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Editor’s comments

by Phil Rivett
Welcome to the second edition of the PricewaterhouseCoopers banking and capital markets journal. In this edition we open with a general interest article exploring China’s developing financial markets, and then move rapidly on to explore the impact of and opportunities arising from five developments currently impacting the global banking and capital markets industry.

China’s entry into the World Trade Organisation and the opening up of its financial markets to foreign scrutiny and competition is attracting significant interest around the world. In ‘What’s ahead for China’s financial markets?’ Kenneth DeWoskin and Kenneth Chung explore the history of the banking sector and what these latest developments mean for China’s role in the global economy.

With the turmoil experienced in the world’s stock markets over the last year or so, investors are understandably reassessing their appetite toward risk and return. As a result, there is now considerable opportunity available for those financial organisations to take a fresh look at how they manage risk to create value. In our second article, ‘Creating value in the new risk paradigm’, Richard Barfield and Richard Reynolds discuss how management might approach this opportunity.

Recent corporate failures and scandals have undermined the trust and confidence that investors place in the corporate reporting system, leading to calls for greater clarity and consistency in the quality of corporate reporting. The new watchword is transparency, and in ‘The future of corporate reporting’ David Phillips, Henry Daubeney and Kimberly Smith explore how organisations are responding to these new demands, and they consider the advantages of approaches based on the principles underlying PricewaterhouseCoopers ValueReporting™ research and the reporting framework proposed by PricewaterhouseCoopers in its recent publication, Building Public Trust – The Future of Corporate Reporting.

OECD developments and in particular the adoption of new rules on the taxation of branches operated in the United Kingdom by foreign banking institutions represent some of the most significant tax issues currently facing the global banking industry. In ‘Branch taxation – is a global change imminent?’ Adam Katz, Simon Leach and Jürgen Kuhn highlight the implications for banks, and consider what management should be doing now to ensure they are not facing increased tax costs when the new rules take effect.

Banking sector consolidation, responding to the needs of the previously unbanked and the threat of currency instability are some of the major developments impacting the South African financial markets. In an article based on the 2002 edition of a series of annual surveys commissioned by PricewaterhouseCoopers, Tom Winterboer, Johan Cloete, and Hardie Malan explore these developments and some of the other current ‘Strategic and emerging issues in South African banking’.

Many institutions responding to calls for enhanced corporate reporting are reassessing the ways in which they collect and distribute financial information. In ‘XBRL – one standard, many applications’, Richard Smith, Bruno Tesnière and Mike Willis consider the advantages and many potential uses of XBRL as a new universal, internet-based reporting language.

Thank you to those of you who provided feedback on the first edition of the journal, and on the topics you wish to see addressed in future editions. Please do continue to contact us with suggestions or any queries you may have.
What’s ahead for China’s financial markets?

by Kenneth J DeWoskin and Kenneth Chung
Picture a country of one billion people with a GDP of approximately US$43 billion. Major banks have roughly 30,000 branches and savings deposits totalling $2.5 billion, about $2.50 per capita. Government revenues and expenditures are roughly in balance, at $13.5 billion each.

That was China in 1978, on the eve of economic reform. Throughout the preceding thirty years since the founding of the People’s Republic of China, progress was made in achieving social and political stability, but robust economic growth had eluded China’s leadership. Upon Mao’s death, the first order of business was to restructure China’s economy, creating what his successor and master of China’s economic reform, Deng Xiaoping, called a ‘Socialist Market Economy.’

More than two decades later, China has a population of 1.3 billion, a GDP of approximately $1.35 trillion, and bank deposits of $1.9 trillion, or about $1,450 per capita (see Figure 1). China is the seventh biggest economy in the world and the first in terms of rate of growth. This level of sustained growth has involved, among other things, a complete restructuring of China’s Ministry of Finance (MoF), financial markets and banks.

As the fourth generation of leaders prepares to take power in early 2003 they will face a broad range of challenges in the financial sector, challenges that will require changes as profound as those of the last twenty years, demonstrating that China’s reform is not only complex; it is unfinished. In many respects, it is China’s banks and other financial institutions that bear the greatest burden of the socialist legacy: decades of central allocation of capital to inefficient State-owned enterprises, frequent shifts in investment strategies, poor corporate governance and internal controls and inadequate management of credit and other risks.

China’s major banks struggle with large portfolios of non-performing assets. Temporary relief was won when asset management companies assumed a large fraction of this burden with a huge debt for equity swap beginning three years ago. However the equity has proved difficult to monetise, and the asset management companies themselves have not been as successful as anticipated in restructuring and disposing of the equity acquired.

China’s equity markets have been nurtured as an alternative source of capital, primarily for the State-owned sector. The growth of the Shenzhen and Shanghai markets, in barely ten years, has been remarkable, but so have the growing pains. From an investor’s point of view, the markets have provided mixed returns and considerable risks. China’s insurance markets have also undergone restructuring, expansion, and opening up to domestic and foreign competition, in order to help individuals and institutions manage risk in an increasingly marketised economy.

A look back

A look forward to what’s ahead for China’s banks and financial institutions requires a brief look back, to understand fully the policy framework in which they have developed. There are two key points in this discussion. First, the regulatory and operating entities in China’s financial sector are directed by policy forces to make the transition from agents of centrally-planned fund allocation to a role shaped by markets and the commercial needs of efficient fund allocation.

Secondly, China is committed to commercialise, not privatise, its State-owned enterprises. This is more than a semantic distinction. So far, the explicit position of the Communist Party and the government is to attempt to maintain majority ownership of the State’s major enterprises while trying to protect the actual operation of the enterprises from...
inefficiencies and distortions caused by control and interference of the government ministries. The mandate is to separate control from ownership.

Given this continued commitment to State ownership, the first and foremost priority in shaping the financial sector is assuring the continued viability of the State Owned Enterprises (SOEs). While the SOEs are reducing their total employment, their crucial role in employment levels will continue to impede their efforts to operate efficiently over the next decade or more. A second, and equally important goal, is to support the government’s large, on-going investment in infrastructure. Constant, display-quality infrastructure development is now an inseparable part of China’s political economy. The domestic commercial customers of the major financial services providers and regulators are almost exclusively the SOEs. They still account for more than half the control of capital and half the fixed asset investment in China. Major banks such as China Development Bank make over 70% of their loans to development projects supported by the State Council, China’s highest executive body.

One of the key prevailing policies of the socialist market economy is separating regulators from operators. This is the reference point for a number of papers, including those from ministries regulating particular industries and organisations like the Chinese Securities Regulatory Commission (CSRC). The CSRC has developed extensive guidelines for corporate governance, that set forth limits on the role of the State in the governance of commercial entities, even where the State owns a large majority share. The policy has also placed considerable pressure on the banks to improve their credit risk management and curtail the unbridled allocation of loan funds to SOEs with no prospect of repayment. SOEs are also under threat from an impending new bankruptcy law that has yet to see the light of day.

Reform

Institutionally, the current system of banks and markets emerged from a highly centralised, unitary banking institution that served as both a central bank, issuing currency and implementing the government’s monetary policy, and a commercial bank, providing deposit, loan, and settlement services. The People’s Bank of China (PBOC), established originally in late 1948 by assembling three regional banks under Chinese Communist Party (CCP) control, worked with the Ministry of Finance, under the State Planning Commission, to implement the national plan. The operations of the bank were guided exclusively by the annual planning process and the plan itself, which focused on balancing a complex set of interlocking inputs and outputs across all major sectors of the economy. The PBOC served not only as the core of central and commercial banking activities but also as China’s insurance regulator and underwriter.

By the mid 1950s, some expansion of the banking system had occurred. The Bank of
China (BOC) had been established, under the PBOC, and the People’s Construction Bank (PCB), under the MoF. The former was responsible for foreign exchange activities and the latter for capital support of construction and fixed capital investment. Rural Credit Cooperatives were also set up, to take deposits and reallocate funds in the highly diverse agrarian economy. Both the BOC and the PCB were run as departments of their managing agencies, not as independent entities, until the reforms of late 1983 and 1984. At that point, the State Council formally established the PBOC as a central bank, charged primarily with standard central bank functions. A number of commercial and policy banks were separated out, and the People’s Insurance Company of China was established as a separate entity. The PBOC now describes its functions as a combination of formulating and implementing monetary policy and supervision of the financial services sector. For the latter, they write, ‘The PBOC performs the following functions: To approve, supervise and administer financial institutions and financial markets, to promulgate ordinances and rules concerning financial administration and business, to maintain the legitimate stable and sound operation of the financial industry.’

As we look at the prospects of China’s largest banks, such as the Industrial and Commercial Bank of China, the Agricultural Bank of China, Bank of China, China Construction Bank and the State Development Bank, it is important to remember that they have been in existence or have operated semi-autonomously for less than twenty years. The first four of these accounted for over 70% of all loans and over 60% of all deposits in China’s commercial banking system at the end of the last decade. At the end of the first quarter of 2002, the PBOC reported total deposits in the State banks at approximately US$1.9 trillion and total loans approximately US$1.36 trillion. These banks continue to operate within numerous constraints and non-commercial pressures, not only at the hands of central government, Party officials and bureaucrats who look to the banks to support industries and enterprises of importance to them, but also at the hands of local bureaucrats and officials whose fate is closely tied to the survival of SOEs in their particular region.

The future fortunes and functioning of China’s banks are integral to a policy role they cannot fully escape. The banking sector has been a key pillar in the remarkable, sustained growth of China’s economy over the last two decades, providing an escalating contribution year on year to the investment and operating funds of the large SOEs. China’s political leaders are involved in bank reform and they are deeply involved in the planning for the survival of domestic banks as they now face foreign competition. Foreign reports on China’s banking system have raised concerns over the extremely high level of non-performing loans (NPLs), the woefully inadequate reserves, the minute provisions for bad loans and the lack of commercial management. Provisions fall short of what is needed to cover even the most obvious NPLs, which could require the banks to use paid-in capital. But paid-in capital and other assets constituting the net worth of the major banks have steadily declined, from an estimated 13.2% of assets in 1985 to 2.7% by 1997. For that same date, the PBOC estimated that upwards of 25% of bank loans were non-performing, a sum exceeding 20% of China’s GDP.

China’s banking regulators have directed banks to:

- Adopt tighter accounting standards;
- Begin more rigorous external audits;
- Strengthen corporate governance and internal controls;
- Report biannually on their financial conditions; and
- Promulgate a detailed credit ranking regime to bring NPLs down to established target levels.
In 1995, the PBOC was officially designated the sole authority to regulate and supervise China’s banking sector and in 1998, the government promoted several reforms to address the NPL crisis. New capital of US$32.5 billion was injected to recapitalise the major banks through a special government bond issue. The PBOC lowered reserve requirements from 13% to 8%, and absorbed the new margin of liquidity by selling MoF bonds to the banks, then re-injecting the capital from the bond sales back into the banks. This essentially doubled the capital of the State-owned banks with the Ministry taking on the additional liability through the bond sale. Banks were set guidelines encouraging them to follow IAS procedures for recognising NPLs, and they were required to make loans on a commercial basis. Finally, local governments were banned from meddling in the lending decisions of regional banks. Except for the new capital injection and the double swap, these reforms offered a blend of regulation and hope. Their implementation is a long-term undertaking.

