








the journal

August 2005

Tackling the key issues in banking and capital markets*



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Editor's comments

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by Phil Rivett



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Welcome to the August 2005 edition of the PricewaterhouseCoopers banking and capital markets journal. This is the 7th edition of the journal and brings together a rich selection of topics from our industry experts.

Central banks are increasingly coming under the spotlight as they face a number of changes and challenges. In 'New Challenges for Central Banks', Chris Sermon, Peter Trout and Elizaveta Filipova highlight some of the new and existing opportunities facing the central banking sector in the areas of accounting, reporting, transparency, corporate governance and risk management and explore the importance of evolving practices and developments.

Trust and integrity are fundamental to the financial sector, no more so than now following recent corporate transgressions. In 'Corporate Integrity: A Foundation for re-building reputation', Phil Case, Allan Goldstein and John Queenan address how the banking sector has responded to this and outlines the need for action to repair the damage to stakeholders' confidence and banks' reputation.

Competition, consolidation and regulation are just a few of the issues tackled in 'The Battleground for consumer banking'. Steve Davies, Harjeet Baura and Karen Loon provide an insight into some of the trends and issues facing the consumer banking industry in Europe, Asia and the US.

Continuing our series of articles on the banking and capital markets industry in different parts of the world, in 'India: From sleeping tiger to stirring elephant', Uday Bhasin, Navin Sambtani and Ashwani Puri look at how India is becoming an increasingly attractive destination for global banking businesses. They explore the different factors which have contributed to India's economic success in the last decade and the growth in potential for the banking industry.

Even though IFRS went 'live' in many markets in January 2005 the banking industry still faces a number of challenges ahead. In this article, Tim Harris, James Hower and Mike Codling consider the wider impact of IFRS on organisations and how sustainable internal and external

reporting needs to be embedded within the finance function and across the organisation as a whole.

The emergence and growth of the Islamic Financial Services industry is explored in Madhukar Shenoy, Mohammad Faiz Azmi and Souhaib Haider's article 'Shari'a compliant financial services – standing its ground'. This article provides a fascinating overview of the developments in the Shari'a compliant banking industry and how it is evolving to match the needs of its clients.

I hope you find the wide range of articles of interest. We base the content of the journal on feedback from our clients and readers about the issues that are of most importance to them. Please do continue to provide us with this feedback on the topics you would like to see addressed in future editions. Online copies of this, and previous editions, are available from our website (www.pwc.com/banking).

New challenges for central banks

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by Chris Sermon, Peter Trout and Elizaveta Filipova



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The world's central banks are facing an increasing number of challenges in today's dynamic global marketplace, primarily associated with globalisation of trade, EU enlargement and greater sophistication of financial markets. As regulators seek to rebuild public trust and confidence in the corporate world, promoting enhancements to corporate governance, risk management, transparency, accounting and financial reporting, so too central banks themselves are coming under increasing pressure to adopt a similar approach to their own activities. How are they responding, and with what degrees of success? What consequences will this have on their counterparties, advisors and the commercial banks they regulate?

Introduction

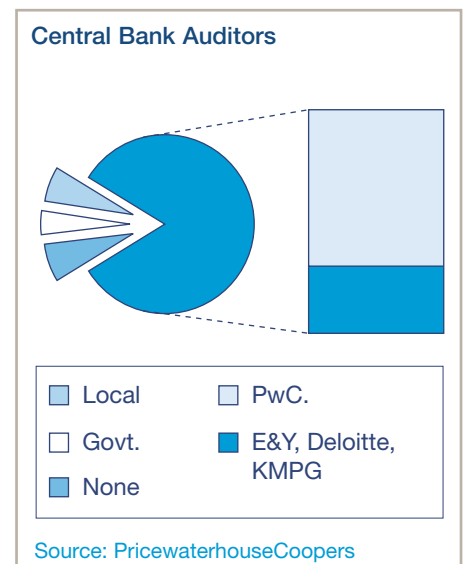
Central banks are increasingly coming under the spotlight as markets and governments assess the relative degree of their accountability, and to whom they are accountable. We highlight in this article three key areas of challenge for central banks, drawn from PricewaterhouseCoopers experience in this area.

Firstly, accounting and reporting – what are the practices currently used by central banks and are they in need of updating? We look at the responses from central banks in terms of the information they prepare, what is made public, and how this is disseminated. At the core is the accounting framework adopted. We examine the trend toward commonality between central banks, the impact of this on the amount and quality of financial and non-financial information which is made available, and some of the problem areas which still need to be resolved.

Secondly, transparency – what do central banks need to do to ensure that their financial and other reporting is sufficiently transparent, whilst also retaining a degree of confidentiality which does not compromise their supervisory and regulatory role? Adopting a recognised accounting framework clearly defines the parameters for determining the extent of the central banks financial reporting, with International Financial Reporting Standards ('IFRS') for instance requiring entities to give a much fuller explanation of the banks business and operations and the significant events during the period. We examine the role of the internet in increasing transparency by

making published information more widely available, and the expanding role of the independent auditor to add credibility to published reports.

And finally, corporate governance and risk management – a survey led by PricewaterhouseCoopers Australia entitled Central Bank Audit Committees highlights how central banks are re-assessing the roles and responsibilities of their Audit Committees' governance arrangements in order to respond to the changing face of management responsibility. This again links back to the reporting framework, where developments in corporate



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reporting have moved on: from disclosure of risk exposures to descriptions of the banks' attitude to risk and the measures taken to control and limit risk; and how requirements to assess and report on the effectiveness of controls and risk management processes (and have this assessment independently verified and reported on).

PricewaterhouseCoopers experience in central banking is second to none auditing more than half of the leading central banks and international financial institutions, including five of the G8 national central banks: Australia, New Zealand and South Africa. We also audit the European Bank for Reconstruction and Development (EBRD), the International Monetary Fund (IMF) and the Bank for International Settlements (BIS).

'The global financial services industry is undergoing massive change, and central banks are having to move with the times. The senior management now regularly discuss their own accountability, governance, risk management, and transparency, which is a welcome development in a world which has traditionally been rather opaque.'

Jeremy Foster, Partner,
IFRS Banking & Capital Markets.

Reporting performance

In May 2004, in conjunction with Central Banking Publications (CBP), PricewaterhouseCoopers brought together 30 leading central bankers to form a Financial Reporting Study Group ('FRSG') to consider how the financial reporting function integrates with other core central bank functions, and to look at the key external developments in the market, which are influencing decisions in this area. This Group met again in 2005 to assess progress towards a common financial reporting framework for central banks.

Accounting and reporting

Historically, central banks have built their accounting and financial reporting on the basis of their legal structure and the legislation underpinning their existence, which sets out arrangements for maintenance of accounting records, reporting of operations, as well as arrangements for independent audit. There is a strong commonality amongst central banks with regard to this practice, in nearly all cases drawing on generally accepted accounting principles and practices in order to construct the framework. However, individual practices do emerge in certain countries, usually as a result of local legal requirements, or the relationship with the ultimate shareholder, the State. A PricewaterhouseCoopers

study of the 2003 Annual Reports of eight of the leading central banks finds a wide variety of practices. A common feature was the reference to compliance with a combination of local accounting standards, Statute, by-laws, or principles established by the Board of Governors of the bank.

As an example, in selecting appropriate accounting practices, the Bank for International Settlements refers to its Statute which requires management to present financial statements which provide a true and fair view of its activities and financial position. BIS management uses generally accepted accounting practices, in particular aligning to all aspects of IFRS, except in those instances where it is considered that such standards would not provide a true and fair view. It considers that the peculiarities of a central bank's activities, provide an important and irrefutable case for adopting certain different practices in its accounting infrastructure and reporting models. These include the following with regard to its statutory objectives:

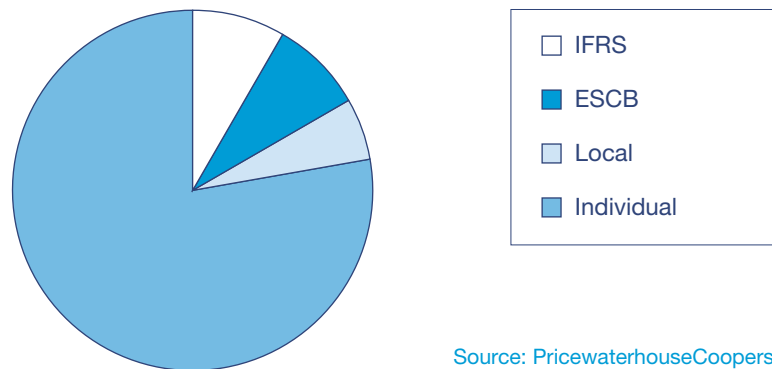
- Foreign exchange reserves management
- Gold
- Domestic currency issue
- Certain activities in the financial markets and banking supervision.



The readers of central bank annual reports must understand fully the basis of preparation of each central bank's financial statements, including the detailed disclosures, notwithstanding the degree of increasing harmonisation in practices referred to above.

The increasing complexity of capital markets' activities, coupled with calls for more transparency and accountability from central banks, have together highlighted the limitations of this selective framework. Financial crises in Asia and other countries have been cited as an incentive for the need for a harmonisation of these practices amongst central banks. Our experience shows that the range and number of users of a central bank's financial information has grown dramatically in recent years fuelled by the global expansion of business, increased capital movements and pressure to open up new markets in emerging countries. This user group includes investment banks and other regulators, as well as those planning investment and other commercial decisions, particularly for foreign direct investment, from public, private and government sectors. Central banks are increasingly upgrading their websites in order to provide more access to information. Financial and other information from central banks is therefore more widely available, accurate, timely and relevant.

Accounting Framework used by Central Banks



Source: PricewaterhouseCoopers

Harmonisation

In an attempt to achieve some harmonisation, the IMF's Safeguard Assessments programme sets out a framework of basic approaches that a central bank or fiscal agent must adopt in order to provide a sound basis for the monitoring of activities, primarily focused on processes and internal controls for monitoring and safeguarding the Fund's own resources which are managed by the central bank. This framework identifies IFRS (incorporating International Accounting Standards) as the appropriate accounting framework for central banks to adopt. Harmonisation of central bank accounting and reporting under IFRS would seek to achieve a benchmark towards which all central banks should strive.

A recent survey undertaken by CBP, in association with PricewaterhouseCoopers, however, found that there are very few central banks who report fully in accordance with IFRS. 39% of respondents had adopted IFRS to some degree. Several emerging market countries, including Russia, Slovenia and Bulgaria, prepare accounts under IFRS. The South African Reserve Bank prepared its financial statements under IFRS for the first time in 2004, and several banks in the Middle East use IAS. The European Central Bank (ECB) is undertaking a study to assess the impact of requiring European central banks to report under IFRS.

Many banks in the survey considered that IFRS was a goal towards which they were striving, but that they were concerned about certain elements of

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IFRS. Recent currency market volatility has brought home the difficulty for many central banks of settling on a practical and appropriate accounting treatment for their large unhedged foreign exchange exposures, including recognition of unrealised gains and losses and their impact on reported earnings and capital. In particular, the required disclosures and the treatment of financial instruments, gold, foreign exchange and related parties, can conflict with the central bank's statutory objectives, and are considered to be more suited to commercial organisations than to central banks. Methods of portfolio management of the foreign exchange position and the valuation of government debt also present difficulties for compliance with IFRS.

A subsequent review of the most recent published accounts of central banks worldwide showed just 17 reporting under full IFRS. These fall into three loose categories. First are the central banks where the country has adopted IFRS for domestic corporations, rather than develop local GAAP. This is typical of former centrally controlled economies. Second are the banks in receipt of significant funding from the IMF, which have been encouraged to produce IFRS accounts under the terms of Safeguard Assessment programmes carried out since March 2002. Finally there is one 'voluntary adopters' (Belize). While a number of other banks use policies which are based on

IFRS (e.g. Kazakhstan), or similar to IFRS (e.g. Ukraine), this does not constitute an unequivocal statement of compliance.

The European model

One view gaining increasing attention is to make wider use of the accounting framework created under European legislation for the purposes of the consolidated reporting of the European System of Central Banks (ESCB). This is the most recent and only example of an infrastructure of common accounting and reporting rules for central banks.

The ECB identifies the main determinants in choosing the basic accounting rules:

- The most influential factor is the concept of prudence;

- Secondly, the accounting rules should, as far as possible, help to preserve the overall credibility and functioning of the Eurosystem;

- Third, the need for considerable reserves or other buffers (particularly in the light of many central banks' large structural foreign exchange position); and

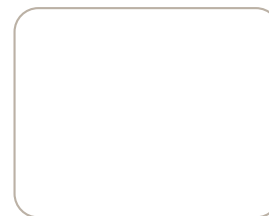
- No scope for material differences between national central banks in terms of calculating monetary income.

The core principle of prudent accounting included a requirement that there should be no distribution of unrealised gains,

whereas all unrealised losses are written off at year-end. There should be no netting of unrealised gains and losses across different currencies and securities. Additionally, prudence should not allow the creation of hidden reserves or understatement of assets or income. The general valuation principle chosen for ESCB reporting is to apply current market values to all balance sheet items, holding unrealised gains and losses on the balance sheet. The policy for valuation assumes greater significance for the generation of distributable profits.

Again, looking at current practice as shown by published reports, just 11 central banks, including the ECB, explicitly report in accordance with ESCB guidelines. These are all members of the Eurozone who are also required to report their results to the ECB in accordance with the ESCB framework, so that the ECB can aggregate and report the activities of the Eurosystem as a whole. In this sense it is more in the nature of a 'group reporting package' for consolidation purposes. Nevertheless the ECB guidance does recommend that National Central Banks (NCBs) use the Eurosystem rules as a basis for their own annual reporting, so as to promote consistency and comparability.

Whilst a number of other EU Central banks do use policies which incorporate ESCB guidelines (e.g. Belgium, Italy), or



which are based on ESCB (e.g. Germany, Portugal, Spain and Sweden), or are similar to ESCB (e.g. Denmark, Ireland), they are not yet in full compliance. Others apply ESCB guidelines only where their local legislation does not specify the accounting treatment (e.g. Aruba, Lithuania).

Interestingly, the ECB's own guidelines state that IFRS should be followed in all areas not covered by the guidelines, although this principle is not extended to the Eurozone national central banks. It is reported that the Bank of Greece, which currently reports under ESCB guidelines, and the Bank of England, are planning to adopt IFRS.

So, one of the biggest challenges is achieving consistency and comparability across central bank financial reporting. This depends to a large degree on a number of inter-linked factors, including the relative stages of economic and political development in each country, currency stability, levels of central bank independence and financial strength (the latter measured by capital as well as levels of foreign reserves). These are important because there is a direct link between central bank transparency and market confidence. Furthermore, many of the central banks that we work with have to operate within differing levels of devolved operational relationships with

the key stakeholder, the government. Independent action, particularly with regard to income recognition and dividend policy, is often quite restricted by law. The central bank is often an operating unit of government, responsible for its Treasury operations. Its activities cannot therefore be looked at in isolation, that is, without some form of consolidated government accounting to assess and measure the results in the context of wider strategic budgetary and macroeconomic policy. Derivatives, fiscal commitments and contingent liabilities associated with this relationship are often difficult to identify fully and even more difficult to measure accurately.

A new framework for central banks?

It is generally accepted that accounting by governments follows different principles, and requires a different accounting framework, from national accounting rules and IFRS which are designed primarily for commercial enterprises. As a result, a degree of 'generally accepted practice' for governments has developed, with guidance from bodies such as the Governmental Accounting Standards Board in the US and the International Public Sector Accounting Standards Board. In Europe, the Statistical Office of the European Communities in Luxembourg (Eurostat) provides rulings

Framework for published reports

IFRS	ESCB
Armenia	Austria
Azerbaijan	Belgium
Bahamas	Denmark
Bangladesh	ECB
Belize	Finland
Bosnia	France
Bulgaria	Germany
Croatia	Greece
Georgia	Ireland
Jamaica	Italy
Jordan	Luxembourg
Moldova	Netherlands
Montenegro	Portugal
Slovenia	
Turkey	Spain
United Arab Emirates	Sweden
Vanuatu	

Source: PricewaterhouseCoopers

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on EC member state accounting, some of which directly impact on central banks (e.g. treatment of proceeds from gold bullion sales) – so why not a separate framework for central banks? One of the problems is that there is no standard setter. The International Accounting Standards Board has made it clear that there will be no 'IFRS for Central Banks'. A round table grouping such as the FRSG sponsored by PricewaterhouseCoopers could bring forward a proposed framework, but to be credible this would need endorsement from key institutions such as the IMF, BIS or Federal Reserve Bank, as well as adoption by a sufficient number of national central banks.

Rather than seek to develop a framework from scratch, one approach would be to take an internationally recognised framework, such as IFRS, and detail the specific areas where different rules should be applied for central banks. For example, the underlying aim of the IFRS income statement is to be a performance statement, but for a central bank the 'big numbers' in the income statement are usually the result of economic policy and the national position rather than the central bank's results. Indeed, having a good economic policy can end in poor results for the central bank as a strong currency could result in losses. The one area that is really under the central bank

Central Bank distributions

This issue arises from the fact that, for virtually all central banks, the government is at the same time shareholder, tax collector and law maker. If the law on banking (set by the government) determines that the central bank should distribute surplus profits to government (however 'surplus' is calculated), then is that payment a dividend, taxation or something else entirely, such as an operating cost? This has a major accounting significance under IFRS, as the treatment of operating costs, tax costs and dividend payments is completely different. Operating costs are accrued and recognised in reported profit, taxes are recognised separately in the income statement and include (as deferred tax) amounts which may fall due in future periods whilst dividends are recognised only when the payment is unavoidable and then reported as movements in equity.

