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Green Technology Financing Bankers' Conference 2012
Green Financing, The New Frontier

Internal Audit Conference 2012
Gearing Internal Audit for Changing Times

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The Institute's Mission Statement

To be a professional and effective training adviser and provider in developing practitioners of the banking and financial services industry to enable them to function effectively in an evolving financial services environment

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Editor's Note

This issue consists of the proceedings of two conferences, the Green Technology Financing Bankers' Conference of 2012 and Internal Audit Conference 2012 with the theme "Gearing Internal Audit for Changing Times". Although substantively unrelated, each conference dealt with key current issues in banking. Environmental sustainability is a major development theme, while internal audit is central to corporate governance.

Green Technology, already a major area of focus in technology research and application, has progressively gained prominence in banking. This is not unexpected, since the development of new technology requires substantial financing. In the Conference, the government's perspectives and initiatives were given in opening remarks by Dato' Muhammad Ibrahim, Deputy Governor, Bank Negara Malaysia, and Datuk Loo Took Gee, Secretary General for the Ministry of Energy, Green Technology and Water, Malaysia.

In the first substantive session, the specific situation in Malaysia, in terms of the sectors and technologies that were attracting green technology financing was surveyed. Global and Regional Development and Trends in Green Financing were reviewed in the second session. The regulatory frameworks, green sectors and products and institutions involved in green financing were among the topics discussed. Session three took a forward-looking stance, looking at renewable energy financing, energy efficiency financing, cleaner production, and programs supporting green technology finance, all of which posed opportunities as well as challenges. The final sessions (four and five) were about experiences and challenges arising from specific case studies. These challenges reflect the fact that green financing is even more recent a phenomenon than awareness of environmental sustainability.

In the second conference, Tan Sri Dato' Setia Haji Ambrin Bin Buang, the Auditor-General of Malaysia, delivered a Keynote Address that spoke to the need to adapt internal audit to changing times. For the reason, internal auditors needed to be equipped with relevant audit competencies. Challenges facing auditors in the public sector, his area of responsibility, were discussed.

The first session was on board effectiveness and the role of internal audit which made this possible. With change as the theme, one speaker explored how changes necessitated revision of business strategies which raised questions on the role of the board during these times. Another revealed the factors contributing to board effectiveness, with the board's ability to meet changing expectations a measure of its effectiveness. For internal audit the key question was whether it could balance the need to meet the needs of management with those of the Board of directors. A third spoke of internal audit failure during times of financial crisis and the proper role of internal audit

The second session saw debate on whether internal audit was a partner of choice or of convenience. While the first speaker argued for the latter, the second took the position of the former. Which was the reality depended of course on the specific situation. Session three was about the key role of internal audit in fighting fraud. Various remedies were surfaced. The role of the Malaysian Anti-Corruption Commission (MACC) was part of this discussion. The specific case of auditing Islamic finance was taken up next, with expositions on shariah audit and non-compliance risks. The broader question of audit and risk was the subject of Session five. In this session instances of recent risk management failures were described, the consequences of which pointed to the importance of internal audits. The need to go beyond discovery of risks to find out about their causes was also posited.

Internal audit as a dynamic process was the subject of session seven. The speaker in this session focused on risks posed by the use of Information and Communications Technology (ICT). Auditors with the needed expertise were needed to deal with the increasingly complex processes made possible by ICT. Another forward-looking session dealt with the aftermath of Basel II, which, with its successor Basel III, would make greater demands on internal audit.

The specific issues discussed in the previous two sessions were just parts of the future of internal audit, the theme of the last session. The topics under this theme that the panelists discussed were the future for internal audit, new learning and sourcing strategies for the internal auditor, new tools and education, effective utilization of audit resources, and the meaning of audit transformation.

If there is a commonality between the two conferences, it is the need to formulate strategies and take actions in a rapidly evolving environment. The ability to respond in a timely fashion will define how effective a role green technology financing and internal audit can play in our common future.

Green Technology Financing Bankers' Conference 2012

Green Financing, The New Frontier

The Green Technology Financing Bankers' Conference (GTFBC) was held at Sasana Kijang, Bank Negara Malaysia (BNM), Kuala Lumpur on 2 and 3 October 2012. Jointly organised by BNM and Institut Bank-Bank Malaysia (IBBM), the GTFBC brought together a number of distinguished speakers to talk about the new frontier of green technology in Malaysia.

Welcome Remarks by Yang Berbahagia Dato' Muhammad Ibrahim, Deputy Governor, BNM

First of all, Yang Berbahagia Dato' Muhammad Ibrahim welcomed and thanked Datuk Loo Took Gee, the Secretary General for the Ministry of Energy, Green Technology and Water (KeTTHA), Malaysia, senior bankers and all the distinguished guests and speakers.

He began the conference by saying that this conference was timely and provided the industry with valuable opportunities to stay abreast of key developments in Green Technology Financing (GTF) and discuss transformative solutions to grow this financing area in a sustainable manner. He remarked that the Malaysian financial system can play a catalysing role in the development of a vibrant and dynamic GTF ecosystem and to continuously support the needs of the economy in becoming a high value-added and high-income economy by 2020.

The world ecosystem is experiencing growing risks of climate change, resource depletion and environment degradation which have been happening for the past 100 years. For example, the global temperature has risen by 0.74°C as the carbon dioxide intensity has increased largely due to increasing use of fossil fuels. More than 80% of our energy needs are currently derived from fossil fuels placing a huge burden on this non-renewable resource. The global forest acreage has reduced by 40% in the last 300 years. In many countries around the globe, hectares of forest are lost annually, resulting in severe deforestation that will leave adverse consequences for future generations.

Sustainable development is hence paramount, necessitating function support, strong political views and fundamental cultural changes to create the necessary enabling environment. Increased awareness for sustainable development is beginning to change the behaviour of consumers, who are beginning to demand for more green financing and solutions. This trend and awareness has began to shift preferences for goods and services as evident from a survey of young adults conducted by Boston Consulting Group where 73% of the respondents stated that green factors are among the key considerations in making purchasing decisions. More households and businesses are adopting a green lifestyle, a trend that is well entrenched in many advanced countries and gaining rapid momentum in several developing economies including the ASEAN region. The environmental product and services market globally is estimated to be worth USD1.4 trillion; the growth potential of this market is tremendous.

On the financing side, the United Nation Environment Programme (UNEP) finance initiative has made important strides working closely with the financial sector to develop and promote linkages between sustainability and financial performance and in developing models for best practices including risk management. Financial institutions themselves have taken the initiative to adopt the Equator Principles where they commit to channel financing to projects which are both economically viable and environmentally sustainable. Such financing is also in-line with ethical and responsible financing principles that contribute towards a long-term sustainability of this business.

Governments around the world are also playing a critical role in catalysing sustainable development through policies and regulations that encourage adoption of the green solution. For example, South Korea has adopted a shared vision for green growth and established the Green Growth Institute to implement efforts to deal with climate change and resolve environmental and energy issues. The Philippines introduced its new legislation of climate change and established a Climate Change Commission to coordinate, monitor and evaluate the government's actions to mitigate and adapt to the effects of climate change. In Malaysia, sustainability represents one of the key principles under Penang's new economic model and has been identified as a key strategic reform initiative which has led to the establishment of key agencies such as Malaysian Green Technology Corporation (MGTC) and Sustainable Energy Development Authority (SEDA). This foreseeable future green technology will be a driver to promote sustainable growth and development.

It is in the financial industry's interest to be involved and engaged in the rapid development in this area. The financial system has played an important role over the last few decades in facilitating the economic transformation and growth of the real economy by channelling investment into productive sectors. This role has been significantly fortified by a strong and well-capitalised financial system that has been built through comprehensive reforms taken over the last decade. The financial system today is characterised by solid financial and strengthened risk management as well as governance practices combined with ample liquidity and improved credit infrastructure. The financial industry is well-positioned to support new areas of growth that are viable and promising including the green technology sector. To meet the needs of the green technology sector, there are two points that might reduce the information asymmetry between financial institutions and businesses, a pre-requisite for building a sustainable financing ecosystem for this sector.

Firstly, the financial institution must have the capacities and capabilities to access the viability of projects despite the complex, diverse and rapidly changing nature of green technology. Secondly, green businesses need continual advisory support as they may be technically strong but lack capability to develop comprehensive business plans and cash flow projections needed to demonstrate that the project is viable to financiers. BNM has worked closely with the Ministry of Finance and the Ministry of Energy, Green Technology and Water to establish the Green Technology Financing Scheme (GTFS), a framework designed to improve the preconditions for financial institutions to finance viable and innovative green technology companies. This is achieved through an arrangement that would bridge information gaps between financiers and businesses. This arrangement also involves credit enhancement and function incentives to address current shortcomings in meeting a legitimate economic need. Also critically important are efforts being pursued to strengthen the capacity of financial institutions to provide continuing advisory support to businesses that are mutually beneficial to other businesses, ventures and financial institutions. Central to this effort is the certification process, to verify that the businesses, which qualify for the green technology framework, are not only able to demonstrate the required technical capabilities but also that their complementary efforts are commercially viable which include education and awareness programmes organised around the country to inform and update financial professionals as well as businesses on the latest developments in the green technology sector. Likewise, courses offered by IBBM are designed to equip finance professionals to effectively access the viability and risk of green technology projects.

In 2010, a joint action committee comprising of government agencies and financial institutions was formed to provide an efficient and coordinated platform to tackle implementation issues such as the compliance and monitoring processes of green projects financed under the green technology framework scheme. As a result of this holistic effort, GTF is beginning to gain attraction among financial institutions. To date, the GTFS has funded RM805 million in financing 65 companies operating in a broad range of green technology subsectors which cover energy, building, transportation as well as water and waste management reflecting a year-on-year growth of 130% in terms of total financing and 171% in terms of companies assisted. While still small in aggregate terms, the value accumulated by participating financial institutions in terms of greater familiar routine with green technology applications and their potential and success factors for commercialisation is an important ingredient in positioning the financial institutions to further expand training into new and increasing important areas of growth. Therefore, the financial industry needs to do more.

Moving forward, the finance industry's ability to leverage on the GTF opportunities will determine the pace of growth in the green technology sector in Malaysia. The SME Masterplan 2012 – 2020 has identified potential areas such as solar power and energy efficiency products as well as other related services such as design and consulting of green solutions that could facilitate Small and Medium Enterprises (SMEs) to move up the value chain. This is expected to contribute towards achieving the targets set under the SME Masterplan to achieve GDP contribution of 41%, 62% of total employment and 25% of total export by 2020.

Another important trend is that with commodity prices and advances in green technology solutions, price differentials between traditional solutions and green solutions are likely to narrow substantially over time. Under this condition, the green technology sector is expected to attract significant investment across many sectors which will produce high value-added output and create high income opportunities. A United Nation (UN) study estimated that about USD75 trillion worth of investment is needed in green technology for the next 40 years to avert climate change catastrophes such as global warming, resource depletion and loss of biodiversity. Already, economies that have invested strategically in the green technology sector are reaping the benefits. For example, Germany which produces 70% of the world green technology output had seen an increase in employment in the green technology sector from 166,600 in 2004 to an estimated 280,000 jobs in 2011. Recognising the immense potential of the green sector, 77 financial institutions from 32 countries have adopted the Equator Principles to enhance the capability to provide financing for both economically viable and environmentally friendly ventures. The adoption of the Equator Principles allows financial institutions to play a leading role to promote responsible environmental stewardship and socially responsible development.

Furthermore, training and access to the tools and research necessary to build up crucial expertise to develop green technology is valuable for global initiatives such as the UN environment programme finance initiative. To achieve more significant progress in green technology, some key priorities in Malaysia could include the following:

1. Financial institutions should constantly develop expertise and support of this sector. The green financing team should have in-depth knowledge and capacity across the entire financing process flow including project development, promotion, sourcing of viable projects, effective assessment, holistic risk management and robust monitoring. The larger regional reach-out by Malaysian banks will also enhance the potential of these banks to access a wider talent pool from the region, catalysing efforts to build a specialised human capital team needed to drive the GTF agenda.

2. Government policies should be further enhanced to spur the growth of the industry and create larger consumer awareness. On the supply side, effort should be taken to build a highly skilled workforce and increase collaboration between research institutions and businesses to commercialise and skill-up innovative green technology research. On the demand side, creating incentives and encouraging consumers to use green technology products and government procurement policies which prioritise green solutions could be explored.

3. A holistic governance structure and performance measurement system should be put in place to drive implementation of policies and ensure that green technology sustainability outcomes are achieved. This could potentially bring us to a more transparent reporting of green initiatives by various players including the government, businesses and the financing community.

4. As Asia becomes increasingly more integrated, economically and financially, Malaysia's financial institutions have the opportunity to leverage on the regional network to scale up their business and serve a growing green technology sustainability market and of course, in an efficient manner. This regional network is further strengthened through the collaboration among Asian countries to further the green agenda and sustainable development through conferences such as the Asia Low Emission Development Strategies (LEDS) forum and the Asian initiative on environmentally sustainable cities.

5. A more diverse and robust financing ecosystem for green ventures should be created. The *Sukuk* market and venture capital industry can play a more active role in supporting this sector. To promote long-term financing, the *Sukuk* market presents an additional avenue to

meet market demand. *Sukuk*, which uses a principle-based approach on having real productive underlying assets, is an ideal financing solution for green technology projects which have large capital outlays and long gestation periods. Another is the promotion of a vibrant venture capital industry in Malaysia to complement the banking system as it has the potential to facilitate the development of small innovative businesses and the commercialisation of intellectual property.

He also informed that the recommendations made from this conference will be forwarded to the government to design a conducive ecosystem that will accelerate Malaysia to the frontier of green technology. It is therefore imperative that recommendation devices are practical, effective and holistic. Large untapped opportunities remain to be explored in the green technology sector in Malaysia. Swift action is necessary not only to address the growing demand for green technology, but also to address the increasing risk to the environment. The growth potential of green technology is boundless, with prospects and expectations to contribute significantly to the country's transformation into a high value-added economy. The financial system plays an important role in this transformation and this day's conference offers an important platform to encourage a new paradigm and to develop concrete transformative solutions moving ahead. With that note, he wished everyone a productive and engaging conference.

Opening Remarks by Datuk Loo Took Gee, Secretary General for the Ministry of Energy, Green Technology and Water, Malaysia

Yang Berbahagia Datuk Loo Took Gee began by greeting Yang Berbahagia Dato' Muhammad Ibrahim, Deputy Governor of BNM, Yang Berbahagia Dato' Sri Abdul Wahid Omar, Chairman of the Association of Banks in Malaysia (ABM), Mr Tay Kay Luan, Chief Executive Officer (CEO) of IBBM, Yang Berusaha Encik Ahmad Zairin Ismail, Acting CEO of the MGTC, and distinguished guests.

She then thanked the organisers for inviting her to deliver the opening remarks at the GTFBC 2012. She also congratulated BNM and IBBM for their efforts in organising such an important conference on green financing.

KeTTHA will continuously support the private and the public stakeholders in Malaysia who wish to venture into the manufacturing of green products, systems and services by providing a very conducive environment backed up by an appropriate institutional and regulatory framework as well as adequate financial assistance.

Green technology has been envisaged as one of the emerging drivers of economic growth for the country and this is evident in the Economic Transformation Programme (ETP), which has included green technology as one of the major areas under the National Key Economic Areas (NKEAs). Under the ETP, several entry point projects can be categorised as green projects specifically in the broad sectors of energy, transport, the built environment and business services. All these services are expected to generate a total Gross National Income (GNI) of RM53 bn by 2020. The government, especially KeTTHA is currently accelerating programmes and initiatives to promote and increase the adoption of green technology to become an integral part of the economy and society.

Economic transformation which is driven by green technology has been clearly spelt out under the National Green Technology Policy which was launched by the Prime Minister of Malaysia in July 2009. The policy is a milestone for the development of green technology towards ensuring sustainable development and conservation of the environment for future generations. The National Green Technology Policy is a statement of the government's efforts in incorporating green elements as a bed rock towards sustainable development and it is also reflected in both the new economic model and the 10th Malaysia Plan. This policy is formulated with the view of providing direction in creating new opportunities for the various sectors by bringing a positive impact on our economic growth. This effort is in-line with our national policies where the growth objectives of the nation are balanced with environmental considerations.

She then commented on the 2006 Stern report where 90% of the problems associated with global warming and climate change are due to man's activities. This is a big challenge for governments around the world. According to a study done by the United Nations Framework Convention on Climate Change (UNFCCC), the world needs to restrict the increase of global temperature to not more than 2°C and the carbon dioxide (co2) concentration in the atmosphere to not more than 450 parts per million (ppm). These are the broad guidelines that governments around the world have to abide by at the Conferences of the Parties (CoP) meetings/Climate Change meetings and for Malaysia, that is the reason why it has chosen to drive the green agenda across the nation.

During the CoP 15 in 2010, the Prime Minister of Malaysia has pledged to reduce the country's carbon intensity by 40% by the year 2020 compared to the then 200 levels and we are currently in the midst of preparing a document which entails the description of the strategies, the action plans and the key resources for specifying the growth of green technology in the mid short-term, the medium-term and the long-term. This document which is known as the Green Technology Master Plan (GTMP) will symbolise the translation of the green technology policy into implementable activities that will guide the stakeholders especially the government agencies, the industries, the academics, the Non-Governmental Organisations (NGOs) and the public at large in the strategic directions that Malaysia would embark in order to enhance and scale up the development of green technology to become a low carbon economy.

The GTMP will realise the green technology strategies for nine economic sectors, i.e. the energy, building, transport, manufacturing, water, waste management, ICT (information, communications and technology), agriculture and forestry sectors. She added that KeTTHA's preliminary assessment of the energy, building, transport, manufacturing, water and waste management sectors has shown that the green business contributed to about 2% of the total Gross Domestic Product (GDP) and employed 1% of the total workforce which is equivalent to 91,405 green jobs in 2009. The study estimates the GDP contribution from green businesses to escalate to 126bn ringgit in 2025 or 8% of the total GDP and this will generate about 451,704 green jobs by the same period.

In view of the fact that reorientating the economy to become green is crucial in the light of global warming and climate change, various steps have been taken especially in the energy sector. The national Renewable Energy (RE) policy and action plan was approved by the government in April 2010 as a result of a study conducted by the Ministry to overcome the major obstacles hindering the growth of RE or green energy in the country. Among the highlights of this policy was the introduction of the RE Act which entails the implementation of the Feed-in Tariff (FIT) mechanism. This mechanism which was implemented with effect from 1 December 2011 allows electricity that is generated by the RE developers to be sold to the utility, i.e. Tenaga Nasional Berhad (TNB) and Sabah Electricity Sdn Bhd at a fixed premium price for a specific duration.

Under the RE Act, KeTTHAhas identified five RE sources i.e. biomass, biogas, solar, mini-hydro and municipal waste as the main fuels which we can consider for generation of electricity and the tariff is fixed for the duration of period depending on the few sources and SEDA is the agency entrusted to promote RE in the country.

The implementation of the FIT mechanism marks a major milestone in the promotion of green technology in the energy sector. The government is keeping a close tab on the progress of the implementation of the RE under the FIT. Both the RE action plan and the GTMP highlight the significance of financial mechanisms to be formulated to support the implementation of the strategies along with other components such as the institutional and legal framework, innovation and Research & Development (R&D), human capital development as well as business promotion.

Financial institutions are an important enabler in advancing our efforts towards a low carbon green economy. To promote the adoption and adaptation of green technology in Malaysia, the GTFS with an initial allocation of RM1.5 bn was established in January 2010. This scheme provides soft loans to companies which are either classified as producers or users of green technology. The maximum funding provided for producers of green technology is RM50 million and RM10 million for users. To facilitate the promotion of green technology, the government bears 2% of the interest rate that is charged and provides a guarantee of 60% on the loan amount via Credit Guarantee Corporation (CGC) Malaysia and the implementing agency is MGTC.

The introduction of the GTFS attests to the government's commitment to encourage green technology development. Although the take-up rate was low in the initial stage, the achievement of the GTFS to date has been commendable and as of September 2012, a total of 209 applications had been certified with green certificates out of which 67 projects have received loan offers from financial institutions, and the amount disbursed from the GTFS was approximately RM800 million. Over the two years, KeTTHA has disbursed RM800 million; however, there is more that they can do to show the government's commitment. An additional RM2 bn for green financing was announced by the Prime Minister during the Budget 2013. As a result, the responsibility of MGTC will increase and the approval of green projects is also expected to scale up as the total amount for green financing is RM2.8 bn plus the RM2 bn that has been approved recently.

There are critical areas relating to the capacity of lenders that led to the slow response of the GTFC, i.e. to understand about green technology and about what 'green project' means. Scaling up the capacity of the lending community on the proposals that are forwarded is necessary. On the part of green developers, they need to come out with a proper financing model with a proper cash flow to give confidence to the lenders when they evaluate the projects.

In respect of capacity building, a series of enhancement and promotional programmes on the GTFS was conducted by MGTC together with BNM and CGC. On behalf of KeTTHA, she expressed their gratitude to BNM for the continued support in co-organising a series of roadshows and pitching sessions which received overwhelming participation from the banking industry. These remarkable efforts were a strong factor in delivering the success of the adoption of the GTFS within the local industry. As a result of these activities, a total of 24 financial institutions have participated in approving loans for successful applications. It was believed that this effort, if continuously undertaken, could increase further the private banking sector's participation in green projects.

Pursuant to the approval of the RM2 bn by the Prime Minister, KeTTHA hopes the banking fraternity will reciprocate by allocating a bigger proportion of their lending portfolio for projects that are listed on the green menu. So, the government and the banking industry need to sit down and discuss what are the items on the green menu that KeTTHA need to partake of.

It is important to create an ecosystem for the financial industry in Malaysia to support GTF as this would spur the industry to adopt green technology. She hoped this conference will provide fruitful insights on the current development of green technology and the issues and challenges arising from the promotion of green technology. She also hoped that will increase and enhance the awareness of green financing among all levels of the financing community. To better reflect the increasing opportunities in the green industry, she took the opportunity to invite everyone to attend the 3rd International Greentech and Eco Product Exhibition and Conference Malaysia (IGEM 2012) which would be held on 10th to 13th October 2012 at Kuala Lumpur Convention Centre (KLCC). With the theme 'Green Tech for Growth', IGEM 2012 offered enormous business opportunities and immense potential for our green economy. On this note, she expressed her appreciation and welcomed all international and local speakers for dedicating their invaluable time and expertise, and to share their knowledge and experience on green financing. She believed the interactive sessions where participants could exchange views and experiences will strengthen the implementation of green financing, identify opportunities and challenges, enhance capability and capacity development on credit and risk assessment, as well as introduce relevant policies and incentives. Lastly, she expressed her heartfelt appreciation to BNM and IBBM for their cooperation in promoting GTF. She hoped everyone would enjoy this conference and reap the benefits of the shared knowledge for the implementation of this noble agenda for Malaysia. With that, she declared this conference open.

Session 1: Overview of Sectors and Technologies Currently Attracting GTF by Mr Chandran Nair, Founder and Chief Executive, Global Institute For Tomorrow (GIFT)

Mr Chandran felt very delighted to be here and thanked BNM for the invitation. He started his presentation by saying why he thinks the 21st century will be very different. Most people would say that most centuries are unique in their own ways. His thought of the 21st century is different for four reasons:

1. Population
   The world population today is about seven and a half billion people. It was seven billion in November and growing very fast. Most of these people will live in Asia. The world population is expected to reach about nine billion people by 2050 and where most of them, i.e. about six billion, will live in Asia. By the end of this century, if things go according to plan, the world population could be anything between 12 and 15 billion. That means that in the next 90 years, we will add no more people to the planet than there are today. More

importantly for the first time in human history, the human race, the most dominant species in the world, will peak and then decline. The world population reached about one billion about 200 years ago, i.e. several thousands of years of stable human growth were observed and then it suddenly peaked. The point he was trying to make is that more people will be added in this century than ever and most of them will be in Asia and after that the human population will start to decline. There was a point raised in the world recently where the climate change would have a 2°C temperature rise (15 months from now), which is seen as potentially catastrophic. So the population rising and declining for the first time in human history in this century marks this century as different.

2. Climate change
Predictions are that in 15 months it will increase by 2°C where it will become uncontrollable, and by 3°C by the end of this century if we continue the way we are, which means the first time in about three million years the climate has changed by 3°C. The most important thing to understand is that climate change is happening right now. What it does mean is that the human population, which settled over hundreds of thousands of years around the distribution of flora and fauna, will completely change. People always settled where conditions were fine for them to live and our human settlement over hundreds of thousands of years rebuilding were based on the climate everyone knows and agrees with. Now, it will create a huge mass movement if one counts in this catastrophic scenario as well.

3. Crisis of capitalism
What is happening in the western world, i.e. Europe and Northern America is the end of two to three centuries of exceptionalism. The exceptional economic model has built the modern world based on two fundamental things, i.e. extracting and exploiting of underpriced resources. The point of this statement is the way it comes to a state where two to three centuries of exploitative growth has come to an end. Resources were free and the modern western world was based on essentially gaining underpriced resources for free. So that was essentially how the modern world was built. The only economic model that won was the modern world model, which was based on three things – promote endless consumption, constantly underprice everything or constantly keep prices down so the masses can continue to have what they want as well as to fight regulation.

4. Technology overreach
Many people believe that technology is always good for everything. This is a very narrow perspective on the role of technology. Today, we can go everywhere, almost anywhere and talk about climate change, for example, to extract fossil fuels. Ten years ago, there were only about 10 deep well drilling rigs in the world that could drill for oil in deep water about a mile. Today, there are more than 200 that can go more than three miles. His point is that technology reigns/cross over region, the crisis of capitalism means that in Asia, we need to think very differently and the result of this is the rejection of the western economic model of consumption-led growth because we have to look at technology very differently and what it will do in terms of addressing the key issue. Climate change is not going to be addressed by just a simple technology fix. It will have to be dealt with by understanding the meaning of 'restrain' and how we would constrain that.

Next, he shared with the audience an article that he wrote in The New York Times and the International Herald Tribune two months ago. Basically, the incentives are not aligned for investment to deal only with carbon. The amount of money spent on carbon capture etc. in terms of reducing carbon emission is miniscule compared to the money spent on extracting fossil fuels. In Malaysia, 40% of its total investment under 2020 will be in oil and gas compared with 2.5% in RE.

He provided a few examples of technology mismatches and why we should be very careful when we speak about green technology. The deforestation rate in Malaysia is three times higher than the Asian average. In Sarawak, we lost 10% of the forests in the last five years. This is a policy issue; this is not going to be solved by technology. But he does believe Malaysia could and with everyone at the conference can be one of the leaders in terms of starting to prize the ecosystem services provided by the forest and trading that off against consumption.

He highlighted that traditional fisheries around the world have collapsed due to technology advances. Today, you can have a super fishing vessel that essentially can get you Bluefin tuna out of the South Pacific and down to a restaurant in Kuala Lumpur, Singapore, Hong Kong or Tokyo within a week. This shows that we have technology that can tell us how much fish we have, but we have not done anything about it. Policy again is the issue. We should not overstate that technology in itself can solve the problem; we need policies and that takes political action and there is no substitute for that.

His next point was on squandering of resources through high-tech automotives. He asked the audience on a typical solution to the problem of all private car ownership given by the technology industry — their solution is that we should invest in green cars. In Germany, there are 40 million cars of which only five thousand are green cars as there are too many disincentives towards the car manufacturers in producing more green cars. The Japanese are producing some but even there, green cars are on a mini-scale. From an economic point of view, we in Asia must adopt the private ownership of cars and in Malaysia, we did it with the Proton etc. Today, China is already the world's largest car market. However, in the Organisation for Economic Co-operation and Development (OECD) countries, car ownership levels are about 750 cars per one thousand people while China's level is only 150. Most of the Chinese cities are fully congested with cars. In India, car ownership levels are only about 50. If Asian cities develop an appetite for cars equivalent to OEDC countries' appetite, there will be three billion cars in the world by 2050. Green cars are not the substitute because we cannot make those cars as much of the technologies are dependent on very rare materials. In the squandering state however while things could be reversed we are still financing those things that create the same problems. Hence, we need to be looking at the whole lifecycle how finance plays a role other than being green. Intellectual dishonesty is at a premium at the moment.

Technology is not magic. We are intellectually subservient to the ideas from the West, e.g. when Thomas Friedman said that every child is going to have a free computer in India, and eventually there are people with more access to mobile phones and devices than to toilets in Asia today. When we talk again about financing and being green, the greatest investment people should be making across Asia is in water and toilets. How did the mobile phone, which features a lot of technology and a huge pricing cost, become 'free' and the toilet became a luxury item instead? Our economic model is skewed towards underpricing. Today, everyone can get a mobile phone for free so long you pay for the service contract. The cost of the mobile phone has been externalised and our economic model is all about externalising cost.

The finance world is driven by different motivations. It plays a crucial role in shaping the world, and if green is not some subtext of a discussion in the hand of the bad people who have no power then nothing changes. The finance world is driven by short-term interest and the animal spirit that attracts people who drive the finance industry is not in tune to the agenda that BNM is trying to get everyone to understand. This is our dilemma. It is all about short-term gains and no hedge fund is interested in 30 years' returns.

Moving on to the investment growth in green technology, generally, the global new investment in RE is in an increasing trend. However, the total investment in RE was at USD257 bn as compared to fossil fuel subsidies at USD775 bn in 2012.

He also shared with the audience on some of the China success stories. In 2011, China again won in the global absolute cleantech ranking as well as maintained its record as the top of the five fastest climbers.

In the future, he sees that Asia will be constrained by resources. There would not be an Asian century unless Asia's governments accept the reality of constraints and start to leverage on technologies. To be able to make this happen, governments must make resource management the centre of policy-making. Collective welfare is relatively important and it must take precedence over individual rights. According to the UN, Asia must reduce its per capita resource consumption by 80% in order to meet the basic needs of its population. Mr Chandran thinks that Asia can, and must, take the lead as China already invested more in RE than the U.S.

The resources constraint is the limitation to growth. The technological revolutions of the past have been premised on exploiting new resources, e.g. coal, oil, silicon, uranium etc. Resources must be distributed equitably; hence this must drive technology and investments. Government policies are critical. Resources must be reprised. Five billion Asians in 2050 cannot, and should not, aspire to live like the West.

Investment opportunities in the 21st century are another concern. We should invest in building social cohesion. Green financing should go to agriculture, water and sanitation, low-cost housing, waste management and disposal, education, healthcare and energy efficiency and low carbon economy.

There is great potential for green technology. However, the transition to a green economy is constrained by a series of resource constraints, pricing and market failures. Government policies play an important role in delivering green growth. Taxes on resources, consumptions and carbon need to be addressed which are constraining the flow of green finance. Green financing for the implementation of road pricing, no-go zones and traffic restrictions can be designed to discourage use of vehicles, fuel sources or more polluting vehicles, and leads to lower environmental negative externalities associated with road travel such as air pollution and greenhouse gas emissions. Governments also need to change their approach towards public transport infrastructure in order to design more sustainable, resilient pathways in green technology.

Mr Chandran ended his presentation with tips on GTF for the future in Asia. It is important to recognise the limits to growth in a resource-constrained world where all technological and financial innovation must be directed towards this reality. Besides that, governments must curb wastage and overconsumption, so that technology can play a key role. Full cost of externalities must also be priced into the cost of goods. This will entail a new economics and a redefining of rights. Lastly, shaping public expectations to 'less is better' can be done by managing economic activities within constraints.

Session 2: Global and Regional Development and Trends in Green Financing

Moderator: Ms Carey Bohjanen, Managing Director, Sustainable Finance Advisory

Ms Bohjanen thanked everyone here for having them appear on the stage present to them. This session is meant to be focusing and sharing on the global and regional development and trends in green financing within a panel group.

