors and other stakeholders.

Regulators are also sending signals that increased transparency and accountability are desirable. In the US, the 'living wills' required of banks are moving in this direction to protect society from financial systemic risks. The Dodd-Frank Wall Street Reform and Consumer Protection Act requires that bank holding companies with total consolidated assets of USD50bn or more and non-bank financial companies designated by the Financial Stability Oversight Council for supervision by the Federal Reserve periodically submit resolution plans or 'living wills' to the Federal Reserve and the Federal Deposit Insurance Corporation. These living wills must describe the company's strategy for rapid and orderly resolution in the event of material financial distress or failure.

However, pointed out Juan Carlos Acevedo, Vice-President, Chandler Corporation, the Feds were 'not happy' with the results of the living wills exercise this past summer. "The fundamental issue remains that Western financial institutions remain 'too big to fail'. Any one of these banks going under continues to present systemic risks." Current plans "demonstrate little ability to cope adequately with failure without some form of government support," he added.

Rebuilding Ethics, Reclaiming Trust

Perhaps the greatest challenge going forward is for banks to establish a cultural and operating mindset that embeds balance sheet risk in everyone's thinking, and goes beyond paying lip service to regulatory compliance. This mindset must be based on ethics and values, and is the key to rebuilding trust.

While Asian and Malaysian banks are largely trusted, the same cannot be said of Western financial institutions. "The Western banks still have trust issues," said Acevedo, referencing debacles such as the J.P. Morgan hacking in 2014 which exposed the data of 83 million customers, eroding public trust and stakeholder confidence. Although this was one of the biggest breaches in history, the bank was reviled for downplaying risks of customer fraud. "From a macro standpoint, since 2008, commercial banks bought time to restore trust, but six years on, we still use the word 'recovery' a lot… I'm not sure we have seen the fundamental changes we expected from 2008, and that's a major risk."

It cannot be stressed enough that transparency and accountability will be integral to the rejuvenation of banks and rebuilding of market and public confidence. "As regulatory reforms gather pace and start re-shaping the financial industry, banks have remained remarkably silent on how they plan to restore the confidence of the public and society at large," said Sankaran. Banks will have to demonstrate that their future business models are beneficial to society, that they can run their business safely and that they are able to restore profitability to a level which makes them an attractive – and less risky! – investment again.

By taking steps to embed the suggested best practices as laid out above, it is hoped that banks and financial institutions will be able to overhaul and strengthen their risk management strategies, systems and infrastructures. Robust risk management based on ethical principles and trust will be the thrust behind creating a healthy banking sector, one able to anticipate problems, withstand crisis and thrive in a volatile and challenging global landscape.✱

■ Reporting by the *Banking Insight* Editorial Team

The Global Financial Crisis (GFC) of 2008 has changed the financial services industry operating environment. The fallout from the GFC is still being felt as the financial services industry adapts to the 'new norm' of regulation, regulation and more regulation. With this 'new norm', it is imperative that financial institutions improve their risk management capabilities, which should not just focus on the 'hardware' such as systems, but also the 'software' like risk professionals. Hence, there is a need to invest in talent development to address the scarcity of risk talents. Here we have Maybank's Group Chief Risk Officer, Dr. John Lee, to share his views and opinions on this evolution of risk management.

Please tell us a little more about your personal experience starting and leading your early initiatives at Maybank.

What we wanted to do at Maybank was to transform our risk management philosophy, which is moving away from being a gatekeeper to being what I would call a business partner. Typically, the risk management role played here previously tended to be more of a reactive one. And we wanted to be more proactive, to get the business to look at risk more strategically, and to make sure that risk is seen as a competitive advantage.

What are your measures of success for evaluating risk management initiatives?

We always ask ourselves three things whenever we do any initiative. One is: How does it improve our risk management capabilities? The second question we ask is: What business value does it bring? That leads directly into the third question: Does it have the overall effect of lifting our performance? Ultimately, it has to have a positive impact on our bottom line.

What are key attributes every senior executive must have to be successful?

I think when it comes to being a risk officer, in particular chief risk officer in any bank, technical competency is a given. So, the key requirements to do well in a job like this will not have to do so much with technical competency, but rather more to do with leadership and relationship building. My job as Group Chief Risk Officer (GCRO) essentially is to influence people to make them understand and buy into the importance of risk management.

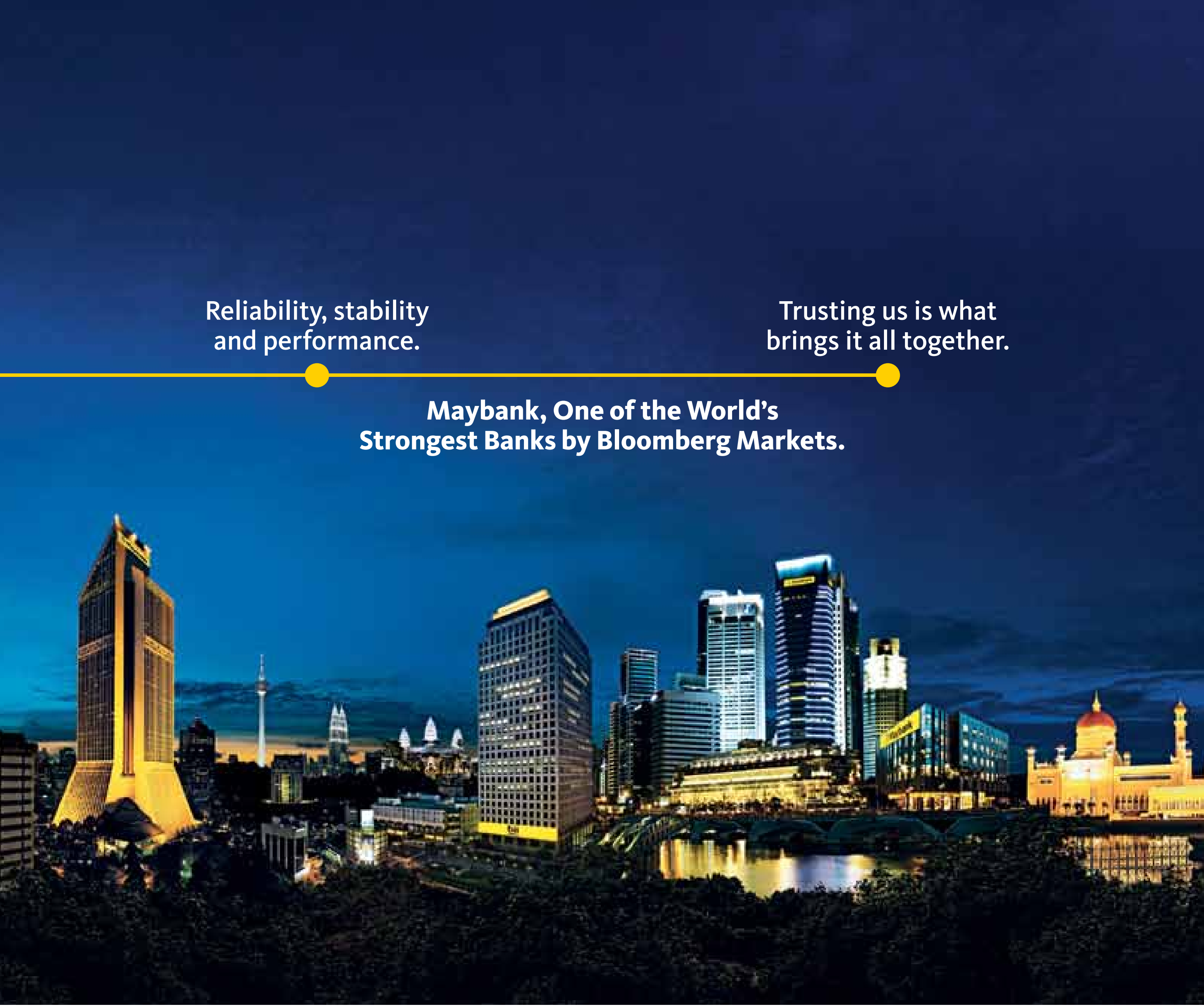
> **Key requirements** to do well in a job like this will not have to do so much with technical competency, but rather more to do with leadership and relationship building.

Another element that is critical, particularly in risk management, is talent development. It is a priority because the business is evolving, the market is evolving, and the expectations of the stakeholders are evolving. Given that, the competency level needs to be improved almost continuously. Having a system in place to develop talent to continuously upskill ourselves is critical.

What would you like to be known for?

The legacy I would like to leave not only with Maybank but also the industry as a whole, is the talent development work I've done. I believe what serves as a nice collective testament to that are the talented people themselves who I have had the privilege of leading at one time or another. Before joining Maybank, I worked in a consulting firm where I ran a team of people. We all moved on, and I came to Maybank. Years passed and one day, one of my proudest moments came when I realised that concurrently four of the CROs of the banks in Malaysia all used to work for me at the consulting firm. So, moving forward, the legacy I would most like to leave the industry is my work in developing talents within the industry, and in inspiring the next generation of risk officers to take Malaysian financial institutions to another level. ✱

Dr. John Lee, GCRO Maybank Group. Before taking on the position of Group Chief Risk Officer (GCRO) for the Maybank Group in 2011, Dr. John Lee had already been doing distinguished work in the financial industry and in risk management for more than 13 years. Dr. Lee - who was named Risk Manager of the Year 2014 by The Asian Banker and Bank Risk Manager of the Year 2013 by Asia Risk - is also active as a leader in the development of talent and standards for the financial services and risk management communities. He most recently established a Chief Risk Officers Forum in Malaysia.



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Maybank is the first and only Malaysian bank in the list. It's this same commitment to ethics and responsible banking that has also made us one of the leading financial services groups in Asia. We've been part of this region's success story for the past 53 years, growing strong across 2,400 offices in 20 countries with assets over USD176 billion.

We've built this reputation by offering an extensive range of products and services, which includes commercial banking, global banking, investment banking, Islamic banking, stock broking, asset management, insurance and takaful.

All these achievements may have placed us in the company of elite group of banks, but it's all done to serve you better. It's all part of our mission to keep humanising financial services.

Source: Bloomberg Markets' Annual Ranking of the World's Strongest Bank.

Humanising Financial Services.

Maybank

RIDING THE silver tsunami

THE SPENDING POWER OF ASIANS AGED 60+ IS ESTIMATED TO BE USD3 TRILLION BY 2017. BANKS WILL HAVE TO REPOSITION THEIR STRATEGIES AND SERVICES TO TAP INTO THIS EMERGING 'SILVER TSUNAMI' MARKET OR RISK ALIENATING THIS INCREASINGLY IMPORTANT SEGMENT.

PREETHA NADARAJAH

The longevity economy is becoming increasingly powerful. A recent Merrill Lynch report 'The Silver Dollar – Longevity Revolution Primer' estimates that the spending power of consumers aged 60+ will reach USD15 trillion by 2020. Meanwhile, an APAC-focused Ageing Asia Pte Ltd report - the 'Asia Pacific Silver Economy Business Opportunities Report 2013' - estimates the spending power of Asian consumers aged 60+ at USD3 trillion by 2017. Furthermore, older persons are projected to exceed the number of children for the first time in 2047. Can banks afford to not take the greying world seriously?

Banking models and strategies

"The global middle class is projected to grow by 180% between 2010 and 2040, with Asia outpacing Europe by 2015. Demographic changes in most Asian territories will mean that, more than ever, banks need to focus on wealth management solutions as they plan for their retirement – and this will include bancassurance products.

"We will see that wealth management will move alongside deposit-taking as a baseline service for retail banking. Banks without a strong wealth offering will lose share, as customers increasingly take responsibility for their lifelong financial well-being and planning," said Antony Eldridge, Banking and Capital Markets Leader, PwC Asia Pacific, via e-mail.

Notable key products that have specifically been created to support the ageing population in the developed countries include consumer products – long-term care insurance and reverse mortgages. Meanwhile, pension providers should be examining opportunities for longevity risk transfer offerings in the secondary markets.

In terms of market segments, financial institutions should ideally review the quiet economic and social revolution within the female market segment given that the female economy – including senior women - represents the largest emerging pool of wealth on the horizon. Furthermore, needs for private banking will increase with the great transfer of wealth from the ageing baby boomers to their heirs.

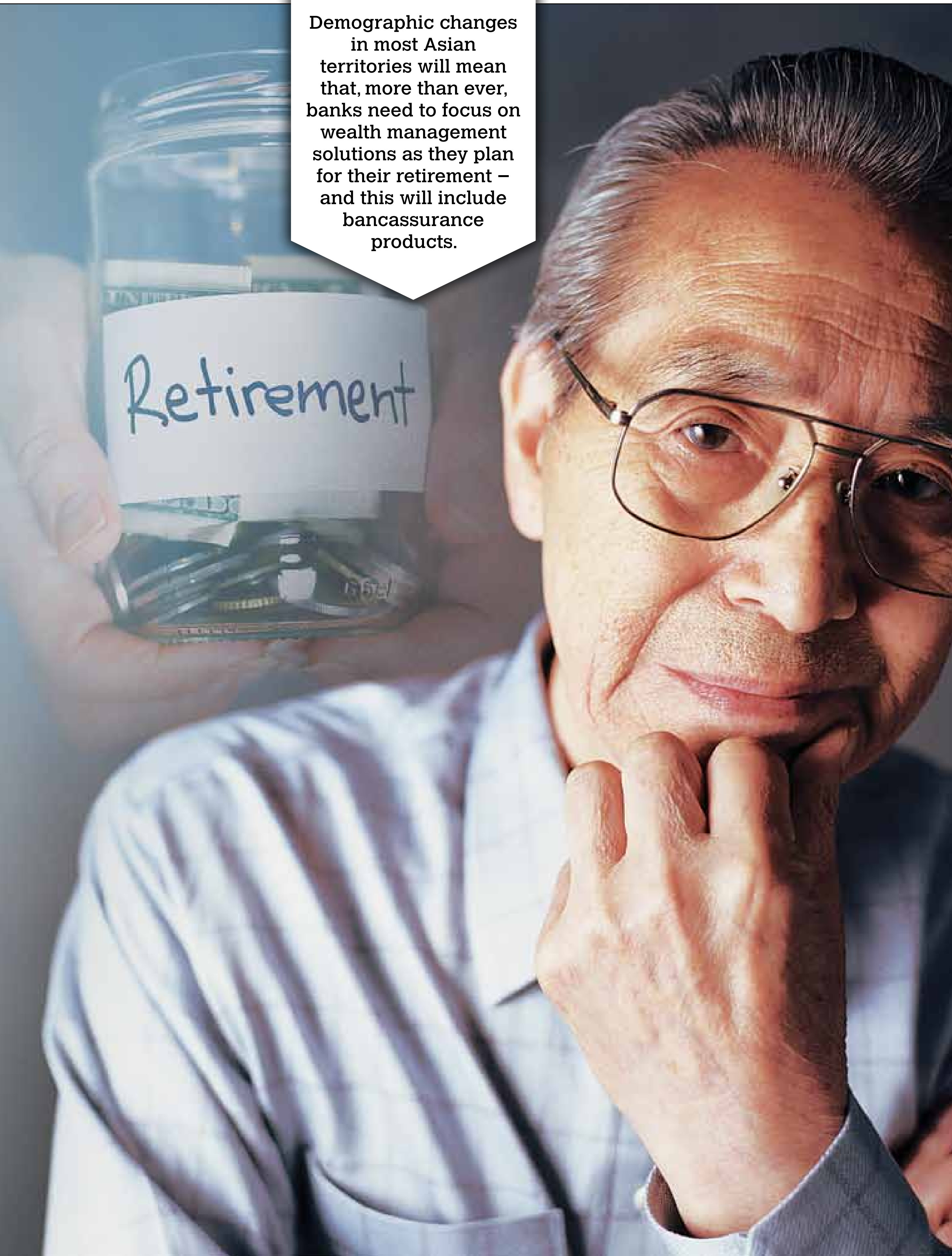
Long-Term Care Insurance (LTCi)

Long-term care (LTC) is set to take off in future as more people age. LTC can be obtained in a nursing or assisted-living facility, adult day care programmes or in-home services. It includes a wide set of services to support daily living activities – help with bathing, dressing, grooming and eating.

LTC can be rather costly, thus

Solutions

Demographic changes in most Asian territories will mean that, more than ever, banks need to focus on wealth management solutions as they plan for their retirement – and this will include bancassurance products.



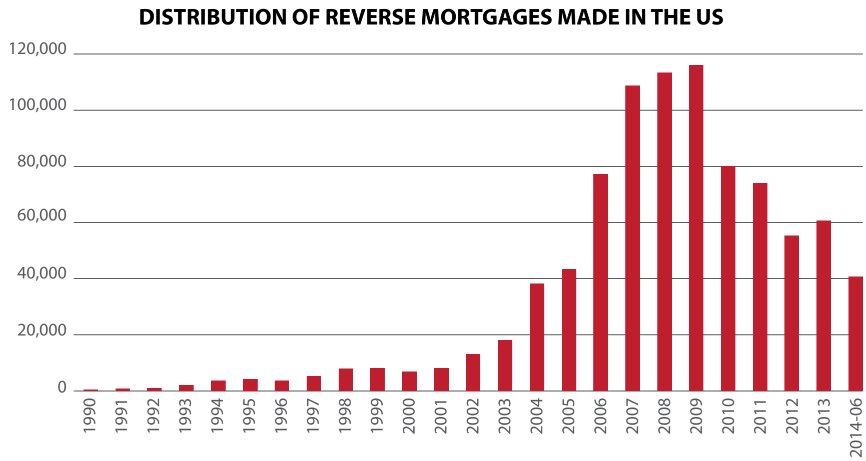


Figure 1: Source: US NRMLA (National Reverse Mortgage Lenders Association) *http://nrmlaonline.org/rms/statistics*

creating a market for LTCi to subsidise such future expenses. The individual LTCi market in the US is estimated to be USD7bn based on premiums earned, with a stubbornly low penetration in the mid-single-digit range for those aged from 45 to 70 years old.

Despite Asia's deep-rooted culture of filial piety where children commonly hire foreign maids to provide elder care, social changes are looming that may force Asians to seriously consider LTC. The key triggers are the reduced supply of foreign maids given tightening of immigration regulations, reduced affordability of this support structure given escalating fees and an increase in awareness of elder abuse. Furthermore, the increased emigration of young Asians abroad and the need for double incomes to make ends meet for the younger generation leaves next-to-no bandwidth for sustainable filial piety. The increase in the number of singletons or DINKs (Double Income, No Kids) also means that the seniors of the future need to be more self-reliant. As such, the developing markets are ripe for LTCi.

Reverse Mortgages

Another way of funding LTC post-retirement has been via reverse mortgages. This allows asset-rich, but cash-flow poor retirees to release the equity from their homes to create a lump sum funding source and/or a regular source of income from the reverse mortgage lender to supplement their pensions. This loan is repaid once the property is sold upon death or moving into care facilities. As of July 2014, almost 900,000 reverse mortgages have been made in the US, the largest reverse mortgage market globally, with the annual loan distributions as indicated in **Figure 1**.

In Asia, applications for the scheme have surged in South Korea, while in Hong Kong, where home prices have doubled in recent years, reverse mortgages have drawn little interest, as retirees opt to resell their homes or rent and use the remaining cash. China, with nearly 15% of the population, i.e. 200 million people, aged over 60, launched a reverse mortgage pilot programme in July 2014. Introduced in India in 2007, the reverse mortgage market is still in its infancy but is expected to gain momentum now that the annuities from home equity are tax-free as of November 2013. Singapore is revisiting the introduction of this product after withdrawing it in 2009.

Longevity Risk Transfers/ Swaps (LRT)

As a result of increased pension costs due to increased life expectancy, a challenge faced by annuity providers, governments and defined benefit (DB) pension providers is the real uncertainty as to the cost of the pension commitments. **Figure 2** shows that some of the largest global pension markets are still dominated by the DB plan.

Estimates of the global amount of annuity and pension-related longevity risk exposure ranges from USD15-25 trillion. According to the International Monetary Fund (IMF), adding an extra year to the global average lifespan increases the world's pension bill by 3-4%, and would more than double the amount of aggregate pension underfunding, resulting in many countries potentially facing additional costs of up to 50% of 2010 gross domestic product (GDP) by 2050.

This results in the need to take de-risking actions to transfer that longevity risk from the DB pension or annuity providers to reinsurers, who now have a role as buyers of longevity risk. As an example, in July 2014, telecommunications giant British Telecom (BT) sold 25% of its longevity risk or £16bn of liabilities in its group pension scheme, Britain's largest corporate pension fund, to US insurer Prudential Financial. BT pays Prudential a monthly fee and the insurer will pay the extra pension costs if the pension plan members live longer than forecasted. Other similar, albeit smaller deals some months prior to this in the UK were: Aviva's £5bn longevity swap with three reinsurers Swiss Re, Munich Re and SCOR Global Life, and ICI's £3.6bn annuity buy-in agreements with Legal & General and Prudential.

Although the UK has been at the centre of LRT activity globally, there have also been three large transactions in the Netherlands and the United States in 2012. A nascent LRT market that could be managed by third-party institutions is developing rapidly considering the sheer size of the DB liabilities, which

Women Power

Women tend to be loyal customers and securing their patronage bodes well for banks intending to capture a larger market share of older, wealthy women.

In a paper titled 'Women Want More (in Financial Services)', the authors from Boston Consulting Group (BCG) concluded that serving women better and securing their loyalty should be a key goal of all financial services companies wanting market dominance of this segment. Women also make up 44% of the global High Net Worth Individuals (HNWI) population, based on Capgemini and RBC Wealth Management's World Wealth Report.

Women are loyal customers and acquiring their patronage bodes well to capture a larger market share of older, wealthy women.

Michael Silverstein, Senior Partner and Managing Director of BCG said via e-mail: "Women live longer than men. It's a function of lifestyle and genetics. They know this. They want investments to be more secure and deliver a stable return. In today's world, if you are willing to give up return, you can give up risk. Financial services firms have a big opportunity to win more business from women by:

- Providing moderate return, lower risk;
- Addressing their needs with information and access;
- Treating women like they will inherit the world because they will!"

