IDEAS FOR LEADERS | **DECEMBER 2015**

banking insight

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ROLE OF HRM, HRD AND TRAINING IN **ORGANISATIONAL SUCCESS**

Ethics and Banking – Ten Lessons from the Financial Crisis

BACK TO BONDS?

CHINA'S SHADOW ON ASIA

China's economic slowdown is impacting global growth and trade partners in the region.

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Editor's Note

STRATEGISING IN A VUCA WORLD

WE LIVE IN A WORLD awash with acronyms. It appears that the banking and finance sector alone has an acronym for every letter of the alphabet.

One abbreviation that has been dominating business headlines lately is the US military-coined VUCA – Volatility, Uncertainty, Complexity, and Ambiguity. We operate in a landscape where VUCA is the new normal; hence, how should we strategise to ensure our perpetual sustainability and relevance?

Shifting geopolitical dynamics are part of the external conditions driving VUCA, and China is a major global actor. Continuing Chinese hegemony and its ongoing efforts to integrate into the global economy means that the Asian behemoth's influence is waxing despite its softening economy. Indeed, its recent actions to curb speculation and ensure sustainable growth going forward will impact the rest of the world, especially Asia whose export markets and supply chains are inextricably intertwined with China. Taimur Baig, Managing Director and Chief Economist, Asia, Deutsche Bank Research, assesses the likely impacts of China's economic decisions going ahead and how these might affect the health of the region's financial markets.

Still in the Sino vein, we assess the potential of the new Asian Infrastructure Investment Bank (AIIB), which will join the ranks of multilateral financial institutions such as the International Monetary Fund (IMF), the World Bank (WB), and the Asian Development Bank (ADB) as of end-2015. What are the risks and opportunities to the AIIB in its quest to fortify China's clout in global finance and to amass influence to balance other world powers?

While geopolitics will shape the prospects for financial markets and all stakeholders involved, innovation and technology are an equally disruptive force to be reckoned with. Jungyeon Yoon, Professor at the Korea Banking Institute, argues that "the development of fin-tech has become the most important influencing factor in the banking industry in recent years." While fin-tech presents challenges to the incumbents, there are certainly opportunities in the wave of digital disruption. The bottom line: we need to integrate ourselves into innovation ecosystems in the fin-tech industry in order to capture growth being driven by new services and productivity, or risk becoming obsolete and irrelevant.

We will also require new paradigms of thinking in the new VUCA order. While finance and banking traditionally emphasise left brain skills, Rajeev Peshawaria, CEO of the Iclif Leadership & Governance Centre writes that in today's 'conceptual age', right brain acumen along with the ability to think in an integrated fashion will be equally if not more important. Meanwhile, Professor Nassim Taleb, author of 'Black Swan' advised that markets and investors must become "antifragile" in order to be resilient in VUCA conditions. Read more on their iconoclastic ideas up ahead.

Lastly, despite all the learning and innovations that we embrace, the banking and finance sector can only become genuinely sustainable in a VUCA world if we understand and implement one fundamental lesson from the financial crisis: that banking must be conducted with principles, ethics, trust and integrity. Sharing his insights into ten key lessons from the financial crisis of 2008, chartered banking trainer and consultant Robert Souster exhorts a banking sector whose policies, people and products are under siege, to promote a new dawn of ethical banking. This is the clear route to banking sustainability. ✱

Hope you have a fruitful read.

The Editor

+ Shifting geopolitical dynamics are part of the external conditions driving VUCA, and China is a major global actor. Continuing Chinese hegemony and its ongoing efforts to integrate into the global economy means that the Asian behemoth's influence is waxing despite its softening economy.

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The views expressed in this magazine are not necessarily those of AICB or its Council. Contributions including letters to the Editor and comments on articles appearing in the magazine are welcome and should be sent to the Editor. All materials without prejudice appearing in Banking Insight are copyright and cannot be reproduced in whole or in part without written permission from AICB. *Note:* All information provided in this publication is correct at the time of printing.

RMB IN SDR BASKET Effective 1 October 2016 the RMB is determined to be a freely usable currency and will be included in the SDR basket as a fifth currency, along with the US dollar, the euro, the Japanese yen and the British pound, stated the Executive Board of the International Monetary Fund (IMF). Launching the new SDR basket on 1 October 2016 will provide sufficient lead time for the Fund, its members and other SDR users to adjust to these changes. ✱

RETHINKING RISK MANAGEMENT

RETHINKING RISK MANAGEMENT: Banks Focus on Non-Financial Risks and Accountability, the sixth annual survey of banks carried out by EY and the Institute of International Finance (IIF) noted ongoing effort and investment aimed at strengthening risk culture. Reinforcing accountability for non-financial risks and conduct risks among the front office – desk heads and business line heads – is the primary focus for most banks, with

77% (compared to 68% in 2014) listing it as their top initiative. Banks also face a high cost of non-financial risks, which include regulatory, conduct, money laundering, compliance, systems and reputation. Sixty-nine per cent of global systemically important banks (G-SIBs) surveyed reported losses from non-financial risks (including regulatory fines and penalties) of more than USD1 billion during the past three years. ✱

ANNUAL GROWTH of Islamic bank assets in Indonesia, home to the world's biggest Muslim population, dropped to 8.1% in June from 12.4% in 2014 and above 20% in the previous two years. *(Source: Reuters)*

GLOBAL *SUKUK* ISSUANCE in the first nine months of this year totalled

USD48.8 billion

down

40%

from a year earlier. *(Source: Reuters)*

FUTURE-PROOF CAREERS

ACCORDING TO the latest 'Hays Quarterly Report' of skills in demand, 'future-proof' professions include:

- ***Finance Technology:*** Employers continue to scout for software development professionals, infrastructure experts, project services candidates and senior managers. Digital remains an area of major focus to help companies further refine the customer experience and expand their e-banking and online solutions, creating jobs for project managers and UX candidates.
- ***Banking & Financial Services:*** Across the board, banks are increasing their front-office trade and cash segments to build platforms for revenue generation. On the back-office side, senior trade finance professionals with CDCS (Certificate for Documentary Credit Specialists) qualifications are highly sought after. In the security services area, candidates able to cover fund operations, custody operations (settlement and reconciliation), transfer agency (including corporate action) and trustee operations are in demand. ✱

"Many large financial institutions are highly focused on responding to disruption. Incumbents are learning from challengers, adapting their offerings and identifying opportunities to collaborate with new players," said Giancarlo Bruno, Head of Financial Services at the World Economic Forum, commenting on the WEF report entitled 'The Future Of Financial Services: How Disruptive Innovations Are Reshaping The Way Financial Services Are Structured, Provisioned And Consumed'.

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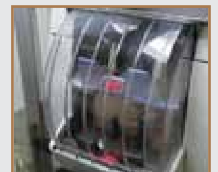

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China's shadow on Asia

CHINA'S ECONOMIC SLOWDOWN IS IMPACTING GLOBAL GROWTH AND TRADE PARTNERS IN THE REGION. TAIMUR BAIG, MANAGING DIRECTOR AND CHIEF ECONOMIST, ASIA, DEUTSCHE BANK RESEARCH EXAMINES THE REGIONAL IMPACT OF A SLOWING CHINA.

As the largest source of global growth, China plays an overwhelming role in regional economic dynamics and markets' outlook. Over the past couple of decades, China's strong growth and large scale have pulled up the rest of Asia, supporting regional income and employment considerably. Indeed, during the global financial crisis in 2008/09, China was an invaluable source of stability for Asia's export-dependent economies while key trading partners in the industrial world underwent steep recessions.

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ASIAN OUTLOOK

But with China's momentum fading, Asia has some major challenges ahead. Already, taking into account an extended period of disappointing data flow and lack of improvement in the external demand outlook, we have scaled back the 2015 growth forecasts for Asia. We began

The downward growth revisions reflect the poor performance of exports so far this year, and also the lack of dynamism in domestic consumption and investment. While regional giants China and India's forecasts remain unchanged, we recognise increasing downside risks there as well.

the year expecting regional (ex-China and India) growth to pick up to 4.5% (from 4.1% in 2014), but we have been compelled to make repeated downside adjustment to our forecasts as both domestic and external demand conditions have progressively worsened during the course of the year. As a result, our EM (emerging markets) Asia (ex-China and India) forecast for 2015 has been revised down by 90bps (basis points) to 3.6%.

The downward growth revisions reflect the poor performance of exports so far this year, and also the lack of dynamism in domestic consumption and investment. While regional giants China and India's forecasts remain unchanged, we recognise increasing downside risks there as well. India remains steady but lacklustre as an improvement in sentiment is countered by an investment malaise that reflects excess capacity and the weak balance sheets of corporations. With respect to China, there are two concerns: first, we see growth falling firmly below 7% from next year onward; second, as the economy recalibrates from exports and investment to domestic consumption and services that are less import-intensive, China's pull for the rest of the world may decline even more than the stated growth rates.

As far as the outlook for the rest of the year is concerned, we see public investment propping up growth in China, India, Indonesia, Thailand, and the Philippines. But for the open economies of Asia with substantial exposure to the global trade cycle, such as Singapore, South Korea, Malaysia, and Taiwan, downside risk from further export-related disappointment remains high.

The latest data shows that despite numerous headwinds, China continues to grow at close to 7%, although indicators such as power production, retail sales, non-oil imports, and fixed asset investment suggest an economy undergoing a major slowdown. Even if one takes the 7% growth figure at face value, the fact is that China is growing by 1.2 standard deviations below its 20-year trend.

It is not just the fact that China is growing well below trend, but from the perspective of those relying on Chinese demand, the additional complication is that the slowdown is rather recent. Even in 2011 the economy was registering nearly double-digit real growth, with trade, sales, production, and credit all growing at or above trend. Indeed, as recently as early 2014, the authorities were conveying expectations of 7.5% or higher growth in the medium term. The scaling down of expectations has therefore taken place over a short period of time.

IMPACT OF THE CHINESE SLOWDOWN

The impact on the rest of Asia from a slowing China is manifold. The most obvious spillover is through trade, with Asian economies increasingly exposed to demands for raw materials and finished goods there. Most economies in Asia have seen China's share of their exports rise by two to three times over the past decade. Initially, the rise in exports share reflected the consolidation of the regional supply chain with China as the hub, but as China grew and became wealthier, more and more goods stayed in China as final demand, increasing the region's vulnerability to the Chinese economic cycle. Of course, for the regional commodity exporters, China's investment cycle became the most important determinant of volume demand and price.

Take, for example, an economy like Singapore. A regression of Singapore's exports to real GDP growth in China, Eurozone, and the US, run with data from 1996-2006, show an overwhelming dependence on the US economic cycle, with estimates on China and the EU failing to be statistically significant. But

The slowdown in the EU and a still-fledging and atypical recovery in the US have hurt Asia's exports, but our data analysis of Korea and Singapore shows that a slowing China poses an equally grave downside. Since many economies in Asia are export-dependent, the implications for growth are also considerable.

when the sample is extended through 2014, the regression shows China's growth becoming a significant determinant of Singapore's export demand (both including and excluding oil). Since China is presently growing 2.5 percentage points below its long-term trend, the regression result would suggest that Singapore's exports face a 6% downside.

We find similar results with the region's export powerhouse, South Korea. Applying the same framework, the coefficient estimate is found to be in fact bigger than that of the US (2.9 vs. 2.1), which means Korea's export fortunes rely most on Chinese demand. This creates two sets of problems for Korean exporters. First, the downside to Chinese growth is the obvious source of risk. Second, as the Chinese economy recalibrates and its manufacturers move up the value chain, a reduction in demand for high-end intermediate goods (a phenomenon already in the making) creates further uncertainty for Korean exporters substantially dependent on China.

The rise in trade linkages *vis-à-vis* China has taken place at a time when global demand has stagnated and trade restrictions (particularly non-tariff barriers) have risen. Consequently, the Asian export growth rate has reached a "new normal," flattening in recent years whereas 10-30% growth was the norm during the most of the last decade. The slowdown in the EU and a still-fledging and atypical recovery in the US have hurt Asia's exports, but our data analysis of Korea and Singapore shows that a slowing China poses an equally grave downside. Since many economies in Asia are export-dependent, the implications for growth are also considerable.

Going beyond trade, a simple regression of putting each Asian economy's real GDP growth against the growth rates of China, US, and EU shows that many Asian economies have the highest growth "beta" to China. Strikingly, for Hong Kong, Indonesia, and Singapore, a 1% reduction in Chinese growth means 1% or higher downside to their respective growth outlook. This same regression, run a decade ago, would have shown Hong Kong and Singapore to be far more dependent on the US cycle, while for a pre-commodity boom Indonesia, external demand would have mattered little. China's inexorable rise in the meantime has made a number of economies in Asia highly pro-cyclical to their largest neighbour.

Furthermore, several Asian economies have seen their bank and non-bank financial sector exposure to China rise considerably in recent years. Trade and project-related loans to China have soared, amounting to around RMB1 trillion between the regional banking centres of Hong Kong, Singapore, and Taiwan. Lending to Chinese businesses appeared to entail modest credit and currency risk in the past; both such assumptions could be challenged in the period ahead.

Lending to Chinese businesses appeared to entail modest credit and currency risk in the past; both such assumptions could be challenged in the period ahead.

Finally, Chinese households and high net worth individuals have become a major source of support for the region's tourism (25% of visitors to Thailand, for instance, are from China), property, gaming, and wealth management sectors. Chinese businesses provide substantial capital to the region's markets as well. This type of exposure is relatively new, but as China slows, such exposure will provide a new set of challenges for Asian economies that have become increasingly dependent on their regional giant. ✱

■ *Taimur Baig, Ph.D. is Managing Director, Chief Economist, Asia, Deutsche Bank Research. Dr. Baig is in charge of the Asia Economics team, whereby his team prepares the analysis and forecasts of the ten key Asian economies. He advises the bank's management and clients about regional risks and opportunities.*
Prior to joining the bank, Dr. Baig spent eight years at the International Monetary Fund, based in Washington, DC. He studied at the University of Illinois at Urbana-Champaign, the London School of Economics, and Wabash College. He has published numerous articles and reviews on economic policy and analysis, including in Review of International Economics and IMF Staff Papers.

ENTER THE DRAGON

A PRESCIENT NAPOLEON BONAPARTE ONCE WARNED, "… WHEN CHINA WAKES, SHE WILL SHAKE THE WORLD." WILL CHINA'S NEW ASIAN INFRASTRUCTURE INVESTMENT BANK (AIIB) SHAKE UP THE GLOBAL SCENE FOR MULTILATERAL FINANCE?

+ The AIIB will provide several opportunities for China to expand its political influence and amass further prestige. Through the AIIB, China will have sufficient agenda-setting and decision-making powers within the international finance circuit, as the WB and IMF are dominated by the US and Europe.

The 21st century heralded the fragmentation of the global trade arena due to the proliferation of bilateral and regional arrangements as nations jockeyed for the upper hand and aimed at avoiding the stalled progress in trade talks at the World Trade Organisation (WTO).

However, a similar scenario has yet to materialise to the same extent in global finance, which remains dominated by a few main players - the International Monetary Fund (IMF), the World Bank (WB), and the Asian Development Bank (ADB). This status quo will expand by one as the prominent China-led Asian Infrastructure Investment Bank (AIIB) joins their ranks as of end-2015.

As its name indicates, the AIIB's mandate focuses on infrastructure financing. This is timely, as bridging infrastructure gaps could spur economic growth in a dismal economic landscape. According to a 2013 World Economic Forum (WEF) study, supply chain impediments diminish trade far more than tariffs, a structural flaw that can be overcome with better infrastructure - something Asia sorely lacks. As the fastest growing economic region, the Asian Development Bank (ADB) estimates the infrastructure investment gap at USD8 trillion for the period between 2010 till 2020; this is a void that cannot be filled by the WB and the ADB alone. According to the Chief Economist of the Asia Foundation, Veronica Salze-Lozac'h, in an article entitled 'To Be or Not to Be Part of AIIB', sustaining high future economic growth rates will require increased investment spending to maintain trade, regional economic cooperation, and connectivity. Both hard and soft infrastructure will be necessary, for example, in the form of roads, electricity, and policies and regulations ensuring that this infrastructure yields optimum results. She noted that "the AIIB's intention to support this much-needed infrastructure development is welcomed both by governments and by businesses managing ever-expanding regional and global supply chains."

JOINING THE CLUB

Given the dire need for developmental finance and constraints on resources, the fledgling AIIB has been warmly welcomed by its counterparts. At the opening of the China Development Forum in Beijing this year, IMF Chief Christine Lagarde remarked that the IMF would be "delighted" to work with the AIIB and that there is "massive" room for IMF cooperation with AIIB on infrastructure financing, sentiments that were echoed by WB President Jim Yong Kim.

The ADB is likewise on board with this new initiative, pledging to cooperate with AIIB and co-finance infrastructure development across Asia. At the 48th ADB Annual Meeting in May, President Takehiko Nakao acknowledged the large infrastructure gap in Asia, as well as infrastructure's pivotal role in supporting sustainable development and poverty reduction - the latter being the ADB's main goal. Takehiko assured stakeholders that the ADB would help execute this shared vision with AIIB by contributing "(the ADB's) long experience and expertise in the region" and will continue sharing necessary information; as of September 2015, both IFIs have begun identifying projects for co-financing.

While there have been positive overtures, it is understandable that some parties regard this new initiative warily. The AIIB may be a

Top China's Finance Minister Mr. Lou Jiwei chairs the Signing Ceremony of the Articles of Agreement of the Asian Infrastructure Investment Bank, held in Beijing on 29 June 2015. **Right** Malaysia's Ambassador to China signed the Articles of Agreement of the Asian Infrastructure Investment Bank (AIIB) on 21 August 2015 in Beijing. Malaysia is the 51st signatory of the Articles. **Photo source** www.aiib.org

multilateral institution devoted to financing regional infrastructure, but its existence will upset the geopolitical apple cart. While military might is a hard power tool, economics, trade, and finance have increasingly gained weight as soft power tools to further a country's agendas and manage alliances. China's AIIB proves no exception, since its influence will imbue the Asian giant with significant clout in global finance and allow it to amass influence to rival the United States.

Overtly, the AIIB will give China a more influential role in Asia, an intention Chinese Finance Minister Lou Jiwei apparently made somewhat explicit, according to Salze-Lozac'h. As noted in the Japan Policy Forum, the AIIB will provide several opportunities for China to expand its political influence and amass further prestige. Through the AIIB, China will have sufficient agenda-setting and decision-making powers within the international finance circuit, as the WB and IMF are dominated by the US and Europe.

Interestingly, Yun Sun from the Center of Strategic and International Studies noted in an article entitled 'China's AIIB Challenges' that the AIIB move alludes to an exercise in democratising the international economic order. For example, despite being the world's second largest economy, China's share in the IMF is a paltry 3.8%. Through AIIB, China aims to usurp the mantle of leadership in globally recognised International Financial Institutions (IFIs). The AIIB's focus on infrastructure financing and development, China's strong suit, will also help boost economic growth in a domestic downturn as it simultaneously exports excess products, secures resources, and diversifies China's investment portfolio.

Meanwhile, AIIB's existence could also pre-empt parachute economics, economic misdiagnosis and external interference. Revisiting recent economic history, the IMF's blanket prescription of further liberalisation contributed to the Asian Financial Crisis of 1997/98, which saw the downfall of the tiger economies. Therefore, a "distinctively Asian development tool" such as AIIB that seeks to match expertise and infrastructure supply to specific regional contexts may very well be a boon.

CHAMPIONING CHINESE INTERESTS

No country exists in a vacuum, and Asia is pivotal to China's continuing prosperity. Officially, the AIIB is an initiative conceived by President Xi Jinping and Premier Li Keqiang to "promote interconnectivity and economic integration in the region and cooperate with existing multilateral development banks," as reported by *Xinhua*. Xi acknowledged further that China's development could not have been achieved without Asia and the world.

