KPMG

frontiers in finance

for decision makers in financial services
March 2009

FINANCIAL SERVICES

Navigating the storm
A new course for financial services

At the crossroads
Managing risk in insurance

Survival of the fittest
Resilience in investment management businesses

Turbulent times

AUDIT ▪ TAX ▪ ADVISOR

introduction

frontiers in finance
March 2009

Brendan Nelson
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Global Chairman, Financial Services

The crisis is far from over. Determined action by governments and regulators seems to have stabilized the banking system and headed off a catastrophic collapse. But in stormy times, the atmosphere remains fearful; credit is still tight; and the twin perils of recession and financial protectionism have the potential to inflict lasting damage on the real economy.

Our challenge in this issue of *frontiers in finance* is to look beyond the immediate turmoil, and to try to identify themes and pointers to how the financial services landscape will evolve in the months and years to come. With a clearer view of the possible future, financial institutions can begin to rebuild and develop their businesses with slightly greater confidence.

Much of this issue is focused on banking. There is much expert commentary here on how regulation is likely to evolve, how risk management needs to be transformed and how banks need to fundamentally reassess their business models. How can tighter regulation, more stringent risk management and drastic cost optimization be reconciled with business development, innovation and the need to reposition for a new commercial environment?

The impact of the crisis is being felt right across developed economies. Two examples examined include increasing levels of fraud now coming to light; and governments' tax revenues are sinking just at the time when increased state spending is being urged to counteract the recession. We also look at the fall-out in both emerging markets – particularly Latin America – and in Spain, where the collapse of the housing bubble has been particularly severe.

A pervasive theme running through the articles in this issue is the need for clarity, structured thinking and strategic discipline in coping with the crisis. As Alison Halsey argues in her contribution, the primary challenge now for CEOs is to focus ruthlessly on their real priorities and ensure that the whole management team is directed at pursuing them.

It is clear that the world of financial services is not going to be the same as it was for a very long time, if ever. Only by rigorous pursuit of clear and appropriate strategies will companies position themselves well for the eventual recovery. Let's hope that it's not too long in coming.

Brendan Nelson

In this issue

For your information

Topics

Series

Insights

Topics: Never again? Risk management in banking

Topics: Survival of the fittest

Topics: Money in the bank

Series: Islamic finance: Hidden potential

fyi...

The crisis in numbers

Over the past 12 months, the economic crisis has produced some staggering statistics: How many governments have implemented bailout plans? How many banks have gone 'under'? How much has been spent on boosting the global economy? Leading to the question, what does this mean for the next 12 months, and beyond? Here we highlight some of the statistics associated with recent events.

US$44.1bn

Amount spent by IMF on International Bailout funding[2].

US$403.7 bn

Global amount spent on Recapitalization of Financial Institutions[3].

US$63.54 bn

Germany announces the biggest stimulus program in Europe[4].

US$4 bn

Chile's government bailout package (1.73% of GDP 2007)[5].

Honesty in business?

How important is honesty in business, when pressure is rising and instances of fraud are increasing?

Discussed in KPMG International's recent report *Trusting & Checking – The Roles of Honesty and Transparency in Business*[1], considerable evidence confirms that companies are becoming more concerned with the issue of trust in business. How to act on that concern is where the challenge lies.

Should companies check or verify everything that employees and partners do? Or should they foster trust, and accept the risks that come with trust?

There are ways of balancing the need to trust and to check. One is to take a global approach, finding norms that are universally respected. Another is to be very open about the process and purpose of checking, showing partners that verification can reduce their risk too.

Understanding the limits of checking is also important. Checking on employees and partners without generating disaffection and distrust will always remain a challenge. "This is a tension that cannot be fully resolved", says Daniel Malan, Special Advisor on Ethics and Governance, KPMG in the UK. "Corporations have to understand and acknowledge that."

For further discussion on fraud and the credit crisis, see article on page 26.

1. Copies of the report 'Trusting & Checking – The Roles of Honesty and Transparency in Business', KPMG International, February 2009 are available at www.kpmg.com.

Bailouts around the world... (% of GDP)[1]

US 61% UK 36% China 17%

and how much more...?

Operational risk management

Financial services in Spain

A recent survey conducted by KPMG Spain with 43 financial services organizations, found that the majority have already developed operational risk management (ORM) as part of their internal controls. Despite identifying that ORM is on executives' agenda, for many financial services organizations, the models identified reflect considerable differences in the procedures employed to identify and evaluate risk[1].

1. Copies of 'Operational risk management survey in the Spanish financial sector' published by KPMG in Spain, June 2008 can be requested at www.kpmg.es/informes.html.

1. "Global downturn: in Graphics", www.bbc.co.uk, February 20, 2009, and "China becomes third largest economy", www.ft.com, January 14, 2009.
2. Countries include: Hungary, Ukraine, Iceland, Pakistan, Latvia. www.imf.org, January 28, 2009.
3. "Interactive feature: State to the rescue", www.ft.com, January 28, 2009.
4. Including offering €17.3 billion for investment in infrastructure, tax cuts, and increase in some social benefits. "Germany approves €50bn stimulus package", www.guardian.co.uk, 27 January, 2009.
5. "Chile unveils $4 billion anti-crisis stimulus package", www.fxstreet.com, January 6, 2009; and www.imf.org, January 2009.
6. "Global downturn: In Graphics", www.bbc.co.uk, February 20, 2009.

Old habits die hard

A Russian perspective

Spending in the good times

During the boom period there was a lot of unnecessary and often excessive spending around the world, and also in Russia. However, for many members of the middle class, facing a potential salary cut of 30–50 percent[1] could mean fundamental changes to their lives with the decline in disposable income.

Changing habits to save

For various reasons, Russians have not been in the habit of building long-term savings, whether planning for retirement, possible redundancy or illness. On the contrary, with the first signs of the economic downturn, many people rushed to spend whatever they had in order not to lose out – through the negative effects of inflation and devaluation.

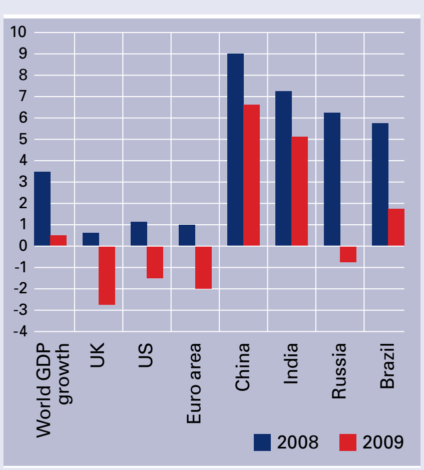
This raises a global issue of what do banks need to do to encourage customers to build their savings?

See more on this topic, in the article on tax incentives for savings on page 28.

For more information on the Russian market visit www.kpmg.ru.

1. "Crisis-hit Russians tighten their belts", BBC News, January 20, 2009.

World economic growth %



Source: IMF estimates Jan 2009[6].

Tax treaty trends in the Asia Pacific funds sector

Tax authorities are increasingly seeking to deny treaty relief to investment structures with arguments over the beneficial ownership or economic substance of the structures. While this approach may have first been seen in the major industrialized nations, we are now seeing such arguments being taken up across an increasingly diverse range of countries.

Published in February this year, *The impact of tax treaty trends in the Asia Pacific funds sector* is a new publication from KPMG's Asia Pacific Financial Services Tax Practice, providing an overview of the basic tax rules applying to funds across 17 Asia Pacific countries. It also considers how tax treaties are being applied across the region and what tools countries increasingly have at their disposal, in order to be able to deny treaty relief to funds and how the funds industry should be responding.

For further information visit www.kpmg.com/tax.

Opening doors...

Incorporation and beyond

Since China's accession to the World Trade Organization, doors have opened for financial services organizations. To date, 30 foreign banks have locally incorporated their business in China, allowing them to provide a wider range of retail and local currency banking services. The early wave of banks included the likes of Citibank, HSBC and Deutsche Bank.

A recent report by KPMG[1] showed that there are significant opportunities for foreign banks in China, but the process of incorporating locally can be costly and time-consuming. It requires more extensive risk management functions and IT platforms to be housed within China, in order to demonstrate the bank's independence from head office.

While many banks took the opportunity to grab first mover advantage, later entrants were able to learn from the experiences of their rivals. KPMG's new report, entitled *Incorporation and Beyond*, includes case studies with three foreign banks that have gone through the process; BNP Paribas, Woori Bank and Mizuho Bank.

1. For copies of "Incorporation and beyond: Challenges for foreign banks in China", KPMG International, December 2008, visit www.kpmg.com/Global/IssuesAndInsights

Navigating the storm

Brendan Nelson

A new course for financial services

It may seem either brave or foolhardy to attempt to forecast the likely consequences of the economic crisis for the financial services industry. One of the main characteristics of the unprecedented turmoil of the last 18 months, has been its continual ability to throw up unexpected shocks. And it is not yet clear whether there are more shocks to come.

The overwhelming consensus is that we are not through the worst of this, and there will inevitably be more difficult times ahead. Many governments and central banks are taking unprecedented initiatives to try to protect financial institutions and stimulate economic growth. It is not clear how successful these initiatives will be as there continues to be a divergence of view as to whether this is a supply problem – so make the banks lend more; or a demand problem – so make the consumers spend more.

Nevertheless, one way or another, recovery will come. The financial services industry is likely to reinvent itself probably far faster than many people currently expect.

Perhaps one of the most fundamental impacts of the crisis is its likely long-term effect on the relationship between financial institutions and the state.

After the crisis

What will financial services look like once the recovery is under way? Some clear pointers are emerging. First, both investors' and lenders' appetite for risk is likely to be significantly diminished, in all probability for a considerable time to come. This is partly a natural reaction to the experience of extremely threatening times. But it will also reflect the knock-on impact of deleveraging and shrinking balance sheets, which will reduce companies' ability to carry risk.

Much greater focus is likely to be placed on risk management in future. Although regulators have been seeking to drive risk management up the corporate agenda in recent years, this has been unable to prevent the current crisis, and to recognize the systematic aspect of risk in financial services. Genuine and thorough risk management is going to be a crucial element in rebuilding confidence over the long term.

Banks that have benefited from government support will be under pressure to serve domestic rather than international markets. There is likely to be greater simplicity. Banks will, at least for a period of time, be less entrepreneurial and may effectively compete to be boring. There will inevitably be a step adjustment in the expected return on equity of the industry going forward.

Regulation

The regulatory environment is likely to change substantially. There is no doubt that financial institutions will feel a heavier weight of regulation going forward. Regulatory capital requirements have gone up so that Core Tier 1 ratios are now at 8 percent or above. Basel II may need to be looked at from many aspects: liquidity risk; the pro-cyclicality effect; and the reliance on ratings and models. What the industry should seek to ensure is that quality, rather than quantity, is the objective. However, taxpayers may seek to extract a higher price from an industry that is seen to have let them down.

A more fundamental issue which policymakers are now exploring is how far it is necessary, possible or politically acceptable to move to a more global regulatory framework. The case grows increasingly strong as financial products, markets and trade become more globalized. But national governments are understandably reluctant to cede the necessary authority. Some greater global consistency is likely to emerge piecemeal through common adoption of similar measures. For example, there is an emerging consensus that the application of the fair value accounting principle should be reconsidered in the light of how 'mark-to-market' is alleged to have contributed to the crisis.