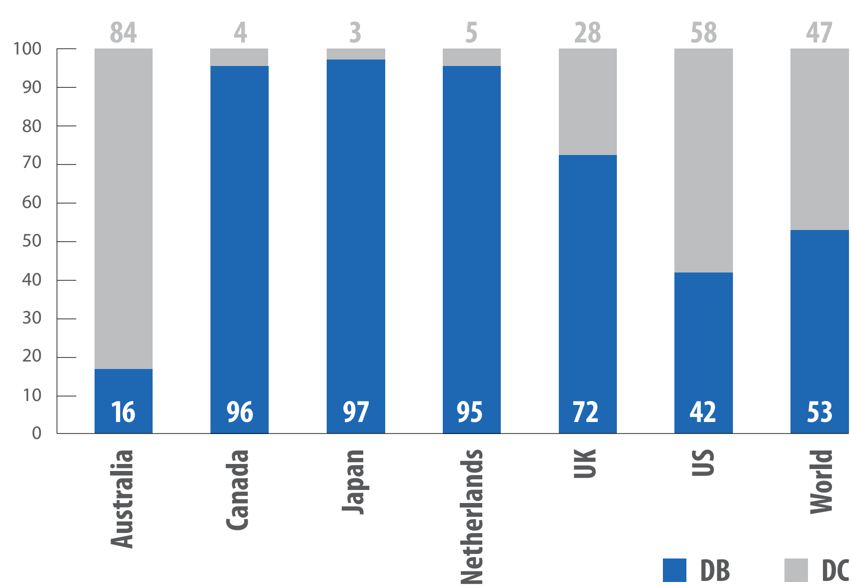


Figure 2: Split between Defined Benefit (DB) and Defined Contribution (DC) Pension Scheme Globally. Source: Global Pension Assets Study 2014, Towers Watson, January 2014.

can only grow with increased life expectancy. More LRT instruments are expected with insurers participating in pension buy-ins, buy-outs and longevity insurance and investment banks and reinsurers providing longevity swap transactions.

Estate Management and the Great Transfer

Most of Asia is still in wealth accumulation mode. Asia has had the largest increase of HNWI and is forecasted to have the largest HNWI population by 2014 and the most wealth by 2015, as depicted in **Figures 3 and 4.** Surveys estimate that about 80% of wealth in the Asia-Pacific region will be passed on to the next generation over the next 15 years.

Much of Asia's wealth is owned by first generation entrepreneurs, making wealth transfer a potentially complex and emotionally-charged issue. Cultural

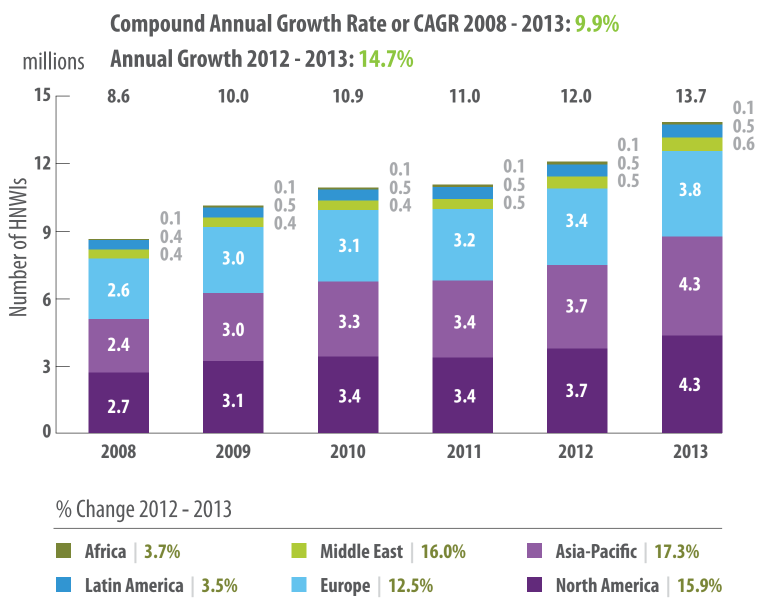


Figure 3: HNWI Population, 2008-2013 by Region. Source: Capgemini Financial Services Analysis, 2014.

Low succession planning could also decimate family businesses: research shows that only 30% of family businesses survive into the 2nd generation and a mere 10% into the third.

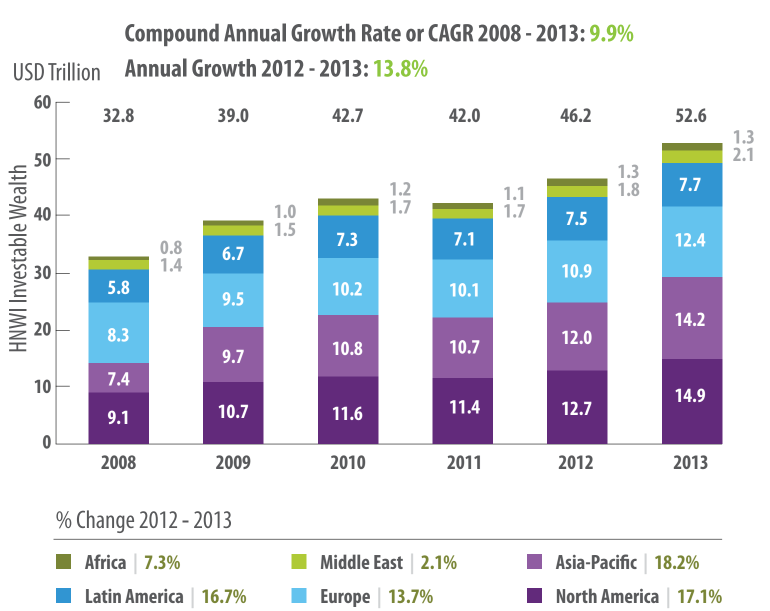


Figure 4: HNWI Wealth Distribution, 2008-2013 by Region. Source: Capgemini Financial Services Analysis, 2014.

sensitivities and distaste for openly discussing topics like death, succession and handover delay preparations for wealth transfer. Peter Kok, ASEAN Head of Private Banking Clients, Standard Chartered Private Bank confirmed this via e-mail: "Our recent 'Business Before Wealth' survey found High Net Worth (HNW) business owners across the region attached a relatively low importance to formal planning for the succession of their businesses."

Young Asians educated in the West frequently hold different ideas and perspectives which challenge traditional Asian ways of doing things, resulting in ever-widening generational gaps in expectations and outlook. Low succession planning could also decimate family businesses: research shows that only 30% of family businesses survive into the 2nd generation and a mere 10% into the third. "Given that the private and business wealth of Asian HNW business owners tend to be closely intertwined, there is a very real need for private banks to play the role of advisors, not just in educating the importance of having early, initial engagements on succession and wealth planning, but also taking steps to improve formal governance and management structures," advised Kok.

The strategies baby boomers use for gifting or distributing wealth will be influenced by tax and estate transfer laws. As these laws are introduced or amended, there will be greater demand for more mass-market wealth management services to minimise the tax exposure of this great wealth transfer.

Innovating Age-Friendly Banking Principles

In addition to products and services that the financial services industry could introduce to support this burgeoning market segment, forward-looking banks have produced other innovations in retail banking that would better support silver tsunami customers.

Barclays UK undertook 'Project BESS' (The Barclays Elderly Simulation Suit), to simulate life as an older member of society using weights, limiting limb movement and artificially impairing hearing and sight. This resulted in introductions of the following:

- 'High Visibility' debit cards as the bank found that visually impaired customers found it difficult to read card details when using telephone banking services;
- 'Audio Cash Machines' which enable

customers with poor vision to use headphones to be guided through the services available at the banks' ATMs;

- Pens that are easier to grip for older people;
- Hearing induction loops fitted in the counter of all branches as part of its ongoing accessibility programme.

Government Support and Elder Education Required

John Taylor, President and CEO of the United States National Community Reinvestment Coalition said in an interview with AICB's *Banking Insight*: "Age-friendly banking begins with NGOs, philanthropists, policy leaders and elected officials believing that it is important that the private financial services sector have an affirmative obligation to meet the credit needs of all the people they serve – safely. Nobody wants anybody getting loans that they cannot pay back. That is not in anybody's interest. In the US, the foundation behind age-friendly banking is the law called the Equal Credit Opportunity Act that prohibits discrimination on the basis of age." The support of Asian governments in enforcing similar values and principles will truly go a long way to achieving ethical and low-risk age-friendly banking.

To support a mixed 'bricks and clicks' channel strategy, training for improved accessibility to lower-cost channels such as online banking services would support this older market segment. Subsequently, supplementing such technology education with financial education is the foundation of effective financial management.

Awareness seminars to provide financial literacy education - ranging from going over basic financial how-tos to more complicated matters such as understanding the pros and cons of reverse mortgages or how to identify and navigate security pitfalls and avoid financial fraud - would better equip elders in managing finances securely and with peace of mind. Asian governments could put in place incentives for corporations to undertake re-education for senior citizens or run such programmes themselves.

Other governments might want to take a leaf from Singapore's book. The Singapore government's Silver Infocomm Initiative provides IT training for senior citizens to learn how to do online transactions, such as travel booking and undertaking Internet banking transactions.

Meanwhile, Barclays continues to target seniors. In Barclays UK branches, 3,500 'Digital Eagles' help novice Internet users to use the latest apps to enhance their daily lives, ranging from using Skype or Facebook to be socially connected to understanding how they can use the latest technology to manage their money.

> **Cybersecurity** and identity fraud are growing threats and the elderly, especially older women, are often seen as easy targets.

Fly in the Ointment?

While opportunities abound, there is a risk that financial abuse of elders could be a looming societal crisis. Cybersecurity and identity fraud are growing threats and the elderly, especially older women, are often seen as easy targets. By 2010, the financial losses resulting from scams against elders were estimated at USD2.9bn in the US; this is expected to increase as the population ages. Worse, most cases of elder financial abuse go unreported.

Regulatory support is mandatory to articulate and enforce a clear set of standards for all financial institutions to follow on elder financial exploitation. The role of banks is equally critical in training bank personnel to identify indicators of transaction abuse – e.g. inappropriate banking activity such as unusually large withdrawals from ATMs when the elder cannot get to the bank or possible legal document abuse indicators, e.g. the power of attorney granted by an elder to another when the former's mental capacity is impaired – and to report the fraud and collect data on such incidents.

Only by providing appropriate regulation and ensuring an ethical and low-risk business environment can age-friendly banking innovations and models thrive in Asia and other developing markets which face the risks wrought by sweeping demographic changes. ✱

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DESPITE THE RISKS OF COMPETITION POSED TO TRADITIONAL BANKS, FINANCING OUTSIDE THE STANDARD BANKING SYSTEM IS A VALUABLE RESOURCE FOR ECONOMIC GROWTH AND A MUCH-NEEDED SERVICE, PARTICULARLY FOR THOSE WITH RESTRICTED ACCESS TO CREDIT. BUT AS THE SHADOW BANKING INDUSTRY GROWS, GLOBAL REGULATORS ARE STEPPING IN TO ADDRESS ITS RISKS AND THE POSSIBILITY OF SYSTEMIC SHOCKS.

Banking in the shadows

JESSICA FURSETH

Shadowy financial markets, where the chase for profits may mean higher risks and poorer transparency, have had a poor reputation ever since the global recession. As the financial markets are at last finding their feet again after the 2008 crash, financial regulators have been walking a fine line: how can it be ensured that the system is less vulnerable to opaque financial transactions, while not stifling the industry's recovery?

Shadow banking, conducted by less-regulated financial institutions such as hedge funds and credit unions, can play an important role in greasing the wheels of the economy by providing credit. While financial regulators recognise this, they also seem to have come to a conclusion: there will be no sustained recovery unless shadow banks are kept on a tighter leash.

Worth a whopping USD70 trillion, the shadow banking market now matches the traditional banking market in size, according to the International Monetary Fund (IMF). In its recent 'Global Financial Stability Report', overseen by José Viñals, Director of the Monetary and Capital Markets department, the IMF sounded a warning: "The global financial crisis revealed that, absent adequate regulation, shadow banking can put the stability of the financial system at risk." In other words, if the shadow

Economy

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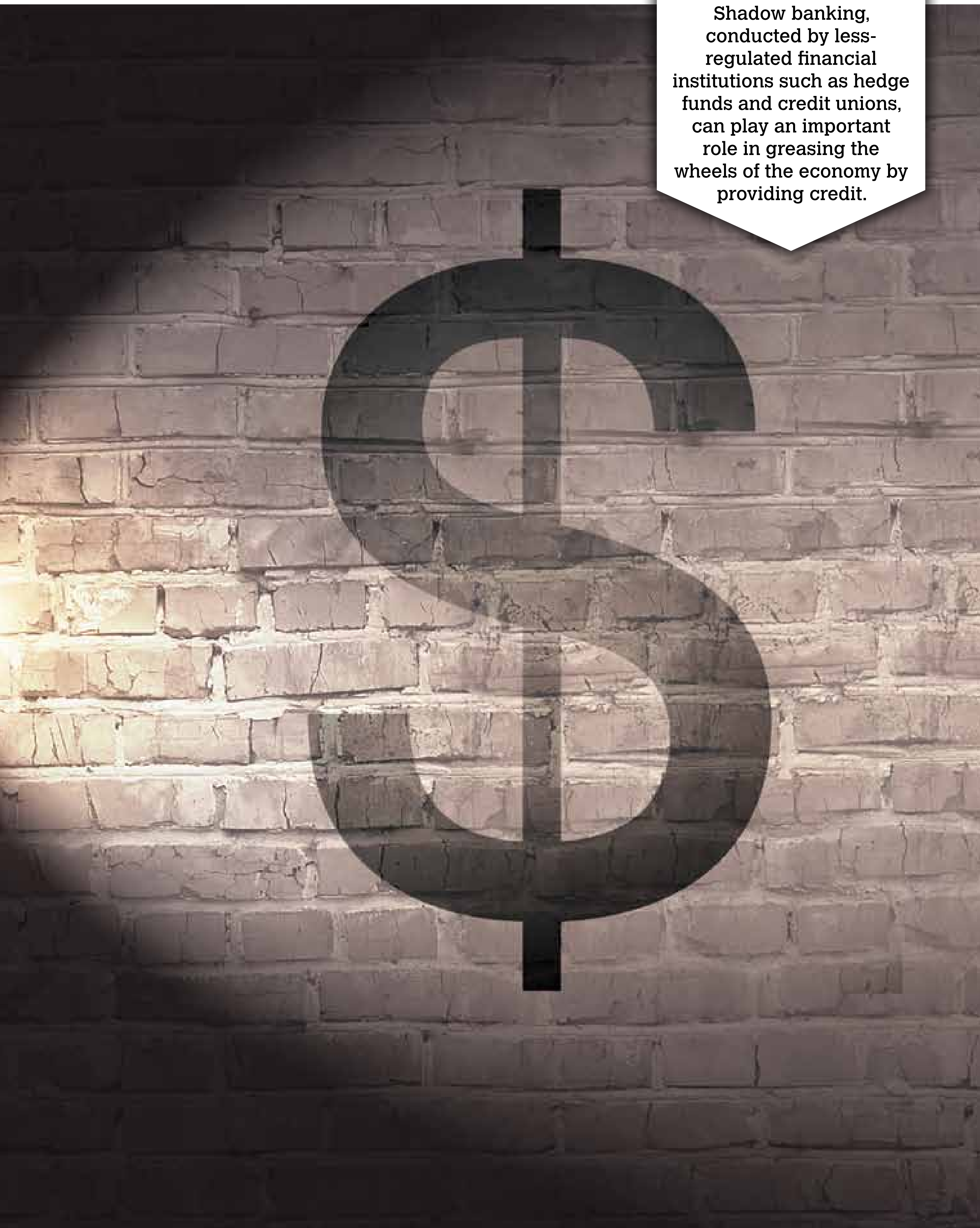

banking market is allowed to develop at its current pace, there is a risk of losing control of the global economy. Worse, the global economy could become vulnerable to another financial crisis.

The first step in what could be described as a global crackdown on the shadow banking industry came in October, when the Financial Stability Board (FSB) issued new rules: banks must impose a 6% discount on securities received from non-banks looking for loans. The rule will make this type of financing more expensive for the likes of hedge funds, and less profitable for banks. The intention is to reduce risk in the core funding markets, and to curb the kind of excessive lending seen in the run-up to the financial crisis. As the FSB coordinates rules for the G20 economies, this will affect two-thirds of the world's population.

"The regulatory framework has been carefully developed, finalised after rounds of public consultation and impact studies, and marks a big step forward in the FSB's overall work programme to transform shadow banking into resilient market-based financing conducted on a sound basis," said Mark Carney, Chairman of the FSB.

What is shadow banking?

Shadow banking represents 117% of the global gross domestic product (GDP), according to the FSB, or 52% of all banking assets. While shadow banking is not a problem in itself, it is the size of the market that is causing concern now. Shadow banking organisations will often lend to weaker borrowers, and this could become a threat to the wider economy if it happens on a larger scale. The other key risk factor is when shadow banks become strongly interconnected with the formal banking system. An over-extended shadow bank could shake the foundations of a standard bank if the two have too many ties.

Of course, having deep and versatile capital markets are important for thriving economies. Developing economies such as China are finding shadow banking to be an important asset for growth; developers in the country's booming property market are often reliant on non-standard sources for funding. A crackdown could have a notable effect on the country's GDP growth. Another problem is that excessive regulation may also risk pushing more financial activity into the shadows:

"Shadow banking tends to take off when strict banking regulations are in place, which leads to circumvention of regulations," said Gaston Gelos, Chief of the IMF's Global Financial Analysis Division. Gelos also pointed out to 'The Guardian' that non-traditional lending tends to grow when real interest rates and yield spreads are low, because investors will be looking for higher returns elsewhere. Putting too much of a squeeze on one type of non-traditional lending could simply lead to returns-hungry investors replicating the problem elsewhere.

For the moment, the FSB has taken particular aim at one key segment of shadow banking: the repurchase market. The so-called repo market was a prime villain in the 2008 crisis, as highlighted also by US regulators when they were looking at curbing the market last year. For now, the FSB are regulating stock and bond-secured transactions between banks and non-banks, but may extend the rules to apply also to transactions between shadow banking organisations themselves.

These regulatory changes are a powerful signal, but shadow banking extends beyond the repo market. The IMF defines the industry as "financing of banks and non-bank financial institutions through non-core liabilities", including hedge funds, private equity, and companies dealing with derivatives, securities and money-market funds. Globally, financial transactions taking place in the shadows of traditional banking also include private lending between individuals, pawnshops, loan-shark operations, and online peer-to-peer lending networks.

Parallel Banking Key to Economic Growth

Regulators also need to weigh the fact that shadow banking can have a positive effect on economic growth by providing funding where traditional sources are unavailable. In the US and Europe, peer-to-peer lending platforms, like Kickstarters and its business equivalents, are providing start-up capital for businesses considered too risky for banks. In developing economies such as China and India, shadow banking is certainly filling a vacuum.

"We consider the growth of credit outside of core commercial banks a natural by-product of the evolution of China's financial system and economic development. The rise of China's parallel banking system is in fact another stage in China's rate liberalisation and disintermediation process," said Dorris Chen, Head of China Financial Research at Standard Chartered. "Proactive regulatory interference and increased state asset injections and fiscal resource allocation by local governments have ensured that the parallel banking system is functioning as a workable medium-term stability tool."

97% of China's 42 million small businesses cannot get a bank loan, according to Bloomberg, and shadow banking practices are further encouraged by savers wanting to do better than the lacklustre returns available from official banks: at 3%, savings rates are lower than inflation. UBS estimates the Chinese shadow banking industry, including private lending and off-balance-sheet vehicles at banks, to be worth USD3.35 trillion last year, representing 45% of the country's GDP.

The rise of China's shadow banking industry represents a new competitive pressure for banks, added Chen: "However, it also gives banks the opportunity to transform from the old 'lend and hold' business model to a new 'originate and distribute' model, in which a larger portion of earnings come from business with private small and medium-sized enterprises (SMEs) and non-bank financial services."

China's shadow economy has grown powerful enough that any amount of disruptive regulation could represent a real threat to the country's growth. Shadow banking accounted for almost a third of the rise in lending in China last year. Any crackdown on shadow banking could have a serious impact on this number. The 7.6% GDP growth over the past two years is the lowest since 1990, suggesting the country's booming expansion is already slowing.

> Regulators also need to weigh the fact that shadow banking can have a positive effect on **ECONOMIC GROWTH** by providing funding where traditional sources are unavailable.

While shadow banking plays an important role in emerging markets, measuring an estimated USD7 trillion according to the IMF, the key players in this field are found elsewhere. The shadow banking industry is worth an estimated USD15-25 trillion in the US, and USD13.5-22.5 trillion in Europe. But in the case of a future crisis, the impact of these economies could easily spread, concluded the IMF in its 'Global Financial Stability Report': "Emerging markets are more vulnerable to shocks from advanced economies, as they now absorb a much larger share of the outward portfolio investment from advanced economies. These structural changes in credit markets have contributed to market and liquidity risks in ways that could compromise financial stability if left unaddressed."

Understanding Before Control

Just as the IMF recognises the importance of regulating the shadow banking industry, the FSB also stresses the importance of understanding the value of this alternative funding system. "The approach to reform recognises that an effective financial system needs intermediation outside the traditional banking sector. When conducted appropriately, it can be a valuable alternative to, and provide competition for, banks in funding the real economy," said FSB Chairman Mark Carney.

"Diversifying sources of finance makes the provision of the credit that is essential for growth more plentiful and more resilient."

As shadow banking can perform those roles only if it is a sustainable source of market-based finance, this depends on three elements, Carney wrote in the 'Financial Times'. Firstly, standards are necessary to limit traditional banks from large exposures. Secondly, shadow banks need to become more resilient, achieved in part by minimum margin requirements to reduce the cycle of excessive borrowing in economic booms, as this cannot be sustained when liquidity dissipates. And thirdly, a mature framework will need to be developed to monitor the financial stability risks arising from shadow banking.

While the FSB have taken steps towards addressing the first of Carney's points, the third point will be an ongoing task. A key challenge here is the fact that the shadow banking industry is, by its nature, more opaque than the traditional financial sector, meaning regulators are not actually entirely clear on the details:

"We need to become better at identifying risks in securities markets, but that is less about more regulation, and more about supervision of the non-banking sector," Steven Maijoor, Chairman of the EU's European Securities and Markets Authority, said at the Reuters Regulation Summit earlier this year. Maijoor added it will take years to fill the data gap, in a sentiment echoed by others at the summit. David Wright, Secretary General of the International Organisation of Securities Commissions, said: "In general we do not fully understand how the financial system functions and I don't think you can unless you have the data you need. I think we have a long way to go to fully understand all the connectivities and subtleties of the financial system."

Positive Effects in Asia

The problem of lack of insight into the shadow banking industry extends also to the ASEAN region, where there is even less research conducted on the topic than in the US and Europe. On the upside, the shadow banking system is generally much less complex in almost all Asian countries, except for Singapore. In Malaysia, assets held by non-bank financial institutions have grown gradually in the past decade, but these still only represent 28% of the country's total assets in 2010, according to data from Bank Negara Malaysia (BNM).

