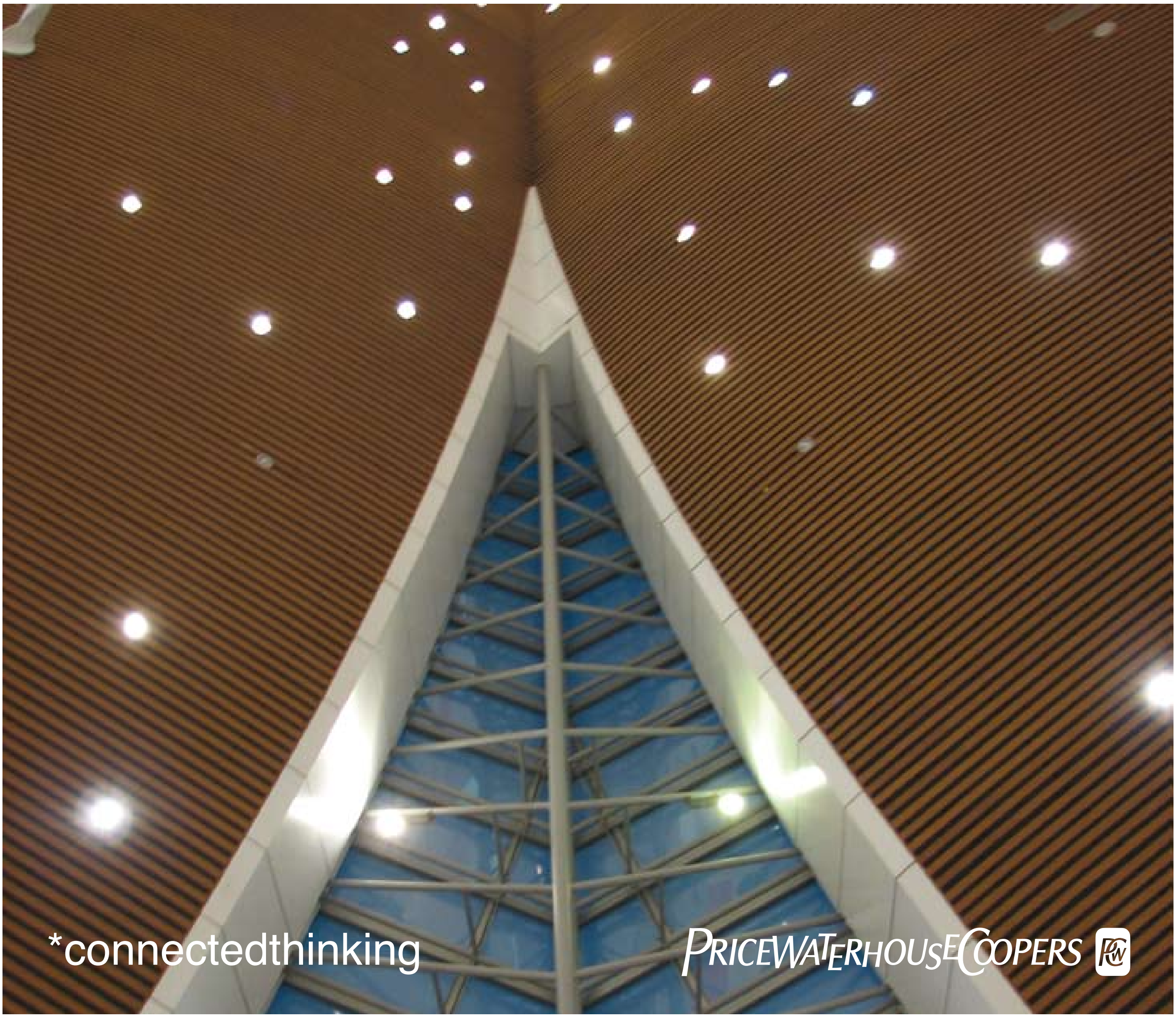
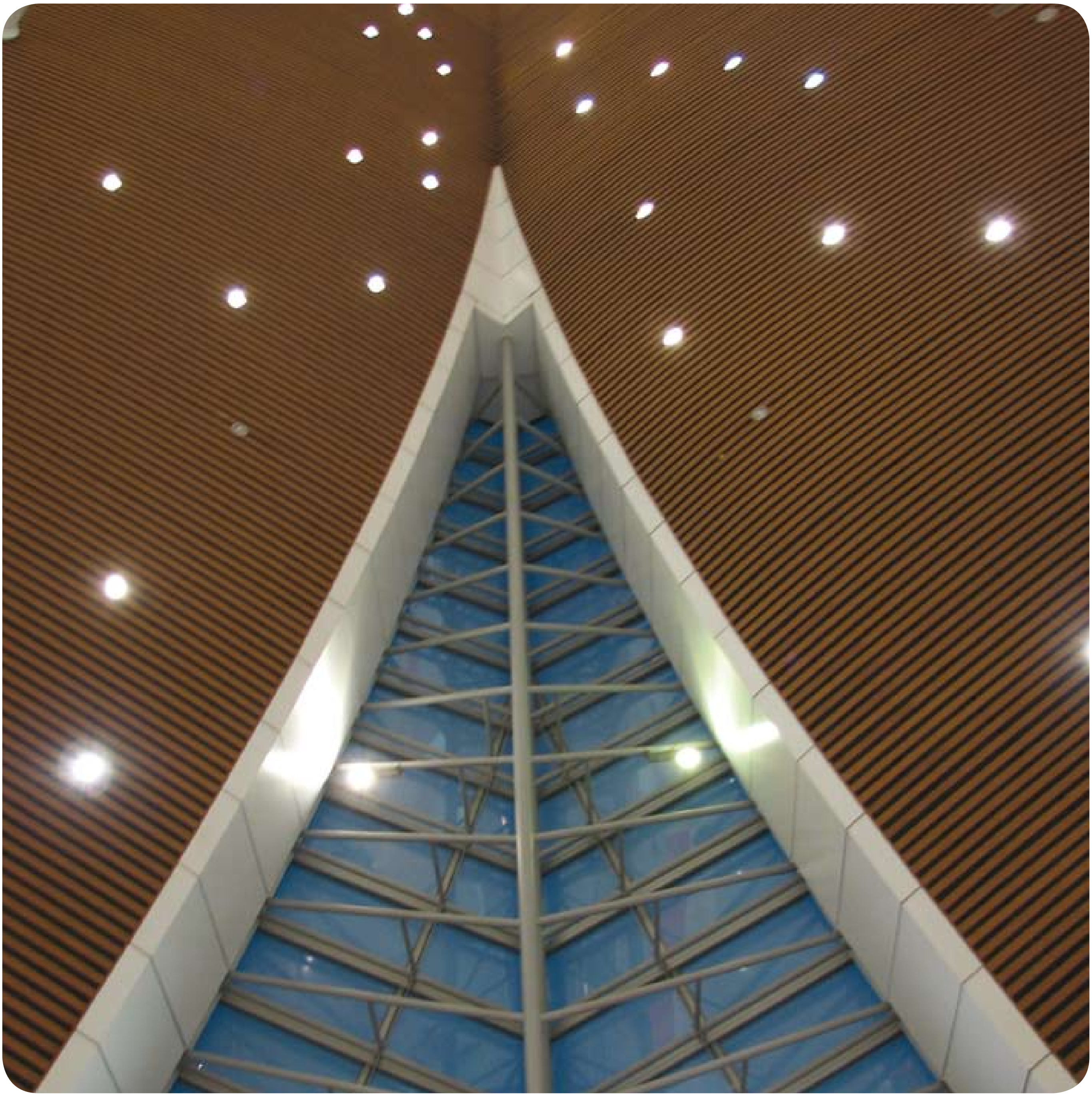
Banking & Capital Markets

Asia Banking Insights

Tackling the key issues in banking and capital markets in Asia*

October 2007





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Much has happened in the last six months in the banking industry in Asia. Not only have many banks continued to invest in their operations across Asia including in China, M&A activity continued in countries such as Taiwan and Korea. However, we have also seen uncertainties arising from the US markets ripple through and have a major impact on Asia's equity and debt markets. The coming year will be a very interesting time for Asia's banking industry.

Despite uncertainties, significant growth opportunities, both organic and inorganic, are available to banks in Asia. In particular, significant opportunities exist in banking in China, a dynamic and booming market which continues to change rapidly, and which many foreign banks are focusing on investing in currently. Shane Knowler and Raymond Yung examine the opportunities, as well as challenges which foreign banks in China are currently and expect to face over the coming years in one of the most dynamic markets in Asia.

As Asian and MNC banks expand in Asia, centralised support and service 'hubs' are developing into an important platform for regional expansion and new market entry. Brian Furness and Mark Jansen discuss the key challenges of hub management.

In the wealth management space in Asia, times are also bright. Based on the results of our recent survey of private banks in Asia, respondents expect revenues to increase 26% per annum over the next three years, with a corresponding increase in AUM of 29% per annum over the same period. Notwithstanding the exuberant expectations, challenges are forming on multiple fronts. Five key Asian themes were identified in analysing the results of the survey including Strategy whereby growth will come primarily through increasing share of wallet; Clients whereby the 'Trusted Advisor' status is still an aspiration rather than a reality; People whereby the Customer Relationship Manager remuneration model needs to be re-engineered; Process whereby technology is the new driver to operations; and Organisation whereby risk management needs to catch up with business growth. Justin Ong and Khoo Wei Lii examine these themes in more detail.

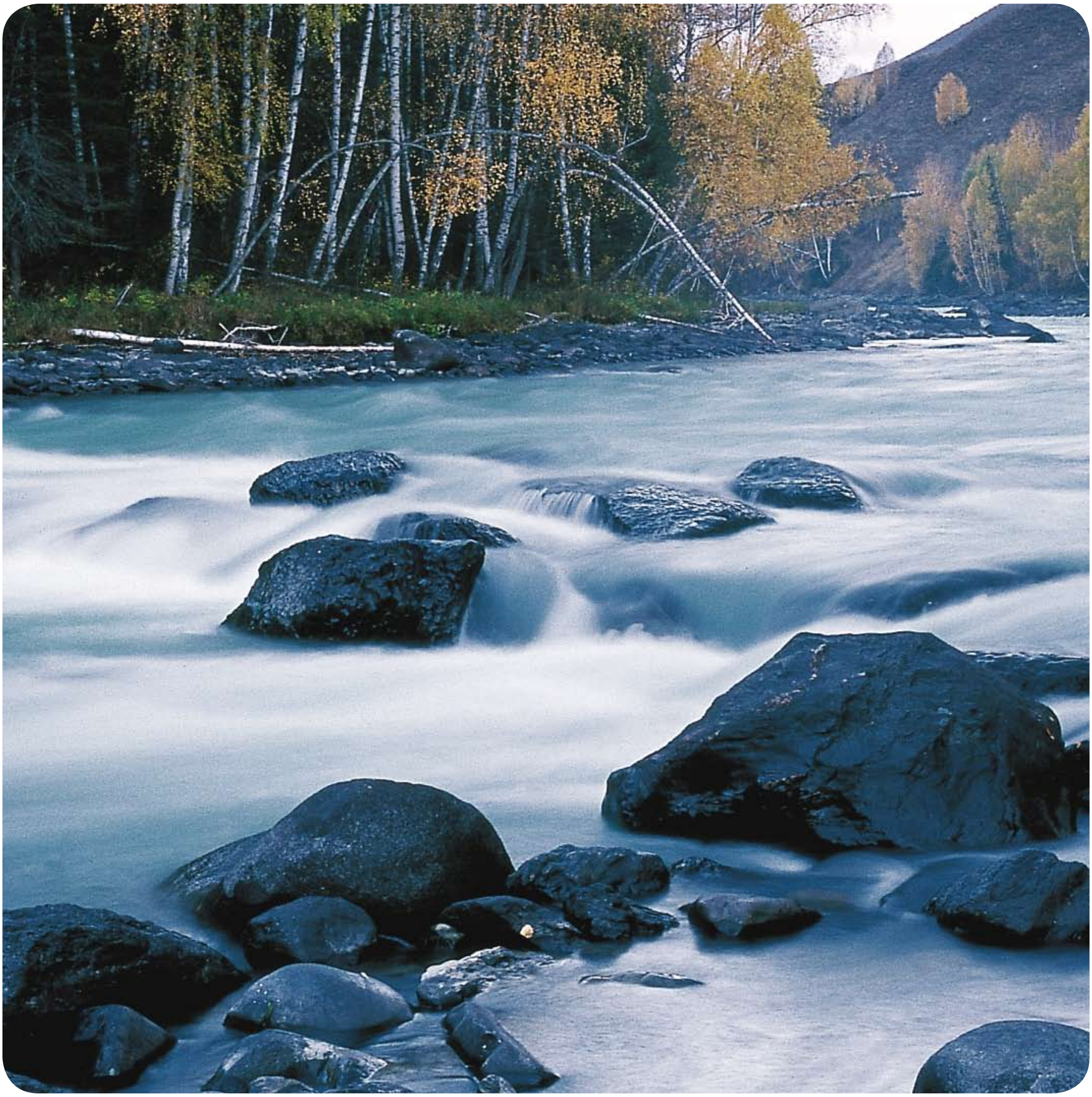
On the M&A front, will the surge of M&A activity seen in 2006 and early 2007 in the banking industry in Asia continue? Yes – at least for the next five years. Buyers, from both within Asia and outside Asia, including strategic and financial buyers continue to be attracted by the high levels of growth in the region. However, with a limited supply of quality assets, there is an increasing risk of overpaying. Karen Loon, Matthew Phillips and Stuart Scoular examine these growth trends in coming years. Stuart Scoular, Cliff Rees, Sahala Situmorang then examine more closely investment prospects in the Indonesian banking sector.

