

the journal








December 2005

Tackling the key issues in banking and capital markets*





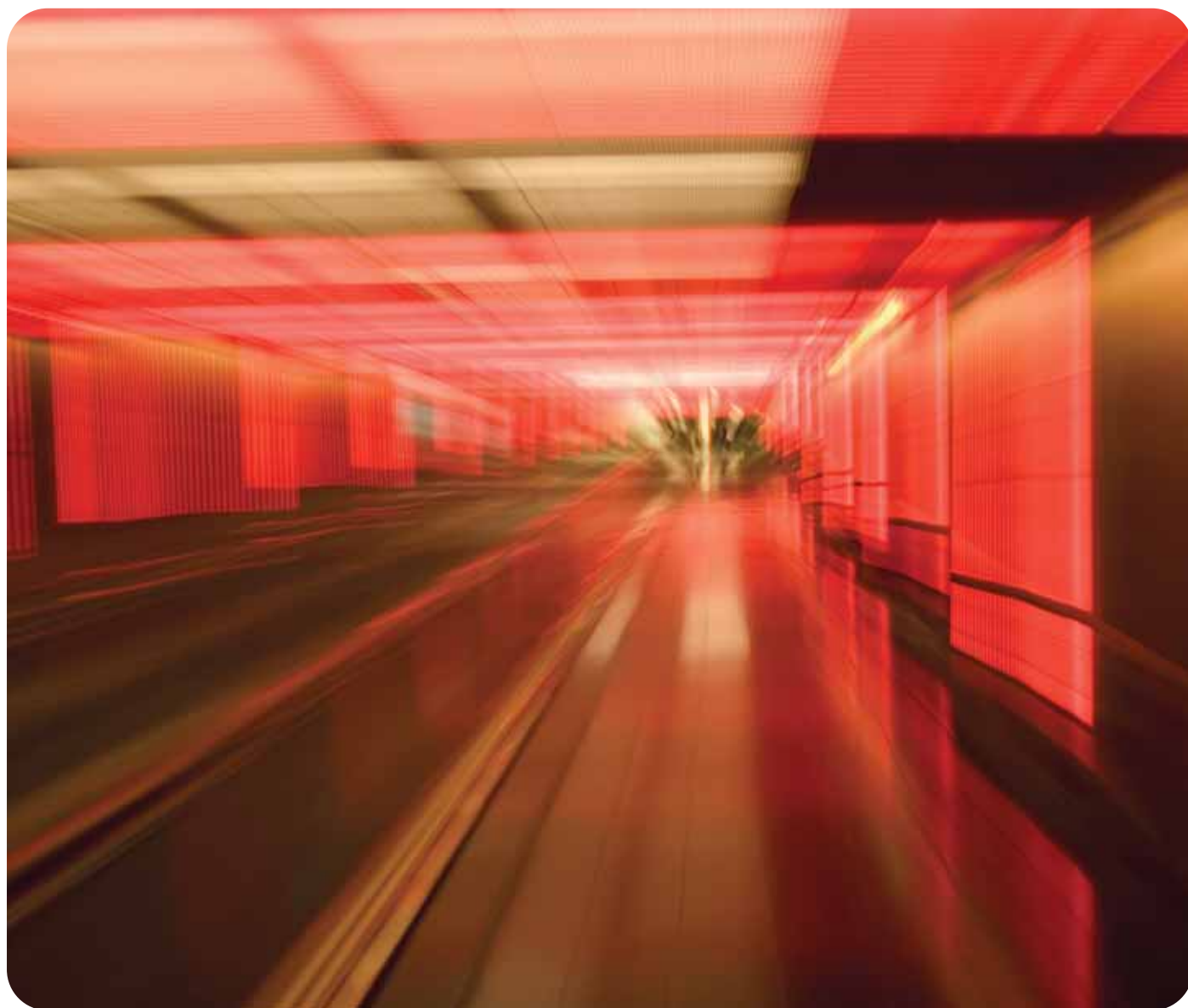
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Editor's comments

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by Chris Lucas

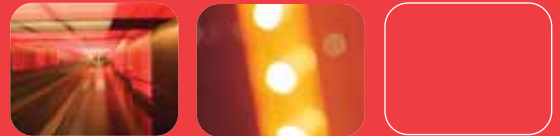


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Welcome to the December 2005 edition of the PricewaterhouseCoopers banking and capital markets journal. In a forever evolving and testing environment, banking and capital markets organisations are facing increasing pressure from the regulatory environments as well as investors and other stakeholders to succeed. This edition brings together a diverse series of articles drawing on some of these challenges.

What is the single biggest threat to financial services institutions today? The most topical, and arguably the most sensitive is that of reputation risk management. In our first article entitled 'Strategic reputation management', Carlo di Florio, Fernando de la Mora and Dietmar Serbée explore the growing importance of reputation risk in organisations and propose a five-step approach for institutions to analyse reputation risks and manage their reputation proactively.

With 130 participants from more than 30 countries, the 2005 PricewaterhouseCoopers Private Banking/Wealth Management survey highlighted key global market trends and analysis and looked at the differences between the ways in which participants provide services to high-net-worth individuals. In their article entitled 'Private banking – competitive challenges ahead', Bruce

Weatherill, Rolf Birrer and Justin Ong consider some of the key issues and themes affecting the private banking and wealth management market as well as highlighting the issues that private banks and wealth managers should be considering when assessing their business.

Getting tax wrong can bruise a company's reputation and shareholder value. Continuing the theme of risk management, Sarah Prior, John Masters and Larry Quimby tackle the increasingly important issue of Tax Risk Management and discuss why it is becoming an increasing concern for financial services organisations. The article looks at how having a tax strategy is fundamental to an organisation's risk management framework.

'If people are an organisation's most critical asset, then measurement has to be crucial' argues Ron Collard, Luan Fox and Christopher Box. In our fourth article, we aim to explore how increasing regulation and demands from investors and stakeholders is encouraging financial services organisations to explore the correlation between effective people management and business performance and suggests how institutions can use people metrics and human capital data to create competitive business advantage.

In 'Management of IT Value', Mark Lutchen, James Chrispin and Peter Broshuis examine the different approaches to placing a value on Information Technology services and explore the key drivers for proving the value of IT and outline the challenges facing the valuation of IT's contribution to the business as well as highlighting some of the different methods which have been used in organisations today. The article asks how financial services institutions need to consider the contribution and impact of IT in a wider business context and outlines a number of key approaches which they should consider to improve the value of IT to the business.

Fair value can no longer be viewed as a purely technical concept driven solely by accounting policy departments. In our final article, 'Fair value and financial instruments – developments and changes', Mark Batten, Doug Summa and Mat Falconer consider the practical consequences and challenges of recent developments in fair value accounting and how the focus on the robustness of the control environment has led to wider business and control implications within financial services organisations.

I hope you enjoy this edition of the journal. Please continue to provide us with feedback particularly topics and issues you would like to see addressed in future editions.

Strategic reputation management – managing reputation risk and value in financial services institutions

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by Carlo di Florio, Dietmar Serbée and Fernando de la Mora



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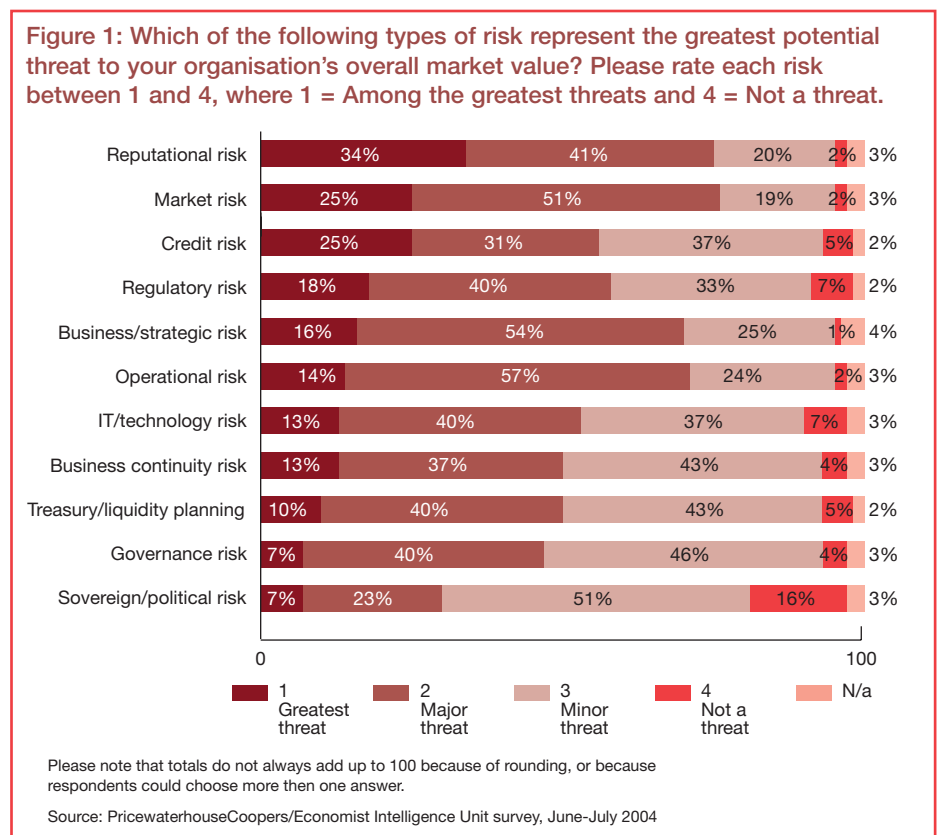
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Reputation has been treasured as an asset since time immemorial. Roman maxims counselled that ‘a good reputation is more valuable than money’, and Socrates defined reputation as ‘the richest jewel’. Today, reputation risk management is one of the greatest challenges facing financial institutions. Research by PricewaterhouseCoopers and the Economist Intelligence Unit (EIU) found that leaders of global financial institutions perceive reputation risk to be the greatest potential threat to market value¹. There is reason for concern: another recent study found that certain operational risk events with high reputational fallout, such as deceptive sales practices and compliance failures, can result in market capitalisation losses far exceeding actual financial losses – up to 12 times the actual loss, as much as a 5.5% loss in total return to shareholders².

Yet institutions’ efforts to effectively manage reputation risk are often hampered by definitional and management challenges. For one thing, reputation is shaped in the eyes of individual stakeholder groups – including customers, investors, employees, suppliers, alliance partners, regulators, enforcement authorities, communities,



and rating agencies – each with its own set of expectations. Additionally, a clear, widely accepted definition of reputation risk has yet to emerge, and this lack of a common language within and across institutions makes it challenging to build consensus around the issue at stake and

the actions needed. Furthermore, recent financial scandals, governance issues and compliance failures in the financial industry suggest that reputation damage can arise as a devastating secondary effect of underlying risk events in any number of areas. While accounting,

¹ PricewaterhouseCoopers/Economist Intelligence Unit study, ‘Uncertainty Tamed? The Evolution of Risk Management in the Financial Services Industry’ Survey Results 2004.
² Dunnett, Robert S., Levy, Cindy B., Simoes, Anthony P., The Hidden Costs of Operational Risk, McKinsey Study on Finance, Winter 2005.

Strategic reputation management continued...

ethics, sustainability, Basel II and value-at-risk principles are all relevant and important inputs to strategic reputation management, each is only one dimension to consider and it is the aggregation and interrelationship analysis, the portfolio view, and the application of enterprise risk management principles that ensures effective reputation risk and value management. Finally, reputation changes dynamically and requires careful management over time. A solid, longstanding well-respected reputation, while no guarantee of survival, may help a deserving company weather a storm, but a company that has no such reputational equity can sink quickly when faced with a large, adverse reputation event. In short, reputation risk events impact value decisively, and shareholders and markets are particularly unforgiving where they perceive the event was preventable and the company irresponsible.

Despite these challenges, there is a growing appreciation among financial institutions that an effective reputation risk management approach must leverage strong governance, risk management and compliance practices, and can help safeguard the franchise and turn reputation into a source of sustainable value creation.

Regulators also recognise that there may be no more elusive, difficult to manage, and feared risk for financial institutions than reputation risk. Not surprisingly, scrutiny and expectations have heightened, and some regulators are openly emphasising the importance of managing common sources of reputation risk, including weak governance and culture, lack of enterprise perspective, conflicts of interest, complex structured financial transactions, money laundering, and sales practices³. While the Basel II capital framework does not envision an explicit capital requirement for reputation risk, it is likely that a sound framework for managing reputation risk can contribute positively to regulators' considerations under Pillar 2. Regulators do not look at reputation risk in isolation, but consider it within the broader context of an institution's governance, risk and compliance structures and culture: is there an environment for sound decision-making that includes effective structural governance and a system of checks and balances to identify, monitor and control the risks to which the organisation is subject? Do the organisation incentives reinforce that no deal, no sale, no loan, no customer and no profit opportunity are worth compromising the institution's integrity and reputation?⁴

This article proposes five key steps to such a reputation risk management approach:

1. **Define reputation risk and segment key stakeholder groups, and map their expectations.** A clear articulation of how the institution defines reputation within the context of its stakeholder relationships is a crucial starting point for forming a common language and consensus around how reputation risk can be managed. In our view reputation has a value that can be measured – and reputation risk is the risk of decrease in an institution's reputation value. Reputation risk arises when an institution's business conduct does not meet the expectations of stakeholders. It is therefore often, but not exclusively, a secondary effect of underlying, primary risk events that can occur anywhere in the organisation.
2. **Identify and measure the risks with the greatest impact on reputation value, and identify the underlying drivers.** The objective of this step is to isolate the key events enterprise-wide, which could affect the ability to deliver against reputation objectives and align the management strategy around reputation risk drivers.

³ Department of the Treasury, Office of the Comptroller of the Currency, Docket No. 04-12, Office of Thrift Supervision, No. 2004-27, Federal Reserve System Docket No. OP-1189, Federal Deposit Insurance Corporation, Securities and Exchange Commission Release No. 34-49695, File No. S7-22-04, Interagency Statement on Sound Practices Concerning Complex Structure Finance Activities, May 2004.

⁴ Remarks by Julie L. Williams, Acting Comptroller of the Currency Before the Conference on Bank Structure and Competition, Federal Reserve Bank of Chicago, Illinois, May 6, 2005 (<http://www.occ.treas.gov/ftp/release/2005-1a.pdf>).



Reputation risks can then be aggregated into an enterprise view of risk and managed as a portfolio. We believe that measuring reputation value is key to understanding the underlying reputation drivers and managing reputation risk. Reputation value-at-risk measures can then be developed by estimating volatility of underlying factors that impact reputation.

3. **Develop proactive and reactive reputation risk response strategies.** This step aims to develop a process that can be taken to control reputation exposures before they materialise, and to manage reputation fallout after the damage is done. This effort should seek to leverage, to the greatest extent possible, existing risk management information and infrastructures. Consider the impact of reputation risk when setting risk appetite strategically.
4. **Clearly define roles and responsibilities for reputation risk management, leveraging existing governance and organisation structures where possible.** The objective is to ensure

independence, authority and standing through board and executive management oversight. Through policy setting, reputation risk management principles should be embedded into key business processes, including strategic planning (e.g. new products, services, M&A), performance management, training, reporting and systems architecture.

5. **Take a risk-based approach to reputation risk monitoring.** Finally, it is crucial to ensure that the greatest reputation risks are:
 - a) monitored by the business units through risk self-assessments, for example, Risk and Control Self-Assessment (RCSA);
 - b) subject to targeted ongoing monitoring by key control functions leveraging technology;
 - c) subject to tailored reputation risk escalation protocols that ensure visible, high-impact, and unique transactions or issues are identified, assessed and mitigated; and
 - d) priorities in Internal Audit plans, ensuring independent assurance of programme design effectiveness and operating effectiveness.

Some context: reputation of financial services companies relative to market

Reputation indices of financial institutions lag behind those of other industries when viewed by a number of reputation metrics put forth by different sources analysing global data (see Figure 2).

- Fortune's Most Admired Companies List shows US financial services in seventh position after industries such as real estate, power, electronics and equipment, and computers and communications⁵. When analysing financial services subsectors, securities firms and mortgage banking obtain lower reputation scores than other areas such as commercial banks, insurance companies and consumer finance firms.
- Business Week's study on The 100 Best Global Brands by Value⁶ shows brand valuation of financial institutions (a major component of reputation) averaging just 15% of market capitalisation.

⁵ Fortune's Most Admired Companies ranking is based on Hay Group's survey among executives, directors, and analysts to rate companies in their own industry on eight criteria, ranking innovation, use of assets, employee talent, management, investment value, social responsibility, financial soundness and products and services.

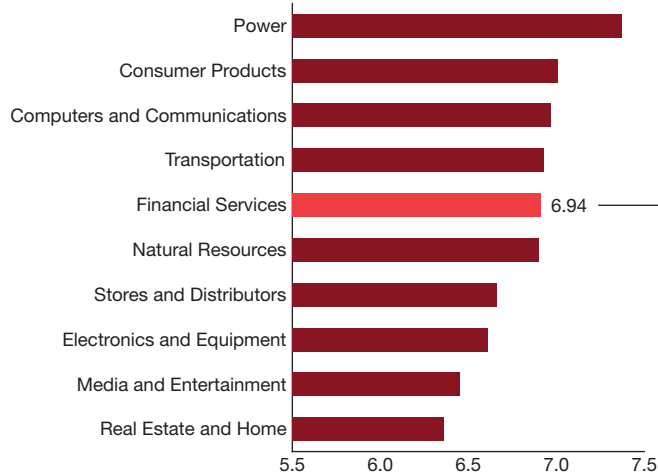
⁶ Business Week's study on The 100 Best Global Brands is prepared in partnership with Interbrand. In the ranking, a dollar value for each brand using publicly available data, projected profits and variables such as market leadership, stability and global reach. Intangible earnings calculations exclude patents and management strength to assess what portions of those earnings are attributable to the brand.