The fair value accounting rules should also be reassessed to distinguish between those that accurately reflect economic value destruction and those that unnecessarily precipitate actions that serve to exaggerate economic loss. However, this should be done with due process; hasty changes to accounting standards can increase the risk of unintended consequences. In short, the industry should seek to make fair value work better rather than abandon it, as the alternatives take us back to a world of opacity.

A new course

The nature of financial services themselves will change. Increased risk aversion and risk avoidance imply a corresponding move to lower returns. This is likely to be reinforced by a wide-scale rejection of the complex derivatives and structured products which underpinned much of the growth in recent years. At the same time, institutions need to work through the deleveraging cycle, rebuild their balance sheets and repay the debt they have taken on. The requirement to generate profits and cash will be intense. So, the focus will be on cost reduction and operational efficiency. New extensions to outsourcing are likely.

A smaller, more cautious, more tightly-regulated financial services sector will nevertheless offer new opportunities. Personal credit constraints will, over time, lead to an increase in the savings ratio. Demographic change will intensify the appetite for innovative new products to serve the needs of an ageing population. 'Back-to-basics' may be a maligned and simplistic slogan. But there is no doubt that financial services companies above all, should seek to rebuild trust and confidence with their customers, focus on building long-term customer relationships – and work twice as hard to provide value and earn a margin for doing so.

Responsibility for the crisis has been widely attributed – everyone from governments, regulators and ratings agencies through to financial journalists and the media has been blamed. But there is no doubt that financial services institutions have also suffered severe damage to their reputation and credibility. Rebuilding trust in individual brands and in the sector as a whole, is essential if a healthy financial system is to be rebuilt in the medium and longer term. But it is going to take time, a lot of effort and a new approach to stakeholder management and communication.

Perhaps one of the most fundamental impacts of the crisis is its likely long-term effect on the relationship between financial institutions and the state. An era of loose control, and a belief in the basically benign nature of the market, is ending. The market has failed, almost catastrophically, and governments will not forget in a hurry. The end of cheap credit in the west may make the structural adjustment to the new world order of economic power more drawn-out and difficult. One of the challenges for more activist and interventionist governments will be how to manage that long-term adjustment while preserving liberal capitalism's ability to continue bringing major benefits to people across the world.

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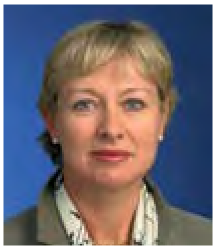

Alison Halsey

Agenda overload

Alison Halsey reflects on lists, more lists and priorities.

Although we are still early in 2009, many in the financial services industry will be feeling that they have already done a full year's work. Each year is unique but there are things happening this year that we have not only not seen before – we have never even contemplated them. Leading brands are disappearing, market values are subject to wild fluctuations and figures quantifying bail out costs have so many noughts attached that some of us may be grabbing our dictionaries to find the correct term for billions of trillions.

It has been a time for setting new priorities and agendas. More than most years, 2009 seems to mark a time to move forward. Barack Obama is now the President of the USA, with probably the most complex and ambitious agenda for change of any individual. We are in his first 100 days and the world is watching to see whether the agenda translates into implementation.

I would challenge any reader who claims that they don't start a new year with some new resolutions or a revised agenda. Many institutions and CEOs will have set their plans and 2009 budgets in the comparatively calm waters of the middle of 2008. Some revisions will now be needed. So how do they approach the task of fine-tuning those plans and what are now the priorities? Wherever we turn there are lists of fundamentals emerging to set the agenda and to repair the past and there are the older classic lists too. The banking supervisor's acronym CAMEL (capital, asset quality, management quality, earnings and liquidity) dates from over 30 years ago, but still seems very well focused.

We at KPMG have been doing our bit for lists too. Our recent global survey into risk management[1] identified key priorities addressing governance, influence, expertise, compensation and measurement. In addition, a few months ago we produced a guide to addressing the current market turmoil[2] which included 10 main topics and some 70 detailed points to consider. And all this against the backdrop of very public interviews of bank CEOs on the important topic of 'How did we get here?' and 'What needs to change?' which is potentially going to set another reform agenda and prompt some more lists.

Stepping back a bit, I have the sense that perhaps the time is right for all this listing of issues and priorities. The first frightening waves of the financial crisis have thundered over us, leaving the industry in an unprecedented state of turbulence. There's just enough time now to catch breath and scan the horizon. Which landmarks are left standing? Which direction should we set out in now? How do we start getting there?

The danger of agenda overload is acute. What tips can we take from the smartest operators? At the risk of being accused of optimism, I have seen examples of just that. The urgent agenda is bringing a tight approach to the fore, which makes us sometimes wonder why we need a crisis to think in this focused way. Business leaders think 'focus' all the time and, perhaps, adopt these principles:

Focus

What is truly the overall goal? Does that goal need to be changed – probably not, but it may need to be simplified. But for some the old motto of 'Keep Calm and Carry On' may apply. It is the time to put the overall goal to the forefront.

Prioritize

Against the current backdrop, the list of secondary objectives may need to be reduced – if it doesn't fit into the capital, asset quality, management quality, earnings and liquidity list, is it the right objective for 2009? Nice to haves may need to wait. Have they been identified with proper rigor and appropriately deferred?

Ensure team support

Fantastic achievements can be made by teams up against a crisis – and has been proven time and time again. The best team players will be entirely focused on the overall goal and the chosen objectives and, once over the shock of events, will be 150 percent on-side. Talented individuals will shine and may perform wonders. Talent spotting may well be easier.

Seek objective advice

One of the biggest challenges in times of turbulence is to maintain a clear-eyed view of the real issues facing the business. An external perspective can be invaluable. Professional services firms can apply independent judgment and creativity to solve apparently intractable problems. 'She would say that, wouldn't she?' I hear you exclaim, but it happens to be true!

2009 is not going to be easy. Nor perhaps is 2010. But with clarity, hard work and determination, there's a good chance that next year's agenda will be about growth and recovery rather than survival. All the best!

1. 'Never again? Risk management in banking after the credit crisis', KPMG International, January 2009.
2. 'Addressing the current market turmoil', KPMG International, September 2008.


- Capital
- Risk
- Liquidity
- Fraud
- Regulatio
- Bailouts

Selected items for an urgent issues agenda

Governance
- Profile of Board experience for recession
- Business appraisal – good book/bad book
- Risk/Audit Committee agenda
- Product set re-evaluation
- Board delegated authorities
- Board and Executive communication

Capital
- Difficulty in raising additional capital
- Volatility in capital utilization
- Impact of wider shareholder base
- Investor relations
- New capital requirements
- Share price volatility
- Capital adequacy and stability

Funding and Liquidity
- Reduced interbank liquidity
- Depositor confidence
- Increased cost of funding
- Wholesale funding outlook

Risk Management
- Risk appetite appraisal – conservatism shift
- Consumer debt levels and defaults
- Changed creditworthiness of counterparties
- Corporate customer failure
- Property portfolio exposure
- Robustness of valuations
- Bank rescues – combined exposure
- Tax authority focus

Profitability/ Cost Management
- Quality business growth/margins
- Staff reductions
- Cost reduction initiatives
- Availability and treatment of tax losses
- Budget restrictions and control
- Business/operating model strategy
- Cost savings/synergies realization
- Competition

Corporate Strategy, Acquisitions & Disposals
- Impact of acquisitions/nationalizations
- Post acquisition integration (for acquirers)
- Impact of Regulator/Central Bank interventions
- Under-performing businesses
- Economic outlook re-appraisal
- Legal entity management
- SPVs – capital, funding and valuation
- Quality of budgeting/forecasting
- Quality of advice
- Tax capacity
- Tax loss optimization

Staff and Remuneration
- Regulatory focus on bonuses
- Conduct of business standards
- Talent retention/attraction
- Integrity

Fraud and Investigations
- Trader/employee fraud in volatile markets
- Internal control systems and quality
- Valuation manipulation
- Reputation management
- Conduct of business/compliance breaches
- Culture

Regulation
- Geographical power shift
- Back to basics – political imperatives
- Likelihood of significant regulatory change
- Temporary suspension of short selling
- Focus on liquidity
- Impact of 'bail-out' funds
- Reputation management
- Regulation of incentive schemes

Counterparty ownership change/ bankruptcy
- Counterparty consolidated exposures
- Implications of counterparty legal entities
- Collateral and security
- Ranking of debt/instruments
- Netting and legal jurisdiction
- Settlement of open trades
- Impact of future acquisitions of businesses under administration/ bankruptcy

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At the crossroads

Managing risk in insurance

Frank Ellenbürger

As much as business executives like to be forward-thinking and ahead of the curve, no one could have predicted the scope and scale of the current financial crisis. Put simply, we live in extraordinary times and there is still a substantial amount of uncertainty about what the future may bring and how exactly the insurance industry landscape will change. Frank Ellenbürger offers his perspective.

Although banking has borne the brunt of the current financial crisis, the insurance industry has seen its fair share of challenges. The near-bankruptcy last fall of one of the world's largest insurers, The American International Group, Inc. (AIG), was a sobering reminder that no company is too big to fail. The current climate continues to breed caution and concern, leaving many insurers feeling that the short term is as much about sheer survival as about rebuilding growth and profitability.

In effect, the insurance industry is facing a financial crisis of unparalleled proportions. As the new President of the United States said in a different context, "The challenges we face are real, they are serious and they are many. They will not be met easily in a short period of time"[1].

The scale of the challenge facing the industry was starkly revealed last November when more than 130 senior insurance professionals from around the world attended the inaugural Reactions Magazine Insurance Conference 2008[2]. Participants at the conference were asked to give their views on a number of major issues currently facing the industry. Their responses provide a helpful framework to consider the future of the industry.

> "It's better to send your guys out fishing than have them underwrite a bunch of garbage. It's certainly cheaper."[3]
>
> Maurice 'Hank' Greenberg
> Chairman and CEO, CV Starr

We are living in stormy times, and although you can't change the wind, you can set the sail.

What do you see as your main priority over the next 12 months?

54% said risk and capital management

In light of recent market failures, how significant do you think the changes will be in regulations?

61% said significant change

Risk and capital management

While a number of the senior executives present were focused on short-term survival, more than half believed that the top priorities over the next 12 months would be risk and capital management. To achieve a holistic view of risk management, many insurers are likely to need to make significant changes to their structures, risk models, and IT. Basel II has proved a major step forward for global banking risk management; in the insurance sector, Solvency II will introduce a comparable framework aimed at defining required capital levels and implementing procedures to identify, measure, and manage risk levels.

However, key aspects of how strictly Solvency II could impact on insurers' capital requirements are still unclear. In particular, the current draft text, approved by the Economic and Financial Affairs Council (ECOFIN) on December 2, 2008, rejects the recognition of cross-border diversification effects. If sustained, this approach is likely to have significant consequences on multi-national groups, with each national operation required to maintain a separate solvency capital ratio.

Whatever the final outcomes, it is clear that much more effective risk management systems and processes will be necessary. One of the keynote speakers at the Reactions conference, Maurice 'Hank' Greenberg, made the point in his inimitable style when he commented, "It's better to send your guys out fishing than have them underwrite a bunch of garbage. It's certainly cheaper".

