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Thriving in  
a changing  
environment



**Beyond rules**

Integrity at the basis of sustainable business success: Wim Kok, President of the Club of Madrid, reflects

**EU Action programme**

Reducing the administrative burdens on the FSI

**Towards a new financial order**

Interview with professor Jan Pieter Krahen

**The new 'F' word**

The four forensic 'must knows' to survive

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Preface

# Yesterday's lessons and tomorrow's value



One year after the crisis started, most Financial Services Industry players agree that the worst is most likely to be behind us, even if new business risks still lie ahead. And none doubt that the business landscape in which our industry operates will be very different from what it ever was.

In today's new reality, the immediate concerns in FSI boardrooms are strengthening the balance sheet, understanding and preparing for upcoming regulations, restoring internal self-confidence, gaining trust on the market and with clients, and getting a sense of being 'in control'.

To be 'in control' means to get a grip on the organisation. Companies need to focus on what really matters, to manage ongoing divestitures and potential acquisitions, and, probably the most difficult, to understand the new risks they are heading for, tomorrow and in the longer term.

There may be limited room now for innovation, expansion or differentiation. But this will not last. Finding the right balance between learning lessons from the past and designing a new business model for the future is not an easy task in the current context. But it is the only way to create tomorrow's value – for many tomorrows to come.

*Olivier de Groot*

Deloitte SE FSI Leader

*Facing the sanctions challenge in financial services*

## Sanction compliance: a growing industry concern



An Economist Intelligence Unit study, sponsored by Deloitte, shows that compliance with sanctions – in other words, restrictions imposed on the economic activity of or interaction with specified individuals, organisations and/or states – has consumed more time, money and personnel of financial institutions in the last three years than ever before.

At the same time the sector as a whole still has an inconsistent record on sanctions compliance, with IT and a corporate culture of sanctions compliance still falling short of requirements. However, new sector-wide best practices are starting to emerge.

The survey shows that financial services companies have been devoting increasing attention to sanctions compliance over the last couple of years as they navigate a shifting regulatory landscape. According to respondents, guidelines are often unclear and even inconsistent, while the increasing global regulatory rigour in enforcing these requirements has made the task facing them all the more pressing.

### Best practices

Under these conditions, new best-of-class standards for sanctions compliance are emerging. Urged by regulators, companies with well-defined sanctions programmes are including risk assessments as part of their best practices. A total of 70 per cent of these companies were either in the process of completing or had already completed a formal sanctions risk assessment in the past two years. Risk assessments can be beneficial in establishing focused processes and allocating resources for complying with sanctions. Although risk-based approaches may be insufficient to protect against the strict legal liability involved in sanctions compliance, a well-designed programme may result in regulators mitigating the punishment imposed in

the event of breaches.

Companies reporting that they have well-defined sanctions programmes are much more likely to have programmes that are consistent across the company: 73 per cent of these respondents set policy at a global level, against just 41 per cent of the other respondents. Respondents said that they found such a global approach to be more efficient and effective. Of greater importance, however, is the fact that such consistency is essential, given that violations of a particular country's sanctions can occur anywhere in the world.

### Fields of attention

Although information technology is essential for the intensive screening involved in sanctions compliance, 44 per cent of those surveyed believed that today's technology did not meet current requirements and 37 per cent thought that this would still be true in three years' time. The overall efficiency of screening technologies – especially the large number of false positives they produce – is a particular problem. Depending on the nature of the products and services offered, technology solutions alone often uncover few real violations that can be resolved without substantial manual follow-up.

Another worrisome point is that only 56 per cent of companies surveyed said that they had established an effective group-wide culture in this area, while the growing importance of sanctions compliance makes creating such a culture more vital than ever. And creating an appropriate culture begins with senior management setting the necessary 'tone at the top' for the issue.

### Fact of life

To summarise, the survey shows that sanctions represent a significant regulatory risk that cannot be completely eliminated. Yet the risks can be substantially mitigated through attention to detail and robust implementation of comprehensive sanctions programmes. And in a global market, financial services companies will have to learn to live with this uncomfortable fact of life.

To download the full report, please visit [www.deloitte.com](http://www.deloitte.com) > Industries > Financial services.

*International regulatory cooperation within the insurance industry*

## A joint effort to move away from antiquated national regulatory silos



Across the globe, stakeholders in the insurance industry are pressing for enhanced international regulatory cooperation. This does not mean, however, that it will be easy to move away from the current, nationally oriented regulation practices. Once the dust of the crisis has settled, national sentiment may once again start dominating the debate.