Since this turning point, the PBOC has steadily published new regulations and guidelines. In 2001 a key set of guidelines was published prescribing a credit risk classification scheme for banks, the ‘Guiding Principles for Loan Risk Classification.’ Most recently, the PBOC issued a draft for comment entitled ‘Guidelines for Internal Control of Commercial Banks’ in April 2002. During the same month, the PBOC published new guidelines for provisions which classify credit risk according to the 2001 guidelines and require banks to have appropriate provisions against bad debt by 2005.

The banks encouraged an internal transformation to focus on customer relationship management, as well as implementing a range of credit risk and internal loss management processes, many defined by the MoF and PBOC. They are building internal information systems, and reaching for more transparency in their operations and accounting practices. Even the major policy banks are reporting their emphasis on operations and risk management to the public, as well as setting objectives that are typical of well-run commercial banks. The conceptual framework for significant progress in the quality of the major banks is in place.

Over ten years, China has steadily moved its accounting practices toward IAS. Historically, banks have not recognised NPLs obscuring their credit profiles. Improvements have focused on a series of changes that provide a clearer picture of the solvency of the major banks and the integrity of their operations. However, accounting firms responsible for implementing changes express frustration at the difficulty of uncovering issues like the identification of structured loans, including the practice of rolling over bad debts and the completeness of related party transactions.

In their newly mandated reports, the major banks have reported progress, including a year-by-year reduction in NPLs, a sharp increase in provisions and the elimination of some of the most egregious accounting abuses that obscured the true financial health of the institutions. Their recent financial reports demonstrate improved provision levels, entirely new risk management processes and powers that are still in the process of being installed. Many independent economists believe the NPL problem is getting worse and may now have reached a level equal to 50% of China’s GDP. Industry-wide, China’s high saving rates keeps banks with a loan to deposit ratio under 70%, sustaining their liquidity with these NPL levels. Sector-wide data shows some change in the lending profile, with a shift towards more long-term lending and a significant movement of assets into portfolio investment. These trends could obfuscate both credit risk and potential erosion of paid-in capital.

What’s ahead for China’s financial markets? continued...
There is no denying that the problems of the banks run deep, and progress is still needed for example in the area of centralised information management and internal controls. The Bank of China, regarded as the best run of the four biggest State banks, has been rocked by a steady stream of embezzlement revelations, including one in its New York branch leading to the removal of a top bank official.

What lies ahead

China’s major banks will have a somewhat extended period of protection, compared with what foreign banking executives had expected after World Trade Organisation (WTO) accession. That extra time, in conjunction with the high level of credibility they enjoy among the banking public and the special relationship they have with SOEs and local bureaucrats will assure their survival and growth, barring a sector-wide collapse. China’s top bankers are reaching for a leadership position in the Asia-Pacific region as well, commercially through moves such as the initial public offering of the Bank of China’s Hong Kong subsidiary in 2002 and diplomatically through an increasing voice at events like the International Monetary and Finance Committee meeting in Washington in spring 2002.

China’s WTO commitments have offered the opportunity for foreign banks to establish new operations. To date the pace of entry has been sluggish, slowed in part by incomplete guidelines and high capital and reserve requirements. International bankers expressed concern about the numbers announced in the regulations. According to the foreign-funded financial institution regulations effective from February 2002, foreign-owned banks or foreign-invested joint venture banks must have registered capital equal to 300 million rmb, while other foreign-invested financial institutions require 200 million rmb.

Accounting for change

It is easy to underestimate the enormity of the challenge of restructuring accounting practices in China. A major effort has been underway since reforms began to achieve consistency with IAS procedures. Global firms like PricewaterhouseCoopers have been an integral part of China’s achievements in accounting reform. The MoF has been active in developing Chinese Accounting Standards (CAS) for a decade. Presently, key regulatory entities for accounting in China include the MoF and CSRC, with the former being formally empowered to set standards and oversee the industry and the latter focusing on listed companies and their reporting.

Figure 2 Capital aggregation is still primarily by the State banks, with the equity markets growing quickly but unsteadily

<table>
<thead>
<tr>
<th>Trillion rmb</th>
<th>GDP</th>
<th>Bank assets</th>
<th>Market capitalisation</th>
</tr>
</thead>
<tbody>
<tr>
<td>12.3 T rmb</td>
<td>8.94 T rmb</td>
<td>4.81 T rmb</td>
<td></td>
</tr>
</tbody>
</table>

Source: People’s Bank of China, Chinese Securities Regulatory Commission
requirements. The most recent revision of China’s law is *The Accounting Law of the PRC*, promulgated 1 July, 2000.

Accounting, like many other areas of economic reform, began changing at an accelerated pace around 1998. In early 2001, the Ministry implemented the Accounting System for Business Enterprises, and this has been developed step by step to cover most areas of IAS and most enterprise structures, including foreign invested structures. A different but derivative system was implemented at the beginning of 2002, called the Accounting System for Financial Institutions. Use of this system is mandatory from the beginning of 2002 for all listed financial institutions and all foreign-invested financial institutions in China. Its use is strongly recommended for unlisted, domestic financial institutions, except those not yet restructured into joint stock limited enterprises. Large banks that have not restructured use the old accounting system.

Chinese authorities continue to attempt to balance the benefits of achieving consistency between CAS and IAS and the special needs of financial institutions in an economy in transition. As a result, one major difference that still remains between CAS and IAS is the level of administrative guidance provided for CAS adding specificity to China’s accounting requirements beyond what is outlined in the statutes. While there is debate about the consistency of implementation and supervision, on paper the accounting requirements for Chinese enterprises listing on domestic exchanges are at least as demanding, if not more so, than IAS.

**Conclusions**

There are three discontinuous and potentially disruptive factors making it difficult to foresee a steady and linear development of China’s banks and financial services industries generally.

Firstly the certainty that a new major wave of restructuring lies ahead for the major players. This will be required if the sector is to continue the push forward towards more commercial and sustainable operations. The second is the change in top Party and government leaders at the end of 2002. As is typical during such transitions in China, those waiting to ascend to top positions respectfully keep their counsel until the mandate to rule is actually in their hands. As a result, not only are we not privy to the specifics of their policy plans for the sector, we are unable to speculate about their broadest commitments to the reform process itself and their individual tendencies in key decision areas.

Thirdly is the role of foreign corporations. The negotiations leading to China’s accession to the WTO took nearly fifteen years, and the financial services sectors were very much in focus. The last issue to be settled, on the eve of China’s formal accession, had to do with grandfathering special arrangements currently enjoyed by some existing foreign insurance companies in China.

China is committed to opening the banking, insurance and fund management sectors to foreign participation, but the commitments are quite specific and contain safeguards to prevent domestic entities from being overrun. These are generally in the form of joint venturing requirements, geographic limitations and equity ceilings. In as much as there are a limited number of banks and insurance companies licensed in China who could be partners, these companies all work closely with the major regulators. As we come to the end of China’s first year of WTO membership, it is evident the regulators are following a go-slow approach to see what impact competition will have on China’s domestic players. The protection built into the WTO commitments has been augmented by rules published subsequently for many service industries that establish large capital and reserve requirements, uncertain application processes and timetables and undefined qualification rules. This will be an enduring feature of the Chinese investment environment and it continues...
underscores the importance of local knowledge and support in all phases of opportunity analysis, strategic planning, commercial and regulatory negotiations. Nonetheless, direct foreign investment in China will exceed $50 billion in 2002, making it the number one destination in the world and surpassing the US for the first time.

Along with that river of capital, the rapid expansion of foreign participation in all subsectors of financial services is a certainty. We now appear to be on the cusp of dramatic change in this regard.

Recent assessments of China’s first year as a WTO member have expressed praise for what has been accomplished but frustration at the slowness of the opening of financial services, and the on-going lack of transparency and legal stability in the compliance process. For the financial services sector generally, this is revealing, for it argues that China’s leaders are as uncertain about the ability of key institutions and enterprises to sustain their reform and development as outside experts are. Or, put another way, in the fast track of China’s overall economic growth, commercial expansion, wealth creation and marketisation campaign, the financial services sector faces considerable reform challenges in the coming decade and presents huge opportunities for foreign participants.
Creating value in the new risk paradigm

by Richard Barfield and Richard Reynolds
The need to manage risk in order to create value has never been stronger. There has been a paradigm shift in equity investors’ expectations, in broad terms, from high growth and low risk to low growth and high risk. Return expectations have fallen dramatically.

Corporate and natural disasters, and questions over the integrity of the financial reporting system (particularly in the US), have created a critical, cautious investment climate. This has had a major impact on the financial services sector.

Finding paths to create value in this new environment requires an understanding of how the world has changed and an integrated approach to managing risk and value. This unprecedented set of circumstances provides management with the opportunity to take a fresh look at how their organisations create value and manage risk. The combination of economic capital based tools with leading approaches to risk management can provide organisations with new sources of competitive advantage.

A recent survey by PricewaterhouseCoopers of 14 of the world’s leading financial institutions showed that 57% do not yet measure performance on a risk-adjusted basis.

Clearly, the opportunities for those that act now are significant.

**How has the world view changed?**

As the financial services industry responds to falling investment portfolio values, increasing bad debt provisions, tightening solvency and new regulatory requirements, share prices in the sector have fallen dramatically.

**Market capitalisation**

Our analysis of the decline in market capitalisation of a sample of 62 of the world’s largest financial services firms (at 1 September 2002) shows a net decline of $657bn (27.5%) between September 2000 and 2002. In the same period the world index (as measured by Morgan Stanley Capital International index) fell by 41%.

The largest declines have been in investment companies, investment banking and the life assurance sectors. Retail banks and pure non-life companies have performed the best in relative terms (see Figure 1). Despite these difficult conditions 14 of the 62 firms in our analysis were able to achieve an increase in value of $104bn over the same period.

Many companies which, a few years ago, were comfortable in setting value-based goals, such as doubling Total Shareholder Return (TSR) in four years, face an uphill struggle to meet commitments to investors.