Re-regulation

It was no surprise that over 60 percent of those attending the conference believed that there would be 'significant' future changes in regulation of the insurance sector. In fact, along with the rest of the financial services industry, the scale of change is likely to be so significant as to constitute a complete *re-regulation* of financial services. As the Economist commented recently: "If 2008 was the year when the flaws in the old model became painfully clear, 2009 is likely to be the one when governments embrace re-regulation in an effort to fix it."[4]

In January 2009 the Group of Thirty, a consultative group on international economic and monetary affairs, released its latest report: *Financial Reform: A Framework for Financial Stability*. The report addresses the policy issues related to redefining the scope and boundaries of prudential regulation, including the role of central banks, the implications for the workings of 'lender-of-last-resort' facilities, the need for greater international coordination, improved governance, risk management, regulatory policies, and accounting practices and standards. It calls for improvements in transparency and financial infrastructure arrangements and measures to address pro-cyclicality via capital and liquidity standards.

Among its 18 specific regulations, the report argues (Recommendation 2) that all non-bank financial institutions, including large, internationally active insurance companies, should be subject to national-level frameworks for consolidated prudential regulation and supervision. A key theme is the need for regulation to guard far more stringently against the risk of systemic failure. Systemic risk is a somewhat slippery and subjective concept. If applied broadly, it could mean that very many insurers – deemed systemically significant – could face massive changes in the regulatory framework and requirements imposed on them.

New opportunities

Despite the turmoil, a majority of the senior insurance executives present in New York saw real opportunities emerging through organic growth, new products and new markets.

In order to grow, insurers will need to look beyond their traditional markets which are seen as mature and constantly under attack from competitive pressures from both within and outside of the industry. Consideration needs to be given as to whether insurers can be all things to all people or if they should actually concentrate on their most valuable competencies.

Demographic changes, and millions of new consumers entering the insurance market in developing countries, will offer major new opportunities[5]. One area of significant focus will undoubtedly be the 'grey dollar' market where the baby boomers are now coming of age, giving rise to greater demand for pensions and health insurance from an ageing population preparing for a long retirement.

To take advantage of these opportunities, insurers will need to change their traditional ways of working. Innovation will be essential as markets for more complex products such as variable annuities emerge. Life insurers, for example, will need to develop innovative product solutions that offer income protection and manage risk. This will also involve getting closer to the customers and producers as well as developing multiple ways to market, both traditional and electronic.

At the crossroads

Governments around the world have fought to stabilize their financial institutions and bring order back to their respective economies. It is an uphill battle, exacerbated by rising unemployment, steep corporate losses, and lack of confidence in the very institutions upon which the public relies as a hedge against risk. Which route the industry takes out of the current crisis is likely to depend on how well it steps up to the opportunities to develop new products and services while simultaneously meeting major changes to regulation and risk and capital management. We are living in stormy times, and although you can't change the wind, you can set the sail.

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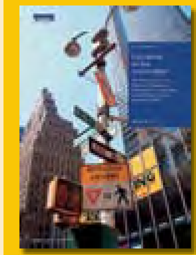
1. "US Celebrates as President Obama vows new era", www.cnn.com, January 20, 2009.
2. The Reactions Global Insurance Conference 2008 was held in association with KPMG International in New York on November 11 & 12, 2008. The key themes emerging are summarized in 'Insurance: At the crossroads?', KPMG International, February 2009.
3. ibid.
4. The Economist, January 15, 2009.
5. See also: 'Facing the future: Changes and challenges in life insurance', *Frontiers in Finance*, December 2008.

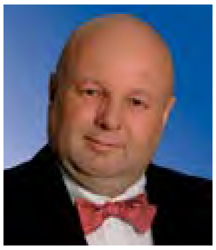
For more information



Insurance: At the crossroads, summarizes the issues discussed at the Reactions Global Insurance conference, sponsored by KPMG International, in November 2008 which focused on risk and capital management in the international insurance industry.

Risk management in banking

Never again?



Jörg Hashagen

Nigel Harman

Michael Conover

The credit crisis has forced banks to take a critical look at how they manage risk. But, as a new KPMG International survey[1] reveals, there is still a long way to go. **Jörg Hashagen, Nigel Harman** and **Michael Conover** discuss.

Recent events, particularly in the banking sector have highlighted a number of weaknesses in the approaches to risk management. While much of the blame has been pinned on a relentless pursuit of revenue growth – and a compensation culture geared to short-term success – such excesses could arguably have been kept in check by more disciplined risk management.

The respondents to KPMG's latest global survey certainly acknowledge that something has to be done; but how far are they prepared to go? Many respondents appear reluctant to reach for the strongest possible medicine, with only four out of ten having made – or planning to make – fundamental changes to their risk management processes.

42%

of respondents have made – or plan to make – fundamental changes to their risk management processes.

Creating a risk-aware culture

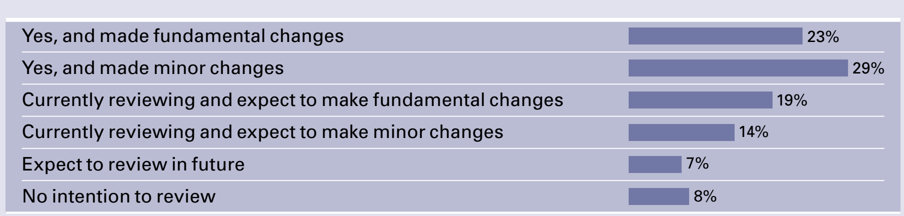
Many of today's financial institutions have highly complex structures, making it hard to gain a clear picture of all the risks being taken across an organization. Some of the products themselves are so complicated they are beyond the understanding even of those selling them. When you add poor internal communication into the mix, then, as Kevin Blakely, President and CEO of The Risk Management Association, a member-driven professional association for financial institutions, puts it: "The right hand often didn't know what the left hand was doing".

The underlying attitudes to risk – or risk 'culture' – have not exactly helped, with many at the frontline seemingly lacking any real awareness of the organization's 'appetite' for risk. Consequently, decisions on individual trades or new products may have been made in isolation, rather than through open consultation with an appropriate risk committee. It's easy to imagine how in such an environment, some banks may have had at best, a rather blurred view of their overall risk exposure.

It's subsequently no real surprise that weaknesses in risk governance and culture were seen as contributing to the credit crisis – and that over three quarters of respondents are actively seeking to improve their performance in these areas by creating a better framework for controling risk. A majority have also pledged to try and deal with the 'organizational silos' that stop different parts of the business talking to each other.

Of course, any reforms are likely to flounder unless those working in risk-related roles are given more authority. Despite some welcome progress in their level of influence, three quarters of those surveyed still believe that risk is stigmatized as merely a 'support function'.

Figure 1 Have you reviewed risk management in your organization?

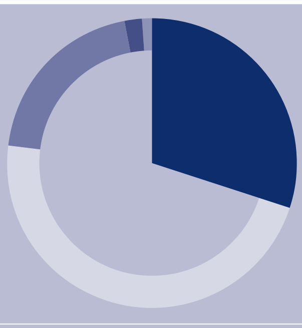


Source: KPMG International, December 2008.

76%

of those taking part in the survey feel that risk is stigmatized as a 'support function'.

Figure 2 Expected change in attention to risk culture (over the next year)



Significant increase	30%
Slight increase	47%
Neither increase nor decrease	20%
Slight decrease	2%
Significant decrease	1%
Total	**100%**

Source: KPMG International, December 2008.

Knowledge is power

The risk expertise of those at the top has also come under the microscope, yet only 45 percent of the respondents believe that their own boards are short of risk knowledge and experience. Indeed, a sizeable minority has no plans at all to appoint non-executives with deep, practical risk management experience.

It's probably no coincidence that over the past 18 months, a number of the better performing institutions have shown greater depth of risk experience at board level. In the same way that US company boards require someone on the audit committee with an accounting background, there may one day also be a similar requirement for risk professionals.

Writing in the Financial Times in October 2008, Emilio Botín, Chairman of Banco Santander, noted that: "Many are surprised to learn that the Banco Santander Board's Risk Committee meets for half a day twice a week… risk management not only has a seat at the table, but is also an active participant in all key business decisions"[2].

Worryingly, a quarter of our respondents see no need for a Risk Committee, leaving many organizations short of a rigorous, independent challenge to decisions being made in the business.

Given that few, if any, banks seemed able to predict the tumult in the sector, it's understandable that eight out of ten now want to provide better information for future decision-making. Yet they should also be aware that an over-reliance on quantitative models was at least partly to blame for some of the decisions that led to the credit crisis. In future, qualitative judgment should take precedence, with data supporting, rather than driving, decision-making in what has become a volatile and unpredictable market.

In future, qualitative judgment should take precedence, with data supporting, rather than driving, decision-making in what has become a volatile and unpredictable market.

We are all risk managers now

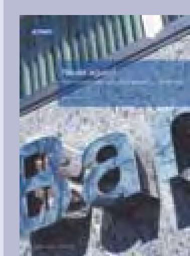
In many ways, this has been a crisis of judgment on the part of many banks, apparently fueled by an excessive focus on short-term gain and a lack of rigor in risk management. By instilling greater discipline into the risk management process, banks can hopefully get back to the basic business principles that served them so well in the past. Furthermore, this should be supported by a compensation policy that is firmly tied to shareholder value.

The modern structure for managing risk should be based on three lines of defense; the business unit people 'on the ground'; the risk management function; and finally, internal audit. None of this will work unless senior management takes a firm lead in creating a strong risk culture, where the risk function holds greater authority and risk is no longer seen as a peripheral issue to be delegated either to regulators or middle management.

In this brave new culture, all employees effectively become risk managers with a firm understanding of the organization's 'risk appetite'. Such an approach will set a foundation for robust risk governance that is flexible enough to meet changing market conditions.

1. 'Never again? Risk management in banking beyond the credit crisis', KPMG International, January 2009.
2. "Banking's mission must be to serve its customers", Emilio Botin, The Financial Times, October 16, 2008.

About the survey



The Economist Intelligence Unit carried out online interviews in October 2008 with over 500 senior managers involved in risk management from leading banks around the world. Copies of the survey: *Never again? Risk management in banking beyond the credit crisis* can be obtained by visiting www.kpmg.com/Global/IssuesAndInsights

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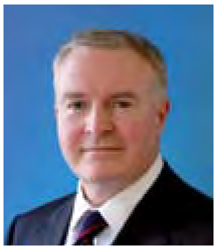
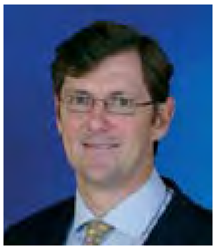
Survival of the fittest

Resilience in investment management businesses



Chris Brideson



Martin Blake

The global financial crisis is fundamentally changing the investment management industry. Chris Brideson and Martin Blake review some of the practical steps firms can take to deal with immediate pressures and adapt for the future.

A changed environment

The shockwaves of global financial turmoil continue to resonate through the investment management industry, bringing unprecedented change. The year to 2008 saw a 47 percent drop in stock market values[1], high volatility and a scandal that has helped put the integrity of the entire investment chain in question.

The impact is deep: funds report falling returns and subscriptions; investors and shareholders have lost trust in fund managers and the whole financial industry; many asset classes have been damaged, and valuation methods are under scrutiny. Although some commentators forecast market recovery in 2–3 years following a shallow recession, others at the pessimistic end of the scale believe the recession could be much deeper, risk will be permanently re-priced, and the readily available credit of recent decades will not return in the foreseeable future.