If the credit crunch and subsequent sharp economic downturn have shown anything, it is that our financial markets, including the insurance industry, are global and interwoven. The problems that started on the American subprime mortgage market have spread, like a virus jumping species, across financial industries, asset classes and jurisdictions alike. Many industry observers have commented that the current regulatory regime does not reflect this global aspect of the financial system. They argue that globalisation calls for regulatory cooperation between countries and jurisdictions. At the same time the crisis has highlighted the benefits of communication and coordination between regulators; in many instances regulators around the globe have collaborated around the clock to deal with liquidity problems arising within multinational financial institutions.

### Broad support

Probably the strongest and most influential supporter of this enhanced regulatory cooperation within the global insurance industry is the International Association of Insurance Supervisors (IAIS). Although the IAIS has no legal teeth to demand compliance, and instead acts as a non-profit, educational organisation, it proclaims itself to be 'the international standard-setting body for prudential supervision of the insurance industry.' Coinciding with the G20 summit in April 2009, the IAIS submitted a list of recommendations to improve the regulation of the global insurance industry. The report called for enhancing group and cross-sectoral supervision, with a focus on internationally active insurance groups. It also stated that the IAIS would work with the Basle Committee and

the Joint Forum's International Organization of Securities Commissions to identify regulatory gaps and areas in need of greater supervision and would incorporate lessons learned from the financial crisis into IAIS Standards, with particular attention being paid to solvency, investment risk management and corporate governance. On top of that the IAIS is also targeting regulatory coordination through the development of its Multilateral Memorandum of Understanding and its renewed commitment to work even harder to improve information exchange and cooperation among its members.

The G20 has also joined the chorus for more regulatory cooperation, specifically declaring that regulators should collaborate to establish supervisory colleges for all major cross-border financial institutions. Their tasks should include regular meetings of the institutions with their respective colleges to discuss activities and the risks they face. Regulators should also take all necessary steps to strengthen cross-border crisis management arrangements, including performing simulation exercises. Lastly, the industry itself is seeking to promote enhanced international regulatory collaboration. Lloyd's, for instance, stressed that international regulators should be supported and encouraged to devise approaches that will enable them to rely on the supervision carried out by the 'home supervisor' and thus avoid onerous, duplicative processes that do not enhance consumer protection.

### Dangers and difficulties

This broad support for enhanced international regulatory supervision does not mean, however, that it will be easy to move away from antiquated national regulatory silos. Regardless of the merits of the standards being developed by the IAIS, there is no mechanism in place to compel any one jurisdiction to comply. Furthermore, the concept of a one-size-fits-all insurance regulatory effort is made more difficult by differences between complex international businesses (including large insurance groups with strong ties to the banking sector) and smaller domestic companies. Some fear that smaller insurance companies might get lost in the mix if global standards are allowed to dominate. And this could mean that once the dust of the crisis has settled, national sentiment might rise once again.

To download the full report, please visit [www.deloitte.com](http://www.deloitte.com) > Industries > Financial services.

The transformation of the global financial services industry

# Thriving in a changing environment

Nobody will deny that the current financial and economic crisis will leave the global financial services industry utterly transformed.

At the same time it is very difficult to predict how the industry will emerge from this transformation. The Deloitte report *The Transformation of the Global Financial Services Industry* tries to answer this question by capturing the thoughts of financial services executives from across the globe, as well as the views of Deloitte subject matter experts. A portrait of an industry at a crossroads.

There's no doubt that the global financial services industry has been dealt a heavy blow over the last two to three years. The problems with subprime mortgages, the liquidity crisis, financial unrest, the stock market crash and the economic downturn that followed have brought many a formerly respectable financial institution to its knees. Others are hanging on by the skin of their teeth, needing all the government help they can get.

There's no doubt, either, that this crisis will leave the industry utterly transformed. Governments around the globe have become key players in the industry, the markets for complex financial products have ground to a halt, the era of high leverage ratios has passed, executive remuneration schemes in general and the bonus culture in particular face more public scrutiny every day.

