

# the journal







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Tackling the key issues in banking and capital markets





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# Editor's comments

2

by Phil Rivett



## Phil Rivett

*Global Leader, Banking and Capital Markets*

Tel: 44 20 7212 4686

Email: phil.g.rivett@uk.pwc.com



If uncertainty is the defining characteristic of the current business environment, then risk is its shadow. Without more effective governance, risk management and internal controls, organisations cannot hope to meet regulatory expectations, withstand or avoid the corporate scandals hitting the headlines on a regular basis and, perhaps most importantly, deliver the consistent returns demanded by a wary investment community. This edition of the PricewaterhouseCoopers banking and capital markets journal explores the interrelated nature of risk and regulation and how aspects of these might be used to achieve competitive advantage for those that lead the way.

There has been much speculation in certain quarters regarding likely implementation dates for Basel II and whether delays are possible. In the meantime, many organisations are preparing for the impact of Basel and in particular how local regulators will interpret and implement its provisions. In our first article, 'Exploding some of the myths around Basel II', Chris Matten, Monika Mars and Peter Trout consider the truth in some of the expectations surrounding Basel II and what, in reality, they will actually mean for organisations.

Most banks would agree with the importance of integrating performance and risk management to help make enhanced business decisions, although few institutions have been able to fully embrace value management at all operating levels. In their article 'Bringing it all together: Leveraging Risk Adjusted Performance Measurement', Fernando de la Mora, Miles Everson and Benoit Catherine discuss how the integration of performance and risk management can help banks to drive value and revenue generation through every decision, and recommend a potential framework for achieving this.

The first Banking Banana Skins – an international survey of the risks facing banks – was published by the CSFI in 1994, and it continues to provide a thought-provoking insight into the views of industry participants, regulators and observers on the key risks facing banking institutions. This article, by David Lascelles of the CSFI and John Hitchens of PricewaterhouseCoopers, draws out some of the major themes identified by the results of this year's survey and the trends which are emerging.

The global nature of money laundering and related financial crime has rendered geographic borders increasingly irrelevant,

and a number of recent regulatory initiatives will affect the way many institutions do business. In 'Anti-money laundering – A focus on recent developments and the Asian impact', Dominic Nixon, Alan Abel and Elizabeth Goodbody look at the implications of these recent developments, and how banks and governments in Asia in particular are responding.

The PricewaterhouseCoopers/EIU 2002 global survey, 'Taming uncertainty: Risk management for the entire enterprise,' identified how leaders in the field of risk management are developing a more holistic approach that integrates financial and non-financial risks into a cohesive and comprehensive framework of monitoring and control. In 'Responsibility: can you afford not to...?', Tina Trickett and Joydeep Datta Gupta look at the developing area of corporate responsibility and the associated risks, and consider how behaving in a responsible manner is emerging as a primary influence on reputation, and the security and long term profitability of business.

I hope that you find this edition of the banking and capital markets journal interesting. Please continue to provide us with feedback, particularly on the topics you would like to see addressed in future issues.

# Exploding some of the myths around Basel II

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by Chris Matten, Monika Mars and Peter Trout



## Chris Matten

*Executive Director, Financial Risk Management, Singapore*

Tel: 65 6236 3878

Email: [chris.matten@sg.pwc.com](mailto:chris.matten@sg.pwc.com)

## Monika Mars

*Senior Manager, Global Risk Management Solutions, The Netherlands*

Tel: 31 20 568 4537

Email: [monika.mars@nl.pwc.com](mailto:monika.mars@nl.pwc.com)

## Peter Trout

*Partner, Financial Services, Australia*

Tel: 61 28 266 7620

Email: [peter.trout@au.pwc.com](mailto:peter.trout@au.pwc.com)



The Basel Committee on Banking Supervision, which sets the framework for the assessment of bank capital adequacy in the G10 countries, is nearing completion of its revised amendments to the Basel Accord of 1988. The new rules are due to come into effect by the end of 2006, although some delay is likely. The Committee's brief covers internationally active banks in the G10<sup>1</sup> countries, however in practice these rules will cover a broader spectrum. The European Union is expected to codify the rules in a directive which will cover all its member countries, including the 10 new joiners. Elsewhere outside the G10, many countries have already stated that they intend to adopt the Basel II framework. As an indicator, over 100 countries have already adopted the original Basel Accord in one form or another.

Over recent months, the volume of debate around Basel II, has been increasing, and the range of participants in the debate has also been expanding. Unfortunately, the rise in quantity has sometimes been associated with a decline in quality and the often glib invocation of the phrase 'Basel II' has led to a situation where the careful thought and analysis which this serious

topic deserves is sometimes replaced by general statements that do not necessarily hold true. This has been particularly acute in Asia, where the Basel II proposals are generally still not well understood.

In this article, we look at a few of the statements that are made so often that they run the risk of becoming clichés, and explore how much truth there really is in them.

### 'Basel II follows what leading banks are already doing in risk management'

There is certainly some truth in this statement, as the genesis of the Basel II proposals lies with the developments in risk management in the leading banks over the past decade or so. It is also true that the Basel Committee has gone to extraordinary lengths to give the private sector opportunity to comment, and to calibrate the overall results through three quantitative impact studies. It would be surprising indeed if the results did not reflect that consultative process. Unfortunately, it is the nature of compromise, particularly when it concerns vested interests in many different

countries, that the final Accord will contain a number of features which have little empirical foundation. A good example of this is the correlation factors that appear explicitly for the first time in the third consultative paper – these constants are used to calculate the risk weighted assets for different classes of assets, but look suspiciously like they have been designed to ensure that the outcome is consistent with what it was expected to be. Another is the use of a normal distribution in the calculation of risk-weighted assets, which has led many people to conclude that credit risk can be modelled accurately using this simplification. As any experienced practitioner knows, credit risk is anything but normally distributed<sup>2</sup>.

However, there are two key areas where the statement heading this section may be inaccurate. Firstly, creating a codified set of regulations that all banks should follow means that there has to be a degree of over-simplification and standardisation. In the more advanced banks some products and areas will already be or will go beyond the level of sophistication implied by Basel II, and we need to recognise that risk

<sup>1</sup> The G10 countries are: Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Sweden, United Kingdom and United States. Switzerland, Luxembourg and Spain are also members of the Basel Committee, taking the total membership to 13.

<sup>2</sup> In a normal distribution, the 99.9% confidence interval adopted by Basel II can be reached by taking about three standard deviations. In a typical commercial loan portfolio, some 5-7 standard deviations might be needed to reach the same confidence level.

## Exploding some of the myths around Basel II *continued...*

management is a developing science. For Asian banks, as in many emerging markets, this should not present too many problems at this stage, as there is still so much ‘catch up’ that needs to be done by many banks before they think about going beyond Basel II.

Secondly, since risk modelling is still a developing science, we do not have a proper understanding of the behaviour of a number of the risks that Basel II attempts to model (not to mention interest rate risk in the banking book, which was put into the ‘too hard’ basket under Pillar 1 but banks are instructed to come up with their own solutions under Pillar 2). Figure 1 gives an estimate of the readiness of the banking industry in terms of risk modelling against the standards that Basel II implies.

The Basel II proposals in the area of operational risk are the least developed and this is also an area where the industry is still the least advanced. Linking formal capital adequacy requirements to models that are broadly untried and untested has been questioned by some banks, and it is entirely possible that it encourages capital-minimisation behaviour that turns out to be misguided in the long run. This is not to imply that banks should not continue to try and develop ways of measuring and managing operational risk, it is just

**Figure 1: State of readiness of internal risk models**



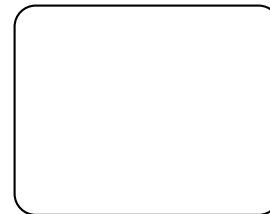
too early to link these to external capital adequacy requirements.

### ‘Basel II will bring capital management in line with risk management’

Historically, there has been a significant divergence between capital needs determined through banks’ internal risk assessments and their formal capital adequacy requirements. Basel II is intended to address this impact by providing a clearer link between the two with its greater degree of risk sensitivity which should bring about a closer

alignment between economic capital and regulatory capital.

Again, this is only true up to a point. For the vast majority of banks around the world that are likely to come under the Basel II ambit (we must remember that the 1988 Accord is now used by some 100-odd countries as the basis for capital adequacy assessment), the Basel II proposals will have the admirable effect of forcing them to upgrade their risk management procedures. However, as noted above, some of the more sophisticated banks already have risk measurement and capital allocation processes that are much more advanced than the Basel II proposals. Ironically, this is less of a problem under the existing Basel Accord. Although the Accord is further away from internal models than Basel II, the cost of compliance under the Accord is also much lower, so it is less of a problem if banks want to build more sophisticated models. Indeed, it can even be argued that it was precisely the nature of the 1988 Accord that provided the incentive to build better internal models in the first place. Given the potentially high cost of compliance with Basel II (up to tens of millions of Euros in some estimates), many banks may find it a stretch to finance further internal developments, with the added risk that Basel II may actually stifle innovation.



We should also note that while the internal risk management processes of many sophisticated G10 country banks go way beyond the requirements of Basel II, they are also faced with significant implementation and compliance issues, not least in the area of the minimum requirements for the quality and comprehensiveness of their data and in estimates of risk parameters.

A related problem is the potential moral hazard in an apparently sophisticated capital adequacy regime, as the appearance of precision in the calculations could lead board members and less well-versed supervisors to conclude that risk is being well, or better, managed. However, risk models are approximations of reality, not depictions of reality, and the less sophisticated the model, the higher the risk that the model fails to describe reality precisely.

This issue is particularly acute in many Asian and other emerging markets where bank supervisors and boards have less experience in the kind of tools required under Basel II, but there is a desire to implement Basel II in a similar timeframe to that being adopted in the G10 countries. For example, the market risk amendments of 1996, which came into force in the G10 in 1998, have only recently been adopted by other countries, yet these are far

simpler than the Basel II credit and operational risk requirements.

**‘Basel II will make the financial services system safer’**

This statement is only partly true. Yes, it will encourage less sophisticated banks to become better at risk management, but the qualifications set out under the previous heading still apply.

Another area in which Basel II (or the imposition of any fixed capital standard over time) runs a risk, is around the issue of pro-cyclicality. With a fixed capital standard such as the 1988 Accord, banks are required to hold a fixed percentage of minimum capital over the economic cycle. This is in a way perverse, as the

whole point of capital is to be able to absorb losses, and yet the minimum capital requirement implies that this only applies in extremis. Thus during the good years banks are awash with profits and capital. During a recession, there is usually a six to twelve month delay between the economic downturn and loan losses starting to impact a bank. Once this begins, banks tend to control their lending to conserve capital, at precisely the time the central banks are trying to re-invigorate demand with a monetary stimulus. Basel II goes even further than this, since capital requirements are more or less tied to credit ratings. If we assume that, in a downturn, average credit ratings across the portfolio go down, then capital requirements will go up.

**Figure 2: Illustration of downgrade of 20% of credits by one notch**

Grade	Probability of default	Before downgrade		After downgrade	
		Exposure	Risk weighted assets	Exposure	Risk weighted assets
1	0.05%	50	11	40	9
2	0.10%	50	17	50	17
3	0.25%	200	113	170	96
4	0.50%	300	240	280	224
5	1.50%	200	252	220	278
6	3.00%	150	242	160	258
7	5.00%	50	99	80	158
<b>Total</b>		<b>1,000</b>	<b>974</b>	<b>1,000</b>	<b>1,040</b>

Source: PricewaterhouseCoopers; Basel II risk-weight functions

## Exploding some of the myths around Basel II *continued...*

Thus banks will be faced with a double impact: lower capital generation, or even capital erosion as a result of higher loan losses, and at the same time a higher capital requirement. From a macro-economic point of view, a sensible approach would be to do precisely the opposite: raise capital requirements in an over-heated economy, mirroring the tightening of monetary policy, and reduce them in a recession, to inject needed liquidity and credit into the system. To illustrate this, Figure 2 takes a broadly representative corporate loan portfolio graded against the minimum 7-point credit worthiness rating scale specified by Basel II, and shows the impact of 20% of the exposures in each grade being downgraded by one notch, using an Internal Ratings Based (IRB) approach with a standard Loss Given Default (LGD) of 50% across the portfolio, and a maturity of 2.5 years. In this example, capital requirements increase by some 7%.

Opponents of this argument will point out that there are a number of factors which mitigate against this effect, such as the more sophisticated risk management behaviour of banks (the way in which big US banks appeared to ride the recent global recession without suffering would seem *prima facie* to support this), and the ability of supervisors to use the Pillar 2 route to adjust required capital levels. The unknown here is how supervisors in particular territories will interpret and

implement this, and how consistency across the industry might be achieved.

While prudential regulation is not designed as a macro-economic tool, it is clear that it has an impact on the economy as a whole. Sophisticated banks and well-versed banking supervisors will be aware of this and will need to plan and budget accordingly. Pillar 2 actually provides a mechanism for supervisors to force this adjustment, which was not explicit in the old Basel Accord, but the manner in which they intend to do this is still far from clear. In less-developed economies, the risk that the imposition of Basel II has adverse economic consequences is more severe.

Another area where Basel II could stray into the macro-economic sphere with potentially dangerous consequences is the impact on bank lending behaviour. Admittedly, this risk is greater in emerging economies, where bank lending is often the only source of funding for the many small and medium-sized enterprises which have been the backbone of the extraordinary economic growth in these countries over the past two decades. In addition, it is possible that Basel II may lead to reduced cross-border lending into emerging economies that, arguably, need it most. Experiences with Mexico and Argentina in the recent past may mitigate this to some degree, but the concerns remain.

The price of risk is constant across the credit spectrum under the old Basel Accord. Under Basel II, the implied risk premium rises as credit quality falls; and the curve is steeper under the IRB approach (which is more risk-sensitive) than under the standardised approach. The consequences are that credit spreads for more risky borrowers should rise, and those for the better quality borrowers should fall. This adjustment has already happened in most developed economies, as banks have for years been using internal credit ratings to make credit assessments and, perhaps only more recently, to drive risk-based pricing. However, in emerging economies, this is not the case and yet there is considerable pressure from regulators and external commentators for banks in these countries to adopt Basel II – and even the IRB approach – quickly, so as to inspire confidence on behalf of investors in those banks' risk management capabilities. However, a rushed implementation could lead to the swift development of a risk-based pricing curve before the system has had time to adapt, leading to a severe credit crunch. Indeed, industry participant debates in the 'tiger' economies of South East Asia have been dominated by this concern in recent months.