Differences in both the timing and the amount of the obligation recognised can have a highly material impact on the bank's reported reserves. A further complication is that banking laws typically refer to accounting profits, and do not determine how losses are treated.

Under IFRS there is a particular concern with unrealised profits. Foreign exchange gains and losses, and fair value changes on derivatives and some other financial assets and liabilities, are reported in profit and loss. These are unrealised, and in the case of foreign exchange in particular, can reverse very quickly. If unrealised profits paid away to the government then reverse as losses the following year, the bank's capital base could be seriously eroded.

Again, under IFRS, there is likely to be a (timing) difference between the reported accounting profit, and the basis for calculating the obligation to government (local GAAP), raising the question of deferred tax/cost/dividend. Finally under IFRS, if the obligation is treated as a dividend, IAS would appear to prevent any recognition of the obligation as long as the bank retains some control over the amount up to the balance sheet date.

The question then is what amounts should be recognised, and how should these be reported, to give a true and fair view?



management's control is costs, which is why several central banks provide additional disclosure here.

The assets and liabilities of a central bank (or most of them) are used for carrying out its functions, particularly its monetary policy operations, so do not clearly fit the commercial split between dealing and investment securities implicit in IFRS. This is an example of the bigger issue that a central bank may do the same transactions as a commercial bank but for very different reasons.

Reaching agreement on the best treatment for all central banks will not be easy. There are severe challenges in areas such as gold bullion, unrealised foreign exchange gains, demonetised currency, distributions and reporting cash flow (in the CBP survey only 64% of respondents produce a cash flow statement).

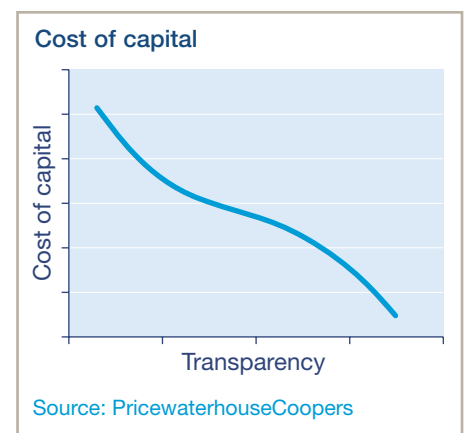
Transparency – measuring central bank performance

Adoption of a recognised accounting framework is a strong driver towards transparency. IFRS embodies a presumption of fair value reporting, with specific exceptions allowed (for example fixed assets), but requires disclosure of fair value in all cases where the reported amount of a financial asset or liability differs materially from its fair value.

Transparency is all very well, but central banks are no different from other financial institutions in having to deal on the one hand with the perception that accounting is concerned with faithfully recording what has already happened, while in the wider financial markets, the investment community is primarily focused on achieving short-term results, with less regard for longer term planning or financial returns. What is evident, however, is that the increased transparency of a central bank, as well as of domestic institutions, has been shown to drive down the cost of capital – a recent PricewaterhouseCoopers survey, undertaken for transparency measurement, found that debt issued by countries that lacked transparency paid a risk premium of up to 1316 basis points higher than countries with relatively high transparency ratings.

93 countries worldwide have sovereign debt issues rated by the independent agency Fitch (April 2005). Many of these countries issue this debt through the central bank. These banks, and their advisors, need to heed the message that time and effort invested in producing and propagating clear financial and operating information can produce a very real financial return.

In addition, central banks increasingly assess and report performance on the total return principle on investment



portfolios. The formal measurement cycle within the financial community comprises the annual accounts, providing a snapshot balance sheet and results on a one year cycle, which does not fit at all well with the longer term nature of the statutory objective of maintaining financial stability, reserves management and monetary policy. Most central banks consider a series of benchmarking methods to assess the efficiency of their reserve management operations. Returns will be measured on the portfolio as a whole, often extending beyond the traditional annual reporting cycle, considering a return 'over the total investment cycle'. The management of interest rate, credit and foreign exchange risk by the reserve managers will be focused on achieving or exceeding the benchmark returns, with a view to also achieving a return over the benchmark.

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Individual asset/liability management within the portfolio may result in short-term realised losses matched by unrealised gains if, for example, interest rates rise and there is a switch to higher yielding assets designed to hedge longer term liabilities. These losses would be reported in the accounting year, without reflecting the total investment cycle.

Transparency therefore, when linked to central bank accountability, credibility, and reputation risk, can allow management to make the link between supervision of foreign reserves, including maximising returns, on the one hand, and the fulfilment of the central bank's responsibilities for monetary policy activities, including support of the domestic currency, on the other. Traditionally, central banks have viewed their foreign exchange reserves as a policy tool for specific monetary policy or exchange rate objectives. IFRS is now changing behaviours within central banks, as it becomes clear that the accounting consequences of a particular choice are influencing the final decision, especially in the area of reserves management. Our experience shows that in some instances, central bankers may make fewer or even sub-optimal investment or policy decisions on the basis that the accounting consequences of the decision may be adverse.

Distribution of reports

In the CBP survey (below) 26 respondents indicated that their financial statements were available on the internet. A more recent examination of central bank websites found that 93% of all central banks have a dedicated web presence, and two thirds of these (well over 100 central banks) included annual financial statements, often in more than one language. This represents a tremendous increase in the availability of financial information on central banks.

Annual report and/or other regular central bank publication	33	87%
Website	26	68%
Government/national newspaper	11	29%
Total responses	38 (of 44)	
Source: Central Banking Publications		

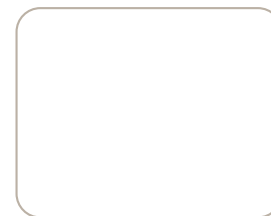
Audit reports

A key element of transparency is the reliability of the information provided, and in large measure this can be provided by independent audit. In the CBP survey, all respondents indicated that the central bank had an annual

external audit, irrespective of whether this was required by legislation, although one fifth of these reviews was conducted by a government agency. A wider review of reports published on the internet shows a similar proportion of audits conducted by either a government or internal auditor.

However, the effectiveness of the external audit report in enhancing the credibility of a central bank's reporting may be somewhat compromised by recent International Standards on Auditing (ISA), which require auditors to report whether financial statements are 'prepared, in all material respects, in accordance with an applicable financial reporting framework'. Only then can an audit opinion 'give a true and fair view' or 'present fairly, in all material respects'.

ISA notes that IFRS and local GAAP in a particular jurisdiction can be presumed to be acceptable frameworks, but, as outlined earlier, the majority of central banks currently prepare their financial statements under accounting policies which are specific to themselves, whether set by law, or determined by management. Auditors struggling to find the evidence to conclude that the policies adopted by the bank constitute an acceptable framework could only report in terms 'properly prepared in accordance with the policies set out...'



For a central bank, adoption of IFRS or ESCB as a framework would presumably be acceptable, and could be reported on as 'true and fair'. IFRS, with exceptions related only to disclosure (where supported by the relevant legislative framework), would probably be acceptable but is still likely to receive no more than a 'properly prepared in accordance with ...' opinion, and an emphasis of matter pointing out that the accounts do not fully comply with IFRS. IFRS with exceptions relating to recognition and measurement would need even more careful examination. A further complication for both bank and auditor is that adopting IFRS with exceptions would not enable a first-time preparer to take advantage of the transitional rules in IFRS1.

Even if the exceptions were considered reasonable and appropriate for a central bank (for example treating gold as a financial asset, or taking unrealised foreign currency gains to reserves), or if the departures from IFRS were to achieve conformity with either ESCB or local GAAP, it is difficult to see how a set of policies developed in isolation could be regarded as an acceptable framework, whether determined by local legislation or by management. However, a framework established by a broad grouping of central banks, with the support of an international body such as the IMF and/or BIS, could become an acceptable

framework for central banks. If widely accepted, this could then raise issues for central banks which chose not to adopt it. The Central Bank Financial Reporting Study Group, with PwC and CBP, is committed to advancing this debate.

Corporate governance and risk management

The recent survey undertaken by PricewaterhouseCoopers Australia, with the participation of several other territories, highlighted the importance of evolving governance practices in central banks. Increasingly, governors and boards are looking to the developments in the commercial sector as a model for their own governance, risk management and internal control frameworks. The findings show that Audit Committees are generally composed of non-executive members of the Board of the Central Bank and include increasing degrees of financial expertise amongst most of the members. The main source of assurance for the Audit Committee is liaison with internal and external audit but best practice involves using a matrix of the central bank's key risks as a basis for making enquiries of management. These key risks are monitored throughout the central bank and reported to the Committee. Importantly, the effectiveness in meeting outcomes may be enhanced by aligning Committee deliberations to its charter, linked to a

periodic review of the central bank's risk matrix and obtaining, from internal audit reports and other sources, sufficient information so that the Committee can sign off annually that it has reviewed all areas for which it has responsibility.

When considering accountability of the central bank, it is considered that, to enhance perceived independent access to the Committee, there is an emerging practice of periodic private meetings with internal and/or external auditors that exclude management. This mirrors what is happening in the commercial sector. However, practice, prevalent in commercial banks, of obtaining formal representations from management in respect of internal controls, financial reporting and compliance with laws and regulations, is not consistently applied in central banks. Our expectation is that the 'tone from the top' should be established and that the Committee should take a proactive role in monitoring the effectiveness of internal controls. Prime responsibility for internal controls is rightly with the governor, but the Audit Committee needs to challenge the risk assessment process and internal controls framework; ultimately, the bank's and parent country's reputation is at stake.

On a general level, CBP findings indicated that, four years ago, risk awareness in central banks was at a

New challenges for central banks continued...

fairly low level, and only 15% of central banks surveyed had an independent risk management unit. A recent high-level update of this indicates that, whilst there has been an increase in the number of independent risk management units at central banks, formal responsibility for monitoring and management of risk is still generally decentralised at departmental or head of function level. This results in a focus on the control of risk rather than active management of it. Many would argue that it is not for a central bank to actively manage risk for its own benefit, since this may conflict with its statutory objectives associated with ensuring stability of the financial system and defending the currency. It is particularly in the context of foreign exchange and foreign exchange reserves management that this aspect is relevant for a central bank.

Global developments since 2000 will have contributed towards a far greater awareness of the need for risk and risk management, the identification of the types and nature of risks faced by a central bank, and how these should be identified, measured, managed and reported to those responsible for governance and control. However, recent experience indicates that risk management practices, including the existence of a central risk management function, are only just being developed

in many central banks. The monitoring and/or management of risk, including reporting to Risk Committees on daily risk exposures, limits etc., is more usual in the financial markets area and in the reserve management department. Only a few central banks seem to have a separate risk management function responsible for the central bank-wide risk. Several developing country central banks are in the process of implementing a separate risk management department that monitors the central bank-wide risks.

Commercial entities consider the monitoring and management of risk as an opportunity to maximise profits, and will undertake risk assessments and set risk limits and risk appetites within which operational departments will be required to perform. The core financial strategies for dealing departments remain geared towards arbitrage and other market opportunities to maximise shareholder value through increased profits. Central banks need to combine prudence, liquidity, safety and the enhancement of returns on invested funds, which represent the fundamental criteria in designing the framework for managing their reserves, including modelling of financial risks. All financial institutions will therefore seek to actively manage risk, but a more conservative approach generally adopted by central banks exposes them to lower levels of risk.

Reporting profits and maintaining reserves

Maintaining an adequate level of reserves is an essential element of risk management for any bank or financial institution. Central banks as regulators require commercial banks to meet minimum reserve standards, either set locally, or in line with the Basel Accords issued by the BIS. By contrast, there is no equivalent standard to indicate the appropriate level of reserves for a central bank.

In the CBP survey, 5% of respondents indicated that the central bank had negative equity, and a further 18% reported that the bank had been recapitalised in previous years. On average, 13% reported negative earnings over the previous three years.

Adoption of a new accounting framework for central banks may not directly impact on reserve maintenance, although some local accounting legislation does distinguish between distributable and non-distributable profits, thereby ensuring that unrealised profits at least are maintained within the entity. This in itself would not prevent a central bank from distributing the whole of its realised profits, potentially reducing its reserves to zero. IFRS does not address the question of



what is distributable or non-distributable, and no accounting framework specifies the appropriate level of reserves to be maintained.

It is clear that developments in financial and risk reporting such as COSO and Sarbanes-Oxley require institutions to disclose more and more information about the risks they face and their responses to these risks. For any bank this must surely include demonstrating their ability to assess the required level of reserves to be maintained to support their ongoing operations. If central banks do move towards more explicit disclosure in this area, we can be sure that the commercial banks they regulate will be expected to do as much, or more.

Business integrity: A foundation for rebuilding reputation

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by Phil Case, Allan Goldstein and John Queenan



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Introduction

‘Customer led, ethically guided’ runs a leading bank’s slogan. A source of competitive advantage for one bank. But what could it imply about others? That they are less ethical, even unethical? Could this be a clue, a reason for the financial services sector’s unpopularity with regulators and the media? What value could firms within the sector derive from demonstrating a genuinely more responsible approach to business conduct?

The financial services (FS) sector has recently suffered bad press. For example, in retail banking, whether it’s for refusing to lend (‘risk averse’), lending too much (‘encouraging over-indebtedness’), mis-selling (‘know your customer’) or refusing to sell (‘financial exclusion’), it seems the sector cannot win. Even ‘responsible citizenship’, or Corporate Social Responsibility (CSR), can get a cynical press. For example, a recent survey by The Economist stated ‘The human face that CSR applies to capitalism goes on each morning, gets increasingly smeared by day and washes off at night.’ As a result of such coverage, one UK MP – Nigel Griffiths (Minister for CSR, Department of Trade

and Industry) – openly called for more positive reporting of companies’ CSR efforts at a recent conference.¹

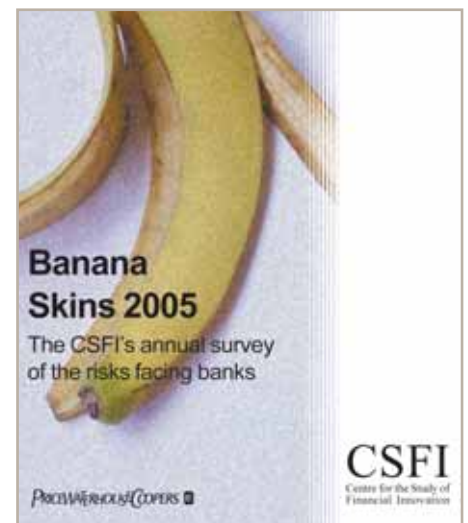
Regardless of media opinion, the facts are inescapable. Confidence in large corporations generally is still recovering from the recent corporate scandals in the USA, Europe and elsewhere. Major global financial institutions have been implicated in many of these corporate failures (Enron, Worldcom, Parmalat et al), damaging reputations and confidence in the whole industry. In the retail sector too, banks’ reputations are badly bruised following a series of high-profile incidents: pension and endowment policy mis-selling, credit card charges, access to basic bank accounts and pricing of ATM transactions.

Global regulatory pressure has intensified, paradoxically undermining confidence further. For example, in the UK one investigation has followed another – ‘Competition in UK Banking’, ‘Cheque Clearing Cycles’, ‘Speed of Account Switching’, the FSA’s ‘Treating Customers Fairly’ programme and soon ‘Provision of Long-Term Savings’ – the list seems endless. Similarly in the US, there have been numerous SEC and New York State Attorney General investigations against

financial services companies. The associated media coverage fans the flames of distrust, and the ratchet tightens. The case for urgent action to rebuild reputations globally – by re-establishing confidence and trust – is clear.

Reputation risk management

The trust placed in a bank – and therefore in its reputation – depends upon a vast range of factors: so many in fact that ‘reputation risk’ was considered too broad to categorise as a distinct risk in a 2005 survey of ‘hot topics’ for risk management in banking (PwC/Centre for the Study of Financial Innovation –



¹ Corporate Responsibility 2005 – Tackling Global Challenges

Business integrity: A foundation for rebuilding reputation continued...

'Banana Skins 2005²'). Nevertheless, at a fundamental level, most of the issues giving rise to reputation exposure have their roots in the values and standards of an organisation and the behaviour of its staff. Recognising this, interest has grown within the financial services sector and elsewhere in espousing better corporate behaviour through Codes of Business Conduct and related ethics, compliance and CSR programmes.

At a sectoral level, in the UK, the relaunch of the Business Banking Code and the Banking Code has focused attention on such issues as giving more notice of branch closures, making basic bank accounts more readily available and acting 'fairly and reasonably'. Although compliance is monitored through an independent Banking Code Standards Board, the Codes are voluntary and are generally seen as complementary to, rather than substitutes for, a company's own code.

Whether sectoral or company specific, the existence of an increasing number of Codes by themselves has so far made little impact on reputations. Something has clearly gone awry. Are the Codes not fit for purpose? Or is it because complacency has set in – that once written, Codes lie fallow on websites and office walls, because management has moved on to 'something more important'?