Strategic reputation management continued...

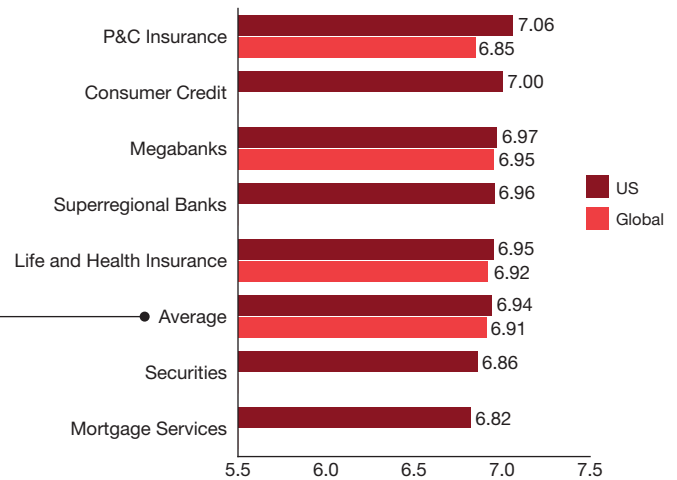
Figure 2: Financial Services Reputation Analysis

Reputation* of the US financial services sector is low relative to other industries.

Top 5 Industry Average Fortune Reputation Index

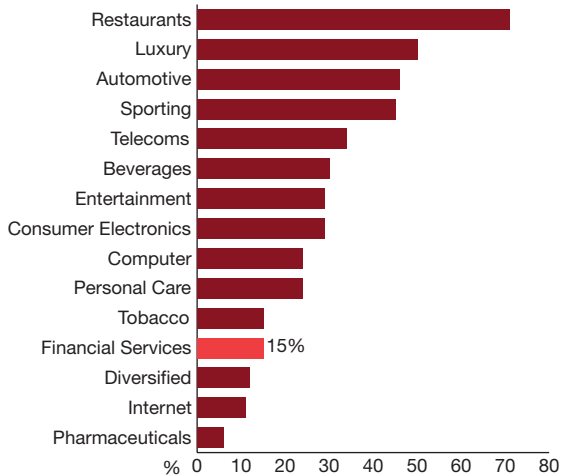


Securities and mortgage banking are the businesses with the lowest reputation* scores.



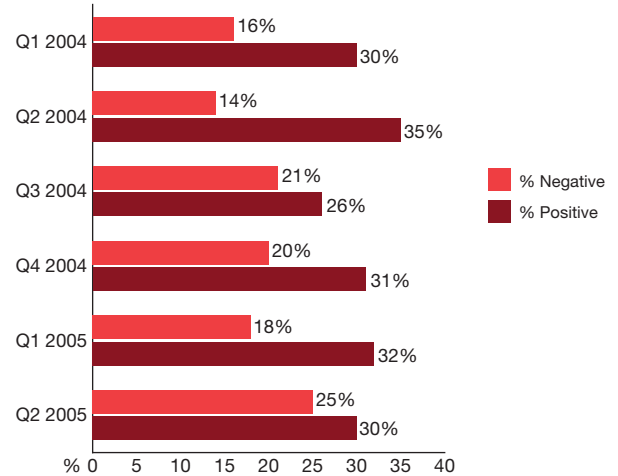
Brand value** of financial services firms, a major component of their reputation value, also lags relative to other sectors.

Brand Value as % of Market Capitalisation



Historical trends of reputation show a gap between US financial services companies and top players.

Delahaye Index***



* Note: Reputation measured using Fortune Magazine's 2005 Most Admired Companies (America and Global). Scores were derived from the average of the top five companies within each industry sector.
 ** Note: Brand value reported in Business Week's Study 'The 100 Best Global Brands by Value' prepared by Interbrand. Brand value as a percentage of market capitalisation was measured based on averages of the reported names by sector.
 *** Delahaye is an index that analyses positive and negative press coverage affecting company reputations.
 Source: PricewaterhouseCoopers



- The Delahaye Index⁷, which includes 21 US financial institutions among its top 100, is based on measures of tone, impact and impression of companies' media coverage, and shows stable levels of positive news, but increasing negative news impacting the reputation of financial services institutions.

The potential factors that may explain why the reputation levels of financial institutions lag behind those of other industries include the following:

1. Being highly regulated, industries such as the financial services industry receive high visibility and are vulnerable to regulatory actions that may adversely impact their reputation more than in other industries (e.g. corporate governance crises).
2. Large consolidation efforts over the last three decades, resulting in a melding of different cultures, appears to have caused dilution of brand value, led to management distraction/complexity, introduced inconsistent ethical behaviour and created customer service disruption.

3. High competition and products and services commoditisation appears to have led customers to not perceive significant differences between financial service providers.

4. Given the financing nature of products and services they provide, financial institutions are not only exposed to their own reputation, but also to the reputation of their clients (e.g. Enron and WorldCom).

5. In line with the less active focus on reputation value and brand management relative to other industries and more of an emphasis on the downside of reputation risk in financial services, reputation risk has not been incorporated into regulatory risk management practices in financial services organisations (e.g. Basel II and Solvency II).

It is our view that the reputation lag of the financial services industry presents significant opportunities for the management of financial institutions to have their reputation value recognised. A later section of this article evidences that the size of reputation value and its impact on shareholder value has

sufficient economic worth to justify allocating an increased investment of resources dedicated to improving ways of managing reputation value and reputation risk.

Linking reputation and shareholder value

Shareholder value added (SVA) is defined as earnings net of cost of capital. 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 generated through organic growth or acquisitions. So, is there a linkage between reputation and SVA?

Figure 3 demonstrates that reputation and price-to-book ratios of financial institutions correlate positively. Investors tend to pay a higher premium for shares with highly regarded reputations⁸. Investors discount that highly reputable firms will have a greater ability to meet future earnings generation expectations. The relationship between price-to-book and reputation shows that incremental changes in reputation have a proportional increasing effect in price-to-book ratios.

7 Delahaye gathers news from America's most prominent national news sources. The 2005 Delahaye Index includes analyses of different print and broadcast news items to measure the reputations of the top 100 U.S. companies. Each company's score is based on how many positive and negative reputation-driving attributes are found within each story. These attributes are classified into five dimensions: stakeholder relations, financial management, products and services, organisational integrity and organisational strength.
8 Reputation index as measured by Fortune 500 Most Admired Companies study.

Strategic reputation management continued...

That is, big changes in reputation have a very large impact in market capitalisation, which are non-proportional to small changes.

Thus, reputations have an important financial impact in shareholder value creation/destruction:

1. High reputations increase investor perception on the company's ability to meet future earnings expectations; and
2. High reputations reduce cost of raising capital (both equity and debt).

Our view is that companies that meet the following three requirements are likely to obtain superior shareholder returns:

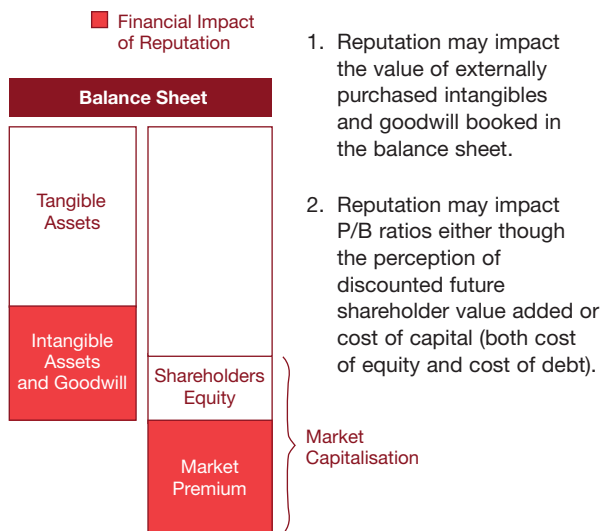
1. Companies that are able to evaluate the degree of linkage between their reputations and market capitalisation;
2. Companies that understand and measure the key drivers of their reputation and how those factors may impact market capitalisation; and

3. Companies that take management actions to influence reputation drivers both on a proactive basis (pre-emptive actions) as well as on a post-event basis (event response/crisis management).

In fact, several industry studies have demonstrated that reputation can drive shareholder returns. For instance, Antunovich⁹ *et al* found that 'most admired' shares outperform by 45% shares of 'least admired' companies in average cumulative five-year returns.

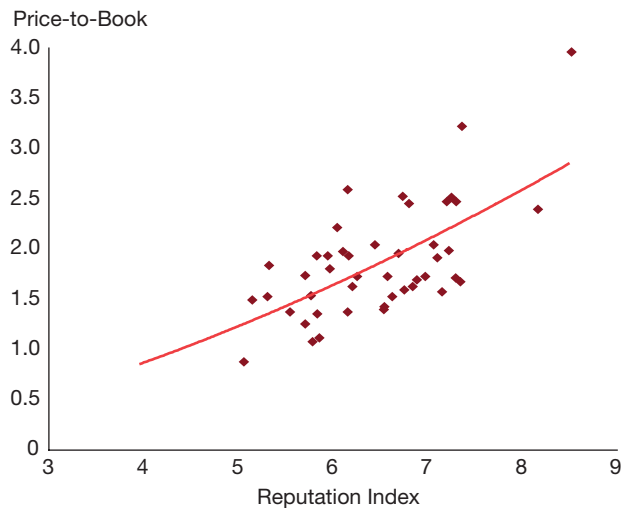
Figure 3: Linking Reputation to Shareholder Value

Reputation has a financial impact in key shareholder value drivers.



Source: PricewaterhouseCoopers

Investors tend to pay higher premiums for companies with better reputation*.



* Note: Reputation measured using Fortune Magazine's 2005 America's Most Admired Companies.

⁹ Antunovich, Laster, Mitnick, 'Are highly quality firms also high quality investments?' Current Issues in Economics and Finance, January 2000.



Management framework – Five step approach

1. Define reputation risk and stakeholder expectations.

2. Measure reputation value and identify key risk drivers.

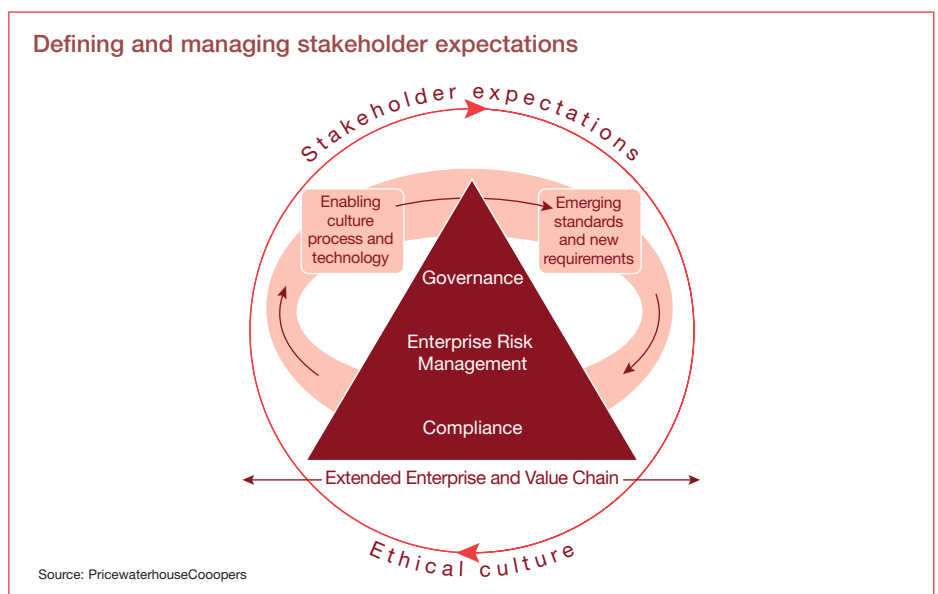
3. Develop proactive and reactive risk response strategies.

4. Permeate responsibilities for reputation risk management throughout the organisation.

5. Take a risk-based approach to monitoring.

Given that reputation can be directly linked to shareholder value creation, what can financial institutions do to manage their reputations more effectively?

In our view, a starting point for effective reputation management is the recognition that institutions cannot rely solely on their existing credit, market, operational and business risk frameworks to manage reputation risk. The reasons are twofold. First, the highly sophisticated risk management practices that institutions have developed over time generally focus on the direct impact of loss risk events on the financial statements, and rarely account for indirect, longer term



reputational repercussions. This is partly a reflection of the difficulties in measuring such impacts. Second, these frameworks tend to take a siloed view of specific risk categories and do not take a portfolio view of the reputation impact of risk events. They therefore fail to account for the cumulative reputation impact of risk events – and the potentially compounding effects on reputation that could arise from a succession of highly visible risk events.

The upshot is that institutions need to implement an approach to reputation risk management that is incremental to the credit, market, operational and business risk management frameworks they have

already in place. The explicit objective of such an approach is to proactively identify and assess risk events with a high impact on reputation before they occur. This then enables the implementation of specific responses to prevent the occurrence of such events, and the pre-emptive definition of targeted strategies to manage the reputation impact of such risk events should they occur.

In our view there are five critical steps to an effective reputation value and risk management approach.

Strategic reputation management continued...

Step 1: Define reputation and stakeholder expectations

A clear articulation of how the institution defines reputation risk within the context of its stakeholder relationships is a crucial starting point for forming a common language and consensus around how reputation risk can be managed. Despite the wide range of definitions provided by industry practitioners in the area of reputation risk, all would agree that reputation is a valuable asset. The absence of definitional agreement comes in part from the difficulties of identifying and measuring the value of reputation. If one can measure the value of reputation, reputation risk could be defined as simply the potential loss or volatility experienced in the value of reputation. Our view is that reputation value can be measured and, as a result, so can reputation risk:

- **Reputation value** can be measured as the sum of the firm's intangible assets as shown in Figure 3. Intangible assets can be generated through acquisitions in which may be reflected in a company's balance sheet. In addition, intangible assets can be generated internally over the course of business in which case they are not part of the balance sheet, but rather they are reflected in the company's market premium (difference between market capitalisation and book equity).

1. Externally purchased intangibles and goodwill booked in the balance sheet typically as a result of mergers and acquisitions (M&A). The value of purchased goodwill can be reduced, in which case write-offs impact the company's earnings. Some companies measure and allocate economic capital for potential goodwill write-offs.
2. Internally generated intangibles such as brand, customer base and loyalty, intellectual property and management talent are not normally recorded in the balance sheet, but rather reflected in the market premium paid by investors (difference between market capitalisation and book equity). This market premium is a reflection of shareholder's expectations of future returns. An institution's ability to deliver such future returns depends in turn on the institution's ability to meet the expectations of a broader set of stakeholders – including customers, regulators, employees, suppliers, and the communities in which it operates. Figure 4 provides examples of core areas in which stakeholder groups formulate expectations of institutions.

- **Reputation risk** is the risk of change in the institution's reputation value. This value may change as the result of credit, market, operational or business risk events that impact the expectations of the institution's stakeholders, affecting future earnings flows, and the market premium investor built into the price of the institution's equity. The risk to reputation is therefore a secondary, yet potentially substantial, effect of underlying primary events in these categories.

Two broad conclusions can be arrived at from the above definitions:

- Reputation damage has a financial impact and can be directly linked to shareholder value creation; and
- Managing reputation risk requires more than relying on existing risk management practices.

We believe that reputation risk is a secondary effect of underlying, primary risk events that can occur anywhere in the organisation. It arises when such risk events create the perception that the institution's conduct differs from stakeholders' expectations. To manage reputation risk effectively it is therefore important for institutions to segment stakeholder groups and map their



Figure 4: Stakeholder group expectations

Stakeholder group	Examples of expectations
Customers	<ul style="list-style-type: none"> • Trust/respect/admiration • Service/fair treatment • Product quality/value • Convenience/accessibility
Employees	<ul style="list-style-type: none"> • Corporate culture • Workplace environment/safety • Fair treatment • Opportunity
Suppliers and Alliance Partners	<ul style="list-style-type: none"> • Volume of business • Management/operations • Financial stability
Investors	<ul style="list-style-type: none"> • Investment/financial performance • Corporate governance • Regulatory compliance
Community/Society	<ul style="list-style-type: none"> • Community involvement • Contribution to tax base • Respect for environment • Fair treatment of people

Source: PricewaterhouseCoopers

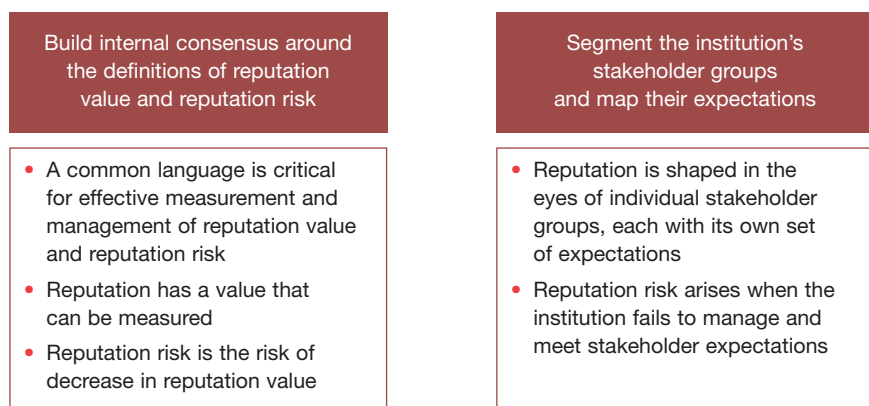
expectations with some level of detail. Stakeholder and expectation maps differ from one institution to the next, but we think that there are a number of common themes (see Figure 5). Consistent and proven ability to meet such expectations drive the perceptions stakeholders hold of a given organisation, in other words its reputation.