Speaker 1: Mr Gregory Liu, Senior Vice President, Investment Banking, Sumitomo Mitsui Banking Corporation (SMBC) Singapore

Mr Liu started his presentation by explaining what RE is. There is an increasing share in energy use in Asia. The rise of RE share in Asia has clear implications via significant growth in energy demand and exponential increase of carbon emission. However, economic turmoil has temporarily slowed down the growth though demand growth will continue to be driven by a strong GDP growth trend. A study shows that Asia's share in solar energy use has increased from 13% in 1973 to 26% in 2005 and is expected to increase to 34% by 2030.

According to the International Energy Agent (IEA) World Energy Outlook on electricity generation, the rapid expansion of wind and solar power has cemented the position of RE as an indispensable part of the global energy mix by 2030. RE is expected to account for 15% of total electricity output in ASEAN in 2030.

Then, Mr Liu provided a little background on the gap in per capita electricity consumption. In the ASEAN region, the electricity consumption hit 2,288 kWh with Compound Annual Growth Rate (CAGR) of 6.94%, compared to the OECD's consumption of 9,141 kWh with CAGR of 1.65%.

At an economic level, many renewable technologies compete on a dispatch basis based on low marginal costs, but the investment decision for RE is constrained by the relatively high capital expenditures. In a perfect competitive market, the dispatch position is based on marginal cost of production, i.e. set by the lowest marginal cost producer. Solar and wind have an intermittency factor which brings down the overall capacity factor despite their favourable dispatch position. The further expansion of supply chains along with technologies advancement will help to lower capital costs down over time.

The overview of the global subsidy regime shows that incentives vary greatly from country to country and can be broadly classified into three categories, i.e. composite bank, negotiated bank and all-in bank. Most countries are generous enough to provide 20 years for the incentive promotion period. These countries include Australia, Belgium, Czech Republic, Greece, Italy, Slovenia, U.S. etc. There are also countries such as Thailand, India, China, Romania etc. that provide incentive promotion periods of up to 10 years. Governments in several other countries are more generous by giving 25 years of incentive promotion.

Although regulation framework in Asia is still under development, they have already established and provided continuing support schemes for RE generation. China has already aggressive government capacity targets driving a range of supportive legislation. It has also moved from tariff bidding to fixed regional tariffs for onshore wind, with higher fixed tariffs relative to previous bids, announcement of National Solar Feed-in Tariff (FIT) and increasing focus on offshore wind, project tariffs to be bid. He also mentioned that India has an attractive Power Purchase Agreement (PPA) for wind, combined with fiscal incentives. Under the National Solar Mission in India, solar projects are the next big mechanism where projects are needed to bid at low tariff levels. They are also in the process of developing a Renewable Energy Certificate (REC) trading mechanism. In Thailand, there are attractive PPAs where the 'Adder' incentive is added to the standard purchasing price for Sustainable Public Procurement (SPP) and VMware Service Provider Program (VSPP), including a 10 years promotional period for wind and solar as well. However, there are more solar projects closed than wind projects. Ever since Indonesia launched its Green Investment Fund of USD100 million in 2010, they have fast tracked two programmes focusing on geothermal energy. Significant investment has been planned under the Master Plan for Acceleration and Expansion of Indonesia's Economic Development. In Taiwan, the RE Act was announced in 2009 and RE FITs was approved in 2010. Besides that, they have a range of support mechanisms such as capital subsidy and FIT/PPA. The introduction of caps and annual review of tariffs was set up to ensure support can be revised depending on performance. In Vietnam, despite the strong wind resources, drafting of RE legislation is in the process. In Malaysia, only a small RE programme was in place, i.e. the announcement of FIT. However, solar seems to be more promising in this country. Lastly, in Philippines, the FIT system was formulated by the Energy Regulatory Commission (ERC) and National Renewable Energy Board (NREB) with priority connections to the grid and priority purchase and transmission. However, the FIT system seems too good to be true. All electricity consumers shall share cost of FIT in the form of a uniform surcharge, i.e. 'FIT All.'

The perception of risks and their probability of occurrence differ between jurisdiction, projects and contractual structures, but ultimately drive the financial structure. Risk identification is always a critical first step, followed by effective risk mitigation. This is key to a successful debt financing and will underpin any financing structure. However, risk factors will vary during different stages of the project.

Mr Liu shared with the audience on real life issues for investors and lenders in Asia. For developers who are familiar with Asia, the key focus has gone beyond PPA. Higher emphasis is being placed on project development issues. The other critical issues occurring are:

1. Availability of adequate site specific data for design;
2. Site location where government permits are required in case government land is to be utilised;
3. Lack of grid connectivity in many rural areas or proximity to project side;
4. Erection of WeCare Technology Groups (WTGs);
5. Unavailability of trained workforce;
6. Tough deadline by developers to ensure time completion;
7. Initial due diligence for RE projects with proper technology, warranty and performance guarantee in place;
8. Partnering with right local entity to assist investors in getting land, permits, approvals or liaison with government authorities;
9. Limited local operations and maintenance capability.

As a result, Asia is different from Europe. Hence, terms cannot be replicated without modification.

In the due diligence for RE projects, lenders will need to follow a structured framework to analyse deals if they do not seek full recourse to sponsors. Besides understanding the feasibility of the project with full risk review, financiers will have to examine in detail at the development and construction as well as the operations parts on various RE, e.g. wind, geothermal, biomass, solar and hydro.

The Asian financial market context is that local banks are generally liquid and capable of lending to RE projects on a corporate basis. However, local banks are lacking sector knowledge and may not recognise small foreign investors. On the other hand, international banks are usually good in structuring and are knowledgeable on RE sector know-how. Agencies like Export Credit Agencies (ECA) and Multilateral Agencies (MLA) are always keen to lend to green projects. SMBC is able to offer their customers know-how and also to bridge the gap between sponsors and different group of banks including local banks. SMBC recommended a green financier to maintain the flexibility of implementing multiple financing options aimed at a successful and timely financing close. Multiple funding sources should be considered 'in parallel' rather than 'in sequence'.

Next, he talked about liquidity and deal sophistication in Asia. Over the last three years, the proportion of nonrecourse debt finance for new projects has fallen to between 5% and 15% from between 20% and 35%. In Asia, despite the increase in overall asset finance in the last three years, the absolute volume financed by debt has also marginally decreased.

It is essential to choose the right tool to finance projects of different sizes. Green financiers have to remember that what suits the developed market may not be replicated in the energy market without modifications in order to make RE financing happen. To define boundaries such as syndication approach, prospective lenders, debt sizing and pricing are part of the keys in RE financing.

Speaker 2: Mr Michael W. Cooper, Director for Infrastructure, Asia Pacific, Project and Export Finance, HSBC

Mr Cooper shared the key sectors and products with the audience on selected cleantech credentials in HSBC. The bank has global expertise across in advisory, equity capital market and debt capital market/project finance. Recent awards achieved, the cleantech research team in HSBC and their research coverage on integrated climate change sector and selected coverage of green technology areas were also mentioned.

One of the RE trends is that the low carbon markets are forecast to show strong growth. The low carbon market is expected to triple in size to from approximately USD740 bn in 2009 to approximately USD2.2 trillion in 2020. Growth is driven by energy efficiency and management, particularly hybrid and electric vehicles, as well as strong growth in RE.

He also touched on a technology cost chart comparison, i.e. Levelised Cost of Electricity (LCOE) of different power generation technologies. Next, he moved to the key drivers of low carbon power production. Worldwide investment in renewables is set to rise from approximately USD200 bn to approximately USD400 bn by 2030. Contraction in European Union (EU) growth is expected as sovereigns continue to reduce mechanisms in reply to debt/budget issues. The growing number of cross-border transactions and emphasis on the ability to secure competitive financing in the capital intensive market are also some of the key drivers.

In the solar market, there are several new trends. For overcapacity, the flattening of demand and rapid inertia-driven increase in supply over the last 12 months has caused short-term pressures on industry players. The second trend of pricing foresees a significant downward in pricing and pressure across the entire value chain. Certain key countries such as the U.S and EU are experiencing protectionism in the solar industry. The fourth trend of consolidation refers to industry re-organisation currently happening with the weakest going into bankruptcy and reducing capacity; it first started in Europe/the U.S. and is now slowly shifting to Asia. Lastly, supplier overcapacity and strong demand generated out of the European markets have been factors in the continuous fall in costs. However, this lower cost should benefit developers, governments and provide greater comfort to lenders. Over time, as technology matures and the learning curve improves, Mergers and Acquisitions (M&A) activities in the solar sector have grown manifold with cross-border transactions holding significant prominence.

In conclusion, the price drivers in the solar sector in the short-term are foreseen to be overcapacity, excess inventory and cost reductions. In order to sustain this sector, module performance, warranty/bankability as well as sector efficiency are the essential tools to maintain module spot prices.

Speaker 3: Eduardo V. Francisco, President, BDO Capital & Investment Corporation

Mr Eduardo began the session with several main areas of green action. It is important to increase awareness and communication among officers and staff via a few channels, e.g. lecture series and information campaigns on the importance of environmental sustainability/green initiatives as a critical issue of the 21st century. Secondly, proper work plans should be in place to promote green initiatives in day-to-day bank activities, in particular, in the areas of reducing energy, paper and water consumption. Lastly is to identify green advocacies and activities and promote volunteerism outside of the bank environment where he shared some examples done by BDO such as the Tree Planting at Marikina Watershed and the Coastal Clean-up.

He moved on by explaining the features of BDO's Sustainable Energy Finance (SEF) programme. In 2010, BDO signed an agreement with the International Finance Corporation (IFC) to facilitate the financing of energy efficiency and RE investment projects where the IFC will provide advisory and capacity building services to help BDO to develop and promote the SEF. The sustainable energy projects include investments in Energy Efficiency (EE) and RE projects. The role of the IFC and EE/RE consultants is to assist BDO in the appraisal and evaluation of specific market segments, technologies and projects involving EE and RE investments. This enhances BDO's capacity in building efforts in managing its sustainable energy portfolio. Several services provided by the IFC include:

1. Market identification by assisting BDO in developing strategy for EE and RE financing and in identifying specific target market;
2. Capacity building for BDO staff through training and workshops for its officers in technical and financial evaluation of EE and RE projects; risk evaluation and management; project and programme monitoring;
3. Conduct market research on specific market segments which BDO would require from IFC;
4. Being a broker in helping BDO to identify equipment suppliers and Energy Service Companies (ESCOs) for the development of BDO's pipeline projects;
5. Giving marketing support in developing marketing and awareness campaigns for BDO's SEF programme;
6. Provision of EE and RE calculators to assist BDO officers to evaluate EE and RE projects in conjunction with the technical and financial evaluation training.

One of the benefits of this BDO's SEF programme is the free-of-charge energy walkthrough audit to assess a client's plant facilities and present audit findings, EE solutions if any, and computation of energy savings. If the client needs financial assistance, BDO can provide financing for EE investment. Besides that, RE consultants will prepare technical evaluation of the RE project and can provide advisory services to clients in the area of technology and feedstock for biomass project assessment.

On the banking side, IFC's advisory services will continue to facilitate BDO's EE and RE loan portfolio in terms of market assessment and development of strategic plan, training of staff on specific features of financing of EE and RE projects, project identification, evaluation and reporting. BDO can continue to avail of the expertise of the IFC staff and consultants in the appraisal and evaluation of specific market segments, technologies and projects involving EE and RE investments. Eventually, this will enhance BDO's capacity through building efforts in managing the sustainable energy portfolio. IFC can also share with BDO on its scoping studies which can provide business opportunities and market leads.

With these services from the IFC, BDO will continue to tap the following sectors for EE financing such as hotels and resorts, malls, commercial building, industries as well as agro-processing. For RE projects, BDO will focus on run-of-river mini-hydro projects and selected biomass projects which use their own plant's agricultural waste materials as feedstock to produce own power (captive). Besides that, BDO will also tie up with ESCOs to finance their projects or their clients' energy projects.

Since the launch of the SEF programme in 2011, there were more than 60 projects evaluated and/or visited for the energy walkthrough audit. Five projects have been approved and several others are in the various stages in the Project pipeline as at end of July 2012.

Mr Eduardo next talked about RE in the Philippines. There are five types of common RE in Philippines, i.e. geothermal, hydro, wind, solar and biomass. Several targets have been set by the Philippines government. The Philippines is expected to have 4.5 gigawatts (GW) RE capacity added from 2003 to 2013 from which 4.7% of the electricity is to come from RE by 2013. On the biomass power, the generating capacity is targeted to increase to 94 megawatts (MW) by 2015 and 267 MW by 2030.

He highlighted a few types of RE which have potential to grow further. Geothermal uses heat energy emitted from within the Earth, usually in the form of hot water or steam to produce electricity. The Philippines' existing capacity is 1,953 MW but the reserve estimate is 4,406.56 MW. For wind turbines, they are used to gather energy from the wind. It has an existing capacity of 33 MW of which its potential can go up to 76,600 MW. Solar energy is derived from the sun's energy to create electricity. The existing capacity is 1 MW, but if solar radiation is implemented nationwide, it has an annual potential average of 5.0 KWh/m2/day. Biomass is another energy source which has high growth potential. It uses biological material from living or recently living organisms such as wood, waste and alcohol fuels to produce power. Local biomass supply potential is expected to reach 323.1 barrels of fuel oil equivalent (MMBFOE) -the equivalent of 26 years - giving Philippines the third largest biomass capacity in the world. He revealed that a number of their clients have also engaged in this particular energy source. Mr Eduardo sees great potential in the RE sector as a list of projects are currently in the pipeline.

Everyone is aware of climate change and the need to reduce the carbon footprint. Hence, recognising needs to save our planet and maximising its resources are important. While these efforts are considerable, RE is not yet a major portion of BDO's loan book. There are no incentives to banks or even required credit exposure from the Philippines' monetary authorities for general greening projects. With the passing of the FIT for RE in Philippines, Mr Eduardo expects to see more launching of green projects. There is a healthy pipeline for these as borrowers have incentives such as tax exemptions plus the tariff protection. Before he concluded his speech, he suggested that the global monetary authorities can attempt to solve the current situation by requiring each bank to have minimum exposures for greening and/or by providing incentives such as capital relief or lower risk asset weighting. These will allow BDO and other banks to pass on reduced funding costs to the borrowers.

Questions and Answers Session

Question 1

What are some of the barriers to growth in the GTF either at the regional level or country level and how would we tackle those barriers?

Answer

Michael: The biggest impediment was some of the sponsors of the projects where they wanted to do it on the balance sheet as a non-record basis on project finance. There was a lack of appreciation for the technology used and the complexity of what they were getting themselves in. There was something wrong with the idea; he thinks the government framework has some faults. But he thinks it was on a structuring perspective as everything was new. This is a fairly common thing in most of the countries that everyone operates in the sense there is a period of time for the sponsors of the projects, the regulators, the central banks, the governments, the technology suppliers and the subcontractors to understand once they obtain the knowledge transfer.

Gregory: Many countries have very ambitious schemes, but they could have more funds if there is more inter-department coordination. The whole plan needs to be thought through. That was why he highlighted generation mix and the affordability issues in his presentation earlier.

Eduardo: It is the people management or the stakeholders that are managing everything at the on-set and educating them. Getting them all together to understand and the give and take are the biggest part.

Question 2

Do you consider projects that do not have a subsidy element? Are these projects purely commercial?

Answer

Eduardo: Everything landing right now is based on a non-subsidy. The fortunate thing about coming from a poorer country is that we do not have the funds as our government is unable to subsidise much; we do not have the luxury where richer countries have. Hence, all the projects have to be on a stand-alone basis.

Gregory: There are two levels of subsidies. Fundamentally the project should be net off if it does not purely rely on subsidy. If people rely on subsidy yet still use old technology, then all users will be taxed heavily. The other subsidy that we see is convention power such as gas fire being subsidised. This creates unfair competition to the renewable side that makes life very difficult.

Michael: There are large numbers of projects in RE that are unsubsidised of which the majority of them are biomass plants in Malaysia, Indonesia, Philippines and others. There are other projects such as wind projects in Pakistan, Mongolia etc. where their green energy power production is without any formal subsidy and as a bank, they preferred that because they can withstand adverse change from the economic perspective.

Question 3

Since the embarking of the role looking at EE, RE and focusing around the activities of GTF, would you see there is any business benefit to BDO in the form of differentiation in the market or do the clients view the organisation differently or more positively?

Answer

Eduardo: Yes, they do. For example, in EE, they do not get the subsidy for it but if the client comes to us to borrow money, to change their refrigeration or air-conditioning so long the bank understand and they show they will save money and therefore will pay for itself in a certain number of years then BDO will go into it.

Question 4

With regards to transaction such as the subsidy role of making that transaction desirable, could we actually do away with subsidies and what will happen if the world does not have subsidies in this space — would it go away or would it eventually emerge of its own accord with time?

Answer

Michael: In time, it will because the cost of producing energy is falling and the cost of producing conventional power is rising. Overall, subsidies will go away over time.

Gregory: I fully support Mr Cooper's view. Another aspect is the demand and supply issue for example, in South Africa, you do not need to worry at all because their generation cost is about US25 cents. Therefore, RE is competitive in that context.

Question 5

Is the problem or challenge of GTF likely to be solved by government or policy makers leading the way with the private sector following? What is the role of the government or policy makers?

Answer

Eduardo: The primary role of the government is at least to have the policy and a stable economic and political environment. In the Philippines, they learnt from the Australian models and they privatise. Water is in a mess, but power is doing very well, therefore it is a good example. Regulations and rules will make it easier even without subsidies.

Gregory: The private sector and the government have a different role to play. The horizons on which they consider issues are also different. The private sector can make things more efficient. By bringing efficiency, this probably will lead to a lower generation cost.

Michael: Regulation is probably the key thing that we look towards governance providing; the private sector which includes banks otherwise will always seek to exploit any opportunities which are put in front of them. Unfortunately, the attribute of man is such that which he thinks the government can moderate that. For example, by bringing in building regulations which will make property development more expensive, so profit will be lower for the developer but the energy consumption, e.g. residential properties would be better, hence society would benefit. The property may not necessary be more expensive because the market for property will determine the sign price. But the developer's profit would be lower because the cost perhaps may be higher.

Question 6

What are the advantages of working with these in syndication or partnering with some of the development of FIs whom the development FIs are quite keen to really drive and see growth in this area of GTF here in Asia and what advice to Malaysian banks can you give about making yourself attractive to partners in the international markets who are willing to push some of that capacity-building in sharing of knowledge and experience with your teams?

Answer

Gregory: The beauty that we see in the syndication is the local bank can rely on the international players who are already been quite familiar with this sector to provide some helpful input. For example, HSBC has done deals in China together with the Chinese banks where HSBC plays a structuring role and the local Chinese bank provides the main liquidity. In doing so, everybody has the skin on the table, so one has to be responsible for the whole project rather than the local sponsor trying to get a foreign bank who does not understand the issue of lending money or vice versa. A corporative syndicate would be helpful and it can also help the counterpart who tenders this contract understand the underlying risk in many circumstances.

Eduardo: Most of the bankers here can do a lot more of projects such as energy, transportation etc. because these are existing corporate clients. If there are no in-house specialised bankers, then they can tie-up with one of the multinational or green efficiency companies that can provide capacity, industry as well as risk-sharing agreements. At least this is one way of doing it without having to build up staff immediately by having this tie-up. There are many such companies out there. Find good companies where bankers can tieup with to build your own energy team quickly.

<u>Question 7</u>

Is there such a thing called a minimum amount of green technology before you decide to participate? If there is, then what other considerations would you have if that minimum is not there?

Answer

Michael: There is no limit per se.

<u>Question 8</u>

What is the success rate or failure rate of financing this kind of project in the Philippines? What will be the second way out in solving or settling these issues?

Answer

Eduardo: In general, the only failure of GTF was one or two years ago which the company went into a restructuring because the proponent was buying sugar from the miller and then sugar prices went up through the roof. Another dilemma that experienced some delay was the wind project.

<u>Question 9</u>

The challenge in green technology is evaluating the project viability. So for a start, what can banks do in having the right skill set and how to develop this skill set?

Answer

Michael: One of the good things about green technology is there is huge material available to banks globally. There are not too many cases of failure. His first suggestion would be for a couple of officers in the bank to take it on as an area of expertise, so potential customers who want to borrow money should go to those lending officers. To start as a corporate basis rather than project finance basis and the numbers of consultants who are available and will often provide some expertise to potential clients at no cost is often better.

Eduardo: First is to participate in a deal and do not lead it. If it is a new technology, then the locals do not have the expertise so they need to rely on foreign experts who have done it elsewhere but they learn as there is a lot of technology transfer. Then the locals will understand what the key drivers are and develop the expertise and assign it to the bank.

Gregory: To have a system to document it in case the staff leaves.

<u>Question 9</u>

What is the key piece of advice for Malaysian bankers on their journey on GTF?

Answer

Gregory: Learn by doing.

Eduardo: To preserve what Malaysia has.

Michael: Do not be scared of doing it.

Session 3: Knowledge Sharing: Financing GT – Opportunities and Challenges
Mr Francis Condon, Partner, Financial Access, The Netherlands

Introduction

Mr Condon began his presentation by outlining the focus areas in green technology. These are RE, EE and Cleaner Production (CP). The typical steps that people, organisations and governments evolve through in their approach to dealing with pollution are:

1. Passive: Ignoring the problem, which will lead to accumulating on and disasters;
2. Reactive: Diluting pollutant concentrations by discharging in streams, rivers and oceans, which also results in slower accumulation but still leads to crisis, often at a later stage;
3. Constructive: Treating pollution by end-of-pipe technology, after wastes have been generated but before they are discharged which requires waste management solutions;
4. Proactive: Preventing or avoiding the generation of pollution/waste generation at source itself through the use of technology.

The three areas of green technology, RE, EE and CP are examples of proactive approaches to pollution management.

A framework for funding of green technology advancement usually contains the following steps: (i) technology research where financial support from the government or corporations is needed; (ii) technology development involving funding by venture capital and private equity funding; (iii) manufacturing scale-up which involves large money supply through public equity markets as well as mergers and acquisitions; (iv) technology roll-out where funding will usually be given by credit markets and other forms of asset finance, and where carbon finance may also play a role.

Renewable Energy Financing

RE provides a solution to the twin challenges of constraining growth in Greenhouse Gas (GHG) and diversifying the supply mix.

The investment needs are significant. According to the International Energy Agency, investment needs in RE to produce electricity are estimated at USD5.7 trillion between 2010 and 2035. Biofuel itself also needs another USD335 bn.

At the same time, RE is the subject of supportive government policies. At least 118 countries, more than half of which are developing countries, had RE targets in place by early 2012, up from 109 as of early 2010. Regulatory policies supporting biofuels existed in at least 46 countries at the national level and in 26 states and provinces by early 2012.

This is reflected in market growth for RE technologies. In Mr Condon's next slide, he shared on the market growth in RE. In the Renewables 2012 Global Status Report, solar PV has the highest annual growth rate. This is significant for Malaysia, where solar technology has the greatest generating potential at 6,500 MW, followed by biomass at 2,400 MW, mini-hdyro at 500 MW, municipal waste at 400 MW and biogas at 410 MW. RE technologies that are important to Malaysia are maturing to the point where commercial bank financing now becomes a viable option.

Here is where Malaysia now faces the technical challenges to RE finance. RE technologies are capital-intensive and require significant upfront investments. Operating cost reductions are essential to large-scale development of RE as currently most are not able to compete on price with conventional (fossil fuel) technologies and RE projects continue relies on some form of financial support to get them over-the-line.

The current uncertainties over Kyoto Protocol finance mechanisms have created a gap in the supply of financial support. Depressed carbon prices have reduced the financial value of permits.

In this environment, it remains essential that government programmes are in place to make renewables attractive to investors, and create markets for them as it is the most important factor affecting the expansion of RE.

Several challenges faced specifically by the banking sector include finding the right loan tenor, and managing interest rate risks, execution risk, exchange rate, equity, technology risk and commercial risk. There is always a risk involved in every financing. Each RE project has its own unique features and risks. Hence, banking institutions need to identify solutions for each RE project to mitigate risks. Project financing skills are essential to RE finance, as are additional structuring skills needed to pull together the developing parties and match up the main contracts.

Energy Efficiency Financing

Boosting energy efficiency is the most economic way to reduce GHG emissions. Worldwide, there is the potential to cut the projected energy demand growth by two thirds, that is from 2.2% to 0.7% per annum by adopting EE improvements that use existing technologies. EE also has an important role to play in stabilising levels of atmospheric GHGs while also enabling economic growth. According to some estimates, USD170 bn annually could be invested productively in energy efficiency improvements up to 2020, with an average return of 17%. This investment would generate energy savings ramping up to USD900 bn annually by 2020. These potential savings come from the industrial sector (39%), residential (26%), power utility companies (16%), transport (10%) and commercial (10%).

In the same timeframe, by 2020, Southeast Asia could achieve efficiency gains of 12% to 30%, equivalent to power savings of 119 to 297 TWh, with a value of USD15 to 43 bn. A study shows that Malaysia has stronger regulatory capacity than both Indonesia and Vietnam when it comes to EE but compared to Singapore, there are further measures that can be adopted. Encouragingly, the example of Singapore demonstrates that such changes can reasonably be expected to have a strongly positive impact on measures of EE. Malaysia's National Energy

Efficiency Master Plan has an implementation horizon of 10 years to achieve energy savings in industrial, commercial and buildings. The total cumulative energy savings potential in these sectors is estimated at 79 TWh, with a consequential reduction of 59 million tone of Co2 emission. Additional policy measures would help to realise these savings.

In the private sector, EE is generally a good investment that is hard to deliver. Key barriers occur at different stages of EE financing, including governments, suppliers/ECOs, users or FIs. The EE market is diverse and complex and covers a range of end-users, technologies and market sectors. Consumers, vendors, manufacturers, banks and policy makers often have inadequate information about EE technologies as well as their costs and benefits. This includes gaps and weaknesses in efficiency standards and labelling which make it difficult to identify and select best available technologies. The situation in which there are split incentives between utility companies, manufacturers and end-users is another challenge faced by EE financing. For commercial banks, managing scale, i.e. dispersed opportunities and large numbers of loans is another issue. Often, small size loans have underwriting and servicing costs outweigh potential income.

Financing risks in EE arise principally from the structure of EE investments. Tenor is variable. Foreign exchange risk is relatively easy to match. However credit risk is fundamental to borrowers and commercial banks perceive additional credit risks in EE markets in the need to manage potential exposure to performance guarantees where these are provided by Energy Saving Companies (ESCos).

Energy efficiency in buildings

Approximately one third of the world's energy use takes place inside buildings. The construction industry consumes more than one third of the planet's resources and generates huge quantities of solid waste. However, over 80% of GHG emissions related to buildings take place during the operational phase, i.e. heating, cooling, ventilation, lighting, appliances and other applications. EE measures can reduce costs significantly, with potential to lower energy consumption in new and existing buildings by 30% to 80% during the building life-span. Among finance institutions in the U.S., green buildings are considered a better risk than conventional buildings because of these lower costs and internal appraisers now routinely add 3% to 8% to valuations due to lower operating costs, higher rents and increased value on sale.

Realising the potential for EE in buildings requires co-ordination between four parties, i.e. developers, operators, occupants and owners. For each of these parties there is the potential for savings of 5% to 60%. A strong barrier for EE in buildings is higher construction costs which may involve land prices, labour, materials energy, water usage etc. These may affect short-term costs for developers. On the other hand, the main beneficiary of energy efficient buildings is usually the tenant who pays lower servicing and utility costs.

Challenges and risks for the banking sector in financing EE buildings are represented by high owner/tenancy risks, split incentives, dispersed opportunities, large number of individually small-scale loans, and credits which often require loan guarantees to support long tenor and fixed rates. Lack of visibility also undermines confidence in the certainty of cash flows derived from energy saving to support debt servicing as well as performance risks in ESCO structures.

Cleaner Production

Cleaner Production relates to the use of technology and processes to reduce the amount of resources consumed and waste generated in an activity. There are benefits in terms of some cost savings as well as product attributes.

However, many banking clients face certain constraints in implementing cleaner production processes in their business. Organisational awareness such as the focus on end-of-pipe solutions and short-term profits, is commonly seen as an environmental, not business issue. Many clients still base their view of environmental responsibility on end-of-pipe solutions rather than 'prevention at source'. Often the absence of an Environmental Management System (EMS) means that baseline conditions and trends towards improvements are not quantified. Where these barriers exist, the ability to convert cleaner production into better cashflow and improved credit worthiness is also limited.

Banks encounter other challenges in providing finance for cleaner production for their clients. The largest of these is that many of the immediate pay-offs for clean production are not capable of being monetised and therefore do not translate easily into improved cash flows which enhance the ability to service and repay debt. Another challenge faced by the bankers is speed of response. Structuring cleaner production investments requires close client involvement and a high level of manual intervention on the part of banks. This can be problematic in market segments where processing time for applications is a key competitive feature. Challenges also exist due to the size of individual projects, creating a scale issue between the overall need for funds at the borrower, and the smaller need for funds at operating or individual investment level.

Banks also encounter various types of risk during the financing process of clean production. These include the overall credit quality of the borrower, the type of product and the risk exposure, and the scale mismatch at the corporate or factory level. Determining clear Key Performance Indicators (KPIs), and applying these to loan conditions is a further challenge as well as lack of clarity determining the benefit of the cleaner production on the approaches to measure, report and verify.

Programmes Supporting Green Technology Finance

Despite the assorted challenges and risks faced by the banking institutions, the governments have a number of direct support options, i.e. regulatory policies, fiscal incentives and public financing that they can use to promote green technology. Often a mix of instruments is the key to success. Some of the larger programmes are outlined below.

The Global Environment Facility (GEF): This was established in 1991. It is an independent financial mechanism that helps developing countries fund projects to protect the global environment and to promote environmental sustainable development. Today, the GEF is the largest funder of projects to improve the global environment and has the longest track record on climate funding. Resources are allocated on a framework that considers the impact of dollars spent on environmental outcomes, while ensuring all developing countries share in funding. Currently, the GEF has 21 donor countries which deposited USD889 million into as part of the GEF's fifth replenishment (GEF 5) in 2010. The GEF 5 has approved a total of USD79 million for seven mitigation projects and USD1 million has been disbursed as of November 2011. There are several criteria that GEF projects target, i.e. projects related to clean energy, integrated waste management, water and wastewater treatment, clean industrial technology as well as healthcare services focusing on China, India, Brazil, Turkey, Mexico, South Africa, Southeast Asia and Eastern Europe. The GEF will also look into the code of ethics that governs conduct of partners in the deal transaction process.

The Clean Technology Fund (CTF): This is one of two multi-donor trust funds within the Climate Investment Funds (CIFs) which promotes scaled-up financing for demonstration, deployment and transfer of low carbon technologies with significant potential for long-term GHG emissions savings. It is administered by the World Bank in partnership with regional development banks and was established in 2008. Nearly two-thirds of CTF funding is concentrated in the RE sector, a fifth is in EE and about 14% is in sustainable transport. CTF usually focuses on large-scale, country-initiated projects in Chile, Nigeria, Colombia, Philippines, Egypt, South Africa, India, Thailand, Indonesia, Turkey, Kazakhstan, Ukraine, Mexico, Vietnam, Morocco, Middle East and the North Africa Region. Every USD1 of CTF funding is expected to leverage USD8 from other sources.

International Finance Corporation (IFC): This is a member of the World Bank Group and is the largest global development institution focused exclusively on the private sector in developing countries. The IFC is the wholesaling climate finance through financial intermediaries. It provides financial instruments that address risk perceptions and funding requirements of local FIs expanding climate investments and includes the blending of donor funds with IFC investments to catalyse markets. Currently, the IFC has invested USD1.25 bn and leveraged over USD2 bn in private finance. Another tool called financial mechanisms for sustainability was created by the IFC in 2008. It provides loans, guarantees, equity, and grants to assist private sector projects with excess project and technology risks as well as technology. The scale of the fund is at USD260 million from CIF and GEF plus IFC matching.

