

Banking & Capital Markets

# The Journal

Global perspectives on challenges and opportunities\*

September 2007










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# Editor's comments





**Thomas Pirollo**

Editor-in-chief  
PricewaterhouseCoopers  
(United States)  
Tel: 1 646 471 3790  
[thomas.pirollo@us.pwc.com](mailto:thomas.pirollo@us.pwc.com)



**James Hewer**

Editor  
PricewaterhouseCoopers  
(United Kingdom)  
Tel: 44 20 7804 9605  
[james.hewer@uk.pwc.com](mailto:james.hewer@uk.pwc.com)

Welcome to the September 2007 edition of The Journal. In this edition, we have brought together a diverse range of articles which address some of the global issues facing organisations operating in the evolving and challenging environment that is today's banking and capital markets industry.

Financial institutions have devoted considerable time and resources to risk management over the past few years, often in response to regulatory initiatives such as Basel II and Sarbanes-Oxley. But how effective is the risk management function at actually adding value to the business? In our opening article entitled, 'Getting value from risk management in a post-Basel world', Miles Kennedy, Dante Peel and Charles Beach analyse the findings of a recent survey, 'Creating Value: Effective risk management in financial services', conducted by PricewaterhouseCoopers<sup>1</sup> in conjunction with the Economist Intelligence Unit, and find indication of a new and exciting agenda for risk management.

Moving on to look at M&A activity, 2006 proved to be a strong year within the European banking industry. In this article, Nick Page and Shaun McNamee shed some light on the common themes

behind the deal activity in 2006 and the possible future drivers of M&A in the European banking sector, raising a number of questions that they consider topical for the sector over the next 12-24 months.

In our next article, Richard Thompson, Daniel Knüsel and Steve Davies examine the borrowing habits in Europe, North America and Asia and look at what lessons lenders in less developed markets could learn from the US and UK experiences. With the consumer credit markets outside the UK and US often touted as growth opportunities for lenders, is the UK and US 'buy now pay later' culture really that infectious?

Looking to Asia, China is currently, and will continue to be, a key market for many banks. Those doing business in China need to understand and appreciate the challenges of operating in the Chinese financial services market. Tim Pagett and Harjeet Baura share their perspectives and insights to this unique market in the article 'Taming the leviathan: Governance and risk management in Chinese banking'.

An equally exciting, but also challenging opportunity exists for foreign banks operating in India, one of the fastest

growing global economies. In the article 'Indian banking: An exciting but challenging opportunity', Jairai Purandare and Radhakishan Rawal explore some of the specific challenges which banks face, and what they need to understand in order to operate successfully in India.

In our final article, we look at the increasing complexity in accounting rules and their implications on risk management. Accounting risk, just like any other risk an institution faces, needs to be managed effectively and efficiently. Organisations need to ensure they have adequate resources and controls in place to allow them to address accounting risk. James Hewer and Craig Stafford look at the current market practice and key challenges which organisations need to address in 'Accounting Risk Management: the missing piece in the risk management jigsaw?'

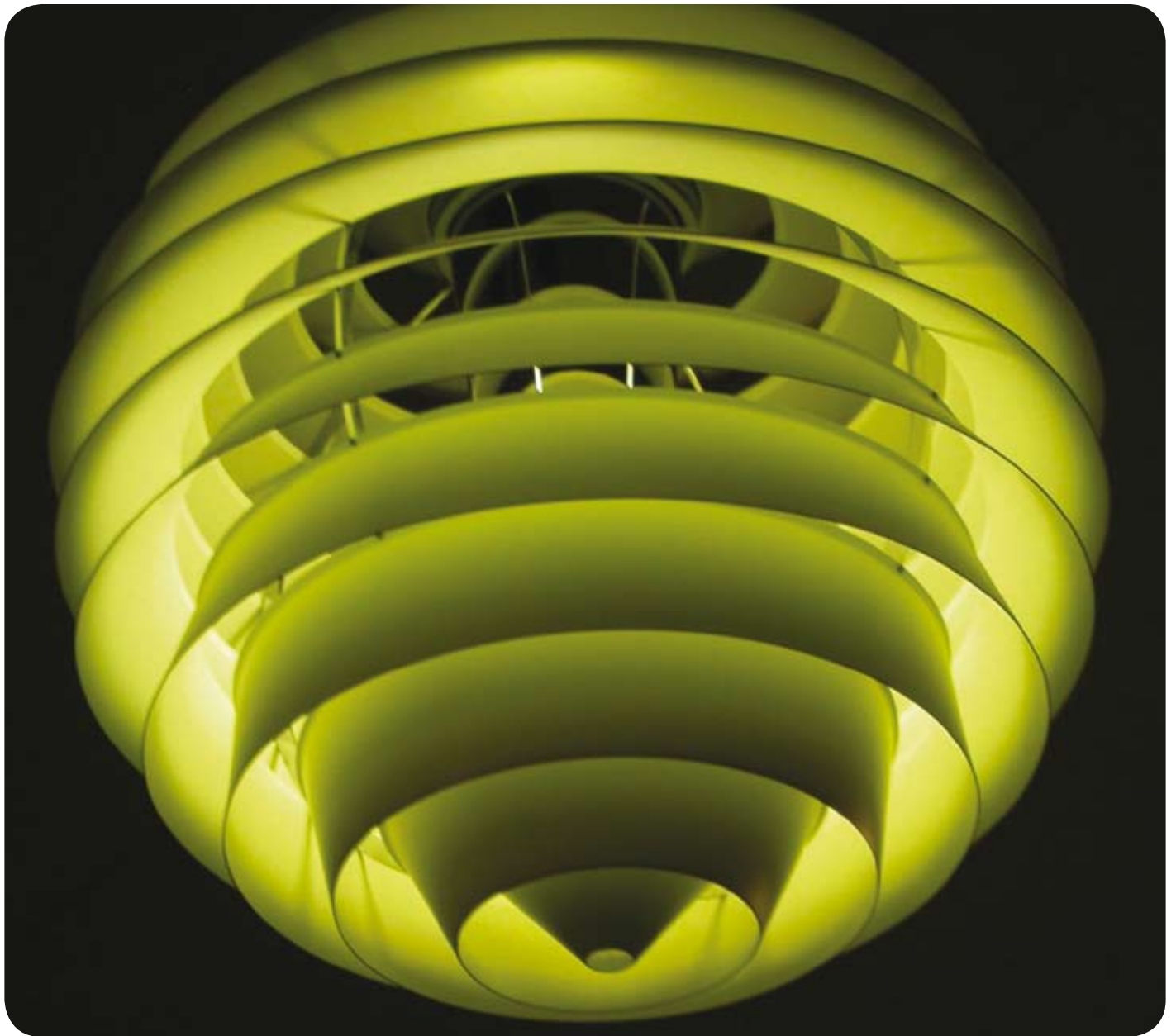
We hope you find this edition of The Journal of interest. Please do continue to provide us with feedback on the topics you would like to see addressed in future editions. Online copies of this edition can be found at [www.pwc.com/banking](http://www.pwc.com/banking).

<sup>1</sup> 'PricewaterhouseCoopers' refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.

# Business risk management: Getting value from risk management in a post-Basel world

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by Dante Peel, Charles Beach and Miles Kennedy





**Dante Peel**

Partner  
PricewaterhouseCoopers  
(Australia)  
Tel: 61 38603 2018  
dante.peel@au.pwc.com



**Charles Beach**

Director  
PricewaterhouseCoopers  
(United Kingdom)  
Tel: 44 777 623 1459  
charles.beach@uk.pwc.com



**Miles Kennedy**

Partner  
PricewaterhouseCoopers  
(United Kingdom)  
Tel: 44 20 7212 4440  
miles.x.kennedy@uk.pwc.com

The risk management agenda is about to undergo a major shift in focus. For the last few years, financial institutions have been anticipating, planning and, more recently, implementing processes and frameworks to comply with Basel II. Given this period of extensive change the agenda for risk management has been dominated by the changing regulatory capital requirements. However, it has to be remembered that risk management is not just about satisfying regulatory obligations or minimising the regulatory capital burden. It is about creating value in an uncertain world by reducing the probability/impact of losses and increasing the probability/impact of gains. In short, it is a fundamental part of running a business well. Accordingly, with the majority of the regulatory capital work now behind them, banks are eager to regain control of the risk management agenda, with the aim of transforming risk management into a more strategic, business-oriented and value-added function. This comes through strongly in a recent global survey of over 400 financial services firms.<sup>1</sup>

The survey identifies the outline of a redefined agenda whereby banks expect that increasing the value of risk management to the business will be the key driver to future change.

**Risk management ‘state of the nation’**

In essence, the PwC/EIU survey shows that, while the profile of risk management has been elevated by the likes of Basel II and Sarbanes-Oxley, the discipline arguably remains neglected in many ways. The current limitations, it surmises, include: a bias towards regulatory, as opposed to commercial, objectives and activities; a disconnect between the risks that are most pressing and those which are managed most effectively; and a lack of engagement of risk specialists on the part of front-line businesses.

Some of the more startling findings include the following:

- Despite very considerable investment in risk data, systems and processes in recent years, only 50% of the risk managers in the survey (23% of others) believe the risk function contributes substantially more value that it did three years ago.

- Fewer than one in ten of the survey respondents believe that risk management is ‘very effective’ at enabling managers to make better business decisions.

- To the question ‘In what ways does effective risk management confer competitive advantage on your organisation?’ the stand-out response was that it leads to a better relationship with regulators ... significantly ahead of other choices, such as leading to a better reputation with customers and an ability to improve returns relative to risks taken.

- To the question ‘In which ... business processes does your organisation include a structured assessment of risk?’ alarmingly few respondents selected the following: strategy development (46%); budgeting and financial reporting (40%); setting prices (37%); process and performance improvement (28%); and the assessment of business unit performance (28%).

<sup>1</sup> Creating value: Effective risk management in financial services. Published by PricewaterhouseCoopers in conjunction with the Economist Intelligence Unit (EIU) in March 2007. The full survey is available at [www.pwc.com/financialservices](http://www.pwc.com/financialservices)

# Business risk management: Getting value from risk management in a post-Basel world continued

How could this have arisen? Could it be, as the survey suggests, that the heavily regulated environment in financial services has inadvertently led to the evolution of a risk management mini-industry with the regulator as its primary customer and with precious little involvement with or engagement by front-line businesses? On the other hand, is it fair to pin all the blame on regulations for this state of affairs, or is there culpability on the part of the firms themselves?

After all, if there is as much untapped potential for risk management to add value as the survey seems to suggest, then both business units and risk functions should be clamouring for the resources and permission to realise that potential. The argument that such initiatives are being crowded out by relentless regulation only goes so far and, to their credit, the regulators seem to be pointing the way even on this point – witness their emphasis on applying the ‘use test’ criteria as part of the capital adequacy evaluation process. Regulators might justifiably claim that they are merely filling the void.

On a more encouraging note, however, the survey also contains evidence of an acknowledgement that the situation is not as it should be, and a resolve to do something about it. So what has industry resolved?

## A new agenda

On this point, the survey asks two related questions: ‘What have been the major drivers of change in your organisation’s risk management priorities over the past three years?’; and ‘What do you think will be the major drivers of change in your organisation’s risk management priorities over the next three years?’. The differences in how these questions were answered tell the story. In particular, regulatory pressure, though still topping the poll, is expected to have a significantly diminished influence.<sup>2</sup> In its place, we see the emergence of a wider set of business drivers (some of which have barely registered before) such as the aim of increasing the value of risk management to the business;<sup>3</sup> financial market volatility;<sup>4</sup> securing competitive advantage over competitors;<sup>5</sup> maintaining

customer satisfaction and minimising churn;<sup>6</sup> and an increased focus on risks pertaining to people and behaviour.<sup>7</sup>

So, how will these drivers manifest themselves, and what, accordingly, should firms be planning to do in anticipation? The survey again provides a clue. To the question ‘What would need to change in order for the risk function to add greater value to the business?’ respondents marked out the following, in diminishing order, as key factors:

- Make risk a more strategic function (66%)

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- Embed risk management processes and people more deeply into the line of business (61%)

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- Define risk appetite more clearly (54%)

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- More effective cross-functional coordination (47%).

<sup>2</sup> Down from 67% to 55% of respondents placing it in the top three.

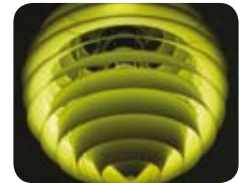
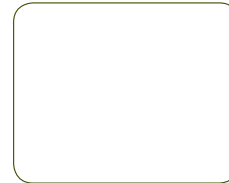
<sup>3</sup> Up from 18% to 27% of respondents placing it in the top three.

<sup>4</sup> Up from 24% to 28% of respondents placing it in the top three.

<sup>5</sup> Up from 12% to 16% of respondents placing it in the top three.

<sup>6</sup> Up from 4% to 8% of respondents placing it in the top three.

<sup>7</sup> Up from 5% to 8% of respondents placing it in the top three.

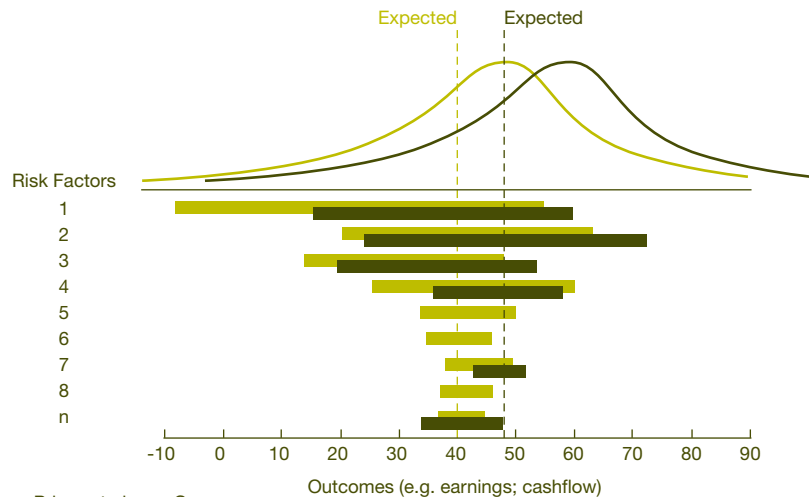


## Value-adding risk management

So if this defines the new agenda, what happens next? What does it actually mean, for example, for risk to be a more strategic function?

