

FRONTIERS IN FINANCE

For decision makers in financial services

January 2011

Featuring:

Turning the corner

The IASB's exposure draft on insurance contracts explained

Formula for success:

Examining key issues, trends and challenges facing the investment management industry

Getting to grips with SIFs

The future for systemically important financial institutions



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Foreword

Three months ago we were cautiously optimistic, while questioning whether the recovery was sustainable. If anything, prospects look a little more gloomy today. Domestic political uncertainties, in Europe and the USA, may weaken the resolve of governments to tackle budget deficits and borrowing, and to push through structural reforms. The threats of protectionism and currency wars are raising their heads. In financial services, a complex and still-evolving regulatory environment may result in an enfeebled industry sector. There is a risk that stability may be bought at too great a cost.

Much of this issue of *frontiers in finance* is devoted to trying to understand the potential impact of regulatory change, the impact of IFRS on insurance contracts and the banking sector and measures to tackle the critical issue of systemically important financial institutions. We look at proposals to improve business reporting and at the new environment for investment management.

Even in challenging times, business has to go on. We have significant reviews of how the real estate and infrastructure sectors are raising capital; how mobile payments are continuing to transform business models; and how banks can rebuild trust with their customers. Continuing KPMG's

commitment to leading financial services industry analysis, we look ahead to our forthcoming annual survey of the M&A market, and to a major new international survey of the relationship between Asian financial institutions and the West.

The next few months may, with hindsight, come to be seen as crucial. Will economic recovery find firm foundations in those major economies hardest hit by the crisis? Can national finances be restored to health without major public opposition and disruption? Can the global political will be sustained for comprehensive and effective regulatory reform which will avoid damage to growth and prosperity? Above all, perhaps, how will the change in the global balance of power in favor of China and the other Asian economies develop?

We have said from time to time that the financial services sector is going to look very different as a result of the crisis. Some of the major themes are already apparent – higher capital requirements and greater regulatory oversight in particular. But there is still a long road to travel. Another thing is also clear: the future of our industry is in large part going to be shaped by forces largely outside our control. At the moment it is not obvious just where those forces are taking us. I hope you find at least some pointers in this issue.



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

Alison Halsey

Alison Halsey

In this issue



Defining the path: Steering financial services in the right direction



Turning the corner: Will the anticipated reform of insurance contract accounting bring greater clarity and consistency, or increased uncertainty?



East meets West: Prospects for the Global Banking Sector



Getting to grips with SIFIs: The future for systemically important financial institutions

For your information

fyi...

2

Topics

| | |
|--|----|
| Defining the path: Steering financial services in the right direction | 4 |
| Turning the corner: Will the anticipated reform of insurance contract accounting bring greater clarity and consistency, or increased uncertainty? | 8 |
| Formula for success: Examining key issues, trends and challenges facing the investment management industry | 12 |
| Are you ready? Are financial services ready for the mobile era? | 16 |
| A golden opportunity: IFRS conversion: an opportunity for banks to streamline and simplify? | 20 |
| Information overload: The paradox of better business reporting | 24 |
| Bridging the gap: Post Merger Integration: securing value from future revenue enhancement | 28 |
| East meets West: Prospects for the global banking sector | 32 |
| Customer in the spotlight: Practical steps for driving customer centricity in retail banks | 36 |

Series

| | |
|--|----|
| Getting to grips with SIFIs: The future for systemically important financial institutions | 40 |
|--|----|

Insights

| | |
|--|----|
| Updates from KPMG member firms, thought leadership & contacts | 44 |
|--|----|

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Running against the wind

While everyone can appreciate how rough the past three years have been for banks, securities firms and insurers, imagine how difficult it has been for the analysts in charge of predicting how the stocks of these firms will perform. According to data compiled by Bloomberg Markets, Goldman Sachs Group and Keefe, Bruyette & Woods (KBW) got it right more than most as far the markets were concerned. The financial sector

research firms were ranked first and second respectively based on stock recommendations made by more than 2,500 analysts at 77 research firms and investment banks around the world between January 2008 and July 2010. Bloomberg devised the rankings by examining the analysts' 'buy', 'hold' and 'sell' calls on shares of 90 of the largest banks, diversified financial service companies and insurers in the US, Europe and Asia with at least 20 analysts covering them.

During one of the most turbulent climates in history, success in predicting the fall and rise of most large financial stocks was modest at best, even for the top-ranked firms and individual stock pickers. Goldman Sachs' analysts achieved their No. 1 ranking by making 30 accurate calls on the 79 financial stocks they follow, or 38 percent, while KBW's No. 2 post was based on 27 accurate calls on 78 stocks for a 35 percent success rate.

Finally, AIFMD official

With businesses already planning a number of decisions in anticipation of the AIFMD, the waiting game is finally over. The European Council and the European Parliament have both now approved the directive. While we will have to wait for the Level 2 measures to interpret the directive in its full detail, the core principals are clear, so businesses can now start actively preparing for the impact.

We can expect the following:

- The Directive will become effective on publication in the EU Journal which is expected to happen as early as January 2011. Each member state will have two years to transpose the directive into national law.
- A European Union passport will be made available immediately post transposition (January 2013) with non-EU passport to follow two years later (January 2015);

- National private placement regimes will continue until at least 2018, after which they will be subject to review and may be phased out.
- The future location of managers and funds will be determined by investor location, appetite for regulation and cost.
- Passive marketing will effectively be legalized, granting potential 'exemption' for managers operating discretionary mandates via third country structures.

Another key area of the Directive relates to Custody. The article within the draft on Depository Liability expresses positive changes that make it possible to have more than a single bank acting as a funds Custodian. Funds would need to be appointed by just one primary depositor, who would then delegate certain responsibilities which re-opens the multi Custodian/multi Prime Broker route for funds.

¹ 'EU AIFMD Negotiation Breakthrough – Good News for Securities Finance', www.dataexplorers.com, October 22, 2010



Wen receives red carpet – Italian style

Chinese premier Wen Jiabao's October visit to Italy was honored by a Rome Coliseum illuminated in communist red. An irrefutable sign of the importance placed on the trip by Silvio Berlusconi's government.

The larger than life greeting came as Italy looked forward to a surge in large-scale investment in infrastructure and high-tech joint ventures, while hoping to win equal treatment for Italian companies in China in return.

Wen and Berlusconi revealed joint ambitions to more than double bilateral trade to US\$100 billion by 2015, with the focus on boosting investment.

But China's foreign investment plans will have a few hurdles to overcome – most notably Italy's notoriously slow and punitive bureaucratic system.

To the delight of Italian business leaders, Wen made promises to respect intellectual property rights, calling them a 'great civic virtue', and put Italian companies on an equal footing with their Chinese counterparts. Berlusconi, a billionaire media magnate, followed up on Wen's promise by saying this would mean equality in applying for Chinese tenders and dealing with the Chinese bureaucracy and legal system.

Italy engineering and high-tech sectors – particularly renewable energy – are of great interest to China's European investment strategy. Wen specifically mentioned Italy's strength in 'design, innovation and creativity' and its dynamic small enterprises.

Source: 'China launches investment drive in Italy', www.ft.com, October 7, 2010





Defining the path

Steering financial services in the right direction



Jeremy Anderson

Over the past three years, *frontiers in finance* has documented the impact of the financial crisis and its aftermath on the financial services industry. It has been a roller-coaster experience as panic gave way to hope and then to the return of some semblance of normality. Through it all, those institutions which have survived – and they are the great majority – have sought to rebuild their strength and continue with business as usual.

It has not been easy. The external landscape has been changing rapidly, and remains uncertain. Economic recovery is weak, at best, and in many regions severe challenges still exist. Confidence among corporate and retail customers is fragile. Trust in the industry is low. Policy initiatives to counter the threat of recession have included bail-outs, guarantees, massive injections of liquidity and correspondingly massive increases in government debt and budget deficits. Since the G20 began to take the initiative to stem the crisis, these measures have gone hand in hand with the creation of new regulatory frameworks designed to ensure as far as possible that such a crisis cannot occur again. These developments are naturally taking time to mature. The imperative of global coordination

calls for extensive political negotiation. When the outlines of a consensus emerge, it takes time for detailed proposals to be formulated and then translated into legislative and regulatory effect. This process will continue for some time to come.

“You cannot step twice into the same river.”¹

A challenging environment

Such an environment makes it immensely difficult for banks, insurers and investment managers to plan for the future. The majority of organizations will have implemented major change management programs over the last decade, but this is change of a different order. Unlike the rationalization of structures or processes or the integration of a new operating unit, where the variables are largely under control, financial services companies face a radical complex of changes to the economic environment, to the behavior of customers and to the way they are allowed to do business. The challenge of change can seem too great, but we believe it is essential that the industry engages with this changing environment.

Engaging with change

The first reason to do so is simple self-interest. It is not possible to forecast in detail how economic recovery will evolve, or how the details of new regulation will impact on business models or financial performance, however, some things are clear. With the exception of large multinationals which can go straight to the capital markets for finance, most corporate customers are going to struggle to make consistent returns; growth financing and the demand for capital will remain depressed. Consumers, facing the reality that they are less wealthy than they previously thought, are going to remain risk-averse and nervous. Returns in the industry are going to be anemic. Higher regulatory capital requirements and constraints on business activities are going to depress profitability for some time to come.

The key to an effective response is to think through the potential implications for corporate strategy in a broad-brush manner, determining the general direction of travel – but at the same time to build in as much flexibility as possible to be able to respond to major perturbations along the way.

The second reason for engagement is that we in the financial services industry have a responsibility to try and shape change in the right direction. While the broad outlines of future developments may be clear, many fundamental details remain to be resolved. The political debate over the shape and regulation of the industry is far from over. And while regulators share a general consensus on the kinds of changes which are necessary, their practical implications are far from certain, as a number of articles in this issue make clear. Even in the USA, where the passage of Dodd-Frank is undoubtedly a significant milestone, a mountain of work is still needed

before its principles can be translated into action.

The financial services industry can help shape the new framework of regulation – and it seems clear that constructive contributions to the debate will receive a receptive response. This is not a call for special pleading. It is a recognition that financial services professionals are best placed to help formulate workable proposals, whatever our perceived shortcomings in the build-up to the crisis.

