

Asia Banking Insights

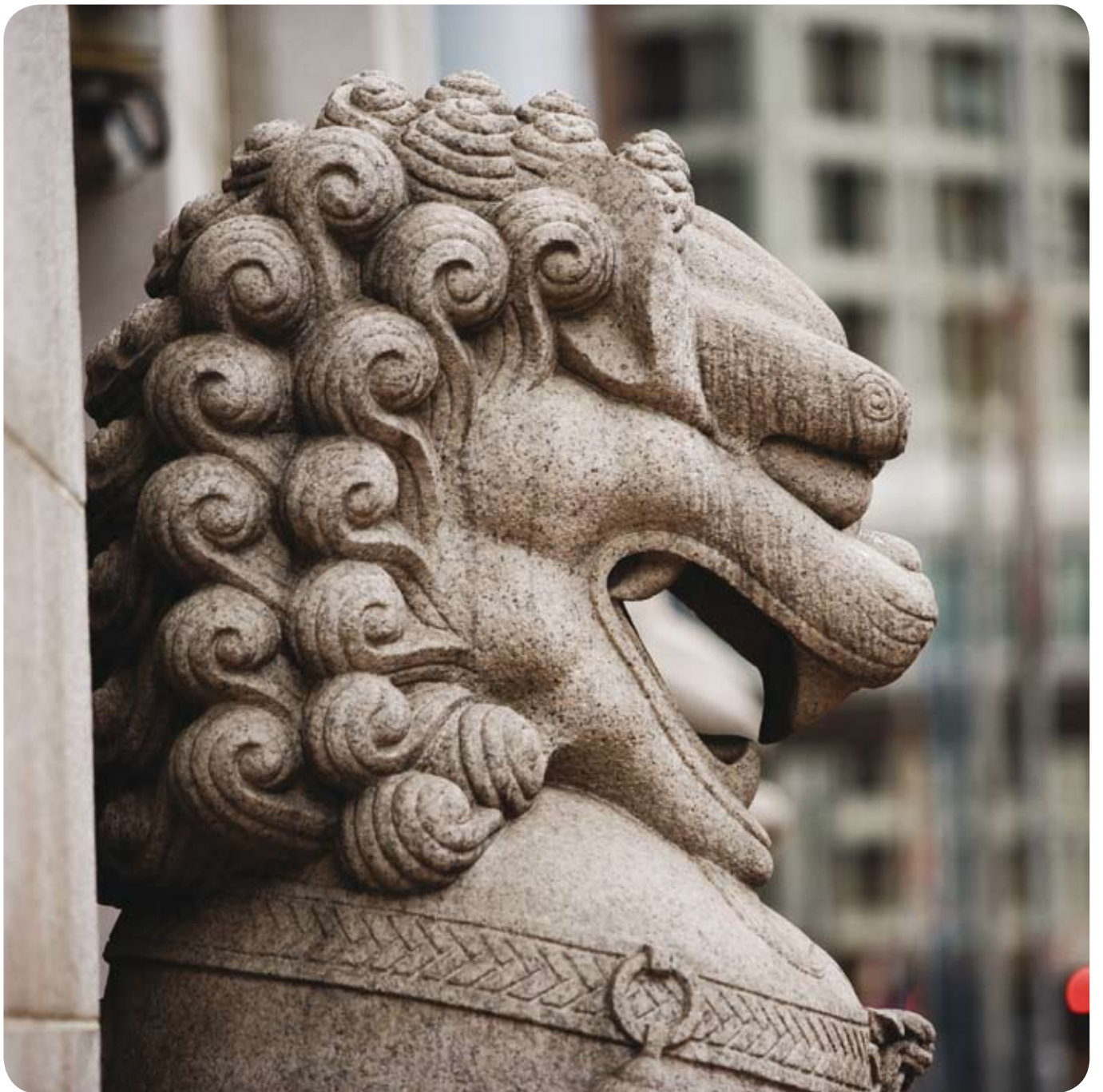
Tackling the key issues in banking and capital markets in Asia*

March 2007



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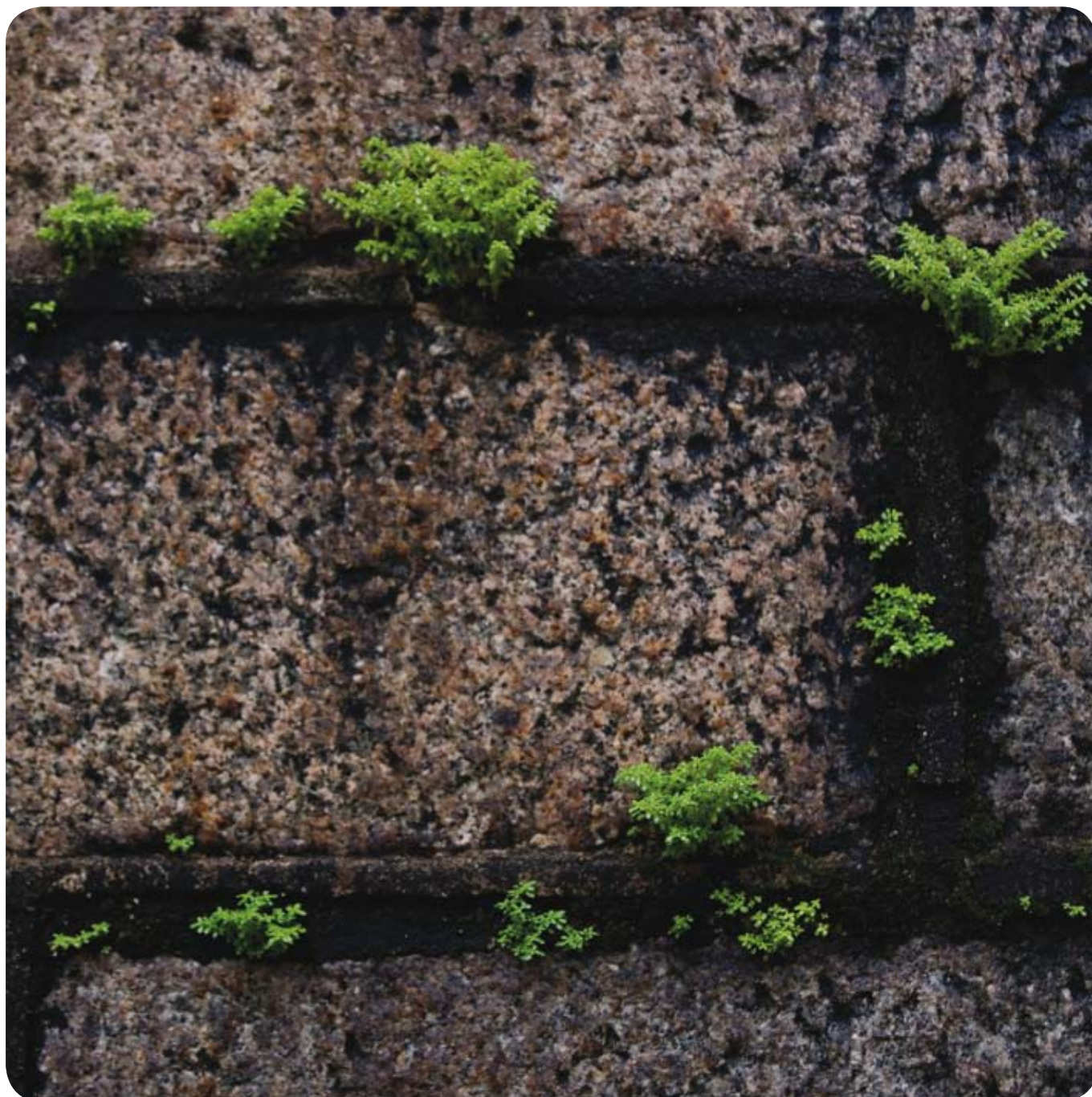


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Welcome to our first edition of the PricewaterhouseCoopers' Asia Banking Insights. In this edition, we have brought together a number of articles on a broad range of topics which are facing banking and capital market players in Asia.

As a result of the developments which have taken place in recent times, China is currently, and will continue to be, a key market for many banks in Asia. Strong interest in undertaking M&A in China is likely to continue in the next five years¹. However, those doing business in China do need to have an appreciation of the risks and rewards within the Chinese financial services market. Tim Pagett and Rick Heathcote provide their perspectives on "Risk and Governance in China".

While some financial services are focusing on M&A to enter China's financial services market, others are pursuing organic growth strategies. Many foreign banks are now seeking to establish PRC-incorporated entities in China. While this will lead to exciting times in the retail banking market in China, these banks will face a number of significant internal challenges as they seek to ensure that they are ready to grow their new businesses. These not only include regulatory and tax challenges, but also operational

and systems consideration. Shane Knowler and Simon Copley looks at some of the possible hurdles which foreign banks will face as they expand in "Foreign Banks in China – An exciting opening of the retail market, but not without internal challenges".

It is currently a challenging time for those working in the finance and risk management functions of banks in Asia, particularly as they face increasing challenges in meeting the demands by various stakeholders. Not only are regulatory changes such as Basel II impacting banks in most markets, but also accounting standards in many territories are rapidly moving towards requiring compliance with the requirements of IFRS. Increasingly banks in Asia are also being challenged by escalating volumes, complexity of products and increasing labour and other costs. Banks now need to take a step back from the detail, and seek to identify ways and means to ensure that they embed these changes into their day-to-day processes, and ensure that these processes are as streamlined and efficient as possible. Karen Loon and Stuart Scoular explore some of the challenges facing banks in the region in "Market reporting in Asia's financial sector: Bridging the gap between perception and reality" which looks at some of

the recent survey results of a PricewaterhouseCoopers survey conducted of Asia's financial services industry in cooperation with the Economist Intelligence Unit.