"We need to become better at **IDENTIFYING RISKS** in securities markets, but that is less about more regulation, and more about supervision of the non-banking sector."

- Steven Maijoor, Chairman, EU's European Securities and Markets Authority

"The gradual growth of the Malaysian shadow banking system reflects the increase in the complementary role assumed by non-bank financial institutions in deepening the Malaysian financial system. On the other hand, banks' assets market share remains above 50% every year, reflecting the position of the banking institutions as the backbone of the Malaysian financial system," said Muhamad Amar Mohd Farid, BNM Associate Analyst, in a paper on the country's shadow banking sector.

Provident and pension funds (PPFs) are the largest component of the Malaysian shadow banking system, playing a significant role in providing liquidity in the domestic capital and bond markets. The country is seeing an increase of sophisticated investment devices such as asset securitisations, in part due to the government's efforts to develop Malaysia's bond market to the point where it is now the biggest in the region. On the other hand, Malaysia's shadow banking sector also includes products offered to low-income groups looking for personal or small business loans, available from the likes of credit co-ops, pawnbrokers, and leasing companies. These institutions play an important part in providing financing to households, estimated by BNM at 60% of this market in 2011. Similarly to other Asian countries, the prevalence of the Malaysian shadow banking market in providing these vital services means it has close ties to the formal banking market; this makes it a potential source of systemic risk.

In August, the Financial Stability Board's Regional Consultative Group (RCG) Asia issued its conclusions in its 'Report on Shadow Banking in Asia' following research into shadow banking in 16 countries, including Malaysia. While each country has different definitions of shadow banking, the RCG found this type of financial activity to represent a valuable resource: "Non-bank financial institutions promote financial inclusion and sustain growth, in particular for emerging and developing markets, where further deepening of financial markets is a priority." The report from RCG Asia, co-chaired by Dato' Muhammad Ibrahim, Deputy Governor of BNM, and Ashley Ian Alder, Chief Executive Officer of the Securities and Futures Commission in Hong Kong, concluded: "The activities of non-bank financial institutions identified in the survey are predominantly domestic and thus, cross-border risks are minimal."

While the countries surveyed recognised the need to continuously review and improve their regulatory oversight, most considered their shadow bank operations to be under adequate oversight. In any case, RCG Asia recommends stronger focus on cross-border collaboration: "Closer regional collaboration will enable members to share information on regulatory developments and policy measures and discuss emerging risks arising from [shadow banking]." Recognising the sector's value to the region's financial markets, RCG Asia called for 'a holistic view' of shadow banking, encouraging light regulation in view of the industry's socio-economic benefits: "Due considerations on the trade-off are also critical to avoid over-regulation that may potentially undermine the ability of these entities to achieve the intended social and economic objectives."

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> - Ashley Ian Alder
> Chief Executive Officer of the Securities and Futures Commission in Hong Kong

Malaysian Regulatory Efforts

Since 2009, the BNM has had the power to collect information and impose measures on the country's shadow banking sector, for the purposes of preserving financial stability. The BNM is paying particular attention to risk factors, such as size and complexity of financial activities, and interconnectivity with the bank system.

Since the Asian financial crisis, Malaysian authorities have been deliberate in their efforts to develop not only a financial system that is competitive, but also one with adequate regulatory oversight. "Underpinning the financial sector growth was also the development of a more robust surveillance, regulatory and supervisory framework," said Tan Sri Dr. Zeti Akhtar Aziz, Governor of BNM, at the China Business News Finance Summit last December. "As the Malaysian financial system evolved to become more complex, sophisticated and diversified, the regulatory and supervisory approach has correspondingly evolved from detailed and prescriptive rules to a risk-based approach that combines greater supervisory judgement and intensity with high-level principles of sound practice."

These measures include increased scrutiny into the country's shadow banking operations, including an oversight authority for credit cooperatives, and improved powers for BNM to respond to financial stability risks. Last year, BNM issued new lending rules applicable not just to banks but also non-bank financial groups, in an effort to "avoid excessive household indebtedness and to reinforce responsible lending practices by key credit providers." This resulted in a slowing-down in the growth of Malaysia's personal and household loans in the first half of 2014, after five years of 12% growth in household debt.

BNM opted to include all financial institutions and credit co-operatives in its new regulation in an effort to reduce the country's household-debt-to-GDP ratio, which at 83% was the highest in emerging Asia. When issuing the new rules, BNM expressed concern over the rise in financial products "not in the long-term interest of consumers", opting to reduce maximum loan terms and prohibiting the issuance of pre-approved credit: "Such practices encourage excessive debt accumulation by households and increase the vulnerability of this sector." In light of these focused efforts to provide regulatory oversight, as well as its moderate size and complexity, the RCG Asia considers Malaysia's shadow banking system to be a "low risk" to the country. ✱

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IGNITING IP *Finance*

BANKS AND FINANCIAL INSTITUTIONS ARE BEING ENCOURAGED TO INCREASE LENDING BASED ON INTANGIBLE ASSETS AND INTELLECTUAL PROPERTY (IP) RIGHTS TO BUSINESSES, ESPECIALLY SMALL AND MEDIUM-SIZED ENTERPRISES (SMEs), IN ORDER TO STIMULATE INNOVATION AND VALUE CREATION. AS IN ANY NEWISH VENTURE, THERE ARE RISKS AND CHALLENGES ASSOCIATED WITH GROWING THIS SEGMENT. HOWEVER, THE BIGGEST RISK WOULD BE TO REFRAIN FROM FUNDING THIS BUOYANT SECTOR, AS THE INTERNATIONAL IP RACE IGNITES.

How can intellectual property rights (IPR) be leveraged to improve access to finance for business and stimulate economic growth? This was the crux of the debate at the Intellectual Property Financing Conference 2014 – IP Potential in Financial Landscape Evolution conference co-organised by the Malaysian Intellectual Property Corporation and the Asian Institute of Chartered Bankers with Bank Negara Malaysia in September 2014.

Intellectual property (IP) financing or intangible assets financing deals with intangible assets such as patents, trademarks, copyrights, licensing, marketing and distribution rights, among others. "In the age of the information economy, the importance of intellectual property as a key enabler of productivity and economic growth has become significantly more pronounced as intangibles make up an increasing proportion of business investments," said Dato' Muhammad Ibrahim, Deputy Governor, Bank Negara Malaysia in his conference remarks.

It is estimated that 53% or more than half of global market capitalisation is currently derived from intangible assets. In Malaysia, IP has been growing steadily, where the number of patent applications in 2013 was more than double that in 1993, and more than triple for trademarks.

Recognising the potential of IP in stimulating business and value creation, Malaysia is racing to build up the sector.

In line with Malaysia's vision to become a developed nation by 2020 and to spur innovation, RM200 million has been allocated to the IP Financing Scheme (IPFS) targeted at the technology industry. This is offered via Malaysia Debt Ventures (MDV), wholly-owned by the Malaysian government, as announced during Malaysia's 2013 budget.

Challenges and Risks

As with anything new, there are numerous challenges and risks with Malaysia's IPFS. These include low IP registrations, the upfront IP valuation cost of at least RM15,000 per application, serial 'grantpreneurs' (i.e. those who create businesses solely to hunt down grants disbursed by the government), a limited IP marketplace to connect IP owners to businesses and investors for IP trading, divestment and disposal, and the limited recognition of the asset by policy-makers and regulators, remarked Datuk Md. Zubir Ansori Yahaya, Managing Director and Chief Executive Officer, MDV.

Valuations are a clear risk area. "The valuation of IP remains a forecast and a view on future revenue streams but within an efficient framework it can be as feasible and reliable as the valuation of tangible assets," said Peter Willimott, Senior Programme Coordinator, World Intellectual Property Organisation (WIPO) Singapore Office.

Fluctuating values are risky for lenders. "IP value is rather dynamic due to the underlying technology lifecycle. The IP pledge value often diminishes not in line with accounting practice of amortisation and it is hard to predict," said KyungJin Hyung, Senior Manager, International Business Department, Korea Technology Finance Company (KOTEC). However, access to appropriate insurance policies to guard against unforeseen events could greatly increase lending confidence.

Intangible assets can be valued according to different standards, such as those issued by the International Valuation Standards Council (IVSC); International Financial Reporting Standards (IFRS), specifically IFRS 13 Fair Value Measurement; and International Standard (ISO 10668) for Brand Valuation. In Malaysia, the Intellectual Property Corporation of Malaysia (MyIPO) IP Valuation Model (IPVM) is consistent with these standards.

IP valuations can be conducted under three methods: the Discounted Cash Flow method; the market approach based on the value of a comparable IP asset either using industry rule-of-thumb or Guideline Public Company Method (GPCM) or Guideline Transactions Method (GTM); or the cost approach based on the value of developing a similar IP asset from scratch.

In doing IP valuation, executive management's competence, technological capability, marketability and business feasibility need to be taken into account as these will affect going concern. As of the time of writing, MyIPO was preparing the IP Valuation Blueprint 2015-2020 to improve IP valuation systems in Malaysia, which could facilitate greater acceptance of IP by banks and capital providers.

KOTEC's Hyung also singled out the lack of a secondary market for IP rights as a notable risk, because "the lender holding the IP right as security for repayment has no way to sell it, if needed." However, Malaysia has already taken the initiative to address this with MyIPO's launch of its IP rights marketplace in June 2014. There were 163 IP listings as of the time of writing.

The Future for IP Finance is Bright

Going forward, Malaysia could risk losing out in the global IP race if banks err on the side of caution and don't move forward with IP financing. In other emerging economies, the Small and Medium Enterprise Development Bank of Thailand, the Chinese Bank of Communications and the Federal Development Bank of Brazil already take IP into consideration for financing. Meanwhile, DBS, OCBC and UOB Bank are participating as the financiers for Singapore's IPFS, with the Singapore government partially underwriting these loans.

"Now that the IP registration, valuation and marketplace infrastructure is in place in Malaysia to support a wider breadth of IP financiers beyond the Malaysian government, the ball is in the financial institutions' court," commented Samirah Muzaffar, Consultant, IP Valuation and Marketplace, MyIPO.

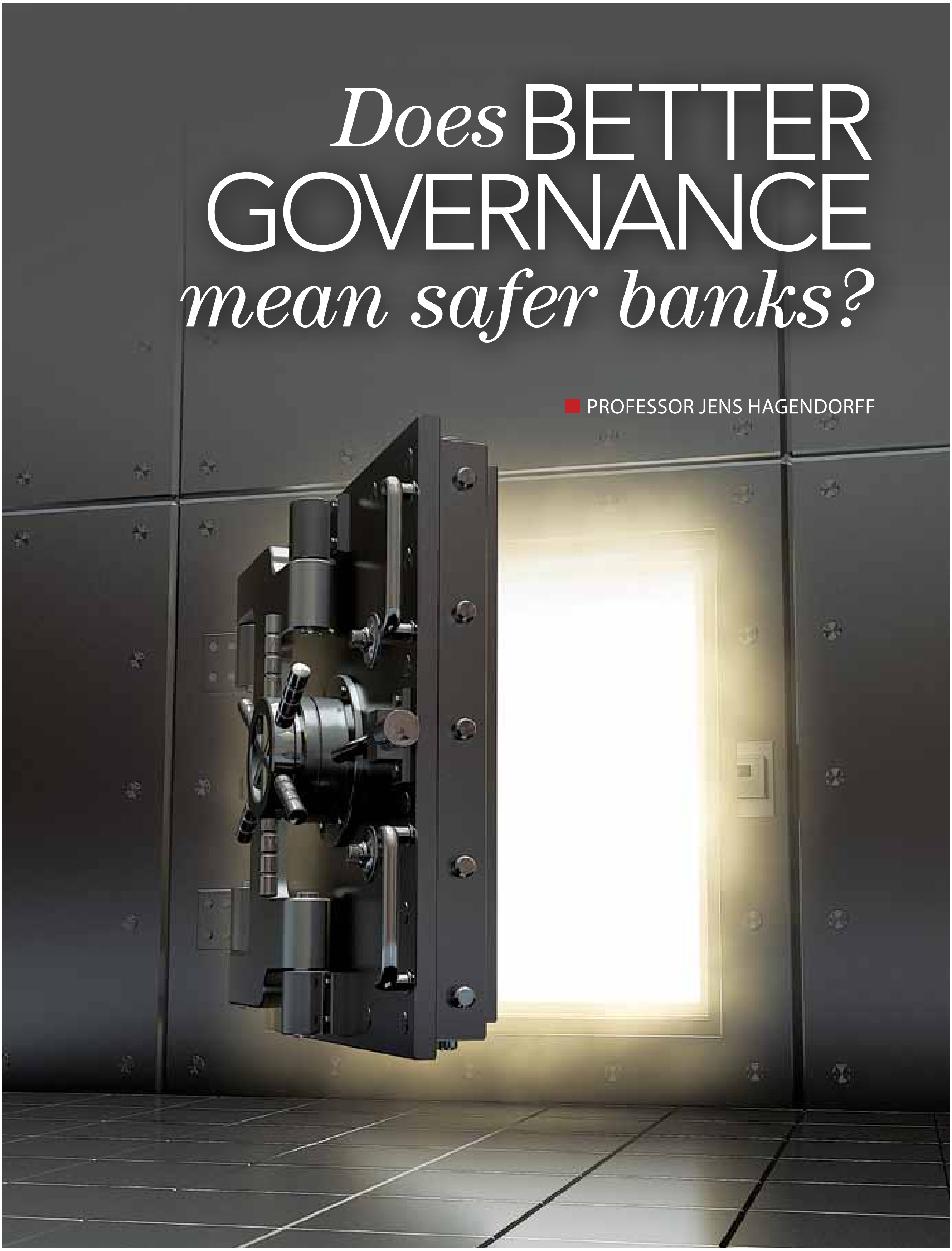
The window of opportunity is open for Malaysian financial institutions to move ahead in IP lending, if they can mitigate the risks and challenges. Tone from the top will be critical to promote IP finance; boards and senior management of the financial service fraternity in Malaysia will have to take the lead in exploring the opportunities and the risks. There is a risk of a knowledge gap; banks will have to build up a pool of expert IP talent and a stronger knowledge base of IP issues. Other urgent initiatives include the need for clear and unambiguous legal documentation for IPR and processes to facilitate the continuous assessment and reporting of IP assets of borrower firms, which will also promote transparency on the performance of the assets and provide early signals of potential distress.

"The real economy is undergoing significant transformation and the financial sector has to keep pace. To remain relevant, just as financing looked to physical assets in the industrial age, it must look to intellectual assets in the information age," recommended Dato' Muhammad. ✱

■ Reporting by the *Banking Insight* Editorial Team.

Does BETTER GOVERNANCE *mean safer banks?*

PROFESSOR JENS HAGENDORFF



THE ARGUMENT IS TAKING HOLD that better governance would have prevented some of the risky excesses leading up to the recent global financial crisis, and that better governance could have protected bank shareholders from the large wealth losses experienced during the crisis. But investors and supervisors need to be careful what they wish for. Banks are fairly unique beasts, and what is accepted as good governance practices in other industries could easily backfire in banking and spur more risk-taking.

Most countries, including Malaysia, now have a corporate governance code in place that makes recommendations regarding the roles and responsibilities of board members. Additionally, a number of countries are in the process of implementing governance codes specifically targeted at banks. In the UK, a review conducted by Sir David Walker regarding corporate governance in UK banks has made recommendations on board arrangements and the qualifications of board members as well as on the compensation arrangements of UK banks. Similarly, the Netherlands has had a Banking Code in place since 2010 that contains guidelines on the make-up of bank boards, including the qualifications and training of board members and their remuneration. Additionally, US compensation guidelines for CEOs and other senior executives at large banks come close to dictating compensation structures in banking.

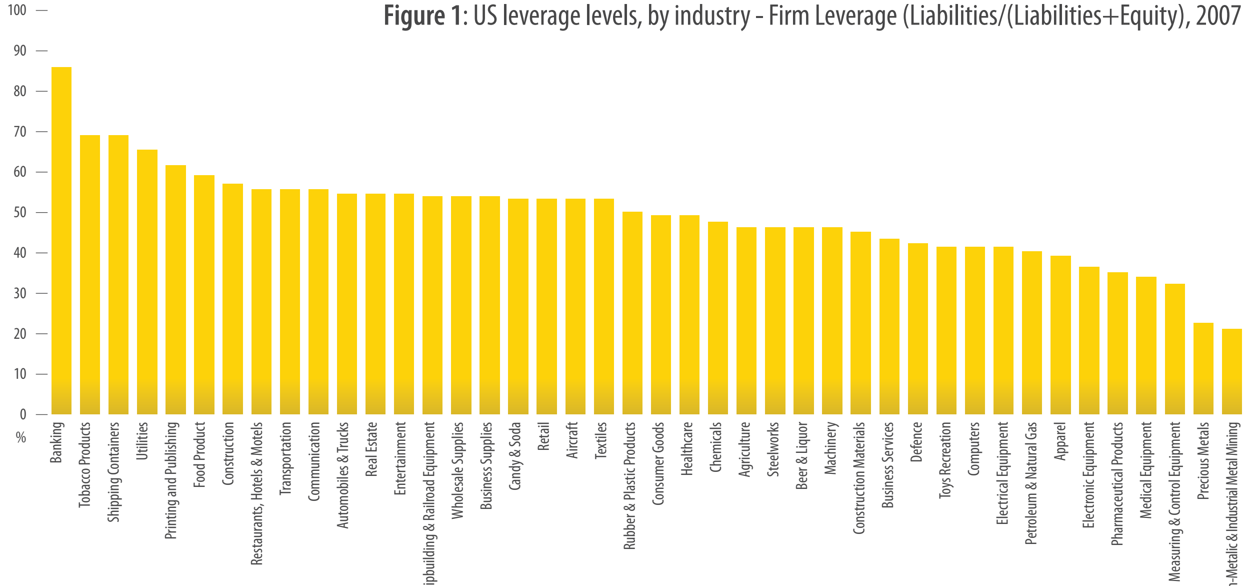
The term 'corporate governance' is something of a misnomer. In governance terms, 'better' essentially means 'more shareholder-oriented'. The results of academic studies over the years have been clear that improvements in corporate governance create value for shareholders. An abundance of academic studies have shown that firms with better governance invest in riskier activities and have higher returns on average. The value premiums linked to good governance can be substantial and as much as 10% of the market capitalisation of a firm. The question therefore is: should more shareholder-oriented governance be welcomed for banks? After all, shareholders in banks suffered some very substantial wealth losses during the crisis.

Would better governance have prevented excessive risk-taking and protected shareholders? The answer to this question is: probably not. More shareholder-oriented governance may be welcome in most industries, but it has to be treated with care in banking. The reason for this are the extremely high levels of financial leverage in banks. That is, banks are much more debt-financed than any other major industry.

Unusual Leverage Levels

It is important to emphasise just how unusual banks are in terms of their levels of financial leverage. **Figure 1** illustrates that the average listed US firm in 2007

Figure 1: US leverage levels, by industry - Firm Leverage (Liabilities/(Liabilities+Equity), 2007



(before the crisis) was funded by around 30% equity (relative to total assets). However, for banks, it is not unusual to have a balance sheet where liabilities account for in excess of 90% of total assets. Some large European banks entered the recent crisis with equity accounting for less than 3% of total assets. As **Figure 1** shows, no other major industry has leverage ratios as high as the banking industry. By point of reference, most Malaysian banks have had equity cushions of more than 10% (in terms of total assets) over the last few years. Nonetheless, equity in Malaysian banks is still substantially lower than in non-financial firms.

High leverage can lead to excessive risk-taking if bank shareholders are too dominant in the governance of the bank. Economic theory tells us there are conflicts between equity holders and external firm creditors over the desired level of firm risk. Since shareholders hold residual claims over a firm's assets (they get what is left after all costs, including the costs of debt, have been deducted), they have incentives to increase firm risk to boost their wealth. While shareholders benefit from pursuing risk-increasing policies, firm creditors stand to bear losses without the prospect of wealth gains from higher risk.

RISK-TAKING

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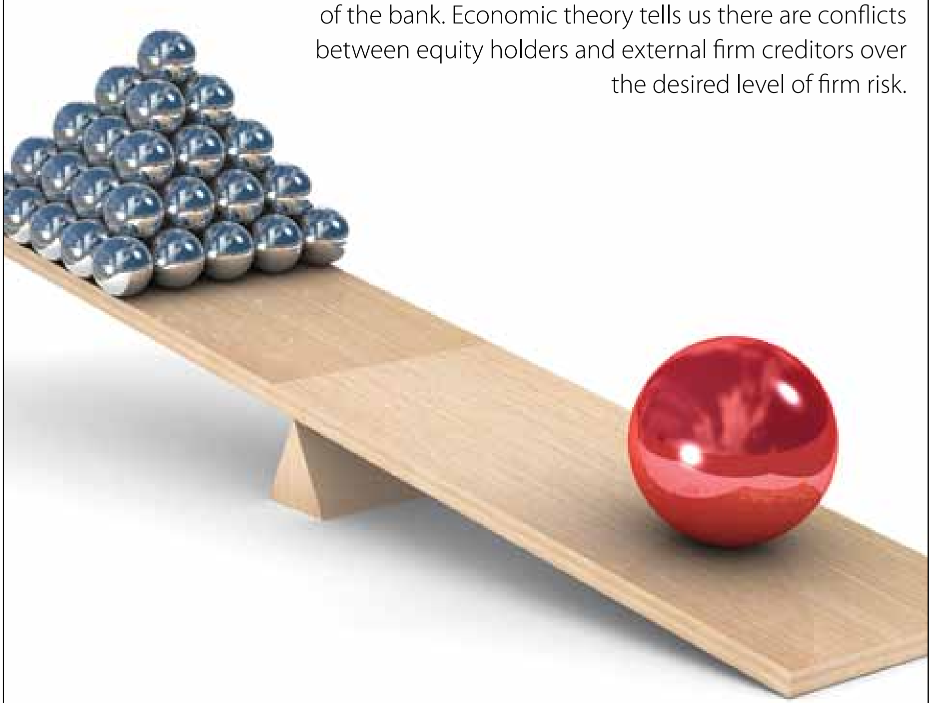


The Risks of Shareholder Dominance

While equity investors are a lot less important than creditors in terms of the funding they provide to banks, equity investors still control key governance devices such as the board of directors, director appointments (and dismissals), and executive pay. Hence, shareholders can put in place monitoring mechanisms and incentives designed to bring about outcomes that favour them - like higher risk-taking.