An obvious place to start is to have the risk function (or risk expertise anyway) more actively involved in the strategy formulation process. Although it is fair to say that many firms do this to some degree, for most, strategy formulation is essentially a deterministic process<sup>8</sup> and any involvement from the risk function tends to come after the main decisions have already been taken. To the extent that there is any consideration of risks at the strategy formulation stage, it tends to take the form of a largely intuitive evaluation by a handful of senior executives. For example, it is doubtful whether the commercial and financial goals which are established as part of strategy, and which underpin decisions to commit investment funds and other scarce resources, are in any sense adjusted for risk.<sup>9</sup> Equally, it is doubtful whether, as part of this, the key risks arising are identified for the purposes of feeding into the strategy execution plan in some way (i.e. forming the basis of a *risk management strategy*).

Figure 1



Source: PricewaterhouseCoopers

Specifically, what the process seems to lack is a structured, quantitative analysis of the probability and impact of key business scenarios<sup>10</sup> to support strategic decisions and to form the basis of an accompanying risk management strategy.

Some financial institutions are starting to address this. For example, one major UK institution has recently adopted a 'Strategic Risk Management' framework which ties the finance, risk and business communities into one integrated business planning process under a unifying concept of risk appetite. Another bancassurance firm is using a strategic

risk appetite framework as a means of putting its banking and insurance businesses onto the same performance management platform.

One way to conceptualise this, as illustrated in Figure 1, is to plot the firm's risk profile as a probability distribution of (say) earnings over a defined period, and a 'tornado diagram' which ranks key risk factors in terms of their potential earnings impact. A key feature of risk of course is that it can be selected and managed in such a way as to modify the expected earnings outcome, as illustrated by the darker bars. This provides the basis for

<sup>8</sup> i.e. based on 'point estimates' of the future values of key business drivers.

<sup>9</sup> Do they, for example, represent the 'expected' case (mean), most likely case (mode) or something more optimistic?

<sup>10</sup> In terms of financial variables, market events, customer behaviours, competitor actions - wherever there is uncertainty.

# Business risk management: Getting value from risk management in a post-Basel world continued

the selection and proactive management of key risks in accordance with where there is greatest scope to add value. For example, some risks are inherently more amenable to influence (in terms of probability or impact) than others; some risks might be considered to align better with particular management competencies than others; or they may be subject to a strong management view. This all contributes to a far richer definition of the organisation's risk appetite, and hence a better basis for strategy selection and ongoing risk management.

In practice, this sort of ex-ante strategic input could result in some fundamental changes to the business planning process, whereby, for example, instead of being rendered as a single column of numbers against particular line items such as earnings, P&L, EPS etc., business units and the organisation overall are challenged to also define:

- Potential upside and downside outcomes with respect to those line items;
- Key risk factors driving those outcomes;
- Key assumptions, and the rationale for any view being taken, in relation to these factors; and

Figure 2

Business plan 200X (Division A)				Key risk factors	Key assumptions	Risk strategies
	Low (P10)	Expected	High (P90)			
Profit & Loss	X	X	X	• XXXXX	• XXXXX	• XXXXX
Balance Sheet	X	X	X	• XXXXX	• XXXXX	• XXXXX
Cashflow	X	X	X	• XXXXX	• XXXXX	• XXXXX
EPS	X	X	X	• XXXXX	• XXXXX	• XXXXX
Economic Profit	X	X	X	• XXXXX	• XXXXX	• XXXXX

Source: PricewaterhouseCoopers

- The key risk management strategies that will be deployed.

This is illustrated in Figure 2 above.

In summary, embedding an appraisal and supporting analysis of risk in strategy formulation provides the key to:

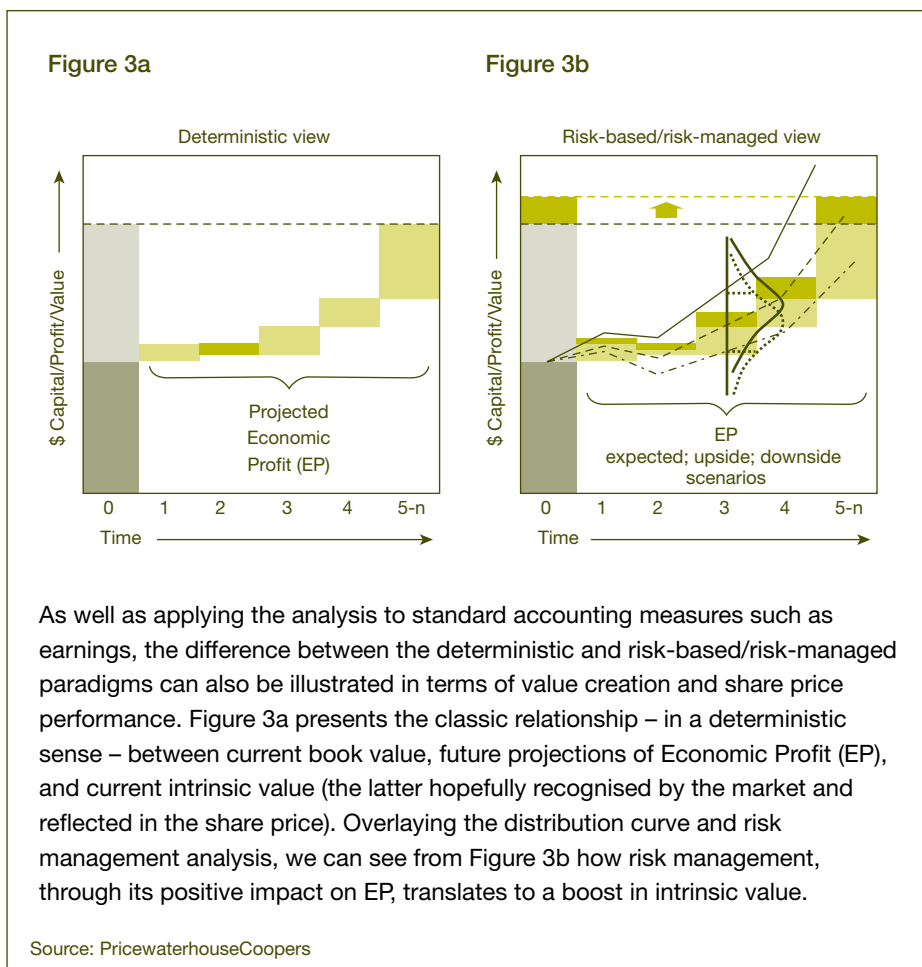
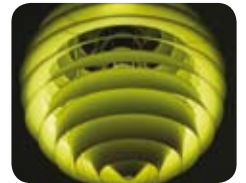
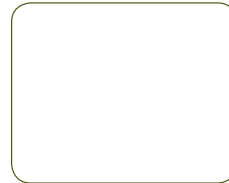
- Establishing a clear link between risk, expected earnings and shareholder value;
- Identifying where, at the strategic level, risk management intervention may boost expected earnings by altering the probability or impact of business risk events (both upside or downside);

- Establishing a clear link between corporate strategy and risk appetite, both in terms of the level of tolerance for downside events of varying degrees of severity, and the desirability of exposure to particular risk types;

- Linking corporate and financial strategies in terms of, for example, investment budgeting, dividend policy, investor relations, target setting and capital planning (all areas where risk has a bearing);

- Placing a value on, and establishing a means to manage (create, trade, exercise etc.) 'real options' at the strategic level; and

- Providing robust and timely support to major investment/divestment decisions.



business decisions are taken in the face of some degree of uncertainty. That is, just about everywhere.

This is where (to quote the survey again) the concept of ‘embedding risk management processes and people more deeply into the lines of business’ comes in. There is a close analogy here with the evolution that has occurred in finance. To get a sense of what embedding risk management might look like, consider the way financial management processes and people have found their way into the fabric of line businesses over the last decade or so. Once upon a time, to put it crudely, finance was something that the Finance Department did while everyone else got on with the business of making and shifting product. Organisation structures were segmented on process and functional lines. Over time, this business model has changed to one which is now dominated by profit centres, cost centres, shared service centres, insourcing, outsourcing and the like. With this, line managers and their staff teams have become accountable primarily in financial terms and, as a result, have become much more financially literate than they once were. The corollary to this is that the primary accountability for financial management has passed to business units, while the role of the finance function has evolved into more

These are all areas where it would be beneficial to tap into the abundant risk expertise which is so often tied up in regulatory compliance and various forms of ‘downstream’ activity such as limit setting, risk monitoring and

reporting, and due diligence. Of course the value in bringing risk expertise upstream is not confined to the executive offices where the really big bets are placed. It arises wherever risk is effectively originated and/or where

## Business risk management: Getting value from risk management in a post-Basel world continued

of a specialist support function and strategic partner to the business, albeit with an ongoing responsibility to lead the external reporting side and to exercise an appropriate degree of financial oversight.

The risk function is ripe for a similar transformation, whereby:

- Business unit accountabilities are extended to encompass risk management;
- Business unit staff and management are encouraged to become proficient in risk management disciplines; and
- The role of the risk function adapts to that of a specialist support function, albeit with ongoing responsibility to represent the organisation to the external world on risk matters, and to exercise an appropriate degree of risk control.

### Accountability and transparency

In terms of how to bring this about, a lot has been written and said about the role of Economic Capital frameworks in driving risk accountability into business units. Although it is undeniably important to drive accountability for *capital usage* into business units, which Economic Capital does very well, capital usage is only one of the many things that business unit managers should think about in taking and managing risk. In particular, risk should be considered explicitly in terms of how it impacts directly on top-line earnings/cashflows or, for that matter, on any other financial, market or operational indicator in terms of which their performance may be assessed.<sup>11</sup> This, we believe, is key in embedding risk management into business lines.

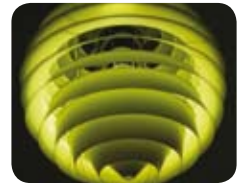
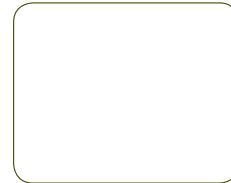
Helpfully, the foundations of an accountability framework to support this already exist in the form of the financial or operational metrics with which we are all familiar. It is by linking risk management directly to these metrics that it is brought to life for people. It makes thinking about risk, and properly evaluating risk as part

of everyday decision-making, an utterly natural thing to do: part of the standard commercial tool kit.

The key, then, is to clarify and make transparent the beneficial or detrimental impact that risks of various kinds can have directly on these metrics. This, in turn, clarifies and makes transparent the ways in which risk management can enhance projected and average actual performance. By asking line managers to drive and own this process as an integral part of the business planning and delivery cycle – with appropriate governance measures and specialist support as required – organisations stand a chance of making risk management a truly embedded and self-sustaining discipline.

So where does this leave the risk function? Apart from looking forward to a future in which its role adapts to that of a specialist support function with streamlined central reporting and oversight responsibilities, the risk function of course has a key part to play in bringing about the transformation by, for example:

<sup>11</sup> e.g. value, market share, reputation, customer satisfaction, staff retention, operational effectiveness, project delivery, compliance etc.



- designing, rolling out, and supporting on an ongoing basis an enhanced business planning, execution and performance evaluation process that explicitly deals with risk;

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- facilitating the incorporation of risk appetite into relevant aspects of business process, governance and behaviours (in areas such as strategic planning, policy setting, limit calibration and portfolio management);

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- embedding and supporting risk specialists within the business lines;

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- conducting training and awareness programmes to build up expertise in foundation risk disciplines (such as statistical analysis, scenario analysis, decision analysis, portfolio theory and option valuation), and providing tailored training in revised business processes and metrics; and

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- Generally working to overcome the barriers to all of this, which include: ongoing regulatory change; legacy attitudes to risk (downside-centric, tedious, restrictive, contrary to

profitability etc.); and inertia (resistance to change, more work, more accountability).

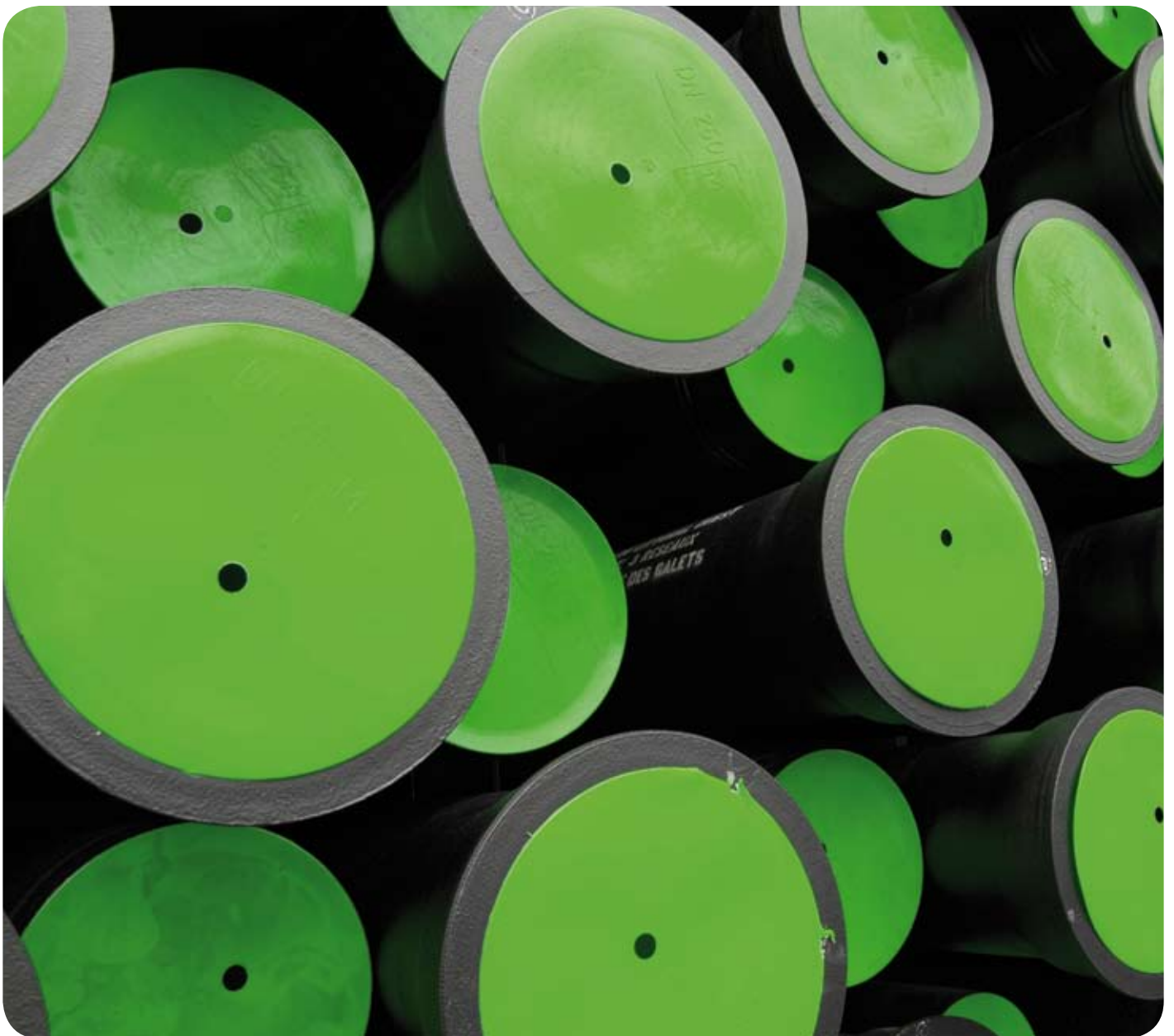
Meanwhile, to invoke the survey's suggestion of greater cross-functional coordination, not only does Risk need to continue to focus on links with the business, but it must also build links with the other support functions. For example, closer integration between Risk and Finance would further their mutual interests in areas such as capital management, planning and performance management.

