



frontiers in finance

for decision makers in financial services
March 2010

FINANCIAL SERVICES

A silhouette of a person riding a bicycle on a paved promenade in the foreground. In the background, the Shanghai skyline is visible across a body of water, featuring the Oriental Pearl Tower and other skyscrapers. The scene is set during sunset or sunrise, with a warm, golden glow in the sky.

Rising optimism

The next stage for financial services

On an optimistic note
The opportunities and challenges ahead

A view from the market
Interviews with senior executives

An accessible economy
Microfinance in China

Foreword

frontiers in finance March 2010



Alison Halsey
Editor, *frontiers in finance*
Partner, KPMG in the UK

It's time to look on the brighter side. A new year is under way. In the northern hemisphere, spring is approaching. And 'green shoots' are visible in many parts of the global economy and in the financial services sector. Significant challenges and uncertainties remain, and we are not seeking to diminish them. But this issue of *frontiers in finance* has a decidedly more optimistic feel.

In our lead article Brendan Nelson outlines a number of encouraging themes in the changing landscape. We have an economic overview of the possible rebound. In a special feature, we have included views from the market by leading executives in the financial services industry. Two articles on emerging markets illustrate the continuing increase in Asian power and influence in the global economy: one looks at the Chinese property market; the second, on microfinance in China, brings with it a perspective from the market also.

As something like normality returns, it is time for CEOs to consider how the fundamental strategic priorities should be pursued in the new, post-crisis, environment. Cost management is an eternal challenge, and one which is all

the more important in a still-uncertain world. We also outline aspects of cost optimization strategies; and explore the potential for financial benefit in the specific area of indirect tax. Following previous articles on brand management in financial services, we suggest that the banking sector has a lot to learn from other industries in terms of managing multiple brands.

One of the key themes of 2010, once again, will be new regulatory developments. We look at potential IFRS developments, an update on recovery and resolution plans and at some of the key issues audit committees should be considering. Finally, not forgetting broader global challenges, we consider the prospects for action on climate change following the Copenhagen Summit.

It's a full and varied issue. I hope you find as many reasons in it for cautious optimism as I do.

Alison Halsey

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fyi...

“ Prosperity is just around the corner”¹

US unemployment has dropped from

25%
in 1933
to
9.7%
in 2010²

The ancestry of US President Barack Obama’s bank reforms announced in January (known as the Volcker rule) fit squarely in the Glass Steagall Banking Act of 1933. They introduced the separation of bank types according to their business, which was created as a result of the great depression – which the last few years have been often compared to. But on an optimistic note, the comparison between today and 1933 show things are much better now. Unemployment rates in the US have dropped from 25 percent in 1933 to only 9.7 percent in 2010²



1. US President Hoover 1932, www.historylearningsite.co.uk/wall_street_crash, February 2010.
2. ‘US unemployment shows a surprise decline,’ www.bbc.co.uk/news, February 5, 2010.

Source: *The New York Times*, Historical statistics of The United States, 2009.

Gaining attractiveness

Despite recent hiccups, Dubai is still growing as a financial center. In a recent study of the attractiveness of international financial centers by the Dubai International Financial Centre (DIFC), the top five locations were unsurprisingly Singapore, London, New York, Hong Kong and Zurich. However one of the fastest climbers was the DIFC. This ranked higher than locations like Frankfurt, Paris and Luxembourg. Firms operating in the DIFC are eligible for benefits such as a zero tax rate on profits, 100 percent foreign ownership, no restrictions on foreign exchange or repatriation of capital.



For more information on the DIFC survey go to: www.difc.ae

A perspective... On regulation in 2010

“ 2010 will be a ‘wait and see’ year for managers with regards to the Alternative Investment Fund Managers Directive (AIFMD). However, the looming threat of this legislation will continue to drive the creation of UCITS products by hedge fund managers. As the larger managers are seen to embrace the UCITS wrapper with good results, the momentum around creating and using these products will increase.

“ In addition, managers will be keeping a close eye on the Retail Distribution Review (RDR), particularly as it seems regulators are starting to think about a more pan-European approach to commission-based sales.”

Tom Brown, EMA Head of Investment Management, KPMG in the UK.

KPMG International recently undertook a temperature check survey, *Feeling the heat*, to understand how the investment management community might react to the proposals of the AIFMD.



For the full report please go to the Financial Services pages on www.kpmg.com

Taxing times

As many governments turn to re-couping some of the money they have paid out through the crisis, tax is rising up the agenda. Already US President Barack Obama has indicated that he intends to see a 'financial crisis responsibility fee' levied on those who were the main contributors to the financial crisis. Interestingly, outside the current scope of the proposal are Fannie Mae and Freddie Mac, two of the largest recipients of the US bail-out. In addition, politicians are suggesting other measures such as a 50 percent tax on bonuses exceeding US\$400,000¹ for companies receiving TARP assistance.

Like the notion of 'Living wills,' (see article on page 44) tax on financial institutions is something that will be watched around

the world, and in some jurisdictions may be copied. However, the possibility of these costs being passed on to consumers should also be considered - as this brings with it a reputational consideration to an already dented industry.

More generally, a government's wider need for revenues may impact other areas, such as talent management. The impact on a person's domicile is also worth noting. In the UK from April 2010, plans to raise the top rate of income tax to 50 percent, make London more expensive for residents earning US\$1 million a year than New York or Hong Kong, according to KPMG estimates²

1. 'Senators Propose 50% Bonus Tax on Bailed-Out Banks (Update2),' Ian Katz, *Bloomberg Business Week*, www.businessweek.com, February 5, 2010.
2. 'Bankers 'Let Down' as Tax Makes London Most Expensive (Update1),' Gavin Finch, www.bloomberg.com, January 14, 2010.

Trusting times

New research shows that trust in financial services globally, while fragile, is gaining strength.

In a recent survey in the US, trust in banks has gone up to 33 percent since it hit its lowest point in March 2009 at 29 percent. Interestingly, local banks scored much better than national banks (53 percent versus 31 percent), and banks in which the government has a stake are trusted the least (21 percent). On an international basis, this rise in trust is fueled by a number of Western countries and a growing confidence in a number of the BRIC countries.

However, as a word of caution, nearly 70 percent of those surveyed in a recent international survey believe business and financial companies will revert to old habits when the financial crisis is over.

Source: www.financialtrustindex.org, January 2010 and www.edelman.co.uk/trustbarometer, January 2010.

Converging functions...

The convergence of governance, risk and compliance

A recent survey by KPMG International and the Economist Intelligence Unit *The Convergence Challenge* looks at the integration of governance, risk and compliance (GRC). It found 64 percent of respondents see the convergence of GRC as a key priority. While half of people surveyed believed costs for these functions totaled approximately 5 percent of annual revenues, only 26 percent believe converging these functions will bring down costs by reducing duplication.

Clearly there is a challenge ahead.



For more information visit www.kpmg.com

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Brendan Nelson

Defining a new, coherent and consistent global regulatory framework poses an enormous challenge.

On an optimistic note...

The opportunities and challenges ahead

We may be through the darkest hours and approaching a new dawn, however where the sun will rise is the question, as [Brendan Nelson](#) debates.

It would be brave, even foolish, to write a glowingly optimistic overview of financial services at the moment. The crisis has taught us once again to expect the unexpected. Even though most of the developed nations seem to have emerged from recession, the recovery is still fragile. Economies burdened with excessive debt may face further setbacks – the dreaded double-dip recession – before returning to sustained growth. So, confidence has to be tempered with caution.

Grounds for optimism

It is not a uniformly gloomy landscape by any means. The more disastrous possible outcomes have been avoided by concerted government action, and the financial sector has been stabilized. In financial services, we are seeing a return to profitability, and some companies have performed remarkably well in Europe, the US and Asia. In the regulatory context, although there is still a long way to go, we can see a growing consensus on the kind of frameworks

which we need to provide greater protection in the future.

KPMG recently surveyed 400 executives¹ in financial services and in the technology, retail and food and beverage sectors. 75 percent of them think that business conditions will improve this year. In financial services, 2010 will be a turnaround year, although in the UK the consensus is that the rate of recovery will lag that of the national economy. In the US, our firms' clients predict a slow recovery: just over half foresee a return to growth this year, although 46 percent believe this will not happen until 2011.

Consumer confidence is improving. Stock markets are recovering their buoyancy. Economic output is generally growing again. However, economic crises caused by failures in financial markets tend to be long-lasting, as do synchronized crises which affect all major economies at the same time. Fundamental imbalances, particularly those between the West and Asia, have not been addressed.



Some mighty challenges remain. Governments haven't even started to tackle the massive public sector debts incurred in fighting the crisis. Fiscal and monetary stimulus needs to be unwound. Unemployment in developed countries is still high compared to before the crisis, with US jobless nearly 10 percent.² The IMF estimates that US\$1.5 trillion of banks debts have still to be written off. But there are some areas where optimism is distinctly justified: rising standards of living in Asia, increasing investment potential and scope for innovation to produce new strategies, products and approaches.

Challenges

Trust

The reputation of the financial services industry has been severely damaged. Banks have lost the trust of customers, stakeholders, investors and regulators. Bankers – perhaps never loved but normally respected – have become the targets of public and political abuse. Who readily admits to being a banker now? Much of this damage has been self-inflicted, the result

of greed, fraud, poor management and shortcomings in corporate governance.

A top priority for CEOs is to re-establish relationships of trust. This is not just a matter of good public relations and advertising. It's a question of managing the whole of the business to produce the right values, and communicating this to the workforce, clients, shareholders and society at large. In order for the system to work, each player has to trust the other, and trust the system to work.

Remuneration

Remuneration and compensation arrangements in financial services have come in for strong criticism. Some of this is rather unedifying: envy of what can be a high-pay, high-bonus industry. But much of it is justified. Compensation and bonus structures have encouraged excessive risk-taking and excessive short-termism. They have too often looked like one-way bets. Pushed for change by the Financial Stability Board (FSB), the G20 and national authorities, companies now face a delicate balancing act between retaining

talent, placating regulators and quieting public outrage.

In future, multi-year guaranteed bonuses need to be avoided. A significant percentage of variable compensation has to be deferred and tied to performance. In the UK, for example, we have already seen executive bonuses for 2009 at Lloyds and RBS deferred until 2012, and no discretionary cash bonuses for anyone paid over £39,000. But it will not get any easier to strike the right balance. Excessive restrictions may drive people abroad or into less regulated areas of the industry, and distortions are inevitable if new arrangements are not universally applied.

Credit risk and pricing

Retail and commercial banking faces particular challenges in returning to something like business as usual. Liquidity remains tight. Companies and consumers are, correctly, de-leveraging and reducing debt, but savings remain in short supply.

China has so far managed to sustain its remarkable continued rate of growth, but Japan, Singapore and Korea are all also looking more healthy.

Rebuilding banks' balance sheets and restoring profitability implies bidding up rates in an attempt to attract deposits. But the impact on borrowers is inevitable. Companies and individuals, already weakened by recession, face higher borrowing costs and the prospect of being starved of funding as banks impose tighter credit risk criteria. Despite general recovery, default rates could increase as the impacts spread through the real economy.

Retail and commercial banking will continue to suffer from pressure on margins and the low interest rate environment; re-pricing credit risk cannot happen overnight.

Enormous regulatory agenda

Defining a new, coherent and consistent global regulatory framework poses an enormous challenge. There is no doubt that the crisis has handed the moral, political and financial high ground to politicians, who are acutely conscious of the responsibility, and opportunity, they now have. The G20 has charged the FSB with monitoring and reporting progress on regulatory reforms, and reporting threats to the stability of the global financial system. Tim Geithner, US Treasury Secretary, has described the FSB as a 'fourth pillar' of international cooperation in the new global financial architecture, along with the IMF, World Bank and World Trade Organization.³

The list of issues regulators face is extensive:

- competition regulation
- cost of state aid
- the 'too big to fail' issue
- capital requirements
- liquidity
- compensation
- corporate and investor governance
- product regulation

On top of this, the structure of the regulatory framework itself needs to change: it clearly proved to be inadequate to prevent the crisis. In the US, the Treasury is proposing a new Financial Services Oversight Council, a new Consumer Financial Protection Agency and a strengthened SEC. In the UK the Conservative party, if elected to government, intends to redefine the tripartite agreement between the Bank of England, the Financial Services Agency and the Treasury to give more powers and responsibilities to the Bank of England.

There is a danger that the scale of the task will prove to be unmanageable, and that national interests will over-ride the need for a global framework. No-one should underestimate the challenges ahead.



Areas for optimism

Despite the challenges, there are considerable bright spots.