Step 2: Assess risks to reputation value and identify the underlying drivers

The objective of this step is to isolate the key events that could affect an institution’s ability to meet its stakeholders’ expectations. This step relies both on backward-looking and forward-looking analyses.

Measurement of the historical impact of risk events on reputation value is a key enabler in understanding risk drivers and provides the core component of the backward-looking portion of the analysis. It should use internal and external data on share price performance, risk events and news flow, to identify events that have had high impact on stakeholder expectations, market premiums and shareholder value added. The analysis should consider both how long specific events affected market premiums once they became public knowledge, and in the case of a negative reputational event, how effective response actions were

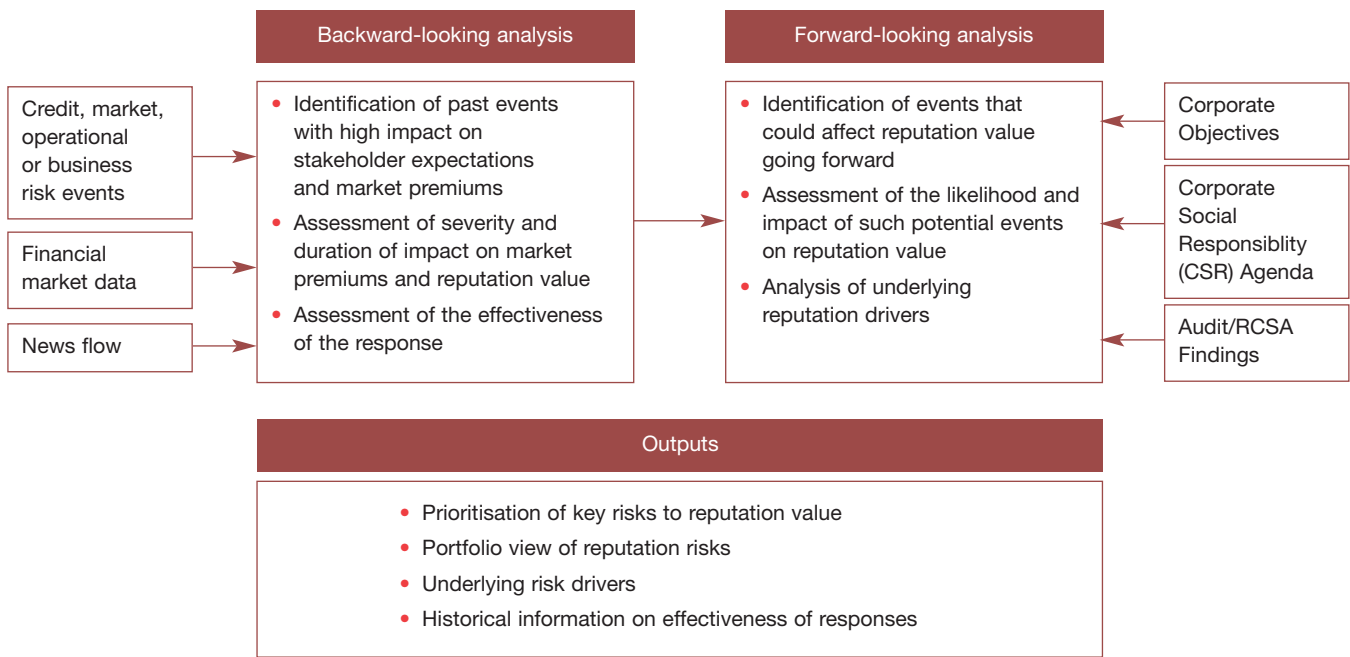
Figure 5: Define reputation and stakeholder expectations



Source: PricewaterhouseCoopers

Strategic reputation management continued...

Figure 6: Assess risks to reputation value and identify underlying drivers



Source: PricewaterhouseCoopers

accelerating the recovery of lost value. Our research in this field suggests that, using this approach, an institution should be able to identify a series of risk events with six to eight key drivers that have the greatest impact on the institution’s ability to meet stakeholder expectations. While such drivers should be expected to be specific to each institution, common drivers will likely include the quality of

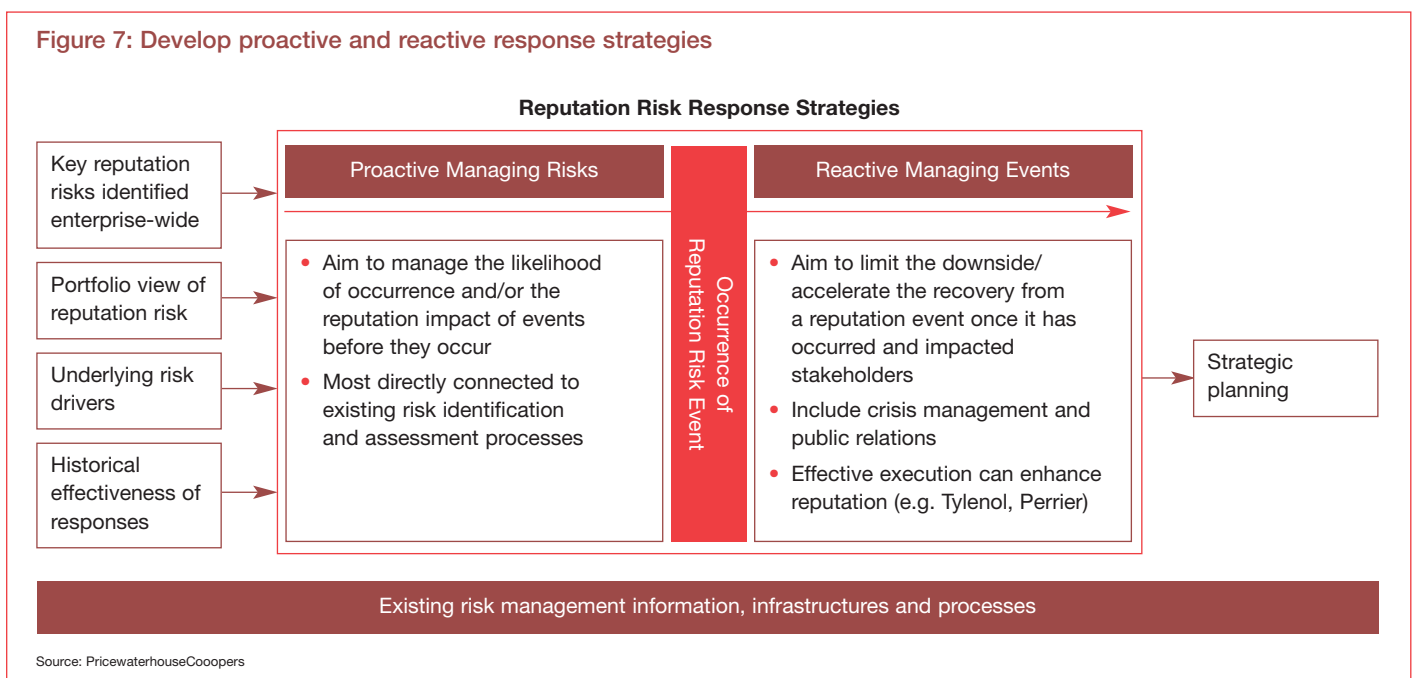
corporate governance, management talent, innovation, customer satisfaction, the effectiveness of event response and crisis management.

The forward-looking portion of the analysis considers the information on risk drivers from the backward-looking analysis of historical data, and seeks to identify potential future reputational

issues. This analysis is performed against the background of the organisation’s corporate objectives, its corporate social responsibility agenda and external factors. It should seek to leverage existing information from audit findings, risk and control self-assessments, and scenario planning processes to the greatest extent possible.

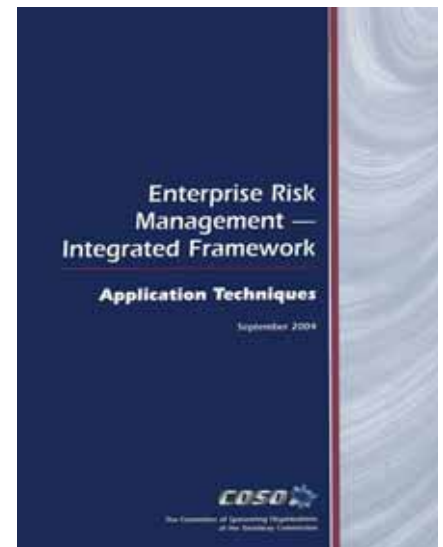
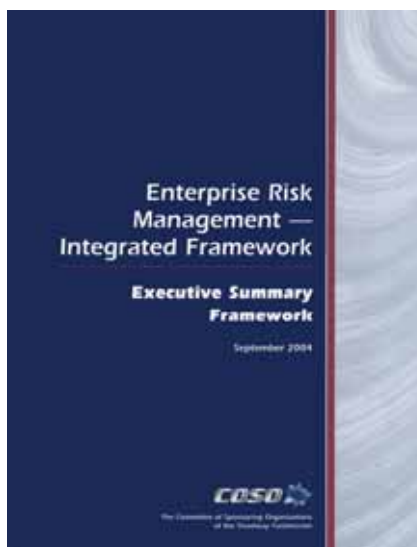


Figure 7: Develop proactive and reactive response strategies



Different institutions may use different approaches to assessing reputation risk and its underlying drivers; however, in our view there are some key attributes of effective reputation risk identification and measurement processes that are constant:

- They should have both a backward-looking and forward-looking component, as outlined above.
- They should combine qualitative and quantitative measures, such as the results from risk and control self-assessment and scenario analysis



Strategic reputation management continued...

Figure 8: Permeate responsibilities for reputation risk management throughout the organisation



processes¹⁰, For instance, the risk and control self-assessment process may identify weaknesses in the IT infrastructure as a key risk to achieving retail customer service objectives, and assess this risk based on the primary, direct financial impact of a customer information security breach. The reputation management process leverages this analysis and

assesses the secondary, reputation impact of such an occurrence, prioritises events with greatest potential impact, and defines action items to proactively and reactively manage their impact.

- They should specifically focus on measuring reputation value and its linkage to market premium.

- They should break down reputation value in manageable components/elements so practical actions can be undertaken.
- They should assess impact length/horizon of events (how long effects last and response actions to recover lost value).

¹⁰ A number of leading institutions are implementing risk and control self-assessment and scenario analysis processes to support their implementation of an advanced measurement approach (AMA) for operational risk under Basel II. Though an effective reputation management framework is not predicated upon the prior implementation of an AMA, it should seek to leverage existing risk information and infrastructures, to the greatest extent possible so as to avoid duplications of efforts and waste of resources.



- They should use both internal and external data (learn from other companies' reputation events and assess effectiveness of their actions and crisis management steps).

The outputs from identification and measurement efforts can then be aggregated into an enterprise-wide, portfolio view of the greatest risks to reputation, and their prioritisation for management action. They should also provide some of the raw material that institutions need to begin exploring the complex interactions and compounding effects that various risk events can have on their reputation.

Step 3: Develop proactive and reactive reputation risk response strategies in strategy setting

An effective reputation management process must define risk responses that are both proactive and reactive in nature. Proactive steps aim to manage the likelihood of occurrence and/or the reputation impact of events before they occur; they are most directly connected to existing risk identification and assessment processes. Reactive steps aim to limit the downside, and accelerate the recovery from, a reputation event,

once it has occurred, impacted stakeholders and become public knowledge. They tend to include crisis management and public relations components, yet are most effective when executed flawlessly, based on a crisis-response plan determined in advance. Reactive reputation management steps can not only limit damage to reputation, but enhance it significantly, as several examples would suggest – the Tylenol withdrawal in 1984 or Perrier's response to the discovery of chemicals in 13 bottles of its products in 1990.

The effort to develop appropriate proactive and reactive response strategies should seek to leverage, to the greatest extent possible, existing risk management information and infrastructures. It must link back to strategic planning activities and be enterprise-wide in nature. There are numerous examples illustrating how events occurring in one business unit may tarnish the reputation of the organisation as a whole. The enterprise risk management framework proposed by COSO¹¹ defines a set of principles that institutions may find useful in guiding their efforts.

Step 4: Clearly define roles and responsibilities for reputation risk management, leveraging existing governance and organisation structures where possible

- Manage reputation risk through an organisational structure that extends existing governance practices and clearly defines roles and responsibilities.
- Ensure independence, authority and standing through board and executive management oversight.
- Embed, through policy setting, reputation risk management principles into key business processes, including strategic planning (e.g. new products, services, M&A), performance management, training, reporting and systems architecture.

Governance of reputation risk management activities is critical to ensure appropriate checks and balances and the deployment of effective people, process and technology resources.

¹¹ Enterprise Risk Management – Integrated Framework and Application Guidance authored by PricewaterhouseCoopers under sponsorship of the Committee of Sponsoring Organizations (COSO), Sept 2004 (see www.pwc.com).

Strategic reputation management continued...

Key steps here include:

- Incorporating reputation risk management into existing roles and responsibilities of the board, senior management, business unit management and control functions. For example, a board should help establish the risk appetite and priorities for reputation value and risk management; senior management should set the tone for reputation risk management and own the responsibility for implementing an effective framework; business unit management should cascade key accountabilities for reputation risk management into day-to-day responsibilities; and control functions should facilitate design, measurement and monitoring of reputation risk;

- Ensuring that reputation risk is a key component of strategic business decisions, including board/management team, succession planning, new product/service development, mergers and acquisitions, stakeholder analysis;

- Ensuring reputation risk management metrics are an explicit part of performance management processes and drive evaluation, capital allocation, compensation, promotion and success; and

- Leveraging Sarbanes-Oxley and other regulatory compliance efforts to enhance effectiveness and streamline processes and technology.

Finally, the reputation risk management framework must have an executive-level 'owner' of the framework, who is able to rally senior management attention and consensus. The 'owner' of reputation risk may vary by institution, but should be somebody with a solid understanding of the institutions risk appetite and profile, and the authority to affect business decisions and direct resources enterprise-wide. This could, for example, be the Chief Operating Officer, Chief Risk Officer, General Counsel, or Chief Executive Officer. Whoever the individual vested with the responsibility for the framework, there should be no doubt that the 'ownership' of the risks, which could have reputational impact, squarely lies with those parts of the organisation that incur the risk, and must be managed at that level.

Step 5: Take a risk-based approach to reputation risk monitoring

The reputation management framework must be supported by formal reputation reporting flows to senior management and those able to take appropriate action. Consider the use of dashboards,

based on key reputation risk indicators specific to an individual organisation and ensure that the greatest reputational risks are:

- 1) Monitored by the business units through risk control self-assessments (e.g. RCSA);

- 2) Subject to targeted ongoing monitoring by key control functions leveraging technology;

- 3) Subject to tailored reputation risk escalation protocols that ensure visible, high-impact and unique transactions or issues that are identified, assessed and mitigated; and

- 4) Subject to Internal Audit, independently validating the design effectiveness and operating effectiveness of reputation risk management functions, policies and procedures.

The existence of formal measures and reports are key in developing senior management awareness and consensus, and prerequisites in ensuring that the framework enables effective decision-making and follow-through.



Conclusion and recommendations

While the implementation of such a framework may take time and resources, there are a number of steps institutions can take immediately to begin managing their reputation proactively. Financial services institutions should build on their risk management capability to adopt a portfolio view of the reputation impact of events.

Our five-step methodology suggests that first, reputation risk should be defined relative to the organisation stakeholder expectations and reputation value. Second, the key events that could effect the ability to deliver against reputation objectives should be isolated, and KPIs and management strategy should be aligned around reputation risk drivers. Third, a reputation risk management framework should be developed to facilitate the identification, assessment and reporting of risks. Fourth, clear roles and responsibilities in relation to reputation risk management should be defined within key business processes. Finally, a risk-based approach to reputation risk monitoring should be adopted. Organisations can thereby improve their ability not only to identify, proactively address or otherwise effectively respond to issues that could

cause potential damage to their reputation, but also to strengthen the areas of greatest importance to their stakeholders, thereby building trust and the value of their reputation.