### Conclusion

The new agenda outlined by the PricewaterhouseCoopers/EIU survey sets out a real challenge for financial services leaders and risk managers alike. It suggests they face a real test in terms of whether the risk management discipline is ready to come of age and become a core part of the commercial curriculum, or whether it has to remain, for now at least, a separate silo of skills and processes deployed largely to keep pace with successive waves of regulatory reform.

# Under the spotlight: European banking M&A activity

12 by Nick Page and Shaun McNamee\*



\*with collaboration from Andrew Mills of the London Valuation & Strategy Financial Services team



**Nick Page**

Partner  
PricewaterhouseCoopers  
(United Kingdom)  
Tel: 44 20 7213 1442  
*nick.r.page@uk.pwc.com*



**Shaun McNamee**

Director  
PricewaterhouseCoopers  
(United Kingdom)  
Tel: 44 20 7213 4139  
*shaun.c.mcnamee@uk.pwc.com*

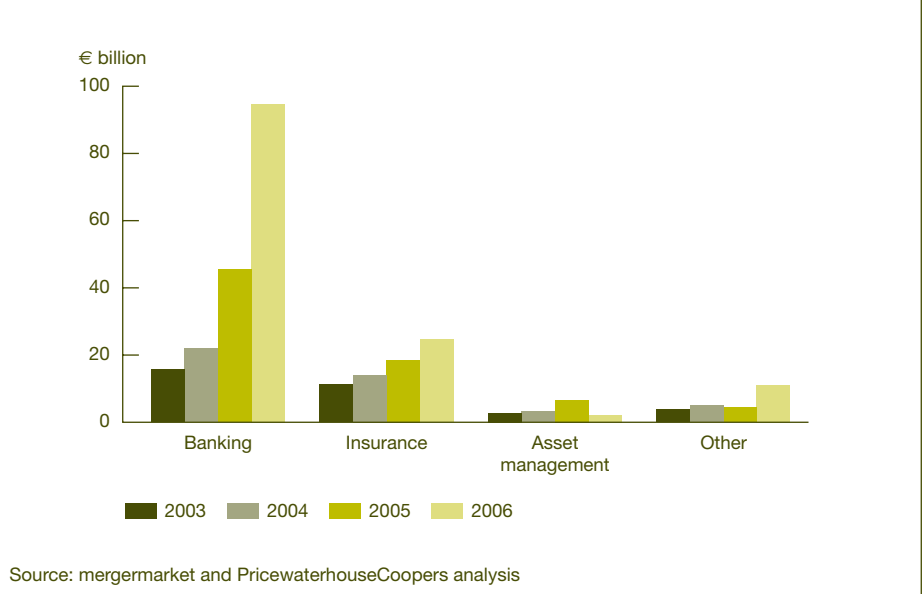
Those who were looking for 2006 to be another strong year in European banking M&A were not disappointed, as total deal values more than doubled on the already high levels seen in 2005. Clearly, while some of the drivers of growth had been anticipated, others proved to be more of a surprise. In this article we hope to shed some light on the themes behind the banking deal activity in 2006 and also to comment on the likely drivers of banking activity in the near future.

In 2006, European banking deal activity<sup>1</sup> increased strongly for the fourth consecutive year, with the total value of banking deals more than doubling in 2006 to €98.5bn, a remarkable growth rate. This performance improved on the already very high growth experienced by the sector in 2005.

Consequently, FS deals represent c.13% of total announced European M&A in 2006, an increase from the 10% reached in 2005, making FS the most active industry for M&A in 2006.

After two years when cross-border transactions represented about two thirds of total deals by value, 2006 put

**Figure 1: European FS deal values by sub-sector, 2003-2006**



domestic transactions back in the spotlight, partly thanks to 2006's largest deal, the merger between Sanpaolo IMI and Banca Intesa in Italy.

With a total value of €76bn, domestic activity was up almost 200% on 2005 levels, representing 56% of overall transactions (by value). Cross-border deals also increased by a more moderate 17% from already high 2005 levels.

Banking was once again the most active financial services sector, with deal values increasing by 109% on 2005 levels to almost €99bn in total, and accounting for 72% of all deals by value (see Figure 1).

<sup>1</sup> Our analysis is of deals announced during 2006 where the target bank is based in Europe and the deal value was reported. The source data was obtained from mergermarket. Mergermarket quotes deals values in euros; mergermarket translates deal value from original currency into euros using exchange rates one day prior to announcement day. We have excluded deals with undisclosed values, deals involving minority stakes of less than 30% and deals which involve the sale of assets rather than equity. This methodology is consistent with that adopted in prior period analysis. Source: mergermarket (www.mergermarket.com) and PricewaterhouseCoopers analysis.

## Under the spotlight: European banking M&A activity continued

The value of announced banking M&A deals grew much faster than those of other financial services sectors such as insurance and asset management. The result of the growth was that banking transactions represented 72% of the value of all financial services deals announced in 2006 on an adjusted basis and, somewhat unsurprisingly

therefore, 15 of the year's largest 20 financial services deals involved banking targets.

A consistent theme in recent years has been an increasing number of cross-border transactions; in 2004 and 2005 approximately two-thirds of deals by value were cross-border. 2006's largest deal,

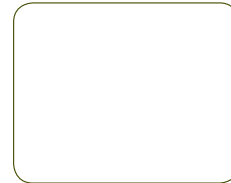
however, was a domestic deal, the merger between Sanpaolo IMI and Banca Intesa in Italy, which brought domestic banking transactions back into focus.

Leaving the domestic deals aside, it is remarkable that 11 of the largest 15 banking deals in 2006 were conducted cross-border (see Figure 2).

Figure 2: Top 15 banking deals announced in Europe in 2006

Rank	Date	Target		Bidder		Value €M
		Bank	Country	Company	Country	
1	Aug-06	Sanpaolo IMI	Italy	Banca Intesa	Italy	29,586
2	Jun-06	Natixis	France	Banque Populaire; Caisse d'Epargne	France	10,000
3	Feb-06	Banca Nazionale del Lavoro	Italy	BNP Paribas	France	9,000
4	Oct-06	Banca Popolare Italiana	Italy	Banco Popolare di Verona e Novara	Italy	8,055
5	Nov-06	Banca Lombarda	Italy	Banche Popolari Unite	Italy	6,087
6	Nov-06	Sampo Bank Group	Finland	Danske Bank	Denmark	4,050
7	Oct-06	Cariparma	Italy	Crédit Agricole	France	3,800
8	Dec-06	BAWAG PSK	Austria	Cerberus; Oesterreichische Post; Generali Vienna; Wuestenrot & Wuerttembergische	USA; Austria; Germany	3,200
9	Jun-06	Emporiki Bank	Greece	Crédit Agricole	France	3,100
10	Apr-06	Finansbank	Turkey	National Bank of Greece	Greece	2,291
11	May-06	Denizbank	Turkey	Dexia	Belgium	1,890
12	Sep-06	Marfin Financial Group	Greece	Laiki Group	Cyprus	1,415
13	Oct-06	Banca Intesa (193 branches)	Italy	Crédit Agricole	France	1,330
15=	Apr-06	HVB Splitska Banka	Croatia	Société Générale	France	1,000
15=	Jul-06	Fiat Auto Financial Services	Italy	Crédit Agricole	France	1,000
<b>Top 15 banking transactions</b>						<b>85,804</b>
Other European financial services transactions						51,070
<b>Total European financial services transactions</b>						<b>136,874</b>

Source: mergermarket and PricewaterhouseCoopers analysis



Half of the top 15 banking transactions involved a target in Italy and 10 of the bidders in the top 15 banking transactions were based in either France (seven) or Italy (three). All of the top 15 banking transactions involved deal values of over €1bn, showing that ever larger deals were being concluded during 2006. By contrast in 2003 there were only four banking deals over €1bn.

### Common themes in banking M&A activity during 2006

**Ongoing drive to build national champions** – In-market consolidation in the banking sector was concentrated in, but was not limited to, Italy. The strategic rationale for the merger between Sanpaolo IMI and Banca Intesa was to create a dominant player within the Italian market that would also be instantly significant on the European stage. Market share statistics suggest Italy has scope for further consolidation; even after the Sanpaolo/Intesa merger the top three banks will only account for a third of all bank branches in Italy.

**Continued development of second home markets** – European banks, the French ones in particular, continued to develop second home markets in search of growth and strategic positioning. The attractions of foreign expansion seemed to be particularly compelling for Crédit Agricole, who announced four of the sector’s 15 largest banking deals in 2006. French banks were not the only players from a European mature market that sought to develop a second home market during 2006. The concept of ‘optionality’ has emerged as a common theme among deals aimed at developing second home markets. The deals show that European banks are not only seeking to diversify and grow, but also to be in a position to participate in any future cross-border consolidation. As an example, Danske Bank’s acquisition of its Finnish counterpart Sampo improved Danske’s ‘strategic positioning and flexibility’.

**Shift in the search for high growth markets from Central and Eastern Europe to South Eastern Europe** – Among cross-border bidders seeking to expand in Europe’s higher growth markets, there was a marked shift from

Central and Eastern Europe (CEE) to South Eastern Europe (SEE). Interestingly, a number of South East European banks themselves became cross-border acquirers. SEE banks increasingly took advantage of strong cash generation and historically high valuations to conduct transactions aimed at improving their own diversification and growth prospects. Two key areas illustrated this theme, most notably the politically sensitive acquisition by National Bank of Greece of the Turkish Finansbank, for e2.3bn, and Cyprus’s Laiki Bank acquisition of Marfin Financial of Greece, for e1.4bn, as part of a three-way combination which also involved Greek bank Egnatia.

**Continued interest from private equity houses, although volumes are down** – Although the large market capitalisation of the financial institutions sector can act as a barrier to PE activity, deals such as the buyout of Austrian bank BAWAG by a consortium led by Cerberus for €3.2bn demonstrate how PE firms continue to shape the European financial services industry, especially among smaller companies and in special situations.

## Under the spotlight: European banking M&A activity continued

### Possible future drivers of M&A in European financial services over the next 12-24 months

#### Will true consolidation ever take place in the German banking sector?

Financial services M&A activity in Germany was modest during 2006, especially in contrast to 2005, when HVB was acquired by Unicredito in the largest European financial services deal of that year. The total announced deal value of €2.4bn for German targets in 2006 certainly looks small at a European level too, representing only 1.7% of European financial services deal activity for the year. There seems little doubt that the German banking market is indeed fragmented by comparison to other European countries. The usual explanation for the low level of concentration is the traditional three pillar structure of the public sector, private sector and cooperative banks which has prevailed in Germany for more than 50 years.

So while there may be some scope for inter-pillar consolidation, it would probably be wiser to predict slow progress rather than dramatic change in the medium term.

#### Are major US buyers interested in Europe or have they moved on to greener pastures?

We feel that the major US banks are more likely to engage in bolt-on deals rather than major M&A in Europe during 2007 and 2008. We believe that the domestic deposit cap restrictions currently imposed on US banks mean that, in the long term, the big US banks will turn to Europe with greater purpose. In the medium term, however, domestic consolidation and the scramble for opportunities in emerging markets outside Europe (with the possible exception of Russia) look likely to continue to dominate their immediate plans.

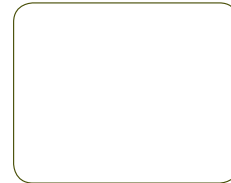
#### Who's best placed to participate in European banking consolidation?

We continue to believe that current activity is part of a wider European banking consolidation trend, but for the most part, large European banks are still conscious of the high execution risks in any M&A and especially in cross-border European banking M&A. Consequently, in the short term, we believe that large-scale, cross-border European banking consolidation will be the exception rather than the rule.

When looking at the top banks in Europe, and conscious of the importance placed on geographic overlap for any European merger, we conclude that there are some large banks that are better placed than others to pursue cross-border M&A. We consider that BNP Paribas, Crédit Agricole and Société Générale (of France) and Unicredito (of Italy) are particularly well positioned to participate in any potential future cross-border tie-up.

#### What are the risks connected to multiple acquisitions and strong price increases in Emerging Europe?

2006 saw significant amounts of interest as well as announced deals in Emerging Europe, with corresponding strong price increases noted. At this stage, we consider that there are parallels between the interest in Emerging Europe and European banks' expansion in Latin America in the late 1990s. With the benefit of hindsight and drawing on the experience of the Latin American expansion, we conclude that some acquirers will struggle to achieve expected profitability and growth ambitions. We also feel that some acquisitions will eventually be reversed, creating opportunities for competitors and/or private equity houses.