Financial results

Some very favorable results are being published at the moment. In February, BNP Paribas in France announced total profits for 2009 of €5.83 billion, an increase of 93 percent from 2008. In October, the bank paid back to the French government €1 billion in state loans. In the UK, Barclays recorded full-year profits up by 92 percent to £11.6 billion. Although the total included proceeds from the sale of Barclays Global Investors to the US firm BlackRock, trading profits, especially from investment banking, reached £5.6 billion compared with £1.6 billion in 2008.

Economic green shoots

Although we are a long way from recouping the GDP loss from the recession – and some argue that we will not resume previous levels of growth for many years – the return to economic growth seems to be a world-wide phenomenon.

In the eurozone, the economy is forecast to grow overall by about one percent in 2010, despite continuing weakness in Greece, Spain, Portugal and Ireland. Chairman of the eurozone group Jean-Claude Juncker said in February, "Growth is on the path of consolidation but growth in 2010 will be fragile, moderate."⁴ In the US, retail sales grew by more than expected in January; consumer confidence remains fragile, but a robust recovery seems possible.

Growth markets

The major Asian economies are once again driving ahead. China has so far managed to sustain its remarkable rate of growth, but Japan, Singapore and Korea are all also looking more healthy. The IMF forecast in the autumn that Asia would grow by 2.75 percent in 2009 and 5.75 percent in 2010.⁵ Asia as a whole continues to generate surplus cash, much of which has been flowing to Western financial centers and,

arguably, supporting the unsustainable boom which preceded the crisis. In the medium to long-term this imbalance will have to be corrected. In the shorter term, Asia can not only power a global return to growth but also provide significant opportunities for growth for those companies with the strength and expertise to exploit them.

Central Europe is currently suffering from the difficulties affecting the eurozone as a whole. It remains to be seen whether internal strains within the euro-economies will increase following the implementation of a support plan for the Greek economy, or whether stability can be re-imposed. Despite the present uncertainties, the medium and longer term potential for growth in many areas of central Europe remains significant.

Growth business

Any crisis disturbs the existing order, and creates new opportunities. The financial services sector faces new constraints, and adjusting to a period of enhanced regulation and lower, less-predictable, growth will require significant adjustment. At the same time, dislocation of previous markets and new industry configurations will present substantial new opportunities. Consumers and businesses alike will continue to rely on financial services. Innovation, spotting new needs and tailoring products to meet them, imagination and well-managed risk-taking will bring rewards. As savers and borrowers struggle to regain their trust in financial institutions, a strong focus on the customer and customer service will be the secret of success. A number of the articles in this edition of *frontiers* touch on this theme.

A new world order

The financial services industry has been through a massive crisis, which has had a major impact on many players and in many markets. As far as possible, the industry should seek to ensure that this can't be allowed to happen again. However, many positive conclusions can be drawn from this.

The industry must expect higher levels of political and regulatory oversight for years to come, which is understandable given the scale of taxpayer support to the industry. But even this, perhaps the biggest cause of current uncertainty, also has a very positive implication: it provides the chance to re-invent the regulatory framework to enhance the contribution which financial services can make to growth, wealth creation and prosperity.

Stronger capital and liquidity requirements will ultimately prove to be good for the industry. Competition, regulation and divestments will lead to the entry of new players into the market. Improvements in corporate and investor governance will strengthen the industry. Accounting changes will lead to more simplified, harmonized codes which increase transparency and responsiveness to market needs.

Above all, the world will find ways to reduce systemic risk, and correct the global economic imbalances between West and East. There is no doubt that we are witnessing a historic change here. With careful international management this transition should be achievable without unacceptable political and economic damage being inflicted on the West. Coordinated growth will be the key. To the extent that the crisis accelerates the inevitable, it will have performed a further service.

The sun may well be rising in the East as usual.

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1. 'Surveys point to recovery in U.S.,' www.kpmg.com, August 26, 2009.
2. 'US unemployment shows a surprise decline,' www.bbc.co.uk/news, February 5, 2010.
3. 'Briefing by Treasury Secretary Tim Geithner on G20 Summit,' www.america.gov, September 24, 2009.
4. 'Eurozone predicts 'fragile' growth in 2010,' www.bbc.co.uk/news, February 16, 2010.
5. 'Asia recovering rapidly, but faces challenges, says IMF,' www.imf.org, October 29, 2009.

Side by side



Martin Blake

Managing multiple brands in banking

The normal processes of mergers and acquisitions have been given greater impetus in the banking sector as a result of the financial crisis. Banking assets are changing hands as failing institutions are rescued or wound down; divestments and reconfiguration of the banking industry are being imposed by regulatory authorities. As a result, many banking groups are finding themselves, perhaps without a clearly thought-out prior strategy, owning multiple brands. How to manage these brands, and how to extract greatest shareholder value from them, is a key issue as [Martin Blake](#) explains.

Historically, the banking sector has not been especially effective at managing multiple brands within a single group.

Other consumer goods and services industries typically have much more sophisticated brand strategies – in many cases identifying their portfolio of brands as their single most valuable strategic asset. By contrast, banks seem to struggle with multiple brands. They tend to succeed only in certain particular circumstances, and otherwise succumb to the temptation to collapse multiple brands under a single umbrella. There are some specific characteristics of banking which mean that sustaining a multi-brand portfolio faces certain challenges. Nevertheless, there is great potential for banks to generate significant value from a multi-brand strategy, which is currently largely untapped.

The heart of brand value lies in the consumer experience. A successful brand communicates a message of a particular and distinctive value proposition.

The consumer engaging with a successful brand understands the promise that it makes, and once committed to a brand, will typically remain loyal to it as long as the promise is satisfied. Industry sectors which understand this, and make brand management a cornerstone of business strategy,

include for example fast-moving consumer goods and service sectors such as the hotel industry.

The healthcare and consumer products group GlaxoSmithKline owns over a hundred consumer brands from Panadol and Zantac to Lucozade and Horlicks. Senior management believe that the group's only significant assets are their people and their brands – the strategies for which are plotted over decades. The multi-brand hotel group InterContinental Hotels maintains a portfolio of brands, each carefully and clearly targeted at a specific customer segment: InterContinental Hotels and Resorts provide 'high-class facilities and services aimed at the discerning business and leisure traveller'; Holiday Inn Express offers 'convenience, comfort and value, ideal for people who are on the road.' Typical successful multi-brand groups such as these balance a ruthless focus on brand differentiation and performance with common operational platforms and back-office systems.

This is a trick which many banks seem to find especially difficult to pull off. Our research shows that the evolution of a multi-brand configuration in a banking group can be heavily dependent on the company's position in the business growth cycle. Many banks acquiring multiple brands may set out

with the intention of maintaining them – and in some cases make promises to regulators, staff and local customers to do so. But integration and cost-reduction programs lead progressively to consolidation of systems, processes and support operations, and from there to 'hollowing out' the distinctive value propositions of different brands. It then becomes increasingly difficult to sustain the case for retaining multiple brands, which are then collapsed. A recent example is the rebranding in the UK of Abbey National, Alliance & Leicester and Bradford & Bingley under the Santander umbrella.

Examples where a multi-brand strategy has been sustained over a significant period of time tend to be found only where specific geographical or consumer segment niches are explicitly targeted: in the UK, again, the Royal Bank of Scotland Group maintains among others the RBS brand (for Scotland and SME customers), NatWest (English consumer operations), Coutts (high net worth individuals and wealth management) and DirectLine (online insurance services). Whether this portfolio can survive the current 84 percent state ownership and eventual attempts to transfer it back to private ownership remains to be seen.



The overall objective is to provide consumers with products and services that are consistent with a distinctive brand promise.

While multi-brand strategies have been proven to generate shareholder value in other consumer sectors, the general failure of banking to do the same represents a significant loss of potential. The root of the difficulty lies in a failure to sustain brand distinctiveness. Part of this can be traced to a tendency to see the provision of banking as a commodity service. Reinforced by the banks' behavior towards them, consumers respond in a predictable manner: absence of brand loyalty, low perceptions of customer service, frequent brand switching (for example, credit cards and deposits) in search of the lowest commodity price or highest rate.

A significant value opportunity therefore awaits a bank which can successfully offer multi-brand propositions addressing the same customer needs through a single set of channels. Achieving this requires a change in mindset in many banks' senior management on how to run the business with distinctive brands, and a focus on brand as the center of why customers choose to engage, purchase, advocate and support their chosen bank. A clear brand management strategy is essential. Clear profit pool maps and 5-10 year aspirations should be developed for each distinct brand.

Responsibilities for brand development and oversight should be carefully defined and

allocated. Engagement of stakeholders from each business is a key element to managing multi-brands, maintaining consistency with the brand pyramid and retaining the distinctive personality of each brand. Understanding and aligning staff beliefs and values with the strategy is extremely effective in winning their hearts and minds, and empowering front line staff with insights and information builds their confidence and trust.

Maintaining a clear view of brand architecture and distinctiveness can help prevent unintentional hollowing out of brands. This also enables a clear view about what to integrate to achieve scale advantage and what is unique and should be kept separate. The overall objective is to provide consumers with products and services that are consistent with a distinctive brand promise.

Many other consumer industry sectors have demonstrated the value of successful multi-brand strategies. The opportunity is open for an enterprising banking group to exploit the same potential.

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For more *frontiers in finance* articles on brand management in financial services:

- "Addressing the trust gap",
June 2009
- "How do you want to be seen?"
September 2009
- "Nowhere to hide",
December 2009

Visit www.kpmg.com/frontiersinfinance



Klaus Ott

Structural change

Meeting the demands of a new capital regime

Improvements in the quality and quantity of bank capital are a key priority for the governments of the G20 – the international forum that is driving the introduction of a new regulatory regime to strengthen the international financial system. But these regulatory moves also offer an opportunity for banks to improve sustained business performance by integrating regulatory and accounting capital requirements in their medium- and long-term business planning. [Klaus Ott](#) explains.

One major outcome of the global financial crisis has been the emergence of the G20 as the world's official forum on global economic issues. True, many of the agenda items identified by the G20 for action had already been developed under other initiatives such as Basel II and the International Financial Reporting Standards (IFRS). But G20 leadership – and the collective expression of political will that it represents – is achieving change more quickly than would have been possible under the auspices of these other transnational bodies.

In addition to its 'Framework for Strong, Sustainable and Balanced Growth', an inter-governmental agreement between the G20 countries to align economic and regulatory policies, the G20 has also put in place a detailed program to strengthen the system for global financial regulation.

In all this, it seeks to ensure that national authorities implement global standards consistently, in a way that avoids fragmentation of markets, protectionism and regulatory arbitrage.

In particular, the G20 has committed to develop by end-2010, internationally agreed rules to improve both the quality and quantity of bank capital and to discourage excessive leverage. These rules are to be phased-in as economic conditions improve, with the aim of full implementation by end-2012. While uncertainties remain, the detail behind these rules is becoming clearer. This is helped by a number of publications at the end of 2009 from Basel II, the IFRS Board, and the European Commission, which has published a number of draft papers relating to the proposed European Union Capital Directive.

Integrating capital requirements in business planning

The transition period to the new capital regime may appear comfortable and there is a natural inclination to wait until all the new rules are fully articulated. But there are two important areas where banks should act now.

First, the detailed implementation of the new regime will require a much closer understanding of the relationships between the forward business plan and the associated regulatory and accounting capital requirements than has ever been needed before. So, for example, business models will need to have as outputs not only profit and loss, but also regulatory and accounting capital requirements; while business plans will need to include risk weighted asset plans and balance sheet items. Scenarios will also have to be run for

each business strategy under consideration, testing the regulatory and accounting capital requirements under best- and worst-case boundary conditions. In short, capital requirements will have to be fully integrated in business decision making, right down to the finer detail of portfolio management. Building such an integrated system will take time, which is why banks need to start now.

Second, the regulatory and accounting environment being created by the G20, the International Accounting Standards Board (IASB) and others is tending to create more volatility in valuations of the capital base. This makes medium- and long-term scenario work on regulatory and accounting capital requirements even more important to establish sensitivities and test alternative options. For example, if a bank's new integrated business model forecasts a capital shortfall in 2012, if the preferred business strategy is pursued; the bank needs to be able to understand the possible effects of a share offer in 2011.

Given the complexity of the work involved, there is a strong argument for banks to begin to develop the necessary planning and simulation tools and processes now. In this respect, an opportunity is presented by the Basel Committee's plans for a Quantitative Impact Study (QIS) in 2010. The Basel QIS will focus on group or bank level, but banks could take the opportunity to drill down and use the exercise to understand better the issues that affect the capital requirements of particular business units and product portfolios.

Achieving a level playing field

While the G20 may aspire to a level playing field, there are numerous potential pitfalls in the way of achieving this goal. For example, the G20, the EU, Basel and national regulators are all keen to improve not only the quality and quantity of bank capital, but also its transparency. Collectively, these three goals will determine how different financial

instruments are treated in terms of capital. This has a number of implications – for example, it could in principle mean the big, international banks, whose capital base lies largely in publicly traded shares, may be treated differently from banks in private ownership, where the capital base is more opaque.