So how can investment managers survive, thrive and deliver sustainable performance in this fundamentally different environment?

Bolstering business resilience

Certainly, current market volatility calls for urgent action to improve business performance and bolster stakeholder confidence. But crisis management is only half the story: it is equally important to devote time to boosting the underlying resilience of the business. Businesses should aim for the right blend of strength and agility to deal with current tough conditions and capitalize on new business opportunities that may emerge. In helping businesses to adapt to the new realities, KPMG member firms have been concentrating on three areas:

1. Getting back to basics: controlling costs, focusing on the core business
2. Creating 'headroom': buying time, communicating your plans
3. Enhancing the business model: preparing for future opportunities

Step 1

Back to basics

The immediate challenge is to seek to ensure the current business is well run, focusing on:

- improving cashflow and working capital management
- enhancing revenues and managing expenses
- identifying non-core businesses for possible divestment

While asset prices were high and generating good profits, it was tempting to neglect cashflow and working capital management. Operating successfully in a recession means coming back to the fundamentals of where, when and why cash leaves a business. Daily reporting of the cashflow position can help to identify where money is getting lost or lying idle, and enable the management team to take remedial steps – giving access to what is, arguably, 'free' capital.

It's helpful to define and prioritize a schedule of profit improvement initiatives in terms of revenue and costs. Beware of slashing costs like headcount or training just for the sake of a quick win. More innovative, but less obvious, cost reduction measures may take slightly longer to implement, but could pay huge dividends when the upturn comes, and should definitely help to build sought-after resilience into the business (see textbox on page 21).

The other basic step is to take a hard look at what can be divested. Whatever does not create value for investors, or provide a competitive advantage in the longer term, can be put into a divestment program. Companies with extensive middle- or back-office functions may also reconsider outsourcing.

Step 2

Create 'headroom'

Turning the management actions from Step 1 into a set of prioritized and well executed action plans, with high quality progress reporting, can help create the 'headroom' a business needs. It can give stakeholders confidence that managers are responding effectively, and secure their support for any subsequent transformation process.

Banks and other debt providers will want quality cash and working capital reporting, on a regular basis. They need evidence that the action to improve performance is working if they are to continue to support the management team. Communication should be made a priority. Give regular updates on plans and how achievements measure up. Show them early wins, but seek to make sure they also know how you are repositioning for the longer term.

Step 3

Enhance the business model

The full business and regulatory consequences of this crisis are anyone's (educated) guess. Managers making decisions on how to reshape their business for the future are speculating that there could be:

- diminished risk appetite amongst investors and lenders
- demand for simpler, more transparent products
- greater focus on governance and risk management
- moves toward global – and more interventionist – regulation

Investors are likely to be demanding greater transparency and clearer reporting about risk and returns, as well as simpler fee structures and less complex investment products. Managers should seek to renew or enhance their product design and risk management skills in response. In turn, this means introducing new performance management systems and incentive structures, and overhauling financial systems.

Back to basics: better cost management

Common cost management initiatives
A quick win, but assess potential long term damage before proceeding:

- Headcount cuts
- Recruitment freeze
- Restricted travel
- Project slowdowns/cutbacks
- Cuts to marketing spend
- Training cuts

Innovative cost management initiatives
Potentially harder to implement – but more rewarding in the long term?

- Reduce process breakdowns/ customer complaints
- Planned contractor leave
- Centralize procurement
- Reduce cost and appropriate level of internal recharging
- Cut absenteeism
- Faster recruitment cycles

Businesses should aim for the right blend of strength and agility to deal with current tough conditions and capitalize on new business opportunities that may emerge.

Darwinism with a vengeance

Last year was one of the worst on record for investors, and 2009 could be just as tough. Charles Darwin wrote that survivors are those who are best at adapting to changing environments. Opinions abound on how the investment management industry needs to change, but essentially building the necessary resilience into your business should start with some very basic questions. Have you defined your core business – and do you stick to it? Do you regularly test your business against a range of scenarios – from bleak to optimistic? How confident is your leadership in its ability to manage through each scenario, and why? If you have clear answers to these questions, and the commitment to continue evolving as conditions change, your chances of survival are good.

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1. MSCI All Country World Index (ACWI), The Economist, January 17, 2009.

Angel Martin Torres

Spain's property market began to collapse just as the global financial crisis took hold. The consequences have been traumatic, not just for the Spanish real estate sector, but also for middle market construction companies, property developers and the very many banks that were over-exposed. The crisis is forcing Spanish banks to develop different ways of supporting shaky debtors. Angel Martin Torres explains.

Boom

Boom…

Spain's decade long residential real estate boom was driven by a unique combination of factors: rising demand fueled by immigration from elsewhere in the Mediterranean and from Eastern Europe; Spain's attraction as a second home or retirement destination for residents in the UK, Germany and Northern Europe; and a domestic culture which has always preferred purchase to rental. By the end of 2007, housing investment in Spain was equal to nearly 9 percent of GDP[1]. Investment in the rest of the construction sector was at a similar level. With virtually 20 percent of the country's economy revolving around the construction industry, the sector was employing 1 in 6 of the total workforce.

This boom, and its continued rapid growth, was massively debt funded, with huge gearing levels. By mid 2008, Spanish construction companies owed the banks €156 billion; property developers had debts of twice this level: €313 billion[2]. Mortgages and loans to property developers accounted for over half the loan portfolio of Spanish banks.

…to bust

The crash was triggered by over supply of residential developments, softening demand and increased regulation of sometimes dubious developments. At the same time, the global credit crisis began cutting off the supply of wholesale funds to Spanish banks, restricting their lending ability, leading to higher interest rates and tougher credit conditions. Finding it increasingly difficult to refinance their massive borrowings, property and construction companies began facing a severe liquidity crisis. Having financed large numbers of developments still in the course of construction, some banks focused scarce resources here, so that the real estate companies had completed assets that could at least be sold, avoiding losing the value of work in process.

As the economic slowdown took hold, unemployment began to rise, borrowers fell into arrears with mortgage payments and repossessions mounted, putting further pressure on the property market. A range of ancillary industries suppliers of concrete, ceramics, furniture, bathroom fittings began feeling severe strain too.

The first significant victim was Llanera, a medium sized real estate group, which went into receivership in September 2007, after failing to refinance its borrowings. Worse was to come. In mid 2008, one of the country's leading property companies, Martinsa Fadesa filed for protection owing €5 billion. Another one, Inmobiliaria Colonial was only saved from bankruptcy by a €7 billion debt for equity restructuring by a consortium of banks, after a deal with Investment Corporation of Dubai failed. In the last quarter of the year, the property group Habitat filed for bankruptcy protection and the private shareholders in Metrovacesa sold 54 percent of the business to creditor banks in exchange for a €2.1 billion debt write off. All told, during 2008 over 1,000 property and building companies went into insolvency (see panel on page 24).

to bust

Lessons from the Spanish property crisis

Spanish real estate sector: the scale of the crisis

2,528 companies went into insolvency in 2008, a 197 percent increase over 2007 – 44 percent of these were building or real estate companies:

- 490 real estate developers, 463 percent up on 2007
- 632 building companies, 283 percent up on 2007

Big failures:

- Martinsa-Fadesa: debts of more than €5 billion
- Habitat: €2.3 billion debts
- Llanera: €700 million debts

Major restructuring rescues:

- Inmobiliaria Colonial: €7 billion debts restructured
- Metrovacesa: €2.1 billion debt exchanged for equity

Sources:
INE (Instituto Nacional de Estadística), Ministry of Economy and Treasury Spain, February 2009.
www.ft.com
www.expansion.com
www.cnmv.es

Challenge for banks

This cascade of failures has posed major challenges to a banking sector already suffering severely from the global financial crisis. While the major Spanish banks are robust enough to withstand the strain, they are increasingly finding themselves owners of distressed property assets or equity stakes in tottering real estate companies. The main foreign banks in the market are in a similar position. However, some of Spain's regional savings banks (cajas), which have financed much of the boom, are in a weaker position due to their smaller balance sheets, coming under increasing pressure to merge and consolidate.

Cultural issues, too, have impaired the ability of the Spanish banks to respond to the crisis. In recent years, Spain has enjoyed a remarkably low level of corporate bankruptcies. Whereas the major UK banks have long had dedicated insolvency, special situation and restructuring practices, Spanish banks appear to have had little experience in this area. This has made reaching agreement among a consortia of Spanish and overseas banks on restructuring programs especially challenging.

Some Spanish banks have been slow to appreciate the need for detailed independent business reviews of debtor companies' balance sheets and business plans. They have tended to be too trusting of companies' forecasts. In the early stages of the crisis, some banks were prone to insisting on restructuring packages which sucked all free cash back to them, starving the company of liquidity and precipitating insolvency in the medium term. The risks are higher in Spain because of a number of technical features of the country's insolvency law. These can result in certain transactions occurring during the two years before the insolvency procedure is approved by the Court. These are then being retrospectively judged against the right of all creditors to be treated equally, and then rolled back once insolvency protection is sought. The creditors were unprepared to deal with the complexities.

Increasing creativity

However, things are changing. Encouraged by their overseas banking partners, and with the assistance of professional services organizations such as KPMG – which are involved in the majority of the biggest crisis situations – Spanish banks are beginning to get more creative and effective in supporting debtor companies in trouble. They try to avoid the insolvency procedures, if possible, working more closely with companies to explore alternative strategies such as accelerating cost-cutting, lay-offs, disposals and the like to improve cash-flow, allowing refinancing while avoiding the risk of insolvency.

In a turbulent environment, with a financial crisis and the economy slowing down, financial entities need to improve their recovery processes. A restructuring advisor with financial, operational and insolvency knowledge can help lenders assess their options for repayment, refinancing and recovery from underperforming businesses. An independent business review can clarify the financial position of the borrowers to the bank, provide them with an independent evaluation of the reasonableness of projections, give an indication of management's ability to run the underperforming business, estimate the debt that will be recovered and offer recommendations on how to proceed.

In the coming year, many small and medium construction and real estate companies may nevertheless disappear into bankruptcy. Some of the weaker banks could struggle to survive. The shortage of liquidity will increasingly affect the consumer sector, and the prospects for unemployment in Spain are particularly poor.

There is a long way to go before the crisis is over. Spain is likely to suffer longer and more severely than other developed economies. The banks have learned some hard lessons. But these should stand them in stronger stead once the recovery comes.

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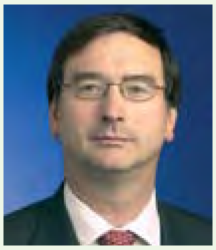
1. "Housing Woes in U.S. Spread Around Globe", New York Times, April 14, 2008.
2. 'Economic Bulletin', Spanish Central Bank, December 2008.



Jonathan Thompson

As real estate asset values collapse, banks may be forced into an unfamiliar role, that of active property portfolio management. Jonathan Thompson assesses the implications.

In the wake of the crash

A new paradigm for real estate banking?

The real estate asset price bubble has been a global phenomenon. Many of the major western economies have been severely affected by the bubble bursting, although the speed and scale of the impact have varied according to local circumstances. Ireland, the UK and Spain have probably been hardest hit. In the UK, value inflation has been more investment-focused, and so the collapse has had (somewhat) more containable consequences. In Spain, however, the focus has been primarily on residential development. A downturn here means returns on capital disappear completely, so the collapse has been faster and deeper – as Angel Martin's commentary shows.