### 2007: year to date

Until the announcement of bids for ABN AMRO and Capitalia, 2007 was off to a weak start in banking M&A terms, with only €3.8bn of announced deals to March 2007. By the end of May 2007, however, banking M&A of over €100bn aggregate value had been announced in Europe, topping the figure for the whole of 2006.

The €66bn bid for ABN AMRO by Barclays and the counter-bid from the RBS/Santander/Fortis consortium has dominated headlines since April 2007 and represents the largest cross-border banking deal in Europe to date.

Excluding the battle for ABN AMRO, the top 10 banking M&A deals in Europe to May 2007 were of an aggregate value of €33.1bn, the bulk of which was domestic in nature.

Italian domestic banking transactions formed the bulk of banking M&A, with the proposed €22.1bn acquisition of Capitalia by Unicredit and the proposed €5.6bn acquisition of Banca Popolare dell' Emilia Romagna by Banca Popolare di Milano being announced at the end of May 2007.

Interestingly, UK domestic activity has picked up in 2007, with the €870m acquisition of Egg by Citibank and the €808m acquisition of Lloyds TSB Registrars by Advent International, a private equity firm.

Excluding any eventual cross-border transaction involving ABN AMRO, six of the top 10 transactions were cross border, with the most significant banking deal announced (by size) being the purchase of Bank Sarasin by Rabobank, although this was effectively the final stage of a deal concluded between the parties some time ago. Two of these cross-border deals involved Scandinavian targets being acquired by Icelandic institutions, further re-enforcing the acquisitive nature of the latter.

It would appear, therefore, that the growth in European M&A activity seen in 2005 and 2006 is set to continue in 2007. Time will tell whether this growth will then continue on into 2008 and beyond.

For further reading on European financial services M&A activity, please visit our website. [www.pwc.com/financialservices](http://www.pwc.com/financialservices) to download a copy of 'Financial Services M&A: Going for growth in Europe' (April 2007).

# Global consumer credit: Is the UK and US ‘buy now pay later’ culture infectious?

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by Richard Thompson, Dr Daniel Knüsel and Steve Davies





**Richard Thompson**

Partner  
PricewaterhouseCoopers  
(United Kingdom)  
Tel: 44 20 7213 1185  
*richard.c.thompson@uk.pwc.com*



**Dr Daniel Knüsel**

Partner  
PricewaterhouseCoopers  
(Germany)  
Tel: 49 (0)69 9585 5803  
*daniel.knuesel@de.pwc.com*



**Steve Davies**

Partner  
PricewaterhouseCoopers  
(United States)  
Tel: 1 646 471 4185  
*steve.t.davies@us.pwc.com*

Most observers agree that the consumer credit market in the US and the UK is now mature. Other markets are therefore often touted as growth opportunities for lenders – expecting that borrowing habits will follow those in the UK and the US. Is this really in prospect, and what lessons should be learnt now that the UK and US markets have finally come to a standstill?

**The development of the US and UK consumer credit markets**

Although the UK and US markets have many different characteristics and have both developed in different ways, they have reached more or less the same position in the total level of borrowing.

The total debt of the UK population (secured and unsecured) now totals 104% of gross domestic product (GDP) compared to 92% in the US. For the first time ever, 2005 saw the penetration of consumer credit in the UK economy overtake US levels, with the outstanding level of consumer credit reaching 18% of GDP. This compares to just over 17% in the US and is approximately double the level of the large Eurozone economies. The average UK consumer is now therefore carrying the highest level of unsecured debt in the OECD countries, and probably the world.

This situation is the result of a period during which UK consumer borrowing growth rates exceeded those of the US. In 1999, the outstanding level of consumer credit within the US economy was nearly 17% of GDP, compared to a notably lower UK figure of 12%. Over the next few years US consumer credit penetration increased steadily, reaching a peak of 18.5% in 2002. It has since declined gently, reaching a level of 17.3% in June 2006. During the same period, the previously less-developed UK market grew at a steeper and more sustained rate, reaching its historic high point of 18.1% in 2005 before declining marginally to 17.9% by June 2006.

It is certainly striking that both countries have so far reached very similar peak levels of consumer credit penetration. The idea that consumer borrowing levels might have a ‘natural ceiling’ may be appealing, but is there any reason to believe that the UK will follow a similar profile to that of the US? If the history of secured consumer borrowing in the two countries is any guide, then the answer may be ‘no’. Levels of secured consumer borrowing as a proportion of GDP were nearly identical in the US and UK between 1996 and 2001, but have diverged since 2002. US home mortgage penetration reached 75% in June 2006, but growth in the UK has been more

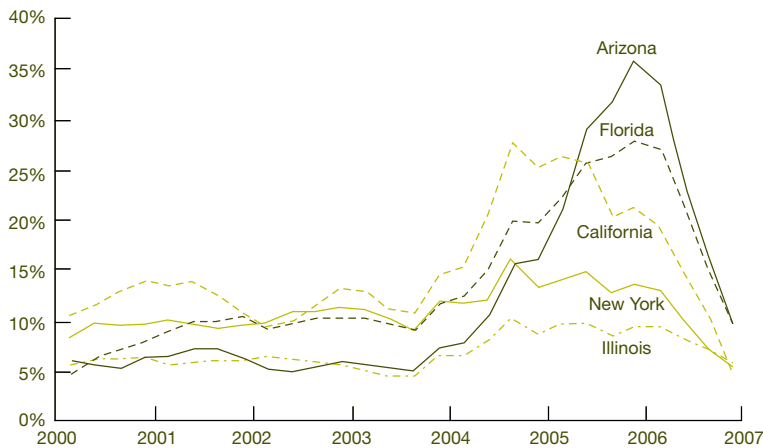
rapid, with the level of consumer mortgage debt reaching 86% of GDP. So while growth patterns in the two countries do seem to exhibit some similarities, it remains to be seen whether the UK consumer credit market will remain at levels similar to those seen in the US, although there is some evidence that the UK market has now reached a natural ceiling.

Over the course of the last 50 years US capital markets have adapted to a consumer culture that is more flexible in the use of credit than other developed countries. The last five years have witnessed a period of sustained low interest rates that, together with a period of sustained increases in house price appreciation, as evidenced for several major states by Figure 1 overleaf, supported a huge wave of mortgage loan refinancings.

As interest rates began to rise, lenders focused increasingly on the non-prime market and other forms of secured lending. When house price appreciation began to fall, as indicated in the graph overleaf, some of the more aggressive non-prime lending practices were exposed to significantly higher rates of default and foreclosure. Consequently, many see the US consumer lending landscape being driven by a form of

# Global consumer credit: Is the UK and US 'buy now pay later' culture infectious? continued

**Figure 1: Year over year price appreciation**

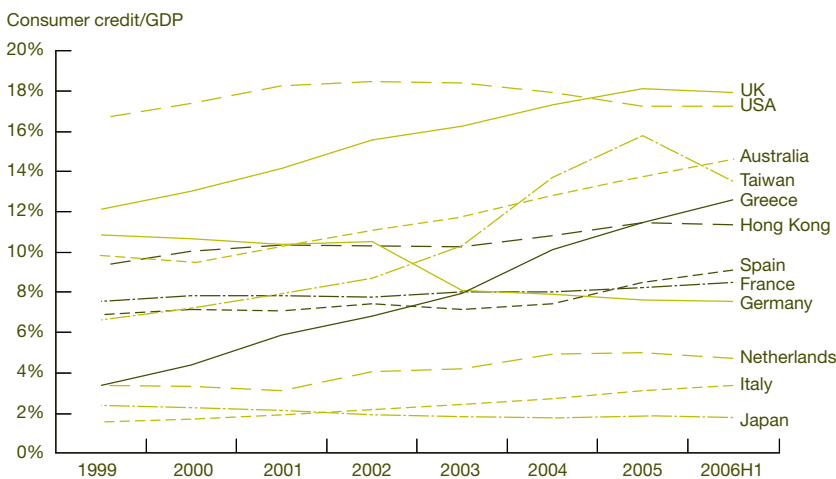


Source: CentralBanks, Eurostat, PricewaterhouseCoopers analysis

correction in the non-prime lending space that has driven capital markets views and appetites for all forms of consumer debt. It is likely that, given the continued declines in house price appreciation and lower housing starts (new home construction), US consumer debt is likely to retrench over the next several years. Analysts and economists are suggesting that we will likely see a return to more normal growth patterns within a two- to three-year period.

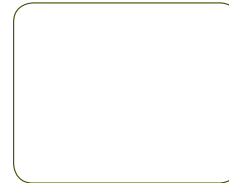
## Most Eurozone countries are not even close to UK and US consumer credit levels

**Figure 2: Consumer credit as a percentage of GDP (%), 1999-2006**



Source: CentralBanks, Eurostat, PricewaterhouseCoopers analysis

The rapid growth in UK consumer credit in recent years means that between 1999 and 2005 British consumers extended their borrowing gap over their major continental European counterparts, contradicting any impression that most European markets have been catching up with the UK. As Figure 2 shows, the proportion of outstanding consumer credit to GDP within European economies has varied considerably since 1999. Greek consumer credit has grown steeply over the past six years, but this trend is the exception to the Eurozone rule and has not been replicated in the larger European economies. After several years of slow growth Spain experienced rapid expansion during 2005 and 2006,



while both France and Italy have seen steady growth from a low base over a number of years. However, consumer credit penetration declined slightly in the Netherlands during 2006, and in Germany unsecured personal borrowing as a percentage of GDP has actually fallen in all but one of the last six years. The end result is that the total amount of consumer credit in the UK economy is now roughly equivalent to that of France and Germany combined.

Given the continuing differences in consumer credit penetration between the UK and the Eurozone, it is natural to ask whether the gap will ever be closed. In the long term, a degree of convergence can probably be expected, if only because UK consumer credit penetration appears to have reached a peak, and consumers in most major European economies clearly have the potential to increase their personal leverage.

### Asian countries show a wide range of consumer credit adoption levels

Among Far Eastern nations, levels of consumer borrowing show even greater variation than within the Eurozone. The Australian consumer credit market has followed a comparable growth rate to that of the UK in recent years, although

coming from a lower base. This is probably not too surprising, considering that the market has experienced strong economic growth and relatively low interest rates during the past few years, with a similar banking industry structure and comparable cultural attitudes to those of the UK. Australian institutions are now beginning to ask whether growth rates will continue and, if so, will consumers become too indebted, leading to significant increases in default rates. Taiwan's consumer credit market is now cooling after experiencing very rapid growth between 2002 and 2005, suggesting again the idea of a natural 'ceiling' to consumer credit penetration levels. Meanwhile the Hong Kong market has been stable, showing only modest growth during the past six years. It is interesting to question whether levels of consumer debt in Hong Kong might have grown faster had the market not undergone a sustained property market downturn during the early years of the decade. Finally, levels of consumer credit penetration in Japan have declined steadily since 1999, the country's experience of deflation having done nothing to overcome a cultural disinclination to use unsecured borrowing.

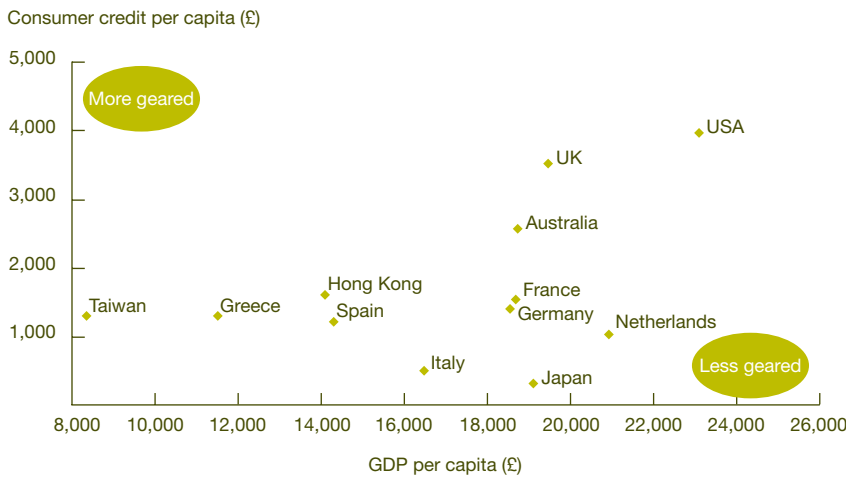
### Which markets offer the greatest growth prospects?

A comparison of consumer credit penetration levels suggests that growth prospects vary widely, and are not always related to the strength of national economies. Figure 3 overleaf shows a country-by-country comparison of consumer credit per capita with GDP per capita; logically, countries with higher levels of GDP might be expected to sustain higher levels of consumer credit. However, the plot of data points provides little evidence of any correlation, implying that cultural factors are probably more important than economic considerations.

Looking first to Europe, in Spain, consumer credit per capita is comparable to that in Germany and France, but is supported by a much lower level of GDP per capita. Despite having a relatively low level of consumer credit per capita, the average consumer in Spain is therefore more highly geared to GDP than his or her counterpart in France or Germany. This reflects the rapid growth in Spanish consumer credit since 2004, which has been driven by negative real interest rates and a generous supply of credit by domestic banks and foreign entrants. As a result, while the Spanish consumer credit market may offer scope for further growth in the short term, the prospects

# Global consumer credit: Is the UK and US ‘buy now pay later’ culture infectious? continued

**Figure 3: Consumer credit per capita versus GDP per capita (£), 2005**



Source: CentralBanks, Eurostat, PricewaterhouseCoopers analysis

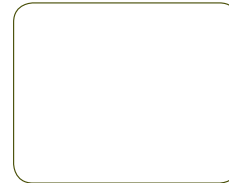
for longer-term expansion appear more limited than in some other European countries. Meanwhile, the development of the Greek consumer credit market resembles the experience of Spain. The penetration of unsecured borrowing in Greece has expanded at a rapid annual rate for the past six years, moving from a very low base to one of the highest levels in the Eurozone. The key drivers of growth have been strong economic growth, low real interest rates and a cultural shift in Greek financial habits. As in Spain, market analysts expect growth rates to remain strong over the

short term, but do not view the current trend as sustainable in the medium term. Unlike their Spanish counterparts, however, Greek consumers have considerable scope to increase their mortgage borrowing, and many analysts predict this type of lending will take up the slack as consumer credit expansion slows.