**Figure 1 Market capitalisation September 2000 vs. 2002 – major FS institutions**

<table>
<thead>
<tr>
<th>Sectors</th>
<th>Number</th>
<th>2000 $bn</th>
<th>2002 $bn</th>
<th>Change $bn</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retail Banks</td>
<td>10</td>
<td>949</td>
<td>796</td>
<td>–153</td>
<td>–16.2</td>
</tr>
<tr>
<td>Insurance – other</td>
<td>10</td>
<td>609</td>
<td>455</td>
<td>–154</td>
<td>–25.3</td>
</tr>
<tr>
<td>Investment Banks</td>
<td>10</td>
<td>333</td>
<td>163</td>
<td>–170</td>
<td>–51.1</td>
</tr>
<tr>
<td>Life Assurance</td>
<td>10</td>
<td>227</td>
<td>132</td>
<td>–95</td>
<td>–42.0</td>
</tr>
<tr>
<td>Non Life Insurance</td>
<td>10</td>
<td>107</td>
<td>106</td>
<td>–1</td>
<td>–0.8</td>
</tr>
<tr>
<td>Investment Companies</td>
<td>10</td>
<td>87</td>
<td>30</td>
<td>–57</td>
<td>–65.8</td>
</tr>
<tr>
<td>Reinsurers</td>
<td>2</td>
<td>81</td>
<td>54</td>
<td>–27</td>
<td>–32.8</td>
</tr>
<tr>
<td></td>
<td>62</td>
<td>2393</td>
<td>1736</td>
<td>–657</td>
<td>–27.5</td>
</tr>
</tbody>
</table>

Source: Datastream/PricewaterhouseCoopers analysis
Capital is a two-headed beast. Investors may be seeking returns for the risks they have assumed, but capital is also there to satisfy regulators’ demands for protection against unexpected losses. The investors’ demand for return on capital to be maximised competes with the regulators’ desire for prudence and stability.

**Risk**

Understandably, in 2002 the regulator (or debt-holder) perspective has dominated. Dividend cuts and rights issues have been used to bolster balance sheets depleted by bad debt provisions and declining equity portfolios.

The challenge of meeting investor expectations in this hostile environment is immense. However, we need to be careful not to be swept away by generalisations. Growth has not declined everywhere and risk has not increased evenly across the board.

For example although investment banking and life assurance are experiencing dramatically reduced returns, consumer banking has stood up well (at least so far) and some general insurance is enjoying a cyclical boost through firmer premiums. Portfolio effects like these allowed Citigroup, for example, to report a 15% rise in second quarter profits to $4.1bn and a third quarter rise of 23% to $3.9bn.

Some geographies are also responding differently (see Figure 2). The country risk map has changed as relative risk premia have moved. Although the country risk premia in Latin America have increased significantly, in the former USSR and sub-Saharan Africa they have declined. Premia in Asia Pacific and Eastern Europe have remained relatively stable.

Therefore, a key issue for institutions is to understand how the risk map has changed and the implications of these changes for strategy, capital allocation and value creation. This represents an opportunity as well as a challenge – in a tougher environment those with superior risk management capability should attract investors and earn higher, sustainable returns. Without these capabilities there is a danger that corporate risk aversion will stifle investment and growth.

Risk and control have never been higher on the corporate agenda, particularly in the US. The challenge for management is to take advantage of the changes being introduced and create economic value.
The challenge

Financial institutions must now rise to the challenge of making value-creating capital allocation decisions within the new risk topography. As institutions feel their way through the new landscape, the opportunities to create value for those who are prepared to act with confidence are likely to be immense. However, many organisations do not yet have the necessary infrastructure in place to take advantage of them.

To succeed, companies require superior abilities to:

- Understand, price and manage risk;
- Maximise value from strategic choices and resource allocation decisions; and
- Implement change in a difficult market and demanding regulatory environment.

Two key conclusions from the papers are that:

- Economic capital is the only tool that allows management to compare performance across the company and make the best investment decisions; and
- Board level management must seize the risk management agenda and make risk management a strategic priority.

Risk management at the edges of the probability distribution – the low frequency, high impact events – is where improvements are needed. Such events are inherently unpredictable, so this does not mean trying to anticipate the unknowable. What it does mean is openness to considering linkages between risk types. Many companies are now much more attuned to the impact of widespread business disruption risks linked to a series of possible, but unlikely events. In doing so, managers need to be encouraged to think more widely and beyond the comfort zone.

It also requires a more flexible approach to strategy so that an organisation can be flexible in response to changing circumstances. This is why many leading organisations now use scenario planning and real option evaluation as part of the strategy selection process.

Few institutions would disagree with the merit of these views: the difficulty is in implementing the changes to make them a reality. Intolerance for unexpected shocks and stakeholder demands for greater transparency mean that the implementation challenges must be overcome. Recent decisions in the US to expense share options are
Creating value in the new risk paradigm continued...

Analysts believe that banks and insurers have been good at disclosing the potential impact of low-probability, high-impact events on their businesses. Many doors are being closed with great panache. However, what is concerning many investors and CEOs is to what extent effective ‘tail-management’ can be strengthened as part of the business-as-usual management of financial institutions.

Making it happen

How then does one start to drill down into these issues and convert plans into practical operational action?

There are essentially two strands – immediate tactical action and the design and implementation of better management processes. What is required is a structured response – balancing short and long-term requirements. Figure 3 illustrates the process that management might follow to develop such a planned, prioritised response. The approach consists of three interrelated phases.

**Diagnosis**

Phase 1 is a diagnostic assessment. The output from the diagnosis should be a clear picture of where capital might be reallocated at a strategic level to increase risk-adjusted value. It is critical in the new environment to have a fresh, objective view, often with a fresh assessment of the risks that are difficult to quantify. In addition, an analysis of risk management processes provides an essential input into the development of management’s agenda for improved performance.

Key actions at this stage include:

- Validating existing strategies against the new environment;
- Using scenario planning to stress test alternative outcomes and better understand uncertainty;

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As an example of moves towards requiring improved transparency, in August 2002 both Citigroup and JP Morgan Chase decided their clients must provide greater clarity about how they are financed. They will refuse to transact with those that do not.

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Key actions at this stage include:

- Validating existing strategies against the new environment;
- Using scenario planning to stress test alternative outcomes and better understand uncertainty;
• Testing optimal outcomes by constraint analysis of value/unit of regulatory capital; and
• Re-evaluating risk management processes and structures.

Many insurers are already revising pricing strategies and rebalancing their customer/product mix as a result of reassessing risk and return. For example, there has been an understandable switch away from US casualty business. Whether all these decisions have followed rigorous analysis of institutions’ business portfolios as a whole is unclear.

A useful way to think of this first phase is of management assuming a much more assertive role as ‘the shareholder’. Clearer and more effective external communication can only be achieved if greater transparency and better risk management are first focused internally.

Design

The aim of Phase 2 is to design new processes, systems and structures that will protect existing value and position the business to take advantage of the ‘new world’ opportunities. As an example of the steps taken to protect value, several organisations have recently announced new appointments and different management structures to address perceived governance issues. However, the necessary change has to drive a lot deeper.

In particular the envisaged change must take account of organisational culture. Cultural change cannot be imposed. Instead the drivers of cultural change need to be managed to achieve the desired outcome. A key aspect is how management’s behaviour communicates the risk appetite inside and outside the institution.

Phase 2 activities include planning interventions to change behaviour and signal what management wants the organisation to do differently in terms of managing risk and value. This will typically involve redesign of performance measures and incentives as well as putting in place appropriate support such as training.

It is essential to achieve a balance between strategic goals, value targets, risk appetite and reward systems. Recently, one global bank has introduced fundamental changes to target setting, performance reporting and credit assessment. The changes have been articulated within a framework of managing risk, returns and growth. The blueprint is based on best practices seen in other leading organisations but creates a framework that is probably unique in the depth and breadth of its application.

This bank is one of the winners in value creation over the last two years, managing to generate nearly $20bn in additional market capitalisation. One of the key reasons for this bank’s successful implementation was that from the start it had the full backing of the CEO who recognised that what was needed was a fundamental, integrated, group-wide initiative.

Implementation

Phase 3 is about execution. The implementation steps and factors for achieving successful change will vary significantly from one organisation to the next.

The implementation challenges should not be underestimated. In PricewaterhouseCoopers’ experience, these are likely to include significant data issues and creating a sense of ownership for new performance measures (for example new, dynamic capital
Creating value in the new risk paradigm continued...

allocations) at all levels. Successful implementation of any new framework will depend on an in-depth appreciation of the drivers of value, sensitivity to the culture of the organisation and mobilisation of senior management behind the agenda.

Other factors associated with the successful implementation of economic capital concepts that management should consider include:

1. Ensure that the whole management team is behind the project.
2. Discuss the proposed system with regulators.
4. Draw on the experience of others, for example, for new sources of risk data.
5. Keep up to date with latest risk assessment methods.
6. Deliver continuing management education.
7. Consider carefully how deep in the organisation the economic capital system should be driven.
8. Create and maintain institutional knowledge.
10. Introduce economic capital as part of a coherent decision-making process. Stick to consistent principles from strategy to pricing and measuring, management and rewarding performance.

The important first step for management is to take the fresh view described in Phase 1 (Diagnosis). In the new paradigm a fresh perspective is needed, as are strengthened risk and value management. Nevertheless, judgement and experience will continue to be paramount.

The Russians have a saying that he who has one eye on the past is blind in one eye; he who has both eyes on the future is blind in both. There is a lot to be learned from 2002.
the journal • Tackling the key issues in banking and capital markets
The future of corporate reporting

by David Phillips, Henry Daubeney and Kimberly Smith
A lack of transparency can distort share values, undermine public confidence and increase the cost of capital. In short, investors and other stakeholders are penalising poor and inadequate reporting. In this article we look at why it is time for financial institutions to come clean.

A rash of recent accounting scandals has shaken public confidence in corporate disclosure practices. Yet, problems with financial reporting are neither new nor confined to a few examples. Indeed, even the most admirably law-abiding companies can be guilty of damaging sins of omission, if not commission.

In many cases, poor communication with the markets and other stakeholders means that genuine value creation is not reflected in the share price. A PricewaterhouseCoopers survey of bank CFOs from around the world1 found that barely a third of respondents believed that their shares were valued accurately. None felt that their shares were overvalued, with a large proportion, particularly in the US, believing that their equity was significantly underpriced.

What we are seeing across the banking industry is an increasing gap between what banks disclose and the data an increasingly diverse and sophisticated investment community needs to gauge a company’s underlying performance and future prospects. The PricewaterhouseCoopers survey revealed that only 10% of investors and 21% of analysts find banking reports ‘very useful’. The research not only highlighted market concerns about the credibility of disclosure, but also the narrow scope of current financial accounting. In particular, investors and analysts indicated that they would like more information on economic profit generation and return on risk-adjusted capital. They would also like to know more about an institution’s key long-term value drivers including service quality, customer loyalty and risk management.