The AIIB will also cement China's formal role in the global order. Over the past 30 years, China has contributed USD30 billion to combat underdevelopment. As noted by Xi at the signing ceremony for AIIB, the bank is China's next step to make "due contribution to world development," perceived as a moral duty that China seeks to uphold as it grows stronger. Proposed projects include China's Belt and Road Initiative, and its *modus operandi* is "lean, clean, and green". Staffed by an efficient and highly skilled small taskforce, the AIIB seeks to be an ethical organisation untarnished by corruption

and will implement policies taking into account the environment and sustainable development.

While its expressed aims are aligned with current expectations on good governance and sustainability, the legitimacy of the AIIB, and consequently its membership, will depend on its institutional processes. Currently, it aims to practice procedural justice, giving its members representation and decision-making power regarding the operational and governance rules of the bank. It remains to be seen how this will be applied, however. As things stand, the AIIB's executive powers are firmly in China's court. With 26.06% of the votes, China is the majority shareholder and has veto power, while India holds 7.50% and Russia 5.92%. The effective veto may translate into agendas being moulded to gain China's approval, perhaps at the expense of others' interests and the greater good. The power relations between major and smaller economic players may also surreptitiously sway opinion; with the main three shareholders being part of the BRICS coalition, agendas may be set in favour of some countries more than others, possibly alienating those who require infrastructure financing the most.

WHAT OTHERS THINK

Targeted to be operational by the end of this year, the AIIB was proposed by China in 2013 and launched in Beijing in October 2014. Already 57 countries, including Malaysia and Singapore, have agreed to become Founding Members.

While the absence of two major economic players may diminish the heft and influence of the AIIB somewhat, the benefits for other developed and developing countries outweigh this disadvantage.

Quick to defend their interests and expand markets, developed nations lined up to join the party. Twenty of the original 57 countries including the United Kingdom, Germany, France and Italy are from outside Asia. Some of these countries cited their reasons for joining as "business potential for their national companies," wrote HK Yong in ISIS FOCUS in a paper entitled 'Malaysia Can Vie for AIIB Projects'. According to *Xinhua*, ministers from other developed nations like the deputy prime ministers of New Zealand and South Korea respectively, Bill English and Choi Kyung-Hwan, praised the AIIB as a timely and important development in international financial cooperation. In their opinion, the bank will "address regional infrastructure bottlenecks and capital constraints, along with enhancing regional trade connections and interconnectivity."

Some countries have refused to participate, however - with the US and Japan being the most notable absentees. One of the Obama administration's biggest foreign policy plays is 'Pivot to Asia', but while this has encouraged amicable diplomatic relations and dialogue, it has not always pointed to inclusiveness between the two countries. Just as China has not been invited to participate in the Trans-Pacific Partnership Agreement (TPPA) - and instead launched its own FTA (free trade agreement), the Regional Comprehensive Economic Partnership (RCEP) - the US has decided to abstain from joining the AIIB.

Generally considered the US' most important ally in the region, Japan has continued its pattern of siding with the US even as the drive for regionalism in Asia grew post-Asian Financial Crisis. Several efforts to create regional institutions for the Asian community were proposed in the past, but eventually fell apart without the support of Japan, which was often constrained by its diplomatic obligations; the East Asian Economic Caucus, was one such example.

Nevertheless, although Japan declined membership in AIIB, the Japan-backed ADB has pledged its support of the AIIB, pointing perhaps to shrewd two-track

diplomacy. As it stands, however, the US absence at AIIB implies both countries' interests in keeping "each other out of their respective regional economic arrangements," wrote Chen Jingyang of the Asia Foundation in an article entitled 'TPP and RECP: Boon or Bane for ASEAN?'.

Moreover, the US views the AIIB as a challenger to its somewhat diminishing hegemony, especially in the international financial order: the AIIB offers another avenue for development financing, subtly undermining the legitimacy of the US-led WB and IMF, argued Economists for Peace and Security (EPS) on the Japan Policy Forum.

BENEFITS AND CHALLENGES

While the absence of two major economic players may diminish the heft and influence of the AIIB somewhat, the benefits for other developed and developing countries outweigh this disadvantage. This proves true for ASEAN as well, but only if their interests align with China since the AIIB may take a more pan-Asian view rather than focusing on ASEAN alone, noted Sanchita Basu Das, ISEAS Fellow and Lead Researcher for the ASEAN Studies Centre.

For instance, China's One Belt, One Road (OBOR) initiative, which will be

MALAYSIA AND PPP

Malaysia can capitalise on its strengths to make up the anticipated shortfall in funds for infrastructure financing, which may be a stumbling block for the AIIB. China has possibly overcommitted and overextended itself by launching not one but three IFIs including the AIIB. The New Development Bank (NDB) initiative started by the BRICS coalition is set for operation in 2016 and plans for the Shanghai Cooperation Organisation (SCO) for Central Asia have proceeded despite objections from Moscow; both are to be headquartered in Beijing and funded predominantly by China, noted June Teufel Dryer for the Foreign Policy Research Institute.

With its foreign aid exchequer divided three ways, and its initial capital of USD100 billion needing to be bulked up in tandem with future demand for infrastructure, the AIIB is predicted to "leverage its capital by tapping the large pool of international private sector funds through the use of Public-Private Partnerships (PPP)," wrote ISIS's Yong. As it stands, Malaysia has the largest PPP programme in the world. By creating a single organisation to channel and coordinate all this PPP knowledge and proficiency - especially relevant since Malaysia's PPP experience is more suitable for developing countries rather than developed countries - Yong contends that Malaysia can further capitalise on the opportunities afforded by this predicament.

Of course, these are not the AIIB's only options. To overcome funding setbacks, wrote Edi Ramadhan for Stimson Centre's Southeast Asia Programme blog, it can also rely on its vast foreign exchange reserves. China has also began exploring the viability of financing via *Sukuk*, or Islamic bonds, with Saudi Arabia's Islamic Development Bank (IDB).

funded by AIIB, will further integration in the ASEAN region and improve the Master Plan for ASEAN Connectivity (MPAC), as well as contribute to the bloc's economic links to China. According to a CEIC Data blog posting, ASEAN members can benefit by prioritising tangible MPAC projects such as the Singapore-Kunming Rail Link (SKRL). The railway will stretch across and link seven ASEAN countries - Cambodia, Laos, Malaysia, Myanmar, Singapore, Thailand, and Vietnam. This rail link will provide economical transnational cargo transportation, improve ASEAN land connectivity, bolster investment, trade, and tourism ties with China, and provide China with more efficient access to global sea routes.

As both an ASEAN and AIIB member, Malaysia stands to gain from this new China-led initiative. Malaysia has generally supported the AIIB's goal of fulfilling infrastructure needs in ASEAN, with Prime Minister Dato' Sri Mohd Najib Tun Abdul Razak optimistic about the predicted increase in investment flows entering the region.

In the ambitious OBOR project, for instance, Malaysia is poised to play a strategic role. According to HSBC, the Maritime Silk Road will utilise Malaysia's central location and the Malacca Straits as a crucial and priority global trade route; once the infrastructure is in operation, international trade is expected to rise and in turn, stimulate consumption and production domestically. The Silk Road will also cement Malaysia's position as China's largest ASEAN trading partner for six consecutive years since 2008, with bilateral trade amounting to USD102 billion in 2014; with plans for economic integration and connectivity being put into motion by AIIB, these numbers are predicted to increase further. It will also bring Chinese FDI into emerging economies like Malaysia with established investment ties to China, according to Basu Das.

THE WAY FORWARD

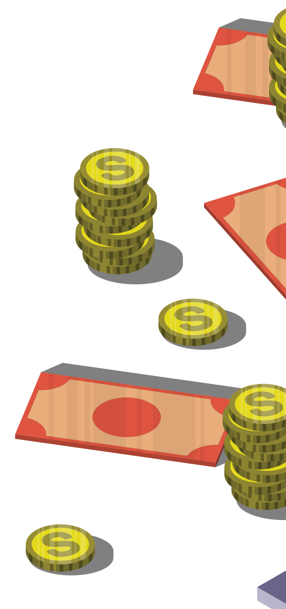
Like any other ambitious project, the AIIB will face tremendous challenges especially given its global scale. Externally, the bank might be hamstrung by the lack of support from the US and Japan, which undermines its legitimacy. Nevertheless, this is assuaged by the vote of cooperation forwarded by other credible IFIs such as the ADB as well as the support of the AIIB member countries.

Potential internal issues are numerous. There is concern over the AIIB's commitment to its "lean, clean, and green" motto: as with any global regime, there runs the risk of compromising on environmental, social, and anti-corruption standards, wrote Salze-Lozac'h.

Furthermore, Yun Sun of the Center of Strategic and International Studies noted that the AIIB's fundraising model has yet to be fully fleshed out. Issues include the lack of a loan guarantor system and China's insistence that the bank act as a multilateral commercial bank instead of an international aid agency. The challenge of furthering the interests of all stakeholders within a multilateral IFI framework according to a fair and transparent manner also persists.

Interestingly, while enthusiasm for the AIIB has been increasing in the international circuit, support in its own backyard has begun dwindling as it becomes apparent that China will not be able to fully dominate proceedings even with veto power. Regardless, Yun Sun notes that as a political and economic pet project of the PRC (People's Republic of China), the AIIB will remain a high priority to Beijing. While the route forward remains vague, only time will reveal the full impact of this waking dragon on Asia and the world. ✱

■ *Amalina Anuar is a KL-based writer interested in political economy, international relations, and comparative integration between Europe and Asia.*



EMPOWERING PEOPLE THROUGH FINANCIAL LITERACY

BANK NEGARA MALAYSIA (BNM) GOVERNOR TAN SRI DATO' SRI DR. ZETI AKHTAR AZIZ RECENTLY SAID AT THE MALAYSIA-OECD HIGH-LEVEL GLOBAL SYMPOSIUM ON FINANCIAL WELL-BEING THAT "WITH ECONOMIC PROGRESS, INDIVIDUALS NEED TO ASSUME GREATER RESPONSIBILITY FOR FINANCING THEIR LIFETIME FINANCIAL NEEDS." EASIER ACCESS TO CREDIT, CONSUMPTION-DRIVEN LIFESTYLES AND STAGGERING DEBT TRANSLATE INTO INCREASED RISKS AND VULNERABILITY. FINANCIAL LITERACY CAN PROVIDE A SAFETY NET.

+ Robust financial knowledge is also becoming even more critical to managing economic well-being as populations age. Many Asian economies are currently benefitting from the demographic dividend, where large young working populations are able to finance the pension and healthcare systems.

Can high levels of debt be directly linked to financial illiteracy? Dissecting recent household debt numbers, it can be seen that the ratio of household debt to personal disposable income in Malaysia, Singapore, South Korea and Thailand – with the exception of China and India - outstrips that in the United States pre-global credit crisis of 2008-2009 (see **Figure 1**).

Asian households clearly binged on credit due to higher consumption on the back of rising incomes and the lure of home ownership, even as Asian governments loosened monetary and fiscal policy post the global credit crisis in order to increase private consumption and stimulate economic growth. Unfortunately, this policy led to the accumulation of higher debt for both individuals and households.

Today, this mountain of debt poses increased economic risks against a landscape of increasing fiscal consolidation, weakening currencies and economic slowdown, which in turn will weigh down these key Asian economies in the near term.

THE IMPORTANCE OF FINANCIAL LITERACY

To help stem debt and stabilise economies, governments are turning to financial literacy and education.

The Organisation for Economic Cooperation and Development (OECD) defines financial literacy (fin lit) as "a combination of awareness, knowledge, skills, attitudes and behaviours necessary to make sound financial decisions and ultimately achieve individual financial well-being." Meanwhile, the recently released Standard & Poor's Rating Services Global Financial Literacy Survey defines fin lit as "the ability to understand how money works in the world: how someone manages to earn or make it, how that person manages it, how he or she invests it, or how that person donates it to help others." In other words, fin lit means being able to understand and negotiate the financial landscape, manage money and financial risks effectively, and avoid financial pitfalls.

Why is there an increased focus on fin lit today? "Financial literacy is a critical barrier to financial and economic participation," noted the 2014 S&P

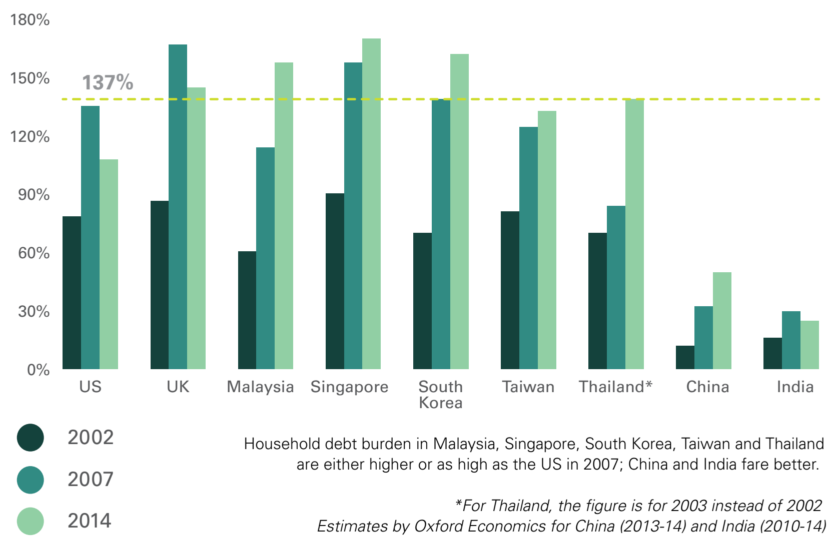


FIGURE 1 The ratio of household debt to personal disposable incomes has gone up in Asia. **SOURCE** Asia Pacific Economic Outlook 3rd Quarter 2015, Deloitte University Press.

Ratings Services Global Financial Literacy Survey. "Because of a lack of knowledge about finance and financial products, many people – especially the poor and women – are not able to access banking and financial services, and are therefore kept out of financial markets." Furthermore, the survey stated that fin lit is "a key component of robust and sustainable financial markets around the world."

Financial education is likewise important in order to acquire and optimise assets and investment portfolios, and as a defence against sophisticated financial crimes such as phishing and fraud. In a world where the universe of financial products is becoming more complex and byzantine, investors and the public need a strong grasp of the concepts of risk management, risks versus returns, diversification, time value of money, entry and exit timing and costs, among others. Legal knowledge will also be essential for investor protection and to understand options for redress.

Robust financial knowledge is also becoming even more critical to managing economic well-being as populations age. Many Asian economies are currently benefitting from the demographic dividend, where large young working populations are able to finance the pension and healthcare systems. However, populations are greying and will need to be able to fund their retirements privately through judicious financial planning even as government funding becomes more constrained. The S&P survey warned of a looming retirement crisis in Europe as public pensions are reduced and citizens called upon to play a bigger part in retirement planning. Here in Malaysia, agencies such as the Employees Provident Fund frequently issue warnings on improving financial planning to prevent poverty in one's golden years.

Finally, history demonstrates that financial institutions are quite myopic in their lending behaviour – liberal in good times, and conservative in bad times. Financially adept consumers will be better able to manage risks via diversification and less likely to fall into debt traps during the times of plenty, thus giving them a better chance of riding out economic downturns. When millions of educated consumers make good personal financial choices, backed by financial literacy, the default risk of debt is lowered and the economy is more resilient. A strong and flexible economy means that resources can be channelled to the areas of greatest need, productivity and innovation are supported, and the ability to withstand shocks is enhanced, thereby bolstering the stability of the financial system.

FINANCIAL LITERACY INITIATIVES

Recognising that household and personal debt are debilitating problems which could destabilise society and the economy, the Malaysian government, regulators and industry have collaborated intensively to develop key national initiatives to boost financial literacy.

For instance, under the Economic Transformation Programme 2010-2020, BNM is empowered to create a coordinated national financial literacy programme based on public-private partnerships. This fin lit programme features customised strategies and delivery models based on targeted community needs and wants.

A cornerstone of this programme is to integrate financial literacy into the formal school curriculum, in order to inculcate basic financial management as an essential life skill from an early age.

+ BNM, the Central Bank of Malaysia, is in collaboration with the Ministry of Education to integrate the following financial education elements into the core school curriculum:

- money, sources of income and career choices
- financial responsibility and decision-making
- money management and planning
- savings and investment
- credit and debt management
- risk management, wealth protection and insurance.

Financial institutions with their extensive reach and customer relationships are uniquely placed to advance the financial education agenda, usually through corporate social responsibility (CSR) initiatives with schools. This is an excellent model of public-private partnerships in this space. According to BNM Governor Tan Sri Dr. Zeti Akhtar Aziz, speaking at the recent Malaysia-OECD High-Level Global Symposium on Financial Well-Being, financial institutions have adopted more than 10,000 schools across the country under the School Adoption Programme with wide ranging activities in money management for the children. This included providing technical support and materials for teachers to improve their knowledge and increase their confidence in teaching finance in schools.

Financial literacy is also a tool to tackle

poverty. A National Key Result Area (NKRA) which is part of PEMANDU's GTP (Government Transformation Programme) 2.0 (2013 – 2015) focuses on raising living standards of low-income households. One key initiative includes providing financial literacy education for 70,000 1AZAM (Akhiri Zaman Miskin) participants and getting successful 1AZAM participants to serve as mentors to new participants. Elsewhere, AKPK (the national Credit Counselling and Debt Management Agency) worked together with micro-credit recipients through Amanah Ikhtiar Malaysia (AIM) to improve their financial literacy and management skills to promote sustainable small business and financial inclusion.

Credit counselling is a direct line to educating people on financial literacy. AKPK, a wholly owned subsidiary of Bank Negara Malaysia, aims to be recognised as the trusted provider of financial education for adult consumers and to continue to promote financial prudence. Working to change the perception that AKPK is the place for highly indebted individuals, as of early 2015, AKPK has revamped its financial education programme to cater for the four different lifecycle stages that people experience. These are university students in tertiary education, fresh graduates entering the workforce, newly-weds starting and raising a family and retirees during their retirement. The content covers cash flow management, borrowing basics, managing debt, insurance, investment, retirement, e-payment, use of credit cards, and car and home purchases. All of these services are provided free of charge.

For those who are financially distressed, AKPK runs a Debt Management Programme to assist these consumers in regaining financial control by working out a personalised debt repayment plan in consultation and agreement with the relevant financial institutions.

Growing assets and investments while minimising debts is a fundamental concept of financial literacy. To create educated investors, the Securities Commission of Malaysia launched the INVESTSMART campaign in mid-2014. INVESTSMART presents investment information in a simplified format through new technology and multimedia platforms, which will supplement existing investor education channels. These include edumercials via print, broadcast and digital media advertising, seminars and workshops on unit trusts and investing via the stock market for those from various walks of life – blue collar workers, housewives, university students, those living in rural areas, and more. The INVESTSMART mobile app also complements the SC Mobile Unit and the nationwide SC Reach Roadshow to reach out to and engage both urban and rural Malaysians on financial planning and literacy.

A GLOBAL PHENOMENON

Country-level financial intelligence ranges from 71% to 13%, according to the S&P Ratings Services Global Financial Literacy Survey, produced by McGraw Hill Financial Intelligence together with Gallup. The survey which claims to be the most comprehensive global gauge of fin lit to date is based on interviews with more than 150,000 adults across 148 countries and authored by Leora Klapper and Peter van Oudheusden of the World Bank Development Research Group, and Annamaria Lusardi of the George Washington University School of Business.

The survey respondents were asked questions corresponding to the basic concepts of risk diversification, inflation, numeracy (interest) and compound interest, and defined as financially literate if they could answer at least three out of the four questions. Based on this, the survey derived that 33% of adults worldwide or 1 in 3 are financially literate. Extrapolating, around 3.5 billion adults globally, most of them in developing economies, lack an understanding of basic financial concepts. "Although financial literacy is higher among the wealthy, well-educated and those who use financial services, it is clear that billions of people are unprepared to deal with rapid changes in the financial landscape," concluded the study.