Executive compensation is probably the clearest example of the hidden dangers of letting shareholders set the governance agenda. The last decades have seen large increases in the value of stocks and option grants awarded to senior managers in banks. Option-based pay packages in particular offer leveraged bets to managers on higher stock prices with no downside potential. The worst that can happen to managers is that the options will expire worthless. Therefore, managers with large option holdings have incentives to increase risk to boost stock prices (and with it, the value of their option grants).

Risk-taking incentives based on options have increased massively over recent years. To illustrate this point, US data is being used because detailed pay data are widely available in the US. Based on publicly available data, US bank CEOs during the 1990s could typically expect the value of their options to increase by USD100,000 if stock volatility increased by 0.01%. By 2006, this CEO payoff from additional risk had gone up to USD250,000. Hence, tiny increases in risk would net bank CEOs ever larger amounts. Intriguingly, risk-taking incentives have shot up much more for bank CEOs than in any other industry.

Leverage Heightens Risk?

Risk-taking incentives in banking have shot up at the same time as banks became more leveraged. It therefore appears that shareholders have put in place ever more aggressive incentives for CEOs to take risk as their share of a bank's balance sheet has shrunk. By all accounts, bank CEOs and other senior decision-makers took the bait. As contractual risk-taking incentives increased over the last decade, large global banks engaged in riskier activities using thinner equity cushions than at any point in recent history.

Compensation is but one possible outcome of better shareholder governance. A flurry of research shows that better bank governance means higher bank risk. These studies show that shareholder-oriented banks, possibly by enhancing the value of the safety net through more aggressive risk-taking, outperform before banking crises, but underperformed during crises. Since it does not seem plausible that shareholder-oriented boards should be intent on diminishing shareholder value during crises, the message from these studies is that better governance causes banks to engage in more risk-taking to increase shareholder value. Unknown to shareholder-aligned boards at the same, the true risk of the investments made could not have been anticipated.

Overall, academic studies do not back the conclusion that the recent global crisis has been brought about by a lack of shareholder-oriented corporate governance and that future banking crises can be prevented by improving the influence that shareholders have on the corporate governance of banks. If anything, academic studies show that shareholder-oriented governance leads to risky outcomes and unsustainable bank policies that have played a major role in the buildup of the crisis.

Needed: Unique Governance Arrangements for Banks

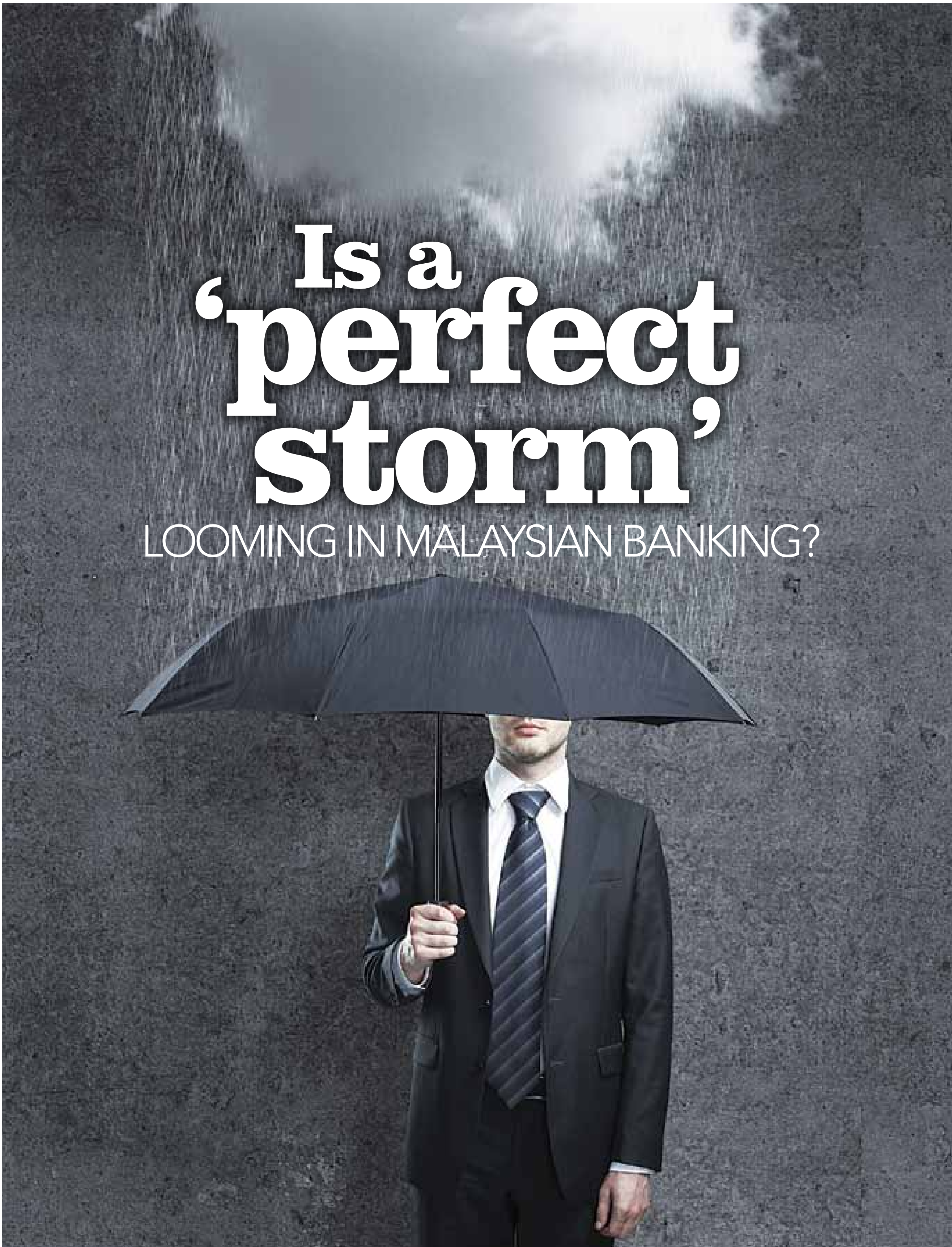
The implications of this for bank governance are simple. The unique features of banks should lead to more unique governance arrangements for the banking industry than can be presently observed. For instance, given the high leverage of banks, pay incentives in the banking industry should align managers more with creditors than shareholders.

UNIQUE

THE UNIQUE FEATURES of banks should lead to more unique governance arrangements for the banking industry than can be presently observed. For instance, given the high leverage of banks, pay incentives in the banking industry should align managers more with creditors than shareholders.

While creditor representation on bank boards is at odds with the principle of proportional shareholder representation on boards ('one share one vote'), it is important to bear in mind that a number of companies have long represented stakeholders other than shareholders on the board. For instance, Germany's *Mitbestimmungsgesetz* (Codetermination Act) mandates that half of the board seats at large German corporations are reserved for employee representatives. One possibility would be to allow for a sliding scale of creditor representation starting beyond a threshold level of leverage and increasing with higher leverage up to a certain point. This would ensure that creditor representation would increase in line with bank leverage and give creditors the opportunity to exert more influence over governance aspects such as executive director appointments, risk management, and remuneration policy. ✱

■ Jens Hagendorff is the Martin Currie Professor in Finance & Investment at the University of Edinburgh. Jens previously worked at the Financial Stability Department of the Bank of Spain and as a lecturer at the University of Leeds. Jens held visiting positions in the US, Italy, and Spain, most recently as a visiting fellow at the Federal Reserve Bank of Atlanta and the Bank of Spain in Madrid. Jens publishes and lectures on a range of topics in finance, banking and investments, in particular the risk and return implications of corporate governance in the banking industry. Jens is one of the authors of 'Size, Risk and Governance in European Banking', a book which has just been published with Oxford University Press.



Is a 'perfect storm' LOOMING IN MALAYSIAN BANKING?

Their defence was that these misbehaviours were the work of the few – the famous 'few rotten apples' – and did not reflect the values of the rest of the bank.

MALAYSIAN BANKS COULD BE FACED WITH A PERFECT STORM WHEN THE NEXT CRISIS HITS IF THEY CONTINUE WITH 'BUSINESS AS USUAL' AND PAY ONLY LIP SERVICE TO THE CRITICAL IMPORTANCE OF CULTURE AND VALUES.

DATUK JOHN ZINKIN

A survey carried out by Thomson Reuters in 2013 showed that 69% of Americans believed in UFOs (unidentified flying objects) but only 20% believed they could trust their banks and that was before the latest stream of fines and threatened prosecutions. Hardly a month has gone by without some new wrongdoing being reported. The catalogue of misbehaviour in western banks is long: subprime; LIBOR fixing; money laundering; 'rogue' traders; mis-selling of payment protection insurance; market rigging; insider trading and forex fixing. Leading global banks with great reputations and long traditions of distinguished service were in this list and have been fined record amounts. Their defence was that these misbehaviours were the work of the few – the famous 'few rotten apples' – and did not reflect the values of the rest of the bank. Moreover, many bankers in Malaysia believe wrongly that such misbehaviour could not happen here, because Malaysia is different from the US.

Not 'Just a Few Rotten Apples'

Is it really the case that there are only a few rotten apples in banks, and even if there were only a few, how many are acceptable in an industry which depends so much on trust? Each year Labaton Sucharow LLC, a US law firm, does a survey on the state of ethics in US banking by asking seven questions. The findings for 2013 make depressing reading on two counts: first the results were worse than in 2012, suggesting that the lessons of the global financial crisis are not being learned; second, the actual replies shown in **Table 1** suggest that there are more than 'just a few rotten apples in the barrel'.

These findings suggest that US banks do not deserve the trust of their clients and that widespread bad behaviour is being encouraged by inappropriate KPIs (key performance indicators), associated reward systems and the wrong 'Tone at the Top'.

52%	believed it was likely that their competitors have engaged in illegal or unethical activity in order to be successful
28%	felt that the financial services industry does not put the interests of clients first
26%	believed the compensation plans/bonus structures incentivise employees to compromise ethical standards or violate the law
24%	would engage in insider trading to make $10 million if they could get away with it
23%	had observed or had first-hand knowledge of wrongdoing in the workplace
17%	expected their leaders were likely to look the other way if they suspected a top performer engaged in insider trading
15%	doubted that their leadership, upon learning of a top performer's crime, would report it to the authorities

Source: Labaton Sucharow LLC, 'Wall Street in Crisis: A Perfect Storm Looming', July 2013

Table 1: Labaton Sucharow 2013 Survey Findings

IGNORING CULTURE AND VALUES

Lord Turner, former Chairman of the UK's FSA (Financial Services Authority), summarised the problem well when he said:

"If the top management and board of a retail bank observes that it is making huge profit margins on an ancillary product sold by a commission-incentivised sales force: what does it do? Congratulate the sales force and increase targets, or ask searching questions about whether the product is truly in consumers' interest, and whether the controls in place to ensure appropriate sales are sufficient to offset the dangers of bias introduced by high margins and commission incentives? *If it is serious about values and culture, it has to do the latter: but that is not what happened in most UK retail banks in the case of payment protection insurance…*

…And in the case of an investment bank, if a fancy new product design will enable a corporate or a country to conceal from the market the scale of its indebtedness, or if a trading desk manages to offload a problematic position onto an unsuspecting customer, *does the top management and the board say, 'Congratulations, take a bonus' or does it say, 'That's not what we do'?"* [Author's italics][1]

Culture and values are what make a bank unique. It is the conflict of culture and values created by merging investment banking with commercial banking that has caused so much difficulty for many of the leading global banks that John Reed, one of the architects of the repeal of Glass Steagall, has publicly admitted the repeal was a mistake.

Cultural Contagion

One of the unintended consequences of the globalisation of banking and the extensive poaching of talent between banks is the transfer of undesirable values and behaviour from one bank to another. Just as extra caution should be exercised in allowing people to move across borders when there is an epidemic like SARS or Ebola, so banks ought to pay closer attention to the culture and values of the people they poach from each other, lest the new recruits have the same harmful effect as a virus on its host.

The extent to which banking appears to have transferred its harmful values from the West to Malaysia is shown in **Table 2**. These findings are the results of a survey carried out by the Universiti Malaya Law Faculty, Universiti Malaya Centre of Regulatory Studies (UMCoRS) and the Asian Institute of Chartered Bankers (AICB) in July 2014, where the same seven questions were asked as in the 2013 Labaton Sucharow survey in the US[2].

Bankers who told me "Malaysia is different" were right, but not in the way they expected. The Malaysian results for conventional banking were worse than in the US for five of the seven findings (percentages shown in the column titled MCB). In the case of Islamic banking (percentages shown in the column titled MIF), they were better than in Malaysian conventional banking, with the significant exception of the last question regarding 'Tone at the Top', where the result was the worst of all. They remain, however, a cause for serious concern because they showed worse scores on five of the seven findings than the distrusted US banks. This is all the more worrying when a key proposition of Islamic banking is that it is supposed to have a more ethical foundation than conventional finance.

Implications of the Findings

Malaysian banks are still trusted. However, these findings suggest that this trust could be undermined by the fact that more than a third of the

MOVE ACROSS

Just as extra caution should be exercised in allowing people to move across borders when there is an epidemic like SARS or Ebola, so banks ought to pay closer attention to the culture and values of the people they poach from each other, lest the new recruits have the same harmful effect as a virus on its host.

[1] Adair Turner, 'Banking at the Cross Roads: Where Do We Go from Here?', speech given by Lord Turner at Bloomberg, July 24, 2012, quoted in John Zinkin, 'Rebuilding Trust in Banks: The Role of Leadership and Governance', (Singapore, John Wiley & Sons, 2014), 255-256

[2] For details of the study methodology, refer to Universiti Malaya Law Faculty or AICB.

Table 2: Malaysian Findings Compared

US	MCB	MIF	Statements reflecting respondents' beliefs and values
52%	38%	33%	Believed it was likely that their competitors have engaged in illegal or unethical activity in order to be successful
28%	43%	39%	Felt that the financial services industry does not put the interests of clients first
26%	42%	27%	Believed the compensation plans/bonus structures incentivise employees to compromise ethical standards or violate the law
24%	11%	3%	Would engage in insider trading to make $10 million if they could get away with it
23%	43%	33%	Had observed or had first-hand knowledge of wrongdoing in the workplace
17%	41%	34%	Expected their leaders were likely to look the other way if they suspected a top performer engaged in insider trading
15%	77%	79%	Doubted that their leadership, upon learning of a top performer's crime, would report it to the authorities

Source: Labaton Sucharow LLC, 'Wall Street in Crisis: A Perfect Storm Looming', July 2013; Universiti Malaya Law Faculty/UMCoRS/AICB Banking Ethics Survey, July 2014

MCB: Malaysian Conventional Banking *MIF: Malaysian Islamic Banking*

respondents in both conventional and Islamic banks believe that illegal or unethical behaviour has been engaged in by their competitors – another way of saying it is fairly common practice and not the behaviour of just a 'few rotten apples'.

Still more threatening to the current level of trust is the feeling that the industry does not put clients' interests first. There is obviously much for the marketing and sales departments of banks to do to ensure that the frontline remembers that putting clients' interests first is essential for long-term success in a service-based business.

HR (human resources) has a job to do if the belief that compensation plans and bonus plans incentivise malpractices is to be changed. They cannot do this on their own, but need to work with top management and the board to ensure that the KPIs, performance appraisals and reward systems are adjusted to promote good behaviour that will reinforce the trust that is essential to long-term success. Perhaps even more important, they may need to change the way they recruit and promote talent, with a greater emphasis on character and values as opposed to just looking at competence.

The board has a clear responsibility to ensure that the 'Tone at the Top' is such that ethical behaviour is rewarded and that illegal behaviour is punished rather than condoned if the person who has behaved illegally contributes to the bottom line of the bank. This will require rethinking desirable rates of return, KPIs and their time horizons, contracts of employment with CEOs and how key people are remunerated.

If the board, top management, leaders of the marketing and sales teams and HR continue with 'business as usual' and pay only lip service to the critical importance of culture and values, then Malaysian banks will be faced with a perfect storm when the next crisis hits. ✱

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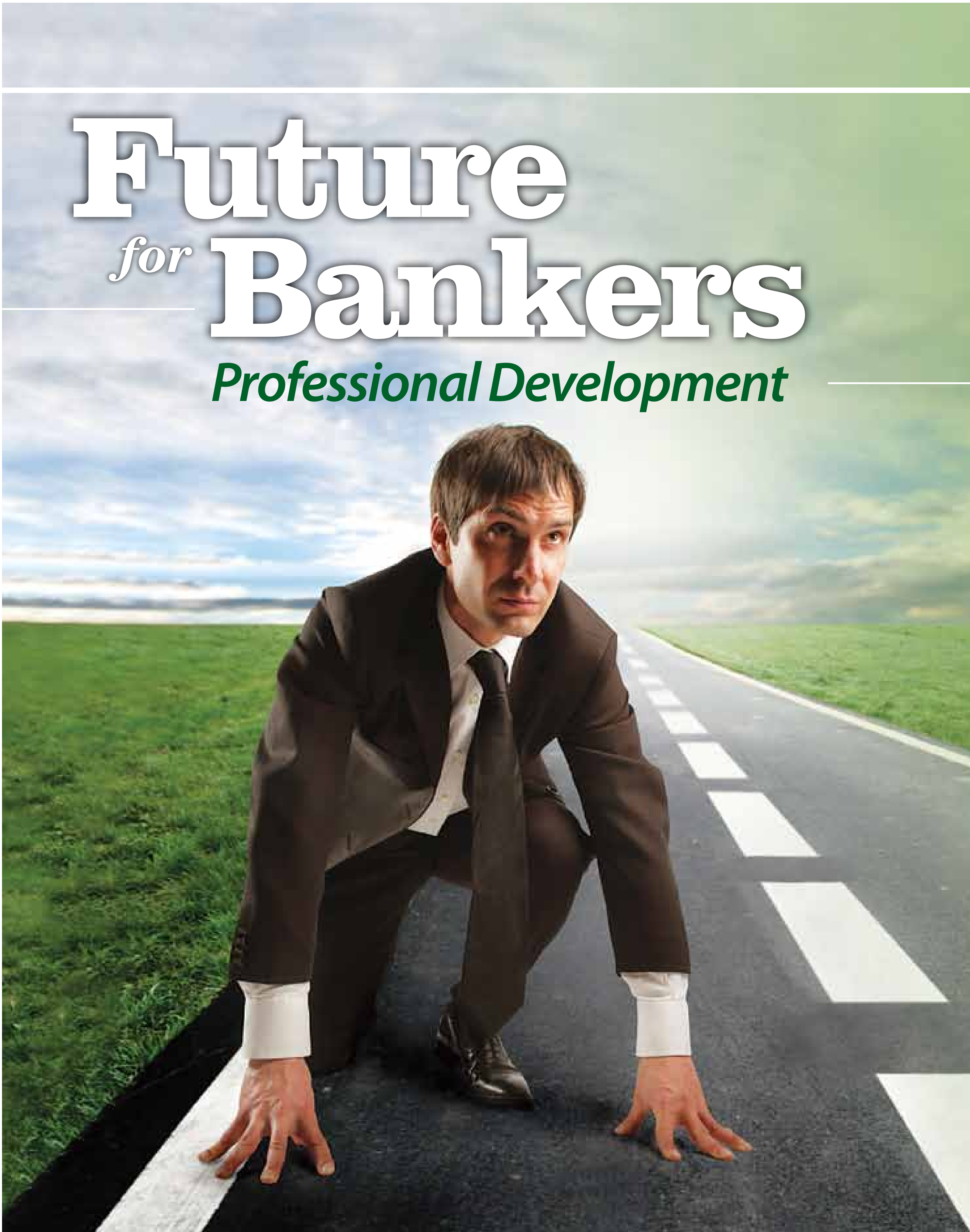
Future *for* Bankers

Professional Development



Scandals

To an extent, this has become a major regulatory risk, and a major concern from the investors' perspective. Bank scandals have also damaged the reputation of the industry in advanced markets.

EMBEDDING ETHICAL COMPETENCIES AND NOT JUST TECHNICAL EXCELLENCE IN BANKING EDUCATION AND PROFESSIONAL DEVELOPMENT WILL BE KEY TO PRODUCING HIGH-QUALITY PROFESSIONAL BANKERS WHO WILL BE AT THE FOREFRONT OF CHAMPIONING BETTER BANKING STANDARDS AND COMBATING HIGH-RISK BEHAVIOURS.

TAY KAY LUAN

British author and award-winning journalist Gillian Tett wrote in the 'Financial Times' of August 29, 2014 that an astonishing figure of £100bn worth of fines had already been paid post-2008 by the top global banks for misbehaviour. The range of misbehaviours - from money laundering, mis-selling subprime mortgages to rate rigging - has kept regulators and legislators awake for a while now.

This figure is not expected to decline - by 2014, Tett wrote, "the fines would have risen towards the £200bn mark." To an extent, this has become a major regulatory risk, and a major concern from the investors' perspective. Bank scandals have also damaged the reputation of the industry in advanced markets.

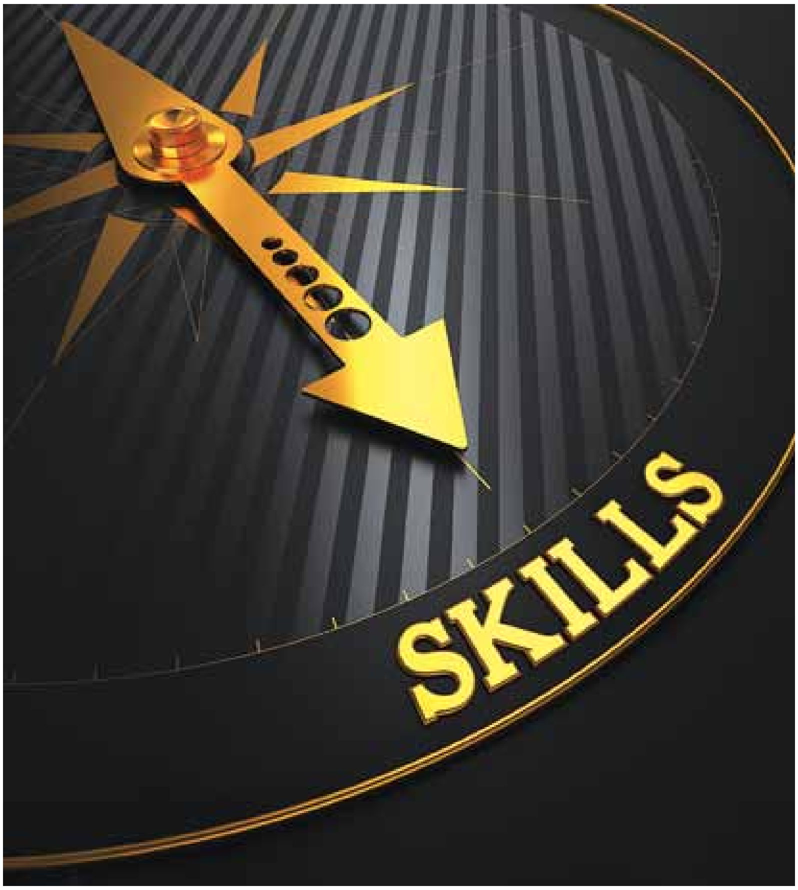
Its remit is to ensure the convergence and harmonisation of professional standards and business ethics with desired practices.