We then explore in further detail some of the specific challenges which face banks in Asia as they seek to comply with the requirements of Basel II Pillar 3, which will impact many of Asia's banks in 2008. In "Basel II Pillar 3 – Challenges for Banks in Asia", Christophe Cadiou, Chris Matten and Peter Li suggest that a strong governance structure, a focus on resolving data and process challenges, and establishment of a coherent disclosure and communication strategy around risk management are key to allowing banks in Asia to best meet the increasing reporting challenges.

Similarly, the requirements of IFRS 7 *Financial Instruments: Disclosures* will become effective for many Asian banks for financial years beginning on or after 1 January 2007. Banks in Asia should be careful not to underestimate the impact that IFRS 7 will have on their financial statement disclosures, risk management processes and systems, as well as their own investor communication strategy. Once again, data gaps,

¹ Going for growth – The outlook for M&A in the financial service sector in Asia; issued by PricewaterhouseCoopers in 2006

Editor's comments *contd.*

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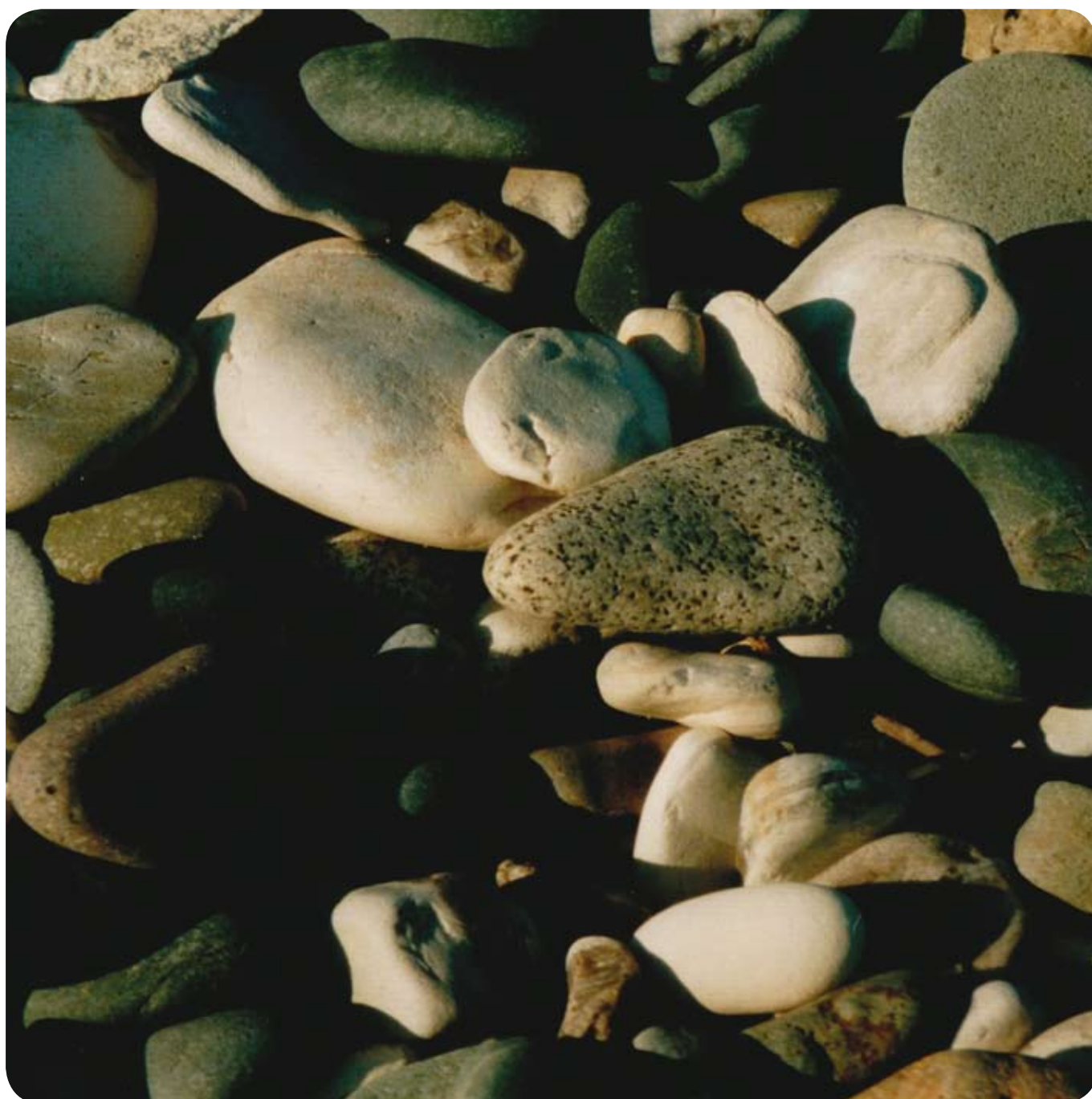
the availability of systems and processes, and the interlinkages between Basel II, local regulatory reporting, customer reporting and management reporting with IFRS 7 can all be disclosure challenges. In “Striking the right balance – Rising to the disclosure challenge of IFRS 7”, Justin Sebire, Chen Voon Hoe and Emily Lam provide their perspectives on how best banks in Asia can rise to the challenges.

Finally, increasing competition as well as liberalisation of many markets in Asia have led to more volatile interest rates. These changes, together with the impact of Basel II and IAS 39 are impacting how Asset and Liability Management (ALM) teams operate, the processes they maintain and the systems that support them. In “Assessing the state of ALM practices in Asia’s banks”, Chris Matten and Bertrand Billon provide an overview of the results of a recent survey conducted by PricewaterhouseCoopers of a number of the region’s banks.

I hope you find these articles of interest. Please provide us with your feedback and ideas for articles you would like to see addressed in future issues. Online copies of this edition can be found at www.pwc.com/banking.

Risk and Governance in China

6 by Tim Pagett and Rick Heathcote





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It is indeed an exciting time for risk and governance professionals living and working in China. In every respect, China just feels like a place that has truly embraced its programme of reform and is rapidly moving to a position to recover the ground reckoned by some to be lost to the so-called “developed world” over the past two centuries. This, above all else, sets the context for appreciating the risks and rewards within the Chinese financial services market.

There are constant reminders of the pace of change and reform, from the number of cranes that shadow the skyline of any of the major Chinese cities to the sprawling manufacturing and economic development zones in Guangdong Province and the Pearl River delta in the south, and around the Yangtze River delta in the north. These amazing sights are tangible and visible proof of the message that is heard both within and outside China – this is a country in the midst of an economic whirlwind.

To appreciate the risks of doing business in China requires an appreciation of the sheer size and cultural and social diversity of the country. With 1.3 billion people, the sheer geographic and population spread of China means that the potential bankable and insurable markets are as varied and diverse

as those experienced across the whole of Europe with just as many language, cultural and economic differences.

Many commentators outside of China seem to be very harsh in their criticism of the Chinese over the pace of regulatory developments, and inconsistent application of practices designed to protect both the investor and the customer. However, it could similarly be observed that attempting to get consensus and consistency across Europe or the US on these matters would appear to have been equally fraught with delays and challenges.

One should not expect simplicity and consistency just because China is one country. The fact is that, similar to the European Union, the principles and governing laws may be set from the centre, but their application is subject to the differing social and political pressures at both a provincial and city level. And don't forget that these cities and provinces are the same size or even bigger than some European countries.

Further, one can't go past the surging economy in China. The sheer momentum in the economy represents a double-edged sword for risk management and governance. That said, it would

appear to attach to it the same potential implications as it would in more developed economies. While increasing personal and corporate wealth and economic strength drive demand for financial services, they also mask potential issues that really only surface when an economy or sector slows. As in other parts of the world, at a time when you can afford it the most – during growth in profits – the business case for risk management is at its lowest as unexpected losses tend to be more than covered by seemingly ever-growing profits. Complacency in the minds of those underwriting risks inevitably increases and the voice of the risk manager, often seen as bearing the message of doom and gloom, can be drowned out by the spiralling optimism of economic success.

What is unique about China is that when you combine the pace of economic growth with the pace of change and reform being experienced, the unforeseen risks are almost certainly among the greatest.

Further, with over 30,000 entities, assets in excess of RMB40 trillion, and with over 75,000 branches and 2,000,000 employees, the challenges of maintaining risk and control in the financial services sector in China could be greater

Risk and Governance in China *contd.*

than anywhere else in the world. How does any organisation get that many branches and people to operate in a consistent fashion against agreed strategies and policies and remain committed to a single overall change agenda?

Many of the major banks have a tiered Branch structure, with Tier 1 Branches operating at a City or Provincial level. The Tier 1 Branches themselves would represent sizeable institutions in their own right, indeed comparable to the size and complexity of some of the major domestic players in Europe and the US. Senior management appointments, strategy and operational focus have historically been set at the Tier 1 Branch level and they have, through their genesis under the political and social regime, been largely autonomous. While the challenges that this provides are not insurmountable, they are indeed significant and should be openly considered when attempting to put context on both governance and risk.

Firstly, for all of the reform and growth that is evident, China remains a state where “government control” is ubiquitous across the country and across industries and social groups. This by itself constitutes a risk factor.

The relationship of the Party, the Government and the People must be understood as they are all variously represented within, around and over the top of the financial services sector. You cannot expect to do business in China without coming up against at least one of these elements. It is still not uncommon to see some senior executive appointments made on the basis of party tenure and many of the branch lending and banking decisions made in line with local, provincial or state priorities rather than purely in the commercial interests of the shareholders.

Of course, for the majority of the major banking and insurance entities, state ownership is still a fact of life and the state/people/society still retain the majority shareholding. The People’s Bank of China exerts its control in much the same way as other Central Banks around the world operate, accepting of course, the fact that there are still tight exchange controls and constraints on both depositor and lending interest rates.