Of course, there are "deep disparities" between nations. The countries with the highest fin lit rates are Australia, Canada, and Denmark. The US ranked at 14th, behind Singapore at 12th. Japan ranked at 38th and Malaysia ranked at 66th.

To counter ignorance, Malaysia, like other countries, is developing national strategies (NS) for financial education. During the Malaysia-OECD High-Level Global Symposium on Financial Well-Being, André Laboul, Deputy Director, Directorate for Financial and Enterprise Affairs, OECD summarised these strategies:

- NS being revised or second NS is being implemented: 10 countries
- (First) NS is being implemented: 22 countries

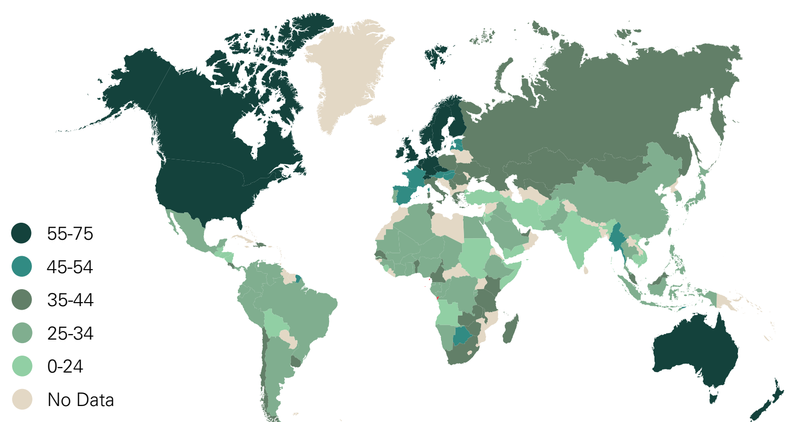
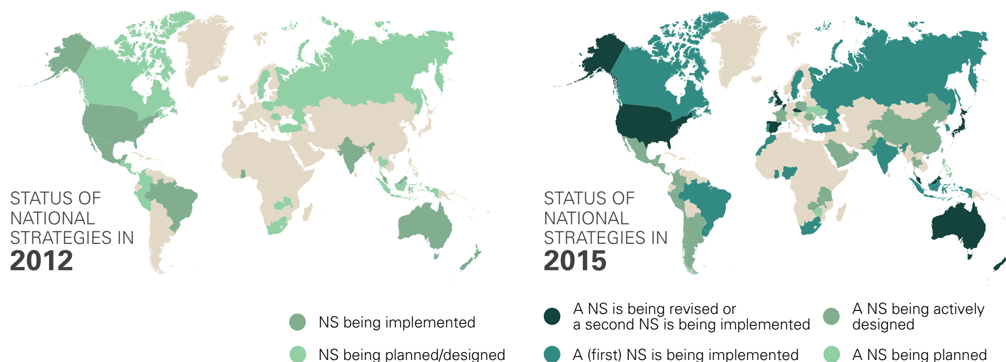


FIGURE 2 Global viarations in financial literacy % of adults who are financially literate.
SOURCE S&P Global FinLit Survey

FIGURE 3 Status of Development of National Strategies for Financial Education. **SOURCE** André Laboul's presentation during Malaysia-OECD High-Level Global Symposium on Financial Well-Being. *http://www.oecd.org/finance/malaysia-oecd-symposium-financial-education.htm*



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- NS is being actively designed: 26 countries
- NS is being planned: 5 countries

What are some of these strategies? In Australia, the National Financial Literacy Strategy is led by the Australian Securities and Investments Commission (ASIC) and the ASIC MoneySmart Teaching programme is recognised by the OECD for best practice in financial literacy education.

Educating the next generation, particularly through the formal education system is one of ASIC's 2014-2017 strategic priorities for financial literacy in Australia. This includes increasing the number of teachers trained through ASIC's MoneySmart Teaching professional learning programme, increasing the engagement and confidence of teachers to teach consumer and financial literacy through the Australian Curriculum, increasing the number of vocational education and training students participating in financial literacy education.

Singapore launched a national financial education programme (MoneySENSE) in 2003, combining industry and public sector initiatives to enhance the basic financial literacy of consumers. The MoneySENSE programme covers three tiers of financial literacy: basic money management, financial planning and investment know-how.

In Japan, continuous deflation and a stagnant economy mean that more than half of Japan's household financial assets are managed as cash and savings. Japan formulated the National Strategy for Financial Education to encourage financial institutions to offer high-quality financial products and effectively deploy these household financial assets for beneficial economic investment. Japan also includes financial education in its school curriculum, although the programme faces many challenges, including a lack of experienced teachers, time constraints and poor student motivation.

COMMUNICATING THE MESSAGE – THE RIGHT PLATFORM

How can financial literacy strike the right chord with its target audiences? Effective financial education, like other learning, depends on the appropriate and catchy content and delivery method. Keeping the message free of economic/finance jargon appeals to women especially. "In Singapore, edutainment delivered via social media such as music videos, based on iconic songs in various local dialects and live performances are used to reach out to the older generation to aid improvement of financial awareness," commented Joanne Yoong, Associate Professor, National University of Singapore, at the Malaysia-OECD High-Level Global Symposium on Financial Well-Being.

Here in Malaysia, online platforms are especially relevant for Malaysians, who are highly connected. "Malaysians are online consumers on-the-go with a 22% year-on-year growth of finance-related searches online, of which growth via mobiles and tablets are 67% and 11% year-on-year respectively," shared Jia Wen Chuah, Google Malaysia's Industry Manager for Finance & Insurance at the Malaysia-OECD event. As such, websites and content which were previously launched to enhance financial literacy, such as bankinginfo and insuranceinfo should be optimised for access via mobile devices.

STARTING FROM THE SCHOOL BENCH

Realistically, financial literacy is a long-term journey – one that will take at least a generation to bear fruit. As such, financial education should start at school and continue throughout one's life as priorities and responsibilities change.

In 2001, Nelson Mandela said, "No country can really develop unless its citizens are educated." Being able to read and write is necessary, but insufficient in today's society. It is a necessity to be financially literate in order to thrive. Financial literacy can make a difference not only in the quality of life that individuals can afford, but also the integrity and quality of markets. Given the volatile, uncertain, complex and ambiguous (VUCA) world we live in today, perhaps it is equally apt to say, "No country can really develop unless its citizens are financially educated." ✱

■ *Preetha Nadarajah is a freelance writer based in Kuala Lumpur.*

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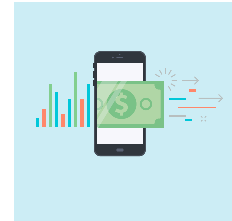
RIDING THE NEW FIN-TECH WAVE

A WAVE OF FIN-TECH START-UPS IS **CHANGING THE LANDSCAPE OF BANKING AND FINANCIAL SERVICES.** WHILE FIN-TECH PRESENTS CHALLENGES TO THE INCUMBENTS, THERE ARE CERTAINLY OPPORTUNITIES ARISING FROM DIGITAL DISRUPTION. BY INTEGRATING INTO FIN-TECH INNOVATION ECOSYSTEMS, EXISTING MARKET PLAYERS CAN BENEFIT FROM FIN-TECH-DRIVEN SERVICES AND PRODUCTIVITY.

Banks have realised that the significant growth of fin-tech - short for financial-technology - industry and the innovations fin-tech start-ups bring are no longer something to ignore. It is clear that the digital revolution is under way in the banking industry, whether banks want it or not. New entrants armed with IT innovation are posing threats to traditional banks by eroding the previously rock-solid positions of banks. The number of entrants has been growing fearlessly in the many areas where banks enjoyed monopolistic control. If banks are not prepared for a paradigm shift, they may find themselves in a similar position to Kodak which did not see digital photography as a disruptive technology.

The match has been lit under fin-tech, sparking explosive growth. Indeed, the number of investments and acquisitions is increasing at an incredible rate. According to reports from CB insights, global investment into fin-tech start-ups quadrupled to over USD14 billion in the past 12 months. A very steady upward trend in both funding and deal activity has also been observed from quarterly data. Funding has grown from UDS1 billion of funding in Q2 2010 to nearly USD3 billion in Q1 2015. Given the dramatic changes in financial services, driven by technology innovation, intensified regulations, changes in consumer behaviour and the need for cost reduction, this global trend is expected to continue in the future. Whether the change comes from a startup, incumbent, or a partnership of the two, major business areas of banks including payments, money transfer, lending, capital raising and investment advisory have been affected.



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PAYMENTS AND MONEY TRANSFERS

Payments and money transfers, which are the traditional revenue streams of banks, are being challenged by fin-tech companies. Notable examples in payments include systems started by network operator, M-PESA, and online retailers, such as Alipay and PayPal. ApplePay, Square and Stripe are among the strong contenders in the payment industry. The development of payments technology has also created a number of interesting opportunities for business models. As electronic payments continue to grow, the potential for parties involved in the business to better understand customers through data will develop. Innovative solutions, such as payments with a single tap or near-field communications, face/voice recognition and fingerprint verification, are designed to support more secure and convenient payments.

Fin-tech companies also sap away profitability of the international money transfer business. By using an innovative peer-to-peer (P2P) transfer system, UK-based TransferWise manages to offer its service very cheaply to its customers and allows customers to avoid dealing directly with the complexity associated with P2P.

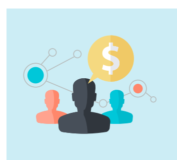
LENDING, CAPITAL RAISING AND AUTOMATED ADVISORY

Lending and capital raising are also big segments of the current fin-tech industry. Since the global financial crisis of 2007-2008, regulation on loans has strengthened and banks have shown a low risk appetite. As a result, banks limited their exposure to loan markets, particularly for home, small enterprises and subprime loans, which translated into unattractive interest rates for saving accounts. The resulting conditions have been fertile for alternative lending models, such as online and P2P platforms to emerge and prosper.

Globally, the US market leads the way, followed by Europe, in P2P lending. Lending Club in the US and Zopa in the UK are successfully taking real market shares in the loans market. Since these lending platforms directly match funds between borrowers and savers, they are free of holding reserves, matching maturities of deposits and loans, leverage and legacy processes. The ongoing expenses of Lending Club in US and Zopa in the UK as a share of their outstanding loan balances is about 2%, while the equivalent for conventional lenders is known to be more than 5%. As a result, alternative lending platforms can offer flexible services to customers at low cost. With big data analytics and automated risk assessment of borrowers, they can potentially offer more lending options for a broader range of borrowers in a timely manner.

Crowdfunding meanwhile seeks to create a platform that allows entrepreneurs to raise capital by tapping into the network of investors who use the platform. As with P2P lending, crowd-funding platforms are concentrating on underserved niche areas which would find it cost-ineffective to raise capital through more traditional ways.

The wealth management industry, which has lost customers' trust over the course of the global financial crisis, now faces competition with "robo-advisors". Betterment and Wealthfront, which are among the better known names, each have more than USD2 billion in assets under management. The automated investment advisory services are cost-efficient and increase the accessibility of wealth management services, especially for individual investors. Though the first generation of "robo-advisors" offers fairly simplistic advice only, it may be only a matter of time before more sophisticated advice can be provided with the use of data analytics. These business models have brought some fundamental changes in the way the industry works and will erode a key revenue stream for many of the more traditional financial institutions.



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IMPACTS, OPPORTUNITIES AND INNOVATIONS

Though fin-tech firms are not about to put the incumbents into extinction yet, the rapid growth of capital being invested in the area underlines how technology is changing the nature of financial services and will reshape the financial landscape. The emergence of cloud computing, open software, easier access to computing power and data servers mean that even small, innovative technology start-ups can quickly turn their ideas into marketable products and erode the market shares of the existing market players by helping niche customers to overcome particular obstacles. This means that banks will increasingly compete with nimble digital players and new generations of fin-tech companies to win customers. It is clear that the fin-tech disrupters will force existing banks to accept lower margins, cut costs and improve the quality of financial services. However, these innovations have potential to generate not just threats to incumbents, but also opportunities.

Many banks are embracing the competitive threats from fin-tech in different ways. As one of their strategic approaches, many banks have increased

Some banks have taken steps to collaborate with fin-tech startups. This collaboration goes beyond superficial vendor-client relationships.

their investment in innovations such as mobile payment solutions, a new generation of risk management and advanced data analytics, behind the fin-tech scenes. Barclays in UK launched its own system for mobile money transfer, called Pingit, in 2012. Some companies, such as Capital One and MasterCard, have set up innovation labs to find ways to increase their customer base and broaden their product and service offerings. Some banks are working together to survive in the rapidly changing environment and to implement the right technology solutions. At the beginning of 2014, major UK banks including Bank of Scotland, Barclays, HSBC, and Lloyds Bank had launched a new mobile person-to-person payment system, called Paym, which is a great example of industry-wide collaboration.

Some banks have taken steps to collaborate with fin-tech start-ups. This collaboration goes beyond superficial vendor-client relationships. Only a few years ago, many banks were reluctant to engage smaller technology vendors. Recently, this has changed substantially. Banks have re-evaluated their capacity to manage the full financial services landscape, and realised they would need to form partnerships with IT innovators or eventually acquire them. Banks need to consider which aspects of their business they want to maintain and which requires collaboration to continue delivering real value to customers.

Since 2010, banks have also begun to open their own accelerators and venture funds to fund fin-tech companies. FinTech Innovation Lab, which was founded in New York and currently runs in different cities, is one of many on the list of fin-tech accelerators which bring together multiple banks to collaborate and provide mentorship to start-ups that could potentially be their future partners. Russia's largest lender Sberbank set up a USD100 million fin-tech venture fund in 2012. Another example is joint investment by American Express and Groupon into the European digital payments firm SumUp. By tapping into fin-tech clusters where a broad range of innovative solutions are being developed, banks can save the time and expenses which would have been incurred if they had developed similar technologies independently. Innovators see this partnership and collaboration as valuable since they are able to ensure that their ideas are implemented at scale and to integrate themselves into the existing value chain.

Some other banks have taken a further step by acquiring fin-tech firms. Such bold move can enable individual banks to deepen or broaden their offerings and capabilities. For example, BBVA, a big bank based in Spain, bought Simple, an online-only start-up bank, which secured the bank a mobile application with advanced financial management tools to help customers manage daily spending. By acquiring the company, BBVA gained a digital platform where users connect with the bank twice a day on average, improving customer relationships without costly and inflexible branch networks.

CONCLUSION

Fin-tech is actually not a new concept. Western Union, which offered a money transfer service by way of telegraph, and the first version of the Visa/MasterCard network can be seen as early forms of fin-tech business models. However, the development of fin-tech has become the most important influencing factor in the banking industry in recent years. While fin-tech presents challenges to the incumbents, there are certainly opportunities in the wave of digital disruption. By becoming a part of the innovation ecosystems in the fin-tech industry, the existing market players are set to benefit from growth driven by new services and productivity. ✱

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BACK TO BONDS?

Bonds have been on a steady path to recovery since the financial crisis. But the rules for fixed income markets have changed. Is it too soon to celebrate the return of bonds?

Are bonds swinging back into favour? They may be, and they may not - it all depends on your point of view. There are plenty of signs that bonds are facing a revival, after the financial crisis caused a collapse in the market. However, it may just be a temporary resurgence; investors are split down the middle on the question about bond market prospects, according to an international survey released by NN Investment Partners in October. 30% believe the bond market will become more attractive over the next three to five years, although 39% of those polled stated it will likely be less appealing. Then, if the possibility of rising interest rates are factored in, the equation shifts yet again: 39% said they expect to see a move towards bonds if rates rise, while 43% said they doubt this would be the case.

There are plenty of signs that bonds are facing a revival, after the financial crisis caused a collapse in the market.

"If interest rates rise significantly in the next five years, [bond] performance may not be spectacular, and equities may indeed outperform, but with greater risk. More importantly, nobody knows if such a rate increase is going to happen," said Sylvain de Ruijter, Head of Global Fixed Income at NN, following the survey.

As of mid-November, the US Federal Reserve is overwhelmingly expected to raise interest rates for the first time in nine years, causing jitters for bonds. But the game for fixed income traders had already changed due to the unprecedented levels of quantitative easing: "Bond markets are entering new territory," said Ruijter. "Asset managers will need to show greater flexibility and have the capacity to assimilate a plethora of market data in order to make active management decisions."

LINGERING EFFECTS OF THE CRISIS

The post-financial crisis environment has arguably thrown out the rulebook for bonds, which have long been associated with predictable and relatively safe returns, if a little lacking in excitement. Nowadays, however, price reversals and other disruptions to bond trading are shaking things up, making traders less certain about the prospects of bonds. The repercussions are felt especially in the US, whose bond market is one of the biggest financial markets in the world: it has USD39.5 trillion outstanding as of mid-2015, according to the Securities Industry and Financial Markets Association. This means bonds are bigger business than stocks and shares, as the US equity market stands at a comparatively lower USD26.3 trillion.

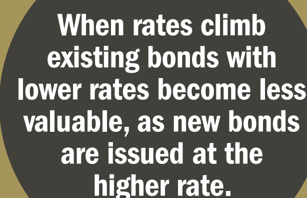
The European bond market also continues to experience after effects of the financial crisis. Most recently, the weakness in the Greek economy has been the main cause of stress across Europe's bond markets. Uncertainty about how the crisis in Greece may spread across the Eurozone has made bond pricing difficult, delaying companies looking to issue bonds and creating pent-up demand. Europe saw just USD33 million high-yield non-financial corporate bond issuances in the first twelve days of July, according to data provider Dealogic. This compares with the average of USD1.54 billion a week seen previously in the year before the crisis in Greece.

The European markets have however seen some recovery this autumn: "It looks like a busy autumn provided the market environment stays like it is," Eric Cherpion, Global Head of Debt Capital Markets at Société Générale, said to the 'Financial Times' following September's revival in the European corporate debt market. Some of the activity has been pent-up demand from the slow summer, said Cherpion, adding: "I take some comfort that the market seems to be quite resilient from the volatility we've seen in the equity market."

Bond push factors

Taking a step back, bonds have traditionally been considered a stable investment. Put simply, investors have tended to flock to fixed income as a low-risk investment in times of distress. In moments of stronger confidence, equities would be more popular, as their higher risk would be deemed more worthwhile for the sake of potentially higher returns.

At its core, a bond is a form of debt, issued by a corporation or a government looking to raise money. The investor can buy a bond with the prospect of getting his or her money back after a set time, along with regular interest payments along the way. Some bonds are more secure than others: government bonds are considered safer than corporate bonds, as a country is less likely to go bankrupt than a private entity. Bonds are rated according to the stability of the issuer: less credit-worthy companies, or countries, will have higher yields on their bonds, to compensate the holder for the added risk they are taking.



If a bond is held to its maturity it matters less what happens in the market in the interim, assuming the issuer does not collapse. Most bonds are however traded during their lifespan. In addition to investor sentiment, a major push factor for bonds is interest rates, as lower interest rates means higher bond prices. When rates climb existing bonds with lower rates become less valuable, as new bonds are issued at the higher rate. This phenomenon was behind October's rush of US bond issuance, as companies were scrambling to sell debt before the potential interest rate hike made it more expensive to do so.