As banks struggle to come to terms with the new situation, what is slowly emerging – in large part led by the Spanish experience – is the realization that a new paradigm is required for banks' engagement in the real estate sector. Banks can no longer act simply as lenders managing a loan portfolio. Increasingly they are becoming equity owners, in legal reality or merely de facto, and in future they may need to behave as such to safeguard their investments. This new environment will be with us for the medium and longer term. Adjusting to it will require profound changes not only in bankers' attitudes and behavior but also in regulation.

Before the crash, it was simpler. A bank acting simply as a lender would support a debtor in trouble up to a point. But beyond that point, foreclosure and repossession would follow. Now, though, this is counter-productive. Where banks are in effect equity holders, repossessions and forced sales can destroy the bank's own capital and contribute to a further downward spiral in asset values. Banks should now be accessing top quality asset management expertise to run their investments actively as real estate portfolios. They should engage with complex strategies of ownership changes, restructuring, debt-equity swaps and the like.

KPMG member firm's experience in the AU$5 billion refinancing of Australia's Centro Property Group, and as administrators to the (largely real estate) Lehman Brothers Far East portfolio, suggests that some banks are realizing that they are not geared up to cope with this new role, and are taking steps to remedy the situation. As ever, it is a matter of acquiring new skills and expertise, both by recruitment and internal development and by selective reliance on external specialists. But equally, it is a matter of changing culture and attitude.

Banks are now at the top table in the real estate business. With substantial equity injections now being made into the real estate sector, values may be driven lower before returns can be rebuilt. There is a lot of trauma still to come. And for the foreseeable future, banks will have to act as engaged and committed property investors.

It's a tough challenge. But in many cases, banks' survival may depend on them facing up to it successfully.

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Karen Briggs

Rowan Taylor

Increased fraud revealed by the credit crisis

As the tide goes

The financial services industry is facing increased pressure across all aspects of the business, given the impact of the credit crunch. This can lead to firms either detecting more existing fraud as they apply greater scrutiny to cost or being the subject of new fraud where some people see the rewards exceeding the risk of being caught. Investigating and dealing with fraud is costly in terms of finances, management time and reputation. In addition, it can lead to increased internal and regulatory compliance requirements.

Financial pressure is often a key motivator for fraud with many fraudsters just wanting to maintain existing lifestyles and pay the bills. Some people step over the line with the resulting fraudulent acts manifesting in a number of ways. Examples include: misrepresenting the value of an asset or liability; overstating an income stream to support an application for credit; misstating financial records; theft of funds and other assets; and obtaining credit with no intention to pay.

Current uncertainties regarding job security are likely to increase the motivation for some individuals to perpetrate fraud. Internal flux and personnel changes within financial institutions may give rise to greater opportunities for fraud to occur. The combination of increased motivation and opportunity is likely to result in an upsurge in fraud, thus the greater imperative to have effective prevention, detection and response arrangements. The cost of fraud is high, not just in the direct loss from the fraudulent acts but also pursuing an investigation and/or litigation. All this combines to impact on management time and can cause significant reputational risk if not handled effectively from the outset.

Fraud awareness and prevention is a critical management issue across the financial services sector

The tough market conditions are raising various issues that banks and their leadership will no doubt be keen to address. The credit crisis and the resulting liquidity issues can result in conflicting issues: the need to ensure effective prevention, detection and response mechanisms (along with the associated resource requirements) against the need to control costs.

Prevention is clearly preferable. The effectiveness of two elements should be considered.

Firstly, the mechanical elements such as adequate controls, processes, frameworks, segregation of duties, second and third-line defenses and whistle-blowing.

Secondly, the 'softer' preventative measures. Firms should ensure that their people have heightened awareness to the types of fraud,

Figure 1

Attributes of a fraudster

A fraudster usually:

- is an insider: 89 percent of the sample were employees
- tends to be a manager: 60 percent of the total were senior managers (including board members)
- exploits organizational and personal weaknesses: 49 percent took advantage of weak internal controls and 15 percent colluded with others
- is a serial offender: 65 percent committed ten or more frauds and 32 percent 50 or more.

Copies of the survey can be obtained by visiting www.kpmg.com

out...

the red flags, the need to report and the mechanisms for raising suspected fraud. A firm's (lack of) tolerance to fraud and appropriate behavior should be in line with their integrity and ethical behavior requirements.

The challenging economic climate can create 'grey areas' where professionals can feel trapped and unable to speak up or report unethical behavior, due to fear of redundancy or removal; thus it is important that people are able to identify legitimate concerns in confidence and without fear of retribution.

Embedding this within an organization requires managers to ensure employees have clear, concise and effective understanding of their responsibilities. More than ever before, leaders across the financial sector should be aware of the long-term impact of badly managed fraud investigations, for their reputation as managers, brands and standing in the market and for their workforce.

It is critical that managers arm themselves with relevant information, ensure they understand it, and take appropriate action based on it. One of the most concerning aspects of some of the cases which are coming to light is no effective follow up when management are put on warning, whether by internal audit, whistle-blowers, consultants or internal reviews or due diligence.

KPMG's *Profile of a Fraudster Survey*[1] provides an interesting insight into the average perpetrator of fraud. Our findings suggest that there are attributes frequently demonstrated by fraudsters (see Figure 1).

Fraud and the resulting litigation are almost certain to increase due to the worsening economic situation in the financial services industry. Firms should be proactive to respond to the increased regulatory and compliance requirements, litigation and investigations. One of the keys to this is the review and follow-up of relevant, robust management information and enhanced vigilance by staff and management.

Fundamentally, financial services firms are facing many important issues where the tough market conditions are exposing wrong-doing meaning forensic skills can be of great value to reduce reputational risk and commercial loss. A clear stance that the long-term impact of fraud is significantly damaging for staff and the business, and encouraging ethical behavior and integrity is paramount across the financial services sector, particularly until the green shoots of recovery emerge.

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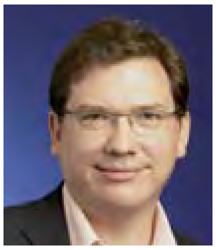
1. KPMG's EMA Region 'Profile of a Fraudster Survey', April 2007. The Survey is based on hundreds of actual fraud investigations conducted by KPMG Forensic practices within Europe, Middle East and Africa member firms. It aims to provide a comprehensive picture of those who commit fraud, the conditions in which fraud takes place and the resulting actions.



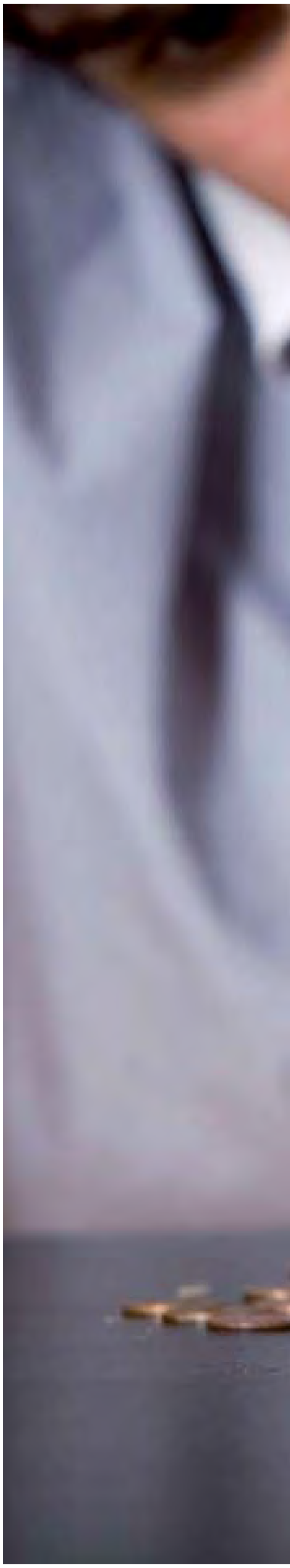
Stuart Secker

Rachel Hanger

Robin Walduck

Considerable research has been conducted into the ways in which the taxation of savings and investments influence savings behavior, however less attention has been paid to the commercial impact of changes to the taxation of savings. Stuart Secker, Rachel Hanger and Robin Walduck look at the implications of the current crisis for tax and savings.

Money in the bank



Tax, savings and the credit crisis

As investors and the financial services sector lick their wounds, financial services groups keen to rebuild their balance sheets and governments eager to restore confidence in financial markets should seek to assess the commercial impact of fiscal incentives on savings behavior. While it seems obvious that fiscal incentives ought to increase the overall level of savings, it is often difficult to disentangle such incentives from the economic, cultural and psychological factors that can also affect savings behavior. We have sought to consider below the effects of those factors, how the savings and investment market has developed in recent years, and comment on what could be the focal points of the future for the financial services industry.

Complex Drivers

One of the most powerful drivers of the overall savings ratio – the proportion of total income saved – is the economic climate. In general, people tend to save less when economic confidence is high and more when confidence is low; Japan is a case study of this phenomenon. But the savings ratio can also be influenced by confidence in savings institutions, inflation and personal savings experience of large gains or losses.

The tax position for different savings products can of course be a driver of choice between competing products; however, it is much less clear what effect if any it has on total savings.

Volume or direction?

Studies of new tax-favored financial products in a number of countries suggest that much of the money flowing into such products from high income earners is simply reallocated from taxable products. However, there is some evidence that the introduction of such products may increase the level of saving by middle income earners. In the UK for example, a study concluded that 15 percent of people investing in tax exempt Individual Saving Accounts (ISAs) would not have saved if ISAs did not exist[1].

This suggests that if tax incentives for saving are to achieve the policy objective of increasing overall levels of savings, they should target middle income earners whose savings ratios are more sensitive to tax incentives. Indeed, if the policy is to encourage saving across income groups, different financial products for different income groups could be a way forward. For example, tax credits, rather than tax deductions, could be more of an incentive to low income earners to contribute to voluntary pensions.

To be effective, the tax incentives need to be easily understood by savers. The complexity of many savings products means they are often sold rather than bought. In this context. the tax benefits compared to other products should – and do – form an important part of the marketing message.

15%

of people investing in tax exempt Individual Saving Accounts (ISAs) would not have saved if ISAs did not exist, in the UK.

Meeting the challenge

There appears to be a growing consensus that cross-border savings and investment should be encouraged, despite the effect this may have on domestic markets. It needs to be accepted that consumers are now more international, more mobile, and more demanding regarding savings products. While fiscal reviews of the taxation of savings may be of some assistance domestically, these need to be undertaken with an eye towards coordinating with other financial markets in the development of new products and incentives. This could be by choice (such as the trial of products in Japan similar to the UK ISA), or it could be by force (such as the infringement proceedings launched in the European Union against providers of domestic pension products). Market competition for savers (and the effects of tax incentives granted on savings products) has never been so intense.

In the current environment, financial services firms will need to respond to customer sentiment. Customers are increasingly fearful of the future, and will demand simplicity, transparency and certainty. Any company that can offer savings products that are transparent, flexible and make the most of available tax incentives could have a substantial competitive advantage.

However, it is not as simple as that. Even apparently plain vanilla products can be complex behind the scenes. Products may be hedged or insured, opening them to the relative complexity of the derivatives market.

The challenge for providers and new product developers is therefore significant. It is to develop new, safer and simpler products even though these may retain some elements of complexity and risk behind the scenes, and to explain them coherently to consumers. This will not be easy when transparency requires honesty about underlying risk, but customers are seeking reassurance that risk is minimized.