Equally, the G20 wants to put in place processes to check the extent to which the financial instruments used to build up a bank's capital base, provide the same protection to each of the bank's creditors in the case of insolvency – with the aim of ensuring shareholders are seen to feel the full effects of any losses. But again, this may create differences in treatment between different types of entity. In Germany, for example, it is common for banks to have 'silent' participation in the capital base. In the old Basel II regime, such participation could be legitimately treated as a component of core capital.





The latest G20 statements, from Pittsburgh and subsequently, undermine this status – but not for all banks. So, for example, a bank that has publicly traded share capital might not be able to include silent participation in its capital base. Whereas a co-operative bank, that is not stock traded, may.

The markets, in the form of the major rating agencies, are already reacting to the G20 consensus, moving to increase the capital requirement for a given rating. This, of course, only has an impact on those large banks with publicly traded shares and particularly the big international banks. Smaller, private banks may not have to respond to such market pressures. But they face the risk that the new capital regime will be created with the larger, publicly traded banks in mind and place extra demands on their business model.

To avoid the same financial instrument being dealt with differently depending on the nature of the bank or the jurisdiction, the regulators of the G20 countries will

have to think through the detail of their proposed new rules and methodologies carefully and explain them clearly, so that all parties understand – and can fully debate – areas where there is the potential for unevenness of treatment.

Conclusion

As banks in Europe face significant changes to their business models due to state support, no-one can be 'too big to fail'; moves to strengthen the international financial regulatory system are gaining pace. Everyone's aim should be to achieve clear, understandable and practical rules that apply consistently to all parties and do not distort national or international markets. More specifically, to meet the demands of the proposed new capital regime and deliver sustainable business success, banks will have to establish models, tools and processes to embed medium- and long-term capital requirements fully in their business planning and scenario testing. That work should be starting now.

Everyone's aim should be to achieve clear, understandable and practical rules that apply consistently to all parties and do not distort national or international markets.

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Top 10 in 2010

10 key issues for audit committees in 2010



Gottfried Wohlmannstetter

After the shock of the crisis, audit committees in the financial services industry are now charged with the oversight of firms in a dramatically-changing environment. **Gottfried Wohlmannstetter** highlights the 10 things audit committees should be considering when setting their 2010 agendas.

1. Prepare for the potential impact of key public policy initiatives on industry regulation and on compliance and governance processes.

New industry regulation is emerging, which may be accompanied by major public policy changes. Additional regulatory obligations are likely to impose new quantitative and qualitative capital requirements and will require modified risk, compliance and governance oversight processes.

2. Help reduce the risk of misalignment as the company undergoes change.

During times of dramatic change, the risk of misalignment - of a firm's strategy, goals, risk, controls, compliance, incentives, and people - goes up exponentially. The audit committee, given its oversight role, is in a unique position to help reduce the risks of misalignment.

3. Understand the risks posed by cost reductions made in response to the economic crisis.

Many firms have engaged in cost cutting as the economic crisis deepened. Boards and audit committees should now be asking whether their business model has been changed permanently, and can be sustained. Is there a good balance between front office functions and support functions? As firms cut costs and reduce their workforce, the control environment becomes even more critical.

4. Rethink the audit committee's role in risk oversight.

The focus on risk provides an opportunity for the board to reassess the oversight role of the audit committee, the full board and the other standing committees such as the risk committee. The crisis raised issues on risk management practices (too much backward-looking analysis; too little stress testing) and a general redesign may be needed. Does the audit committee have the expertise and time to deal with strategic, operational, and other risks? Is the expertise of other board members being leveraged?

5. Make sure internal audit is properly focused and fully utilized.

Help focus internal audit's activities on key areas of risk, as well as risk management generally. Seek to ensure that the internal audit plan is risk-based, focuses on the critical risks to the business, and not just compliance and financial risks.

6. The economic crisis continues to put pressure on compliance and anti-fraud programs. Be vigilant.

The economic downturn has placed tremendous pressure on management to achieve operating results; at the same time, cost cutting and workforce reductions may have exacerbated these pressures. A comprehensive review of the firm's anti-fraud and compliance programs may be in order.

7. Focus closely on all financial communications.

Narrative reporting, earnings releases and analyst briefings can pose difficult issues – they contain important business information which often does not come from the financial reporting system, is not audited, and is not subject to internal controls. Engage early-on in reviewing the 2010 disclosures.

8. Continue to monitor fair value issues, impairments, and management's assumptions underlying critical accounting estimates.

These issues, together with pension funding shortfalls and going-concern challenges, will continue to be among the major areas of focus for audit committees. At the same time, there are important new financial reporting developments that may require the committee's attention.

9. Take a fresh look at the audit committee's composition and leadership.

The audit committee's effectiveness and accountability hinges on meaningful self-assessment. Take a hard look at the committee's composition, independence, and experience.

10. After the shock of the crisis, refocus the audit committee agenda.

As signs of recovery from the crisis emerge, take the opportunity to develop more focused (yet flexible) agendas, with an eye on the company's key financial reporting risks. Don't let compliance activities crowd-out substantive discussion.

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An enduring rebound?



Bill Robinson

The role of finance in the economic recession and recovery

The effects of the financial crisis have been felt around the world – in some countries worse than others. The UK economy has faced the worst recession since quarterly national accounts were invented after the Second World War. It has been part of an unusually steep, synchronized global downturn in industrial production and, more especially, world trade that has invited comparisons with that following the Great Crash of 1929. History suggests that the consequences will be felt for years to come, as **Bill Robinson** explains.

This is not to say that we will see a re-run of the Great Depression of the 1930s. Economists and policy makers have learned from the disastrous policy errors of that era, so the policy response this time around has been very different. Many banks have been bailed out rather than being allowed to fail. Governments have maintained spending in the face of a fall in tax revenue, rather than cutting spending in pursuit of a balanced budget. The resulting deficits have been financed, to some extent, by printing money. In consequence monetary growth, which in the 1930s went negative, has been underpinned by the bank rescue plans, very low official interest rates and easy finance.

These policy responses have averted Armageddon. The frighteningly rapid decline in industrial output that followed the wave of bank failures in September 2008 has been halted. The financial markets, which had registered the sharpest declines since the dotcom bust, have recovered. Even the fall in house prices, which was probably the trigger event for this recession, appears to have been arrested, at least in the UK and the US.

Causes of the recovery: the role of quantitative easing

It is important to understand why:

- clearly many governments' willingness to run budget deficits has been essential
- but equally important and perhaps less widely recognized has been the way these deficits have been financed.

In March 2009, following agreement thrashed out in the G20, the major global players (the US Federal Reserve, the European Central Bank, the Bank of England, and the Bank of China) simultaneously embarked on the policy of so-called 'quantitative easing'. The central banks agreed to use their power to create money and spent the proceeds buying securities – mainly longer dated government bonds – in the open market.

This forcible injection of cash into the system had a dramatic effect on securities markets. When those who sold government bonds looked for somewhere to place their money, they were reluctant to leave it on deposit with the banks - the returns were too low and the memories of recent bank failures too vivid. Investing in property seemed unattractive, following the recent collapse of both the residential and commercial markets.

Buying government bonds was not an option for these people, since they had just taken the decision (perhaps triggered by the huge government deficits) to sell bonds. Thus by a process of elimination the money found its way back into the equity and (to a lesser extent) commercial bond markets. Commodities, including gold, also benefited.

The financial recovery has had a massive effect on sentiment. It has also had a perceptible effect on the real economy. Bankruptcies, often a delayed effect of any economic downturn, are lagging more than usual. Superficially this is puzzling, because the credit crunch has made banks less willing to support companies through troubled times, which might suggest that bankruptcies should be earlier and worse than usual. That has not happened for the important reason that companies with cash flow problems are relying less than usual on the banks. Although unusually at this stage in the cycle, they have been able to tap the financial markets with share or bond issues. The proceeds have given them enough cash, and enough breathing space, to fight another day.



The sharp downturn following the autumn 2008 bank failures was a classic stock cycle. When demand fell, firms cut production and supplied goods out of stock. But stocks do not last for long and when they reach dangerously low levels, de-stocking comes to an end. Even if stocks are maintained at the new, low level (i.e. there is no re-building of stocks) the end of de-stocking gives a boost to output as demand previously met from stock, is met once again from the production line.

So 2009 has been a good year, compared with 2008, for three reasons:

1. Quantitative easing has boosted financial markets.
2. Government spending has sustained demand.
3. The end of de-stocking has boosted production.

Future prospects: an optimistic assessment

Any assessment of future prospects must start with the fact that UK output, having fallen 5 percent over a two year period when it could have grown by 5 percent, is now some 10 percent below capacity.

This gives plenty of headroom for a long period of non-inflationary growth. Despite an uptick in inflation as VAT went back to 17.5 percent, underlying inflationary pressures are weak, being held down, according to the received wisdom, by that very large output gap. Businesses with a lot of spare capacity do not put up their prices, and UK plc is no exception.

So the UK has spare capacity and can expand output. Inflation is subdued. The exchange rate is very competitive. If there is a global upswing, the UK should be a strong beneficiary – just as it was in 1992, when the UK exit from the Exchange Rate Mechanism gave British exporters a significant competitive advantage, and ushered in a golden period of non-inflationary growth.

Today, in the global financial turmoil, a much larger fall in UK sterling has occurred almost unnoticed. Britain today is more competitive than at any time since the 1970s. A similar period of export-led, non-inflationary growth could be possible (see chart 1).

A pessimistic assessment

However, there are other parallels with the UK recession in 1992 which are

less encouraging. Now, as then, there is a huge government deficit. After the election (expected by May 2010) some tightening of government policy is inevitable whichever party wins. Cuts in public spending and increases in tax, though widely anticipated, could depress sentiment when they happen and financial markets may react accordingly.

Quantitative easing, currently creating some £15 billion of new money each month in the UK alone, cannot continue indefinitely. Without the support of regular cash injections, financial markets are likely to dip. The conjunction of higher taxes and the end of quantitative easing could be particularly toxic.

The effect of an increase in household savings only adds to these concerns. During the golden period of steady growth with low inflation (1992-2007), household savings as a percentage of disposable income fell from 12 percent to zero. The savings ratio usually lies somewhere between 5 and 10 percent of disposable income. However, after the recessions of 1975, 1980 and 1990 the savings ratio peaked at 11 percent, 14 percent and 12 percent respectively.

This current recession has already witnessed a sharp rebound in the savings ratio from zero to 5 percent. Based on past performance, a further rise to 10 percent would not be surprising.

Until recently, homeowners could expect their main dwellings to rise in value and, in effect, do their saving for them. That era has probably come to an end. A continuing rise in the savings ratio will continue to damp consumption. Each percentage point rise in the savings ratio means that consumption is nearly one percent lower than it would have been, and consumption accounts for some 70 percent of UK GDP. A rising savings ratio is a severe headwind.

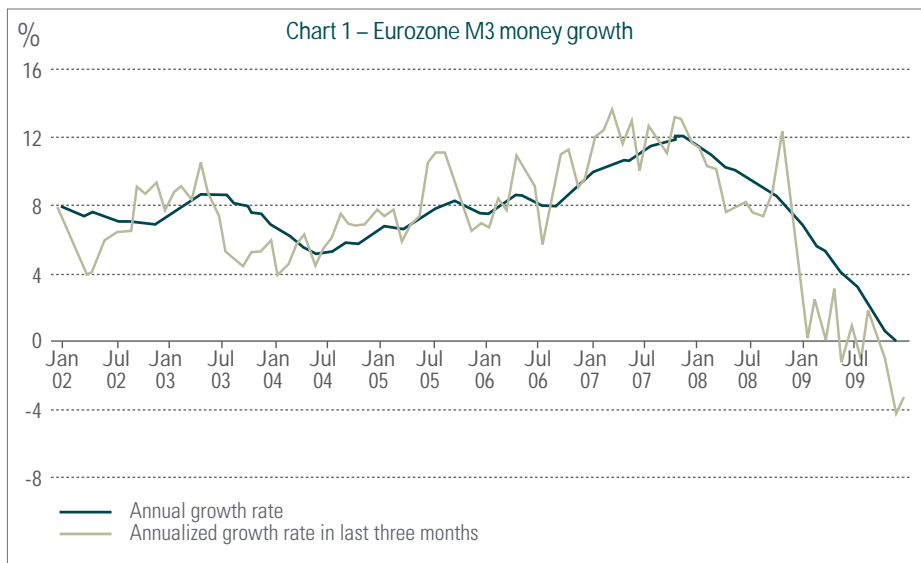
Causes and consequences of the slowdown in monetary growth

The case for pessimism is underlined by the extraordinary collapse of global monetary growth. Historically the money supply in major economies grows as fast, or faster, than nominal GDP. As output grows, and prices rise, the money stock needs to rise in parallel to finance the higher level of monetary transactions. It is very unusual for the money stock to fall, yet that is what has been happening over the past six months in the US and in the Eurozone (see chart 2).