Finally, we need to engage with the challenge of change because our industry is important. Banks, investment managers and insurers provide products and services which underpin growth and wealth creation for the benefit of all. We allow companies and individuals to mitigate and transfer risk. We provide real solutions to meet real customer requirements. An efficient and effective global industry is essential to future prosperity, to the relief of poverty and to international harmony. If we get it wrong, the damage could be severe and long-lasting.

A changed role

Getting it right, however, means accepting that the nature of financial services is going to be different in the future. The phrase ‘back to basics’ has often been heard over the last couple of years. What it means in practice is that we need to reconnect with the underlying economic purpose of our industry: taking deposits, financing lending, processing transactions, facilitating maturity transformation, mitigating risk. The more esoteric and exotic aspects of our profession will still have a place, but they will need to be more clearly subordinated to its utility functions. It may be a less glamorous and a less profitable future, but it is the direction to which change is leading us.

The key to an effective response is to think through the potential implications for corporate strategy in a broad-brush manner, determining the general direction of travel – but at the same time to build in as much flexibility as possible to be able to respond to major perturbations along the way.

Shaping the future

The crisis was traumatic. As frightening as what actually occurred was the prospect of the greater catastrophe which would follow a complete collapse of the financial system. It is understandable, and right, that world leaders should seek to prevent a recurrence. However, it would be a profound mistake for them to imagine that risk can be eliminated from the system. Risk is as inevitable as uncertainty, and is indeed one of the currencies in which we trade.

A balance has to be struck. Measures to control and limit systemic risk are

essential. Reckless exploitation of excessive liberty needs to be curtailed. But financial institutions in a free market have to be allowed to fail as a consequence of their own misjudgements and poor performance. Reasonable protection for investors and customers is important, but not at the cost of moral hazard or implicit government guarantees regardless of responsibility.

The danger of institutionalizing excessive risk aversion in new controls on the financial services industry is that this would stunt the industry's ability to perform its proper economic

function. Far from improving stability, it would lock in chronic under-performance and feeble or no growth. Some in our industry have had their confidence shaken, and are fearful for the future, but it is time to engage with change to shape it in the right direction.

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1. Traditional translation from Heraclitus, 535–475 BCE



The IASB's Exposure Draft on
Insurance Contracts explained

Turning the corner



**Will the anticipated reform of insurance contract
accounting bring greater clarity and consistency,
or increased uncertainty?**

The International Accounting Standards Board's Exposure Draft ED/2010/08 Insurance Contracts ('the ED'), published in July 2010, proposes a new standard for accounting for insurance contracts. If implemented in their current form, the Board's proposals would have a major impact on financial reporting for insurers. The associated changes in accounting policies and practices would be likely to have a significant effect on the assessment and perception of insurers' financial performance between one company and another, and between the insurance sector as a whole and other sectors. In addition, they may carry substantial implications for product design, data requirements, systems, controls, financial reporting and tax.



Frank Ellenbürger



Gary Reader

The IASB's proposals represent the latest stage in a process of debate and reform of insurance accounting which has continued for many years. The Financial Accounting Standards Board (the FASB) joined the project in 2008. The two Boards reached broadly similar conclusions in many areas, but placed different emphasis on certain areas, especially in respect of some key aspects of the measurement model.

In a special issue

In a special issue of IFRS – Insurance Newsletter,¹ KPMG firms' insurance specialists analyze a number of the emerging implications of the Exposure Draft as shared with them by insurers and other commentators. Here we summarize some of the principal changes being considered.

Recognition

Historically, under most major GAAP accounting frameworks, recognition of the revenues and expenses associated with an insurance contract begins when coverage under the contract starts, unless the contract is onerous. Under the new proposals, an insurer would recognize an insurance contract liability or an insurance contract asset as soon as the company becomes a party to the insurance contract, or possibly even earlier, when a binding offer is made, depending on how the ED is to be interpreted. Many insurers are modeling the impact of the proposals to determine the scale of the possible effect. If it turns out to be material they may require significant systems changes or enhancements, which are likely to be both time consuming and costly. Conversely, if the impact for many insurers proves to be immaterial, the justification for the Boards' proposals may be undermined.

Unbundling

Many contracts entered into by insurers embrace aspects of additional products and services in a bundle of rights and obligations, such as a deposit component or various ancillary commitments. The ED measurement model proposes that

these features should be *unbundled* from the core insurance business and accounted for separately to the extent that they are not closely related to the insurance coverage. Many insurers find the guidance on which components should be unbundled unclear. Insurers may not be able to perform unbundling consistently without expanded principles or additional application guidance. Without more guidance it may be difficult to determine which services are 'closely related' to the insurance component and which are not.

Presentation

The proposals on presentation in the ED represent a fundamental change in the architecture of financial statements for insurers. The Exposure Draft proposes that the combination of rights and obligations arising from an insurance contract would be presented as a single insurance contract asset or liability, with each portfolio of insurance contracts presented as a single net item within the captions for insurance contract assets or insurance contract liabilities. In addition, the ED will require a summarized presentation model for reporting income and expense arising from insurance contracts based on margins consistent with the new measurement model, except where the modified approach is adopted for some short-duration contracts.

The presentation proposals will involve significant changes to KPIs and performance metrics. Even where familiar metrics are used in the modified approach required for certain short-duration contracts, these may not be consistent with previous reporting bases. These are issues which insurers are exploring identifying the key drivers of their results on the proposed new bases, how results might be explained to users of the financial statements and testing the extent to which traditional metrics can be married to the ED's proposed approach.

Disclosure

IFRS 4 already contains extensive disclosure requirements for insurers. They are consequently concerned that

the proposals in the ED represent a significant increase in the degree of granularity of disclosures. Substantial extra costs may be imposed for gathering additional information and have a corresponding impact on systems expenditure. In addition, the commercial sensitivity of some of the information required to be disclosed is a potential issue and some insurers have concerns as to whether the volume of data can be generated in the short reporting periods in some jurisdictions.

Volatility

The yield on an insurer's invested assets includes a spread for credit risk and therefore can be substantially higher than a risk-free rate. The discount rate proposed for insurance liabilities does not include an adjustment for credit risk, rather it includes an adjustment for illiquidity and, therefore, some insurers are concerned that this may create losses at inception and subsequent volatility in profit and loss. In addition, changes in circumstances (including discount rate) that result in a change to the present value of future cash flows will have to be reflected in measurement immediately and recognized in the profit and loss account. Insurance liabilities could become highly volatile as a consequence of changes in discount rates. This may result in distorted perceptions of the insurance sector relative to other sectors such as banking.

Underlying these concerns is a tension between the desire for transparency as to the short-term impact of changes in current expectations in profit and loss, and the very long-term nature of many insurance contracts. The business model of many insurers poses particular challenges to efforts to make financial reporting both realistic and informative. The drive towards greater use of fair values and other measurements that reflect up-to-date market variables to reflect current reality is understandable. However, it needs to avoid short-term volatility that does not reflect the long-term nature of many insurance contracts.



Transition

In considering the transition process to the new regime, the Exposure Draft proposes to derecognize all insurance contract assets and liabilities recognized in the pre-transition balance sheet, and to recognize contract assets and liabilities measured under the new standard, but with no residual margin at the date of transition. However, this simplification of the transition rules results in an unintended consequence, particularly for life insurance – embedded profits would be recognized in equity at the transition date, therefore depressing future earnings from profitable contracts in force at the date of transition. Some insurers would like the option of full retrospective application. And some have been investigating whether the use of current prices and cost estimates for contracts that are still open to new business at the date of transition would be a sensible way to avoid delving back into the mists of time.

Conclusion

Many agree with the IASB that significant improvements to accounting for insurance contracts are long overdue. The revisions to insurance accounting eventually agreed will undoubtedly have a major impact on how the industry measures and presents its performance and results. In turn, the associated changes in accounting policies and practices are likely to have a significant effect on the assessment and perception of insurers' financial performance, both as between one insurer and another and between the insurance sector as a whole and other sectors. It is important that the financial reporting changes and impacts are well understood by preparers, users and all other constituents. Everyone connected with the insurance industry should be following the debate as the IASB and FASB work to resolve the comments that they have received.

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1. IFRS – Insurance Newsletter Issue 10, KPMG International, November 2010

For the investment management industry, the world has changed. The 'new normal' is far tougher than ever before: revenues have plummeted, costs have remained sticky, the industry is more competitive than ever and there is an increasing differentiation between winners and losers. **Martin Blake** reviews the some of the key trends, issues and challenges in the investment management industry.



Martin Blake

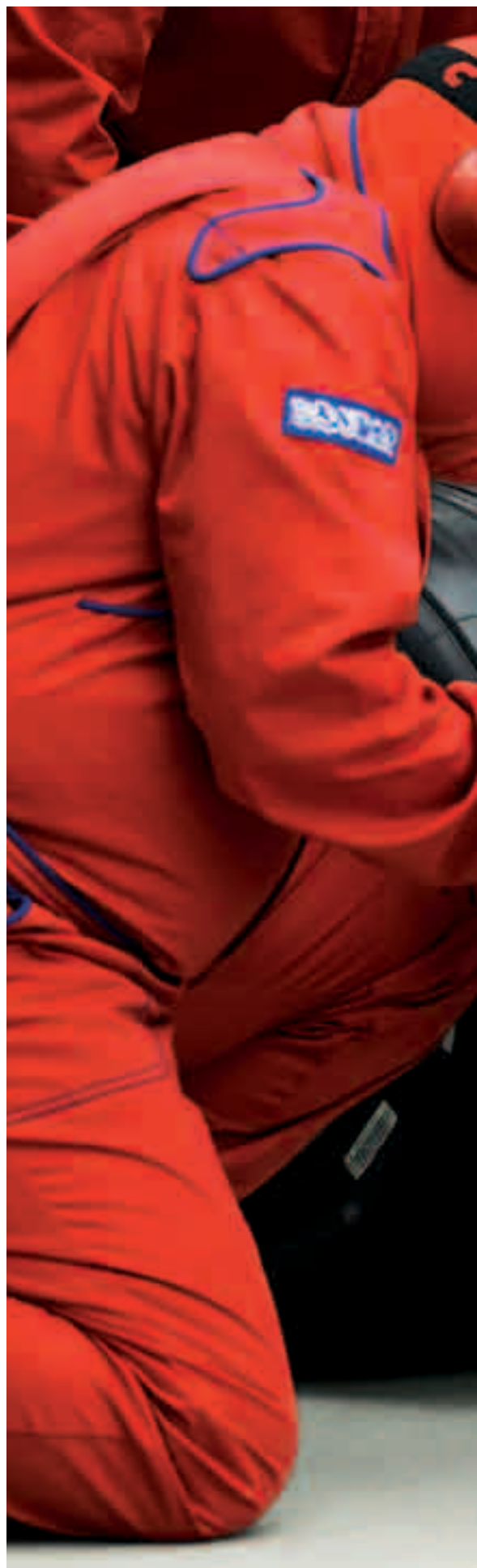
Formula for success

Examining key issues, trends and challenges facing the investment management industry

When the global economic crisis ripped through the Financial Services sector in the USA, Europe and beyond, one of the first casualties was client trust. Retail investors began to question whether distributors and asset managers were acting in their clients' best interest or their own; while institutional investors suddenly saw the vulnerabilities in their own asset allocation and control processes. At the same time, the majority of active fund managers have underperformed market index – meaning many retail and institutional investors are paying fees for disappointing performance.