Focus on legislative reforms continues to be in the minds of regulators and policymakers. One of the steps taken forward in the UK is the establishment of a Banking Standards Review Council (BSRC) whose remit is help drive the standards of ethical behaviour and competence in UK banking. The purpose of BSRC is to champion better banking standards in UK, and one of its objectives is to work closer with professional bodies to place emphasis on professionalism and certification.

Recognising the contagion risk from the inherently interconnected nature of global banking, the Financial Services Professional Board (FSPB) was launched recently through the Asian Institute of Finance and with support from Bank Negara Malaysia, to play strong advocacy roles for higher standards of business ethics, responsibility and professionalism across the local financial services industry. Importantly, its remit is to ensure the convergence and harmonisation of professional standards and business ethics with desired practices.

Institutional Developments

The establishment of the FSPB complements one of the principal roles of the Asian Institute of Chartered Bankers (AICB). Raising the standards



of professionalism and business ethics has been recognised as a major but significant milestone as AICB transforms to become a more complete and robust membership body for bankers. The focus on the development of internationally agreed professional standards is to be embedded across its admissions, monitoring and examination processes. The process is part of the changes to the proposed membership framework, expected to be fully implemented in the early part of 2015.

Such development is in line with the stricter compliance and risk management measures undertaken by leading regional banks, which includes implementing adequate capital ratios, to sustain a sound financial system. This development will also allow AICB to initiate and strengthen members' professional conduct through education and continuous learning.

Business Ethics and Education

An important development and a major difference is the emphasis and integration of business ethics and professionalism principles into the banking curriculum of the Chartered Banker Qualifications series, the forthcoming certification in Bank Risk Management and the current Anti-Money Laundering certification. The syllabi of these examination-based qualifications have incorporated ethical competence focusing on moral values and judgements across the varied practices in banking. New course content with strong emphasis on business ethics is to be included in the future syllabus, including responsible lending, market conduct and ethical practices.

Incorporating business ethics into the syllabus at the early stage of development is important to test students on their own principles and views *vis-à-vis* their roles and business expectations. Interestingly, personal values may not necessarily coincide with the organisation's code of conduct. Ethical conflicts are common, and finding the right balance during the decision-making process helps recognise the concerns from various stakeholders' perspectives. Attention will be paid to the potential differences this can make towards raising the standards of behaviours on professionalism and business ethics in banking. Focus will be placed on teaching bankers the basic concepts on what constitutes responsible and ethical management.

Acquiring such competencies is part of managing such operational risk. Among the desired changes are setting criteria and recognition for Continuing Professional Development (CPD) and ensuring that these meet the basic needs of the banking fraternity. AICB will ensure its education and learning strategies and policies will be adaptive to the evolving requirements of professional banking curricula. Research and thought leadership will also enable AICB to meet the current and future talent demands of the industry and to ensure regional and global recognition of its awards.

One of the challenges is also to help the training side of the banking business to raise its standards to churn out future talent. Building a more stable, ethical and responsible workforce requires addressing and putting in place the sustainable foundations on which the education supply chain is being configured and managed. For this purpose, a fundamental re-think of the career pathways for banking talent is necessary. It is important and meaningful for HR (human resources) to integrate ethical principles into in-house programmes, including new staff orientation.

A strong and ethical workforce is only possible if the values are built into the system from the very beginning. It is for this reason that CPD continues to be important across the profession to ensure appropriate skills and knowledge continue to be emphasised. HR and business must work hand in hand to implement the right policies to ensure that the learning and development of bank professionals are intrinsically linked to professional conduct and principles.

Training divisions must benchmark their CPD policies with the right balance of both technical and non-technical offerings. One benchmarking opportunity is to conduct external benchmarking. A more recent international benchmark is that of the United Nations-supported Principles of Responsible Management Education initiative rolled out in 2008, which aimed to inspire and champion responsible management education, research and thought leadership. As universities are encouraged to be the signatories to these principles, they have been embedding business ethics, responsibility and sustainability issues into the curriculum and aim to ensure that all students will be literate on social responsibility and sustainability by the time they graduate. This includes setting up a range of courses in this area and requiring all students going on placements in business to question how companies are addressing these issues.

WORKFORCE

A STRONG and ethical workforce is only possible if the values are built into the system from the very beginning. It is for this reason that CPD continues to be important across the profession to ensure appropriate skills and knowledge continue to be emphasised.

More than 500 leading business schools and management-related academic institutions from over 80 countries across the world now participate in this UN global initiative.

One of the other major steps should include setting requirements in business ethics and professionalism as a standard item among the accreditation bodies, including the Financial Accreditation Agency on international benchmarks for technical education.

The learning objectives of banking education should also ensure that students understand the need to consider the economic, social and environmental impact of what they do and integrate these issues into their business' core activities. In this regard, the concept of corporate sustainability has to be better understood in the context of mainstream banking. The integration of such values can possibly mitigate the risks of business scandals like those that had taken place in major global banks and avert potential financial crises in the region.

AICB has the opportunity to have in place a series of innovations with core offerings, in relation to the design and development of CPD policy and benchmarks. These developments are a necessary part of transformation to enhance its relevance and reputation in employment markets.

Partnership

To drive transformation, AICB seeks productive partnerships with banks to support mutual efforts to grow the talent pool, while maintaining high

Fit for business

The development of an ethical workforce is necessary to sustain public interest and trust, key elements in ensuring business confidence. Lessons learned from the recent scandals indicate that students find business ethics a difficult area, especially in complex situations where the scope is grey and decisions can be complex. To avoid bank scandals in this market, the industry must be prepared to invest in raising standards of behaviours and competences. The narrow bottom line-driven approach is no longer appropriate in an environment where risks are high.

The industry support and partnerships with AICB will share common objectives to ensure a robust and sound professional development and education proposition that is fit for business. AICB as the only professional body for bankers has to innovate and deliver its value propositions that take into account the broader societal role and needs of banks. An agenda that goes beyond technical requirements is the obvious solution.

global standards that promotes strong business ethics and professionalism. This presents immense benefits to employers. The activities which AICB will possibly influence and employ will include ensuring appropriate recognition as an important and integral part of employers' HR strategies. AICB will need to forge productive partnerships with employers to ensure high-quality qualifications and professional development programmes.

The partnerships between AICB and employers will be based on a broad range of value propositions that will include raising professional standards, increasing capacity of banks in educating non-tangible risks, playing a significant role towards training students, or supporting members in career and professional development.

It will also be important to ensure that delivery is managed appropriately and to ensure that propositions are aligned to AICB's goals and aspirations.

AICB within this context will introduce the concept of 'Approved Learning Partners', with a broad suite of qualifications and certifications in mind. The programme will be designed to not only support career growth, but also to ensure that employers are more productive in helping AICB meet membership growth objectives. There is also an opportunity to help banks' training units to receive recognition as a producer of future chartered bankers whose reputation will be synonymous with quality and professionalism. AICB will ensure its student-member conversion tools will be adequately developed to enhance student performance. ✱

■ Tay Kay Luan is the Chief Executive of the Asian Institute of Chartered Bankers (formerly the Institute of Bankers Malaysia). He brings with him more than 25 years of corporate leadership and strategy experience. In his current capacity, he leads a transformation agenda that aims to reposition the Institute as a more complete and modern professional body for bankers.

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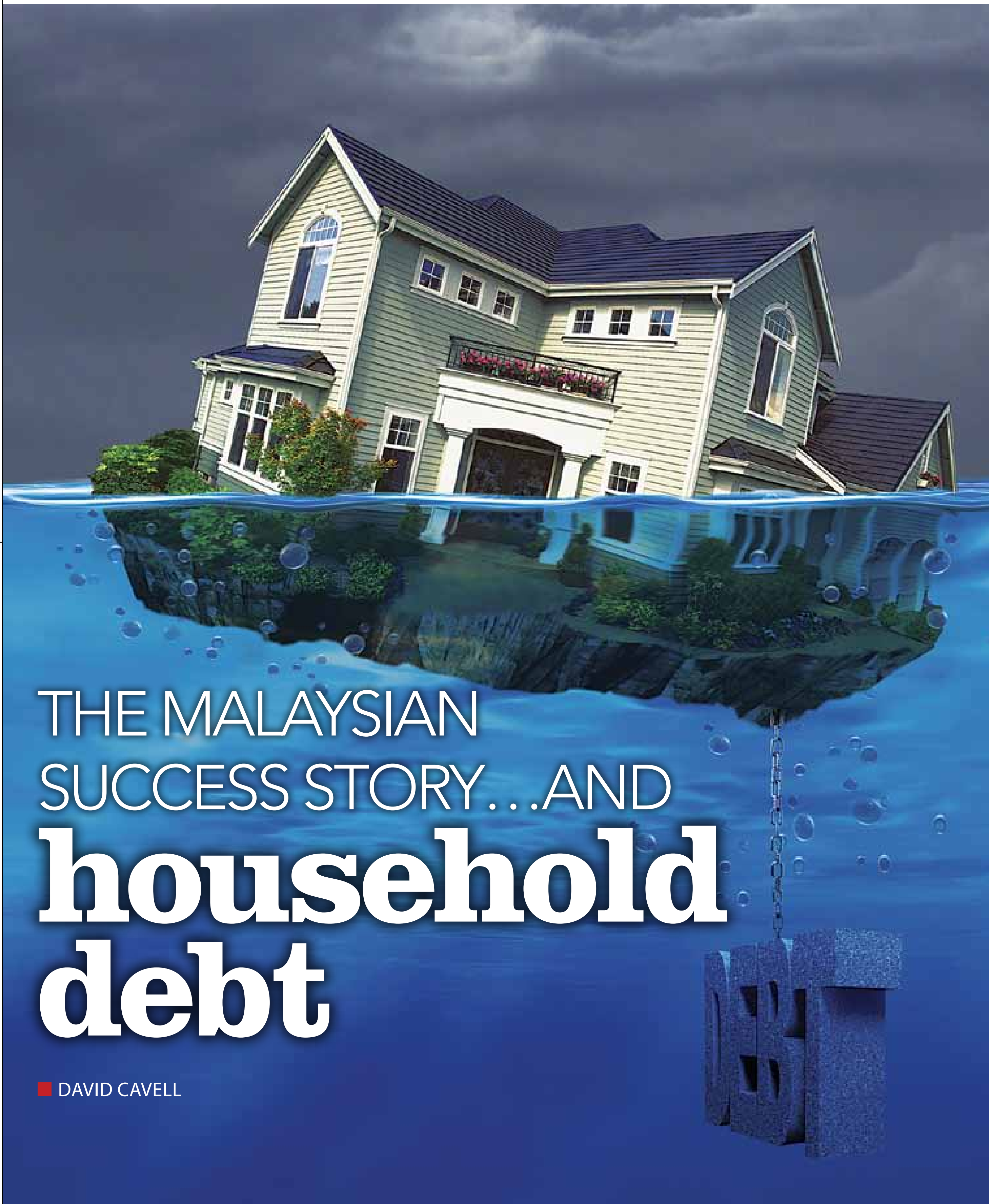

THE MALAYSIAN SUCCESS STORY…AND household debt

DAVID CAVELL

Problem

The ratio of household debt to GDP increased to 86.8% in 2013, and certainly has the potential to become a major problem for the economy.

DESPITE HEALTHY ECONOMIC GROWTH, RISING HOUSEHOLD DEBT LEVELS – INCLUDING CREDIT CARD DEBT - COULD POSE A RISK TO FUTURE ECONOMIC STABILITY.

So far, so good!

There is much to celebrate about the economic progress that has been made by Malaysia. Year-on-year increases in the gross domestic product (GDP) are running at very healthy levels with economic expansion of 6.4% in the first half of 2014, according to statistics from DBS Research Group 'Economic Markets Strategy' September 2014. Exports recorded an annual growth of over 8.8% in the second half with imports falling back to 3.9%. With a strong export record and equally buoyant domestic demand it is easy to see how unemployment has recorded a low of just 2.8% in the second quarter. Overall, the country is benefiting from sound government economic policies, which fully justify the optimistic projection for stable growth over the coming years. A review of the annual reports published by the country's leading financial institutions reflects a sector at ease with itself, and optimistic about the future. Against a background of so much good news, is it reasonable for so many commentators to express concern about the rise in Malaysian household debt? Well, yes! The ratio of household debt to GDP increased to 86.8% in 2013, and certainly has the potential to become a major problem for the economy.

The credit card sector

The figures published by Bank Negara Malaysia (BNM) provide a view of the credit card sector that is instructive. Credit cards are a good proxy for the general health of household finances because of the different ways in which they can be used. They allow cardholders to exercise discretion in managing their credit line, and the trends that can be seen in the key statistics provide a view of how much pressure they may be under, if any.

BNM figures show a major decrease in the number of principal cards in issue from 9.8 million to 7.2 million over the five years to mid-2014, some of which may have been attributable to the closure of dormant accounts. Nevertheless, there was still an increase in the aggregate amount of the credit lines enjoyed by the remaining cardholders. The total amount of the credit lines extended to cardholders went up by over 16% to RM125bn and the aggregate borrowing on the remaining credit cards also increased, from RM22.6bn to RM32.0bn during the same period. There was a corresponding increase in the proportion of their credit line used by cardholders, moving up from 21.0% to 25.6%. Taken together, the consequence of these increases is that the borrowing of the average cardholder can be seen to have risen substantially, by over 90% in just five years.

Another equally worrying area is the recent short-term rise in the ratio of balances that are up to three months in arrears. This has increased from 6.1% in 2012 to 7.6% in 2014. These

▪ *South Korean credit cards – the power of consumer indebtedness*

The historic problems precipitated by South Korean credit cards resulted from a materially different scenario to that which exists in Malaysia in 2014. Household debt in Malaysia has developed differently, and the economic backdrop is considerably more optimistic.

However, the South Korean experience provides a vivid illustration of the downside resulting from consumer over-borrowing. Government measures had acted as a significant stimulus to the sector, which grew from 39 million cards to 105 million in the three years to 2002. The Korea Non-bank Financing Association estimated that the number of cards held by economically active people increased three times to average 4.5 during this period. The proportion of turnover resulting from cash advances rose to around 60%. In many markets cash advances are known to be a significant indicator of a weaker ability to manage credit. By March 2003, the number of delinquent accounts had reached nearly 12 million, and those ineligible for credit had reached a record 2.96 million, with a massive increase in the numbers of personal bankruptcies. The adverse consequences for the consumer, card issuers and the national economy were significant, with implications for the credit ratings of the country's largest banks.

CREDIT LIMIT

It seems **HIGHLY IMPRUDENT** to sustain a situation where the average debtor enjoys a credit limit that will, in theory, allow them to almost quadruple their current borrowing.

cardholders typically wish to meet their commitments but are experiencing problems that inhibit their ability to repay even the minimum amount required each month.

What does it all mean?

The current and projected state of the Malaysian economy is very good, and commensurate optimism might be appropriate when reviewing the BNM credit card figures. On the other hand, it is arguable that the downside scenario for domestic household debt is so great that a more prudent interpretation is the better course. A conservative review of the BNM figures reveals a number of trends which, taken together, emphasise the need for early action.

The most worrying statistic of all must surely be the percentage of credit lines that have not been taken up. Credit card marketers have long understood the relationship between the outstanding debit balance on an account and the limit. The former will tend to move towards the latter, hence the role of credit limit increase decision tools and campaigns, when seeking to encourage cardholder borrowing. At a time when there is such widespread concern at the level of household debt, it seems highly imprudent to sustain a situation where the average debtor enjoys a credit limit that will, in theory, allow them to almost quadruple their current borrowing. Looking at the collections side of the business, there may be further cause for concern. Over the last two years, at a time when unemployment has been at relatively low levels, there has been a 24% increase in the value of balances that are up to three months in arrears. This suggests that there is already increasing stress in the system.

The presence of unwanted levels of inflation in the economy has already caused BNM to move rates upwards, and it is possible that 3-months Klibor (Kuala Lumpur Interbank Offered Rate) could breach the emotive barrier of 4% sometime during 2015. The increasing cost of money will not only put further pressure on indebted households by raising the cost of borrowing, but it will also cause an unwelcome upward movement in business costs.

When so much of the country's economic success has been attributable to exports, it is impossible to ignore vulnerabilities that might arise from external factors. Looking at the broader picture in Asia Pacific, it is reasonable to ask whether there are country markets whose slowdown might cause economic difficulties for others in the region. Moody's is the latest organisation to raise the possibility of wider negative regional implications arising from the fears of a housing crash in China. An unexpected economic slowdown, with adverse implications for demand and employment levels, would certainly hit cardholders (and issuers), causing significant difficulties. Two of the biggest contributors to arrears and charge-offs arise from loss of earnings (mainly through redundancy) or other unexpected events.

Action now?

The subject of high household debt is a significant issue, even in a thriving economy. It must be recognised and a strategy developed to ensure that it does not become a threat. This article has looked at the credit card sector but it recognises that there will be other forms of finance that consumers may have used to realise their aspirations, not the least of which is for house purchase. In passing, the perversity of home ownership is that financial relief through downsizing is not always an easy or available option when it is most needed, such as in a recession.

A strategy must be developed with government and issuers working together to deal with three key issues. In the first instance, action must be taken to radically reduce the readily available lines of credit still at the disposal of cardholders. Current available limits may well not see appreciably greater short-term utilisation across the board. However, they do act as both an incentive and opportunity for households to further increase their borrowing, especially if they are coming under financial pressure. The second initiative must be a more rigorous assessment of applications for all types of borrowing. Simply raising the scorecard threshold may not be sufficient. A (high-scoring) longstanding employee with a good salary may be no less vulnerable in the face of adverse economic developments, or the demise of a sector that has been superseded. For example, the smartphone has reduced the global demand for compact cameras by around 75% in only three years, with significant workforce implications in the region. Finally, more resources must be applied either centrally or locally (through branches) to ensure that debtors beginning to experience problems are both identified and receive counselling at the earliest stage in their difficulties.

Practical and meaningful measures are now required and it is acknowledged that they carry resourcing implications. However, it is better to deal with the issue at a time of strength, when any additional costs are more affordable. What is clear is that consumer over-indebtedness is a potent force which, when managed badly, can add critical impetus to even the slightest deterioration in economic prospects. ✱

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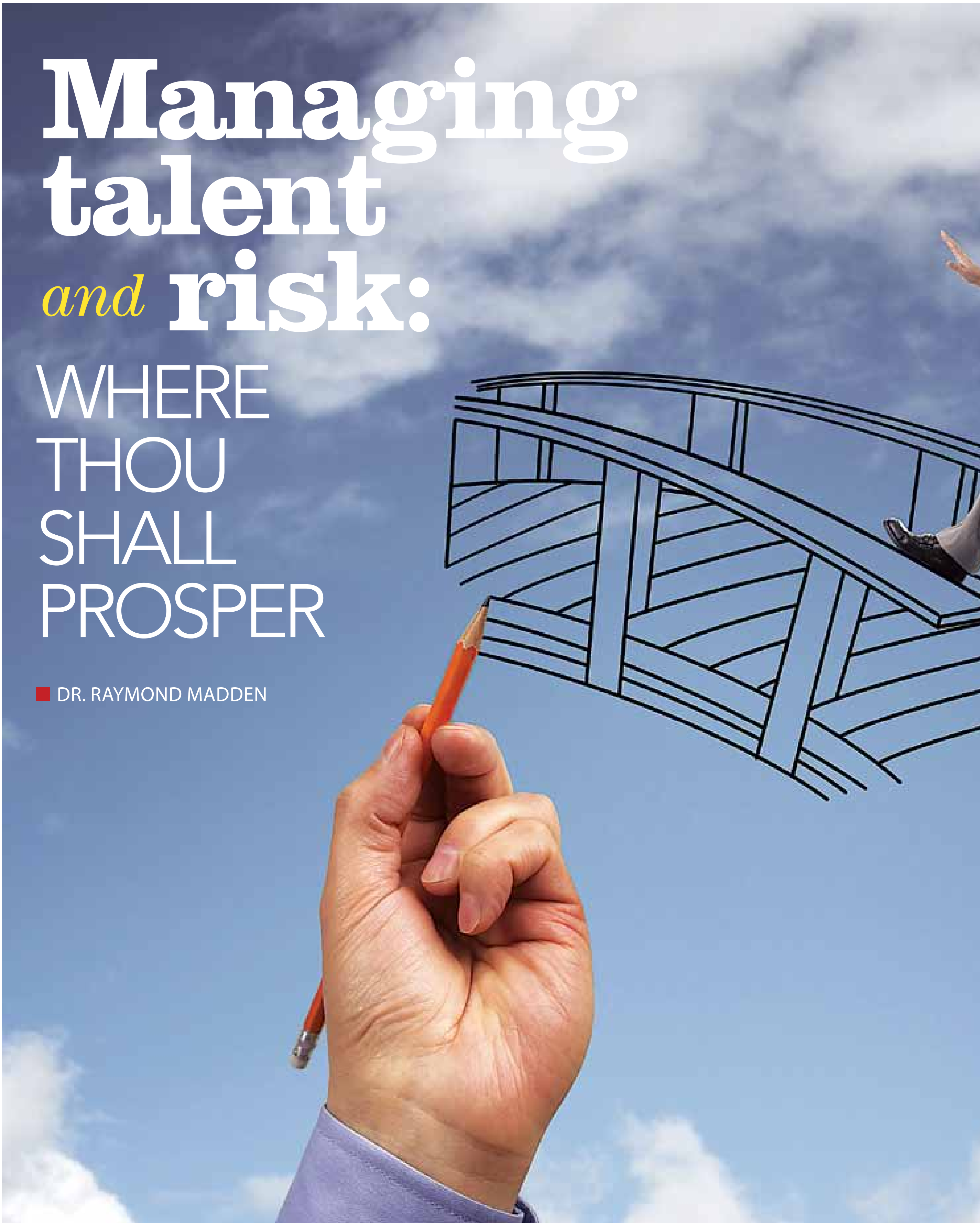
Managing talent *and* risk: WHERE THOU SHALL PROSPER

DR. RAYMOND MADDEN



IN A KNOWLEDGE ECONOMY where talent is a critical business imperative that leads to sustainable competitive advantage, the inability to attract and retain qualified talent has become a key business risk.