Although France and Germany have similar levels of both consumer credit and GDP per capita, placing them in the middle of Figure 3, the two countries have arrived at this point by very different

routes. France’s appetite for consumer credit has increased slowly but steadily in recent years. A strong supply of credit by France’s large domestic banks and increasing house prices also suggest that the French market should have good scope for further growth in the medium to long term. In Germany, however, the level of consumer credit in the economy has fallen by 30% since 1999. This exceptional trend reflects an ever-stronger propensity to save and a continuing indifference to a consumer credit culture. German politicians and business leaders may have been hoping that consumer spending might give the economy a boost, but take up of credit cards is low for such a developed economy and users remain reluctant to revolve balances. Considering this track record, the outlook for consumer credit growth in Germany must be considered uncertain.

In contrast, based on their positions in Figure 3, Italy and the Netherlands appear to offer greater scope for consumer credit expansion. Once again though, cultural differences suggest that actual growth potential varies between the countries. Although Italians have shown an increasing appetite for consumer credit in recent years, the



average consumer is extremely under-borrowed compared to other European markets. This has led Italian and foreign banks to predict long-term expansion in consumer borrowing, and this potential has been cited as a key motive for investment in the market. At first glance the Netherlands appears to offer strong scope for consumer credit growth, considering its high level of GDP per capita. This impression is further reinforced by the extremely high level of secured consumer borrowing in the Netherlands, the result of widespread home ownership and a history of tax incentives. However, credit card usage is very low, with approximately two million cards in issue among a population of 16 million. This low adoption has been attributed to heavy promotion by Dutch banks of debit cards. The result is that while Dutch consumers may use credit cards for payment abroad, they typically prefer to use debit cards for day-to-day domestic use.

Looking into Asia, the prospects for growth once again seem to owe more to cultural factors than economic considerations. The position of Australia in Figure 3 suggests that growth rates may soon begin to slow as consumer credit penetration approaches a 'frontier'.

This market seems to offer some short-term potential for further growth, but it is unlikely that this will be sustainable in the longer term. In Taiwan, the key question is what long-term growth rate the consumer credit market will experience once the aftershocks of its recent dramatic collapse have subsided. Following a period of heavy unsecured lending losses in 2005 and early 2006, domestic banks are beginning to show some signs of returning to lending and some foreign lenders have been making strategic investments in the Taiwanese market. However, the lengthy, low interest rate arrangements that many lenders were forced to make with their debtors during the recent credit crunch may reduce the long-term prospects for the supply of consumer credit in Taiwan. Not only have they reduced the profitability of existing lending, they have created a potential moral hazard for future borrowers who may believe they can reschedule in the event of over-leveraging. These developments make the future evolution of the Taiwanese consumer credit market hard to predict.

Consumer credit levels in Hong Kong, by contrast, are perhaps more likely to follow a predictable growth path. Penetration levels in this market were

remarkably stable during several years of deflation, but the economy has now returned to an inflationary phase. This should encourage Hong Kong residents to revive their traditional willingness to borrow, especially now that the crucial residential property market is recovering. Slowly increasing interest rates are also likely to stimulate the supply of credit, so it is likely that consumer credit penetration levels will reverse their slight recent decline in the short to medium term. Lastly, the growth prospects for the Japanese consumer credit market look far from certain, despite the return to cautious economic growth. An ageing population and rapidly decreasing returns for consumer lenders suggest that the decline in the absolute level of Japanese consumer credit from its high point in the mid 1990s will continue. Industry analysts expect the sector's profit margins to fall dramatically in the medium term, following a recent reduction in the maximum permitted loan rate from 29% to 20%, and a Supreme Court ruling that has boosted legal claims for recompense for 'predatory' lending practices.

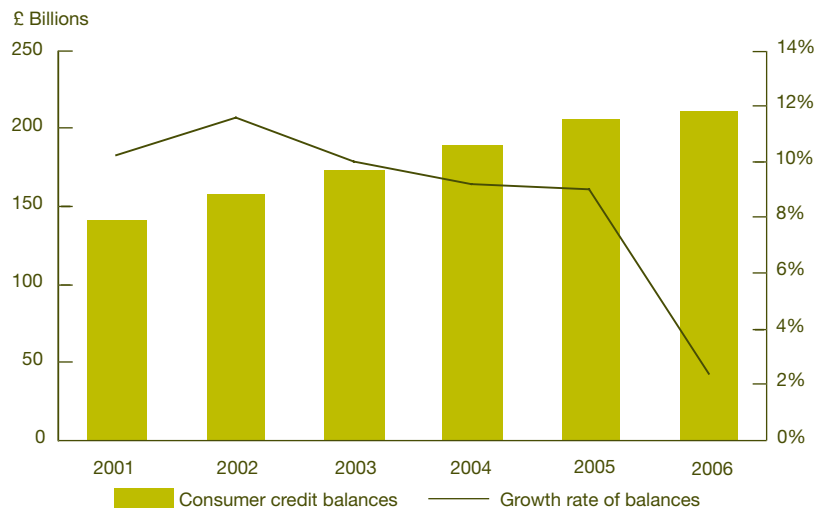
# Global consumer credit: Is the UK and US ‘buy now pay later’ culture infectious? continued

## What lessons should less developed markets take from the UK experience?

The strong growth in the UK consumer credit market is clearly shown in Figure 1 and a further analysis is shown in Figure 4. Between 2001 and 2005 the market grew by around 10% per annum, with outstanding balances increasing from around £150 billion in 2001 to well over £200 billion by 2005. Since 2005, growth has stalled and in some sectors, e.g. credit cards, balances are actually declining. Whilst some of this change in trend may be attributed to supply side factors, in the main we believe it to be a function of reduced demand.

The increase in the level of defaults has been of particular concern to the industry. In the credit card sector, for example, bad debts have increased from under 4% at the end of 2004 to over 7% by 2006. In the UK many lenders have attributed this increase to the dramatic rise in personal insolvencies. Someone now becomes insolvent every minute of every working day. Our research indicates that the primary reason for debt difficulty is simply consumers living beyond their

Figure 4: Consumer credit balances and growth rate



Source: Bank of England, all dates as at June.  
 Note: Figures have been revised to include data for lending to students through Government student support schemes.

means – it is no longer the case that redundancy and divorce are key drivers. This research supports our view that the UK market may have reached a natural ceiling.

Lenders are now faced with the prospect of a static market and significant pressure on margins from both increased levels of

defaults and intense regulatory scrutiny. Lenders have also bred a fickle customer base – spending huge amounts on the recruitment of new customers, arguably at the expense of retaining existing customers. The high prevalence and consequent cost of 0% balance transfer offers in the UK credit card market is a graphic illustration.



## So what are the lessons to be learnt?

- If borrowing levels increase in the less developed markets then lenders will need to take care to ensure that borrowers do not take on too much debt. Lenders need to look beyond their own position with a particular customer to form a true picture of the likely risk. The sharing of customer data remains an issue in the UK market, and the lack of sharing has clearly been a factor in allowing customers to ‘borrow too heavily’.
- The regulatory pressure in the UK market remains a threat to industry profitability. Institutions do not seem to be making an effective case to the regulators. The consumer credit industry in the UK undoubtedly has some of the most consistently negative and one-sided media reporting of any industry. This negative publicity and resulting political pressure is likely to have been a driver behind the recent regulatory initiatives. The consumer credit industry has provided major benefits to the UK economy as a whole,

although these benefits have not been actively promoted and are therefore not widely known or understood. Lenders in emerging territories need to consider whether they may fall into the same trap.

- In the search for market share UK lenders appear to have focused on acquiring new customers rather than looking after existing customers. For example, in the credit card market, the introductory balance transfer offers are not only expensive but have also led to the proliferation of so called ‘rate tarts’ – fickle customers who take advantage of the benefits of constantly moving from issuer to issuer. UK lenders now need to pay increasing attention to their existing customers, as high costs of acquisition are less sustainable in a market with increasing pressure on margins.

The perception that Continental European and some Asian markets are a fertile area for growth opportunities is probably misplaced. At the moment there is little evidence that consumers in most of these markets are catching the borrowing habits of their counterparts in the UK

and the US and growth expectations should be more modest. Whilst it may be true that in some cases, supply has constrained demand, we believe that cultural differences play a large part in influencing levels of demand.

The UK and US markets are entering a phase where there is unlikely to be much real growth. Increased regulatory pressure and rising defaults are constraining lender margins. Some of this could be regarded as self inflicted – lenders in the less developed markets would do well to study and learn from the UK and US experience.

# Taming the leviathan: Governance and risk management in Chinese banking

26 By Tim Pagett and Harjeet Baura





**Tim Pagett**

Partner  
PricewaterhouseCoopers  
(China/Hong Kong)  
Tel: 86 10 6533 2352  
tim.pagett@cn.pwc.com



**Harjeet Baura**

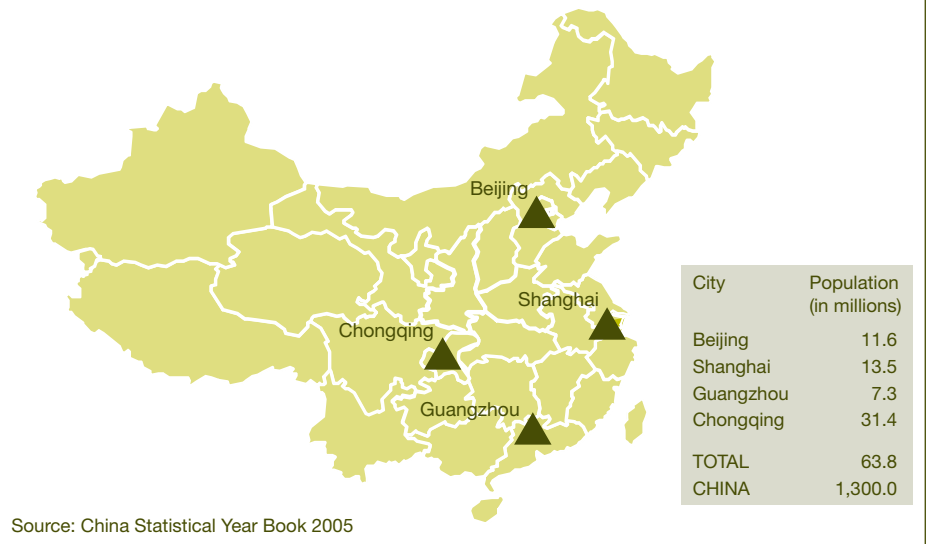
Director  
PricewaterhouseCoopers  
(Hong Kong)  
Tel: 852 2289 2715  
harjeet.baura@hk.pwc.com

International banking groups are increasingly keen to tap into the surging Chinese economy. But how strong are the controls needed to underpin effective operational practice and safeguard their investments? Between 2010 and 2013, the largest and most sophisticated of China's major banks will be expected to be ready to implement some of the key requirements of Basel II. This ambitious statement of intent is a testament to the pace of development in the banking sector, the willingness of its supervisor, the China Banking Regulatory Commission (CBRC), to embrace reform and the determination of industry leaders to achieve parity with international regulatory and competitive standards. With the resources available within the sector, both human and financial, it would be premature to judge that achieving Basel II readiness in such an ambitious timeframe will not be achieved. However, there are tough hurdles ahead, which highlight the wider risk and governance challenges facing both domestic and international institutions in China.

**Background**

An understanding of the risks of doing business in China requires an appreciation of the vast size and cultural and social diversity of the country. With 1.3 billion people, the geographic and population

Figure 1. The vast scale of the country



spread of China and its bankable markets is comparable to Europe, with just as many linguistic, cultural and economic differences (see Figure 1).

China's cities are administratively divided into three tiers, with Beijing, Shanghai and Guangzhou forming the first tier, though by size a tier two city such as Chongqing could be larger.

Many commentators outside China have been critical of the pace of regulatory developments and the inconsistent application of practices designed to protect investors and customers. However, achieving consensus and

consistency across Europe on these matters can often appear to be equally fraught with delays and challenges.

As much as China's central regulatory authorities may wish to promote reform, their directives are subject to interpretation and application by a complex array of city and provincial administrations. Many of these administrations preside over populations comparable in size to large countries in their own right and face differing and often highly localised social and political pressures.

# Taming the leviathan: Governance and risk management in Chinese banking continued

This enormous expanse of people, language, culture and local interests is also reflected in the banking sector itself. China's banks employ more than two million people spread across some 75,000 branches. All the five leading banks each maintain more than 10,000 branches, and the largest of these branches have historically represented virtually autonomous enterprises in their own right. This has included setting their own strategy and having their senior management appointments made by local and provincial governments.

Ensuring that so many people in so many branches act in a consistent fashion in line with agreed policies and remain committed to a single overall change agenda can clearly be difficult in the midst of such long and tenuous lines of command. A critical example of this governance challenge is lending policy. Despite continuous attempts to reform and homogenise lending practices across a bank's operations, the underlying basis for loan approval can often still be very different from branch to branch. In a country where, despite widespread economic reform, the government and party continue to demonstrate ubiquitous control and leverage over business, including in some cases the appointment of bank branch managers, lending decisions may also be influenced by state, provincial or local economic

objectives rather than the pure commercial interests of the institution as a whole. Taking all this into account, one should not be surprised at the hesitation of the CBRC to fully recognise the relevance of the specific Basel II-style operational risk capital measures at this stage of China's market development.