In a body blow for investment management global net revenues shrank significantly. Attempts to cut operating costs failed to achieve the necessary savings and the result has been a significant deterioration in the underlying economics of the industry. 2009 may have been a year of recovery for global assets under management, but even the most optimistic scenarios predict it will take until 2012 or longer for the asset management industry to return to the profitability levels of 2008.

For the banks and insurance companies that have been the asset managers' typical corporate parents, these are especially difficult times. They are looking for reliable profits at low risk. But capital requirements are





now increasing, the profits from asset management are becoming more volatile and risks – both investment risk and reputational risk – are rising. As a result, these corporate parents are questioning the strategic fit of asset management within their portfolio; and some of them are divesting their asset management businesses – examples include the sale of Barclays Global Investors to Black Rock and Axa's attempts to sell its asset manager Axa Asia Pacific Holdings.

5 key drivers

As investment management goes through these uncertain times, five key drivers are likely to determine the final shape of the industry.

1. The economy

The economies of the West face huge challenges. A range of issues – from austerity measures aimed at bringing down sovereign debt, to high levels of unemployment, especially among the young – are putting a strain on social cohesion. At the same time, the once inexorable growth in personal prosperity from generation to generation is now under threat.

2. Regulation

Given the current climate of client distrust, regulation is becoming far more than just a cost; it is helping to shape the industry. For example, in the UK, the Retail Distribution Review aims to encourage fee-based advisory models and impose more rigorous professional and disclosure guidelines on advisory services. The effect is likely to be a significant consolidation of distributors, which will place even more power in the hands of those who remain. More broadly, tighter regulation will increase the costs of running and distributing funds and consequently reinforce the shift in new fund offerings from active

to passive (see below). In addition, some fund managers may change jurisdiction in pursuit of a more 'friendly' regulator and tax jurisdiction – three major hedge fund managers have recently moved their operations from London to Geneva.

3. A continued transfer of power from asset managers to distributors

Demographics and increasing individual ownership of pension provision is creating a wall of money from retail investors that can only be accessed if asset managers and their distributors work closely together. As end-client relationships become more important, however, power moves from the asset manager to the distributor, who can often decide what kinds of products they will put before their clients and even dictate conditions to fund managers. Increasingly, an asset manager's success is being determined by the performance of their distributors.

4. The rise of passive asset management

Passive and Exchange Traded Fund (ETF) products are growing rapidly worldwide. Asset managers that have large stakes in active management and fail to consistently deliver a significantly higher risk-adjusted return than the index (alpha) could come under severe pressure. But it is not too late to take action, and more and more players have been announcing ETF launches.

5. Competition

The fierce competition for retail and institutional inflows, coupled with rising costs and increased transparency, is widening the gap between winners and losers. At the same time, the asset management industry is becoming increasingly international as the large global players absorb struggling local firms in order to widen their client base.

What next?

The situation is fluid, but a commonly held view within the industry is that asset managers will look to Asia for new clients and investment opportunities. However, this shift will happen in small steps, not one giant leap. This will partly be attributed to legal, cultural and economic barriers, as well as the global economic rebalancing that has begun, which has the East saving less (although Asia's saving rates are still very high compared to US and Western Europe) and consuming more, while the West is saving more and spending less. Investment culture will take root in Asia, but not so fast as to create a honey pot any time soon.

At the same time, the increased focus from institutional clients and fund distributors on due diligence and understanding operational risk means asset managers now have to combine a rigorous risk management approach with a flexible business model that enables them to cope with upturns and downturns. In particular, they need to identify and focus on their core business, identifying what they are good at – from asset classes to aspects of client service – and what they can outsource. Where the aim was once cost control, the focus now is on operational excellence and business resilience.

Simplification is also high on the business model agenda. In the boom years business models became more complex as asset houses ventured into new client segments, geographies and sales channels. With the proliferation of job titles, rules and procedures, diseconomies of scale emerged and in response, asset houses have embarked on two distinct tracks: multi-boutiques and virtual managers. Looking forward, multi-boutiques are likely to be the dominant operating model for medium and large asset managers due to the fact that asset management is a people business, where size creates remoteness, remoteness creates detachment, which in turn, can undermine alignment of interests.



... the industry desperately needs to rebuild trust and confidence, which means giving customers what they really want...

Indeed, there is a clear consensus that alignment of interests between fund manager and client will be at the center of the winning business model. In this context, the recent explosion in the use of social media takes on added significance. Social media offer an important way to engage with clients and understand their individual wants and needs. But the all-pervasive nature of this form of communication also means global reputation damage can occur overnight. Looking to the future, asset managers ignore social media at their peril.

Giving customers what they want

The long-term nature of the investment industry means it is slow to change, and change tends to only take place one funeral at a time.

But the industry desperately needs to rebuild trust and confidence, which means giving customers what they really want – unbiased advice, convenience and service excellence –

and eliminating the disconnection between fund managers and their clients. Improved levels of communication, education and a return to investment fundamentals will be vital. The firms who eventually win out will be those that know each of their clients individually, understand their needs – and can deliver them.

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Are you ready?

Are financial services ready for the mobile era?

The most recent edition of a recurring KPMG global survey – Consumers and Convergence IV, released in July 2010 has found customers are increasingly comfortable using mobile technologies for banking and payments. **Mitch Siegel**, **Chris Hadorn** and **Claire Berkey** discuss the survey results and explore the implications for financial institutions.



Mitch Siegel



Chris Hadorn



Claire Berkey

According to KPMG’s 2010 global Consumers and Convergence survey¹, millions of consumers across the globe have been increasingly integrating mobile technology into their busy lives despite continuing concerns over privacy and security. In the 2010 survey, 28 percent of consumers indicated they had used an online retailer’s site from their mobile phone – nearly three times as many as in 2008 (10 percent). Asia Pacific (ASPAC) is a regional leader, with 41 percent in 2010 saying they had used their mobile device for online retail transactions.

Similarly in 2010, 34 percent of consumers said they were comfortable using a mobile device to handle their online banking and financial transactions, compared to only 14 percent in 2008. More importantly, nearly half (46 percent) of the consumers in the survey said they had used their mobile device for banking purposes – only 19 percent did so in 2008. Almost a third (30 percent) of consumers said they conducted personal banking from their mobile phone at least once a month, triple the 10 percent that did so in our previous survey.

As we have previously identified², ASPAC again led the way, with

KPMG’s Global Consumers and Convergence survey

10% in 2008

28% in 2010

41% in 2010 (ASPAC)

of consumers indicated they had used an online retailer’s site from their mobile phone

14% in 2008

34% in 2010

of consumers said they were comfortable using a mobile phone to handle their online banking and financial transactions

19% in 2008

46% in 2010

of the consumers in the survey said they had used their mobile device for banking purposes

10% in 2008

30% in 2010

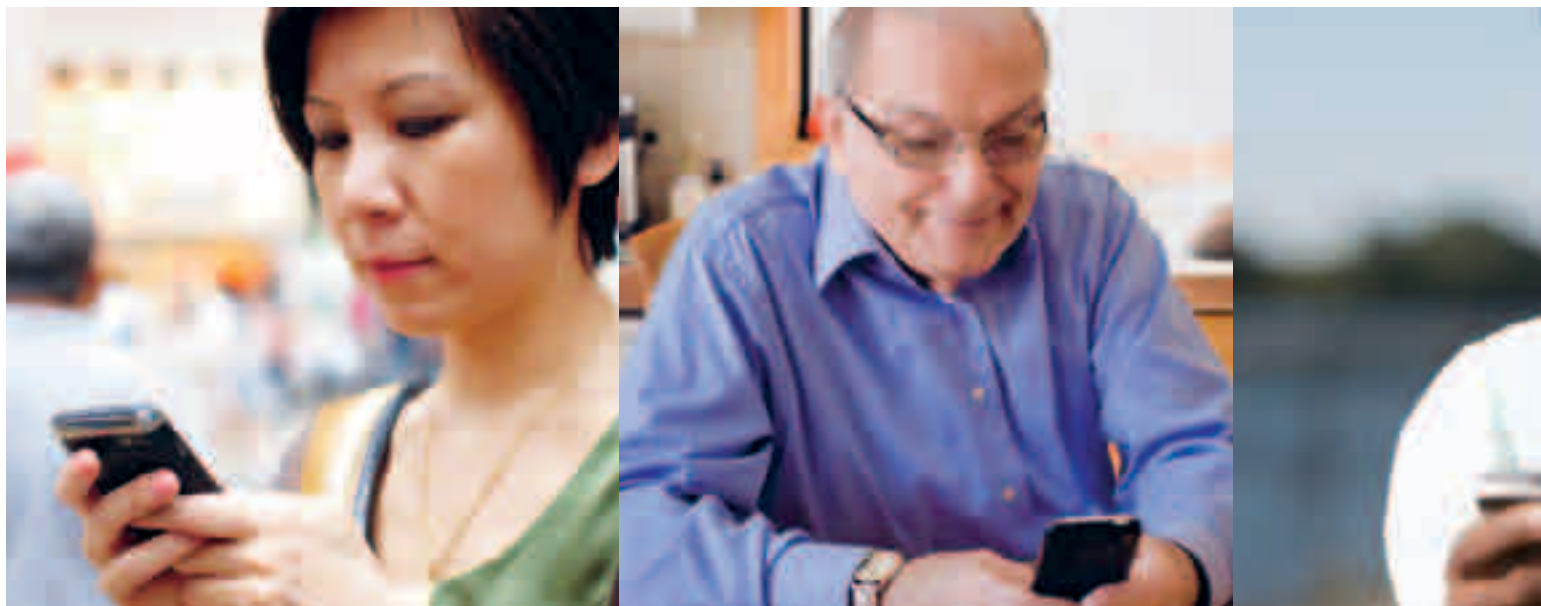
44% in 2010 in ASPAC

26% in 2010 in CEE

15% in 2010 in EMA

13% in 2010 in Americas

of consumers said they conducted personal banking from their mobile phone at least once a month



44 percent saying they make mobile banking transactions at least once a month. That compares to 26 percent in Central & Eastern Europe (CEE), 15 percent in Europe, Middle East & Africa (EMA) and 13 percent in the Americas.