Asian Development Bank (ADB): ADB has created a programme named Clean Energy Financing Partnership Facility (CEFPF). This programme was established in 2007 to help to improve energy security in developing member countries and decrease the rate of climate change. As at 2011, the grants since inception are at a total of USD66.7 million. Leverage to projects is estimated at 27 times, resulting in projects enabled of USD1.8 bn. Sector coverage under this programme include biomass, biofuel, biogas; rural electrification and energy access; distributed energy production; waste-to-energy projects; demand-side management projects; energy-efficient district heating, transport, street lighting, buildings and end-use facilities; clean energy power generation, transmission, and distribution and energy service companies development.

The EU: The EU has created a development cooperation under the SWITCH-Asia Programme which has introduced the EU-Malaysia Biomass Sustainable Production Initiative (Biomass-SP) with the aims of developing Malaysia family-owned Small and Medium Enterprises (SMEs) to implement sustainable production models in the biomass industry; reducing industrial emissions by improving production process of biomass commercialisation projects; and improving policies in biomass. This initiative offers commercialisation grants, business start-up funds, asset financing or commercial loans, soft loan, developing RE projects.

CONCLUSION

Mr Condon ended his session by summarising the GTF opportunities and challenges.

RE finance: This sector is growing strongly where financing is increasing through balance sheets and project financing. Challenges remain in structuring the right RE financing with risks associated in timing and currency mismatch, execution, technology and commercial risks.

EE finance: This is most often constrained by credit risks. On top of this, banks also face knowledge issues and split incentives. Unlike EE financing, building EE is constrained by scale issues, credit risks and long tenor.

CP finance: The main challenge is usually equating cleaner production with financing benefits.

Important supporting factors in addressing these challenges are the development of government policy and measures, and the significant sources of risk-sharing finance which are available. On the part of banks, their capacity to deliver Green Technology Finance is a function of their ability to structure the transactions, understand the technology aspects, manage the risk factors, and deliver the appropriate banking products that meet the needs of their clients.

Session 4: Knowledge Sharing: Experience in Providing GTF Services
Mr Ken Furukawa, Senior Vice President & Head of Renewable Energy and Carbon Business Team, Global Structured Finance Division, Mizuho Corporate Bank Japan

Mr Furukawa kicked-off the session by giving an overview of Mizuho Financial Group's history, performance, global reach and of course the office branch in Malaysia.

Mr Furukawa then mentioned about the Japanese Government's Environmental Policy. The creation of this Japanese policy is that it is necessary to achieve both economic growth and Co2 reduction. However, the impact by the earthquake is uncertain — without nuclear technology, GHG might be dramatically increased. Therefore, in addition to the current Kyoto Mechanism, the Bilateral Offset Mechanism (BOCM) is essential.

The BOCM concept has been considered by the Japanese government and the Ministry of Economy, Trade and Industry (METI). The METI has started to fund feasibility studies, which have been conducted by Japanese private companies in cooperation with organisations in developing countries, with a view to explore and design possible joint GHG reduction projects and the BOCMs.

For large enterprises, they have signed off the Voluntary Action Plan (VAP) to contribute to meet Kyoto target by Japan. In order to achieve the VAP, large enterprises are allowed to utilise the domestic Construction Design and Management (CDM) credits scheme. Under this scheme, large enterprises provide funds and technologies to SMEs and can count emission credits once they are certified by verification committee which was set up by the government of Japan.

Recently, in July 2012, the government of Japan has introduced FIT with obligation for utilities to purchase from RE sources such as PV, wind, geothermal and biomass. For power generators, all of the renewable electricity shall be purchased; for residential use, excess electricity shall be purchased.

Similar to other banks, Mizuho has its own environmental business initiatives. Since 2000, Mizuho established its code of conduct with the statement of their belief is that a responsible environmental policy makes sound business sense and being mindful of their responsibilities to society, Mizuho will consider environmental issues as a part of their business decisions. The bank recognises that FIs have a public role to have a major impact on society and bear heavy responsibilities towards society. Recognising that maintaining and preserving the natural environmental is the basis of sustainable social and economic development, Mizuho has set forth basic environmental policies in their code of conduct for group companies to follow in their ongoing activities.

In order to contribute to the sustainable development of society as a good, responsible corporate citizen, Mizuho keeps the quality of their communications through dialogue with stakeholders, customers, shareholders, government, local communities, employees etc. to understand the society's expectations towards it. Mizuho also conducts an outgoing dialogue with experts to deepen their involvement in priority areas including environmental business. For example, the bank held a stakeholder dialogue on the topic of environmental business in June 2012 where participants in this dialogue included experts and employees engaged in environmental business activities. These participants assessed Mizuho's environmental business efforts to date and talked about their expectations for the future. As a result, Mizuho Financial Group was represented in the Carbon Performance Leadership Index (CPLI) in 2012. This shows that the bank has demonstrated a strong approach to climate strategy and emissions reduction in their Carbon Disclosure Project (CDP) response.

The Equator Principles (EP) is another policy with common standards employed by private FIs ensuring projects, financed with total costs above USD10 million, adhere to local social and environmental requirements. Mizuho believes that the adoption of and adherence to these Principles offers significant benefits to themselves, their borrowers and local stakeholders through their borrowers' engagement with locally affected communities.

Besides that, Mizuho believes it is important to contribute to the environmental issues through the financial products and services as part of its own core business as well as efforts to reduce its own environmental burdens and Corporate Social Responsibility (CSR). The bank's environmental businesses can be divided into the following three categories , i.e. project finance, environmentally conscious financing products and consulting services and carbon trading.

1. Project finance
   In Japan, Mizuho played a key role as lead arranger and/or advisor to a multitude of RE projects, assisting sponsors to attain benchmark pricing with creative structures. Mizuho has successfully committed to financing 67 RE projects globally. Since the introduction of FIT in 2012, solar projects in Japan showed an increasing trend. A number of parties from various sectors are developing solar projects throughout Japan. Mr Furukawa shared an example with the audience that Mizuho is going to provide project structuring and financing to a 70MW solar power plant in Kyushu.

2. Environmentally conscious financing products
   This is commonly applied to SMEs in Japan. Mizuho has introduced its approach called the Eco-Cycle scheme, a series of environmental business that build a bridge among small, medium and large organisations and even individual customers. Through engagement in these efforts, the bank will expand the Eco-Cycle to reduce Co2 emissions throughout society. In 2005, Mizuho offered its first scheme, namely, the Mizuho Eco-Assist programme. When certain conditions are met, Mizuho Eco-Assist, a financing package with attractive conditions will be offered to support customers' environmentally conscious management. Financing conditions are set in accordance with environmental ratings assigned by Mizuho. Approximately 700 transactions worth JPY100 bn were executed. Then, the Mizuho Eco-Grade system was announced in 2011. The bank began to use their own standards to evaluate the status of environmentally conscious management. As a result, a more attractive financing package called Eco-Assist Plus was provided. To service the Eco-Cycle, 'Environmental Business Matching' was established to facilitate meetings between SMEs who are interested in energy conservation and large enterprises who have the expertise and technologies to deliver energy conservation.

3. Consulting services and carbon trading
   Mizuho provides its clients with full-range solutions for clients' countermeasures against global

warming including research, strategy formulation, support for Clean Development Mechanism (CDM)/Joint Implementation (JI) participation as well as advice on carbon credit acquiring, together with group companies within Mizuho Financial Group. In terms of strategy planning consulting, Mizuho Corporate Bank provides an analysis of the positions the clients are currently in and formulates a forecast on future scenario of regulations based on government measures and trends related to global warming. Mizuho also introduces CDM/JI projects where it explores through the network with developers in Eastern Europe, East Asia, Middle East, South America etc. Mizuho will provide full support ranging from project development to credit transfer including documentation, risk analysis and advice on development and financing. In addition, Mizuho made contributions and inputs to the government of Japan/overseas countries' environmental policy through consulting advisory business with various ministries and agencies of the government of Japan. In order to enable the sales of carbon credit in a large lot including search for trustworthy sellers/buyers, support for negotiation between buyer and seller, support in documenting the Emission Reduction Purchase Agreement (ERPA), Mizuho has partaken in brokerage services. The bank has also been involved in feasible studies in many countries funded by the Japanese government, and supported the dissemination of low-carbon technologies taking advantage of BOCM, CDM and JI.

Before Mr Furukawa ended his session, he talked about challenges and the future. There are always uncertainties ahead such as global economy, government support, nuclear safety, political consensus after the expiry of the 1st period of the Kyoto Protocol, Certified Emission Reductions (CER) price, financial market and others. However, in the future, Mizuho will still continue to reduce the environmental burden generated through their own business activities and to reduce the environmental impact of society as a whole through the financial products and services it offers as part of their core business.

Question 1

Does Mizuho have any plan to implement Mizuho Eco-Grade in Malaysia?

Answer

At the moment, it is only in Japan. However, he will pass the message from today's meeting to the relevant parties when he returns to Tokyo.

Session 5: Case Studies – Financing Challenges
Mr Kenji Baba, Head of Environment & New Business Group, Growth Industry Cluster Department, SMBC Japan

This session began with a short introductory of SMBC's profile and departmental organisational structure such as roles, functions, business flows etc. SMBC has started to commit to contribute to sustainable development by offering various financial services. Environmental Assessment Loan is one example of a product developed to encourage customers to enhance environmental management and it also enables SMBC to seize chances to support those environmentally conscious companies. Favourable lending terms are to be considered for higher ratings based on environmental assessment conducted by designated assessment entity, subject to other conditions. The 'Eco Loan' scheme is now launched by SMBC Malaysia Bhd; the first lending under this scheme is now under development. This scheme was developed jointly by Ernst & Young and SMBC.

Buildings are one of the growing sources of GHGs in many countries. SMBC offers a product, the 'Sustainable Building Assessment' loan that aims at encouraging construction of renovation of environmentally-sound sustainable building. Sustainable building assessment is conducted by CSR Design & Landscape Co Ltd that provides professional and objective evaluation, which is further reviewed by an auditing firm.

Effective 1 July 2012, Japan implemented a new FIT system under the Act on Special Measures Concerning the Procurement of Renewable Energy by Operators of Electric Utilities. Under the terms of the FIT system, power utilities must purchase electricity from applicable RE sources including solar, wind, hydro, geothermal, biomass, and others at a fixed price for a given period. This system also imposes the electricity users to pay the 'Surcharge for RE'.

The next item was on Japan's solar PV market. Most challenges in considering financing PV projects are derived from being new or having a lack of track record in the bank's past experience, in terms of technology, players, cash flow model under FIT, legal framework or FIT itself and so forth. In a nut shell, it is a nascent business model. This unfamiliarity leads to difficulty in assessing project risk, in finding out the way to mitigate the risk. It also results in perceived risk within the bank sometimes due to insufficient understanding of PV projects. Several issues such as project management capability, insolation risk, technology performance risk, completion risk, institutional risk and natural disaster would require customers to address.

There is no one-size fits all in SMBC's solution service. One has to sort out a structure appropriate for each customer's needs. In order to meet various customers' needs as far as possible, SMBC provides a spectrum of solution service for RE, i.e. providing financial and enterprise advice from a very early stage, matching relevant players with various needs, and proposing finance schemes/structures. To ease perceived risks persistent even within the bank, it is important to establish an in-house system in collaboration with all relevant divisions, e.g. forming a RE sector specialised team, providing opportunity to learn, inventing user-friendly tools for regional branches and so forth.

SMBC often acts as an incubator by covering budding/blooming industry (sub-) sectors from its early stage which can enable it to build up the business as early as possible once the market begins to take-off. SMBC also endeavours to maximise business opportunities for the whole bank by tracing and capturing the sector's value chain. SMBC has a few finance options, i.e. project finance, corporate finance and lease finance. In light of cost benefit balance, project finance can be used only for larger scale projects. Although SMBC has extensive experience of project financing abroad, there had been no PV project financed in the past in the form of project finance in Japan. The reason is due to the expensive financial cost and lead time can be long until an agreement is reached. For corporate finance, the range of project scales can be from small to large with a relatively cheap price but a shorter lead time where the tenor will be limited to 10 years at the longest. However, there is a flexible option under this financing called the semi-project finance approach that adopts elements of project financing such as fund management and security package. Lastly, lease finance, similar to corporate finance, also has project scales ranging from small to large and a shorter lead time. The unique part of this financing is that it has a cost-cutting effect in asset management and levelised cash flow. He supported his explanation of financing option through a few project models (cases).

The implication for Malaysian's policy-makers is they need a long-standing consistent policy that gives investors and developers certainty and predictability concerning RE projects. In this sense, while the introduction of the FIT system is a quite significant step to promote RE given predictability of cash-flow under the scheme, the government still has a lot to do in addressing concerns about connection to grid, the timing of the tariff decision for next year, qualification of installation and so on. For bankers, it is always challenging to consider the bankability of projects involving unfamiliar technology different from conventional ones. There is no magic wand to get a breakthrough. Normal due diligence process, tailor-made structure, and risk mitigation measures are what banks have to go through. Malaysian bankers can make a difference in terms of speed of addressing real and perceived risk by functioning as an incubator themselves to promote RE, building up a network of experts and people of great interest and adopting supportive in-house system.

This year, SMBC Japan and SMBC Malaysia have successfully co-worked to finance the 1MW PV project in Malaysia to Kemuning Sumikin Bussan Sdn Bhd, an affiliate corporation of Kemuning Structure Sdn Bhd and Sumikin Bussan.

Mr Baba also shared some of the SMBC global and domestic project finance credentials before he ended his speech.

Question 1

Do you have any plan to implement carbon trading this year?

Answer

The Japanese government is expected to establish the new mechanism, but they do not know how and when to start.

Question 2

Is this a competition or collaboration when it comes to working with other Japanese banks?

Answer

Basically this is for them to differentiate with other banks and clients are aware of their activities.

Session 6: Case Studies — Evaluating Risk of Green Financing
Mr Michael Cooper, Director Infrastructure, Asia Pacific, Project and Export Finance, HSBC

Mr Cooper started his presentation with sources of renewable financing via four channels, i.e. bank lending, equity and mezzanine, bond markets and corporate bridge. The majority of the funding through bank lending for renewable projects will be driven by domestic and local international banks and in time ECAs and vendor financing. On the public equity financing, investors usually seek for long-term winners and current weak sentiment while on the private equity financing, investors are more selective. Hence, growths of renewable/environmental funds are determined by numbers and size. In the bond markets, it is usually onshore issuance with few international issues. Requirement to secure credit rating will slow the initial issuers, but this is likely to attract great interest in Malaysia. Corporate bridge usually covers investment needs until due diligence for non-recourse debt is complete and there will be a corporate guarantee during the construction period.

Financing considerations are needed for regulations such as the Renewable Energy Act 2011 and SEDA Act 2011, technology, debt-sizing, foreign exchange and interest rates, grid connection as well as carbon credits. There are four key structuring parameters needed to look into in order to achieve certainty. The deal-specific parameter refers to debt-sizing and due diligence. On the other hand, regulatory framework and macroeconomic are the country-specific parameters.

Risk allocation in relation to the construction contracts is the key to satisfy potential lenders. Hence, lenders and Independent Technical Advisors will have to carefully review the Energy Performance Certificates (EPC) and technology-related issues.

Resource assessment is also essential for the approval of green financing in HSBC. Often, solid resource data and consultants are fundamental to get lenders comfortable with the resource for a proposed project. In addition, independent consultants will review other site-specific conditions. This will be restricted to conditions that may affect the suitability of the proposed designs for the site, which are important for specification of equipment, construction progress or which may result in operational disruption.

Next, Mr Cooper talked about the considerations in Operations & Maintenance (O&M) as well as grid connection. The analysis of O&M arrangement involves comprehensive assessment which focuses on the track-record of the operator and the warranty package proposed under the O&M contracts.

The most important item that the bank needs to evaluate is equity. A successful RE project using a non or limited recourse basis will be achieved on the back of highly experienced project sponsors committed to the long-term.

Lastly debt-sizing is also significant in financing a project. Hence, the bank needs to understand the relationship between debt-sizing, Debt Service Coverage Ratio (DSCR) and equity Internal Rate of Return (IRR). HSBC has successfully advised on and financed seven wind farms in Asia and can comment on the debt-sizing parameters acceptable to lenders.

Mr Cooper's closing remarks was on EPs. He said that EPs are a credit risk management framework for determining, assessing and managing environmental and social risk in project finance transactions. The EPs are based on the IFC performance standards and social and environmental sustainability and on the World Bank Group EHS guidelines. Enhanced Capital Allowance (ECA)'s most international banks and increasing number of regional banks require compliance with EPs.

<u>Question 1</u>
Is there a success story as far as green technology in Malaysia, particularly in biomass?

Answer
Yes, there are a number of them in Malacca, Penang etc. and a couple upcoming for project financing.

Internal Audit Conference 2012

Gearing Internal Audit for Changing Times

The Internal Audit Conference (IAC) was held at Bank Negara Malaysia, Kuala Lumpur on 18 and 19 July 2012. Organised by the Institute of Bankers Malaysia (IBBM), the IAC brought together a number of distinguished speakers, panellists and moderators to talk about preparing internal auditors for the changing environment in the banking industry.

Opening Remarks by Mr Tay Kay Luan, Chief Executive of Institute of Bankers Malaysia

First of all, Mr Tay welcomed and thanked YBhg Tan Sri Dato' Setia Haji Ambrin Bin Buang, the Auditor-General of Malaysia, all the distinguished guests and speakers.

He said that as a supporter of Internal Audit and governance, he felt for the banks' internal auditors, because auditing internally can be a thankless job.

He then said that he would start the day by acknowledging and thanking them for their efforts. He also thanked the conference committee for inviting him to officially welcome all guests, speakers and participants.

Dramatic events including bank failures during the past 10 years have contributed to significant and radical changes to international standards of Internal Audit. The regulatory authorities have also made several amendments to the legislation related to the banking business, which included significant developments in the audit methods and techniques adopted. These improved the concepts of audit and control and the new relations between the Internal Audit Department and other parties both in the bank (Internal Audit Committee issued by the board of directors) and outside it.

Beginning with the introduction of the Sarbanes-Oxley Act which strengthened the need for proper risk identification and ensured that appropriate controls are in place, Internal Audit together with the Risk Management team will perform the necessary validation. The theme, Gearing Internal Audit for Changing Times, reflects the impacts of the changes in the external environment including regulatory requirements, and on the role of Internal Audit as an independent activity.

The Conference allowed a dialogue within the banking community on what has taken place, how effective Internal Audit is in its readiness to embrace the impacts, and what are the gaps the community can fill in especially towards the acquisition of skills, knowledge and experiences. Given that this is the inaugural IAC, it was thought that it would be a good idea to look at the important roles internal auditors have to play in the evolving economic scenario so as to ensure sound corporate governance, proper risk management and fraud prevention.

The post global economic downturn phase has seen Internal Audit assuming greater significance, with the pressing need for efficient corporate governance, risk management and compliance systems felt across boards and organisations. Internal auditors also saw their stature rise within the banks as they have more direct contact with the audit committee and the Chief Executive Officer (CEO) to understand what the top management expects out of them and what risks they should be focusing on.

Corporate governance is fast evolving into a key measure of stability, efficiency and transparency for investors and businessmen all over the world. Given the volatility and the increased complexity of the business environment, the legislative and regulatory demands, and increased competition, many banks now turn to Internal Auditing as a vital function to help the business sustain and make sure risks are adequately mitigated.

Over the past few years, the role of Internal Auditing has evolved gradually to a more strategic role of independent risk assurance function. With the increasing expectations from various stakeholders on the Internal Auditing function, sound strategies have to be developed that begin with carefully understanding the stakeholders' needs and expectations; drawing positive perceptions to Internal Auditing; and developing a function to be an independent entity that adds value to the business.

To maintain value-adding strategic aims, Internal Auditing should also establish a quality assessment mechanism through clear and measurable metrics for continuous improvement.

In fact, the Basel Committee on Banking Supervision through its Principles for Enhancing Corporate Governance requires banks to have an internal audit function with sufficient authority, stature, independence, resources and access to the board of directors.

It is appropriate that leadership is committed to creating and sustaining a culture of corporate governance, and this means the issue of corporate governance must be integrated and woven into the fabric of how business is conducted within an organisation. The effective internal audit function must be able to independently and objectively evaluate the quality and effectiveness of a bank's internal control, risk management and governance processes, which assists senior management and the board of directors in protecting their organisation and its reputation. Underpinning this is the commitment and participation of senior leadership and it is worth emphasising that at the end of the day, for good corporate governance to flourish and prosper, it must have unwavering top leadership commitment.

The culture of good corporate governance must be institutionalised through developing an incentive system that requires good corporate governance.

Banking supervisors must be satisfied as to the effectiveness of a bank's internal audit function that effective policies and practices are followed and that management takes appropriate corrective action in response to internal control weaknesses identified by internal auditors.

There is no denying that an effective internal audit function can be a vital assurance to a bank's board of directors and senior management (and bank supervisors) as to the quality of the bank's internal control system. In doing so, the function helps reduce the risk of loss and reputational damage to the bank. Adequate internal controls within banking organisations must be supplemented by an effective internal audit function that independently evaluates the control systems within the organisation.

To be effective today, internal auditors have to keep pace with changes in regulatory demands, and complexity in business models. Internal auditors are also expected to go beyond the financial elements of the organisation.

Overall there is an opportunity for Internal Audit to take a 'whole of organisation' view, which not only provides comfort that value is being protected, but also offers a more forward looking view, showing that value is also being enhanced. A PricewaterhouseCoopers (PwC) survey predicts that internal auditors will take on a broader approach and go beyond just focusing on their banks' controls by adopting a risk-centric mindset. Doing so will involve anticipating higher-ups' needs, considering risk assurance as a main objective and enhancing how they cover risk in technology and fraud.

Mr Tay concluded by saying he hoped that the participants would find the two days useful and inspiring. He said that a range of high level speakers had been invited. Board effectiveness, the changing roles of the internal auditor, Internal Audit in fraud, Islamic finance, Information Technology (IT) and risk, the future roles and education of internal audit were some of the chosen topics for sharing, discussing and learning.

He once again thanked all the speakers and moderators/facilitators for their contributions to the conference.

Keynote Address: Gearing Internal Audit for Changing Times

YBhg Tan Sri Dato' Setia Haji Ambrin Bin Buang, the Auditor-General of Malaysia, Department of Internal Audit

YBhg Tan Sri Dato' Setia Haji Ambrin Bin Buang began by saying that Internal Audit should be independent in terms of structure and reporting. Internally, audit committees should be established to monitor the development and performance of Internal Audit.

Next, adequate resources in terms of funding, manpower and appropriate tools and technology should be provided. A professional practice framework especially for those in the public sector is needed to guide internal auditors in their work performance.

Internal auditors must also be equipped with relevant audit competencies. A holistic capacity building strategy should be formulated and appropriate incentives should be in place. The public sector's internal audit services should be modernised by making changes to the structure and management of the Internal Audit unit, focusing more on functions such as assessing organisational risk management, fraud detection, IT, risk assessment and governance.

The results of a recent survey also noted the higher degree of cooperation existing between the Internal Audit units and the Supreme Audit Institutions (SAIs) in countries which have laws and regulations stipulating the relationship between Internal Audit units and SAIs or which have a mechanism for formal meetings between them. The SAI and the Ministry of Finance (MoF) of the majority of these countries reported the possibility of convergence in the risk assessment process and the scope for sharing audit findings, reports, management letters and action taken on reports, training programmes, and formal and structured meetings.

He then proceeded to share some internal audit issues in the public sector. The National Audit Department of Malaysia is now working very hard to enhance the quality of Internal Auditing. The independence of internal auditors is still an issue of concern. The quality of auditing is affected whenever they have to perform operational tasks alongside their internal audit duties. As a result they can only conduct control assessment instead of risk management assessment at mitigating potential fraud cases.

The reporting line of the internal auditor is also unclear. It is important that the Chief Audit Executive (CAE) reports to a level within the organisation that allows the internal auditors to fulfil their responsibilities.

Yet, it is heartening to note that the attitudes and actions of the heads of ministries, departments, and agencies have now improved. In the wake of the global credit crunch and the result of several fiascos of Malaysian corporations including Government-Linked Companies (GLCs), the internal auditors are slowly being viewed as corporate governance partners, and the management of organisations values their inputs.

As for the audit committee, most of the audit committees in these ministries, departments and agencies have discharged their responsibilities well. However, the effectiveness of the audit committees still depends on the composition of the audit committees and inclusion of audit committee members with relevant experience, frequency of meetings and relationship with the internal auditors.

The financial scandals of the past decade have resulted in a general breakdown of trust that stakeholders have for the auditors. To build this trust, the auditors need to be actively involved in promoting transparency, good governance and ethical business practices.

Internal auditors should focus on the following areas in order to continuously add value and maintain their relevance in the marketplace.

Firstly, they should display professional competence. Internal auditors must keep up to date with the banking industry and the regulatory changes as well as professional standards. They must have:

A) A solid understanding of the banks' functions and business issues;
B) Conceptual and analytical thinking to identify, analyse, and interpret trends from databases;
C) Strong communication skills be it oral, written, report writing or presentation;
D) Good influencing, relationship and behavioural management skills.

All these competencies should be combined with suitable audit methodologies and tools and sufficient knowledge of auditing techniques. They must be given sufficient, appropriate ongoing training in order to meet the growing technical complexities of bank activities. Certification is also important. Moreover it is important that internal auditors apply the care and skills expected of a reasonably prudent and competent professional. Experienced internal auditors should supervise those who are new internal auditors having limited competence and experience in a particular area.

Secondly is professional ethics. The internal auditors should act with integrity. They should inculcate ethical conduct in carrying out the auditing tasks and comply with the internal auditors' Code of Ethics as well as the banks'

Code of Ethics, if there is one. They should watch out for threats to ethical conduct posed by inadequate self-review, undue influence of the management, board or audit committee, and/or intrusion of one's own interests or the interests of someone close to them.

Thirdly is audit coverage. The internal audit function of a bank should ensure adequate coverage of the bank's activities and include a review of key risk management, regulatory capital adequacy and liquidity control, regulatory reporting and regulatory compliance functions. It should focus on providing the assurance that strategic risks are strategically managed. In other words, internal auditors should adopt a risk-centric mindset rather than a control-focused approach. Methodologies and techniques should be developed to implement a continuous assurance programme.

Fourthly is governance partnership. Internal auditors must work closely with other governing partners such as the management, board, audit committee and external auditors to understand where the business control risk is within the organisation. Internal auditors must realign priorities to reflect the emerging needs of the audit committee and the board as well as the stakeholders proactively and consistently. Also the internal auditors should cultivate a strong link with the CEO and elevate his authority and visibility. There should be constructive and regular communication between the internal auditors and external auditors.

Fifthly is the role of the management, board of directors and audit committee. Internal auditors must maintain a good working relationship with the management, board of directors and the audit committee. The management is responsible for ensuring that the internal auditors has the necessary resources, financial and otherwise, to carry out their duties. They should be accountable for ensuring that timely and appropriate actions are taken on all internal audit findings and recommendations. It is the responsibility of the bank's board of directors to review the effectiveness and efficiency of the internal control framework and to review the performance of the internal audit function. From time to time the board of directors should consider commissioning an independent review of the internal audit function. Banks should also have an audit committee which should oversee the bank's internal audit function in terms of reviewing and approving the audit plan, audit report and ensure that the management is taking necessary and timely corrective actions to address any weaknesses.

In conclusion, today's internal auditors are a new breed. To be effective internal auditors, it takes a delicate balance of initiative and restraint, distance and personality, ethics and flexibility, optimism and conservatism, and above all an uncompromising commitment to the health of the organisation. The internal audit profession has now reached the level of maturity where it is able to extend audit and audit-related services without affecting its professional status.

PRESENTATION 1: BOARD EFFECTIVENESS: KEEPING PACE WITH THE CHANGING ENVIRONMENT

Moderator:
Mr Prakash Kirpalani, Managing Principal, Praktika International

Mr Kirpalani began by saying that the above subject is extremely topical and important. The seismic events that have traversed the global markets in the last few years have had a huge impact on how the world views the way companies should be run in the communities they serve. The focus has never been so strong on banks and financial services because they provide essential services to the communities. The role of the board of directors is to represent shareholders and oversee management in ways that meet standards of good governance. He then raised the question of what is the measurement of effectiveness. To help them along, there are various board committees such as the audit committee, the executive committee, the nominating governance committee and the risk committee. The audit committee and the risk committee are very important in today's climate.

A few years ago, the Corporate Executive Board which is a Washington based think-tank and research organisation did a study of creating a Corporate Governance Framework and profiled some leading financial institutions like the Bank of America, Visa, MasterCard, JP Morgan Chase, and Wells Fargo, and came up with a conclusion in their report that there is a semblance of best practice in establishing a Corporate Board. One needs to understand a few things like understanding the operating environment, having the right board committee, creating the framework for satisfying and staffing the board, determining the selection criteria and processes, assessing board performance, and evaluating the director's performance. All these elements are there but this has not been enough. This is an Internal Audit conference and the internal audit function has never been so important. The first two speakers talked about the emergence of the internal audit function being closely linked with the risk-centric function.

One comment from the CEOs was that the authorities like regulators, government, and most importantly, board members, are too focused on ticking boxes, producing and processing risk assessment checklists instead of seriously addressing systemic risks.

Another comment was that hence the mandate to the internal auditor was to do the same and prepare reports for the board to review that all were in order and exceptions were being addressed. This converts a serious risk management function to a mere bureaucratic form-filling one.

Will the boards recognise that the internal auditor is a critical cog in the wheel to be able to independently advise them of the distortions caused to the markets by the regulators, politicians, bankers and the board itself and, thus be motivated to genuinely understand and address price distortion risk?

Speaker 1:

En Nik Mohd Hasyudeen Yusoff, Executive Chairman, Audit Oversight Board, Securities Commission, Malaysia

En Nik Mohd Hasyudeen Yusoff started off by saying he would talk on three issues, *viz.* change itself, how change affects organisations' business strategies, and thirdly the issues that a board would face in confronting the first two issues.

Change

Looking at change, he said some of the previous speakers had already alluded to the drivers of change. He said there were four or five drivers of change.

Firstly it is the politicians as they are the ones who enact the laws in Parliament. Some of these laws will affect the way some organisations work. Especially for the banking industry, the way they work is affected by a lot of regulations. Some of these regulations are not only passed by local regulators but also international regulators, for example, Basel. Secondly, there is the economy at large because business prospers in a healthy economic environment. Over the past 10 years, there has been a very significant change in the business environment, not just within the region, but globally as well. He said that ten years ago, the trend was for a set of rules to be set for businesses everywhere to follow and the rules would converge. Then suddenly there was the Global Financial Crisis (GFC) and now there is a lot of thinking on how the world should move forward. Liberalisation, or the lack of it, would decide how businesses would compete in the market place. Moving forward, he believed some Malaysian businesses would move outwards regionally as well as globally and the way other markets operate would affect business strategies.

The third driver is people. People have their own traits and flavours and collectively they can also shape the market place. If, for example, people are very conscious about the environment, they would demand that corporations should be more environmentally friendly.

Another driver was technology. If one looks at handphones, for example, over the last ten years, one can see how technology has advanced and driven change. Current phones have resulted in a lot of new business channels being opened as there are now things like mobile banking. Transactions can now be executed from anywhere around the world. The advances in technology have resulted in many products and services, including financial products, being introduced.

Finally, he believed that the environment would be one of the major change drivers. People are now looking at water shortages in Kuala Lumpur, for example. The way businesses operate would therefore have to take into account the environment.

He then raised the question as to what change means to business. He defined a business as one which offers a valued proposition to a customer based on its supply chain at the right price at the right cost. What this means is that all the drivers of change can influence the way a business operates. Looking at airlines as an example, you have what is called a full service airline as opposed to a low cost airline. Each of them is performing the function of moving people, but they operate on different models. So, the changes would affect each of these businesses differently.

Change may not be that visible. It cannot be expected that a change would be brought up and shown to a business. In a classroom, where a question is raised to the students and a solution is explained, the students have to work out the answer. In the real world, one has to start with the question of whether there is a problem in the first place. In an organisation, it is very important to have a mechanism to watch out for all these potential changes that are going to affect the business strategy. Risk would be driven very much at a strategic level.