Yet history shows that in the midst of every crisis the seeds are sown for the next economic upturn, and that financial institutions tend to take the lead in this recovery. To explore whether the same is happening this time, Deloitte's Global Financial Services Industry (GFSI) practice conducted a survey, aimed at capturing the thoughts of leading executives about what institutions need to be

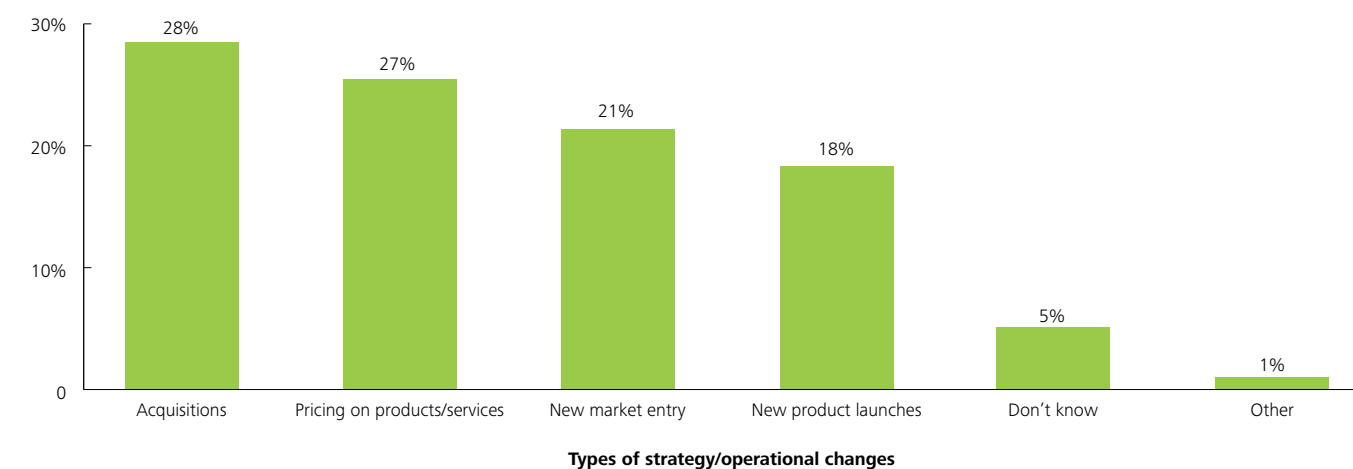
doing to turn this transition to their advantage. How are financial institutions around the globe responding to the current challenging circumstances? What strategies are they designing to thrive again in the long term?

## New funding sources

The immediate challenge that financial institutions face is a simple one: in light of the continuing freeze in the capital markets, they are looking for stable sources of funding. Venture capital, private equity and short-dated commercial paper used to be essential funding sources for many industry players such as banks and investment management firms. Due to the credit crunch, the wholesale market for capital funding has essentially collapsed, leaving institutions relying heavily on more traditional sources. Survey respondents ranked customer deposits the most accessible funding source and expect non-wholesale sources of funding to dominate financial services for the foreseeable future.

Interestingly, although these traditional sources of funding are regarded as intrinsically less risky, they can develop their own disturbing dynamics. Where the credit crunch was partly caused by short-term financing of long-term liabilities (short-dated mortgage-backed securities), now the opposite seems to 'be happening. Or, as the CFO of

Figure 1: Negative impact of funding freeze on strategy and operations



# Government interference in the sector will result in a seismic shift in industry regulations

a boutique M&A firm put it: 'There is very little new issuance of shorter-dated maturities today. People are funding long, which will create another interesting dynamic because the assets of these firms are not long-dated... Managing the interest rate mismatch and the funding mismatch is going to get more interesting for these firms as they stop funding short and fund more longer-dated to ensure stability.'

### Back to basics

It's not surprising that this environment of dried up capital and frozen credit markets has a big impact on the way day-to-day business is being run in financial institutions. The GFSI survey reveals a trend of curtailed business activity, with acquisition plans taking a major hit, followed closely by pricing, with new product launches and new market entry close behind (see figure 1).

In the end, the survey implies, financial institutions will also be cutting into their revenues; the majority of survey respondents did not think that the market could presently support raising margins on core products and services, such as charges on overdrafts or increased premiums. Specifically, it will be difficult to raise prices on financial products that people are sceptical of, from brokerage services to riskier banking products. 'If you are asking if

you can get away with raising prices in an environment where a huge percentage of people are losing jobs, you have a slowdown economically, higher taxes, the answer would be absolutely not,' the senior VP of a US investment management company asserted.