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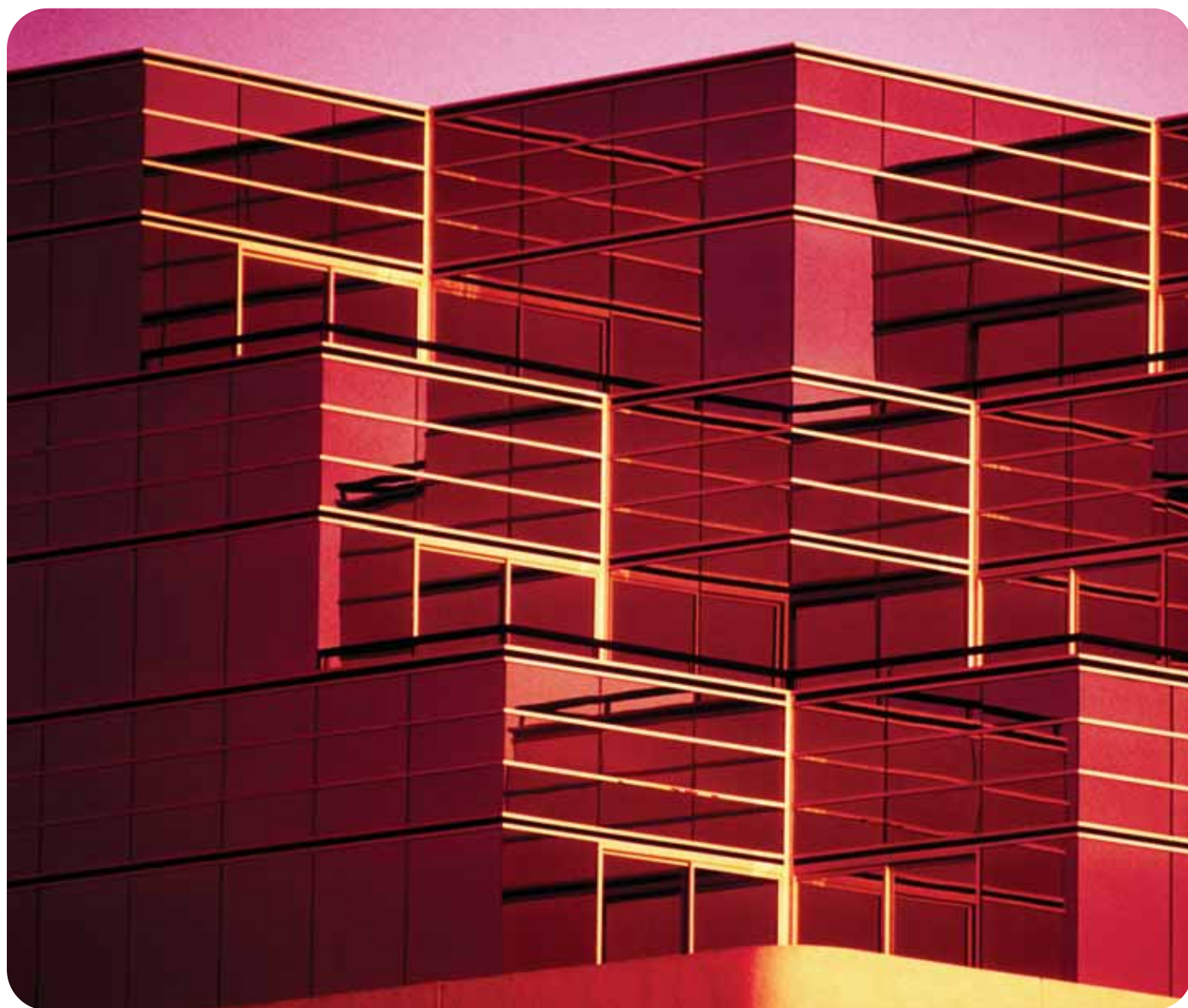
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Private banking – competitive challenges ahead

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by Bruce Weatherill, Justin Ong and Rolf Birrer



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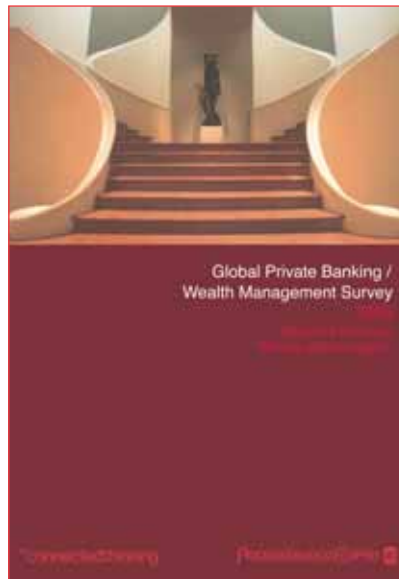


With over \$30 trillion of High Net Worth Individual (HNWI) global wealth, many different product offerings and an immeasurable number of service providers, the private banking industry is clearly an interesting and diverse area of the wealth management arena.

Introduction

The 2005 PricewaterhouseCoopers Global Private Banking/Wealth Management Survey¹ reveals an industry with optimistic expectations of growth. Yet not everyone can be a winner, and in a sector marked by rising competition, mounting pressure on margins and increasing vulnerability to acquisition, private banks must have a clear focus and well-defined strategy for success.

Since its inception in 1993, the in-depth biennial survey has been charting the drivers and direction that are likely to shape the private banking sector in the years to come. The 2005 study is based on the findings from detailed questionnaires completed by 130 organisations from more than 30 countries. It covers Europe, Asia, North America and, for the first time, includes input from the Middle East,



Scandinavia, South America and a number of offshore centres. From niche players to private banking giants, the participants represent a broad spectrum of entity sizes in what remains a largely fragmented sector.

The findings show that respondents are confident about their industry's prospects as they emerge from the investment doldrums of the earlier part of the decade. Participants anticipate that assets under management in their domestic markets will grow by an

average of 7.5% and revenues by 8% over the next three years. This is in marked contrast to the survey of 2003, in which European participants, which make up the majority of those surveyed, predicted that assets would increase by just 3% during the year.

Respondents are even more buoyant about their own particular fortunes, forecasting that their revenues and assets will grow by an average of 13% over the next three years. Asian participants anticipate that their assets under management will increase by 21%, reflecting the increasing wealth and sophistication of clients in the rapidly expanding economies of China and India.

There are undoubtedly grounds for optimism at a time when the rich are not only getting richer, but also rising in number. This includes the most valuable HNWIs (assets of more than \$50 million), who now account for an average of 19% of respondents' funds under management (see Figure 1), compared with 11% two years ago. Clearly, however, not every participant can hope to outperform the market as a whole and competitive differentiation will be critical in achieving these ambitious growth targets.

¹ For a full copy of the Private Banking/Wealth Management Survey 2005 visit www.pwc.com/wealth

Private banking – competitive challenges ahead

continued...

Competition for custom

Participants expect an average of 18% of their revenue growth over the next three years to come from clients new to wealth management, with a further 46% being derived from more business from existing clients or new customers won from competitors (see Figure 2). As the battle for a greater share of customers' wallets intensifies, 64% of respondents expect to hold more than 40% of the assets of their clients by 2008, compared

with 45% today. This offers the potential benefit of increased income with only a minimal rise in cost.

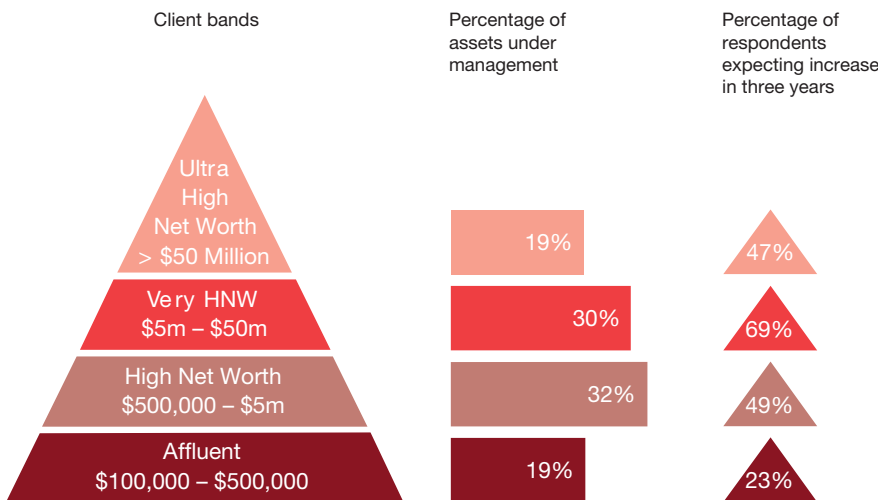
However, the findings of the PricewaterhouseCoopers survey raise concerns about whether participants are paying sufficient attention to holding on to existing clients, leaving them open to poaching by competitors. Branding remains a surprisingly limited priority, with some 30% of participants spending less than \$100,000 per year on brand

protection. It is equally telling that 46% of respondents have no client retention process. Experience suggests that well-developed client segmentation can help companies to better understand the needs of their customers. Yet, our survey found that segmentation is still generally rudimentary, predominantly focusing on geography and new/current client assets rather than profit considerations. This begs the question as to how private banks can offer the 'tailored' service they are so eager to promise. Without knowing their customers they cannot know what they really want ... or need.

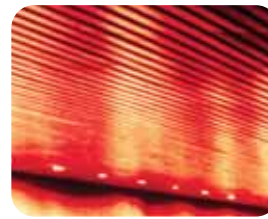
The talent and capabilities of wealth managers are clearly critical in developing and sustaining profitable relationships. However, only 21% of respondents believe that the quality of their staff is very strong. Most respondents (70%) recognise that training is likely to prove ever-more important as the demands on customer relationship managers (CRMs) increase. Yet, 45% of those surveyed have training budgets of less than \$5,000 per person per annum, which is very low, given the importance of CRMs to the business and the huge challenges that they face in meeting clients' needs and expectations.

The scope of CRM training and resulting knowledge base may also be too limited, especially if CRMs are to reach the competitive pinnacle of becoming trusted

Figure 1: What percentage of your organisation's total assets under management fall within the following bands and how do you expect this to change over the next three years?



Source: PricewaterhouseCoopers



advisors. While more than 80% of training programmes cover companies' own products, less than half focus on taxation. This is surprising, as tax planning has always been at the heart of wealth management and is a key driver in the development of both onshore and offshore products. Recent years have also seen significant developments in both domestic and international tax legislation that will have important implications for capital gains, tax deferral and inheritance structures. Yet, while 83% of respondents recognise that tax planning is important, only 27% rate their CRMs as competent

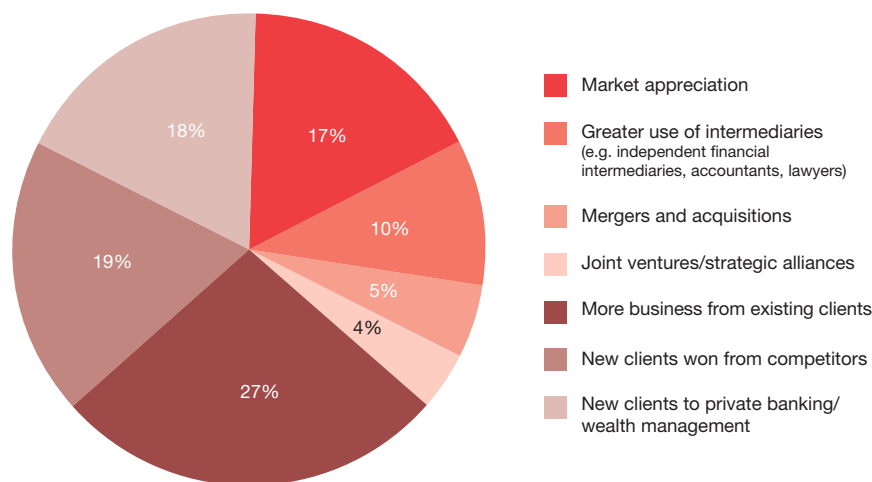
in the area of international tax and barely 50% competent in the area of domestic tax. One common and rational response to this problem is to outsource to specialists. Errors with tax planning can be very costly to clients and ultimately the 'costs' are passed back to the private banks. Monetary costs are only one aspect; damage to the brand and reputation is often more significant. If private banks do decide to outsource, one thing they must ensure is that their outsource provider is reputable; again, failure to do so may have severe consequences.

Pressing strategic choices

Our survey indicates that participants are looking to enhance returns and respond to clients' increasingly complex demands by extending the range and sophistication of their products. In particular, alternative investments such as private equity and hedge funds have now moved into the mainstream. However, the study questions whether wealth managers can offer their clients the most appropriate products for their requirements when most still manufacture them themselves or via their parent. It would appear that the 'open architecture' that could help enhance CRMs place as trusted advisors is more myth than reality, for now at least.

Today's ever-more discerning customers are unlikely to settle for second best. Wealth management businesses will therefore need to articulate and concentrate on their strengths and consider outsourcing their remaining products and operations to more able partners. For many, this will mean choosing between being primarily a producer or a distributor. Some organisations are already looking to specialist providers to manage their alternative investments. As Figure 3 highlights, others now recognise that they will need to make clear strategic choices about where they wish to compete if they are to differentiate themselves in the marketplace.

Figure 2: What percentage of your revenue growth is expected to result from your own efforts and what percentage will come from market appreciation?

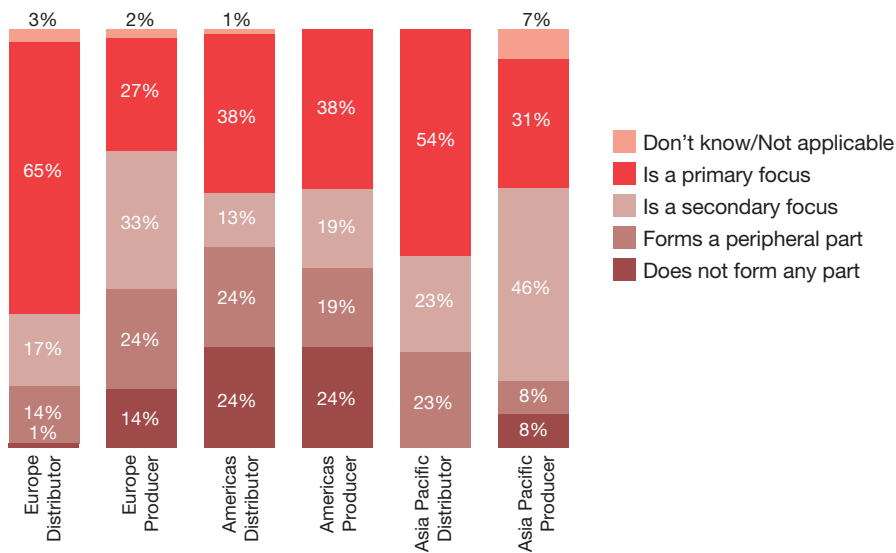


Source: PricewaterhouseCoopers

Private banking – competitive challenges ahead

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Figure 3: What is the current strategic direction of your organisation in terms of being a producer or distributor?



Source: PricewaterhouseCoopers

Pressure on profitability

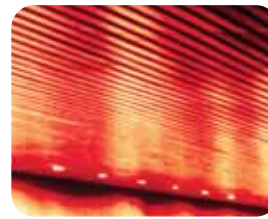
The growing competition in the private banking sector is reflected in the increasing pressure on margins. Customers expect higher quality at lower cost. As a result, 32% of respondents expect margins to fall, despite the anticipated rise in revenues, compared to 18% who believe they will rise and 46% who see them standing still.

Many organisations are looking to cut costs by increasing the number of clients served by each CRM.

However, investment in people, especially your CRMs, and IT will be needed to ensure that the greater demands do not undermine the quality of service. Many businesses are also looking to enhance profitability through improved performance management and reward, although as we have reported, segmentation by profit remains limited. It is also surprising that only 53% of respondents collect data on the returns from individual clients and only 54% use profitability by product data in their decision-making. We would also ask the question around the adequacy of

analysis of total cost of servicing clients. As we have highlighted, the metrics used for profitability measurement are relatively narrow, and it would appear that fully understanding the overall cost of service and thus knowing the true profitability of clients is some way off. There are solutions to this common problem, and those companies that have effectively implemented improved measurement procedures have seen the rewards.

The pressure on margins is likely to be compounded by the increasing cost of compliance and risk management. More than 80% of respondents have established risk management frameworks in the past five years, though gaps remain, particularly in the area of outsourcing. Ironically it is the gaps in third-party frameworks and understanding of third-parties' risk management processes that provides one of the biggest areas for reputational risk. Although participants increasingly recognise the link between risk and reputation, it would appear that compliance remains the primary driver for the development of risk management. Only 22% of respondents view risk management as a source of competitive advantage. Just 9% have sought to maximise the business benefits of their investment by developing integrated risk and value management systems that link performance and capital efficiency.