How Change Affects An Organisation's Business Strategy

He stated that he would look at this from three angles.

Firstly he would look at how change affects the demands for an organisation's products and services. A business that is selling a product that has no market is committing suicide. In Malaysia, there are a lot of supply-driven businesses rather than demand-driven businesses.

This creates a risk because if one does not understand what creates the demand for one's services, one may unnecessarily assume risks. For example, products offered by banks prior to the crisis no longer have a demand. If one looks at the managing of assets, a shrinking product can also shrink a balance sheet very fast.

Secondly, business has to compete. In Malaysia some people had not realised that they had to compete. They demand that people buy their products without articulating the real value proposition. This is important as one may be in the white spot where one has created a new product that no one else had looked at. One may command a premium initially but once the competitors awake to this and if they have more capability, they can come in and offer the same product at a better price and squeeze one out very quickly. So business is exposed to risk if it does not know its competition. The third point was capabilities. When change is mentioned, and the organisation's response to change is looked at, people are the ones who will eventually drive the change. So people are a challenge and one should have the right people at the right time at the right cost so that a product can be sold at the right price. Beyond people one also has to think about systems and processes. One can imagine and understand what needs to be done but if this is not supported by systems and processes, the business will have a challenge as well. The other question is how to finance change.

When one talks about change, one needs to understand the impact on the business as a result of that change. So the point is how to react to this. How does one respond in a manner that creates more value to the organisation rather than otherwise? This requires a very effective management of risk. However, not many people understand risk. For example, when risk is discussed at the board level, it is different from the type of risk faced at the operational level. When one looks at risk management, one cannot run away from risk appetite. The higher the risk appetite is, the more possible it is to do more things, to the point where one is actually approaching gambling. The consequences can be very detrimental if the situation suddenly swings the wrong way.

Looking at change, the impact on an organisation, and understanding the risk that comes with it, will require controls to be put in place. He said that we should understand risk and be comfortable with it. When one looks at the definition that profit depends on the risk one takes, one has to take some risks. When looking at the profits that come from taking some risks, one should welcome risk.

The Board

Talking about the board, it is important to see who is around the table. The mix of people around the table in the boardroom is a critical part in ensuring the board will be effective. Having the right people occupying the board is an issue because when one looks at the scarcity of talent and competition for talent, it is not just at the operational level but also at the board level. There is now the question of how to get the right people on the board of organisations. Some people may be risk-averse and do not want to be associated with an organisation. Some can have a 'cowboy' type of personality and they would not be suitable for the board. The right mix of people is therefore an issue. He said when talking about the right mix, he was also talking about the management team.

The other part is trust. The board has to trust the management. Otherwise it would be difficult to work together. A situation with a high level of mistrust would not be good for companies.

Thirdly there are capabilities. Business is very complex, especially when there is cross-border presence with different jurisdictions and different markets and issues. This makes it more challenging for organisations. The other question that arises when talking about boards is how low does one go? For example how far down does one go in analysing reports — how deep does one have to go when looking at issues? Does a CEO's report suffice or does one have to go further down the ladder? When one sits on the board the question arises as to whether reports from the ground or operational level are required or the CEO's report is sufficient. This is a key in ensuring the effectiveness of the board.

In conclusion, he said that he just raised questions and did not give answers. He just talked about what drives change, how it impacts businesses and organisations and what would the challenges be at the board level in looking at the various issues. He also only talked about how to right-size an organisation to have a working relationship between the board and management.

Speaker 2:

En Badlisyah Abdul Ghani, Executive Director and CEO, CIMB Islamic Bank Bhd

En Badlisyah Abdul Ghani said he was at the conference to fill in the gap when it came to Islamic banking, how it impacted on internal audits and how to go about doing banking businesses nowadays.

In his first audit job at Bank Islam in Labuan, the policies and processes were whatever the auditor said and did respectively as there were no guidelines. Today, the way auditing is looked at and the policies and procedures in place are very important. His presentation would be divided into three topics.

Board Effectiveness

The first topic discussed was board effectiveness and he believed it depended on a few factors.

Firstly, as a board member, one must first determine one's mission and purpose. What is the business being done and how to measure the success of the business that is being done? In banking in Malaysia today, this is fairly much not communicated because the banking business today is divided into separate entities. There is the Islamic bank and the Conventional bank and sometimes an Investment bank. How does one align the mission and the purpose of the business, given that the Conventional bank is all about conventional banking and the Islamic bank is all about Islamic banking? How does one measure the success of the Islamic bank compared to the success of the Conventional bank? There must be alignment. Board members today have this kind of headache when it comes to articulating the business and how to measure its success.

Secondly is the support that is given to the CEO and the valuation that the board places on the CEO. Who does one bring in to run the bank because at the end of the day it is the board that is responsible and accountable for managing the bank? But the board is only made up of a few people who cannot run the whole bank. That is why they require a senior management team to come in and manage the bank for them. This does not mean that it absolves their responsibility and their accountability. They must therefore bring in a good candidate with the right kind of knowledge, skills and attributes to manage the large number of people and a large number of issues and businesses. There is then the issue of roles and relationships. What are the roles of the board and senior management? It is not just the role of the board compared to those of the senior management that needs to be sorted out. The board members among themselves have to articulate their respective roles as well. The plan is to allocate the resources that they have. For example who is going to take care of the audit committee or the *Shariah* function? At the end of the day the board is responsible and accountable for *Shariah*. It is no longer the *Shariah* committee. Those are the resource allocation and the planning that the board has to undertake at the beginning of every year.

These days, a board member cannot just get on the board and assume that the board takes overall and shared responsibility. He has to have a particular and peculiar responsibility because of his peculiar skill sets. The board sometimes forgets this and so does the management. The board members have to be reminded that they are in because of their particular skill sets.

Do they walk the talk? What is the agenda and who drives it — the management or the board? Today, the management will try to bulldoze all the agendas that have to be discussed and deliberated and approved rather than the Chairman identifying what is important for the board.

Quite often the agenda is set by the management rather than the board itself. When it comes to the agenda for the board, it is sometimes forgotten who is in control. The effectiveness of the board depends on the board itself having control of the agenda. Today there is a hybrid mixture of what the management wants and what the board wants.

The third point is one of monitoring and evaluation, and assuming accountability. In today's world, for the Malaysian banking industry, one has the Islamic bank and the Conventional bank, because of the existence of banking regulations. The culture is different between the two entities and what is acceptable in one particular business line may not be acceptable in another. For example if today one sells the Islamic bank's banking business, it is important that the right dress code is applied. So, the board member in the Islamic CIMB bank, for example, has a mission and a purpose which is not in line with the mission and purpose of the board of the Conventional CIMB bank. How do board members of two different banks in the same group operating as a single value proposition align their mission and purpose and ensure that the culture across the business is aligned?

The fourth point is to enhance public standing. There is a lot of focus on management enhancing public standing. More often than not, the CEOs of the banks are public personalities. However, not enough is heard about board members. By right board members should have an enhanced public standing because it creates credibility in the organisation. It brings the reputation that will enhance the company's business in the long term. What sort of public events should board members participate in? Management can meet people in various conferences and meetings. But for the directors of the board, a lot are independent board members and cannot go to a conference and represent their company. So what kind of events can they attend?

Fifthly, integrity also needs to be maintained. One of the board's responsibilities is to maintain integrity at all times. Integrity is made up of three things, viz. legal, ethical and financial. The legal aspect is the effect of the laws and legislation. As for the ethical aspect, does the bank allow the offering of finance to single mothers and to pensioners, for example, and charge them high interest rates? Is it responsible lending? The effect of priorities taken where priority to one issue may be at the expense of another reflects on the financial integrity of the firm.

Lastly is the issue of recruitment and continuous performance assessment. It is not about succession of the management, but rather about the succession of the board. Quite often, in many companies, the succession of board members is not thought about by the board members but by the management. Basically it is to bring in someone who can be controlled and managed by the management. For the board to be effective, the board must have a proper succession plan in place and must recruit the members on a rigorous basis and make a recommendation to shareholders.

Can The Board Meet Changing Expectations?

There have been many changes in the banking industry, including changes to technologies, and En Badlisyah believed the board could meet those changes through continuous education. Members cannot look at continuous improvement as something that is cumbersome. It is not just about doing things better because of better knowledge but also about survival. If one does not do better, then one is not required as a board member.

Improved relations is not just about improving knowledge but also improving networks. It is about improving relationships with regulators, clients and even the staff. This is because eventually the middle management will take over and may move over to senior management and there must be a good relationship with board members who will stay on and oversee the management team.

Strategic development is important in terms of thought processes and knowing where the next big things are. Monitoring, tracking and evaluation methods must be enhanced.

Can Internal Audit Strike A Balance In Meeting The Needs Of Management And The Board Of Directors?

The board and the management have a collective responsibility and accountability to manage the firm, to grow the firm, and to make money for the firm. There are distinctions in the specific items that boards continue to carry on their own to a degree. These are items such as the fiduciary duty to manage the institution, and the responsibilities for the consequences of how sound or imprudent policies are taken up. They cannot transfer these to management. Collectively, the management and board are of one mind, one purpose and one direction. Because of that, in essence, it should not be difficult for Internal Audit to balance the needs of both the management and the board. Unfortunately this is only in theory. In reality, there is a mismatch because people do not go back to the basics to understand the common responsibility, and the common accountability. There is this conflict between the owner/manager. The shareholder is the owner. As the owner, the shareholder wants everything and this creates a conflict. It tends to destroy the alignment of the purpose. Internal auditors need to recognise where the misalignment may happen, and manage it accordingly.

In conclusion, it is very important for internal auditors to maintain a good relationship with the management as well as the board and ensure that there is a good working arrangement.

Speaker 3:

Mr Philip Koh Tong Ngee, Senior Partner, Mah-Kamariyah & Philip Koh, Advocates & Solicitors

Mr Koh began by saying that there is a distinction between governance and management. Management runs the business. The board ensures that it is being well run in the right direction. He then raised the question as to what is an effective board. It is not just an efficient board. There are many efficient boards. Papers are read hurriedly, documents are passed, circular resolutions are endorsed, and decisions are made outside the boardroom and endorsed within.

In his experience as an academic, a board director and a legal adviser, he asked himself what went wrong in the three recessions he experienced. He went through the Savings and Loans scandal. The same cries went out by many in each recession. Where were the boards? The same was asked about the external auditors — at that time there was not too much of internal auditing. Professor John Coffee Jr, when he studied the academic aspects of the Enron crisis and post-Enron, asked what went wrong. Was it the board? Coffee Jr, being a realist, said that the boards had always been ineffective (see John C Coffee Jr (2003) What caused Enron: A capsule of Economic History of the 1990s in Peter K Cornelius, Bruce Kogut, Corporate Governance and Capital Market Flows in a Global Economy, 'Oxford'). Mr Paul McEvoy from the Yale school said that in examining various boards, the non-executive directors so prized as independent directors, were generally ineffective given time constraints and information asymmetries. A recent writer, Ms Margaret Heffernan in her book, Willful Blindness: Why we ignore the obvious at our peril (2011), 'Simon Schuster' wrote about wilful blindness. There is an inability to want to see the elephant in the room, especially when there is a dominant CEO/Controller. There is a dilemma between the dynamic CEO imbued with entrepreneurial flair which gives rise to what Mr John Keynes said was animal spirits. The question is whether animal-spirited people are needed. It is true that the balance between compliance, governance and animal spirits is the never-ending balancing quest for an equilibrium that might come about. This is the equilibrium where management wants to manage and board directors need to govern but where does one go from there? He said he would shortly like to summarise this with 4 D's.

Coffee Jr asked the question as to why board directors need to be effective and he answered it that it was not because the boards needed to be effective as they were always ineffective. What gave rise to the decade of collapse, and post-Enron, even more collapses? It has become one big fatigue when lectures are given on governance. Coffee Jr argued that there is a failure among the gatekeepers who were ordinary people. In Malaysia people are very courteous and very civil and do not ask the tough questions. In essence, they have abdicated their responsibilities.

Coming back to the 4 D's, Mr Koh said first of all there was the duty of care — a fiduciary duty of care which rested with the director. For the fiduciary part, he said the director cannot place himself in a position of conflict. He cannot convert corporate transactions for his own benefit but he also has a duty of care. The duty of care in a modern corporation means more than just turning up in the boardroom, having a few drinks and playing golf. The director needs to have specific knowledge. In section 132 of the Companies Act, it is stated that every director must bring to bear his own specialised skill. A director who is an accountant cannot say that he does not understand balance sheets or numbers. However in Enron, the Chairman of the audit committee was a professor in accounting theory in Stamford. Yet in the treatment of the Special Purpose Vehicles (SPVs), he said that he did not know about the SPV treatment in accounting theory. He said it was not in his area of responsibility, but rather to ask Arthur Anderson for answers.

This brings one to the second D, which is delegation. Delegation is permissible but abdication is not. Most people delegate and abdicate. Moral leadership analysis shows that the diffusion of authority and responsibility in a large organisation means that no one single person is responsible. What glues the board room together is the singular decision-maker and one does not pass the buck. One cannot sit down in a due diligence meeting or an internal audit meeting and say “No one told me that”. Mr Koh said that he had clients facing regulators who are now saying such things. Mr Koh wrote to the regulators telling them this, but the regulators responded by saying that by knowingly permitting something to happen also means that one ought to know. One must know and has to have a reasonable suspicion of the issue taking place. He used an analogy and said that auditors, both external and internal, must not only be watchdogs, but also should be bloodhounds. If one smells something then one’s suspicion is evoked. If it is evoked then one must pursue. Mr Koh said that he had come across many cases where instead of being sentinels of the night watch, they were silent sentinels who went to sleep. He said it was important to have the right kind of lawyers to draft agreements and documents. When it comes to delegation one has to ensure that the lawyer is a specialist in a particular field or subject matter. You may delegate to a lawyer but was it the right kind of delegation and a reasonable one? Was the delegation based on information available and one that could be relied on? In the Animal Welfare Act (AWA) case, for example, the liquidator sued their auditor, the auditor counter-claimed against each and every director said that the directors are contributorily negligent. One of the arguments was that the auditor performed historical past accounting audit and had relied upon management to supply the data from this perspective; the risk management issue has to rely on the proper internal control systems, and the burden on internal auditors therefore heightens.

There is an ethical drift (the third D) in many organisations. Many organisations that collapsed had wonderful risk manuals and fancy matrices. Enron had them, Bank Bumiputra had them, and so have major Malaysian corporations. The drift creates an environment where wrongful, unethical decisions are made. There is no one taking charge, and there was a diffusion of responsibility.

The final D is disclosure. Disclosure is required but to whom? He said that he had once received a call saying that the CEO of a particular organisation was doing a transaction that was benefitting him. When asked why it was not reported to the Chairman, the reply was that the CEO was close to the Chairman and might be part of the scheme. There is the dilemma of whistle blowing in that to whom should one whistle blow to. After that will one become employable or unemployable? Under the Companies Act, an officer may whistle blow, and an external auditor shall whistle blow upon discovery of serious misconduct.

He said that internal auditors are gatekeepers, and as gatekeepers one should make sure one stays awake and also not be sleeping sentinel.

Questions 1

How important is the role of whistle blowing and the legal, human and ethical ramifications or the dilemma associated with it?

Answer

Mr Koh said that under the Companies Act, if an officer comes across an act which is fraudulent and seriously fraudulent, one may bring it to the attention of the Companies Commission of Malaysia (SSM). All the companies are incorporated under the Companies Act. The word ‘may’ is discretionary. The external auditors, however, if they pick something up has a mandatory duty to do so. So there is some space given for officers for a corporation which is fair. If there is a compulsory mandate for employees to whistle blow, the SSM will not be able to cope as there would be far too many reports. The legal dilemma can be resolved in a way that if one is an officer, one will not be held at fault if one whistle blows. The protection given under the law theoretically is that one cannot be dismissed. Mr Koh said that it is a conundrum. This is the true worth of these conferences where one becomes aware that it is a reasoning process, and the intent is clear and pure. It is the objective of professionalism and the outcome. Weigh these carefully. There are protocols and maybe this could be a topic for future workshops, for example, the scope of The Whistle Blowing Protection Act.

Questions 2

A lot has been heard about banks that cannot fail. Is there a need for a seat on the board for a nominee from the government?

Answer

The simple answer is ‘no’. It is not right for a regulator to sit on the board of a company that they regulate. The government that owns the bank may have a representative but not the Central Bank. Mr Koh asked as to why government nominees should be cleverer than other members of the board. Looking at the failure of government corporations throughout the world, it shows that having government nominees will not solve the problem. The failure of nominees is not necessarily the failure of the principle of nominating. There is a whole area of nominees under the Companies Act. If one confuses the role of supervisory nominees, there are some serious issues there. One cannot merge the two roles. Market failures are the result of a combination of factors. He stated that there is no great virtue but rather inexorable conflicts if a regulatory authority has a nominee on the board. Under certain conditions, e.g. impact on financial stability and the failure of a corporation where the whole board is paralysed, the regulators can then send in nominees to control the board.

<u>**Questions 3**</u>

Going back to the comments that boards and management should be aligned in their thoughts, their strategies and their vision, and linking this to the animal spirits mentioned by Mr Koh, when the CEO overwhelms the board in the same direction as himself, but the auditor is in a different direction and there is a conflict. How do boards deal with this? Ultimately governance rests with the board.

Answer

In that situation, one should whistle blow.

PRESENTATION 2: PARTNER OF CHOICE OR CONVENIENCE

Moderator:
Datin Josephine Low Suet Moi, President, The Institute of Internal Auditors, Malaysia

Datin Low started off with saying that the topic was something close to her heart. For example, as an analogy, when one marries a person because it is someone one really likes, that is a partner of choice. However, if over time the situation changes and it turns out that that someone is not the right person but one still decides to stay married, that person becomes a partner of convenience.

She then said that there would be two speakers speaking on this topic and introduced Mr Corray.

Speaker 1:

Mr Raymond Corray, Managing Director, RC Advisory Services Sdn Bhd

According to Mr Corray, the choices confronting the non-financial services employees (internal employees) are not something (to a large extent) that confronts those who are internal auditors. He said that internal auditors in the financial services industry are luckier than those who are in the non-financial services industry; this is because internal auditors have a very strong regulator and if the regulator sees something that he does not like, he acts to correct this. In the non-financial sector the situation is very different.

The first question he asked himself when confronted by the topic was, what is really his (the internal auditor's) role? He then talked about a number of companies like Polly Peck, BCCI and Maxwell Communications that went down. These failures prompted the setting up of the Cadbury committee which resulted in the enhanced position of internal auditors in organisations. It was the Cadbury committee that said that apart from external auditors, a more transparent and vigilant internal audit position was required. It was also the Cadbury committee that went on to distinguish between what the external auditors and the internal auditors do. Hence there was a re-birth of internal auditors in the late 80s and the early 90s. During this period a lot of regulators tried to enhance the role of internal auditors.

In Malaysia internal auditors were really lucky because in the late 90s, Bank Negara Malaysia (BNM) came out with the Garis Panduan 10 (GP10). BNM was at the forefront because GP10 was a very well crafted document which gave importance to the internal audit function, it further redefined the role of the internal audit function, and more importantly it determined where in the hierarchy internal auditors should be. The Chief Internal Auditor must have a position of senior management ranking. BNM's failure was that the Asian Financial Crisis set in and because of that, the implementation was not as vigorous as it should have been towards embracing GP10, as banks were now managing problems relating to non-performing loans. They had to put business ahead of the frameworks that were required. In early 2000, in the corporate world, there was the Malaysian Code of Corporate Governance. This talked about audit committees and their role and the requirements of internal audit.

In the mid 2000s, there were the local failures like the Mega Media, Transmile, Prime Utilities etc. Bursa Malaysia together with the Securities Commission (SC) revamped the Malaysian Code of Corporate Governance and said that not only do they want an internal audit function but they also want an audit function that reports to the Audit Committees and that the Audit Committees will be responsible going forward with regards to the appointments of internal auditors, yearly assessments of internal auditors, and the functioning of the internal audit function. Trying to separate/distinguish the role of the internal auditors had was a problem because in reality management was deciding their bonuses, their pay rises and internal auditors had fear in them because if they made too much noise there would be no bonuses or pay rises.

He said internal auditors in the financial services industry were luckier because they were subject to BNM's guidelines. Because of this BNM comes to audit them and audits management as well. The environment that the financial sector auditors were in was much better than that of the private sector.

Bursa Malaysia issued a Practice Note defining the role and operations of the Internal Audit. It reminded internal auditors that there could not be cross-auditing and that the internal auditor had to be independent of the management.

In reality the situation was that internal auditors were partners of convenience because of the mandate and the requirement to be there and not because the board and management wanted them there. Far too often, the problem faced is: internal auditors do not know enough or are not educated enough (How could internal auditors talk to officers in the bank about derivatives, for example? How could internal auditors talk to graduates of Oxford or Cambridge and talk to them about Treasury functions? Internal auditors are chastised by the banks' officers for going in after the facts and questioning investment decisions.) The truth of the matter is that the blame should rest with the board, management and as well as with the internal auditors themselves.

Addressing the issue of internal auditors being to blame, internal auditors should remind themselves what their roles are. The role of the internal auditor is to provide assurance independent of management and operations. Far too often the internal auditors do not want to play that role. They get ostracised because of the role they play in writing reports on operational matters. Internal auditors then decided to convert their role from taking a risk-based approach to one of risk management.

Right on top are the shareholders who entrust their money to the board. In Malaysia a lot of board members do not understand that. The board selects management. Management is supposed to fulfill the aspirations, i.e. the objectives and the goals of the board. Risk managers are the management, and not internal auditors. This is the reason for the phrase 'independent of operations'. Internal auditors provide an opinion with regards to the integrity and the effectiveness or adequacy of internal control. Adequacy means the controls have been checked. Integrity means when they are checked, they are actually working. By the time the internal auditor steps in it is already too late. Internal auditors thus have to stay true to what they are there for and what they are expected to do.

The real challenge is to move away from being nice fellows to a point where people begin to understand and respect the internal auditor for what he can do. Internal auditors have a helicopter view and are paid busybodies. There is no better position than that of an internal auditor. This is because one goes in after the event and learns what the processes are as well as what the mistakes are, and from there have an objective and independent view and can lend advice.

In some companies, employees are required to go through a two-year stint in internal auditing because it gives them an opportunity to learn about the processes. Integral to the work of an internal auditor is the understanding of what the processes are, and within the processes, understanding what the risks and the controls are.

The board unfortunately does not realise that they are also part of the process. Regrettably in corporate Malaysia today, a lot of grey areas are developing. The truth of the matter is in Malaysia, the board members are not well educated.

He said that in corporate Malaysia the infrastructure is in place, the processes are in place but unfortunately, people do not understand the internal auditor's role. He said the internal auditors are partly to be blamed. Another point was that there were too many people sitting on boards who do not embrace the duties and responsibilities of board members.

He took the view that the SC in Malaysia, the Financial Services Authority (FSA) in the UK, and the Securities and Exchange Commission (SEC) in the USA can come up with all sort of rules, guidelines and regulations but nothing is going to change because the understanding is not there. What needs to be done is for directors to understand that they play a role and within the board there must be such a thing known as checks and balances. So there is a collective board made up of executive directors, non-executive directors and independent non-executive directors. There is a very good reason for them to be there because they are a check and balance between themselves. There are committees of the board which are meant to focus on things. The directors have to understand that being a director of a company means that they have a function to play regardless of whether they are independent, non-independent or executive.

As far as internal auditors are concerned, the major challenge going forward is to be partners of choice. To be partners of choice, they have to stay true. They need to understand their roles, they need to educate the audit committee members and they need to show that they can deliver value.

For one to consider oneself to be a successful auditor, one needs to have an audit client who seeks one's views and opinions on the controls he should consider, or a client that seeks help to solve a problem. That is the direction an internal auditor needs to move towards. As far as internal auditors are concerned, they should stay true to what they are meant to be. Internal auditors are not gatekeepers. Risk happens and crystallises at the time the operations take place and the operational department makes decisions. They should be the number one gatekeepers. Internal Auditors are an assurance function that provides comfort that everything is working properly. Management reports back to the board. The board needs the internal auditor to give the assurance that things are working properly. Unfortunately, far too often internal auditors do not get the recognition because there is a very cosy relationship between the CEO and the board or there is a very dominant CEO who dictates the way things are done and no one challenges him.

As an internal auditor, one wants to be a partner of choice but ends up being a partner of convenience. Internal auditors are there because they have to be there.

Internal auditors play a very important role. Another thing people do not want to acknowledge is that even though they are only one part of an assurance function, the other parts of the assurance functions which are the external auditors are not performing very well. He said there were cases where even bank reconciliations were not done properly. So how do we know whether the accounts are right or wrong? There is therefore an additional burden on internal auditors because they have to do some work which external auditors are meant to do. They are inundated with a large amount of work for very little reward.

He concluded that he tried to stay true to what he has said. The part he had not addressed and to which attention should be paid is that which relates to culture and the behaviour of the three different groups of people. One of the biggest challenges is the behaviour of the individual, senior management and people as a whole. His contention is that the infrastructure is there and does not need to be tinkered with anymore. What is required is good implementation and that is getting people to understand what internal auditors do. Also people have to stop blaming everything that goes wrong on the internal auditors but should blame the management instead because management was there when it happened. Internal auditors came in after the event. His proposition is that internal audit is there out of convenience and not out of choice and have to take steps to making themselves partners of choice.

Speaker 2:

Ms Sandra Theraviam, Director, Ernst & Young Advisory Servicers Sdn Bhd

Ms Theraviam began by saying that she was going to contradict what the previous speaker said. She agreed that in some cases, internal auditors were partners of convenience but in a lot of other ways they are partners of choice.

She said that in terms of the internal audit function, Mr Corray had given a good run down of the whole process, so she was not going to dwell on the topic. She said that when looking at the financial crisis in 2008 and 2009, in Malaysia, there was not too much of an impact as compared to overseas parties. We really were sheltered because of good governance practices in Malaysia as a result of BNM's actions.

Looking at the banking and capital markets today, there has been a lot of focus on regulatory risks and strategic movements. In the insurance sector, there is Basel. In asset management, there is a lot of attention with regulators coming into the picture.

To become a partner of choice, there is a need to step up. There is a question of whether executives and audit committee members listen to management and bow to their whims. In recent times with a lot of change in regulations and tightening of the rules, more people are turning to Internal Audit for assistance. In meetings, internal auditors are actually being asked a lot of questions and are being treated more seriously. Management and others are now looking for assurance from internal auditors. Internal auditors are not only partners of choice to the business, but also to the audit committee and other parts of management. Looking at business insights today, one can be a subject matter expert in some of the deals about to happen. They do not just go to lawyers but also to the internal auditors to ask about risks and opinions. People who look at risks and processes also turn to internal auditors and ask how to fix problems. It is no longer acceptable to management for an internal auditor to list out the problems and recommend that they be solved or fixed. They actually want to be told how to rectify the problems; in this way internal auditors become business advisers as well. The internal auditors have an idea of all the processes because that is what they cover and that is where their expertise comes to light in an organisation. It is about balancing risks and costs and that is how they bring value to the business. In a lot of companies today, boards are asking of the internal audit function what value they are going to bring to the business.

These days, when the Chief Internal Auditors present their audit plans to the board, they ask what the expectations of management and audit committees are. How do they present the reports to ensure they cover most of the risks and manage costs, as well as add value to the company? It is no longer a question of the reports being prepared because they have to, due to the rules, regulations etc. When an audit plan is now presented internal auditors make sure that they cover the correct areas and add value.

In a recent survey, results show that 96% believe that risk management has an impact on the bottom line, 94% believe that the internal audit function has an important role, 94% also feel Internal Audit needs an improvement in their risk coverage through internal audit and 77% have actually asked to improve Internal Audit with a reduced budget. On the other side, only 44% of companies believe that Internal Audit helps their businesses, 38% say Internal Audit is strong across geographic locations, 37% say that Internal Audit is involved in key business decisions and strategy and only 32% say that Internal Audit's strength attracts future leaders. So the survey is saying that Internal Audit is not that important. This is a worldwide response.

When we look at Asia, however, 100% believe that Internal Audit plays a role in risk management and they have asked for improved coverage through internal audit. 94% also ask that their internal audit function be improved with the same or reduced cost budget. What this is telling us is that companies in Asia Pacific are looking at Internal Audit in a different light today. They want Internal Audit to be their business partner and also to improve so that they can help the business.

The question of how to get to that stage was then raised. Firstly, go through it from a strategic angle. Organisational strategy is usually about growth, branding, marketing entry, products and operations. The Internal Audit strategy should now be looking at time horizons, stakeholder expectations, compliance, making the business better, risk coordination and internal audit initiatives. To do these, people with the right knowledge are required. It is not necessary to go out and recruit. It is possible to borrow personnel to join your team. There are a lot of personnel who actually want to see what internal auditors do. It is something that management can do and make decisions on.

How does one transform into a partner of choice? Does one look at the Internal Audit strategy? Apart from giving assurance, how can internal auditors be an adviser to the business? There are many ways of doing audits so one should change the ways audits are done. Management can then be shown the value, for example, by doing something in a different way, so much can be saved.

Some areas will now be examined. One should look at optimising the Internal Audit business. One has to be strategically aligned and focus on being a partner. How does one do that? To bring value to the business, one needs to be well positioned, one needs the right people, and one needs to look at the correct business risks and give that strategic value to everyone.

In the past monitoring controls and compliance activities were looked at. One has to make sure that processes are in place. In looking at provider insights, one would be looking at aligning with what management wants. Find out what they want and see if there are the right people on the team to deliver this. Focus is required, as well as training so that they are fully aware of the areas that they have to audit. They are able to plan and deliver what is needed. In terms of being a strategic and valued adviser, proper research is required. It is no longer a matter of writing reports anymore, but rather what is done with the finding. People want to know the root cause as well as what others are doing. Internal Audit therefore has to give them those views and ideas.

Auditors today have to give reliable assurance. Looking at improvement and efficiency, that is the aim or objective. One needs to look at strategy and initiatives as well as data. One also needs to change the way audits are being performed. When audits are required across a few branches or geographical areas, and Internal Audit wants them to be benchmarked against each other, Internal Audit has to show management where people are, how they stand and how benefits can be realised by identifying the good ones against the others. In many cases a certain location may not be aware of what another location is doing. That is where Internal Audit will bring in the value, by highlighting the differences so that everyone can learn from them.

In the traditional model the position of Internal Audit was always one of a lower level to stakeholders. This has to be changed. Internal Audit used to go to the base and look at certain key processes and then report that the processes are alright. What needs to be done is an end-to-end audit from the initiation right to the end. Internal Audit has to understand every step of the way and tell management where they have gone wrong and where they can improve in terms of efficiency, and effectiveness.

Looking at issue-based aspects there are a lot of changes taking place. There are lots of Mergers & Acquisitions (M&As) taking place, changes in IT systems, new product launches, capital projects and contracts. An internal auditor does not want to be at the back end of this and audit it one year down the road and report what went wrong. Internal auditors should be at the front end instead.

To do this they have to choose as samples, projects that people are working on rather than past projects. It is a value-added process to the person working on the project. One needs to understand the product very well and look at the process being covered and look at the risk profile that has been identified. When launching a new product, it has to be asked if those areas have been covered.

In terms of mergers, one has to look at the company's readiness to go into the merger. In a lot of cases people who are invited to a meeting include Finance, Legal, and Treasury but never the auditors. Internal auditors have to make known to the relevant department that they want to audit them midway and not audit a sample that is completed. It may be private and confidential but it is something that Internal Audit can add value to.

In terms of process improvements, there are lots of levels of processes and success. The Internet is a great source of information and should be used to carry out research so that one is well equipped to advise on an issue.