Formed in 2003, the China Banking Regulatory Commission (CBRC) is rapidly enshrining itself in its role of establishing and maintaining prudential and regulatory supervision within the banking sector. Although its influence has

been relatively benign compared to the influence of emerging shareholder and reform related drivers, the CBRC is increasingly becoming the principle driver for enhancing the governance and risk management practices of the sector. In December alone, they have announced:

- New measures underpinning the approval of wholly owned foreign enterprises to participate in domestic RMB banking operations
- Enhancements to the market risk management requirements of all banking entities
- Their expectation that major market participants will be compliant with the advanced approaches of the Basel II framework by the period 2010 to 2012.

Although progress in the regulatory and legal system continues, there remain significant risks associated with:

- Protecting intellectual property rights;
- Enforceability of collateral in default situations; and
- Property ownership and disputes.

Potentially the most significant focus for commentators, risk management professionals, regulators, shareholders and management alike is credit quality. If there is one aspect of the banking sector that has, and continues to be, the focus of almost continuous international conjecture, misinformation and challenge is the issue of asset quality and specifically non-performing loans (NPLs).

It is not surprising that, given the integral role that the banking sector plays in the achievement of social and political objectives, as mentioned previously, there would be a higher level of non-performing assets overall within this sector. In recognition of this fact, a critical element in the reform process for banking institutions has been the opportunity to segment their balance sheets, segregate their NPLs to support a more robust valuation and the provision of a platform for reform through their ultimate removal using one of the centrally owned and controlled asset management companies.

According to official figures, over the past couple of years, the banking sector has seen a continual improvement in the NPLs position. Although there are some clear examples of improvement, one cannot rule

out the possibility of risk that this is being exaggerated somewhat by the overall increase in lending being experienced on the back of the economic growth. Further, challenges remain with the measurement criteria applied to the assessment of NPLs and questions arise on whether the convergence of Chinese Accounting Standards and International Financial Reporting Standards will increase the level of overall NPLs through a broadening of the recognition and measurement criteria.

One concern that any rational observer could and should hold, is that in light of the rapid expansion in both the domestic and international markets, is the risk of economic slow-down making lending too risky? Clearly, concern needs to be given to potential complacency in lending practices, as much in China as in any other economy. Despite there being an overall level of optimism on the continued strength of the economy, almost all major financial institutions are investing in the continued reform of their lending practices and processes, governance, and credit risk measurement tools. However, despite much of the good news, these institutions still have a long way to go to surpass the practices seen in the better international competitors. The size of the

challenge remains considerable – re-tooling Head Office is one thing – but the challenge of achieving consistent application across a branch network where the Branch Governors are still in some instances appointed by, and accountable to, the Party first and the Chief Executive second, can and does slow down the pace of change.

Finally, there are some interesting dynamics that are introducing a level of unforeseen volatility to the financial and developing capital markets in China:

- Domestic interest rates, albeit low by the standards of many developed economies, continue to move in an upward direction. Balance sheet management is increasingly becoming an issue with continued margin pressure, changing depositor behaviour, and limitations in the range of instruments that facilitate management, all adversely impacting progress in this regard.
- The RMB continues to strengthen against the major global currencies. This is obviously a double-edged sword, given the positive trade balance and the fact that foreign currency reserves are now in excess of US\$1 trillion.

Risk and Governance in China *contd.*

The currency effect is particularly evident through the volatility in earnings potentially generated by the investment of the significant level of USD-denominated IPO proceeds arising from the reform of the banking sector.

- Finally, most banks continue to face the potential for capital constraints. In addition to the increasing pressure arising from the potential impact of more risk-sensitive risk capital requirements under the Basel II framework, the existing CBRC Capital regime and the People's Bank of China's liquidity regime can be, and have been, used to constrain the extent of lending in order to support policy concerns that the economy may or was over-heating.

Regardless of whether one takes an optimistic or pessimistic view of China from this article, there are two absolute certainties that a risk management professional should heed:

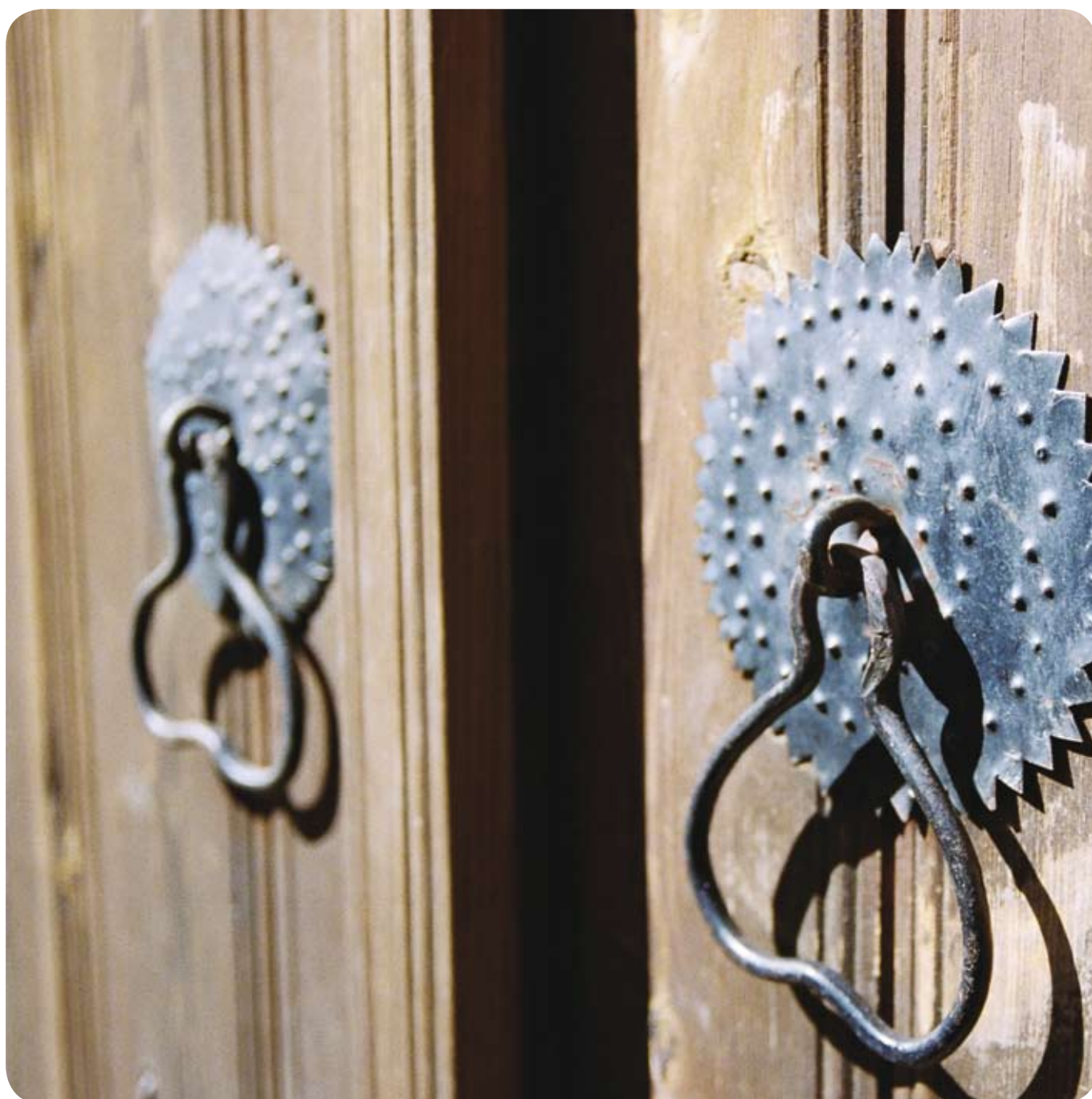
- Firstly, it is fool-hardy and naive to think that anyone can predict with certainty what will happen with the economy and business prospects in China over time.

- Secondly, regardless of whether the economy continues on its upward march or faces a correction – the impact will be massive both in China and across the world.

Risk and governance processes and procedures are absolutely critical to survival in a world where the only certainty is that the impact of risks will be significant – either adversely or favourably. Continued focus and investment in risk and governance are critical to manage exposure to the inevitable rather than what exists in the present.

Foreign Banks in China – An exciting opening of the retail market, but not without internal challenges

12 by Shane Knowler and Simon Copley





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Back in 2001, China's admission to the World Trade Organisation (WTO) was on everyone's agenda. It seems like a distant memory, but now, more than five years later, the last of the key measures to progressively open up the banking market to foreign banks has been implemented, and foreign banks are finally on the verge of being able to target the Chinese retail banking market: the fabled trillions of dollars in simple bank deposits; the huge numbers of increasingly wealthy potential customers seeking more sophisticated products.

But not so fast!

Foreign banks are indeed technically able to offer full-service, RMB-denominated retail banking services to the general public, subject to establishment of a China-incorporated legal entity, and the various regulatory approvals for that entity to be established and then to operate as a bank. Foreign banks are establishing their PRC-incorporated entities as Wholly Foreign Owned Enterprises (WFOE). Several foreign banks are well down the path towards local incorporation and authorisation, and the first of these are expected to go live with their WFOE subsidiary banks as early as March or April 2007. The main regulator, the China Banking Regulatory

Commission (CBRC), has been extremely professional and helpful in guiding the foreign banks through the registration and authorisation process.

The challenges ahead

Banks, however are finding that the main challenge is not in fact the regulatory process, but rather the operational and systems issues involved in converting their existing China branch businesses into separate legal entities.