## So is Basel II a good thing?

On balance, the Pillar 1 proposals on credit risk are probably beneficial for the banking system as a whole, although there will be individual losers, such as those with a high concentration of low quality corporate lending (although the Basel committee has stated that it does not wish to see a reduction in the aggregate capital level of the banking system). The proposals certainly provide an opportunity for the less sophisticated banks across the world to do some much needed 'catch up'. However, this will hold true only until the industry as a whole has reached the new level outlined by Basel II. Thereafter it is possible that the high compliance cost and the appearance of sophistication might stifle further innovation across the industry. Time then for Basel III?

The Pillar 1 proposals on operational risk are more controversial, and it might be advisable to let the industry spend more time learning about this particular risk, although Pillar 2 generally makes good sense, and the individual adjustment of minimum capital requirements on a bank-by-bank basis reflects what is already happening today in many well-developed markets, such as the UK and Australia. One warning to banks on Pillar 2, though: a lot of the debate around Basel II has thus far focused on meeting the technical

requirements of Pillar 1. To be fully Basel II compliant, a bank has to meet the requirements of all three pillars as interpreted and implemented by national regulators and legislators. Some of the details of Pillar 2 may come as a shock to those banks which have not yet paid them due attention, such as the principle that banks should have a process for assessing their overall capital adequacy in relation to their risk profile. This means that banks need to be able to estimate all of their risks, not just those captured under Pillar 1, and will probably need some form of economic capital model. For example, a recent survey by PricewaterhouseCoopers<sup>3</sup> of European banks showed that only 10% of those surveyed felt that their internal economic capital models were fully developed and operational.



There is also some concern over the way in which supervisors plan to implement Pillar 2 and the skills they require to do this. A number of banks are concerned that any benefit they earn through adopting an advanced approach to measuring credit risk will be offset by an increase in Pillar 2 charges. Consistency in approach between regulators will also be needed if competitive disadvantage issues are to be avoided. More guidance is needed from supervisors to allay these fears.

The Pillar 3 proposals have probably received the least attention, and to a large extent they represent a fixed compliance cost with little business impact. Most of the data required to meet Pillar 3 disclosure requirements should be generated by the kind of risk systems that Basel II compliant banks will need to have anyway. The compliance burden has been lessened in the third set of consultative papers, by setting the disclosure requirements in terms of a list of minimum contents, moving away from the fixed tables envisaged in the earlier drafts. However, banks also need to bear in mind the impact of international developments in financial reporting, which could potentially overlap or even conflict with the Pillar 3 requirements, significantly increasing the compliance burden. In any event, management will need to ensure that the information disclosed is accurate

<sup>3</sup> Basel...Hopes and Fears – A European banking view of the practical application of Pillar II. For more details please visit [www.pwc.com/banking/pillar2](http://www.pwc.com/banking/pillar2)

## Exploding some of the myths around Basel II *continued...*

and subject to adequate levels of assurance procedures. Furthermore, it is likely that Pillar 3 disclosures will serve to highlight differences in credit and risk pricing – a competitive issue from a business perspective – and will impact the way in which those banks themselves are viewed by those supplying funds to the banks, regulators and credit rating agencies. Lower sophistication of approach may result in increased costs of funds and greater capital needs.

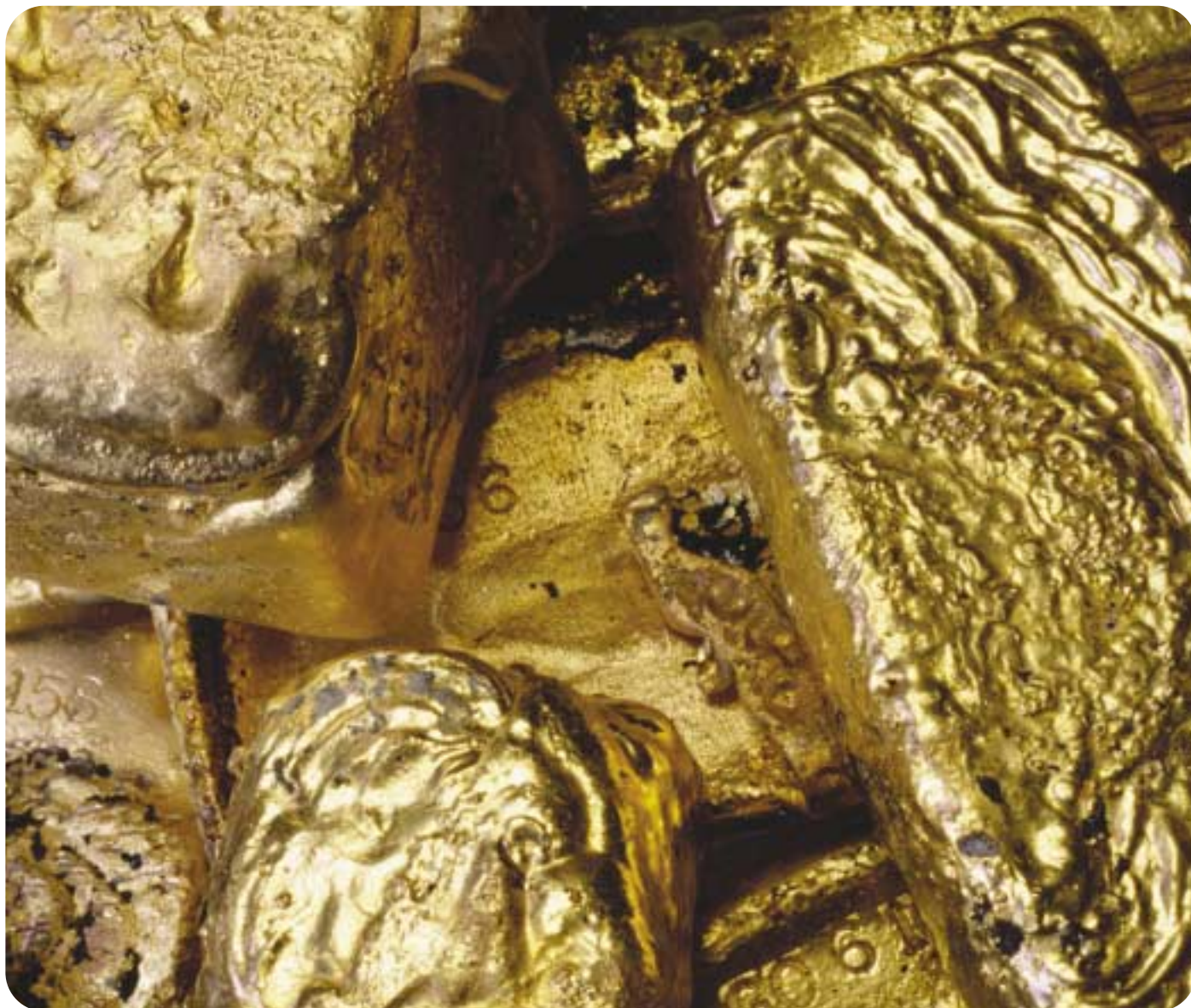
What does this mean for banks and their supervisors? In general, the G10 countries are thought to be aware of these issues, and in many cases have been dealing with the necessary changes to the financial system even before the Basel II proposals were first drafted, although due care is still required when implementing the revised Accord. In less developed markets, banks and their supervisors have much less experience dealing with these issues, and the need for careful planning and intelligent impact analysis is much stronger.



# Banking Banana Skins

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by David Lascelles and John Hitchins



## David Lascelles

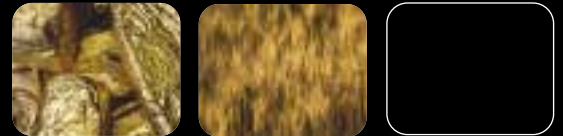
Co-director, Centre for the Study of Financial Innovation

Tel: 44 20 7493 0173  
Email: info@csfi.org.uk

## John Hitchins

UK Banking Leader

Tel: 44 20 7804 2497  
Email: john.hitchins@uk.pwc.com



Banana Skins 2003 provides a fascinating snapshot of the concerns of the global banking industry, providing a useful benchmark for individual institutions to compare their own risk priorities against.

The survey, which is carried out annually by the Centre for the Study of Financial Innovation in conjunction with PricewaterhouseCoopers, makes it clear that institutions must deal with risks which are a blend of the topical and the hardy perennial. While the concerns raised by September 11, which featured prominently in the last survey, have not gone away entirely, it is the

wider issues of credit losses and the position of the global economy and regulation which continue to dominate the industry's thinking. The survey covers the views of bankers themselves, regulators, major customers and observers of the industry (see Figure 1).

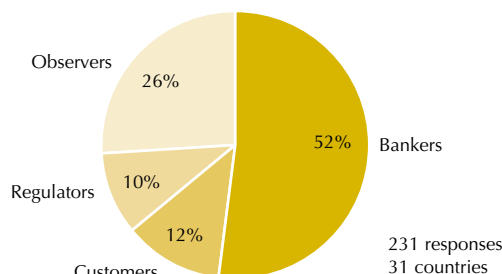
### Credit losses and a new number one

Credit risk has maintained its position in the top three this year; historically it has always been the biggest source of bank losses. However it was overtaken this year by worries over the use of complex financial

instruments, which headed the survey for the first time.

Although other complex instruments were mentioned, the concerns were mostly about derivatives, and in particular credit derivatives. This is surprising given that the credit derivatives market is now much more firmly established than at the time of previous surveys, but it seems it is the market's success that has bred the concerns.

Figure 1: Survey respondents by type



Source: Banking Banana Skins 2003



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www.centralbooks.co.uk or +44 20 8986 5488

## Banking Banana Skins *continued...*

### Banana Skins 2003

2002 ranking in brackets

1. Complex financial instruments (4)
2. Credit risk (1)
3. Macro economy (2)
4. Insurance (7)
5. Business continuation (5)
6. International regulation (10)
7. Equity markets (3)
8. Corporate governance (-)
9. Interest rates (21)
10. Political shocks (14)
11. Fraud (18)
12. High dependence on technology (13)
13. Domestic regulation (6)
14. Money laundering (11)
15. Hedge funds (16)
16. Risk management (12)
17. Banking market overcapacity (9)
18. Currencies (19)
19. Grasp of new technology (20)
20. Management incentives (28)
21. Retail sales practices (17)
22. Emerging markets (8)
23. Rogue trader (24)
24. Back office (23)
25. Payment systems (27)
26. Commodities (22)
27. Merger mania (26)
28. Competition from new entrants (30)
29. E-commerce strategy (25)
30. Environmental risk (29)

Source: *Banking Banana Skins 2003*

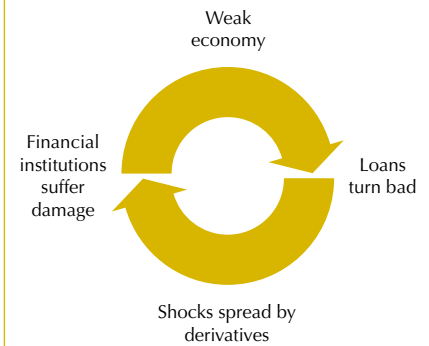
The biggest concern voiced by respondents was that the ease of transfer of credit risk now offered by the market may well result in concentrations of residual risk ending up with particular institutions without this being apparent to the market. Others voiced the more traditional concern that senior management doesn't fully understand the risks in complex products.

Ironically, in view of the industry's opinions on regulation, which are addressed later in this article, several respondents felt that the credit derivatives market is insufficiently regulated, or 'lacks controls', while legal interpretation remains a problem for such complex financial instruments, in particular the likelihood of contracts being challenged in the courts, leading to a sense of uncertainty about the true level of risk and exposure faced in this area.

Gloom about the global economy has helped keep credit risk as a whole in the spotlight in Europe, America and the Far East, although the main concern is not about the current condition of banks but rather their vulnerability to rising interest rates, higher unemployment and a collapse in real estate prices. For bankers themselves credit risk was the number one issue, overshadowing the worries about complex financial instruments, with concerns expressed in their case about the quality of the

portfolios as well as the pressure from the wider macro-economic deterioration (see Figure 2).

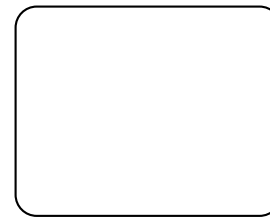
**Figure 2: Vicious circle**



Source: CSFI

### The global economy

Indeed, it is the position of the global economy generally which continues to give most cause for concern overall, with one US regulator speaking for many when he said, 'The overriding sources of concern are global in nature.' Interest rates and the equity markets continue to figure prominently in the top ten, and the economic cycle has a clear impact on the significance of a number of the other risks facing banks, not least credit risk itself.



Any sudden movement in interest rates could have a significant impact on balance sheets, and presents a double-edged risk, because although a sudden increase in rates is seen as the more vicious option, persistently low rates will squeeze the margins for banks, making it more difficult for them to maintain and grow profit levels.

On balance, respondents to the survey felt that we were past the worst of the economic cycle and the pressure on the equity markets has eased, although it will be a long road back to economic buoyancy and there remains the risk of future systemic shocks.

## Regulation

Regulation emerged last year as a key issue in the survey, although as the regulatory focus has shifted, so priorities have switched from domestic to international issues, in the shape of Basel II and International Financial Reporting Standards and, for European respondents, the many EU directives currently in the pipeline. Respondents were concerned about both the complexity and the implementation costs of these measures. There was also a frustration about the length of time it is taking for definitive final rules to emerge.

Despite receiving the most comments from survey participants, domestic regulation is now seen to be less of a risk; however the main concern is still the overall burden of regulation and what is seen as the over-regulation of the industry, with many people expressing concerns about the potentially damaging effect this could have in the long-term.