Where next?

Our research[2] has highlighted a number of trends that should be considered by financial institutions looking at savings products. Firstly, there has clearly been a loss of confidence on a global scale in the financial markets, particularly financial institutions in recent months; this will need to be re-affirmed before the savings and investment market can recover. Secondly, recessionary pressures leave us somewhat gazing into a crystal ball; it is notable that investors have diversified into short-term investments to take advantage of rising inflation, although this could be short-lived because of pressures on mortgages and unemployment.

In many ways, an increase in savings will be welcomed by governments anxious to promote savings, reduce excessive indebtedness and improve the deposit funding base of banks. It may, however, conflict with short-term policy efforts to increase consumer expenditure and mitigate the worst effects of recession. So though it seems unlikely now, in future governments may well introduce new tax incentives to encourage specific classes of savings investment. Retail financial institutions specializing in products designed for lower and middle income groups may benefit from such changes and may feel it is worth encouraging tax authorities to design cheap-to-administer products targeted at these groups.

1. OECD Tax Policy Studies: Encouraging Savings through Tax-Preferred Accounts, 2007.
2. This article draws on the recently published KPMG Study into the tax environments for savings products in 12 key economies, KPMG International, February 2009.

Any company that can offer savings products that are transparent, flexible and make the most of available tax incentives could have a substantial competitive advantage.

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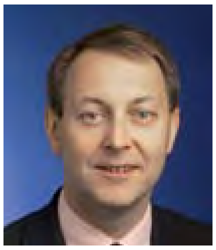
Cost optimization


Michael Robinson


Jörg Haupt


Hugh O'Reilly

As recession bites, cost optimization is now more likely than ever, to be a key element of companies' survival strategy. With the whole financial services sector suffering from the world-wide economic turbulence, a renewed focus on costs is essential. But 'slash and burn' is not the answer – and in fact may make the situation worse. Michael Robinson, Jörg Haupt and Hugh O'Reilly outline the need for a more strategic approach.

Lean not **mean?**

A shock to the system

Developed economies have experienced a decade or more of economic growth, rising prosperity and increasing corporate profits. The financial services sector has been both the engine and the beneficiary of much of this remarkable growth. So for the engine to stall – and even slam into reverse – is profoundly disorienting.

It's not simply that it's a shock to find the external environment drastically changed, with demand falling, liquidity hard to manage and credit in short supply. It's that recession challenges the foundations of current business models. Stability and growth lulled investors and consumers alike, into a false sense of security, encouraged them to borrow excessively and overpay for assets. But in a declining economic environment, capital is being eroded by a dramatic increase in the level of arrears and impairment charges for secured and unsecured lending, and a continuing decrease in returns on investments. Financial services firms have moved virtually overnight from an unprecedented period of revenue growth and cheap money, to one where the daily challenge of balancing capital requirements, risk and liquidity becomes a drain on management focus. In this environment cost management is one of the few directly controlable and manageable profit drivers.

Hold your nerve

In good times, many companies can inevitably tend to lose their focus on costs. Just as the credit crunch started to bite, a KPMG survey[1] found that 42 percent of more than 400 senior executives admitted that revenue growth had led their businesses to take their eye off the ball on costs. Today, many businesses are suddenly realizing that ruthless cost control will be a key to survival.

42%

of more than 400 senior executives admitted that revenue growth had led their businesses to take their eye off the ball on costs.

Unfocused approaches to cost reduction compromise the ability to deliver revenue growth and profits in future, and succeed only in destroying long-term shareholder value.

The immediate reaction is all too often to panic. Financial services firms over the last decade have been outsourcing, standardizing processes and moving to shared service centers, in the interests of increased efficiency and improved performance. The temptation now is to believe that radical across-the-board cuts are the only way to make the necessary readjustments rapidly and extensively enough. But this is a profound misconception. Unfocused approaches to cost reduction can compromise the ability to deliver revenue growth and profits in future, and may succeed only in destroying long-term shareholder value. And it is the medium and long term which are important: more companies fail coming out of a recession, than in the period leading up to or during a recession.

One of the key challenges is to move to a low-cost operating model that is relevant in the new strategic landscape, and to do so in a way which preserves flexibility and the capacity to respond to future change, whether adverse or benign. While cost *reduction* is almost always a consequence, cost *optimization* should be the objective. Achieving it, and then sustaining a rigorous cost management approach across processes and disciplines, is hard. It's like weight loss. A crash diet will reduce weight in the short term. But it takes a permanent change in lifestyle to deliver long-term health.

A number of factors are essential to success.

A new business model – low cost and agile

Sharp readjustments in trading volumes lead to business models which have costs that are no longer in the right location to optimize value. Typically, many financial services organizations may still be operating business models that are designed to fuel growth with sales-heavy structures. Organizations should move quickly to recalibrate and rethink their whole business model around a low-cost design that is relevant in today's marketplace. It is essential to extract every dollar of value from every dollar spent. Companies should understand the linkage between cost structures and value creation, to treat every dollar of expenditure as a dollar of investment.

Leadership is key

Ensuring that the necessary structural changes are delivered requires deep cultural change which, in its turn, is about leadership and commitment. It is essential that the leadership team is prepared and able to step up to the mark with a clear vision and a well articulated route map to the business model of the future. The successful leaders of the next decade are likely to make cost optimization part of a positive and inspiring future for their staff, customers and stakeholders.

One of the key challenges is to move to a low-cost operating model that is relevant in the new strategic landscape, and to do so in a way which preserves flexibility and the capacity to respond to future change.

59%

of expected savings are achieved, on average, through cost reduction initiatives.

8%

of businesses reach or exceed their cost savings targets.

Clear lines of responsibility

One of the core arts of leadership is knowing how to inspire management to implement strategic decisions. Given the size and scale of the challenge ahead, organizations cannot afford to have any confusion about roles and responsibilities. Cost management and delivering cost programs require unremitting executive level commitment and ownership of both the solutions but also the benefit delivery. With it will come much greater focus on cash control, benefit realization and investment analysis.

A highly motivated, cost conscious culture

Delivering a low-cost business model demands a radically new focus on cost, right down the management chain. KPMG's member firms experience has shown that some of the most successful and enduring cost management initiatives have been delivered when staff at all levels are engaged and motivated in the culture of effective cost management. Active staff engagement is one of the most effective ways of ensuring buy-in, reducing the risks of implementation and making sure all staff feel they are playing an active part in delivering the future of the organization.

A fresh look at cost reduction

Cost initiatives often disappoint. The KPMG research cited earlier reveals that on average companies achieve only 59 percent of expected savings. Just 8 percent of businesses reach or exceed their cost savings targets. Removing excess is not easy; it requires absolute executive level commitment and support not just for identifying targets but for delivery of the benefits. Successful cost optimization programs offer a balance of top-down drive with enough bottom-up analysis to confirm changes are viable.

Leading cost management disciplines

It can often be hard to get people excited about the traditional cost management disciplines: effective budgeting processes, variance analysis, investment prioritization etc. However, organizations that have achieved a sustainable competitive advantage through the delivery of a low-cost base have invariably succeeded in embedding fundamental cost disciplines within their culture.

Visibility

Organizations should seek to move quickly to address their cost challenges; this can often demand cross-organizational thinking and challenges to traditional thinking. Unfortunately, many organizations may not have a clear view of products and customer profitability or even what are the key drivers of costs. They need to have clear visibility of their current cost base and a clear vision of what the future looks like.

The tough times are going to be here for some time. Cost optimization is likely to become an enduring dynamic process for leading organizations. Successful organizations will have a continuous, structured, ambitious approach to managing cost; and will control the investment of scarce resource with clear governance and a leadership visibly committed to its success.

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1. 'Rethinking cost structures: creating a sustainable cost advantage', KPMG International, 2007.

What is real?

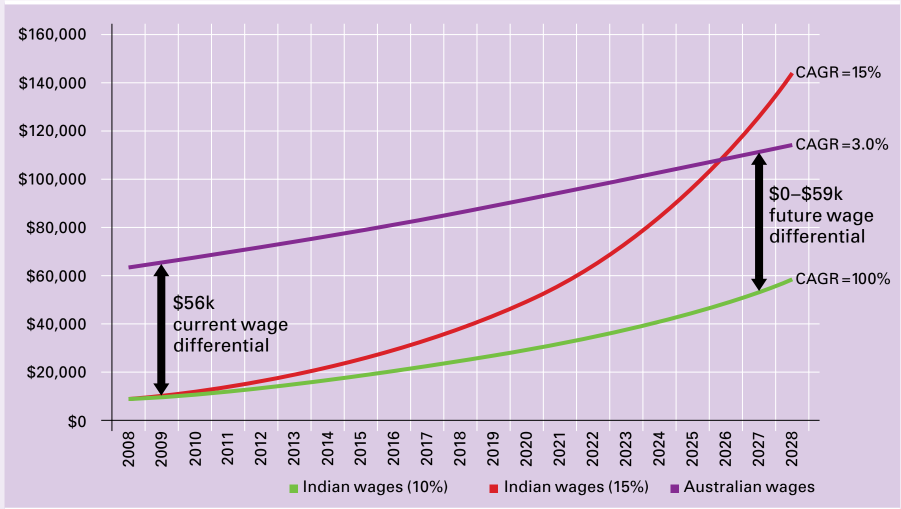
The truth about outsourcing for banks

Geoff Rush

Over the last five years, many banks have remained resistant to the trend for outsourcing non-core activities, that is being enthusiastically pursued in a lot of other industrial sectors. The fact that banks have enjoyed rising revenues and relatively mild cost pressures has been one underlying factor. But opposition to outsourcing has also reflected exaggerated concern about the risks and limited benefits. In the aftermath of the financial crisis, Geoff Rush argues, it may be time for banks to think again.

> "There is no evidence to suggest that consumer data is at greater risk in India than in the UK"
> The UK Financial Services Authority

Figure 1 Wage differential: Australia vs. India BPO (in AU$)



Source: KPMG in Australia, 2008.

From 2003 to the start of 2008, many banks around the world took the decision not to offshore business processes to lower cost countries like India and the Philippines. Experiencing strong revenue growth and decreasing cost-to-income ratios, these banks did not see the need to initiate offshoring programs. In addition, banks were concerned about the possible risks of outsourcing, and skeptical of the possibility of sustained benefits.

In the first case, there is an understandable belief that the risks of data security breaches increase when processes are offshored to low-cost countries. The second reflects concern that, due to significant wage inflation in these countries, the labor arbitrage benefits that early movers like American Express and Citibank have achieved may soon disappear. In fact, neither of these beliefs is true. Given the downturn in the global economy, the time may be right for banks to reconsider offshoring as a method for sustainably reducing costs.

Offshoring is not a panacea, and should be considered as part of an overall business cost reduction strategy. But tackling these two concerns head on can facilitate a rational assessment.

Concern 1

Offshoring to low-cost countries increases the risk of data security breaches

This is the notion that offshoring increases the risk of security breaches (for example, customer data being stolen or misused). At its core, this appears to be based upon the notion that since staff of Business Process Outsourcing (BPO) companies in low-cost countries earn considerably less than their first world counterparts, they are therefore more likely to be tempted to profit from the misuse of customers' data.