Emerging Channels

Mobile financial services are still in their infancy and there are numerous challenges that lie ahead – not the least of which is the need to develop a business model of cross-industry cooperation between banks, mobile network operators and other stakeholders that delivers a fair balance of risk and reward for all parties. But already five clear trends are emerging:

- Top retailers are beginning to establish a foothold in the mobile payments marketplace.
- Consumer adoption of Smartphone applications is growing, creating a new customer channel for financial institutions.
- The popularity of mobile devices for person-to-person (P2P) payments – such as Amazon Payments, Obopay and PayPal Mobile – is increasing.
- Acceptance of contactless payments is growing. Contactless payments use Near Field Communication (NFC)

technology, which employs an embedded computer chip and radio frequency antennas to send payment details wirelessly to the credit or debit card network. Most current applications use a card, key fob, or sticker to case the NFC chip. NFC-enabled phones are currently available but not yet widely used and opportunities exist for further development and more widespread adoption. The ultimate goal remains the 'mobile wallet', where an individual's credit and debit card information are stored securely on a mobile device with both remote and contactless payment capabilities. Again, some mobile wallet technologies already exist, but they are not yet widely used.

- Partnerships between stakeholders across the mobile financial value chain are forming. For example, Barclaycard, Orange Mobile, and MasterCard have teamed up to develop a mobile solution offering point-of-sale contactless payment plus P2P funds transfers, mobile ticketing, and loyalty programs, while Sprint and PayPal have created a mobile application that can be downloaded to conduct banking activities and make P2P transfers.

The sums involved are significant – according to a 2010 report by IE Market Research Corp, the combined global market for all mobile payments is expected to exceed US\$1 trillion by 2014, with over one billion users estimated in that year.³ Of this, mobile P2P money transfers are expected to be one of the fastest growing mobile payments products, with Asia, Africa and Latin America driving adoption.

... the combined global market for all mobile payments is expected to exceed US\$1 trillion by 2014, with over one billion users estimated in that year.

The time to act is now

Financial institutions, in particular, may stand to benefit significantly from increased acceptance of mobile technologies. For example, mobile remote deposit capture⁴ coupled with other mobile banking services could significantly reduce the need for customers to visit branches, enabling more flexible branch network strategies and minimizing costs.



Nor are the opportunities limited to process efficiencies. Emerging marketing functionalities include the ability for customers to track and redeem credit card reward points via mobile, and direct-to-mobile marketing. Mobile technologies also provide an opportunity for banks to extend their reach to the previously 'unbankable' and to those who engage in micropayments or micro-loans – providing a potential additional source of income. Overall, mobile technologies of themselves can become a valuable differentiator to help financial institutions attract and retain certain customers.

These are some of the reasons why providing mobile banking services has become a table stake among major financial institutions. As a result, most banks now offer four primary mobile services – account inquiry, transfers, ATM/branch locators and bill paying – while emerging service functionalities include mobile remote deposit capture and P2P payments.

However, as with most emerging products, financial institutions must be willing to adapt and innovate quickly – to keep pace with both the competition and rapidly evolving customer expectations. For example, since mobile P2P payments are

expected to continue to grow in popularity, financial institutions that have remittance solutions should consider investing in this technology to compete with non-traditional players such as PayPal and Obopay, who have taken an early lead.

Above all, banks that want to win in the mobile space will need to understand and adopt the right technology as part of their overall business model. This suggests partnerships with technology vendors will be vital to continually develop both enhanced mobile banking applications and user features that differentiate from the competition.

While more consumers are increasingly comfortable using their mobile phones for banking or retail purchases, the majority still are not. Financial institutions may be able to influence customer behavior and reach these customers by making mobile phones a leading channel of communications to the individual customer and improving mobile banking training at the retail level to enhance the customer experience. Non-traditional partnerships with the mobile applications of social networks can also help financial institutions develop their brands with the key target segment.

With the speed of Smartphone innovation, increasing consumer demand, aggressive non-traditional competition and significant potential cost savings, leading financial institutions will need to act quickly to develop a roadmap that defines how this new operating model will be delivered in order to position their mobile offering and realize the potential benefits.

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1. *Consumers and Convergence IV*, KPMG International 2010.
2. *frontiers in finance*, March 2008, page 32.
3. 3Q. 2010 Global Mobile Payment Market Forecast, 2010–2014, www.iemarketresearch.com, July 19, 2010
4. Refers to the process of electronically capturing check images and data, transmitting that information for deposit and clearing, and truncating the original paper checks.

Banks in a number of countries around the world face conversion to IFRS accounting over the next few years. For those who have already converted, there are significant new changes including new standards on financial instruments, insurance and leasing. The challenges are significant, but so are the opportunities – and, as **Colin Martin** explains, valuable lessons have been learned from the European experience in 2005 that should make the process easier and ultimately more rewarding.

A golden opportunity

IFRS conversion: an opportunity for banks to streamline and simplify?



Colin Martin

With IFRS conversions imminent for Canada, India and Mexico and the US set to announce in 2011 whether and how to incorporate IFRS into the US financial system, many banks face a challenging period – especially in light of continuing regulatory reform, such as Basel III, and the fact that many of the accounting areas subject to the most significant change directly affect their businesses. As if that was not enough, the G20 commitment to develop a single global set of accounting standards means IFRS is itself currently subject to review and amendment in critical areas such as financial instruments and consolidation.

Conducting a conversion to accounting standards that are themselves in a state of flux may seem daunting. But

substantial experience with such projects has already been gained – not least from the European conversions in 2005 – that has helped to clarify the most effective approach and highlighted those issues most likely to prove challenging.¹

IFRS implementation projects, whether arising as a result of conversion or changes to existing GAAP, have some consistent themes and milestones. But a key to success is for each bank to tailor the implementation process specifically to its own issues, management style, structure, stakeholders and corporate governance.

One of the key areas to tackle first is the impact of new requirements on the bank's accounting and reporting. This involves an in-depth gap analysis of the differences between existing GAAP and IFRS, from which will flow

A major effect of implementing IFRS will be the increased effort required throughout the banking organization to capture, analyze and report new data to comply with the new IFRS requirements.

all the project requirements around which any organizational change should be managed. Because of the pace of change in international accounting standards, this impact analysis should be a living document. The evolution of IFRS has to be continually tracked, the implications of any new changes assessed and appropriate plans made for implementation.

The accuracy and completeness of this gap analysis is critical to a successful implementation; and while some issues are common across industry segments, our firms' experience does show that banks will face a number of specific high-level accounting and reporting issues. A Top 10 is listed in the panel – nine of them are also relevant for existing reporters as they are subject to new standards either recently or expected in the next 12 months according to the IASBs workplan – but as with any new rule change, the devil is in the detail. Banks need to focus in particular on those issues that may:

- Result in significant accounting policy decisions that affect future results. For example, deciding whether to account for certain financial instruments at amortized cost or fair value, or whether to apply hedge accounting.
- Require significant time and cost to evaluate and implement. For example, reviewing Special Purpose Entities to decide whether they should be consolidated, or determining whether contracts meet the definition of an insurance contract.

- Have significant impact on information systems and processes. For example, calculating effective yield or impairment of financial instruments, or collecting data for the additional disclosures relating to financial instruments.

A second key area is systems and processes. A major effect of implementing IFRS will be the increased effort required throughout the banking organization to capture, analyze and report new data to comply with the new IFRS requirements. Once the accounting gaps have been identified, their effect on internal processes, information systems and internal controls has to be determined and decisions taken on which systems and processes will need to change and new specifications set. Making these strategic and tactical decisions relating to information systems and supporting processes early in the conversion project, helps limit unnecessary costs and risks arising from possible duplication of effort or changes in approach at a later stage. Also, the more new accounting and reporting processes are automated, the less they will disrupt day-to-day operations. Temporary workarounds introduced at the time of conversion to IFRS can be labor-intensive and often remain in existence years after the conversion project is finished, adding real long-term cost and operational risk to an organization. In our firms' experience, many organizations did not grasp the



opportunity in 2005 to streamline processes and systems – leading to significant and costly post implementation projects to address shortcuts and residual control, system and data issues left over from the project.

A third key area is people. People are always at the heart of any change project and IFRS conversions or new standard implementations are no exception. From an accounts payable clerk coding invoices differently under IFRS, to Audit Committee approval of the internal controls over IFRS reporting, there is a broad spectrum of people and process related issues – all of which require clear identification of the changes that are needed under the IFRS reporting regime. Timely and effective knowledge transfer is an essential part of a successful and efficient IFRS project. Not least, the preparation of a bank's first financial statements under IFRS requires IFRS knowledge to have been successfully transferred to the financial reporting team. The scale of the training effort should not be underestimated.