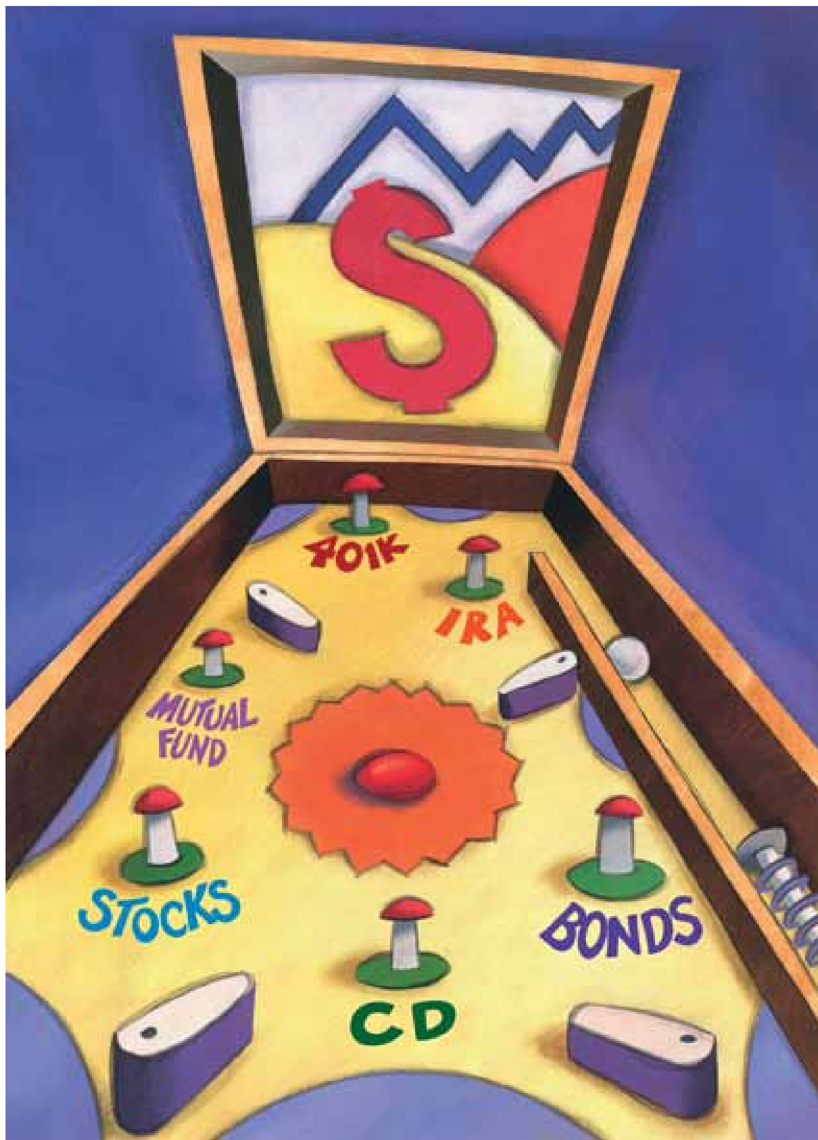
LIQUIDITY WOES CONTINUE

Looking beyond the immediate effects over the looming possibility of rising interest rates, concern over poor liquidity is another factor that's been hampering the recovery of the bond market. A key factor in this liquidity squeeze is how regulation introduced after the financial crisis, intended to prevent banks from holding too much risk on their balance sheets, has made it harder for bond traders to move their goods. This was the conclusion in an August report from PwC, commissioned by the Global Financial

Markets Association and the Institute of International Finance:

"The findings from our research suggest early warning signals that regulation and other market factors are contributing to a reduction in certain aspects of secondary market liquidity that is likely to be exacerbated by the unwinding of quantitative easing or another stressed market situation," said Nick Forrest, Director in PwC UK's Economics and Policy Practice, and the report's author. The Bank of England has also added its voice to this debate: "We find that dealer holdings act less as a shock absorber than they did around a decade ago. Instead, bond spreads rise more. We also find that greater declines in issuance now follow these shocks," Yuliya Baranova, Louisa Chen and Nicholas Vause of the Bank of England's Capital Markets Division, wrote on the staff blog 'Bank Underground' in August.

There are a number of potential solutions to the bond trading liquidity crisis, argues the PwC report, such as harmonisation of global regulation, further exploration of the links between liquidity and regulation, and better market data and analysis. The latter has tentatively started to happen, partially as a result of fresh thinking from technology start-ups. In October, *Bloomberg* reported that venture capitalists Peter Thiel and George Soros are leading a USD25 million investment into New York-based TruMid, a new electronic trading marketplace for corporate bonds created by former Goldman Sachs traders. TruMid works to improve bond market flow by using electronic trading tools, which push traders into ten-minute windows of activity to create bursts of liquidity.



Emerging market corporate debt remains a small portion of the overall credit market still, but the outstanding amount of emerging market dollar-issued bonds are now seven times higher than a decade ago.

Another technology start-up working on a solution to the liquidity squeeze in the bond market is London-based Algomi. A group of former UBS traders founded the company in 2012, creating an algorithm-based bond trading information network aimed at equipping traders with the tools to find liquidity in a squeezed market. "What is it that helps traders identify opportunities across the myriad of systems they have access to? Information. Who holds the bond? Where is it priced? When was it last traded? We realised this information can help people understand where liquidity resides," Usman Khan, Co-founder and Chief Technology Officer of Algomi, told 'FusionWire'. Algomi takes a different approach to TruMid by maintaining the human relationships in bond trading; only 10-15% of bond trades come from electronic trading, according to Algomi's research. Bond trading runs on interpersonal relationships, argues Khan. However, technology can play a vital part by helping traders find the relevant information to complete trades in a quick and efficient manner.

Brazil, China and Russia represent the biggest activity in the emerging market corporate bond market; however, the ASEAN region has also seen increased activity. Malaysia's bond market has been particularly active, after having grown to a total of RM1.11 trillion at the beginning of 2015.

EMERGING MARKET OPTIMISM

While commenters are on the fence about the outlook for the US and European bond markets, emerging market bonds are a much more optimistic story. Debt sold by companies in emerging markets has been expanding at a much less stifled pace of late, according to Barclays research seen by *Bloomberg*. "Emerging market corporate debt has grown more rapidly than virtually every other fixed income segment over this horizon," say the Barclays researchers, whose conclusion comes after looking at a number of bond indices.

Emerging market corporate debt remains a small portion of the overall credit market still, but the outstanding amount of emerging market dollar-issued bonds are now seven times higher than a decade ago. That means one out of every five dollars of global corporate issuance now comes from an emerging market company, representing a significant growth pattern. The Barclays researchers said a key reason emerging markets companies have been turning to the international bond markets is to make up for a slowdown in bank lending.

Brazil, China and Russia represent the biggest activity in the emerging market corporate bond market; however, the ASEAN region has also seen increased activity. Malaysia's bond market has been particularly active, after having grown to a total of RM1.11 trillion at the beginning of 2015. The country has maintained its position as the third-largest local currency bond market as a percentage of GDP, after Japan and South Korea.

Unsurprisingly, the looming prospect of a US interest rate hike is affecting bond markets in this region as well. Having said that, the prospects of ASEAN-issued bonds are also affected by somewhat different drivers which set this market slightly apart; specifically this has to do with government subsidies and infrastructure spending. When it comes to *Sukuk* bonds, tax breaks and other support from Malaysia's government have been vital for ensuring the country's stance as the region's leading hub for *Shariah*-compliant assets. Malaysian *Sukuk* banking assets expanded by an annual average of 17% in the five years through 2014, according to *Bloomberg*, to RM625.2 billion.

In its 2016 Budget, the Malaysian government further broadened tax exemptions to environmentally-friendly *Sukuk* bonds, making these even more competitive. "Sustainable and responsible investments (SRI) is at the heart of Islamic finance, and more vibrant SRI-related funding and financing activities will add a new dimension to the local capital market scene," said Datuk Mohd Najib Abdullah, Group Managing Director of Malaysia Industrial Development Finance, as the subsidy was announced in October.

In the meantime, commentators are optimistic that Prime Minister Najib Razak's USD444 billion development programme will help revive *Sukuk* sales from the slowest quarter since 2010. Mohd Effendi Abdullah, Head of Islamic Markets at AmInvestment Bank in Kuala Lumpur, estimated to 'Gulf Times' that Malaysian infrastructure projects backed by corporate bond issuance could be worth as much as USD13.6 billion this year.

Not to be left out, the *Sukuk* bond market is growing also on a global scale. The UK, which became the first non-Muslim country to issue a *Sukuk* bond in 2013, has been vocal about the prospects of the Islamic finance industry. Chancellor George Osborne has claimed that expanding the UK's role in Islamic finance would be a key step in making Britain "the undisputed centre of the global financial system." The value of *Sukuk* listed on the London market has exceeded USD34 billion over the past five years, while the total *Sukuk* market is now estimated to be worth nearly USD2 trillion. The dominating force in the *Sukuk* market is however Malaysia, which reported 12% annual growth in Islamic bonds for the fifth year to RM1.59 trillion last year. As *Sukuk* now makes up 58% of Malaysia's total capital market, the Securities Commission Malaysia confirmed the country has "retained its position as the largest *Sukuk* market in the world, accounting for 66% of global issuances". ✱

■ *Jessica Furseth is a freelance journalist based in London.*

The findings from our research suggest early warning signals that regulation and other market factors are contributing to a reduction in certain aspects of secondary market liquidity that is likely to be exacerbated by the unwinding of quantitative easing or another stressed market situation.

Nick Forrest
Director in PwC UK's Economics and Policy Practice

Sustainable and responsible investments (SRI) is at the heart of Islamic finance, and more vibrant SRI-related funding and financing activities will add a new dimension to the local capital market scene.

Datuk Mohd Najib Abdullah
Group Managing Director of Malaysia Industrial Development Finance

EVANGELISING EQUITY CROWDFUNDING

HAILED AS THE DEMOCRATISATION OF FINANCE, EQUITY CROWDFUNDING OR ECF IS GAINING TRACTION IN ASIA. AS MALAYSIA GETS SET TO LAUNCH ITS OWN ECF PLATFORM IN 2016, WHAT CAN STAKEHOLDERS EXPECT?

While other segments of the financial industry might be slowing, crowdfunding is growing at a preternatural pace, albeit from a small base. The global crowdfunding market grew 167% from USD6.1 billion in 2013 to USD16.2 billion in 2014 and is forecast to reach USD34.4 billion in 2015, according to Massolution's March 2015 Crowdfunding Industry Report.

The rising star of the show is equity-based crowdfunding (ECF), which climbed 182% to USD1.1 billion in market value in 2014. Although it is still small, by 2016, the global ECF market could account for more funding than today's entire venture capital (VC) industry, Massolution predicted.

While North America is still the largest crowdfunding market, Asia overtook Europe by a small margin in 2014. Exponential Asian growth stemmed largely from buoyant P2P (peer-to-peer) lending market growth in the Chinese market, and Massolution forecast that Asia's lead will increase significantly in 2015.

Regulators have been taking the lead in driving Asian crowdfunding, especially ECF. Indonesia's Financial Services Authority, OJK, is set to regulate crowdfunding before 2015 ends. At present, regulators are more concentrated on P2P lending and once these rules are in place, it will be easier to move on to ECF, commented Iggi Achsien, an independent commissioner at Bank Muamalat Indonesia, at a crowdfunding conference.

Neighbouring Thailand's SEC (Securities and Exchange Commission) recently released an operating framework for crowdfunding platforms and is slated to authorise the launch of ECF before year-end.

Singapore meanwhile is focused on managing crowdfunding risks and ensuring an orderly market. The Monetary Authority of Singapore (MAS) in its February 2015 consultation paper proposed to strike a balance between enabling private financing for start-ups and SMEs and safeguarding investors. Placing limits on the "crowd" is part of the Singapore prescription, where only

accredited and institutional investors will be eligible to participate in ECF; individuals should have an annual income of at least SGD300,000 or SGD2 million in net personal assets and corporations should have net assets exceeding SGD10 million.

In Malaysia, the focus of regulators is very much on ECF. The Securities Commission Malaysia (SC) released the 'Guidelines on Regulation of Markets under Section 34 of the Capital Markets and Services Act 2007' in February 2015, and announced the six selected ECF platform operators including Alix Global, ATA PLUS, Eureeca, Propellar Crowd+, Crowdonomic and pitchIN in April 2015.

Malaysia became the first ASEAN jurisdiction to publish an ECF legal framework when the Capital Markets and Services (Amendment) Act 2015 was passed in the Malaysian Parliament on 1 July 2015. The ECF platform is set to start operations in the first quarter of 2016.

ECF IN MALAYSIA: THE WAY FORWARD

Key to successfully operationalising ECF in Malaysia will be building sustainable mass and educating stakeholders.

Fortunately, market conditions favour ECF. The global economic slowdown augurs well for ECF in Asia and ASEAN, remarked Daniel Goettfert, Executive Director of Alix Global. The history of ECF successes in the UK and Europe came on the back of the 2008 Global Financial Crisis, which stymied traditional bank lending and created a conducive environment for alternative financial instruments from non-institutional lenders.

Obviously, the first step in moving forward will be to get the ECF platforms up and running smoothly in Malaysia. "Once this happens and businesses are listed and investors investing, educating the market about ECF and its benefits must occur for the model to be embraced, appreciated and utilised," said Sam Quawasmi, Co-founder and Managing Director, Eureeca. However, in the early months, ECF operators face the challenge of "sufficient quality deal-flow origination and investor base in the short-term and the possibility of price war amongst operators if the take-up is slow in the longer term," warned Elain Lockman, Director and Co-Founder, ATA PLUS Sdn Bhd, which aims to focus on financing for *Shariah*-compliant businesses.

Reforming investor mindsets will be challenging, in a market where retail investment is typically driven by the appetite for short-term returns rather than sustainable long-term returns and the going concern potential of their investments. Investors might be overreliant on the due diligence done by the ECF platform operators, and they might not exercise sufficient independent thinking and professional judgement. "Total capital loss is something they are likely unused to from their investments in other asset classes but it comes with the territory of buying SME private equity," cautioned Quawasmi.

Where the issuers are concerned, their primary challenge would be to understand how ECF works – from how to value their businesses to the work that they have to do offline before launching a campaign on the ECF platform. "ECF is not a money tree or do-it-all-for-you service. We recommend that entrepreneurs bring at least 40% to 60% of their funding needs to the table from within their own personal networks to create the tipping point necessary for the campaign to be fully funded. Additionally, while ECF makes raising funds more convenient and efficient, it doesn't make

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it easy. Issuers must be prepared to put time and effort into curating their campaign and engaging with investors," said Quawasmi.

Once the ECF campaigns are concluded successfully and funds raised, the next hurdle is at the point of exit. "If the forecasted exit criteria are not met at the estimated timeline, be it via acquisitions, further financing rounds or in the case of the proverbial jackpot – going public via IPOs, issuers will need to manage their shareholder expectations and issuers may well need to continue to be patient. There will be pressure for the SMEs to deliver better numbers and facilitate exit of some investors through a corporate exercise," said Bryan Chung, COO, Propellar Crowd+.

Liquidity is definitely a concern as there may not be a secondary market for ECF shares. Given the growth stages of start-ups or SMEs and the nature of this illiquid asset class, the introduction of a secondary market may be necessary at a later stage. However, the lack of liquidity is unlikely to pose a systemic risk until the industry grows to a sizeable level.

The current cap on ECF funding limits might pose a challenge when businesses want to scale up, pointed out the operators. Current guidelines impose fundraising limits of a maximum of RM3 million within a 12-month period, irrespective of the number of projects, and a maximum amount of RM5 million in total. "Initially, the limits should not impact SME growth financing very much. However, there is a need to segment SMEs more finely to understand the role of funding at each stage of their growth. Eventually, we see the need to raise this limit," explained Lockman.

"Growth-oriented SMEs typically need to raise capital a number of times during their development, with the size of the raises scaling up each time at a higher valuation. We anticipate that as the model proves itself, both businesses and investors alike will call for the cap to be raised or removed so they can continue accessing capital or accessing larger deals through ECF platforms respectively," said Quawasmi. Otherwise, the scale-ups would need onward funding from VCs or angels or even from traditional financing institutions such as banks.

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Existing business legislation might eventually have to be amended to accommodate ECF. The Malaysian Companies Act currently allows for a maximum of 50 shareholders for private companies. Such a limit restricts the extent to which the 'crowd' can get involved in ECF and this ceiling may need to be revised eventually. "In the UK, it is commonplace to see 200, 300, 400 people investing in a single deal on a platform," explained Quawasmi. "This is why businesses on UK platforms can complete multi-million pound raises!"

OF STAKEHOLDER PROTECTION AND "GATED COMMUNITIES"

In its numerous stakeholder engagements and public consultation papers leading up to the legal framework issuance in Malaysia, it is evident that the SC emphasises good governance. Indeed, SC's regulation is aimed at providing a framework for healthy market development and investor protection.

All ECF platform operators in Malaysia must be registered as a Recognised Market Operator (RMO) and are subject to supervision by SC. The registered platform operators not only have to comply with the guidelines, but also the imposed terms and conditions - this includes operators ensuring that their internal procedures and rules have accorded investors with the necessary protection.

The guidelines also provide protection for investors by imposing requirements relating to, among others – monies received to be kept in trust accounts, minimum

disclosures, investment limits, obligations imposed on the operators to educate investors relating to ECF, and processes to monitor anti-money laundering requirements. Importantly, the SC has sounded a warning that the "guidelines issued by SC are enforceable. If there is a breach by the operator, SC is empowered to take actions against the operators."

This is in contrast to Europe, where a lot of countries have allowed ECF without emplacing regulations, and is similar to the UK model. Quawasmi noted that "the guidelines are similar to what UK's Financial Conduct Authority (FCA) has in place, under which the most thriving and mature ECF market in the world has developed. To our knowledge, there have been zero instances of fraud in the UK ECF industry, and we think that investors there have a clear idea about the mechanics and risks involved with crowd investing."

"The SC, to its credit, is constantly seeking feedback from the operators on striking the 'balance' between all stakeholders. The best way to protect stakeholders is not to over-regulate, but, by adhering to full transparency at all times, whilst at the same time prioritising education, transferring information, skills and knowledge," Lockman said.

Of course, the ECF guidelines will need fine-tuning as the industry matures in order to support future growth. "We are mindful that ECF is a new industry that is fast-evolving globally; hence, there will be a need to have regular engagements with industry participants. As a result of the engagements, we may, when necessary, conduct a periodic review of the regulatory framework to nurture the growth of ECF as an alternative channel for capital-raising. We will also have regular engagements with the registered platform operators to ensure that the regulations in place to safeguard investors are adequately balanced with the needs to allow for innovation and rapid growth within this space," stated a spokesperson from the SC.

As the SC conducts its periodic reviews, if there are causes for concern, additional measures could then be put in place to further safeguard investor interests. These might mirror international best practices tailored to fit the local environment. For example, the UK FCA introduced new consumer protection rules to ensure that retail investors need to self-declare that they will limit their investments in unlisted equity and debt securities to less than 10% of their net investible assets. These net investible assets exclude their primary residence, pensions and life insurance. This is similar in concept to BNM's introduction of the Debt Servicing Ratio affordability measure created to support the responsible use of leverage as a proportion of income.

To further investor protection, Crowdonomic in Singapore is considering limiting the investor crowd to a "gated community" of the better-educated members of the public such as white-collar professionals from industries such as accounting, financial services and law. Similar to banking rules on provisions to mitigate risks, another measure could be to regulate the base capital requirements of issuers to set aside a certain proportion of funds received to pay shareholders in the event of litigation or disputes.

EXCITEMENT AHEAD

At this point in time, the crowdfunding space in Asia is highly nascent and still evolving. Indeed, the rules of the game may change as ECF matures and further disruptions emerge in the fin-tech space. Furthermore, the ECF arena might be more suitable for more sophisticated investors with a high tolerance for risks.

"Essentially, two things will drive this fin-tech initiative forward: Winning the trust of both investors and investees, and early success stories that demonstrate that equity crowdfunding is not just an alternative investment option, but a more exciting and engaging one offering opportunities for brand evangelism and higher returns. Participation would be more intense and rewarding than in traditional capital markets," concluded Lockman. ✱

■ *Preetha Nadarajah is a freelance writer based in Kuala Lumpur.*

BY JESSICA FURSETH

RATING THE RATERS

CREDIT RATING AGENCIES FAILED TO STEM THE ONSET OF THE FINANCIAL CRISIS. SINCE THEN, EFFORTS TO REGULATE THE SECTOR HAVE YIELDED LITTLE SUCCESS. IS A CULTURE CHANGE IN ORDER?