There is also some legal uncertainty. At the time of writing, it is not clear what mechanism the PRC authorities will introduce or permit to allow the transfer of contractual arrangements from the existing branch operations of the banks to the new subsidiaries. In an extreme situation, banks may have to enter new contracts with all of their customers, suppliers, and employees. This would be a considerable logistical exercise and problems would arise where parties did not agree or did not respond to requests to enter new contracts. Hopefully, a high-level ruling will be issued with the necessary authority to allow novation of contracts in such situations without the agreement of the other party.

Whatever the mechanism for novation of contracts, it is still a

significant logistical exercise to prepare an inventory of all the branches' contractual obligations and advise the counterparties of the transfer of the obligations to the WFOE entity. Whether legally required or not, banks should give their contracting parties reasonable notice of the change. In cases where the bank has an obligation (for example, advances credit or gives a guarantee), the other party may perceive a reduction in the credit worthiness of that obligation in the transfer from a branch to a (less substantial) subsidiary. The other party may seek to obtain additional credit support from the branch before agreeing to the transfer. This will require the head office or branch to issue a guarantee or other support, which will have administrative and credit processing requirements, and may have a capital impact also.

Currently, PRC branches of foreign banks usually enjoy the credit ratings of their parent organisation, as they are the same legal entity. However, under the approach followed by most ratings agency, a subsidiary will likely be limited to no higher than the sovereign rating of its country of domicile. New PRC subsidiaries may therefore have credit ratings no higher than the sovereign rating of the PRC, which in some situations may be less than the rating previously enjoyed by the

Foreign Banks in China – An exciting opening of the retail market, but not without internal challenges *contd.*

branch. This may have implications for the fund raising capacity and cost of funds of the new subsidiary. Banks need to be assured of the ongoing availability and cost of interbank and other funding to the new subsidiary, irrespective of any potential differences in credit rating.

In addition to the authorisation and approval of the WFOE entity itself to operate as a bank, PRC regulations require individual products and branches to be separately authorised. Although the new entity will probably offer most of the existing products through existing branch and sub-branch locations, the fact that these will be offered through a new entity means these products and outlets need to be re-approved by the relevant authorities, usually the CBRC.

Regulatory issues

As in any jurisdiction, dealing with the authorities itself requires planning. Although PRC regulatory authorities have generally become more helpful and user-friendly, simply communicating and maintaining relationships with relevant authorities is time consuming and needs to be appropriately managed to maximise the value of these relationships. Again, as with any authority with offices in multiple jurisdictions, this is made more complex by the

authorities usually having divisions in different cities or provinces who may interpret regulations in a slightly different way to their colleagues in other locations.

External to the PRC, the approval of the bank's home regulators may be required for the establishment of the subsidiary and transfer of assets, especially if the amount is significant. There also needs to be consideration as to the composition of the Board of Directors of the WFOE subsidiary.

The issue of whether to retain a branch in the PRC (in addition to the new WFOE subsidiary) also requires some analysis. Although most of the branch's business is likely to be transferred to the subsidiary, there may be good reasons to also retain the branch itself. In this case, the issue of the split of assets, liabilities, staff, and operations needs to be considered and planned for.

Operational and systems considerations

Logistical and physical activities need to be planned for. New signage for premises, new stationery, advertising, websites and customer communications all need to be updated for the new entity on the changeover. Of course, a good communications

programme to staff will help ensure buy-in to the change, and enable staff to better deal with customer queries.

There are likely to be some IT issues. At the time of writing, it is not clear what requirements (if any) there are for banks to have any of their IT facilities (particularly the customer databases) within the PRC. Systems will have to have additional instances established for the new subsidiary. Interfaces will have to be established with the bank's international networks, and with external systems such as payments systems and SWIFT.

The finance function should not be forgotten either. It will be necessary to establish new accounting, reporting and control mechanisms for the new entity. Depending on systems used, simply establishing a new general ledger may have a considerable lead time and take some resources to establish the opening position, ensuring an appropriate level of control and reconciliation over the process. If a branch operation is to be also retained, the finance function will need the capability and resourcing for duplicate reporting – i.e. for both the branch and the subsidiary. There may also be issues for the reporting of the PRC assets in the form of consolidating a subsidiary versus the previous

branch operation. Compliance with the financial ratio requirements of the CBRC may also add some complexity, as banks need to transfer their existing business into the WFOE subsidiary while complying with stringent financial ratios, primarily the maximum loan-to-deposit ratio of 75% (although a grace period has been allowed for this requirement).

Tax is another area requiring careful consideration, particularly around the value of assets on transfer.

The road ahead

In this article, we have mentioned but a few of the issues that foreign banks operating in the PRC need to consider in a change from branch operations to a separate WFOE subsidiary structure, in order to be able to offer full service RMB retail banking services.

Needless to say, given the huge number of activities, complexity, and interdependency of issues in establishing and transferring branch business to a WFOE subsidiary, good management of the process becomes a critical success factor. A formal project management structure needs to be established, with appropriate reporting and control structures to ensure activities are going to

plan and deadlines will be met. It is important to resource the work required, either through internal teams or the use of external consultants. The project should also have appropriate sponsorship at a very senior level.

Market reporting in Asia's financial sector: Bridging the gap between perception and reality

16 by Karen Loon and Stuart Scoular





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Globalisation of standards, increasing cross-border M&A and tightening local regulations are all driving Asia's financial services sector to move toward international standards of market reporting (the reporting of financial and non-financial information to stakeholders). Developments such as Pillar 3 of Basel II and International Financial Reporting Standards (IFRS) are helping to drive this step forward. But are Asia's financial services firms meeting the expectations of analysts and other stakeholders?

Financial services firms in Australia, Hong Kong, Japan, New Zealand and Singapore believe that Asia as a whole is further away from reaching international best practice in market reporting, compared to their counterparts in China, India, Indonesia, Malaysia, Pakistan, Taiwan, Thailand and South Korea, according to a recent survey by PricewaterhouseCoopers (PwC) and the Economist Intelligence Unit (EIU).

Forty-one percent of respondents in developed markets say that market reporting in Asia will not be on a par with international best practice until 2015 or later, while 40% say they will be on par by 2010. By contrast, 59% of their counterparts in emerging markets are confident this will be achieved by 2010, with

only 38% believing this milestone will not be reached until 2015 or later. This discrepancy indicates that firms in emerging markets may not yet have fully grasped the size of the challenge.

Despite this perception gap, the region's financial services sector concurs on the importance of market reporting as supported by 86% of survey respondents. Additionally, 63% of respondents feel their market reporting is very effective. However, the survey finds many firms are benchmarking their reporting against domestic peers, rather than overseas players, and equity analysts judge Asian firms against the standards of the Asian markets they cover rather than New York or London.

Although international best practice is itself a moving target, firms in developed markets are more aware of these standards, having been exposed to global markets for longer. They have also expended more effort in trying to reach such standards and thus have a more realistic view of what is involved.

Entitled "Market reporting in Asia's financial sector: Bridging the gap between perception and reality"², the report surveyed more than 123 senior executives in financial services firms in Asia during August and September 2006 and looks

at how their firms approach the enhanced demands of market reporting and explores whether stakeholder expectations are being met.

According to the survey, globalisation of standards, increasing cross-border M&A and tightening local regulations are the top drivers moving Asia's financial sector towards international standards of market reporting. Developments such as Pillar 3 of Basel II and IFRS are also helping to drive this forward. With over half of respondents believing that regulatory pressure for greater disclosure will increase substantially over the next three years, it is not surprising that respondents say regulators play a more decisive role in setting expectations on accounting requirements. Interestingly, India and China consider globalisation to be a more important driver of change than regulatory demands; this may reflect the increasing interest in companies from these countries to access funds from global capital markets.

Challenges in meeting international standards of market reporting

Respondents recognise that there are a number of challenges in meeting international standards

² Market reporting in Asia's financial sector: Bridging the gap between perception and reality; available at <http://www.pwc.com/financialservices>

Market reporting in Asia's financial sector: Bridging the gap between perception and reality *contd.*

of market reporting. Respondents in more developed markets cite increasing volumes of work, cost pressures and a lack of skilled personnel as their most significant challenges.

In emerging markets, firms struggle with a lack of procedures to aggregate/produce information, unreliability of information, lack of management interest, and unavailability of information. However, as labour costs in these markets rise, firms need to invest more in the areas of compliance, risk management and IT. Add to

this a scarcity of human capital, increasing sophistication of products and higher transaction volumes, firms will be faced with little choice but to seek ways to improve performance through automation, to reduce costs and to lower operational risk.

Financial services firms across the region, particularly in developed markets, believe that greater IT investment is vital in improving market reporting. Data collation and compatibility problems are common in Asia, where many markets are still developing and there are fewer

established indicators. More than half say enhancements in this area require better IT systems. Respondents also believe senior management commitment is also essential to promote a culture of disclosure and an increased awareness across the company. Establishing better processes is another factor for improving reporting.

For Asia to make improvements in market reporting, firms in Asia should focus on management commitment, culture and technology.

What do you think are the most significant challenges to providing market-reporting information?

		%, up to three options						
Asia-headquartered, assets over US\$10bn		Unreliability of info	Unavailability of info	Lack of procedures to provide	Lack of management interest	Lack of skilled personnel	Volume of work	Cost
Respondents from:								
More developed markets		24	24	27	18	40	40	40
Japan		8	8	4	15	46	58	54
Emerging markets		40	34	43	34	21	26	26
China		67	25	58	33	17	25	17
India		22	35	48	26	30	35	30
Overall		33	30	35	25	30	33	33

Source: PricewaterhouseCoopers/Economist Intelligence Unit survey, August-September 2006

What steps could be taken to improve market reporting at your institution?