If so, this may well be because consistent implementation of Codes is simply proving too difficult to achieve, and the results – in terms of value added – are just too difficult to measure.

Fit for purpose?

To provide protection from reputation risk, an effective Code should be developed from an analysis or determination of corporate values and business principles. Take a commitment to 'develop and market new products responsibly', for example: what aspects of such a commitment affect reputation? Could they include whether new products satisfy and anticipate market demands? Perhaps. Or, whether sales and marketing materials are transparent and avoid misrepresentation? Certainly. Or, whether effective controls exist over product risk management and the adequacy of sales staff training? Undoubtedly.

Once such an analysis has been completed for all business principles, a 'reputation health check' would add real value. This would examine each aspect of all the principles for evidence of compliance with the underlying commitment. Most importantly, priorities would then be assigned for action – for not all issues are equal in giving rise to reputation risk. To judge which issues

give rise to the highest risks, a three dimensional model would help: one that combines judgements and information in relation to three distinct parameters;

- The consequences, or detrimental reputational impacts resulting from an issue, a foreseeable incident or reasonable worst-case scenario;
- The likelihood or chance of those detrimental reputational impacts occurring;
- The importance of risk management – that is, the ability of management to take action in mitigation of the risk.

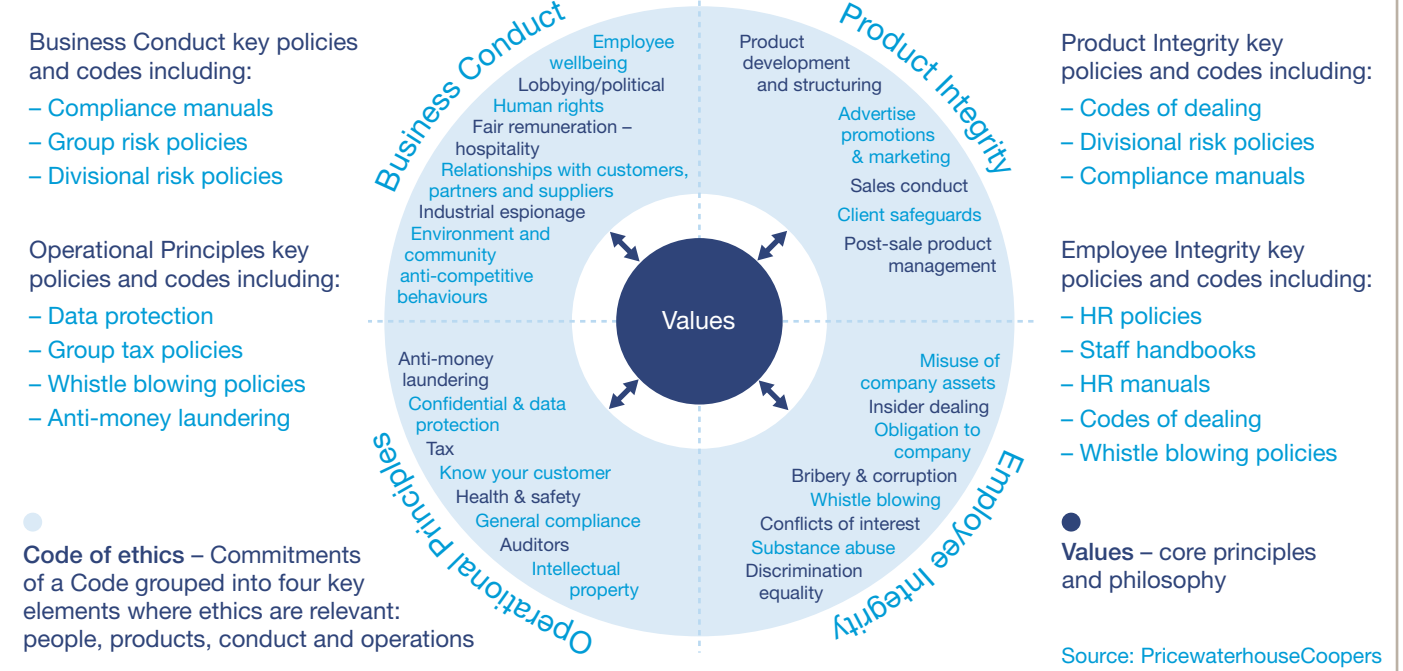
In developing a Code it is important to keep in mind whether it will meet internal and external expectations. Figure 1 provides a guide to some of the common issues needing to be considered, but it cannot be considered definitive, as an approach that is tailored to the specific needs of the business is imperative.

So ask yourself, what purpose is your company's Code intended to serve, and does it deliver? Is it ambitious, yet realistic, in its aspirations? Is it comprehensive in scope, and does it cover issues of corporate integrity in a sufficiently flexible way, so as to meet the needs of diverse global cultures? What resources would it take to implement and monitor such a Code?

² Please visit www.csfi.org.uk



Figure 1: Key Elements and Commitments



Walking the talk

So far so good. But in practice, articulating a Code of Conduct or Business Ethics is undoubtedly the easy part. The key question is, can it be made to work in practice? Can it be embedded within the organisation such that it ‘lives and breathes’ as part of business as usual wherever an FS company operates worldwide? Lay the foundation stones carefully, though, and the task is made much easier.

Embedding, of course, needs to start from the top, with clear ownership and a statement of commitment to implementation from the Chief Executive Officer and the Board. Thereafter, in terms of reassuring stakeholders (particularly regulators), demonstrating effective governance, risk management and compliance (GRC) processes are paramount. In the US, this is widely recognised in the revised Federal Sentencing Guidelines and COSO internal control framework implementation. On a more global scale, Banana Skins 2005

recognised corporate governance had risen from 8th to 2nd ranking of all the risks facing banks.

Governance is clearly a hot topic in the wake of the US Sarbanes-Oxley legislation and parallel initiatives globally. But the benefits are recognised as going beyond enhancing internal controls and minimising legal liabilities. In the PricewaterhouseCoopers 8th cross-sectoral survey of more than 1300 global CEOs³, 56% credit GRC as having a major positive impact on reputation and brand.

³ 8th Annual Global CEO Survey entitled ‘Bold Ambitions, Careful Choices’

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Figure 2: CSR reporting levels

Source: CorporateRegister.com (Figures based on 2643 companies)

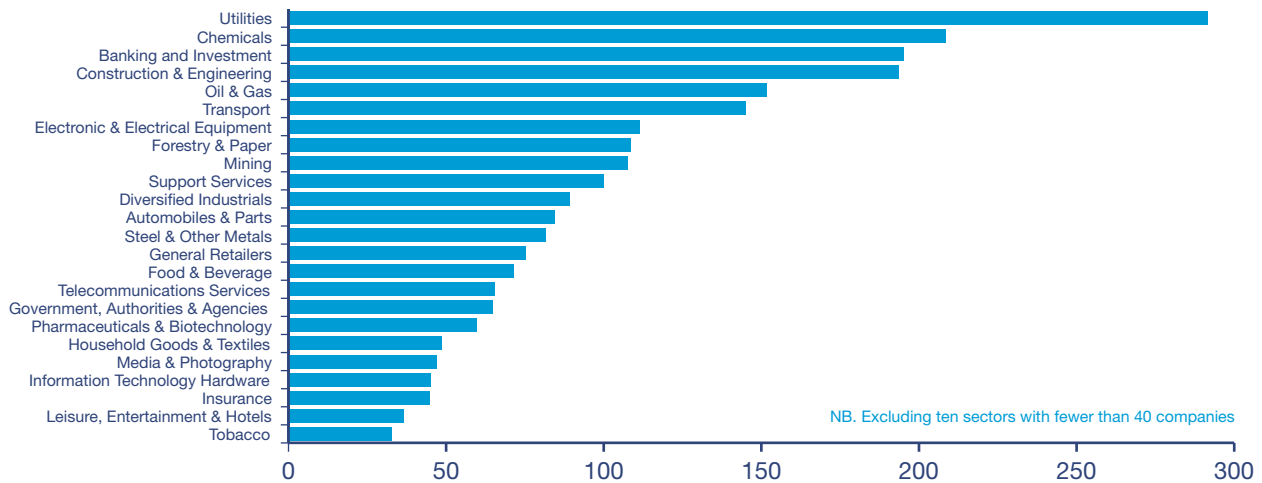
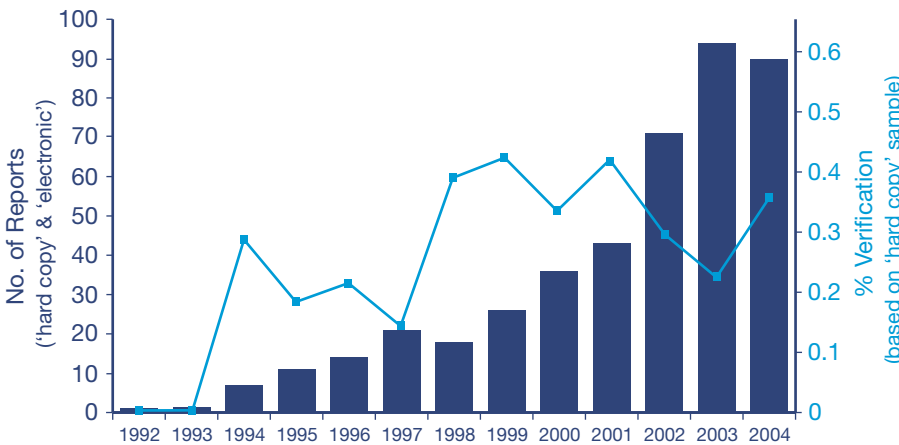


Figure 3: Global CSR report output from the 'Banks' sector since 1992 with external verification trend

Source: CorporateRegister.com (Based on 433 reports)



The survey focused on a number of elements that are basic to GRC effectiveness – elements which CEOs confirmed are all 'in place' in their organisations. However, the picture is less rosy in terms of 'full development' of these elements. Some of the lowest responses related to full development of 'corporate/ organisational codes of conduct' (53%), and 'compliance and ethics training' (only 36%) – not impressive figures for such basic elements, and reinforcing the view that insufficient attention is being devoted to Code implementation.

Support for these findings – at an FS sector level – comes from Business



in the Community's 3rd Index of Corporate Responsibility.⁴ Although all of the FS Sector Index respondents reported that they have a published Code of Business Conduct, only 76% of respondents had provided training for staff on business principles.

The essential elements of an effective governance structure for embedding a Code of Business Conduct are no different from those for any other company policy. They include defining roles and responsibilities, achieving internal awareness through communication and training programmes and incorporating the Code into existing documentation (employment contracts, compliance and risk manuals etc.). The real challenge, though, lies not in these generic steps, but in devising ways of gaining confidence that the Code is indeed embedded.

One US based FS institution with global footprint is implementing a simple, intranet-based quiz that tests employees knowledge and understanding of the firm's code of conduct. All employees must take the test of a dozen questions annually, and meet strict performance standards – with results reported centrally to the compliance function and senior business management.

Of course, 'check controls' can be built in – the usual 'end of pipe' measures

that, for example, check for breaches in the Code (e.g. regulatory action, adverse press on a business conduct issue etc.). However, these types of control suffer from being confined to spotting the absence (or presence!) of a negative, and from intervening too late to prevent reputation damage. What is also needed are timelier, preventative controls and processes. Controls that test whether staff behaviour consistently matches expectations – for example, whether the level of internal consultation on key decisions is sufficient. Or controls that test the existence and efficacy of an issue escalation procedure. Or new employee performance management systems that put weight on corporate values as they do on financial values. Cross-matching the nature and number of issues escalated for resolution with those appearing in customer complaints records can also be highly effective in identifying concerns regarding implementation of a Code (e.g. is more training needed in compliance 'hotspots').

Trust through transparency

The next, crucial, step in rebuilding trust in the financial services sector is to communicate publicly – and transparently – both on financial issues and the 'non-financial' issues, such as business ethics, that increasingly concern stakeholders.

To satisfy demands for more information, the practice of CSR reporting (sometimes referred to as 'sustainability reporting') has grown significantly in recent years. The financial services sector hasn't been slow in embracing this trend. A recent analysis by CorporateRegister.com shows that the banking and investment sector is the third most prolific CSR reporting sector (see Figure 2), with close to 200 reports now being produced each year.

Furthermore, to improve credibility, there has been increasing interest in external assurance, with nearly 40% of reports produced worldwide in 2003 being assured, using international standards such as AA 1000 and ISEA 3000. In the financial services sector, the figure was only slightly lower at 36% (see Figure 3).

The Global Reporting Initiative – an attempt to standardise CSR report content – includes a requirement to report on 'Mission and Values and internally-developed Codes of Conduct or Principles'. Yet, despite some 500 organisations from over 40 countries citing the GRI's 2002 Guidelines by mid-2004, disclosure in this area does not appear to have improved.

Perhaps the forthcoming legal requirement – in the UK – to start producing operating and financial reviews as part of the annual reporting

⁴ Business in the Community, April 2005

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process will lead to better disclosure of progress in implementing Codes of Business Conduct and companies' ethical performance. It should do. Directors will be required to identify, quantify and report publicly on the areas of their business which drive sustainable value – both financial and non-financial: it might be considered hard to argue that fundamentals such as values, principles and ethical performance are not areas driving sustainable value. Such non-financial issues feature prominently in our ValueReporting™ Framework, a framework which may assist companies in meeting the requirements of the Operating and Financial Review regulations.

Whatever the vehicle for reporting, the key issue remains that of transparency. In this respect there is a need to really grasp the disclosure nettle: too often, PR departments consider that good publicity consists exclusively of telling 'good news' stories. Paradoxically, better PR may come from real 'warts and all' reporting, in particular making sure that whatever has been reported publicly by the media during the reporting period is referenced and debated in public reports, not brushed under the carpet. Furthermore, companies need to take care that public statements, especially those in CSR reports, are consistent with political lobbying stances, especially

those made through third parties, such as industry trade associations.

Maintaining and enhancing reputation is critical to any company's future success, but this is especially so in the financial services sector. This is not achieved by accident – it requires explicit and proactive management, both of the type of business transacted, and the way that it is done (which must be sensitive to the expectations of customers and media commentators).

Until FS sector companies can better demonstrate their integrity – through their daily operations and public reporting – reputations will continue to suffer and distrust will persist. Meanwhile, the debate over a 'hostile press' versus 'green wash' in non-financial reports will continue.

Rebuilding Reputation Through Integrity

1. Determine values and business principles that will meet the expectations of stakeholders.
2. Analyse those aspects of business principles that could give rise to reputational risk.
3. Conduct a 'Reputational Risk Health Check' – assigning priorities for action.
4. Articulate a Code of Business Conduct.
5. Embed the Code throughout the organisation, demonstrating effective governance, risk and compliance procedures and focusing on priority areas for action.
6. Measure effectiveness.
7. Communicate progress and challenges.
8. Review and amend the Code.



The battleground for consumer banking

24

by Steve Davies, Harjeet Baura and Karen Loon



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Globally, returns on retail (or consumer) banking have been a key driver for many financial services companies over the last two years, eclipsing corporate and investment banking returns. In the developed economies, much of this growth has come from a mortgage market boom caused by lower interest rates fuelling record consumer and personal refinancing. The US consumer landscape faces similar pressures to those faced by European and Asian bankers: worries of the housing bubble bursting, increased regulatory and operational risk and also increased exposure to credit risks. In Asia, many local and regional institutions have been focusing aggressively on expanding their consumer banking businesses, particularly in the areas of credit cards and unsecured personal loans. However, in some countries, there are concerns over the ability of these young portfolios to weather a sudden economic downturn, given that the credit skills and scoring models of some institutions may be less developed.

Despite several waves of consolidation over the last ten years, the consumer financial services market remains fragmented. Very few banks have been truly successful in the strategy of

building global international brands, and in each of the markets in which these banks operate, they face different competition. On the one hand, each geographic area will have a number of banks that may have a regional or community focus – these institutions play to their strengths of locally managed businesses that reflect the culture of the region they work in. On the other hand, in individual countries, each product the bank offers may also be competing against monoline companies that are focused primarily on that product.

The ability for many institutions to expand into various Asian markets is restricted by licensing rules in each jurisdiction which protect local institutions.

But traditional market forces of competition and consolidation are not the only ones currently affecting consumer banks. The current economic and regulatory environments mean that there are a number of additional factors concerning market position, cross-border regulation, reputation and profitability that lenders need to tackle head on.

Profitability – new forces, old forces

Size and scale provide many opportunities for organic growth. For years, many of

the larger financial institutions have been trying to build systems and tools to understand and track the actual economic performance of their assets, down to a customer level, to make better pricing and asset allocation and management decisions. Very few institutions have succeeded in doing so.

PricewaterhouseCoopers has consistently held the view that accurate measurement and accountability are key to understanding and managing business profitability. Put simply, detailed tracking and assessment of actual asset performance will drive the efficient allocation of these assets and consequently, profitable business decisions as described in Figure 1 overleaf.

We believe this approach, which focuses on the underlying economics at a detail level, should be applied across the business:

- Channel profitability – measuring the underlying short-and-long term return on channel investment strategies.
- Pricing – moving toward a pricing model that takes the better of market or economic price.
- Product configuration – understanding where multiple product relationships deliver incremental value and using

The battleground for consumer banking continued...

this information to better price different configurations of product offerings.