Credit rating agencies have been dragged through the mud in the years since the financial crisis, and for good reason. The global downturn exposed what can justifiably be described as fundamental flaws with the credit rating agency (CRA) model - flaws which resulted in the sector playing a not-insignificant part in enabling the conditions that created the 2008 crisis.

By no means did the CRAs escape the downturn unscathed: the collapse in the bond market during the recession meant the raters saw roughly a third of their income vanish. The recession post-mortem then found the CRAs had exacerbated the severity of the crash by giving unduly favourable ratings to mortgage-backed securities in the run-up, leaving investors with a false sense of security. Shockingly, there was even evidence that CRAs had occasionally been doing this knowingly.

THE BACKSTORY

The CRA market is dominated by the so-called Big Three - Standard & Poor's (S&P), Fitch, and Moody's - who issue 95% of all ratings. A CRA exists to provide an independent analysis of how likely a bond issuer is to meet its obligations, and the integrity of this system has been a bedrock of the financial system. According to Moody's own reports, AAA investments "should survive the equivalent of the US Great Depression", but the recession proved this to not always be the case. When US housing prices began to tumble in 2007, Moody's downgraded 83% of the USD869 billion in mortgage securities it had rated at the AAA level the year before.

The Moody's rating is but one piece of evidence showing CRAs had issued misleading ratings in the run-up to the crisis. The US Department of Justice took the blame game a step further, however, when it launched a lawsuit against S&P for knowingly and deliberately issuing overly-generous ratings. S&P reached a USD1.5 billion settlement deal over the lawsuit this February, over two years after the US government initially brought charges. Under the terms of the settlement, S&P did not admit to any law violations, but the company acknowledged that its executives delayed implementing new models in 2005 that would produce more negative ratings. The Department of Justice argued the motivation for this delay was to keep clients happy, as ratings are paid for by the bank that issues the securities, not the investors.

Compared to some of the more salient facts uncovered during the legal process, the language in the S&P settlement is modest. One damning fact cited in the lawsuit came from an instant messaging exchange between two S&P analysts discussing a bond: "It could be structured by cows and we would rate it." Further to the drama surrounding this case, S&P had initially claimed the Department of Justice was bringing the case as an act of retaliation for downgrading the US's

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credit rating. After thorough investigation, no evidence was however found to support this allegation.

REGULATORY EFFORTS BEGIN

While several years have passed since the flaws in the ratings system were flagged, the work of fixing the structural problems is still in the early stages. The CRAs themselves, however, have recovered from their beating during the crisis - at least if their reputational problems are not taken into account and the focus is solely on earnings. Revenues from rating services at the Big Three exceeded pre-crisis levels last year, with profits at Moody's now at a record high and those at S&P also close to a peak. This recovery is partially due to the fact that the bond industry at large has rebounded since the crisis, and the CRAs are still the go-to agents for rating fixed income securities. Regulation makes it very difficult to sell unrated bonds, and issuers are further incentivised to pay for ratings as it leads to significantly lower borrowing costs.

In Europe, the European Union has established a new regulator to supervise CRAs: the European Securities and Markets Authority (ESMA). The new regulatory standards, as established by the ESMA, will allow investors "to consult and easily compare all available credit ratings for all rated instruments", the European Commission said as the new rules were announced in September last year. Streamlining the process will improve efficiency, said the Commission: "It also integrates the existing reporting requirements for the purpose of historical performance data, available in the central repository established by ESMA, for the purposes of ongoing supervision." Under the European rules, CRAs will be obliged to report how much they are charging clients, in order for ESMA to verify "whether pricing practices are discriminatory and thereby facilitate fair competition and mitigate conflicts of interest". Michel Barnier, European Union Commissioner for the Internal Market and Services, said at the time of the announcement: "[This is] another step in improving transparency and restoring

The ratings industry has mostly escaped reform despite its central role in the financial crisis because the (US) Securities and Exchange Commission has failed to implement many proposed changes and the companies themselves have fought off others.

confidence in the financial system."

Looking to regulatory efforts in the US, the 2010 Dodd-Frank law took steps to hold the CRAs more accountable. The US Securities and Exchange Commission now has a dedicated Office of Credit Ratings, which, similar to the new European regulator, is charged with surveying registered CRAs on an annual basis and has the power to levy fines. While the US Securities and Exchange Commission was meant to issue new rules for CRAs by May 2011, progress has been slow: as of November 2015 these have yet to be finalised.

Partially because of this delay, the effectiveness of the US regulatory response has been widely questioned and criticised. In addition to the leisurely progress on new regulation, a number of points outlined in the established legal framework are currently not being enforced. "The ratings industry has mostly escaped reform despite its central role in the financial crisis because the (US) Securities and Exchange Commission has failed to implement many proposed changes and the companies themselves have fought off others," concluded Alison Fitzgerald in a report for the Center for Public Integrity. This is further illustrated by the fact that the US Securities and Exchange Commission has promised not to enforce part of the Dodd-Frank law that would make credit raters liable for bad ratings. Instead, any rating proven to be inaccurate is deemed to merely be an "opinion", meaning it is protected by the constitutional right to free speech.

CHANGE STILL NEEDED

The modest progress to regulate CRAs have failed to create any change to just how reliant the financial system remains on the raters. Nor has the tradition of ratings being paid for by the issuers been challenged. A culture change may

The reason why the subprime bubble could happen, or the reason why the European sovereign debt crisis can happen is, largely, that very blind investors bought bonds relying on ratings, and [did not do] their own homework about what the real credit risk was in the bonds.

be necessary to reduce the influence of the Big Three. One way to do this could be for investors to start looking at factors beyond credit ratings, argued Sebastian Mallaby, Senior Fellow at the Council on Foreign Relations, the independent think tank. "The reason why the subprime bubble could happen, or the reason why the European sovereign debt crisis can happen is, largely, that very blind investors bought bonds relying on ratings, and [did not do] their own homework about what the real credit risk was in the bonds," Mallaby wrote in a paper.

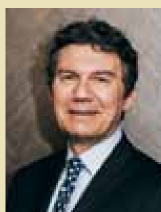
Another weakness with the ratings system in its current shape is that it is frequently backward-looking, relying on past financial performance. This can be highly misleading: at the time of its collapse, Lehman Brothers still had investment-grade ratings on its debts, based on past performance. "Credit rating agencies and investors made the mistake of thinking that because the federal government intervened with Bear Stearns, it would do the same with Lehman. Bear Stearns was sold to JPMorgan Chase in a government-engineered takeover that protected Bear's debt holders," Bonnie Baha, Portfolio Manager at DoubleLine Capital, said to 'USA Today'. "Investors betting the same would be done with Lehman lost big." Baha added that even today, many credit rating agencies continue to pay too much attention to recent history, rather than using good judgement to determine how a market might be set to change.

One way to gain a fuller outlook than the one awarded by formal ratings is to add textual analysis, argued Andreas Kremer, Associate Principal at McKinsey. "Textual information can help banks … improve their credit-risk assessment, in particular their approach to qualitative assessment. This information includes professionally-produced content such as analysts' reports and business journalism, as well as informal texts such as blogs and posts on social networks," Kremer wrote in a paper. As the internet unfolds in real time, there are vast amounts of information available, and this can be efficiently mined with the help of data analytics tools. Noted Kremer: "We argue that if banks can put even a portion of this information to use in their systems, the accuracy, timeliness, and forward-looking character of their credit-risk-assessment systems would all be improved."

Enter global competition?

The Big Three continue to dominate the CRA market as issuers of 95% of all ratings, and competitors continue to find it challenging to gain significant ground. The strain on the industry after the financial crisis has however opened the door to change; a number of European officials have called for the establishment of an independent European CRA to counter the dominance of the Big Three, whose headquarters are predominantly in the US.

In 2013, the market was intrigued to welcome a new CRA competitor with a fresh take. ARC Ratings was established as a joint venture between local CRAs in five countries: CPR of Portugal, CARE Rating of India, GCR of South Africa, Brazil's SR Rating, and MARC of Malaysia. The goal for ARC Ratings was to provide an alternative to what it argued is an oligopoly, as well as introduce a CRA more suited to a global market economy. "Working together, [the agencies] will provide ratings answers to the new multi-polar world economy in direct competition with US-centric agencies," ARC said at the time of the launch. ARC's ratings will be guided by a "multi-perspective approach and local expertise".



The company will focus on critical thinking and qualitative analysis, rather than just plugging numbers into a model. Ratings have been around since 1909. It is time for a change.

Uwe Bott
ARC Chief Ratings Officer

The jury is out on whether a new player can make significant inroads in the established CRA market. The Big Three have proved surprisingly impervious to change, despite years of harsh criticism and ongoing efforts by lawmakers and regulators. However, the founding agencies of ARC have over 6,000 clients between them, meaning they are not starting from scratch. Speaking to 'The New York Times' at the time of launch, ARC Chief Ratings Officer Uwe Bott said the company will focus on critical thinking and qualitative analysis, rather than just plugging numbers into a model. Concluded Bott: "Ratings have been around since 1909. It is time for a change." ✱

■ *Jessica Furseth is a freelance journalist based in London.*

'CASH IS AN AGGRESSIVE APPROACH'

The current volatility in global markets could ironically be positive for investors as it forces them to underinvest. Headlining the recent AICB Global Banking Conference on 4 November 2015, 'Black Swan' author Professor Nassim Taleb recommends holding cash and waiting for opportunities to arise in order to build an antifragile portfolio.

Hold cash in large amounts and invest the rest in high-risk counters. This is the strategy Professor Nassim Taleb, a former risk trader who shot to fame with the book 'Black Swan' in 2007, is advocating.

Taleb has written other bestsellers, including 'Antifragile' and 'Fooled by Randomness'. But 'Black Swan', which focuses on the impact of unpredictable events, gripped the financial world because of its timeliness - coming out at the start of the global financial crisis.

With the global economy not in the best of health, Taleb believes that those who are holding cash will be in the best position to make returns during a financial crisis. "The best return on anything... is on cash when nobody has it. People don't realise that cash is an aggressive approach if you are not afraid of inflation. Cash can be huge ...you do a lot better because of what you can buy when you have cash in a crisis," he tells *Personal Wealth* in an exclusive interview.

Having cash will allow investors to have a strong filter in their investment strategy, even though it may not yield any returns. "You can put a very strong filter. Most people have a weak filter in their investment strategy... People ask me, what do you do with your cash? Zero per cent return is much better than minus 10%. Be there to invest when everyone else is scared," says Taleb, who is Professor of Risk Engineering at the New York University Tandon School of Engineering. He was the keynote speaker at the Global Banking Conference 2015, organised by the Asian Institute of

Chartered Bankers and held earlier this month.

To be ready for the opportunities that could arise, an investor should have a portfolio made up almost entirely of cash while allocating a small portion to high-risk and speculative investments, says Taleb. "Have a portfolio that can benefit from the crisis. Have 80% to 90% cash and hedge against inflation with very speculative bets.

"On average, it is better to have a medium-risk portfolio than to have your portfolio in medium-risk investments. I call this the barbell (investment strategy). If there is a crisis, you lower your cash... but keep the speculative portfolio because these don't depend on crisis. And have 50 small investments in crazy ideas."

Have a portfolio that can benefit from the crisis. Have 80% to 90% cash and hedge against inflation with very speculative bets.

A staunch believer of having "skin in the game", Taleb holds a large amount of cash himself, along with some speculative bets. He singles out the potential of solar companies.

"(With solar,) almost all of the countries outside Northern Europe that do not have a lot of sun and the US would be autonomous... We are getting so much more sophistication in the batteries and that is what we are waiting for so people can get off the grid."

Taleb's interest in solar was sparked when a hurricane in New York three years ago deprived him of electricity for 18 days. Instead of buying a generator, he began looking at solar batteries and panels.

"(They) fill up and can sustain you for 'x'

number of days. So I started studying solar and realised that there were optionalities because the raw material - the sun - will never change and fluctuate in value.

"The panels themselves are getting more sophisticated. You can buy just a roof now for your house - they look like slates. In 10, 15 years, I am looking down the road for long-term investments. I like these speculative things."

At the other end of the spectrum, Taleb is known for his disdain for the genetically modified organism (GMO) industry. He reiterates his stand on the issue and tells *Personal Wealth* that he avoids anything linked to the industry. "They spend too much money lobbying to convince people that there is no risk, and we are discovering that this may not be true."

Taleb recently wrote an article titled 'The Most Intolerant Wins: The Dominance of the Stubborn Minority', with the proposition that companies doing anything controversial will suffer in the long run. "The point is, which companies will suffer because their product has a stigma against it?"

Taleb says it is the GMO companies and traditional agriculture. Companies that produce organic and natural products will be in favour. There is a rising awareness that in the long-term, organic production will be more efficient and sustainable.

The following is an excerpt from the interview with Taleb.

Personal Wealth: What are your views on the state of affairs in today's global markets?

Nassim Taleb: Not good, and let me tell you why. We had the global financial crisis due to overleveraging. We implemented policies that were necessary to smooth the cycles and stop the pain - monetary policy by lending at cheap rates. The problem is, the crisis came from a lax monetary policy... people were not trained to handle uncertainties and bad companies were allowed to survive. They see the central bank as 'someone who will help them when they have problems'. (Alan) Greenspan did in 1991 - giving the banks cheap money to replenish their balance sheets. And later,

Volatility presents risk better. The fact is that after a period of volatility, investors become a little more tolerant of risk variation.

they asked the state to bail them out. The financial crisis happens, what do they do? They say, 'Okay, we need to ease (monetary policy)'. So, they put interest rates at zero.

There is no evidence that there is a difference between 3% and 0% on the economy's recovery... but you can't leave interest rates at zero forever. So interest rates are at 0% and who do they help? It helped inflate (the prices of) luxury apartment buildings, more than regular ones. In 2013, New York City (luxury) apartments went up on average by more than USD100,000. But medium-cost apartments went down by USD20,000. Basically, there was a reallocation of money to the rich, thereby increasing inequality.

Let's go back to the central point: you have to do something when there is a crisis. But if you go to the doctor and you have a problem, the doctor will give you painkillers. But it is unpardonable for the doctor to give you painkillers for many years without curing the underlying condition, which in this case, is too much debt. What happened during that period? Debt has swelled, but it is now government debt. That's the problem. How healthy we are today cannot be measured without putting back interest rates at where they were before, which is at least 3%. We have to do it for us to gauge whether we are out of the woods.

You said there is no inherent difference between interest rates of 3% and 0%. Then why do it in the first place?

They (policymakers) panicked. They kept lowering rates. But no one is finding it easy to borrow at 0%. So where did the money go? It went to the banks to fund themselves and in the US, to generate themselves a little annuity. The banks take free money from the government and try to give it back to the government to make 25 basis points. It is a joke. But (rates at) 0% is really a distortion - it is penalising investors without favouring borrowers, and such low rates are pushing people into asset classes, such as real estate, which only the rich can own.

Are we seeing cracks? Is there an impending global financial crisis?

The numbers look good in the US as far

as employment (numbers are concerned). And the US will not suffer as much as other countries from the US policy. That's tragic because the rise in debt that we have seen in the US has also happened outside.

Which asset classes will suffer the most?

Luxury real estate. Typically, it is very sensitive to interest rates.

Is this real estate in the US alone?

It is worldwide. Some places in central London - it is crazy. Central London is not the smartest place to buy real estate when it is trading at such a high premium to the suburbs of London. But people tell you, `It is safe here'. Well, it was safe in Florida (too) before the big shock. Take 1994 and look at what happened. Real estate got hammered and it will happen again... it's the same in New York. The luxury premium comes basically from the fact that the superrich have inflated wealth.

Fixed income will suffer a lot more than equities because equities in the end have delivered and the companies (in the US) are very healthy. Let me tell you why I like equities better. Let's say we have too much borrowings and they raise rates. Raising rates is good but still, bonds will go down. Or they could realise that printing money could lead to inflation. Then, bonds will also go down. So both cases are bad for fixed income. Inflation is short-term bad, long-term good for stocks and the lack of inflation is also not that bad. So stocks appear to be the safer bet. Of course, (there is) speculative buying, but the companies are healthy and American companies are very good insofar as debt is concerned (and they are) very wise in their debt policy.

Will we see volatility in the global economy in the next 12 months?

I have no idea, but volatility presents risk better. The fact is that after a period of volatility, investors become a little more tolerant of risk variation. So I'm not worried about volatility. Volatility is good because it forces people to underinvest. If you have no volatility in the market and you have a million dollars, and you lose USD10,000 here and there, you are not going to be scared. But if you lose USD100,000 in a day, then you know that you have overinvested. It makes them scale down their investments.

There are fewer panicked investors because people are less exposed to markets when they are volatile. Part of my `antifragile' idea is that volatility in the stock markets make people allocate less to stocks, (or at least) allocate as much as their appetite allows. They can measure their appetite to risk in the market. But when there is no volatility and one day sees a big movement, this is when it hurts and bankrupts people.

Real estate doesn't seem to be volatile. But it has burnt a lot of investors in history. Investors tell you about New York City (where prices are going up) but not Philadelphia. It is called survivorship bias.

What is the biggest risk to global markets today?

You cannot maintain interest rates at 0%. It is not working. You have to bring it back to some natural level. If there is a problem in the market today, the Fed has nowhere to go. And there are 16 sovereign bond markets that are trading at 0% interest rate.

Central banks have been playing an unprecedented role in the global economy since the global financial crisis. What is your view?

(For real growth,) you should be talking about real things like industries - what people are inventing, what people are discovering, what people are manufacturing and who people are hiring. Unfortunately, all we talk about now is central bank policies. It is like in the hospital - you should be talking about cures and not about painkillers. If you are talking more about painkillers than remedies, it means something is wrong.

What do you think should be done?

Structural reforms are what you need to fix the problems. You should have some kind of punishment for those who make mistakes. We don't have that. If we allowed the banks to fail (in 2008), there would be short-term pain, but long-term gain. The bonuses of banks in 2010 were higher than in 2007 in the US. It wasn't until now that the banks are talking about compressing (payouts) a little, and only because they are making less money. The second point is that there are many good banks that were penalised by the mistakes of the big banks.

Is Islamic banking something we should be moving towards?

We should have done that because it would have reduced debt instead of transferring it to the general public. People thought it would be painful, but it wouldn't have been. Many companies and homeowners that suffered would have recovered.

Islamic banking allows some kind of debt, provided there is some equity. Some people think debt is the only form of financing. This is the biggest mistake and also the biggest argument in favour of Islamic banking. Take the industrial revolution. How much of it was based on debt? Zero. Take the modern industrial revolution. How much of it came from debt? Zero. In 2000, we had a crisis in the Silicon Valley. It was an equity crisis and it looked scary. How much debt was there? Zero. Warren Buffett complained then about Internet companies. He said these people can do an IPO for a billion dollars but they can't borrow USD5 million from the bank. He thought it was a bad thing.

So, the Islamic finance model could be a possible solution?

Islamic finance to me is a vastly more sophisticated method than a lot of the stuff you learn in business school. There is nothing new about Islamic finance as it is 3,750 years old. The mechanism of civilisation is built into this. You have to realise that it is not just Islamic. It has Babylonian, ancient Greek and Roman laws in it. ✱

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BY RAJEEV PESHAWARIA

INTEGRATED THINKING

IS THE RIGHT BRAIN BETTER THAN THE LEFT BRAIN IN A 'CONCEPTUAL AGE' WHERE KNOWLEDGE IS NO LONGER POWER, BUT SIMPLY A COMMODITY?

In a recent talk, Raghu Krishnamoorthy, Chief Learning Officer of GE, made a couple of bold statements that hooked his audience immediately:

> **One** – Talent is abundant not scarce.
> **Two** – Intelligence is now a commodity.

To illustrate his first point, he talked about how GE Aviation redesigned their engine brackets through crowdsourced innovation. They ran a global contest for designs to reduce the weight of the brackets by 30%, and offered a prize of USD20,000 for the best design. To their surprise, the winning design came from a small town in Indonesia, which reduced the weight by a whopping 84%. Now how's that for exceeding your innovation KPI by 180% at the cost of just USD20,000? And who would have thought that the world's biggest aviation giant would achieve such a breakthrough for so little, and more importantly, with input from a small town in Indonesia?