In particular there is concern that heavy handed regulatory initiatives are now leaning too far towards the customer and one survey respondent pointed out that the increasing complexity of regulation raises the risk of non-compliance, leading to potentially costly compensation claims and reputational damage. Some also thought that the complexity of the requirements could have the knock-on effect of forcing more consolidation and, arguably, reducing competition in the industry. The threat posed by new entrants to the market has receded according to this year's survey, and this may well be because the challenges and cost of such daunting regulatory requirements actively deter potential new entrants.

A number of respondents voiced frustrations about the conflicting requirements of EU and US regulatory bodies, indicating that they see the international regulatory scene as a poorly-co-ordinated mish-mash of regulatory initiatives, often working at cross purposes.

## Corporate governance

Perhaps the most striking new entry in this year's survey is corporate governance. Here respondents had several different perspectives.

Despite the recent high-profile scandals, a number of participants believe that it is not awareness of the risk which is the issue, but a pervasive complacency; the belief that corporate governance does not matter, and that an 'Enron' or a 'WorldCom' could not happen again.

In contrast a sizeable proportion of respondents felt that the real risk was not poor governance itself but rather the overreaction of regulators to individual scandals. There is a real risk of the majority being punished with stifling over regulation in response to the actions of a few.

However, one respondent identified the key issue which banks must face up to in this area when he said, 'Accounting issues and corporate governance in their widest sense continue to detract from public confidence in the markets and the banks.' It is the public perception of the industry and the risk to its reputation which should be the real concern for institutions. The banking industry as well as the accounting profession faces an uphill battle to restore public confidence in the capital markets.

# Banking Banana Skins *continued...*

## Reputational risk

Reputational risk was cited by many as an issue; however it is the risk which is most difficult to define and it is too broad to categorise as a banana skin in its own right. Some linked it to corporate governance, some to social responsibility and the environment (which is addressed in an article in this edition of the Journal entitled 'Responsibility: Can you afford not to ...'), while others referred to money laundering and unfair selling practices. One message was clear: financial institutions need to be very alert to reputational damage and need to manage this risk more proactively.

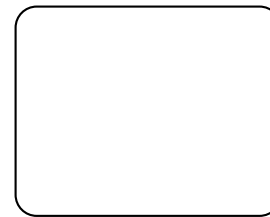
## Insurance

The insurance industry is seen as a fast rising risk by those in the banking industry in view of pressures on capital, and exposure to pension schemes as well as links to a number of other risks, including concentration of derivative exposure, vulnerability to the equity markets and interest rate pressure.

## Changes and fallers

The most remarkable fall in this year's survey is emerging market risk, which is clearly felt to be manageable now that banks have largely shifted these risks off their balance sheets. As a result of continuing economic uncertainty, industry participants are now more concerned with





first world, or developed market, risk rather than third world risk.

It is also interesting to note that retail sales practices has slipped down the list, with a marked shift of focus away from mis-selling issues to matters of service quality, with several respondents identifying an innovation challenge with a need for banks to target the right sectors with the right product.

The survey shows comparable data since 1996 and the top ten from 1996-2003 shows how concerns have changed over that period (see Figure 3).

Over the longer term, recession-based fears have taken over from the strategic concerns of the 1990s, with merger mania falling away and market overcapacity also slipping down the rankings. Internet banking, unsurprisingly, is also less of a concern now that it is 'part of everyday strategy'.

### Ability to deal with the risks

Respondents believe that industry is getting better at risk management, and as a result this has fallen slightly as a banana skin in its own right. The majority of respondents to the survey feel that banks are 'moderately well or better' prepared to manage their risks. However, the figure was slightly down on last year as a result of concerns voiced by bankers themselves. In contrast, regulators and observers gave

the industry an improved rating. If bankers are becoming more sanguine about their risk management capabilities, maybe regulators are deriving additional comfort from this.

### Turning to the future

While the survey tends to highlight current concerns it also often contains some interesting pointers to the future among some of the lower ranked banana skins.

Fraud is heading back towards the top ten as the industry worries about the increasingly sophisticated use of technology by fraudsters. Identity theft is also highlighted as a potential major issue.

Outsourcing also emerged as a risk for the first time in this survey, with people pointing to the loss of control and the ensuing risks involved as the main areas of concern. Outsourcing partners have to be chosen and contracts negotiated with great care, many learn the hard way about contracts without Service Level Agreements and remediation.

In contrast, environmental risk remains firmly rooted at the foot of the list. Despite all the growing worries over increasing pollution, global warming and sustainability, the banking industry remains unmoved. Only time will tell if this is realism or misguided complacency.

### Conclusion

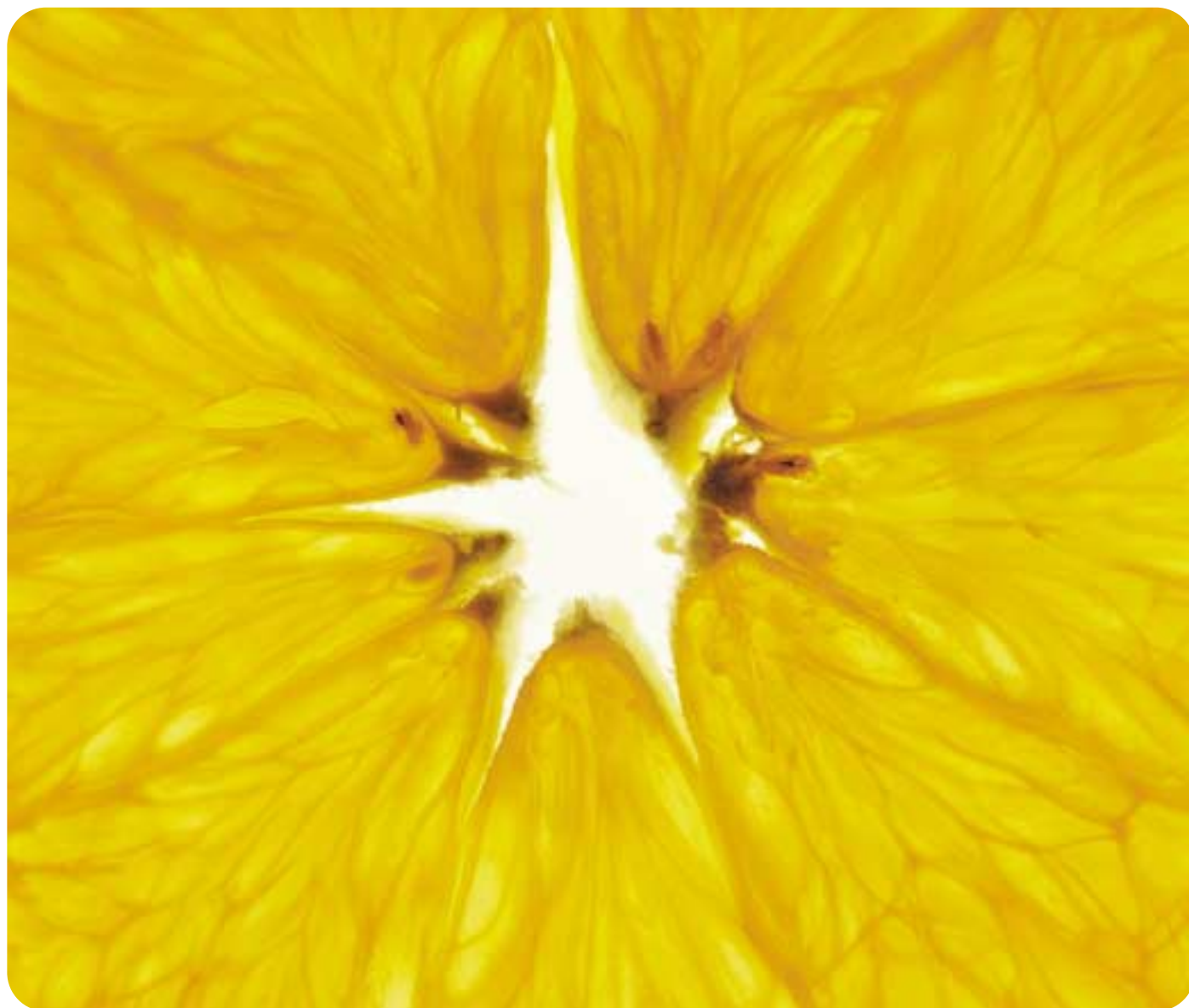
While credit risk remains the most pervasive risk facing the industry, the most striking feature of this year's survey is the highlighting of business complexity as a systemic risk in its own right. Whether this comes from market developments in the form of complex financial instruments or from external pressures in the form of increasing regulation, it represents significant issues for the industry to manage. Although risk management processes are thought to have improved in recent years this is no time for the industry to rest on its laurels.

There is a further challenge too, in a world which places increasing value on transparency: how can financial institutions report on this growing complexity in a clear and understandable way? This is an issue that bankers, their accountants and their regulators will need to give priority to over the next few years.

# Bringing it all together – Leveraging risk-adjusted performance management

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by Benoît Catherine, Miles Everson and Fernando de la Mora



## Benoit Catherine

Lead Partner, Financial Risk Management Services, France and Continental Europe

Tel: 33 15657 1238

Email: benoit.catherine@fr.pwc.com

## Miles Everson

Partner, Financial Services Advisory Services, US

Tel: 1 646 471 8620

Email: miles.everson@us.pwc.com

## Fernando de la Mora

Director, Financial Services, Spain

Tel: 34 91 568 4064

Email: fernando.de.la.mora@es.pwc.com



The focus of strategies in the financial services industry is shifting from cost reduction to the pursuit of revenue growth generation opportunities. Efficiency gains have been the major driver of shareholder value creation in the past two years and although cost discipline should be maintained, it is now time for banks to focus on revenue growth initiatives to satisfy shareholders. With this in mind, risk-adjusted performance measurement and capital allocation decisions are crucial to identifying, measuring and managing revenue generation paths.

Integrating performance and risk management to make enhanced business decisions has never been more important. Few institutions, however, have been able to embrace fully value management at all operating levels throughout the enterprise. Organisational, cultural and technological obstacles have been difficult to overcome. In this article, we discuss how the integration of performance and risk management can help banks at both strategic and, most importantly, tactical levels to drive value and revenue generation.

### Trends in risk and performance management

Risk plays an increasingly important role in today's financial services environment. The introduction of Basel II, for example, is forcing financial institutions to link capital requirements with levels of risk being assumed. As regulatory capital converges towards economic capital (that is, the capital needed to support the true economic risks of the business), risk-adjusted performance measurement becomes an increasingly important tool for shareholder value creation.

Regulators, however, are not the main reason why banks are integrating risk and profitability information for decision-making purposes. It is the opportunity to make informed strategic and tactical business decisions that drives best in class risk and performance management practices at leading banks. Some examples of how institutions are using risk-adjusted performance measures for managing risk and rewards can be seen in Figure 1 overleaf.

Historically, risk management and performance management have been

undertaken on a stand alone basis (see Figure 2). Both fields have experienced significant progress around the development of methodologies to measure income, transfer pricing, cost and risk sources across the enterprise. Recently there have been advances in modelling techniques for credit risk and operational risk measurement. Although there is still a long way to go<sup>1</sup>, measurement of risk and return is more precise today. As a result, financial institutions are in a relatively good position to understand and measure risk-adjusted performance and shareholder value creation to drive enhanced business decisions.

The most common measure used for integrating risk and return in the industry is shareholder value added or SVA (also known as Economic Value Added, EVA). SVA is created when capital spread, the difference between return on economic capital and cost of capital, is positive. Value is magnified when positive spread is steadily generated over time through organic growth or acquisitions.

Integrated management of return, risk and growth across all relevant dimensions of the business will be essential to achieve

<sup>1</sup> Significant efforts must still be undertaken around proper calibration of models over longer periods of time than those captured by existing historical data. In addition, a more objective approach to incorporating business and reputational risks is required.

# Bringing it all together – Leveraging risk-adjusted performance management *continued...*

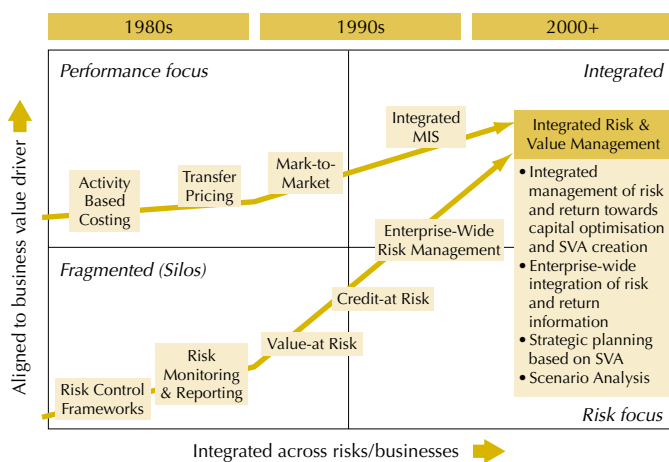
Figure 1: Applications of risk-adjusted performance measurement – Excerpts from banks’ investor publications

Strategic decisions	Technical decisions
<p><b>Performance evaluation</b></p> <ul style="list-style-type: none"> <li>• ‘We adopted shareholder value added (SVA) as a measurement tool to bring more financial discipline to our business decisions, both at the corporate level and throughout the business lines. Simply put, we believe that SVA as a performance measure and a decision-making tool has an extremely high, direct correlation to stock price performance, and will help us do a better job of managing the company.’</li> <li>• ‘SVA has been introduced as a new managerial yardstick to evaluate added value for shareholders. SVA enables the bank as a whole, as well as each business group, to recognise how much SVA was generated during a fiscal period. This measure will become key in evaluating the progress of the bank.’</li> </ul> <p><b>Strategic planning and capital allocation</b></p> <ul style="list-style-type: none"> <li>• ‘For strategic planning purposes, the bank has a balanced and disciplined deployment of capital at group level. Capital is allocated across business units based on SVA objectives and expectations as well as the strategic direction of the bank.’</li> <li>• ‘Value Based Management is used to influence all levels of its staff to make decisions and take actions that will deliver superior performance. Managers define and measure risk to determine changes on capital utilisation and to evaluate risk-return trade-offs when making choices about business mix and other decisions. The bank has increased SVA more than fivefold in four years.’</li> </ul>	<p><b>Portfolio management</b></p> <ul style="list-style-type: none"> <li>• ‘The introduction of the use of SVA for product and customer decisions resulted in higher spreads on retained assets and the disposition of less attractive loans. The firm’s SVA discipline continues to discourage the retention of loan assets that do not generate a positive return above the cost of risk-adjusted capital. SVA remains a critical discipline in selecting loan assets, particularly when combined with other credit and capital management disciplines (e.g. credit derivatives).’</li> <li>• ‘Our preferred banking business model seeks to originate debt to distribute to the market vs. the originate to hold model. This in effect outsources capital while retaining fee income, thus reducing capital costs and boosting returns.’</li> </ul> <p><b>Risk-based pricing and customer relationship</b></p> <ul style="list-style-type: none"> <li>• ‘Risk based loan pricing is a system to assist business units to manage the risk-return profile of their portfolio on a facility/borrower level. It’s an ex-ante tool that supports loan officers in negotiations with clients, ensures overall profitability of a relationship and promotes optimal provisioning.’</li> <li>• ‘The bank’s CRM application allows it to perform analyses of its customers’ preferences, risk and profitability to the bank, so it can develop an approach to retain these customers and to maximise their risk-adjusted value through better customer service and customised product offerings.’</li> </ul>

Source: PricewaterhouseCoopers and company annual reports



**Figure 2: Evolution of risk and performance management**



Source: PricewaterhouseCoopers

Traditionally, SVA approaches have focused on historical analysis at the entity level and in most cases have used proxies to determine underlying components of economic capital. With the sophistication of risk measures and the ability of management information systems to drill down to clients, relationship managers, products and accounts, SVA measurement can be more precise and increasingly used not only for strategic purposes but also for undertaking tactical decisions. This implies that organisational models should be aligned both at management and operational levels, to ensure that day to day decisions that affect shareholder value creation are taken correctly. Equally important, is the technology infrastructure required to support SVA at operational levels where data integrity management and reporting engines are key to success.