- Value protection and margin tracking – there is a trend to track the actual performance of expected margins to better understand the internal and external factors that drive differences.
- Capital allocation and measurement – appropriate measurement of risk-based capital ensures that the bank’s capacity for risk is not wasted on low value business. In addition, allocating capital on a risk-adjusted basis down through the business means a better method to both measure the full economic costs of writing business and set prices accordingly.

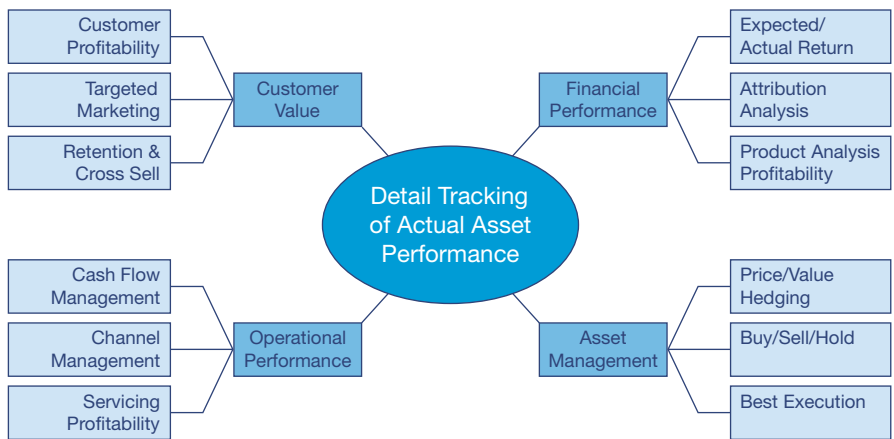
While certain industries do track actual performance to make more informed pricing decisions (for example airline ticketing), the consumer financial services industry is only beginning to develop and use such tools. It is clear, however, that there is a long-term trend toward economic-based pricing. But, access to the right data in the right format has always been an obstacle for many lending institutions, with the further challenge being the inability to analyse and interpret data that forms the basis of such decisions.

Once this hurdle is overcome, this approach will also provide management with the information necessary to implement, monitor and measure a

balanced product portfolio that provides the desired results across the business cycle according to the institution’s strategy. Investors and other stakeholders can become concerned when there is a concentration of business profits from one stream, for example mortgage originations, which is cyclical. Successful consumer financial services companies are those that have demonstrated a track record of earnings performance across interest rate and economic cycles.

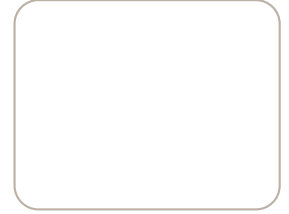
In the US, product specialists or smaller, more nimble niche players are already creatively analysing data, markets and past performance to target high return segments, often overcompensating for

Figure 1



Source: PricewaterhouseCoopers





their lack of scale efficiencies enjoyed by the largest companies.

In Asia, consumer banking has traditionally focused more on generating volume, rather than customer profitability. Many are now focusing more on increasing profits through differentiating their service to customers by developing sales cultures, reconfiguring branch networks, implementing risk-based pricing and improving business processes. Many international players in Asia do not have the scale to grow organically in consumer banking and their challenge is how to identify and implement innovative ways to achieve profitable growth. This may include establishing alliances and alternative channels with local partners, development of new products, as well as consolidating back office support.

Off-shoring and outsourcing

The global credit boom has been keeping financial institutions active but there is a risk that credit demand will begin to decline, intensifying the competition among the larger lenders that has been driving down margins. So far, the industry has proved remarkably successful in cutting costs through developments such as centralised loan processing. Greater use of outsourcing could offer further

savings and potentially provide access to best-in-class capabilities, though there are limits to such strategies. Institutions clearly need to weigh up any benefits against the potential impact on their customer relationships and reputation, especially at a time when outsourcing is attracting ever-increasing attention from regulators. Negotiating effective service level agreements and overseeing such contracts also requires particular skills and often underestimated management time.

There also needs to be a clear distinction between outsourcing processes to third parties and off-shoring, i.e. moving processes off-shore but continuing to manage them in house. Indeed, continuing concerns about control and management from a distance mean there is still further opportunity for off-shoring amongst lenders. There has been more outsourcing to offshore suppliers but here as well concerns over service quality and security of customer data have restricted growth and some of the recent growth forecasts may prove wide of the mark.

Innovation and finding new markets

As well as cutting costs, financial institutions have increasingly been focusing on differentiating their offerings to attract customers from other institutions. In the late 90s, the concept

of the mortgage-current account or offset account was introduced from Australia to Europe, and later, other parts of Asia, and took the market by storm, offering customers the chance to pay off their mortgages early or to save interest. Lately, teaser credit card rates (for example, zero percent balance transfers) have been used to attract customers to new credit card offerings, although recent evidence indicates that the level of churn in many of the developed credit card markets is reaching levels where such activity is no longer sustainable. Current issues for the credit card market are explored further in 'Precious Plastic 2005 Consumer Credit in the UK'¹.

While banks have for a number of years set up branches in overseas countries to cater for their home communities, it is telling that the larger institutions are increasingly focusing on these communities for lending services, offering superior service standards as well as access to vast global networks. HSBC, for example, has developed a Shari'a banking proposition and recently Lloyds TSB has announced a link up with ICICI bank, one of India's largest banks, to offer banking services to the more than 1m people of Indian descent living in the UK. More details on these issues can be found in the articles entitled 'Shari'a compliant financial

¹ Please visit www.pwc.com/uk/preciousplastic for further information

The battleground for consumer banking continued...

services – standing its ground’ and ‘India: From sleeping tiger to stirring elephant’.

Regulation

The increasing burden of regulation is also having a direct impact on the profitability of consumer banking. The regulatory tide, the growing focus from nearly all regulators on the treatment of customers, and the increased burden of compliance are causing transaction costs to rise. Many now question how much protection this really provides the customer and whether the impact is actually reducing customer choice by stifling innovation. Overregulation was named as the biggest risk facing the banking industry in the recent CSFI/PwC ‘Banana Skins 2005’ survey of the industry’s fears on risk.

New York State Attorney General Eliot Spitzer has recently announced an investigation of potential discriminatory practices in setting mortgage rates and fees in the US. Regulators in the UK are similarly looking at whether banks follow responsible lending practices. It is clear that regulatory interest is not just a passing trend and the industry must not be complacent.

For consumer banks, the real challenge is to demonstrate responsible lending in a way that is both efficient and adds to the customer experience. In the UK,

the recent introduction of mortgage and general insurance regulation has led to an increasingly onerous process which has, in some cases, extended the length of a mortgage interview by a factor of four, with a corresponding detrimental effect on customer service levels. With increasing regulatory convergence across markets, the burden of compliance is likely to spread initially across Europe, then globally. Lenders will need to look at streamlining their practices to achieve the regulatory requirements as well as a competitive advantage from a consumer’s perspective.

Looking over your shoulder

Managing costs, sustaining core margins, and managing regulatory risks can collectively be a full-time effort. However, an additional cause for concern for many consumer banking executives is the potential threat from new entrants. In many core product markets, for example mortgage, personal lending, credit cards and retail checking or current accounts, the business models in place today are largely those that have evolved over the last twenty years. There have been a number of new entrants in each of the developed markets and many of these have tried to take on the large established institutions, some achieving relative success and some failing outright.

In Europe, the partnership approach has tended to work best for the new entrants. For example, in the UK, Tesco and the Automobile Association have both been particularly successful in selling consumer lending products through their distribution networks and to their vast existing customer bases, by partnering with established lenders and utilising their underwriting and back office processing experience. In the US, regulatory barriers have prevented significant penetration by retailers into consumer financial services, although the long-term trend is evident with significant co-branding of services and credit card partnerships: the ‘Wal Mart Money Center by Sun Trust’ concept being just one example.

In Asia, as per capita income and wealth increases, as many markets deregulate, and as restrictions on foreign players entering markets and entering into alliances with local players are lifted, competitive pressures are growing for financial institutions to increase (or even just maintain) margins and manage costs. Local banks are trying to move upmarket to take on foreign competitors who tend to focus more on the mass affluent as well as private banking sectors and leave the expensive business of providing a network of branches across the whole country to the local banks.



Understanding and managing the risks

The quality of risk management is also crucial. Those companies that have successfully navigated the interest cycle of the last five years (and can show it), that have proven credit and market risk expertise, and that can embrace compliance requirements from Sarbanes-Oxley through Basel II and even IFRS, are well placed for the future. While financial institutions have made considerable strides in recent years, CRM and other techniques have led to them being swamped in a deluge of often unfathomable data. Better filtering of data is essential. Many institutions are also struggling to deal with increasing levels of operational risk. In particular, financial crime, such as identity theft and 'phishing', is an ever more serious problem, with criminals proving more organised and sophisticated in their use of technology. In the face of pin number protection for credit cards in an increasing number of countries, more and more fraudsters are now looking to hack into internet accounts. Institutions may therefore need to look at the potential benefits of e-signatures and other security methods (such as using SMS messages). Without such precautions the risk of undermining public confidence, if identity theft and other cyber crime becomes widespread, will impact the use of such services.

But what about the customer?

We have recently seen the re-emergence of the traditional bank branch as a 'store' providing a customer experience – lenders are realising that, with the increasing financial literacy and transparency afforded to customers by the internet, the overall customer experience is vital in order to attract and retain customers. The use of CRM techniques is increasingly being employed to achieve the industry's holy grail of cross-selling. Consequently, lenders are opting for executives with a proven retail background. In the US, lenders have for a number of years sought out experienced retailers and brand managers to help position themselves in a market where growth can sometimes be slow but the competition fierce. In the UK, this trend is catching on, with more and more consumer lenders seeking out experience from the retail market; not just experienced senior management but also recruiting branch staff from retailers such as leading supermarket chains. Retail style marketing campaigns have also been appearing with 'January Sales' in the UK earlier this year.

However, can a bank's products really be viewed as groceries waiting for customers to take them off its shelves? The products a bank sells can be highly complex and the cost to a customer and

the impact on an institution's reputation can be significant if it all goes wrong. UK institutions have not yet forgotten endowment mis-selling and the hundreds of millions of pounds they have so far paid out in compensation.

The next few years will be a critical test for the sector as the boom fuelled by mortgage refinances comes to an end. Increased consolidation, customer expectations, regulatory scrutiny and margin compression all add up to a challenging few years ahead.

India: From sleeping tiger to stirring elephant

30

By Uday Bhasin, Navin Sambtani and Ashwani Puri



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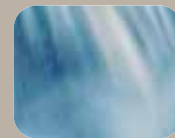
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“India is not a tiger and change will always be slower than in East Asia. India is an elephant which has stirred from its slumber and has finally begun to move ahead with a degree of determination. However, unlike a sprinting tiger that runs out of steam, the elephant has stamina.”

Gurcharan Das

India is a country of many colours and contrasts with a rich history, unique diversity of people and geographical expanse. It is also a vast country with 325 languages and one billion people spread across 29 states, each having a distinct identity and culture. Although India has always had the potential to be a great economic power, it is only recently that its true potential has emerged and it has become an increasingly attractive destination for global businesses and investments.

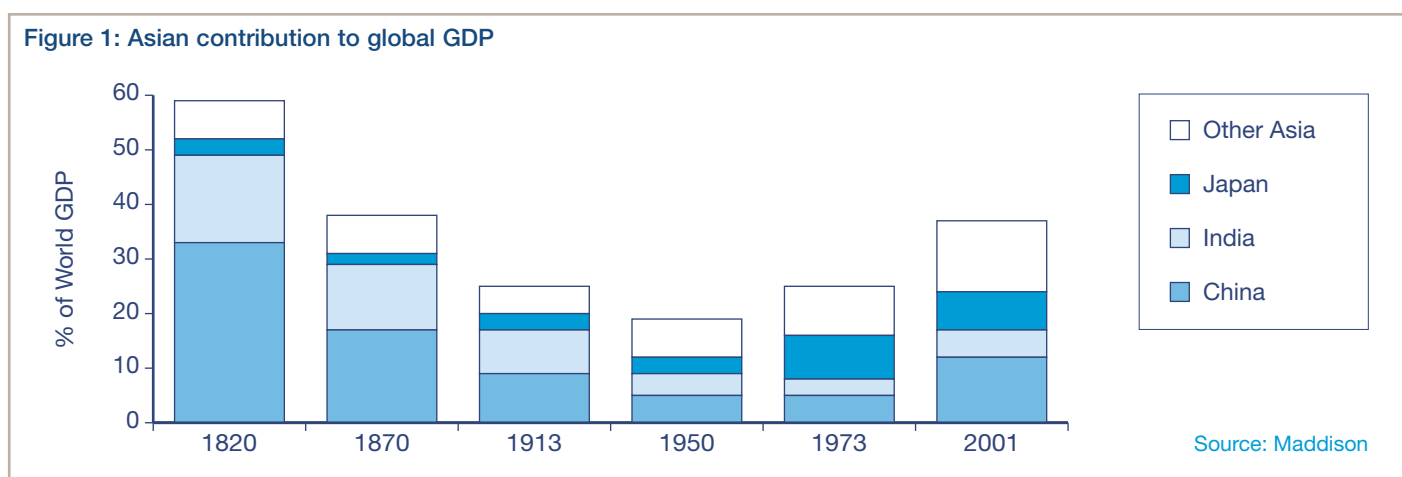
Despite having achieved independence in 1947 and attaining the status of being the world's largest democracy, India has, in the past, progressed slowly on the road towards economic liberalisation. This is due to the ideologies and policies followed by the various ruling governments who maintained a largely socio-economic agenda, which protected the domestic economy and its players from foreign competition.

In the early nineties however, with Dr Manmohan Singh as Finance Minister, the economic landscape underwent a long-awaited change. Dr Singh, who is currently the Prime Minister of India, is

widely considered to be the ‘architect’ of Indian economic liberalisation. He initiated reforms to the erstwhile protectionist policies and introduced an atmosphere which became relatively more conducive for foreign investment. With an average growth rate in GDP of 6% since 1993 (8.2% in 03/04 and expected 6.9% in 04/05), it is clear that the juggernaut Dr Singh had started has continued to gather momentum and has helped achieve the current economic buoyancy. Growth has enabled India to become a dominant player on the world economic and political stage. Figure 1 shows the growing percentage of contribution to Global GDP by Asian countries. Although China's share of World GDP grew by 140% between 1973 and 2001, India has increased its contribution by an impressive 67% over the same time frame. Given these growth rates, the potential for further expansion and the growing middle class, India is becoming an increasingly attractive destination for foreign capital. This is evident by the rise of foreign investments in Indian capital markets and the growth of Foreign Direct Investment (FDI) which increased from an impressive US\$4.26 bn in 2003 to US\$5.6 bn in 2004.

India: From sleeping tiger to stirring elephant continued...

Figure 1: Asian contribution to global GDP



Apart from the shift in economic policies started by Dr Singh, there are other contributing factors to India's economic success in the last decade which are equally important:

Good monsoons – India has traditionally been, and still is, an agriculture-dependent economy with approximately 25% of its GDP and at least half of the population being accounted for by this sector. Given this dynamic, it follows that monsoons have a significant impact on the economic performance in India in any particular year; a fact often overlooked by many external and internal observers.

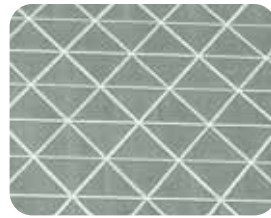
The importance of the monsoons on economic growth is evident by looking at the estimates of GDP growth by various government and non-government agencies. Prior to the monsoons last

year and on expectation of good rains, the growth rate for 2004-05 was predicted to be approximately 7.5%. However, when the monsoon was not as good as expected, the rate of GDP growth was revised down to 6.9%.

Infrastructure investment – The Indian government has begun to focus on infrastructure investment and in the last five years they have spent considerable sums on upgrading or replacing existing infrastructure, especially power plants, roads and utilities. The government is looking to continue this programme of investment and is exploring public/private partnership structures which will present banks with the opportunity to increase their project finance portfolios. For the last financial year (2004-05), the government had earmarked Rs 40,000 crore (US\$8.7 bn) for infrastructure

projects. The Finance Minister has recently proposed the setting up of a Rs 10,000 crore (US\$2.3 bn) Special Purpose Vehicle which would assist the funding of the public sector but simultaneously assist commercially viable private sector projects.

Software and IT – This continues to be India's biggest selling story and has put India on the global map for various reasons. Earnings from this sector have grown significantly to approximately US\$8bn in the last financial year and are set to grow even larger in the coming years despite the pressure from lobby groups in US, UK and elsewhere. Partly in a bid to combat this pressure from lobby groups and partly as companies begin to 'outsource outsourcing', Indian companies like ICICI OneSource have been on the acquisition trail throughout



the 'value chain' from the US/UK to low-cost countries such as Mexico.

Growth in working population/ spending patterns – The growth in the working population (see Figure 2) coupled with a cultural shift in behavioural and spending patterns, which aside from spurring economic growth, has created a significant opportunity for the consumer banking industry in India.