A fourth key area relates to the wider business operations of the bank. A bank's staff is not the only stakeholder affected by change. For example, external stakeholders include the tax authorities, regulators, industry analysts and the financial media. Internally, Audit Committees and Board members need to be fully engaged. One of the challenges of IFRS implementation stems from the number of stakeholders that have a vested interest in the financial performance of the organization. Any project will have to engage with a large number of internal and external stakeholders – including investors –, to explain that, while the 'scoreboard' of the financial statements gives a different result under IFRS or a new standard, the operational performance stays the same.

Drawing on experience

The challenges are great and the volume of change significant. But the good news for banks facing imminent conversion or a raft of new material to implement is that this is well-trodden ground. Considerable experience exists and lessons have been learned from the European conversions of 2005.

Above all, implementation is not just about compliance. On the plus side, IFRS may offer more global transparency and easier access to foreign capital markets and investments that may help facilitate cross-border acquisitions, ventures, and spin-offs. Over and above that, the process of IFRS implementation is a golden opportunity to analyze the finance function in detail, to correct systemic issues and to simplify and streamline processes and controls.

The result can be a reduction in the long-term costs of reporting and the creation of a more flexible operation

that can cope with the continuing high speed of accounting standard evolution. When formulating and implementing conversion strategy and goals, it is important these benefits are borne continually in mind.

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1. See: Impact of IFRS: Banking, KPMG, 2010

IFRS conversion: Top 10 issues for banks

1. Financial instruments – classification, measurement, recognition and derecognition*
2. Financial instruments – impairment*
3. Hedge accounting*
4. Consolidation of Special Purpose Entities (SPEs)*
5. Definition of debt versus equity*
6. Presentation of financial statements and disclosures of financial instruments*
7. Leases*
8. Insurance contracts*
9. Post Retirement benefits*
10. IFRS 1 – first-time adoption

* New IFRS Standard either recently issued or due within 12 months

Information overload

The paradox of better business reporting



Corporate reporting faces serious challenges, especially in the financial services sector. Disclosure requirements and best practice have always evolved in response to developing regulation and accounting standards. What is especially disruptive at the moment is that accounting standards and regulation in financial services are changing radically in response to the financial crisis. More and more weight is being loaded onto corporate reporting, but there is a risk that the benefits of progress may be swamped under a mass of detail. **Gary Reader, Manfred Hannich and Karl Braun** support calls for a renewed focus on the needs of one particular stakeholder – the user.



Gary Reader



Manfred Hannich



Karl Braun

In 2009, the annual investor presentation of a major international bank contained 63 slides. Its annual report contained 166 pages, while its 20-F submission ran to a colossal 645 pages of closely-spaced type. All of the material contained in these documents was not only required by regulation and best practice, it was all relevant and valuable in its own right. But many in the profession are questioning whether the scale of reporting and disclosure risks overwhelming its intended audience(s) and becoming counter-productive. The amount and complexity of reporting now required may be exceeding the capability of shareholders, regulators and informed analysts to absorb and understand it. Are we missing something? Many think something needs to be done.

Over recent decades, more and more requirements have been bolted onto the annual report and accounts of listed financial services companies. The first wave of change came in response to a heightened focus on corporate governance. Following a series of notorious corporate scandals, voluntary and statutory codes were tightened progressively, and reporting

requirements followed suit. A further wave of change resulted from the growing emphasis on Corporate Social Responsibility. More recently, as the theoretical framework for socially responsible corporate management has developed, this has developed into a framework for business sustainability in the broadest sense. All of these trends have led to richer, but more complex, reporting.

The amount and complexity of reporting now required may be exceeding the capability of shareholders, regulators and informed analysts to absorb and understand it.

In parallel, the move towards convergence of international accounting standards (see *frontiers in finance* Q3 2010) looks set to create further changes to the reporting process. The global financial crisis has given renewed impetus to reform, with the G20 leading the drive both for tighter regulation of the

financial services industry and for a globally integrated framework of financial accounting and reporting. Banks and insurers are facing a radically new environment where standards, regulation and reporting are all in flux at the same time. How can improved corporate reporting emerge from this uncertainty?

The issue is less one of compliance, although conforming to a host of new requirements will certainly pose challenges. It is more a matter of making business reporting more fit for purpose. This requires maintaining a focus on the needs of the end-user(s) of corporate reports as well as ensuring that reporting satisfies all the formal requirements placed on it. Shareholders, analysts, industry professionals and members of the public all bring somewhat different perspectives to their reading of reports. But they all need a clear and simple presentation of all salient performance information, in a manner which aids comprehension and facilitates inter-company comparison.

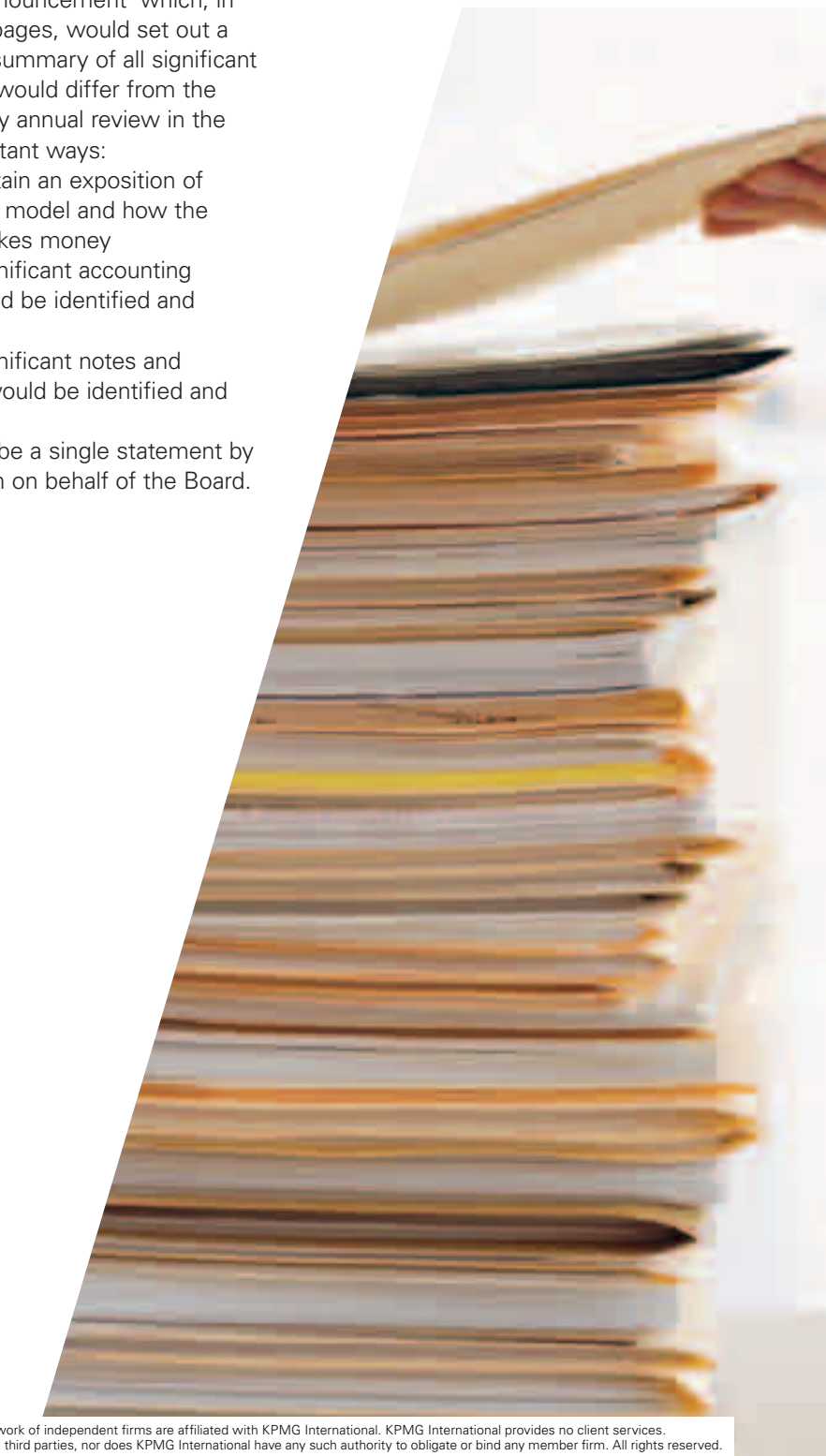
Many in the financial services industry are now focusing on these key issues of reducing complexity in corporate reporting and enhancing its value. Both the Securities and Exchange Commission in the USA and the Financial Reporting Council in the UK have started a dialogue with the industry to stimulate reform. The Treasury Select Committee of the UK Parliament recently argued that the global financial crisis exposed how the complexity and length of financial reports failed to improve users' understanding of the financial health of companies. Both the International

Accounting Standards Board and the Financial Accounting Standards Board are working to reduce the complexity of financial reporting and improve the usefulness of the information provided in financial statements to help users' decision-making.

The Institute of Chartered Accountants of Scotland recently published proposals, including a detailed sample pro-forma, for a new 'Short Form Annual Report and Results Announcement' which, in fewer than 30 pages, would set out a self-contained summary of all significant information.¹ It would differ from the typical summary annual review in the following important ways:

- it would contain an exposition of the business model and how the business makes money
- the most significant accounting policies would be identified and summarized
- the most significant notes and judgments would be identified and summarized
- there would be a single statement by the Chairman on behalf of the Board.

It is more a matter of making business reporting more fit for purpose.



The IIRC's remit is to create a globally accepted framework for accounting for sustainability: "a framework which brings together financial, environmental, social and governance information in a clear, concise, consistent and comparable format".

We believe proposals such as these ought to stimulate serious debate.

Pressure to build more requirements into business reporting will continue. Even greater focus on corporate responsibility and sustainability is highly likely. In August 2010, the Prince of Wales's Accounting for Sustainability Project (A4S) and the Global Reporting Initiative (GRI) announced the formation of an International Integrated Reporting Committee (IIRC). The IIRC's remit is to create a globally accepted framework for accounting for sustainability: "a framework which brings together financial, environmental, social and governance information in a clear, concise, consistent and comparable format". Its intention is to help with the development of more comprehensive and comprehensible information about an organization's total performance, prospective as well as retrospective, to meet the needs of the emerging, more sustainable, global economic model.