### What do we mean by operational enterprise SVA management?

In order to harmonise corporate risk management practices and value generation, financial institutions have developed tools for capital budgeting, risk-adjusted capital allocation, capital structure optimisation and continuous reallocation of capital to those businesses that generate value. These tools have promoted the integration of risk management and strategic planning

superior stock price performance in the future. The ability to understand risk-adjusted performance across business lines, countries, products, distribution channels and clients, and to reallocate resources accordingly is critical. This implies making SVA management operational so that value can be extracted in every single decision being undertaken.

### Why care? The importance of risk-adjusted performance measurement

Adopting SVA as the key corporate measure for success in banking is not something new. Investors already tend to pay higher premiums for those companies with larger

spreads of return on capital net of cost. SVA is the measure most widely used by investors to assess long term performance and, if accompanied by management integrity, strong culture and rigorous decision making processes, should ensure stock price over-performance.

In the pursuit of revenue generating initiatives, banking innovation will come from driving SVA management down to operating levels. It will not be enough to allocate capital to the best risk-adjusted performance units or market segments; branch managers will need to understand client SVA so they can take appropriate commercial actions.

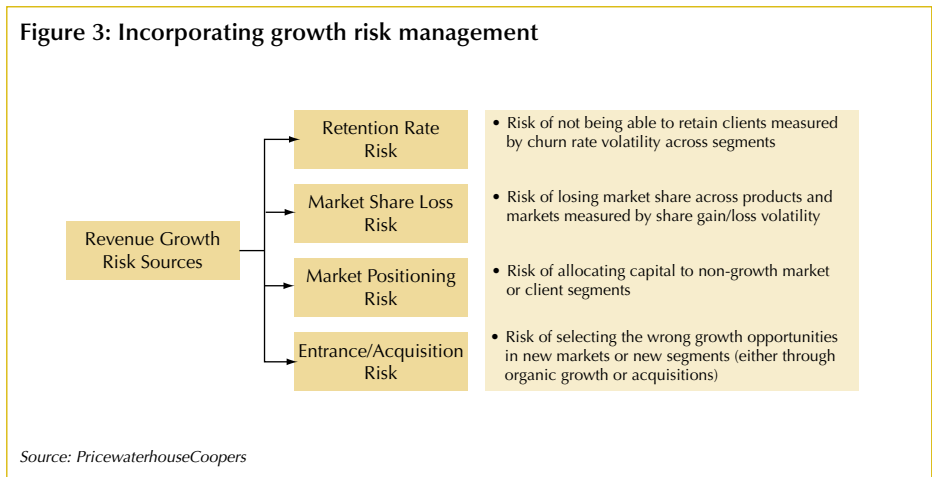
# Bringing it all together – Leveraging risk-adjusted performance management *continued...*

processes, but have lacked detailed and consistent drill-down capabilities at the lower operating levels of an organisation (e.g. products, clients, branches, etc.). Managing value requires not only making the correct decisions at strategic levels but also influencing all levels of staff to make proper decisions on a day to day basis.

Making SVA management operational across the enterprise implies consistently determining earnings, risk capital and growth across business units, locations, distribution channels, products, clients and accounts under one single common and consistent methodology. Only in this way superior performance companies will be able to extract value in every decision they make.

Adopting this approach requires the implementation of calculation, allocation and aggregation techniques (see Figure 4).

Making SVA management operational requires a great deal of data and complex business rules. Most firms are still far from having an integrated technology infrastructure that meets all desired specifications. The creation of centralised databases that integrate finance and risk data and the development of business rule engines that automate RAROC<sup>2</sup> and SVA calculations across all operating levels and allow for scenario analysis are still challenges for the financial services



industry. However, before exploring the IT implications of our proposed management model, let us first illustrate some of its business applications and benefits.

## How we can use it – Strategic and tactical business applications of SVA

There are a large number of business applications (see Figure 4) to support decision-making processes through our proposed SVA framework.

### 1. Strategic planning

Strategic decision-making at the firmwide level should be directly affected by SVA. Evaluating businesses only on the level and rate of growth of earnings fails to take into account their capital consumption

and relative risk. Thus, senior management must understand RAROC and SVA across business lines so that capital can be allocated according to strategic plans and their entry/exit decisions. Incorporating SVA into strategic planning requires the streamlining of the planning and budgeting process itself, in order to align strategic objectives with stock price and operating goals. Using SVA in the strategic planning process should link internal objectives and plans with stock price performance.

The next step is to extend strategic decision-making within each business line. Each business manager should be responsible for optimising allocated capital and achieving stated SVA goals. The challenge for managers is to align their team’s behaviour and actions across all activities towards business unit goals.

<sup>2</sup> Risk Adjusted Return on Capital



**Figure 4: Key components comprising operational SVA management**

1. **Earnings** should be calculated at the transaction level so they can then be aggregated bottom up across clients, locations, business units, etc. Net interest revenue can be easily determined by transaction (based on contractual interest rates or commission levels as well as agreed transfer pricing mechanisms for the cost of funds). However, cost calculations require top down allocation techniques especially for indirect and overhead items. In addition, expected losses for credit risk (calculated by client) and operational risk (calculated by unit) need to be deducted and properly allocated to arrive at earnings at the transaction level. These processes illustrate the heavy reliance on aggregation and allocation engines for proper performance management.
2. **Risk capital** calculations also require complex processes for aggregation and integration.
  - a. **Credit risk:** Every asset-related transaction has a credit exposure associated. In order to estimate credit risk capital we need to consider the exposure at default for each transaction, the probability of default (as a function of the client's credit quality) and the severity of potential losses (which varies across product types). Aggregation of credit risk capital across portfolios and businesses will be required based on diversification assumptions.
  - b. **Operational risk:** New approaches to quantify expected and unexpected losses for operational risk need to define allocation criteria to estimate operational risk capital by product, client or transaction.
  - c. **Market risk:** Market risk capital only affects treasury, capital market and proprietary trading units, assuming that commercial business units have been appropriately immunised from interest rate risk through transfer pricing mechanisms which have been developed by the industry based on internal and external loss experience. Value-at-risk approaches are used for estimating market risk capital for both the trading book and non-trading activities.
  - d. **Insurance risk:** Financial conglomerates with insurance activities should incorporate insurance risk capital (to cover situations where premiums are not sufficient to overcome actual claims) within their SVA management frameworks. European regulators have recently launched Solvency II, an initiative with the same principles underlying Basel II, but adapted to the insurance industry. Insurance risk capital is calculated by product type using actuarial techniques. Similarly to credit risk, diversification should be accounted for across segments.
  - e. **Business risk:** Some companies have started to include business and reputational risks in their economic capital calculations, with the adoption of subjective scenarios or simulation approaches. As these approaches evolve, business risk will play an increasingly important role in financial planning processes.
  - f. **Risk aggregation:** Although still in early stages of evolution, aggregation techniques are applied to estimate economic capital across various risk types. Diversification benefits exist at various stages in the risk aggregation process (intra and inter risk types) and institutions must decide whether those benefits accrue at the firmwide level or rather diversification is pushed down to lower levels such as products, clients or transactions.
3. **Growth** is an important driver of SVA which is not typically incorporated in RAROC or SVA approaches, as they tend to just focus on one year performance evaluation. As approaches evolve to incorporate forward-looking estimates, growth scenario analysis and growth risk sources measurement, institutions will avoid emphasis on short-term results at the expense of long-term performance. Additionally, growth analysis should be integrated within strategic planning so the right capital allocation decisions are made when choosing among various revenue generation opportunities (see Figure 3).
4. **RAROC and SVA** calculations are a result of all performance and risk inputs described above.

# Bringing it all together – Leveraging risk-adjusted performance management *continued...*

Figure 5: Adapting business decision-making processes

Strategic	Tactical
<p><b>Strategic Planning</b></p> <ul style="list-style-type: none"> <li>• Firmwide level                             <ul style="list-style-type: none"> <li>– Strategic planning</li> <li>– Capital allocation</li> <li>– Performance evaluation</li> </ul> </li> <li>• Business unit level                             <ul style="list-style-type: none"> <li>– Strategic planning</li> <li>– Capital allocation</li> <li>– Performance evaluation</li> </ul> </li> </ul> <p><b>Corporate Finance</b></p> <ul style="list-style-type: none"> <li>• Optimal capital structure</li> <li>• Mergers and acquisitions</li> </ul>	<p><b>Portfolio Management</b></p> <ul style="list-style-type: none"> <li>• Credit portfolio</li> <li>• Product portfolio                             <ul style="list-style-type: none"> <li>– Existing portfolio</li> <li>– New products</li> </ul> </li> </ul> <p><b>Relationship Management</b></p> <ul style="list-style-type: none"> <li>• Risk-based customer relationship management</li> <li>• Risk-based pricing</li> </ul>

Source: PricewaterhouseCoopers

## 2. Corporate finance

Decisions around optimal corporate financing and capital structure which do not take into account SVA implications are quite likely to lead to serious inefficiencies. Defining an optimal capital structure requires decisions on whether to transfer or retain major risks. New risks can be financed by issuing new equity, by issuing new debt or transferring them using risk management products. For instance, significant growth in a mortgage banking unit can be either externally financed (via equity or debt issues) or transferred through securitisations. SVA analysis can also provide insights into

evaluation processes for potential mergers and acquisitions opportunities.

## 3. Portfolio management

As banks move away from a buy-and-hold strategy with respect to their loans, successful credit portfolio management can stabilise banks' earnings and have a positive effect on shareholder value. RAROC techniques have been adopted to manage credit risk portfolios on a centralised basis, using instruments such as loan trading, credit derivatives and securitisations to optimise portfolio risk-adjusted returns.

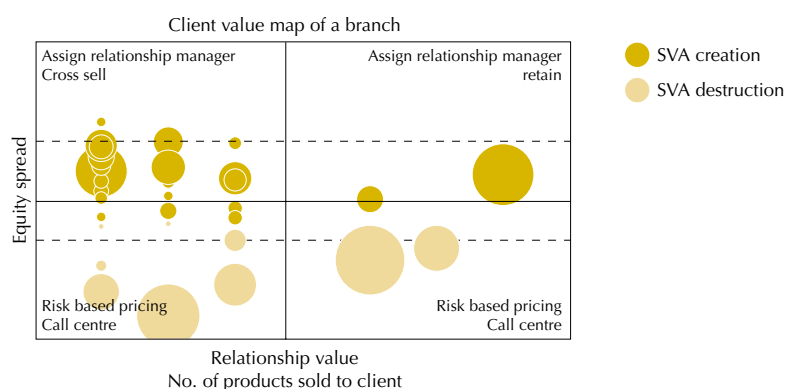
Product portfolio management can be leveraged through SVA. Understanding which products add value and which products do not can serve to identify corrective actions and support marketing decisions. Launches of new products should also be evaluated in SVA terms.

## 4. Customer relationship management (CRM)

The ownership of information about customers, their lifestyle, their needs, and their behaviour to better service clients has become critical in every financial institution. CRM has traditionally focused on data mining efforts to exploit cross-selling opportunities and retain clients. Understanding the value generated by each client should become a key driver to prioritise commercial actions. Some banks measure client value based on earnings from that client. However, decisions based on earnings may be misleading since they do not take into account clients' capital consumption and cost of capital. Client SVA is a more complete measure for value generation and can promote better commercial decisions (see Figure 5).



**Figure 6: Integrating customer relationship management and SVA**



Source: PricewaterhouseCoopers

inputs of the business, finance, strategic planning, human resources and technology infrastructure (See Figure 7).

### 2. Change corporate culture

To be effective the right incentives need to be built to align the behaviour of all managers towards common objectives, language, performance and decision drivers. Key aspects in managing this change in corporate culture are as follows:

- Clarity of the long-term value goal and key performance measures;
- Clarity of cause and effect relationships between decision-making processes and objectives;
- Leadership focused on same set of performance measures;
- Employees who can distinguish key performance objectives from supporting measures and useful indicators;
- Incentives and SVA based compensation agreed with employees; and
- Appropriate management information to monitor all of the above.