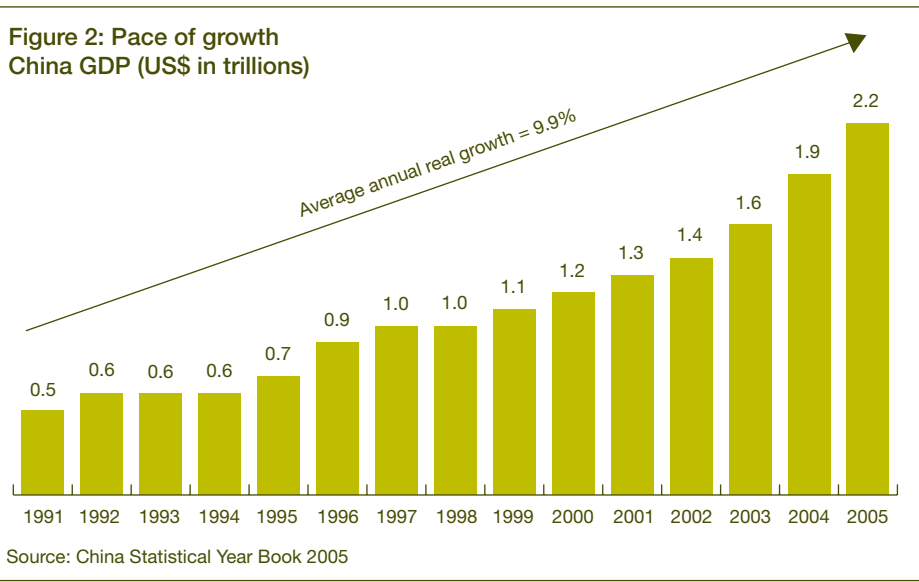
### Risk of success

Many of the other key challenges for risk management in the Chinese banking sector stem from the phenomenal momentum of the economy (see Figure 2).

The pace of development can be a double-edged sword for governance and risk management. While increasing

personal and corporate wealth drive demand for financial services, they may also mask a myriad of potential issues that may only surface when the economy slows. Experience suggests that while the cautious voice of the risk manager is vital, it can all too easily be drowned out by the spiralling optimism of financial success. Factors that could temper this optimism include interest rate rises, currency price pressures and stock market volatility.

An issue that has already attracted considerable international attention and could come further to the fore in any downturn is credit quality. The legacy of non-performing loans (NPLs) is perhaps unsurprising given the fact that lending





decisions have often been made on seemingly valid and plausible social or political grounds rather than on a primarily commercial basis. However, a key element of recent banking reform has been a process that enables banks to segregate their NPLs so as to support a more robust valuation and create a platform for their ultimate removal. According to official figures, the ratio of NPLs has fallen in the past two years. Nonetheless, there is a risk that the reduction may have been exaggerated by the considerable increase in lending generated by the economic surge.

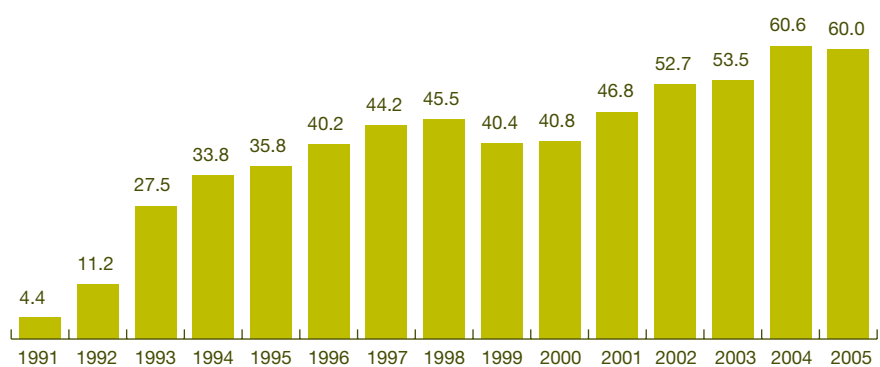
This increase in lending could present further default risks in the future, especially if the economy does slow. However, many leading institutions continue to tighten up their lending practices, strengthen governance and invest in more sophisticated credit risk tools. The move to more risk-sensitive capital management under Basel II could add further impetus to the development of better credit evaluation and more rigorous controls. Nonetheless, many banks still have some way to go in reaching international standards, especially when translating the commitment of the centre into action on the ground continues to be an often slow and painstaking process.

Another potential concern is fraud. With a massive influx of finance chasing a relatively limited range of investment opportunities (see Figure 3), there may indeed be increased opportunities for misappropriation. The regulatory authorities are quite open about reporting identified financial crime and keen to impose harsh deterrents. As with any economy, however, the hidden cost of fraud may never be fully known. Investors must closely monitor their investments, on the ground and with local support, and this must be factored into their investment equation. However, this is arguably the case everywhere, not just China. For example, how different is the

recent high-profile misappropriation of funds from the Shanghai pension fund from the Maxwell or Enron scandals?

An equally pressing issue that has perhaps attracted less attention is the risk associated with enforcing and valuing collateral, particularly with respect to the burgeoning housing market. Property rights remain an area in need of further legal clarification and reform. With 50% annual property price rises in some cities, this may not be a concern at present. However, if the economy did falter and there was an increase in defaults, lenders may find that they are not in a position to enforce their

**Figure 3: Influx of investment**  
Inflows of FDI into China (US\$ in billions)



Source: China Statistical Year Book 2005

# Taming the leviathan: Governance and risk management in Chinese banking continued

security. Even if they could, they may find that they have to find suitable alternative accommodation for the evicted tenant. Loss given default may therefore be higher than countries where property rights are more clear-cut.

## Regulatory risk

As we have said, the reform agenda has been moving ahead at pace, albeit with challenges in its application. Leading banks have been or are being commercialised. In accordance with World Trade Organisation accession commitments, domestic accounts are being opened up to foreign competition. In terms of governance and risk management, the CBRC, formed in 2003, is proving to be a determined champion of progress. Ahead of the move to Basel II, a flurry of recent CBRC directives include enhancements to the market risk management requirements of all banking entities. Banks themselves are also playing their part, including improved management training and incentive programmes to help promote corporate objectives.

However welcome, the unstinting pace of change and reform can prove a risk in itself, especially when put next to the equally rapid developments in the market and economy as a whole. One of the most critical, and often least appreciated, aspects of regulatory and wider business risk is language and understanding, not least as all directives are communicated in Chinese. It is necessary to understand at least 3,000 written characters to acquire a working knowledge of Chinese. Face-to-face dialogue can be even more complicated, especially as the same word can be pronounced in four distinct ways – some say that it generally takes 10 years of study and experience to develop the language skills needed to maintain a credible business negotiation. The need to overcome the omnipresent language barrier once again underlines the need for the right local partners and advisors.

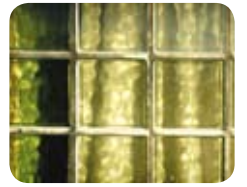
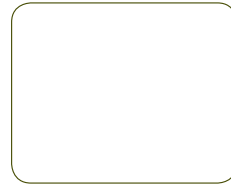
## Patience and understanding

Effective governance and risk management are absolutely critical in managing the huge expanse, complexity and uncertainty of the Chinese banking sector and wider cultural, business and

political arena. While the commitment to reform is strong, both among regulators and business leaders, continued improvement and investment will be vital both in the lead up to Basel II readiness and beyond.

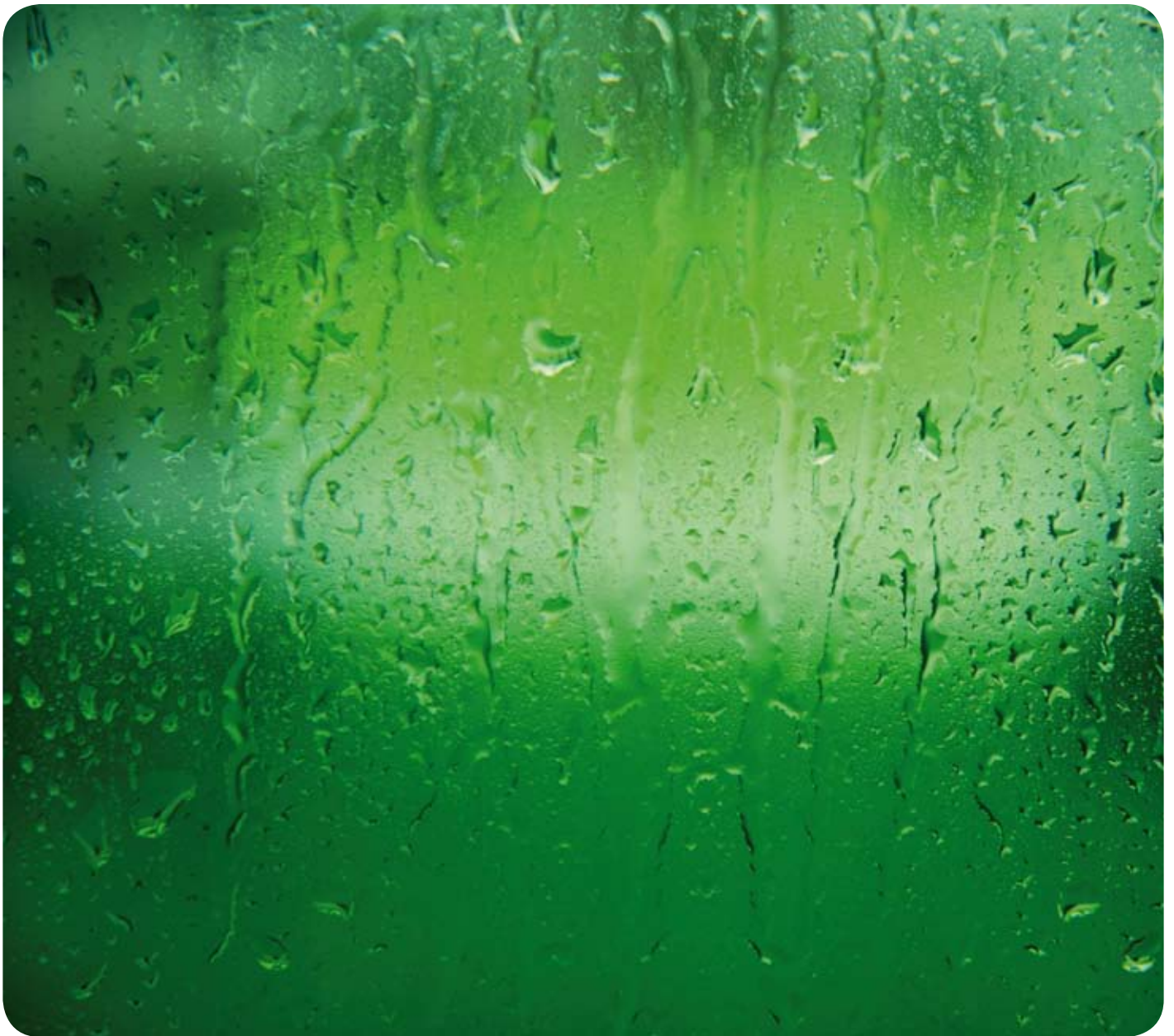
Key challenges include moving from a relationship-influenced banking control culture to a comprehensive, consistent and enforceable firm-wide control environment and strategic approach. Investors also need to chart a careful course through economic developments that are barely fathomable in their speed and which are creating huge inherent risks in their wake. The key to all this is vigilance, local understanding and, not least, realistic expectations about the hurdles to be overcome and how to surmount them in such a vast and diverse setting.

The intrinsic challenges of developing world-class risk and governance procedures are comparable for all developing and, to some extent, developed countries. What sets China apart is the scale and pace of its development.



# Indian banking: An exciting but challenging opportunity

32 by Jairaj Purandare and Radhakishan Rawal





**Jairaj Purandare**  
 Partner  
 PricewaterhouseCoopers  
 (India)  
 Tel: 91 22 6669 1400  
 jairaj.purandare@in.pwc.com



**Radhakishan Rawal**  
 Senior Manager  
 PricewaterhouseCoopers  
 (India)  
 Tel: 91 22 6669 1421  
 radhakishan.rawal@in.pwc.com

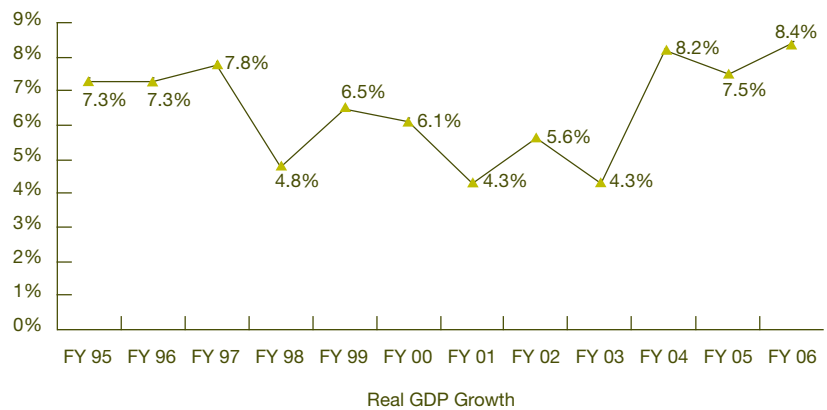
India is one of the fastest growing global economies with GDP currently growing in excess of 8% p.a. (see Figure 1). Given this backdrop, the Indian banking sector holds exciting but challenging opportunities for existing and new participants, as they compete for customers and to expand their presence in terms of both market share and revenue growth. Banks are increasingly entering into strategic alliances with other participants to offer and cross-sell a wider range of products and services to a larger customer base in order to enhance both their interest and their fee income. To be successful in India, it is important to understand the structure of the banking industry, the emerging regulatory trends and the key growth areas.

**Background**

India is the seventh largest nation in the world by land area and the second most populous, with over 1 billion people. India has foreign exchange reserves of over USD\$185 billion reflecting foreign investor confidence in the economy. Goldman Sach's widely quoted BRICs report has predicted that India's economy will become the third largest in the world by 2032, ranking just after the US and China.

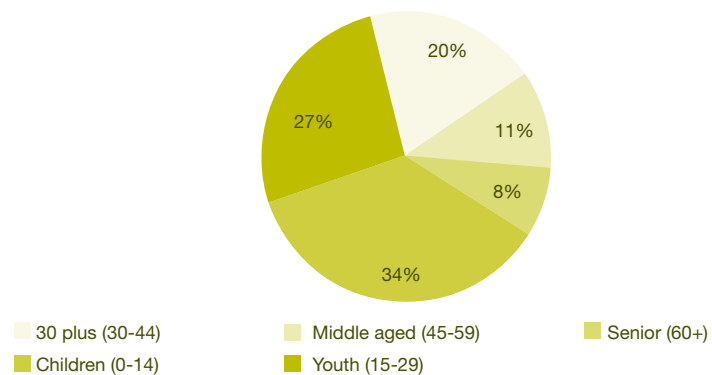
India is a young country, with over 60% of the population below the age of 30 (see Figure 2).