Earnings game

Part of the problem clearly stems from what many analysts, investors and indeed bankers themselves believe has been an undue focus on short-term earnings, which can lead to manipulation and divert attention from sustainable value creation. Investors and other stakeholders are increasingly focusing on other measures which are already available to management through their own internal reporting systems. Indeed, our research shows that banks themselves rank service quality and customer loyalty as more important value drivers than accounting results. Many leading banks now also use and disclose economic profit and other such capital-based measures as their key performance indicators (KPIs).

The importance of factors above and beyond ‘historical cost’ accounting can be seen in the market to book value ratio of the Standard & Poor’s 500, which stood at 4.2 in September 2002. All too often, the information gap between what is achieved and what is disclosed is filled by uncertainty and supposition, which as many will recognise inevitably leads to share price volatility and fails to reward true performance. At a time of increasing caution and scepticism among investors,
those markets are also tending to penalise financial institutions perceived as being more opaque and secretive with a higher risk premium and cost of capital.

Many banks continue to believe that greater openness could compromise commercial confidentiality and provide information that would be seized upon by competitors. These are certainly important concerns, especially for institutions facing the threat of predatory take-over. However, management has failed in its responsibility to shareholders if value is created in an organisation, yet a lack of transparency ensures that this is not reflected in its share price or the returns to investors. Management also has a responsibility to establish a viable business strategy, based on the setting and realisation of key performance targets. Failure to communicate such strategic coherence will naturally call its credibility into question.

**Wider responsibilities**

As ethics and probity come under ever increasing scrutiny, corporate disclosure also needs to look beyond the capital markets to address the interests of a wider group of stakeholders ranging from employees, customers and business partners to supervisory bodies, consumer and environmental groups.

Effective communication can lead to significant benefits in key areas such as improved staff motivation, enhanced brand loyalty and a better relationship with regulators (see Figure 1). However, credibility is hard to win, easy to lose and virtually impossible to restore, demanding consistency, transparency and the ability to make information understandable to the target audience, even when presenting bad news. All stakeholders will tend to read more into silence and obfuscation than is necessarily valid.

Equally, banks are themselves among the most important users, interpreters and disseminators of corporate information. The industry’s place at the heart of the financial system offers it the unique scope and ability, indeed some would argue the responsibility, to lead and shape the development of more open and useful reporting practices. However, it is regulators rather than banks that appear to be setting the pace.
Regulatory response

International Financial Reporting Standards (IFRS, formerly IAS) will become mandatory for EU-listed firms in 2005 and the agreement by the SEC and FASB regarding the convergence, in principle, of IFRS and US GAAP, provides what we believe will be important steps towards a more transparent and globally comparable framework for financial disclosure.

For the international banking industry, Basel II edges ever closer. Pillar 3, which focuses on market discipline, will have far-reaching implications for reporting, including the requirement to provide information on risk and capital management across business units.

The move to increase reliance on internal risk analysis will also intensify the focus on the credit assessments performed by banks. In turn, banks will want to find out more and more about the credit risk and assessment processes of potential borrowers and trading counterparties.

Many bankers have expressed reservations about the merits of much of this reform, especially as there appears to be little correlation between the new financial reporting standards and the economic profit measures and other KPIs used by management. However, it is clear that the reforms will intensify the spotlight on communication and disclosure strategy, potentially requiring a fundamental overhaul of reporting systems and practices.

New reporting models

A basis for a more holistic approach to communication and disclosure practices is outlined in a new book, Building Public Trust – The Future of Corporate Reporting, written by Samuel DiPiazza, CEO of PricewaterhouseCoopers and Robert Eccles, President of Advisory Capital Partners and a former professor at the Harvard Business School.

The book draws on examples of best practice and forward thinking from around the world to develop an integrated three-tier framework for corporate disclosure (see Figure 2). This model does not seek to

Figure 2 Three-Tier Model of Corporate Transparency


‘The negative consequences of incomplete and unreliable information can extend well beyond an individual company or even the stock market. They can affect an entire economy.’

From Building Public Trust –
The Future of Corporate Reporting
replace statutory financial reporting standards. Rather, it aims to complement them by identifying and communicating the performance measures and processes that indicate a company’s ability to enhance shareholder value. This is consistent with the themes underlying PricewaterhouseCoopers’ ValueReporting™ research, and builds on the need for improved communication, both to create value and to rebuild public trust in financial reporting in general.

**Tier one: Global GAAP**

The foundation tier is a single set of common global financial reporting standards. This would make it much easier for investors to compare performance in different countries and industries. The adoption of IFRS within the European Union (EU) alone would harmonise accounting across 8,700 companies, representing around 25% of the world’s capital market value. A number of other significant markets, such as China and Australia, have recently indicated a commitment to adopt IFRS in the near future. Taking into account the impact of convergence with US GAAP, which would bring in a further 50% of global capitalisation, it is clear that the establishment of this tier is well under way.

**Tier two: Industry-based standards**

The development of common performance measures for key industry-wide value drivers would allow investors to compare companies against their competitors. Hotels, for example, now publish revenue per room, while many retailers report sales per square metre. Banks already employ a range of comparable metrics such as coverage ratios that could be used as a basis for reporting and comparison. Quantitative analysis in other key areas is also feasible. Innovation, for example, could be charted by the percentage of revenue generated by new products. Institutions that have been taking the lead in this area include Deutsche Bank, which reports a comparable ‘value-at-risk’ measure for each individual trading unit. UBS Warburg provides a clear graphical analysis of its credit exposures by credit rating, industry and geography.

**Tier three: Company-specific information**

Certain key value drivers are unique to each company. These include strategy, the quality of management, performance against objectives and management’s view of the competitive environment. Tier three also looks at how banks can more effectively communicate their commitment to the wider stakeholder community.

As outlined in the latest edition of PricewaterhouseCoopers’ annual ValueReporting™ Review, the Co-operative and Santander Central Hispano Banks are leading the way in measuring and reporting ‘human capital’ and the delivery of value returns to specific ‘partner’ stakeholders. Equally, this could be an opportunity for institutions to provide regulators, for example with better information about how they analyse and control risk. While it would be difficult to define standards for the content of this tier, it would be possible to develop common guidelines for the scope and format of reporting.
ValueReporting™ Review 2003
Transparency in Corporate Reporting

The ValueReporting™ Review 2003 (earlier editions were published as the ValueReporting Forecast) demonstrates that ValueReporting™ is a real working model – not theory. The Review presents real-life examples of forward-thinking corporate reporting from 61 companies worldwide as well as expanded case studies of three companies that are currently moving along the path towards greater transparency through the development of a wider corporate reporting agenda.

The Review provides valuable insight into how ValueReporting™ works and guidance – perhaps inspiration – to others that have decided to embark on the difficult, but ultimately highly rewarding, journey towards greater corporate transparency.

For more information visit: www.valuereporting.com

Figure 3 ValueReporting™ Framework

<table>
<thead>
<tr>
<th>Market Overview</th>
<th>Strategy</th>
<th>Value Creating Activities</th>
<th>Financial Performance</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Competitive Environment</td>
<td>• Goals and Objectives</td>
<td>• Customers</td>
<td>• Financial Position</td>
</tr>
<tr>
<td>• Regulatory Environment</td>
<td>• Organisational Design</td>
<td>• People</td>
<td>• Risk Profile</td>
</tr>
<tr>
<td>• Macro-economic Environment</td>
<td>• Governance</td>
<td>• Innovation</td>
<td>• Economic Performance</td>
</tr>
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Source: ValueReporting™ Review 2003 published by PricewaterhouseCoopers
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Realising the vision

Clearly, management needs to be comfortable and confident about the relevance and reliability of the information it is disclosing. Expert advice and independent verification may therefore be necessary. Management also needs to develop a coherent framework for presentation and comparative analysis. PricewaterhouseCoopers ValueReporting™ Framework is one route, providing an overview of a company’s market, its strategy, the way it creates value and how these link to financial and other measures of performance (see Figure 3).

Equally, banks will need to educate investors, analysts and other stakeholders about what is being reported and why. There is no point deluging people with information that they will ignore or misinterpret. Finally, rebuilding and sustaining public trust will require every participant in the corporate reporting supply chain – management, auditors and analysts – to work together in a spirit of integrity, transparency and accountability (see Figure 4 overleaf).
Taking the lead

With the focus now firmly on reporting, banks can derive significant competitive advantages from pioneering more transparent and relevant disclosure. Openness is a sign of institutional confidence and will enhance management credibility. This credibility can attract a more stable investor base, reduce share price volatility and lead to a smoother relationship with regulators.

Those at the forefront can also help to set and raise the standards for others to follow. Several years ago, the Bank of Montreal put itself in the vanguard by benchmarking its shareholder return against its North American peer group. Its compatriots CIBC and Scotia Bank have now followed suit, with CIBC taking this to the next level by disclosing economic profit by business unit and actively discussing its capital management strategy with investors. Clearly this is an evolving competitive process. Innovation by one institution inevitably raises market expectations about what should be disclosed by its peers, requiring further innovation to stay one step ahead of the pack. At the very least, no company can afford to fall behind.

Taking the credit

Does your share price truly reflect the strengths, achievements and capabilities within your organisation? Are you communicating your values to the key stakeholders upon which your success and reputation depend? Are you satisfied with your current cost of capital?

The stark fact is that all too few organisations could give an entirely positive answer to any of these pressing questions, let alone all three. At a time of ever increasing competition for investment and scepticism about corporate reporting, many institutions are failing to provide the breadth and quality of information they need to sustain stakeholder confidence and the creation of shareholder value.

A number of pioneering institutions are addressing the information gap to turn effective communication into a source of competitive differentiation. For others, the need to revamp their reporting practices to meet new regulatory requirements offers a once in a lifetime opportunity to develop a more viable and coherent approach to corporate disclosure.

Communication needs to be reliable, verifiable and where possible aligned to the KPIs used for internal management purposes. It also needs to be tailored to
the specific user. Above all, credibility depends on transparency, even if this means revealing unfavourable news. This can be a daunting prospect and naturally entails some element of risk. Nevertheless, as *Building Public Trust – The Future of Corporate Reporting* suggests, the goal of credible and comparable disclosure is not only desirable, but increasingly realisable. Those that act now will reap the rewards of enhanced credibility and set the benchmark for others to follow.
Branch taxation –

is a global change imminent?

by Jürgen Kuhn, Simon Leach and Adam Katz
Any article dealing with branch taxation is unlikely to elicit fits of enthusiasm from the reader. Many people will already be familiar with the ideas and issues surrounding transfer pricing arrangements, however, in a further development, the basis on which overseas operations are taxed is changing. It is becoming increasingly important for management within institutions in the financial services sector with branch operations in multiple jurisdictions to have a sound understanding of the issues. This comes as a result of the ongoing debate at the OECD level and recent domestic developments concerning the taxation of branches. It should be stressed this is not an academic debate: the outcome of the current discussions is likely to have a significant impact on the allocation and reshaping of taxation rights between states and could in turn have a very significant impact on the overall tax paid globally by financial institutions, particularly banks.