Such issues are absolutely relevant to the share price and although they are not – yet – specified in as much detail as IFRS, companies will, in time, need to report these with the same degree of trustworthiness and auditability. In future, it will become equally important to have reliable information on both financial and non-financial aspects of a company's performance.

Just as significant, the internal systems and processes for producing corporate reports and the data underlying them need to be clear, consistent and stable. Too much of the increase in reporting requirements is currently being satisfied by ad-hoc

processes which may produce misleading results with adverse consequences. Reducing complexity entails smarter reporting.

The potential benefits of a global accounting framework are significant, but the benefits will not be fully realized unless we continue to enhance financial reporting to make it even more meaningful to users. All those in the financial services community should be considering how best they can contribute to the debate.

Numbers taken from the balance sheet aren't always appropriate for decision-making. Although the underlying financial products and transactions might be complex, adding vast disclosures of the same complexity won't necessarily add real value. Efforts undertaken by the standard setters to make financial information more relevant and meaningful, such as looking at a Disclosure Framework, are extremely important and should be further pursued.

It's sometimes difficult to understand how companies are really performing under current financial statement presentation, and we're really starting to question how intrinsic value is measured. Going forward, pure IFRS compliance may not be enough. Users will continue to need information that can be easily understood and acted on – real insights based on forward-looking information, with more detail around strategy and its execution.

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1. Making Corporate Reports Readable: Time to cut to the chase, ICAS 2010

Delivering the projected benefits of mergers and acquisitions is notoriously difficult. Purchase price, realism of expected synergies, pre-deal planning and effectiveness of post-deal management are all critical factors. KPMG International has been studying mergers and acquisitions for over a decade. As the 2010 survey of the M&A market gets under way, **Nicholas Griffin** and **Moh Sheikh** discuss some key issues, including the significance of synergies from future revenue enhancement.

Bridging the gap

Post Merger Integration: securing value from future revenue enhancement



Nicholas Griffin



Moh Sheikh

For over a decade, KPMG International has been systematically surveying the mergers and acquisitions market, trying to understand drivers and trends and studying the factors which differentiate successful from unsuccessful deals. This period has spanned very great changes in the market for corporate transactions, from boom times through its collapse in the global financial crisis to its uncertain recovery today. The range of deals studied has included agreed transactions, hostile takeovers, rescue deals, conglomerate acquisitions and Private Equity purchases. Perhaps surprisingly, the key indicators of success have proved to be quite constant.

It is clear that making a success of a takeover is hard. In the highly-charged atmosphere of a deal, acquirers may

over-pay. In a competitive market, auction fever may drive prices higher than justified by the fundamentals. Deal structures may be over-burdened with debt. Projections of future earnings or cost-saving potential may be over-optimistic. Too many deals still result in excessive transfer of value from acquirer to vendor, at a significant cost to the acquirer's shareholders.

Four years ago, we reported that over two thirds of deals failed to enhance value, with 43 percent being value neutral.¹ But there was a wide gap in perception, with the vast majority of acquirers believing that their deal enhanced value. We suggested that companies were not prepared to make an honest assessment of the success or otherwise of their deals. One of the key factors which contributed to a successful deal was the achievement of both cost and revenue targets built





On average it took nine months for companies to feel they had control of the significant issues facing the business post-deal.

into the initial planning. There was a strong correlation between companies that enhanced value and those that met or exceeded their synergy and performance improvement targets: nearly two thirds of companies whose deal enhanced value met or exceeded their internal synergy and performance improvement target. Cost saving is not enough: where companies just focused on delivering the cost synergies they failed to capture the full value of the deal.

Early planning for the post-deal period is critical. Although the majority of acquirers start planning beforehand how to integrate the new organization, in hindsight, the majority believe they should have started sooner. The advantages of early planning cited by respondents included limiting the risk

of losing customers, bringing forward synergy delivery and avoiding a communication vacuum, where rumors and misinformation prevail. The main challenges experienced by acquirers included complex integration of two businesses, dealing with different organizational cultures and difficulty in integrating IT and reporting systems. On average it took nine months for companies to feel they had control of the significant issues facing the business post-deal. Our firms' experience is that the major benefit of starting planning early is that it enables the buyer to make an informed view on prioritizing those initiatives that will be most critical to protecting and enhancing value, managing and mitigating risk and accelerating momentum.

In 2008, we reported that the challenge of delivering the full projected value of a transaction after the deal had closed had become greater.² With much greater professionalism being introduced to the M&A market in recent years; KPMG firms expected to find that the professional buyer was now matched by a professional seller and that a 'perfect' market was forming. This would mean that the buyer would pay over a proportion of the upside while retaining the potential for further value realization. In fact, we found that acquirers were finding it more challenging to deliver the full value post-deal. With higher purchase prices and more of the future synergies being paid over, post-deal integration was becoming much harder: the proportion of deals that had reduced value had grown from 26 percent to 39 percent in the two years since the previous survey.

Despite our earlier findings about the importance of cost and revenue synergies, cost reduction continued to be the prime focus of both valuations and post-deal integration. On average, corporates included 44 percent of their cost synergy targets in the purchase price. Consequently, acquirers had to deliver nearly half the potential upside just to break even. We found this focus on cost synergies incongruous, since the main strategic objectives driving deals were market and geographic growth. If it was all about growth, then why were revenue synergies absent in many corporate valuations?

At least part of the answer was, and remains, market perception. Markets tend to discount revenue synergies; consequently it is market practice for corporates to quantify only the cost reduction element. Revenue synergies are seen as challenging, with areas such as cross-selling notoriously difficult to deliver. So corporates prioritize cost synergies at the expense of revenue synergies. That corporates do not put more effort into identifying and delivering revenue synergies is interesting because although investors may attach a higher confidence factor

to capturing cost synergies, they tend to be more excited about revenue synergies and attach a higher value premium. We suggested that if better information on revenue synergies were available, the market could form a fuller view of the strategic rationale and therefore improve valuations.

This year's survey is attempting to explore this issue of revenue enhancement, its role in valuation and its delivery post-acquisition. It will break down the different sources of revenue synergy being targeted in the deal, for example:

- expansion into a new sector;
- expansion into a new geography;
- cross-selling products and services;
- leverage of intellectual property and technologies; and
- growth of market share in existing markets.

We suggested that if better information on revenue synergies were available, the market could form a fuller view of the strategic rationale and therefore improve valuations.

We shall be looking more closely at the balance between cost savings and revenue growth as contributors to success: to what extent is the overall value of the deal delivered by revenue synergies and to what extent by cost synergies? Does pre-completion synergy assessment involve a detailed bottom-up process or would it be better described as a top-down high level approach? Before completion, are synergy targets signed off by all key stakeholders?

More generally, it is clear that the balance of drivers and expectations of M&A activity changes over time and according to the prevailing economic climate. We are keen to discover whether, as the market recovers after the financial crisis, companies are now

undertaking acquisitions to focus more on revenue rather than cost synergies.

Creating shareholder value from mergers and acquisitions will always remain a challenge. Effective integration and post-merger management remain critical. But strategy, planning and realistic objectives are equally important. When deal values accurately reflect potential synergies from both cost savings and revenue enhancement, and when these remain the focus of management attention after the deal, the rewards are more likely to meet or exceed expectations.

The results of the 2010 survey will be reported in the next issue of *frontiers in finance*.

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1. The Morning After: Driving for post-deal success KPMG 2006
2. All to play for: Striving for post-deal success KPMG 2008

East meets West

Prospects for the global banking sector





Stuart Robertson

One of the major strategic factors in the development of financial services in the years to come will be how the Asian economies – and China in particular – engage with Western financial institutions. As KPMG embarks on a major international survey of this topic, **Stuart Robertson** discusses some of the background issues.



A Google search for the phrase 'the Asian Century' yields nearly three quarters of a million results. The topic has its own, substantial, page on Wikipedia. Despite arguments over detail and interpretation, there is clearly a broad consensus that the center of gravity of world economic power is shifting to the East. In this scenario, developing nations such as India, Indonesia, Malaysia and – above all – China, look set to join earlier developers such as Japan and Korea to create a regional economic force which will rival the USA and Europe.

Quite how this fundamental shift in the balance of the world economy will play out over the coming decades is a matter of major debate and controversy. At present, these new Asian powers are driven by manufacturing, infrastructure development and exports. China is attracting growing levels of foreign direct investment, while increasingly pursuing its own strategic investments in regions such as Africa. But it is in the global financial sector that China's coming economic pre-eminence will be most purely felt. Just as the later decades of the 20th century were dominated by successive oil crises and the aftermath of petrodollar recycling, the coming decades will be dominated by how China and the other emerging Asian economies decide to exert their new economic and financial power – and how Western institutions respond.

... the assumption that Western banks will simply head for China and the East while the Chinese and Asian banks will look to reciprocate and Hoover up assets in the West, is likely to be proved incorrect.

Speculation around banks' growth ambitions is accelerating. However, the assumption that Western banks will simply head for China and the East while the Chinese and Asian banks will look to reciprocate and Hoover up assets in the West, is likely to be proved incorrect for some time.

Chinese banks are not showing much interest in the West except for gaining access to Western banking

expertise. Their focus is on Africa and Latin America as they chase to gain a foothold in nations where banking can be greatly developed, and strive to establish a presence in the areas which are rich in primary resources. That's not to say they won't turn their attention to Western banks in time, especially as their own banking sector becomes increasingly sophisticated and they feel more confident of being able to



It is likely that we will see a short burst of smaller deals in the latter half of 2011 as a number of 'crown jewel' operations are bought and sold by banks looking to raise capital or to transform their operational models.

leverage Western banking assets. However, it does not seem as if that moment is near, as their priorities lie elsewhere right now.

As for the Western banks heading to China and other major countries, there are no majority holdings to buy and only the major banks have granular individual country strategies in place to make a serious play of this anyway. Additionally, there is still a resistance in both the East and the West to embrace true global banking; to a certain extent as a result of protective local laws and but also linked to a pride in one's own national banks. For the time being the focus is likely to be on alliances, joint ventures, intellectual property and know-how.