### 3. Develop systems infrastructure

Finally, and most importantly, risk-adjusted performance management will not be conducted in an efficient and effective

## Making it happen: Implications and implementation issues

The integration of performance and risk management has significant implications around three fundamental areas:

1. Organisational models
2. Corporate culture
3. Systems infrastructure

### 1. Redesign organisational models

The underlying principle in operational SVA management is full integration between risk and finance data for consolidated business planning and decision-making purposes. Such integration poses challenges in organisational structures that need to work

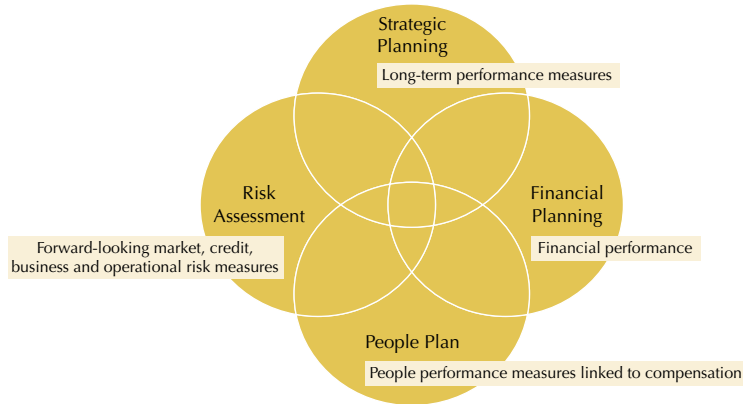
towards linking the risk management, finance and planning functions. Typically, today's organisational models are characterised as follows:

1. Value management, cost management and risk management initiatives are not coordinated and are typically undertaken in silos;
2. Performance management is not frequently integrated with customer relationship management objectives; and
3. Measurement of returns relative to risk lacks a consistent approach across businesses and customer groups.

An integrated planning process can help to ensure a balanced view of potential business performance by integrating the

# Bringing it all together – Leveraging risk-adjusted performance management *continued...*

**Figure 7: Organisational framework for integrated business planning**



Source: PricewaterhouseCoopers

manner without technology solutions specific to the needs and the level of sophistication of each bank. A best-in-class technology architecture for operational SVA management should be based on all three components as follows (see Figure 8):

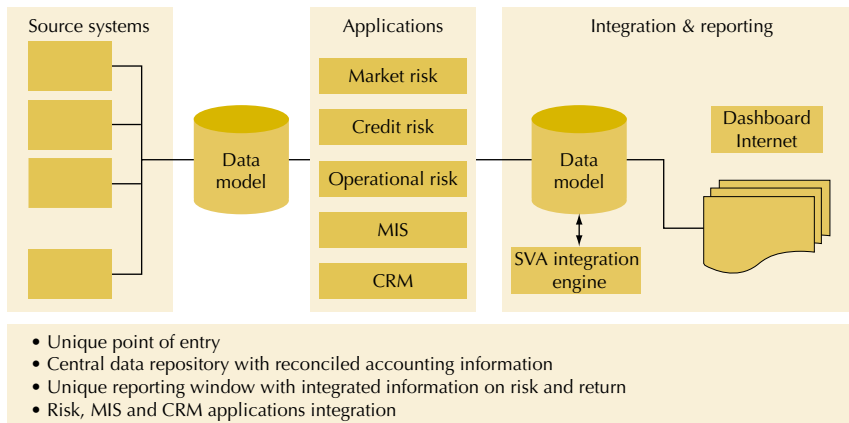
- **Central data repository**

An integrated logical data model capable of supporting all areas of the bank's business, including new emerging areas such as Basel II and IFRS. This provides a 'single version of the truth' and supports all reporting, analytical and other non-operational data requirements. The database must have acceptable attributes on scalability, flexibility, security and performance.

- **SVA integration engine**

The objective of the SVA engine is to provide the ability for business users to define rule-based aggregations and/or key performance indicator calculations (RAROC, SVA, etc.) which will be run and populated into appropriate formats for use in dashboard reporting and other applications such as risk-based pricing and remuneration. The engine should have the flexibility to adopt multiple aggregation approaches and be able to make changes in pre-established calculations assumptions. In addition,

**Figure 8: Best-in-class IT architecture for operational SVA management**



- Unique point of entry
- Central data repository with reconciled accounting information
- Unique reporting window with integrated information on risk and return
- Risk, MIS and CRM applications integration

Source: PricewaterhouseCoopers



the engine should incorporate a scenario-based analysis module with what-if modelling ability to change parameters and see in near real-time the impact on SVA and other financial and/or risk measures.

• **Reporting and analysis engine**

The objective of this component is to provide a single, integrated means of displaying financial, risk and other relevant information and/or KPIs in multiple formats. It should deliver to the user descriptions and/or definitions about the information being displayed. Dashboards will promote and facilitate decision-making processes.

**Conclusion and recommendations**

Full risk-adjusted performance and SVA measurement allows management to get to the operational level needed to make optimal business decisions. In today's environment, where value management strategies are increasingly shifting towards revenue generation avenues, SVA skills applied strategically and tactically will allow banks to align towards business fundamentals to obtain superior performance in the market.

Institutions need to:

- Design organisational structure and corporate governance guidelines so that finance, strategic planning, risk management, marketing and business units work together towards SVA optimisation through the enterprise;
- Develop analytics and methodologies to measure risk-adjusted performance across all levels of the enterprise, regardless of whether there might be individual components not completely covered, such as operational risk or business risk;
- Incorporate relevant growth management analytics and growth risk measures into the SVA framework;
- Adopt the right incentive arrangements so corporate culture is driven by SVA creation at all levels of business activity; and
- Develop and implement a single view systems platform and architecture with a consolidated data model, business rule engines and enterprise dashboards with relevant drill-down capabilities.

# Anti-money laundering –

## A focus on recent developments and the Asian impact

28

by Dominic Nixon, Alan Abel and Elizabeth Goodbody



## Dominic Nixon

*Partner, Banking and Capital Markets, Singapore*

Tel: 65 6236 3188

Email: dominic.nixon@sg.pwc.com

## Alan Abel

*Americas Head for Anti-Money Laundering, US*

Tel: 1 202 257 9178

Email: alan.abel@us.pwc.com

## Elizabeth Goodbody

*Head of Anti-Money Laundering Services, Indonesia*

Tel: 62 21 521 2901

Email: elizabeth.goodbody@id.pwc.com



The global nature of money laundering and related financial crime has rendered geographic borders increasingly irrelevant. Money launderers continue to move their activities to jurisdictions, sectors and businesses where they believe that their relationships and their activities are more likely to go undetected.

Money laundering has become universally regarded as a major operational risk area for financial institutions (FI), particularly by regulators and by the Basel Committee of the Bank of International Settlements (BIS). The new Basel Capital Accord (Basel II) requires banks to take this into account when determining operational risk capital charges.

The USA PATRIOT Act (PATRIOT) of October 2001 and the revised recommendations of the Financial Action Task Force (FATF, the inter-governmental body established by the G-7 Group of industrial democracies) in June 2003, are significant developments that will substantially affect FI globally.

One of the most immediate impacts for many Asian FI arising from the passage of PATRIOT was the increase in information required for assurance and PATRIOT compliance purposes by US

banks. If Asian banks, especially those from NCCTs (Non Cooperating Countries and Territories as defined by FATF), wished to establish or maintain correspondent banking relationships with United States banks, they needed to be able to convince them that they had adequate AML (anti-money laundering) regimes in their countries and that the banks concerned had appropriate KYC (know your customer) and related policies and procedures in place. AML regimes vary significantly in the region. As indicated in the results of our Asia Pacific Private Banking/Wealth Management Survey 2002/2003, these regimes are relatively sophisticated in the most advanced markets of Australia, Singapore and Hong Kong. However, Asian countries still on the NCCT list include Indonesia, the Philippines and Myanmar.

The October 2002 terrorist attacks in Bali and the more recent bombing of the Marriott Hotel in Jakarta in August 2003 have also highlighted the importance of Asian institutions specifically focusing on ways to counter terrorist financing (CTF) and reiterated the need for them to enhance their AML regimes. In Indonesia, the AML law passed in April 2002 had been seen to be deficient in a number of

areas, including the threshold with respect to criminal proceeds, the absence of 'tipping off' provisions and the time given to report suspicious transactions. After the Bali attack and the Marriott Hotel bomb, there was an even greater focus on Indonesia's AML and CTF measures and, on 16 September 2003, significant amendments to enhance the AML legislation were passed by the Indonesian Parliament.

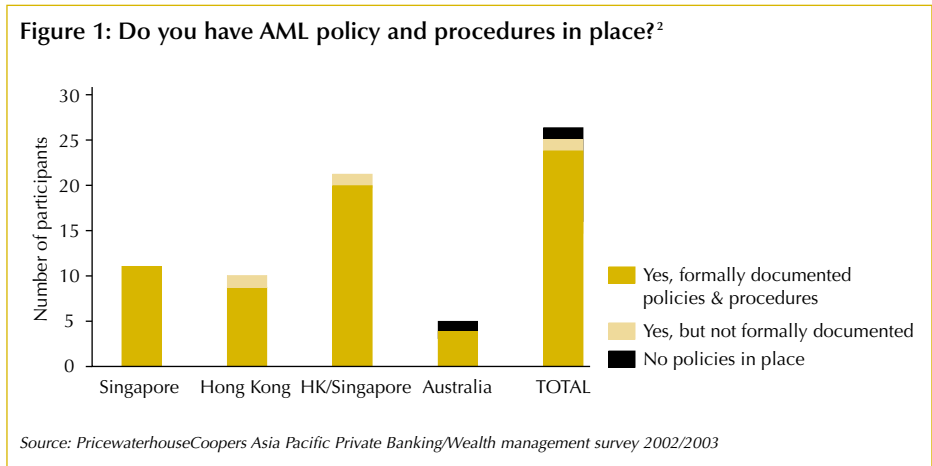
Money laundering is by no means limited to the banking sector – indeed, money launderers are adept at identifying new channels and techniques for laundering illicit proceeds where they believe that the likelihood of their activities being detected is less. The revised FATF recommendations are intended to extend the global AML regime to non-bank FI and other businesses such as real estate agents, lawyers, trust and company service providers amongst others. Some Asian countries, including Indonesia and the Philippines, had been slower to extend their AML regimes to the non-bank sectors. For example, in Indonesia the capital markets regulator and the regulators for the insurance, pension fund and finance sectors did not promulgate their AML regulations until January 2003. Other Asian countries, such as Singapore, have had

# Anti-money laundering – A focus on recent developments and the Asian impact *continued...*

extensive AML regimes in place for some time (see Figure 1) while the Thai Anti-Money Laundering Act became effective on 20 August 1999.

As identified in the results of the recent PricewaterhouseCoopers Global Economic Crime Survey, FI, both in Asia as well as other parts of the world, face a growing risk of economic crimes including fraud and money laundering.<sup>1</sup>

There is an increasing focus on the use of informal networks of value exchange or underground banking and charities in terrorist financing and smuggling to facilitate laundering. Such systems of value exchange include the Hawala/Hundi as well as the Chinese and other Asian systems that originated in southern Asia or the Far East but have now spread throughout the world following immigration patterns. Although such operations are illegal in a number of locations they remain a significant way for a large number of businesses in Asia as well as other parts of the world to repatriate funds. They are essentially based on a system of trust, often among ethnic groups, and their operations are difficult to trace because of the lack of records, or, where records do exist, the fact that they are coded.



The revised FATF recommendations now include 20 designated categories of offences for money laundering, including terrorism and terrorist financing, corruption and bribery, fraud, smuggling, insider trading and market manipulation. Certain leading Asian countries' AML legislation mirrors this list or even extends it.

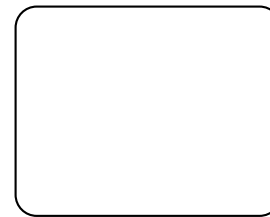
Increasing global pressure on countries to move towards implementing international standards, including the FATF recommendations, is resulting in the tightening of legal frameworks in a number of countries and jurisdictions to provide assistance on criminal or other proceedings related to money laundering offences. The Asia Pacific Group on Money Laundering ('APG') has included among the goals in its Strategic Plan for 2001-2004 to:

- Develop a better understanding of the nature, extent and impact of money laundering in the region; and
- Oversee and facilitate the implementation of comprehensive AML measures in all member jurisdictions.

### Raising international standards

There are a number of areas including Asia where revised FATF recommendations and PATRIOT will require organisations to 'raise the bar' globally. It is expected that over time, countries will move towards implementation of these international standards as appropriate. As noted above, several countries in Asia have either already implemented comprehensive AML regimes (see Figure 1) or, like Indonesia and the Philippines,

<sup>1</sup> For further information about the survey, please visit [www.pwc.com/crimesurvey](http://www.pwc.com/crimesurvey)  
<sup>2</sup> Results based on small, non-representative sample of Asian FI



have recently updated their AML laws to take into account the FATF recommendations as well as inherent weaknesses in earlier legislation.

### 1. Corporate transparency and privacy

The revised FATF recommendations require countries to establish systems to ensure that adequate beneficial owner information is obtained, verified and recorded for corporate vehicles like private limited companies, bearer shares and trusts, and to ensure availability of such information to FI. Once implemented, these requirements will increase the onus on FI to ensure that this beneficial ownership information is kept up to date.

PATRIOT has certain provisions that many believe excessively erode privacy by giving too much license to investigators. At the same time, however, there is an increasing momentum towards voluntarily sharing information for due diligence purposes in the private sector.

### 2. Extra-territorial impact

PATRIOT's impact is clearly felt across national borders. The Act has already had a major impact on FI with correspondent banking

relationships in the US, with respect to new information, due diligence and reporting requirements. Non-compliance may result in account closure and the forfeiture of balances. The US Treasury Office of Foreign Assets Control (OFAC) maintains a considerable list of Specially Designated Nationals (SDN), which includes names of terrorists. This also has an impact as transactions in the US can be stopped using this information.

The US Money Laundering Criminal Laws, as amended by PATRIOT, prohibit transactions involving the proceeds of any foreign crime that is covered by an extradition treaty, whether or not the underlying conduct is a crime under US law.

'Persons' (including businesses) who conduct business outside the US can be prosecuted for laundering if they use US FI for receipt and clearance of cheques drawn or cleared through them (that is deemed to be 'conduct' in the US).