Finally, in such uncertain markets, coming up with fair values for financial instruments, particularly structured products, is increasingly a challenge for many banks. Further, many Asian banks have been increasingly developing structured products to meet customer demands. These fair values are important not only for ongoing regulatory and risk management purposes, but also for financial reporting purposes. Chris Matten, Liew Wai Meng and Chen Voon Hoe closely examine the importance of model validation which is becoming increasingly more important in current times.

I hope you find these articles of interest. Please provide us with your feedback and ideas for articles you would like to see addressed in future issues. Online copies of this, and previous editions can be found at www.pwc.com/banking.

Foreign Banks in China – Their views of a changing market

by Shane Knowler and Raymond Yung



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PricewaterhouseCoopers[1] has recently published "Foreign Banks in China", the second survey of this nature that we have carried out. Representing the views of 40 senior international bankers from a range of foreign institutions, the survey reveals some valuable insights into issues currently facing banks in the PRC, particularly how those issues have changed in the two years since the previous survey. The survey questions covered both the immediate outlook for 2007, and longer terms views through to 2010.

In this article we summarise a few of the key findings of the survey, and consider some of the implications of these for foreign banks operating in the PRC.

The China banking market has a number of unique aspects. It is growing rapidly as a result of economic liberalisation and expansion. It has a number of well-entrenched and strong local banks who are rapidly building product and service capabilities and can leverage very large existing client bases. The foreign banks are aggressive new entrants who are bringing internationally established capabilities and strong brands, but have only small existing bases of business to grow from. The survey provides valuable insight into how the foreign banks view this unique market.

Expectations of market growth

Perhaps the single biggest theme evident from the survey is the very significant growth that the foreign banks are expecting. Only 16% of the survey respondents to this question predicted revenue growth of less than 20% in 2007, with 38% predicting growth in excess of 50%. This growth is not just a short term expectation, with only four banks predicting growth of less than 20% in 2010. Not surprisingly in view of these bullish revenue expectations, all survey respondents are expecting profitability to be greater in 2010 than in 2007.

There is clearly continued strong commitment by the foreign banks to the Chinese market. When asked to characterise the commitment of their parent bank to the Chinese market in relation to other markets around the world, on a scale of 1 (no commitment) to 10 (extremely aggressive), 74% of the respondents awarded a score of 8 or higher. In fact seven banks awarded their parents the highest score, of 10.

The foreign banks in China can therefore expect the focus of their head offices on the China market to continue. This is positive in that requests to head office for investment and support are likely to be viewed favorably, though perhaps also suggests the PRC subsidiary or branch will need to continue to educate and support the head office on issues and developments in China. Given the importance of the Chinese market to banks' overall strategies, banks have an obligation to strategically understand the market and the opportunities and risks, and execute a plan that delivers value to shareholders.

Product focus areas

In the retail market, three product categories are expected to experience rapid growth by 2010. They are credit cards, investment products, and mortgages. This is hardly surprising considering the development of the Chinese economy and the rapid build up in personal incomes and wealth. Foreign banks have the advantage of being able to leverage on well-established product offerings in these areas that they can apply from overseas markets, however in launching or expanding these products, they can expect other foreign banks and the domestic banks to be competing strongly in these sectors.

In the wholesale space, the four RMB-denominated product areas expected to grow by 2010 are interest and cross currency swaps, structured products and debt

[1] PricewaterhouseCoopers refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.

Foreign Banks in China – Their views of a changing market *contd.*

capital markets. Over 25 banks rank each of these areas as the having most potential. Once again, foreign banks should be applying skills and experience gained in overseas markets to target market segments, but nevertheless looking at niche product opportunities where they have a particular competitive advantage – perhaps through strength in a particular currency. The recent difficulties in credit markets may change demand patterns for some wholesale products.

Competition intensity to continue

The survey questioned respondents on their views on the intensity of competition in different sectors of the banking market.

Retail banking was seen as being intensively competitive. Over 70% of the respondents indicated they had made significant or fundamental changes to their retail strategy in response. This is reinforced by the trend for foreign banks to incorporate locally (see "Foreign Banks in China" in the March 2007 issue of *Asia Banking Insights*), as a precursor to rolling out a more aggressive retail banking service offering, including a wider range of RMB denominated products.

Specific retail products that are likely to be under consideration are likely to be RMB-denominated mortgages, private banking offerings, and credit cards. Foreign bank credit card offering in the past have all been via co-branding arrangements with local banks. Private banking services have only been offered on the Mainland on a limited basis in the past due to foreign exchange controls. Although most banks have been servicing key private banking customers from their bases in Hong Kong or perhaps Singapore, they are likely to now establish more of a domestic private banking base.

Interestingly, the respondents record declines in the competitiveness of the market in both trade finance and corporate banking. Trade finance seems to have been more of an issue in the previous survey in 2005, when 90% of respondents believed it to be intensely competitive and over half had made significant changes in their strategy in this area.

The banks surveyed unanimously agreed that foreign banks would continue to enter or leave the China market. In addition to banking organisations, some banks expect a range of non-traditional financial services organisations to enter the market in one way or another, possibly driving changes in the competitive environment. These include leasing companies, large retailers (such as those with existing credit card and consumer finance businesses in other locations), and even private equity firms via their investments.

In terms of the foreign banks' views on the competitiveness of the domestic banks, Bank of China, ICBC and China Merchants Bank were seen as being the most competitive of the domestic banks.

Having made all of the points above, it is interesting that only a third of the banks viewed the China banking market to be overcrowded. This contrasts to the previous survey in 2005 when over half the participants believed the market was overcrowded. This change in sentiment is probably a result of the opening up of the market offered through local incorporation, which creates more product and market opportunities for the foreign banks.

When foreign banks first began local incorporation, it was thought by many that only a small number of foreign banks, those who wished to expand aggressively through full retail services, would incorporate. However the survey indicates that

20-30 foreign banks will incorporate by 2010. This is perhaps because banks are keen to signal their commitment to the Chinese market through incorporation.

Rapid pace of regulatory change

The single most important driver of change among the banks surveyed continues to be (as it was in the previous survey in 2005) the pace of regulatory change. In addition, the regulatory environment was rated the single most difficult aspect of Chinese banking.

The moves by many foreign banks to establish separate legal entities in the PRC, and transfer their existing branch business into those entities reflects the regulatory requirement for full retail banking services in the PRC to be offered by a separate legal entity rather than a branch.

Personnel and resourcing challenges

An obvious implication of the growth ambitions of the foreign banks is the challenge of resourcing such growth. After the regulatory environment, finding and keeping good staff was rated as the second most difficult issue facing foreign banks. This is hardly surprising, given that over two thirds of the banks are experiencing turnover in excess of 15%.

Similarly, recruitment and training of front office staff is seen as the second most pressing issue, while appropriate staff incentive schemes increased significantly as an issue over the 2005 survey.

In addition to the expected growth, staffing pressure arises from competition for staff from new foreign bank entrants who see target staff of existing banks, but also may increasingly come from local banks seeking to gain international-level expertise through hiring staff from the foreign banks. This may increase as foreign banks are able under their new WFOE structures to offer more sophisticated retail banking products and both local banks and late-coming foreign entrants need to catch-up.

In addition, survey participants are expecting a number of new entrants into the financial services sector, such as the auto finance companies. This will likely also increase demand for staff and contribute to turnover.

Dealing with personnel pressure is not easy in such an environment. Ensuring that people are well-trained and developed will also increase their attractiveness to other employers, in a market where changing jobs for even a relatively small increase in remuneration is common and individuals' remuneration information is an open secret.

Part of this demand will be met by a continued growth in the number of expatriate staff; however the proportion of expatriates to total staff is expected to decline.

For larger organisations, such resource needs translate into a sheer number that must be recruited and trained. Six of the banks plan to recruit in excess of 1,000 people each over the next three years, and three of those banks plan to add in excess of 3,000 people each. Recruitment of such numbers requires a significant investment in a formalised and high-volume recruitment process, probably entailing graduate recruitment schemes, assessment centers and so on, not to mention executive time in assessment and interviews, and the training effort required.

The Asian hub: Developing an effective platform for growth

by Brian Furness and Mark Jansen

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The establishment of centralised support and service centres in India, Singapore and other parts of Asia has enabled many financial services groups to reduce costs and enhance efficiency by consolidating operations that may have been previously aligned along geographic, product or business lines. Such ‘hubs’ can also provide the infrastructure for global expansion at a time of rapidly increasing trading volumes, greater complexity of systems and processes, and a growing focus on product innovation and development.

Now, as the vast commercial potential of the Asian financial services markets begins to unfold, these hubs are developing into an important platform for regional expansion and new market entry. In particular, operational centralisation can provide a critical advantage in managing the profusion of new products being offered across multiple markets. This includes enabling groups to meet the demand for more sophisticated investment, hedging and structured products in markets where locally they may lack sufficient mass, expertise or informational and risk management capabilities.

In turn, as groups move into new territories and product portfolios become more complex and diffuse, the key challenges of hub management are now evolving from cost reduction to the broader and often more complicated considerations of control, governance and operational effectiveness.

The nature and scale of these challenges have been highlighted by several high profile cases of account fraud and breaches of information security involving staff at call centres in Asia. Underlying the evident lapses in screening and operational management are the problems of recruiting and retaining quality staff at a time of salary inflation, high employee turnover and ever more rapid growth in the business of centralised service centres.

Other telling difficulties faced by centralised service centres include delays and failures in facilitating the filing of statutory accounts and regulatory returns in specific local operating territories. Staff in offshore hubs may lack sufficient understanding of local regulations or may not be able to co-ordinate the supply of information from local operations.

Looking ahead, these challenges can only increase as the risks, client expectations and associated regulatory focus within the Asian and wider global markets become more exacting. It is therefore essential that groups carefully consider the most viable location for their hub; what can be centralised and what capabilities need to be available on the ground and how to ensure the necessary understanding and co-ordination between hubbed and local operations.

Based on PricewaterhouseCoopers’ experience of supporting financial organisations in the development of their Asian hubs, here are what we believe are some of the most important and at times less well-addressed, considerations for strengthening control, governance and operational effectiveness:

What to hub?

Some product lines including more sophisticated areas such as derivatives can benefit from concentrations of expertise, underpinned by the necessary depth, quality and specialisation of middle and back office support in areas such as IT, market analysis and settlement. These functions can then serve a number of local markets, while allowing for greater focus and product specialisation/targeting. However, many critical capabilities need to be available locally. Clearly, this includes client facing teams that speak the local language and understand clients’ specific needs.

Ultimate responsibility for governance and regulation also needs to be maintained in the initiating location. However much

The Asian hub: Developing an effective platform growth *contd.*

operations are streamlined, specialised and centralised, experience indicates that there still needs to be at least a small core of personnel on the ground. This includes a person or persons specifically responsible for certifying financial reporting and regulatory returns and acting as a suitable point of contact with local supervisors.

Division of responsibility

The need to provide local oversight does not mean that the hub cannot maintain overall control of a specific function or that ownership needs to be set at the process level. For example, nostro reconciliations are often performed by the hub. Nonetheless, end accountability for any breakdowns should be maintained at the local initiating level, not least as local clients and regulators would demand it be so. Similarly front office trade input can be managed remotely by a middle / back office function, though accountability for authorisation, completeness and accuracy of the trade should be clearly defined and remain onshore regardless of the physical location of the process.

Although the need for local accountability would appear to be a relatively self-evident, the consistency of application across multiple processes remains problematic. For example, onshore control functions are not always responsible for resolving issues with end users.

The overall control model therefore needs to provide a clear and consistent platform for cross-market compliance and risk management that runs across front, middle and back offices, while ensuring that the necessary local oversight and end accountability are built into and demonstrable within the governance framework. It should be noted that failure to address the need for consistency at global, regional and local levels has led to serious sanctions for some institutions in key financial markets such as Japan. Underpinning this model are clearly defined key performance indicators that can be fully integrated into the management of hub and local operations.

Effective reporting and compliance

With the increased centralisation of operations and associated control functions, there may be a case for rethinking the approach to reporting, whether in relation to the requirements of Sarbanes-Oxley, IFRS, Basel II, or indeed management or statutory financial accounts. While each of these activities does have distinctive demands, common systems and expertise can be applied.