**Figure 1: Indian economy growth (real GDP growth)**



Source: Economic Survey & RBI

**Figure 2: Population distribution by age**



Source: Statistical Outline of India 2005-06, Tata Services Ltd

The large, young population base, combined with growing literacy rate (currently at 65%) represents an attractive market for most participants

across industries and this, along with a rising middle class, gives India a strong demographic advantage and helps to fuel the current GDP growth.

# Indian banking: An exciting but challenging opportunity continued

## The banking sector

The Indian banking sector has been keeping pace with India's rapid economic growth. The last few years have seen a significant increase in lending by commercial banks, with a significant part of the credit being provided to the growing small and medium enterprises (SMEs) and retail customers. As of September 2006, deposits grew at 21%, while advances grew at a faster pace of 30%.

Governance of the banking sector in India is robust and with standards broadly in conformity with international standards. The banking sector is regulated by the Reserve Bank of India (RBI), which is the country's central bank.

There are broadly three types of banks operating in the Indian banking industry and regulated by the RBI. These are illustrated in Figure 3.

Public sector banks are banks where the Government of India has majority shareholding. These include the State Bank of India (SBI), its seven associate banks and the 19 nationalised banks (domestic banks which were nationalised in 1969 and 1980).

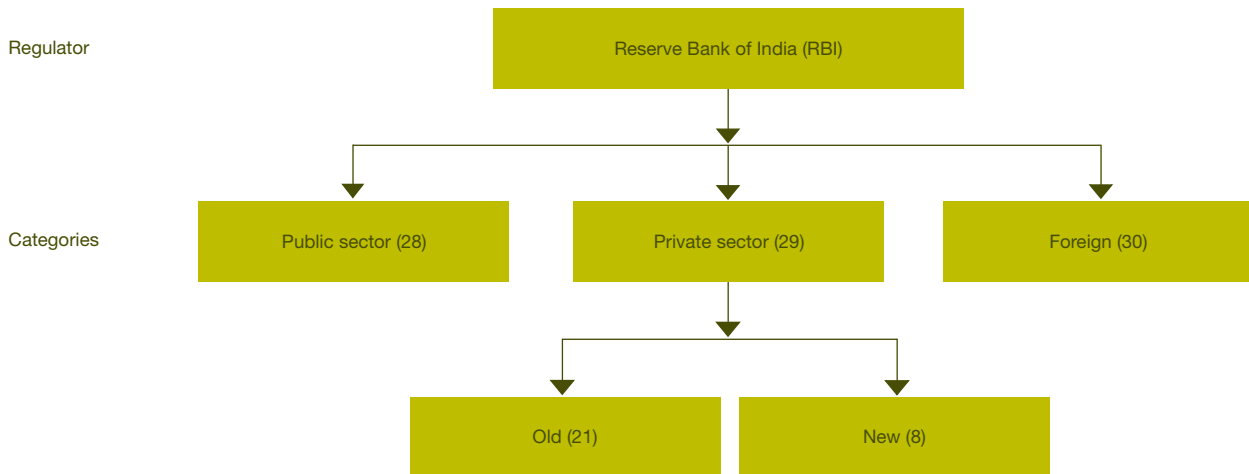
Private sector banks fall into one of two categories, old or new. Old private sector banks refer to banks that were set up before 1994 and, as the name suggests, have private ownership. As part of India's financial reforms and liberalisation

process, from 1994 the Reserve Bank of India granted licences for new domestic banks to set up their operations in India. These are referred to as new private sector banks.

Foreign banks are banks set up by foreign institutions in India and which offer commercial banking services.

Public sector banks continue to be dominant participants in the banking industry, accounting for over 73% of total advances and 75% of total deposits (see Figure 4). However, following the introduction of the new private sector banks they have seen their market share decline significantly from the 85% of total advances and deposits they had in 1994.

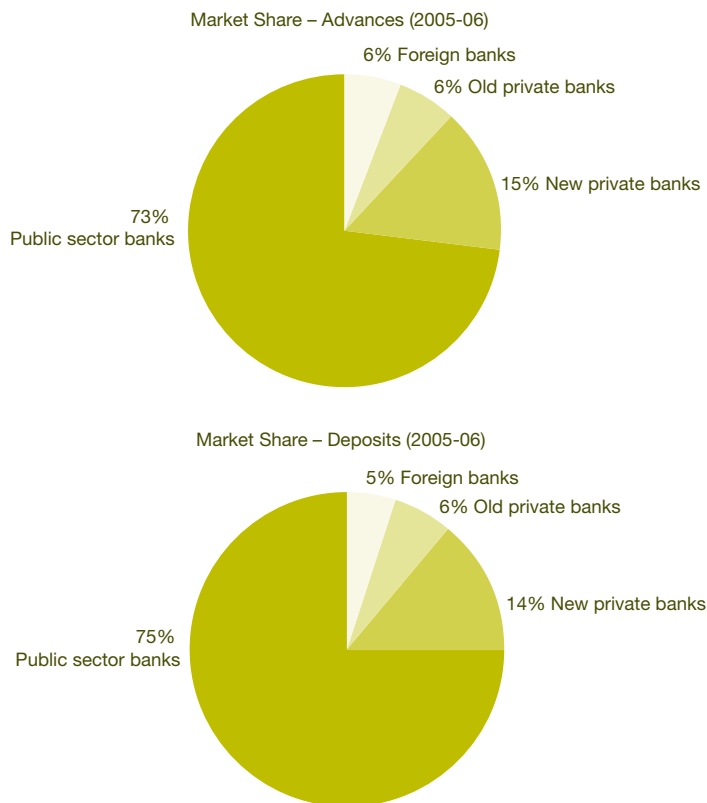
Figure 3: Indian banking industry structure



Source: IBA Performance Highlights 2005-06



**Figure 4: Market share analysis**



Source: RBI Report on Trend and Progress of Banking in India, 2005-06

Competition has increased significantly in the past few years with all banks competing aggressively to gain new customers and cross-sell to existing customers. Most public sector banks have embarked on technology-led, transformation initiatives to improve customer orientation and streamline systems. Banks in India have also leveraged their own branches and staff and other outsourced direct selling agencies to acquire new business.

### The roadmap for foreign banks

A number of foreign banks have a presence in India in the form of branches. In February 2005, the RBI announced a roadmap for foreign-owned banks in India which consists of two phases:

During the first phase (2005-2009), foreign banks are required to have a capital of INR 3bn to set up a wholly owned subsidiary in India. Foreign banks operating in India in the form of a branch are also permitted to convert the branch into a wholly owned subsidiary. As per the WTO commitment, India is required to grant a minimum of 12 branch licences to foreign banks per year, and indeed the RBI has actually been granting more than 12 licences per year. It is, therefore, possible to establish and expand a branch network in India.

These new private sector banks are all technologically enabled and adopt customer-focused practices with aggressive marketing, resulting in them having become significant participants in the Indian financial services market in a relatively short period of time. They have focused on retail banking, SME banking

and expanding their presence across the country in the form of both branches and direct distribution channels. Leading participants include ICICI Bank, HDFC Bank, UTI Bank and Centurion Bank of Punjab. ICICI Bank is now the second largest bank in India after SBI in terms of assets.

# Indian banking: An exciting but challenging opportunity continued

However, there is a lead time to obtaining a banking licence which in practice restricts the ability of foreign banks to expand rapidly within India.

The other option for foreign banks is to acquire or invest in existing Indian banks, however investment in Indian banks is capped at 74% and approval is required for purchase of shares in excess of 5%. Foreign banks are also required to follow 'single form presence' (i.e. either as a branch or as a subsidiary) in India. During this phase, permission for the acquisition of shareholdings in Indian private sector banks by eligible foreign banks will be limited to private banks identified by RBI as in need of restructuring.

In the second phase (April 2009 onwards), the RBI may, depending on the experience during the first phase,

consider certain policy changes. This would include full national treatment to the wholly owned subsidiary of foreign banks, dilution of the equity holding in the subsidiary by foreign banks by way of an Initial Public Offer or an offer for sale and merger and acquisition of any private bank in India.

Non Banking Finance Companies (NBFCs) are also governed by the RBI, but the regulations applicable to NBFCs are not as stringent as those applicable to banks. Unlike banks, non-deposit-taking NBFCs do not require an RBI licence to establish a branch. Foreign banks operating banking branches in India have also established NBFCs and then leveraged on the latter's branch network. However, RBI has recently indicated that the banks should not use

an NBFC as a delivery vehicle for seeking regulatory arbitrage opportunities or to circumvent banking regulations.

## Consolidation in the banking industry

Several studies on the Indian banking sector have outlined the need for consolidation to enable banks in India to reach a critical mass in terms of size, expertise and reach. Consolidation is important for the sustained viability of the financial sector and to enable domestic banks to face competition from global participants going forward.

Consolidation needs to be based on business synergies and to be commercially viable. In the past, a number of bank mergers in India have been driven by the financial failure of certain banks. This has led to banks in stronger financial positions taking over the failing banks to protect the interests of depositors and employees. It goes without saying that consolidation will be more beneficial in the long run if the selection of merger partners is based on a sound business case with the objective of gaining a strategic advantage.

### Country-specific issues: Enforcing security

A few years ago, a court's intervention was required for the purpose of recovery of mortgages and charges over immovable properties, thus making recovery of loans a lengthy

process for the banks. Subsequently, a law was introduced (Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002) to give special powers for recovery of such loans. Accordingly, special provisions now apply to facilitate speedy recovery of bad loans.



In recent years, there has been some activity in this area, with the merger of a few weak banks in the old private sector with new private sector banks. Looking ahead, domestic consolidation is expected to gain pace, particularly among public sector and private sector participants.

### Regulatory change for the banking industry

The RBI has announced its timetable for banks in India to comply with Basel II regulations using the standardised approach. The deadline for this compliance has been extended to 31 March 2008 for foreign banks operating in India and Indian banks having a presence outside India and 31 March 2009 for all other banks. Basel II is likely to have significant implications for banks in India, particularly the public sector banks and old private sector banks which are likely to need more capital to meet their revised minimum capital requirements.

### Country-specific issues: Tax rates

Indian tax laws recognise the specific nature of banking businesses and contain certain provisions which apply specifically to banks. The banks are allowed a deduction for provisions created for bad and doubtful debts subject to certain conditions. Further, banks are required to pay tax on interest on such bad loans only if such interest is recognised in the books as income. A foreign bank operating in India as a branch is allowed deduction

for general administrative expenses incurred by the head office. As per the Indian laws the foreign companies are required to pay a higher rate of tax than that applicable to a domestic company. Certain foreign banks have tried to claim benefit from the article of the tax treaty dealing with non-discrimination but without success. Recently, the domestic law has been amended to provide that such higher rate of tax should not be considered a discrimination against the foreign companies.

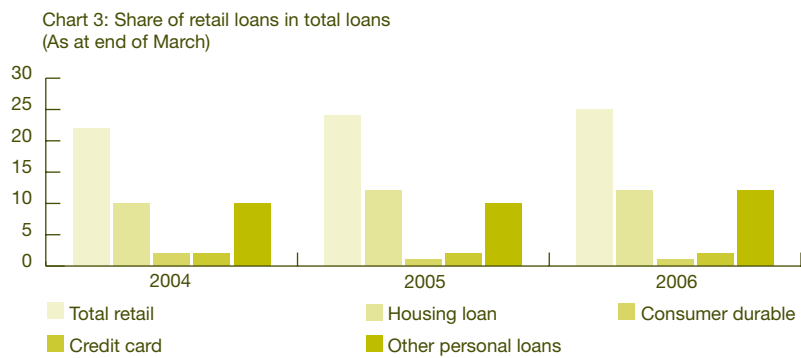
### Trends in the banking industry

There has been rapid growth in consumer finance and credit cards over the past five years. Banks and other financial services participants have been actively marketing and selling consumer lending products to a wider range of retail customers. Products sold include personal loans, vehicle loans, consumer durable loans, housing loans and credit card products. There has been intense

competition among banks to gain share in this rapidly growing market fuelled by increasing consumer demand. Retail loans now constitute more than 50% of the assets of most private sector and foreign banks and over 25% of the total loans in India across banks. There has been a significant growth in the number of credit cards in India over this period, with the total number in circulation now exceeding 18 million (see Figure 5 overleaf).

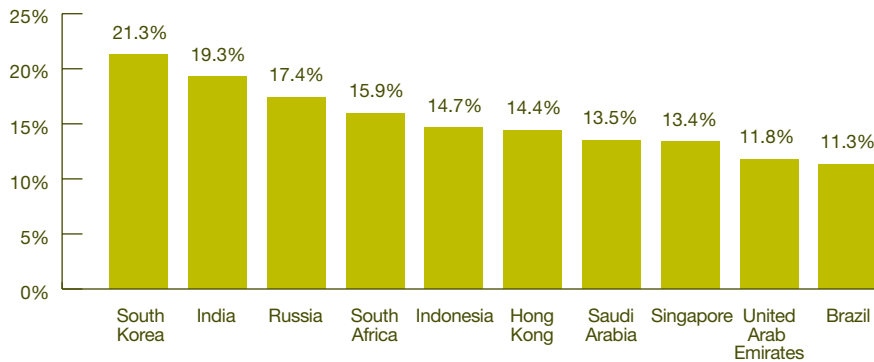
# Indian banking: An exciting but challenging opportunity continued

**Figure 5: Growth in retail loans**



Source: RBI Report on Trend and Progress of Banking in India, 2005-06

**Figure 6: High net worth individual (HNWI) population growth by selected market (2004-2005)**



Source: Cap Gemini World Wealth Report 2006

Banks have also been focusing on providing structured wealth management offerings to wealthy individuals in India. The Cap Gemini Merrill Lynch World Wealth Report 2006 has estimated that there are over 83,000 individuals in India with financial assets of over USD\$1m, a growth of 19.3% (see Figure 6) when compared to the previous year. There is therefore an increasing demand for structured solutions to preserve, grow and manage wealth. Key participants in this market include banks, broking firms and asset management companies. Some banks now have separate divisions which focus on high net worth customers. Wealth managers are also trying to move into the role of trusted advisors by providing their customers with access to both own and third party products and services, especially in the area of mutual funds and insurance products. Wealth managers have started widening their product range to offer alternative products, including art advisory, real estate advisory, structured products and tax planning, both through their own institutions and through their partnered alliances.