Until recently, homeowners could expect their main dwellings to rise in value and, in effect, do their saving for them. That era has probably come to an end.

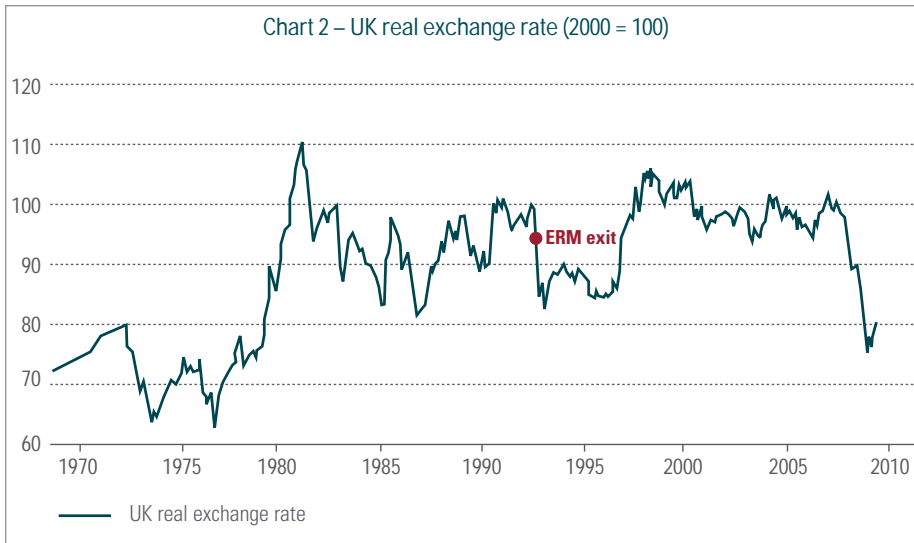
A fall in the money stock occurs when loans are falling due at a faster rate than new loans are being issued. Is this because banks won't lend? Or is it because households and companies don't wish to borrow? The answer is probably a bit of both. In these difficult times, companies and households bent on repairing their balance sheets are reluctant to take on new commitments. Sluggish bank lending is a normal feature of economic downturns.

What is different about the present downturn is that the conjunction of rising unemployment and falling house prices has caused mortgage losses to rise sharply. Provision for loans losses in the major UK banks started to rise in the second half of 2007, when the subprime crisis hit. They have risen in every half year since. Loan provisions erode bank capital, and bank lending is limited to a multiple of equity capital. So rising mortgage losses translate naturally into lower bank lending.



Source: Thomson Datastream, 2009.





Source: Bloomberg, 2009.

Loan provisions have risen over the past three years, because the probability of default always goes up in recessions. Housing loans have been particularly affected because loss given default has risen as house prices have fallen. Unemployment, a lagged effect of falling output, may go on rising this year, so the probability of default on personal mortgages will also rise. Rising losses on property backed loans have played a central role in this crisis, and even though the worst of the recession (as measured by output) may be over, the rise in loan losses may still have some way to run.

Continuing impairments will restrict banks' ability to lend. Moreover, the natural instinct of policy makers in international forums

such as the G20, is to prevent a re-run of the current crisis by imposing tougher restrictions on bank lending. In practical terms, this will probably mean reducing the size of the banks' loan books expressed as a multiple of their equity capital. So banks are now suffering a double hit: lower equity

Banks could easily suffer a double hit: lower equity capital resulting from mortgage write-offs, and a higher capital adequacy ratio.

capital resulting from mortgage write-offs, and tighter regulation in the form of higher capital adequacy ratio.

Conclusion

The role of finance in the recession and in the recovery has been profound. This is a finance-led recession. History tells us, unfortunately, that finance-led recessions also tend to be long recessions. The recovery in the financial markets since March 2009 has suggested that this recession may be the exception to the rule. And the UK in particular is, in principle, well placed to enjoy another long spell of steady growth accompanied by low inflation.

In practice however, the UK recovery appears to be lagging behind the other major economies and it is all too easy to envisage a scenario in which the end of quantitative easing, rising taxes, falling public spending and a rise in the personal savings ratio combine to push the UK back into recession. This scenario, if it happens, could most plausibly be triggered by a second downturn in the UK housing market.

The future is hugely uncertain. The only sensible strategy is to have contingency plans in place for either of the two scenarios outlined above.

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Richard Iferenta



Robert Venn

Cost savings and cash optimization in financial services

A UK perspective on indirect tax

Efficient and effective cost control plays a key role at any time in driving bottom line results. In the current economic environment, financial services companies are under particular pressure to enhance profits and rebuild their balance sheets. Cost control and cash-flow management are more important than ever. Indirect taxes are typically one of the main cost burdens suffered by financial services companies. **Richard Iferenta**, and **Robert Venn** explain how effective management of this burden has significant potential to enhance earnings.

Virtually all large jurisdictions have some form of indirect tax. In the European Union, Value Added Tax (VAT) is applied to the majority of goods and services. Similar forms of indirect tax also go under the name of Goods and Services Tax (GST) in other jurisdictions. Interestingly, the US is one of the few major jurisdictions not to operate a VAT or GST system currently, but there are some murmurs about an introduction of such a system.

Typically, a business is charged VAT on its purchases by its suppliers, and charges its own customers VAT on its sales, with the balance paid to or reclaimed from the relevant fiscal authority. However, the majority of services supplied by financial services institutions are exempt from VAT. So while VAT does not apply on the charges they make, VAT recovery on their costs is denied. This means that in most cases banks, insurers and other financial services companies suffer VAT as a cost. With rates of VAT in the UK at 17.5 percent rising up to 25 percent in parts of the EU, the impact on profitability can be substantial.

Managing the impact of VAT – reducing the costs and incidence of VAT, making the best use of recoveries where possible, and obtaining potential cash-flow benefits – requires a detailed understanding of how the tax is applied, administered and collected. While the principles of the tax are the same across the European Union, their practical implementation is largely a matter for national fiscal authorities. For the purposes of this article, the UK VAT regime is used to illustrate how financial services companies can secure significant benefits from better VAT management. However, the principles of VAT optimization in the UK should broadly apply to other indirect tax regimes throughout the world, although sometimes rates applicable are lower than in the EU which will reduce the cash flow at stake.

Clearly, one of the first priorities is to avoid incurring VAT in the first place, as far as possible. For example, while outsourcing is common in the financial sector, the risk with outsourcing is that VAT becomes payable on the total value of the contract, including the

One of the first priorities is to avoid suffering VAT in the first place.

supplier's own staff costs. To the extent the outsourced supply can be re-engineered as a financial service, VAT may not apply.

Another consideration is to ensure that where services are provided by an associated company, then proper advantage is taken of VAT grouping rules to avoid VAT being levied on inter-company transactions or to operate cost sharing arrangements.

The second priority is to maximize the extent to which input VAT can be recovered. This means first that it is important to recognize fully all input tax incurred, and to do so as soon as possible. All tax directly attributable to taxable supplies should be clearly identified so that it can be recovered in full. Careful management of accounting periods, and a process which recognizes VAT on supplier invoices at the earliest opportunity



can also be very advantageous. Much VAT is incurred on costs which cannot be attributed directly to supplies, for example general overheads such as office costs. In the UK, the attribution of VAT-bearing input costs between different categories of income-generating activity is governed by partial exemption agreements reached with the UK tax authority, Her Majesty's Revenue and Customs (HMRC), which allow partial recovery of input VAT according to an agreed formula. The aim of these agreements is to ensure a fair and reasonable attribution of input tax to taxable supplies, satisfying the 'principle of use', a concept established by European legislation and case law, but which offers significant scope for flexibility and negotiation with HMRC.

Tax-efficient sub-division and sectorization of the business, and effective cost accounting, can offer significant recovery advantages. Once a partial exemption agreement is reached, it is important that it is operated to the best advantage. Our firms' experience shows that even businesses which have agreed methods which appear to give reasonable recovery, can often fail to operate the method correctly and therefore fail to recover the full amount of VAT available. It is also important that any agreement is reviewed regularly to ensure that it reflects any change in the balance of the business, and that the opportunities for VAT recovery are exploited.

The above principles equally apply to overseas costs incurred by the business. First it is necessary to determine whether such costs fall to be treated under the reverse charge procedure, or whether the place of supply could be argued to be where the service is performed. If the place of supply is the UK, there may be an argument that the service would be exempt and therefore no VAT would be due on the reverse charge. If VAT is due, it is important to ensure that where it is directly attributable to transactions that carry a right to recovery it is recovered in full.

Bad debt relief and price adjustments can be a significant issue for financial services businesses, especially in the current economic climate. Particular areas include the repossession of goods under hire-purchase agreements and legal and professional costs incurred by mortgage lenders in respect of repossessed properties. HMRC applies specific conditions to how and to what extent VAT relief can be gained. The rules in this area

are complex, but grasping and applying these rules can often yield significant returns to asset finance businesses.

Finally, cash-flow management can be improved by the judicious selection of accounting periods. Many businesses that submit quarterly returns have not considered whether their VAT periods are suitable for their business profile, particularly if the business is subject to seasonal or periodic variation. A good example is a business incurring significant VAT on rents. Subject to other business issues it would ideally want VAT returns that end on calendar quarters, in order that it can recover the VAT charged on the quarter dates at the earliest opportunity. Equally, a business charging quarterly rentals, for example a leasing business, would want VAT periods ending furthest from the date it issues its invoices.

For those businesses in the sector that do make significant taxable supplies (for example commodity trading and leasing), billing cycles can be important in VAT cash flows. Tax points and the issue of bills need careful consideration to ensure that VAT charged (and collected from customers) is paid over at the latest opportunity.

There are numerous other cash flow planning tools. Sometimes, for example, payment of a supplier invoice may be delayed because of a dispute. Yet in many cases, the invoice cost can be accrued and the VAT component recognized for recovery as soon as the invoice is received. Invoices which arrive towards the end of an accounting period should be swept into the system as fast as possible, to avoid the books being closed before the costs can be recognized.

In short, the potential for reducing VAT incurred, and for making the most of VAT recovery, are often not fully appreciated. Many financial services companies could gain substantial benefits from improving their performance in this area.

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The future is flexible



Rachel Campbell



Tim Payne

A new approach to cost optimization

When the current recession started to bite hard, redundancies inevitably followed. Organizations of all sizes struggled to contain expenditure in the face of falling revenues and continued economic uncertainty. But, as **Rachel Campbell** and **Tim Payne** explain, flexible working can provide an alternative to such drastic measures.

Having invested heavily in their workforces in recent years, companies are understandably loath to let go of the very people they've strived so hard to recruit and train, fearful that this could damage their competitive position in the event of an upturn. A further concern is the impact upon morale and productivity of the looming threat of job losses. In the midst of a slump, the challenge is to build greater flexibility into the cost base while maintaining the trust and loyalty of employees.

Asking staff to reduce their working hours – and therefore their salaries – is fairly common in manufacturing, but less so in the professional services sector. Nonetheless, in January 2009 KPMG in the UK took a brave step forward, asking its 11,000 UK-based people to volunteer to: reduce their working week by one day, unpaid, or take between 4 and 12 weeks leave at 30 percent pay. Staff could volunteer for either or both of these options, with the maximum annual salary loss capped at 20 percent, and a continuation of full benefits. Alternatively they could also choose to remain on their current terms and conditions.

Crucially, by voting for such a change, staff would give the UK firm's leadership the power to decide if and when to reduce their hours and associated pay in much smaller timeframes, offering an effective tool for managing costs while also retaining talent. The scheme – entitled *Flexible Futures* – would last for just 18 months and required a temporary change in employment contracts.

Building upon firm foundations

Such a radical approach involved a carefully orchestrated rollout, creating a strong ongoing conversation across the UK firm. *Flexible Futures* was initially unveiled to partners, then to line managers, and finally to the entire workforce. The firm utilized question and answer sessions, conference calls and a dedicated website – which even included a calculator to determine take-home pay under the various options.

An overwhelming 85 percent of partners and staff subsequently signed up for one or both of the options – testament to the high trust between leaders and staff. Indeed, in the same year, KPMG in the UK was also named *the Best Big Company to Work for* by London's *Sunday Times* in 2009.¹

In the 11 months since this groundbreaking initiative was launched, 2200 people have been asked by the firm to exercise their options. This represents a range of flexible working, from one or two days off during a quite period, to several weeks over the summer months. As a result, KPMG in the UK has saved approximately £4.7 million, equating to circa 100 fulltime salaries. Some KPMG member firms in other countries have replicated this success with similar schemes adapted to meet local labor regulations.