In Asia, as elsewhere, the key challenge for organisations seeking to centralise their operational and control functions is how to keep track of these requirements across multiple jurisdictions. In our experience, this demands a systematic and proactive approach to compliance and reporting that underpins adherence to local laws and regulations with a broader and more widely applicable principles-based framework.

A more holistic approach can help to simplify and streamline the underlying processes, hubbed activities in particular. This is important at two levels. First, for globally hubbed activities, the focus needs to be on ensuring the data and associated processes are fit for purpose and can be used in multiple jurisdictions seamlessly, while being able to be consolidated at a group level. Within Asia in particular, it is important to consider the high level overlaps and resulting potential for synergies across multiple reporting regimes and jurisdictions. Regulators in the region often have similarities in particular areas such as onshore oversight and associated governance frameworks.
By leveraging a single consistent

control framework, organisations can meet multiple regulatory requirements, while taking into account any local variations in their reporting requirements. To achieve this, organisations need to understand the distinctive nuances of each location and be able to interpret and demonstrate how their overall control framework can be applied to meet specific local demands. This is not to say that local reporting requirements can be ignored; rather control frameworks should be pragmatically applied and consideration given to driving consistency across the organisation.

Location, recruitment and retention

The choice of location clearly depends on the presence of a strong and stable business environment, a large pool of suitable candidates from which to recruit and the ability to attract that talent. The quality of the country's infrastructure and level of tax incentives can also of course be important considerations.

A core issue for many Asian hubs is recruitment and retention of staff at a time when the competition for talent is intensifying. As a result, successful organisations are looking beyond short-term salary escalation to the establishment of career models that focus on the developmental needs of staff. While the concept is not new, maintaining the necessary training, support, motivation and long-term career prospects can be difficult, especially as many hub operations are focused on lower level skills. Smarter organisations are therefore linking the development of junior staff with the future needs of the business as a whole.

By nurturing staff from a junior level, they can develop in value throughout their career with the group and support business growth objectives both at a hub and local level. This development can be linked to incentives that serve the mutual needs and aspirations of the individual and groups as a whole. For example, it may be necessary to attract Korean nationals to Singapore to help ensure that hub operations meet the specific needs of the local Korean market. The lure could be a guarantee of promotion when the seconded personnel eventually return to their home country.

To ensure that the various functions can operate holistically from a centralised hub it is important for staff to learn how to balance the common region-wide principles that underpin their work with a clear understanding of local needs and differences. This is particularly critical in ensuring that local cultural distinctions and regulatory nuances are understood and addressed. For many personnels, this will require a shift from an insular hub-focused perspectives to a more proactive end user-led approach.

IT interdependence

Effective IT systems and exchange of information are clearly essential to the success of any financial services institution. As a pivotal part of what could be highly diverse and extended operations, the IT challenges for hub management are especially critical. Maintaining the necessary functionality and systems interchange is proving ever more challenging as product offerings grow and groups face a corresponding increase in the number of applications and spreadsheets being used across all lines of business. This can lead to significant difficulties, especially when complex data streams need to be reconciled across multiple systems, locations and reporting platforms.

Often, the problems are the result of legacy systems brought together through mergers or acquisitions and the increase in new products that use new systems or spreadsheets as they cannot be integrated into legacy

The Asian hub: Developing an effective platform growth *contd.*

platforms. This has created a labyrinth of complexity which, if left unchecked, becomes not only cumbersome, but also increasingly difficult to unravel.

While a single all-encompassing system would be ideal, in practice this may be too difficult or expensive to implement. The key area of focus should therefore be ensuring consistency of data quality across all systems. Too often, financial services organisations struggle to reconcile what should be the same information from multiple systems that perform different reporting tasks. As companies seek to rationalise systems, a data warehouse can then provide a single and versatile source of information for different reporting and compliance requirements.

Tied in with the data quality issue is many organisations' reliance on spreadsheets. While these may seem integral to the running of the business, they can easily lead to confusion and potential errors. In particular, spreadsheets can grow increasingly complex and convoluted as multiple users make amendments to underlying formula or cannibalise them for alternative purposes. While the use of spreadsheets is not going to disappear overnight, groups need to ensure that appropriate controls are in place for high risk spreadsheets used in areas such as product valuation, complex accounting and regulatory reporting. Key considerations should include version and change controls, periodic review of spreadsheet integrity via reference to master version checks, and restricting access to spreadsheets or even the underlying data on a business

Hub of the operation

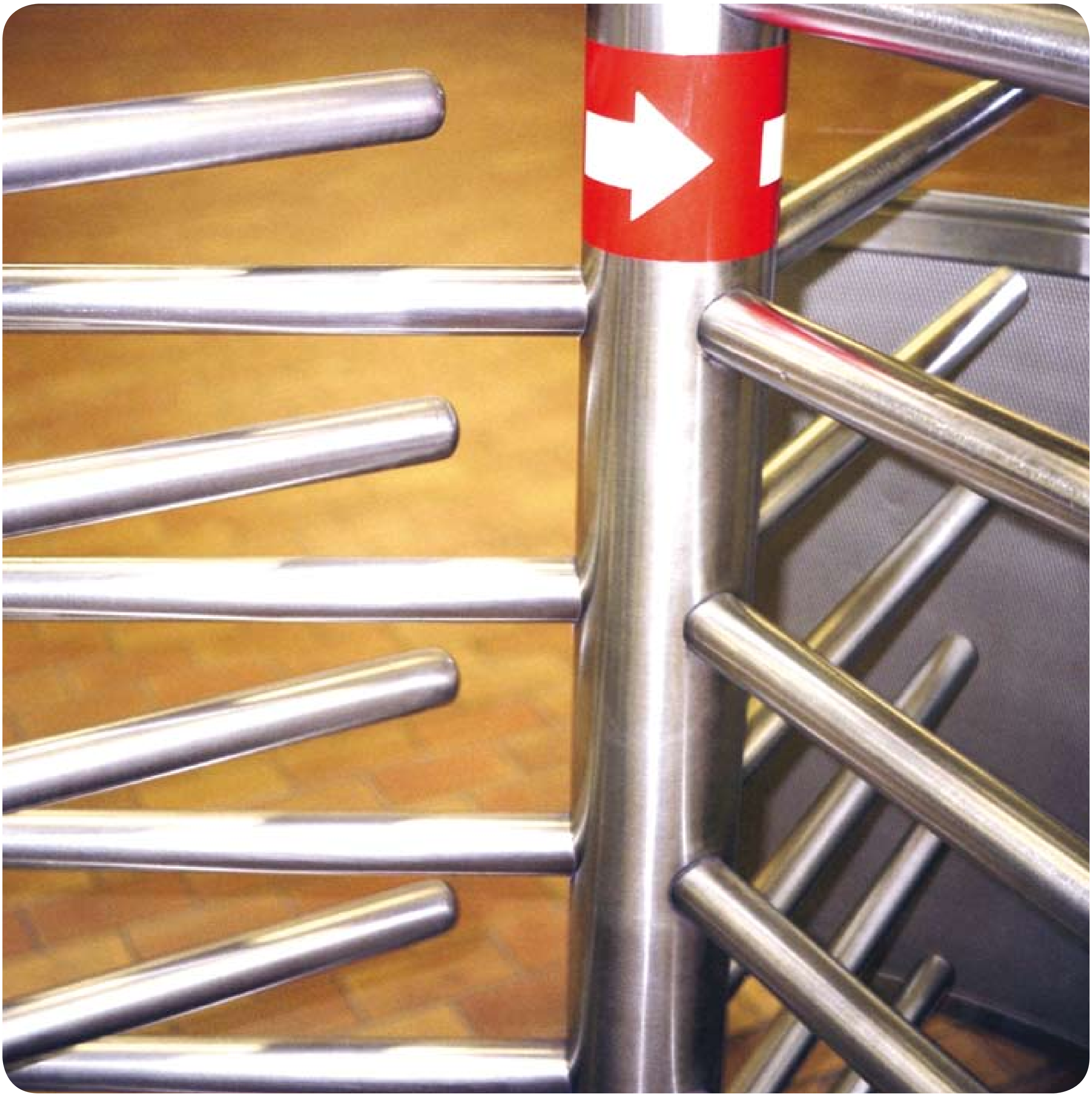
Financial services groups are stepping up investment in shared service and support centres in Asia as they seek to develop more cost effective global operations and realise the opportunities opening up in the region's fast growth markets. In particular, Asian hubs can provide the necessary infrastructure and concentration of expertise to exploit the growing demand for more sophisticated products and services within the region. However, many groups are finding it increasingly difficult to ensure that their centralised hubs can meet the specific and often very distinctive client and regulatory expectations within the different Asian markets.

The development of consistent control frameworks covering the full spectrum of front, middle and back office functions is therefore critical. This should ideally be underpinned by effective data exchange and co-ordination between different systems and processes. The pursuit of synergies and consistency should also be balanced with attention to different local requirements, particularly in such a culturally and regulatory diverse region as Asia.

The prize is the creation of seamless and proactive end-to-end operations that can not only facilitate more effective control, but also enable groups to bring products and services to market more swiftly and efficiently than their competitors.

Private Banking: Focus on competencies, manage your risks

by Justin Ong and Khoo Wei Lii



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It is indeed an exciting time for private banks in Asia. PricewaterhouseCoopers' latest 2007 biennial Global Private Banking/Wealth Management Survey reveals a period of unprecedented opportunities for wealth managers. The 2007 survey attracted the participation of over 265 private banks, making it the most content-rich survey in its history. Of this, over 60 private banks responded from Asia (including India) contributing a rich vein of data on Asia-specific trends and thoughts.

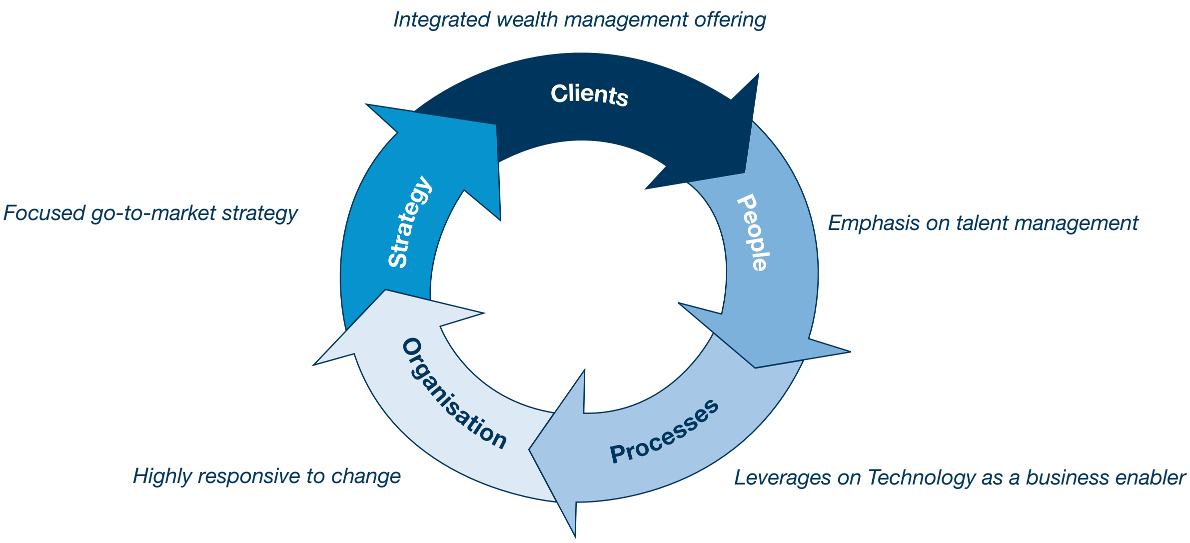
Based on the results of the survey, private banks expect revenues to increase 26% per annum over the next three years, with a corresponding increase in AUM of 29% per annum over the same period. Notwithstanding the exuberant expectations, challenges are forming on multiple fronts.

In mid-2006, we introduced the concept of 'Tomorrow's Leading Asian Private Bank' based on our research and experience working with a range of private banks across the region. We believe that to become a leading private bank, private banks in Asia must get five key business components right. The key components are summarised in the diagram below.

Five key Asian themes were identified in analysing the results of the 2007 survey. Broadly, these are:

- Strategy: Growth will come primarily through increasing share of wallet
- Clients: The 'Trusted Advisor' status is still an aspiration rather than a reality
- People: The Customer Relationship Manager (CRM) remuneration model needs to be re-engineered
- Process: Technology is the new driver to operations
- Organisation: Risk management needs to catch up with business growth

Tomorrow's Leading Private Bank



Source: PricewaterhouseCoopers proprietary model

Private Banking: Focus on competencies, manage your risks *contd.*

Growth

There has been a drive for private banks in Asia to increase 'share of wallet'. Over 88% of private banks will be seeking to gain 'share of wallet' from current clients as a key strategy over the next three years.