Background

In February 2001, the OECD published a draft discussion paper on the attribution of profits to ‘permanent establishments’ (PEs) for tax purposes. For those unfamiliar with the term, a PE is, very broadly, a tax term for a branch of a foreign resident company (as opposed to a separate legal entity). Whilst the OECD paper addresses the attribution of profit to a PE of any enterprise, the second part of the OECD paper focuses solely on traditional banking activities in recognition of the fact that the branch structure is far more common in the banking sector.

The OECD debate is still some way from reaching a consensus and discussions are continuing following publication of the draft discussion paper. What practical impact is this debate likely to have? There are essentially two schools of thought. One view, held, for example, by the US, is that the OECD debate serves as little more than a discussion forum and is unlikely to have any real practical impact. The alternative view, which has been borne out by recent developments in the UK, is that the impact is likely to be significant.

Despite the difficulties faced at OECD level, the UK tax authorities have decided to press ahead with introducing domestic legislation, which implements the OECD proposals in part for accounting periods beginning on or after 1 January 2003.

These proposed changes to UK domestic law are likely to have an almost immediate impact on all overseas retail and investment banks operating in the UK through a branch (including a large number of US, French, German, Swiss and Japanese banks) and preliminary indications are that many could be paying significantly more UK tax as a result. The additional tax yield from the new rules has been estimated by the UK Treasury to be in the region of £1bn over the next two years.

The UK is unlikely to be alone in this experience, as a number of other major jurisdictions such as Germany are also considering changes based on the OECD proposals. Conversely, while the US global dealing regulations (which address the transfer pricing methods to be applied in determining the profits allocated to the US where a bank operates a global trading book), proposed in March 1998, have not yet been finalised and the US tax authorities appear to be taking a ‘lock-step’ approach with the OECD.

The changes to UK domestic law only deal with the attribution of capital to branches of overseas banks. The outcome of the OECD debate is likely to be even more far-reaching as it will cover all aspects of profit attribution to PEs.
The importance of the branch structure

The PE concept is of vital importance to banks, since many of them choose to carry on their overseas activities through branches rather than separate legal entities. One of the main reasons for this is efficient use of a bank’s capital. If a foreign bank were to operate in an overseas jurisdiction through a separate legal entity, local regulators would normally require it to hold some equity-type capital to safeguard the interests of depositors. In contrast, local regulators do not normally require branches of an overseas resident bank to hold such capital, since the overall bank is regulated in the home jurisdiction. As a result, a foreign bank is typically able to fund its overseas branches with debt finance rather than equity capital. Key advantages of the branch structure therefore include a lesser requirement for capital overall and flexibility since debt finance is not ‘locked up’ in the way that equity capital is.

Why is this so important for tax purposes? As an example, consider how a traditional retail bank makes money. Its gross profits are determined by the ‘margin’ between the average cost of the bank’s available funding and the return it makes by lending on those funds to borrowers. A key component in determining a bank’s profits for tax purposes is therefore its average cost of funding. As noted previously, where a bank operates in an overseas jurisdiction through a branch, that branch will typically be funded by debt. As a result, other things being equal, its average cost of funding will be higher and its reported profits lower than if it were a subsidiary. In reality, the issue will be complicated by the fact that a branch is likely to have a higher credit rating than an equivalent subsidiary as it will assume the credit rating of its head office, and this will act to reduce the branch’s average cost of funding.

Under OECD principles governing the calculation of profits attributable to the PE of a banking enterprise, it is accepted that interest payments made between a branch and its head office in relation to advances of debt financing (as opposed to allotted capital) should be deductible for tax purposes. Accordingly, the view of the OECD seems to be that a branch’s taxable profits may also be lower than those of a corresponding legal entity. It is this mismatch that tax authorities in a number of jurisdictions have been looking to address, by attributing interest-free capital to the branch of a foreign bank as part of the process of determining its taxable profits. This notional allocation would have the effect of reducing the levels of debt interest available to offset profits, and increase the tax costs of the branch as a result – instead of being taxed on a spread the branch will be taxed on a gross margin.

Determining the taxable profits of branches

Double tax treaties are bilateral agreements entered into by countries all over the world in order to prevent double taxation (situations where the same income is taxed more than once in the hands of the same person). Under the OECD Model Convention, the country where a company is resident gets the primary right to tax its business profits. However, where the company has a branch or agency (PE) in another jurisdiction, the country where the PE is located is also allowed to tax the business profits. In such cases, double taxation is avoided because the overseas jurisdiction is only entitled to tax the profits ‘attributable’ to the PE. In other words, the PE concept is used to determine which ‘slice’ of the overall ‘cake’ (being the overall tax profits of the company) can be taxed in the overseas jurisdiction.

Most double tax treaties include a section that sets out how the profits attributable to a PE are to be calculated. This section of the treaty is known as the Business Profits Article and typically includes a number of assumptions that have to be applied in making the calculation. These are that the branch is assumed to be a distinct and
separate enterprise (the ‘separate entity’ assumption), which is engaged in the same or similar activities as the branch and operating under the same or similar condition and dealing wholly independently with the enterprise of which it is a PE.

Applying these assumptions can often give rise to conflicting answers and this makes it extremely difficult to apply the Business Profits Article in practice. Nowhere is this better illustrated than in addressing the question as to whether or not a branch should be attributed a notional capital base in computing its taxable profits.

By definition a branch would not have its own equity capital, as it is not required to do so for regulatory purposes. Therefore, if we assume that our hypothesised separate entity is operating under the ‘same or similar conditions’ as our branch then it appears that the branch should not be attributed a notional capital base. Conversely, the application of the ‘separate entity’ assumption would lead us to conclude that the branch should be attributed capital on the basis that an independent subsidiary would be required to hold equity capital for regulatory purposes.

The OECD paper places a strong emphasis on the ‘separate entity’ hypothesis and concludes that capital should be attributed. However, there are a number of inconsistencies in the detail of the OECD proposals that again reflect the tensions between the different elements of the Business Profits Article.

Case study: A US perspective

On July 7, 1999, in a case before the United States Court of Federal Claims (National Westminster Bank Plc vs US), the court held that the provisions of US Treasury Regulations Section 1.882-5, which sets forth a formulaic apportionment method (see overleaf) to compute the interest expense of foreign corporations doing business in the US, were in conflict with the UK/US double tax treaty. In ruling on a motion for partial summary judgement, the court found that the provisions of the treaty superseded the rules contained in the regulations, and declined to enforce the formulaic method. In its opinion, the US Court of Federal Claims concluded that the formulaic apportionment method violated the Business Profits Article of the UK/US double tax treaty.

The court noted that the approach in the Business Profits Article to treat the branch as a ‘separate enterprise’ was interpreted by the drafters of the OECD Model as a requirement to recognise the branch’s books, including inter-branch transactions, for the purposes of computing interest expenses of the branch. However, the court noted that inter-branch transactions should reflect arm’s length principles.

Notwithstanding that the case is still ongoing, it is clear that arm’s length principles can only be achieved where the parties treat each other as unrelated. Under this approach, separate entities could not absorb each other’s credit rating. Because the separate entity/branch would have to stand on its own and could not rely on the credit rating of the overall bank, its cost of funds would be higher than that of the bank as a whole sending its profits margins lower.
Conceptual weaknesses

As noted earlier, the OECD discussion paper suggests that a branch should be regarded as having equity capital for tax purposes (even if, in reality, it has none) on the basis of the ‘separate entity’ assumption. However, some of the other details of the OECD proposals (and the recent UK legislation) seem to take the opposite approach, favouring the ‘same/similar conditions’ assumption above the ‘separate entity’ assumption. For example, both propose that a branch should be regarded as having the same credit rating as the bank itself (which is a reflection of the fact that, in dealing with the market, external counterparties will treat the branch as having the same credit rating as head office). Also, intra-entity transactions like guarantees from the head-office to the branch will not be recognised however they are in Germany. These factors would not apply if the branch were a separate entity.

Recent developments in the US (where there is already existing domestic legislation dealing with the attribution of free capital to a branch of an overseas company) have indicated that the US courts consider that the ‘separate entity’ assumption should take precedence in applying the Business Profits Article of the existing UK/US double tax treaty and that arm’s length principles should be applied in determining the profits attributable to the branch of a UK bank operating in the US (see case study).

Even if it is accepted that notional equity capital should be attributed to a branch in calculating its attributable profits, what basis should be used to attribute capital? The discussions at OECD level indicate that this question boils down to a choice between a thin capitalisation approach and a formulaic approach. The difference between these two approaches and the relative pros and cons are set out in Figure 1.

Under a formulaic approach the starting point is the total equity capital of the company as a whole and the ‘separate entity’ assumption is merely used to devise a formula for dividing this total capital up among the branches of the company and the head office. The OECD proposals envisage a formulaic approach, allocating the total capital of a bank to its branches based on each branch’s share of...
the bank’s total regulatory Risk-Weighted Assets (RWA).

The draft UK legislation adopts a thin capitalisation approach under which the required level of capital for a branch is determined by looking at the level and type of activities conducted in that branch (this would usually take the minimum regulatory capital as the starting point). The main problem with a thin capitalisation approach is that there is a greater risk of double taxation if this method is adopted by all jurisdictions, since each individual branch will be considered in isolation and hypothesised as a separate entity without regard to the actual capital held by the bank. In contrast, a formulaic approach should ensure that the capital attributed to each part of the bank will not exceed the total capital held by head office and therefore double taxation should be avoided.

More fundamentally, some are wondering whether the OECD proposals have lost touch with what the current standard Business Profits Article actually says, or is supposed to say. Reading the Business Profits Article as a whole, it is apparent that its objective is not to create an unreal world where there is no difference between a branch and a separate company. The idea is simply to determine what portion of the company’s overall taxable profits belongs to a particular country. It is very difficult to see how the basic intent behind a Business Profits Article can be anything else – at least, as long as the purpose of tax treaties is still to avoid double taxation.

Implementation issues

The international consensus on the attribution of interest free capital sought by the OECD probably lies years, rather than months, ahead. Even assuming that agreement could be reached on the basic principles involved, further difficulty is likely to lie in implementation. A number of very important issues are already apparent:

- The introduction of legislation based on the OECD developments in the territory in which a branch is located could well lead to an increased tax bill for the branch. Like any taxpayer, the bank would expect to get corresponding relief (a deduction or tax credit) in its home country. However, because the OECD developments are still in a state of flux there is no guarantee that it will be possible to resolve the issue – except perhaps by time-consuming and possibly unsuccessful negotiations with the tax authorities in the bank’s home territory.