### 3. Know your customer (KYC) and the role of technology

KYC is often an even greater challenge for Asian FI than for those in many Western countries. In Asia, many customers are not accustomed to being

questioned about the source of their wealth and funds and the intent of the transactions they enter into (see Figure 2). Thus, KYC in Asia needs to become more culturally acceptable in order for FI to continue to make progress in this area. Not only is there an increasing focus on KYC per se, but also in understanding customer's business in areas previously not required, for example in correspondent banking transactions.

PATRIOT highlights a number of documentary and non-documentary verification methods to be used in connection with customer identity (see Figure 3 and Figure 4). These include negative verification (fraud and bad cheque databases), positive verification (credit reports), and logical verification (identifying whether information is logically consistent). In light of the apparent increase in the incidence of identity fraud, businesses are encouraged to rely on non-documentary, as well as documentary, methods of verification. Regulators are increasingly requiring banks to implement transactions-monitoring software to detect and escalate the reporting of suspicious activity. Access to sophisticated software is another challenge for many Asian FI. In countries such as Indonesia, the impact of the financial crisis of the late 1990s is still being

# Anti-money laundering – A focus on recent developments and the Asian impact *continued...*

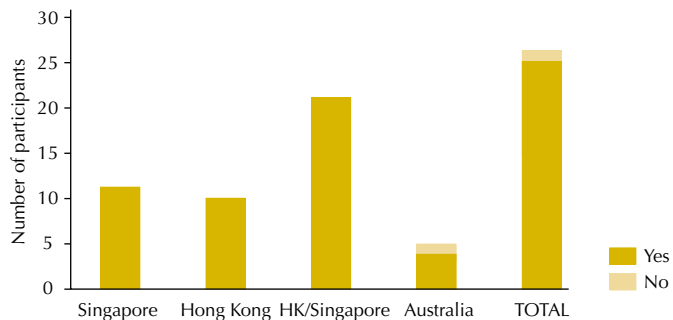
felt and banks and other FI are still working to upgrade their technology generally, not only as relating to AML. In many cases, lack of access to appropriate technology comes from cost constraints.

## 4. Customer Due Diligence (CDD) and record keeping

The revised FATF recommendations strengthen CDD and record keeping in a number of areas. These include:

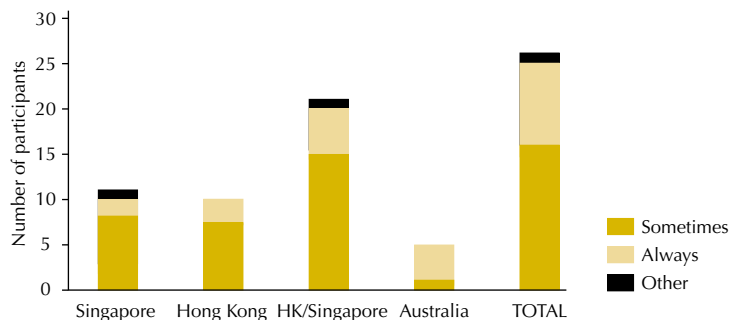
- Adoption of a risk-based approach – FATF recommends a risk-based approach to AML activity and focus. Risk assessments should be enterprise-wide and business units should drive risk assessment processes, co-ordinated and facilitated by risk and compliance management. Risk typologies and assessment should consider the context of the business – its customers, products and services, geographies and distribution, subject to FATF, PATRIOT and legal requirements (for example, FATF and PATRIOT specify certain higher risk businesses).
- While the revised FATF recommendations include simplifying CDD processes for lower risk transactions (such as when opening accounts for publicly

**Figure 2: Processes in place to verify identity and addresses of clients?<sup>3</sup>**



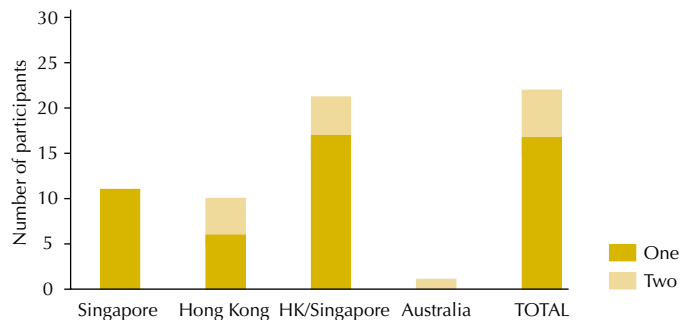
Source: PricewaterhouseCoopers Asia Pacific Private Banking/Wealth Management Survey 2002/2003

**Figure 3: Do you obtain references from existing customers for new accounts?<sup>3</sup>**



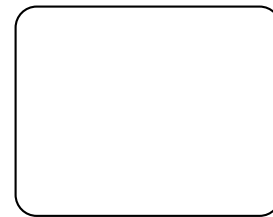
Source: PricewaterhouseCoopers Asia Pacific Private Banking/Wealth Management Survey 2002/2003

**Figure 4: Number of references obtained for new accounts<sup>3</sup>**



Source: PricewaterhouseCoopers Asia Pacific Private Banking/Wealth Management Survey 2002/2003

<sup>3</sup> Results based on a small, non-representative sample of Asian FI



listed companies), on the other hand FI are expected to conduct enhanced due diligence (EDD) where appropriate, leaving significant onus on each FI to decide and justify such decisions. For example, when there are significant or new events with a customer such as an existing customer opens a new account or takes out a new product. In addition, there should be periodic reviews of customer risk assessments. Experience suggests that updated information obtained through meetings, discussions or other communications with the customer should be documented as part of the on-going risk management process.

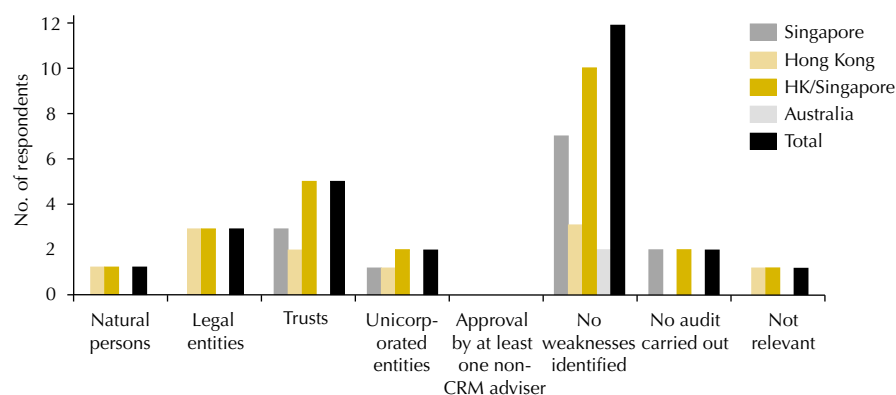
- With regard to private companies or trust arrangements, FI should identify and verify the beneficial owners by performing adequate due diligence to form an understanding of the ownership and control structure and take reasonable measures to verify the identity of such persons.
- Focus on selected high-risk areas – Specific higher risk areas which institutions need to focus on include politically exposed persons (PEP), correspondent banking (including prohibiting shell bank accounts) and non face-to-face businesses.

- Suspicious Transaction Reporting – FI should consider filing a Suspicious Transaction Report (STR) wherever CDD is not successful, even if the transaction is aborted or the account is not opened. FATF and many national governments expect all suspicious transactions, including attempted transactions, to be reported regardless of the amount of the transaction. National regulations vary across Asia with some countries specifying thresholds for STR. In Indonesia, the AML law has always required reporting of suspicious transactions whatever their value and no threshold for STR applies. The revised FATF recommendations specify that there must be a ‘direct

legal requirement to report’, and states clearly that reasonable grounds to suspect is now the explicit standard for STR purposes.

- ‘Tipping off’ – The revised FATF recommendations clarify that if an institution reasonably believes that performing the CDD process will tip off the customer or potential customer on a possible STR or investigation, it may choose not to pursue that process and should file an STR.
- Third party due diligence – The revised FATF recommendations also allow, and in fact encourage, the use of third parties to conduct

**Figure 5: Areas identified as weak in AML controls during organisation audits<sup>3</sup>**



Source: PricewaterhouseCoopers Asia Pacific Private Banking/Wealth Management Survey 2002/2003

# Anti-money laundering – A focus on recent developments and the Asian impact *continued...*

CDD (for example, executing brokers and affiliated banks/clearing brokers), provided the ultimate responsibility for customer identification and verification is not delegated by the FI.

- Strengthen controls over funds transfer – FATF Special Recommendation 7 on Anti-Terrorist Financing (ATF) requires that banks enhance their controls for funds transfers in the area of originator information (name, account number, address), record keeping and due diligence requirements for both domestic and cross-border funds transfers.

## Continuing challenges for Asian financial institutions

For Asian FI, the PATRIOT and revised FATF recommendations reinforce the need for efforts to be made at the senior management level to ensure that the relevant controls are put in place to guarantee an appropriate risk management framework for AML.

## Senior management and board oversight

Regulators around the world expect to see compelling evidence that bank and non-bank FI govern themselves well in all respects – AML included. A critical element of AML good governance is that Boards

### Key AML governance ‘TO-DOs’

- At least once a year, or as frequently as changes are made or are required, the full board, at the direction of the AML Officer, senior management and the designated AML oversight committee (usually audit or risk management) should, at a minimum, review, update and re-approve a written AML policy framework.
- The board should, at least annually, review and reaffirm the position and job description of the AML Officer and the appointee.
- The board should periodically review and revise its strategic plan that assesses AML risk in the customer base, geographies, jurisdictions, products and services, distribution channels, service providers, mergers and acquisitions, strategic alliances and deployment of new technologies. The board needs to get accurate and meaningful business and customer profile information so that it clearly understands and demonstrates understanding of the customer base and segments, channels and jurisdictions of operation, particularly highlighting higher risk customers, areas and issues.
- Legal counsel, compliance management and risk management should periodically report to senior management and the board on risk and potential institutional and individual criminal liability and important cases.
- Report on how the policies have worked in practice and provide a summary of AML issues for the board.

of Directors and senior management are well-engaged and well-informed about key aspects of AML compliance, policy and programme decisions, risk management and events that may require Board and senior management attention and action.

To the extent that Asian countries have appropriate AML regimes in place and environments fostering corporate

governance, this will make their task easier as they will be addressing many of these features as a matter of course. In countries such as Myanmar, Indonesia and the Philippines which are still on the NCCT list, this will mean ever greater scrutiny by the international regulators and code setters as to whether or not their FI measure up in their AML compliance.



## Controls and procedures – A risk-based approach

When putting in place appropriately detailed AML controls, Asian FI should seek to approach AML/CTF issues from a business risk perspective, rather than a purely regulatory compliance perspective. This could include a systematic review of their products, customers, transaction types and geographic locations that pose a higher risk of money laundering or terrorist financing. Management should not be overly obsessed with specific rules

and details that run the risk of losing sight of good governance and well-informed judgement. There are challenges here as some of the legislation in countries in Asia is more descriptive than risk-based. Regulators are considering how to integrate the risk-based approach of the revised FATF recommendations with current AML regulations in several Asian territories, including Indonesia.

Such areas will in time then be subject to reviews of AML policy compliance by the appropriate FI regulator on a periodic basis.

## Conclusion

Compliance with the new AML and FATF requirements is not just a regulatory compliance issue, but also a broader enterprise-wide risk management issue. This sort of approach is more familiar to some Asian countries than others where more rule-based approaches have been the norm in the past. AML programmes and controls need to be embedded within the control frameworks of FI. Senior management and Boards need to understand the implications of

### Areas where Asian FI should particularly focus include:

1. CDD and High Risk Businesses – FI should revisit their CDD processes to ensure that appropriate controls are in place to ensure compliance with the rules on filing of STR. Processes should be able to identify and flag high risk businesses such as money managers, money services businesses (high risk for terrorist financing), cash-intensive businesses and PEPs, and subject these accounts to enhanced monitoring and independent testing (enhanced due diligence). FI could consider using public PEP databases to ensure proper identification of these higher risk customers, but, at the same time, take into account areas such as the country risk of the customers.
2. Beneficial ownership of accounts – FI are expected to take on more explicit responsibilities for monitoring beneficial ownership both at the account opening stage and during the life of an account.
3. Awareness versus training – Building awareness is as important as training. There is often a perception that AML training is a compliance matter, and that awareness of the issue is communicated through training alone. Awareness of the money laundering issue is linked to the top-of-mind recall of AML, which requires an ongoing internal marketing campaign on the concept, in order to successfully create an enterprise-wide AML culture.
4. Each of the above listed areas can pose challenges for Asian countries that have more ‘socialisation’ to undertake to ensure greater customer as well as FI awareness, and achieve compliance with AML provisions.

## Anti-money laundering – A focus on recent developments and the Asian impact *continued...*

these AML trends on their control frameworks and put in place appropriate preventive measures.

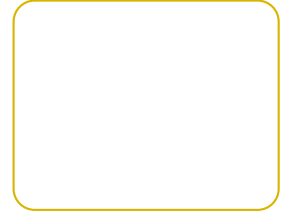
While considerable progress has been made in the Asian region towards strengthening AML regimes specifically and complying with global requirements generally, there is still more work to be done. The cost of being non-compliant can be considerable, as was seen when the Philippines was on the verge of having sanctions applied. This would have severely impacted the speed with which overseas funds from migrant workers could be remitted to the Philippines through the formal banking system.

Many international donors and multilateral agencies have been providing funding to assist the enhancement of AML regimes in the Asian region, including the Asian Development Bank in the Philippines, Vietnam, Thailand and Indonesia. In addition, JICA, the Japanese aid agency, recently commissioned the compilation of an AML manual for all banks in Indonesia. There are plans now to extend such a tool to the non-bank sector in Indonesia and to FI generally in other parts of the Asian region.

Other developments related to donor agencies that have been very helpful in progressing the enhancement of AML regimes in the Asian region include legal

and regulatory drafting assistance to countries drawing up or amending their AML laws and the provision of on-call assistance to expert committees of Parliament via briefings on the implications of revisions to laws that will come before them later.