The major flaw in this assertion lies in the fact that employees of BPO companies are actually well-remunerated by local standards. For example, the average salary of entry-level employees at an Indian BPO company performing rules-based back-office processing ranges from US$6k–8k per annum. This may not seem like much by US standards, but by Indian standards this puts them in the top 11 percent of earners[1]. In addition to high salaries (again, by local standards), employees of leading Indian outsourcing companies also enjoy the benefits of:

- good working environments, often on university-style campuses replete with open-air cafes and health clubs
- medical facilities and comprehensive medical coverage that extends to the employees' immediate families
- significant career development prospects, including opportunities to work overseas.

Combined with the fact that leading BPO companies have remarkably strong physical security controls[2], it is irrational to think that offshoring processes to low-cost countries increases the risk of a data security breach. The UK Financial Services Authority (FSA) summarized the point succinctly when it stated that: "There is no evidence to suggest that consumer data is at greater risk in India than in the UK"[3].

So, the lesson is not that offshoring is bad per se, rather that companies considering offshoring should be extremely vigilant in executing their due diligence and should make sure they have both appropriate clauses in their contracts to address the liabilities and robust business continuity plans.

Estimates of wage inflation in low-cost countries typically range from

10–15%

Of the total tariff charged by BPO companies, staff salaries only represent

20–25%

Labor arbitrage will continue to provide benefits for at least another

15 years

Concern 2

Rampant wage inflation in low-cost locations will quickly nullify any labor arbitrage benefits

This remains a commonly-held belief, however estimates of wage inflation in low-cost countries typically range from 10 to 15 percent per annum. Compared with the current wage inflation rates of 3.3 percent in both Australia and the UK[4], this does seem to suggest, at a superficial level, that this belief is justified. However, what is often not appreciated is the fact that staff salaries only represent a small portion (20–25 percent) of the total tariff charged by BPO companies. For example, in Australia, banks are typically paying their BPO service providers between AU$28k–35k per full-time equivalent (FTE) per annum for experienced data processing (i.e. non-voice) agents[5]. This tariff includes allocations to cover the salaries of the service provider's senior managers as well as other overheads such as real estate costs and basic hardware/software required to perform the services. Using this information we can estimate the salaries of these FTEs to be AU$8,750 (25 percent of $35k) per annum. Comparing this to the average Australian salary of AU$65k per annum and using the aforementioned wage inflation rates, we see that even in the most extreme scenario labor arbitrage will continue to provide benefits for at least another 15 years (see Figure 1).

Nevertheless, while the key concerns that have prevented some banks from initiating offshoring programs in the recent past either do not or no longer hold, new obstacles are likely to complicate the decision to proceed with offshoring. In particular, rising unemployment rates in the United States, Australia, the United Kingdom and many parts of Europe may serve to increase scrutiny of offshoring decisions by governments, unions and the media. Offshoring has always been an emotive topic and can present a difficult public relations challenge for those institutions looking to mobilize such a program in the current economic environment. For their part, service providers are likely to respond by offering lucrative deals that have not been seen since the dot.com crash in 2001. These include, for example, service providers offering banks a domestic outsourcing deal at offshore prices, the intention being for the service provider to take responsibility for moving the outsourced processes offshore at some point in the future. While they seem attractive, banks considering offshoring should not be uncritically tempted by deals of this nature. KPMG firms recommend a structured approach to offshoring as part of a broader cost optimization program (see textbox).

As banks re-assess their business strategies in the wake of the financial crisis, offshoring can indeed be a potent weapon in the cost-reduction armory. The banks which manage the change process most appropriately are likely to be the ones that outperform their peers over the next 3–5 years.

1. www.microfinancegateway.org, 2009.
2. Typical physical security controls include: biometrics for ensuring only authorised personnel can gain access to the production environment, CCTV cameras to monitor staff activities, a paperless working environment to ensure data is not written down, disabling of all storage devices (e.g. hard drives and USB drives), strict prohibition on bringing cameras and mobile phones into the production environment.
3. Financial Services Authority, "Offshore Operations: Industry Feedback", April 2005 p.17.
4. "Average Weekly Earnings, Australia, Aug 2008", Australian Bureau of Statistics, November 2008, and 'Economic and Labour Market Review', Office for National Statistics, February 2009.
5. The variation in tariff is due to a number of factors including the particular location from which the service is delivered (for example, services delivered out of Bangalore cost more than services delivered from Jaipur) as well as the effectiveness of the team negotiating the contract with the BPO provider.

Structured approach to offshoring

This structured approach entails the following steps:

- clearly defining the organization's strategic objectives for offshoring
- developing robust business cases and risk assessment frameworks
- detailed design of the organization's target operating model
- piloting the offshored services to ensure that lessons learned can be incorporated into the full scale ramp-up
- establishing robust performance management capabilities to monitor the achievement of quality and efficiency targets
- ongoing review and continuous improvement of the offshored services

At the core of the approach is an emphasis on effective change management. Change management is the cornerstone of all successful offshoring programs, the potential benefits include:

- improved awareness and better understanding of the need for change
- increased ownership and reduced resistance to change.

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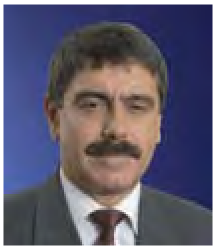
Emerging markets

As we live in a globalized world, the reach of the current financial crisis extends even to the emerging markets, including Latin America, as Ricardo De Lellis and Ricardo Anhesini Souza discuss.

The spirit of Latin



Ricardo De Lellis **Ricardo Anhesini Souza**

America

The global uncertainty has caused palpable aversion to the risk associated with investing in emerging markets, which has in turn seen domestic bonds and the stock market plummet, and local currencies devalued against the US dollar. This situation, however, differs from country to country across the region. Some of those countries have a significant presence of international investors; the selling of bonds and equities has resulted in an outflow of funds to the home markets, or in the purchase of government bonds issued in US dollars. In others, the reaction was mainly from local investors who directly bought the forging currency (US dollars) or transferred currency to accounts held abroad.

The reactions of the various governments to counter these trends also differ. Some governments let the currency be devalued, protecting their markets from further deterioration and gaining competitiveness in the economy; and others, especially those that already had a high inflationary environment, welcomed a combination of a much lower level of devaluation of their currencies with monetary tools, in order to reduce the slump in the economy. A number of these countries are major food suppliers worldwide. So how will the trade and fiscal surplus be affected by the slump in the international price of raw materials? The downsizing of personnel in the automotive and construction sectors and the deceleration of consumption are clear examples of the impact on the real economy. What are the short- and long-term implications? And what opportunities might arise for the region, as a result of the global crisis?

> Chile, Brazil and Peru, whose governments appear to have a good grasp of the global scene and made the necessary changes just in time, are likely to fair better in the crisis than other emerging market countries.

Undoubtedly, the emerging markets have come a long way in recent years, and an international economic crisis of this nature is unlikely to have the same effect it could have had a decade ago. However, the same factors that triggered the rapid expansion of globalization and spread growth to almost all countries in previous boom periods, have now helped spread the effects of the downturn to the developed countries over the last 18 months.

Understanding globalization and acting accordingly may provide the emerging economies with an opportunity to overcome the crisis. However there are a number of differences between the emerging markets other than their economic conditions. One of the key differences is each governments' degree of understanding of globalization; many do not appear to be fully aware of the implications of belonging to a globalized world.

While capital markets and trade have become globalized throughout Latin America, many governments in the region have not adapted to these changed conditions. Some took advantage of the benefits generated by globalization without making any provision in case the conditions were reversed, as has recently occurred. These governments increased fiscal expenditure based on the rise in price of commodities; but failed to develop further trade agreements with other countries. They also failed to encourage the development of their own capital markets, in order to take advantage of growth rates and reinstated inflation. In a few cases, certain countries have defaulted on their public debts and flirted, from a political and commercial viewpoint, with low-reputation countries of the globalized world.

Now that the crisis has hit, not all the countries will be able to apply the Keynesian policies advisable in many of these cases – to increase government expenditures – in order to reactivate their economies; partly due to the weak domestic capital markets, but also the impossibility of resorting to foreign capital as a result of their lack of creditworthiness.

Likewise, they may be restricted in the application of appropriate monetary policies such as interest rate and exchange rate adjustments by the role of stagflation. Alternatively they may choose to reduce tax pressure in order to stimulate the private sector.

Chile, Brazil and Peru, whose governments appear to have a good grasp of the global scene and made the necessary changes just in time,

In short, in a region with its combined population of more than 500 million people, these countries have undergone many hard times and as a result applied the lessons learned to varying degrees.

are likely to fare better in the crisis than other emerging market countries. Countries such as Argentina and Venezuela, whose governments offered higher growth rates in previous boom periods, are now at a crossroad and may find it difficult to overcome this situation without affecting society.

In the medium and long term, each country will have to learn from past errors in order to recover from the crisis. Argentina for example, has a well-developed agribusiness sector comparable to that of developed countries, which is not subsidized – but significantly tax burdened. Its chances to succeed depend on the government's change of mind (which may lead to a societal shift, and vice versa), to take advantage of the country's competitive strengths and develop the agro-food related industries; thus promoting job creation so that the development may include the whole population.

The Latin American countries have experienced tough times over the last 40 years, and almost all of them have benefited from the lessons learned during these crises. Hence, from an economic perspective, Latin American countries do not need further lessons in fiscal or monetary policies or instruments to control inflation. Or to avoid the temptations of the currency peg to hard currencies, the consequences of the dollarization of the economy or the inconvenience of a heavy government indebtedness especially in hard currencies.

Consequently, today there are four investment grade countries (Brazil, Mexico, Chile and Peru[1]) in the region. One of these well recognized for its potential, Brazil, is likely to manage to keep all the fundamentals of its nomination even after the crisis is over.

In short, in a region with its combined population of more than 500 million people, these countries have undergone many hard times and as a result applied the lessons learned to varying degrees. There is still significant divergence in terms of confidence and credibility in the political and economic system, corporate governance, compliance, cross-border cooperation and democracy. However, the progress made in the past, allows for some optimism for the future. This crisis as every other, despite its severity, should be used as an opportunity to improve some of the regions' weaknesses.

Indeed, despite the effects of the crises already mentioned, the region still holds important assets for future global trade and development – including water, commodities, telecommunications and natural resources. With more stabilized political and regulatory structures, in this field, a long-term investor may identify local partners to jointly explore future business opportunities and potentially benefit from the partner's local experience.

As soon as local governments decide to explore some of the promising opportunities that the regions' common markets could offer in a globalized world, and support those by appropriate political action, the results are likely to exceed any previous expectation.

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1. "Peru gets investment grade rating", www.businesswithlatinamerica.blogspot.com, July 21, 2008.

Islamic finance

Anita Menon

Jason Lim

Islamic finance has generated renewed interest of late, with the onset of the financial crisis around the world. Anita Menon and Jason Lim explore the opportunities for Islamic finance and its potential, particularly in Indonesia.

Hidden potential

A wealth of opportunity in Indonesia

While the the Islamic finance industry does not appear to have been entirely unscathed by the credit crisis, it seems to be fairly robust in the turmoil. The underlying principles of Islamic finance prohibit speculation and excessive risk taking, and promote mutual profit and risk sharing. The onus is on Islamic banks to ensure that financing decisions are supported by rigorous due diligence. As a result, Islamic banks have performed relatively well, in the midst of a crisis that appears to be a result of increased and arguably excessive risk taking.