Currently under 20% of private banks hold more than 40% of their clients' investible wealth (refer Figure 1). Over the next three years, this is estimated to increase dramatically, with almost 60% of the private banks expecting to hold over 40% of clients' wealth.

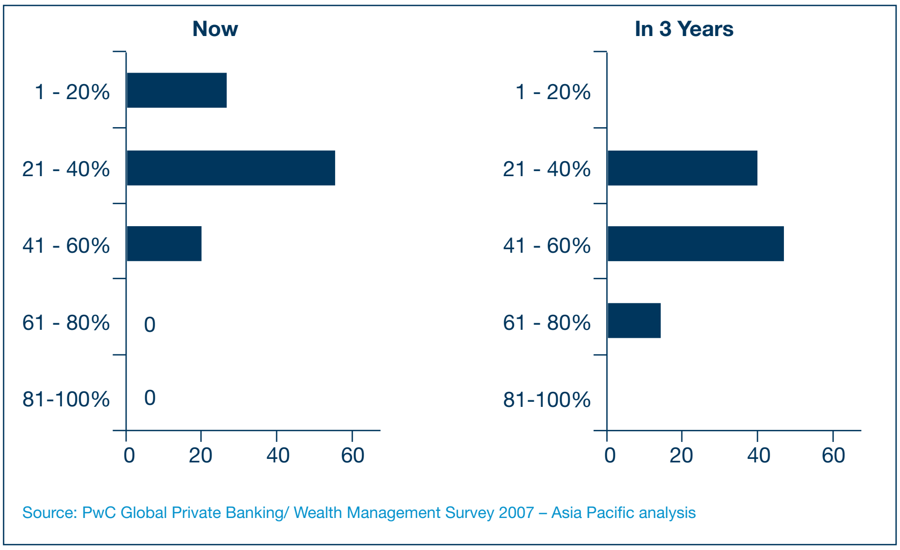


Figure 1: Percentage of existing clients' investible wealth held

The strategy to increase share of wallet is sensible from both a cost and resource viewpoint. The incremental cost of revenue from a larger share of wallet is nearly negligible, and especially this does not tax their scarcest resource – the CRMs. By expanding their share of clients' wallets, minimal additional cost is incurred on activities like know-your-client (KYC), account opening and other administrative tasks associated with new clients, yet this translates to an excellent source of new assets, revenue and increased profitability for the private banks.

Another key strategy by private banks to meet growth expectations is to expand into other markets. In particular, private banks expect to focus on markets such as Singapore, Hong Kong, India, China and the Middle East to build business networks and enhance the private bank's brand and client reach. This approach is however fraught with compliance risks. Private banks will need to fully appreciate and think through issues such as regulatory restrictions surrounding entering and marketing to onshore residents in different jurisdictions. Private banks also need to think through the associated tax risks from such marketing activities, as the risks of creating permanent establishments for the private banks, or a tax residency for the CRM, can be a serious issue.

A strategy divergence is also appearing to take place in how private banks see themselves servicing client needs. From the 2007 survey, the advice-led model (open architecture) still reigns supreme, but in three years' time, many organisations see themselves moving back to being a hybrid of producer/distributor (refer Figure 2). The move to increase production capabilities at the expense of an open architecture model is indeed a worrying development. The real question is whether this is for the benefit of clients, in tailoring or customising products to clients' needs, or the private banks themselves in keeping margins in-house?

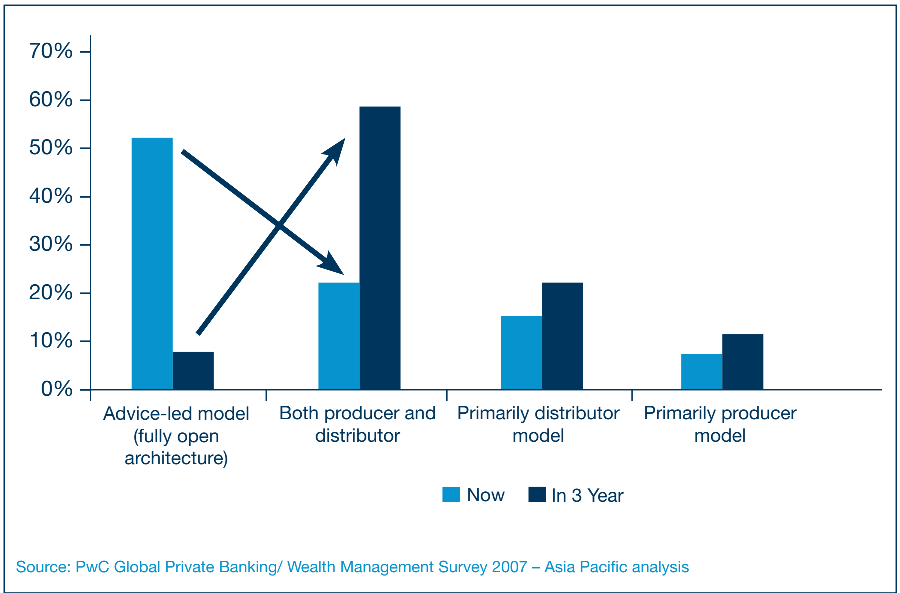


Figure 2: How CEOs see the transformation of their private banking business model

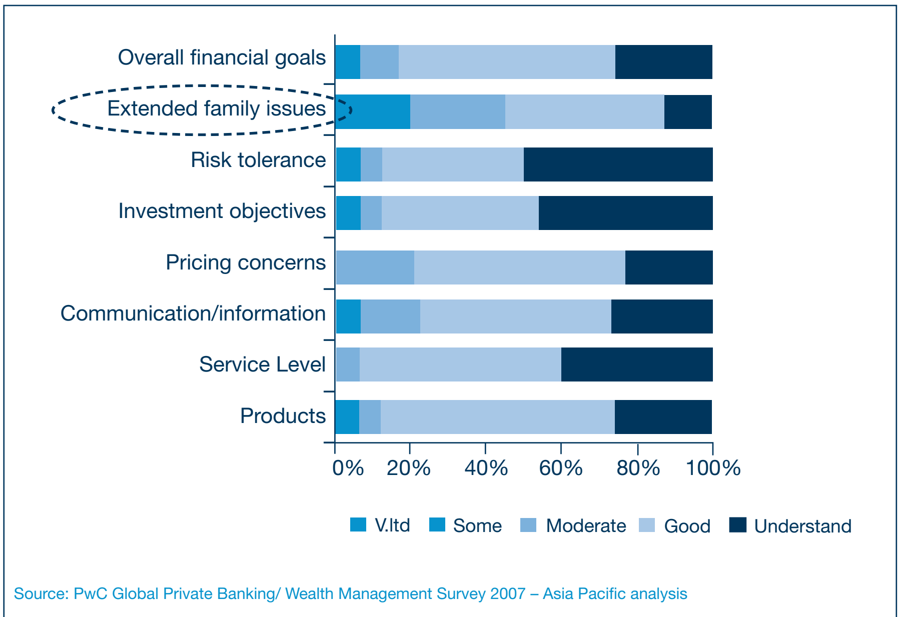


Figure 3: How well CRMs believe they understand the needs of their clients

Private banks need to realise that the ability to achieve 'Trusted Advisor' status will be one of the key success factors to their success in tomorrow's environment. The ability for the private banks to convince their clients that the increased production capabilities are for their 'good', will be critical as the competition intensifies.

Clients

For many years, wealth managers have claimed to be client-centric and sought to embed themselves as being 'trusted advisors'. Our survey trends have illustrated that in reality, this is still aspirational as many banks have yet to achieve this. Less than 20% of the CRMs understand their clients' needs especially in the area of their extended family issues (refer Figure 3).

The need for wealth managers to achieve 'Trusted Advisor' status is no longer a nice to have. As Asia poises itself for the biggest transfer of wealth ever in history over the next 10 years, issues of inheritance and wealth transfer are already emerging in the consciousness of High Net Worth Individuals (HNWIs). Getting CRMs up to the mark on rendering advice based on family-specific situations; and knowing clients needs in the context of extended family issues will become a key success factor for the private banks.

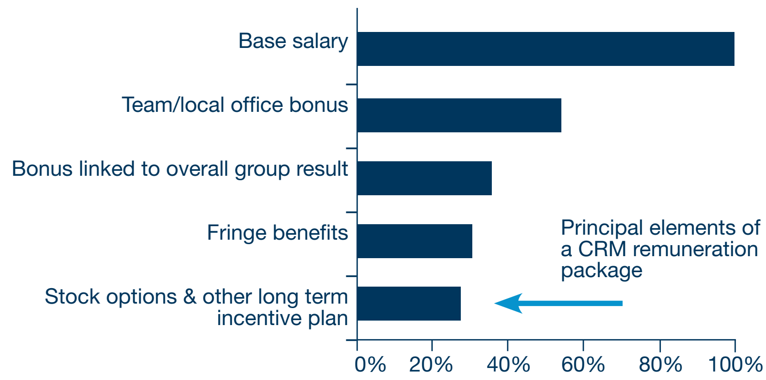
Private Banking: Focus on competencies, manage your risks *contd.*

Training needs of CRMs must also be reviewed in light of the competitive business environment. Our survey points out that 43% of CRMs do not believe that their organisations are adequately committed to effectively training them, or that the focus of training has not been right. CRMs are not getting the training they want, and unless this is taken seriously, private banks will increasingly find that client needs, CRM expectations and the organisations' goals will be incongruous.

People

Remuneration strategies are very much still centred around short-term performance of CRMs, and do not encourage long-term behaviour towards client satisfaction. Stock options and other long term incentive plans currently make up less than 30% of CRMs remuneration package (refer Figure 4). The focus at the moment is still primarily on AUM (current and potential) and net new money as performance KPIs. Private banks need to re-align the CRMs' focus back on creating value for clients, and not towards self-reward.

Private banks also need to get serious about HR. Whereas other functions seem to be aligned to the needs of the business, there is a real risk of HR falling behind the rest of the organisation. There is a lack of clarity and seriousness around the role of HR in addressing people issues, with over 70% of private banks not having a HR representative on their Boards. In addition, only 30% of private banks strongly agreed that HR is an integral part of their organisations' risk management strategies.



Source: PwC Global Private Banking/ Wealth Management Survey 2007 – Asia Pacific analysis

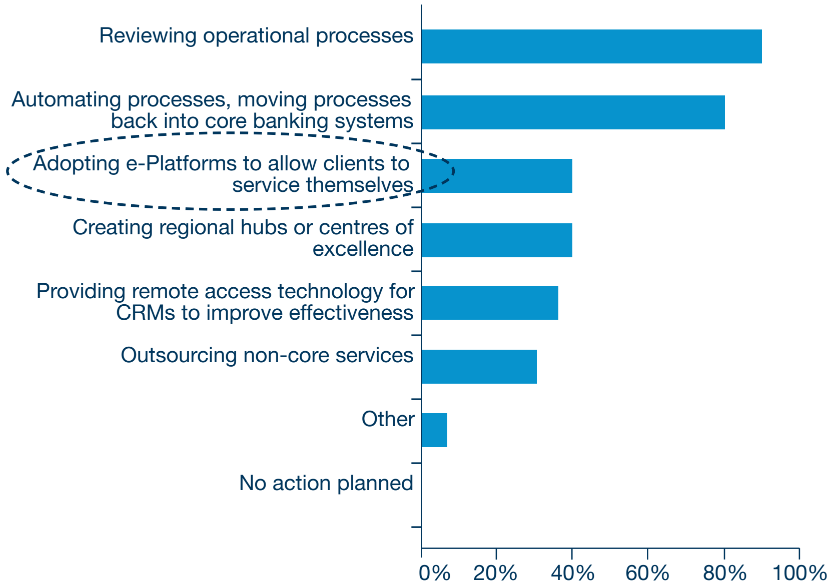
Figure 4: Principal elements of a CRM remuneration package

Process

With the current shortage of quality CRMs, and the need for more talent to meet client needs over the next decade, private banks must be smarter and more innovative in how they use technology to leverage on efficiency and effectiveness of the business. Survey results indicate that Chief Operating Officers are looking at a number of ways to improve operational and service capabilities in order for them to cope with business growth, with investing in operating infrastructure being on the forefront of their minds.

Some of the mainstream approaches undertaken include reviewing operational processes and automating/moving processes back into core banking systems. Some have gone a step further to adopt innovative methods such as e-Platforms to allow clients to service themselves; creating regional centres of excellence and providing remote access technology for CRMs to improve effectiveness (refer Figure 5).

We envisage that client servicing will increasingly take new forms as more on-line, real-time capabilities develop and technology will be the enabler behind this drive to change the way private banks operate.