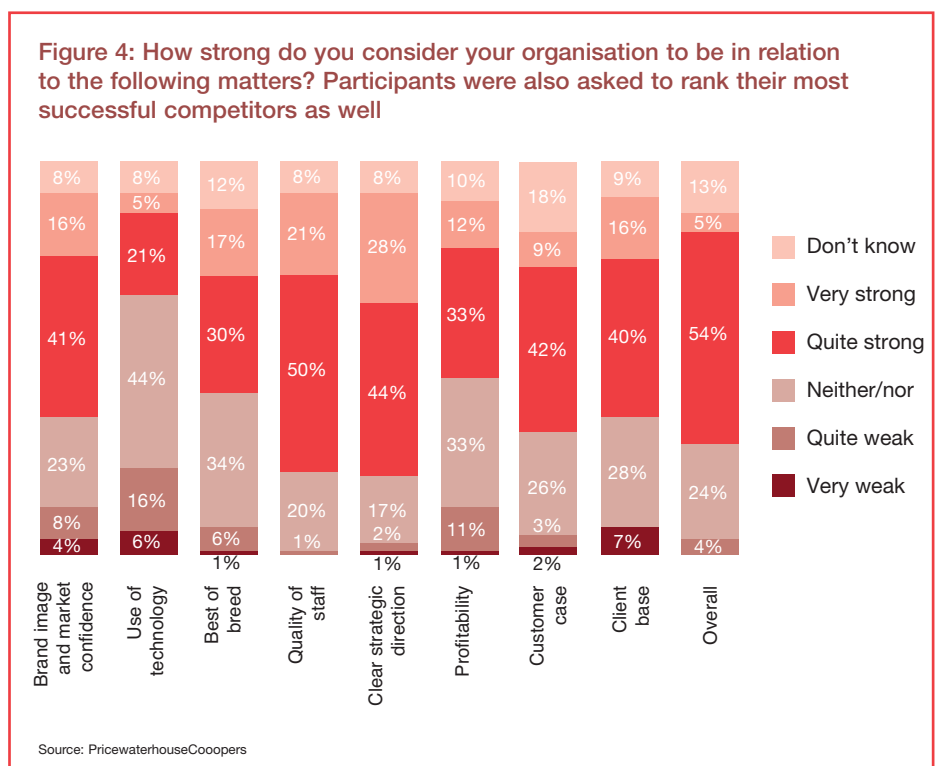
Impetus for consolidation

Continued compliance demands, not least of all, Know Your Customer and Anti-Money Laundering and the continuing fragmentation of the private banking sector, could increase the impetus for industry-wide consolidation and the rationalisation of offshore centres in particular. However, takeover prices still appear to be unrealistically high, which could inhibit further deal activity.

Indeed, we believe there could be a split in the market, with a significant number of international banks looking to increase their presence in the sector through acquisition, while smaller institutions seek to sustain growth through less costly means, such as joint ventures or poaching key personnel. Some mid-tier businesses may even decide to exit the market altogether, especially as our analysis shows that larger players are beginning to reap the benefits of scale, both in terms of profitability and asset growth.

What it takes to succeed

The 2005 survey highlighted both the huge growth potential and the enormous challenges facing the private banking/wealth management sector. The winners will be businesses that can understand and meet their customers' ever-more exacting expectations and



ultimately be seen as trusted advisors. As Figure 4 highlights, a number of players are beginning to pull away from the pack by opening up a decisive lead in a number of the critical differentiators identified in the survey, including clarity of strategy, quality of staff and 'best in breed' product/service capabilities.

To catch up and compete with the leading pack, organisations will need to focus on what they do best, rather than trying to be all things to all people.

Open architecture will enable them to offer first-class products that precisely match individual customer needs. Investment in CRMs can improve service and advice and help to enhance relationships. Effective use of technology can lower costs and improve management information. As affluence increases, the potential rewards are considerable. However, failure could leave customers, client teams and even whole businesses open to acquisition by predatory competitors.

Tax risk management

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by Sarah Prior, John Masters and Larry Quimby



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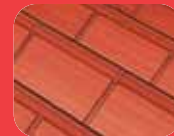
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Earlier this year BP Russia faced a back tax claim of \$1bn. While this was subsequently reduced to \$247m, it is a clear example of the increasing importance for companies to identify, monitor and manage their tax risks. In this first of two articles looking at tax risk management, we will consider why this has become such a hot topic and why having a tax strategy is an important part of any risk management framework. We will also consider approaches to risk management and look at the key challenges within the banking and capital markets sector.

To the directors or senior managers of many businesses, tax has often been seen as something of a mysterious art; a complex technical specialism not readily measured or monitored by the scorecards or dashboards that might be used to manage the rest of the organisation; often immune from internal audit overview, it can be seen as a technical function left to do its own thing.

This situation is changing however, and many in-house tax departments across the banking sector are beginning to engage senior management on the issue of tax risk and are introducing a

control mindset, previously lacking within tax functions. Here we take a look at why this is.

Why is tax risk management higher up the agenda?

A number of pressures are resulting in tax risk becoming a concern for organisations for possibly the first time.

Regulatory environment

When exploring at the factors making tax risk management more of a focus, the first place to look is at the changing regulatory environment. Regulators are not specifically looking at tax risk, but they are interested in robust controls with the objective of enhanced transparency and accuracy in financial reporting. With the advent of Sarbanes Oxley 404 (SOX 404) there has been an uncompromising approach taken in demanding a certain level of control. Many tax departments have had to move from a standing start, some of them lacking the right skills for this kind of work. Consequently, there has been an urgent need to focus on risk and getting policies, procedures and documentation in place.

For US companies reporting under SOX earlier this year, 9% of all disclosed material weaknesses up to the end of May 2005 were in relation to tax.

Source: PricewaterhouseCoopers

Tax authorities

The second group casting a bright light on this area are the tax authorities around the world. They are increasingly taking the fight to taxpayers in relation to tax planning, which they may challenge as avoidance, including transfer pricing and the quality of core financial data.

In the international arena, various tax authorities have been encouraging moves to push tax onto the boardroom agenda. Examples of this move, which represents a quite unprecedented change of approach, include Australia, where the Australian tax office has published a list of ten questions that a CEO should ask about tax planning proposals; and the UK, where the head of the Inland Revenue has made direct contact with the CEOs of some major banks to discuss their tax planning activities.

Tax risk management continued...

Ten questions put by the Australian Tax Commissioner to company boards to be asked in relation to transactions affecting the company's tax position.

1. What level of confidence do you have in the correctness of your advice?

2. How likely is it that the tax office will take a different view of the application of the law and assess the company accordingly?

3. If the Australian Tax Office takes a different view and the matter proceeds to litigation, what is the risk of the Federal Court or the High Court deciding the matter in favour of the tax office?

4. What is the potential downside if the company is unsuccessful in litigation with the tax office?

5. If there is a dispute, what is the likelihood of the tax office being prepared to settle the dispute and, if so, on what terms?

6. How likely is it that the tax office will identify the tax issues that arise from the proposed course of action? Allied with that, to what extent will embarking on the proposed course of action increase the tax risk profile of the company and increase the possibility of audit scrutiny?

7. In light of the potential risk, would it be desirable to approach the tax office for guidance in the form of a private binding ruling?

8. Where a position has been taken on a tax issue, would it be desirable, in the interests of appropriately managing any risk, to be upfront with the tax office in identifying the issues before or when lodging the tax return and endeavouring to constructively handle any disagreements which may ensue?

9. Is the advice based on the actual transaction or on an expectation of how the transaction will be implemented?

10. Are you satisfied that the factual basis for your opinion to the board has been properly checked?

Source: PricewaterhouseCoopers

We are also seeing increasing international co-operation. Last year saw the establishment of the Joint International Tax Shelter Information Centre, a co-operation aimed at information sharing between the US, Canada, Australia and the UK. Their stated aim being to curb the use of abusive tax structures. In the same year the OECD (Organisation for Economic Co-operation and Development) met in New Zealand to consider how tax authorities could share information to detect and prevent tax avoidance.

Individually, many jurisdictions have also adopted one of a number of other ways to tackle tax avoidance: general anti-avoidance rules in Australia, Canada, Germany, Hong Kong and Ireland; abuse of law doctrine in France, the Netherlands and Switzerland; and tax avoidance disclosure in Canada, the US and the UK (also recently mooted in France). All of these enable the tax authorities to react rapidly when they see behaviour they deem to be unacceptable. In some instances, we have seen these authorities adopting quite aggressive legislative and regulatory change, often paired with an increasingly uncompromising approach to investigation and negotiation.

This changing approach creates increased tax risk for organisations. It can affect businesses that engage in



very aggressive tax planning, particularly where a management decision is taken without being properly monitored. It can also impact organisations that are not able to monitor and manage their tax affairs, key issues and exposures on a global basis. Many tax managers are comfortable with the ‘domestic’ positions and issues, but have less confidence outside the ‘home country’.

The changing approach has also affected the climate in which tax planning transactions are considered – for the tax director, yesterday’s acceptable behaviour has become today’s unacceptable behaviour. The result may be higher costs associated with justifying transactions and managing tax investigations and the risk of negative press coverage.

‘We have seen things we either would never have picked up or would have picked up years down the road. We have seen a series of kinds of transactions... that merit follow-up by individual taxing authorities’

Mark Everson, Head of the US Internal Revenue Service interviewed on the results of the Joint International Tax Shelter Information Centre in the Financial Times

The Board

Last, but not least, when looking at those issues affecting the tax risk landscape, are senior management and shareholders. One reason for this is that there is an increasingly moral perspective being taken in relation to tax avoidance, very often deliberately encouraged by the tax authorities.

This emphasis on the morality of tax avoidance makes companies increasingly sensitive to the activities in which they engage, particularly when considered in the context of their corporate social responsibility policies. As an example, many ethics policies state that the company follows the ‘spirit’ as well as the ‘letter’ of the law. How many companies have looked at how such a policy squares with some creative tax planning, which meets the strict letter of the law but, in the view of the tax authorities, certainly not the spirit?

This sits alongside an increasing recognition of the profound damage that can flow from negative publicity. No-one wants their dirty tax linen washed in public, so there is a greater need from management to know what is going on in relation to taxes within their businesses and to have confidence that the risks are controlled. An indication that some companies may have a way

‘...it is vital that we have international cooperation to tackle (tax avoidance) as we do for terrorism, organised crime, money laundering and fraud’.

John Healy, Economic Secretary to the UK Treasury

to go can be found in a survey of the FTSE 350, published in early 2005 by Henderson Global Investors. One of the most striking conclusions of the survey was the proportion of companies with no tax policy through which to manage tax risk to the desired level.

‘Seventeen of the 44 companies that consider their overall approach to be ‘medium’ have not conducted a board review of strategic tax matters within the last year and 19 of these companies do not have a documented tax policy. A ‘medium’ willingness to take on tax risk that is not underpinned by adequate board involvement may suggest flaws in corporate governance.’

Henderson Global Investors: Tax, Risk and Corporate Governance February 2005

www.henderson.com/global_includes/pdf/corporate_governance/tax_paper.pdf

Tax risk management continued...

But I am SOX 404 compliant

At this point, it would not be unreasonable for an organisation to ask: 'the tax climate is changing and increasing my risk, but I am SOX 404 compliant, so am I managing my tax risk?' This is a good question, even for companies who are not SEC registrants, as increasingly, SOX 404 is becoming a general controls benchmark. Before we consider the answer we should look at what SOX sets out to do.

The goal of SOX 404 is to provide 'reasonable assurance' as to the reliability of financial reporting and the preparation of the financial statements. It is well understood that this covers the corporate income tax in the profit and loss account, and balance sheet and controls on tax payments. As we go beyond that, however, the picture becomes less clear. Most organisations recognise that VAT falls within the scope of SOX 404, but employment-related and other operational taxes are very often thought to be outside the scope of some organisations' SOX controls (if material to the financial statements, they need to be in scope). For banking organisations these areas represents a significant swathe of tax risk. Let's just consider these risks for a moment.

First, taking employment taxes and social security

The banking and capital markets sector employs many highly paid people, particularly within investment banking. There are large bonus pools and sometimes, inventive reward planning. Many of these employees work as expatriates where there are additional tax issues. There may be dual contract arrangements or other tailor-made employment arrangements.

The tax issues arising in this area are complex and often not adequately co-ordinated between HR and the tax function. The arrangements are sometimes poorly implemented (dual contracts are a prime example) or are disliked by the tax authorities (UK National Insurance bonus planning). Where there has been a systematic failure of control or proper implementation, tax or social security tax losses can result in significant tax, interest and penalty costs, all 'above the line'.

Secondly, turning to other operational tax risks

These are the tax risks arising from day-to-day transactions, many of which in the banking sector are embedded with the settlements or operations process that supports transaction settlement and custody services. Examples include

operation of withholding taxes and stamp duties, management of customer double-tax treaty reclaims, tax reporting and maintenance of tax documentation.

Experience shows that it is in this area that banking tax departments are most likely to see errors and have to make large settlements with tax authorities. These areas will not necessarily have received attention as SOX 404 focuses on financial reporting.

How many banks, for example, have had trouble maintaining adequate records, reconciling accounts and achieving accurate reporting under the US qualified intermediary rules? A warning perhaps for the operation of the European Savings Tax Directive? How many banks have had problems with the operation of Hong Kong or UK stamp duty? There are many more examples than these. These tax risks have the capacity to be very large, due to the volumes involved, and are often sitting in no-man's-land between tax and settlements departments in terms of responsibility.

Returning, therefore, to the question of whether SOX 404 compliance is sufficient to control tax risk, it is important to realise that controlling risk was never the focus of SOX 404, since the legislation focused on financial reporting controls.



Basel II

Having mentioned the potential gaps in coverage of SOX 404, it is worth considering Basel and operational risk. Basel II defines operational risk as the risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events. This definition includes legal risk, but excludes strategic and reputational risk.

In terms of what this means for tax, some of the operational tax risks described above seem to fall squarely within this definition. To some extent this is explicitly recognised by the Basel Committee on Banking Supervision which mentions tax in the context of internal fraud risk. It is also a consideration in relation to the risk arising from 'clients, products and business practices' and 'execution, delivery and process management'. As yet, however, the involvement of tax functions in banks' Basel II projects varies greatly. Tax risk should not be forgotten in the process of identifying, monitoring, and mitigating and controlling operational risk.

Why do I need a tax strategy?

The second question arising from this whole debate might be: 'why do we need a tax strategy?' In response, it is challenging to think how an organisation could otherwise achieve cohesive tax risk management consistent with the objectives of the board and shareholders. Such a strategy is a means through which there can be a dialogue on tax risk between the board and the tax function.

'Our research shows that companies are implementing their principles on responsible tax by:

- Including explicit requirements in their tax policies to comply with overall business principles and commitments on social responsibility;
- Ensuring explicit board discussion and approval of tax policies; and
- Providing written guidance to staff on how to deal with dilemmas and challenges'.

Extract from Henderson Global Investors: Responsible Tax October 2005

www.henderson.com/global_includes/pdf/corporate_governance/ResponsibleTax.pdf

The key deliverable of a tax strategy is consistency with the organisation's overall business strategy and clarity in a number of areas:


- **Goals in relation to the organisation's costs.** Sometimes this can be seen as a target-effective tax rate or a benchmark of tax costs against a peer group.
- **The organisation's risk appetite.** What it will and won't do (e.g. no social security tax planning or only entering into planning transactions where there is a 'more likely than not' opinion). Besides the risks arising from aggressive tax planning, there is also the risk of not planning and paying too much tax, and this may be reflected in a strategy.
- **Responsibility for taxes within the organisation.** For banks this is a significant issue. As the above comments on risks falling outside SOX 404 make clear, there are many tax risks (e.g. the operational tax risks that are threaded right through the organisation's activities that are not within the clear control of the tax function or any other one function). Are these risks the responsibility of the tax department or is it settlements or HR or finance?

Tax risk management continued...

Only when there is clarity of responsibility can there be certainty that all risks are being controlled.


- **Use of 'tax capacity'.** Many banks have structured finance teams and other front-office staff engaging in tax structuring. Who should allocate 'tax capacity' to them? Does the tax department sign off their deals? What is the policy with regard to provisioning for risks? Answering these questions helps ensure that there is control of a group's overall tax position.
- **Communication with, and by, the board on tax matters.** What do the board need to know with regard to tax and when? Does the board want wider communication of certain tax matters? We are starting, for example, to see companies analysing and publishing details of the total taxes that they are paying.


There are many other aspects that can go into a tax strategy. Whatever these may be, the key goal is clarity of understanding within the organisation of its objectives with respect to tax, together with the responsibilities and the mechanism for achieving those objectives.




Total Tax Contribution Framework
 What is your company's overall tax contribution?*

A PricewaterhouseCoopers discussion paper

*connectedthinking 



Tax in the boardroom
Tax risk management – key considerations



Source: PricewaterhouseCoopers



The future

Returning to the original question of why tax risk management is becoming more important, the world is clearly changing, requiring more professional risk management within organisations.

The tax authorities are turning up the heat in the tax avoidance sphere and in many jurisdictions are adopting a more confrontational style to that which taxpayers have been accustomed to. All of which is putting increasing pressure on boards and senior management to understand what is going on in relation to tax within their organisation, and to have a view on whether or not it is acceptable. They also need to ensure there is a framework for adequate control. Tax can no longer remain the mysterious subject understood by a select few, and a clearly defined tax strategy is one step towards ensuring adequate dialogue and understanding.

For more information on approaches to tax risk management go to:
www.goodriskadvice.com

Is measurement crucial if people are an organisation's most critical asset?

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by Christopher Box, Ron Collard and Luan Fox



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People in Banking and Capital Markets organisations are seen as the critical differentiator, the organisation's most important asset, typically accounting for over 50% of the annual fixed cost to the business. It is perhaps surprising, therefore, that there is often relatively little understanding or data highlighting the impact of people on business performance.