- So far, the recent re-negotiation of the UK/US treaty is the only instance where these OECD developments. Although this may have clarified the future position between the UK and the US, it has emphasised at the same time that many other treaties may have to be re-negotiated before an international consensus is achieved.

- Recent regulatory developments, such as Basel II, are likely to have an impact on the new rules dealing with capital attribution to branches as this will impact on the calculation of risk-weighted assets. The current OECD and UK proposals only take account of credit risk. However, the position may change as the Basel II debate progresses.

- In cases where a bank operates a global trading operation the allocation of assets to branches is a particularly tricky issue to address. It is much more difficult to ascertain where a financial asset (e.g. a loan) ‘belongs’ for tax purposes when compared with a physical asset, such as a computer. Whilst the OECD has issued some limited guidance in this area, it is far from comprehensive. This presents major difficulties when trying to ascertain what capital should be attributed to a PE because this is likely to be primarily driven by the assets which it is deemed to own for tax purposes.
So what next?

The OECD developments on the attribution of capital to branches probably represent the most significant tax issue currently facing international banks. That these developments constitute a danger area to the industry is apparent from the example of the UK, where the issue has been accelerated by the announcement of draft legislation. The UK approach has generated a great deal of concern due to the process surrounding the implementation of the new law and may increase the risk that other jurisdictions will follow suit.

It is important to bear in mind the significant impact the changes to branch taxation could have. Without careful monitoring and planning, the tax paid globally by banks and other financial institutions operating in multiple jurisdictions could increase dramatically.

Institutions need to:

- Develop strategies to optimise their position depending on the likely impact of the new rules.
- Ensure they identify individuals to monitor developments at the OECD and domestic level in each territory in which they operate.
- Assess whether they are likely to be winners or losers from the OECD proposals and any changes to domestic law in the revised approach; and
Strategic and emerging issues in South African banking

by Tom Winterboer, Johan Cloete and Hardie Malan
With its many contrasts, South Africa is a unique mix of first and third worlds. The country that has set aside millions of hectares for conservation has also suffered international criticism for its handling of the AIDS crisis. South Africa is the world's largest producer and exporter of gold, its manufacturing industry is a world leader in synthetic fuels and mining equipment and its transport and energy sectors supply large parts of the Southern African region. Yet, in contrast to this, large numbers of its population are outside the reach of basic housing, education and health infrastructures.

South Africa has not escaped the turbulence seen in world markets in 2002 and in addition, its banking sector has experienced a number of high profile incidents: Saambou, one of the top ten banks in the country in terms of market capitalisation and market share of deposits, was put into curatorship in February 2002 following liquidity problems and it was eventually taken over by FirstRand Group. In March 2002, the South African Reserve Bank had to provide an explicit guarantee for all depositors with South Africa's fifth largest banking group by market share of deposits, Board Of Executors Bank (BOE). BOE was subsequently taken over by Nedcor. Concerns have also arisen around the quality of the micro-lending business conducted by some of the smaller banks. And a number of banks, such as Brait Merchant Bank (fourteenth largest) have surrendered, or announced plans to surrender, their banking licences, bringing to 25 the number of institutions which have either merged, been taken over, put into liquidation or have handed their licences back over the last three years.

The retail banking sector in South Africa has traditionally been focused around four large domestic banking institutions. There is a high measure of concentration with respect to banking assets, deposits and bank accounts, with the so-called 'big four' (Absa, Standard Bank, Nedcor and FirstRand) currently enjoying an estimated combined market share, almost equally distributed, of at least 92% of the market on any of these measures.

The private banking sector continues to be dominated by Investec, the fifth largest banking group following BOE's takeover by Nedcor, although the 'big four' are making determined efforts to expand their market share in this area. As in many other banking centres, client qualification criteria are being revised, and in many cases downscaled, as critical mass is sought. The corporate banking sector has seen most activity by foreign entrants, who are providing significant levels of competition to the domestic banks, especially in investment banking services.

The South African banking sector in turn is supported by a business infrastructure which includes:

- An established and tested legal system, entrenched in the South African Constitution adopted in 1996. Contracts are enforceable in law, and property rights and access to legal process are all specifically protected;

- A financial regulation and supervision framework that has received positive comment from the IMF and World Bank, whose most recent review reported the overall South African financial system to be stable; an assessment echoed by Standard and Poor's and Moody's. Indeed, in the Saambou crisis the South African Reserve Bank limited its intervention to the protection of depositors rather than shareholders indicating perhaps a desire on the part of the government to regulate the industry according to market principles;
Strategic and emerging issues in South African banking continued...

- A reputation for sound accounting and disclosure practices. The South African accounting framework is based on International Financial Reporting Standards (IFRS formerly IAS), and in many cases is identical; and

- A clear focus on developing good corporate governance. In 1994 the King Report on Corporate Governance (King I) was published, which aimed to promote the highest standards of corporate governance in South Africa, in the interests of a wide range of stakeholders. Earlier this year, the King II report was issued. This reinforced management responsibility for the economic, environmental and social aspects of a company’s activities and introduced recommended disclosure and assessment practices to support it.

International context

South Africa’s banking sector is well developed in comparison to the emerging market status of its economy. Indeed, South Africa’s economy was ranked only 39th out of 49 in the 2002 edition of IMD’s World Competitiveness Yearbook, while its banking services were ranked 19th.

The aggregate deposits held by South Africa’s banking sector total $102 billion, and aggregate assets amount to some $120 billion. Both these figures account for in excess of 40% of the relevant totals for emerging Europe, the Middle East and Africa.

The South African retail banking sector in particular is considered in many regards to be sophisticated and well developed, with an infrastructure to match: 2,697 bank branches, $28.3 billion in residential mortgages, 8,000 ATMs, 21 million bank accounts (of which over one million are provided on-line through internet banking services) and a credit card population of 4 million. Although not necessarily the most extensive in absolute terms, these are impressive in relation to the relative size of the country. Its facilities are spread between 44 million citizens giving a higher banking service to head count ratio than, for example, Brazil.

In comparison, Brazil, which has a population 10 times that of South Africa, has 16,600 bank branches, 15,335 ATMs, 3.1 million credit cards and residential mortgages of $9.1 billion.

Of the 32 leading banks active in South Africa, 19 are drawn from the international community. When assessing the extent of foreign bank involvement in South Africa, however, one should not be misled by the numbers. As mentioned above, the retail market is dominated by four large domestic banks. It is, rather, in the investment banking sphere that the international banks have been making their mark. Those most active locally include ABN Amro, Barclays, Citibank, Commerzbank, Credit Agricole, Deutsche Bank and JP Morgan Chase. The foreign banks have, so far, been competing primarily for corporate business, and with large multi-nationals like SABMiller, de Beers, Old Mutual and Anglo-American doing more cross-border transactions, having a presence in the country has paid off for many in commercial terms.

However, while many foreign banks have found South Africa’s banking soil to be fertile, certain perceived disadvantages have perhaps limited the number and scale of international banks in this market to date. One such perception stems from the tendency among a large number of international investors to marginalise anything that is African; a stance exacerbated by the recent turmoil experienced in Zimbabwe.

The largest South African banks have in turn expanded internationally. Their strategy, derived mainly from a desire to track their clients’ activities, and to earn hard currency income, has seen the ‘big four’ create operations principally in London, New York and parts of the Far East and Australasia.
Strategic and emerging issues in South African banking

PricewaterhouseCoopers, with the assistance of Dr. Brian Metcalfe, an Associate Professor at Canada’s Brock University, has, since 1996, been conducting an annual survey of the banking industry in South Africa. The survey focuses on strategic and emerging issues in the banking sector, highlighting the ongoing development of the industry and its outlook going forward.

The most recent survey, based on interviews with managing directors and senior executives of 32 banks selected to represent a sound and comprehensive overview of the banking industry in South Africa, was published in April 2002 entitled Strategic and Emerging Issues in South African Banking.

The 2002 survey highlighted a number of common themes regarding major areas of change in the South African financial services industry, including:

- Continued consolidation within the sector, and problems surrounding the flight of deposits from the smaller banks;
- Threat of currency instability;
- Foreign banking institutions rethinking their role in South Africa;
- Issues related to banking the ‘previously unbanked’;
- New corporate governance requirements introduced by the South African Reserve Bank; and
- Increases in the levels of regulatory capital required by the South African Reserve Bank to further strengthen the capital base of local banks.

While the impact of globalisation and technology were not highlighted as major themes in relation to the development of the financial services industry as a whole, they did rank amongst the key drivers of change in the banking sector. In the light of the takeovers of Saambou and BOE earlier this year, consolidation as a key driver of change was a common theme.

We go on to discuss below some of the themes highlighted in the survey and the responses of the participants when asked to identify the key drivers of change, measures of success, threats and issues facing the South African banking sector.

Currency instability

While the Rand strengthened by more than 20% between January and October 2002, it remains vulnerable to events in other emerging markets and neighbouring countries, and concerns regarding the threat of instability are unlikely to disappear in the short term. International investors’ apparent inability to discern between Zimbabwe and South Africa for example, is an enduring source of frustration to the local business community and is viewed locally as a prime contributing factor to the collapse of the Rand at the end of 2001. To counteract the inflationary pressure this caused, the South African Reserve Bank increased interest rates by 300 basis points between January and September 2002. In January 2002 the government launched the Myburgh commission of enquiry to investigate speculation in the Rand. This in turn was criticised by those who felt that its
Strategic and emerging issues in South African banking continued...

International banks – rethinking their role in South Africa?

Investment banking was reported as the sector experiencing most intense competition, and it is here that foreign banks have made most inroads. While the international banks compete in all major investment banking areas, for example foreign exchange and derivatives, they tend to dominate when it comes to large-scale merger and acquisition activity (M&A), and major listings. This is especially the case when cross-border transactions are involved, a typical example being the restructuring of De Beers during 2001.

One measure of the competitive position between foreign and local banks in certain spheres of banking activity was when the survey’s participants were invited to rank their peers on the grounds of success in twenty industry sub-sectors by reference to factors such as performance, presence and progress. Domestic banks topped most of these categories with only UBS Warburg and Deutsche Bank appearing on behalf of the foreign bank groups, for M&A and institutional brokerage services respectively.

The survey revealed that a number of foreign banks were re-thinking their role in the South African market. Some reported significant changes to their businesses and downsizing of their operations. One European participant commented that some foreign banks were ‘losing interest’.

Foreign banks have, from time to time, expressed interest in tackling the South African retail banking market, particularly in the past 18 months to two years. However, international events including the slump in global stock markets and global economic uncertainty have deterred them from taking action.

A number of survey respondents saw Citigroup as the bank to watch over the next year, probably because it has in recent years been more aggressive than its peers in trying to expand its presence in emerging markets globally.