Culturally, India has been a savings-oriented market where 'frivolous' spending was forgone in order to save for education or to meet wedding expenses (significantly more if one had to make dowry payments!). With the availability of 'western' goods, which carry significant aspirational value,

consumers prefer to buy more 'luxury' goods than before. As spending habits change with increasing per capita incomes, dual income households and higher aspirations, India is becoming a favoured market for global consumer goods industries which in turn will boost growth further through increased investment and employment. According to Goldman Sachs, per capita income has the potential to raise by 2050 to 35 times the current level of US\$514.

According to the A. C. Nielsen Asia-Pacific Consumer Confidence and Opinions Survey (2004), an overwhelming majority (89 per cent) of all those polled said they would spend spare cash, and in India that figure was even higher at 90 per cent.

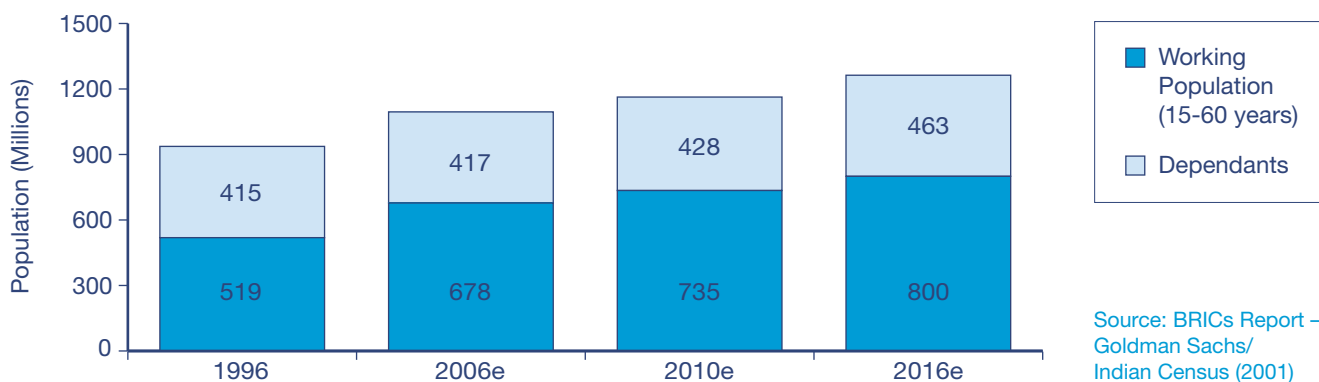
Statistics on scale of Indian banking sector (as of March 31, 2004)

Total deposits – US\$350 bn

Total bank credit – US\$195 bn

Total investments in government securities – US\$151 bn

Figure: 2



Source: BRICs Report – Goldman Sachs/ Indian Census (2001)

India: From a sleeping tiger to a stirring elephant continued...

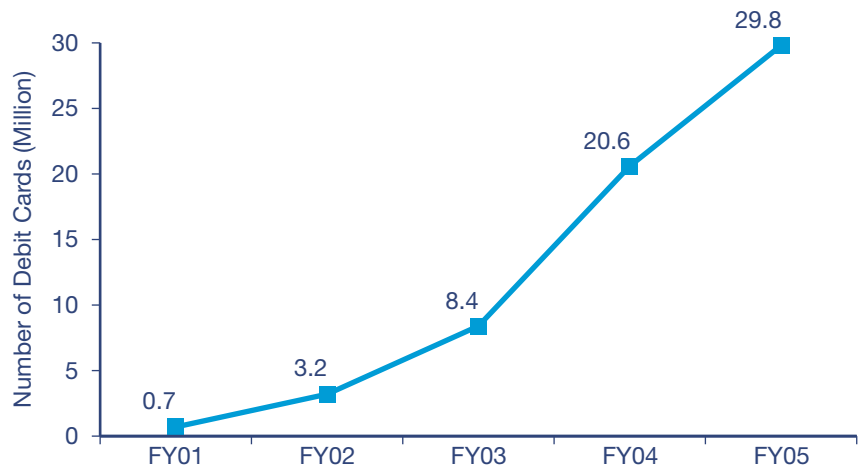
The potential for the indian banking sector – the market

Consumer Finance

The change in consumer tastes and spending behaviour has in turn created an increase in demand for money and has resulted in a significant growth in non-traditional forms of spending through credit card finance and housing loans. The use of credit and debit cards – the acceptance of plastic – is growing rapidly. As an example, the total number of debit cards has grown by 17.4 m since 2002 and is expected to touch 29.8 m by the end of 2005.

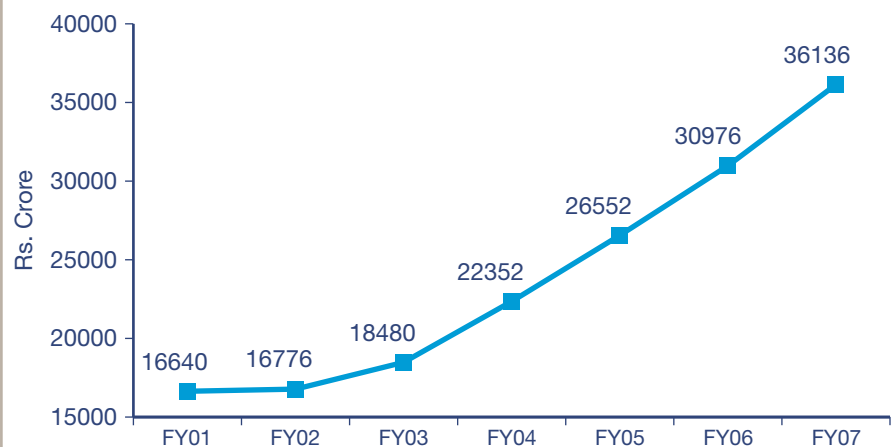
Along with increased usage of cards, the appetite for loans of Indian consumers is also on the rise. Retail loans grew at a rate of 51% in 2002-03 whereas industrial loans went up by 13% in the same year. The Rs 80,000 crore (US\$17.5 bn) housing loan segment has grown 32% in the last five years and 70% in 2002-03 spurred on in part by the low interest rate environment. The car finance segment has grown over the last few years and has growing with credit demand now expected to increase at 25-30% per annum.

Figure 3: Debit Cards



Source: Cygnus research

Figure 4: Estimated Car Finance Market in India



Source: ICICI Securities research

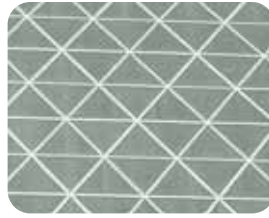
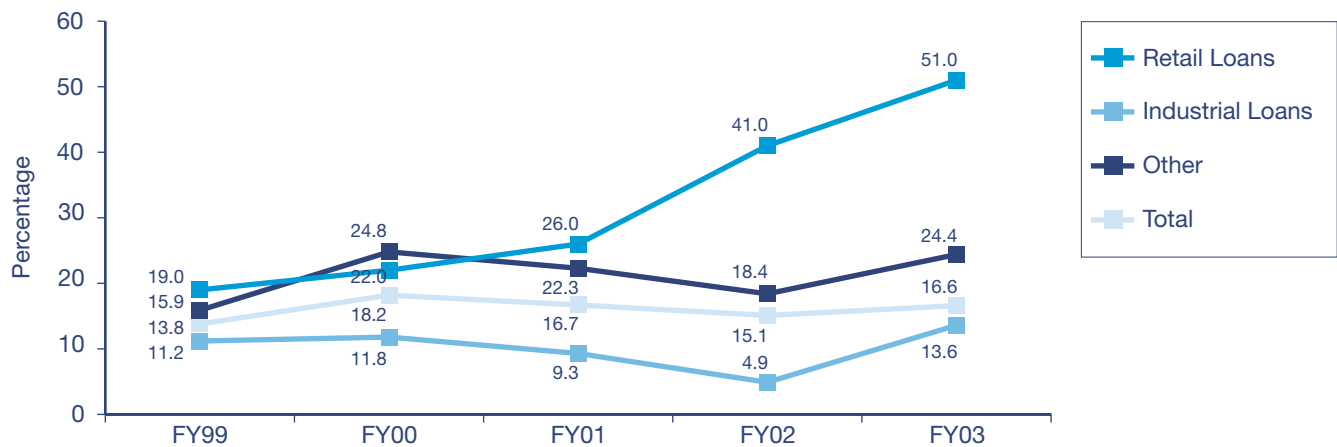


Figure 5: Segment Loan Growth (Year on Year%)

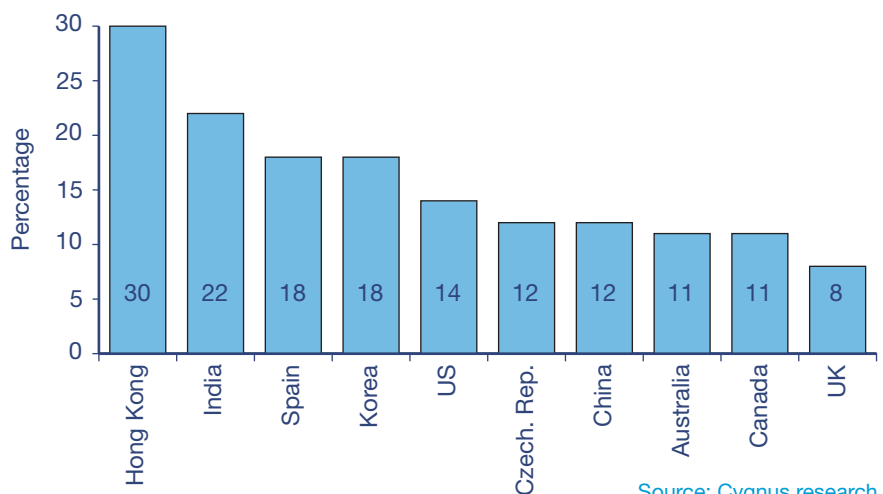


Source: Cygnus research

Figure 5 above indicates the growth rates in retail and industrial loans between 1999 and 2003.

In addition to the growth in the Indian middle class, there has been a significant increase in high-income earners, both resident in India and those who have made their money overseas and are looking for ways to reinvest 'back home' (Non-Resident Indians or NRIs). With a growing NRI population, repatriations into the country have boosted foreign exchange reserves. The NRI community combined with the 'home grown millionaires', of whom there are 61,000, have also led to the growth of the private banking industry in India (see Figure 6).

Figure 6: High Net Worth Individuals (HNWI) Population Growth (2003)



Source: Cygnus research

India: From sleeping tiger to stirring elephant continued...

Corporate Banking

The growth and potential for banks is not restricted to consumer finance and wealth management but extends to the active corporate/wholesale sector in India whose participants apart from experiencing growth in the country are also actively establishing a global footprint. With the overcapacity in the manufacturing sector being almost fully utilised by growing demand in the last few years, Indian corporations are set for a phase of capacity expansion which signals an increasing off-take for the lending community. Corporates have lined up significant capital expenditure plans, which, if implemented, could transform the Indian economy even further. According to data collated

by the Centre for Monitoring Indian Economy (CMIE), the total planned investment by the private and public sector over the next four years is approximately Rs 700,000 crore (US\$150 bn).

Sectors that demonstrate this best are textile manufacturing, which, with the advent of WTO agreements, is increasing its export capacity and the outsourcing industry which continues to attract more business from the UK, US and recently Australia. As the exposure to markets outside India grows, the demand for an increased volume and complexity of products to hedge financial risks is also rising. Growing business confidence and the country's credit standing in international

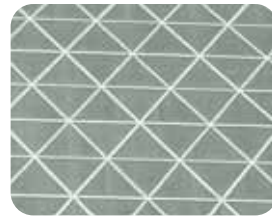
markets has helped in reducing borrowing costs for Indian companies. The challenge, as discussed later, is for banks in India to cater for this growing demand without compromising on their operational, credit and market risk profiles.

The Players

So who are the players in this market? The players in the Indian Banking Sector can broadly be classified into three distinct groups, who, although they face common issues, are subject to specific issues pertaining to their sector. The three main segments are the public sector banks, private sector banks and the foreign banks.

Indian Banking System				
	No of banks	No of branches	% share in deposits	% share in bank credit
Public Sector Banks	27	46,316	77.2%	72.5%
Private Sector Banks	32	5,290	13.7%	17.5%
Foreign Banks	42	184	5.0%	7.3%
Regional Rural Banks	196	14,486	4.0%	2.7%

Source: Reserve Bank of India



The Public Sector Banks

As is evident from the table above, the public sector banks constitute the majority of the Indian banking system, be it by geographical reach or deposit and credit volumes. The public sector banks which, although in theory are independent, take strategic direction from their majority shareholders. They have historically been and continue to be, important mechanisms by which the government delivers policy promises and maintains confidence in the banking system.

As a result of the design of the Government policies to extend credit to the rural population and the accidents of failed banks in the Indian system, the public sector banks have grown to establish a formidable network of branches. The largest of these is the State Bank of India (SBI) which is the largest Bank in India as measured by the number of branches (over 9,000 branches, and 15,000 branches including its affiliated banks) and asset base (Rs 407,815 crores or US\$88 bn). The large branch networks that are owned by some of the public sector banks, and particularly SBI, present themselves with a significant advantage over the private and foreign banks, who, although they have well established operations in the metro cities need to establish better distribution capabilities in the semi urban and rural areas.

Despite owning these impressive networks, the lack of investment in technology leads to inefficiencies in processes and restricts the bank's ability to equal customer promises made by private sector and foreign banks. The need for more sophisticated technology has also become more relevant as the public sector banks start to tap foreign capital markets to raise funds to meet their expansion plans. The exposure to foreign markets will require them, amongst other things, to raise the bar with regard to customer service, efficiency and producing timely, auditable financial and non financial information. Although the banks in this sector have embarked on modernising their technology infrastructure and streamlining their internal processes, this will absorb both time and resources.

The public sector banks have not traditionally been regarded as very 'customer-centric' organisations but the advent of private sector banks and market-savvy foreign banks has changed the competitive landscape in the Indian consumer banking industry. Although the customer service levels of public sector banks are now growing to meet the complex needs of customers, some suggest that there is still along way to go.

'Indian banks are regulated by the Reserve Bank of India (RBI), an autonomous organisation set up under a specific legislation of the Parliament with limited Government control, as per provisions of Banking Regulation Act. The RBI regulates all banking sector aspects such as cash reserve ratio, statutory liquidity ratio and capital adequacy. No one can carry on the business of banking in India without a licence granted by the RBI and all banks have to adhere to a transparent reporting system of the RBI.'

The Private Sector Banks

The private sector banks in India have really established themselves over the last ten years and with aggressive marketing and, focus on customer care, have begun to take the market share away from the public sector banks. Most notable amongst the private sector banks are ICICI and HDFC Bank which have introduced a level of sophistication in the banking sector that has not been apparent in India before. Apart from adoption of relatively sophisticated technology, these banks have been quick to grasp the consumers' psyche of 'Time is Money'. Another advantage of large private banks in the country is that they are 'universal banks' which cross-sell a host of financial services and offer all solutions to

India: From sleeping tiger to stirring elephant continued...

customers' financial needs under one roof. Some of the smaller private sector banks have not yet employed the use of sophisticated customer relationship management systems.

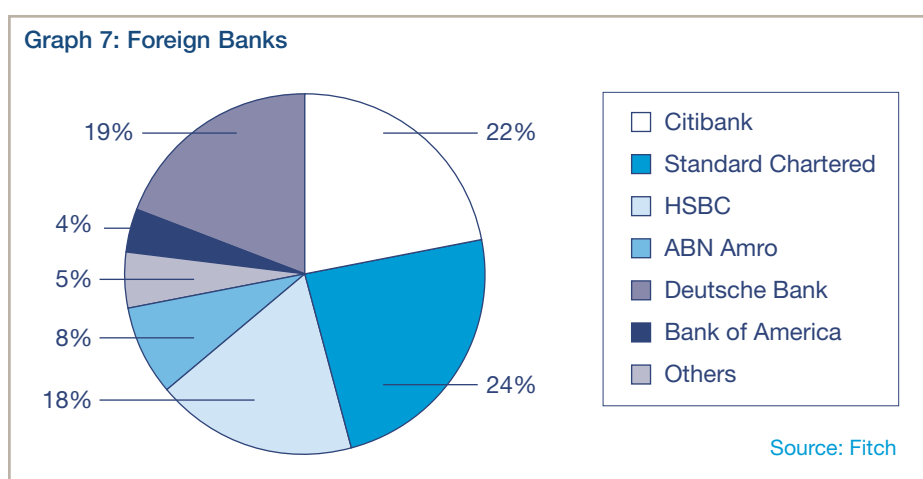
Management of the banks in this sector is largely Indian, by people who understand the Indian market and the Indian consumer and are able to successfully compete with the larger public sector banks in the metro cities where they have appeal to the more urban customer. As they continue to grow and the urban markets become saturated, they, like the foreign banks, need to establish an operational network that will reach the wider population. Also, an emerging trend with the private banks is that they are seeking to establish a presence in global markets with the aim of attracting lucrative NRI business.

Foreign Banks

The third sector is the Foreign Banks of which there are 42 currently operating through more than 184 branches in India.