Talent risk is further heightened as financial institutions compete for talent on an unprecedented scale and in a changing talent marketplace. Understandably, managing talent is a burning issue for many financial institutions, as the risks associated with talent management will impact overall productivity and ultimately the businesses' bottom line. Few financial institutions integrate human capital into their risk management and planning process; and even fewer are effective in managing talent risk.

So what is talent risk? How does talent risk affect business operations? How can financial institutions mitigate such risk? Talent risk is defined as the risk of not having the right people in the right roles at the right time with the right skills and the right ethical behaviour based on an organisation's business principles. Based on this definition, talent risk can be categorised into four types: capacity, competency, retention and ethics.

Skills gaps arise from the asymmetry between the profile of employees and the skills that employers require.

Talent Capacity Risk

This refers to the risk that organisations face in attracting the talent needed to drive business success. Hence, the risk of not having sufficient capacity of talent to fill various positions in the organisation has proven to be a significant challenge for many financial institutions. A recent survey conducted by the Asian Institute of Finance (AIF) found that 76% of employers in the financial services industry in Malaysia are struggling to fill key positions in their organisations.

This talent shortage is not only putting an enormous pressure on their potential to expand into new markets, but when viewed in the context of business performance represents a serious risk to business as it has a direct impact on the top and bottom lines. Effective succession planning can mitigate the opportunity and productivity risks associated with talent gaps.

Talent Competency Risk

Talent competency risk is defined as the failure of developing skills and competencies required by the organisations to achieve their business goals. Skills gaps arise from the asymmetry between the profile of employees and the skills that employers require. This gap impacts a variety of organisations which, in turn, affects their ability to grow and sustain competitive advantage. The widening skills gap is making it difficult for financial institutions to find qualified talent, especially when it comes to filling senior management and specialist roles. The AIF survey entitled 'Talent Gaps in the Financial Services Industry' suggests that employers in Malaysia are experiencing a critical skills gap especially in the areas of leadership and soft skills.

Talent Retention Risk

Talent retention risk can be categorised according to the 3Ps of why people leave an organisation - Push, Pull and Personal factors. In a study entitled 'Talent Circulation in the Financial Services Industry' conducted by AIF, it was found that a range of 'push' factors affected employees' disposition to leave including job satisfaction, work-life balance, family, career progression and promotional prospects. These pull factors are more intrinsic in nature.

TALENT MANAGEMENT

Quantifying talent retention risk that measures an organisation's exposure to such risk will enable HR (human resources) to make more informed decisions about talent management in the context of the needs of the business.

Meanwhile, factors such as international exposure, professional opportunities, better benefits, and higher salary were identified as 'pull' factors. Personal factors such as health problems, family-related issues, children's education and social status contribute to turnover intentions. However, the unrealistic expectations of employees have also been classified as an important personal factor that contributes

towards talent retention risk. When unrealistic expectations are not realised, employees are at risk of becoming disappointed with their jobs and are likely to leave.

Talent retention risk is more pronounced when those employees leaving are top or high potential talent, especially specialists and middle managers. Quantifying talent retention risk that measures an organisation's exposure to such risk will enable HR (human resources) to make more informed decisions about talent management in the context of the needs of the business.

Talent Ethics Risk

Talent ethics risk has become central to financial institutions' sustainability as demonstrated in the recent global financial crisis. It does not only have serious implications to the businesses' bottom line, but has clearly been shown to have greater serious consequences on the economy as a whole due to globalisation. It is evident from the recent global crisis that significant business and talent risks occur when rewards and incentive programmes are misaligned. In many instances, these have led to extensive risk-taking which did not punish or penalise unethical conduct. As Adair Turner, former Chairman of the Financial Services Authority succinctly put it: "Inappropriate incentive structures played a role in encouraging behaviour which contributed to the financial crisis".[1]

Talent ethics risk can be mitigated by having compensation practices that are externally competitive but at the same time incorporate long-term ethical performance as one of the metrics when designing rewards and incentives programmes. But this calls for leaders to see themselves as stewards of ethical behaviour. They must believe the importance of exercising ethical leadership and recognise that this should be at the heart of any compensation discussion.

PULL FACTORS

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Conclusion

Financial institutions should consider talent and HR practices as part of their broader risk management strategies. Incorporating the various types of talent risks as defined above into risk management strategies will ensure that such risks are quantified, measured and mitigated.

But many financial institutions have failed to consider talent risk as part of their broader risk management strategy. A more open dialogue between HR and risk managers should be encouraged especially in the areas of compensation, hiring, succession planning, professionalism and ethics that support business continuity and growth. ✱

[1] *Turner, A (2009), A regulatory response to the global banking crisis, March, Financial Services Authority.*

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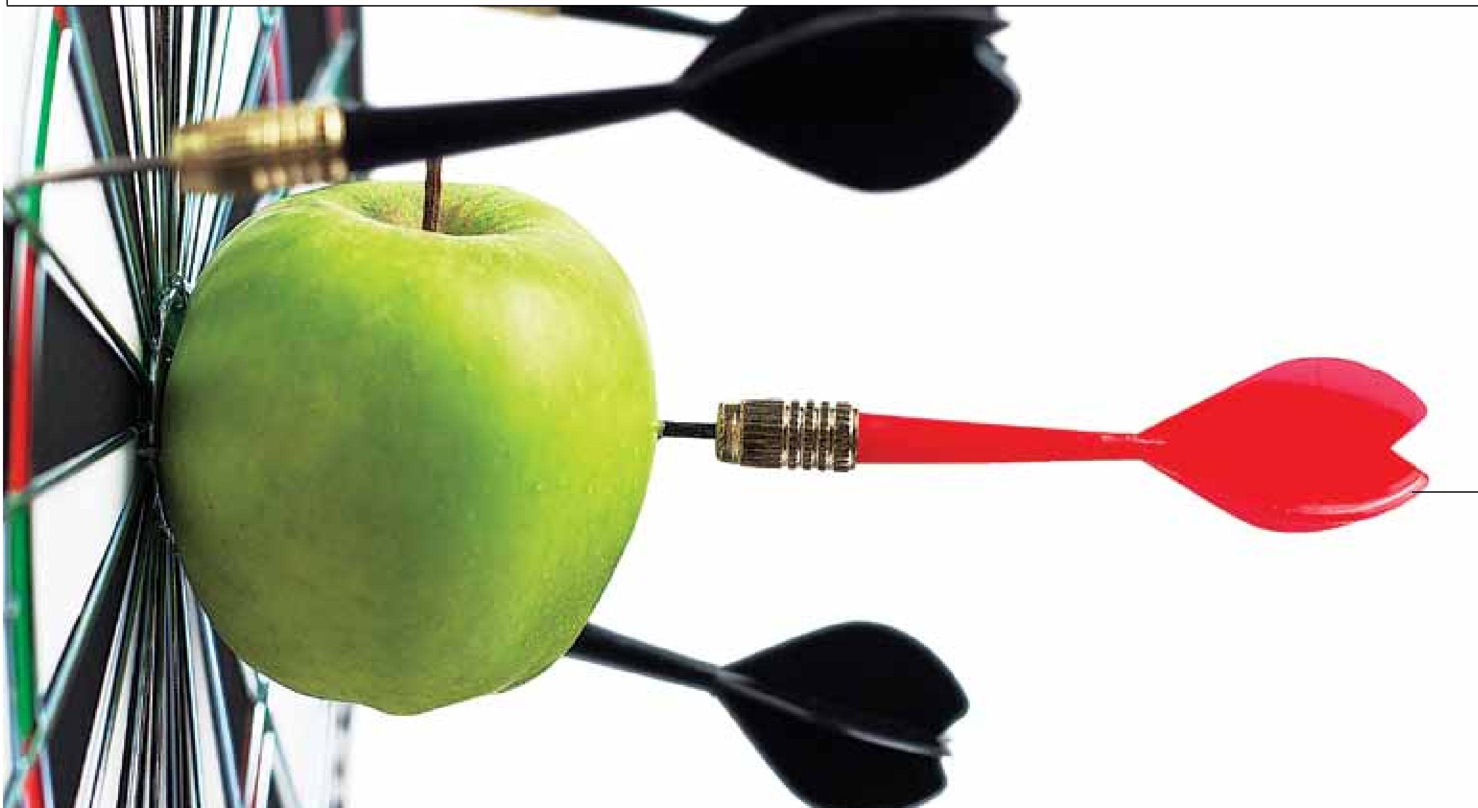
He brings to the region experience from several senior roles in human capital development within the European financial services industry, including tenures as Global Head of Learning at ABN AMRO Bank and Lloyds Banking Group.



The talent and skills crunch remains a major risk threatening the sustainability of the Malaysian banking sector.

Key developments in banking and finance are driving the ebb and flow of talent in banking and finance. These include regulatory changes, technology, demographic changes, and innovation/cross-selling to diversify revenue streams. Changing banking regulations are transforming the way banks operate, develop products and interact with customers, while technology is integral to maintaining banks' competitive edge. Demographics are changing, making it necessary to offer newer, more innovative banking products and services, and this in turn will push banks to cross-sell products, in order to diversify their revenue streams. Bankers will need to upgrade and update their skill sets in order to be able to manage the risks of operating in this dynamic environment, but reskilling is not happening fast enough to meet industry pressures. As such, talent shortages have been identified across the board, but particularly at middle management and specialist levels.

How acute is the shortage? The report estimates that over the next ten years, Malaysia's financial sector will require 56,000 workers in addition to the 144,000 already in the sector today – a staggering number given Malaysia's existing talent constraints.

TRANSFORMING

CHANGING banking regulations are transforming the way banks operate, develop products and interact with customers, while technology is integral to maintaining banks' competitive edge. Demographics are changing, making it necessary to offer newer, more innovative banking products and services, and this in turn will push banks to cross-sell products, in order to diversify their revenue streams.

Tackling the TALENT RISK

TALENT AND SKILLS SHORTAGES STAND OUT AS MAJOR RISKS TO THE LONG-TERM SUSTAINABILITY OF THE BANKING AND FINANCIAL INDUSTRY IN MALAYSIA. A RECENT REPORT RELEASED IN JUNE 2014 BY THE INSTITUTE OF BANKERS MALAYSIA, NOW KNOWN AS THE ASIAN INSTITUTE OF CHARTERED BANKERS, ENTITLED **'STUDY ON TALENT AND SKILLS REQUIREMENTS FOR THE BANKING SECTOR IN MALAYSIA'** SEEKS TO OFFER SOLUTIONS FOR THESE CHALLENGES.

While the talent pool is already limited, the ongoing brain drain and the movement of talent to other sectors and countries is likely to compound the problem. Malaysia is losing its banking sector talent to markets and sectors where the grass is greener, for example to non-banking sectors such as manufacturing, oil and gas, and FMCGs (fast-moving consumer goods). Banking skills are highly marketable and transferable, with former bank officers moving to positions in asset management, insurance, other finance-related professional services, advisory services and regulatory agencies.

As part of its thought leadership initiatives to address talent risk, the Institute of Bankers Malaysia (IBBM), now known as the Asian Institute of Chartered Bankers (AICB) sought to offer solutions to build capacity which were recently published in its 'Study on Talent and Skills Requirements for the Banking Sector in Malaysia'.

The recommendations were derived from five different surveys conducted across four bank types: retail/ commercial, development/industrial,

Malaysia is losing its banking sector talent to markets and sectors where the grass is greener, for example to non-banking sectors such as manufacturing, oil and gas, and FMCGs.

Islamic and investment banks. Feedback was sourced from interviews with C-suite and HR (human resources) heads, as well as from two workshops involving 34 HR representatives.

New Risk Management Skills Required

What are the skill sets expected of bankers today, especially those in the middle and upper management echelons?

As the industry places increasing emphasis on risk management and regulatory compliance, bankers – especially those in the risk function – will need to be abreast of internal risk controls and embed the risk awareness culture to reduce risk. In particular, Basel III regulations will have an immense impact on capital requirements and liquidity management, among other game changers, and understanding of Basel III compliance is vital for risk managers and staff at all job levels.

Talent at senior level can no longer afford to operate in silo, and will require the appropriate holistic and high-level strategic thinking and integration skills that drives banking forward. Meanwhile, mid-level talent will be expected to innovate or customise products that cater to dynamic markets and comply with regulations.

Investment banks will require their talent to have the ability to interpret risks, such as liquidity, credit, market, interest rate, and foreign exchange risks, while being able to structure innovative products and manage operations. *Shariah* governance will be a unique and in-demand skill set for talent in Islamic banks; talent at all levels must be able to embed the *Shariah* risk culture in order to ensure *Shariah* compliance. As banks embrace mobile and internet banking, talent – especially frontliners - must be increasingly computer literate.

Furthermore, demographics will dictate skill sets. As populations age and become more affluent, demand will escalate in the areas of wealth management, retirement and long-term healthcare. As the number of high-net-worth customers grows, banks have to be ready to aid this premium segment to manage their investments and wealth. Staff must be armed with skill sets that include communication, presentation, negotiation and extensive product knowledge – plus the ability to cross-sell. New products will also be needed to cater for Generation Y (Gen-Y) customers, an increasingly important segment as larger numbers of millennials enter productive work.

Speaking to Stakeholders

Who are the key stakeholders that banks should address in order to manage the talent risk?

The report identified Gen-Y as a segment that will have to be managed differently when it comes to retaining talent. Gender diversity will be key: the growing number of women in the workplace and their unique needs will have to be factored into future strategies and policies. Banks should thus be positioning themselves to become more inclusive, flexible and commit to change management in the talent space to genuinely manage talent risk.

Investing in succession planning should be prioritised. The worrying lack of middle-level talent implies a gap in succession planning which could eventually hamper the continuity of vision and strategic implementation as the top echelons exit. Strategies to tackle shortages at specialist levels should be implemented as well as this gap will hinder banks' vision to expand into new areas, develop new products, or increase staff capabilities.

It is recommended that banks reengineer their internal and external policies to integrate the top five talent-attracting factors, as identified by the report. These five are the bank's branding and culture, competitive basic salary, strong leadership and management, competitive benefits, and clear career progression.

Retail/commercial banks with strong brands tend to attract more talent; development/industrial banks are usually not as high profile and as a result, do not attract as much talent as retail banks do. Islamic banks attract talent that identifies with *Shariah*-compliant principles. In most cases, banks are able to reward better than other sectors, hence they attract more talent. But rewards alone are proving to be insufficient when viewed from the perspective of a dynamic and mobile workforce that expects engaging and challenging work. Talent is also looking to be led by strong, ethical leaders who instil confidence and support.

Enhance retention by mapping out clear career development routes for talent. According to the report, talent will look for situations where their own aspirations can be fulfilled with the help of management/leadership, and where skills can be developed through structured training that is tied to a defined career path.

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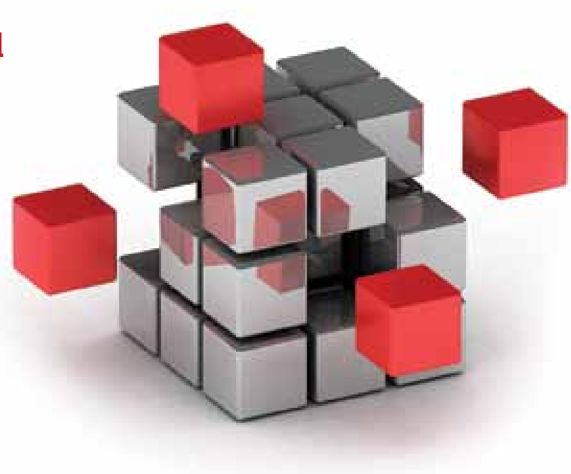
Access to learning will be a driver for recruitment and retention. There is hence a need to put in place both technical and non-technical training programmes, internally and externally, to support talent development needs. Talent development in banks currently and going forward requires a balance between technical and non-technical skills. Organisations should aim to develop talent that is well-rounded, with technical knowledge, and the ability to engage meaningfully with clients in order to provide holistic advice. The technical training programmes of many banks already encompass core operating matters such as regulation, product knowledge, financial risk management and IT, while non-technical training usually covers communication and presentation skills, critical thinking, language proficiency, team-building and leadership, innovation, negotiation, and marketing.

Banks and financial institutions should bear in mind that talent strategies and policies must keep evolving in parallel with a dynamic market scenario.



Set Risk as KPIs

In order to ensure that employees are cognisant of the various risk parameters and are ethical in their judgements, risk should perhaps be designated as one of the key performance indicators. Business Continuity Management (BCM) in risk management can be embedded in training, and structured risk management frameworks and tools utilised to measure and monitor risks. All this will be vital to train and support talent in identifying potential risk, and to be able to develop and implement effective risk mitigation strategies with the goal of business sustainability.

Critically, banks and financial institutions should bear in mind that talent strategies and policies must keep evolving in parallel with a dynamic market scenario. Talent needs to be upskilled and trained continuously to fuel Malaysia's financial sector which is anticipated to grow between 8% and 11% annually. Consider collaborating with universities and structured internship programmes to ensure the early development of talent; banks could also initiate employee exchange programmes or try to attract talent from other sectors to tackle the crunch.

Finally, it must be mentioned that regulators and professional bodies play a vital role in supporting the sustainability of talent management in Malaysia. AICB's championship of a banking institute to develop talent specifically for the sector - with the appropriate certification status, will be the crux of building a sustainable talent pipeline.

■ Reporting by the *Banking Insight* Editorial Team.

FINANCE TRANSFORMATION *meets* RISK MANAGEMENT

INTEGRATING RISK AND FINANCE THROUGH THE FINANCE TRANSFORMATION AND RISK-ADJUSTED PERFORMANCE PROCESS PERMITS FINANCIAL INSTITUTIONS TO RECONSIDER THE ENTIRE GOVERNANCE APPROACH AND ENABLE A TRULY RISK-BASED DECISION-MAKING APPROACH WITH MUCH GREATER TRANSPARENCY AND EFFICIENCY.

JOHN FOULLEY

In recent times, financial institutions are facing daunting challenges to enhance their business models, and at the same time to comply with a plethora of new regulations. Strong pressures from regulators are driving financial institutions to embark on a more integrated risk and finance approach to ensure reliable results and soundness of their financial structure.

Key regulations such as Basel II, Basel III and IFRS (International Financial Reporting Standards specifically IAS 39 and IAS 9, where IAS stands for International Accounting Standards) are placing greater demands onto ASEAN financial institutions to streamline their financial, management and regulatory reporting. Regulators are requesting financial institutions to present all relevant financial and risk information pertaining to performance, liquidity and capital in a transparent and consistent manner based on agreed metrics and methodologies and under a controlled environment to ensure consistency between risk policy and management decisions.

Regardless of whether it is provisioning, hedging, scoring systems or risk assessment, financial institutions need to prove that managerial decisions are consistently translated into risk governance. This requirement can be accomplished only through consistent reporting across the entire organisation.

> Regardless of whether it is provisioning, hedging, scoring systems or risk assessment, financial institutions need to prove that **MANAGERIAL DECISIONS** are consistently translated into risk governance.

However, most financial institutions today view their 'supply chain' of financial information as fragmented. This may result in multiple sets of general ledgers (GL) with differing charts of accounts, inconsistencies with accounting rules, and overly cumbersome GL structures. These institutions have responded by segregating management reporting and analysis from core financial processing causing unfulfilled risk governance and unmet regulatory requirements.

These institutions therefore recognise the need for a more responsive and progressive integration of risk and finance data that can support ad-hoc requests and provide proof points for use-tests to regulators. The supporting architecture is generally known as finance transformation and risk adjusted performance (FTRAP).

Setting FTRAP Right for Risk Management

Whilst the business and functional requirements of FTRAP development may vary depending on the size and complexity of the financial institution, the overarching objective is to maintain an acceptable level of profitability in this ever-changing business and regulatory environment. Following are some identified regulatory and business drivers that can translate into the FTRAP business and functional requirements.

- ***Comprehensive accounting process and financial reporting control***

The FTRAP process should support a complete and efficient multi-GAAP (generally accepted accounting principles) accounting for all financial

Approach

Strong pressures from regulators are driving financial institutions to embark on a more integrated risk and finance approach to ensure reliable results and soundness of their financial structure.

transactions. Controlled, manageable and timely updates to the GL are paramount to provide transparency and auditability. The design of process flow has to be done with careful consideration of the chart-of-account complexity, leveraging core system's embedded GLs where appropriate, and focusing on the speed of support for the financial close. The architecture and data flows should also accommodate accounting that is driven by valuations rather than by accounting rules alone, as IFRS and other emerging standards will need robust support in the accounting flow.

▪ ***Virtually seamless and transparent consolidation and close process***

Financial institutions require support for an efficient, timely and accurate monthly close. While the regulatory and business needs are trending towards a faster and more controlled process, closing still requires significant manual intervention in most cases. This is because the majority of financial institutions' systems still remain not automated and prone to inefficiencies and quality issues.

Current and incoming regulations, such as Basel II, Basel III and IAS 9, involve an increasing amount of reference and reconciliation as an integral part of financial reporting. Financial institutions need to demonstrate the practical connections between risk appetite, policy and accounting approach to be compliant with these and other regulations.

To overcome this challenge, a harmonised integrated view of risk and finance with a formal well-articulated reconciliation framework has to be in place.

▪ ***Consistent financial and management reporting including risk-adjusted performance***

Crucial for financial institutions is the timely availability of all relevant financial information at the GL level and at the required granularity. Enforcement of consistency across financial and management reporting has to be exercised at the data level with a robust capacity to manage top-line adjustments.

The financial and management reporting process needs to provide the ability to incorporate risk information into the management results which allows financial institutions to perform any risk and finance action on data concurrently and to support a unified data flow for reporting.

Moving Forward with the Finance and Risk Integrated Approach

Current regulatory and business requirements call for a more progressive and integrated approach between risk and finance. This takes place in many areas of the bank, specifically for provisioning, risk-based pricing and reconciliation of operational loss with accounting data.

To progress towards this integrated approach, financial institutions need to ensure all relevant systems work together based on the same principles and data. The system should also provide regular reconciliation to prevent additional manual intervention. Manual intervention is to be treated on an individual basis and should be constrained to cases such as large exposures, exception to credit policies and management decisions.

The integration of risk and finance is a process that is becoming an increasingly important requirement in the financial services industry. The FTRAP process is positioned to help seamlessly handle multiple accounting regulations, provide consistency in management and financial reporting and lastly to leverage a single, unified analytical repository for risk, finance and accounting.