This article explores the expanding focus on people measurement and the use of data to assist in providing a greater insight into people practices within an organisation. Some of the challenges in providing people data are explored and some of different options are analysed in order to provide a framework for organisations that are considering a more extensive use of their people data.

We are entering a new era that demands organisations facilitate greater transparency of people costs and people-related data, particularly in the financial services sector. This is in part a response to reporting and other regulations, but increasingly it is investor appetite for more transparency and more robust indicators of business performance that fuels the need to understand how an organisation's people effect its success.

Gaining that understanding and tapping into the appropriate metrics also presents an opportunity to increase competitive business advantage and to address the business performance issues attributed to the lack of talent and human resources (HR) process effectiveness.

What's the minimum you have to do?

At present, legislation in this area is emerging from different regulators and in different ways around the world. From Employment Equity Acts, such as the Affirmative Action Requirements (and associated reporting requirements) in South Africa, to the recently introduced Operating and Financial Review (OFR) affecting all quoted companies in the UK, the burden on employers to both act and be able to report on people data is increasing. While legislation is not yet by any stretch either applicable or consistent on a global basis, the new UK standard has arisen in response to the growing levels of pressure to report people data both in the UK and abroad, and the likelihood is that other jurisdictions will follow suit with similar standards. Given that even this UK standard is not wholly prescriptive, there is considerable latitude in terms of what

people metrics organisations can report – so, from a global perspective, organisations have the opportunity to define their own metrics and use this as a basis for lobbying as and when new regulations are proposed.

It's not just pressure from increasing regulation that is driving the need for people reporting. Investors and other stakeholders are increasingly demanding detail from organisations on their people policies. There is a need to analyse and document the link between business performance and effective people management. If investors understand that improvements in business performance are sustainable when there is a corresponding and appropriate level of investment in the people, then that judgement is being made based on investor interpretation of the data presented.

Preparation for a people report

It is important for organisations to adopt an institutional mindset and define a specific approach to preparing their people metrics and the resulting reports. To be successful, the effort cannot be a one-off activity, nor can it be rigid as the

Is measurement crucial if people are an organisation's most critical asset? continued...

process should be continually monitored and changed to ensure the required data is captured accurately and effectively. Organisations need to plan, not only the process and what it will entail, but also how the data will be shared and how they will react to the results (positive or negative) both internally and externally. There is always the risk that, as with the other elements of stakeholder reporting, analysts, shareholders and other readers may not view the data as positively as the organisation would have liked. The organisation needs to have thought about potential reactions, implications for its reputation and, ultimately, its share price. For example, an organisation holding itself out as a diverse employer, or a pioneer of corporate social responsibility, needs to carefully analyse its actual diversity statistics and how they appear in a vacuum, without historical or peer data, before giving others the opportunity to comment on data that is (voluntarily) disclosed.

As reporting standards become more established and the markets respond to those reports, there is likely to be a convergence in the nature of the metrics contained within them. However, the standards will always be the minimum reporting requirement, so organisations have the opportunity to shape their people metrics in the way that adds

greatest value to their own management data and external brand. Now is the time for forward-thinking organisations to act.

How else can better people data help?

Aside from meeting the demands of investors and other stakeholders, as well as regulatory requirements where they exist (e.g. the OFR in the UK), organisations can gain a great deal of value from understanding how they compare against their benchmark organisations and how people policies and practices impact the 'bottom line'. That understanding is not likely to come from the relatively narrow set of metrics that the reporting requirements necessitate; so, it will require additional commitment from management to both collate the desired metrics and to take action on the results. An effective set of people metrics will add quantitative strength to the qualitative data that HR currently reports to management, giving a better understanding of the financial value of an individual contribution and the contribution of the HR function. These metrics will serve as evidence of where the organisation needs to improve its human capital performance and where Return On Investment (ROI) is being maximised. Meaningful people data can help the organisation achieve business

targets and human capital goals by informing decisions and focusing limited financial and other resources on the areas with the greatest potential for ROI. In addition, this data can strengthen the position of the HR function in the organisation, by demonstrating where and how it drives value.

We have developed the checklist in Figure 1 to help organisations review their requirements and more specifically meet the UK OFR requirements. This also enables a wider debate about the use of people metrics in organisations, and moves towards using meaningful human capital data as a means of creating competitive advantage.

This checklist raises some interesting challenges and attempts to focus the business on clarifying their objectives and the practical implications of human capital measurement.

Which metrics to use?

Different organisations require different levels of detail in their metrics. Saratoga, the human capital measurement benchmarking practice of PricewaterhouseCoopers, recommends the use of three categories of human capital metrics:



- Generic human capital metrics, relevant to all commercial organisations in all sectors and all regions;
- Specific sector or subsector human capital metrics directly related to a company within its sector or subsector, region and/or against direct competition; and
- Specific metrics related to issues or challenges likely to affect the future success of a company.

Figure 2 illustrates a set of generic human capital metrics that can be useful as a basic toolkit for people data measurement. This, and other metric data, is available from Saratoga¹.

It is important that the organisation focuses on the metrics that will be measurable and meaningful to it; the metrics that will provide the greatest added value and satisfy the reporting and business objectives. One organisation, for example, found 10-12 metrics combining measures that could be related to employee satisfaction (e.g. total absence rate) and business performance improvement (e.g. profit per employee), which provided them with a manageable set of data that could be obtained across the business as a whole. Their next step has been to analyse detail within individual business

Figure 1: Human Capital analysis checklist

This checklist is a guide for HR executives to help assess their existing position and to respond positively to the expectations of company boards and shareholders. The answers to these questions will highlight where major action may need to be taken.

1. What are the priority business challenges facing your company in the next two years?

2. What human capital actions are required to maximise the opportunities required to guarantee business success?

3. How will you make these actions happen?

4. What are your Key Performance Indicators and how are these related to the business challenges?

5. What data is required to measure human capital performance?

6. Are you fully informed and/or involved in your company's people reporting plans?

7. What human capital information will be most useful to your shareholders and in what format?

8. What information gaps exist and how do you intend to fill them?

9. Are information systems advanced and flexible enough to respond to all recognised demands?

10. Are you satisfied that the information you produce is robust and can withstand scrutiny?

11. Are you conversant with key human capital subjects and major global trends that may be raised by shareholders?

12. Is there a direct link between what the HR function does and what the board want it to do?

Source: PricewaterhouseCoopers

¹ www.pwc.com/saratoga

Is measurement crucial if people are an organisation’s most critical asset? continued...

units, focusing on the particular areas highlighted by the broad review. This client intends to perform the broad analysis on an annual basis to identify improvements, trends and determine where to prioritise spend in future. The message has been to keep it simple, especially at the outset.

Consider the example of using more detailed metrics in effecting business plans in a banking organisation, which recently spent significant resources on defining a five-year business plan and ambitious financial growth targets. The success of its business plan depends to a large extent on developing business in a number of new markets, which, in turn, requires specialist skills not widely available in the employment market. Detailed people data covering current skills within the organisation, individual talent potential, and current and forecast compensation is helping to lay the foundations for targeting an appropriate mix between the development of individuals internally to fill key roles, and the targeted use of external hiring.

Figure 2: Example set of generic human capital metrics

	Definition
Wealth Created per FTE	$(\text{Profit After Tax} - 10\% \text{ Shareholders' Equity}) \div \text{Total FTEs}$
Profit per FTE	$\text{Profit Before Tax} \div \text{Total FTEs}$
Revenue per FTE	$\text{Revenue} \div \text{Total FTEs}$
Cost per FTE	$\text{Total Costs} \div \text{Total FTEs}$
Human Capital ROI	$\frac{\text{Revenue} - (\text{Total Costs} - (\text{Compensation} + \text{Benefits}))}{\text{Compensation} + \text{Benefits}}$
Remuneration/Revenue	$(\text{Compensation} + \text{Benefits}) \div \text{Total Revenue}$
Remuneration/Cost	$(\text{Compensation} + \text{Benefits}) \div \text{Total Costs}$
Total Absence Rate	$\text{All Absent Days} \div \text{FTE Workdays}$
Resignation Rate	$\text{Resignations} \div \text{Headcount}$
Acceptance Rate	$\text{Job Offers Accepted} \div \text{Job Offers Made}$
Cost per Hire	$\text{External Recruiting Cost} \div \text{External Recruits}$
Training Hours per FTE	$\text{Learning \& Development Investment} \div \text{FTEs}$

Note: FTE = Full Time Equivalent, ROI = Return On Investment

Source: PricewaterhouseCoopers



Risk management

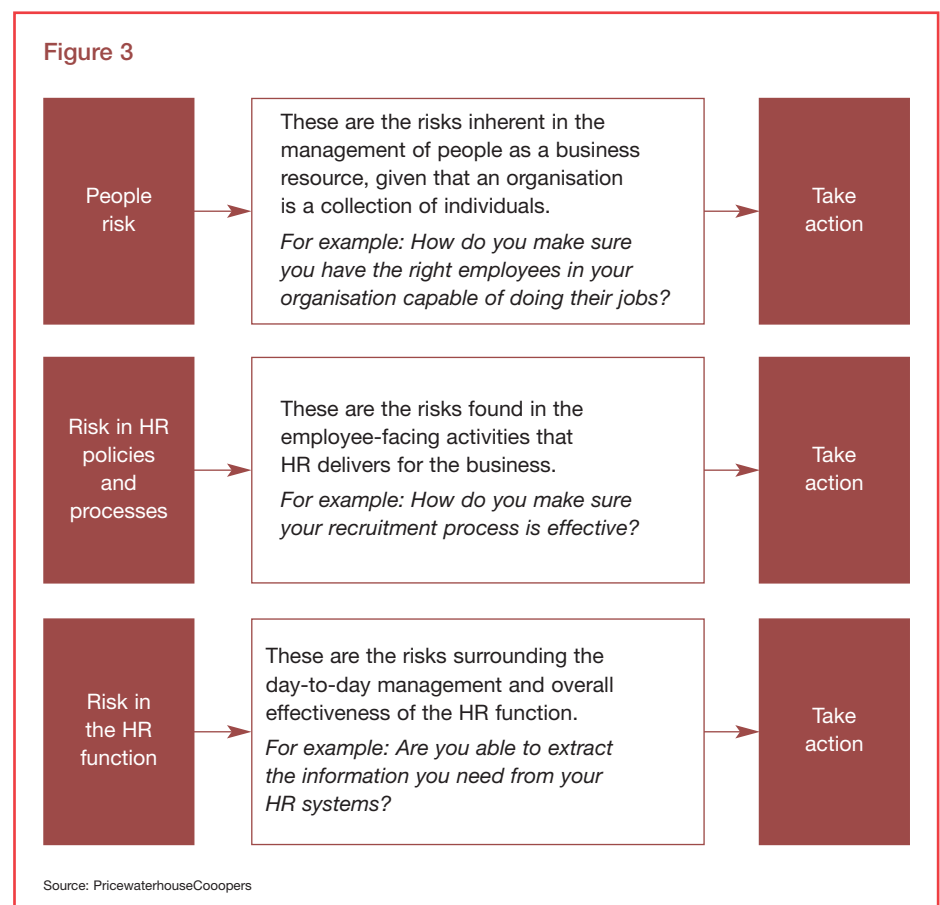
Greater transparency of people costs and HR data will help an organisation make informed business and strategy decisions, meet new reporting requirements and will better inform risk management.

Management's job when scrutinising costs and seeking to enhance business performance is to do so while mitigating risk. The same people metrics applied to cost management and performance improvement can also be used to address business risks attributable to people, the HR function and HR policies and processes. After all, cost management, performance and risk management are all inextricably linked.

Figure 3 illustrates the people/HR risk perspective and some of the questions that might be addressed by appropriate metrics.

So where are people metrics going next?

Increasing regulation, pressure from stakeholders and a growing awareness that there needs to be some substance behind the assertion that people are an organisation's most valuable asset, means that we will see an increase in the quantity and quality of people metrics



used and reported by organisations. The financial services sector is leading the way in this area, and some of the most sophisticated analyses so far have been undertaken by banking organisations. There is a rapidly growing pool of benchmark data,

so organisations are more easily able to assess their performance against relevant comparators. In addition, the amount of data available for trend analysis is increasing all the time, allowing an organisation to see the impact of any changes implemented.

Management of IT value

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by Mark Lutchen, James Chrispin and Peter Broshuis



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Background

Strong information technology (IT) competencies and capabilities are a competitive imperative. Few will disagree with this statement, but what does it mean in practice? Does IT offer a business a competitive advantage or does it merely enable an organisation to compete on a level playing field? In addition, does having the best, most advanced technology always create competitive advantage and greater value, or is the advantage and value created more as a direct result of how effectively IT is actually managed? With such differing views, what is the correct approach to placing a value on IT services?

The desire to place a value on IT is nothing new and there can be very few IT investments that have not been through a process of business case development and analysis, designed to clearly demonstrate that the new system will deliver significant value to the organisation. In the past, business cases were often based on the ability to save headcount, but have subsequently progressed through increasingly more sophisticated analysis. Examining the Return On Investment (ROI) from platform

rationalisation, increased revenue from improved customer data and greater efficiency from the seamless integration of systems are examples of the factors that are used to determine the value a new system will deliver. The one thing that business cases have traditionally had in common is that once the system has been implemented, no-one ever goes back to check that they delivered the planned benefits. In many cases, the necessary metrics would have been pulled together solely for the purposes of building the business case and are not subject to ongoing monitoring by the business, thus rendering before and after comparisons impossible. Closed-loop 'benefits realisation', related to IT efforts, although sought after by many, has remained an elusive objective rather than an operationalised process within most organisations.

Assessment of the initial costs and benefits of IT investments is only half the equation. There is also the ongoing IT operational expenditure, which has to be balanced against the business benefits delivered and, to be truly meaningful, this balancing process must occur continuously over a period of time rather than at a single point in time. Organisations are getting better at

identifying the costs of delivering IT services, but continue to struggle with debates between IT management and business users around the balance of service level, costs and value. In this article we have examined some of the issues and suggested a number of techniques for resolving the tensions arising from a lack of transparency with respect to IT cost and value.

Drivers for proving the value of IT

There has been an increasing interest in the transparency of IT costs and assessing the value that IT contributes to the business. Key drivers behind this are the increasing level of spend on IT, both in absolute terms and as a proportion of total operating expense, and the uncertainty over the benefits that the business receives for its money. Consequently, it is necessary to hold rational discussions on the choices available to the business and IT, and to recognise that in a dynamic environment this is not a one-off exercise. The reason for this is that changing business value or costs impact on the optimum level for a given service. Hence, there is a continuing need for IT investment to refresh the existing technology and

Management of IT value continued...

to sustain the competitive advantages of the business, and maintain as 'efficient' an IT spend and mix of spend (i.e. capital and ongoing operations) as possible.

By improved understanding of the areas in which IT delivers greatest value to the business, it should be possible to focus the management of IT, more appropriately, so as to realise the twin benefits of reducing the costs to deliver services and maximising the return to the business from value-adding, differentiating investments.

Challenges in IT value management

There are a number of challenges facing the valuation of IT's contribution to the business, and as the following observations illustrate, the traditional lack of transparency serves to exacerbate the situation.

- IT has traditionally been regarded as an undifferentiated lump of expenditure that is accounted for in a way that is acceptable for financial reporting and recharged to the business in what some regard as an arbitrary fashion.
- From a business unit perspective, the level of recharges has not necessarily reflected what they see as the fair

costs or contribution to business value, the only advantage being that the approach is simple. However, it frequently leaves a feeling of inequity and a negative view of the IT function.

- A number of alternative approaches to the valuation of IT have been developed over the years. None is perfect and in some cases they exhibit a degree of complexity that is counterproductive and serves only to raise suspicions that something is being hidden among the smoke and mirrors.
- Typically, business management attention is only drawn to IT when they want something or when there is an operational problem. IT is not often recognised as the ongoing, nondiscretionary expenditure it has become, sustaining the viability of virtually all aspects of the business.

- A significant proportion of IT spend does not contribute to the development of strong information technology capabilities. Levels of waste have been assessed by various commentators at up to 25% of total budgets. This 'waste' can also be considered 'inefficient' IT spend, primarily due to a lack of ability to continually rebalance the 'mix' of capital and ongoing operations

expense. Therefore, one key objective to increasing the value of IT is the identification of waste and taking steps to reduce or eliminate it; however, the elimination of waste is a seldom practised art. Again, this can be a counterproductive exercise from the point of view of demonstrating the value of IT as cost-reduction exercises tend to be ad hoc and the results generally show how expensive and wasteful (or inefficient) IT was before the cost-reduction exercise.

- The value of IT is assessed by perception, due to lack of agreed value metrics. This has been compounded by the IT industry in general, through a history of overpromising the benefits and underplaying the costs and risks in their delivery. Consequently, it is of little surprise that surveys such as the recent PricewaterhouseCoopers/ Economist Intelligence Unit survey frequently underline the poor perception among business executives of the way in which IT contributes to their business¹.