Talk of major acquisition sprees is therefore somewhat misguided, especially when considering that current estimates suggest that in Europe alone as much as €139 billion¹ of capital could effectively be withdrawn from the banking sector as it comes to terms with new capital adequacy rules and also tighter liquidity requirements. Financing empire-building acquisitions suddenly looks a lot tougher.

It is likely that we will see a short burst of smaller deals in the latter half of 2011 as a number of 'crown jewel' operations are bought and sold by banks looking to raise capital or to transform their operational models. Other than that though, we look set for a prolonged quiet period within the cross-border banking M&A market. To compensate, transformation and strategy alignment, rather than

acquisition, will remain the buzzwords in the short term as banks realign their business models.

In time, one likely catalyst for M&A will be an easing of the current reticence of both Western and Asian regulators to countenance deals involving Private Equity or Chinese acquirers. Private Equity certainly appears to be taking more of an interest in the sector – but for now they must continue to bide their time and concentrate on joint ventures and on making acquisitions in the lightly-regulated areas of banking.

Something else which will change is the likely introduction of vehicles and structures to separate retail banking and investment or so-called casino banking. For sure, banks will take a serious look at how they are organized as the pressure around this continues to build. Structural change will come, but the sector will find innovative ways to meet customer demand and to flourish in the new world order.

Broader geopolitical considerations will play an increasingly important role: the growing tension over China's reticence to allow more than a gentle appreciation of its currency could be a foretaste of more acute difficulties to follow. On the other hand, we may see a benign trade-off emerging: Chinese institutions enter joint ventures with Western companies which give know-how and expertise to the Chinese and give conduits into China to Western banks. In the meantime, China uses its growing capability to

make strategic investments where it sees vital interests.

In view of the fundamental significance of how the 'Asian Century' will impact on financial services in the developed world, KPMG is launching a major international survey. We shall be exploring in depth with senior financial services professionals around the world the alternative ways in which East and West might meet in the years ahead. In a future issue of *frontiers in finance* we shall report the results of this major initiative.

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1. 'Europe's banks face harsh reality of Basel III jolt', www.reuters.com, February 2, 2010

The days of banks as faceless organizations that expect customers to come knocking at their doors are gone. Recent UK high street campaigns promoting the 'old style bank manager' – Lloyds TSB – or customer charters – NatWest – herald the banks' attempts to rebuild relationships and trust with their customers. It is clear retail banks must become more attentive and responsive to customer needs, but what does this mean in practice? **Hugh O'Reilly** and **Catherine Law** explain.

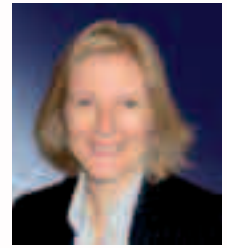
Customer in the spotlight

Practical steps for driving customer centricity in retail banks





Hugh O'Reilly



Catherine Law

The business environment for retail banking is changing fast. Following the banking crisis and global economic downturn, competition has increased significantly, as have the costs of acquiring new customers. Meanwhile, the rapid consumer uptake of 'Smartphones' and other mobile technologies is helping to create new channels for customer-bank engagement that are being exploited by non-traditional competitors.

As governments prepare more stringent regulation and new players enter the industry, it is now more important than ever that banks strengthen relationships with their existing customers. Banks not only need to listen, they also need to

be seen to respond; to consider their business from the customers' point of view and to recognize that customers want a single consistent relationship with their bank across every channel – a relationship that recognizes and rewards the value of their loyalty.

As governments prepare more stringent regulation and new players enter the industry, it is now more important than ever that banks strengthen relationships with their existing customers.



What does this mean in practice?

Systematic approaches to creating a customer-centric bank can address four key areas: Knowledge; Customer Focus; Culture; and Delivery.

Knowledge

The voice of the customer must be captured often enough and in sufficient detail to provide a stream of fresh feedback on which to base operational and strategic decisions. This means developing both a direct customer feedback loop and system-based data capture processes that are able to gather customer views of the organization in a way that can drive financial performance. Increasingly, KPMG member firms are seeing the use of customer measurement frameworks such as 'Net Promoter Score' that seek to identify the levers organizations can pull to deliver a superior customer experience and a resulting improvement in financial performance.

For many complex, multi-channel, financial services organizations a fully operational single view of the customer remains a holy grail – but increasingly banks are able to provide more relevant customer information at point of sale. This single view of the customer enables staff to see exactly how the customer wants to interact with the bank and consequently to identify the best way to deal with each of them as individuals. And when this information on individual customers is aggregated, it can be used to allow the banks to consider different tailored approaches. The key is to give the organization – particularly customer-facing staff – the necessary information to customize the service model to meet the individual's requirements.

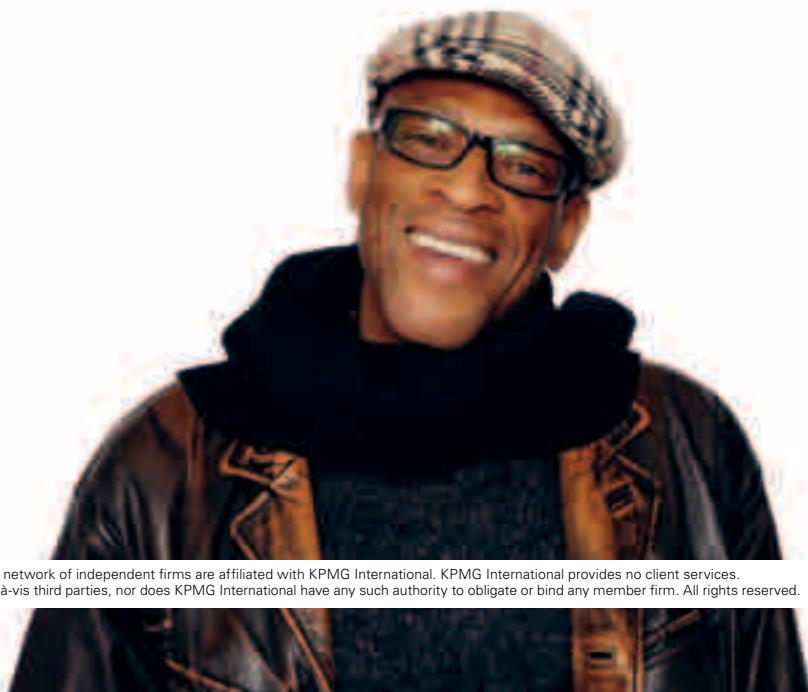
Customer focus

Armed with the voice of the customer and traditionally gathered performance data, banks can conduct the multi-dimensional segmentation that both underpins true customer focus and informs the design of an operating model aimed at meeting customer needs. Ideally, all channels should be inviting, secure and accessible to customers; and products need to be available through the channels customers want to use. From a customer perspective, multi-channel integration should be a given.

But the design of the branch network, call center, IT systems and sales processes is one thing – ensuring that staff have the time to focus on the customer and really listen and react to what they are saying is another. This involves carefully considering whether staff activity that is not customer focused is really essential to the business – and stripping out whatever is unnecessary. It also includes recognizing that staff and people are a key element to defining the customer experience. Staff training and HR policies should be at the heart of ensuring positive, empathetic attitudes in all customer-facing staff.

Staff incentive structures – and in particular referral models – should be reviewed to ensure they are driving the right behaviors. Banks also need to recognize the benefits of long-term, deep customer relationships and take steps to ensure that loyal customers feel valued and supported.

Ideally, all channels should be inviting, secure and accessible to customers; and products need to be available through the channels customers want to use.



Culture

Customer focus has to be at the core of the brand principles and lived by everyone in the organization. Behaviors are crucial; and it is just as important to be helpful and responsive to internal customers and colleagues as it is to the public.

Senior managers have to visibly lead the new customer focused culture. Publishing an explicit customer charter – as NatWest has done – that sets specific goals and targets is a sign of clear commitment and strategic intent. Customer focus also has to be embedded in day-to-day work – in the decisions that are taken, in personal behaviors, in reward and recognition strategies, in the inclusion of customer focus measures on all employee scorecards, both in back and front-office and in allocating individual responsibility and accountability for improvement actions arising from customer feedback.

Customer-facing employees have to be trained and empowered to do the right thing for customers. This embraces everything from setting appropriate levels of employee discretion – for example, to refund fees – to encouraging them to take ownership of customer issues and pursue a satisfactory resolution. For junior employees to take responsibility in this way, they must feel they have a stake in the bank's long-term success. They therefore need to understand their career development opportunities and be aware that high performance in customer focus is just as important a factor in progression as high performance in other areas, like sales.

Delivery

Long-established organizational designs built around channel and product silos make it difficult to deliver the single, seamless relationship customers want. With the visible leadership of senior management and armed with a suitable mandate, teams formed around customer segments can cut across these silos and drive change. At the same time, all new organizational system and process change initiatives should have customer focus as a top priority and internal service level agreements need to be aligned with the organization's customer charter commitments and other customer-led initiatives.

Customer focused processes lie at the heart of these changes. In particular, banks need to be clear about the customer journey and provide concise, clear communications that guide the customer through. All processes need to be addressed – especially those that relate to highly emotive 'moments of truth' events such as fraud or a death. Complaints processes are also important, since prompt and effective resolution can improve customer perceptions of the bank. Similarly, while automation is an undoubted benefit to both bank and customer, when it fails there should be people available to help clients conduct their business.

Of course, banks cannot just be reactive, relying solely on the 'voice of the customer' to generate actions for improvement. A huge amount of customer focused best practice is available from a wide range of industries – from supermarkets to online social media. This can be captured and analyzed to identify new offers or novel means of interaction which customers really value.

Establishing the baseline

Customers' trust and willingness to invest will only increase when banks and other financial organizations can demonstrate that they are listening and acting on what their customers are telling them. Certainly, there are a lot of issues to address that may appear challenging, time-consuming and expensive to fix. But with a systematic approach the task becomes less daunting. In particular, an initial review of where the bank currently stands in each of these four areas can highlight quick fixes that can make real differences to the customer experience – and to financial performance. Such a review also forms the basis for developing an efficient, effective customer focused strategy that creates real value for both customers and the banks that serve them.