Source: PwC Global Private Banking/ Wealth Management Survey 2007 – Asia Pacific analysis

Figure 5: Wealth managers intended response to business volume change

Private Banking: Focus on competencies, manage your risks *contd.*

Organisation

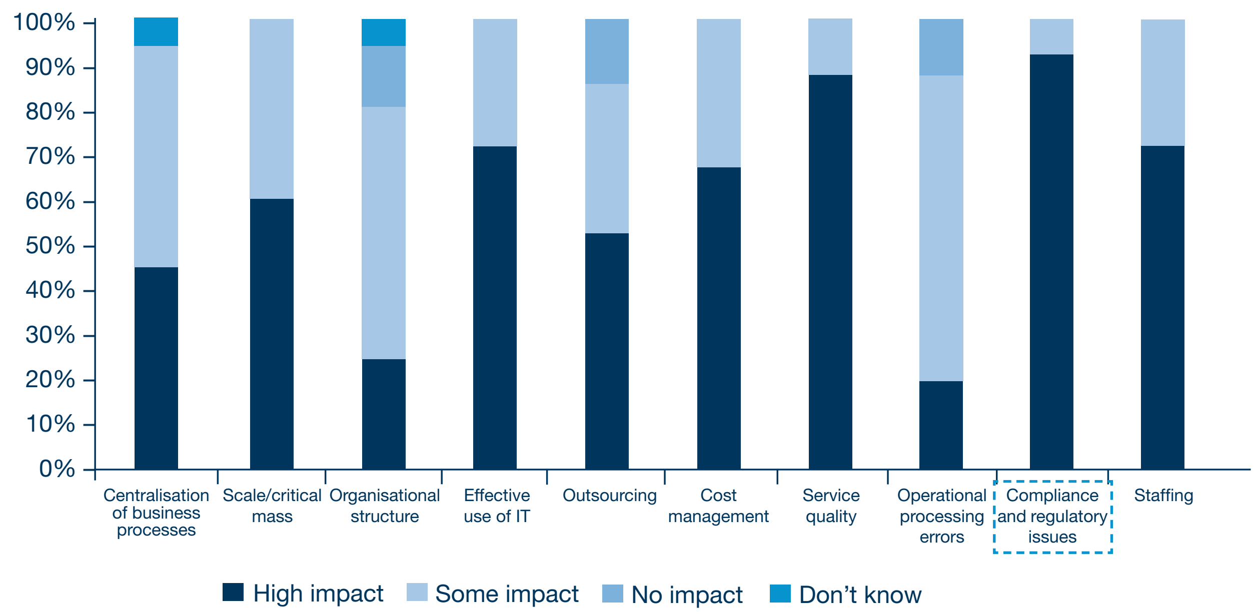
The 2007 survey shows that while private banks' confidence in their internal risk management are high, this confidence may not be justified. Regulatory compliance, in particular onshore/offshore issues will dominate the landscape for the foreseeable future, and as offshore risks become more prevalent, and increased regulatory oversight and demands for greater governance take precedence.

While anti-money laundering (AML) and KYC processes are an integral part of business practices, our survey shows that AML processes are still not up-to-mark, with half of private banks still in the process of re-identifying existing customers, or not having done so. At present, only 57% of private banks update their KYC information on a regular basis.

Private banks in Asia are also increasingly moving to outsource and centralise business processes. The right risk management framework must be put in place to ensure that processes are properly monitored and controlled. While functions can be delegated, ultimate responsibility still remains with the private banks. Thus, it is surprising that 29% of private banks who outsource do not know whether their service providers have equivalent and appropriate risk management frameworks in place in their organisations (refer Figure 6).

All these lead to the message that private banks will need to do more in actively managing organisational and risk management issues to ensure that their growth initiatives are not done at the expense of good risk management.

Impact of the following drivers on the organisation in three years' time



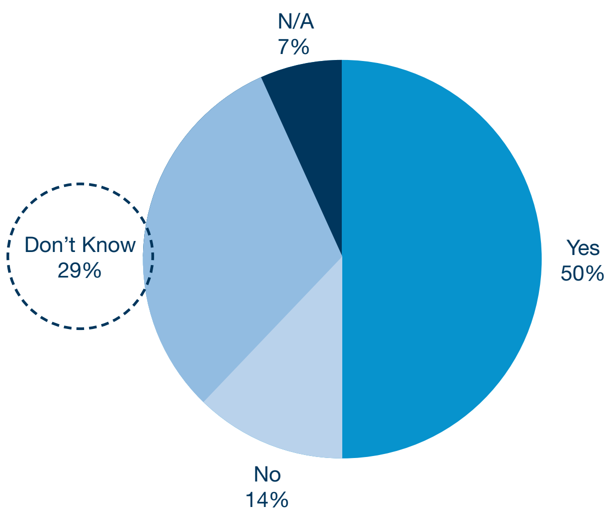
Source: PwC Global Private Banking/ Wealth Management Survey 2007 – Asia Pacific analysis

The road ahead

In this article, we have highlighted a few of the issues that private banks will need to mull over. Essentially:

- Growth must come with appropriate levels of oversight and control, particularly in the areas of regulatory compliance
- To become a 'Trusted Advisor', plan your proposition around the clients, not the bank or CRM
- Speed up investments into systems and infrastructure – win the battle with new technology
- People management continues to be an issue – reward, retain and development strategies must change

While Asian private banks have made significant progress in the last five years, they should stay attuned to changes in the industry, focusing on their competencies and managing their risks as they ride on the wave of growth. Some of these developments may require a change in the mindset of management. But banks who can achieve this will be well on their way toward becoming Tomorrow's Leading Asian Private Bank.

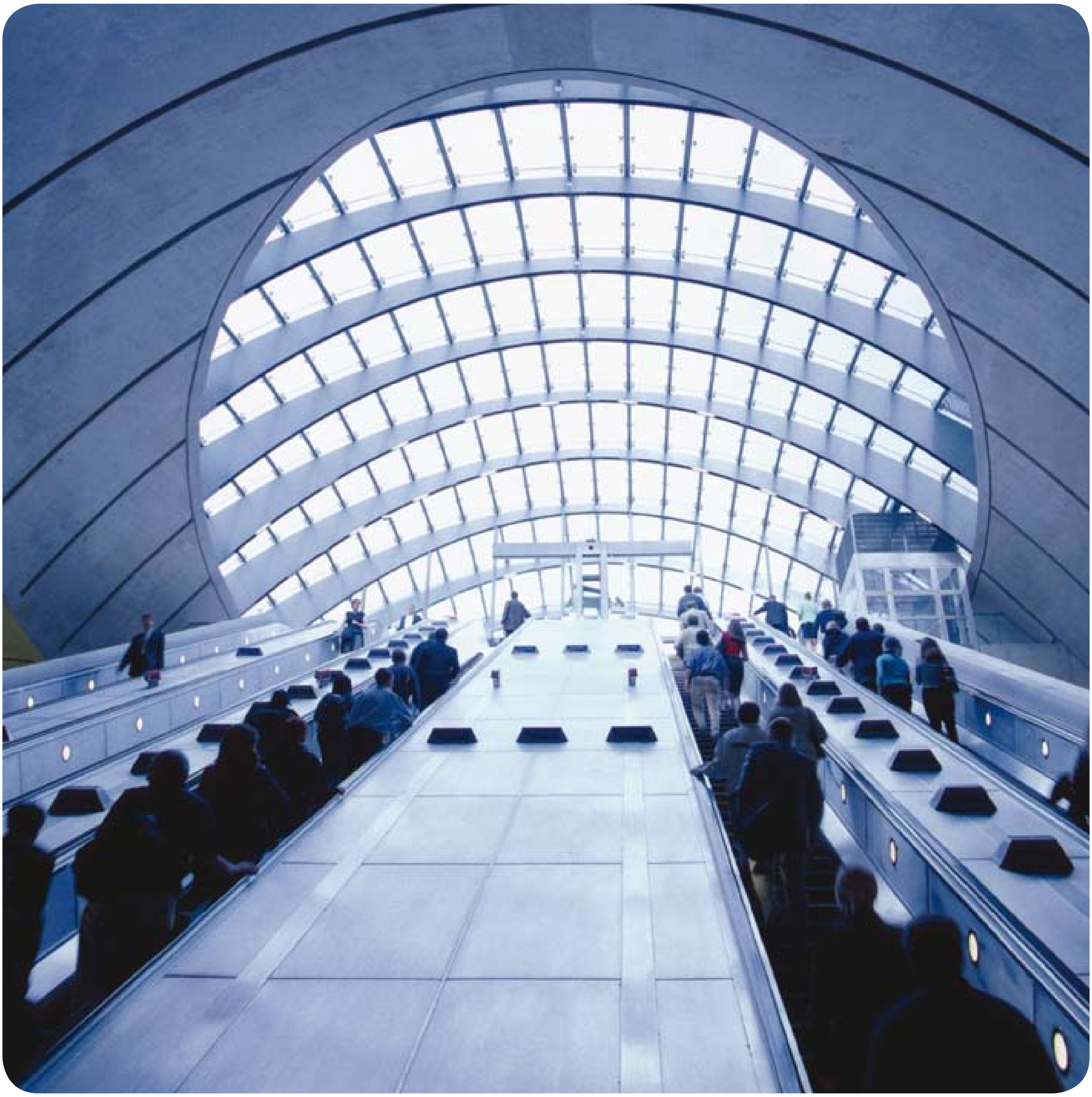


Source: PwC Global Private Banking/ Wealth Management Survey 2007 – Asia Pacific analysis

Figure 6: Whether outsourced third parties used have equivalent risk management frameworks

Going for growth in Asia – Will the banking boom in Asia continue?

 by Karen Loon, Matthew Phillips and Stuart Scoular



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Will the surge of M&A activity seen in 2006 in the banking industry in Asia continue? Yes – at least for the next five years. Buyers, from both within and outside Asia, including strategic and financial buyers continue to be attracted by the high levels of growth in the region to invest across the banking industry. However, with a limited supply of quality assets, there is an increasing the risk of overpaying.

Asia's long term future is bright

Why are buyers so bullish about banking in Asia? According to PricewaterhouseCoopers economists[1], the banking sector will grow significantly faster than GDP in the 'E7' emerging economies of China, India, Brazil, Russia, Indonesia, Mexico and Turkey. Further, total profits from domestic banking in the E7 could be around half those in the G7 (US, Japan, Germany, UK, France, Italy and Canada) by 2025 and larger than in the G7 before 2050. The projections are based on an analysis of developments in G7 and E7 banking markets since the 1950s, which highlights the tendency of the banking sector to grow faster than GDP as economies develop. The new projections for the banking market, using projected market exchange rates, suggest that total domestic credit in China could overtake the UK and Germany by 2010, Japan by 2025 and the US before 2050. India could also rise from relatively low levels today to emerge as the third largest domestic banking market in the world by 2040 and, in the long run, could grow faster than China. Indonesia is also a strong candidate for a rapid expansion of its banking sector over time with domestic credit expected to grow 70 times between 2004 and 2050. Restructuring of the E7 economies should also create major opportunities for private equity firms.

However, while the E7 banking markets will become ever more important in the global banking sector, the report predicts that institutions that do not develop strong positions in these markets will find it difficult to maintain the same growth rates of assets and profits as those that do.

The survey has forecast that continued interest in banking opportunities in Asia is likely to lead to continued high levels of deal activity in the E7 markets, albeit with the normal short-to-medium-term cyclical variations over time. M&A will encompass consolidation activity 'in-market' as local banks acquire one another, foreign banks enter the E7 markets, and banks from the E7 expand internationally through acquisitions.

The more immediate trends

The surge of M&A activity seen in Asia's banking industry in 2006 is likely to gather force over the next five years as firms both within the region and from the West continue to look to Asia as the 'home of growth'. The impact of this focus on Asia is already being felt in the form of intense competition for a limited supply of quality assets, higher prices and the spread of activity to more countries across the region – and indeed to more sub-sectors of financial services. Based on data from M&A Asia, M&A in the financial services sector (including insurance) skyrocketed by 66% to US$64.5 billion in 2006 from US$38.8 billion in 2005.

A recent PricewaterhouseCoopers survey conducted by the Economist Intelligence Unit on financial services M&A activities in Asia[2] highlighted a number of trends in M&A activities in Asia in the banking industry:

Price has become a concern

Half of all survey respondents cited high pricing, a significant rise when compared to almost one-third (32%) of respondents in

[1] Banking in 2050: How big will emerging markets get?, 2007
[2] Financial Services M&A – Going for growth in Asia, 2007

Going for growth in Asia – Will the banking boom in Asia continue? *contd.*

2005, is the principal barrier to undertaking M&A activity from a company's point of view – a clear sign that competition for deals is intensifying. Rising prices have, however, brought more deals on to the market – the number of respondents citing lack of attractive targets as a barrier to M&A dropped from 52% in the same survey in 2005 to 34% in 2007. Concerns about value for money will undoubtedly lead some organisations to put more emphasis on organic growth plans.

Financial services institutions are casting the net wider

Both China and India remain crucial markets for financial services companies looking for growth and, barring radical shocks, are likely to remain so for years to come. However, other markets are beginning to compete for capital and attention: Taiwan and Malaysia are considered ripe for consolidation, while others such as Vietnam, Indonesia and Pakistan are attracting those interested in emerging economies.