The larger foreign banks enjoy strong franchises, both in corporate banking as well as in retail savings products among high net worth individuals. That said, they have an increasing market share in retail lending including auto loans, credit cards and personal loans. Growing acceptance

Graph 7: Foreign Banks



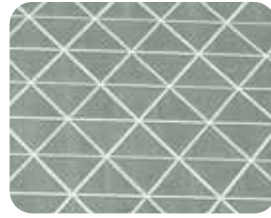
of foreign banks is partly as a result of the high 'aspirational value' attached by consumers to banking with a foreign brand. Robust systems, well-defined processes of their global network and an attractive market have enabled these banks to move from a 'dipping the toe' strategy to establishing and cementing their foothold in the Indian market.

Whereas the state and private banks are largely locally incorporated banks, it is important to note that most of the foreign banks operate as branches of the parent bank which, due to regulatory considerations, puts a constraint on the number of branches they can open. In the retail space, if foreign banks are to participate in the growth of the Indian banking sector on a footing equal to their Indian counterparts, they would need to establish a wider distribution network

than is currently allowed under the foreign branch structure. Although the central bank is meeting and exceeding its WTO commitments with regard to allowing the branches of foreign banks to be set up, foreign banks would need to wait for some time before they have flexibility on their distribution network.

This presents an interesting conundrum for the foreign banks who recognise the need to establish a distribution network but are limited due to their current structure and by the government's ceiling on foreign ownership of private banks.

An alternative that foreign banks are increasingly pursuing is the setting up of Non-Banking Financial Companies (NBFC). Although there are various restrictions on resource mobilisation and certain restrictions on foreclosure



rights otherwise available to banks, NBFCs are subject to relatively less stringent regulatory requirements than banking subsidiaries. For example NBFCs are not required to comply with certain prudential measures such as the Statutory Liquidity and Cash Reserve Ratios or provide, at RBI's behest, priority sector lending (NBFC's are, however subject to almost identical capital adequacy requirements as banks).

Although many internationally active banks have an 'India strategy', in order to succeed, it is imperative that foreign banks understand the culture within each state they wish to operate in. This alone is a significant challenge that should not be underestimated.

Foreign Ownership

Ownership and governance of banks (private banks and foreign banks as discussed previously) is high on the Reserve Bank of India's (RBI) agenda. The RBI is committed to strengthening the domestic banking sector before allowing further room for foreign investment and the recent announcement limiting foreign banks from owning controllership rights of more than 5% in private sector banks is evidence of this. This presents the foreign banks with a significant challenge in the race for customer acquisition. In the meantime

however, consolidation among public sector banks who will seek to merge themselves based on operational, geographical and asset synergies is widely believed to be imminent.

Credit Growth and Basel

The RBI has issued guidelines recently for the adoption of elements of the Basel II framework (the Standardised Approach for credit risk and Basic Indicator Approach for operational risk) with effect from March 31, 2007.

Following the sharp credit growth and in order to comply with Basel II norms, it is widely believed that Indian banks will need significant capital infusion over the coming few years. A recent study done by a leading credit rating company in India reveals that if Basel II norms were applied to the Indian banks' portfolio (as at March 2004), capital adequacy would have been 160 basis points (bp) lower than reported. This 160bp decline is a function of a 70bp gain on credit risk and a loss of 120bp on market risk and 120bp operational risk. This reinforces the view that although Indian banks have begun integrating effective credit risk management systems into their operations, adequate progress needs to be made for the assessment and monitoring of market and operational risk.

One obvious area for these banks to consider when looking at their market/operational risk framework is derivative trading which is a relatively new area for Indian banks (particularly in the more structured products) and is set to grow further. It is widely accepted that as the volume of transactions increases, they need to upgrade their current internal control environment and create/upskill their middle and back offices.

Transparency and disclosure standards are also important constituents of a sound corporate governance mechanism. Although transparency and accounting standards in India have been enhanced to align in many ways with international best practices, there are still many gaps in the areas of risk management strategies and practices, risk parameters, risk concentrations, performance measures and components of capital structure. Hence, the disclosure standards need to be further broad-based along with improvements in the capability of market players to analyse the information objectively. This will help in their efforts to comply with Pillar III requirements of Basel II.

Apart from the challenge of managing capital adequacy by establishing/enhancing operational and market risk

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management frameworks, Indian banks will need to establish capital raising programmes.

Securitisation

Securitisation and loan sales have made a slow beginning in India. With higher growth rates now being witnessed in loan assets as compared with deposits, securitisation will be a key area for banks to maintain adequate short-term liquidity in order to capitalise on the expected growth. Lack of legal clarity and high transaction costs (stamp duties) are acting as impediments to the securitisation market. Although recently passed legislation does address these issues, continued commitment from the regulators is required to develop these markets.

Bankruptcy laws in India have traditionally favoured borrowers which has in the past resulted in a large amount of assets becoming distressed, since the powers of lenders were limited. Recent legislation empowers banks to take action against defaulters without resorting to the painfully slow traditional recovery methods like those accessed through the Debt Recovery Tribunals. However, this legislation needs to be further refined and may take some time before it is practically implemented and the benefits realised.

Conclusion

There is no doubt that India presents a huge opportunity for the banking sector but, as outlined above, there are various hurdles that need to be overcome before the true potential can be realised and the elephant begins its charge.



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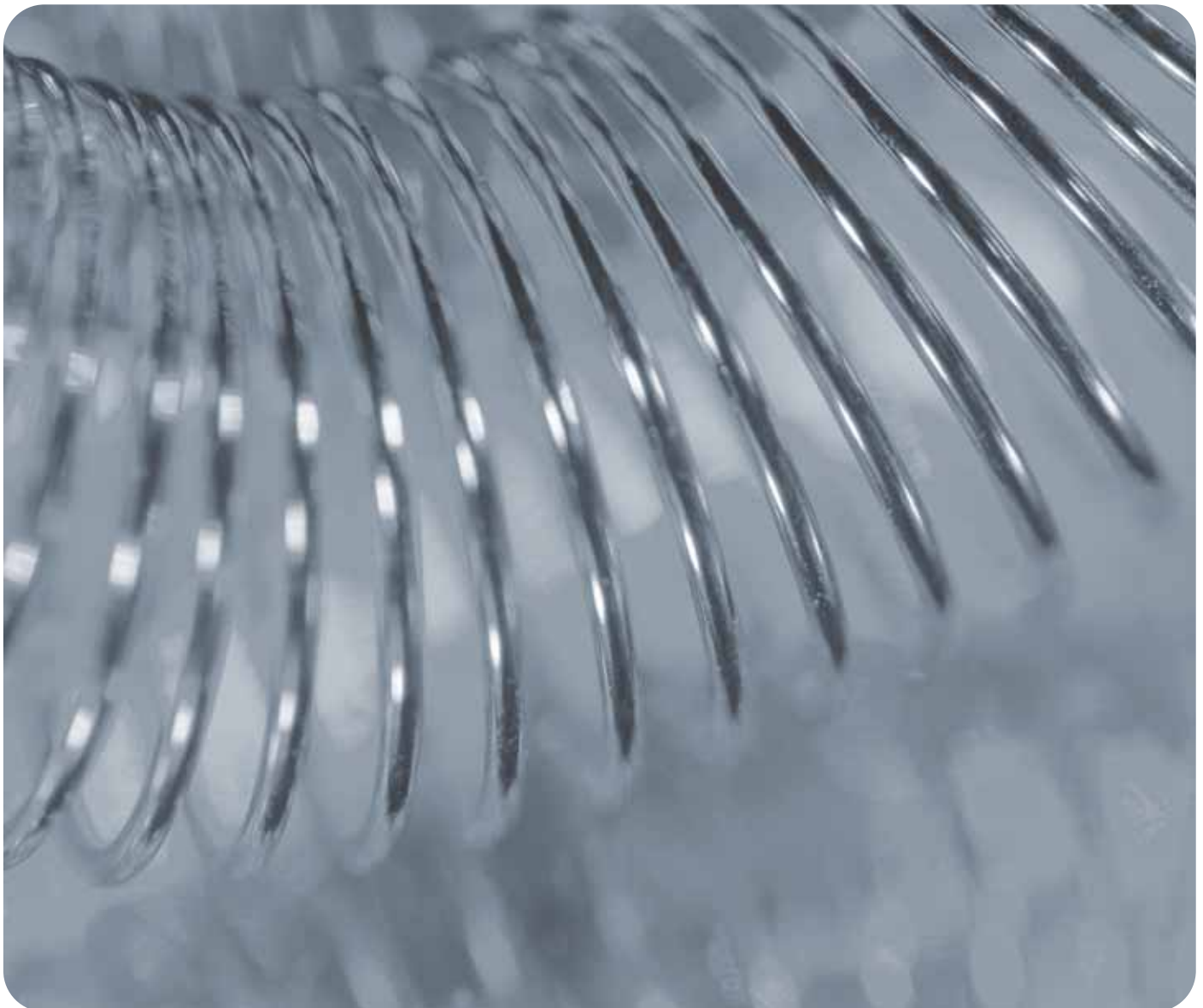
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IFRS: Is your financial reporting sustainable?

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The banking industry is poised at the IFRS starting line. It has not been an easy journey to get there; the financial services industry, more than any other, has faced the greatest number of IFRS dilemmas, potentially due to the complexities of financial instrument accounting and disclosure. At least for banks (in contrast to insurers), most technical issues have now been resolved.

Any bank tempted to rest on its laurels, however, should first consider whether it has merely changed the numbers or whether they have managed to embed sustainable reporting, able to weather the challenges ahead. IFRS financial reporting needs to be core to how banks look at and think about their operations, not just an adjunct to the finance function. It is also of crucial importance when considering regulatory compliance and the impact of Basel II. Together with IFRS, these represent the most profound change in business economics and operating dynamics for the past 20 years. If IFRS does not yet permeate the decision making and financial reporting of the organisation, banks may find themselves on the defensive in the coming weeks and months.

Many of the larger banks have been proactive in giving the market early indications of how IFRS will impact their businesses. There have not been significant market movements in share price as a result of the initial reporting. However, the evidence we have seen in the market suggests that there is not yet full acceptance of the message that the business economics are unchanged. With IAS 39, which has become closer to finalisation more recently, the learning curve of the market is likely to be even steeper. At this stage, many banks are modelling the impact of IAS 39 internally, but little of the detailed impact has been communicated to the market, even though IAS 39 will of course be relevant for June 2005 interim results.

Banks should never underestimate the sheer difficulty, from a technical viewpoint, of getting the numbers and the process right, particularly with regard to hedge accounting. There will be ongoing interpretative difficulties of the present rules, and these rules will continue to undergo future changes. IFRS is a journey, not a step change. Banks, regulators, and industry associations need to work closely

together to manage this change to avoid further uncertainty and damage to the corporate reputation. Changes in reporting need to be properly disclosed to ensure full transparency. The most pressing first deadline, which will set the benchmark, is 2005 interims, which are due out in the next few months. After years of familiarity with legacy GAAP, companies, analysts and investors are looking at the numbers afresh (without the benefit of trend data) under IFRS. As companies struggle to understand and implement complex new standards, some changes of interpretation are inevitable as the rules are embedded.

It is not yet widely recognised in the market that under IFRS the threshold requiring restatement is lower; that is, while under UK GAAP, for example, only fundamental errors need to be restated, under IFRS any material error necessitates a restatement. Given that restatements were a rare occurrence under UK GAAP and usually accompanied by negative connotations, will the market be able to suspend traditional prejudices when restatements occur because of these IFRS policy or interpretation differences? Could a flurry of restatements even

IFRS: Is your financial reporting sustainable? continued...

precipitate a wider crisis in confidence in financial reporting? Recent market experience of restatements in the US shows that these have created uncertainty and shareholder concern.

It is perhaps worth noting that the SEC, in postponing the application of Sarbanes-Oxley for foreign private issuers, did so primarily in recognition of the difficulty of implementing IFRS. It is some relief to those foreign SEC registrants to have another year to ensure there are no material weaknesses in their IFRS reporting before their executives are held personally accountable. Banks must really use the 'breathing space' to embed IFRS into the operating financial processes of the business. Several banks are also using the Sarbanes-Oxley s404 requirements to upgrade their financial reporting framework.

Thus there is no room for complacency. The management of market expectations by banks needs to be ongoing, and those responsible for the finance function and financial reporting should anticipate that confusion over IFRS may put them under significant scrutiny. To establish credibility and demonstrate resilience, banks must have sustainable IFRS reporting embedded in their organisations, with the finance function demonstrating effective leadership, in relation to both internal and external reporting.

From tactical to sustainable to flexible

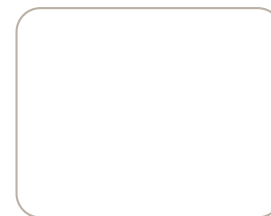
To the outside world, the image of a swan gliding serenely across troubled waters may be how the organisation appears to be coping with IFRS. In reality, many organisations are paddling frantically under the surface to cope with current IFRS challenges, let alone those that lie ahead, not only in financial reporting but also in regulation. In truth, IFRS has been approached tactically by many organisations, albeit out of necessity due to the uncertainty surrounding the final form of the set of IFRS standards, particularly IAS 39. This is particularly relevant with regards to cashflow hedging – easy to designate relationships but proving very hard to run in practice. On a day-to-day basis, especially with the complexity of hedging. The short-term tactical fixes may prove unsuitable in the long run.

The preparation of external reporting to date may have been largely performed by an operationally independent project team at the centre, often staffed by contractors. There is, therefore, reduced long-term sustainability or knowledge transfer within the organisation, making it extremely difficult to effectively embed the process into 'business as usual'. This data was more often than not produced

outside the normal reporting systems, with limited knowledge transfer to 'business as usual' staff. This might be sufficient for a one-time snapshot of the business, but it is not what will be needed for ongoing IFRS reporting, and the monitoring and explanation of results much less for a 'fit for purpose' finance function going forward.

Given that there are usually only one or two windows a year when significant change in finance can be readily implemented, careful planning is needed. What an organisation should seek to embed is external and internal reporting disciplines which are easily replicated period after period, in a reliable, efficient and robust manner without reliance on resources, processes and systems that can only be assured in the short to medium term. Compliance with the new reporting standards must become business as usual.

Going back to the IFRS swan, it's not just paddling furiously under the surface, but it is also actually having stones thrown at it from the shore. These stones represent several extra challenges, including the complex regulatory and compliance framework being introduced over the next few years through Basel II and Sarbanes-Oxley, as well as a host of International Accounting Standards Board (IASB) financial reporting



improvements and research projects. The IASB has an ambitious agenda and many of the present solutions are short-term interim fixes that arose from the improvement projects. Companies must have the flexibility to change their IFRS approach to accommodate both minor and major future changes.

For an organisation to cope, it will need to be moving toward a flexible approach where it is not just embedding reporting, but also embedding the ability to change. Under this scenario the necessary organisational structure, systems, data capabilities and people will need to be in place so that future changes can be factored into the activities of the finance function without undue stress. But this is easier said than done. This is a huge task for any organisation – requiring a highly effective and integrated change and development plan. It may be enough in the short term to embed the requirements of IFRS and Basel II, moving on to these structural and systems changes in due course.

Operational risk looms large

The price some organisations have paid to meet IFRS deadlines has been a deterioration in the overall robustness of the control environment, underlying processes and systems; and experience of people, as well as a reduction in

overall efficiency. There has been heavy reliance on manual intervention, spreadsheets, and ‘back of the envelope’ responses. There has been a single-minded emphasis on external reporting with less emphasis on the less visible. For instance, the operational risk created by business practices, management accounting and incentivisation arrangements not being properly aligned with the new external reporting requirements is potentially significant.

Furthermore, and especially for financial institutions, the knowledge and understanding of IFRS must go deeper than just the finance function.

Customer relationship managers and credit analysts are now revisiting the way they interpret financial statements, and analyse ratios and covenants of customers. M&A teams and equity analysts are using the new rules to assess targets and proposed business combinations differently pre- and post-deal as the changes in relation to goodwill and intangibles take effect. Recent conversion experience has shown that the impact on distributable reserves, for example at British Airways, can be significant. The skills shortage will be particularly acute in the front office, where understanding of the accounting implications for customers of their proposed transactions, particularly in

relation to derivatives and structured products, will be key.

How to embed sustainable reporting

The challenge for finance functions seeking to make themselves ‘fit for purpose’ requires careful scrutiny of six key enablers:

1. Processes;
2. Controls;
3. Organisational structure;
4. Data systems/technology;
5. People capability; and
6. Planning strategy.

IFRS can be embedded within a broader process improvement strategy, and the sustainability of financial reporting can of course be improved incrementally. The focus should be maintained on immediate deliverables, whilst seizing each opportunity for greater effectiveness, efficiency and control, and also building in the capacity for future developments.

IFRS: Is your financial reporting sustainable? continued...

Some examples of where effective IFRS change can or should be facilitated include:

1. Reporting needs to be timely and accurate, with a minimum of human intervention. Reporting disciplines need to be able to cope with increased data collection analysis and disclosure. Technologies like XBRL may be useful to eliminate communication difficulties and duplication between systems.

2. Controls and procedures need to be reviewed to ensure they remain appropriate, with the right policies and procedures in place. These need to be seen to be supported by management. Accounting manuals throughout the organisation are needed to help IFRS be understood and implemented in a consistent way. These should also be Sarbanes-Oxley compliant, a process much easier to do whilst the controls are being put in place. This is good business practice for all banks, not just SEC registrants.