Further underlining these challenges, IT and business management have tended to see their respective roles and contribution to the business differently. For example, IT has tended to focus on providing a reliable and efficient service,

¹ 'From aspiration to achievement: improving performance in the financial services industry', a survey of financial services organisations published by PricewaterhouseCoopers in association with the Economist Intelligence Unit. To download a copy please visit www.pwc.com/financialservices



offering cost-reduction opportunities as the means of increasing corporate performance. Front line business managers by contrast have preferred to focus on top line growth and it is these differing points of view that have on occasion contributed to problems in communicating the cost and value of IT services. As a result IT is frequently seen as an overhead and a cost to the business, hence the tendency for a CIO to report to the CFO.

In the absence of a framework for valuing IT's contribution to the business, which is supported by both business and IT management, the personal credibility of the CIO among business executives takes on a disproportionate significance, and discussions centre on cost – indeed, the typical first actions of a new CIO are to reduce costs to establish personal credibility.

Methods of IT value management

The valuation of IT remains a difficult concept to pin down and a number of definitions of value have been used. IT forms part of a business and there is an argument that says it should be run like a business, meaning that fundamental business disciplines, used successfully and effectively elsewhere in the company, can be applied within

IT (e.g. management cost accounting, performance measurement, investment portfolio management). The alternative view is to assume that IT does not create value in itself, but enables or facilitates the business to realise value and should be managed accordingly. Neither approach, taken independently of the other, has been found to be perfect.

Extending business value approaches into IT

Business value methods in general depend upon the business being a profit centre, i.e. with both income and costs. While the trend is for IT to be regarded as more than a cost centre, it is not typically run as a profit centre with market prices set in competition with other suppliers and taking its own decisions on investment opportunities. However, certain characteristics of profit-oriented businesses can be applied successfully within an IT organisation.

The benefits from extending the business value methods used elsewhere in the business are that they provide consistency across the organisation and encourage IT management to run the business on a more commercial basis. A further important benefit is the behavioural impact within IT – the majority of staff prefer to enhance profitability or

business value than to focus on cost reduction, albeit that cost management is critical to improving profitability.

Business value methods that have been applied to IT valuation include:

- Pseudo profit centre where income is derived from charges levied on the business;

- Real options concepts to recognise the differing contributions of current operations and future growth opportunities;

- Shareholder value derived methods to recognise the balance between business growth, costs and risks; and

- Return On Investment (ROI).

While these methods improve the basis for discussions between business and IT, they are not perfect and have a number of major conceptual flaws.

- Application of business value methods to IT in isolation is somewhat artificial as IT is not a discrete business that stands alone from the rest of the organisation, but is integral to the day-to-day business processes and operations.

Management of IT value continued...

- Not all IT activities feed through directly to the bottom line, but do so more indirectly through enabling the business to realise their objectives.
- The IT asset management life-cycle does not necessarily fit with the business life-cycle. This reduces the use of business value methods in managing IT other than as a snapshot, such as at the time of M&A business valuation.
- ROI computations can be complicated and are subject to further criticism as IT does not have full control over business outcomes, future anticipated

benefits are not necessarily robust, and inter-dependencies between investment phases and other investments or existing infrastructure, and by assumptions made such as those on the life and quantity of returns.

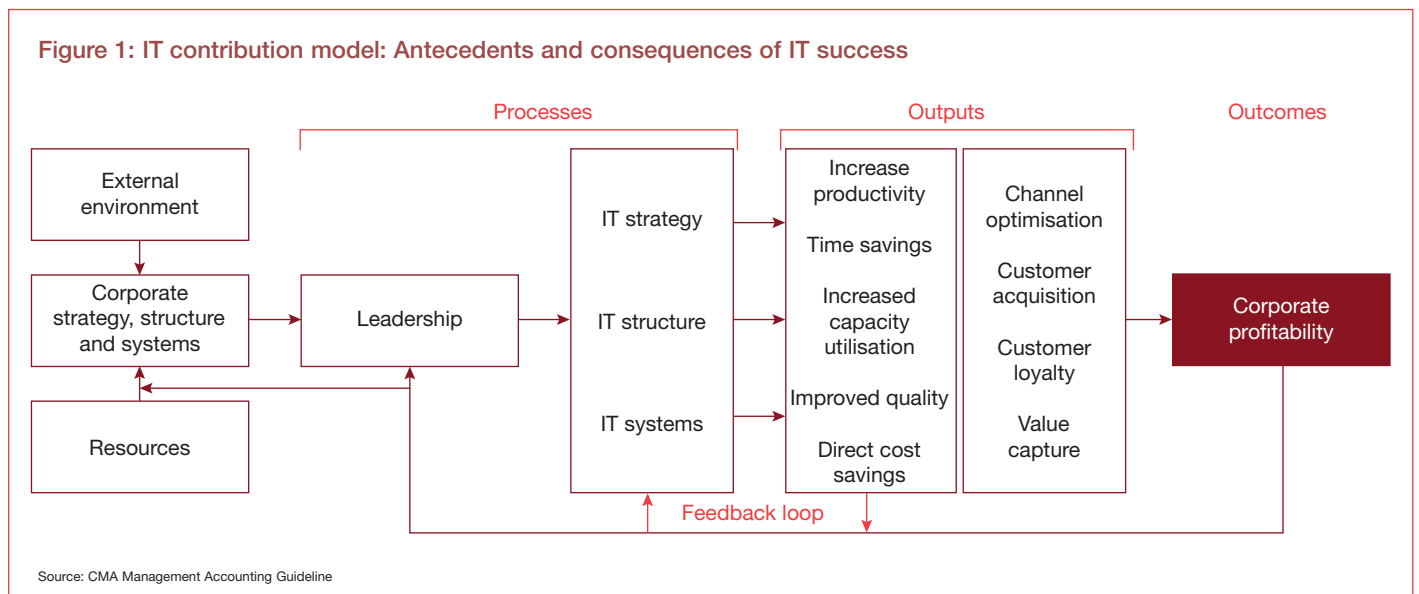
IT-focused valuation approaches

IT-focused valuation methods start within IT and have not always been closely linked to the wider business. Methods have been devised to address particular challenges and each consultancy has devised their own particular slant.

The majority of approaches have stemmed from either providing assistance to the development of an IT strategy and the general direction of IT's contribution to the business or to the management of a proposed project portfolio. These approaches have continued to develop, but no common framework has yet evolved. A variety of possible approaches is discussed in more detail below.

CMA model

CMA Canada and AICPA published a management accounting guideline in December 2004, which focuses on measuring the payoffs of IT investments





and introduces an IT contribution model to provide a framework for assessing the value of IT to the business, through the separation of the immediate outputs from an IT investment from the business outcomes that it supports – in other words the approach recognises that the business benefits of much of IT investment are indirect.

Consultants also have strong theoretical underpinnings, though their approaches have typically been devised to support executive management requirements. They have followed the business cycle, supporting the leveraging of IT to create business value during times of investment and cost reduction during economic downturns.

While much can be gleaned from these approaches, they do not provide a complete IT contribution framework.

Balanced scorecard

An alternative approach to the assessment of IT's contribution to the business has been the balanced scorecard. This is one of the most established formal performance measurement frameworks used in business. It has the benefit that it recognises that the contribution of IT

to the business is multi dimensional and its performance should be considered from differing perspectives. An overall business scorecard can be exploded to greater levels of granularity enabling a fuller picture of IT's contribution to the business to be captured. However, one of the difficulties of using the balanced scorecard approach is that it is rarely driven to a granular enough level to effect the specific behavioural changes necessary to achieve a measurable improvement in IT value.

The main challenges in implementing the scorecard across the business are restricting the number of metrics considered and identification of the most relevant to the business. However, the development of the strategy map concept has helped to give a structured approach to resolving these. A strategy map is used to identify the critical success factors underlying the implementation of the business strategy, and the balanced scorecard can then be derived to support the operationalising of the strategy.

Challenges with existing methods

While these approaches to the management of IT value have increased understanding of the contribution IT

makes to business, there are other challenges that need to be considered. These include:

- Business strategy and value drivers (e.g. cost leader, operational excellence, customer intimacy, innovation);

- Alignment of IT with business;

- The maturity of IT capability;

- The governance of IT and its place in the organisation structure;

- The asset life-cycle (maintenance and replacement);

- Level of relevance and granularity of the analyses conducted;

- The lumpiness of capital expenditure;

- Financial structuring considerations such as VAT and Research and Development tax credits;

- Cross-border considerations;

- Shared service centres; and

- Arrangements with third parties, including joint ventures and outsourcers.

Management of IT value continued...

What can we do now?

We noted earlier that the understanding and quantification of the contribution of IT to the business needs to be considered in a business-wide context and cannot be undertaken in isolation. However, there are a number of actions that can be undertaken in the short-term to improve the contribution of IT to the business, while a more comprehensive framework is developed.

An underlying premise is that there should be active management of IT as a business, operating for, and accountable to, the business as a whole. This has led

on to the identification of four imperatives for IT management: align IT to the business, maintain service quality, and provide effective and efficient delivery of services. This structure may be thought of as a wheel with management focus being given to different areas according to priorities facing the organisation at that time. IT investments can then be mapped onto this structure and can be considered to be either protecting the value delivered by IT or creating new business value.

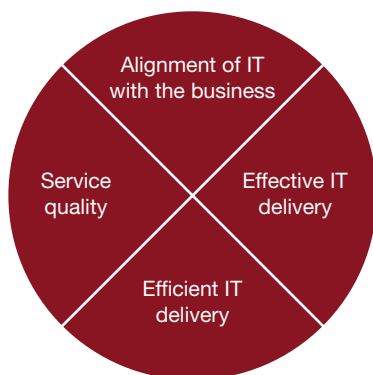
Next we expand on this concept and outline a number of ideas to improve the value of IT to the business.

Differentiating and commodity expenditure

IT expenditure balances price, risk, business need and added value. The spend represents a mix of IT service delivery and investment, and maximising the IT value requires a range of complementary management techniques, based on this understanding.

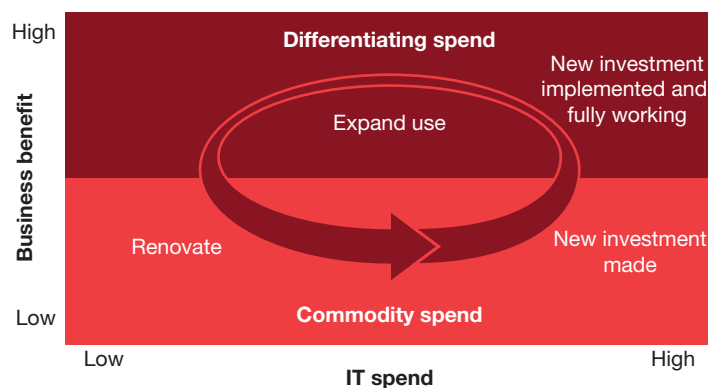
For some items of spend, the service is needed, but it reflects the cost of doing business rather than helping the organisation sustain its competitive position. Such items of expenditure as cost drivers and price, dominate the

Figure 2: IT management imperatives



Source: PricewaterhouseCoopers

Figure 3: IT investment life-cycle for a differentiating investment



Source: PricewaterhouseCoopers



procurement decision-making process. Examples of this commodity spend include business support services, such as payroll, regulatory requirements and items of standardised technology.

For other items, the procurement decision is more discretionary and the benefits must outweigh the costs and risks. At its most value adding, such spend enables the business to differentiate its services and thereby provide competitive advantage.

A further consideration is the impact of time. A one-off investment, which provides for business differentiation, loses its distinctiveness over time as competitors make similar investments and standardised technology solutions are developed. In short, a differentiating spend becomes a commodity spend over time.

Examples of past differentiating investments that have now become commodity spend, include much of the infrastructure, such as desktop terminals, networks and support applications (e.g. payroll), while differentiating spend is now typified by the development of new, well-focused applications as part of business unit-driven initiatives.

From the perspective of IT value management, the key points are:

- Clarity of business benefits, costs and risks, are key to assessing the value delivered by IT. However, this is not always straightforward as:
 - Business benefits can be difficult to quantify (for example, business revenues are estimates which are not necessarily reliable);
 - IT differentiating services may depend on IT commodity services; and
 - There are varying practices with IT cost allocation and recharges.
- There are different business drivers for the IT commodity and differentiating spend reflecting the benefits that business realises from the spend;
- Business benefits derived from investment in new technology tends to move from differentiating to commodity over time;
- However, certain commodity spend can, if managed effectively, over the life-cycle of that spend, be refreshed on a well-planned, periodic basis to provide greater differentiation. However, the IT management/

leadership disciplines to accomplish this are not technical ones. They are business disciplines;

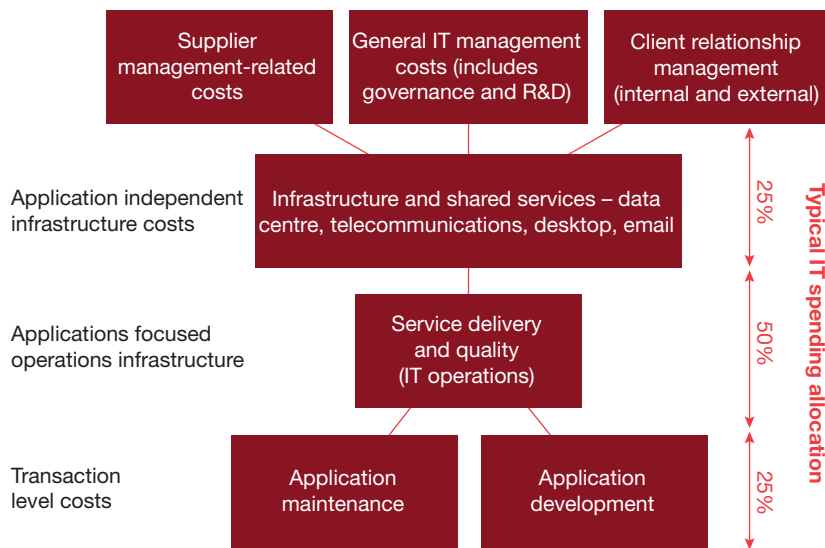
- There is significant uncertainty with new IT spend: IT portfolio management is an area requiring attention; and
- A different management approach is required depending on the position of the IT spend in the commodity/differentiating continuum and this approach needs to be modified over time as the business drivers change as shown in Figure 3.

Although this shows that determining IT's contribution to a business is a complex task, there are also sufficient pointers to provide the basis for sensible discussions between business units and the IT function. These can provide a basis for proactive management action to be initiated to assess how IT's value to the business can be enhanced.

As a first step, to determine the appropriate management approach for a given element of IT spend, it is necessary to disaggregate the IT expenditure and this can be achieved through the development of an analytical model to assess the items of major spend and major contributions to the business.

Management of IT value continued...

Figure 4: A sample IT cost hierarchy



Source: CMA Management Accounting Guideline

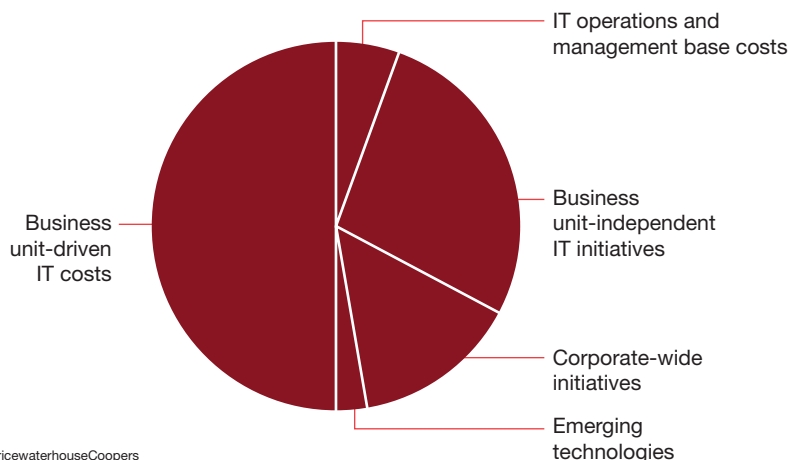
Disaggregation of IT spend

One approach is to start with the cost structure of the IT spend. This provides transparency of IT costs, clarity of cost drivers and ties in with recharge mechanisms where required.

One noteworthy aspect of this cost structure is that it separates out the IT functional management overheads and the costs of communication with clients and suppliers (see Figure 4). Such a structure enables both the business and IT to drill down to the appropriate detailed level of costs. It also strips out the ‘arbitrary’ allocation of overheads and provides improved understanding of how IT resources and their costs are put together to provide a service to clients. This can also be used to clarify the cost drivers for delivering the service and the overall approach thereby facilitates improved predictability of future spend and can act as the basis of a ‘fairer’ recharge mechanism.

This structure also helps to highlight the focus of IT spend. Not only does this indicate where productivity improvements will have the highest payback, but it also illustrates the balance of IT spend between maintenance and operation of existing technology, compared to investment

Figure 5: Example business view



Source: PricewaterhouseCoopers



in new areas. Typically, investment in new areas amounts to only around 30% of total IT spend – the area that provides the best opportunity for improving business value.

Implications for management of IT

Differing management approaches are required, depending on where the IT spend lies in the commodity differentiation continuum.

For commodity constituents of IT spend, the key factors to be considered are the service levels required, the risk appetite and the costs associated with delivering the service within these parameters. There are cost implications associated with changing the parameters and both technology advances and competing service suppliers exert a downward pressure on the cost of technology supply.