		%, up to three options				
Asia-headquartered, assets over US\$10bn		Greater senior management commitment	Better processes	Better IT systems	Better integration of functions	Greater info sharing with stakeholders
Respondents from:						
More developed markets		41	56	60	38	21
Japan		35	58	58	35	19
Emerging markets		68	58	54	39	28
China		64	55	55	45	18
India		65	70	65	35	4
Overall		54	57	57	38	25

Source: PricewaterhouseCoopers/Economist Intelligence Unit survey, August-September 2006

Market reporting in Asia's financial sector: Bridging the gap between perception and reality *contd.*

Senior management commitment It is critical for senior managers to overcome their customary distrust of disclosure, and promote effective market reporting. More than half of our survey respondents cite greater management commitment as being vital in driving improvements in market reporting. This is particularly true in emerging markets, where middle managers accounted for a greater proportion of survey respondents. The greater share of C-level executives among survey respondents in developed markets suggests a greater involvement in market reporting by senior management in those markets.

Culture Senior management commitment is essential for promoting a culture of disclosure and an increased awareness across the company – from credit to IT and finance. Different departments are frequently using the same data and facing many of the same issues but may not be aware of this. Fostering a culture of openness within the organisation and embedding processes are both necessary to meet the demands for the collection and analysis of increasingly complex information. Of the respondents to our survey, 57% said that better processes were required to improve market reporting at their firm. In addition to investment in IT systems, companies must place equal importance on processes that support them. And processes must be continually improved in order to reduce costs, cope with increasing volumes and minimise operational risk.

Technology Data collation and compatibility cause headaches in all markets but problems are even more severe in Asia, where many markets are still developing and there are few established indicators. In fast-growing economies such as China, financial services firms can only imagine what their customer base will look like in ten years. Of survey respondents, 57% said improvement in this area would require better IT systems. Financial services firms need a long-term IT vision that takes into account likely future regulatory, demographic and economic changes, not a “sticky tape solution”. This vision should also take into account the interlinking data requirements of Basel II, IFRS and other reporting requirements.

The way forward

In order to bridge the gap between the current perceived quality of market reporting and the reality, firms in Asia will need to work harder to create a corporate culture that views good reporting as a means of improving shareholder value, rather than simply an obligation to regulators. Technology alone is not the answer – to improve the quality of data, firms must also improve procedures and processes to ensure that the relevant, and not sheer volume of data is reliably collected. Ultimately, reporting must provide what stakeholders require, and firms need to work with them to understand where improved disclosures have the most impact.

In order to succeed in improving their market reporting, senior managers at Asia's financial services firms will need to:

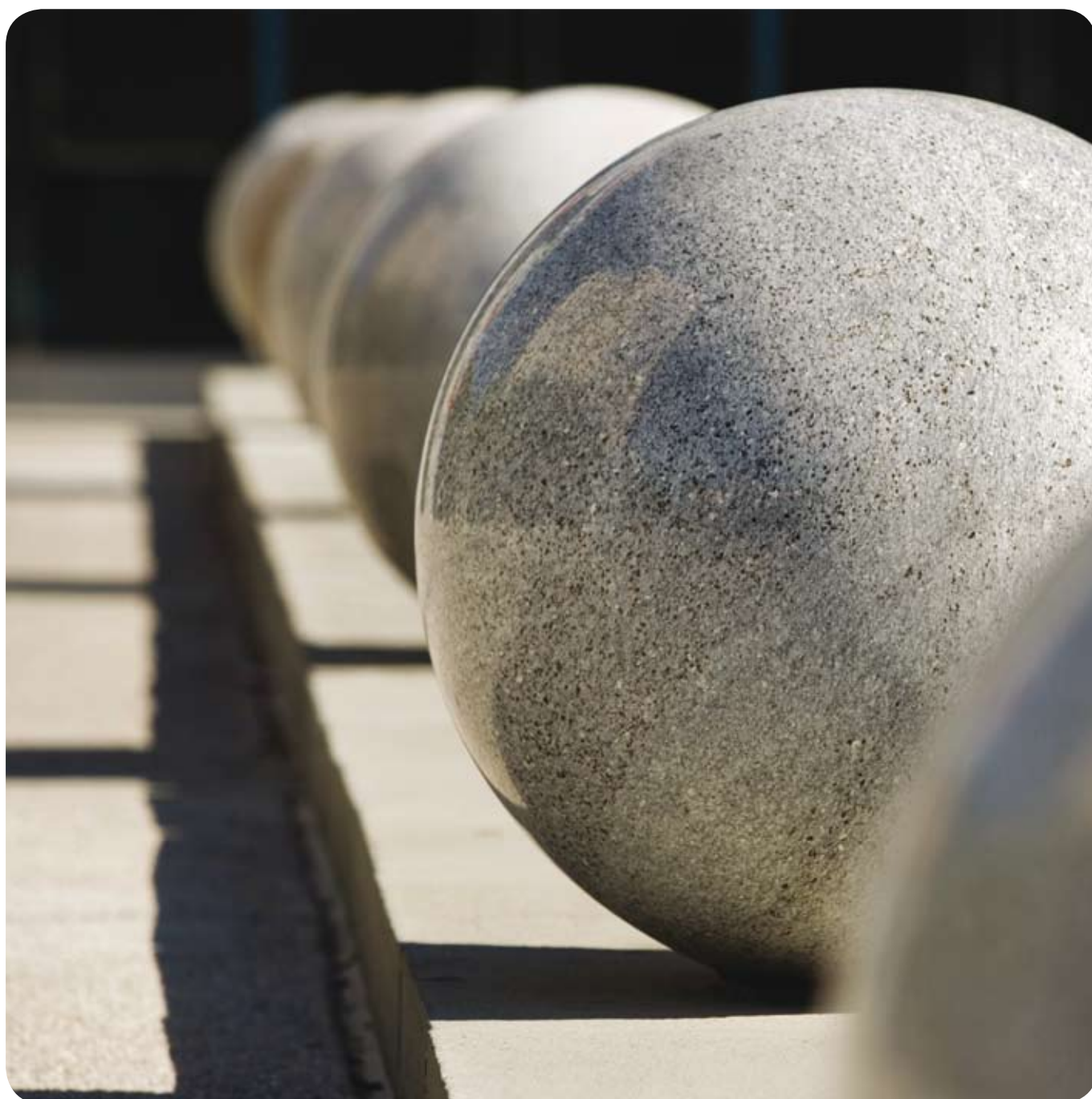
- **Take a holistic view** Market reporting should not be left to the finance department alone. In order to embed good reporting practices, senior management and organisational commitment is required across multiple functions, including risk management, finance and operations. A centralised approach, drawing on the efforts of a number of different functions, is the best way to ensure improvements. However, this should be led from the top – management must take the opportunity to increase its involvement in market reporting and to embed the reporting concept as a means of improving performance, rather than simply reacting to regulatory requirements.
- **Think beyond the silo** Processes and functions overlap and affect each other. Risk managers, treasurers, financial and regulatory reporting accountants all use the same data and face similar issues when determining how to meet the demands of their various stakeholders. However, in many cases these parties rarely talk to each other. A greater awareness of how other functions are using data should result in the organisation thinking more as one rather than as several units. Promoting such a culture should also help ensure that data sources are used effectively, promoting efficient and consistent reporting to multiple stakeholders. This is a particular challenge in Asia where matrix-reporting structures are not as common as they are elsewhere in the world.
- **Develop a long-term vision for technology** Good quality market reporting to various stakeholders requires an organisation to use efficiently the data it has for multiple purposes. Quick-fix solutions that meet the requirement of one stakeholder may not provide sufficient information for reporting to another stakeholder, and could result in misreporting of information as well as considerable reconciliation efforts to ensure consistency. More advanced organisations are using more flexible data warehouse solutions to help them manage their numerous data requirements.
- **Establish clear and efficient processes** Great technology is of no use if the data being collected by it is rubbish. Clear and efficient processes covering the information required, and reliable data are important. Usually the first issue is the availability of data (although) improved procedures are required in order to ensure that the data is collected. The difficulty in many Asian markets is that they are changing so fast that one indicator, such as exposure to a certain sector, may be relevant in January but less so in June. Moreover, monitoring exposure to a specific sector in itself is a difficult task given the dearth of reliable information. Financial services firms need well-defined and automated processes in place to aggregate the data required and to process it. Voluminous manual processes increase operational risk, and are bound to result in erroneous reporting in the longer run.

Market reporting in Asia's financial sector: Bridging the gap between perception and reality *contd.*

- **Make productivity a priority** Employing more technically qualified accountants on the finance team is not a longer-term solution in an environment where business volumes are increasing. Rather than increasing the number of finance personnel, companies would be better advised to focus on improving the overall quality of people they have. Even if throwing more accountants at problems were a solution, it is increasingly not an option. Well-qualified finance professionals are increasingly difficult to come by and costly. The only solution is to identify innovative ways to improve processes, leveraging the technical expertise that is available. In other words, accounting should not be left just to accountants.
- **Know what stakeholders want** Accounting and other standards are minimum disclosure requirements, but may not be all that stakeholders require. Companies should have a good understanding of where improved disclosures will have the greatest impact.

Basel II Pillar 3 – Challenges for banks in Asia

24 by Christophe Cadiou, Chris Matten and Peter Li





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Pillar 3, a significant step towards better market reporting

In recent years, policy makers such as the International Accounting Standards Board (IASB) and the Basel Committee on Banking Supervision (Basel) have taken significant steps to improve market reporting with IFRS 7 and Pillar 3 of the revised Framework for International Convergence of Capital Measurement and Capital Standards (Basel II).

In particular, Pillar 3's objective is to improve market discipline through effective public disclosure to complement Pillar 1 and Pillar 2 requirements. Pillar 3 will represent a significant increase in the amount of information made publicly available by banks around capital structure, capital adequacy, risk management and risk measurement. In some countries like Japan, Pillar 3 disclosures are just around the corner as some banks will make their first disclosures before the end of June 2007. For other countries, Pillar 3 disclosures will arrive in 2008 in most cases.