Liberalisation is less of a driver

Regulatory liberalisation is considered less of a driver of M&A in part because there are signs of regulations easing across the region, particularly in smaller markets. Indeed, regulatory pressure to restructure or merge in some markets, such as Thailand, is acting as a positive influence and considered a more significant driver than in previous year. Asia's financial services industry is learning to live with the current regulatory environment, or at the very least, putting more emphasis on growth.

From your company's point of view, what are the principal barriers to undertaking M&A deals?
Select up to three

High pricing of M&A deals	50%
Lack of attractive targets	34%
Uncertain regulatory requirements	23%
Lack of capital	17%
Resource constraints within management team/inability to recruit senior managers for new operations	15%
Potential exposure to reputational risk	13%
Poor shareholder value	13%
Compliance issues	11%
Competition restrictions	10%
Lack of information on target organisation	10%
Lack of market understanding of M&A deals	9%
Organisation unable to accommodate further change	9%
Poor track record of M&A success	6%
Concerns over language difficulties/potential cultural issues at target	6%
Don't know	6%
None of the above – there are no significant barriers	5%
Other, please specify	0%
Total	**100%**

Source: PwC Financial Services M&A – Going for growth in Asia, 2007

Coming out on top

Competition for deals in the financial services sector in Asia is expected to intensify and prices are likely to be driven ever-higher as a result. How can companies navigate this environment and come out on top?

Examine prices carefully

As prices rise and previously unavailable targets suddenly show interest in selling, the temptation to pay more than in normal circumstances will be greater. With today's relatively high prices, it is more important than ever for buyers to weigh deals carefully in the context of strategic goals and to fully price synergies. For example, China and India, for all their imperfections and still unfolding regulatory regimes, are simply too large an opportunity to ignore and conventional methods of pricing will often need to be tailored to fully reflect the overriding strategic objectives and the opportunity cost of deferring an investment decision. In most cases however, growth assumptions should be critically analysed – any number of global shocks, from a global economic slowdown to political turmoil to a major natural disaster could throw growth prospects off track, further increasing the risk of over-paying.

Find a balance between organic growth and M&A

Some people believe that organic growth is an extremely important strategy for achieving most corporate goals, and it is likely to increase in importance as prices rise. M&A, while providing opportunities for rapid growth, is distracting and often poorly executed – and carries even more risk in an over-heated market. While gaining an early toehold in an emerging market via acquisition of a minority stake will almost certainly pay future dividends, with today's relatively inflated prices, it will be necessary to carefully weigh the benefits and drawbacks in the context of each individual market.

Be prepared for competition from regional players

While the largest Western financial services companies have provided the most competition for Asian assets in the past, regional companies, notably from Japan and China, are expected to take a very active role in the market in the coming years. This is already beginning to happen in the insurance sector and the trend has implications for the nature of competition. Japanese companies, for example, take a different approach to valuing assets and are generally willing to wait longer than their Western counterparts for a deal to pay off.

Build capability and capacity

The enormous shortage of human capital in Asia's financial services sector is a major inhibitor of growth – both organic and inorganic. The shortage is not confined to Asia and likely to worsen as institutions from emerging markets begin to compete for talent. Clearly, strong management will become an increasingly important source of competitive advantage and those companies that have prioritised the development of their management team will be best placed to capitalise on growth opportunities.

Outlook

Interest in Asia's financial services sector will only increase, going forward. Asian institutions, having grown rapidly in recent years, are now seeking to expand beyond their borders, posing a new form of competition for traditional players, namely Western institutions. For example, Japanese institutions are beginning to expand their footprint to a size that is commensurate with their asset and customer bases. The strategies of Chinese institutions for the rest of Asia have yet to become clear, but they too have the scale to become regional, and perhaps one day, international, players. Singapore banks are already active in the region and there is the prospect of more players emerging.

Going for growth in Asia – Will the banking boom in Asia continue? *contd.*

Adding to the frenzied environment is the prospect of further opportunities opening up – as barriers to foreign investment in the financial services sectors of India and Malaysia are lowered after 2009 and 2010, respectively.

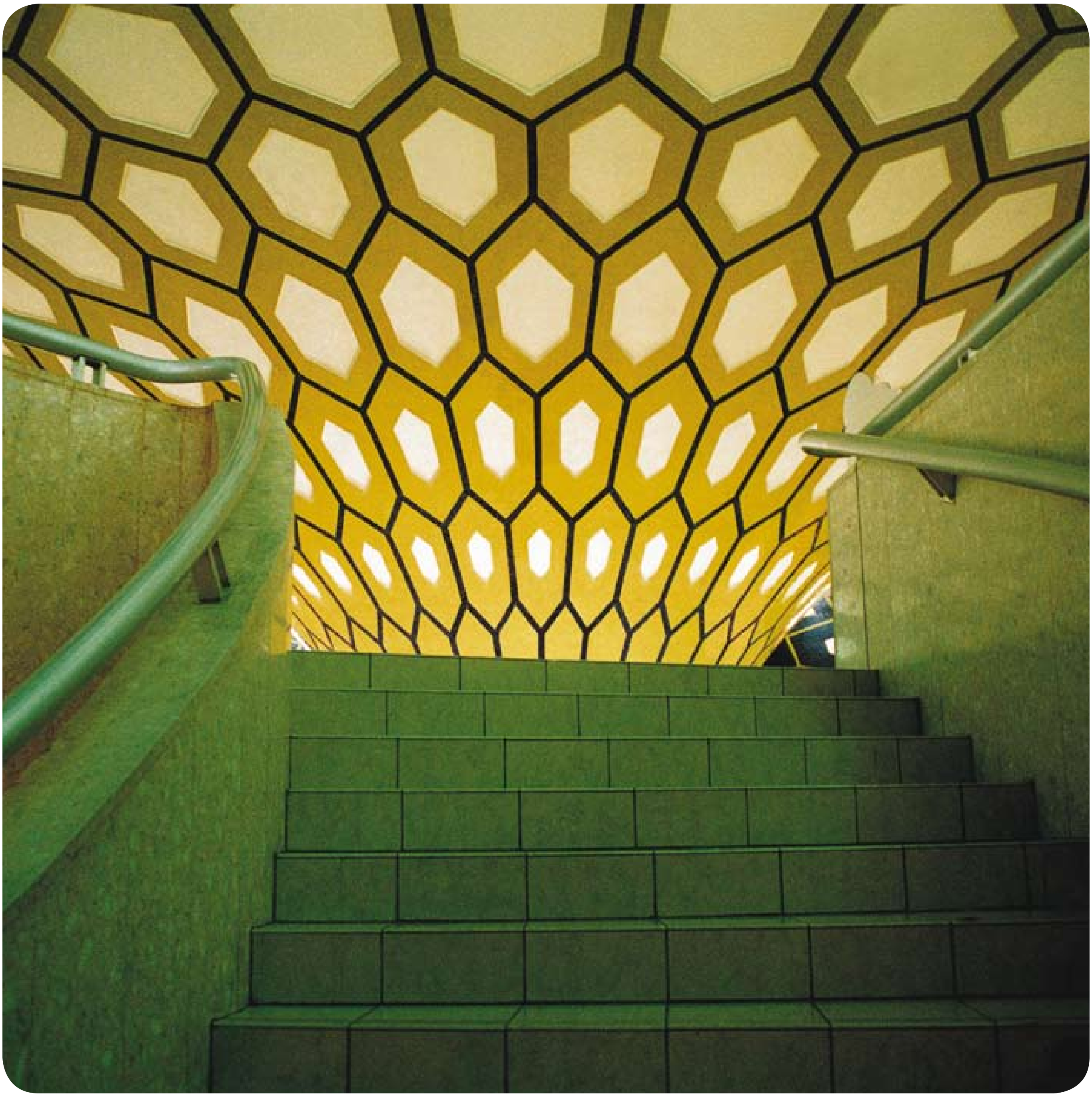
As prices continue to rise and the already scarce supply of quality targets begins to look overpriced, more institutions will opt to put emphasis on organic growth and collaboration. But organic growth alone is unlikely to be enough to bring the kind of rapid expansion many are looking for, or to offer an effective reply to the aggressive plans of the world's financial services giants.

Although growth might be shifting in terms of key markets, Asia is still the 'home of growth'. When compared to Europe or the US, entry into the Asian market presents more of a challenge as the environment is less conducive to control deals, which in turn increases the risks if you are not able to find the right partner. Although this risk in Asia remains high, the growth potential will continue to present compelling opportunities.

To explore these factors in more detail, see our recent publication, *Financial Services M&A: Going for Growth in Asia 2007*, available for download at www.pwc.com/financialservices

Investment prospects in the Indonesian banking sector

 by Stuart Scoular, Cliff Rees and Sahala Situmorang



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Introduction

Indonesia is set to be one of the economic powerhouses of the twenty-first century. The country is the fourth most populous in the world (refer Figure 1), is rich in oil, coal and minerals (including gold, copper and the world's largest tin mining industry), and has a rapidly developing industrial sector. By 2050, Indonesia's economy could be bigger than the UK or Germany[1].

Although international organisations have built up a significant presence in the Indonesian banking sector through the sale of banks following the Asian financial crisis of 1997, the recent pace of investment has been tempered by high interest rates and high levels of non-performing loans. Now, Indonesia is moving to the centre of the radar as interest rates decline, bad debts come under control and credit demand begins to accelerate. By 2050, the size of the Indonesian banking sector could rival that of France or Italy, while returns could be considerably higher[2].

Organisations require a clear strategy to match their ambitions to the relative pros and cons of organic growth, acquisition, branch or joint-venture options. This article outlines the prospects for market growth and assesses the various options for entry and development.

Overview

- Indonesia's banking sector has stabilised, ready for rapid future growth. Bad debt ratios are declining, demand is rising and balance sheet quality has improved;

- The compound annual growth rate (CAGR) of consumer lending between 2002 and 2006 was 30%. By 2050, projected domestic credit is expected to be some 70 times larger than 2004[2];

- Acquisition (up to 99% foreign ownership permitted) could prove to be a relatively quick and effective way to establish a market presence, especially if the strategy is to enter niche segments;

- Takeover prices are relatively high (2.5 to 3 times book value) on account of the limited supply of available targets in Indonesia, along with the increasing demand for banks in growth markets regionally. However, further privatisation, government curbs on multiple ownership and changes to capital adequacy requirements will mean that there are more banks available to acquire; and

- Over the years, several leading international groups have established greenfield (up to 99% foreign ownership permitted) or branch operations. However, gaining new licences could prove difficult at a time when the government and regulators are keen to reduce the number of banks.

Population	235 million (July 2007)
2006 GDP (MER – market exchange rate)	US$364 billion
2006 GDP (PPP – price purchasing parity)	US$960 billion
2006 GDP per capita (MER)	US$1,640
2006 GDP per capita (PPP)	US$4,752

Sources: CIA World Factbook, International Monetary Fund World Economic Outlook Database, April 2007

Figure 1: Key facts

[1] The world in 2050, March 2006
[2] Banking in 2050: How big will emerging markets get?, April 2007

Investment prospects in the Indonesian banking sector *contd.*

Investment Environment

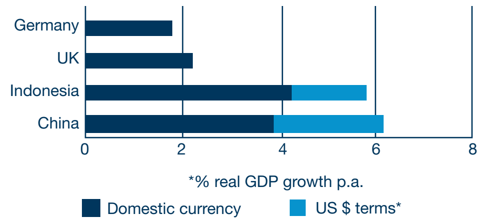
Having largely recovered from the impact of the Asian financial crisis of 1997, the Indonesian economy is now pushing forward into a period of strong and sustained growth. GDP expanded by 5.5% in 2006 and is expected to increase by an average of 5.8% until the end of the decade (refer Figure 2). Inflation has fallen from a high of 18% in late 2005 to around 6% in July 2007[3].

The stock market rose by more than 25% over the first two quarters of 2007, before reaching a record high in July[4], reflecting the increasing confidence about both domestic and export prospects. Though August saw a significant fall in share prices reflecting the global redistribution of capital and re-pricing of risk. More recently the market has recovered with the Jakarta Stock Exchange Index reaching a new high in October 2007. Key growth sectors include mining, chemicals and plantation businesses, which have been buoyed by rapidly increasing demand in China, Japan and other parts of Asia (Japan has overtaken the US as Indonesia's leading export destination)[5].