With the view to reducing costs, how does one improve the work if there are not enough people to do the jobs? A lot of people are now using data analytics which requires a lot of planning upfront. One downloads data and performs an analysis on the data which can be used to see which areas need to be tested. In terms of using data, one can look at the opportunities, and the analysis and the insights. There is a lot of scope to use it. In finance, for example, it can be used for cash flows, for aging of loans etc. For Human Resource (HR), one can look at workers' compensation and deductions for instance. This will save time and actually bring value because these are areas where if you take samples you may not be able to pick out errors from the smaller sample. Use full samples, i.e. the complete population and the errors will identify the total ringgit benefits that you will bring to the business.

In terms of a value scorecard, traditionally, for training, the internal audit Key Performance Indicators (KPIs) were about utilisation, and how much training was given to the teams, about audit plans being achieved and about risk areas being covered. What is happening around the world is that cost savings are being looked at together with benchmarking, subject matter resources and business insights.

In terms of competency planning, sometimes there are not the right people or technical skills. How does one go about doing this? Surveys indicate that only 47% of competency plans are there for communication and leadership and 54% say that they have the proper business acumen. To address this, one needs to look at the enablement gap and the competency and identify the areas where improvement is needed. One can have auditor rotation where people are rotated to different functions so that they gain the business knowledge and insights that will help in the audit. One can also have guest auditors so that training can be given. In summing up, to become a partner of choice, one basically has to meet stakeholder value, there has to be quality service and one has to make an impact on the business with insights and ideas and also facilitate change. The Internal Audit's vision is to give world-class assurance not only to audit committee members but also to management. One needs to have talent, and one wants to drive efficiencies and to integrate with the business. In order to play the advisory role, one needs to align oneself to the business objectives and change the way one looks at the internal audit plan. One has to look at strategic areas or focus, and has to be able to participate in capital programmes and give advice to the business, help identify cost efficiencies and also look at the broader risk coverage.

Questions 1

For every assignment there is a time factor and deadline, how does one propose to deep dive and look at every process from end to end?

Answer

Ms Theraviam answered by saying that in many audits, there seems to be a lot of processes. One does not look at one process but rather at five or six at one go. One needs to reduce the number of processes. For instance, one only looks at procurement and another process, rather than many different processes. One needs to understand the risk of the organisation or entity that is being audited and go for the most important processes. Regardless of the spectrum of the processes where the risk lies, one has to audit those processes from end to end, while forgoing certain others which may be of lesser importance. One is taking those with the highest risk and deep diving and auditing those processes from end to end.

Mr Corray added that if the samples chosen are leading to a conclusion, then one must say enough is enough. Sometimes 100 samples are selected and one says that all have to be finished. This sort of attitude should not be adopted because if the control is broken, no amount of testing is going to fix that control. One must know when to cut and move on, thus saving time.

Ms Theraviam added that that is where data analytics also comes in. By analysing the data and identifying the trends and understanding the trends, one will also know where to focus.

Questions 2

This is just to pick on Ms Theraviam's statement of focusing on high risk areas. If the fraud has taken place in a low risk area, management will pick that up and ask why auditors did not pick that. What does one do?

The second question is on training development of inexperienced auditors. Since this morning, the topic of auditing is not just about providing base line assurance function but also about auditors who would also like to add inputs and be advisers to the business where value-added services are provided. In the real world today, the attrition rate is high. The question is how to train someone in the shortest time in order for that person to provide value-added services to the clients.

Answer

Ms Theraviam said that to answer the first question, one can go back to management and ask why they did not discover the fraud, where was their due process of checking, and their checks and balances. Secondly if one has not identified a function or process to be audited, how would one identify a fraud taking place?

Mr Corray then added that the internal auditors' role is not to be fraud highlighters, but rather to go into the processes and identify whether there are proper controls to mitigate the risk. The first thing we need to understand is the auditor's perception of where the risk is. The internal auditor should go and look at those areas where management says there is no risk because proper controls exist. The internal auditor should not take the management's word that they have identified the high risk areas and have put in place the controls. The question to be asking is what the consequences are if those controls fail.

Next is the question of how best to train a person. The audit firm used to be a great teacher in the old days. They did not just teach auditing but also general knowledge. This resulted in well rounded inquisitive auditors who wanted to know what made a business tick and what the drivers were etc. He said there was no substitute for that. Unfortunately today we live in a different world where graduates are not only hired at low pay but also leave early and are not interested in what they do. So the short answer to the question of training is that it is not possible in today's world.

PRESENTATION 3: FIGHTING FRAUD: THE FIGHT THAT NEVER ENDS

Moderator:
En Nik Shahrizal Sulaiman, Executive Director, PWC

En Nik Shahrizal Sulaiman felt that the action of fraud can be performed by a small number of individuals. However, the risks and the impacts and the problems it causes to the system or financial institution are quite huge. For example, Barings bank was brought down by the actions of just one individual. Locally one can read in the papers about Internet fraud and credit card fraud eroding the faith that people have in the system. The reasons why fraud is very important to Internal Audit are not just the loss that is caused to the institution but also that it affects the confidence in the financial markets.

He then introduced the first speaker and provided a bit of background on the speakers.

Speaker 1:

Mr Jerome Hon Kah Cho, Chief Audit Executive, Malayan Banking Bhd

Mr Hon started off by saying that fraud will never end. Many times fraud is caused by greed, opportunities, desperation, lifestyles and morals. He said that greed and opportunities come together. A person who is greedy will see an opportunity and commit fraud. Lifestyle and desperation also come together. The lack of morals causes all four to happen.

Internal audit should perform fraud assessment for a variety of reasons. For one, it is regarded as the most independent department in the bank. As an assurance and service provider to the bank, a fraud-related case will have an impact on the audit plan. Very often, the skills also reside in the Internal Audit department. Investigation and audit while being two distinct matters have similarities in approach. In Mr Hon's view internal auditors should be the ones doing the investigation.

There are a few requirements before the role of internal auditors as investigators can be fulfilled. The first is to establish a fraud investigation team. It requires skills in various areas. Many frauds have a similar modus operandi and experiences gained over time will enable specialisation within the team. Another point in having this team is that it will allow Internal Audit to focus on the audit plan. The advantage of having a special team is that as soon as an investigation is required, this team is ready to start immediately.

Special skills are required of the investigation team. There are certain preparations required, like asking the right questions, and being prepared for the answers so as to ask follow-up questions. The team also has to be able to analyse trends that come out during the investigation and come up with a conclusion. The most important skills are writing skills. One can do all the work that is required over a period of time but if this cannot be followed up with a report that is meaningful to the stakeholders, regulators etc. all the work goes down the drain. This is something that needs to be developed and is a prerequisite and something that should always be emphasised to the team.

In specialised cases like Treasury cases, IT cases or insurance cases, the team will have the core skills, but would need specialised skills to come from these areas. What is normally done is for the Internal Audit team to provide the technical support or form part of the team and assist in these specialised skill areas.

Mr Hon then presented a graph which showed that the more significant a fraud is, the higher is the need for external help. There were three types of fraud shown. Routine fraud is one where there are things like cash shortages or things that are simple. In this case, one can use the internal team to investigate. The next category is semi-complex fraud, which is fraud that is a little bit more complex and requires a bit more technical skills. As for the third case, complex fraud, this involves large fraud or accounting fraud and has a significant impact.

For this kind of fraud he recommends that the investigation be outsourced. At the end of the day, when one is faced with a scenario, one has to make the decision, assess the situation, and evaluate the constraints.

Possible factors leading to fraud include inadequate controls and people who do not follow procedures or processes. More often than not there is collusion. If there is collusion between a few people then all else fails. Another fact is the profile of fraudsters. If one starts to examine the profile of fraudsters, one will notice a certain trend. They could be of a certain age or salary bracket or in some cases lifestyles or commitments caused by having girlfriends or more than one wife etc.

Looking at fraud schemes and scenarios, some of the more basic ones like operational frauds are cash embezzlements, credit cards, insurance etc. Operational frauds like illegal withdrawals include forging of signatures and oversight by officers. The basic point here is there is lack of supervision and negligence. A lot of the time, the customer detects the fraud when he checks his balances. Where is the failure? It is at the first line of defence. Managers and officers are not doing their jobs. Controls are generally adequate. Banks are regulated and are required to place high standards on controls.

There are also cases where bank officers debit expenses and credit their own accounts. Again the failure lies with the oversight by officers who are supposed to check the transactions. Quite often reconciliations can detect fraud. Hence it is important to have periodic reconciliations.

Misappropriation of cash collected is another area. This happens in cases of premiums in advance or payments in advance collected by cashiers in branches. This can happen with insurance where the cashiers just collect the cash and then cancel the policy pocketing the cash. These are difficult to detect and the reconciliation between the subsidiary ledger and the main ledger becomes very important. He said that one could never over-emphasise the importance of reconciliations.

Credit frauds, are very common in mortgage loans. Sometimes it could be likely the applicants have been paid a commission for the use of their names. Then there is the area of clean Central Credit Reference Information System (CCRIS) records which are too good to be true and often turn out to be fraudulent applications. There are also cases of overvaluation of properties with valuers colluding and inflating the values of properties so that a person can get higher margins of finance. One should not underestimate the importance of a site visit. Often the document shows that a site inspection has been carried out. Credit frauds are syndicated these days with a lot of collusions. One also has fraudulent medical and insurance claims taking place regularly. However, if the controls are in place these things will not happen.

Mr Hon then presented the approaches to conducting investigations and comparing basic auditing with investigations. He said that the most important area is motive determination. For normal audit assignments, motive is not important but for fraud investigation, it is an integral part of the investigation. As for sampling, in all audit procedures there is sampling whether it is 50 samples or 100 samples etc. that are established in the framework. For investigation, however, one has to cover as much as possible. If the volumes are not large, 100% of sampling is done. However, if one is looking at hundreds of thousands of samples, then one has to set a threshold, cover as much as possible, and base one's conclusions on the samples done. Based on the samples, is one able to form a conclusion? If not, then the sampling has to be extended. It is the investigator's duty to be able to come to a conclusion ensuring that the sample size selected is adequate.

On the approaches to investigation, there were eight points Mr Hon wanted to cover.

The first one was examining documents. He said a trained eye was required to determine the authenticity of a document. There is superimposed text for example, where certain parts of the document are blanked out, replaced with new words and figures, and then photocopied to produce a new document. He also cited faxed documents which can be sent from other machines.

The next item was site visits. It is important to take a camera along to capture the true nature of the business or the property in question. One has to establish the condition of a property or asset. If it is a business one can ascertain if the business is running as well as stated by looking at the business first hand.

He then touched on the topic of phone enquiries. These can establish the authenticity of information provided as well as the legitimacy of the business.

He then spoke about interrogation versus interviews and said that the approach was normally one of conducting interviews. Gentle persuasion is normally sufficient enough to obtain the necessary information. However, if the evidence that is provided is inconsistent, then further probing is required. One has to pose interrogative questions to get the answers.

Then there is research. An investigation cannot be completed without research. For example you can go to the Companies Commission to find out if a person is a director or office holder in a particular company as stated in his application. One also has to compare facts gathered against evidence obtained or interview responses.

Trend analysis was next — one should carry out an analysis to establish if there is a common pattern such as transaction type, frequency, and threshold. For example, fraud could be confined to the perpetrator's authority limit.

Establishing a motive was the seventh point. Most frauds have a common motive, i.e. money. For other non-fraud related investigations, motive can be tougher to establish as perpetrators rarely confess unless they are cornered. If the motive can be established, some other evidences that were not so apparent earlier become related. Motive is normally established through confessions when the investigation produces sufficient evidence. Sometimes, accomplices or colleagues provide leaks to reveal the motive.

The final point was connecting the dots. Once the different bits of information are put together, one could get the whole picture of how and why the fraud occurred. One should get the background, objectives and the scope covered. The views and the conclusion should be aligned to the objective. One should then provide recommendations, if any.

How far should internal audit go? He said the internal auditor could review all the information like documents and records owned by the bank, and those not owned by the bank but made available during the course of the review. One should leverage on relationships as this would normally lead to more cooperation. One should also work with the business units. Generally people would not cooperate unless they are affected by the fraud. Internal Audit could conduct interviews but should not harass or cause physical harm. Site visits could be made but one should not trespass. Information could be gained from intelligence through contacts or connections.

To increase the awareness of anti-fraud and ethics, he suggested that anti-fraud campaigns be carried out. These would involve establishing a framework, communication, implementation, tracking the progress and revisiting the framework to update it if necessary. As for ethics, he said it was more than just a document but a tone from the top, and should be signed off annually.

In conclusion, he outlined other relevant points to help reduce fraud. One could establish an integrity or fraud hotline to facilitate reporting. One should provide assurance of anonymity to callers reporting through this line. Management must make people accountable regardless of amount and seniority. Police reports should also be made as it is the internal auditor's responsibility. Finally, one should involve the board and senior management in fraud campaigns.

Speaker 2:

Datuk IG Chandran, Special Advisor to the Chief Commissioner and Head, Forensic Accounting, Malaysian Anti-Corruption Commission (MACC)

Datuk Chandran said his talk would be divided into two parts. Firstly he would talk about the MACC and then look at the internal auditor's role in fighting fraud.

The MACC was established under the Malaysian Anti-Corruption Commission Act 2009. The Act was enacted by Parliament and came into effect on 1st January 2009. The principal objectives of the Act are to:

A) Promote the integrity and accountability of public and private sector administration by constituting an independent and accountable anti-corruption body; and

B) Educate public authorities, public officials and members of the public about corruption and its detrimental effects on public and private sector administration and on the community.

He then went on to quote some relevant sections of the Act and their applications.

He said that the MACC was not an anti-fraud organisation but an anti-corrupton commission.

The MACC only became involved when there was corruption, abuse of power and/or false claims. If it was found that there were violations under the Penal Code (i.e. criminal breach of trust, cheating, etc.), then it could continue its investigation.

He said that there were three parts to the equation. Firstly the MACC would carry out its investigation to determine if the case involved corruption or whether it violated any sections of the penal code. Secondly if there was such evidence, the investigating officer would then pass on the case and investigation papers to the Attorney General's Office for review and if the Attorney General's Chambers found that there was sufficient evidence and an offence has been committed, then the accused would be charged and case would be taken to court. The third part of the equation is the judicial outcome of the case. This was entirely up to the judges.

He said that there were three challenges that the MACC faced.

Firstly, there were public issues. These involved public perception where there was a feeling that only small fish was caught. There was also the people factor and impatience if people felt that the investigations were taking too long. Other examples were high profile and public interest cases, perceived violations of human rights, and the so called unseen hand which supposedly drives the MACC's decisions.

Secondly there were operational issues like funding, human capital and expertise, turn-around time, undercover operations and entrapment.

The third challenge was legal and prosecution. This involved the case of crimes without victims, hostile witnesses, specialisation of judges, evidence retrieval and admissibility, and the admissibility of confessions.

He said that developing an effective anti-bribery and corruption enforcement agency involved a three-pronged approach which was deterrence, prevention and education. It was a case of 'don't want to corrupt, can't corrupt, don't dare corrupt'. The message sent to people was that corruption was a high risk crime.

Datuk Chandran then went on to talk about the Corporate Integrity Pledge which basically was a voluntary pledge for companies to make a commitment to uphold the anti-corruption principles for corporations in Malaysia. The effect of the pledge was to show clearly where the company stood in the way it operated. It was also meant to send a signal to stakeholders that its business did not involve any hidden costs or risks associated with corrupt activities. Anti-corruption for corporations in Malaysia consisted of five principles, viz., a) committing to promoting values of integrity, transparency and good governance, b) strengthening internal systems that support prevention of corruption, c) complying with laws, policies and procedures relating to fighting corruption, d) fighting any form of corrupt practice, and e) supporting corruption prevention initiatives by the government and MACC.

He wrapped up his discussion on the MACC by talking about the integrity pledge which was a process that included an agreement between a government or government department and all bidders (private sector/business entrepreneurs) for a public sector contract. The pledge was meant to show that no corruption was involved in bidding for and/or winning a public sector contract.

Datuk Chandran then moved on to the second part of his talk which was Internal Audit. He said that an effective Internal Audit department depended on people, processes and position.

He asked the same question that other speakers have mentioned, i.e. where was Internal Audit in the financial institutions that received bailouts. He then quoted Daniel Kaufmann, a former director of governance at the World Bank who said, "The financial debacle has many causes and implications, but it would be wrong to underestimate systemic corruption".

He then talked about the bailout of AIG and explained how it got to the position of requiring a bailout. He also talked about Barclays and its rigging of the LIBOR. In both cases, he asked where Internal Audit was.

As a result of the two above cases and the GFC in general, banks are required to observe a much stricter vigil about compliance to 'Know Your Customer' and 'Suspicious Transaction Reporting'. He questioned whether this was working and the role of Internal Audit in ensuring that it was.

In his concluding comments, he said that the fundamental factors for worldwide success in fighting corruption are the political will of leaders, appropriate legislative framework, prosecutions and court judicature processes, strong preventive measures, extensive build-up of public support through an independent media and NGOs, strategic partnerships, funding, effective and efficient investigation, and integrity of staff within the organisation.

PRESENTATION 4: AUDITING ISLAMIC FINANCE – HOW DIFFERENT?

Moderator:
Associate Professor Dr Shahul Hameed Hj Mohamed Ibrahim, Head of CIFP Department, INCEIF

Associate Professor Shahul began by providing the backgrounds and credentials of the two speakers: Dr Aida Othman and En Nik Shahrizal Sulaiman.

He then said *Shariah* auditing is a growing field not only for Islamic Financial Institutions (IFIs), but other organisations as well. Any business can be *Shariah* audited if they want to follow *Shariah* in their operations. Currently there is a *Shariah* Advisory Committee in the SC which provides a half-yearly list of *Shariah* organisations. Eighteen or 20 Islamic banks are not quite a big enough pool of clientele for professionalising the *Shariah* audit business. However if 70% of the stock exchange listed companies are *Shariah*-compliant and they require a *Shariah* audit for all these companies then there is a big opportunity for *Shariah* audits.

Speaker 1:

Dr Aida Othman, Director, ZI Shariah Advisory Services Sdn Bhd

Dr Aida Othman said that her talk would be based on providing a background of what *Shariah* Audit is about.

She said that she would talk about *Shariah* Audit as a requirement under current Malaysian law, the nature and objective of *Shariah* Audit, and how they differ in nature from the ordinary audits. This would be followed by the features of *Shariah* Audit.

In the last quarter of 2010, BNM circulated a draft of the *Shariah* Governance Framework for 2011, which was a new regulation that came into effect on 1 January 2011. So, in the last quarter of 2010, the requirement began to be seen for *Shariah* audits. This guideline supersedes the only *Shariah* Governance Guideline issued by BNM to cover governance of Islamic banks and Takaful.

The aim is to meet demands required by new developments in Islamic finance and higher expectations of key stakeholders of IFIs pertaining to the *Shariah* compliance process. It sets out BNM's expectations of an IFI's *Shariah* governance structures, processes and arrangements to ensure all its operations and business activities are in accordance with the *Shariah* principles. It provides a comprehensive guidance for the Board of Directors (BOD), *Shariah* Committee and management in discharging their duties and responsibilities in *Shariah*-related matters.

She said it is a very wordy regulation and presented an excerpt which said "An IFI carrying out Islamic financial business shall ensure that the aims and operations of its business are in compliance with *Shariah* principles at all times". An end-to-end *Shariah*-compliant control mechanism should be established in all aspects of its business operations to ensure that all activities are *Shariah*-compliant. BNM wants all Islamic banks and Takaful operations to have end-to-end control mechanisms to ensure that they achieve *Shariah* compliance in all of their activities. It is considered to be quite a pervasive regulation by industry players.

In 1983 when the Islamic Banking Act was introduced it imposed on all Islamic banks the requirement of setting up a *Shariah* Committee so that the *Shariah* Committee could provide the oversight to ensure that all activities of the bank were *Shariah*-compliant. In 1984, the Takaful Act was enacted to impose the same requirement on Takaful companies. After some years later, in 2010, BNM said it did not find that this was adequate and satisfactory because the *Shariah* Committee could give approval or certification on *Shariah* issues but the operational aspects of a bank were beyond them. The new 2011 *Shariah* Governance Framework requires that there are four *Shariah* compliance functions to back up the work of the *Shariah* Committee. These are: a) the *Shariah* Review process by a *Shariah* reviewer inside the bank, b) a *Shariah* research process to review presentations to the *Shariah* Committee or any issues raised by management, c) *Shariah* Risk Management to work at mitigating *Shariah* risks that arise from product services and operations, and d) *Shariah* Audit which is the subject of the later afternoon talk. So when the *Shariah* Committee provides their reports, the annual sign off by the *Shariah* Committee can take place.

She then moved on to the work of the *Shariah* auditor and what it entailed. She presented two main international standards which needed to be looked at. These were the Islamic Financial

Services Board (IFSB) standards. These are called *Shariah* Review but in BNM they are known as *Shariah* Audit. They are required to verify that *Shariah* compliance has been satisfied, during which any incident of non-compliance will be recorded and reported. Next was an excerpt from the Accounting and Auditing Organisation For Islamic Financial Institutions (AAOIFI), a non-profit organisation based in Bahrain. This also required the *Shariah* Audit to ensure that the IFI achieved *Shariah* compliance.

The definition in BNM's *Shariah* Governance Framework is "*Shariah* Audit refers to the periodical assessment conducted from time to time, to provide an independent assessment and objective assurance designed to add value and improve the degree of compliance in relation to the IFI's business operations, with the main objective of ensuring a sound and effective internal control system for *Shariah* compliance". To those new to *Shariah* Audit, the footnote explains that "the *Shariah* compliance refers to compliance to *Shariah* rulings and decisions issued by the *Shariah* Advisory Council (SAC) and *Shariah* Committee of the IFI respectively, and as determined by other relevant bodies".

It also looks at *Shariah* non-compliance and says "*Shariah* non-compliance risks refer to possible failures to meet the obligation to *Shariah* principles or in other words, possible incidences of *Shariah* non-compliances. *Shariah*-compliance risks may or not may not lead to or result in a non-*Shariah* compliant event, but it is to be minimised. A breach of *Shariah* principles may lead to contravention of laws and regulations, in particular if a *Shariah* ruling has been incorporated into the law."

The objectives of a *Shariah* Audit thus are to: a) assess/check if an IFI's business operations and activities are *Shariah*-compliant, b) assess if an IFI's internal control system for ensuring *Shariah* compliance is sound and effective, c) ensure recording and reporting of incidences of *Shariah* non-compliance events and risks, d) ensure rectification of *Shariah* non-compliance events, e) prevention of recurrence of *Shariah* non-compliance events, and f) ensure minimisation of *Shariah* non-compliance risks.

According to the IFSB, Standard one sets out guiding principles for risk management in IFIs. It says that *Shariah* risk is an aspect of operational risk for an Islamic bank. There are new operational dimensions to risks in an IFI and *Shariah* risk is part of that.

She then provided an excerpt from the relevant standard on *Shariah* non-compliant risk: "*Shariah* non-compliance is the risk that arises from an IFI's failure to comply with the *Shariah* rules and principles determined by its *Shariah* Board or the relevant body in the jurisdiction in which it is operating".

She explained that *Shariah* compliance is critical to an IFI's operations and such compliance requirements must permeate throughout the organisation and its products and activities. It falls within a higher priority category in relation to other identified risks as: a) a majority of the fund providers use *Shariah*-compliant banking services as a matter of principle, and their perception regarding an IFI's compliance with *Shariah* rules and principles is of great importance to its sustainability, b) certain contraventions of *Shariah* rules and principles could lead to the IFI's transactions being cancelled and income generated from them to be considered non-permissible, and c) non-compliance could lead to fund providers' withdrawals, loss of income or voiding of contracts leading to a diminished reputation or the limitation of business opportunities. The new regulation sets out how a *Shariah* Audit needs to be conducted.

She then talked about the activities of an Islamic bank and how structurally it is different from conventional banking. Islamic banking is an effort by people in the industry to look for alternatives to interest-bearing and other prohibited loans and transactions. It is a shift from the interest-linked deposits and borrowings to a novel way of doing business because it is the only way allowed by *Shariah* principles. It is achieved by the use of various Islamic contracts such as sale, lease and partnerships that have formed the body of Islamic commercial law since the beginning of Islamic legal history. One way *Shariah* scholars work today is based on nominate contracts where they try to guide Islamic banks on what they can do. Looking at the whole business activities of an Islamic bank, all their activities including when they are dealing with a customer, have at their core Islamic contracts. That is why checking and auditing the transactions of an Islamic bank introduces the checking of the risk profiles of transactions that are very different from those of a conventional bank. These components are at the core of the workings of an Islamic bank and the working of a *Shariah* auditor. She then quoted another excerpt from the IFSB: "The relative complexity of contracts, combined with the fiduciary obligations of Islamic banks, means that for Islamic banks operational risk is a very important consideration".

She then moved on to the features of *Shariah* Audit and how they differ from ordinary audits. Due to the differences in the objectives of a *Shariah* Audit, benchmarks and standards for checks, the areas of audit, auditors, auditees, areas of audit, methodology and procedures for audit, reporting, and deliverables all could be different as well.

When the mandate to conduct a *Shariah* Audit is received, according to BNM guidelines, internal auditors are required to develop competencies in *Shariah* Audits. So one has to get training, and maybe get people with a *Shariah* background to form a *Shariah* Audit team. In a few years one may be able to build up satisfactory competencies. In the early years after the introduction of the regulation, *Shariah* advisories came in and helped with *Shariah* Audit.

She then went on to say what was looked at when one does a *Shariah* Audit. At the international level and also based on local law is a *Shariah* Governance Principle that the rulings and the decisions of the internal *Shariah* Committee of an IFI hold sway over the operations. That means what they say goes. *Shariah* principles are universal principles. One has to look at what the *Shariah* Committee has agreed on and use this as the main standard. It will form the body of a checklist.

The scope of the audit based on BNM's *Shariah* Governance Framework is to cover the audit of financial statements of the IFI, compliance audit on organisational structure, people, process and information technology application systems, and review of the adequacy of the *Shariah* governance process.

She then posed the question of how does one do a *Shariah* Audit of *Shariah* financial statements. Let's say one takes a product and the BNM's *Shariah* Governance Framework says one must have end-to-end *Shariah* compliance. It also calls for a pre-approval process and a post-approval monitoring process. It means one has to take care of *Shariah* approval principles beginning from the development up to the end cycle of the product.

She wrapped up her session with a description of the organisational structure, people, process and IT systems. What are the manuals for the *Shariah* approval process, for example? BNM says if one deliberates on approving a product, the *Shariah* Committee must follow a structured delivery process and be consistent in their approach. They must provide the rationale and reasoning for approving a product.

Speaker 2:

En Nik Shahrizal Sulaiman, Executive Director, PricewaterhouseCoopers

En Nik Shahrizal Sulaiman said that there were a number of key points he would like to convey in his presentation.

The first was *Shariah* non-compliance risk. He said that this was a key risk that was affecting the Islamic finance industry. Because it is an important and emerging risk, *Shariah* Audit is therefore important. The way one does an effective *Shariah* Audit is by having a structured thought process and by having more clarification on how *Shariah* Audit should be conducted.

He then went on to explain *Shariah* non-compliance risk, based on the IFSB definition, which is the risk that Islamic banks fail to comply with *Shariah* rules and principles.

The reason why he said that *Shariah* non-compliance risk is bigger than what we think it is because there have been a number of *Shariah* non-compliance events in the last few years which escalated to a bigger risk event. Examples include the investment Daar versus Blom case which resulted in a credit risk event.

Shariah Audit is critical not just because it is a regulatory requirement in the country by virtue of the BNM's *Shariah* Governance Framework; it is also an important line of defence to manage *Shariah* non-compliance faced by the banks. Secondly, it helps to protect the bank's reputation and integrity in Islamic finance.

BNM's definition of *Shariah* Audit refers to the periodical assessment conducted from time to time, to provide an independent assessment and objective assurance designed to add value and improve the degree of compliance in relation to the IFI's business operations, with the main objective of ensuring a sound and effective internal control system for *Shariah* compliance.

He then talked about a survey carried out by PwC on *Shariah* Audits and presented some of the key points of the survey topics. With regards to *Shariah* Audit competence, many of the CAEs believe that most of their *Shariah* Audit staff is competent to perform the *Shariah* Audit work. There were difficulties in getting the talents and resources to populate the *Shariah* Audit team.

En Nik Shahrizal then elaborated on *Shariah* non-compliance risks in a financing process. A typical process chart was shown and he said that *Shariah* non-compliance could take place in any one of the processes.

Should *Shariah* Audit be covered by trained Islamic scholars or by professional auditors trained in Islamic finance? This is pertinent because the reasoning in the industry why there are not enough auditors in the industry is because there are not enough trained Islamic scholars who are professional auditors. It is very difficult to find a professional in Internal Audit and a professional in *Shariah* jurisprudence as well because these two are very different distinct disciplines.

Moderator:
Associate Professor Dr Shahul Hameed Hj Mohamed Ibrahim, Head of CIFP Department, INCEIF

Associate Professor Shahul then briefly shared his view of what had been discussed. He said that the two speakers had presented the topic from different perspectives. Dr Aida Othman's talk was based around BNM's *Shariah* Governance Framework, the IFSB and the AAOIFI standards. She looked at the descriptive aspect and from a legal perspective. On the other hand, En Nik Shahrizal's talk was from an auditor's perspective. He said the questions raised by En Nik Shahrizal were all very pertinent.

He felt that *Shariah* Audit presents a very good potential and opportunity to become professionalised. In order to be professionalised, what is needed is two sets of standards besides defining the difference between an audit and a review. Comparing financial statement auditing there are two sets of parameters, i.e. auditing standards and the established criteria or benchmarks.

For accounting, we have the International Financial Reporting Standard (IFRS) and the way auditing is done is benchmarked by the audit standards. In the case of *Shariah* Audit, there are problems because the *Shariah* auditing methodologies, although having three or four standards, are not very detailed compared to the conventional audit standards. The second more important parameter is established criteria, i.e. *Shariah* standards. The AAOIFI started well with their standards but Malaysia has taken a different route. BNM tried with its Shariah parameters. These parameters are defined in a very easy way to make them into audit criteria. After the *Shariah* Governance Framework was issued by BNM, there was a project by International Centre for Education in Islamic Finance (INCEIF) to do the *Shariah* Auditing Framework. After it came up with proposals, they were not issued by BNM. That is building the roadmap and the infrastructure that he was talking about. It would probably take 10 to 20 years to get to the position of where conventional audit is.

Another point raised by En Nik Shahrizal was what are the boundaries or scopes of the audits. *Shariah* auditing is very wide. It involves marketing, human relations and contracts. If the desire is to achieve something different from conventional banking, more ethical banking or socio-economic justice through the practice of Islamic finance, then the higher objectives of the *Shariah* principles have to be looked at. Of course this involves cost and the fact that a lot of parameters and guidelines must be established. However, there should be an attempt to have some *Shariah* standards without which a *Shariah* Audit cannot be done. If each *Shariah* board of a bank has its own fatwa, then the auditing results of one bank will be different from another. This does not happen in a normal audit because the same criteria are being used, i.e. IFRS or Malaysian Accounting Standards Board (MASB) standards.

<u>Questions 1</u>

A question was raised regarding the scope of a *Shariah* Audit. Should a conventional auditor follow *Shariah* standards of a dress code for example, and have ladies wear scarves?

Answer

Dr Aida Othman responded by saying there was a process to follow and the minimum requirements are set out in the *Shariah* Governance Framework. One of the processes of a *Shariah* Audit is that at the mandate stage the *Shariah* Committee has to be involved. They have to be consulted separately from the management and auditors have to ask the committee what its concerns are. The manuals and the policies of the IFIs should be used as the benchmarks.

Looking at HR policies as an example, one had to look at HR policies and look at what they say.

If a bank says for ladies, they are following a certain policy, it is possible to ask why something is happening in certain branches or the head office. Sometimes there could be exceptions. One has to get explanations from the *Shariah* Committee.