In a nutshell, Pillar 3 disclosures cover the following aspects from both a qualitative and quantitative standpoint:

- Scope of application of the capital adequacy framework
- Capital Structure and Capital Adequacy
- Internal Capital Adequacy Assessment Process (ICAAP) strategies and processes under Pillar 2
- Credit Risk (requirements are very extensive for banks adopting the more advanced Internal Ratings-Based, or IRB approaches)
- Securitisation
- Market Risk
- Equities
- Interest Rate Risk in the Banking Book
- Operational Risk (requirements are more onerous for banks adopting the Advanced Measurement Approach, or AMA)

By nature, Pillar 3 disclosures draw heavily from information already gathered through the Pillar 1 preparation. However, banks should not underestimate the implementation effort associated with the Pillar 3 disclosure process, and maybe more importantly,

they should not overlook the communication strategy implications associated with the publication of this information.

Establishing a strong governance structure early is critical

The first challenge that banks face when preparing for Pillar 3 disclosures is to establish a governance structure around the disclosure process. Due to the multiplicity of organisational units involved, one of the key risks associated with the production of Pillar 3 disclosures is the lack of ownership of the entire process, and/or the late involvement of key stakeholders. Typically, successful Pillar 3 implementation projects are sponsored by the CFO and will involve the following organisational units at the very beginning to make sure that all inputs are considered and that responsibilities are defined:

- Board of directors (must approve the formal disclosure policy)
- Finance and accounting (generally has primary responsibility for financial and regulatory reporting)

Basel II Pillar 3 – Challenges for banks in Asia

contd.

- Risk management (usually owns most of the data that needs to be disclosed under Pillar 3)
- IT (responsible for the design and maintenance of the data collection solution)
- Internal/External auditors (may be required by local regulators to validate Pillar 3 disclosures)
- External communication and investor relations (define the overall communication strategy around risk management and ensure consistency of messages between all aspects of market reporting)

Pillar 3 presents significant data and process challenges

Once the governance structure is established, the next challenge is around data availability and quality. While in most cases, roughly 80% of Pillar 3 qualitative and quantitative disclosures should be available from data accumulated for Pillar 1, banks have not always contemplated Pillar 3 requirements when preparing for Pillar 1. Accordingly, data is not always organised in such a way that it can be easily retrieved and organised for public disclosure. Additionally, certain disclosures

come from accounting records, such as period-end and average gross credit exposures, changes in the allowance for loan losses, or the amount of impaired loans, to name a few. A methodical approach to sourcing the data for Pillar 3 disclosures is therefore key to ensure that data gaps are identified and resolved early in the process.

Beyond data availability, data quality is also a major issue that banks have to deal with. Historically, the risk data that was used in the risk management process was for internal use only, and may not have been of “auditable” quality – after all, data that is 90% or 95% accurate may be fine for risk measurement and management information purposes. Pillar 3 raises the bar considerably in respect of the quality of this data. Pillar 3 requires that appropriate internal controls over the production of disclosures be in place. Additionally, banks must have an independent validation process. In some cases, regulators have imposed that the validation be performed by external auditors, even for disclosures made outside of the financial statements. In other cases, the validation process can be internal, as is the case for model validation under Pillar 1 for instance. In jurisdictions that do not require an external validation of Pillar 3 disclosures, it is likely

that the independent validation process will be placed under the responsibility of internal audit. For banks subject to SEC requirements, Sarbanes-Oxley requirements will also apply to Pillar 3 disclosures if these are made in the financial statements or a SEC filing. Few banks around the world have yet fully managed the interdependencies between Sarbanes-Oxley and Basel II; in that respect, Japanese banks listed in the US will be the first in the world to report under Section 404 of Sarbanes-Oxley on Basel II. One would expect that a lot of controls required under Basel II (for example, model validation process under Pillar 1, governance and oversight process under Pillar 2) will go a long way to fulfilling the Sarbanes-Oxley requirements. However, controls required for Sarbanes-Oxley around spreadsheets and IT applications may not have been fully considered for Basel II purposes.

Banks should establish a coherent disclosure and communication strategy around risk management

This is probably the most strategic issue that banks will need to consider, as Pillar 3 will considerably increase the volume

of public disclosure around risk management, in particular in the areas of credit and operational risk as well as Pillar 2. This coincides in most countries with the effective date of IFRS 7, the IFRS standard that deals with disclosures on financial instruments.

Figure 1 highlights the considerable overlaps between the requirements of IFRS 7 and Pillar 3. In particular, regarding credit and market risk, most of the qualitative disclosures can and should be aligned. Similarly, there is a considerable amount of quantitative disclosures that overlap, such as the analyses of credit risk exposures and value-at-risk measures. There are differences, however, between the two disclosure frameworks. For instance, Pillar 3 does not cover liquidity risk and IFRS 7 does not address operational risk.

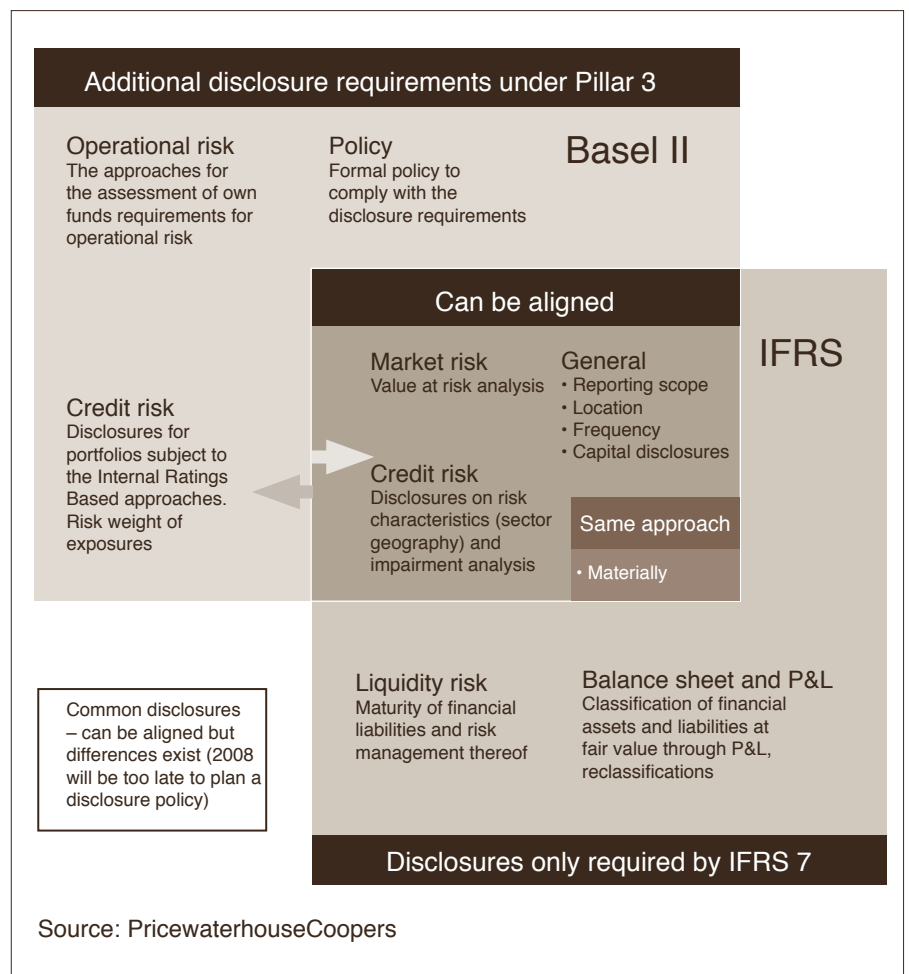


Figure 1: Analysis of overlaps between IFRS 7 and Pillar 3

Basel II Pillar 3 – Challenges for banks in Asia *contd.*

In order to present a coherent and credible picture to the financial markets, there will need to be consistency between the IFRS risk and capital management disclosures and the corresponding Pillar 3 presentation. Beyond just IFRS 7, banks will need to review the consistency of Pillar 3 and other risk management disclosures with other public disclosures such as segment reporting. This is key in meeting regulators', analysts' and investors' demands for more consistent and insightful information about risk and capital management, and the results thereof. While a more transparent approach to disclosure will likely open banks to the spotlight of scrutiny, it will also certainly work to the benefit of those who can demonstrate clearly their strengths in that area.

Experience suggests that risk management and accounting teams do not always communicate effectively. In the context of Pillar 3 and IFRS 7 implementation, failure to do so will potentially increase the cost of complying with these requirements, and worse still the information presented could be inconsistent. Whatever the source, disclosures should be consistent and reflect the views of management. It is therefore essential that a uniform message be delivered from the CEO's address to shareholders all the way

to the accounting footnotes, along with Pillar 3 disclosures. This will require a concerted effort between all parties involved, which further emphasises the need for a strong governance structure as highlighted above.

A further issue that needs to be considered by the investor relations department is that the level of sophistication that the bank has been able to achieve under Basel II will be immediately visible. Under Basel 1988, all banks were subject to the same set of rules, and the only numbers of interest to outside parties were the capital adequacy ratios themselves. Basel II allows a range of different approaches to be adopted, with increasing levels of sophistication. Under the Pillar 3 disclosures, it will be apparent which approach an individual bank has adopted. How will investors and analysts react if, say, Bank A has adopted only the more basic approaches while peer banks have adopted more sophisticated approaches? Does this say something about the level of sophistication and/or data quality in Bank A relative to its peers?