The GE experiment is just one small example of how drastically the business world is changing. Thanks to Google and 24/7 connectivity, Raghu's second point about the commoditisation of intelligence is also easy to see. But I am not sure if the real impact of this knowledge-is-free-and-abundant age is fully appreciated and understood.

KEYS TO FUTURE SUCCESS?

In a class I gave to 30 emerging leaders from different companies recently, I posed the following three questions:

- What skills and mindsets determined professional success until the mid-1990s? Why?
- What disruptive changes began in the 1990s, and how are they shaping the global business landscape today?
- What skills and mindsets are most important for professional success today and in the next 10-20 years?

The group found no difficulty in answering the first two questions accurately. In essence, knowledge was power until about the mid-90s. The more specialised knowledge one had, the more one was likely to succeed. As Daniel Pink nicely puts it in his wonderful book 'A Whole New Mind', our left brains have made us rich in the last century. Thanks to the knowledge-is-power era, we now live in a world of abundance, where we have an amazing array of choices for anything we want to buy or experience.

However, as knowledge is becoming free and easily available, and as computers are replacing human tasks (and thinking) at an alarmingly fast pace, is knowledge likely to remain the key to professional success going forward? My class rightly determined that it will not. However, there was no agreement about the answer to the third question. Some said relationships, others said caring leadership, while still others said integrity.

So we discussed the third question at length, and concluded that the following three abilities will determine success going forward:

- **Symphony Making:** The ability to think big picture, and to integrate seemingly unconnected elements within and between systems in order to find holistic solutions.
- **Connecting Deeply:** The ability to touch people's sense of meaning and happiness.
- **Designing For Beauty:** The art of creating solutions that are visually and emotionally appealing.

These three abilities combined together are what we call Integrated Thinking. To paraphrase the words of Daniel Pink again – in today's 'conceptual age', right brain acumen will be equally if not more important than left brain acumen.

EMPHASISING RIGHT BRAIN DEVELOPMENT IN ASIA

If Pink is right, the implications are huge, particularly for Asia. While educating and developing our kids, we in Asia place a disproportionately high emphasis on science, technology, engineering and mathematics (STEM). Someone studying liberal, fine or performing arts is not always considered smart enough. With some exceptions, while evaluating candidates for key jobs, we still largely regard left brain (STEM) skills higher than right brain skills. It might be time for us to think differently, and give right brain development its due share of focus going forward.

While the education sector is beginning to do its bit, Asian corporations will serve themselves well if they incorporate right brain development within their employee ranks. So far, we do not see enough evidence of this happening. As we partner with companies across Asia to help develop leadership and management skills within their organisations, we routinely work clients' competency models. In five years, we have seen only one example where an organisation lists Integrated Thinking as a core competency for success. Other than this one, we are yet to see any hint of right brain emphasis in competency models or corporate curricula. If you approve or oversee talent development for your organisation, it might be worthwhile looking at your mix of offerings to make sure you have the right balance. ✱

+ Thinking about the following questions should help

How is the market place for our products and services changing thanks to automation, 24/7 connectivity and abundance?

What core capabilities determined our success in the last 10-20 years? How many of them were left brain skills versus right brain skills?

What capabilities do we need in the next 10 years? Will the left-right mix remain the same? How should we build the new capabilities within our organisation?

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 BY ROBERT SOUSTER

ETHICS AND BANKING

10 LESSONS FROM THE FINANCIAL CRISIS

THERE ARE **TEN KEY** INSIGHTS WHICH BANKS MUST TAKE TO HEART TO PROMOTE A NEW DAWN IN ETHICAL BANKING.

All industries go through challenging times. The first few years of the twenty-first century saw the 'dot.com' bubble burst, and at roughly the same time the airline industry imploded with the fallout from the World Trade Centre atrocity.

The financial crisis struck in 2007 with the failures and near-failures of investment banks in the USA, and the Northern Rock, RBS and Lloyds crises in the UK. All of a sudden, banks which were once considered to be of the highest repute found themselves under massive public scrutiny. The proud public image that had been built up over centuries could no longer be taken for granted, as a sceptical public fuelled by headline-hungry media challenged their policies, their people and their products. Reputation built up over decades was lost in seconds.

This article offers ten lessons from the last eight years or so. Its conclusions are not based on research, but observations put together from the author's own experiences in working with banks, the views of participants in the Chartered Banker MBA programme at Bangor University and the pioneering work of the Chartered Banker Institute, which was the first professional banking institute to promote a new dawn in ethical banking.

LESSON 1

ETHICAL STANDARDS HAVE TO BE DRIVEN FROM THE TOP

The majority of headlines criticising the banks in the tabloid newspapers in the UK did not look at capital adequacy, or products, or mis-selling, or indeed anything to do with what banks actually offer. They were instead devoted to human failings. Many of the scandals in banking during the 1990s and the following decade were rooted at the point of sale, including endowment mortgage shortfalls, mis-selling of payment protection insurance and misleading advice on pension annuities. So blame was apportioned to intermediaries, to sales people, to call centre staff, and to anybody who came into contact with customers. In doing so, responsibility was confused with accountability. Policies start at the top and are driven by the top. This is the single main reason for the emergence of the most popular buzz phrase of recent years – the need to set the right 'tone at the top'.

LESSON 2

ORGANISATIONAL CULTURE HAS TO BE RIGHT

We know this already. Good organisational culture emanates from lesson 1, and if the culture is toxic it is a failure of management. But how is organisational culture shaped? It starts with setting standards and maintaining them, which is an executive responsibility. But thereafter it is everyone's concern, including divisional managers, departmental managers and functional managers, especially human resources specialists, who recruit, select, induct, train, design reward systems and appraise. Most likely, most heads of credit got to their positions by being good at lending, and most heads of IT/IS got to where they are now by being good with technology, but how good are they at the less tangible but equally important aspects of management, such as making sure that they and their people do the right things?

LESSON 3

EVERYONE HAS A PRICE

Offer a Manchester United supporter £10 to go along to Anfield to support Liverpool and you have no chance. Offer £1,000 and you have a better chance. Offer £1 million and you are sure to have a deal, if only for one game. If the reward is compelling enough, people will move in the direction you want. This is why short-term bonuses work. Many outcomes in banking became ridiculously short-termist in nature, and this was especially true in investment banking. Too little care was taken in aligning reward systems to the medium to long-term policy objectives. An exaggeration? Ten years ago, the Financial Services Authority (then the UK regulator) did a survey of most mortgage lenders in the UK and found that the majority of lending practitioners were targeted on quality and quantity of lending business transacted, yet a staggering 61% of organisations had no clawback of performance-related rewards for lending that turned bad.

LESSON 4

RISKS ARE DYNAMIC

With the pace of change accelerating, risks come and go. Just as the risks associated with many traditional, paper-based systems have receded, new, emerging risks appear quickly and without warning. Businesses have to be structured to deal with this, starting with a properly constituted Risk Committee at Board level. Then the organisation has to decide whether a dedicated risk function should be put in place, or if not, how risks will be managed. In turn, risk management has to be synced to internal controls, and this brings us to lesson 5.

LESSON 5

INTERNAL CONTROLS MAY BE BORING, BUT ARE IMPORTANT

Fifteen years ago, the Turnbull Report in the UK came up with some blindingly obvious common sense, but like all common sense it sometimes needs to be spelt out. Organisations should have a sound system of internal control, which means that the system should provide reasonable assurance that the organisation can achieve its objectives. The stress should be on 'assurance' and 'achieve'. These are positives, but how many people associate internal control functions with negatives, such as authorisation limits and being forbidden from doing things? To too many people, an internal auditor is seen, wrongly, as some kind of traffic cop. Control will never be fun, but its objectives can be achieved more readily by automating out the routine while building control objectives into reward systems.

LESSON 6

BE PROUD

Bankers were right to be fearful when successive scandals emerged during the crisis. They were not used to the wrong kind of headlines. But to put it in perspective, just how many banks and how many people were caught up in

this? Banks have an enormous right to be proud of their history and heritage, from their role in generating invisible exports, to their part in generating wealth and incomes, to their ability to act as catalysts for the growth of businesses of all types and

sizes. During the 1980s and 1990s, banks became very good at selling products, but must now call upon their leaders to sell themselves. Successes should be shouted from the rooftops. Muhammed Ali was good at this, as also was Jose Mourinho. But what happens if, like Jose Mourinho, you hit a bad patch? Sorry, but it goes with the territory: you can't take the salary and expect a round of applause.

LESSON 7

UTILITARIANISM DOES NOT ALWAYS WORK

Utilitarians are those who believe that serving the greater good is right, so if it works for the majority, let's go with it. For this reason, old business models have been gradually abandoned in favour of standardised services through online banking and call centres. This was inevitable, as the old face-to-face banking model is no longer cost effective, and banks can no longer be expected to have huge branch networks in which customers can idly pass the time of day and transact little business. Yet we have to ask whether our industry does enough, in the new economic climate, to really get to grips with small business needs, the requirements of vulnerable customers and other niche groups in society. A little less utilitarianism and a little more pluralism may be in order.

LESSON 8

EXPERTISE IS THE KEY TO ETHICAL BEHAVIOUR

The more a person knows, the more that person can deliver and the more that person can be motivated, and the more they will deliver for the organisation. However,

there is no point in putting a person in a sales position, or any customer-facing position, if they don't know what they are talking about. One of the most powerful weapons in the armoury of any business is training, but many organisations have forgotten how important it is to equip their people with basic knowledge. If this is not in place, they cannot give correct information or advice. And that is unethical.

LESSON 9

THINK HARD ABOUT THE 'GREEN' DIMENSION

Ordinary people care about the planet, the environment and the social dimensions of business, and bankers have a role to play here. We can choose how funding is raised and how commercial assets are deployed, and those choices can be for good or bad. Ethical decisions are notoriously subjective. Ask business people about working with weapons manufacturers, tobacco producers and breweries. It is seldom for us as bankers to decide what is right or wrong, but it is necessary to hone in on public sentiment and where stakeholders draw lines in the sand. In the future these issues will become more important, and already the accountancy profession is moving forward with initiatives in full cost accounting and integrated reporting, both of which put a stronger emphasis on less tangible externalities.

LESSON 10

BANKING MUST BECOME A PROFESSION

Pardon? Isn't banking already a profession? If you are a doctor and make a bad mistake, somebody may die and you'll be struck off. If you are an accountant and you make a bad mistake, you might never practice again, and if you are in the USA, might even go to jail for 25 years. In our industry, a pitifully small proportion of our staff are members of a banking institute. Even in the British isles, home of one of the oldest banking industries in the world, only one of the three main professional banking bodies even has a professional code of ethics. So an individual who really messes up a bank, or takes decisions that threaten the wealth of a customer for decades to come, can walk away or be dismissed, only to be re-employed and do the same over again. That is not professionalism. ✱

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Championing the Underdogs

How can bottlenecks in SME finance be undone to support this important global growth engine?

Small and medium-sized enterprises (SMEs) are frequently upheld as the lifeblood of global business and society. Arancha González, Executive Director of the International Trade Centre, labelled SMEs "the world's most concentrated, booming, and innovative engine for world trade and growth."

The numbers from different agencies and associations support these contentions. "Small businesses account for more than half of the world's GDP and two-thirds of all employment," said Peer Stein, Director of Finance and Markets Global Practice at the World Bank Group. Meanwhile, SMEs are the most common business models, comprising "99% of all businesses in most economies and between half and three quarters of the value added (industries)," wrote Tim Mazarrol, President of the Small Enterprise Association of Australia and New Zealand Ltd, in 'Growing the Global Economy through Small and Medium Enterprise: The G20 SME Conference'.

Likewise in ASEAN, SMEs comprise a significant part of the economy. They contribute to 74% of employment and 41% of GDP in ASEAN alone, albeit it stands for only 21% of direct exports, noted Ganeshan Wignaraja, Advisor, Economic Research and Regional Cooperation Department of the Asian Development Bank (ADB), speaking at the East Asia Forum.

SME FINANCE: THE GLOBAL GAP

Despite their ubiquity, SMEs lag behind when it comes to gaining access to the resources that they desperately need to sustain and expand performance.

Although there are several systemic blocks to growing SMEs, one of the most tangible is the persistent lack of access to financing. SMEs are generally financed by the private sector, which funds approximately 45.9%, followed by state-owned banks and government enterprises at 28.3% and non-bank financial institutions (NBFI) at 12.9%, according to an International Finance Corporation (IFC) enterprise datasheet presented

at the 2015 SME Finance Forum.

"Financing for SMEs is lacking although there is an ample amount of cash ready to get deployed," said Michael Koenitzer, Financial Inclusion Project Lead at the World Economic Forum and Council Manager. In 2015, the credit financing gap for SMEs globally was estimated at between USD1.5 to 1.8 trillion with USD0.9-1.1 trillion of that linked to developing countries, according to the IFC figures. Moreover, this number only accounts for formal SMEs; according to the World Bank (WB), the total credit gap for both formal and informal SMEs stands at USD2.6 trillion.

The need for SME financing is widespread. The UK, Italy, Spain, the Netherlands, Turkey, Nigeria, Morocco, China, Canada and Argentina are among the dozens of countries worldwide where businesses indicate access to finance as a top three concern for doing business, stated the recent World Economic Forum (WEF) Global Competitiveness Report 2015-2016, as a consequence of the global financial crisis.

Asian and ASEAN SMEs too are hampered by lack of access to financing. Dato' Ramesh Kodammal, a member of the ASEAN Business Advisory Council (ASEAN-BAC), told the press that access to finance is still the overriding issue for ASEAN SMEs. In addition, the 'ADB-OECD Study on Enhancing Financial Accessibility for SMEs' identified obstacles as a one-size fits all approach which does not apply to diversified SMEs, and limited models for SME financing that rarely stretch beyond traditional bank lending.

Other barriers to expanding SME financing occur on both the demand and the supply side. Examples of the former include lack of verifiable borrower information or business plans, absent or incompetent record-keeping, and a poor repayment culture amongst borrowers. The latter meanwhile includes the poor capacity in the financing pipeline; there are a relatively limited pool of banks and financial institutions with the commitment and capabilities of financing SMEs - commercial banks rarely lend to SMEs since they are not designed to do so, noted ADB's Wignaraja. These are compounded by limited and non-innovative financial services catering to SMEs.

SOME SOLUTIONS

While the private sector is urged to play a more proactive role in SME financing, it is hardly surprising that many initiatives in the SME segment are government-led. Government measures like establishing SME development funds, providing credit guarantees for SME loans,

and setting quotas for mandatory SME lending are among the measures that have boosted SME finance.

Government policies have also increasingly included SME development plans, which mainly focus on enhancing SME bankability, credibility and governance. According to the ADB-OECD Study, this encompasses "encouraging market access, productivity enhancement, sound competitive environment, formalisation of informal SMEs, capacity development, concessional business regulatory environment, and technology adaptation to innovative SMEs" as well as central bank support.

Where Malaysia is concerned, it achieved improved access to finance for SMEs through financial innovation and pragmatic solutions. Amongst the measures implemented are SME refinancing schemes overseen by the government or central bank and the SME Master Plan 2012-2020, with RM9.5 billion allocated for various pro-SME initiatives in the 2016 Budget.

SMEs also have opportunities to access Malaysian capital markets through initiatives such as the upcoming equity crowdfunding platform to be launched by the Securities Commission Malaysia in 2016. Venture capital, factoring, and leasing facilities are also available through non-bank financial institutions.

Neither is Malaysia limiting its drive for SME development to local markets. As chair of ASEAN, Malaysia is championing regional integration, and this applies to SMEs as well. Tan Sri Dato' Sri Dr. Zeti Akhtar Aziz, Governor of Bank Negara Malaysia (BNM) called for the enhancement of SMEs in the ASEAN integration process and plugging them into "regional and global value chains" at this year's ASEAN SME Conference.

The BNM governor further detailed key benefits of the upcoming ASEAN Economic Community (AEC) for SMEs. Namely, SMEs will gain access to an expanded marketplace, lower regulatory trade barriers, and an encouraging business environment based on increased connectivity. Regionalisation will also see the implementation of SME-focused policies by ASEAN member countries, such as a regional SME internship programme to hone human capital, the ASEAN Marketplace acting as an online directory and information platform on SME-related processes in member countries, and the ASEAN Strategic Action Plan for SME Development 2016-2025.

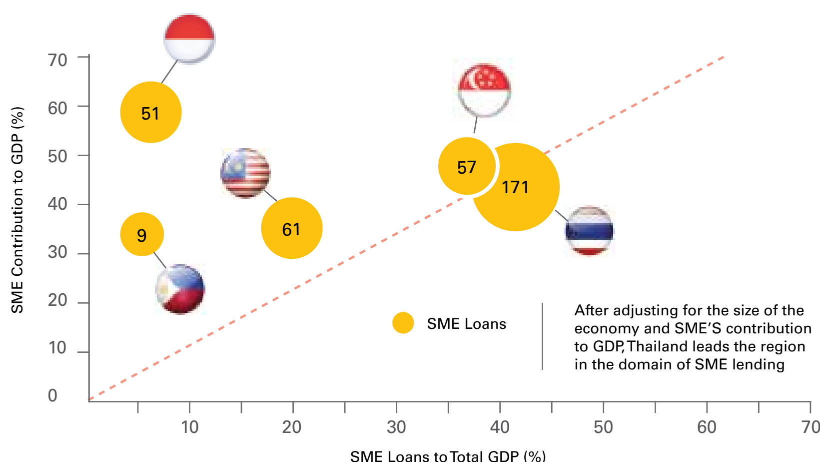


FIGURE 1 SME Loans-to-GDP vs SME Contribution to GDP (USD billion[1], 2014[2])
NOTE [1] 08 March 2015 exchange rate used: 1USD = 3.6MYR, 1USD = 44.31PHP, 1USD = 12,747IDR, 1USD = 33THB, 1USD = 1.36SGD [2] GDP figures from 2013
SOURCE Asia SME Finance Monitor 2013, Bank Negara Malaysia, SME Corporation, Securities Commission Malaysia, Bank Indonesia, Bank of Thailand, MAS, Bangko Sentral Ng Pilipinas, World Bank, Deloitte Analysis

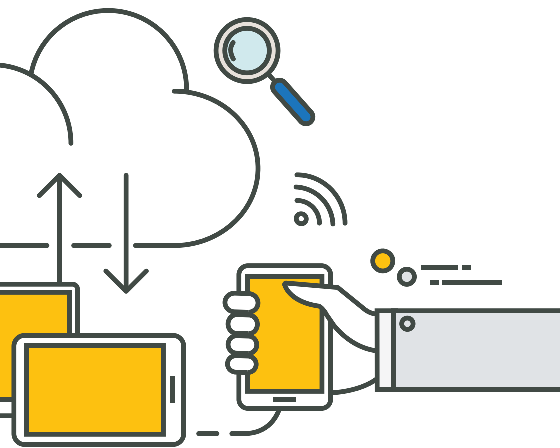
With specific regards to finance, Malaysia has pressed for the establishment of an ASEAN SME Bank to finance SME innovation, investment and expansion. On this note, the ASEAN Business Advisory Council Malaysia (ASEAN-BAC) is recommending the development of a regional MSME bank (micro and SME) that can support MSMEs in expanding their business and facilitating cross-border trade, said Chairman Tan Sri Munir Majid in April 2015 to the press.

Malaysia has also proposed leveraging on Islamic finance and credit guarantees as two options for funding ASEAN SMEs. According to remarks made by Datuk Hafsah Hashim, Chief Executive of SME Corp Malaysia, at the ASEAN Summit, Islamic financing offers lower rates for borrowers and Malaysia's Credit Guarantee Corp (CGC), which acts as a guarantor for financing and loans, could be a role model in ASEAN SME financing.