There may be other examples, for instance, for investments the bank might say that the assets owned by the bank can only be leased out to *Shariah*-compliant businesses. This is a universal *Shariah* principle. She said there may be an instance where the lease is given to a bank that is conducting both *Shariah* and non-*Shariah* activities. In this instance the bank's *Shariah* Committee might say that in ten years' time, the objective of the bank is for the *Shariah* business to dominate its activities. The benchmarks, and the policies and manuals that the *Shariah* Committee has helped to approve are there for the decisions of the *Shariah* Committee.

The *Shariah* Governance Framework is very clear. The *Shariah* Committee of an IFI can take a different stance from the SAC. They can take a more conservative approach. The implication of the *Shariah* Governance Framework is that if one wants to take a more liberal approach than that of the Islamic perspective, one has to be very careful.

The moderator then closed the session with some remarks. He said that Malaysia was a liberal country which took an evolutionary rather than a revolutionary route. He said that in Malaysia there were many Islamic banks which are majority-owned by non-Muslims. In that instance one cannot impose 100% holistic *Shariah* in the sense of dress code etc. Muslims may be asked to follow the rulings but it depends on what the *Shariah* Committee has set up in the policies. That is why BNM gives latitude to different *Shariah* Committees depending on the bank's circumstances, depending on whether it is a multi-racial bank or a multi-religious bank. Perhaps the percentage of revenue derived from Islamic activities could be an indicator of whether a more holistic *Shariah* framework is required as opposed to a liberal one. The more important thing to ask is whether socio-economic justice is being achieved because finance is concerned with economics and Islam is concerned with socio-economic justice. Examples of the latter are less disparity in income levels and giving financing to the poorer sections of society. Now there is something called non-exclusion or inclusion of all sectors of financing. It is called financial inclusion.

PRESENTATION 5: AUDIT AND RISK

Moderator:
Mr Jason William Smith, Head of Governance and Provisioning, AmBank Group

Mr Jason William Smith began by providing a background of his experience with the ANZ Bank in Australia. He thanked the IBBM for allowing him to facilitate the session.

He then proceeded to introducing the two speakers to the audience.

Speaker 1:

Mr David Lim, Former Chairman, Audit Committee Institute, Malaysia

Mr David Lim said that he would be talking on the first two topics, with the second speaker covering the remaining two.

The new Securities Commission Corporate Governance Framework was launched officially earlier this year. One of the footprints put in place was risk management for public-listed companies. This was spelled out for the first time and is relevant for the day's topic.

Mr Lim started with a brief summary of what had been happening within the financial institutions in Europe and the US in the last few weeks and the last few months, i.e. Barclays and the LIBOR scandal; HSBC's money laundering fiasco; ING's complicit cover-up in avoiding U.S. sanctions; and JP Morgan's USD2 billion loss. People thought of banks as being honest, but over those last few weeks and months, there had been a slew of banks all coming up with bad news. He said that BNM was doing a good job because from all the things learned from the U.S. and the U.K., it showed that the regulators there did not do their jobs well.

He then expanded on how risk management failed in those institutions. Firstly, Barclays Bank said it advertised that it could provide the best fixed rates. However, it became embroiled in the LIBOR fixing scandal; unfortunately for Barclays, it was given the first mover status, which means that of all the banks to be investigated, Barclays was the first to be made an example of. Mr Diamond of Barclays Bank did not cover himself with glory as people reckoned that he lied: he defended himself that "on the majority of days no requests were made" or that "the requests were not always accepted by the submitter". Barclays wanted to look good so if their lending rates were higher, they wanted to suppress that. They did not want people to know that they paid more for their rates. They manipulated the market because of the knock-on effects and the LIBOR rates were the criteria for setting rates.

Moving on to the example of HSBC, which is closer to home, Mr Stuart Gulliver had just come on board in late 2010 or 2011, so it was very easy for him to blame his predecessor. What actually happened in HSBC was money laundering, especially in the Mexican branch; HSBC then joined the 'Hall of Shame'. Adding that the full story about HSBC could be obtained from the Internet, Mr Lim remarked that the bigger problem coming up would be the LIBOR scandal which was going to cost quite a lot of money.

Then there was ING. It had to pay USD619 million as a settlement amount for covering up for its clients in helping them evade U.S. sanctions. This again demonstrated weaknesses of controls.

The fourth case was JP Morgan which involved their CEO, Mr Jamie Dimon. He called the situation 'a tempest in a teapot', which basically means that it was not a big issue. However, the latest news was that the loss was in the region of USD5.6 billion.

All of the cases above show that controls were not working as well or that the internal auditors were getting bullied into not making waves. There was the question of how much push back auditors can make. The Head of Compliance of HSBC who occupied his post for ten years resigned to take some of the flak away. Mr Lim then showed the last example following up the JP Morgan case; it was a bank that was so big that it could take the losses and Mr Dimon admitted that it was more of a breakdown in the risk management department at JP Morgan.

Mr Lim noticed that too many directors treated their jobs like part time hobbies and had neither the will nor the capability to challenge each other. The question that arises is how much does one push back when certain proposals come one's way? The common theme coming from all the examples mentioned is that there was not enough of a push back from all the directors and even at the regulator level. In the HSBC case, even some regulators are going to face the repercussions for not acting.

So the question that arises is where were the controls? Were the people responsible looking at the wrong places? If things like this could happen in the bigger banks, what could be happening in the smaller ones?

Mr Lim then presented his agenda: the first one was the relationship between internal auditors and the risk management department. Risk managers are now compulsory for public-listed companies. Internal Audit is also compulsory whereas previously it was not. The second point was the importance of the risk management process in internal audit planning. It is something that has to always be in the minds of internal auditors because there were a lot of litigators who were more than willing to sue over the slightest mistakes.

Coming back to the first point, for internal auditors it comes down to the issue of whether they want to work with risk managers. His view was that there was a risk framework in place but it was dynamic and internal auditors have to work around it. Next was the relationship issue—for instance, should Internal Audit and Risk Management be integrated or should they be independent of each other? Should they work in a tailored structure that suits the requirements of an organisation? The roles of Internal Audit and Risk Management, as part of the overall governance structures of organisations, have been the subject of an ongoing debate since the initiation of the first modern review of corporate governance. The role of the internal auditor is to help an organisation accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes. The role of Risk Management is to establish protocols designed to enable defined strategies to be addressed and achieved through a process that evaluates the exposures an organisation faces. Given these roles, it is apparent that the responsibility of managing risk lies with operational management, and Internal Audit is independent of operational management. The internal auditor looks back at historical issues while the risk manager looks forward.

The problems that tend to blur the issue are driven by factors such as organisational structures that result from differing governance models, uncertainty regarding the respective roles and responsibilities of internal auditors and risk managers, knowledge levels and understanding by management of the respective roles and responsibilities, use of differing internal audit and risk management frameworks, and determination of who owns these frameworks.

There is a variety of opinions about how the relationship between Internal Audit and Risk Management should be structured. There are some organisations that maintain Internal Audit and Risk Management as two distinct functions reporting into separate audit and risk committees. Others maintain Internal Audit and Risk Management as two distinct functions reporting into a combined audit and risk committee. Still others integrate Internal Audit and Risk Management under the responsibility of a single person, although the two functions are separate, which then report into a combined audit and risk committee. Then there is a fourth structure which is the least desirable whereby the functions of Internal Audit and Risk Management are combined into a single department (this is rare and creates conflicts with internal audit standards), and report into a combined audit and risk committee. There are a variety of opinions on which structure works best.

He then produced a slide showing a prism, with the board sitting on top, while the committees are at mid-level. The three gatekeepers are there, i.e. internal and external auditors as well as management, with the stakeholders all patrolling around. The prism shows very succinctly where different people sit.

It is imperative that the Internal Audit and Risk Management leverage off each other, continually developing knowledge and awareness of the environments in which they operate. They must work within the risk management framework set by the board of directors and maintain dialogue. They must continually question each other's perspective of the nature and severity of the risk profile.

The second point of Mr Lim's presentation was the importance of the risk management process in internal audit planning. He started by asking some questions. Can the organisation leverage the expertise of the internal auditors effectively to address risk management? Can the board of directors use the internal audit function beyond its role of testing financial reporting controls? A great opportunity exists to utilise the internal audit function to increase efficiencies and upgrade an organisation's risk management programme. Internal Audit is suitable to advise management and directors in Risk Management through various standards like the International Standards for the Professional Practice of Internal Auditing, the International Standards for the Professional, the Practice of Internal Auditing, the Practice Advisory 2120-1 – Assessing the Adequacy of Risk Management Processes (PA 2120-1), and the Committee of Sponsoring Organisations of the Treadway Commission (COSO). Also there is the unique role of Internal Audit because it is typically granted access across operating and functional areas and thus is in a prime position to formulate a more complete picture on the health of the entire organisation. This, combined with an independently organised internal audit function along with the objectivity of individual auditors, should lead to more trustworthy communication with both management and directors.

There are three groups: the board, management and Internal Audit. The board sets the tone of the organisation from the top and they have to utilise Internal Audit well. Then there is the management which has to lead by example and understand the lines of communication between the board and internal audit. Internal Audit has to raise its game.

To conclude, the importance of the risk management process in internal audit planning should include the principle of the prism and employ the resources to do well. The Basel Committee on Banking supervision spells out three lines of defence, viz. operational management, risk management; governance and monitoring function; and thirdly the internal audit function.

Speaker 2:

Mr Tan Nyat Chuan, Head of Internal Audit Department, BNM

Mr Tan welcomed those present and said that he did not think he would do justice to them by providing an ideal state of what the internal audit function should be and how it would add to its value proposition. To give a broad perspective, he would demonstrate how he tried to move on from a compliance mindset in the traditional audit environment to something that is more risk-centric and more value-adding to the organisation.

He then set out the context of his talk by talking about a survey done in 2007, where the Fortune 250 CAEs were surveyed and asked what Internal Audit should look like. The survey basically said that the value proposition in terms of the controls focused approach is going to diminish. Today there is going to be a little bit more blurring between Internal Audit and Risk Management. That is the value. To stay relevant means to reinvent. One has to provide the value proposition to the organisation. Today Internal Audit has come (from five years ago) from a risk-based internal audit plan that is based on controls assurance to something a little bit more than just providing controls assurance to risk management assessment.

BNM has 39 departments, six branches, two of which are regional offices, three overseas offices, several subsidiaries and some other interested entities. The balance sheet size is RM480 billion and BNM's objectives include preserving monetary and financial system stability, issuance of currency, regulation of financial institutions, payment systems operations, and management of the international reserves. He said it was a fairly complex organisation to do assurance. He said while he was also the secretary of the Board Audit Committee (BAC), he was not breaking any governance rule because there was also a senior management representative who sits in attendance and provides the checks and balances. He said he placed an emphasis on quality control because in a changed situation one has always got to be on the ball. This is because transitioning mindsets is not something that happens overnight or a month's time or a year's time. It happens very incrementally over a medium term.

He works independently of risk management. His Charter provides for him to have full access to information but there is a qualifier. Information that he seeks becomes his responsibility and he has to justify receiving it, and it has to be relevant to the objective he wants to meet. Where there is a dispute the Charter provides it to be escalated to a management committee chaired by the Governor where they will decide whether it is relevant for the objectives he would like to achieve.

He said that he audits the risk management department but he still has to work with them. They house strategic planning and also the second line defence functions. So he partners with them in some regards. This love-hate relationship has to be handled very delicately so that people can see where they are coming from which is out of sincerity. When he approached a particular topic and people can sense he is sincere about the issues, people are more willing to let their guard down. He said it was a confusing relationship but it needs to work because they are working towards the same objective of assuring that the organisation's stage of Risk Management as well as the internal control system is adequate and robust enough for the function it undertakes.

He also partners with several departments which he called risk policy owners. The risk management department alone are the guardians of the framework, but there are also some other functional departments that somewhat provide a risk management role. They are the ones that go across what is called transversal risk. The IT department manages the IT risk across the bank, for example. If he raises an IT risk in a different department, he will issue the report with the IT department's input. They will have to provide the report as the IT risk owner and will then have to provide a view as to whether or not the level of controls should be improved. They might be summoned to the BAC in addition to the department that is issued with the line report.

He went on to say that if one wanted change, it does not come fast enough if one does not do 'blood transfusion'. How to be an eagle (i.e. someone who flies across his domain, able to watch over the environment and when necessary swoop down to deal with issues)? One has to stay relevant, see what matters to senior management, and keep an eye on the business plan, strategic objectives, and risks. One has to understand the business and take proactive measures to learn what the auditees know about their job. Also, one needs to stay ahead of the curve and know what is coming next and speak the lingo that senior management wants to engage one in.

Mr Tan concluded his talk by saying that if there are breaches of control and internal auditors pick them up as an audit issue, they have to find out what caused the breaches. They need to look at the root issues and solve them. They need to demonstrate value proposition. Those three steps that move along beyond the symptoms are where the value proposition is. The key value that an internal auditor brings to his organisation is telling senior management what the first and second lines of defence have missed, and demonstrate that the third line is always on the ball.

Questions 1

Mr Smith said that if one looked at the introspections and the lessons learned and everything that went on in the GFC one of the things that became very obvious is that the risk officer was not very much at fault per se. It was more a case of the risk officer not being listened to. Everyone was just looking at the dollar signs. So he was interested about Mr Tan's and Mr Lim's views as to the role of audit in making sure that the risk officer is being heard.

Answer

Mr Tan said that in BNM they actually had a board risk oversight committee and the risk management department is heard by the independent directors, so there is a direct line that goes all the way to the board.

Mr Lim said that in his firm the risk manager sits on the executive committee and this is important. If he does not sit there then there is no traction. As earlier mentioned, the SC blueprint puts Risk Management high up on the agenda. If the framework is right, it will become easier for the internal auditor to work at a higher level.

Questions 2

Another thing that Mr Smith picked up on from both the speakers was about some forward thinking on Internal Audit's part in the way it goes about its audit. He then gave an example of where the Internal Audit and Risk Management departments teamed up and went and did a consultancy rather than an audit. Instead of giving a bad report, they prepared a consultancy report and gave the company that had problems twelve months to undertake all the recommendations put forward in that consultancy report. They would then go back and do an audit. He then asked the two speakers if they saw more forward thinking approaches for Risk Management and Internal Audit to collaborate and perhaps doing things a little bit differently and outside the traditional norms.

Answer

Mr Tan said he thought there has to be a balance because they had multiple stakeholders and time and manpower was always a constraint. When he first started at BNM he offered to do consulting and it would be a safe environment for line departments to engage audit because audit would not bring issues up if it was something discovered during the audit exercise. He said there were constraints because they had to time bound it and they ran the risk if they did not highlight it to the BAC. They set a time limit beyond which they were duty bound to report it. He said that he later found it to be too time-consuming and also consumed resources and he would not be able to cope with the audit plan if he did too much of the consulting work.

Mr Lim said that it depended on the thinking of the board as to how they should handle issues. He cited the culture of a firm which was very aggressive and measured risk against growth. If one wants growth, risk should be cast aside. Risk is a four letter word and how management thinks is very important. One should terminate, reduce, accept or pass on the risk.

Questions 3

A delegate said that as an auditor, she believed in leveraging and migration of best practices and also in learning from the experience of others. BNM has the opportunity to audit all financial institutions locally and regionally. Coming from a small bank, she would like to function in a forward looking manner. She questioned why the examiners did not share the experience of their work in terms of where there were areas for improvement based on their works with other financial institutions. She was not interested in the financial institutions but just the areas for improvement so that she could learn from the experiences. She said that there could be a repository where everyone could go and pick up examples of deficiencies and how to overcome them. She asked Mr Tan for his views.

Answer

Mr Tan said it was a wonderful idea. He did not engage in practices abroad. He said that he looked at what he needed to do in-house. He said he had enough problems to solve before thinking about the next level. His supervisors did not have a repository of good practices or findings. Today the supervisors' objective is to assess safety and soundness of financial institutions. They look broadly at whether they can rely on the lines of defence within an institution to gauge what the residual risk is. Given that if a particular institution has very weak internal audit or risk management, they need to increase the intensity of supervision, and vice versa. He said he doubted that financial institutions had repositories of information that could be tapped into.

PRESENTATION 6: THE CHANGING PARADIGM OF INTERNAL AUDIT

Moderator:
Ms Nejolla Korris, CEO, InterVeritas International Ltd

Ms Korris began the session by introducing the speaker Ms Jo Coulson to the audience and providing a background summary of her experience.

Speaker 1:

Ms Jo Coulson, Head of Audit – Technology and Operations, Standard Chartered Bank

Ms Coulson started by explaining a bit more about her background; she had spent more than thirty years in technology.

She had seen a lot of advances in technology from the punch cards, and paper tapes of the late 70s and early 80s through to cloud computing, mobile technology, and WiFi today. She also tried to change her audit teams to match those technological advances. She had been a developer, technological risk manager and back office risk manager and thus had seen audit from both sides. She had also seen how technology can really impact the business and how events change people's lives in view of what to audit.

Her talk would be based on specific examples of the challenges faced in IT audit and how the IT audit responded to them. She would also be focusing on risk and not compliance.

Her agenda included IT hotspots that have been seen over the last seven or eight years, IT risks like CAEs, complexity of IT and the global nature of IT nowadays, how IT is responding to the changes and what one sees about IT auditors in terms of skills they have to have.

Every year, IT audit management and audit management get their crystal balls out and say what do they need to audit next year, what is the next big challenge, how can they avoid LIBOR and rate fixing, how can they avoid NatWest and customer data changes and so on. A lot of groups and consultancies provide information to help make those important decisions.

She shared in a table the top five IT risks that Internal Audit departments had been concerned about; they are applicable to an array of companies and are neither specific to the finance industry nor to any specific location or region.

Over the past seven years the hotspots have changed quite a lot. There are some common themes running through them such as data privacy and change management. Information security is always going to be there, but what one is looking at in terms of information security can be quite different. Obviously things do change to reflect the technology advancements.

For example, for wireless technologies, around 2006 there was wider use of smart phones and there were a lot more WiFi hotspots coming along. That gave rise to concerns in the technology audit space of the risks associated with that. IT audit was no longer in charge of the technology because the technology was not at the end of a piece of wire. It is out there roaming free, and is anywhere it likes to be. How does one ensure that the data that is transmitted by a WiFi to those technologies is not being intercepted? So those were the concerns in those days. It is still a concern now but it shows the technology advancements over the years.

Move forward to 2010 and we are looking at social media. Social media from a bank's perspective, if one sends a bank customer a password and they have forgotten it, they can change it by phoning up or entering some personal details into a website. Those personal details might be their date of birth, or mother's maiden name, all of which is available if one does enough trawling through the Internet. One can get somebody else's password and see their account details or maybe get a loan out in their name. So that was becoming a concern from an IT-related perspective.

Cloud computing is really a buzz word especially in 2012. A lot of banks are very hesitant about moving into cloud computing and using cloud services because they lose control of their data. They have the information but the data is managed and sort of owned by the vendors, the sub vendors and outsourced parties. It is a great technological advancement but one has to ask what is the risk and whether those risks should be looked at going forward.

There have also been a lot of changes going on over the last seven years as far as a technological audit is concerned in response to events, threats and activities that have occurred. In 2007 there were a lot of disasters or contingency events like the terrorist attacks in London and Spain. The following year one of the hotspots everyone was concerned about was whether they would be able to cope if any one of these events affected their organisations. Twenty or thirty years ago, an eight hour outage of a computer system would not have impacted a bank as considerably as it would now. One has to think about the resiliency controls that are in place over disaster recovery risks.

Next on the list is cost reduction pressures. In late 2008, there was the market crisis. Suddenly everyone wanted to know how they could reduce costs while still working on all those projects to increase revenue. From an IT audit perspective, looking at all those projects, the question to ask is, are they cutting corners to meet the budget restraints? So we are not looking at just the governance of the projects but at the financing as well.

She then talked about malicious insiders. There is system A which is well controlled; everyone is recertified with the right access. In system B, the same thing applies. Put them together with one person up front with back office activity and functionality and it gives the opportunity for a fraudster to do some damage.

And finally looking at disaster recovery again, post the early 2011 tsunami in Japan, this was brought to attention again. People are thinking what they need to do to protect their systems.

Those are the areas that were focused on over the last seven or eight years. What has changed in technology and what has the response been to these changes?

Looking at risk criteria in the area of confidentiality, security of data will always be a problem, but how is it changing, and what does one need to be aware of? Then there are data privacy regulations. A lot of countries and regulators are requesting now that an institution should be able to provide data within 48 hours of the request. It is important to understand whether there are systems which are able to cope and the capability is there to gather that data within a short space of time.

Integrity, data accuracy and fraud are things that also have to be looked at. Also requiring attention are availability, service interruptions and denial of service attacks as one moves into the Internet age and continues with the Internet age.

But there are other criteria and other risks that need to be considered at this moment. For example there is the risk of authenticity — is it a genuine transaction? How do we prove that an instruction sent by mobile phone was received and how to ensure that it is a genuine transaction, i.e. it has not been intercepted and amended? How do we know if there is a fraud going on? How does one prove one's identity if it can be retrieved from Facebook? How do we know that the password a customer is entering actually proves that it is them? Should further levels of authentication not be added? Even six or seven levels of authentication are being seen. All this is to ensure that one is a genuine customer and not an imposter.

Efficiency is a strange one from an audit perspective. Is it a risk that an internal auditor should look at or is it an operational risk? In this day and age, when one looks at the European crises a lot of organisations are in serious trouble and close to bankruptcy. If they have a project worth USD10 million that is going to give them all their revenue generation that they really need to survive as an organisation, but nobody is telling management that it is going to take USD20 million to complete and is actually going to deliver only half the functionality, or half the benefits, then should not audit be raising the flag? Or should audit not be checking to see that there are controls in place to raise the flag? That is what IT auditors need to do when reviewing projects. The cost of controls needs to be looked at as well. IT auditors should look at the efficiency if a control is being implemented. If the cost of control is USD3 million and the risk is only USD1 million then flag should be raised as well.

The next item discussed was non-repudiation. How does one ensure that if a customer has transacted from a mobile phone that it has arrived but the recipient says that it has not? How does one prove that the recipient is not trying to defraud one, using digital signatures for example?

So these are some of the things looked at and IT risks have to be considered alongside business risk. Ultimately it is the business and she echoed what people have already said. She always asked her staff when she read the report 'so what?'. So what if there is a logical access issue? If it is the teabag ordering system she did not care. If it is the payment system of the bank she cared enormously. So business risks have to be considered alongside IT risks.

The biggest risk for her because of the advancement of the technology is the complexity of the environment. She then put up a diagram of a small electronics retailer. There were about thirty or forty applications in the diagram and the interactions between all those applications could be seen. She said that her organisation had 850 applications and if the multiple instances of some of the applications are counted there would be over a thousand. She says that is quite small for a bank. She said it would be very complex. That is just the applications layout. Then there was the hardware, the middleware, the networking, and one could see how complex things get. So how does one know how a particular application on the right hand of the diagram impacts a payment application in the bottom left corner of the diagram for instance?

The other challenge faced is that technology is global nowadays, and is not just a mainframe that everyone used in the room locked away behind closed doors with a 128kb of memory. Everyone is linked to the mainframe and nobody outside the building had access to it. Nowadays technology is global and she put up a slide showing the Internet cabling around the world after a couple of incidents impacted on the cabling. One instance was when a ship's anchor damaged the concentration of cables in the Suez Canal and knocked out a good proportion of those and impacted the Internet cabling in Asia.

She then gave an example of her own company's network. She said her company was in 99 countries globally. Her company has users in Kuala Lumpur logging on to systems where the hardware is based in the U.K., the systems support is based in India, the implementation of the software will be occurring with a group in Singapore and the backup site is maybe in Hong Kong. Maybe the client or the user logging onto the system is in Brazil and the vendor who provides the system might be in New York. The bank cannot just focus on one aspect, all the dots must be joined and the risks assessed from an end-to-end perspective. If technology is global, so must be technology audit. It may not be happening now but that is where the challenge is.

Is IT audit being outpaced by technology? Financial institutions are now technology companies. In one of the banks she worked for, a CEO who joined the company brought back to the fold all of the technology that had been outsourced to a technology vendor. The reason for the outsourcing was that the bank was not a technology company. The CEO's reason for bringing it back was, if the bank is not a technology company, then what is it? Nowadays it is not possible to put manual contingencies in place for more than an hour or two. It certainly is not sustainable for a long period of time. A great deal of reliance is placed on the controls over IT risks to safeguard organisations. Therefore the IT department's assurance that controls are working properly is absolutely key. However, a majority of audit functions do not as yet place enough emphasis on understanding and assessing their IT risks to know where those issues might be. The IT risk is still not considered to be as significant as business risk. The two should go together hand in hand. It should not be that one is more important than the other. Many Internal Audit departments still do not feel that they have sufficient resources or expertise to apply the necessary audit coverage. One would suggest with all the complexities that have already been talked about, with the global nature IT audit should form maybe 50% of the overall audit function. Very rarely is it more than 20% or 30%.

So how does one respond to all the challenges? It can be done by looking at resources. Who does one have, what skills are required, where do they need to be assigned and also how many people are required? The 'what skills' is interesting in that there is still a lot of legacy technology in many organisations but are there people to support that legacy technology? In NatWest for example, it is believed what they did was a patch to some mainframe software that corrupted the centralised data and impacted a huge number of customers for one or two weeks. NatWest not long ago outsourced their technology support offshore to a number of vendors. Those vendors are in countries where they are looking ahead at new technology. It is quite difficult to find expertise in mainframes in those countries. So when they had this issue, the ability to respond might have been more difficult because they did not have the expertise that would have allowed them to correct the problems as quickly as they would have liked. This problem can be seen in many companies.

Risk assessment is very important to establish what needs to be covered and how many people are needed to audit it. So business risk has to be looked at, as well as how technology can be used to support that business, what risk does technology introduce and what is the impact of a combination of risks.

The next item is the review. Although risk assessment is done on an annual basis it has to be ongoing. Using continuous auditing and continuous monitoring allows a focus on the awareness of the risks, how technology is advancing and making sure the response is appropriate. However, the evaluation has to be done as to whether there are enough people to do that.

She believes audit automation is the way forward, certainly in the ability to audit the ongoing norm in an automated fashion so that more attention can be focused on the non-standard in a more manual user based way. So Computer-Aided Designs (CADs) are very important in this regard.

The next point raised was what does one need in terms of IT audit skills. An IT auditor needs to be analytical, creative, and to think what is coming up next year not just right now. That is why a lot of firms hire ex-hackers to try and improve their security. They want the creativity. They need to be knowledgeable in the technology, business processes and the industry. They need to be thorough. She said she does not want an IT auditor who is going to stop at the scope of the audit. The best auditor would be someone who had a technology and operations background.

In summary, the changing face of internal audit or the changing paradigm is driven by the new technologies that are coming out, the issues driving new risks and the complexity of processes. It is important to assess the IT risk and to respond to that by looking at the risk, ensuring that the legacy and the new technology can be evaluated and that the dots can be joined. It is also important to have the right people that are able to join the dots to be able to identify the risks that could impact the banking industry.

Questions 1

If one were to recommend to the general auditor who wants to move to IT or wants to become a bridge between the two areas, what are the recommended steps?

Answer

Ms Coulson said she found it easier to train them how to audit rather than how to understand technology. She suggested that if somebody wants to move into IT audit s/he should spend some time outside of the audit department in a technology function. This is a very good opportunity to gain the understanding and the skills as well as the processes in technology. It is a matter of how it happens and what potentially could happen and what the risks are from the other side of the fence and then move back into the audit function.

Questions 2

What was the greatest threat that was turned into an opportunity for each of the speakers?

Answer

Ms Coulson talked about the late 1990s when they were preparing for the euro currency and she was working for a large investment bank. There was a lot of looking at the clearing systems. There was a huge amount of payments processing and they did the clearing for a number of currencies. But when they were asking questions from an audit perspective about the controls they were putting in place in their systems, the new Euro processing, it actually came about that nobody really knew what the end-to-end process was for the overall payments and clearing for that organisation. They got every person involved in the process right through to reconciliations to go into the audit room and explain how they did their piece of the process so that they could draw it out on a whiteboard. There were a number of senior managers who said things like “I never knew I had that interface”, “I did not know I was dependent upon that part of the organisation” and “I certainly did not know that my work impacted that group to that extent”. It really broke down the barriers or the silos that are still seen today where people are working on their bits of the puzzle without looking at the bigger picture. What was really great was that the Treasury department took on the diagram on the whiteboard and still maintains it to this day.

PRESENTATION 7: BASEL II AND BEYOND

Moderator:
Mr Prakash Kirpalani, Managing Principal, Praktika International

Mr Prakash said that the session would explore Basel and the preeminent role of the internal auditor in it. Basel is more than a set of accords, it is really a journey. Basel I had its genesis in 1988 and this was followed by Basel II in 2004. The banking crisis in 2008 highlighted significant deficiencies within the banking system and the regulations to manage financial risks. In response to the crisis, the Basel committee on banking supervision released in 2010 a series of amendments to the existing Basel II framework. These agreements are collectively referred to as Basel III and the objective was to address the global systemic nature of modern banking and provide a more risk-sensitive framework for banks. Basel III adopts both a macro and micro prudential approach as well as strengthening the risk management, governance and transparency requirements. Another key consideration is to take into account stress conditions when calculating capital.

On a parallel track, insurers are adopting Solvency II. This is an European development which is a similar push to that of Basel III. It emphasises an enterprise approach to managing risks and not only covers the calculations but also the management approach. The core of Solvency II is the three pillars. The first pillar consists of the quantitative requirements, for example, the amount of capital an insurer needs to hold. The second pillar sets out the requirements for the governance and risk management of the insurers as well as for the effective supervision of the insurers, and the third pillar focuses on disclosure and transparency requirements. Basel III attempts to overcome the limitations of Basel II, which will add up to much higher capital requirements for banks. The implementation of Basel III has 2025 as the deadline. This is to ensure that banks are in a position to fulfil their increased capital requirements. However, Basel III is already morphing into Basel 3.5, and is Basel IV looming ahead? Six years seems to be the timeframe between each version. In this changing regulatory environment, banks need to refine the role of the internal auditor and look towards building future capability and bandwidth. The session addresses these issues and gears up the response to these challenges.

Mr Prakash then invited the first speaker, Mr Eckart Koerner, to the podium and gave a background of his experience.

Speaker 1:

Mr Eckart Koerner, Executive Director, Head of Financial Risk Management Services, KPMG Management and Risk Consulting Sdn Bhd

Mr Koerner began by looking at the challenges for internal audit and said that was what he wanted to focus on when he talked about Basel II, Basel III and risk management. One can say that the regulator also provides some guidance on internal audit, specifically the newly issued supervisory guidance on the bank/internal audit function by the Basel Committee on Banking Supervision (BCBS). They have asked internal auditors to reconsider their approaches and effectiveness by looking at the implementation of the Basel II framework and the Basel III framework. Also, one needs to be aware of the supervisory developments and practices related to governance and look into the past to see what has been learnt about the GFC and how it affected their institutions. Where are the areas of concern, where does one need to take action and to what extent does one need to take action?

He talked about independence and the three lines of defence and showed several models of how internal audit and risk management could be segregated. If one looks at this guideline (which he presented on a slide), then it is rather clear that a mix of Internal Audit and Risk Management would not be accepted by supervisors because principles two and ten clearly state that the two functions should be independent. Internal Audit should have sufficient standing and authority and an internal audit committee should be established to oversee the bank's Internal Audit function. This means there cannot be a mix of risk management and internal audit committees. In principle 13 it is also stated that for the three lines of defence, Internal Audit should be segregated from the other two lines of defence which are operations and Risk Management. One of the principles highlights the expanded relationship with the supervisors and one needs to be able to discuss with the supervisors not only internally within the bank, but also externally where one needs to answer queries. That is in line with Basel II where the dialogue between the supervisors and the banks should be enforced.

The regulatory frameworks from Basel I in 1988 were very simplistic approaches. Basel II was introduced with more risk awareness and there is now Basel III to be implemented from 2013. This means banks have to start taking action even from this year onwards. There is going to be an expanded scope for internal audit with more complex banking activities. If one looks at the banking activities from 20 or 30 years ago and looks at the products on offer and compared to those being offered now, the risks which were not relevant then are now becoming important. Citing an example, Mr Koerner said that during a discussion on structured products in 2006, he pointed out that a particular bank would face liquidity risk which at that time was not seen as relevant. The answer he got was that the market would never dry up. One and a half years later that exactly happened.