According to the survey, foreign banks see the ‘big four’ as expensive, and they are also critical of the quality of the service levels. Despite this, in the absence of any foreign bank’s forays into the retail market, the ‘big four’ look poised to become further entrenched in the market in the years ahead, especially given that retail banking emerged from the survey as one of their core immediate focuses.

It was commonly agreed by respondents that retail banking is likely to see significant growth over the next three years. The main barriers to entry for foreign banks, however, include the infrastructure costs required by the local payments system, access to ATMs and a network of branch offices.

Drivers of change

Technology was again identified as the primary driver for change in the future (see Figure 2), even though levels of spending on technology had declined compared with the previous two years.

As elsewhere in the developed markets, internet banking gained in popularity, with some 582,000 new clients signing up during the year. The total number making use of internet banking increased to just over a million, a figure which is expected to double by 2005. Contrary to expectations, however, internet banking was perceived as failing to deliver as a tool to gain competitive edge. Two-thirds of the banks surveyed made minor or no change to their internet strategies, but they did emphasise the continued importance of a presence in this area.

The two next most important drivers of change after technology were identified as consolidation and globalisation. Foreign bank entry into the market has receded as a likely driver of change, and expectations regarding any significant impact from new domestic competition are low.
While not directly identified in the survey, the introduction of formal bank deposit insurance arrangements, now under consideration, has the potential to increase the levels of cheaper retail deposits available to the sector.

**Measuring success**

Participants were asked to identify the factors used to measure success in their bank’s operations.

For the first time in the history of the survey, respondents placed image and reputation management ahead of other success factors for their businesses – replacing return on capital. Revenue growth remained the third most important measure (see Figure 3).

The increased focus on effective image and reputation management is a reflection of the growing competition in the market place, and also the result of the growing prominence being accorded to corporate governance issues globally.

**Major threats**

Participants were asked to identify what they considered to be the greatest threats currently facing the banking sector.

Concerns regarding the availability and recruitment of skilled employees (referred to in the survey as the ‘brain drain’), long considered a major concern by the industry, once again topped the list of threats facing the banking sector (see Figure 4). Both domestic and foreign banks reported that recruiting good personnel was a serious challenge. And affirmative action concerning the recruitment and advancement of black employees was considered an important issue, particularly to the ‘big four’.

The impact of AIDS ranks just below the ‘brain drain’ and the likelihood of economic downturn in terms of threats, and it overshadows concerns about crime for the first time. With life expectancy of less than 50 for nearly 40% of the population, questions surrounding staff incentivisation, behaviour and the responsibility of banks to their employees, become increasingly complex.

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**Figure 2 Drivers of change in the South African banking industry**

The journal • Tackling the key issues in banking and capital markets
Strategic and emerging issues in South African banking continued...

Figure 3: Factors used to measure success

<table>
<thead>
<tr>
<th>Factor</th>
<th>Score</th>
</tr>
</thead>
<tbody>
<tr>
<td>Image and reputation</td>
<td>150</td>
</tr>
<tr>
<td>Return on capital</td>
<td>120</td>
</tr>
<tr>
<td>Revenue growth</td>
<td>90</td>
</tr>
<tr>
<td>Client retention</td>
<td>60</td>
</tr>
<tr>
<td>Absolute profit before tax</td>
<td>90</td>
</tr>
<tr>
<td>Cost income ratio</td>
<td>90</td>
</tr>
<tr>
<td>Client profitability</td>
<td>60</td>
</tr>
<tr>
<td>Revenue/client relationship</td>
<td>30</td>
</tr>
<tr>
<td>Return on assets</td>
<td>30</td>
</tr>
<tr>
<td>Investment performance</td>
<td>30</td>
</tr>
<tr>
<td>5 year return on shareholder investment</td>
<td>30</td>
</tr>
<tr>
<td>Earnings per share</td>
<td>30</td>
</tr>
<tr>
<td>Size of on balance sheet assets</td>
<td>30</td>
</tr>
<tr>
<td>Share price</td>
<td>30</td>
</tr>
<tr>
<td>Other</td>
<td>0</td>
</tr>
</tbody>
</table>

Figure 4: Major threats facing the South African banking sector

<table>
<thead>
<tr>
<th>Threat</th>
<th>Number of banks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Brain drain</td>
<td>20</td>
</tr>
<tr>
<td>Compliance and regulatory constraints</td>
<td>15</td>
</tr>
<tr>
<td>Economic downturn</td>
<td>10</td>
</tr>
<tr>
<td>AIDS</td>
<td>10</td>
</tr>
<tr>
<td>Crime</td>
<td>10</td>
</tr>
<tr>
<td>Exchange controls</td>
<td>10</td>
</tr>
<tr>
<td>Fee and service charge erosion</td>
<td>10</td>
</tr>
<tr>
<td>Previously unbanked market</td>
<td>10</td>
</tr>
<tr>
<td>Labour laws</td>
<td>10</td>
</tr>
<tr>
<td>Current competition</td>
<td>10</td>
</tr>
<tr>
<td>New entrants – Financial services industry</td>
<td>10</td>
</tr>
<tr>
<td>Pace of technological change</td>
<td>5</td>
</tr>
<tr>
<td>Other</td>
<td>0</td>
</tr>
<tr>
<td>Legal constraints</td>
<td>0</td>
</tr>
</tbody>
</table>

Servicing the needs of the previously unbanked market

There is a particular issue with which South African banks are grappling: one that sets the industry apart from its international counterparts.

Since 1994, when South Africa attained full democracy, there have been an increasing number of calls for the retail banks to lend more freely to black homeowners and black entrepreneurs whose creditworthiness might not be readily demonstrable using measures traditionally employed by the banks. The banks are having to strike a balance between lending prudence and vocal demands from the trade unions and certain elements in the government.

While housing delivery to low income earners has grown in recent years, the relevant finance has come primarily from government agencies and institutions employing guarantees (from the state or foreign agencies) to encourage the banks to deliver the requisite mortgages. Even so, housing the poor remains one of the nation’s prime challenges and a leading government priority.

The retail banks have been castigated for what is perceived as ‘red-lining’ (declining to lend to homebuyers wishing to buy houses located within areas perceived as exceptionally high risk by the banks).
The banks counter that to put their balance sheets at risk would be of no benefit to anyone, least of all prospective borrowers who would in due course qualify for finance on conventional mortgage lending criteria.

The debate rages on. Encouragingly, the polarisation that exists between the two sides is gradually becoming less marked. It will be a great challenge, however, to alter negative perceptions toward the banking industry among South Africa’s majority low-income earners.

Pressing issues

Participants were asked to rank a series of issues to provide an indication of those which were considered to be the most pressing (see Figure 5).

Profitability and client service quality are reported as priorities for most banks. So too is improving revenue growth. Expected growth rates at an average of 20% are a couple of percentage points behind the average actual rates experienced in the past few years. Taking the effects of inflation into account, this would nevertheless represent a real growth rate of some 13%; impressive when compared to those experienced in other financial markets.
The search for revenue growth and cost control is expected to enhance the role played by outsourcing, and collaboration with partners outside the financial services sector (such as those seen between banks and airlines for example in other parts of the world) is expected to continue to grow in importance. The domestic banks believe that such arrangements will help generate new customers, retain existing ones and provide greater flexibility on costs and operations.

In conclusion

The problems experienced by institutions such as Saambou and BOE have renewed the focus on consolidation within the South African banking sector. The retail banking sector nevertheless continues to be dominated by a small number of relatively large institutions, and their entrenchment looks set to continue in the foreseeable future.

PricewaterhouseCoopers survey identified a number of specific local social and political issues, such as the concerns regarding the availability of skilled personnel, the impact of AIDS, affirmative action and addressing the needs of the unbanked which are having a particular impact on the South African banking sector. For the most part the other issues and challenges being faced by banks operating in South Africa are not conspicuously different from those facing banks operating in the developed world.

One view of recent events in the South African banking sector would be that it has shown signs of strain and that the good days, associated with a high inflationary environment, are over. Another way of looking at it would be to say that it has done well to survive an extremely difficult year.

Whatever your view, the South African banking sector currently appears less than attractive to foreign entrants, and the threat from new domestic competition appears low. It remains to be seen whether foreign banks will have the appetite to challenge the ‘big four’ for a share of the South African retail banking market. After their recent experiences in South America, it may be that the wait and see approach adopted to date remains the right choice.
XBRL: One standard – many applications

by Bruno Tesnière, Richard Smith and Mike Willis
XBRL is a universal information format which offers tremendous opportunities for the financial services industry in terms of cost reduction, efficiency gains and data analysis. XBRL can be used by banks to radically reduce the time and costs associated with key business processes such as credit analysis and monitoring, and streamline their own business reporting processes. XBRL also allows disparate information systems to communicate seamlessly with each other over the internet. This is something banks have aimed at for a long time; with the advent of XBRL they are finally able to achieve it.

Financial information: Fuel for the financial services industry

There have been dramatic changes in how companies communicate with investors, customers and suppliers. The financial services industry is dependent on the quality and timeliness of business information, perhaps more than any other industry, as it is both a user and producer of such information. Today, in many banks management information is buried under a mountain of irrelevant figures or is presented as complex raw data, whilst external sources are rarely available in reusable formats. The collection, collation and formatting of the information needed for running the business can be slow, prone to error and extremely costly.

Proprietary data standards are often put in place for internal purposes but they require proprietary data translation schemes so that back-end systems are able to retrieve that information. Even less efficient, electronically delivered information on the web is today just a digital duplicate of a paper report; it is not possible to identify directly and therefore retrieve the information that is embedded in these formats (html, pdf, doc, etc). The link between format and content can only be broken by manual parsing (search and retrieval) processes, which are labour-intensive, time-consuming and prone to inputting errors. These factors can drive the cost of producing information up to a level where, although the information is available, it is effectively redundant.

XBRL provides a solution to many of these problems by making the reported information more flexible for interested parties to use.

### Figure 1 XBRL: One standard – many applications

<table>
<thead>
<tr>
<th>One standard</th>
<th>Many applications</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounting systems</td>
<td>Business reporting (ValueReporting®, balanced scorecard)</td>
</tr>
<tr>
<td>Other sources of information</td>
<td>Credit analysis</td>
</tr>
<tr>
<td>Specific banking information system</td>
<td>Preparation of regulatory information (Basel II)</td>
</tr>
<tr>
<td></td>
<td>Financial consolidation process</td>
</tr>
<tr>
<td></td>
<td>Management reporting</td>
</tr>
</tbody>
</table>

Source: PricewaterhouseCoopers

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So what exactly is XBRL?

Extensible Business Reporting Language, or XBRL, is a derivation of Extensible
Mark-up Language (XML). XML, a platform-independent communication
standard, has been designed to facilitate the exchange of information between
applications through corporate networks or the internet. Supported by virtually all
software vendors, XML is gradually imposing itself as the primary facilitator for
transferring data over the internet and is now entrenching itself in enterprise
applications. XBRL has been specifically designed to leverage XML technology to
support the business reporting supply chain.