Starting with a quintessential bottom-up approach from data to strategy, the FTRAP process can force financial institutions to reconsider the entire governance approach and enable a truly risk-based decision-making approach with much greater transparency and efficiency. ✱

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Targets

Online and mobile banking websites have been the primary targets of financially-motivated cybercriminals.

Securing financial data

against malware and targeted attacks

INCREASINGLY SOPHISTICATED MALWARE AND NEW ATTACK TACTICS PUTS PRESSURE ON FINANCIAL INSTITUTIONS TO UPGRADE THEIR IT SECURITY STRATEGIES AND ACQUIRE NEW TOOLS AND APPROACHES TO DETECT AND PREVENT TECHNOLOGICAL AND INTERNET RISKS.

IVAN WEN

Online banking has provided the ability to conduct instantaneous electronic financial transactions over the Internet for nearly 20 years now. However, at the same time, cybercriminals have evolved just as quickly to figure out how to effectively glean some serious wealth from financial frauds. Today, most cybercriminals who target financial institutions are financially motivated, although trade secrets, espionage, political, and religious motives still come into play in some cases.

Online and mobile banking websites have been the primary targets of financially-motivated cybercriminals. Recently these crooks are focusing their attention especially towards new financial institution victims which host high volumes of large dollar transactions. These targets include Automated Clearing Houses of financial transactions in the United States and Single Euro Payments Area credit transfer agencies in Europe. In addition, security analysts have also noted an alarming rise in mobile malware targeting these types of financial institutions.

For many years, most attack vectors exploited human beings as the weakest link in any cybersecurity defence chain. It is how cybercriminals trick users into inviting malware onto their systems in order to bypass automated IT security defences.

How Malware Infiltrates the Banking Network

For many years, most attack vectors exploited human beings as the weakest link in any cybersecurity defence chain. It is how cybercriminals trick users into inviting malware onto their systems in order to bypass automated IT security defences. Via this method, the infection can spread to the entire banking network once compromised. For banking malware, compromising the Web browser is often the primary attack vector for effectuating financial

NEEDED: A LIFECYCLE DEFENCE

Today, there is no single solution to prevent the intrusion of destructive and costly malware. Financial organisations need to evolve to leverage a lifecycle defence strategy that covers traditional defences, advance defences and continuous threat monitoring — in order to combat the threat and minimise the amount of malware reaching and infecting the banking network.

- Traditional defences include security gateways, proxies, and firewalls, the use of strong unique passwords or multi-factor authentication for each user and system, plus encryption of sensitive data while in storage and in transit on the network.
- Advanced defences include next generation firewalls and specialised network protection appliances aimed at various attack vectors including web, email, and file systems.
- Continuous threat monitoring is the ability to collect and analyse suspicious unknown samples for the presence of malware based on behavioural risk scoring and proactive heuristic analysis. Despite its power, the practice of malware analysis still remains relatively rare even in the face of steadily expanding threats.

fraud. The most common vectors of malware attacks targeting banking networks are as follows:

SPEAR-PHISHING – Bank users invite this based on highly targeted personal messages from senders that appear known to the recipient.

WATERING HOLE ATTACKS – Hackers infect vulnerable websites of a common interest to their targets and then redirect them to malware on servers they control.

EXPLOIT KITS – these are for sale on the Internet, designed to exploit weaknesses in banking and finance software.

BRING YOUR OWN DEVICE - this trend is difficult to monitor and nearly impossible to stop.

REMOVABLE USB MEDIA DRIVES – these auto-run enabled drives pose particular risks even to systems lacking Internet connections. They are popular, highly portable, and frequently shared by users.

Beware the 'Undetected' Threats

On the other hand, the malware authors of today are increasingly crafting unique advanced persistent threats (APTs) and targeted attacks to exploit vulnerabilities - focusing on particular companies, business processes, software applications, or individuals. These advanced malware applications can get through to attack core banking networks, systems, and databases because the filtering security approaches of traditional defences and advanced defences are not designed to detect these sophisticated APTs.

For example, banking Trojans infect the Web browsers of banking customers by intercepting communications and altering data on its path between the user and the institution. Web 'injects' create fake forms or data fields seeking additional user credentials that attackers use to log in and fraudulently transfer funds.

These new attack tactics reveal gaps in existing IT security strategies in banks and require new tools and approaches to detect and prevent these sophisticated security risks using protocol-based file scanning and automated dynamic malware analysis. Financial institutions are recommended to do the following:

- Add malware collection and analysis capabilities from across networks to the organisation's existing multi-faceted defence strategy. The threat is growing and detection and prevention efforts inevitably come up short, leaving analysis as the last line of defence.
- Formalise the organisation's response to the growing threat of APTs and targeted attacks.
- Empower skilled resources to effectively respond to these threats by providing them with the right tools to continuously monitor suspicious samples to understand the nature, source, and effects of malware targeting specific organisations to aid in mitigation and remediation efforts.

Boost Organisational Defences

Traditional defences no longer suffice to protect financial institutions against advanced malware attacks. It has become the responsibility of financial organisations to consider and adopt specific security measures - including access controls on customer information systems, background checks for employees, and incident response programmes - together with new tools and processes to combat today's advanced threat landscape. Not all malware can be detected and prevented from entering organisational networks, but their samples can be collected and analysed to ensure that unknown threats are continuously discovered, damage is mitigated, and defences are remediated. ✱

On the other hand, the malware authors of today are increasingly crafting unique advanced persistent threats (APTs) and targeted attacks to exploit vulnerabilities - focusing on particular companies, business processes, software applications, or individuals.

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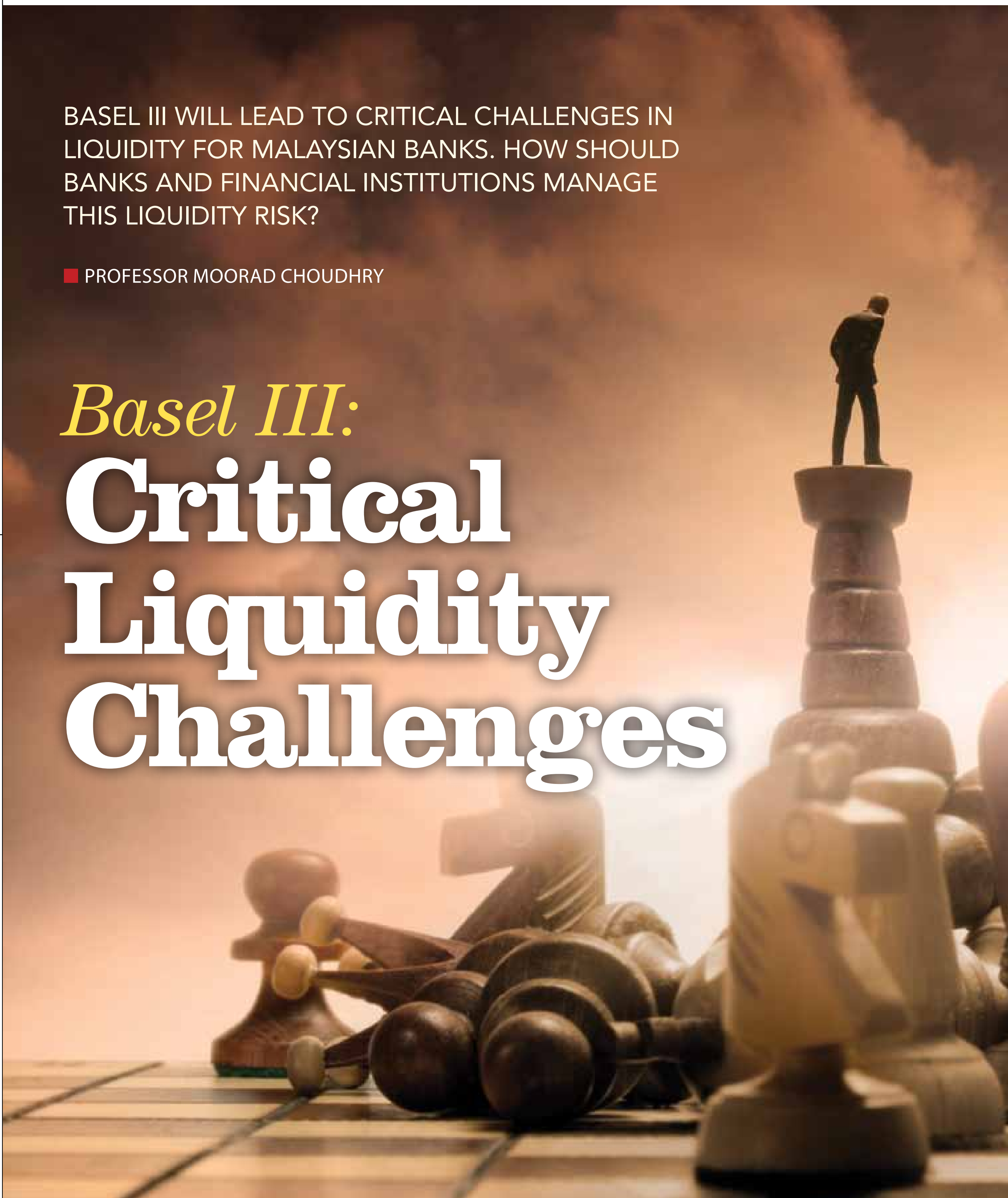


BASEL III WILL LEAD TO CRITICAL CHALLENGES IN LIQUIDITY FOR MALAYSIAN BANKS. HOW SHOULD BANKS AND FINANCIAL INSTITUTIONS MANAGE THIS LIQUIDITY RISK?

PROFESSOR MOORAD CHOUDHRY

Basel III: Critical Liquidity Challenges

The art of banking is that of managing liquidity. While capital is rightly viewed as being of utmost importance to a bank's risk manager, the practitioners' saying that "capital kills you slowly, while liquidity kills you quickly" is indeed accurate.

Because banks are so important to the economy's health, central banks operate as "lenders of last resort" to assist any bank that finds itself in liquidity difficulties. But a bank that has to resort to the central bank has failed, and this is a failure of its management. Bankers should not start thinking that - simply because some of the stigma attached to going to the central bank for a liquidity bailout has diminished - it is now an acceptable form of funding. The primary objective of a bank's executive is to maintain the entity as a viable going concern through the business cycle. That is why any recourse to the lender of last resort, even in the post-crash era of extensive central bank involvement in providing market funding (most obviously by the European Central Bank), is to abrogate one's responsibility as a bank manager.

This article reviews the current challenges in liquidity risk posed by the requirements of the Basel III liquidity regime, and specifically its liquidity coverage ratio (LCR) and net stable funding ratio (NSFR) reporting metrics.

◆ THE SCOPE OF LIQUIDITY RISK

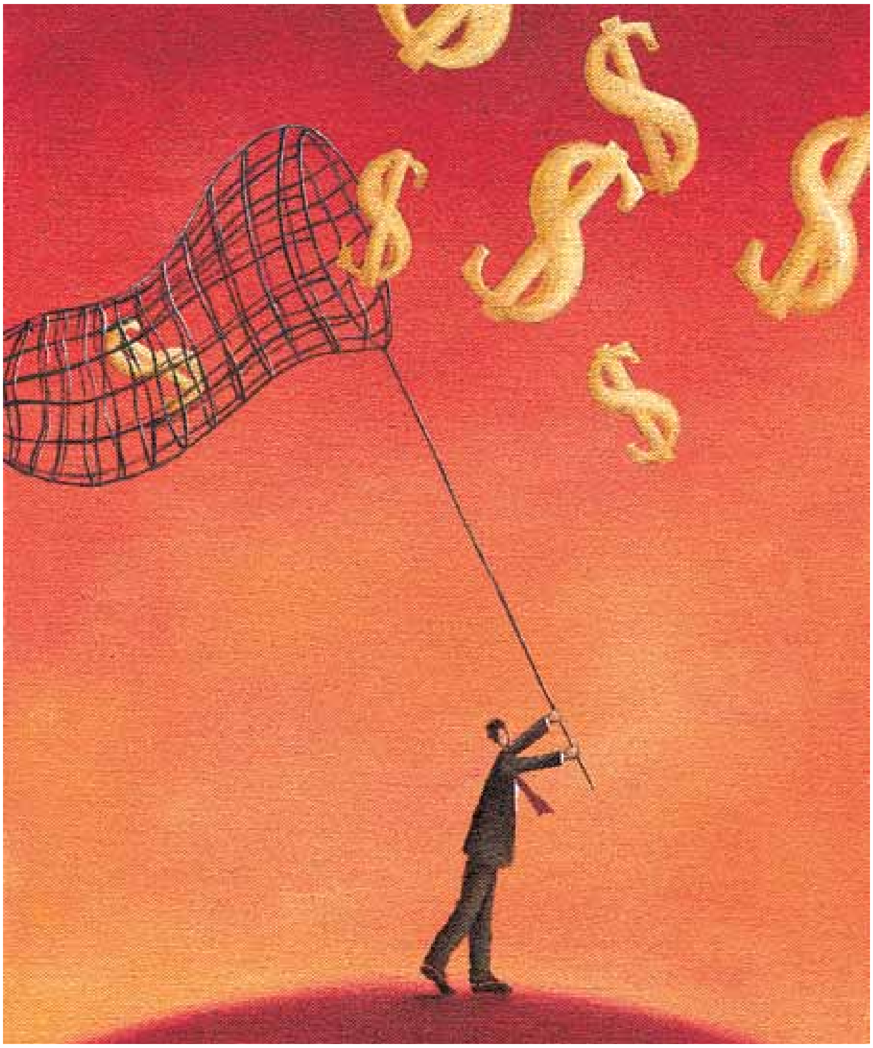
If liquidity is defined as the ability to meet obligations when they become due, the important part is to understand exactly what is meant by "when they become due". Essentially this means in perpetuity, or at least as long as the bank wishes to remain a going concern. In other words, maintenance of liquidity at all times is the paramount order of banking.

The crash of 2007-2008 was as much a crisis of liquidity as it was of capital. Many banks ran a funding regime that was heavily overweight in short-term liabilities and volatile liabilities, such as wholesale funds. That this is accepted as a prime causal factor of the crash is apparent from the way banks are adjusting to the new requirements of Basel III. Basel I and Basel II did not concern themselves with liquidity, only capital. The new regime, which was introduced from January and will be fully implemented by 2019, makes material demands on banks with respect to the way they manage liquidity.

Basel III first liquidity structural metric: LCR

Basel III enshrines the new risk approach in formal regulatory law with a new structural risk metric for short-term funding. On the face of it this represents a step-change in liquidity management culture, but only because principles accepted as commonplace in the 1860s or 1960s had been discarded by many European and US banks by 2008. Nevertheless they will prove to be a challenge to work towards for all banks, including banks in Mauritius which will now have to demonstrate the tenor behaviour characteristics of their customer liabilities to the national regulator.

The objective of the LCR metric is to promote short-term resilience to liquidity shocks. Setting a limit for it, and requiring banks to hold a stock of sufficient high quality genuinely liquid assets, results in a more stable funding regime that will be less susceptible to a freeze in interbank markets of the kind observed in October 2008 following the Lehman default.



The LCR for a bank is given by:

$$\frac{\text{Stock of high quality liquid assets (HQLA)}}{\text{Stressed net cash outflows over a 30-day time period}} > 100\%$$

High quality assets are specified by the Basel Committee, and include sovereign bonds and multilateral agency bonds. The LCR identifies the amount of unencumbered, high quality liquid assets required to offset the net cash outflows arising in a short-term liquidity stress scenario. A regulatory limit for the LCR ensures that banks meet this requirement continuously.

In other words, the LCR requirement results in banks having to maintain a liquidity buffer that matches expected cash outflows in a stressed environment. The amount of funds that might be observed in a market stress situation is given by the stress tests that banks run every month, under specified assumptions. The time period covered in the stress test is 30 days. This implies that a stressed environment would last for only a month, which is unrealistically short. For this reason, banks should always treat the LCR-driven HQLA as a minimum size to maintain. Equally they should calculate and work to a 90-day time period over which the stress would be assumed to take place for their internal assessments.

Are the stress tests themselves reliable? Any analysis undertaken under assumed conditions is always at risk of inaccuracy, which is why continuous review and back-testing is also part of a bank's risk management regime. However, for this reason it is recommended that the size of the liquidity buffer should be a function of other metrics, including the following:

- Set at 2.5 times the size of the aggregate of a bank's liabilities that are of less than one-year maturity;
- Set at 110% of the LCR stressed outflow number.

What is the implication of the LCR for the world's banks? In essence, they will all be holding, in differing amounts, a stock of genuinely liquid assets. The challenge comes from the impact this will have on the bottom line, as a risk-free portfolio generates less income (if it is run at a profit at all), and so all else being equal a bank's profits will reduce. However, it is not acceptable to suggest, as some practitioners do, that there is a 'shortage' of liquid assets with which to populate the HQLA portfolio. One can always hold the HQLA as cash. The HQLA portfolio should be viewed as a cost of doing business, not as an investment portfolio to maximise return on.

The other challenge is to understand fully the liquidity value of different types of customer liability. Basel III defines 'stable' and 'non-stable' types of funds and customers: the former generates higher assumed outflow results in stressed market conditions, thus increasing the size of the LCR metric. All else being equal, banks will wish to maximise stable liabilities.

Basel III second liquidity structural metric: NSFR

The critical long-term metric is the net stable funding ratio (NSFR). The NSFR is designed to promote liquidity resilience over the longer term; setting a limit for it ensures that sufficient long-term funding is in place to support a bank's balance sheet. In other words, maintaining an adequate NSFR should help considerably in ensuring a stable funding structure because more of a bank's liabilities will be comprised of longer-dated funding. (In Treasury terms, 'long-dated' might be defined as being over 12 or 24 months in tenor).

The NSFR is given by:

$$\frac{\text{Available Stable Funding}}{\text{Required Stable Funding}} > \text{c.}100\%$$

The metric measures the amount of stable funding as a proportion of the total requirement for such stable funding. Definitions on what constitutes 'stable' are given by the Basel Committee. The NSFR is typically used to monitor and control the level of dependency on volatile, short-term wholesale markets. A low ratio indicates a concentration of funding in shorter maturities (under 1-year tenor) which can give rise to

funding roll-over risks.

Setting a minimum level for term funding would reduce dependency on short-term funding, while increasing cost of business as more liabilities are moved into longer-term funding. Again, the challenge for banks is one of cost, and impact on profits. Longer-dated liabilities cost more than short-dated liabilities, and in a stressed environment are difficult to raise.

Conclusions

Liquidity management is a discipline that is as old as banking itself, but one lesson that must be learnt is that its principles need to be refreshed and maintained throughout the business cycle. Under the new regime being implemented under Basel III, the need to adhere to old-fashioned beliefs on sound liquidity practice is something that will be enshrined in law. However, the new funding metrics reflect banking logic, and one feels that the principles behind them should be followed regardless - simply because bank management would be aware of their importance anyway.

The calculation of the metrics is not an intellectual challenge. However, it is a technology challenge. In order to optimise the balance sheet for LCR and NSFR, a bank will need to have good data analytics capability for the entire balance sheet, for both assets and liabilities. This is not the case for many banks.

Perhaps the biggest challenge is for banks to recognise how the two metrics will impact their particular business model, and to revise their strategy and operating model to reflect this. A critical first imperative is to assess the LCR and NSFR results for balance sheet impact, and use this assessment to influence strategy. This means integrating LCR into both the banks' liabilities strategy and its internal funds pricing policy, to ensure that the bank works towards optimising the balance sheet from a regulatory, net interest income and customer franchise perspective. This is not a trivial undertaking. ✱

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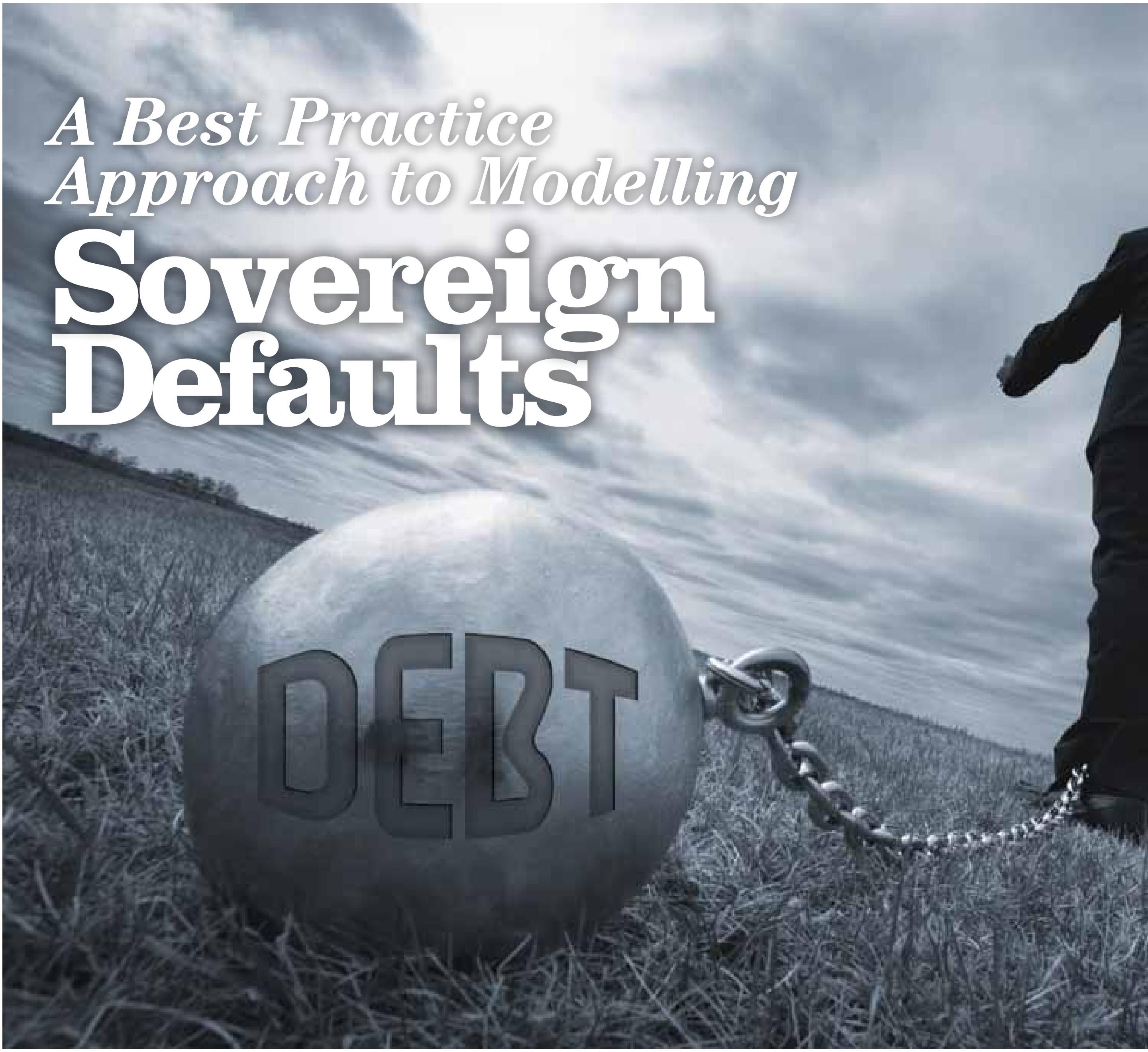
A Best Practice Approach to Modelling Sovereign Defaults



RATHER THAN RELYING ON LEGACY CREDIT RATINGS TO ASSESS SOVEREIGN CREDIT RISK, WISE RISK MANAGERS MAY WANT TO MIGRATE TOWARDS MODERN REDUCED FORM DEFAULT PROBABILITIES, WHICH ARE JUST AS IMPORTANT IN ASSESSING SOVEREIGN RISK AS THEY ARE FOR PUBLIC FIRMS, SMALL BUSINESSES, AND RETAIL BORROWERS.