Also, Pillar 3 significantly increases the level of detail that are disclosed and that can be used by investors, analysts and rating institutes to compare and analyse each bank's risks. For instance,

Pillar 3 disclosures will provide an opportunity for analysts and others to benchmark key data (for example, Probability of Defaults or PDs) for each bank against its peer group. This will inevitably pose some questions about the robustness of risk management practices and/or the reliability of data disclosed.

The workload associated with explaining the increasingly complex Basel II numbers should also not be underestimated, especially in the early years, where banks may also be operating a mixture of approaches during a transition period to the more advanced levels. Investors and analysts may be inclined to draw conclusions based on an incomplete understanding of the numbers. For instance, for banks adopting the IRB approaches there is a strong element of pro-cyclicality in the risk-weighted assets calculation – in an economic downturn, one would expect customers to be downgraded and/or probabilities of default to increase. This would result in an increase in Risk Weighted Assets (RWAs) relative to the balance sheet volumes, which could lead to incorrect conclusions being made about the quality of the loan portfolio.

Furthermore, the Tier 1 capital and capital adequacy ratios,

that under the current rules have been comparable between banks, will now depend on the Basel II approach that has been chosen. For instance, how do you compare a Tier 1 ratio of 7% for a standardised approach bank versus an IRB bank?

What should be your next steps?

The effort associated with the implementation of Pillar 3 disclosures should not be underestimated. The key next steps banks should take to approach this project are, from our experience, the following:

- Set-up a separate project structure under a strong sponsor (for example, CFO)
- Establish key Pillar 3 policy decisions, such as the location of disclosures, their frequency, the scope, definition of materiality, etc. Dividing the information which should be on the audited annual report from the information that should be on other media such as the website can be a great challenge
- Perform an analysis of what information will be needed in addition to Pillar 1 information
- Perform an analysis on what the other internal and external requirements for disclosure are (in addition to the supervisory requirements under Basel II)
- Perform an analysis of the overlaps between Pillar 3 disclosures and other publicly disclosed risk and capital management information (for example, IFRS 7)
- Design disclosure templates that meet the requirements of Pillar 3 and other public disclosure requirements
- Source required data from existing systems and identify data gaps
- Define an IT architecture for data gathering, aggregation and reporting
- Establish a validation process around Pillar 3 disclosures
- Define a communication strategy and involve the investor relations team at an early stage
- Produce disclosures

Striking the right balance – Rising to the disclosure challenge of IFRS 7

30 by Justin Sebire, Chen Voon Hoe and Emily Lam





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IFRS 7 Financial Instruments: Disclosures (IFRS 7) is applicable for financial years beginning on or after 1 January 2007. While the requirements consolidate and expand a number of existing disclosures currently found in IAS 32 *Financial Instruments: Presentation and Disclosure* (IAS 32), it also adds some significant and challenging new disclosures on top of the existing disclosures required for banks under IAS 30 *Disclosures in the Financial Statements of Banks and Similar Financial Institutions* (IAS 30).

What appears to be most commonly misinterpreted in the banking industry is that IFRS 7 will not pose a significant challenge for banks given the level of their existing disclosures. Many financial institutions have yet to seriously consider the impact that IFRS 7 will have on their financial statement disclosures, their risk management processes and systems, as well as their overall investor communication strategy.

Key requirements of IFRS 7 for financial institutions

While by no means an exhaustive list of the disclosure issues, outlined below are some of the more significant implementation

issues specific to banks implementing IFRS 7.

Classes of financial instruments

A “class” of financial instrument is not the same as a category of financial instrument as defined in IAS 39 (such as held-to-maturity or available-for-sale) and would likely be defined at a lower level of the IAS 39 categories of financial instruments. As an example, we would expect a bank to break down the category “loans and advances” into categories that are meaningful to that bank’s portfolio, such as by type of customer (residential, business, etc.) or by type of loan (credit cards, mortgages, personal loans, etc.).

Perhaps the easiest disclosure to overlook when implementing IFRS 7, this requirement to provide disclosures by class of financial instrument sounds much easier than it actually is once you consider the knock-on effects to other disclosures. This would mean providing information by class of asset for credit risk disclosures, reconciliations of impairment write downs and fair value disclosures. Not an easy task if a comprehensive data system has not been implemented.

Derivatives and hedging

Financial institutions are one of the heaviest users of

hedge accounting under IFRS. PricewaterhouseCoopers’ survey of IFRS annual reports prepared by banks³ indicated a lack of detailed disclosure regarding the sources of volatility that the banks faced, the economic hedging strategies adopted to mitigate this volatility and how these economic strategies translated into hedge accounting strategies adopted by banks. Sources of potential and actual ineffectiveness were also not disclosed. IFRS 7 contains enhanced disclosures on hedge accounting and now requires disclosures around the ineffectiveness of the hedging strategy.

Further to the additional hedging disclosures, IFRS 7 also requires specific disclosure for recognising “Day 1” and “Day 2” profits arising from the use of derivative financial instruments. The accounting for such “profits” has long been a source of contention and discussion and this new disclosure requirement seeks some consistency across the users of derivative financial instruments.

Disclosures for impaired financial assets

PwC’s survey of IFRS annual reports prepared by banks revealed that the implementation of IFRS in 2005 only marginally improved the comparability of key measures

³Accounting for change – Survey of banks’ 2005 IFRS annual reports; available at <http://www.pwc.com/banking>

Striking the right balance – Rising to the disclosure challenge of IFRS 7 *contd.*

of credit risk between banks. For instance, the ratio of collective provisions to total provisions ranges from 5% to 76%. The disclosures required under IFRS 7 will provide a step towards greater transparency. This includes the disclosure of the objective factors used by management in making the impairment assessment, as well as the accounting policy for financial assets, such as loans, that are subject to renegotiated terms. Depending on the quality of the loan book, such disclosure may be a sensitive issue for some banks in Asia.

Qualitative and quantitative risk management disclosures

Much has been said about the new qualitative and quantitative risk management disclosures. Financial institutions with the US reporting obligations may be familiar with some of these requirements through the market risk disclosures in the US annual reports. The additional disclosures under IFRS 7 (as compared to previous disclosures) are primarily in relation to new disclosures around credit risk as well as the market risk quantitative sensitivity analysis.

For credit risk, the disclosures centre on financial assets that:

- are past due and impaired, including an analysis of the age of financial assets past due but not impaired;
- are individually determined to be impaired, including the factors considered in determining impairment; and
- have collateral available and/or other credit enhancements as security for such assets and an estimate of the fair value of such security/credit enhancement

For the quantitative sensitivity disclosures, financial institutions may opt to use their own risk management models to measure market risks, such as a Value at Risk (VaR) model. However, this is only allowed to the extent that such a model is used by management in the measurement of financial instrument risks. Otherwise, the standard prescribes minimum disclosures that must be met. In addition, the standard is silent on what is considered to be a “reasonably possible” change in a market risk variable. Accordingly, there may not be consensus amongst competitors as to the appropriate risk factor to use (for example, a 40-basis point shift in interest rates versus a 100-basis point shift in interest rates).

The disclosure implementation challenges

Based on the above summary of some of the more significant IFRS 7 reporting requirements for financial institutions, it is clear that a significant challenge lies ahead.

The data gap

The availability of detailed data to support the required disclosures could be a significant issue for many financial institutions. The level of information availability differs significantly across Asia especially for countries that are yet to adopt IFRS as their base accounting framework. A good example of the data availability issue was recently demonstrated in China. Prior to their listing on the Hong Kong Stock Exchange, some of the large Chinese banks spent a significant amount of time and effort to align their disclosure standards to IFRS. The lack of quality information was cited as one of the key implementation challenges as part of that process.

Availability of systems and processes

Another key challenge is whether financial institutions’ existing systems are able to efficiently generate information in the format required by IFRS 7. For example,

to generate the disclosure for the sensitivity analysis, most banks would have to obtain information from separate systems – credit card, hire purchase, mortgage, treasury systems. In certain entities, these systems may not be integrated and additional effort needs to be taken to analyse and process this information. In many instances, this is typically carried out using spreadsheets. Such manual processes require significant time and increase the risk of errors in financial reporting. Coupled with the requirement for these disclosures to be signed off by senior management and audited, financial institutions will need to ensure that adequate controls are in place and operating effectively.

Implications of Basel II and other reporting requirements

In addition to IFRS 7, financial institutions also face market reporting demands from numerous sources such as Basel II, local regulatory reporting, customer reporting and management reporting. There may be significant overlaps as these reporting requirements may use the same source of base information. A significant challenge for many banks in the Asia region will be the dual implementation of IFRS 7 and Basel II Pillar 3, which share a number of similar

disclosure requirements, but yet have differences as well. A summary comparison of these disclosure requirements is provided in the article “Basel II Pillar 3 – Challenges for banks in Asia”.

However, as some of these competing disclosure requirements were not introduced at the same time, financial institutions will often not have an integrated system in place to generate adequate disclosures for these competing purposes. This may result in additional time and effort to prepare and reconcile the differences between the various disclosure requirements.

External communication

Answering the perennial question “how does the use of financial instruments enhance shareholder value” should be front of mind when formulating the communication strategy for qualitative disclosures. This will entail identifying a bank’s financial instruments and associated risks, as well as ensuring that the scope of the disclosures cover all financial instruments and related risk management activities, including capital management. What on paper appears quite simple is often quite complex when it comes to writing a clear and coherent summary of risk management strategies.