Figure 2 What XBRL is not:

You may already have heard about XBRL. The word is certainly getting out and, unfortunately, so are the misconceptions. Below is a list of what, exactly, XBRL is not:

- XBRL is **not** a detailed universal chart of accounts, but rather a GAAP/industry-sector oriented tagging scheme or language;
- XBRL is **not** a new accounting or auditing standard;
- XBRL is **not** designed only for US GAAP financial reports but rather oriented to a range of territories as well as IFRS (International Financial Reporting Standards formerly IAS) business reporting; and
- XBRL is **not** a requirement to conform to a specific financial reporting template.

**XBRL International**

XBRL International is a non-profit international consortium consisting of approximately 170 leading companies, associations and government agencies around the world and fulfilling several roles such as development, liaison and education. The consortium has built an XML based specification for business reporting as well as standardised data definitions for different financial reporting frameworks, for use in ledger entry reporting (XBRL General Ledger), credit reporting, performance press releases, risk reporting, regulatory filings and tax filings.

PricewaterhouseCoopers has recognised the benefits that XBRL could bring to its clients and to the financial markets and has dedicated resources supporting the efforts of the XBRL consortium. Since the inception of XBRL, PricewaterhouseCoopers has taken a leading role in its development¹.

¹ For more information, visit www.xbrl.org
XBRL provides tags (context) that describe each element of data (content) in greater detail so that information can be understood and used by different information systems. For example, the turnover for a specific company, and that from its corresponding reporting period, will be included in tags, along with further information such as company name, country of origin, industry sector, year and so on. The tagging of data instructs the receiving system about the information being transferred and so the user, with the help of a software application, can locate the necessary information without leafing through numerous pages of financial reports. As a result, banks are able to generate complex data queries and comparative and up to date analyses on a borrower’s credit application information package at the touch of a button, something that is almost unimaginable today.

The tags are based on standard and uniform taxonomies defined and agreed through collaborative efforts of XBRL consortium members. XBRL International is made up of many of the world’s leading accounting, technology, government and financial services bodies, including Morgan Stanley, Hitachi, General Electric, Microsoft, Deutsche Bank, Bundesbank, Fujitsu, Moody’s, Reuters Group, PricewaterhouseCoopers and many others. Members of XBRL International are currently developing taxonomies for different accounting standards such as IFRS (IAS) and US-GAAP, and where industries, such as financial services, are significant these taxonomies are also expected to be tailored to meet the specific requirements of that industry.

**XBRL for the Financial Services Industry**

Because of the high volume of financial information prepared and processed by the financial services industry, it is in a unique position to leverage XBRL technology. While there are numerous applications where XBRL can support business processes, in this article we will take the opportunity to focus on three specific applications where XBRL can greatly support financial institutions in particular.

**Credit analysis**

Credit is the most fundamental risk that many financial institutions take and manage. Traditionally, credit processes within different business units are supported by stand-alone information systems and reporting sub-systems. These systems assist management in credit analysis, credit decision-making and limit...
monitoring (see Figures 4 and 5). Transferring information from counterparties to in-house systems as well as from one stand-alone system to another normally requires inefficient, tedious and time-consuming re-keying and re-formatting of information. Such mechanical processes increase the risk of inputting errors and reduce the efficiency of credit assessment and monitoring. In many cases 80% of process time is allocated to data management with 20% left for analysis. XBRL can reverse this ratio, allowing greater time for valuable decision making. XBRL provides banks with a structure and procedure, allowing consistent analysis and reporting. It also helps ensure better data quality and data integrity, leading to clearer and more accurate business reporting.

Information received from borrowers can be directly recognised, manipulated and formatted, leaving credit risk managers to concentrate on credit risk analysis and management, not on collection of data.

**Operational risk management**

Many banks are currently in the process of developing operational risk management methodologies for both internal economic capital evaluation purposes and meeting the New Basel Capital Accord requirements. For both, banks will need to collect detailed operational loss data. This data needs to correspond to the business lines defined by the Basel Committee as well as contain further information about the underlying loss events. It is important that data is collected consistently across the organisation in areas such as date, description, event category, amount,
contributing causes and business line. Such consistent data collection is also key for external data sharing initiatives, which are currently being established.

Banks have also recognised the challenge of operational risk quantification in financial risk management. The main obstacle for the development of sophisticated risk quantification methodologies is the lack of detailed and high-quality data. A taxonomy using XBRL could offer a practical solution to allow consistent and structured collection and exchange of data by business areas and periods. Publishing operational risk reports leveraging common XBRL taxonomies enables consistency and re-use. XBRL has many of the facilities and advantages invaluable in supporting the development of operational risk management functions.

**Corporate reporting**

Financial institutions are also under increasing pressure to fulfil more stringent external reporting requirements, as markets and regulators demand greater corporate disclosure and transparency. A key promoter of enhanced disclosure is the Basel Committee, which published its proposals in the New Basel Capital Accord under Pillar 3: ‘Market Discipline’. In addition, IFRS implementation will also introduce greater transparency through enhanced disclosure requirements. Under these circumstances, establishing integrity in external reporting is a key priority for banks, and management needs to be confident as to the validity and accuracy of such data, much of which would not have been subject to independent assurance. Within most banks the reporting environment is complex and data is provided by many different systems. XBRL allows the implementation of a more streamlined and efficient reporting environment.

XBRL can support banks to enhance their reporting processes needs in several ways. By reporting their financial statements in XBRL, banks make it easier for the investment community to analyse company data in a more efficient and transparent manner. Regulatory reporting arrangements can also benefit from the use of XBRL, as has been recognised by APRA (see Case Study).

XBRL will also support banks in preparing their financial statements. As different taxonomies are created for different accounting standards it will be easier to transform the financial statements from one accounting standard to another providing that in-depth data is present. This benefit is especially appealing to large financial institutions that have to comply with several standards.

The New Basel Capital Accord will lead to greater reporting requirements for banks. XBRL International has already formed an XBRL Basel Working Group with the goal to foster collaborative efforts for the development of a taxonomy suitable for the new reporting and disclosure needs.

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**Case Study: APRA**

Australian Prudential Regulatory Authority (APRA) has implemented XBRL arrangements in collecting data from the entities that it regulates. XBRL has helped APRA to overcome challenges in an environment comprising six different technology platforms and four different databases with diverse data collection philosophies. XBRL improved the efficiency and integrity of the data collection process and equipped APRA with powerful web-enabled analysis tools. The banking community also benefits from the introduction of XBRL in regulatory reporting as APRA passes submitted information onto other regulatory organisations for re-use. In this way, the regulated entities only have to submit data to one authority. In addition, the data quality and comparability has resulted in increased availability and quality of aggregate and benchmarking data.
XBRL and the financial markets

As mentioned earlier, XBRL will play an essential role in enhancing the integrity of corporate reports because of its ability to tag individual pieces of information with a precise contextual description. XBRL will also improve investor access and dramatically increase the speed at which management, investors, creditors and other users can obtain information. Adopted on a broad scale, XBRL will greatly simplify how information is produced and consumed. Every member of the corporate reporting supply chain will benefit through:

• Enhanced quality and usability of information;

• Information being obtained more efficiently; and

• More comprehensive and streamlined information.

For those institutions which have yet to experience the benefits of XBRL first hand, NASDAQ, in conjunction with Microsoft and PricewaterhouseCoopers, is providing XBRL data on a group of companies in a web-enabled pilot demonstration1. Through the XBRL demonstration tool, interested investors can discover the benefits of using XBRL to analyse financial information and to compare it with that provided by similar companies.

Key success factors

XBRL is a relatively new initiative and its ultimate success will depend on a critical mass committing to jointly develop and use the technology on which it is based. Banks can only use XBRL to its full potential if data is delivered to them in XBRL. This in turn is dependent on software applications allowing easy preparation of XBRL data. At the moment, early adopters are implementing XBRL pilots and some have already experienced significant benefits.

XBRL is receiving a further boost as regulatory authorities, such as APRA, recognise its benefits and encourage its use by a broader range of companies. The FDIC in the US and the Inland Revenue in the UK have announced plans to re-engineer their regulatory processes in the near future with XBRL playing a key role. Many other regulators around the world are following suit.

However, XBRL is not the only initiative in this area. There are other initiatives in the Netherlands and France to develop information reporting standards. In contrast to XBRL, which uses a free standard, these initiatives are based on a proprietary reporting standard which means effectively that XBRL can be integrated more easily into different applications by a wider range of users. Ultimately, the success of any of these activities is dependent on the number of companies and financial institutions using it and the continued pro-active involvement and cooperation between companies, jurisdictional reporting bodies, accounting standard setters, regulators and other governmental entities. To date the XBRL initiative has created a far greater awareness and support and appears the more likely of these initiatives to achieve a critical mass.

Looking ahead

XBRL is revolutionary but has to become a de facto industry standard with a critical mass using its technology before the financial services sector can experience the full benefits.

Enthusiasm and momentum are clearly building. Leading organisations including Microsoft, Reuters and Morgan Stanley, have begun to use XBRL in the preparation and publication of their financial statements. Systems and software suppliers are beginning to release XBRL-enabled tools and regulatory authorities such as APRA are requesting XBRL based filings.
Management should be assessing whether there are business areas or processes that might benefit from introducing XBRL-enabled tools, or whether using XBRL to enhance its own external reporting arrangements could be turned into competitive advantage.

Although XBRL is a relatively new technology, its application is broad ranging and the financial services industry, as a key user and producer of financial information, is likely to benefit more than most other sectors from the development and implementation of XBRL-enabled processes.

The winners with XBRL

All participants in the corporate reporting supply chain win:

**Companies that publish financial statements**
- XBRL allows more efficient preparation of financial statements
- Increased integrity of financial statements
- Consolidation of internal information stores is facilitated via the XBRL General Ledger

**Analysts, Investors and Regulators**
- XBRL allows better distribution and usability of existing financial information
- Speeds up analysis time and makes information retrieval easier
- Formatting versatility means financial information can be tailored to suit specific analysis and regulatory requirements

**Financial data publishers and Data aggregators:**
- XBRL information supply chains are streamlined and efficient
- Operating costs associated with data collection and aggregation (i.e. unreliable or erroneous data feeds) are reduced
- Financial data publishers and data aggregators add value to the data and increase their transactions

**Software vendors**
- XBRL creates exciting opportunities for interoperability with existing and developing financial and analytical applications
- Software products that manage financial information can use XBRL for data export and import formats
## Contact details

<table>
<thead>
<tr>
<th>Editor-in-chief</th>
<th>Editor</th>
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### What’s ahead for China’s financial markets?

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### Creating value in the new risk paradigm

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### The future of corporate reporting

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