2006	2007	2008	2009	2010
5.5% (actual)	6.3%	6.0%	5.2%	5.9%

Source: Economist Intelligence Unit, 'Country Profile' Indonesia, 21 May 2007

Figure 2: Projected growth (GDP)



Source: Banking in 2050: How big will the emerging markets get?, April 2007

Figure 3: Projected average real GDP growth 2005-50

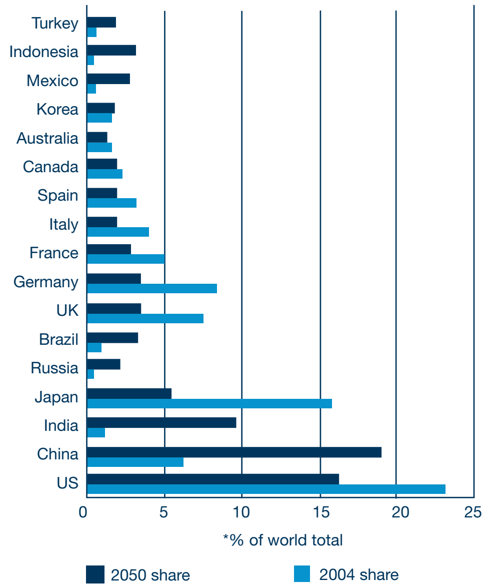
Looking ahead, research carried out by PricewaterhouseCoopers suggests that the combination of sustained high growth, and a sizeable and relatively young population* means that the economy of Indonesia could outstrip both the UK and Germany by 2050 (refer Figure 3).

The corollary of this immense economic potential will be transformational long-term growth in demand for banking services. PricewaterhouseCoopers research indicates that by 2050, Indonesia will have developed a banking sector comparable in scale to a major European economy such as France or Italy (refer Figure 4). Domestic credit in Indonesia is projected to grow from US$0.1 trillion in 2004 to US$7 trillion in 2050 (at constant 2004 prices)[2].

Regulation and consolidation

The upper end of the Indonesian banking sector is relatively concentrated, with the top ten

[2] Banking in 2050: How big will emerging markets get?, April 2007
[3] Bank Indonesia Inflation Report, July 2007
[4] Reuters market report, 19 July 2007
[5] Economist Intelligence Unit, 'Country Profile' Indonesia, 21 May 2007



Source: Banking in 2050: How big will the emerging markets get?, April 2007

Figure 4: Projected shifts in shares of global banking assets

banks accounting for more than 60% of total assets and credit[6]. However, with 130 commercial banks in all, the sector as a whole is overcrowded. Many of the smaller institutions are poorly capitalised.

The government is therefore seeking to promote consolidation and strengthen capitalisation through a policy framework known as the Indonesian Banking Architecture (API). The API includes new capital tiers for banks that wish to operate internationally, nationally or regionally.

Underpinning the API is the Single Presence Policy (SPP), which would prohibit shareholders from having a controlling stake in more than one bank by the end of 2010[7]. Those with multiple stakes will need to either divest, establish a bank holding company or merge their banking interests in Indonesia (plans need to be submitted to Bank Indonesia, the central bank, by the end of 2007)[7]. The SPP would have the particular benefit of enhancing regulatory oversight by reducing the number of separate entities that need to be supervised, especially the extensive array of multiple stakes held by conglomerates.

The Indonesian government and Bank Indonesia also recognise the importance of improved transparency, governance and risk management in winning the confidence of investors. Recent reforms include tighter controls on lending, greater non-executive scrutiny, the requirement to have formal risk committees in place and mandatory good corporate governance standards, along with curbs on the number of related family members that can hold board-level positions[8]. Under current plans, 2008 would potentially mark the beginning of the introduction of Basel II in Indonesia. Ultimately, the embedding of robust standards of governance will come down to the culture of the organisation as much as regulatory supervision.

[6] 'Indonesian Banking Statistics', Bank Indonesia, May 2007
* Source: CIA World Factbook – The average age of the Indonesian population is 27, compared to 44 in Japan and 33 in China. Indonesia's birth rate (20 per 1000) is also more than double that of Japan (8 per 1000)
[7] Bank Indonesia Regulation Number 8/16/PBI/2006
[8] Bank Indonesia Regulation Number 8/4/PBI/2006

Investment prospects in the Indonesian banking sector *contd.*

Market Environment

Although still small in relation to the size of the population, the Indonesian banking sector is already generating a strong return on assets (refer Figure 5).

The resurgence of the economy is leading to an acceleration in credit demand. The overall CAGR in lending between December 2002 and December 2006 was 21%. The fastest expanding segment was consumer/retail credit (CAGR of 30%, 2002-06), which now makes up nearly 30% of the overall loan market[9]. The value of small- and medium-size enterprise (SME) lending has also more than doubled since 2002 to reach some US$45 billion in 2006[9]. A key spur for the growth in the credit sector has been the reduction in Bank Indonesia's base rate, from 12.75% in late 2005 to 8.25% in July 2007. This has fallen in line with inflation.

Sales and restructuring had reduced the gross non-performing loans ratio of commercial banks to 6.1% by May 2007 (refer Figure 5), releasing fresh funds for new lending and improving the quality of the industry's balance sheets. Bank Indonesia is pressing for further reductions by insisting that institutions that wish to qualify as 'anchor banks' will need to cut their non-performing loan ratio to less than 5% by 2008[10].

Assets	US$188 billion
Deposits	US$142 billion
Loans	US$90 billion
Number of banks	130
Number of offices	9,110
Gross non-performing loans	6.1%
Capital Adequacy Ratio	22%
Return on assets	2.98%

Source: Bank Indonesia 'Indonesian Banking Statistics', May 2007

Figure 5: Banking sector overview (May 2007)

While product choice and distribution options on the consumer side are still relatively limited, development is beginning to gather pace. For example, Bank Mandiri, Indonesia's largest bank, has built a successful bancassurance platform.

Having been subdued in the aftermath of the 1997 crisis and subsequent global downturn in 2002 and 2003, corporate banking in Indonesia is now coming back to life. Proposed initial public offerings include Adaro Indonesia, one of the world's largest producers of thermal coal, which if it goes ahead will be the country's biggest ever flotation[11]. Other opportunities opening up as the economy gathers speed range from derivatives to help control the volatility of the Rupiah and interest rates, to the fast-growing demand for SME credit and advisory services.

The demand for Islamic banking is still surprisingly small in what is the world's largest Muslim country. However, a number of providers are looking to extend the range of Sharia-compliant products.

[9] Calculated from Bank Indonesia 'Indonesian Banking Statistics', May 2007.
[10] Bank Indonesia 'Indonesian Banking Booklet', March 2007
[11] Financial Times, 2 July 2007

		US$ billion	
Rank	**Name**	**Assets**	**Credit**
1	Bank Mandiri**	27	11
2	Bank Central Asia	20	6
3	Bank Negara Indonesia**	19	7
4	Bank Rakyat Indonesia**	17	10
5	Bank Danamon	9	4
6	Bank Internasional Indonesia	6	2
7	Bank Niaga	5	4
8	Citibank NA	4	2
9	Bank Permata	4	2
10	Panin Bank	4	2

* Rounded to nearest billion
** State-owned banks

Source: Bank Indonesia 'Indonesian Banking Statistics', May 2007

Figure 6: Top 10 banks by assets (as at 31 March 2007)*

	Year	Stake sold	Acquirer
Bank Central Asia	2002	51%	Farallon Capital
Bank Niaga	2002	51%	Commerce Asset Ventures Sdn Bhd
Bank Danamon	2003	51%	Temasek/Deutsche
Bank Internasional Indonesia	2003	51%	Temasek/Kookmin
Bank Lippo	2004	52%	Swiss Bank Consortium
Bank NISP	2004/05	71%	OCBC
Bank Buana	2004/05	61%	UOB
Bank Permata	2004	51%	Standard Chartered/Astra
Bank Lippo	2005	83%	Khazanah Nasional Bhd

Source: PricewaterhouseCoopers/Bloomberg Research

Figure 7: Significant foreign investment in banking sector (2002-2005)

Ownership and investment

Many of Indonesia's leading banks, including Bank Mandiri, are state-owned (refer Figure 6), though the government appears keen to renew privatisation. This includes the sale of a 30% stake in Bank Negara Indonesia in August 2007, which raised approximately US$875 million in the government's largest banking divestment to date[12]. Foreign investors hold significant stakes in a number of the top ten banks. Much of this investment stems from the sale of stakes in nationalised banks between 2002 and 2005 (refer Figure 7).

International groups that have banking subsidiaries in Indonesia include Rabobank, DBS Bank, Commonwealth Bank of Australia, and the Australia and New Zealand Banking Group. A number of international groups, including HSBC, Citibank, ABN Amro and Standard Chartered have also established branch operations.

Renewed interest from regional and global groups is now evident as the economy and credit markets continue to grow. For example, a survey of 230 financial executives from across Asia, which was carried out by

[12] Jakarta Post, 1 August 2007

Investment prospects in the Indonesian banking sector *contd.*

PricewaterhouseCoopers in April 2007, found that 20% expect to carry out M&A activities in Indonesia over the next five years. Among respondents from Indonesia itself, 56% expect to undergo significant M&A, 50% anticipate a sizeable divestment and 75% will seek a foreign strategic investor or partner in a major new venture over the next five years[13].

International groups that have extended their presence recently include Rabobank, which took control of Bank Haga and Bank Hagakita as part of its aim to become the 'bank of reference' for SME business in Indonesia[14]. Prospective entrants include private equity and other financial buyers. In May 2007, for example, US private equity company TPG (formerly Texas Pacific Group) agreed to acquire a majority stake in Bank Tabungan Pensiunan Nasional, a niche bank that mainly serves retired people[15].

Entry Strategies

Companies looking to control a banking operation in Indonesia have three main options: establishing a new bank, opening a branch of a foreign bank or acquiring an existing institution. Investors need to weigh up a number of regulatory and operational factors before choosing which route to take.

Option 1
Establishing a new bank
Greenfield entry (up to 99% foreign ownership permitted) naturally provides the flexibility of starting afresh and eliminates the risk of liabilities from past activities. However, companies must provide more than US$330 million in paid-up capital, which could be a sizeable disincentive. Establishing a new business also tends to be more time-consuming than acquisition. In particular, companies need to allow at least a year to complete operational preparations, including feasibility studies, licence applications (120 days at least), recruitment, IT and marketing development. Even then, gaining approval for a new start-up may be difficult at a time when Bank Indonesia is looking to reduce the number of banks. In this respect, it is notable that no new banking licences have been issued since 1999.

Option 2
Opening a branch of a foreign group
If the bank is one of the global top 200 by assets, it can open a branch in Indonesia. This route does away with the need to find a local partner and comes with no risk from past activities. However, the paid-up capital requirement (US$330 million) is the same as greenfield entry. The nature, extent and time needed to complete the operational and regulatory preparations are also similar. Although current regulations permit this approach, the fact that Bank Indonesia has issued no new branch licences since 2003 would suggest that gaining its approval may be difficult.

Option 3
Acquiring an existing institution
Acquisition (up to 99% foreign ownership permitted) offers an established customer base, existing operational systems and distribution channels. While target identification through to due diligence, negotiation and sale can take four to six months, this is still considerably less than the greenfield route. Bank Indonesia is also far more likely to grant approval.

[13] Financial services M&A: Going for growth in Asia, 2007
[14] Rabobank media release, 10 January 2007
[15] Financial Times, 17 July 2007

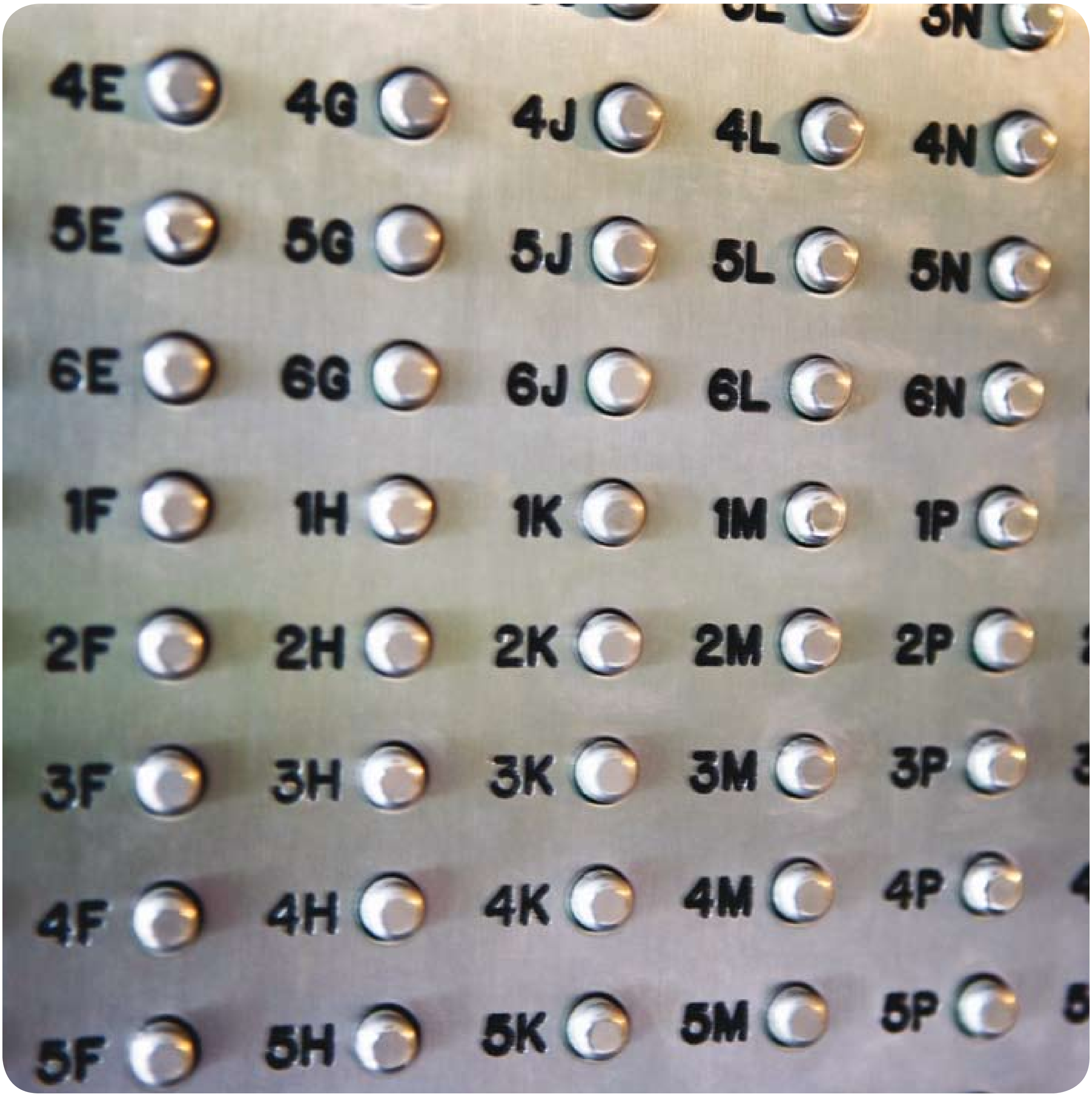
On the flip side, buyers run the risk of taking on unwanted liabilities from the past. Moreover, acquisition prices have been running at 2.5 to 3 times net book value, reflecting the increasing demand for banks across this fast-growth region and, within Indonesia itself, the shortage of available supply in a country where most leading institutions are either state, family or foreign-owned and therefore rarely for sale. Now, however, both privatisation and the impact of the Single Presence Policy are adding to the supply of potential targets. The relatively fast turnaround of private equity investment could also mean that recently acquired entities could soon be back on the market. Developments in price and availability may encourage more acquisitions as an alternative to greenfield start-ups.