3. Certain areas of IFRS, for example effective interest rate calculations, fair valuation of derivatives and hedging, create new balance sheet intangible assets and liabilities. Therefore companies need to ensure they have rigorous and robust validation

procedures in place to establish balances. In addition, controls over the balance must be developed given that as they do not easily lend themselves to traditional controls, such as reconciliation to third party information. They must also be able to explain their volatility, particularly if they use cashflow hedging. Skilled resources are in short supply in the market – a good training regime is a way to mitigate some of this risk.

4. On the people side, specific work needs to be done to motivate personnel to embrace, instead of feel excluded by or from, IFRS. This needs to be built into training, development and reward structures. Critically, resources must be made available for change implementation. Training and updates are the norm, but IFRS needs to form part of the language of the business. For example, IFRS needs to be used when and where business is booked, not in a remote central finance function. All of management, not just those in finance, need to be aware of the requirements of IFRS and their associated implications.

It is entirely possible to implement this sort of finance change, but it does require significant investment of time, resources and commitment. In our experience, the critical success factors include:

1. **A clear and sustainable vision** at the outset, with the business units included in the design;

2. **Genuine executive sponsorship**, particularly asserting leadership on priorities and ways to improve controls;

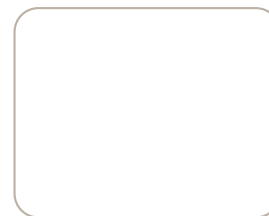
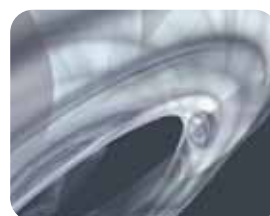
3. **Effective, simple governance and programme methodology** without bureaucracy;

4. A programme which ‘fits’ the organisation and addresses culture and **behavioural issues**, rather than dictating from the centre;

5. **Manage accountability** by getting those responsible involved early on, and using consultants and contractors appropriately;

6. **Not overpromising** – for the most part this is tactical, not transformational, change; and

7. **An effective internal and external communications programme** explaining the impact of IFRS on business practices and performance measures.



Financial institutions that are not being required to explicitly adopt IFRS as a result of being publicly listed, for example, may find that regulators, competitors or other stakeholders initiate such a change. In other cases, the adoption of IFRS may result from convergence of national financial reporting frameworks. In any event, the only certainty for financial reporting in the coming years is that it will be a time of continuous change. Recent analyst reports show that the more significant impacts will be in areas such as goodwill amortisation (IFRS 3) share-based payments (IFRS 2) and adjustments arising from pension amounts. To thrive and succeed in such an environment will require the embedding of a sustainable reporting infrastructure, in the finance function and throughout the organisation.

It goes without saying that a thorough understanding of, and preparation for the requirements of IFRS and its implications need to be in place to avoid undue disruption to the business, and the risk of market confusion regarding the consequences of IFRS for the institution's financial performance. Furthermore, however, as IFRS is amended and re-interpreted, the finance function must have the flexibility and capability to take this in its stride, and exude confidence to the organisation and the market.

Shari'a compliant financial services – standing its ground

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by Madhukar Shenoy, Souhaib Haider and Mohammad Faiz Azmi



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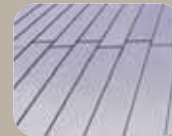
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Shari'a compliant financial services – standing its ground

A decade or so ago, few in the conventional financial services industry outside the Muslim world were familiar with 'Islamic banking', 'Shari'a compliant banking' or 'Shari'a compliant financial services products'¹. It is reasonable to say that, today, the financial services marketplace and its participants are beginning not only to recognise it, but also to believe that this segment of the banking business is here to stay and grow. Today, growing calls for Muslims to avoid dealing with non-Shari'a institutions, except where these are the only available option locally, and greater recognition of the opportunities to be had in serving the Muslim community, have resulted in growing prominence for this sector. The recent \$2.35 billion financing for the Ittihad Etisalat company is considered a significant milestone, and the development of new sectors, including the *Sukuk* and *Takaful* markets demonstrate the promise and dynamism of this sector.

Evolution

Although the Muslim world practised financing and trading activity using the principles of Islam for centuries, organised Shari'a compliant banking activity emerged only in the 1970's, principally in the Middle East. The formation of the Islamic Development Bank ('IDB') in Saudi Arabia in 1975 was an important stimulant in the development of organised Shari'a compliant banking activity, at least in the Middle East. One of IDB's founding objectives was the promotion and development of Islamic banking worldwide.

Over the last two decades, the Arabian Gulf saw many institutions being established, with UAE hosting the first contemporary Islamic bank – Dubai Islamic Bank. Bahrain established itself as a major Islamic banking hub; its neighbours are now seeing numbers of Islamic banks growing too.

In the Far East, Malaysia has given much attention to meeting the needs of the consumers who wish to deal in financial products that are Shari'a compliant and has earned itself a reputation as a leader in the field.

Sudan is yet another country with several Islamic banks and financial institutions. Saudi Arabia, Pakistan and Iran have prohibited interest and consider their banking systems to be compliant with the Shari'a. However, in many respects they operated in much the same way as their conventional counterparts.

In the US, efforts to introduce Shari'a compliant banking activity have been restricted largely due to legal hurdles and the lack of full recognition of the alternative banking system by the regulatory oversight and other authorities. Nonetheless, Middle Eastern institutions have established a presence in the US and have structured Shari'a compliant asset-based products, principally to whet the appetite of investment opportunities of the overseas (predominantly Middle Eastern) institutional and high net worth individuals. Such activity has largely been in the area of real estate and lease-based products. Organised banking activity which caters properly to the persistent demands of the growing Muslim community, mostly based in the New York and California areas, will, perhaps, take some time.

¹ Banking activity consistent with the Islamic Shari'a ('Shari'a').

Shari'a compliant financial services – standing its ground continued...

The United Kingdom, too, has paved the way for Shari'a compliant banking to come into mainstream financial services by authorising, in August 2004, the Islamic Bank of Britain, the first stand-alone bank in Europe planning to operate in accordance with Shari'a principles.

Realistic estimates of the assets held by the Islamic banking sector are not available; but the amounts quoted range between US\$200 billion and US\$250 billion, and about 200 Islamic banks operate worldwide today.

Growth too in 'Islamic windows'

Added to this growth in the number of banks is also the emergence of the concept of 'Islamic windows', meaning conventional banks and financial institutions offering Shari'a compliant products through their specialised branches or subsidiaries. These Islamic windows typically offer Shari'a compliant private banking and asset management products and normally target institutional investors and high net worth individuals. Such products include:

- Private equity
- Funds

- Real estate
- *Sukuk*
- Other structured products (with underlying *Murabaha*, *Musharaka*, *Ijara* components).

Some top Islamic banks

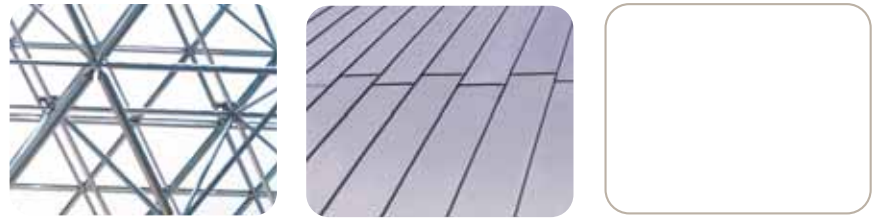
- Abu Dhabi Islamic Bank, UAE
- Al Rajhi Banking and Investment Corporation, Saudi Arabia
- Bank Islam Malaysia Berhad, Malaysia
- Bank Muamalat Malaysia Berhad, Malaysia
- Dubai Islamic Bank, UAE
- Arcapita Bank (formerly First Islamic Investment Bank), Bahrain
- Islamic Bank of Britain, UK
- Islamic Development Bank, Saudi Arabia
- Kuwait Finance House, Kuwait
- Qatar Islamic Bank, Qatar
- Shamil Bank of Bahrain (Dar Al Maal Al Islami Trust), Bahrain

Murabaha

Sale of goods with an agreed upon profit mark up on the cost. Murabaha is of two types. In the first type, the Islamic bank purchases the goods and makes it available for sale without any prior promise from a customer to purchase it. In the second type, the Islamic bank purchases the goods ordered by a customer from a third party and then sells these goods to the same customer. In the latter case, the Islamic bank purchase the goods only after a customers has made a promise to purchase them from the bank.

Musharaka

A form of partnership between the Islamic bank and its clients whereby each party contributes to the capital of partnership in equal or varying degrees to establish a new project or share in an existing one, and whereby each of the parties becomes an owner of the capital on a permanent or declining basis and shall have his due share of profits. However, losses are shared in proportion to the contributed capital. It is not permissible to stipulate otherwise.



Ijarah

Ijarah is the transfer of a service for an agreed upon consideration. According to fuqaha, it has three major elements;

- a form, which includes an offer and a consent;
- two parties, lessor (the owner of the leased asset), and a lessee (the party who enjoys the services of the leased assets);
- the object of the (Ijarah) contract, which includes the rental amount and the service (transferred to the lessee).

- The principles of good faith, transparency, ethics, discipline etc. in commercial activities.
- Profit and loss sharing on the principle of no pain no gain.
- Prohibition of usury (*Riba*) or interest, transactions based on speculation (*Gharar*) and trade in certain commodities such as pork, tobacco, alcohol, gambling etc.

The prohibition of *Riba* has parallels in the usury laws in many western countries and a ban on excessive interest.

Profit and loss sharing deemed by many to be 'pure' Islamic banking is similar

to venture capital finance, non-recourse project finance or ordinary equity investment. The investor takes a share of the profits, if any, of the venture and is liable to lose their capital. It involves investing but not lending.

The business model

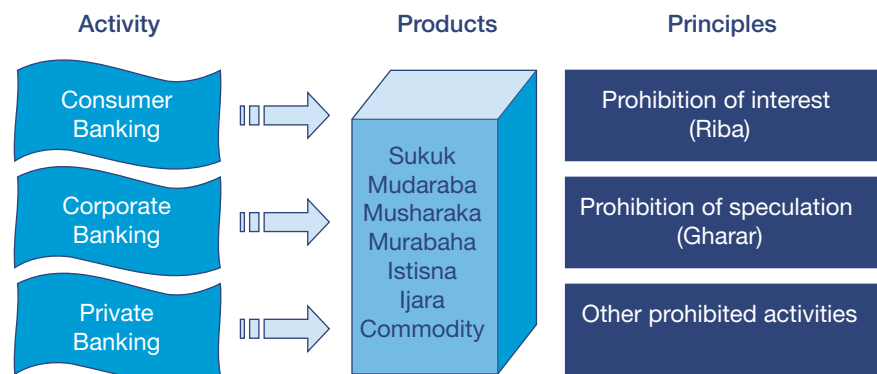
Islamic banks have been quite innovative in the use of a somewhat limited range of products in matching the needs of their consumers, who include corporate as well as private banking clients. Some of the common forms of raising capital and non-capital funds as well as ways of deploying them are described below.

Several major banks now offer Shari'a compliant products² – Citibank, HSBC, ABN Amro, UBS, American Express, Bank of America, Standard Chartered Bank and Société Générale, to name a few.

But then how different is Islamic banking?

The ethical requirements³ that are embedded in the Shari'a form the distinguishing feature of Islamic banking. Without being exhaustive, they cover the following principles:

Figure 1: The business model



Source: PricewaterhouseCoopers

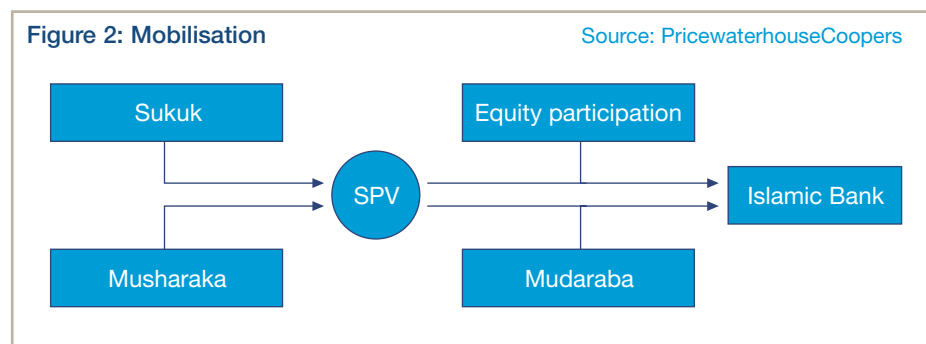
² Source: General Council for Islamic Banks and Financial Institutions.

³ Islam does not entertain the dichotomy between spiritual and temporal affairs of life.

Shari'a compliant financial services – standing its ground continued...

Mobilisation of capital and non-capital funds

Funds raised by an Islamic bank fall typically under the following four categories.



Equity participation: Capital is normally raised through the issuance of ordinary shares that carry equal voting rights. Different classes of shares with varying rights are uncommon unless they can be attributed to different asset pools.

Musharaka contracts: Raising equity through *Musharaka* contracts is akin to equity capital in a joint venture. Under a *Musharaka* contract, one or more parties pool cash or other assets to participate in the venture.

In Islamic banks, these contracts are usually found in the context of the bank acting as a ‘financier’.

Sukuk: *Sukuk* are similar to bonds, except that in the case of a conventional bond the risk taken by the investor is typically that on the issuer and the

coupon is generally predetermined. In a *Sukuk* issue, the risk and the return are associated with the assets underlying it – not dissimilar to an asset-backed securitisation structure.

For its role as manager of the *Sukuk* issue, and the associated assets, the Islamic bank issuing these instruments is eligible for a fee or a share in the profits attributable to the underlying assets.

Mudaraba accounts: Islamic banks accept funds under *Mudaraba* or *Wakala* (agency) contracts from clients (called ‘*Rab Al Maal*’ in the context of *Mudaraba* contracts), who wish to earn profits on their liquid funds under similar terms as savings/term deposit accounts.

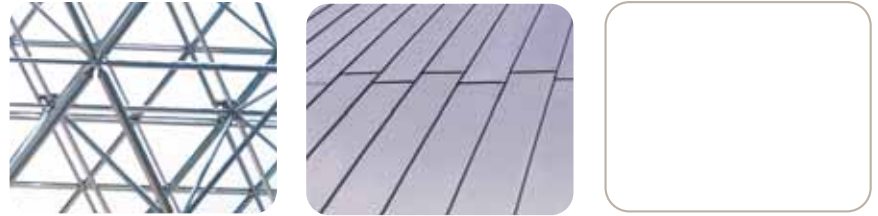
Client funds are invested in accordance with the terms stipulated in the relative

contractual instrument (*Mudaraba* or *Wakala*). The profits attributable to the invested assets are shared between the Islamic bank acting as *Mudarib* (manager) or *Wakeel* (the agent) and the clients. However, losses, if any, are borne solely by the clients except in the case of negligence by the bank.

An Islamic bank creates different pools of assets for its various classes of clients to allow variability in risks and maturities, as well as profitability, to match client risk/return appetite.

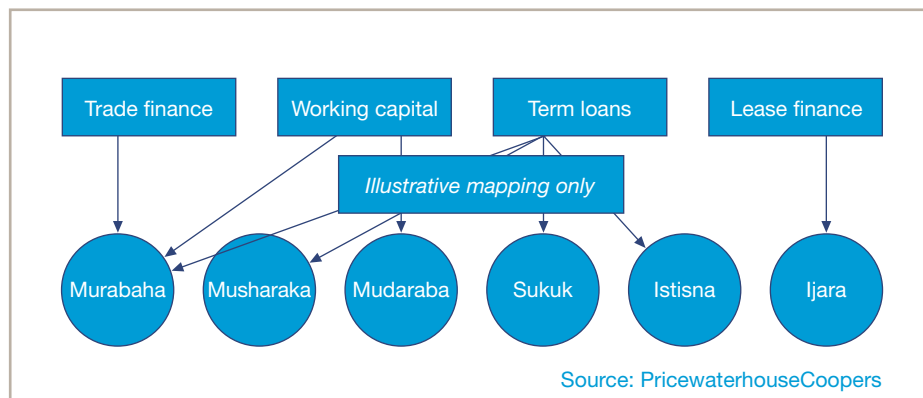
Thus in the arrangements above, non-capital funds accepted by Islamic banks are similar to funds received in collective investment schemes, largely in view of the risks being borne entirely by clients. Many Islamic banks retain such funds and the attributable assets on the balance sheet depending on:

- local accounting, regulatory or human resources practices,
- whether the funds are combined with its proprietary funds, and
- whether the bank will or will not compensate its clients in circumstances where the pooled assets do not provide adequate returns to clients (generally known as ‘displaced commercial risk’).



Deployment of funds

While asset allocation strategies will need to meet the Shari'a standards or principles, Islamic banks are able to imitate their conventional counterparts in a wide range of commercial and investment banking activities.



While there is a range of products available in the marketplace, following are some common ones.

Mudaraba: The *Mudaraba* concept described earlier in the context of raising funds is also used for deploying funds, whereby an Islamic bank could invest its funds with other Islamic banks under *Mudaraba* arrangements.

Musharaka financing: Islamic banks often use this vehicle in participating in a private equity venture where the bank is an investor or a 'financier'. The bank may or may not actively participate in the operating policies of the investee

company. In a 'diminishing *Musharaka*' contract, invested capital is redeemed as and when the underlying assets are realised over the period of the joint venture.