So, is this type of approach right for your organization? It has undoubtedly worked for KPMG in the UK in a temporary downturn, but may be less appropriate for those facing more fundamental change. Furthermore, having a culture which can accommodate open dialogue and where senior management genuinely discuss the scheme with staff to find an approach that works for all parties, is crucial.

On a legal level, it's essential to get sound advice on the impact upon pensions, benefits and other employment-related matters (which can vary by region). IT and HR systems and processes should also have the flexibility to cope with major changes.

The option to reduce working hours at short notice gives leadership a precision tool for managing costs while also retaining talent.

Flexible Futures gives employees some control over their own destiny, reducing stress levels often associated with uncertainty. Rather than worry about job security, KPMG's people are able to focus on their clients. More importantly, the scheme allows KPMG to deal with economic realities while keeping top talent on tap, so the firm can quickly gear up for new business as opportunities inevitably arise.

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1. The Sunday Times Best Big Companies to Work for 2009, *The Sunday Times*, March 8, 2009.

A view from the market

Thoughts for the future

Interviews with senior executives




Oliver Bäte



Garth Rossler



Sir Brian Pitman



Most of the developed nations are now emerging from recession. However, substantial fragility remains; and it will take some time before global economic output returns to pre-crisis levels.

In recent issues of *frontiers in finance*, we have presented a range of views from KPMG firms' professionals and other industry experts on the causes and lasting consequences of the crisis, and particularly the impact of regulatory change and government involvement in the industry. One of the key themes of this issue of *frontiers* is the return of optimism, albeit to a significantly different world, and a significantly different framework for the financial services industry.

To explore this theme, KPMG firms' partners around the world have undertaken in-depth interviews with senior and well-respected practitioners in the marketplace. These stimulating and insightful views come from:

Oliver Bäte, Chief Financial Officer, Allianz SE

Garth Rossler, Managing Director, Maple-Brown Abbott Limited, a privately-owned investment management company specializing in the management of Australian and Asia Pacific ex-Japan equity portfolios

Sir Brian Pitman, Senior Advisor, Morgan Stanley, currently Chairman, Virgin Money and former Chairman of Lloyds TSB Group

In our series section we have also interviewed **Roy Jacobowitz**, MD External Affairs, ACCION International about the potential of microfinance in China, in 'An accessible economy: Microfinance in China.'

This collection of opinions from the market gives a fascinating insight into the current view of where financial services stands in its recovery and some of the key challenges the industry should be seeking to address. The thoughts range from the tensions already emerging over how general principles for balance sheet strength, liquidity and defence against systemic risk, should be translated into practice, through to the issue of returning to the basics of serving customers.

We hope you gain some insights that challenge, or confirm your own thinking.



Oliver Bäte, CFO, Allianz SE

Looking forward...

Transparency in insurance

Oliver Bäte, Chief Financial Officer, Allianz SE speaks to **Frank Ellenbürger** about the state of the insurance industry in 2010.

Frank Ellenbürger: How do you see the insurance market developing over the next 12-18 months?

Oliver Bäte: Overall I think 2010 will be at least as challenging as 2009 was, because a number of the financial market effects will further spill into the real economy in 2010. In insurance, we are predominantly fixed-income investors, and interest rates are still too low, so revenues will remain under pressure, both from premium volume and from investment income. The next issue we have to consider is credit defaults. I think we could face some surprises in the industry in relation to increased default on the credit side. It's going to be a very challenging environment in 2010, and we remain very cautious.

FE: If you look at valuations, there seems to be a contrast between life insurers on the one hand and non-life and reinsurance on the other. The outlook for reinsurance seems to be rather optimistic, whereas the life industry seems rather negative.

OB: During the end of 2008 and the beginning of 2009, people were very nervous about asset quality on the life side and about the true pricing of the options embedded in life contracts. However since the end of Q2 2009 and the beginning of Q3, sentiment has begun to change.

Reinsurers have been doing well because they have had a very conservative asset base. However, we need to see how prices develop. We haven't yet seen the kind of price increases in the reinsurance market which the industry expected.

What we are currently faced with is that the allocations of key investors to the insurance sector are relatively fixed, and they're moving investments between insurers rather than into and out of the sector as a whole. Investors have become more restrictive in terms of allocating capital to the sector, and this is one of the key reasons why we're facing very low valuations relative to inherent earnings power.

FE: What has to change in future then in terms of regulation, accounting or market communications to address the under-valuation of insurance companies?

OB: I think we as an industry have not done ourselves a lot of favors. We've been lacking true discipline in terms of capital allocation and pricing discipline. Consequently investors are penalizing us for this. Second, it is clear that on the life side the economics have been increasingly opaque, while we've been promising the opposite: clear communication of the actual risks. All our investors have been telling us that we need more transparency over what are the true drivers of results, expenses, risks and how we are creating value.

“It's going to be a very challenging environment in 2010, and we remain very cautious.”

The third problem is with mark-to-market modeling, which is based on spot prices. We've seen how MCEV valuations have fluctuated by 60 percent over the course of the crisis, and this is no basis for managing a risk model. We need to be very careful how we use these numbers in the future. Companies need to be managed on economically meaningful assumptions. Market valuations of our business based on spot rates don't make any sense at all.

FE: 2010 is a decisive year, with developments forthcoming in IFRS 4 Phase II, Solvency II etc. The industry view on the current proposals is now very different than it was before the financial crisis. Do you think we're going to see positive outcomes for the industry in terms of regulation, solvency and financial communication?

OB: There is a lot of debate over whether Solvency II is the right framework. I'd like to reiterate that it's absolutely the right framework, and that in the financial sector it's the best and most comprehensive framework for managing the risks in the industry.

The problem is not with the concept but the application. Because of the crisis, assumptions in the model were tightened strongly, leading to much higher capital requirements for the insurance industry. And that despite the fact, that the insurance industry has dealt with the financial crisis without their business models being endangered or their capital base being erased. We need to get a much better understanding through integrated models how a crisis affects the industry's capitalization before we raise the bar for our capital requirements and thereby jeopardizing the wellbeing of a whole industry.

A further problem is that insurance is always discussed in the same framework as banks, which still surprises me - the business model of the insurance industry differs significantly from that of banks. We are getting dramatically lower returns on investments because rates are low since we are propping up the banking system. In effect, we are paying for the crisis twice, once by bailing out the banks, then by providing them with cheaper funding. We cannot go on doing this.

FE: On the accounting side, there's a considerable overlap between Solvency II and IFRS 4 Phase II. Are you confident that we'll get things on the right track when it comes to accounting under IFRS for insurance companies?

OB: First of all, many of the proposals of the IASB were very useful and pointing in the right direction. However, two things concern us.

One is financial instruments: It is important to find reconciliation between accounting principles and economic reality. We need to account for equity investments in a way that makes sense, and should continue to be able to account for these instruments as "available for sale". I really hope we can get a resolution of this.

The other issue is the new accounting standard for insurance contracts. By and large we are very happy with the proposals from the IASB. But we might get a dilution of the original proposals in the final standards as a result of discussions, especially with the FASB. We do want convergence, but not at the price of getting too complicated.

FE: If you follow international discussions about systemic risk, you get the impression that the issue is dominated by the banks. Insurers' lobbying power seems to be relatively limited. How can regulators, the G20 and others get a better view of the insurance side?

OB: The first problem is a matter of presence: who sits at the table when these things get discussed? Ideally, we need those that invest, insurers and pension funds, to be at the table too, and I think we should have spoken up more forcefully. At the international level, when finance ministers meet, the investor community needs to be more strongly represented. We need to find a mechanism for organizational representation which makes that happen.

The other point is around the Financial Stability Board which deals more with the macro view of the system. It's very important that we have this. But I'm very surprised that some see Allianz as an institution which could pose a systemic risk, as I don't believe Allianz is causing, or could potentially cause one. Inter-bank relationships can bring the system down, but insurers per se are not bearing a systemic risk! The key problem is not preventing banks from failing; it is ensuring that they can fail *without* causing damage to the overall system. We look forward to actively participating in this ongoing debate.

FE: Mr Bäte, thank you for your time and insights – it has been extremely interesting.



Frank Ellenbürger

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Garth Rossler MD, Maple-Brown Abbott Limited

Back on track?

Garth Rossler, Managing Director Maple-Brown Abbott Limited talks to **Paul Reid** about future challenges in the investment management industry in Australia.

Paul Reid: How optimistic do you feel now about the financial services industry, both here in Australia and globally?

Garth Rossler: I feel much more optimistic than we would have been this time last year, given a lot of the foundation work that's been done here in Australia during 2009, particularly recapitalization of financial institutions and so on. I feel that we in Australia, enter 2010 in a much stronger position. However, banking globally still has major challenges ahead of it, and although things look better in Australia it would be foolish to say that there are no challenges facing the Australian financial services sector.

PR: What do you think are the key learning points for the global asset management industry coming out of the financial crisis?

GR: I think the key lesson is that over-valuation almost always corrects itself even if the catalyst for that correction is not what you think or what other people might have foreseen. Related to that, is that the focus on short-term performance has been shown to be unwise. Certainly in our industry, all players – whether it is consultants, fund managers, or pension fund trustees – are under continuous performance pressure and the short term focus can lead to a herd mentality. You end up with people chasing bad products (or what turn out to be bad products).

So as I say, those sorts of over-valuations and inefficiencies generally get squeezed out.

PR: Do you think people lost sight of the fundamentals of sound asset management in this period by virtue of this focus on short term performance?

GR: To my mind there is little doubt that was the case. I think many commentators were of the view going in to 2007 that things were pretty fully priced in the stock market generally, but there was a lot of enthusiasm around commodities, global growth and so on. Thus, while people were concerned about the outlook, it was hard to step back from that when everybody else was enjoying the party. Leaving the party early can be a very painful experience.



PR: The G20 has been brought together to oversee global regulation. How do you think that group should work together to ensure a level playing field for financial services regulation?

GR: I think global coordination at the highest level is necessary – both at a political level and at the regulatory level. If you think of the Basel Committee and things like that, it's clearly important everyone works together. Having said that, there are very clear differences between the banking systems across different countries and so I think it's inevitable that self-interest is going to play a role. Each country is going to want to ensure that it's not disadvantaged relative to others. For example regulation which suits a country that's long on savings may not be equally suitable to a country that's short on savings. So, you are going to get those sorts of conflicts. Clearly work needs to be done to try and achieve a level playing field, but I think it's a pipe dream to think we will get there.

PR: Reputation and trust are key in the personal financial services business. How do you think trust can be re-established not just with personal customers but also with industry commentators, the regulators and even the institutional investment community itself?

GR: I think the passage of time is going to be the critical factor at play here, and I mean years not months. You only have to look at recent discussions in Europe and the UK around bonuses for banking executives, to see clearly how trust is a long way from being restored. I think the focus is going to have to move from bonuses, remuneration and so on to delivering acceptable outcomes to consumers and investors and that's going to take time. In Australia, there is a lot of debate around the banks passing through to consumers, via mortgages, the higher cost of funding.

Both sides of politics seek to make political mileage out of that, and in this

environment consumer trust and reputational repair is clearly not going to happen very easily.

PR: What efforts do you see being made to promote sustainable development in the financial services industry broadly, and in asset management specifically?

GR: Here in Australia, banks are increasingly focusing in on these issues, such as the adoption of the Equator Principles by the major banks. The UNPRI principles for responsible investments are also gaining wider acceptance in Australia. Asset managers are increasingly becoming signatories to the UNPRI. We have been signatories now for close on two years and we were one of the early movers in that space. I think there is a strong movement in that direction.

PR: Do you think the signatories have thought carefully enough about what they need to put in place to monitor adherence to these principles for responsible investment?

GR: That's a good question. I think their hearts are in the right place. I think people want to be seen to be doing the right thing and so have been keen to embrace the changes. There is little doubt that the structures that you need to administer some of those principles and put them into practice, are still evolving. I guess that's why as part of the UNPRI we're encouraged to share our knowledge of those things with other people in the industry and try to get everyone on the same page. There is much development work still to be done.

PR: Turning once more to the global environment, what do you believe the next growth areas or the new markets will be, and where do you see investments required into the new products for the asset management industry?

GR: It seems to me that in many of the developed countries, including here in Australia, the ageing population and the shortfall in retirement savings is probably

“I think global coordination at the highest level is necessary both at a political level and at the regulatory level.”

the key issue in asset management. There is a great deal of focus from both the regulatory perspective as well as from the asset managers' perspective to develop product for this demographic. It seems to me, that there needs to be encouragement for people to save or to contribute to their savings and that we will probably see some government fiscal policy actions taking place. As for the product development matter, I think it's very much a focus on products that can produce income over time. I don't think that's new but I think what is important is that it has got to be 'genuine' income, because I think that's where the whole sub-prime crisis began. One of the aspects that drove the marketing of these products was that apparently you could obtain greater yield at limited risk – and that wasn't the case.