Under these conditions, refocusing on core products has emerged as a major theme. Insurance companies are expected to gravitate towards selling more term life insurance policies rather than focusing on annuity products, in the interest of generating more positive cash flow. The investment management industry will be orienting itself towards retirement products because they are steady and structured, rather than relying on complex products. Refocusing on core products is part of a back-to-basics operational trend that is in keeping with the survival mode many companies find themselves in (see figure 2).

### Uncertain future

In contrast to this seemingly broad agreement on the necessary and beneficial short-term approach for dealing with the crisis, long-term expectations are more mixed, unclear and in instances even negative.

Figure 2: What source of replacement revenue streams are you targeting?

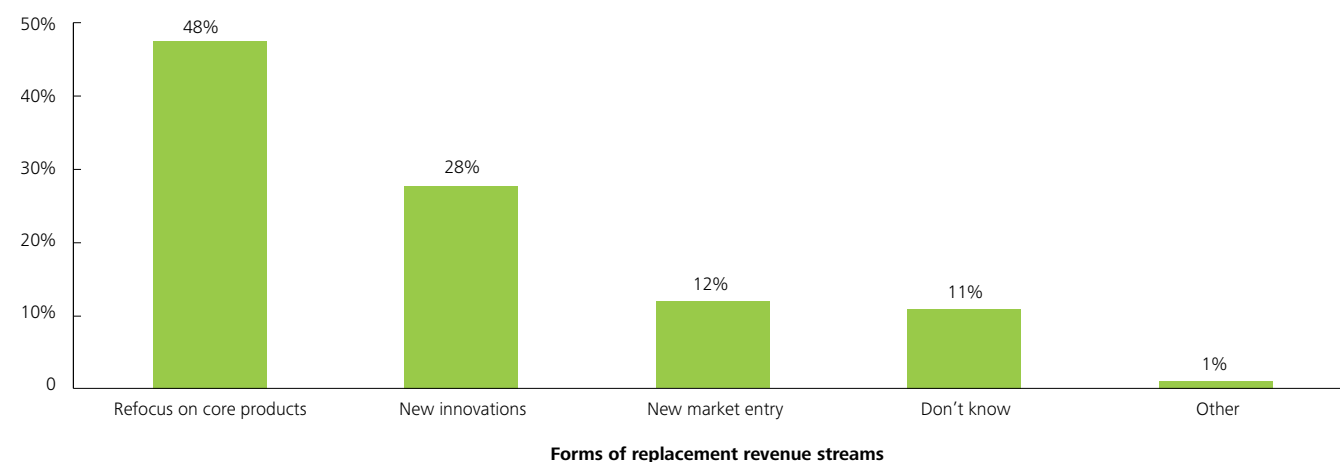
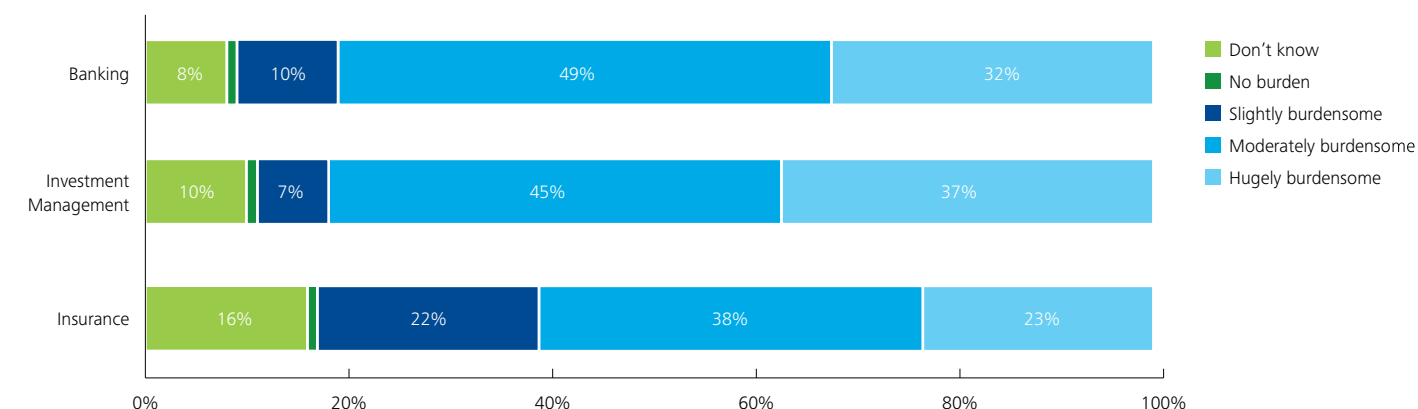


Figure 3: How burdensome do you expect any new regulation to be in your industry?