DIGITAL INNOVATIONS AND FIN-TECH DISRUPTIONS

Investing in innovation and technology could help SMEs fix their flaws that limit access to funding.

Notably, a recent Visa and Deloitte Digital SME Banking Study which focused on SMEs in the markets of Singapore, Malaysia, Thailand, Indonesia and The Philippines highlighted the poor visibility of SME transactions in ASEAN. This coupled with the low risk appetite of banks limited the amount of lending for SMEs, hence,



leading to inadequate cash flow problems burdening many SMEs.

Referencing the Deloitte-Visa study, Ooi Huey Tyng, Visa Country Manager for Singapore and Brunei pointed out opportunities for SMEs to adopt innovative electronic payment solutions to bridge the gap in cash flow receivables and payments and improve visibility and transparency. Credit access and payment tracking solutions and the use of electronic platforms for procurement and payment could alleviate problems associated with cash flow. "Once there is better cash flow visibility, banks will be able to approve loan applications since lack of collateral was cited as the key reason behind rejected loan applications," she said.

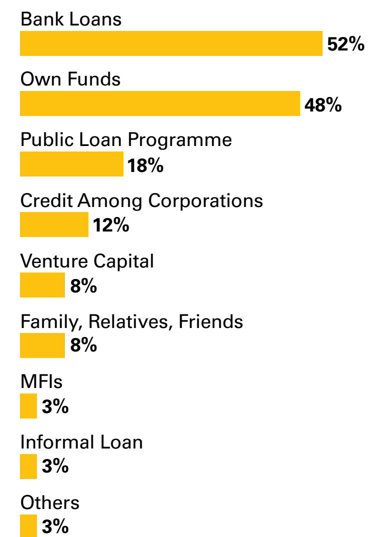
Lack of access to finance could also be mitigated if SMEs embrace alternative lenders and the services emerging from fin-tech disruption. According to a white paper released by the World Economic Forum's Global Agenda Council on the 'Future of Finance & Capital', financial technology companies are helping to bridge a USD2 trillion funding gap for millions of SMEs seeking credit to grow their business.

The WEF noted that equity investment into the fin-tech businesses quadrupled to USD12 billion in 2014, up from USD4 billion in 2013. These fin-tech entrepreneurs are offering tailored services to SMEs such as invoice and supply chain financing, equity crowdfunding and SME-to-SME lending.

"In this case fin-tech disruptors are increasingly filling the gap banks and investors leave," said WEF's Michael Koenitzer, Financial Inclusion Project Lead at the World Economic Forum and Council Manager, who added that "fin-tech is providing a much needed relief to small businesses around the world." "If fin-tech can provide levers to help them succeed, we should create the right environment to make this happen," concluded Stein of the World Bank Group. ✱

■ *Reporting by the Banking Insight Editorial Team*

FIGURE 2 Funding Instruments[1] (% of SMEs cited using) **NOTE** [1] Data from 2013 **SOURCE** Third Quarter 2014 Malaysia SME Survey; First Quarter 2012 Malaysia SME Survey; SME Corporations Malaysia; World Factoring Yearbook



04 WAYS
TO BOOST SME ACCESS TO FINANCE FROM COMMERCIAL BANKS IN ASEAN

BY **GANESHAN WIGNARAJA**, ADVISOR, ECONOMIC RESEARCH AND REGIONAL COOPERATION DEPARTMENT, ASIAN DEVELOPMENT BANK

Concerns about moderating economic growth and rising income inequality in ASEAN economies have brought small and medium-sized enterprises (SMEs) into the policy limelight. Arguing that SMEs have significant potential for creating jobs, some commentators are suggesting a host of industrial policies such as financial subsidies and local content rules to promote SMEs. However, government failure may result from heavy-handed state intervention for SMEs.

An alternative is to reform SME finance - particularly by commercial banks - in ASEAN economies. SMEs make up most of the enterprises, 74% of total employment and about 41% of gross domestic product in ASEAN economies. But these contributions are not reflected in trade, where SMEs

+ SMEs make up most of the enterprises, 74% of total employment and about 41% of gross domestic product in ASEAN economies.

account for only 21% of direct exports across the ASEAN region. Today, trade increasingly means global supply chain trade, which is about being involved in factories across the world, and trading in parts and components. Since the 1980s, ASEAN's participation in supply chains accounts for a sizeable part of its respectable 5-6% annual economic growth. ASEAN economies, though, will face competition from India, Bangladesh and other new entrants in the future due to moderating regional growth and rising costs. Adjusting business strategies and reforming commercial bank finance are critical to expand ASEAN's role in supply chain trade – and firm size matters. Being a big firm naturally creates advantages to participate in supply chains due to a larger scale of production, better access to technology from abroad, and capacity to pay higher wages for skilled labour and spend more on marketing. Smart business strategies such as mergers, acquisitions, and forming business alliances with multinationals or large local business houses are all rational approaches. Under some circumstances, nimble SMEs in ASEAN economies can also join supply chains. By clubbing together in industrial clusters, SMEs can overcome some of the disadvantages of their small size and rely on the benefits of interdependence. For instance, small firms located in clusters can jointly finance a training centre or a technical consultant to upgrade skills. Business associations can facilitate clustering by mitigating trust deficits to cooperation among SMEs, and by coordinating collective actions.

Adjusting business strategies and reforming commercial bank finance are critical to expand ASEAN's role in supply chain trade – and firm size matters.

Financial systems in ASEAN economies are dominated by a few commercial banks. One critical constraint affecting SMEs in ASEAN economies interested in supply chains is their lack of access to finance from commercial banks, although the credit gap seems greater in poorer economies like Cambodia, Lao PDR, and Myanmar. Banks in ASEAN economies typically undertake more certain and profitable lending to consumers and big corporations. Accordingly, SMEs continue to rely on internal sources - their own savings, moneylenders, and non-bank instruments - for most of their financial needs.

So what needs to be done to improve the situation?

❶ EXPAND BANKING SYSTEMS

ASEAN economies should continue to encourage the creation of sound and effective banking systems to increase the supply of finance including to SMEs. Encouraging competition among commercial banks is vital, through privatisation of state banks and facilitating the entry of reputable foreign financial firms. Enacting competition laws provides a level playing field for domestic and foreign financial institutions alike, and effective central bank regulation of commercial banks are prerequisites for deep financial systems.

❷ CHANGE COLLATERAL LAWS

Commercial banks lend little to SMEs, partly because many banks are not designed to do so. Commercial banks may not know how to properly evaluate the working capital requirements of SMEs and their investment projects, so we could allow using non-fixed collateral, and work with business associations to ratchet up peer pressure. In SME clusters in Japan, peer pressure within a network of SMEs is effective in getting businesses to pay back their loans.

❸ INVEST IN FINANCIAL LITERACY

Commercial banks require business and financial plans, but many SMEs that really need credit do not have the capacity to prepare these plans. SMEs use a single-entry accounting system, while banks expect to see something more complex. Investing in financial literacy for SME entrepreneurs and managers is therefore crucial. Financial literacy programmes in high schools and universities, along with short financial literacy courses for SME managers, would be ideal.

❹ IMPROVE CREDIT ASSESSMENT FOR SMEs

Many ASEAN economies lack independent market institutions capable of rating SME creditworthiness. Establishing a domestic credit bureau for SMEs as a public-private partnership is a useful way forward. Later this institution could become an independent company.

A more effective system of commercial bank finance for SMEs in ASEAN is better than a plethora of industrial policies for SMEs. There are no quick fixes to reforming commercial bank financing of SMEs, and the process will take some time and require political will. But this can be a good start.✱

■ *This article was first published as an ADB blog posting on 2 October 2015.*

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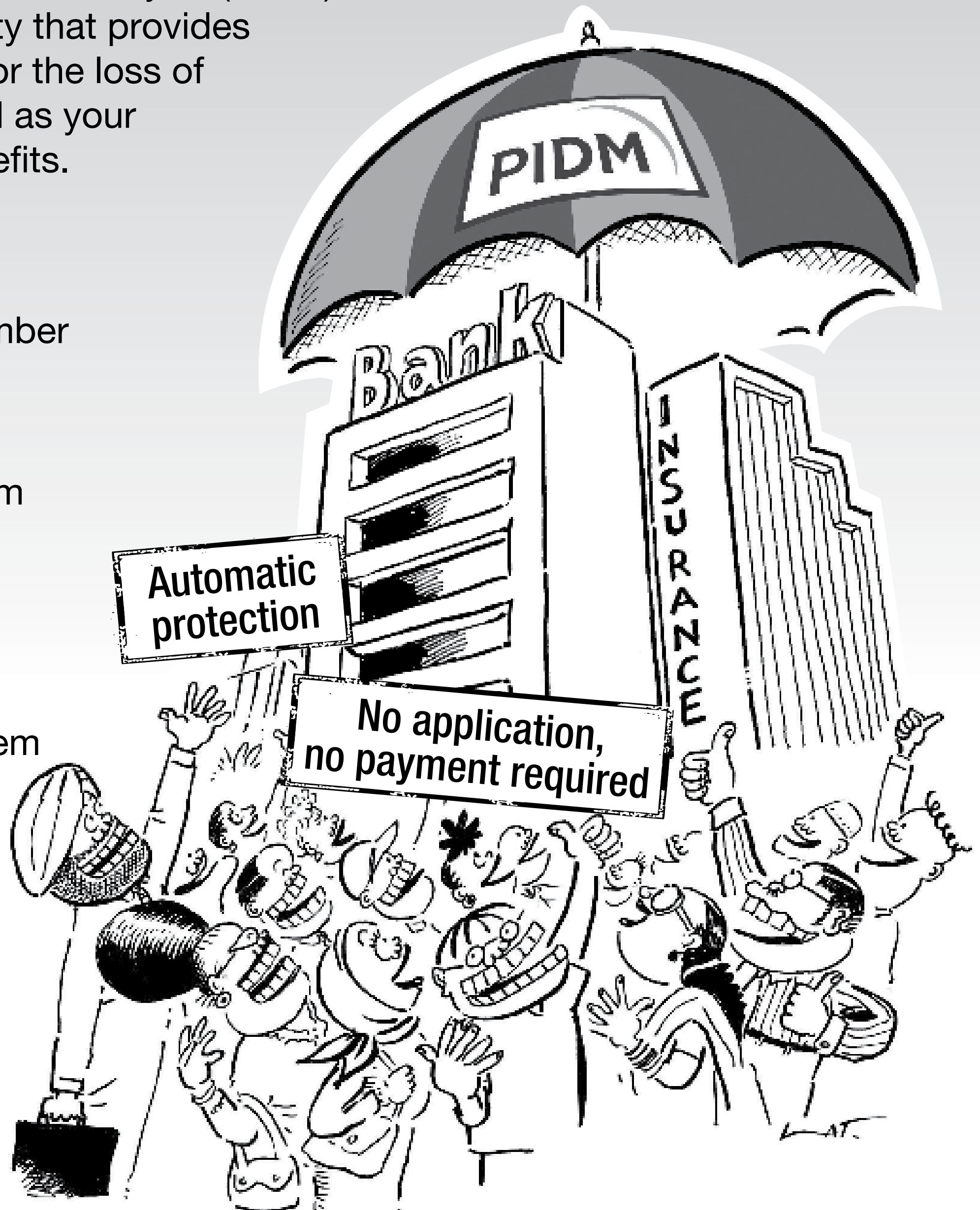

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Protecting Your Insurance And Deposits In Malaysia

BY DR. K. RAJESH NAYAK

Resource

People are the key resource from which flows the ultimate strength or weakness of any organisation. They may play a managerial or leadership role by taking an active part in the policy-making process or they may choose to play an operational role by helping to give shape to the policies, goals and objectives as set out by the former.

ROLE OF HRM, HRD AND TRAINING IN ORGANISATIONAL SUCCESS

How can financial institutions **transform themselves into effective organisations** that facilitate the learning and development of employees in order to achieve long-range sustainable success?

If you wish to plan for one year, sow seeds. If you wish to plan for ten years, plant trees. If you wish to plan for a lifetime, develop men.

Give a man a fish and you feed him for a day. Teach a man how to fish and you feed him for a lifetime.
- Old Chinese Proverbs.

The above statements reflect the critical importance of Human Resource Development (HRD) for the long-range success of any collective enterprise, especially business. In fact, human capital is considered to be one of the four drivers of business success in the current millennium (the others being financial capital, technology capital and speed capital). People are the key resource from which flows the ultimate strength or weakness of any organisation. They may play a managerial or leadership role by taking an active part in

It is universally accepted that individuals have a basic need to grow and that they are not static but change by acquiring new knowledge, skills, attitudes and beliefs. They also tend to demonstrate certain capabilities that do not get adequate opportunity for expression in the normal course.

the policymaking process or they may choose to play an operational role by helping to give shape to the policies, goals and objectives as set out by the former. Together, they constitute the manpower resources or human resources of an organisation.

To integrate these resources into the mainstream of the business, to understand people and their needs, to help them develop the required skills and to inspire them to greater levels of efficiency and achievement is the task of Human Resource Management (HRM). HRM considers human resources as an influential partner in business success and an asset with a vast potential, and emphasises that the contribution of individuals becomes manifold if there are collaborative (team) efforts on the part of all concerned.

The belief that an individual is hired for a specific job which he continues to do all through his work life has now been discarded. It is universally accepted that individuals have a basic need to grow and that they are not static but change by acquiring new knowledge, skills, attitudes and beliefs. They also tend to demonstrate certain capabilities that do not get adequate opportunity for expression in the normal course. In the course of time, some critical event brings forth these capabilities, which can best be described as a process of learning and discovery. As observed by Charles Handy, "The problem of managing development within organisations is to understand how one may hasten or accelerate the process of learning and discovery."

Human Resource Development (HRD) as an approach to manpower management is based on the premise that employees should be provided with continuous learning opportunities to enable the achievement of their individual goals as well as the organisational goals. Since the prosperity and growth of any company stems from the creativity of ideas and soundness of judgement of its management, the development of this management is clearly a primary and fundamental part of business direction with which the Board of Directors is preoccupied. In the life of a corporation, present success is largely the product of three types of executive actions taken in the past. Selecting the right people, placing them in the right job and seeing to it that they are able to grow to meet their needs as well as that of the organisation.

The needs of the organisation should be linked to the career paths of individual employees so as to satisfy their growth needs. The activities related to this are training (learning related to a present job), education (learning to prepare the individual for a different but identified job) and development (learning for the growth of an individual not related to a specific present / future job). Training can therefore be viewed as a sub-system of the HRD system.

EFFECTIVE TRAINING

Effective training is a combination of programmes designed to accomplish early results, know-how - both technical and of training, instructors who can transmit know-how in the shortest possible time, trainees who are capable and motivated to learn, methods that best fit the material to be transmitted, standards to measure results obtained against programme plans and administration that coordinates all phases of the activity. Hence, any corporate philosophy on training should outline the direction to be followed by the organisation in each of these crucial areas so as to maximise the impact of training on the individual employee as well as on the organisation of which he is a part.

Training is a highly dynamic process

and is designed to play a critical role in ushering in change, providing valuable feedback on the organisational climate, building the right perspective, promoting and building human competencies and imparting problem-solving and coping skills.

In a free market environment, the survival of an organisation depends on its ability to enjoy a sustained competitive edge in the market in terms of innovation, originality of service and proper perception of customer needs. The core competency of an organisation does not lie in particular products or product categories but in the unique expertise or knowledge pool and skills of its people, which is the only factor that can provide such an ability. Reengineering of business processes will not succeed unless the right people with the appropriate set of skills are in place to manage the new processes. Their knowledge about the customer's needs and the bank's capabilities, as well as the ways in which the latter can be leveraged to meet the former, will undoubtedly enhance the marketing skills of a bank. It is rightly said that organisations having ambitions will have to nurture and retain knowledge workers (employees who are on a constant quest for growth and development, whether by training or by self-development) and reposition themselves as learning organisations.

A learning organisation is one in which people create the climate that facilitates the continuous development (a continuum in which, in a structured way, all people learn, are challenged and motivated so that they can grow and develop as individuals throughout their lives) of all members who, as a result, are able to continually develop the organisation. A learning organisation is also described as one where people continuously expand their capacity to create the results they truly desire, where new and expansive patterns of thinking are nurtured, where collective aspiration is set free and people are continuously learning how to learn together.

As indicated by the above viewpoints, a learning organisation not only facilitates the learning and development of its employees but is itself in a constant process of transition and change. Its employees are forever attempting to learn new things and apply what they have learnt to improve product or service quality. It is characterised by a systems perspective, shared vision, personal mastery and team learning. Improvements do not stop when formal training is completed.

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Systems Approach

Since training is regarded as an important mechanism for gaining a competitive business advantage and also for attaining organisational objectives, a Systems Approach to training (viewing training as a set of inter-related parts and as a sub-system of the larger organisational system) alone can contribute to its effectiveness.

Ultimately, any discussion on organisational methods and systems would not be complete without reference to training. In the emerging competitive environment, there is a need for specialised expertise in any organisation to improve the ability of its personnel and thereby, the quality of its products or services. For achieving this, the role of HRD in general and training in particular is important. Training and orientation courses designed to improve professional expertise and to motivate the employees should not become routine exercises. Care should be taken to ensure that the quality of training imparted in banks does not become uneven and training methodology does not become stereotyped on account of insufficient attention being paid to selection and development of training faculty. There should be periodic revision of the curricula for training in relation to emerging needs. More importantly, corporate commitment to training should be clear. Modern management is getting increasingly skill-oriented and employee training is being recognised as an important instrument to develop knowledge, skills and attitudes in people. ✱

RRP in the Malaysian Context

Taking the lead from best practices in other jurisdictions, Malaysia should consider implementing a formal recovery and resolution planning (RRP) regime to avert the need for bail-out funds and reliance on public monies and debt in the event of another contagious global financial crisis.

"A repeated lesson from the (financial) crisis is that insolvency doesn't work for banks ... Instead, on failure, we must cover losses and recapitalise firms so that they can be reorganised in an orderly way."

Andrew Gracie, Executive Director, Resolution, Bank of England, 2014

One key takeaway from the 2008 global financial crisis is that the conventional public bail-out approach needs rethinking. To stem systemic risks, governments had to dig deep into public funds to rescue behemoth financial institutions (FIs) which were considered too big to fail. The bailouts were exorbitant: at the height of the crisis, the US Federal Reserve committed USD7.7 trillion to rescuing the financial system, equivalent to more than half of the country's GDP for that year.

The hefty costs of restoring trust and stability triggered the current thinking behind recovery and resolution planning (RRP). RRP is likened to a "living will" and aims to achieve two outcomes. Firstly, to minimise the need for public funding when an FI is in severe financial turmoil. Secondly, to resolve the FI in an orderly fashion when it eventually fails, without putting severe stress on the financial system.

Under RRP, the onus is on the shareholders and creditors of the FI to revive the business. They would be the first to absorb the losses and convert their debts with the distressed FI into equity to help with recapitalisation. While in theory the FIs should not need public support for their recovery planning, the central bank, however, may intervene as a Lender of Last Resort to provide short-term liquidity support.

Given that RRP is a fairly new topic in Malaysia, it's timely to create greater awareness and provide Malaysian banks with useful information and best practices on how best RRP can be tailored to suit the banking industry in Malaysia. 'Recovery and Resolution Planning: A Discourse in the Malaysian Context' is the first in a series of thought leadership collaborations on the subject between PwC and the Asian Institute of Chartered Bankers (AICB) and aims to get the ball rolling in the RRP space. The following are some highlights from the report which are hoped will be food for thought for local FIs in today's volatile and complex landscape.

+ The aim is now to systematically wind down the failed FI, minimise the impact to the financial system, and reduce the need for government intervention and support.

TIMING

When should an FI embark on a RRP? And what does RRP entail? Typically, FIs face three possible stages of the business cycle. During the business as usual phase, FIs should be planning for recovery and resolution, in other words preparing for and pre-empting crisis. During the financial distress phase, FIs will need to set recovery plans in motion and the focus is to stabilise the financial condition of the FI. During the acute phase of failure or likelihood of failing, the business is no longer viable, and needs resolution. The aim is now to systematically wind down the failed FI, minimise the impact to the financial system, and reduce the need for government intervention and support.