There has also been a steady growth in lending to SMEs by banks. Banks in India have to meet their priority sector lending



obligations and to meet these requirements they used to lend to the small-scale industry sector along with agriculture and other identified areas. However, in recent years, the reliance of large corporates on banks has decreased due to their ability to raise finance themselves via other methods. Banks have therefore increased their focus on the SME sector given the often attractive margins when compared to lending to large corporates.

Microfinance in India is in its early stages of growth. Microfinance serves about one fifth of poor households in India and has helped to widen the provision of financial services products to India's vast population, 80% of whom have no access to banks.<sup>1</sup>

Nearly 70% of India's population lives in rural areas where traditional moneylenders who charge high rates of interest are the main source of finance. New private sector and foreign banks and some venture capital firms have increased their focus on the microfinance business.

India continues to be a popular destination for outsourcing/offshoring of certain processes by foreign banks.

A large English-speaking population and favourable cost structures have made India one of the most attractive destinations for outsourcing back office work. Several banks and financial institutions have set up captive operations in India for the purpose of carrying out back office operations and call centre activity. India is also starting to move up the value chain as a result of its skilled population.

### Opportunities

The availability of a large customer base offers great potential to banks operating in India. Banks will aim to configure a mix of both physical and direct distribution channels to access a nationwide base of customers for sales and servicing. Banks and other financial services participants will also increasingly tap smaller cities and towns to widen their access to potential customers.

The increasing consumerism and affluence of the Indian customer represents an attractive target market for retail lending products and services. Growth in consumer lending is likely to continue. Increasing affluence will result in a growing

need for tailored wealth management offerings by different categories of customers (e.g. mass affluent customers, high net worth customers, ultra high net worth customers). Banks will look for avenues to grow their interest and fee income and customer share by offering a wider range of financial products and services (e.g. insurance products and mutual funds). Rural banking and microfinance are also likely to continue their upward trend, with more and more participants focusing on these areas.

The SME segment will continue to grow and will require assistance in areas such as project finance, capital structuring and fundraising.

Banks operating in India therefore need to prepare and position themselves to be able to meet and capitalise on these opportunities.

<sup>1</sup> 2006 report on Microfinance in India, a joint initiative of the Swiss development agency, the Ford Foundation and Care.

# Accounting risk management: The missing piece in the risk management jigsaw?

40 by James Hewer and Craig Stafford





**James Hewer**  
 Director  
 PricewaterhouseCoopers  
 (United Kingdom)  
 Tel: 44 20 7804 9605  
 james.hewer@uk.pwc.com



**Craig Stafford**  
 Partner  
 PricewaterhouseCoopers  
 (Australia)  
 Tel: 61 2 8266 3725  
 craig.stafford@au.pwc.com

With the recent developments in financial instrument accounting and the widespread adoption of International Financial Reporting Standards ('IFRS'), accounting is becoming ever more complicated, subject to increasing levels of prescriptive guidance and a seemingly ever increasing pace of change.

With this increasing complexity comes increased risk of misinterpretation or misapplication of the accounting standards, leading ultimately to increased risk of misstatement. This risk of misapplication or misinterpretation is what we refer to as 'accounting risk'. This all comes at a time when the focus on 'getting the numbers right' is higher than ever and, at least in certain countries, the penalties for getting the numbers wrong are becoming ever more draconian.

In addition to this increased complexity, there is the current steady but sure trend of companies returning to structured financial products, which, with the introduction of IFRS in the last few years, many companies have tended to avoid based on the unknown or potentially unpalatable accounting implications, perceived or otherwise.

Accounting is no longer a simple issue, if indeed it ever was, and the accounting implications of structured products can be extremely complex. The current key

driver is on good accounting practices which, while reflecting the economics of the transaction, also comply with the spirit of the standards. The scope for applying alternative interpretations which, while complying with the letter of the standard, do not (or could be argued not to) comply with the spirit of the standard has greatly reduced.

### Accounting risk and accounting risk management

Accounting risk is therefore a key risk which companies and institutions need to understand and manage efficiently and effectively just like any other risk which they face as an organisation. There are two key areas where accounting risk arises, firstly in relation to a company's or institution's own books and records, being the risk of inappropriate accounting practices being used in the preparation of a company's or institution's own financial information. Traditionally this element of accounting risk has been well focused on and with the development of regulation in this area, such as the Sarbanes-Oxley Act in the USA, this is an area that is subject to ever more scrutiny.

Second, and of particular importance for the investment banking industry, is the focus on the client's proposed accounting treatment for deals which the bank is structuring/selling to that client.

As we have seen in relation to some of the corporate scandals in recent years, a number of investment banks have found themselves subject to very significant claims under legal actions from the company's creditors due to the fact that they sold clients transactions which were themselves allegedly inappropriate, or where the accounting adopted for them was allegedly inappropriate.

Whether under IFRS or US GAAP, an investment bank's clients can find the accounting treatment required by the standards for structured transactions to be, at times, unpalatable. The accounting treatment is often therefore one of the key concerns each client has in relation to any proposed structured transaction. The accounting in question can be extremely complicated, compounded by the fact that there is often no direct guidance and therefore one has to interpret the given rules and guidance in order to come to an appropriate answer.

Clients which do not or cannot get comfortable with the accounting may well choose not to undertake the transaction in question. Appropriate management of this accounting risk through the right internal controls and consultation with professional advisors therefore becomes critical for both the investment bank and the client.

# Accounting risk management: The missing piece in the risk management jigsaw? continued

## Current market practice

There are generally two models currently being adopted in relation to the client-centric accounting risk: either this risk is managed directly by specific individuals in the front office, or it is managed by the Accounting Policies Group ('APG').

In the majority of investment banks it is the front office which has hired in specific accounting technical resource to help manage and mitigate this risk. These individuals are accounting experts, and they use their expertise to manage the risk as well as helping to sell the transactions. While the banks never formally give accounting advice to the clients, they also help to ensure as far as possible that the proposed accounting adopted by the client is appropriate.

The alternative model is to give responsibility to the APG to deal with these issues, as they have the individuals with the right skills and expertise. However, they often do not have sufficient resource to adequately cover the additional responsibilities in relation to client accounting while at the same time addressing the bank's own accounting issues.

Whichever model a bank chooses to adopt, individuals with both a deep knowledge of financial products and an

expertise in the new accounting standards are hard to find. This means that banks face real challenges in ensuring both that they have a sufficient level of resource and that the resource has the appropriate skill set to be able to effectively manage the associated accounting risk.

Irrespective of which model a bank adopts, banks are producing more and more detailed accounting sections to their pitch or proposal documents or indeed even separate detailed accounting memos which they are giving to their clients. It is therefore imperative that the bank has undertaken sufficient due diligence and external consultation before forming its view on the accounting for a specific structured transaction.

Banks also need to be able to ensure that their interpretations for clients are consistent with their interpretations for their own books and records. Where the bank has employed the APG model, this is naturally addressed by having the same individuals addressing both client and own accounting issues. However, where the bank has adopted the model of having individuals in the front office to manage accounting risk, rather than giving this responsibility to the APG, there is often no formal link between these individuals and those in the APG.

## Key challenges to be addressed

However an investment bank chooses to address and manage this accounting risk, some obvious questions arise that senior management need to be confident are adequately addressed:

- Are the relevant individuals qualified/ up to date with current developments/ interpretations and how do they ensure that they stay up to date with developments in standards and interpretations?

What training and support mechanisms are in place to ensure all 'accounting experts' within the organisation are sufficiently qualified and up to date with the current rules, particularly given the continued pace of change in accounting standards? Often there is little coordinated support for the individuals in the front office. As a minimum they should be included in any finance function training and above that they should attend appropriate update course with external professional services firms.

- What information tools do they have access to in order to ensure they are up to date and referring to the latest available guidelines and information?



What information channels do they have to stay on top of new standards, interpretations by interpretation committees, changes in interpretation by the profession and proposed developments or changes? What research tools do they have at their disposal to ensure they are looking at the latest information when investigating issues? With the speed of change and volume of guidance it is imperative that these individuals have access to real time online research tools which allow access to up-to-date standards, interpretations and guidance.

- What policies and procedures are in place for getting/requiring independent accounting sign-offs, either from the APG, if they are deemed to be independent, or from external advisors?

The level of consultation varies dramatically across the market. Formal policies or guidelines for consultation are rare and those that do consult and fully understand the issues arguably have a significant competitive advantage over their peers.

- What contractual arrangements are in place with professional advisors to allow these individuals to consult on a timely basis?

Most standard audit engagement terms will not allow for the provision of accounting advice in relation to potential client accounting issues, if indeed the bank's auditors are the chosen provider of this service. In addition there are strict professional and ethical rules, as well as auditing standards in certain jurisdictions which restrict the services the auditor is allowed to provide. As such, specific engagement terms will need to be agreed and put in place with chosen professional advisors.

- Are accounting issues identified early enough and are the appropriate individuals involved at that stage?

A recurring theme is that accounting issues are not identified at an early stage in a transaction and hence what may have been simple issues to resolve at the beginning become significant issues as transaction documents have been drafted and the transaction presented to the client. A consultation with professional advisors at the beginning of the transaction can save significant costs if there are issues which would otherwise only have been discovered very late in the process.

- What is the culture and attitude of the organisation to accounting risk?

The attitude to accounting risk varies enormously both by institution and indeed across individual institutions. If a institution is to effectively manage its accounting risk then it is imperative that the recognition and awareness of accounting risks is embedded in its culture.

- Are the accounting risks fully understood and considered and are they given sufficient weight/consideration/attention?

Traditionally the front office has been focused on understanding and managing the risks in their deals and then pricing their deal appropriately. Just as other risks, like market and credit, are at the forefront of their minds when structuring deals, they must also consider the accounting risk if it is to be adequately managed by the organisation.

- What is the level of knowledge/awareness of these issues in the front office?

One of the key weaknesses with the current control mechanism employed by most banks is the heavy reliance on the structurers to know when there is an accounting issue or risk on which they need to consult. As such, the

## Accounting risk management: The missing piece in the risk management jigsaw? continued

knowledge and awareness of these individuals to the accounting issues is critical to the effective and efficient operation of those controls.

- Have front office staff received sufficient training to be able to identify when these issues are present and hence to know when to consult?

As referred to above, awareness of the accounting issues is critical, yet in most institutions the level of training on these issues which has been given to front office personnel is minimal. As well as leaving the bank exposed from an accounting risk management perspective, this also leaves the bank at a competitive disadvantage to its competitors who have undertaken comprehensive training programmes for these individuals.

- Are all accounting options considered or just ones that give the preferred answer?

As discussed earlier, the focus is increasingly on the appropriate application of the accounting standards and compliance with the spirit of the standard rather than just the form.

Professional advisors have often been involved with the consultation processes on the various standards and in a number of cases now have former standard setters working for them and hence they are able to give a comprehensive insight to the spirit and the form of the standard.

- How does the institution manage 'product creep'?

With the increasing complexity of the rules the details of transaction matter to the accounting analysis and small changes to those details can at times fundamentally affect the accounting analysis. All too often a trade is amended post accounting sign-off without any consideration as to whether that change may impact the accounting analysis.

- How does the institution cope with the fact that rules change over time and the answers may be different for different jurisdictions?

The limitations in the sign-off of the accounting analysis need to be understood, in the same way a small change to the deal may affect the

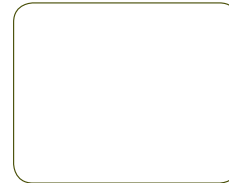
accounting analysis, that accounting analysis may well not hold true for another jurisdiction or indeed may no longer be appropriate as and when the rules or guidance changes.

- How is this risk captured, managed and reported to senior management?

Accounting risk is not a risk that is easily quantified and hence it is imperative that there are mechanisms in place to allow senior management to monitor, review and control the levels of accounting risk being taken on by the business. Key elements in this process normally include, but are not limited to, the new product approval process, deal approval procedures and reputational risk management processes.

- What percentage of the amount spent on external professional advisors is on due diligence in relation to the accounting risk as opposed to legal risk?

It is an interesting statistic, but for the majority of investment banks, the involvement of legal advisors dwarfs the involvement of accounting



advisors, which raises an interesting question as to whether that is representative of the risks, and if not, how is the institution happy that it has done sufficient due diligence on the accounting risk?

### Review and oversight

As mentioned above, the independent oversight and review of the accounting risks is normally addressed as part of one or more of the deal sign-off procedures, new product approval and/or the reputational risk management procedures. However, these procedures are only as good as the referral procedures, companies need to ensure that adequate consideration has been given to accounting risk and that all appropriate transactions are being subjected to the required approval processes.

In addition, are there arrangements in place which allow the approval committees/senior management to seek or request independent professional

advice on accounting issues if it hasn't already been obtained and they consider it necessary?

As discussed, current market practice is either for the front office to hire in specialist resources to help address and manage this risk, or for the Accounting Policy Group to be given this responsibility. Both models raise questions about independent review and oversight which institutions need to consider and address.

### Conclusion

Both accounting complexity and the focus on accounting issues are ever increasing and organisations need to ensure they have adequate resource and appropriate consultation arrangements in place to allow them to address and manage the associated accounting risk.

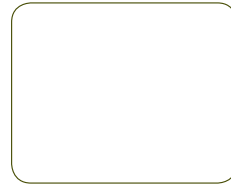
This will be of particular importance over the coming years with further changes expected, including the planned

convergence of IFRS with US GAAP and the convergence of many national standards, such as UK GAAP for example, to IFRS.

When determining the appropriate business model to address this accounting risk, a key consideration must be the independent management and oversight of that risk. Going back to basic risk management principles, there needs to be a division of responsibility between those committing the firm to risk and those independently monitoring the levels of that risk.

Appropriate consultation with professional advisors similar to that in relation to legal risks is vital in ensuring that a bank's interpretation of the standards remains in line with that of the wider accounting profession.

# Notes



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