### Government interference

First of all there's the current large-scale government interference in the sector. Survey respondents generally expect governments to remain heavily involved in the financial services industry for a long time. Almost 90 per cent of respondents thought that involvement would last at least three years, with over 40 per cent indicating that government involvement would last for five years or even indefinitely.

Most of the survey respondents agreed that in the short term, government support has some very significant advantages, for example providing access to capital, acting as a share price stabiliser, and helping businesses keep their doors open. However, there was also strong agreement that over the long term, government support transitions into a competitive disadvantage. Respondents cited concerns such as the potential for the government to become controlling in its role as shareholder, tendencies towards political expediency, and operating restrictions.

Respondents also pointed out the seemingly contradictory demands presently coming from authorities. On the one hand, governments are pressuring institutions to lend in order to stimulate business. On the other, increasing regulatory requirements on capital ratios have created a situation in which even though banks have large amounts of capital, they don't have it in sufficient amounts to dramatically expand lending.

### Increasing regulatory pressure

This government interference in the sector will, according to the respondents, result in a seismic shift in industry regulations, extending to risk models, executive remuneration schemes, fee structures and leverage models. Respondents foresee products and services being designed to pass government muster. Deloitte experts expect increased transparency with regard to fees, commissions and charges, and a standardisation across markets to promote simplicity. This theme will be particularly dominant in the hedge fund industry, where the previous fee structure, characterised by survey respondents as 'completely unsupportable', will be changed, along with the treatment of capital gains as ordinary income. Eventually, hedge funds will be regulated in much the same way as mutual funds, especially in the wake of several high-profile hedge fund scandals.

Coordination among global regulators is also expected to improve, in line with the recent announcements from the G20 Summit. Although stopping short of expecting the creation of a new global body with formal regulatory powers, 69 per cent of respondents predicted there will be more consolidation among regulators within each jurisdiction. Other expectations included the creation of a global clearing house of information on capital, trades and risk accumulation.

## Risk management will play a key role in regaining trust of customers and counterparties

Respondents also expressed their support of better enforcement of existing rules and policies, and of expanding the funding of regulatory institutions, making the distinction between improving supervision and introducing more new regulations.

But whatever the changes in oversight, respondents are not optimistic that new regulations will be painless. 37 per cent of respondents expect new regulations for the investment management industry to be hugely burdensome, while 32 per cent expected regulations for the banking sector to be hugely burdensome, and 23 per cent indicated new regulations for the insurance industry would be hugely burdensome (see figure 3).

### It's all about trust

The true challenge for financial institutions, however, both those who have had their reputations tarnished and those seeking to capture market share, will be to find ways to build reputations and regain trust. Respondents generally agree that being portrayed in the press as financially irresponsible has a tremendous impact on an institution's reputation, and that there is a premium customers are willing to pay to be associated with an institution they trust.

Respondents agreed that risk management will play a key role in regaining the trust of customers and counterparties. 'I think all companies will be more focused on risk management as a cultural dimension, as opposed to an operational function. We really need to get at risk management as an embedded core discipline that is reflected in the culture of a company, rather than better models, better measurements, and corporate risk management functions,' the CRO of a US insurance company said. Along these lines, respondents reiterated the need for changes in corporate structure that would position risk management professionals at the top table along with senior management, in order for risk management to be more accountable.

Transparency (clarity about off-balance-sheet obligations), extending and simplifying disclosure, communication and PR campaigns and changes in executive compensation were among the suggestions that respondents put forward to regain trust and confidence (see figure 4).