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Sir Brian Pitman, Chairman, Virgin Money

Business class service

A personal touch for banking

Sir Brian Pitman, Senior Advisor, Morgan Stanley, Chairman, Virgin Money and former Chairman of Lloyds TSB Group, talks to **Alison Halsey** about the optimism in financial services. Sir Brian has also been appointed by the Financial Services Authority as one of five advisors assisting the regulator on a framework for ensuring effective governance in financial institutions.



“ We’re not out of the woods yet. But generally speaking the policymakers have succeeded in stabilizing the markets, albeit with huge amounts of money.”

Alison Halsey: How would you characterize the state of the global economy and financial markets now, as we begin to emerge from the crisis?

Sir Brian Pitman: I think we have to say the position’s better than it was a year ago, when the level of uncertainty was absolutely enormous. We’re not out of the woods yet. But generally speaking the policymakers have succeeded in stabilizing the markets, albeit with huge amounts of money. Looking back, everybody – individuals, companies, banks, governments – they all borrowed too much. This led to an illusion of prosperity, based on debt which is going to be painful to correct. There is no quick fix in my opinion. In the last year, we have seen companies raising a lot of capital and reducing debt. Individuals have been repaying a lot of debt too, and increasing their savings. But governments haven’t even started to tackle their debt problems.

The big divide, of course, is still between the Asian nations with big piles of cash, and Western nations with piles of debt. The shift in economic power to Asia is now irreversible. Western debt is one of the most intractable problems, because in the end dealing with it is likely to mean a reduction in the standard of living in the West, at least temporarily. No government will find it easy to manage this. Sometimes it takes a crisis, as we’re seeing in Greece now, to allow action to be taken. There isn’t the same sense of crisis in the UK or US, and that makes it extremely difficult for politicians to impose really tough measures. For example, President Obama’s latest budget proposals are hardly draconian, but it’s not going to be easy to get them through by any means. We shall get over it in time, but there are enormous imbalances to resolve, and it will need a big change in our habits after years of excess.

AH: What do you see as the main impact on banks in particular?

BP: It’s clear that banks will have to hold much more capital, and much more liquidity, than before but you can’t do

that overnight. One of the major issues they have to resolve is funding, because there’s no doubt that the banks relied far too heavily on money market deposits in the past. These were really deposits which came from savings in Asia, which were used to prop up the standard of living in the west. The banks have a massive gap between total assets and customer deposits. It’s impossible to narrow this gap in the short term. In a country like Britain, you would have to bid up the cost of borrowing from customers to an impossible level; there simply isn’t the volume of savings to achieve it. And even if you could do it, the impact on the price of mortgages, corporate loans and so on would be very great indeed. So I think the authorities are right to try to steady the ship right now, and not attempt anything too drastic too soon.

AH: You mentioned the price of corporate loans. Major companies can still go to the capital markets for funding. But what about smaller businesses?

BP: I think this is an absolutely key issue. The real difficulty is with very small companies and small and medium-sized enterprises, which depend almost entirely on the banks. If you’re not big enough to go to the capital markets and attract investors, you’ve got to go to the banks, and that’s still very difficult. As we’ve seen, a number of countries are making special arrangements to support companies in this sector, in effect subsidizing them with special schemes and guarantees, because they’re the future of growth and employment. Unless we can finance small business, we will not generate the growth.

AH: Should customers now expect to pay more for borrowing?

BP: I think there’s little doubt that the cost of borrowing for individuals and small businesses is going to go up. Once we start to remove the props to the banking system we’ve put in place over the last year or so, market forces will begin to take effect. Attracting deposits will be more expensive, and this will have an inevitable impact on the cost of borrowing. As I’ve

said, banks can’t go on depending on the money markets for comparatively cheap funding, and relying on securitization to free up the other side of the balance sheet, because, at best, revival of securitization is likely to be a slow process and will be different in form anyway. We have got to get more customer deposits.

AH: Where do you see positives for the banks?

BP: In recent years the focus on investment banking, which has been very profitable, means many banks have tended to neglect retail banking, because the returns aren’t as good. But there are plenty of opportunities in the personal side of the business if the risks are managed correctly. It’s the banks’ behavior which is so important.

AH: What attracted you to your current role and this aspect of retail banking?

BP: I think there’s a real gap in the market for genuine personal service, for example where a customer can go into a branch and get a loan agreed on the spot by someone with the necessary authority. As the big banks have de-skilled their branches, and converted staff from bankers into sales-people, they’ve lost the ability to do that, and it would be a major challenge for them to reverse this. But the right people are actually readily available. All sorts of people tell me they’re unhappy with the way their own bank has deteriorated, they’re thinking of buyouts and so on.

People get fed up with everything being remote. It’s clearly cheaper to do that than have a set of branches. But it takes away the ability to discuss with someone face-to-face how to go about business planning, how to finance an investment and so on.

There are plenty of examples in the US, for instance in the community banks. They do not offer loads of new-fangled products. They offer genuine personal service, and a lot of them make very good returns. The research shows very clearly that they serve a local community. In the UK, Svenska Handelsbank now has about 60 branches offering a genuine personal

“All the new banks now starting up will concentrate on personal service.”

service. I've looked quite carefully at how they do it. For example, the branch in Cambridge has its own website – for Cambridge, not for the bank as a whole. The whole basis of their activity is personal service.

AH: And can that personal service be facilitated by technology?

BP: Of course, technology gives you all sorts of advantages in terms of information. But it's the way you use it that's crucial. For example, take the branch of Metrobank they're building in London. It will have space for customers to sit down with staff, discuss their requirements, and get an answer there and then. But across the road where all the big banks have branches, you can't do that. You'll have to fill in a form. Even the process of opening an account can be painful, partly because of money-laundering regulations. But if the focus is customer service you work out how to make it easy while still complying with the law. It is striking to see what some banks are managing to do. It comes down to what customers really value. Fractional differences in rates are not the issue. All the new banks now starting up will concentrate on personal service.

One of the reasons I agreed to join Virgin Money is that they already have 2½ million customers, and they've achieved this with a look and feel which is different from the big banks. It's a small business. Everyone knows one another, they all communicate. They've got that sense of personal service, being small.

For years, I've been on the board of Singapore Airlines, and their attitude has always been not to be the biggest, but the best. The attention to the customer experience is staggering. It's a completely different experience from any other airline. When I recommend that my friends travel with them, they ask if I will speak to the

Chief Executive to make sure they get properly treated. I tell them I don't need to do that. Every passenger gets first-class personal treatment. It's been built around the customer experience. Every point of contact with the customer is analyzed: booking, checking, boarding, all the things that matter to the customer. How easy is it to do these things? How can we improve the customer experience? When you put it all together, you get much greater customer loyalty. Singapore Airlines is one of the most profitable airlines in the world because of it. And I think this kind of approach is what we're going to see in successful banking in future.

AH: Some of the big banks have spent an absolute fortune trying to do exactly what you've just described, redesigning branches and so on. Do you think they're simply not going to succeed?

BP: Just the sheer size of these banks makes reversing course and focusing on customer service very difficult. What's happened is more and more pressure to sell, sell, sell. They've converted their branches to sales outlets. You get to the point where practically no-one in the branch has any experience of actual banking. Customers know whether someone understands what they're talking about. In so many bank branches, the minute you ask for advice about a personal or business matter, they haven't got a clue. They refer you to a specialist hundreds of miles away. Once you've de-skilled the branch, it's very difficult to reverse that. But I think that the new banks without the legacy of the old will be able to have branches which are significantly different.

Banks have to serve a social as well as an economic purpose. They have to enable transactions to proceed swiftly and efficiently, and they have to use savers' deposits to finance growth, trade and economic prosperity. There is a lot we need to fix about banking.

We have discussed the structural issues of leverage and capital-raising. We need to tackle corporate governance and the remuneration issue. Regulators need to translate the perfectly sound principles they're developing into workable practice. But in the end, I'm convinced that the key to success in the future doesn't lie in any of these things. They're simply the infrastructure, the framework. The essence of successful banking has once again, to become serving people, understanding their needs, focusing on their specific requirements. And this means much more attention to customer service and improving the customer experience.



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Emerging markets



An accessible economy

Microfinance in China

Simon Gleave and **Harry Hughes** discuss the developments and implications of microfinance in China.



Simon Gleave



Harry Hughes

Providing banking and other financial services to the poor has always presented particular challenges. By definition, people with little or no money lack all but the most basic financial resources and economic influence. Their exclusion from the financial system means they have no credit history and no basis for participating in modern financial transactions. Poverty means they have little if any collateral to underpin lending. In large areas of the world, poor people also live in remote rural regions without access to the infrastructure of modern commerce and communications. This inability to benefit from financial services plays a large part in preventing the poor from making even modest improvements in their lives, and helps to trap them in poverty. More than 1 billion of the world's population subsist on less than US\$1 a day.

“ If financial resources can be made available to the poor people on terms and conditions that are appropriate and reasonable, these millions of small people with their millions of small pursuits can add up to create the biggest development wonder.”

Muhammad Yunus, Grameen Bank

Finance for the poor

The microfinance movement challenges the view that poor people are also poor credit risks, and that they cannot benefit from financial services. The origins of microfinance go back to at least the 1700's. Since then the principle has grown with a number of organizations specializing in this including ACCION, SEWA Bank and Grameen Bank to name a few. As an example, founded in 1976, Grameen Bank has shown that with careful management, the provision of small amounts of credit to poor people can transform their economic prospects and be sound business at the same time. Grameen Bank now has 8 million borrowers in Bangladesh, 97 percent of them women.¹

The China context

Despite rapid and continuous economic growth over the last 25 years, China is still home to tens of millions of the world's poorest people. Many of these live in impoverished rural areas with few prospects of economic improvement aside from migration to the rapidly industrializing cities. Large-scale displacement of the rural poor is creating massive social disruption and further deepening income inequalities and the rural-urban divide. The Chinese government has been attempting to tackle this complex set of problems by promoting economic development in rural areas, the creation of small and medium-sized enterprises and the provision of a financial services infrastructure to support these objectives. Microfinance is beginning to play an important role.

Potential and challenges

Over the last decade, the People's Bank of China (PBOC) and the China Banking Regulatory Commission (CBRC) have encouraged the creation of rural credit cooperatives and village banks.

More recently, trials have been taking place to establish dedicated Micro-Credit Companies (MCCs). To begin with, the Chinese government was very cautious, granting only 20 licences initially. ACCION, a not-for-profit organization which has been active in microfinance for over 40 years, originally in South America, was invited to apply for one of the pilot MCC licences by the provincial government of Inner Mongolia. In December 2009, the company made history by becoming the first wholly foreign-owned organization to receive an MCC licence in Inner Mongolia, making its first loans shortly afterwards.

Alongside the government's drive to expand MCCs, however, has grown a degree of confusion over the role that microfinance should be playing and the best way of managing and regulating the sector. China has little experience in this area, and knowledge and understanding of industry best practice are limited. Despite this, the initial government caution rapidly gave way to greater enthusiasm, and to date more than 1000 licences have been granted for MCCs, credit cooperatives and similar bodies. At the same time, the focus of lending has blurred, with substantial proportions of funding being channeled to SMEs, rather than being used to support true microfinance initiatives. Where traditional MCCs such as ACCION concentrate on providing small loans of the order of RMB10,000 (US\$1,500) many of these new licencees are providing financing of RMB100,000 (US\$15,000).²

Is this a problem? In principle, no, if such credit supports economic growth in rural areas, reduces poverty and helps reduce the impact of the rural-urban divide. There are two dangers, however. The first is that lack of experience in managing credit provision to this sector could lead to an escalation of default rates,

and damage confidence in the viability of true microfinance by association. The second is that the very poor, whose lives could be transformed by even small amounts of credit, are likely to still remain largely excluded from access to financial services.

Roy Jacobowitz, ACCION's Managing Director External Affairs, argues (see page 34: 'A view from the market') that far better guidance on standards for secure and prudential lending, and widespread adoption of industry best practice in microfinance, are required if the sector is to meet the challenge. Lending comparatively large sums to SMEs is riskier, and defaults can rapidly destabilize financing institutions. This is especially the case when, as in China, the government limits permitted leverage and constrains balance sheet strength.

China's millions of rural poor face brighter prospects than they did a generation ago. But they remain far from fully integrated into the financial services system. Despite the Chinese government's policy initiatives in recent years, this still means that their lives are impoverished and lacking the most basic opportunities for self-determination.

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A view from the market:

A dollar a day...

Roy Jacobowitz, MD External Affairs, ACCION International discusses the potential of microfinance in China with **Simon Gleave** and **Harry Hughes**.