Rising to the challenge

For banking institutions to rise to the challenge presented by IFRS 7, they need to start their projects now, if they have not already, given the disclosures will need to be made for 2007 (including comparatives) for banks with financial years ending from December this year. The implementation of IFRS 7 might entail the following high level process:

Striking the right balance – Rising to the disclosure challenge of IFRS 7 *contd.*

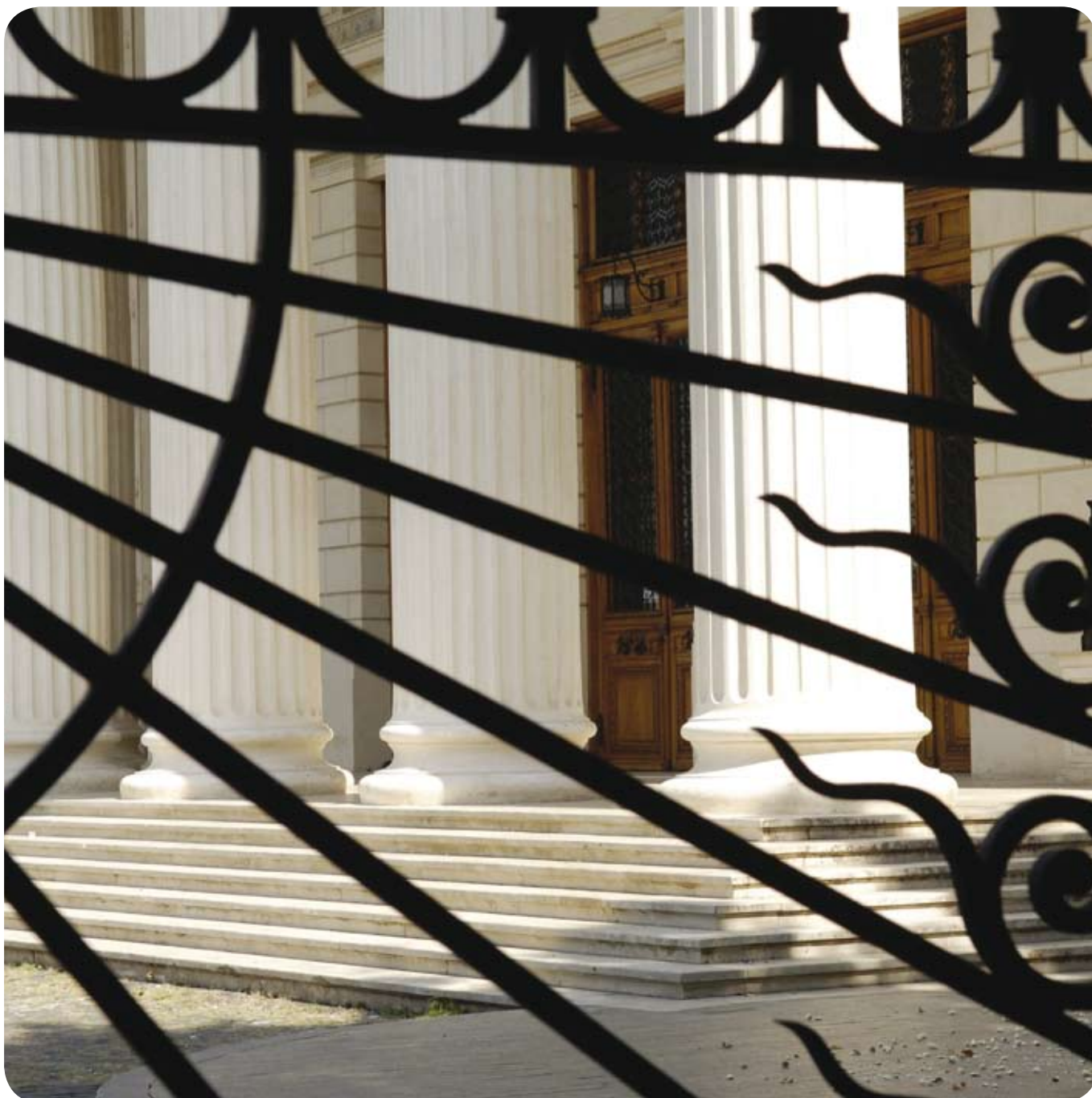
Scoping	Gap analysis	Data sourcing solutions	Quantitative analysis	Quantitative disclosure	Communication strategy	Internal control & embedding
<ul style="list-style-type: none"> Identify specific information to be disclosed 	<ul style="list-style-type: none"> Conduct data gap analysis 	<ul style="list-style-type: none"> Development of data sourcing solutions (Spreadsheet vs. treasury system) 	<ul style="list-style-type: none"> Perform quantitative analysis development of supporting tools 	<ul style="list-style-type: none"> Draft qualitative disclosures 	<ul style="list-style-type: none"> Consider communication strategies by considering the key stakeholders 	<ul style="list-style-type: none"> Development of internal controls

Given the pervasive impact the IFRS 7 disclosures are likely to have on a bank's information systems, striking the right balance of disclosure while meeting the minimum disclosure requirements will be a key consideration in any IFRS 7 implementation project. Those who start early and take a proactive approach to implementing IFRS 7 by including all stakeholders in their projects (rather than just the financial accounting department) should be better placed to avoid the pitfalls of being squeezed on resources or time or lacking the availability of relevant data.

The end result should be a well thought out communication of financial instrument risks and a strong statement that shows how such risks are being managed, whilst meeting the minimum disclosure requirements as a base. Those financial institutions that achieve this right balance should be rewarded in the market place to the extent that they can clearly explain how the risk management strategy can enhance shareholder value, while meeting the expectations of regulators and other key stakeholders.

Assessing the state of ALM practices in Asia's banks

36 by Chris Matten and Bertrand Billon





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Asset and liability management (ALM) primarily involves the management of two of the longest standing risks to which banks have been exposed – interest rate risk and liquidity risk. The financial services industry continues to evolve across Asia: competition is increasing with both local and foreign banks going head to head; further liberalisation of the markets brings in new products as well as more volatile interest rates.

This rapidly-changing environment brings new challenges to the ALM function in banks. At the same time, new regulations such as Basel II and the adoption of International Financial Reporting Standards (IFRS), especially IAS 39 are affecting ALM organisations, their processes and systems.

PricewaterhouseCoopers recently carried out a survey of ALM practices involving a large number of European, Australian and Asian banks. In Asia, some 20 leading financial institutions from China, Hong Kong, India, Japan, Singapore, Taiwan and Thailand participated in the survey.

The survey was designed to cover both qualitative and quantitative aspects of ALM approaches currently being utilised by industry participants. The objective of the

survey was to provide the industry with an overview of the state of ALM in banks, to identify areas for improvement and help ALM functions prepare for the future.

In this article, we focus on the results of the Asian survey, but make reference where relevant to the broader findings covering the practices at leading international banks across the three continents. We refer to them in this article as “global”, such as in “global best practice” or “the global survey”.

We will be discussing the individual benchmarking of each participating bank with the bank involved, but set out here some overall themes which should be of interest to all banks in the region.

Key findings of the survey

The general impression is that the basic components of ALM are generally in place in Asia – structure, governance, reporting, limits, etc. – but the detailed techniques used, especially in areas such as interest rate risk measurement and funds transfer pricing, are still relatively modest. As the market continues to be de-regulated and ALM exposures become more complicated, there is a clear need to start work on upgrading banks’ capabilities in these areas.

- **ALM and ALCO structure:** The governance structures around the ALM function are generally well developed in Asia, with dedicated ALM functions and ALCOs which are in line with global practices. However, there is still some work to do around clarifying the exact roles and responsibilities of these two areas.
- **Policies, objectives and responsibilities:** There is still a lack of board involvement in ALM policy-setting, both at the global level as well as across Asia, although in the latter case there is more ground that needs to be made up. Various other aspects of policy show room for further improvement.
- **Methodologies:** It is in the technical aspects of ALM where Asian banks tend to lag furthest behind global practices. While all the key areas are generally covered, the techniques used to measure interest rate risk in particular are still relatively simplistic. For instance, there is still a heavy reliance on static repricing gap analysis at the expense of more complex techniques, and modelling of products with uncertain cash flows and/or repricing terms is a long way behind leading practice.

Assessing the state of ALM practices in Asia's banks *contd.*

- **Limits framework:** As with methodologies, all of the basic building blocks are generally in place, but with a lack of sophistication in the measurement techniques that are used to define limits.
- **Hedging decisions:** Governance around limits and limit breaches is fairly well-developed across Asia. However, reflecting perhaps the relatively undeveloped state of the derivatives markets in many Asian countries, active hedging is not well advanced.
- **Funds Transfer Pricing:** Again, this follows the comments made above on methodologies. The basic concepts are generally implemented, but with a relative lack of sophistication that may lead banks to make sub-optimal decisions, both in terms of product design/pricing as well as in the allocation of resources.
- **Reporting:** Practices across Asia are broadly in line with global practices, although once again there is room for considerable improvement in the measures adopted to produce these reports.
- **Systems and controls:** The main areas of weakness lie in the frequency and scope of internal audit reviews of the ALM function, and there is significant opportunity for improvement in this area.
- **Impact of IFRS:** As the adoption of these new accounting standards is still work-in-progress in many countries across Asia, banks have yet to feel the full impact. However, for those that have adopted IFRS (especially IAS 39), this had an impact on their hedging strategies due to changes in the way certain hedges are accounted for.
- **Basel II:** Pillar 2 is only gradually appearing on banks' radar screens, and even in the earliest adopters of Basel II in the European Union (EU) there is still work to be done in understanding and meeting the requirements. As the Basel II timetables in Asia are generally one to two years behind the EU, it is no surprise that many Asian banks have yet to come to grips with the Pillar 2 aspects.

The way forward

While banks across Asia have made significant progress over the years in adopting better practices in the ALM area, there is clearly still a long way to go before they can catch up with their international peers.

For further information on the survey, please contact Chris Matten or Bertrand Billon.

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Foreign Banks in China – An exciting opening of the retail market, but not without internal challenges



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Striking the right balance – Rising to the disclosure challenge of IFRS 7



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