He then mentioned that he liked the example of animals in the morning's talk and asked whether one wanted to be a watchdog, or be considered as a watchdog. The answer is probably not. He liked the analogy of the eagle. He said one would have to have that view but would also go beyond that into a more advisory role which comes into play for Internal Audit. This is because as an internal auditor, one would have to play an independent role which allows one to bring in an opinion. Is what the bank doing sufficient or appropriate? What is the independent view? It is not only a finding, but also what a bank can do better. From that perspective, there has to be a change of approach.

The other challenge is deriving a more principle-based approach from those guidelines specifically and he would cite some examples later. It goes beyond just box ticking. What is appropriate, what is adequate, is it acceptable and what should the respective unit do?

He said he really wanted to look at details where he sees challenges for Internal Audit looking at Basel II. Currently in Malaysia what is strongly discussed and challenged is the Internal Capital Adequacy Assessment Process (ICAAP), the design and implementation, and how to manage capital adequacy. In relation to that there is development of the risk appetite statement which can be one page or 50 pages long. Here the challenge starts: is one page sufficient or is fifty too much? There has to be a balance. Is the right view expressed in the one page or is the right view not expressed in the 50 pages? There is the area of stress testing which is being stressed by BNM. One has to look at the effectiveness of stress testing and the comprehensiveness of stress testing. One has to understand what those stress tests mean for the bank and how they are applied. If one looks specifically at the ICAAP, then the key challenges would be how to calculate internal risk, where do you calculate and when you calculate, how do you calculate and can one agree to the approaches taken and on the other hand agree on the risk areas which are not measured. To what extent is that acceptable, is there sufficient documentation to fortify the approach that it is not measured even when it is material. How to determine internal capital and what are the capital needs and what is the capital available? Is the bank taking the right approach? It is forward looking, it is not only looking at regulatory capital but also the effect it has on the bank over, say, the next three years. The third topic is that one should be aware of is that the ICAAP is neither for the sake of the regulator nor risk management — it should be used internally for the bank. One has to determine what the adequate capital needs are and have strategies in place on how to get there.

It is linked to the risk appetite statement which is then linked to the business strategy. From the business strategy you derive the risk appetite. Then there is the question of the matrix that is used. Did the development process consider all the areas and how is it applied? Is it a one page document and how are the goals set in the risk appetite statement applied? Do they limit the business to certain products? How is it measured? How is it verified so that one follows the strategy? One sees a lot of discussion on needs for getting the awareness. What should be covered in that statement and to what extent? How is that then broken down to the different levels? How is it applied, how is it monitored?

The third point when looking at Basel II is stress testing. Stress testing is also related to the ICAAP. In Malaysia, one considers an expert judgment as the approach. For the internal auditor it makes it more difficult to measure or verify whether the expert judgment is applied accurately. There has to be knowledge on how to come up with stress scenarios. What are the macro-economic factors which have an impact on the bank? What is the magnitude of what you need to apply? How are the spillover effects, or the second round effects considered? What is the impact on the business in the end? When do you say in a stress situation where you would see a certain amount of capital losses that one needs to stop certain businesses or that you need to refine the business strategy? That is very important here and where he sees the challenge is exactly in those areas of determining the scenarios and the magnitude, spillover effects etc.

Basel II is thought to be responsible for too much leverage, excessive credit growth and insufficient liquidity buffers, just to mention a few. That of course is not correct because where the issues of the GFC started was in that country where Basel II is not applied — the U.S. They are still using Basel IA which was never implemented in Malaysia. It took five years to come to an agreement on Basel II after the first consultative paper was issued in 2004. Then Basel II was agreed upon. Basel III only took two years to be agreed upon. There is quite a long timeframe for it to be implemented but this revised framework is quite impressive. While it just took two years, one will see ongoing discussion because there is a transition period. Then will one only see what has to be applied if one talks about a liquidity buffer or a more accurate risk measurement.

The Basel III framework looks quite overwhelming but there are three areas which have to be emphasised upon:

Capital — what is capital and how to increase the quality and the quantity of capital? What are the risks to cover the capital? Not only are credit market and operational risks relevant but liquidity risk is also quite significant. Also there are other areas like reputational risks.

Leverage ratio — this is more or less attached to capital. It is meant to hamper excessive growth of the balance sheet or off balance sheet items. One therefore has to look not only at the on balance sheet but also the off balance sheet items.

Liquidity ratios — where one needs to comply with short-term liquidity requirements which have significantly increased from what is in place but also need to look at medium term liquidity to ensure one has stable funding so that one does not get into a liquidity crisis.

Where are the challenges? If one looks at internal audit one will see a strategic response. Liquidity risk requires the bank to have more High Quality Liquifiable Assets (HQLA). On the other hand the more one holds onto those assets, the less revenue one has. That might even affect one's salary. The point here is how much does it impact the business model and from those business model adjustments, how does it affect the pricing strategy? How many of the banks have a risk-based pricing model? Even if they have one, do they apply it? Product design has to be looked at as well. One might avoid liquidity risk but end up getting more credit risk. Is there a comprehensive assessment of those strategies and designs?

For modelling one needs to look at areas in addition to credit markets, operational risks, and liquidity risks. Does one have the understanding of what effect it has, for example, different run off rates, different stress scenarios? What are the reporting requirements in that area?

Infrastructure is another area. For IT does one have the right tools, or the right systems that measure those risks? Then one looks at the security that exists followed by data because of 'garbage in garbage out'. How can one ensure data quality? If one does not have the right data to assess, how does one know how many of one's retail depositors leave in a particular period? What are the proxies used, and how does one derive from those proxies?

All of that goes with the adequate governance framework. What is going to be measured, monitored etc. on the risk?

He said that he would then go beyond Basel III, without discussing Basel IV because that is on portfolio models just to give a flavour to what it is about. There are certain issues to be aware of which could affect the banks and one of the things which became obvious with the GFC was the poor incentive system or setting the wrong incentive and the interconnectedness of the financial system. If bank A fails, what effect does it have on the other banks? Another point worth highlighting now is whether the regulator has a critical view of the shadow banking activities. The European regulator has just issued a concept paper on how to regulate these.

The question which now comes up is whether the internal auditor is prepared for those regulatory and risk management issues. Does one have the right knowledge? How does one ensure that those topics can be handled adequately? One needs to get external support in or leverage on internal resources to the extent one can make use of the people in the risk management department. One can also leverage on technology. It is important that one has the right tools and with that does one have the appropriate testing plans? Is it really considering the material risks a bank is exposed to, or is one really busy with action on points which do not have that much impact? That is an important point to make. What are the areas one needs to spend more time on where one needs to test more thoroughly to ensure that one's bank is not hit by any risk?

Speaker 2:

Mr Dennis William Cox, CEO, Risk Reward Ltd

Mr Cox said that he was going to start with a few 'game changer' ideas. He said while the conference was a bank internal auditor type of event, he believed that 50% of those present would not be working for banks in five years' time. He expected them to be doing the same job but in non-banks. The world is changing, and he was going to explain why it is changing. Also one will have to know where one is going because if one does not know that, then how does one understand when one gets there or not?

The Bank International Settlements, or BIS for short, came up with a set of rules and the BIS themselves are following inside a political framework which is actually the party driving things. He said banking was previously a good profession to be in but bankers have now become the whipping boys for the world. When one looks at Basel II and the 8% rule, one has to ask why 8%? The G7 came up with this number. The 8% had no qualitative basis, and Basel II found it better to retain a number with no basis. The question is, is Basel III better? It is different and that is all one can say.

It is not just about capital calculations, this is a game changer. If a bank does not realise it is a game changer, then it does not understand what is happening. Why are we talking about Basel? Because these are the future rules. If one focuses on the BNM laws, which one must do, then one does not know where the future is taking one to. The future will change a lot for the banks here and what they are doing.

He said he would quickly go through the three regulations. He was going to talk briefly about Dodd-Frank, the U.S. regulation and the Volcker rule. If a bank wants to operate internationally, it has to understand these requirements. He said one should not just think of Basel as there was a lot more going on. For example, all the money laundering rules have changed this year, so have the accounting rules and the solvency rules for insurance. Currently there is Solvency II, but Solvency III is sure to come out. He thinks that Basel VII will look more like Basel I. He said that he has had a look what the IFSB is doing. They are going to have to come up with a new set of rules. He is going to look at the changing way that the AAOFI is going to look at the changing IFRS rules and the point of all this. The point is to show that the regulators did not really mess up but it was the banks.

Ben Bernanke stated that Dodd-Frank will make bank bailouts illegal, and this is on the Federal Reserve's website. He said he needed audit to be looking into the future and not the past. One of the things about Basel III is that it separates out internal control. It puts internal control into a new framework probably reporting to the spare director if there is one. Some of the monitoring that is being talked about will be moved there. This is not a problem as it allows audit to become more strategic. Audit is supposed to try and see what is going to happen and understand its impact. It is a fundamental change. He said he does not foresee an SME borrow money from a bank anymore. There is a complete disintermediation going on around the world. If one does not understand that, then one is not helping one's bank. One really has to understand the impact of the changes and the way it is going to go. He said he is scared when he sees some of the audit functions. If one is not good at one's job, there is only one place that one could possibly work and that is Internal Audit. He is really coming across some teams that are working in that sort of paradigm. He needs audit to find out where it is going to go ahead of the competition and the idea that one is not going in the right direction is quite important and changes the way things are going.

He was thinking of the IT presentation and was thinking that the more things change the more they stay the same. There is a whole lot of the audit programme which Basel III and Basel 2.5 and bits of Basel II and some of the new papers will change the way one does things. The audit programme is going to be driven by the regulations going forward and there is no choice.

The ICAAP has to be audited. It is an independent review by someone equally independent from Internal Audit. The wording is 'on at least an annual basis' which means every 11 months. Then one has to go and do the audit knowing the regulator is going to go through the documents straight afterwards. That is called auditor risk: the risk that one misses something and everything is one's fault. The reason that a risk director likes an independent audit function is that if anything went wrong, they could be blamed. One has to audit governance which is the board. Models have got to be audited and risk-based.

One is going to have to audit the models. It is cyclical or periodic depending on whether it is a credit risk model or a market risk model, the liquidity final guidance is not available yet, and that means one needs to have in internal audit someone who has mathematical skills. One needs to know the limitations of the model and know that Internal Audit is going to be audited. He said he had done some reviews of audits recently. He found that the audit universe misses maybe 15% to 20% of the auditable units. He finds that they tend to do the audits they have the skills for and they leave out the other ones that they do not feel comfortable with, for example, legal risk. Does one really want to do that? As for model risk, how is one going to audit the systems administrators and what are they really doing? The thing about all this is that they are moving along and more things are being added. Capital is important and then there are Risk Weighted Assets (RWAs). RWAs are now seen as bad by Boards due to the capital impact. And one has to get rid of them as much as one can so one is changing the scope of the bank. The consequence is that nobody can borrow any money, which means no growth in the economy, unemployment, civil unrest etc.

When one is looking at what is going on in the world and the nature of the changes one is seeing, it has to be understood that there are capital changes going through. If one is doing anything like a fixed rate facility and it is a twenty year loan or a twenty five year fixed rate loan like the Americans do, one cannot price it for twenty five years, as it is going to have a negative margin for at least 19 years and this is a problem. Even if it is a floating rate mortgage, if it floats off an index and the requirements do not allow one to re-price for changing capital rules, one is going to be under water for those facilities. What auditors need to audit is not what they see but rather what they should see. It is not to accept a policy, but more to question the policy and start to try to drive a bit more. If one audits what one does see, then one might be enforcing bad rules. There is Basel II which tries to strengthen stability. It was not fully implemented in America, where they had essentially Basel 1.5 although it is embedded in the Office of the Comptroller of the Currency (OCC) rates as well as in the Federal Deposit Insurance Corporation (FDIC) guidance but it was not fully implemented around the world. China wants to wait until 2024 to implement Basel II. So when one looks at the world, one has to recognise that it comes out with all these issues.

Standardised approach credit risk is about putting things into boxes based on ratings. Ratings are out for anyone who is American-based because of Dodd-Frank. Securitisation framework is being changed. If securitisation has been done, part of the risk comes back onto the balance sheet. Five percent in America would be from the new guidance, 20% out of Basel, so they are not coming along the same lines and none of this is finalised.

Operational risk talks about a basic indicator approach, a standardised approach which uses seven calculations, and an advanced measurement approach.

Market risk talks about a ten day 99% bar. This means holding a certain position for 10 days.

You do not always go to the top of an institution to find a structured, innovative and helpful risk-based learning. So, the point about having to use a regulation to justify a finding as an auditor is that one gets the 'so what' comment. And one has got to justify it on the impact on one's business to see the way it works. One has got to understand how all of it fits together and how one is going to do the reconciliation which is now required. The rule which was in Basel II went out and came in again in Basel III. One has to reconcile across between economic capital, the accounts and the risk management data set as a requirement and one is supposed to be doing that through the ICAAP.

The ICAAP is not just about capital but about how one runs one's business. Too many firms have hired a consultancy firm to write their ICAAP. They are nice documents but it looks like one has built a Concorde with the engines of a lawnmower. When the regulator gets around to actually looking, they are going to say, 'I need you to do what a Concorde does' and one cannot. He wants the auditors to start thinking about what they are doing and where they are. To make things interesting, they have changed the rules of the operational risk loss database. He does not think the audience thought that operational risk was part of the crisis but they decided to change the sound practices paper. They have changed the rules on the database. Remember the database is trying to predict the next year's loss. One does not stress test in silos but across the business. That is in Basel III. Basel II sort of allowed one to do it separately but this cannot be done anymore because it does not make sense. As a risk director, if someone told him they knew the loss for an event, and is asked for the impact on liquidity risk and the answer is there are other calculations for that, are they helping the director? They all run together. It is a requirement. The credit risk rules are changing; one cannot use the ratings for Basel III that came out of Basel II. They are going to be looking at the standardised approach and the recommendation coming through in Basel IV. How can one say that a country is zero risk and rated AAA when every taxpayer owes the world USD180,000 (that is just the government debt) and one then has to add USD120,000 for municipal debt and another USD100,000 for Fanny and Freddy? It does not make sense and does not work. Credit risk is changing.

One other point to worry about as an auditor is that they have to look at data that comes out of historical trends. There is a lot of historical trend data analysis. Now, for 'year-on-year' one is expecting interest rates on balance to go up. Until a year ago, one was expecting year-on-year interest rates on balance to go down. That trend started in 1982. So, all the systems and the rules are predicated on a market that is not there. There is a situation where there is a market risk data set which cannot support risk analysis. Market risk models and credit risk models are not working. So, audit is needed not just to check the calculations but also to see if the models are actually working and have good predictability.

One has to really start to understand enterprise risk management and the auditor is needed to update everyday to really see the way these rules are going. When one is looking at the risk and capital frameworks, the way all the stuff goes together, then one realises that one has everything built into the risk management framework. This means one needs accounting skills, mathematics skills and economic skills. Where does the bank get its economic advice from, what are they guessing is going to happen to the oil price? One has to think how one's currency is going to go against the dollar, the euro, the sterling etc. Look at what is happening to Japan and the way the country is being destroyed by their currency and one can see that these things are really significant.

One is going to be rated based on one's ability to comply with Basel III. The regulator, the European Banking Authority (EBA) is actually going to go and check on behalf of Basel. They seem to have got the job whether a country is complying with Basel III. If one does not then the ratings agency is going to downgrade one's country. This is expensive stuff, there is a lot going on here to worry about. And the auditor has to think whether his audit approach and the way business is being done are coming through.

He added that the ICAAP does have aggregation and diversification. Supervisory guidance is there. Basel produces a paper a week. It introduced the one on Internal Audit just the week before.

The whole framework is about total risk, scenario modelling and stress testing. It has got to be done because it is the most important piece of work the auditor does in the bank but one has to be wary because if one gets it wrong one falls down a hole. Supervisors have to report what they do not like.

In order to have new sound practices papers for operational risk, one has to know when this happens. If operational risk has not changed its policies there is a problem.

He shared about the loss distribution — if anyone is using that graph (which he presented: the graph line peaks up to the maximum probability level and tails off very low) and sees that in Risk Management there is a problem. It means small losses are not collected. It does not mean they do not exist. No loss profile looks like that. Having provisions for small losses, if they are not collected, does not mean it is right.

One has to do the Advanced Measurement Approach (AMA) for Basel II, and also the risk and control assessment process and try and build everything.

Driving and making consistency of Risk Management has got to take place across the business. It needs to be driven and is not just a theory.

He briefly touched on portfolio management and said the papers on that were now coming out. He said there were too many concentrations and one has to understand how it all comes together. He talked about the use test. If one is doing all of one's audits one should be using all available data and does not need a risk register in Internal Audit and Risk Management. However, one needs a risk register in the business. It has to be implemented and integrated in the way business is done.

Basel has now come to the conclusion that Value-at-Risk (VaR) is not enough because it is historic. VaR is a measure of how much one loses under certain circumstances. They are now looking at coming up with a very simple basis. They think one needs to come up with new measures and the report will be out in September for implementation in 31 December 2012.

Stress testing is designed to estimate potential economic losses in abnormal markets. Extreme market movements occur far more frequently than a normal distribution would suggest. Stress testing provides a more comprehensive picture of risk.

Mr Cox then highlighted 17 BIS Sound Principles of bank liquidity risk management: chief among them is the bank being responsible for such risk management through a robust framework that is able to withstand various stress tests and taking quick action if the bank's framework and liquidity positions are compromised. There should be supervisory cooperation within and across national borders as well.

That is why BCBS's paper review of vendors' models, published in 2010 can also help, particularly for credit risk measurement and management. Models that could estimate the probability of default, loss-given default or exposure at default were reviewed; several findings were found including advanced methods being not well-documented, and some vendor products differing in ease of use for stress testing.

In addition, for auditing model risk, Mr Cox brought up two approaches: the auditor could focus wholly on the approval and monitoring process or the auditor audits the model. These auditing models are really important as they are a significant chunk of the audit and will probably take up 20% of one's time; the auditor has to look at all the gaps and enterprise-wise threats on one's business, i.e. asset impairment, internal & external fraud and credit defaults among others.

He then talked about Basel 2.5 which brings in new restrictions on the use of ratings and also a 99.9% tail capital charge which significantly increases the market risk capital charge. Basel III changes the rules on capital calculation and content. It also brings in higher corporate governance requirements and new collateral monitoring rules. It enhances the importance of stress testing. It changes the way regulators work.

The implementation of Basel III can extend up to 2025, which means new rules are likely to come along for auditors to take note of. He predicts the next crisis to be in 2013, and the one after that to be in 2015. He said that crises are constantly being earned. The next crisis is in response to the previous crisis and in fact is probably caused by it. He said that the current situation is as good as it is going to be in the next twenty years. The environment is going to be one of rising interest rates and doing business is going to get harder. The greatest change within Basel III is the rules on central counterparty which fundamentally change the nature of banking business. Basel III moves the rules across from Over The Counter (OTC) derivatives into a single central counterparty.

The point of all that is, does it matter? Previously if one was doing an interest rate swap OTC one did not need to put up a margin. Under the new rules one has to. How much margin? He said it was more collateral than the world has. It is not plausible.

He concluded by saying that there was a lot going on and one needed to know about it. Otherwise, one just needs to be systematic; one has to make sure that someone in the bank is looking at the rules. One has to understand how to interact with them and how it impacts on the strategy.

<u>Questions 1</u>

Looks like audit is concentrating on the capital adequacy ratio which even the 8%, if it is correct, is not enough because banks are losing more than 8% of their capital. The person asking the question always thought that Internal Audit meant getting to the three E's, viz. economy, efficiency and effectiveness. Why concentrate on the risk and does the model really work?

Answer

Mr Cox said that because the model does not have to work, you have to do it. Basel does not have to be right; it has to be implemented. Of course it is the 8% to the 10.5% over a period of four years. The 10.5% is a buffer to increase the level of capital. Then up to 12.5% if you have the countercyclical which nobody would ever have. If you are a Systematically Important Financial Institution (SIFI) then it is another 2.5% and the new rules that came out two weeks before look at local SIFIs and there are at least three of those in Malaysia. So it is a higher capital figure. But Basel is not about capital calculation. Going in to the buffer, the rules are quite specific: no bonuses to staff, no dividends, and no share buybacks. Basel is about a change in the thinking where risk is the driver. To a bank taking risk, this is one's blood. The question is, were we putting adrenaline in our blood? One was flying too fast and they are trying to slow one down. It is about a way of thinking and risk then becomes the driver, and to him, Basel III is about management education. Remember that the governance rules come in. Under the new non-executive director rules, new directors need to have the skills such as accounting, risk, finance, business, legal, communications, and compliance individually and collectively. Now they do not have it collectively. There are a lot of thought processes there that changes the way one works.

Mr Koerner said with the ICAAP one has to assess how much capital one has and how much one actually needs. He has to stress on the risk part, so has one made sure that all types of risk have been considered? And having considered their materiality thoroughly then it is still up to one to determine one's capital requirement and not just one's own loss experience but also what one sees in the market. So one should not only concentrate on the regulatory figures.

Questions 2

One of the frequent statements made by auditors is, first there was Basel I and then Basel II. Before Basel II is fully implemented Basel III is born. Before Basel III is implemented somewhere in the world Basel III is already not working. So please share with the audience your views as to where it went wrong.

Answer

Mr Cox said that where it went wrong is that we tend to produce regulation as a knee-jerk reaction to a historical problem that we did not understand the cause of. We tended to produce the regulation before we worked out what the cause was. And if one thinks the crisis started in 2007, then one has missed the point. The mindset of regulators is that if one bank fails another bank will not fail. Any bank can have its own goal. Will they ever get regulation right? The difficulty is that it should be for a future environment but it is predicated on an historical environment. The BIS are a group of central bank governors. So when one asks does it work, the question he had was whom it works for. For example, if one has traffic wardens deciding the way one drives cars then they might turn around and say they do not want any car to go faster than 20 mph. If they put speed limits on every car then they will be able to read the numbers as they go past. It is a good rule for them and for the police, but it is not a good rule if one wants to get somewhere fast and that is the problem. The Basel rules actually stop us from getting out of the crisis and create a new crisis. Not enough collateral is a classic one. If a central counterparty fails, it creates a systemic risk, and is going to need loads of capital to keep the central counterparty running. He is not justifying Basel. He is trying to explain Basel and suggests that there are wonderful opportunities for someone out there to do something quite different and game changing and one could be the next billionaire if one gets it right.

Questions 3

For the benefit of the smaller banks and smaller audit firms they will not get the necessary skill sets within a few years. What do they do? How do they step up and pass on the audit risks?

Answer

Mr Koerner said one approach to get this is by sharing within the banking community. Another approach is to get experts from other departments, but one will need to ensure there is no independence issue. Lastly, there are also external advisors who would be happy to help.

PRESENTATION 8: FUTURE FOR INTERNAL AUDIT

Moderator:
Ms Carol Yip, CEO, Abacus for Money

Panellists:
Ms Margie Pagdanganan, Managing Director, Internal Audit – Asia Citi Private Bank, Technology and Global Functions, Citibank Singapore Ltd

Mr Ranjit Singh, Managing Director, Columbus Advisory Sdn Bhd

Ms Nejolla Korris, CEO, InterVeritas International Ltd

Ms Carol Yip said that there were five topics that would be discussed, viz. what the future holds for Internal Audit, the new learning and sourcing strategies for the internal auditor, new tools and education, effective utilisation of audit resources, and the meaning of audit transformation.

She said that while these topics may have been covered by the speakers over the past one and a half days, the panel would be discussing them from a different perspective and may look at case studies.

Future for Internal Audit

She then kicked off by asking what the future holds for Internal Audit. She said after the last presentation, she heard that the future is moving towards social media, Facebook, online banking, mobile banking and so on. Ms Pagdanganan started the ball rolling by saying that what is really in store is more change, more dynamism, more regulation and higher expectations from each of the regulators. It is very important for Internal Audit to no longer be the tick box auditor of the past, nor be the person who reports on past events but to start becoming proactive. A lot of speakers had talked about the things that Internal Audit need to do to move onto the next level. That includes keeping up to date with the information, knowing where the risks are, becoming more critical, becoming more questioning and really starting to change their mindset as to how they audit. In the old days there used to be an audit plan for the entire year. Nowadays that is no longer sustainable or acceptable. So as things happen, it is important to have a dynamic audit plan. If there is something that puts the bank at risk, for example the rates episode when it happened, the question posed by her audit committee chair to the Chief Auditor was “Is it happening here as well, can he check?". So immediately they had to mobilise resources to check. These are the things that happened and this is the future. Internal Audit has to be able to look where the risks are, to be able to be dynamic and to be able to change.

Ms Pagdanganan also added that a recent incident was when they looked at a regulatory report. In Japan, an error is not acceptable to the regulators no matter how minor it is. So what happened was that because of that incident they looked at local regulatory reporting as a focus area. They looked at a few countries and sampled just regulatory reporting and out of that they were able to look at exceptions, some deficiencies and controls. One of the things never to forget is that sometimes one has to go back to the basics and look at the design of control. In some places the design was not even there. What is being tested if the design or control is not even there? This exception should be reported to the next level. And what they did was to share their findings with the regional CFO and he shared it across the region. This is something they had done which could initiate change across the organisation.

In sharing his experience, Mr Ranjit said he would put them in two areas.

Mr Ranjit questioned whether internal auditors will be relevant in the coming years. Looking at a few cases that have happened around the world, if one takes the banking industry per se, and then talks about Barclays, there was no mention of internal auditors. What happened was one person was charged and sentenced and he was now appealing, but he wondered what happened to the internal auditors in that environment. If large cases of fraud could take place without the internal auditors picking them up, the organisation will start to question whether one really needs internal auditors. He said that internal auditors should start looking at these things and change their thinking.

The second aspect was when one starts to set up performance indicators, he found that the indicators only looked at what could be achieved in terms of the number of audits against the plans. If there is an area where fraud takes place, and it is not in the audit plan, it means they have not looked at their risk-based plans properly. That means they have failed in their duties as internal auditors and therefore their performance will be affected. Unless internal audit reaches that level of looking at their indicators, he was not sure where they would stand in ten years' time. Internal Audit is critical and in the Malaysian environment, Internal Audit is compulsory for all listed companies. The banking environment is governed by the Central Bank. Because of that Internal Audit is not really worried as Internal Audit is always going to be there. He was just looking globally and asking whether there was a place for Internal Audit in the future.

Then there are the audit committees. He feels that the audit committees had over the years asked that internal auditors write thinner reports because nobody had time to read the reports. Especially at the audit committee level, he attended a lot of audit committee meetings and board meetings and they hardly looked at the reports. Given this, he wondered if it was really worth writing thick reports but instead write reports that are a couple of pages long and make them more exciting to read.

He said these were some of the things to look at to remain relevant in the future. He found that audit committee members were getting frustrated with internal auditors, and management also do not really like internal auditors. This is because internal auditors tend to look at compliance rather than adding value although the definition has changed to say that they are adding value. Internal audit should be moving towards risk-based planning and towards areas that are critical to the board and audit committee members.

Ms Korris said that fraud is a big risk and that it is a growing field of interest for Internal Audit. Many organisations claim to have fraud policies but lines of authority on who did what during an investigation were rarely clear. In practice she found that there is rarely a clear delineation of who or what department is authorised to deal with fraud and conduct the details of an investigation. What is Internal Audit's role and what can they do? What is the role of an investigative team if there is one? What is the role of upper management and the audit committee? What is the role of the legal department and also what is the role of HRs? A lot of times she found that those are the key groups that do not come together in an organisation to have a common understanding about how work in an investigation is going to be deployed at some point. It is great to say yes there is a policy, but when something hits within the organisation - who is doing what? She found that in some cases there is hesitancy from various departments to get involved because they were not sure if they had clear cut authority. And in other cases, either the audit team or the investigative team had taken the initiative to go and get started and they were stopped by management or human resources. So fraud investigations internally have their own dynamic component. She found that that kind of dialogue is really necessary from those components within the organisation.

What she thinks are other challenges including auditing things like online privacy. There are two components of online privacy. The first is protecting the integrity of clients' information. There are interesting emerges in that particular area because the Federal Trade Commission (FTC) in the U.S. has required both Google and Facebook to be audited every two years for the next 20 years to actually prove that they are protecting the data of their membership. That is going to be an interesting process because there is nobody who has that kind of audit down pat. What is going to be seen is that the practice will evolve over time as a necessity with the FTC's ruling. But she thinks that Internal Audit needs to be aware of those components and grow with that part of the industry.

The other component of online privacy is the responsibility and privacy that employees have in relation to their employer. There is a lot of talk about auditing social media. That is great but in 90% of cases it is looking at what the corporate profile is with social media and whether one should be on Twitter etc. In her professional experience where everybody thought to have a footprint on the Internet, people are now trying to step backwards and start to erase their footprints. She said people have heard about employees speaking poorly about their employers on Facebook. Although they claim that they want privacy with it, to what extent do they have privacy? The Internet by its very nature is not private and that means that someone may be monitoring the postings or activity of their employees online. The question arises as to whether that is ethical, what right of privacy does one have as an individual. She thinks that that is a component that needs to be looked at.

Another point for her was the necessity to audit human capacity and human risk within an organisation. One goes into it when looking at fraud. How happy are people in the workplace? When internal audit goes in, there is the opportunity to have a cursory look at that particular risk. No matter how good the technology is, the greatest risk to an organisation is the individual. So is that a role for Internal Audit? She thinks it is. Some corporations are now requiring what they call integrity testing although that is not what she would call it. One could look at the activities of some of the executives in the organisation — a cursory look at the online reputation and what that executive's footprint is. It is okay that one has a Facebook, it is okay that one Twitters within certain parameters. It is not okay if one is on a site that is looking for a marital affair and one actually posts a picture that is taken by the Corporation. Lines get blurred on what is a corporate profile versus what an individual can and should post for all to see.

<u>Question</u>

Ms Yip posed the question as to why banks should talk about online banking and mobile banking. She said she would not know how to use the technology to perform transactions in ten years' time. Speaking from a consumer's point of view, what kind of value does one get now?

Answer

Ms Pagdanganan said that from a banking perspective and the economics of it one really has to keep up. This is because at the end of the day the bank has to meet whatever the customer wants. Nowadays the average customer or consumer has two phones, an iPad and goes online anywhere etc. Therefore, they want the convenience and the ability to transact. So the banks have to innovate. That is the reason one has to keep up.

Mr Ranjit said that one of the cases he was involved in was a company called China Emission Oil in Singapore and what happened was they were initially involved in forward contracts and they had a manual which talked about their policies and procedures and one of the policies that they had was that for every new product or service that they introduced, they first had to assess the risks involved in that particular product or service and to ensure that there were enough internal control systems in place before the product was actually launched. It goes on further to say that the internal auditors have to be trained on how to audit the particular product before it is launched. In this case what happened was that they moved on from a forward contract operation to another product which was options. They never realised how differently options worked and that the internal control environment that was required was different, let alone training the auditors on how to audit options. The profits that they made in forward contracts which were around SGD500 million were all wiped out within six months when they went into options. This is because they never had any internal control systems to manage the options and internal auditors also did not really know what to do as they were not trained in auditing options.

Mr Ranjit then added that technologies are definitely advancing. The banking environment will be changing with new technologies, and as internal auditors it is very important that one starts looking at all the new services and products and be comfortable with the internal control systems. It is important that internal auditors get involved when new services and products are introduced to see and check whether the internal control environment is sufficient to manage the risks involved. Otherwise internal auditors will always be left behind. Internal Audit's function is to look at the whole organisation and to add value. Where does the value come from if one does not stay ahead of the things that an organisation does? Technology will change but Internal Audit has to change as well. In fact one has to be in the forefront whether it is going to be through training or other ways. Very often he found that the staff rely on the organisation to send them for training. If the organisation does not do this, they just say that is too bad, and that is just not enough. One has to think for oneself what can be done for self improvement within the areas they work to provide a benefit to the organisation they work for.