Roy Jacobowitz

For the millions of rural poor in the world, poverty is not simply a matter of having too little food to eat, or no access to the consumer goods we in the developed world take for granted. Beyond the straightforward economic impacts of poverty are issues of morality, human dignity and the right of people to determine their own future and achieve their potential. Poverty robs the poor of power over their own lives, and traps them into a future where there is little prospect of better.

The microfinance movement has demonstrated convincingly, that remarkably small amounts of financial support can enable people to escape the trap of poverty, begin to take control of their own lives and start building a more prosperous future. For men or women living on US\$1 or US\$2 a day, a debt of a few dollars owed to a local loan shark can blight their lives. For a poor subsistence farmer, lack of simple tools or access to a reliable water supply can mean the difference between hunger and plenty. Financing these small shortages of capital can transform lives.

Traditionally, the poor have been excluded from conventional banking, credit and other financial services. It was believed that poverty made people un-creditworthy and – worse – untrustworthy. After nearly 40 years providing microfinance to poor people, ACCION International has shown emphatically that this is not the case.

ACCION were pleased to be invited by the provincial government of Inner Mongolia to bid for one of the first pilot Micro-Credit Company (MCC) licences, and excited to become the first foreign-owned institution to begin microfinance operations, at the end of 2009. China faces major challenges in alleviating rural poverty, in narrowing the urban-rural divide and developing a successful grass-roots entrepreneurial economy. Microfinance can play a pivotal role in this endeavor.

However, as the previous article explains, it needs to be done properly, and in full awareness of industry best practice built up internationally over decades by microfinance providers. The determination of China's government to address the issue of rural poverty is not in doubt. As with any policy initiative that is new to a country, they will face a number of challenges in making this happen.

The key to successful microfinance, as in any other lending, is a prime focus on risk and credit management to ensure a high-quality portfolio. Since 1973, ACCION's partners have lent nearly US\$20 billion, with a loss rate of less than three percent. How have we achieved this? The fact is that the poor are not bad credit risks. Sometimes, through what's called solidarity-group lending, we extend credit to small groups of borrowers who all act as co-guarantors. If an individual borrower defaults, he or she faces exclusion from their group of fellows, loss of face and very public loss of dignity and self-respect. Most importantly, he or she faces being cut off from future finance for the tools or equipment needed for future growth. Such a borrower is highly motivated to observe agreed payment schedules.

Business cycles for those supported by true microfinance are very short, often a matter of days or a few weeks at most. This means that if a borrower is one day late with a payment, loan officers need to intervene rapidly, discover what the problem is and get things back on track with immediate advice and help. This continuous interaction with our clients allows us to build up a detailed picture of their individual characters, and support the successful ones with stable, stepped increases in lending. As has been well said before, only two types of clients see their banker regularly: the very wealthy and the very poor.

Beyond the straightforward economic impacts of poverty are issues of morality, human dignity and the right of people to determine their own future and achieve their potential.

The lack of experience in China in managing microfinance portfolios carries clear risks, as does the recent widening of focus to include comparatively large commercial lending to SMEs under a broader – and in my opinion, more fuzzy – microfinance umbrella. Microfinance can play a key role in helping China's economic transformation. A good start has been made. We hope it can help build a strong, stable, long-term finance market to serve China's poor. It has the potential to create a foundation of financial inclusion which allows the poor to make prudent use of financial services, increase their incomes and wealth, manage their assets and contribute to the betterment of society.

Some experimenting is necessary, and some failures will inevitably occur. However, greater attention to regulation, guidance and advice on industry best practice can help ensure that microfinance institutions have the most beneficial impact on the wider Chinese economy and society.

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'Good ideas must bend, otherwise they break'



Flexibility. As critical in business as it is in creating the perfect straw. Which is why the story of Joseph B. Friedman comes to mind. One day, after watching his daughter struggle to reach her milkshake, he invented the flexible straw using only a screw and some dental floss. The rest is milkshake history.

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Emerging markets



Jonathan Downer

Strong foundations

Real estate in China

The Chinese property market has managed to escape the worst ravages of the credit crisis, thanks to continued liquidity for local investors and strong underlying domestic demand. And, as [Jonathan Downer](#) explains, the fundamentals are in place to support longer term growth – particularly for those prepared to look beyond the confines of Beijing and Shanghai.

The severe decline in global real estate values over the past 20 months led to fears that a similar fate lay in store for China. With credit becoming ever harder to find, these concerns heightened as international institutional investment in the People's Republic slowed to a trickle, with some investors even disposing of assets in order to raise cash to fight fires elsewhere. (Asia is one of the few regions where they have been able to realize a profit on any sales).

Yet in spite of such pressures, the Chinese market remained remarkably robust in 2009, due in no small part to the ongoing availability of bank financing, which has enabled domestic investors to step in and fill the gaps left by their external counterparts. Banks on the mainland lent a staggering US\$1.39 trillion in 2009 – over three times the initial targeted figure. This has been further boosted by the estimated US\$586 billion fiscal stimulus package,¹ much of which is thought to have filtered through to the real estate market.

Although commercial property prices did not escape completely unscathed, the fall was far less steep than in Europe, the US and Middle East. The real success story however has been the huge residential sector – the backbone of China's property industry – which enjoyed a 60 percent² surge in sales in the past 12 months on the back of strong GDP growth.

Homes not investments

The above figures only serve to highlight some of the differences between the real estate market in China and many other developed markets. A prime example close to home is Hong Kong, where property is seen very much as another asset class, with prices typically mirroring stock exchange movements. Consequently the market is far more prone to bubbles, as speculators hurry to get a piece of the action, often fueled by the availability of cheap financing. As the recent crisis demonstrated, such growth is highly sensitive to a fall in confidence or the removal of funding.

In mainland China, on the other hand, the housing market is driven less by speculation (although not immune, the luxury residential segment is a good example) and more by the burgeoning middle classes' desire for a better lifestyle, through trading up to bigger and/or better homes. This view of real estate as 'bricks and mortar' is also reflected in relatively low gearing levels in China compared to the US and Europe. Such modest gearing makes owners far less susceptible to fluctuations in the supply and cost of liquidity. The aspirational middle class is also having a positive impact on retail property values by spending its increasing disposable income in shopping malls and high streets.

And the relentless rise of the Chinese consumer class shows no sign of slowing down. Per capita income is several times below that of the more affluent nations,³ while consumer expenditure as a proportion of income is also relatively low (domestic consumption as a total of GDP was 35 percent in 2008; the equivalent figure for the US was 70 percent)⁴ Both these figures would be expected to rise considerably as the Republic plays an accelerated game of economic catch up.

The fundamental strength of the economy was amply demonstrated during the current global downturn, where a dip in exports was compensated for by strong domestic demand, enabling 2009 GDP growth of 8.7 percent.⁵ And despite the recent blip, exports are now already well on their way back to pre-crisis levels.

The Chinese housing market is driven less by speculation and more by the desire for a better lifestyle.



Uncharted territory

A majority of international investors entering the Chinese real estate market will, initially at least, tread the well worn path to Beijing or Shanghai. This is understandable; much of the 'quality' property is in these locations, while sticking to high profile cities gives an extra comfort level to lenders. On the other hand, such an intense focus on a limited target can lead to occasional overheating.

Shrewder local private investors are seeking opportunities in the many secondary and tertiary cities, utilizing their local knowledge and contacts. Demand for commercial property, shopping malls and of course housing, continues to rise across the Republic, as a result of economic growth and increased urbanization, with many provincial cities at a relatively low base.

But where to start? The sheer scale of the Chinese market can appear daunting. There are close to a hundred or so cities across the mainland with over a million inhabitants⁶ and twenty or so regions with a population greater than 30 million.⁷ Each of these regions represents huge markets in themselves, with very distinct languages, culture, legal processes, regulations and customs. All of this represents a steep learning curve. The business climate may also differ greatly from province to province, so it's vital to understand the localized economic conditions.

As the past year has shown, China is not dependent upon overseas investment to fuel its real estate sector. However, as liquidity starts to improve, there are plenty of opportunities awaiting those international investors prepared to devote the time and resource to developing local

knowledge and contacts. Crucially, the Chinese growth story has real substance behind it, with property values continuing to benefit from the wider expansion of the economy.

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Sustainability



After Copenhagen

Qualified failure, notable achievements

The Copenhagen Summit on climate change failed to reach the binding agreements many had hoped for. Nevertheless, there were some significant achievements, and the drive towards a low-carbon future received renewed impetus. Particularly notable was the commitment of the global business community to the process.

[Alan Buckle](#) and [Barend van Bergen](#) discuss how the business world now needs to engage directly with the implications.

The long-anticipated 2009 United Nations Climate Change Conference (the ‘Copenhagen Summit’) took place in Copenhagen in December 2009. Much media commentary on the outcome has played on the ‘failure’ of the conference to meet its stated objectives. But a considered assessment suggests that significant progress was made in a number of respects. To put this in context, it is important to appreciate how Copenhagen fits into the continuing international process of climate change mitigation.

Two years ago in Bali, representatives from over 180 countries began negotiations on a binding successor to the Kyoto Protocol to the United Nations Framework Convention on Climate Change (UNFCCC), and agreed a timetable leading to a framework for climate change mitigation beyond 2012 to be finalized in Copenhagen. The Copenhagen conference thus embraced both the 15th Conference of the Parties to the UNFCCC and the 5th Meeting of the Parties to the Kyoto Protocol.

In the event, as has been widely reported, the Copenhagen negotiations failed to produce a legally-binding international treaty. In hindsight, this was always going to be a massive challenge, requiring unanimity among representatives of nearly 200 nations and the resolution of fundamental differences of perspective between developed and developing nations. Indeed, there is some doubt whether such a conference is now the most effective method of taking the international process forward over the coming months.

Despite this failure, a group of five major nations (the United States, China, India, South Africa and Brazil), encouraged by the direct intervention of US President Barack Obama, announced that they had reached a ‘meaningful agreement’. Subsequently dubbed the Copenhagen Accord, this was ‘taken note of’ by delegates on the last day of the conference. The precise legal status of this accord remains unclear, and it is not even certain whether all participants endorsed or will endorse it. Nevertheless, the UN Secretary General Ban Ki-moon welcomed it as an ‘essential beginning’. Intensive discussions are now under way to build on the Copenhagen Accord in preparation for the next UN Conference in Mexico at the end of this year.

The Accord addresses six key issues:

- developed countries had to submit emission reduction targets for 2020 by January 31 (although no global target has been established). The US has offered to reduce emissions 17 percent below 2005 levels, by 2020¹
- developing countries must submit details of their adaptation and emission reduction plans by the same deadline
- developing countries¹ initiatives will be checked every two years, while respecting the sovereignty of their national governments
- a fund of US\$30 billion has been created for 2010-2012, with a target of US\$100 billion by 2020
- a transfer mechanism has been established to speed up the development of mitigation and adaptation technologies
- the next review will take place in 2015.



Alan Buckle



Barend van Bergen

Behind this superficial summary, however, lie more fundamental achievements. The most significant is that the leaders of all the major economies, including the US and China, are now committed to and involved in the process. For the first time, leaders of the major CO₂-emitting nations have accepted the majority scientific view that the increase in global temperature should be limited to less than two degrees Celsius compared with pre-industrial levels. Over the last year or two the scientific basis for the theory of anthropogenic global warming has come under increasing criticism; the debate has received new impetus in recent months with allegations of manipulation of data, corruption of the peer review process and improper political interference. Nevertheless, the fact that the world’s leading political figures are now publicly committed to this objective is especially significant.

The second key achievement is that hard, specific targets, both for emissions reductions and for funding, are now on the table. The US has proposed emission-reduction targets rising from 17 percent compared with 2005 levels by 2020 to 42 percent by 2030 and a massive 83 percent by 2050. China has always opposed absolute reduction targets because of its need to continue industrialization. However, it has now

A considered assessment suggests that significant progress was made in a number of respects.

The US has offered to reduce emissions 17 percent below 2005 levels, by 2020¹

promised to cut the carbon intensity of its economy by 40 – 45 percent by 2020. This means that although China's emissions are still likely to double by 2020, the growth in its emissions should slow significantly. As noted above, to accelerate progress towards mitigation and transparency on implementation, developed countries have committed themselves to providing US\$100 billion dollars by 2020 to address the needs of developing countries. This funding will come from a wide variety of sources, public and private, bilateral and multilateral, including alternative sources of finance.

From a business perspective, the third major achievement of note is that the international business community is now more than ever engaged with the climate change process. At times, and in its side events, the Copenhagen conference seemed more like a meeting of the World Economic Forum than a UN meeting. Over 1000 senior business leaders took part, and a discussion panel featuring a number of Fortune 500 chief executives (including those from Coca Cola, Unilever, GDF Suez and Alstom) was heavily over-subscribed.