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A regulatory view

Getting to grips with

SIFIs

The future for systemically important financial institutions

In the wake of the crisis, one of the most significant new acronyms to emerge is SIFI – the Systemically Important Financial Institution. Limiting the risk that such institutions pose to the global financial system is now a prime concern of many international political leaders and regulators, but as [Simon Topping](#), [Jim Low](#) and [Giles Williams](#) discuss, the task is complex and fraught with difficulty.



Simon Topping



Jim Low



Giles Williams

The financial crisis starkly exposed the vulnerability of the global financial system. Quite how close the world came to a catastrophic collapse in confidence will long be debated. But it became frighteningly clear that the scale and economic importance of modern financial institutions, and their global interconnectedness, meant that the failure of one major financial institution – such as Lehman Brothers – had the potential to trigger a cascade of similar collapses. Since the crisis, one of the prime objectives of policymakers and regulators has been to control systemic risk in the market and eliminate the possibility of a similar disaster in future through a series of proactive measures. No bank should be ‘too big to fail’.

But regulators face a dilemma. To acknowledge that a particular institution is too big to fail would be tantamount to guaranteeing that it would be bailed out and supported, whatever difficulties it encountered and however reckless it had been – a prime example of ‘moral hazard’. In practice, then, policy responses to these systemically important financial institutions (SIFIs) are being developed to ensure that the risks of failure are strictly limited; and that if failures do occur they can be managed in an orderly fashion without threatening the stability of the entire system. A parallel remedy is to prevent individual institutions from becoming ‘too big’ in the first place or, if they are judged to be so already, to intervene directly to break them up. This threat is implicitly hanging over a number of major multi-national institutions, however the general feeling of the

industry on this seems to be that measures that reduce the likelihood of failure of SIFIs, or that reduce the effects if they do fail, are possibly more palatable than breaking them up. SIFIs provide financial support and services to millions of customers – multinational corporations, business enterprises and consumers across the world – and regulation has to avoid undue damage to these institutions’ capacity to serve their customers and fulfill the classic role of intermediating between savers and borrowers, thereby contributing to economic growth.

One of the key concerns around SIFIs is that many governments cannot afford, either financially or politically, to bail out the banks again. In some countries, the SIFIs are actually larger than the GDP of the country, which gives an indication of how significant the impact of their failure or bailout could be.

In November 2009, G20 finance ministers agreed that SIFIs should be identified on the basis of three criteria recommended by the Financial Stability Board (FSB):

- **Size:** the volume of financial services provided by an institution or group.
- **Lack of substitutability:** the financial system’s relative dependence on the financial services provided by a single entity, indicating the system’s immunity to its potential disappearance.
- **Inter-connectedness:** the direct and indirect links between financial institutions that might contribute to the spread of systemic risk and its contagion to the real economy.

The FSB has since been developing policy approaches to limit the danger

posed by SIFIs. Following the G20 summit in Seoul in November, the FSB issued a press release confirming that the policy framework should include the following elements:

- Improved capacity to resolve SIFIs without disruption to the financial system and without taxpayer support.
- Additional loss absorption capacity for global SIFIs (G-SIFIs), initially, beyond the Basel II minimum standards, which could include combinations of capital surcharges, contingent capital and bail-in debt.
- Increased intensity of SIFI supervision.
- Higher robustness standards for core financial infrastructure, including central counterparties to reduce contagion risk in the OTC derivatives market.
- A mutual policy review process to promote consistent national policies.

Since the crisis, one of the prime objectives of policymakers and regulators has been to control systemic risk in the market and eliminate the possibility of a similar disaster in future through a series of proactive measures.

In addition, the FSB set out a broad policy framework for addressing SIFIs. For the first time, a clear distinction has been made between globally significant (G-SIFIs) and national SIFIs. This raises an interesting issue of the different

treatment systemically important national banks may receive versus G-SIFIs. In particular, there is a renewed focus on recovery and resolution plans for G-SIFIs, as the FSB recommended that they be made mandatory by home jurisdictions.

Concurrently, within the framework of 'Basel III', the Basel Committee is developing proposals including capital surcharges, contingent capital and bail-in debt. The aim is to decrease the probability of banks reaching the point of failure; but if they do reach that point, to ensure that there are additional resources available to manage their resolution or restructuring. The Committee is also considering what additional loss absorbency SIFIs should have, and further measures to mitigate the risks or externalities they pose, including liquidity surcharges, tighter large exposure restrictions, and enhanced supervision.

Elsewhere, the Swiss National Bank (SNB) has already proposed stringent new capital requirements on the country's two largest banks, Credit Suisse and UBS. These would comprise:

- total capital requirements amounting to some 19 percent of risk-weighted assets
- 10 percent of the risk-weighted assets to be held in the form of common equity
- 9 percent of the risk-weighted assets to be represented by contingent convertible bonds ('CoCos'), which are automatically converted into common equity when a bank's common equity ratio drops below a predefined level.

The SNB comments that these requirements are substantially more rigorous than the minimum standards of Basel III. It remains to be seen whether other regulators will adopt a similar approach. There are perhaps a number of factors that distinguish these particular institutions from most other SIFIs, which may account for their particular proposed capital treatment.

The parallel approach, directly restructuring the banking sector to eliminate the danger posed by SIFIs, is being explored in the UK, for example,

by the new Independent Commission on Banking chaired by Sir John Vickers. This will investigate how to:

- reduce systemic risk in the banking sector, exploring the risk posed by banks of different size, scale and function
- mitigate moral hazard in the banking system
- lessen the likelihood and impact of firm failure
- promote competition in both retail and investment banking while ensuring the needs of customers are addressed
- consider the extent to which large banks gain a competitive advantage from being perceived to be too big to fail.

This is widely, and perhaps too simplistically, being interpreted as an exploration of the case for breaking up the big banks, which would be seen in some quarters as just 'punishment' for having caused the crisis in the first place.

In the US, the recently enacted Dodd-Frank Welfare Reform and Consumer Protection Act establishes a Financial Stability Oversight Council ('Council') to identify, monitor and respond to systemic risk posed by large interconnected bank holding companies ('BHCs') and large non bank financial companies. The Council may make recommendations to The Federal Reserve to address systemic risk in the financial services industry. In particular, The Federal Reserve gains supervision authority for all non bank financial companies that are determined to pose a systemic risk if they were to become distressed, and is required to prescribe certain heightened prudential standards for, large, interconnected BHCs and large non bank financial companies under its supervision. These standards include: risk-based capital, leverage, liquidity, contingent capital, credit exposure, concentration limits, public disclosure, resolution plans and overall risk management.

A primary objective in all these developments has to be to eliminate the risk of regulatory arbitrage. Without a coordinated and consistent international approach, it would be possible for certain SIFIs to restructure themselves

and relocate parts of their operations to take advantage of less onerous regulation. The relationships between lead regulators and local regulators and between supra-national policy and individual national implementation will be critical in this regard. An internationally consistent framework is clearly desirable, although some account needs to be taken of local circumstances. Future financial stability depends to a considerable extent on national and global policymakers getting to grips with SIFIs.

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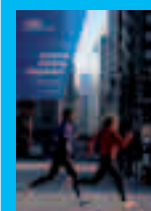
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For more insight into the direction regulation is headed in, see KPMG International's latest thought leadership on **Evolving Banking Regulation** at www.kpmg.com

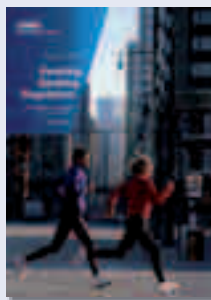
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Evolving Banking Regulation: A marathon or a sprint?, November 2010

KPMG International's regulatory specialists investigate the changing regulatory landscape for banks, the challenges and implications of new developments and the future direction regulators are likely to take. This publication focuses on some of the key changes including capital requirements, treatment of systemically important financial institutions, governance, supervision and remuneration.



Defining the Future of Swiss Private Banking, November 2010

Current regulatory developments in Switzerland are heavily influencing private banks within the Swiss financial sector. Building upon the results of last year's survey, this year's study, *Defining the Future of Swiss Private Banking*, presents a focused picture of the private banking landscape in Switzerland on the following central elements: Mergers and acquisitions, customer loyalty and advisory excellence, cross-border banking and regulatory requirements and finally, client data confidentiality.



Dodd-Frank for foreign banks, October 2010

Will the competitiveness of US banks really be undermined by Dodd-Frank? Signed into law on 21 July 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act will have implications for foreign banks with operations in the US.



Corporate Indirect Tax Survey, October 2010

KPMG International's Corporate and Indirect Tax Survey has been run every year since 1993. It now covers 114 countries. This year's survey compares corporate income tax rates as on 1 July 2010, with their equivalent each year back to 2000. The survey also includes information on Value Added Taxes or Goods and Services Taxes in 114 countries, going back six years. Tax professionals from across KPMG's global network of member firms have contributed to the survey.



Creating a new mould for banking – Evolving business models in banking, September 2010

Banks' business models are continually evolving, as they are constantly having to review and revise their strategy in light of new market conditions, new competition, changing customer expectations and the evolution of technology.



Banking & Finance in Switzerland, October 2010

The legislative and regulatory environment for Swiss banks is not merely fast-moving, it is ever more complex. Although the 6th edition of KPMG's Banking and Finance in Switzerland offers insight into many of the issues affecting the banking industry in Switzerland and also provides a comprehensive English translation of the acts, ordinances and circulars relevant for banks in the country.



Focus on transparency: Financial reporting of European banks in uncertain times, June 2010

The 4th edition of an annual survey of 15 leading European banks, finds a collective return to profitability. However, it is clear that with growing regulatory pressure, balance sheet management will remain the banks' primary focus.



KPMG Australia's General Insurance Industry Survey 2010

This publication is KPMG's 24th annual survey of the Australian general insurance market. The survey includes the financial results of general insurers that represent a significant part of the Australian market and also examines the market conditions of the last year; issues facing the industry; market outlook; share price performance of the major listed insurers and detailed analysis of the insurers' results.

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