The Way Forward

The Indonesian banking sector is set to be transformed over the next few years as the number of banks decreases, foreign investment continues to increase and institutions respond to the impact of the API, Basel II and other pressing regulatory developments. The result is likely to be a more competitive market, marked by heightened pressure to improve efficiency, drive down payroll and other costs, and generate greater product and service differentiation. Those spearheading investment and development are likely to include financial buyers, capable of turning around under-performing institutions ready for selling on to more long-term acquirers. The longer-term investors are likely to include the key regional and, increasingly, global players attracted to the huge potential of what is set to become one of the world's biggest banking markets.

Model validation: How recent market turmoil highlights the importance

by Chris Matten, Chen Voon Hoe and Liew Wai Meng



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Introduction

Recent turmoil in global credit markets, sparked by higher-than-expected losses on sub-prime mortgages, has focused attention on the susceptibility of funds and banks to assumptions in their models. Although the problems started in the sub-prime mortgage market in the USA, they have spread across the globe. Firstly, CDOs and other instruments backed by US mortgages are held in portfolios almost everywhere. And, secondly, jitters in the credit markets have spread to other types of CDOs. At the same time, Asia has witnessed exponential growth in the trading of complex structured financial products in the recent years. The onset of this market growth has been driven largely by increased demand by consumers for new and more innovative products, as well as the availability of new financial derivatives brought about by stronger financial analytical and modelling capabilities. In a recent survey by PricewaterhouseCoopers of more than 265 private banking/ wealth management firms across the globe ranging from global giants to niche players, it was found that many market players consider themselves to be competent in manufacturing best of breed products and that they plan to increase their products and service offerings within the next three years (refer Figure 1).

Of the mix of products that banks are currently offering, a significant number are offering structured and alternative products, many

Do you believe the product/service range at your organisation is wide enough to meet all of your clients' needs?

Do you plan to increase the range of products and services offered by your organisation over the next 3 years?

Source: PwC Global Private Banking/ Wealth Management Survey 2007, Asia-Pacific (ex-India) Data

Figure 1: Firm's indication of intention to offer new product and services

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of which are developed in-house which require more complex modelling for proper pricing and hedging of risks (refer Figure 2).

Based on indications from the survey, this situation also introduces new opportunities and challenges in the management of risk exposures inherent in the use financial derivatives. Imagine this scenario: A bank has just structured a complicated derivative deal for which there is no secondary market price available. As the current internal model may not work well in this particular situation, this deal may not be marked to market properly; and it may not be hedged properly. How does the bank protect itself from such risk exposures?

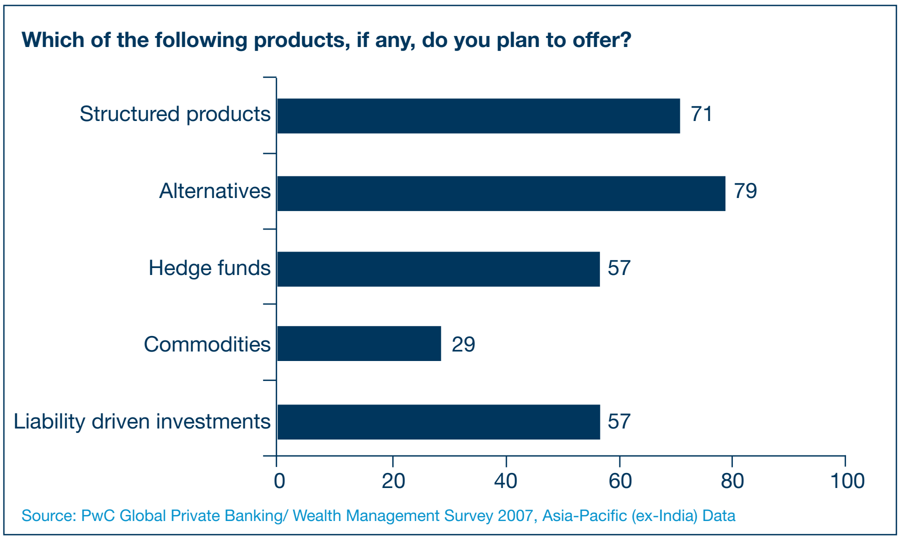

Figure 2: Firm's indication of products offered

What is Model Validation?

'Model validation' is one control approach that should be explored thoroughly in order to avoid the situation where internal models are inadequate or applied improperly. Model validation basically assesses whether the internal model is working as intended. It aims to reduce modelling risk which results from the incorrect use of model. Hence, it increases the reliability of a model by providing a clearer understanding of the model's strengths and weaknesses so that improvements can be made to improve accuracy, and reserves set aside to cover any potential inaccuracy in the model. Certainly in the context of complex derivatives or structured transactions, model validation will help to mitigate the risk of mis-marking the positions that are valued using complex internal models, especially when observable market data is not available. Besides, it also assists to identify the uncertainty and the sensitivity of mark-to-market values with respect to modelling assumptions. This will also help to ensure that the bank has a proper process in place to calculate the fair value and its related accounting disclosures in its financial statements.

Importance of model validation

Model validation forms a key component of an effective risk management process. It is important to identify and highlight any mis-specification or improper usage of model early so that remedies can be made before the bank suffers a large loss due to any mis-pricing from using the underlying internal model. The increasingly important role of some of these models in business decision-making processes has made model validation even more crucial to eliminate or reduce modelling risk.

In recent years, most regulatory authorities have become very concerned about the robustness of the control environment surrounding the use of complex internal models, and now fully expect proper model validation programmes in product areas that rely heavily on quantitative internal models for pricing and hedging. Model validation is also a focus in the Basel II Framework. It is an essential factor ensuring that internal models and other parts of banks' internal processes used for Basel II meet the requirements for regulatory capital calculations. Good model validation is viewed as part of sound risk management and good corporate governance.

The remainder of this article briefly discusses model validation from the perspective of risk management and internal control.

Risk management and controls over models are key

As quantitative internal models become an increasingly important means of pricing and analysing risk exposures, it is necessary that banks have a robust control environment governing these internal models and their implementation. As part of the validation process, banks should develop formal policies that ensure that all of these procedures are applied under the appropriate circumstances. The depth and extent of the validation should be consistent with the materiality and complexity of the risk being managed. An effective validation process should contain the elements[1].

1. Governance
   As part of the overall governance for internal modelling, there must be a proper framework in place and effectively applied. This framework should dictate the following issues clearly:

   - the roles and responsibilities of senior management in creating a risk-aware culture within the bank;
   - articulation of the risk appetite and exposure limits;
   - good practices relating to model purpose, scope, design, specification, development, testing, usage and independent validation;
   - oversight of model and source data control; and
   - reporting of principal results, exceptions and other issues, plus relevant follow up action.

2. Documentation
   It is essential to have proper documentation in place for important areas, such as the assumptions on which the model is based, the limitations on its applicability, and implementation process. Formal evaluation of the financial analytics used in the model is also necessary to provide clearer understanding of numerical solution procedures and the related software codes. The bank should have an inventory of models, clearly setting out who developed the model, what it does, who reviewed it and when it is next scheduled for review.

3. Development and testing
   Another control requirement is to have proper designation of responsibilities in the development and testing of the model with the aim of maintaining independence between these two tasks.

[1] PwC/ Group of Thirty – Best practices for valuation of financial instruments, 2004

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Two relatively effective ways of organising this task are:

a) Establishing an independent quantitative evaluation group within the bank (perhaps within internal audit) to do the model validation. While independence is assured, there will be issues relating to the ability to hire and retain qualified personnel to staff this function; or

b) Engage an external consultant to undertake validation work. While independence will not be an issue, it will be necessary to ensure that the external party has the necessary expertise to carry out the task properly. Moreover, there could be an issue surrounding the release of proprietary information regarding the internal models.

4. Alteration procedures
   After a model is implemented, there will be subsequent changes and enhancements to the model. Proper procedures need to be established to record the changes so as to provide an audit trail, as well as to clearly specify who is authorised to make the changes, who reviews the changes, and controls over the implementation of the model. It is also important to have internal audit ensure that the model validation adheres to the formal policy.

5. System support
   As the models run on complex IT systems, it is critical that proper procedures are established covering the maintenance of the IT platforms and the integrity of the source data that is fed into these systems.

Conclusion

With the increasing focus in recent months on the need for accurate fair values, model validation will become increasingly more important. Model validation is a continuous process as internal models need to be revisited periodically to ensure that they are still appropriate. It is critical in controlling and mitigating the inherent exposures relating to model risk and the mis-marking of complex derivatives. Putting proper procedures and controls in place and maintaining an appropriate level of risk awareness is all part and parcel of a sound risk management process. Model validation (complemented with back testing and price verification methods), forms a critical and effective approach towards managing risk exposures arising from internal models.

Fair value accounting

Accounting standard setters have been grappling to find the best way to measure the value of financial instruments. Prior to fair value accounting, financial instruments had been accounted for at historical cost. However, historical cost does not provide a meaningful value in many cases. For example, some derivatives have a historical cost of zero. Hence, accounting standards have evolved over the years to require most financial instruments to be measured at fair value with limited exceptions for certain instruments to be kept at amortised cost.

Trying to determine what exactly fair value is has proven elusive especially in the world of complex derivatives. International Accounting Standard 39 (IAS 39) which deals with the recognition and measurement of financial instruments prescribes a hierarchy for the measurement of fair value. IAS 39 states that the best evidence of fair value is the quoted prices in an active market However, for many instruments, such an active market may not exists.

For products with no active market, IAS 39 states that the fair value derived using valuation techniques (or commonly known as mark to model prices) can be used. In view of the myriad of financial instruments with various level of sophistication, the accounting standard only specifies that the entity uses a technique that is commonly used by market participants and has been demonstrated to provide reliable estimate of price obtained in an actual market. Further, the technique chosen must make maximum use of market inputs and relies as little as possible on entity-specific inputs. However, determining which valuation technique or inputs to use has proven to be a daunting task. Firstly, the valuation technique (or model) used may not resemble the market especially for derivatives with illiquid underlying instruments or in times where there are adverse market conditions. Further, it is hard to differentiate between market and non market inputs and small changes to the model inputs can change the fair value significantly. Such uncertainty affects the fair value and the gains or losses which the entity recognises in its financial statements and casts doubts on the reliability of these fair values.

Accounting standard setters are trying to bridge the gap by requiring more disclosures on the valuation techniques and the related inputs used to calculate fair value. The USA's Financial Accounting Standard Board, had recently adopted FAS 157 which require disclosures of valuation inputs to be prioritised into three levels depending on whether the inputs are observable or not observable. The International Accounting Standard Board has issued a discussion paper based on similar principles. To comply with these accounting requirements, entities would need to put in place proper policies and procedures around their fair valuation processes. It is hoped that with more disclosures, users of financial statements will be able to make a more informed judgement on the fair value of these financial instruments.

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