Management of FI in these countries need to ensure now that new local legislation and the PATRIOT and FATF recommendations are adequately incorporated into their organisation's business practices. For those operating in countries still on the NCCT list, responding, and being able to demonstrate a convincing response, to the new requirements adopted elsewhere, and to the growing risk of involvement in economic crime, in particular money laundering, is a competitive business issue that they cannot afford to ignore.



# Responsibility: Can you afford not to...?

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by Tina Trickett and Joydeep Datta Gupta



## Tina Trickett

Senior Manager,  
Sustainable Business Solutions, UK

Tel: 44 20 7804 2569  
Email: tina.trickett@uk.pwc.com

## Joydeep Datta Gupta

Partner, Global Risk Management  
Solutions Leader, India

Tel: 91 33 2357 3417  
Email: joydeep.datta.gupta@in.pwc.com



Does your company behave in a responsible manner? Can you demonstrate consistent, responsible behaviours? Are you doing the right things to protect reputation and improve performance? Is behaving in a responsible manner really helping your business perform better? Could you realise more value from the work that you are doing?

The 'corporate responsibility' (CR) debate is maturing. It is increasingly being recognised as a body of principles and practices which enables a business to operate with integrity. Delivering and demonstrating integrity is becoming a fundamental and essential part of maintaining business performance in the 21st century.

The debate however is far from over. Almost universally, business leaders and others recognise that the principles are sensible and right. However, what actually happens in corporate practice is relatively unexplored; now the task of business is to define and deliver the detail. The voice which has been quietest in the debate so far is that of business itself. The banking sector, under increasing pressure from all sides, faces particular challenges due to its unique position as the source of finance to governments, corporates and individuals

**Figure 1: Public trust in financial institutions**

**How greatly has public trust been eroded by the various corporate scandals of the past year?**

Trust has been eroded and will only return when institutions themselves change the way they are run and report results	60%
Trust has been eroded and will only return when new regulations and harmonised accounting standards are in place	37%
Trust has been eroded but will return naturally when the economy strengthens	23%
Trust has not been eroded in my part of the world	7%
Other	7%

Source: The Trust Challenge, PricewaterhouseCoopers/Economic Intelligence Unit, December 2002

and thus an enabler and influencer of development and change. It should now bring its voice to the discussion to explain what responsibility and integrity look like in practice.

Globally, the banking sector remains in a defensive position and subject to negative criticism resulting from exposure of misselling, corruption, scandal and failure to be independent advisers. It is faced by a considerable challenge to manage expectations and change perceptions, build trust and re-establish reputations. It is also faced by difficult economic conditions which demand that business decisions are made on the best information, with the minimum of uncertainty. It has to evolve to understand

and define its role in relation to governments, retail outlets and international competitors. Leading organisations have recognised that demonstrating responsibility and integrity is critical to achieving these goals (see Figure 1).

This article presents the context in which organisations are working, the unique challenges for the banking sector and proposes the main elements of a response.

### How does the financial services industry compare with others in responding to the CR debate?

Behaving in a responsible manner is emerging as a primary influence on

## Responsibility: Can you afford not to...? *continued...*

### What does corporate responsibility mean for banking and capital markets organisations?

Several banks have developed community programmes and environmental management systems. These are a necessary element of business practice; however, they are not a substitute for addressing the critical issues for the financial services sector. The heart of 'responsible behaviour' revolves around the design, delivery and management of its products and services. Leading banks are now starting to address these issues from a responsibility perspective. The list below details critical elements of responsibility for banking and capital markets institutions:

- Ethics of business conduct.
- Access to products and services.
- Fairness in product design and delivery.
- Transparency of products and communications.
- Product suitability.
- Customer service.
- Privacy of customers' personal information.
- Marketing techniques and terms of business (eg commissions).
- Supplier relationships.
- Profitability and delivery of 'value' to customers.

reputation, competitive advantage and investor and regulatory confidence. Twenty years ago, the call to act 'responsibly' could be assuaged by multinationals through charitable donations and philanthropy and, more recently, through good environmental and employee management. Today this is not enough.

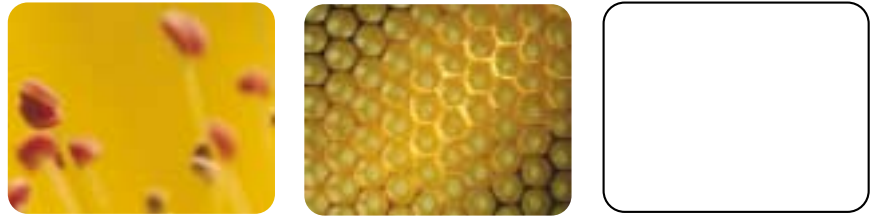
Certain industries have taken a leading position within the CR debate: for

example, the oil and gas and pharmaceuticals industries, although arguably this has been forced upon them more quickly as a result of stakeholder activism. The financial services industry is in the second wave, acting now of its own accord, but influenced somewhat by corporate scandals. Others that are likely to follow are media and service industries. However, the banking sector is now under increasing pressure from a wide range of stakeholders to take action, and it is, we

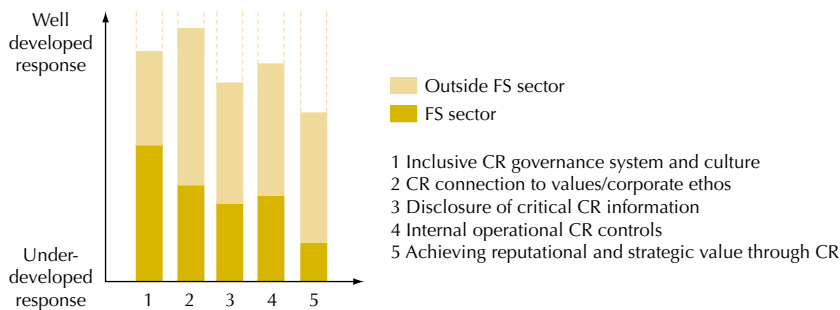
believe, in their best interest to do so. Figures 2 and 3 overleaf highlight key elements of responsible behaviour and compare, the sector's performance against multinationals from a variety of sectors.

Increasingly, institutions are expected to demonstrate how CR issues are managed within their organisation and disclose publicly critical elements of 'non-financial' performance in this area. The governance, management and disclosure around CR is crucial to obtaining reputational and strategic value – an area where the sector is yet to see the full value of responsible behaviours.

The sector is behind other sectors in all key components of CR. Examining non-banking multinationals' response is potentially indicative of future expectations for the banking industry. As previously stated, marketplace activities are the critical sphere of influence for the sector. In this area, in other industries, multinationals are starting to examine and report on their marketplace, impacts in all areas of their business, including their relationships with all business partners and in every country in which they operate. Banks are starting to respond to certain marketplace issues, e.g. financial inclusion and supplier relationships. However, activities for most are far from complete in coverage terms.

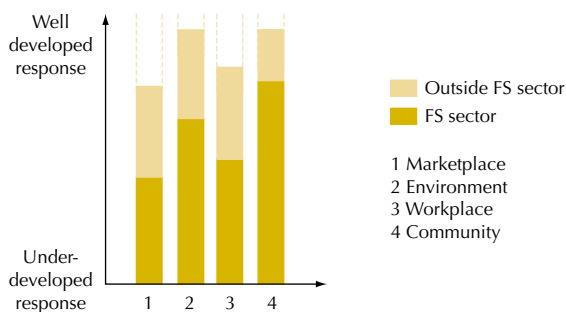


**Figure 2: Financial sector performance in governance and reporting versus other sectors**



Source: PricewaterhouseCoopers

**Figure 3: Financial sector performance in the elements of corporate responsibility versus other sectors**



Source: PricewaterhouseCoopers

### Why is responsibility important to this sector?

The success of financial services institutions is underpinned by reputation, and trust. These in turn are partially dependent upon being able to explain and

demonstrate how responsible practices are achieved through the design, sale and management of financial products and services. The banking sector has the opportunity to use its unique market position to become a positive agent of influence and change by

considering ‘responsibility’ in the business that it does.

There is a more tangible, underlying, but complex, reason to embed responsibility into core business practices. Dependent upon its customers, the financial services sector can use responsibility as another indicator in assessing customer and transaction risk and opportunity. The integrity of customers influences an organisation’s risk to capital, equity fluctuations, asset valuation, debt risk and debt management procedures and customer service costs. Assessing responsibility is therefore becoming a critical factor in determining the security and long term profitability of business.

Regulators are also starting to drive the debate beyond strict compliance to matters of ethical practices. This is particularly evident in the developments being made by the Financial Services Authority in the UK, where their focus on these issues will require institutions to demonstrate a full and adequate response to matters which trespass into the responsibility debate.

Responsibility can deliver financial benefit by being reflected in stock valuations and analyst ratings. However, developing a suitable response that enables this result can demand significant internal cost and commitment. It is vital, therefore, that this investment delivers some return if the

# Responsibility: Can you afford not to...? *continued...*

response is to be sustained. Many organisations are not yet realising the value from the work that they are doing; more importantly, few have identified the real sources of extra financial value and are in a position to measure and report them.

Failing to deliver a credible response adds costs for reactive management. These are impossible to predict. While the direct costs can be relatively small, there can be significant reputational cost and profitability impact in the longer term. Due to the long term nature of financial products it is likely that the full scale of costs and future liabilities originating due to irresponsible (not illegal) practices have yet to become apparent (see Figure 4).

## Who is driving the debate?

The profile of the responsibility debate continues to increase. Recently, the demands for the banking sector have become more institutionalised with government, regulatory and investor perspectives adding to the voices of activist groups and the media. This brings new and real challenges for the sector.

### Government and public financing institutions

Public/government obligations continue to migrate towards the private sector. Key challenges surrounding societal wealth, indebtedness, capital provision and pensions provision are increasingly being left to market forces. Organisations such as the World Bank and IFC are

imposing greater levels of responsibility related requirements on those applying for funding. This has greatest impact in emerging economies, where activism and regulation are generally in very formative stages.

### Regulators

Increasing regulations impose more demands on what needs to be achieved, in particular with regard to customer protection, but there is limited advice on developing an appropriate response.

### Competitors

Selected banks, reacting to direct pressure from corporate scandals, and perhaps seeing an opportunity to differentiate themselves, have started to impose responsibility and ethical factors on lending criteria eg. the Equator Principles.

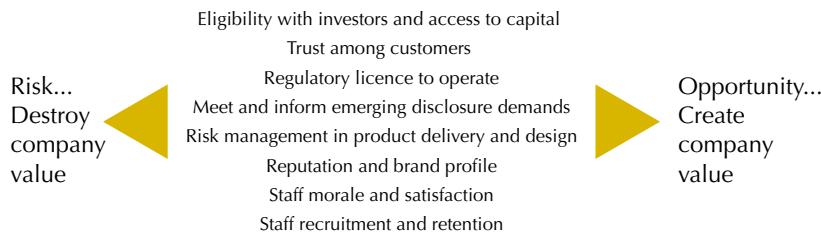
### Employees

Employees are demanding more from their 'contract' with their employers with expectations for reciprocal agreements and commitments, and responsibility is increasingly a factor in recruitment and job acceptance.

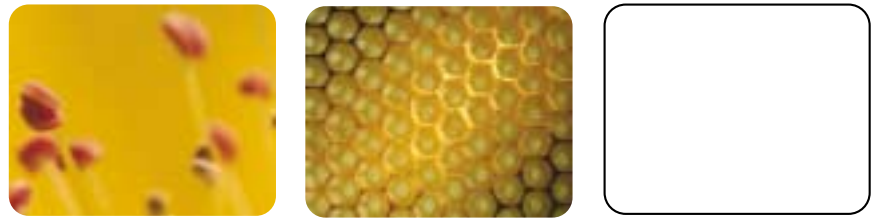
### Customers and consumer organisations

Increasingly demanding of their rights with greater expectations surrounding service provision and taking an increasingly activist role. Consumer groups are focusing on the sector with effective, targeted campaigning on specific products.

**Figure 4: Opportunities and risks from corporate responsibility management**



Source: PricewaterhouseCoopers



**Figure 5: Influences on an organisation’s approach to responsibility**

Influence:	Extensive or considerable impact (%):
Reputation and brand	79
Attractiveness to employees	69
Cost management/reduction	66
Risk management	64
Improved shareholder value	63
Government and regulations	62
Board influence	61
Investor pressure, including socially responsible investment	39
Outside pressure groups	26

Source: PricewaterhouseCoopers Sixth Annual Global CEO Survey 2003

PricewaterhouseCoopers Sixth Annual Global CEO Survey, conducted in collaboration with the World Economic Forum, asked CEOs from across the globe who or what influences their organisations response to responsibility (see Figure 5).

**Which banks are responding to the debate?**

Many banks are now responding to the responsibility agenda, having heard many of their stakeholders. However, the response is not consistent across the industry. For example, banks primarily based in the UK, France, the Netherlands and Scandinavia have been more proactive than those based in other areas. This is not surprising when one looks at where activism and regulation levels are

**Investors**

Legislative and good practice pressures for increased shareholder activism in respect of managing and ‘enforcing’ responsible business behaviours.

**Activists/non-governmental organisations**

Activists continue to challenge the sector with increasing sophistication and impact as a result of improved knowledge, global access and better organised activities.

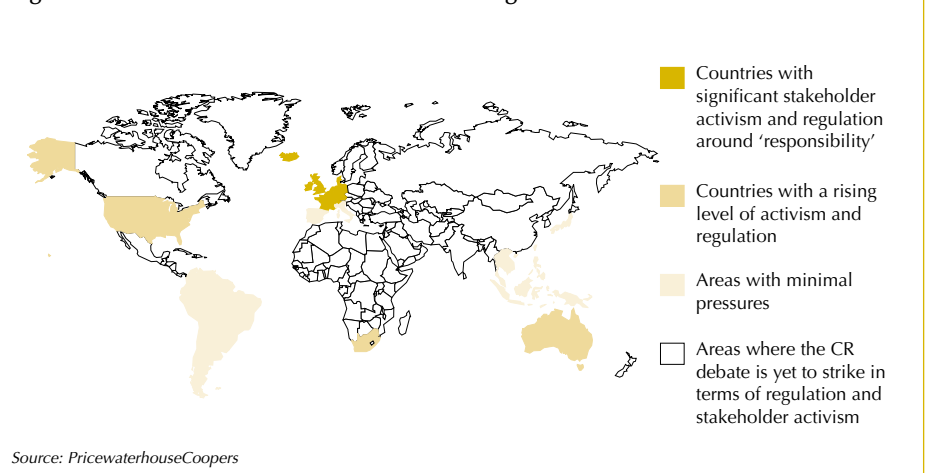
**Rating agencies**

Continue work to determine how responsibility could affect corporate ratings, with some agencies now establishing direct engagement programmes with companies to assess responsibility approaches and arrangements.