Murabaha: In a *Murabaha* transaction, a bank provides financing to its clients through a mechanism of purchase and simultaneous sale of commodity/goods with deferred repayment terms. The difference between the purchase and the sale price is the profit to the bank. The bank does not assume any risk in respect of the underlying commodity/goods through this purchase and sale. The residual risk to Islamic banks is merely the credit risk in relation to its client.

Islamic banks are able to use this mechanism to provide liquidity to or place excess liquidity with the counterpart.

Istisna: In an *Istisna* transaction, the Islamic bank finances the construction of property, equipment etc. in a mechanism which is not too different from a *Murabaha* transaction.

Ijara: *Ijara* is the equivalent of a leasing transaction. All leases are however structured as 'operating leases' in view of the restriction in using pure finance-type leases. Here the bank buys capital equipment or property and leases it out under instalment plans to end-users. As in conventional leasing there may be an option to buy the goods at the end of the *Ijara* built in to the contracts – *Ijara-wa-iqtina*. The instalments consist of rental for use and part-payment.

The customer selects the asset to be financed and the bank then purchases it from the supplier and leases it to the customer for an agreed period. Re-financing of assets owned by the client in a sale and leaseback arrangement is allowed under certain circumstances. The bank, being the owner of the asset, is paid rent, fixed or variable as agreed by the parties. The rental amount is often linked to Libor.

Shari'a compliant financial services – standing its ground continued...

The bank must exercise all the lessor's rights and obligations such as maintenance, insurance and repair. The lessee gets the use of the asset for the period of the lease subject to payment of the rent. The lessee may assume the obligations such as maintenance, for example, for a reduced rent.

In some cases (known as *Ijara-wa-iqtina*), there is an option on the part of the customer to buy the asset at the end of the lease term, at a pre-agreed price.

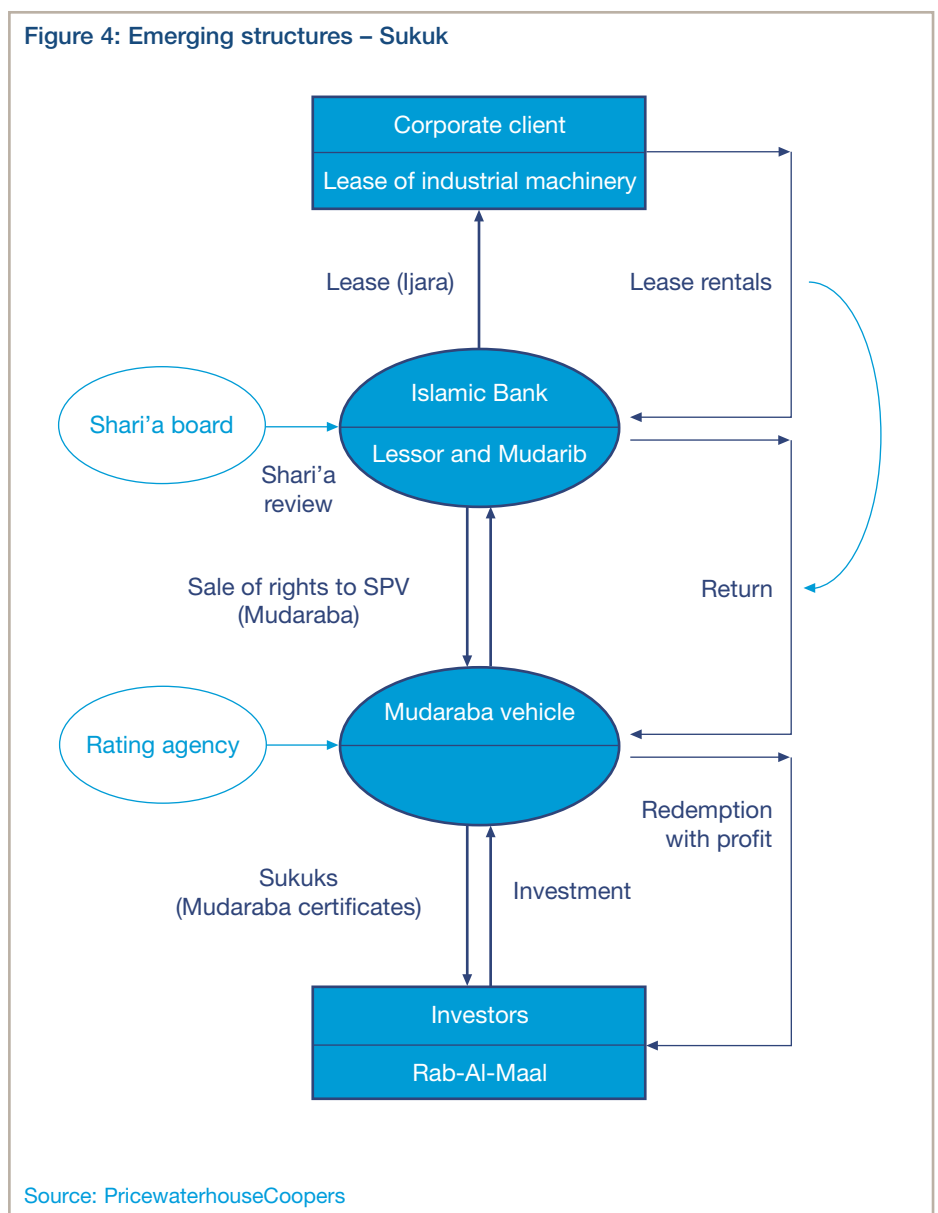
Mortgage banking

Islamic banks meet mortgage finance requirements normally by using the '*Ijara Munthahia Bitamleek*' or *Ijara-wa-iqtina* models, (similar to a finance lease). Mortgage banking is a key area of focus in several markets, including Malaysia, and for banks which want to operate in Europe in areas where there is a significant Muslim population.

Emerging structures – Sukuk

In a combination structure in the illustration opposite, the bank is able to match the needs of a wide range of clients – as an intermediary, acting as the *Mudarib* or manager for the fund in a *Mudaraba* vehicle, the bank issues *Sukuk* or *Mudaraba* certificates to private banking/corporate clients for a return in

Figure 4: Emerging structures – Sukuk



Source: PricewaterhouseCoopers



the form of profits linked to underlying assets owned by the vehicle.

In products structured by Islamic banks, the counterparties could be conventional enterprises, subject to some conditions of course; and this allows greater flexibility in their dealings.

The illustration opposite describes how an Islamic bank acting as an intermediary raises funds through its special purpose vehicle (*Mudaraba* Fund) from investors who are issued *Sukuk* using a *Mudaraba* instrument for providing lease facility to its corporate client which wishes to lease industrial equipment under the *Ijara Muntahia Bitamleek* instrument. The lease rentals received are used to redeem the *Sukuk* after collecting management fees.

Takaful (Insurance)

One of the ways to reduce the risk of loss due to misfortunes is through insurance. The concept of insurance where resources are pooled to help the needy does not contradict Shari'a, and Islamic banks are increasingly involved in the development of this business.

The Takaful concept is in line with the principles of compensation and shared responsibilities among the community. It is not a new concept; in fact it was

Takaful is an Arabic word meaning 'guaranteeing each other' or joint guarantee.

The principles of Takaful insurance are as follows:

- Policyholders cooperate among themselves for their common good.
- Every policyholder pays his subscription to help those that need assistance.
- Losses are divided and liabilities spread according to a community pooling system.
- Uncertainty is eliminated in respect of predetermined subscription and variable compensation.

practised by the *Muhajrin* (refugees) of Mecca and the *Ansar* (residents) of Medina following the *hijra* (migration) of the prophet over 1,400 years ago. It is generally accepted by Muslim Jurists that the operation of conventional insurance as transacted in most financial markets currently does not conform to the rules and requirements of the Shari'a.

Conventional insurance involves the elements of uncertainty (*Al-gharar*) in the contract of insurance, gambling (*Al-maisir*) as the consequences of the

presence of uncertainty and interest (*Al-riba*) in the investment activities of the conventional insurance companies which contravene the rules of Shari'a. *Takaful* is an alternative form of cover which a Muslim can use to protect himself against the risk of loss due to misfortunes.

And what about derivatives?

Islamic financial institutions are, generally, unable to arrange or deal in traditional derivatives, either because the derivative financial instruments have an inherent interest element or because they are speculative in nature. Nevertheless, some Shari'a scholars have allowed the use by banks of some derivatives. A purchased put option transaction in respect of an equity security that is held by the bank (covered put), for instance, has been allowed. One of the current debates surrounds the use of Islamic Rate Swaps (IRS) to allow returns from one source to be swapped for returns from another source. For example, in the illustration earlier, the fixed lease rentals may be exchanged for profit receivable from a *Mudaraba* which has short-term assets, say, a *Murabaha* portfolio.

Call for a transparent Shari'a compliance process

Unlike conventional institutions (which normally have predominantly profit driven

Shari'a compliant financial services – standing its ground continued...

aims), Islamic banks exist to conduct their commercial activity in accordance with the precepts of the Islamic Shari'a.

Shari'a compliance is achieved principally through the mechanism of a separate 'Shari'a supervisory board', which has the responsibility of laying down the underpinning Shari'a principles and rules that the institution should adhere to. The Shari'a supervisory boards, typically, also advise on any issues surrounding new products, or new structures and have a responsibility to report, at year-end, on satisfactory Shari'a compliance by their associated institutions. Such boards reassure themselves as to proper adherence to the principles and rules laid down through a process of internal and external Shari'a reviews. Effectiveness of Shari'a compliance will depend on transparent interactions between the Shari'a supervisory board or its members and management. Examples of the typical concerns facing banks, their boards and their counterparts are as follows:

- Clarity in the definition of respective roles and responsibilities of members of the general board, management, Shari'a supervisory boards, internal and external Shari'a reviewers and auditors, insofar as Shari'a compliance is concerned; and

- Timely interaction or appropriate communication of matters concerning new products or transaction structures by managements to the Shari'a supervisory boards and so on.

Although the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI), the accounting, auditing and governance standards setter, has issued four governance standards in the area of Shari'a compliance with a view to harmonising the governance practices in this area, they do not cover all aspects of governance and, moreover, few countries have fully adopted its standards. Furthermore, current practices amongst Islamic banks vary even in countries where the AAOIFI standards are used.

For the industry to have the desired added credibility, it is important that standards are established to ensure there is a transparent Shari'a compliant process to remove any ambiguity with regard to the respective roles of boards, management, internal or external Shari'a reviewers, internal or external auditors and regulators.

Conventional investor and Shari'a compliant products

What should be a conventional investor be aware of in dealing with Shari'a

compliant products? It is important to recognise that risks transferred to a client by an Islamic bank on financial products that often appear to be much the same as those offered by conventional banks are not comparable with those transferred by its conventional counterparts.

A predominant portion of funds invested by conventional investors is based on the *Sukuk* or the *Mudaraba* concepts. This would necessarily mean that more often than not, the investor is exposed to risks of the underlying transaction/assets as opposed to a mere counterparty risk. In other words, while a savings depositor in a conventional bank is only exposed to the counterparty risk of the bank he/she is dealing with, a savings accountholder in an Islamic bank normally (signing a *Mudaraba* contract) will be exposed to the risks underlying the assets created with funds he/she has provided. At least this is the legal position. In practice, however, many banks do not necessarily pass on the losses relating to attributable assets to their accountholders due to their desire to retain their clients. The potential risk the bank is exposed to in managing *mudaraba* accounts is that it may have to compensate its clients for losses legally not its own. This has been termed by AAOIFI in its statement on capital adequacy as 'displaced commercial risk'.



In a *Sukuk* transaction, the investor's position is similar to that of a debt holder in a conventional collateralised asset obligation programme. The *sukukholder* takes on the risk of the associated assets rather than of the bank/intermediary issuing or selling *sukuk*.

Generally, in other finance-based contracts such as *Murabaha*, *Istisna* and *Ijara* contracts, however, the risk taken on by counterparts is generally the counterparty risk. Legal and operational risks are perhaps higher at the contract signing stages in view of the nature of the structure of transactions – there is often a sale and a parallel purchase in many contracts. It is important to ensure that legal implications of a contract do properly match the commercial intent of the transactions.

Challenges facing Shari'a compliant banks

While Islamic banks have provided their customers with a number of Shari'a compliant alternatives, they face several challenges in the marketplace in addition to those that conventional banks face.

For example:

- There is no single, global Islam-wide authority that determines what is *Hallal* (acceptable) and what is *Heram* (prohibited) and there is a danger that some will go around 'opinion-hunting' to get Islamic approval for their schemes.
- There is a lack of uniformity in the religious principles applied in Islamic countries. In the absence of a universally accepted central religious authority, Islamic banks have formed their own religious boards for guidance. Islamic banks have to consult their respective religious boards, or Shari'a advisors, to seek approval for each new instrument. Differences in interpretation of Islamic principles by different schools of thought may mean that identical financial instruments are rejected by one board but accepted by another. Thus, the same instrument may not be acceptable in all countries. This problem could be addressed by forming a uniform council representing different schools of thought to define cohesive rules and to expedite the process of introducing new products.
- A potential shortage of scholars with the right combination of knowledge of Islamic law and modern finance to serve on the Shari'a committees of institutions (as reported in the *New York Times* in February 2005).
- Islamic banks have difficulty managing their excess liquid funds in view of lack of an active Shari'a compliant inter-bank money market.
- The sale/purchase format of several products causes double taxation in the form of transaction taxes, stamp duties, etc. in many countries. For example, only now in 2005 have the tax inequalities between Shari'a and equivalent conventional transactions and financing arrangements been addressed by the UK tax authorities.
- The legal definitions and the substance underlying the products are not always understood by local law courts, and more so in non-Muslim countries. Issues arise too where a transaction goes wrong, and the application of Shari'a and national secular law produce different outcomes.
- The regulatory frameworks in many countries hinder or reject Shari'a compliant banking concepts, inhibiting cross-border activities.
- Clients have also tended to take advantage of the interpretations of the contracts in their favour in some situations. In particular, there is often a lack of clarity on the outcome when a client defaults on or significantly delays payment in terms of how the bank is compensated for this loss of revenue.
- Hedging currency, fair value or profit volatility exposures are not easily achieved in the absence of Shari'a compatible derivative instruments.

Shari'a compliant financial services – standing its ground continued...

- Conventional banks who are also able to compete with similar Shari'a compliant products through their special subsidiaries, branches or 'windows' are sometimes better placed than Islamic banks in view of the infrastructure and the accessibility to more sophisticated operational risk management as well as marketing tools.
- The capital markets are currently geared to cater to conventional banking activities.
- There is no single, sizeable, and organised financial centre that can claim to be functioning fully in accordance with Islamic principles. Although stock markets in emerging Islamic countries such as Egypt, Jordan, and Pakistan are active, they are not fully compatible with Islamic principles. The stock markets in Iran and Sudan may come closest to operating in compliance with Islamic principles. Moreover, the secondary market for Islamic products is extremely shallow and illiquid, and money markets are almost non-existent since viable instruments are not currently available.

Looking ahead

Looking ahead more work needs to be done in building a robust financial market for the Islamic financial services participants. The following are key issues:

- The business models need further refinement to compete with the more sophisticated conventional banks;
- There is a need for more uniformity in commercial practices;
- More work needs to be done in the area of public disclosures (market discipline and transparency), to allow customers to understand the returns and 'residual risks' in the various Shari'a compliant transactions; and
- Supervisory frameworks will need to be re-evaluated and aligned with supervisory risks posed by these specialised products and institutions.

Conclusion

The formulation of standards for the regulation of Islamic finance is proceeding in leaps and bounds. The General Council for Islamic Banks and Financial Institutions (GCIBFI) and the role of the Islamic Development Bank and its member banks, as well as the work done by AAOIFI, are central to this. The Islamic Financial Services Board (IFSB) has firmly established itself as a regulatory and supervisory standard-setting organisation for the industry in the two years since its foundation. In March 2005, IFSB issued an exposure draft of the Capital Adequacy Standard for Institutions (other than insurance institutions) offering only Islamic financial services. The best practice standards it is preparing in other areas such as risk management, corporate governance, disclosures and transparency are awaited with interest by the industry and supervisors alike.

The development of standards specific to the needs of Islamic finance is taking place within the process of convergence in global financial standards generally. In practical terms, it signals the growing maturity of the market, and will help to bolster investor confidence, and thereby promote the growth of business.



PricewaterhouseCoopers' Islamic financial services offering

PricewaterhouseCoopers has served the evolving Islamic Financial Services industry since its beginnings. We have played an important role in developing the focus of the business models of some of these banks as well as assisting in the development of standards for governance, accounting and regulation, supporting the efforts of both the industry players as well as regulators and standards-setting bodies such as AAOIFI and IFSB.

We have dedicated teams in the primary Islamic financial services centres, including, Amsterdam, Bahrain, Beirut, Cairo, Dubai, Frankfurt, Karachi, Kuala Lumpur, London, Riyadh, Singapore, New York and Washington DC.

These efforts were well recognised when EuroMoney decided to award PricewaterhouseCoopers the 'Islamic Assurance Advisory Services Award' for 2003.

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New challenges for central banks



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