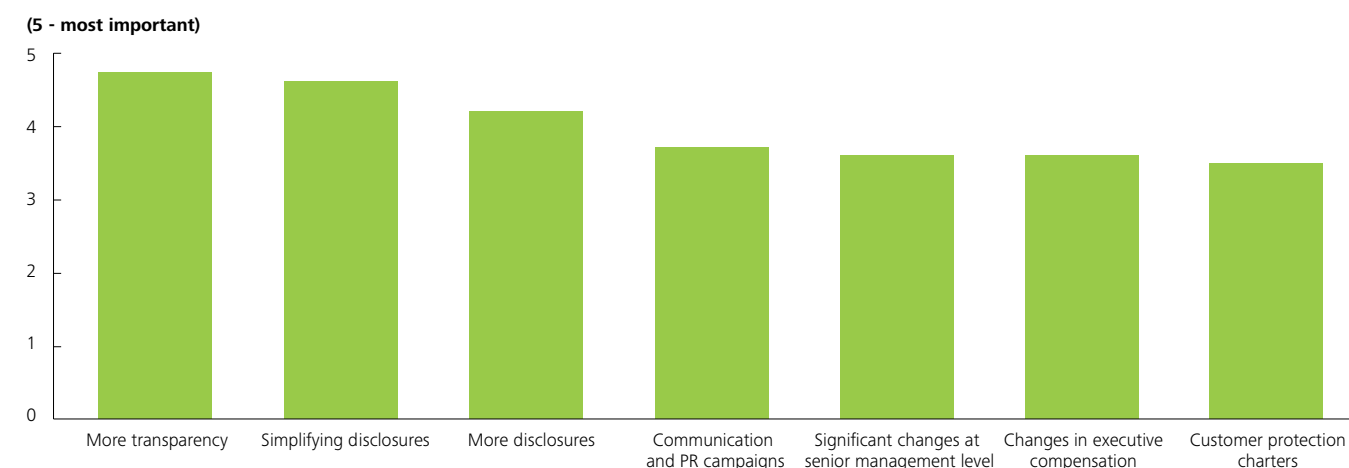
### A call for innovation

The respondents were torn on the issue what these different developments mean for innovation in the financial sector. Some think increased oversight will stifle innova-

tion and say they have already started to see the results of talent migration to other industries. Others are more optimistic and predict that talent, and the locus of innovation, will merely migrate to smaller, more entrepreneurial firms as capital becomes less of a competitive differentiator and the large firms scale back product and service offerings.

Most respondents were on the whole optimistic that it will be possible to preserve an environment of innovation, although the precise direction and focus of that innovation is not yet clear. Almost all respondents agreed that recapturing the innovative spirit will be crucial for financial institutions and broader society alike. Deloitte experts agree that implementing sophisticated and innovative strategies to increase revenue is critical for individual firms. When the dust settles, businesses will not be able to go back to their previous operations and offer the same products in the same configurations at the same prices. Financial innovation will also be of paramount importance to society as a whole. If anything, the current crisis has demonstrated beyond doubt just how vital the financial services industry is to the health of the global economy.

Figure 4: Which actions are most important in regaining trust?



### GFSI Summit

Each year, Deloitte Touche Tohmatsu hosts over one hundred of the world's leading financial services executives at its Global Financial Services Industry Summit. The 2009 GFSI Summit was held in Geneva on May 14-16, with the theme 'Thriving in a changing environment'. A new publication *The transformation of the Global Financial Services Industry* was launched at the Summit. To download the report, please visit [www.deloitte.com](http://www.deloitte.com) and search for 'Thriving'. Over the two-day Summit, senior industry executives, academics and influencers came together to share their thoughts on the future of the Global Financial Services Industry and join their peers in breakout groups to discuss current topics. The next GFSI Summit will be held on 20-22 May 2010 in Venice, Italy. More details are available at [www.deloitte.com/summit](http://www.deloitte.com/summit).



CFO Survey in the UK, the Netherlands and Belgium

# CFOs foresee a slow recovery and no return to business as usual

These are the key messages of the second-quarter CFO Survey, individually executed by Deloitte in the Netherlands, Belgium and the United Kingdom. The combined country results show that corporate CFOs are becoming more optimistic about the corporate sector. However, they remain cautious and alert: funding conditions remain tough and recovery is expected to be sluggish.