While the precise pathway to a low-carbon future has still to be defined, the momentum to achieve it is now unavoidable. The business world now needs to consider seriously the implications for its own strategies and operations. One of the most obvious areas to tackle is the direct impact of operations on companies' own carbon emissions and contributions to the overall environmental impact. There are still many

opportunities to pursue in the areas of good-housekeeping, operational efficiency and CO₂ reductions. In the medium and longer term, achieving the Copenhagen targets will require mechanisms for carbon pricing and regulatory frameworks, which have yet to be developed. However, research on CO₂ abatement technologies suggests that up to half of them can deliver positive economic returns as well as limit CO₂ emissions. These are the areas where businesses should start focusing now to determine which strategies best match their own operational configuration.

The international business community is now more than ever engaged with the climate change process.





Financial services businesses are increasingly confronted with the implications of climate change. We observe among clients around the world that the subject is steadily moving up their agendas. They recognize that climate change poses both risks and opportunities, with strategic and financial implications for their businesses. The insurance industry has been slightly more engaged than some sectors due to the nature of their business, and the direct impact of climate change, such as increasing extreme weather. However, for those sectors not as advanced, and planning to confront these challenges, there are three steps they should take:

- obtain clarity on the opportunities (banking, insurance, investment and trade - eg energy-efficiency, renewable energy, carbon management and adaptation)
- manage risks: from the direct and indirect risks on your business
- be transparent: disclose what you are doing (direct impact on buildings/ operations but more important indirect impact via your services and products). The public want to know what organizations are doing.

Whether or not the next 12 months sees the creation of a global, legally binding agreement on climate change, the journey to a low carbon economy will still continue. Following Copenhagen, the implications should now be high on all chief executives' agendas.

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1. 'US pledges 17 percent emissions reduction by 2020.'
Juliet Eilperin, www.washingtonpost.com, January 29, 2010.

IFRS...

Things to look out for in 2010



Stacey Howard

Stacey Howard outlines the potential IFRS developments which could impact financial services

Until now...

December 18, 2008 ED:
Consolidated financial statements issued

March 31, 2009 ED:
Derecognition issued

July 14, 2009 ED:
Classification and Measurement issued

November 5, 2009 ED:
Amortized Cost and Impairment issued

November 12, 2009 first chapters of IFRS 9:
Financial instruments issued

What's coming...

First half 2010:
ED on hedge accounting expected

Quarter 1 2010:
ED on classification and measurement of financial liabilities expected

FASB proposals on financial instruments accounting

Quarter 2 2010:
ED on insurance contracts expected

Second half 2010:
IFRS on consolidation expected

IFRS on derecognition expected

Planned completion of IAS 39 replacement project

Unknown date:
EU endorsement of IFRS 9

2012:
IFRS 9 comparative year

2013:
January 1: IFRS 9 mandatory adoption

Overview and introduction

Without a doubt, the biggest accounting challenge facing financial institutions in the near future will result from the proposed replacement of IAS 39 *Financial Instruments: Recognition and measurement*. The current accounting requirements have been heavily criticized for both their complexity and, more recently, in light of weaknesses exposed by the financial crisis.

The G20, the Financial Stability Board and others have asked standard setters to look at improving standards with the aim of achieving a single set of global accounting standards.

Key concerns raised about the current standards relate to delayed recognition of credit losses, difficulty in applying fair value accounting in illiquid markets and the complexity of financial instruments accounting rules.

A phased approach is being taken to the replacement of IAS 39 with IFRS 9. The three main phases are:

- *Phase 1: Classification and measurement of financial instruments*
- *Phase 2: Impairment of financial assets*
- *Phase 3: Hedge accounting.*

Additionally, fundamental changes are proposed to the derecognition criteria for financial instruments and to the basis on which the need for consolidation is assessed.

IFRS 9

Phase 1: Classification and measurement

The first chapters of IFRS 9 issued in November 2009, deal with classification and measurement of financial assets only. The current four IAS 39 measurement categories will be reduced to two (amortized cost and fair value).

Financial assets may be classified at amortized cost if:

- under the entity's business model the purpose of holding the asset is to collect contractual cash flows; and
- the contractual terms provide solely for payments of principal and interest on specified dates.

All other financial assets will be measured at fair value.

IFRS 9 also simplifies the accounting for embedded derivatives, limiting the requirements for separation. The fair value option is further restricted and only available where it eliminates or significantly reduces an accounting mismatch.



Phase 2: Amortized cost and impairment

The current incurred loss impairment model in IAS 39 has been heavily criticized for delaying recognition of credit losses.

In response, fundamental changes are proposed, replacing the current 'incurred loss' model with an expected cash flow approach. There would no longer be a requirement to identify a trigger or loss event before credit losses are recognized. Entities would instead adopt a more forward-looking expected cash flow approach, recognizing the effect of estimated future losses based on current expectations.

There is also an impact on amortized cost accounting as expected credit losses are incorporated in the effective interest rate (EIR) – a key change likely to result in lower EIRs and reported interest income.

Phase 3: Hedge accounting

The IASB's deliberations on the future of hedge accounting are ongoing and an exposure draft is expected imminently. The principal objective is to simplify the existing rules which have been widely criticized for their complexity.

It is likely this will see fair value hedge accounting changed to something similar to the current cash flow hedge model.

Derecognition and consolidation

The IASB also propose changes to derecognition and consolidation in response to the financial crisis.

Derecognition

The key change proposed for financial assets is the focus on a single control concept, a simplification of the current standard which combines elements of several derecognition concepts.

The ED aligns the derecognition criteria for financial liabilities to the definition of a liability, meaning financial liabilities are derecognized when they no longer qualify as a liability.

Consolidation

The ED on consolidation proposes a single control model for all entities including SPEs and will replace IAS 27 *Consolidated and Separate Financial Statements* and SIC-12 *Consolidation - Special Purpose Entities*. The concept of power is modified and could potentially be broader than that currently in IAS 27.

Insurance Contracts

Phase I of the insurance contracts project culminated with the IASB publishing IFRS 4 *Insurance Contracts* in 2004, which is currently in effect. The standard sought to bring limited improvements to accounting for insurance contracts, while minimizing the amount of change required from pre-existing accounting policies and practices. In October 2008 the FASB added a project on insurance to its agenda and the Boards agreed to continue the project jointly. The speed of the project has accelerated in recent months with an exposure draft planned for Q2 2010.

The effective date of the standard has not been determined but it will likely be consistent with IFRS 9.

Key decisions made to date regarding the measurement of insurance liabilities (new measurement model), accounting treatment for acquisition costs (expensed when incurred) and no recognition of profit at inception would result in significant changes to current practice for many insurers.

Summary and conclusion

The need for change in financial reporting is clear, but there will be significant challenges for financial institutions and particularly banks in assessing and implementing the new requirements. All major aspects of the current accounting for financial instruments and insurance contracts are being overhauled and there will be systems, tax and regulatory consequences.

Phase 1 of IFRS 9 alone, requires financial institutions to revisit the classification of all financial assets. Additionally, many financial institutions will have to implement a radically different impairment standard and undertake a complete reassessment of whether special purpose vehicles should be consolidated.

These are likely to be the biggest accounting projects for financial institutions since IFRS conversion with many critical elements of the financial statements being affected. Planning for the change now is essential in order for financial institutions to be properly prepared for implementation in 2013 or earlier.

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Planning for the future



Andrew Davidson



Tracy Benard



Jim Low

Time to make a living will

The debate over the nature of global banking reform has captured the attention of bankers and regulators, with the issue of recovery and resolution plans (RRPs) – more commonly known as “living wills” – claiming its share of the headlines.¹ This is an issue that has significant implications for the future shape of the industry, as [Andrew Davidson](#), [Tracy Benard](#) and [Jim Low](#) explain.

The need to maintain contingency plans and procedures for use in the event of a bank’s wind-down was first agreed at a G20 summit in April 2009, and work on a final framework has been under development since then.

The US is taking action in this area: to date, regulators have been authorized to restrict or prohibit large firms from engaging in excessively risky activities, and President Obama has issued proposals to restrict the size and scope of US banks. Meanwhile, a comprehensive US Senate Banking Committee financial reform bill – which, inter alia, aims to establish a new protocol for dealing with failing firms without the need for taxpayer bailouts – is eagerly anticipated, but has been hit by delays.

However the most significant developments on this are in the UK. They have taken this opportunity to consult on national proposals, and run a pilot exercise during the first quarter of this year in order to gather sufficient evidence and experience to influence international debate.²

Broader international progress is expected after a G20 summit in June, when the Financial Stability Board (FSB) is due to publish its interim recommendations for addressing the moral hazard risks posed by ‘too-big-to-fail’ institutions. Among the options being considered are:

- targeted capital, leverage and liquidity requirements
- improved supervisory approaches
- simplification of firm structures
- strengthened national and cross-border resolution frameworks
- changes to financial infrastructures to reduce contagion risks.

Once a global framework and any national rules have been finalized, RRPs, in conjunction with related regulatory initiatives, are set to re-shape the banking sector and change the operating model for systemically important firms.

Recovery planning

Recovery planning is designed to reduce the probability of failure through the preparation of a detailed recovery strategy under a range of forward-looking stresses, including systematic stresses and the failure of an organization’s largest counterparties. A successful recovery strategy, therefore, needs to incorporate stress testing output (including a reverse stress test), based on the most recent regulatory guidance from authorities. In addition, it should identify how much time contingent capital (e.g. enhanced capital notes) and contingent liquidity will allow in order for recovery actions to be implemented.

These management actions will need to be carefully planned in advance to improve their likelihood of success in restoring the capital and liquidity position of the group. As such, they should include detailed plans to de-risk the business quickly and allow individual assets, businesses and/or subsidiaries to be sold.

However, if regulators judge a bank’s recovery strategy is insufficient for the task, it is likely a firm’s capital and liquidity requirements will be increased.

Resolution planning

But what if an institution’s recovery plan were to fail? To try to mitigate the impact of such situations, regulators will need to agree an appropriate resolution strategy. Resolution planning, therefore, aims to present regulators with a range of options other than whole bank rescue i.e. allow the group (or parts thereof) to fail with minimum disruption to the economy and minimum recourse to public funds.

Resolution planning is also intended to facilitate:

- a release and payout of insured deposits
- a release and distribution of client money and customer assets
- an unplugging of market infrastructure in an orderly fashion
- winding down of the remaining businesses.



Policy effectiveness

While the nuances of resolution planning are likely to be different depending on jurisdiction, some of the keys to effective resolution planning are to:

1. Understand the relevant legal framework(s) for resolution, including tools such as deposit transfer and the bridge bank that allow for the separation of investor funding from customer funding.
2. Identify in advance the level of internal contagion risk (i.e. key business, financial and operational interdependencies between group entities, and the contingency plans should those relationships be interrupted).
3. Understand the current level of connectivity to the wider market infrastructure and to other firms, and how to disconnect in the event of failure by either party.

Adopting a resolution mindset will be new to many firms, but it will serve to highlight potential barriers to resolution that are inherent within the current legal entity structure and operating model. Furthermore, the insights gained from resolution planning should confirm the feasibility of the bank's intended recovery options, and confirm what data is required to support both recovery and resolution planning.

Once potential barriers to resolution and any associated dependencies have been identified, it should be possible to begin questioning the current level of complexity, to determine if the inherent risk requires a change in business policy.³

Acting now

Although the framework and rules for RRP are still evolving, they will have a significant impact in reshaping the banking sector and individual operating models over the coming years. Therefore, it is essential that firms make a start in understanding their strategic position and options, including their ability to shape any final framework.

In addition, a measured strategic approach should help to quantify the scale of the challenge. It can provide senior management teams with sufficient time to identify any commercial imperatives that may be under threat, anticipate future changes to business strategy, including capital and liquidity planning, and start to factor.

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1. "If a business is too complex to produce a living will then it is almost certainly too complex to manage and it represents an unacceptable regulatory risk," Paul Myners, Financial Services Secretary to the Treasury, quoted in *The London Evening Standard*, September 18, 2009.

2. "We in the UK have probably been in the fore in promoting living wills, but there is general recognition that the concepts behind living wills have real utility," Paul Myners, Financial Services Secretary to the Treasury, quoted in *Reuters*, February 3, 2010.

3. 'Living wills, will be a forcing device for the clarification of legal structures,' Adair Turner, Chairman of the Financial Services Authority (UK), quoted in *Reuters*, September 3, 2009.

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Sustainable Insight – Looking back at Copenhagen, January 2010

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The global insurance industry is currently facing possibly its greatest challenge ever – Getting the balance right in capital and risk management within an increasingly regulated environment. To address this, KPMG International commissioned the Economist Intelligence Unit to undertake a second survey in August 2009 of 392 senior executives from insurance companies around the world.

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