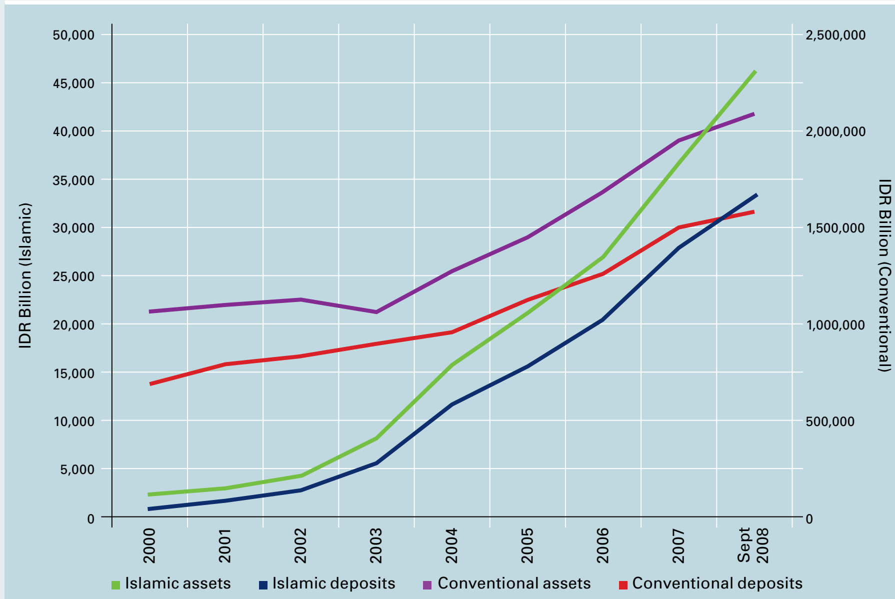
The longer-term outlook appears positive with Islamic banks continuing to expand internationally. Indonesia is home to the largest population of Muslims in the world, close to that of the entire Middle East[1]. This makes it a potential giant in the world of Islamic finance.

Despite the size of its market, Indonesia's Islamic finance industry is not yet as vibrant as that of Malaysia, United Arab Emirates (UAE) or Bahrain. This article seeks to establish the case for Indonesia's Islamic finance potential, and then to discuss recent developments that will stir the giant from its slumber.

Islamic banking in Indonesia is referred to as Sharia banking and falls under the purview of Bank Indonesia (BI), Indonesia's central bank. As of the last quarter of 2008[2], Sharia banks in their different forms comprised of three fully fledged Islamic commercial banks, 28 Islamic banking units of private national banks, which conduct conventional banking activities, and 128 Islamic rural credit banks, which are not involved directly in the payment system and have restricted operational areas.

Sharia banking assets have flourished in the country, averaging approximately 74 percent annual growth from 1998

Figure 1 Islamic assets and deposits in Indonesia



Source: Bank Indonesia, Report on Islamic Banking Development 2007 & Islamic Banking statistics 2008.

3.7m

The total number of deposit accounts held by Indonesian Sharia banks...

...of total banking deposit funds this constitutes just

2.09%

to 2001 and close to 50 percent cumulative average growth rate from 2001 to 2008[3]. This rapid pace of asset growth has allowed Indonesia to catch up with the rest of the Islamic banking world.

A major strength of Indonesia's Islamic banking industry is its large customer base on the funding side of its banking business. Particularly in times of low liquidity, Islamic banks in Indonesia can draw on this large and possibly more loyal, deposit fund pool to withstand the pressure of increasing cost of funds to sustain financing activities. Total number of deposit accounts held by Indonesian Sharia banks amount to 3.7 million[4] and constitute 2.09 percent of total banking deposit funds. In a country of approximately 209 million Muslims, this indicates a massive source of funding still untapped.

Despite its potential, Sharia banking's official presence in Indonesia was relatively recent, coinciding with the amendment of the Banking Act No.7 to account for the presence of Islamic banks and adoption of a dual banking system in 1992.

Formal development of the industry was set in place with the introduction of BI's Blueprint of Islamic Banking Development in Indonesia for the 2002–2011 period. In December 2006, midway through the Blueprint's 10 year period of implementation, BI announced the launch of the Sharia Banking Acceleration Program to further increase the role of Shariah banking in the national banking industry up to 2015.

The results of these initiatives may be a case of too little too late to keep the industry on track towards achieving the goal of 5 percent market share of total banking assets in 2008. As at September 2008, Sharia banking assets as a proportion of total banking assets only stood at 2.16 percent, despite strong growth which outpaced that of conventional assets. BI is instead setting its sights on a new target of 10 percent market share by 2013[6].

Compared to Islamic banks' share of 2.16 percent of total banking assets, the proportion of total rural banking assets held by Islamic rural banks was higher at 4.71 percent[7] in the same period. This implies potentially attractive opportunities for the microfinance market to be tapped further, either by the rural branches of Islamic commercial banks or by the numerous Islamic rural credit banks targeting lending towards small scale agriculture businesses.

In order to boost Sharia banking asset levels beyond the levels currently observed, a higher percentage of corporate customers should be

Figure 2 Table of comparative development of Indonesian and Malaysian Islamic banking industries

	Indonesia	Malaysia
Number of full fledged Islamic banks	3	17
Development Targets	10 percent total banking asset market share by 2013	20 percent total banking asset market share by 2010[5]
Unique developments	Branding of Islamic Banking industry under the IB logo	Development of Malaysian Islamic Financial Centre
Money market infrastructure	Interbank Financial Market (PUAS)	Islamic Interbank Money Market (IIMM)
Sharia governance bodies	Dewan Syariah Nasional	Shariah Advisory Council
Legislation	Act. No. 21 of 2008 on Sharia banking	Islamic Banking Act 1983

Source: Bank Negara Malaysia, Monthly Statistical Bulletin, November 2008.
Bank Negara Malaysia's Governor, Zeti Akhtar Aziz, 'The Malaysian banking industry – gearing up for excellence, May 2002.

Structural issues notwithstanding, Indonesia still holds an attractive position of being the largest Muslim nation and fourth most populous nation in the world.

targeted. Comprising only 8 percent of financing in 2007[8], corporate customers will be more actively wooed by Sharia banks as they will allow banks to grow assets more quickly than small to medium enterprises (SME) and retail customers.

A much needed boost could come from the entry of established foreign players. Indonesia's Islamic finance industry potential, while recognized by foreign financial institutions, has not led to a massive influx of investors. However, with the recent developments in new regulatory infrastructure, interest in the market is slowly but surely growing. Al Baraka Group and Asian Finance Bank have expressed intentions to enter the Indonesian Islamic finance industry in 2009 and 2010, respectively. This is additional to expansionary plans of local or existing market actors as well as other foreign players such as Malaysia's Bank Islam and the Saudi based Al-Rajhi bank[9].

While retail banking is the obvious entry route for a newcomer, this also requires strong distributor capabilities. Given this scenario, the potential market segment for new players without a local partner is in the corporate and wholesale space. However, this is also somewhat contingent on having an active Islamic capital market to ensure that Islamic banks have sufficient access to manage their liquidity. While BI has in recent years introduced measures to strengthen its infrastructure, such as the establishment of the Interbank Financial Market (PUAS) as well as the Jakarta Islamic Index (JII), it is still some way away from established countries where there are sophisticated debt capital markets and sufficient instruments for liquidity management.

Structural issues notwithstanding, Indonesia still holds the attractive position of being the largest Muslim nation and fourth most populous nation in the world. Islamic finance continues with its transformation from niche to mainstream, the industry will be heavily influenced by a giant, such as Indonesia and the speed with which it rises to its full awakening.

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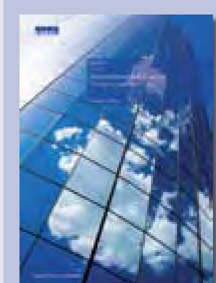
Trusting and checking – The roles of honesty and transparency in business, February 2009.
The rising importance of trust in business is a key issue discussed in KPMG International's recent report. The paper explores the importance of balance between trusting employees and their business, with thorough checking, and understanding the limits of both.

The impact of tax treaty trends in the Asia Pacific funds sector, February 2009.
This report investigates the trends in the Asia Pacific funds sector, highlighting the trends for tax authorities in the region to deny treaty relief to investment structures. It also explores how the funds industry should be approaching these trends.



Incorporation and beyond: Challenges for foreign banks in China, December 2008.
This KPMG International report outlines the challenges and opportunities for growth for foreign banks looking to incorporate in China. These issues are addressed along with how the business and regulatory landscape has changed in China.

Bridging the Global Infrastructure Gap: Views from the Executive Suite, January 2009.
In this report, KPMG International, in cooperation with the Economist Intelligence Unit investigates the impact of infrastructure on business: how important it is; how it affects growth and costs; what the critical issues are; and what needs to be done so businesses and countries can better compete?

Insurance: At the crossroads, February 2009.
This publication summarizes the issues discussed at the Reactions Global Insurance conference, sponsored by KPMG International, in November 2008 which focused on risk and capital management in the international insurance industry.

Never again? Risk Management in banking beyond the credit crisis, January 2009.
The credit crisis has forced banks to take a critical look at how they manage risk and has exposed some significant weaknesses in risk management across the financial services industry. KPMG International's recent report, produced in cooperation with the Economist Intelligence Unit, investigates the impact on risk management procedures within the banking sector.

Future of the Saver, February 2009.
A new wave of cooperation between governments and the global financial services industry is needed. To encourage consumers around the world to save, and to create an alternative to the wholesale markets as a source of capital. This survey looks at taxation of savings in 12 large economies, and the work being done by international bodies, both to open up the market in cross-border savings and to counter tax evasion.

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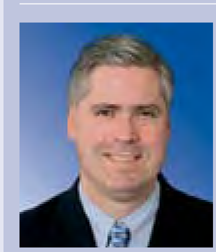

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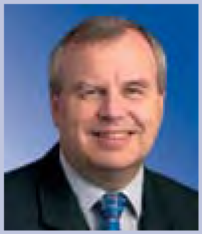

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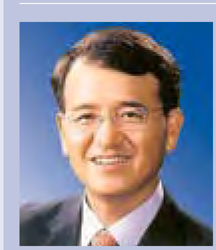

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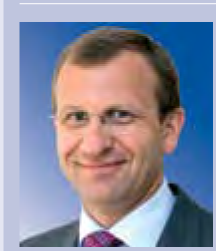

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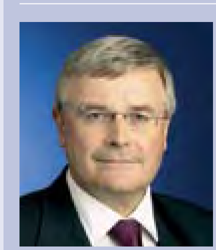

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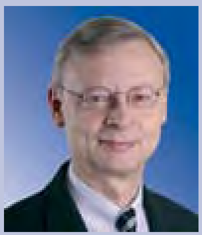

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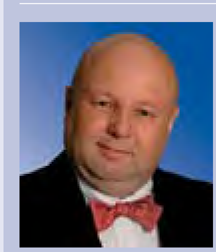

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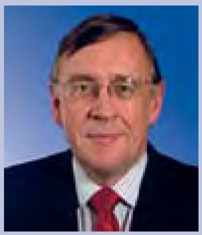

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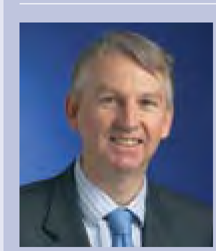

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