THE PROCESS

There are six critical actions recommended for FIs undertaking a successful recovery and resolution plan. These are:

FIGURE 1 A new mindset to financial system supervision **SOURCE** PwC

+ Educate and communicate new rules

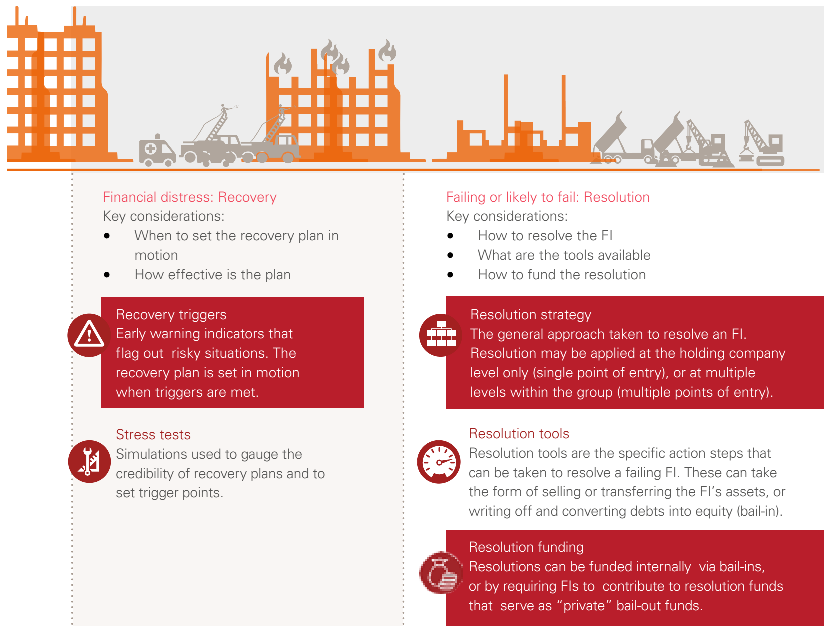
Stakeholders' buy-in is very much dependent on their understanding of the new rules. FIs will need to educate stakeholders, especially shareholders and bondholders, on complex concepts such as bail-in and loss-absorbing capital, for example. Bail-ins aim to recapitalise FIs internally via write-down and conversion of liabilities into equity. The concept of total loss-absorbing capacity (TLAC) sets the minimum amount of loss-absorbing liabilities firms should have for recapitalisation purposes in times of distress. It is also important to renegotiate capital and debt instruments to include bail-in clauses.

+ Collect and maintain fit-for-purpose data sets

RRP involves significant amount of data collection and detailed analysis. For example, asset valuation is key to the feasibility of recovery options. It is recommended that FIs assess information requirements and develop capabilities to run valuations quickly and at short notice.

FIGURE 3 Nine key elements for FIs to consider **SOURCE** PwC

FIGURE 2 Key components of recovery and resolution **SOURCE** PwC



+ Consult regulators early to ease compliance

Focus on regulators' key areas of concern and engage them early, and set these areas as top priority.

+ Appoint an owner, manage all stakeholders

The broad scope and depth of RRP will require extensive resources, senior management engagement, and Board engagement. It is recommended that FIs appoint an RRP owner, set up a project team, and agree on timelines and key milestones. Ensure that the Board, business unit heads, and middle and back offices are briefed. Significant content creation and internal engagement will be required to finalise and approve the plan.

+ Be diligent in delivering RRP requirements

These include setting recovery indicators or triggers, conducting scenario analysis and testing, and designing the governance framework. It is also important to organise workshops to discuss triggers, stress testing, recovery options, roles, responsibilities and lines of reporting, etc.

+ Anticipate and connect the dots

Similar to Business Continuity Management (BCM), RRP is about anticipating incidents and coordinating various operations to develop solutions that protect critical functions in the event of a crisis. This requires people with good foresight and a sound understanding of interdependencies between business functions. FIs must put a holistic approach in place and commit to planning for the unexpected.

THE MALAYSIAN CONTEXT

Although Malaysia does not currently have a formal RRP framework in place yet, Bank Negara Malaysia (BNM) together with the Malaysia Deposit Insurance Corporation (PIDM) possess a broad range of powers to intervene and undertake recovery and resolution measures. Under the Financial Services Act 2013 (2013 FSA), BNM has the capacity to remove senior officers, directors and chief executive officers, as well as to wind-up institutions and assume control over these companies to manage risks and avert crisis. The Act also gives BNM a significantly larger purview over non-FIs that pose potential systemic risk to the financial system, including financial holding companies and non-banking FIs.

Meanwhile, PIDM will provide coverage to the depositors, with a capped rate of RM250,000, which should cover 99% of depositors in the event of a bank failure. PIDM also has the authority to undertake the resolution of banking institutions and insurers, as may be required based on the assessment of BNM. Once a member institution is deemed to be no longer viable by BNM, PIDM can assume control to resolve the member institution in a manner that minimises costs to the financial system.

Increased compliance on RRP and bail-in standards looks likely to be part of the regulatory arsenal going forward. At the time of writing, BNM was working towards issuing standards on bail-in funding as part of its wider RRP initiative. Among the issues under scrutiny are:

1. The condition that capital instruments issued by banking subsidiaries contain group-level loss absorbency triggers. Currently, qualifying capital instruments issued may be converted into equity or written-off in certain trigger events, namely when capital falls below predetermined levels, or when the bank is declared to be non-viable.
2. The future impact of including a group-level trigger on the ability of banks to raise affordable loss-absorption funding.
3. The role of a group-level trigger in amplifying group contagion risk caused by non-regulated affiliates.

BNM expects to issue the final standards in 2015, while compliance with the minimum group capital requirements are expected to take effect from 1 January 2019.

CROSS-BORDER DIMENSIONS

The expansion of Malaysian FIs to regional markets also creates unique challenges relating to recovery and resolution planning. With regards to financial markets which are less developed than Malaysia's, such jurisdictions are more vulnerable to external shocks, and have limited or no formal RRP framework and tools. Under such circumstances, FIs need to consider the following cross-border resolution issues:

- Intragroup exposures and financial interdependencies (for example guarantees and contingent claims) should be managed and reduced to help cushion the intragroup contagion impact of resolution.
- Sufficient loss-absorbing capacity – in the form of equity, subordinated debt, and other unsecured debt - should be made available at the right location and should be extended to foreign operations and subsidiaries of FIs.
- Cross-border resolution agreements should be drawn up between regulatory authorities in order to define roles and coordinate implementation of resolution strategies involving multiple regional operations.
- Different jurisdictions have different levels of development in RRP, which make it difficult to achieve a consistent approach towards RRP for FIs with regional reach. Generally, what works for one country may not be optimal for another, which reinforces the need to tailor global RRP standards to fit the local context. ✱

■ *Reporting by the Banking Insight Editorial Team. This article is extracted from 'Recovery and Resolution Planning: A Discourse in the Malaysian Context', the first in a series of thought leadership collaborations between PwC and the Asian Institute of Chartered Bankers (AICB) on how RRP could apply in the local context. To learn more, check out the complete publication on 'Recovery and Resolution Planning: A Discourse in the Malaysian Context', available soon from AICB.*

ISLAMIC FINANCE

Given their emphasis on *Shariah* compliance, Islamic finance institutions have their own unique set of challenges when dealing with RRP best practices. Among these are:

Clarifying the rights and liabilities that Islamic banking transactions entail in the context of resolution.

Defining the roles of the resolution authority and the *Shariah* Board in the resolution of Islamic banks.

Application of bail-in power to an Islamic bank may prove difficult due to the limited availability of "bail-inable" liabilities.

Furthermore, there is a potential lack of liquidity in times of crisis for recovery purposes, as the *Sukuk* and Islamic money markets in Malaysia are less developed compared to their conventional equivalents.

BY DR. ZULKARNAIN MUHAMAD SORI AND DR. SHAMSHER MOHAMAD

IS THE SHARIAH GOVERNANCE FRAMEWORK EFFECTIVE?

Shariah Committees weigh in with their opinions on how to strengthen Shariah governance in Islamic Financial Institutions.

Islamic Financial Institutions (IFIs) have enjoyed rapid growth globally and the total global assets of the industry as of end-2014 exceeded USD2.0 trillion or a compounded annual growth rate (CAGR) of 17.4% between 2009 and 2014.

Like other sectors, IFIs are expected to practice good governance to inspire public and stakeholder confidence and trust. To this end, the government introduced the Islamic Financial Services Act 2013 to provide greater regulatory clarity and focus on good governance and social responsibility. Likewise, leading markets like Hong Kong, the Philippines, Singapore and the UK have initiated regulatory reforms with the aim to build well-governed Islamic banking and capital markets.

These developments highlight the importance of developing robust *Shariah* governance for IFIs; complacency on this issue will have long-term consequences of market failures and collapse of the IFIs.

SHARIAH-BASED CORPORATE GOVERNANCE

Islamic finance practices have been structured to comply with *Shariah* principles that emphasise on fairness to all stakeholders through greater transparency and accountability. Standard 3 of the Islamic Financial Service Board (IFSB) defines corporate governance of IFIs as "…a set relationship between a company's management, its Board of Directors, its shareholders and other stakeholders which provides the structure through which the objectives of the company are set; and the means of attaining those objectives and monitoring performance are determined."

Guidelines

It must be noted that Shariah does not prescribe the details on Islamic finance practices, but only provides general guidelines on how to conduct the operations, and the Shariah Governance Framework fills in the details and standardises the practices for everybody.

Shariah governance is a governance system that ensures all activities and business transactions by IFIs are free from non-permissible elements of *riba*, *gharar* and *maysir*.

How different is *Shariah* governance from conventional governance? *Shariah*-based corporate governance is more involved than conventional corporate governance, in the sense that the Board of Directors, *Shariah* Committee, depositors or account holders, investors and regulators have direct interests in the IFIs' business operations and performances. Therefore, it is interesting to ascertain whether *Shariah* governance functions well in practice, especially when the infrastructure the IFIs have to work with is all conventional.

RULES AND REGULATIONS ON *SHARIAH*-BASED CORPORATE GOVERNANCE IN MALAYSIA

Malaysia is globally recognised as the hub for the Islamic finance industry and has, to date, the most advanced legal and operational infrastructure to operate Islamic finance compared to other Middle-east countries that also have an Islamic finance industry. The Malaysian Central Bank or Bank Negara Malaysia is the regulatory body that supervises the practices through the Islamic Financial Services Act 2013 (IFSA 2013). Besides this Act, listed Islamic financial institutions have to carefully observe the Bursa Malaysia Listing Requirements (BMLR) and the Malaysian Code on Corporate Governance (MCCG). The IFSA 2013 was introduced to provide better supervision and a regulatory framework for Islamic Financial Institutions and to mitigate potential *Shariah* and Islamic finance business risks. The IFSA 2013 categorically states that all Islamic financial institutions must comply with *Shariah* requirements in their business operations. The Central Bank of Malaysia Act 2009 (Section 51 (1) of the Act) gives authority to the *Shariah* Advisory Council (SAC) to enforce the IFSA 2013 requirements. The Central Bank has mooted a significant effort to ensure the overall Islamic financial system in Malaysia operates within the *Shariah* Governance Framework for Islamic Financial Institutions (SGF) that took effect on 1 January 2011. The framework was developed with the expectation to enhance the role of the Board, *Shariah* Committee and management in relation to *Shariah* matters, including enhancing the relevant key mechanisms in executing *Shariah* compliance and research functions. The two-tier *Shariah* governance infrastructure comprises two vital components namely the centralised *Shariah* Advisory Council (SAC) at the Central Bank and an internal *Shariah* Committee within the IFIs. The SAC has the ultimate authority in the determination of Islamic law on any financial matter relating to Islamic business operations, activities or transactions. On the other hand, the *Shariah* Committee is given a mandate to

provide guidance to the respective IFIs on *Shariah* matters.

The key players of *Shariah* Governance as shown in **Figure 1** are the Board of Directors, Board Risk Management Committee, Board Audit Committee, Management and *Shariah* Committee in ensuring *Shariah* as the overarching principle in Islamic finance. To ensure the key players of *Shariah* Governance can effectively perform their responsibilities, four main functions are recognised, namely the Risk Management Control Function, *Shariah* Review Function, *Shariah* Research Function and *Shariah* Audit Function. **Figure 1** depicts the lines of communication or reporting between key players with respect to these main functions.

WHAT DOES THE *SHARIAH* COMMITTEE SAY ABOUT THE *SHARIAH* GOVERNANCE FRAMEWORK?

Having a well-defined and drawn-up framework is incomplete if the main operators of these functions do not effectively deliver their responsibilities to ensure holistic *Shariah*-based governance in practice. It must be noted that *Shariah* does not prescribe the details on Islamic finance practices, but only provides general guidelines on how to conduct the operations, and the *Shariah* Governance Framework fills in the details and standardises the practices for everybody.

Proper governance brings strategic advantages to the IFIs, Islamic finance industry and to stakeholders who are committed to *Shariah*-based banking and finance activities. One of the main operators in the governance framework is the *Shariah* Committee in the IFIs. To ascertain how well these committees buy into the idea and deliver their expected responsibilities, sixteen *Shariah* Committee members (i.e. experts) from different Malaysian Islamic financial institutions were interviewed on issues relating to the *Shariah* Governance Framework. The responses posited that the ultimate objective of *Shariah* governance is to serve the purpose of establishing IFIs i.e. to uphold Islamic values that are guided by Islamic teachings and guidelines. *Shariah* governance is to ensure that all IFIs' activities are consistent with *Shariah* principles.

According to the survey, the respondents believe that the depositors, investment account holders, shareholders and other stakeholders put their trust in the financial institutions to ensure that their conduct and practices are *Shariah*-compliant. However, there is a significant challenge to conduct Islamic finance business in a conventional space and the *Shariah* Governance Framework was introduced to facilitate the Islamic finance business within the conventional space.

One practical issue raised by respondents is that currently, the chairperson of the *Shariah* Board only reports to the Board of Directors of the IFI. The effectiveness of the *Shariah* Board function could be better achieved if the chairperson were part of the IFIs Board, enabling them to be actively involved in deliberating recommendations, developing planning, observing financial reporting, conducting risk management and many other relevant issues.

The respondents also raised concerns that the *Shariah* Governance Framework requires IFIs to set up *Shariah* Risk Management Control, *Shariah* Review, *Shariah* Research and *Shariah* Audit functions. There might not be enough willingness by IFIs to set up these units that require extra budgets and experts to effectively perform the designated functions. For example, a full-fledged Islamic bank might have the capacity to establish a *Shariah* risk management department or division, and smaller-sized IFIs such as the Islamic window of a conventional bank might have risk management staff within the group risk management department. To be effective, the officer performing the *Shariah* risk management function should be equipped

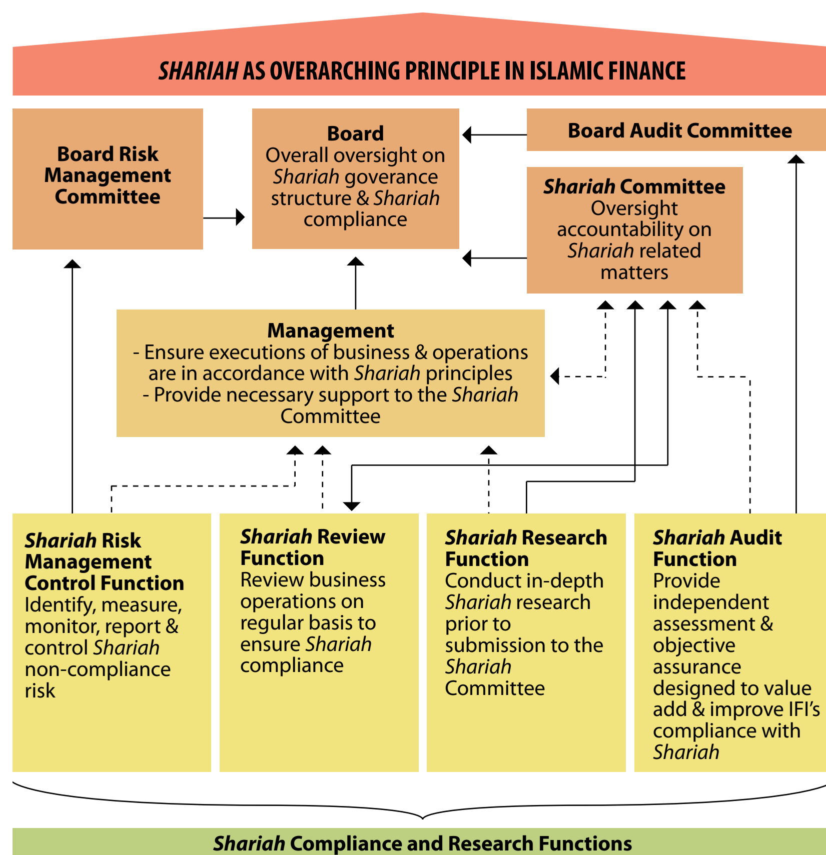


Figure 1: *Shariah* Governance Framework Model for Islamic Financial Institutions
Source: Bank Negara Malaysia (2010)

with risk management knowledge and training. Besides personal qualities, the interviewees believed that the IFIs' ecosystem like sound infrastructure, robust information technology, as well as effective internal control systems and communication networks could play an important role in ensuring an effective *Shariah* risk management control function. There are also concerns that the officers currently employed by IFIs should be conversant not only with the banking business but possess diverse knowledge to help in product development, product marketing and sales.

The *Shariah* review function relates to the review of IFIs' *Shariah* compliance where a structured auditing process at the respective branches or departments can identify and examine incidences of non-compliance and rectify these through a consultative approach. In general, *Shariah* audit is expected to perform value-added services that examine operational activities, financial recording and reporting, and the adequacy of policies and procedures of IFIs. Their function is more towards providing assurance services in the process of delivering their duties. Their role includes citing of documents or forms relating to business operations, evaluating issues on products through examining transactions, contracts, products, and financial implications on clients, assessing operations flow and evaluating marketing exercises by the IFI.

The respondents viewed the *Shariah* research function on new products, principles, and new prospectuses as necessary to overcome issues relating to non-compliance risk. This is to assist the *Shariah* Committee in collecting, collating and updating information relating to the various aspects of the IFI's business.

Additionally, the *Shariah* Governance Framework outlined that the majority of the minimum five members of the *Shariah* committee in the IFIs should have a *Shariah* background, while at least one member should be qualified in other disciplines like law, accounting and banking. Preferably, *Shariah* scholars should be qualified as well in commercial jurisprudence in order to better understand business decisions and make effective decisions.

Conclusion

Summing up, it is clear to see that corporate governance has gained more importance in the wake of recent corporate scandals and global crisis. The Malaysian government has taken initiatives to further strengthen corporate governance with the introduction of the Malaysian Code on Corporate Governance in 2000, which was later revised in 2007 and 2012. Specifically, the resurgence of Islamic economics and finance in practice necessitated the need for a *Shariah* Governance Framework to provide guidelines for Islamic Financial Institutions.

How effective is the *Shariah* Governance Framework? Our survey findings revealed that while there is consensus on the objective and the need for such a framework to regulate the major players in the Islamic Finance industry, experts raised certain concerns on the issue of the framework's effectiveness. For better effectiveness, it is recommended that the chair of the *Shariah* Committee in the IFI should not only report to the Board but should be a member of the Board. This will allow the *Shariah* Committee to make more practical business-orientated decisions rather than deciding purely from the jurisprudence perspective. Furthermore, there is a need for proper infrastructure and resource persons with diverse backgrounds to effectively perform the risk management function in a diversified economy. The members of the *Shariah* Committee should not only be conversant with commercial jurisprudence but also conventional finance, economics and commercial law. ✱

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