DONALD R. VAN DEVENTER,
SURESH SANKARAN
AND CLEMENT OOI

Many investors who in 2006 would have said they had no exposure to sovereign risk now find themselves in a much different position. With the Euro crisis, effective nationalisation of large financial institutions in the US and the UK, and the invasion of the Ukraine by Russia, sovereign default risk is now a critical issue. This article explains the best practice differences between modelling sovereign default and the default risk of more traditional retail and corporate counterparties.

Sovereign default risk is a key risk for many other reasons than recent government rescues of financial institutions and country bailouts in the Eurozone:

- Government bond markets represent some of the biggest counterparty exposures worldwide, particularly after the extensive deficit financing of the last six years
- Much of the financing of sovereign government debt is now being done by private sector lenders and other sovereigns, rather than multinational development institutions
- Cross-border financing is now the norm, not an exception, in today's capital markets

With the Euro crisis, effective nationalisation of large financial institutions in the US and the UK, and the invasion of the Ukraine by Russia, sovereign default risk is now **A CRITICAL ISSUE**.

For all of these reasons, more institutions, both private and public, have sovereign default risk exposure than ever before.

The Problem with Ratings

Like corporate ratings, the ratings for sovereigns suffer from many problems when one is interested in very precise, quantitative risk assessment:

- Ratings lack an explicit maturity
- Ratings lack an explicit default probability
- Ratings change only infrequently, not in real time like bond spreads and credit default swaps
- Ratings are potentially subject to external political pressure, since governments have the power to regulate the raters. A case in point is the US government lawsuit against Standard & Poor's (S&P). Is it a coincidence that S&P was the only US rating agency to downgrade the US government's credit rating?
- Rating agency credit assessments of sovereigns are heavily weighted towards recent years and are almost exclusively focused on bonds, even though there are a wide range of borrowing tools used by sovereigns
- Ratings agencies are currently the victims of a crisis of confidence because of well-documented ratings inflation of structured products

in the credit crisis and the obvious conflict of interest from the 'issuer pays' ratings model.

For these reasons, an explicit default probability at key maturities is essential for the measurement of sovereign risk.

Best practice in sovereign default modelling is very similar to best practice for modelling corporate defaults:

- The default database should be monthly to maximise the ability to measure the impact of macro factors on default risk.
- Defaults should include defaults on all borrowing instruments, not just bonds.
- There should be a full-term structure of default probabilities derived from the modelling exercise.
- There should be strict adherence to Basel II, III, and corporate default definitions. For many, being in arrears is 'OK' if the borrower is a sovereign government. Best practice calls 90 days past due a 'fail' whether the borrower is a sovereign or not.
- Macroeconomic drivers of default should be extensively examined for statistical significance.
- An extensive test regime to measure the accuracy of the prediction should be employed.

The database employed for the Kamakura Risk Information Services sovereign default service is a monthly database which goes back to 1980, 10 years further back into history than one can normally go with corporate default databases. The reason corporate default databases are limited to 1990 onward is the lack of daily stock price data that commercial users are legally allowed to use for modelling.

There are substantial differences between sovereign default analysis and corporate default analysis:

- Much less sovereign debt is rated, compared to corporate debt, so there is much less data to work with in modelling.
- 'Cross default' clauses in lending to sovereigns have historically been much less common than in the corporate lending world. In fact, sovereigns have much more in common with retail borrowers, who might be in default on a credit card but not on their mortgage. Rating agencies, for example, have often ignored defaults on sovereign bank debt as long as bond holders were being paid as scheduled.
- Much sovereign default has a 'social welfare' purpose and this has in some cases affected whether or not an analyst would judge the borrowing to be in default.

Because of these considerations, many studies of sovereign default have dramatically under-counted the number of default events or erred dramatically in identifying the date of default. From an analytical point of view, there has historically been a strong feeling that one should treat sovereign defaulters kindly because analysts are rooting for the sovereign to succeed, hoping that the sovereign can lift its citizens from poverty. Unfortunately, inaccurately assessing the risk of sovereign lending has the opposite effect in the long run.

The definition and timing of defaults in the Kamakura Risk Information Services sovereign default database is the earliest of the following events:

- Being in arrears on interest by the World Bank definitions.
- Being in arrears on principal by the World Bank definitions.
- Being in arrears on borrowings from the International Monetary Fund (IMF) by the IMF's definition.
- Declaration of the intent to default or actual default on any form of borrowing, regardless of the amount.
- Being rated D (default) or SD (selective default) by any major rating agency.
- Being 'rescued' by a multinational lender when, without the rescue, default was very highly likely.

Maturities

An explicit default probability at key maturities is essential for the measurement of sovereign risk.

A strict adherence to this definition of default results in much greater accuracy in the number and timing of defaults. One has to be careful to adjust for 'arrears' events that are clearly temporary, operational errors in funds transfers. Both South Africa and China, for example, were in arrears by the World Bank definitions in recent years but these represented failed wire

transfers or other operational issues, not true defaults.

For a database beginning in 1980, one has to remember that a country that was in default prior to 1980 will have no entry in the database until the original default was cured and the country becomes current on its borrowings, exactly as one would do for a corporate defaulter. Note that it is much more common for sovereigns than corporate for a given entity to be a 'serial defaulter' so it is necessary to track exits and entrances to the database by the same country very carefully.

Case Studies in Sovereign Defaults

In this section, it is demonstrated that the application of a 'cross-default' methodology to sovereign risk has a dramatic impact on the perceived timing of sovereign defaults. As Kamakura Senior Research Fellow Jens Hilscher says, "Corporations default because they have to. Sovereigns default because they want to." The implications of that 'desire to default' are explained in this section, and the role of macroeconomic factors as determinants of sovereign risk as analysed by Hilscher and Yves Nosbusch, authors of 'Determinants of Soverign Risk: Macroeconomic Fundamentals and the Pricing of Sovereign Debt', is emphasised.

In what follows, for each example rescheduled debt (the blue bar) and interest and principal in arrears (the green bar) are plotted. The data graphed was provided by the World Bank. The 'failure' definition from the previous section is applied, so the failure date is the earliest of an arrears event, a declaration of default, a rescue, or a D or SD rating from a major rating agency.

Argentina is every economist's favourite serial defaulter, with sovereign defaults dating back more than 100 years. The fact that Argentina, in 2014, is in the throes of another potential default is a surprise to no one. Argentina is currently the fourth riskiest sovereign in the world when ranked by one-year default probability, as summarised in

Ticker	Company	Country	S&P Rating	KDP (%)	1 Day Change	1 Month Change
VEN	Venezuela	SOV	B-	69.18	-0.02	-0.42
BLZ	Belize	SOV	B-	55.65	-0.02	-0.87
TJK	Tajikistan	SOV		33.59	-0.02	0.72
ARG	Argentina	SOV	CCC+	33.41	-0.02	-0.34
HTI	Haiti	SOV		28.32	-0.02	-0.38
ZWE	Zimbabwe	SOV		25.38	-0.01	0.28
GEO	Georgia	SOV	BB-	20.65	-0.01	-0.42
MWI	Malawi	SOV	A	18.84	-0.01	-0.20
CPV	Cape Verde	SOV	B	18.32	-0.01	0.39
BIH	Bosnia and Herzegovina	SOV	B	16.81	-0.01	-0.37

Chart 1

ARGENTINA

Model	1 Month (%)	3 Months (%)	6 Months (%)	1 Year (%)	2 Years (%)	3 Years (%)	4 Years (%)
KDP-SD5	42.74	36.08	33.10	33.41	28.44	24.07	-

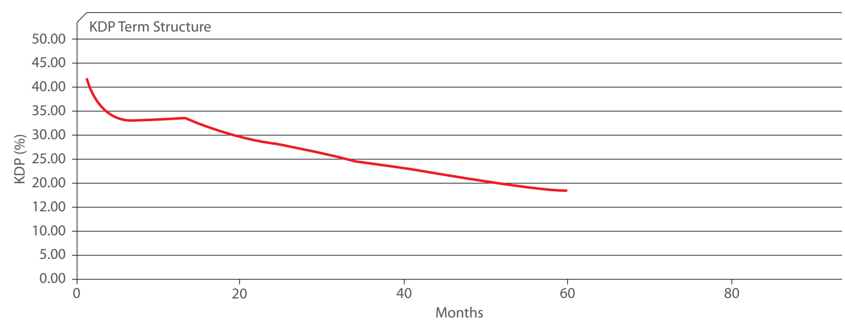


Chart 2

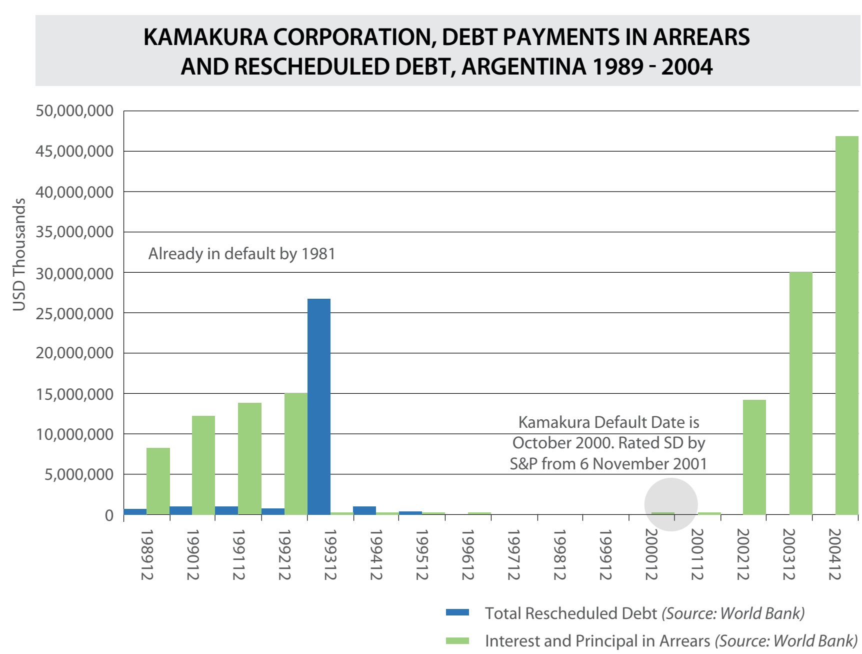


Chart 3

KDP = Kamakura Default Probability

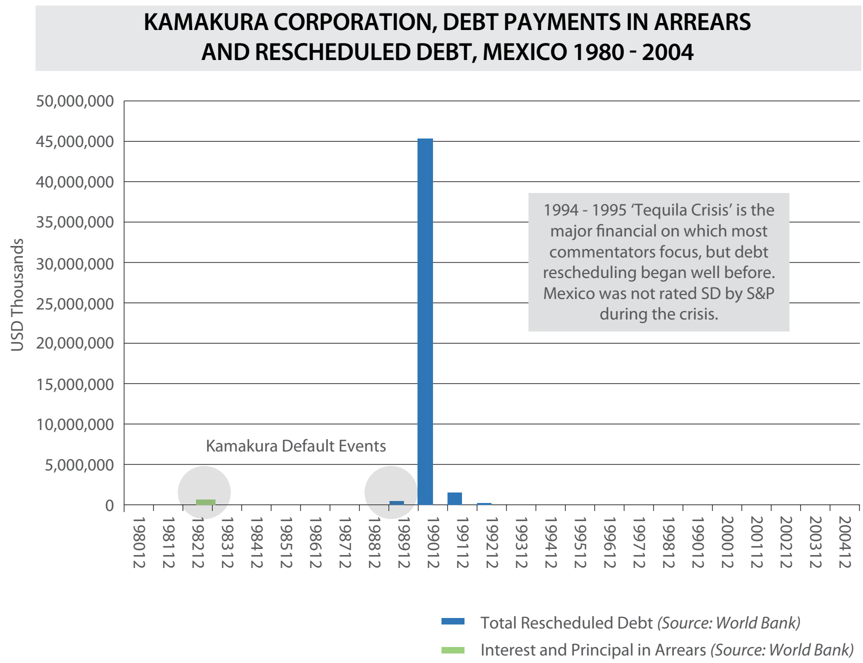


Chart 4

Chart 1.

Depending on the maturity, the term structure of default probabilities (annualised) for Argentina shows short-term default probabilities of more than 42% (**Chart 2**).

Chart 3 shows the key dates in an earlier era for Argentina, the 1980-2004 time period.

Because Argentina was already in default at the start of the period, it does not appear as a non-defaulter until 1995.

While the scale of the graph makes it hard to see, Argentina went into arrears by the World Bank definition in 2000, but it was not rated SD by S&P until November 6, 2001. Kamakura uses the earlier date as the default date.

Another interesting case is that of Mexico (**Chart 4**).

The country has had two arrears 'failure events', but neither date coincides with the much-publicised tequila crisis of 1994-1995. Mexico was never rated D or SD during this period.

These examples show that the date of failure for sovereigns is strongly dependent on the definition of default. Indeed, the data makes it clear that "sovereigns default because they want to." The data also shows that sovereigns tend to default on bank loans or loans from multinational lending organisations before they default on bonds. In the same vein, the traditional view of retail borrowers has been that they would selectively fail to pay on credit cards while they continued to pay on their mortgage.

In a world where the cross-default clauses are rapidly being added to sovereign loan agreements, recognising these earlier dates as 'fails' is essential in predicting future sovereign defaults. To ignore them would lower estimated default probabilities and cause a long delay in the prediction of a potential sovereign failure.

Is Domestic Currency Default a Possibility? Why Don't Sovereigns Just Print Money?

Unlike corporate default, where cross-default clauses make a default on yen borrowings the same as a default on dollar borrowings, the currency matters with sovereigns. It matters for two reasons. First, cross-default provisions are not as all pervasive. Secondly, the sovereign in theory has a right to just print money, as this Zimbabwean bill indicates.

This bill, presented to one of this article's authors by Pieter Strydom at Ernst & Young in Johannesburg in 2008, was about 75% less valuable a week after receipt. Not long after, a third redenomination of the Zimbabwe dollar converted one trillion old dollars into one new Zimbabwe dollar. Since the government's pledge to pay was no better than before, redenomination was abandoned in April 2009 and the US dollar became the main medium of exchange. Clearly, there are practical limits as to how much money can be printed before the government effectively ceases to function.

For that reason, 'failure' is treated as if cross-default clauses were the norm and differences in the currency of the borrowing are ignored for this reason.

Case Studies in Sovereign Default Risk in Southeast Asia

Now take a 20 year view of one year default probabilities for a number of countries in Southeast Asia, spanning the Asia crisis which was triggered by the July 2, 1997 abandonment of the currency basket supporting the Thai baht. First look: Cambodia.

A 20-year view of default risk for this complex country shows a one-year default probability that is currently 11.99%, varying in a range from 5% to 25% over the period

Indonesia, along with Thailand and Korea, was dramatically impacted by the Asia crisis.

By 1999, the country's one-year default probability had risen as high as 23%. The one-year default probability now is 3.93%.

Malaysia fared much better in the wake of the Asia crisis than most of its neighbours. The one-year default probability peaked near 4.25% in 1999.

The one-year default probability is now 0.67%.

Thailand's one-year default probability jumped to more than 9% in 1999, but over the last 15 years the default probability has declined in fits and starts to its current level, 0.74%.

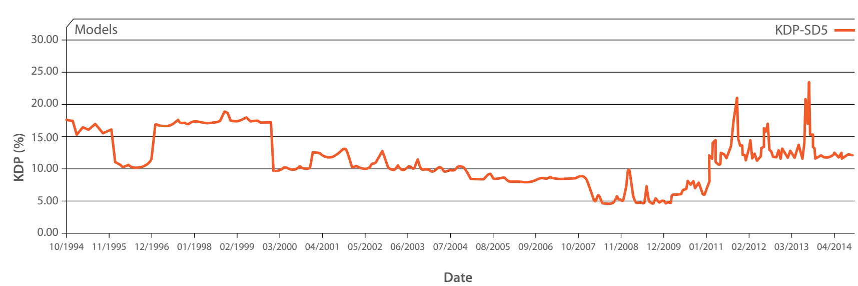
Vietnam, like Cambodia, is another emerging economy in the region. After reaching a peak of more than 7%, Vietnam's one-year default probability fell below 1% in 2009, a time when the US and much of Europe was engulfed in the credit crisis. After hitting that low point, the one-year default probability for Vietnam has risen again to reach 3.69%.

Conclusion

Modern reduced form default probabilities are just as important in assessing sovereign risk as they are for public firms, small businesses, and retail borrowers. Legacy credit ratings represent a credit assessment tool that was state-of-the-art more than a hundred years ago, but ratings are well past their prime. Ratings have no stated maturity, no associated default probability, and they suffer from the conflict of interest from the issuer pays model. As shown by Hilscher and Mungo Wilson, authors

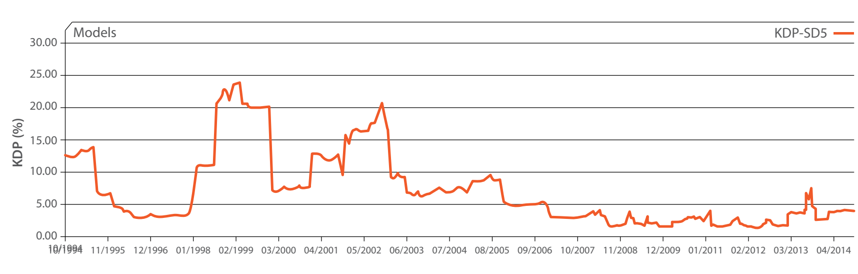
CAMBODIA

Model	KDP (%)	1-Day Change	1-Month Change	3-Month Change	6-Month Change	1-Year Change
KDP-SD5	11.99	-0.01	-0.27	-0.26	-0.06	-2.20



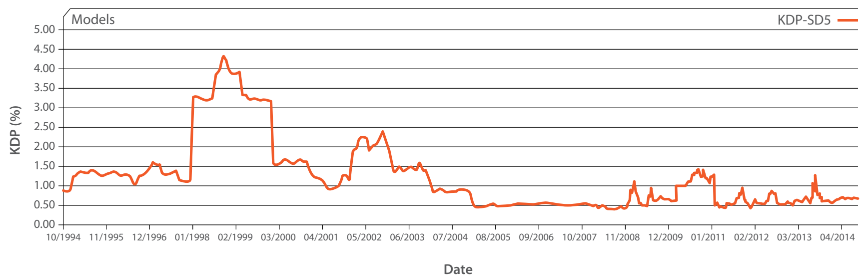
INDONESIA

Model	KDP (%)	1-Day Change	1-Month Change	3-Month Change	6-Month Change	1-Year Change
KDP-SD5	3.93	0.00	-0.05	-0.04	+0.04	-0.41



MALAYSIA

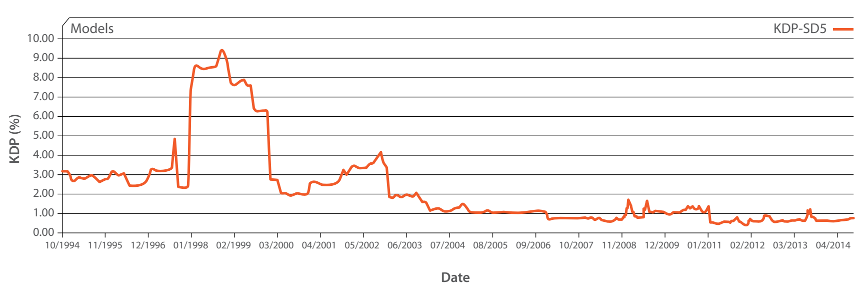
Model	KDP (%)	1-Day Change	1-Month Change	3-Month Change	6-Month Change	1-Year Change
KDP-SD5	0.67	0.00	-0.01	-0.01	+0.01	-0.04



Modern reduced form default probabilities are just as important in **ASSESSING SOVEREIGN RISK** as they are for public firms, small businesses, and retail borrowers.

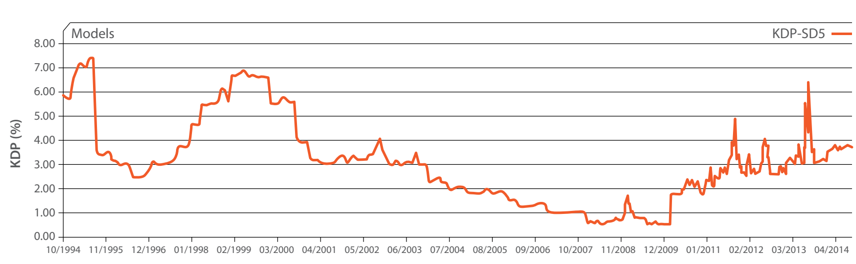
THAILAND

Model	KDP (%)	1-Day Change	1-Month Change	3-Month Change	6-Month Change	1-Year Change
KDP-SD5	0.74	0.00	-0.01	+0.06	+0.13	-0.02



VIETNAM

Model	KDP (%)	1-Day Change	1-Month Change	3-Month Change	6-Month Change	1-Year Change
KDP-SD5	3.69	0.00	-0.06	-0.05	+0.05	+0.03



of 'Credit Ratings and Credit Risk: Is One Measure Enough?', ratings are much less accurate than reduced form default probabilities in the corporate context. A wise risk manager would be well-served to move to reduced form sovereign default probabilities as soon as possible. ✱

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