For differentiating constituents of IT spend, the key factors are more varied. In addition to the factors that need to be managed for commodity spend the differentiating aspect of the service also needs to be supported. Typically, these differentiators will fall under one of the following headings and can be broken down to further levels of detail:

- Operational excellence;
- Innovation; and
- Customer intimacy.

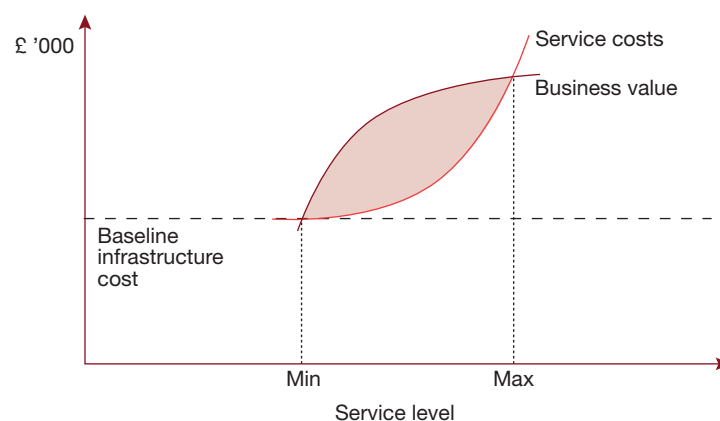
Selection of optimum service levels

In considering the balance between the service levels and the associated costs, and the value that these deliver to the business, an alternative model is to determine the range of acceptable options and then for IT and the business to agree the preferred choice.

This model begins by recognising that there is a level of baseline infrastructure cost just to 'be in business'. There is a choice over the level of service to be provided, but the cost of delivering higher service levels rises. While the first increases in service levels can give a much improved value to the business, the law of diminishing returns sets in and eventually the incremental increase in business value is less than the incremental increase in costs. This is mapped out in Figure 6.

The shaded area on the diagram represents the combination of service costs and business value, where the

Figure 6: Balancing business value with service costs



Source: PricewaterhouseCoopers

Management of IT value continued...

business value exceeds the costs. This diagram helps to show where the maximum and minimum service levels should be set.

This simple concept can be used to frame discussions on the choices available to the business and IT, and to begin to recognise the impact of changing business value or costs on the optimum service level to be provided. It is also possible to expand this concept into linear programming, so as to be able to consider the impact of other constraints, such as limited resources on the optimum service levels.

By focusing on the areas in which IT delivers greatest value to the business, it should be possible to focus IT investments more appropriately so as to have the twin benefits of reducing the costs to deliver services and maximising the return to the business from value-adding, differentiating investments.

There are various pieces of research in this area, which show that this typically leads to an increase in the proportion of new investment to IT operating expenses, while reducing the overall spend. While the numbers are only indicative, the research suggests that IT investment increases from 25% towards 50% of total IT spend, while overall

spend can fall by up to 20% – in other words, some of the savings from reduced IT operations are used to fund additional investment and the lower overall level of ‘fixed’ IT operating costs gives more flexibility to the management of IT.

This remixing of capital and operations expense within IT is crucial to ensuring that IT spend, overall, remains focused on, and relevant to, always delivering value to the business.

Conclusion

It is clear that there is no panacea or all-encompassing solution that satisfies the criteria for determining the value of IT. There are quantitative techniques that enable us to define the raw numbers. However, this is not the full story, as there are other, often qualitative factors, such as the culture of the organisation and communication between IT and business managers, which needs to be taken into account.

However, the law of diminishing returns applies and it is important to avoid getting into a loop of paralysis through analysis, where too much data is collected in regard to functions that provide commoditised undifferentiated services. Gathering and analysing detailed information across all functions may not always be a worthwhile

exercise. Prioritisation is key to obtaining the greatest return for the effort expended. Pareto’s Law does hold true with respect to IT spend, as it does concerning other areas of the business.

As we have indicated in this article, tools and techniques exist to support the value management of IT. The art is in effectively using those tools within the context of a given organisation to get behind the raw numbers: a ‘one-size-fits-all’ solution is unlikely to be successful.

You will never be able to achieve transparency, and hence build trust between IT and business units, if you do not collect and effectively analyse the underlying raw numbers in the first place! That is the first and most important step towards the management of IT value.



Fair value and financial instruments

– developments and challenges

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by Doug Summa, Mark Batten and Matthew Falconer



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The effects of recent developments in accounting frameworks concerning the use of fair value measures are being felt far more broadly than just within the accounting policy departments of financial services organisations.

Standard setters in both Europe and the US have endorsed the use of fair value accounting for financial instruments. As these frameworks for fair value are applied, focus is moving from the technical accounting issues to the broader business and control implications.

This article explores the practical consequences of these changes, in particular the impact on control frameworks.

Recent developments

The International Accounting Standards Boards' (IASB) has amended the fair value option under IAS 39 (June 2005) to reflect stakeholder concerns over the fair valuing of liabilities, and the US standard setter (Financial Accounting Standards Board or 'FASB') is in the midst of a project on fair value accounting. This project will deliver new guidance on fair value measurement, impact on concepts

such as Day One revenue recognition and provide further prescriptive disclosure requirements regarding the source of valuation data.

As the focus increases and the framework continues to develop, regulators, industry groups and others contribute to the debate. Boards and management, shareholders, regulators, analysts and beyond, are now far more aware of the importance and impact of these financial accounting concepts and are beginning to respond.

Group of Thirty (G30)

The work of the G30 during 2003, under the banner 'Enhancing Public Confidence in Financial Reporting', contributed to the debate on the use of fair value measurement for financial instruments. The work provides guidance to market participants by way of best practice statements for the controls over valuation of financial instruments against which organisations can benchmark standards and identify gaps. While at first glance an organisation may feel that it meets the standards set out, a more detailed review will typically identify shortcomings and areas for improvement.

The work of the G30 has served to raise the profile of the issues at hand and has provided an opportunity to communicate to wider stakeholders the depth and quality of the control environment typically found in financial services institutions.

Regulators

A recent consultation paper from the Basel Committee on Banking Supervision sets out draft guidance for regulators concerning the prudential supervision of banks' use of the fair value option. Although the detail may change, the message is clear; supervisors are focused on the importance of fair value and will consider risk management and control practices related to the use of fair values when assessing regulatory capital. The draft guidance references the G30 best practices.

Analysts

Complex accounting matters such as Day One profit recognition are increasingly the focus of those outside of finance teams.

Fair value and financial instruments continued...

Equity research analysts are taking ever-greater notice of such rules. Recent comment considers the impact on reported results and stock prices in the sector, with focus on the potential for hidden upside in results as an outcome of such rules and a call for greater disclosure. With this increased level of awareness, organisations need to be clear in their interpretations, and senior management and boards must be well informed as to the impact of such concepts. Finance directors will want to be prepared for questions from analysts, boards, audit committees and shareholders.

Market developments

New sources of data to support financial instrument valuation have developed. Consensus pricing services are offered by independent organisations who collate instrument pricing data from financial institutions and feed the averaged data back to those that contributed. New sources of prices have also been established over recent years in the form of new markets for products. A good example of this phenomenon is the development of the iTraxx credit indices, which provide liquidity and price availability in the structured credit markets.

The practical challenges

Against this background organisations are asking themselves new questions with regard to the application of fair value accounting:

- Is the interpretation of the accounting rules clear, communicated to the relevant users and correctly and consistently applied across all parts of the business and products?

- How can we be comfortable that the valuations used are appropriate and that data underpinning these valuations is accurate and relevant?

- Can our compliance with the accounting rules be effectively evidenced?

- How sensitive are reported results to fair value measures, particularly where judgement is involved?

These questions can be difficult to answer; fair value practices have sometimes developed in business line silos, influenced by market convention and established practice rather than explicit reference to accounting rules. Controllers whose main focus is profit and loss analysis may not concentrate on the application of accounting concepts to those businesses for which they are responsible.

Reporting to senior stakeholders can often be disjointed or so detailed that they are unable to adequately monitor the application of fair value on an organisation-wide basis.

In response to these challenges, leading organisations are now focused on ensuring a robust control environment around the use of fair values.

Getting the control environment right

The G30 work highlights key features of an appropriate environment:

- **Governance** – A clear governance structure should be in place with appropriate segregation of duties. This structure ensures issues are escalated and appropriate risk management is performed. The governance structure also ensures senior management to take responsibility for the oversight and control of fair value;

- **Control** – Sufficient controls need to be established over risk limits, model verification and control (see Figure 1), approval of financial instruments traded and complex transaction reviews. All of the controls should be documented; and



- **Price verification** – Institutions should engage in rigorous price verification exercises at least monthly. This review should also consider valuation adjustments used.

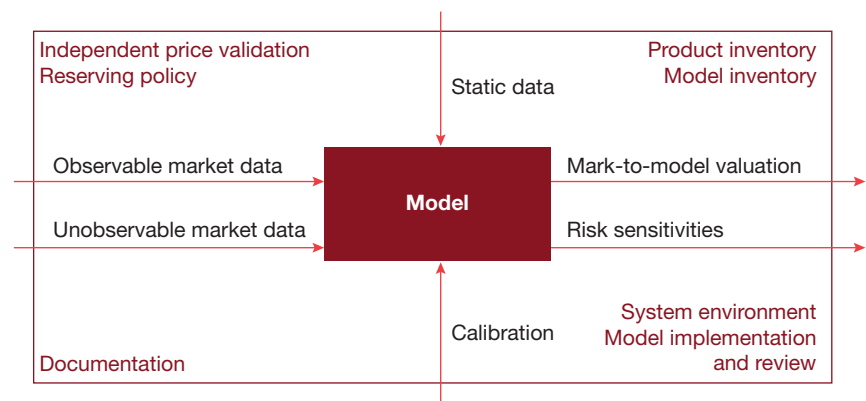
While many components of a good fair value control environment are accepted and understood, there are areas where practical implementation has proved difficult.

Model control and validation

Documentation and maintenance of an up-to-date model inventory and ensuring all changes to models are adequately reviewed and applied consistently remains a challenge. Questions often arise over ownership of the model inventory within the institution (who is best placed to monitor the inventory and suggest updates), and the process of updating and reviewing changes to models. Responsibility for identifying when a model needs updating is difficult since typically, front-office staff are best placed to pick this up first.

Organisations that have succeeded in this area have developed a common standard for all models. Controls are established to ensure changes to models are only made once properly approved. In addition, dedicated groups have been established to review models in use.

Figure 1: The fair value model control environment



Over-the-counter derivatives often require the use of a financial model in order to help determine a relevant fair value. Such models take static data (deal terms, counterparty information) and market data (observable or unobservable) relating to a specific financial instrument to generate a valuation for that instrument.

The control attributes that support this process include the following:

- Models are developed on a secure platform and are tested by independent parties within the institution to ensure they are calibrated to market and achieve their stated objectives;
- Product and model inventories are maintained to allow management to control the products traded and the models they are traded on;
- An independent party checks the inputs to the model to independent sources to validate the marks made. Where reserves or valuation adjustments are required they are calculated in accordance with set policies, consistently; and
- The controls above and the output from them are documented and maintained. Key findings are documented and reported to senior management.

Source: PricewaterhouseCoopers

Fair value and financial instruments continued...

Consistency of application

Where organisations are run on a business line model, decisions can often be made in isolation of the other business lines. Management need a methodology for ensuring consistency of approach across business lines. Such inconsistency can come in the form of disagreements over the application of the rules or in fair value measurement itself.

Many institutions have dealt with this challenge by establishing separate valuation groups within finance to specifically perform monitoring procedures. Common policies and procedures have been established by management and these groups have been charged with ensuring compliance with these policies.

People

The requirements of the fair value accounting framework and the effort required to maintain a robust control environment, coupled with ever-increasing product complexity has placed new demands on financial controllers.

For management to be confident that the valuations are appropriate, organisations must invest in sufficient, competent resources, which are motivated to deliver the correct accounting result. To meet this standard institutions have had to focus on:

- Quantity – institutions have hired more accountants and controllers to adequately cope with the increasing complexity of corporate governance needs. In addition further quantitative resource has been hired to deliver development in models and model control;

- Specialisation – increased complexity means increased requirements in terms of knowledge and experience of relevant resources; and

- Reporting lines – for organisations to achieve best results they must carefully consider where to locate key resource. The balance to be achieved is to ensure ownership and responsibility while also maintaining independence of the functions concerned.

The Day One challenge – a case study

A good example of the practical impacts of a fair value accounting framework can be seen in the application of the Day One profit recognition rules – one of the biggest financial reporting challenges for investment banks in recent years.

In the past, almost all trading institutions would determine their best estimate of fair value on the day a transaction was entered into and would recognise the difference between this fair value and the consideration in the income statement as their Day One profit. This amount is effectively the trader's margin; the difference between what they sold the contract for and what they determine the value of the contract is to them. As a result of relatively recent changes in both International Financial Reporting Standards (IFRS) and US GAAP, if this profit cannot be evidenced by reference to market-based observable data it cannot be recognised as profit in the accounts.

This has had a significant impact on financial services institutions. As well as potentially deferring profits that once



would have been recognised upfront, it has also caused a number of control and resource challenges, including:

- Enhancement of controls to capture and track Day One profits;
- Documentation of new policies and procedures;
- Addition to headcount to perform analysis of trades affected; and
- Investment in senior and experienced resource.

There are a number of key issues that different areas within an institution need to ensure are addressed. These are highlighted in Figure 2.

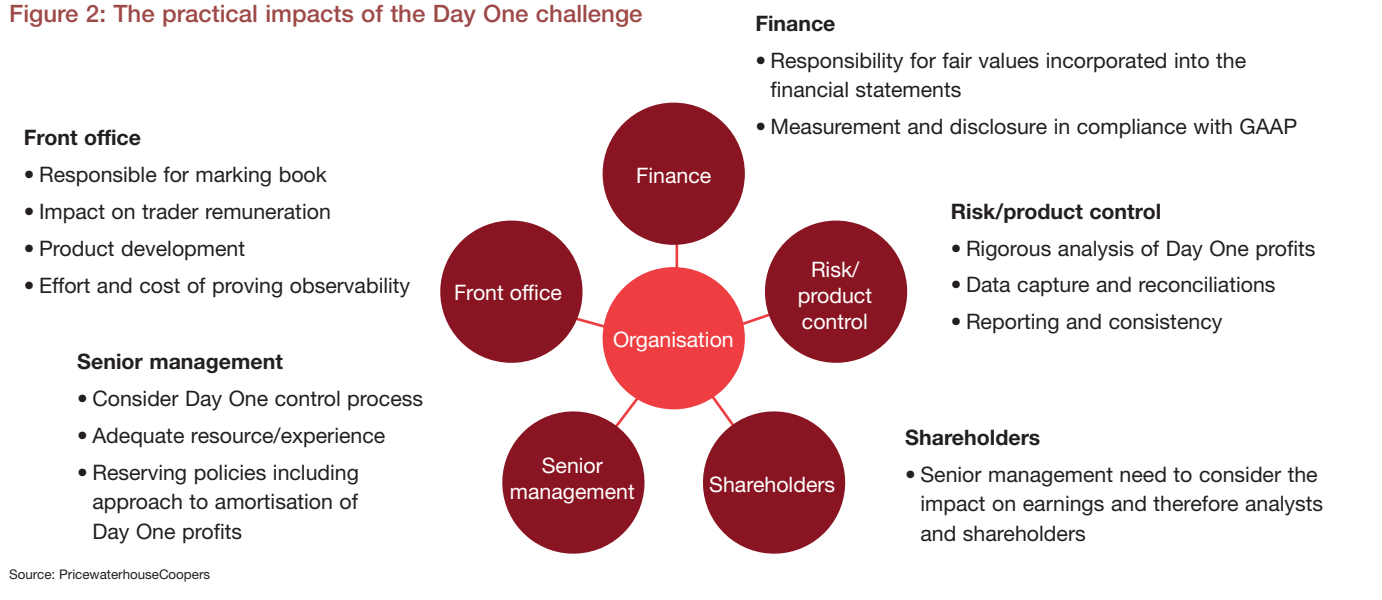
Application to all institutions

Some of these practical challenges are most relevant to the larger investment banks. However, this does not mean other organisations do not have to respond to the challenges created by the fair value framework. The lessons learned and practical challenges arising

are relevant to some extent to all institutions that opt or are required to carry financial instruments at fair value.

For smaller institutions or those organisations that only deal in a small number of financial instruments, a further challenge exists to create and develop a fair value environment that encapsulates the appropriate controls and processes for their level of activity. This challenge can be as difficult as trying to develop a large sophisticated fair value control environment.

Figure 2: The practical impacts of the Day One challenge



Fair value and financial instruments continued...

Beyond accounting

In the current environment, accounting accuracy and compliance is paramount. Guidance is developing fast and disclosure requirements are growing. Growth in the breadth, complexity and usage of financial instruments means that the accounting and control challenges will not disappear, even if and when the accounting platform becomes stable.

Senior management in all financial services organisations must ask themselves whether they understand the sensitivity of reported results to fair value estimates and whether they are comfortable with the control environment in this regard.

As the level of activity by standard setters, regulators and other commentators shows, fair value can no longer be viewed as a purely technical concept, best left to accounting technicians.

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Is measurement crucial if people are an organisation's most critical asset?



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Fair value and financial instruments – developments and challenges



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