**Media**

The insatiable appetite of the global media for scandals and bad news stories is now combined with developing an investigative role as part of a self made mandate to protect consumers.

**Figure 6: Levels of stakeholder activism and regulation**



Source: PricewaterhouseCoopers

# Responsibility: Can you afford not to...? *continued...*

highest, as shown in Figure 6. In the Netherlands, for example, legislation adopted in 2001-2 requires banks to provide public reporting on corporate responsibility. It is important to note that any bi- or multi-national banks are expected to demonstrate their response not only within their country of origin, but within all countries of operations.

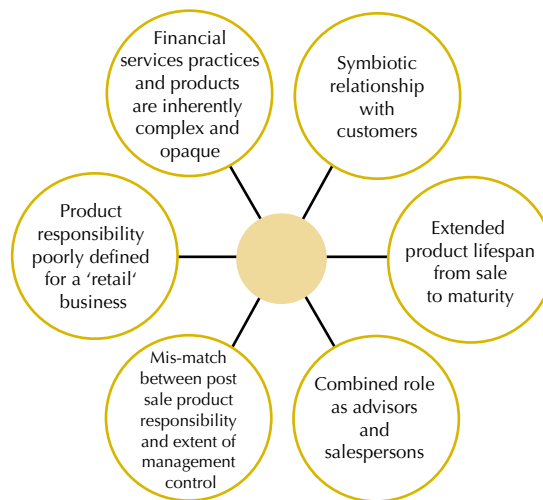
## The business perspective

Everyone's interpretation of what comprises 'responsibility' is unique. It depends upon the perspectives and circumstances of the individual and the context in which business is being performed. What is acceptable practice in one country may not be in another.

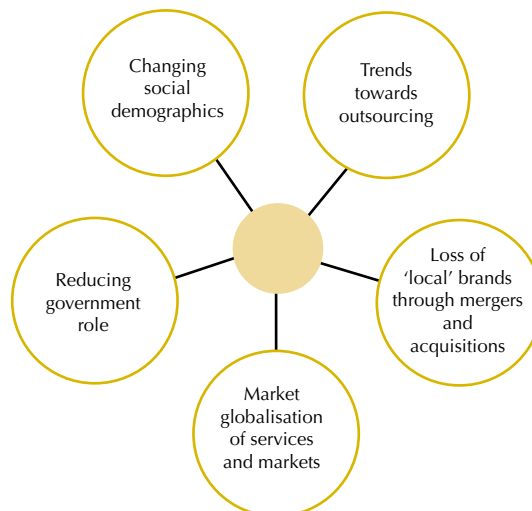
Before trying to define an end point it is important to recall the fundamental objective of most commercial organisations – to create financial return to sustain business activity. Failure to achieve this will result in destruction of the business. Anything which reduces return to an unsustainable level could therefore be deemed irresponsible. By the same token, excessive profits can be correlated with unscrupulous behaviour.

Within that context, responsibility is concerned with achieving financial return by conducting business in a manner which takes into account the needs of key

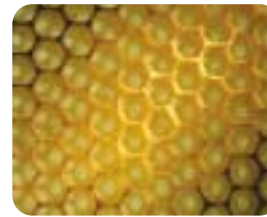
**Figure 7: Challenges for the banking sector**



Demographic and industry evolution continues to create further challenges for the sector:



Source: PricewaterhouseCoopers



### Developing an industry response:

In the UK, nine major financial institutions have come together to articulate what corporate responsibility means in practical terms for the UK financial services sector. The FORGE consortium is sponsored by the UK government and supported by both the Association of British Insurers and British Bankers' Association, with PricewaterhouseCoopers acting as the project managers and advisors to the group. In November 2002, the group published guidance on implementing corporate social responsibility management and reporting for the financial services sector. Coming together as a group has been important for FORGE members both in terms of developing their own responses, and also in establishing an industry standard within the UK. The FORGE model has also now been adopted as the basis for corporate responsibility both within other UK firms and internationally and has attracted interest as a model for developing corporate responsibility in other countries. For example, in France, the Association Française des Banques (AFB) has recognised FORGE as a useful industry model.

stakeholders. Constrained by this basic objective, decisions on what is an appropriate response ultimately have to be made by the organisation itself. Only the leadership of an organisation can identify which are the right priorities (alongside other issues) and the manner in which these will be addressed. Those organisations which develop a response shaped to meet external demands but without real internal purpose are unlikely to sustain their efforts and realise value.

An organisation, however, should not operate in isolation. It is important that stakeholder input is sought and that decisions are made with due and appropriate attention to the relevant stakeholder opinions and views.

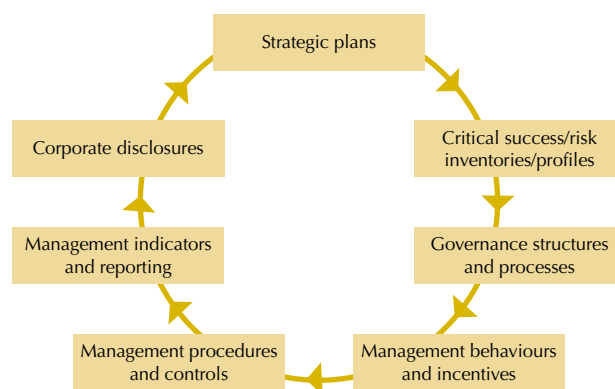
Delivering responsibility and integrity in line with today's expectations brings some

unique and significant challenges for the banking and capital markets industry. Diminishing trust in the financial services industry means that in relative terms it is not starting from a neutral position but a negative one (see Figure 7).

### Developing responsibility in practice

Many banks recognise the importance of responsibility in mission statements and brand identity. Few have gone beyond these statements to articulate what needs to happen to ensure that they are achieved in practice, consistently. Fewer still measure performance and achievement. Under increasing scrutiny there is the risk of a disconnect between statements and practices.

Figure 8: Building a response



Source: PricewaterhouseCoopers

## Responsibility: Can you afford not to...? *continued...*

### Examples of what banks are doing now

#### Involving staff:

Halifax Bank of Scotland (HBOS) has recently conducted an extensive review to better understand what corporate responsibility means in practice. HBOS published its first corporate responsibility report in 2003 and has established a corporate responsibility team and forum, with representatives from across the company. In May 2003, a staff survey was completed to assess the importance of corporate responsibility to staff. Nearly three quarters of respondents stated that corporate responsibility was an important issue to them personally. Many respondents commented that corporate responsibility was a factor in their choice of company to work for and affected how they felt about the bank. All aspects of corporate responsibility were important to staff. However, interestingly, core marketplace activities were seen as one of the key areas of importance to staff. The information gathered through this survey is now being used by management to build HBOS's corporate responsibility activities going forward.

#### Reporting performance:

Many European banks have publicly disclosed information on their environmental and social impacts in recent years. This trend is being demonstrated elsewhere, where forward-looking banks are realising the benefits of proactive communication to stakeholders beyond reporting on traditional measures of financial value. Banco Itau in Brazil intends to publish a sustainability report for 2003.

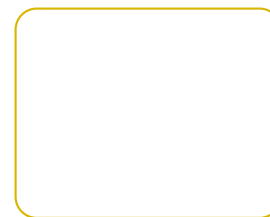
#### Integrating policies within business processes:

ICICI, India's second largest bank, has developed an environmental policy and procedures that meet the requirements of the World Bank and IFC. This has included developing procedures that enable environmental impacts to be considered within the lending decision process and mechanisms to rank the significance of environmental risks.

Implementing responsibility, transparently and consistently across the business, demands a paradigm shift. Contrary to common perceptions, responsibility is not in conflict with good business practice. The only business it should prohibit is business which is undesirable – companies and governments which could cause reputational damage via association, ventures which are unsustainable and those which create unacceptable financial risk. Responsibility is no longer about excluding business, it is about doing business differently – better.

For any response to be successful in delivering value and sustained, consistent results, it is essential that it is integrated into routine business practices. It demands inclusion of a responsibility perspective and dimension into corporate planning, product design, sales and management. It is also essential that it is prioritised to focus on the one, two or few most critical issues first – those which create the most significant risk/opportunity. It is not possible, or necessary, to do all things at once. Importantly, it must also be built upon a systematic decision/response process (see Figure 8).

It is only through this integration that the financial services sector will determine what it really takes to deliver responsibility. It will enable the sector to reduce the



### Responsibility in Practice: The Equator Principles

In June 2003, ten leading banks from seven countries signed up to the Equator Principles, they have since been joined by an additional seven signatories. The Principles are a voluntary set of guidelines developed by the banks to manage social and environmental issues related to the financing of development projects. The banks have agreed to apply the principles globally and to project financings in all industry sectors, including mining, oil and gas and forestry to all loans for projects with

capital costs of \$50 million or more. The Principles are based on the policies and guidelines of the World Bank and International Finance Corporation (IFC).

Current signatories are ABN AMRO Bank, N.V, Barclays plc, Citigroup, Inc, Crédit Lyonnais, Credit Suisse Group, Dexia Group, Dresdner Bank, HSBC Group, HVB Group, ING Group, MCC, Rabobank Group, Royal Bank of Canada, Standard Chartered Bank, The Royal Bank of Scotland, WestLB AG and Westpac Banking Corporation.

Too many in the banking sector still consider responsibility to be about public relations, external affairs and communications. If you are one of these, you are creating a serious reputation and financial risk for yourself through your own actions. Such an approach is both shortsighted and blinkered as it fails to address the real source of the risk. It also creates a visible disconnect between what you say you do and what you really do. This disconnect will be exposed by your stakeholders – regulators, investors, staff, customers and activists, and will undermine their trust in you. This loss of trust will have a direct impact on your ability to maintain and grow market share, achieve high productivity, operate efficiently and, ultimately therefore, your financial performance.

For organisations with better vision, there is opportunity now to shape and inform the debate, manage the risks of operating in today's world well, achieve market differentiation and brand strength.

Given this scenario, can you really afford not to?

opacity of processes and products and enable the sector to manage expectations better and alter perceptions.

### Can you afford not to be responsible?

Scrutiny and criticism of the industry will continue. External expectations are high, public perceptions are often misplaced and there are many skeletons in the archives that will create real financial liabilities as products mature and transparency grows.

To survive these pressures, the industry cannot just defend what it already does,

it has to change from within in the manner in which it conducts its business.

Banking and capital market institutions all have at least some legacy deals, trades, products and services which need to be assessed for their potential impact in today's transparent and responsible world and managed accordingly. Equally importantly, institutions have to demonstrate how the benefits of experience and hindsight are enabling practices and behaviours to change, in order to reduce the potential for the same legacies to develop in the future.

# Contact details

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## Editor-in-chief



**Phil Rivett**

Tel: 44 20 7212 4686  
Email: phil.g.rivett@uk.pwc.com

## Editor



**Darren Meek**

Tel: 44 20 7212 3739  
Email: darren.l.meek@uk.pwc.com

---

## Exploding some of the myths around Basel II



**Chris Matten**

*Executive Director, Financial Risk Management, Singapore*

Tel: 65 6236 3878  
Email: chris.matten@sg.pwc.com



**Monika Mars**

*Senior Manager, Global Risk Management Solutions, The Netherlands*

Tel: 31 20 568 4537  
Email: monika.mars@nl.pwc.com



**Peter Trout**

*Partner, Financial Services, Australia*

Tel: 61 28 266 7620  
Email: peter.trout@au.pwc.com

---

## Banking Banana Skins



**David Lascelles**

*Co-director, Centre for the Study of Financial Innovation*

Tel: 44 20 7493 0173  
Email: info@csfi.org.uk



**John Hitchins**

*UK Banking Leader*

Tel: 44 20 7804 2497  
Email: john.hitchins@uk.pwc.com

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**Bringing it all together – Leveraging risk adjusted performance management**

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**Benoît Catherine**  
*Lead Partner, Financial Risk Management Services, France and Continental Europe*

Tel: 33 15657 1238  
Email: benoit.catherine@fr.pwc.com



**Miles Everson**  
*Partner, Financial Services, Advisory Services, US*

Tel: 1 646 471 8620  
Email: miles.everson@us.pwc.com



**Fernando de la Mora**  
*Director, Financial Services, Spain*

Tel: 34 91 568 4064  
Email: fernando.de.la.mora@es.pwc.com

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**Anti-money laundering – A focus on recent developments and the Asian impact**

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**Dominic Nixon**  
*Partner, Banking and Capital Markets, Singapore*

Tel 65 6236 3188  
dominic.nixon@sg.pwc.com



**Elizabeth Goodbody**  
*Head of Anti-Money Laundering Services, Indonesia*

Tel 62 21 521 2901  
elizabeth.goodbody@id.pwc.com



**Alan Abel**  
*Americas Head for Anti-Money Laundering, US*

Tel 1 202 257 9178  
alan.abel@us.pwc.com

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**Responsibility: Can you afford not to...?**

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**Tina Trickett**  
*Senior Manager, Sustainable Business Solutions, UK*

Tel: 44 20 7804 2569  
Email: tina.trickett@uk.pwc.com



**Joydeep Datta Gupta**  
*Partner, Global Risk Management Solutions Leader, India*

Tel: 91 33 2357 3417  
Email: joydeep.datta.gupta@in.pwc.com







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Kirsty Parker, PricewaterhouseCoopers, Southwark Towers, 32 London Bridge Street, London SE1 9SY.

Fax number: (44) 20 7212 4152

E-mail: [kirsty.parker@uk.pwc.com](mailto:kirsty.parker@uk.pwc.com)

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