The New Learning and Sourcing Strategies for the Internal Auditor

Ms Pagdanganan said that because of the increasing complexity of products in the environment, it was very important to have varied skill sets within an Internal Audit department. It is easy when one has a big department but when the Internal Audit department is small, it becomes a challenge. One of the things done is a detailed skills assessment for auditors. This is looked at against the risks they are assessing. Risks go hand in hand with controls. One has to focus on key risks. In a bank there is credit risk, market risk, technology risk, reputational risk, legal risks, operational risk etc. The question is, typically all of these skills are not with one individual so whilst the skills assessment is done, one is able to find out where one is lacking and who one needs to hire. In her firm, they had switched from 100% pure auditors to having a mix of people who are pure auditors as well as people from the business. For example, they take a person who has worked in Treasury and bring him into the audit team. She found that this sort of environment makes the audit report better as well as relevant. One can produce reams and reams of paper but at the end of the day the question remains "so what". One should be able to go to the CEO and say "because of this deficiency, the risk is this and this is how much it is going to cost". Whether one likes it or not, if one has a treasurer who has worked in Treasury telling another treasurer that this is bad, that has more credibility. One of the other things they were looking at is co-sourcing. Basel II and the need to audit the ICAAP have been discussed. She said she had a conversation with someone from the Monetary Authority of Singapore (MAS) who said that their guidelines talked about 'independent review'. He said that 'independent' in his books meant internal or external auditors. The question again is whether Internal Audit has the right skills to look at the ICAAP to assess if the ICAAP is done adequately, to look at capital adequacy, liquidity, and planning. So again when the first review was done, resources were brought in from various fields. These are the sourcing strategies for Internal Audit. One has to think out of the box and bring in the right skills to deliver a quality audit.

Mr Ranjit said that sourcing is something that is going to become more difficult. Taking Malaysia as an environment, in the Institute of Internal Auditors (IIA) there are 3,000 members and almost 960 listed companies, banks and so on. On average, if a listed company needs three auditors, that is three thousand people. In Malaysia, companies are really struggling to find the right resources. It makes it even more difficult when one thinks about the fact that Internal Audit is a profession where there is only one set of standards, the International Professional Practices Framework (IPPF). This standard is used worldwide. It means an internal auditor can move around any part of the world and can find a job anywhere in the world. The problem of a shortage of internal auditors is worldwide. Therefore, when one looks at sourcing strategies, it is going to become more and more difficult to find the resources. He believed that the strategy was to go back to the universities and tertiary institutions to source for graduates and start training them. He thinks graduates should be encouraged to look at Internal Audit as a profession and one should bring them in and start training them. One could move them around the various departments in the bank before moving them to Internal Audit so that they could decide if that is what they wanted to do. It is going to be a challenge. In Malaysia, with the recent change of the Code of Corporate Governance, there is a lot of emphasis on Internal Audit. Even the Bursa Malaysia and SC are looking very closely now at organisations to see if they have a proper Internal Audit function. The audit committee members now are getting a bit more worried because recently people have been sent to prison and fined heavily. So they are taking the Internal Audit function very seriously and are willing to pay well for good auditors. From a sourcing perspective for the banks, it is not going to be easy to find people.

Ms Korris added that she encountered so many talented people in the audit departments that she really encouraged the audit departments to cultivate specialties and interests in the teams that they had. A lot of times they are supposed to be all things to all people and that is really difficult. Within organisations, if one sees that somebody has a particular interest in learning about options, for example, they can be made to audit those. They can become the options specialists. A lot of the times she found that management, because they are understaffed, will say they do not have time for any of their existing team to go and learn a specialty. So they decide to bring somebody else in. That just creates dissention within the ranks. One should just cultivate the people one has, build the specialty within the organisation and build stronger teams from there as well.

New Tools and Education

Ms Korris said that there were several tools she would like to talk about. One of the most important things for an internal auditor is to be able to communicate with whomever they are dealing with. She said that it was important to work on interviewing skills and how to get information from people. It is very important to know how to interview and ask people questions. The more one is encouraged to cultivate those skills, the better one becomes in interacting, and being able to pick up signs of deception and signs of truthfulness. One has to be able to learn functions beyond audit. And one should marry what one has with some more IT, not necessarily delving into the IT audit realm but one can become the conduit between those two areas. These are just examples but interviewing is the number one important skill for anybody in the audit team.

Question

Ms Yip said that she really wanted to know how one does an interview and asked for some tips.

Answer

Ms Korris said it is not just interviewing. It is important to investigate the time period before the incident occurs because that is what usually defines the motivation for the crime. She would ask people to give an account of everything that they did from the time they woke up to the time they went to sleep. It was not for her to determine when the incident started. Her experience was that if an incident happened at 2pm, for example, that is the only time most interviewers were interested in. However, fraud was not something that happened in an instance. It takes time to occur, and by asking the question above, one is able to determine more easily when and why the incident occurred. One is able to determine the predicating factors that built up to the fraud. For example, there may be tensions in a relationship, or money problems and these might be the factors that led to the fraud. Most investigations require one to make assumptions about what happened. The questions are based on those assumptions. But what happens if the assumptions made were incorrect? The fraudster will know by the questions asked, what the interviewer knows.

One example was the OJ Simpson case. OJ Simpson was asked by the Los Angeles Police Department (LAPD), “Did you kill Nicole Simpson and Ron Goldman?” His reply was “I never killed two people” and he was telling the truth. That response was taken by the LAPD to believe that he was denying both. He was not. He said he did not kill two. That becomes the clue to the interviewer to ask the next question, which is “Which one did you kill?”

Question

Ms Yip then asked if one also looks at body language and the non-verbal signs.

Answer

Ms Korris said that she was not a fan of body language because she travelled all over the world and there are so many different cultures that it was difficult to understand the body language. She would much rather take the statement from somebody and then adapt to that.

Question

A member of the audience then asked Ms Korris that in terms of fraud investigations, did she think that Internal Audit was the right party to conduct the investigation, especially when one talks about handling of evidence and so on.

Answer

Ms Korris said that with some components yes, and with other ones, no. This is because usually it is Internal Audit that has the continuity of knowledge to build the case. In terms of handling the evidence, she said it was something that anybody could learn and she did not think it was that complex a measure. She said that she did not think it should be only Internal Audit handling the case, but a lot of organisations by default ship it to Internal Audit. But Internal Audit has to play a role for the continuity of the case and also because Internal Audit carries more integrity of the organisation than an investigative department, but the two have to work hand in hand.

Ms Pagdanganan said that she did not think Internal Audit should be the one to handle the investigation, but as Ms Korris was saying, in some instances where one is able to find something then one immediately works hand in hand with other organisations to make sure the right expertise can be brought in. She said she had come across instances where she had worked together with the investigative department and come up with a good report not only because the report cited the root cause, but audit was able to come up with the deficiencies.

Ms Korris agreed but said that the bottom line is that the investigators are not trained either. There is a great void in the entire process of fraud investigation. But also it is not who conducts it, it just defaults to the easiest organisation whether it is audit or external investigators because they have those in the organisations. One does not just have to investigate it but has to be supported. She has been doing training that is compulsory for upper management, audit committees, auditors, investigators, HRs and legal. Sometimes the greatest impediment to an investigation is the HRs department. It is an entire area that has room for improvement not only in Asia but globally.

Ms Pagdanganan said one of the things they had done was to get all the auditors and the investigators for training and they would get the basics of evidence and what to do. It starts with training, education and certification and then continues with specialised training.

A member of the audience then said that if one were to go back 15 or 20 years, one can see that many activities were conducted under Internal Audit and when it became more significant a separate function was established. If one goes back 20 years, Internal Audit used to look at customer complaints and when it became important a customer service function was established under the management. Then Basel came out with a paper to separate compliance and subject it to internal audit. If one goes further, risk management used to be part of Internal Audit and then it became important enough to separate it from Internal Audit. For banking especially, investigation also becomes a separate function and most medium and large banks have a department that is not only for investigation. It is in two parts. For the investigation they have lawyers and people with a legal background who chase the case until it becomes a police case. They have another part which is anti-fraud which manages the fraud risk. They carry out a fraud risk assessment to find out the critical area and what kind of prevention they need to do. From a conceptual point of view if any activity is needed to be done and there is no one to do it, it goes to Internal Audit. Later on when it becomes significant or important or Internal Audit finds that it is breaching their independence or exhausting their resources they need to give it to management.

Ms Yip then asked Mr Ranjit if he had anything he would like to share.

Mr Ranjit said that he would look at fraud as well. When he set up the forensic department in KPMG, he was transferred to Internal Audit to set up a forensic practice. What he found was that generally the internal auditors that they had and even some external auditors they hired did not pass the test of really being in a forensic department. From his experience he found that one could not have all internal auditors do the investigation. He thought that a combination of people was required and the combination should comprise someone with a financial background because a lot of the cases deal with financial issues. Also, someone with good interview skills was required and he found that people who conduct good interviews generally are not internal auditors. It is generally those who come from the police or the MACC. Having said that, he thought technology also played a very important part as an IT expert is also required to track deleted information from laptops and computer systems and so on. Also a lawyer is required to make sure one has the evidence.

Coming back to the tools, Mr Ranjit said there was a survey done which involved interviewing many CAEs and what they found was the skills which the internal auditors actually lacked. Top of the list was presentation skills, followed by persuasion and interviewing skills. What he found was that they come out with audit reports and then go through these in the following year to make sure that the outstanding issues have been resolved. They force the management to make sure they have implemented the recommendations. At the end of the day, if he came up with an issue, he would want to motivate the management to make sure they addressed the issue. An issue with negative connotations could be changed to sound positive to motivate the management to implement the recommendation. That is a skill which needs to be taught. When one talks about tools and skills he thought those are the areas to be looked at. When it came to presentations, when dealing with the audit committee or the board, they do not have time to listen for long, so the presentation must be such that it covers all the necessary issues. He found that with internal auditors, these were some of the areas where they need to improve on and then one can look at whether to move into forensic accounting. There are other skills required and one really needs to be trained. There is usually one opportunity and if that is missed the next time you come back, that information is destroyed.

Ms Pagdanganan agreed with Mr Ranjit in terms of communication. That is very important to add value and be able to convince senior management that change needs to happen. Unfortunately this is one of the skills that are missing in companies. So what has happened with auditors is that they conduct training on presentation skills, interviewing techniques and even have mock debates where there is a band of people who pretend to be management and auditors are taught to make presentations to them. So they challenge the auditors and say okay they have found a problem, two minutes is the time you have to explain what has happened. Going back to the "so what", technology auditors talk about access controls that are lacking or that the configuration is not okay. So, what applications have been impacted and if they say it is a procurement application or an expense application, again what magnitude are they talking about when compared to a payment system that is moving millions of dollars? The communication and the ability to articulate the "so what" for findings and exceptions is very important. Moving on to other tools, one of the things that is very important for banks because they deal with millions of data is automated auditing. One needs to be able to analyse massive amounts of data to bring out the exceptions. She felt that this is an area where many audit departments are lacking. The Chief Auditor in Citi said that there were a thousand of them globally but only 120 are IT auditors and the chief auditor wants to make it 200. So he wants to double it, which is like 20%. But 20% is not enough with the increase in technology and the pace with which technology is moving. The number should be increased and there should be Computer Assisted Auditing Techniques (CAATs) teams who work with the product auditors because one cannot be siloed. These are not new tools; they have been around for ages. It is just that they have not been used to maximise the efficiency.

From the floor, one speaker added that with communication tools and techniques, one of the techniques that are getting very high interest is extrapolation where instead of reporting some issues in an accepted way of audit findings, they extrapolate on the bank level and it becomes very interesting. He thought also in communication, an audit report is not only the product of Internal Audit, but also as mentioned, the presentation and the way one communicates the issues and sells the issues to stakeholders are very important.

Effective Utilisation of Audit Resources

Ms Yip said that when one talked about utilisation of resources one should first look at what the resources are.

Ms Pagdanganan said that the key resource is people and when one talks about effective utilisation there is only a finite number of resources. Again depending on the size of the organisation one may have an audit team of one person all the way to an audit team of one thousand. How does one effectively utilise auditors to be able to meet the requirements of the stakeholders, the audit committee and the regulators? That is where risk-based auditing becomes very important. One talks about audit deliverables and sometimes one does not identify the universe correctly. There are some things not audited because the auditors do not see them and there are some things one does not like to audit because one does not know them. The first thing to look at is whether one has all the entities one wants to audit. Then one has to risk-assess all of these entities. In her organisation there is a risk scoring mechanism. They put in various inherent risks for each entity and come up with any mitigating controls or any regulatory comments, ask whether these areas have been audited in the past. The score determines the risk rating of the entity. Also, there is a debate that one is not looking at low risk items, for example, one considers that procurement carries no risk but suddenly a fraud occurs there and the question will be asked, "Where were you?". But that is the only way to utilise one's resources to prioritise and risk-assess. The next thing that she mentioned earlier on was dynamic auditing and the ability to change the audit plan. So as events occur and one is able to do a post mortem and decides one wants to look at other areas, then one should also be able to remove some items from the audit plan and substitute them with those that have higher priority.

Question

Ms Yip said she had a question for Mr Ranjit. These days there are so many mergers like bank mergers for example — what about resources — internal auditors?

Answer

Mr Ranjit said that the resources also merge. One has to look at the number of internal auditors whom one has. Every year one does a run down on the electronic functions of Public Limited Companies (PLCs). What he found was when he analysed the costs of Internal Audit functions which are now a disclosure item in the annual report, he found the costs of Internal Audit functions in the top ten companies seem to be quite a big figure. The top three companies like Sime Darby, Maybank, and CIMB bank when compared to other organisations like Multi-National Companies (MNCs) — their cost is so much more even after converting the currencies. He said when they merged, they put the internal auditors together. Whether they are moved around is another question. He guessed it was a matter of how internal auditors were utilised. The board and audit committee always want an added level of assurance. Even they want internal auditors to look at compliance areas. But then one looks and says is compliance really the responsibility of internal auditors or is it the responsibility of the management team itself in making sure that all areas of the bank comply with certain standards or regulations? Who is responsible — is it the internal auditor or is it management? What he found that around the world was that it is management who took responsibility. They have their own compliance team dealing with this. The internal auditor just makes sure that it is done. In the Malaysian environment, he still sees that for the Quality Assurance Reviews (QARs) he has done for one or two banks and also for the larger organisations and PLCs he found that internal auditors do compliance in a big way. And then management questions why the Internal Audit cost is so high. It will be high if you allow internal auditors to do all this. Whether internal auditors should do compliance work is another question. He believes internal auditors should be used for high risk areas. For compliance one should just get graduates to do the work. Using an internal auditor to do compliance is not a good utilisation of resources. If one looks at Microsoft, the head of Microsoft said they only had 50 internal auditors and out of those, 10 were investigators and 10 were on special jobs. So in actual fact effectively, they only had 30 internal auditors. They managed with only 50 auditors by using technology and they only focused on areas that were critical, not on compliance which they passed back to management. It is a question of balancing what internal auditors should do and what they should not do.

Ms Korris said that Mr Ranjit talked about the biggest challenge being the internal auditors' resources. So the question has to be asked, if human capacity is going to be a constant source of frustration, that internal audit could always use more people, why cannot Internal Audit audit human capacity in an organisation? It is a huge issue and a huge risk to any corporation whether it is a bank or in the government; it does not matter. She gave an example of one government department that she managed. She noticed there were a lot of people not showing up for work so she started taking attendance. On any given day, she had 37% absenteeism and this was for a department that collected child support payments. So, number one, what did that cost the government every single month? It was interesting because one could always peg people who did not come to work on a Friday or a Monday. Out of the 112 staff she had, 15 of them became so skilful at every leave they could take. They only had to come to work 40% of the time to garner 100% of their pay. Why do internal auditors not audit this? Because if one did, she believed there would be more resources for auditors. This is a very general component of what one could look at. The more she heard about revolutionising Internal Audit and where it is going, she was always hearing that the first solution is to mechanise more. She was not entirely convinced that that was the way to go about it these days.

A member of the audience then commented: when one had this moving in and out of the audit management programme so to speak, a word of caution is if one overdoes it where he is coming from the subject of independence arises. If one knows that he will eventually go back to the business and there is a hot potato on the table or his hand, he will just leave it. So that is one point to be treated with caution. In general, it is a good way of training people with a control mindset and also part of the management programme.

Ms Pagdanganan said it was a very good point. One of the things that they have tried to also implement is if one is joining audit for example, one cannot audit the team one has come from for at least one year. That is why the chief auditor wanted not just a rotation of people but also a rotation of auditors. If an auditor has been looking at one department for say seven years, he would want the auditor to look at something else because independence is still very important.

One of the speakers on the floor wanted to go back and look at the education for the new internal auditor. If one looks at education for the past 25 years, what has happened is that in those days, if one wanted to become a professional, one finished high school and became articled for three or four years, depending on the profession. After all those years of slogging, one became a Chartered Accountant or another professional. But the training now has shifted to universities and that is one reason why the IBBM which used to give professional exams in those days, dropped these. What has happened is that more and more universities have come up and they are doing more of the professional courses, but not professionally. They are doing these academically. The problem is if one wants to have education for professions one has to teach it from an outcome-based education point of view which means imparting skills during the academic years. This is because it takes three to four years to get a graduate degree. Unfortunately most of the graduates coming out do not have professional skills. One cannot replace this during training. An employer does not have time to train. But least they should help graduates achieve a certain level of competency when they come to the industry. For example, if one is talking about specialisation of resources, it can be done at the employment stage. The way the education is going nowadays is a dysfunctional system in operation. If one wants to be a professor one has to publish, but if one wants to be a good teacher one has to research into teaching methodologies and assessment methodologies and develop cases. This is something for the internal auditors to do because one does not encourage lecturers or educators to come up with a system of teaching and training and education so that one produces professionals. One does not have time to come up with suitable training materials or education materials. For example, regarding interview skills, there should be role play or interviewing in the class. If the industry wants at least partially competent people then the education has to go that way. Otherwise it is best to go back to a three- or four-year degree and perhaps take the training to the work place.

The Meaning Of Audit Transformation

Mr Ranjit said it was important that one moves towards risk-based auditing. When he did his quality assurances reviews for organisations, and especially for the banks he had done, one thing they tell him is that they are doing risk-based audits. When he went and looked at what risk-based auditing they were actually doing, he quickly found out that it was not risk-based auditing. They were doing a lot more work in areas which were not strategic in nature, or areas which could probably bring a bank down and these were the critical areas that they needed to focus on. To do a good risk-based audit, the risk management function of a bank really must be good enough to provide the necessary information as a starting point for the internal auditors. How does one transform internal auditors to do a risk-based audit? Even looking at the cases whether in Malaysia or overseas, a lot of times the issues are not really at the branch level. The bigger issues are actually at the Headquarters (HQ) level. There seems to be a lot of time spent at the branch level and he wondered why. Was it actually a risk-based approach? While there may be a fraud in the branch area of maybe a million or two million dollars, when a fraud takes place in the HQ level it could be in the region of hundreds of million dollars. When looking at cases like Barclays, the fraud happened at the HQ. Even for the Malaysian cases, the fraud is always at the HQ level. At the branch level the figures are very small. So how does one transform Internal Audit to areas where there are high risks and whether one is actually trained to look in those areas and whether one has people to move towards those areas is a question that has to be asked. If one is not, then how does one move towards that? Does one really understand what risk-based auditing is all about? That becomes a critical question.

Ms Korris said that Mr Ranjit had brought up something interesting. What is fraud? If one looks at fraud at the branch level in the earlier example that Mr Ranjit gave that it is only a million or two dollars but at the HQ level it could be much higher than that, does that mean one does not care about the million or two dollars? A lot of times when one hears fraud, it is only a fraud if it is one of the top 5% made up of Barclays, whatever scenario it is. But is fraud not fraud at the million dollar level in the branch as well? And that is what she heard all the time, that everyone just wants to talk about the huge cases and what role Internal Audit plays there. But she thought Internal Audit plays a role in any fraud and whether one wants to deal with it or not, she still thought that any fraud is Internal Audit's business.

Mr Ranjit said that at the branch level, it would probably be looked as an ethics issue rather than a fraud issue. He then gave an example. In one of the organisations where they were doing a quality assessment, they had various subsidiaries and listed companies within the group, one of the issues he argued with Internal Audit was one where a senior manager had over-claimed toll charges. In that situation, the internal auditor said that it was misappropriation or cheating which warrants direct reporting to the audit committee. Here one has the audit committee members and they are looking at multi-million dollar issues and the auditor comes in and says he has an issue with a RM30 case. Does he expect the committee to spend time on that issue? He then told the CAE that if he really wanted to bring up the issue, well and good. He said that the way the issue should be brought up is not the issue of the RM30 anymore, but more of an ethical issue of that particular department or that particular organisation. Mr Ranjit would then do a scan to see whether the issue is one in the other departments or it is just an isolated situation. If it is just an isolated situation, then management could deal with it at that level. But if it is an issue of ethics which cuts across the organisation, then it is not just an issue of value anymore. The issue is now of ethics of the organisation which is a big issue and has to be dealt with by the audit committee.

Ms Pagdanganan thought what Mr Ranjit was saying was adding value to the table and she agreed with Ms Korris that every case of fraud or breakdown should be looked at. But again, given the resources, one really had to switch to risk-based auditing and if one is finding certain things one maybe does a thematic review to see whether it is happening elsewhere and if it is happening elsewhere, then one is able to bring more significant issues to the table. It is not something that one just leaves. When people talk about branch fraud, it happened with Citi last year. It happened in a few countries and a few branches. They decided that maybe they should look across the region to make sure. At the end of a three or four month period, they came up with a report which gave management all the systemic issues that were at the branch level.

Moving on to Mr Ranjit's point about transformation, Ms Pagdanganan said that in the last two days the talk has been about value. Everybody asks what is the value that audit brings. The value that audit brings is the change that they bring to the organisations for organisations to become better, and more profitable because at the end of the day that is what one wants. One wants to become more profitable to give value to the committee, to bring value to the board to protect them and to give value to the shareholders. So that is the value audit brings. When auditors find things, how does it bring value to the organisation and how can they transform what is being found to become something of value? The way she looked at it was transformation from tick box auditing or compliance checking to value-add, leading edge and real time auditing.

Mr Ranjit then said there were two more areas. The second part of the Internal Audit definition talks about internal auditors having to evaluate and enhance internal controls, governance and risk management processes. He thinks they did very well on the internal control part of it, but he does not get the feeling that enough is being done in terms of looking, evaluating and enhancing the risk management function, the risk management activity or the governance area within a bank. If one has not audited the risk management function to one's satisfaction and is going to rely on the work that they do, then one will also be in a very difficult situation. The other area is governance which is also very critical because governance touches areas of board of directors, and their effectiveness. One can have all the internal controls one wants, but if the board of directors is not active, what is the use of having effective internal controls? How does one go and tell a Chairman that he is not effective? It is a difficult part, but something that is provided for in the internal audit definition. How it is carried out is very critical because it is the tone at the top which then starts off and creates the environment of the organisation. If one is not looking at that, then what does one need to look at?

Ms Pagdanganan said that the governance audit is looking at the local subsidiaries to make sure that they meet the requirements. It is very difficult to question the competence of the board. It is easy to look at attendance, at whether they were following the local incorporation rules and local corporate law or not. She rarely sees a comment which says that the board is incompetent and not doing their job. What is interesting is when one looks at Japan or Korea, they have what they call the standing auditor. Part of their responsibility as per law is to comment on the board. She thinks it is one area where auditors really need to step up and that is the transformation that is expected. The other question is where one has a risk officer who is taking risky deals, does one have an auditor who can tell the risk officer that he disagrees with him, and that he should not be taking those risks?

Question

One of the speakers on the floor then questioned about the two roles of risk and audit. He wanted to ask how to integrate them with the operational risk. He wanted to know where operational risk stops in their work and where audit then takes over.

Answer

Ms Pagdanganan said in her organisation they work hand in hand with them. One of the things they were trying to do and work on was the common risk language. Sometimes the language of risk is not the language of risk for auditors. In her company operational risk is looking at specific events. For large types of events, they do deep dives for certain events and they do end-to-end audits. So they do not audit everything. If operational risk has looked at that already, then they do not repeat that but just leverage on their work. This is not just for risk but also compliance because there is compliance monitoring and testing and sometimes there is duplication as well.

Question

One of the audience said that a previous speaker had said that Internal Audit was always looking backwards. If management decided to dance in a tiger's cage (in other words, take risks), there is nothing much Internal Audit could do. How does one tell management or how does one audit Risk Management in the same perspective?

Answer

Mr Ranjit answered that when one talks about the future of Internal Audit, what he said was that Internal Audit was always auditing historical information whereas the risk guys are always looking at what can happen in the future which can affect the strategy or objective of the organisation. He said that when the bank introduced new products, internal auditors should get involved in the process and start thinking about what could go wrong and putting the internal controls in at that point in time. The auditors always asked Mr Ranjit what would happen if they suggested something, and a product was introduced and subsequently there were still some weaknesses. He said to him what Internal Audit had done was already part of enhancing the internal control process. The following year there would be new challenges. There is no way anyone can say that the internal auditor has not done his job. It is just that sometimes certain things cannot be seen at that point of time. If one gets involved in that, it is no more a hindsight — internal auditors are suggesting how some of the areas can be better controlled and managing the risks that one is going to take for a new service, product or investment per se. That is important in terms of moving forward.

Secondly on the management, Mr Ranjit said the governance area is critical. If you do not have governance, one can have all the internal controls but if management decides they want to do something otherwise, it makes it very difficult for Internal Audit. So one should make sure that the governance area is covered first to make sure that right from the top the tone is proper and all the good practices start right from the top.

Ms Pagdanganan said that there is nothing that stops one from moving forward, and some of the things that can be done to move forward are getting involved in new products and in pre-implementation audits. They do a process which they call business monitoring which monitors the business on a quarterly basis and if one sees risk there is nothing that stops one raising it to management. Nothing stops an auditor from having a conversation with senior management saying one sees a risk and management might want to look at it. This is what stops Internal Audit from becoming a dinosaur. As to the point that the internal auditor knows something is wrong but management still wants to do it, if one is truly independent, reporting straight to the audit committee will be the avenue.

On the second question of auditing Risk Management, one has to have competent skills in Internal Audit is to be able to have a good discussion with the risk manager and say that one is not happy with the market risk he is taking. It has to start there before one starts challenging them. After that one also has to look at the framework of risk management to see if they have the adequate tools and the adequate inputs. Credit risk is another example. One has to have people who have approved credit to question the credit managers and that is the only way one will be able to challenge them, if one has the people who understand the risks and the issues.

Question

The person asking the question said that the perspective of his question really was that auditors were far remote these days, as opposed to being connected and staying connected. And to be able to stay connected and continue to be in that manner, how does one stretch one's self? He said he was quite perplexed to see that auditors were still being seen as backwards rather than going forward in the slides that were presented.

Ms Yip then commented that auditors were quite current and going forward, and it was the management that was backwards. She said it was an issue of perception.

Ms Pagdanganan said that if it is a perception thing, to some extent it is also a sales pitch and is also an advertisement for audit. One has to have the right people sitting at the right tables and being engaged in the right management meetings to be able to have a say. For example, in her company, they had meetings for the whole country, it was called the country coordinating committee and the auditor sits there. But if one sits there and keeps quiet for the entire two hours, then management's perception of auditors will be that they are just occupying a chair. Now the mandate being given by the chief auditor is that every person who is representing audit on every single committee or every single meeting needs to be the right person and needs to add value to that meeting. The other thing he is mandating is anything that is being spoken about audit, whether audit results or audit findings, has to be reviewed and vetted by him. She agreed that auditors were current and knew what was happening but sometimes auditors did not talk enough to managers. If they do not want to talk to auditors, let the auditors talk to them.

Ms Yip commented that presentation and personal skills come in and management has to do a bit more listening.

Another speaker from the floor then commented that as Mr Ranjit had said, up to now the perception of audit is looking backwards. Here there was a group of auditors comprising advanced people as well as a group of people who are probably backwards. He said that more importantly, based from the slide that was given the day before, where one has to learn the business and one has to speak the same language as risk, is what one is trying to aim for.

With those comments, the session was wrapped up by Ms Yip. She said that there were so many things going around and also the government has said that it is going to raise the retirement age to sixty. We are going to have Baby Boomers, and Generations X and Y coming up. The younger generation is now working until five o'clock and looking at work-life balance. But the older generation still stays back until midnight and continues to do their audit jobs. Moving forward one calls this an audit transformation, and she heard that HRs are the most important part of Internal Audit. What can be done now may be one point for the audience to sit down with the boss and talk about it and see what could be done better.

Ms Pagdanganan said that internal auditors were in a unique position within all of their organisations. They actually knew more than they thought they knew and they were actually more capable than they thought they were capable of. So what needs to be done is to harness what one knows and one needs to talk and advertise, and one needs to add value in order to bring one's organisation to a better place.

Mr Ranjit said that he wanted to give further assurance that the internal auditor definition had not changed for 10 years. Even when they set the definition then, they talked about internal audit being a consulting activity to add value to the organisation. When they came out with that definition, the only thing they had in mind at that point in time was to move forward as a consultant in providing good advice to add value to the organisation. They then went on to talk about governance and risk management which was very critical. If that is taken one step forward, one finds that Internal Audit is really going towards that direction in terms of adding value to the organisation. But they are going to change the definition as he understood it. Some of the changes they want to make to the definition are whether Internal Audit is a consulting activity or it should be an advisory activity. The debate which is going on is that consulting activity should be seen as independent and objective. They are having a debate about whether it should be two words or just one. The other debate is whether the definition is too long. So with all these activities going on, the point is valid that Internal Audit should start moving forward. He thinks that IIA has done all they could to get internal auditors to start to think in terms of how to move forward and add value. Sometimes one of the things one always looked at was knowledge in best practices and if one does not think enough one would not be able to suggest best practices or better practices. Coming back to the question of the youngsters not really wanting to work, he said it is not a matter of not wanting to work long hours. He said that if one worked effectively between 8.30 and 5.30 and did not have any personal calls during that time, one could still go back early. He said, however, that if the time at work was spent on personal matters like Facebook etc. then it is not acceptable. He said he had found that while youngsters wanted a work-life balance, they also had good work ethics. They worked effectively and got the job done. Some people who worked long hours did not have the productivity.

Ms Korris said that a lot of times she was hired by the management or audit committee to go in and when she worked with the audit teams of the corporations, communications disconnect happens every single time. Many times she felt that she had been the broker of information in between both parties. She thought it was really interesting to try and get that dialogue improved between audit, the audit committee and management. One of the things she liked to suggest was that the organisation take the lead and start a conference like this by having a joint session of their audit teams and having somebody from management or their audit committee spend two hours together in the morning bringing some of the key issues up, and this is not just audit saying this is what they are looking for. So this was her idea of what she would like to see and maybe this was the forum that could start that kind of dialogue.

This ended the discussion and Ms Yip also thanked the speakers from the floor who had commented on the issues.

Closing remarks from CIANG chairman Mr Joseph Chan, Head, Audit, OCBC Bank (Malaysia) Bhd

Mr Chan said that first of all as Chairman of Chief Internal Auditors Network Group (CIANG) he liked to thank all those present who had made time to attend the first ever conference for internal auditors, and also thanked the speakers who had provided insightful and thought-provoking ideas on the various topics covered over the last two days. The topics could be quite loaded in a sense. He said that if further clarification or information on these topics was required, this would be provided to all. The other party that he would like to express his thanks to was the fellow committee members who had given their inputs and thoughts in organising this conference. He said the CAEs had spent a lot of time on all the topics covered. He also thanked the IBBM, and Ms Chow and her team for organising the excellent conference.

He said the key message in the last two days was really about change and how to embrace change and enhance audit skills and so on to ensure that IAs remained relevant to the industry. On this note he closed the conference.

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