By Jan de Rooij and Richard Faas



### Cautious optimism

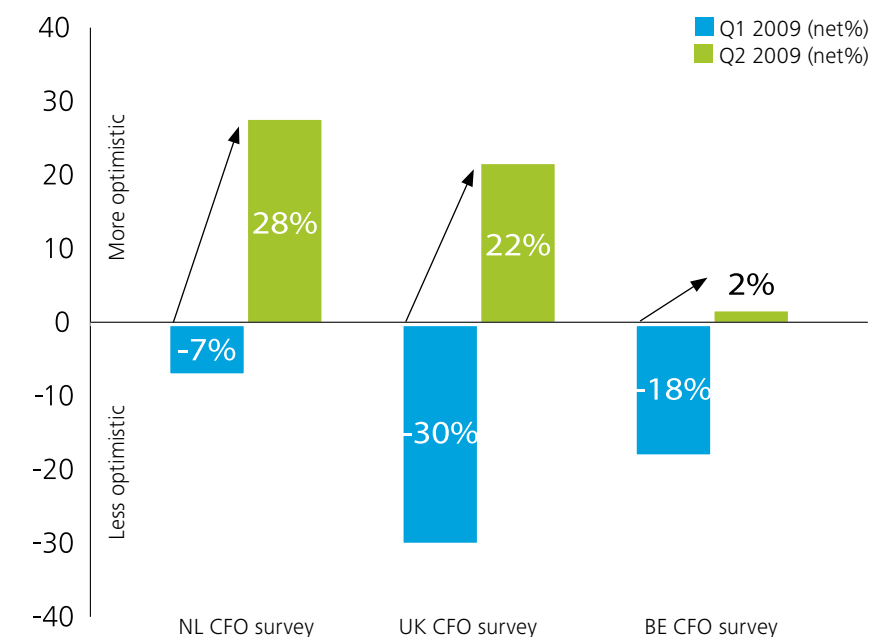
The second-quarter survey results show most CFOs are in control and have taken sufficient cost-cutting and capital strengthening measures to slowly broaden their horizon and start contemplating M&A moves. Nonetheless, retrenchments and headcount reduction are expected to stay high on the corporate agenda in the coming 12 months.

The UK results show the biggest-ever improvement in sentiment, taking it to the highest level since the UK survey started two years ago. A net 22% of CFOs is more optimistic about the financial prospects of their company than three months ago.

Although overall sentiment is improving, CFOs remain cautious and alert, and expect the business environment to remain very difficult well into recovery. Such expectations help explain why a vast majority of Dutch CFOs believes now is not a good time to be taking greater risk on their balance sheet.

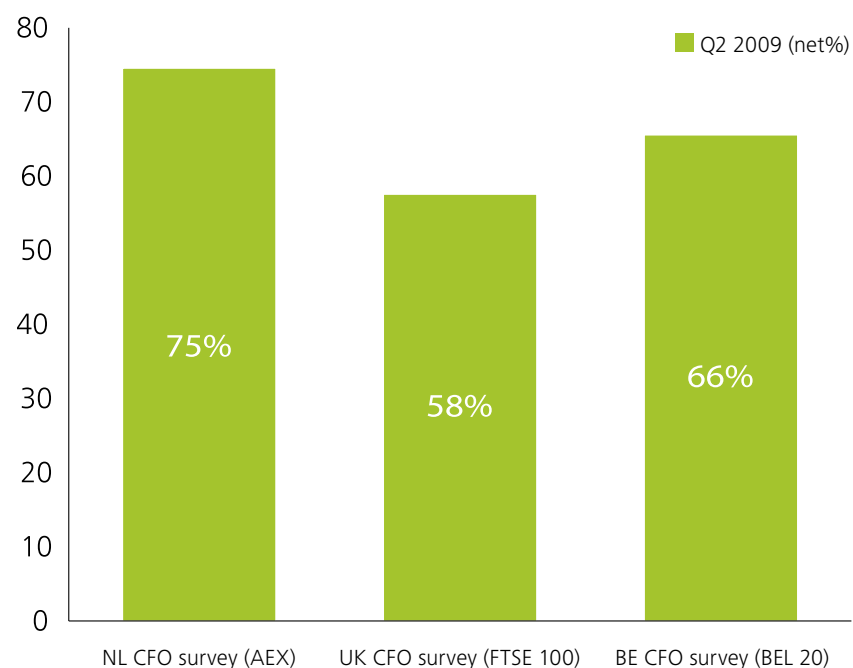
Graph 1. Financial prospects

Net % of CFOs who are more optimistic about the financial prospects of their company now than three months ago.



**Graph 2. Stock market evolution**

Net % of CFOs who expect the stock market index to rise over the next 12 months.



**Bank borrowing out of favour**

The credit crisis has triggered a shift in CFOs' preferences for sources of financing for their businesses. All three country surveys show that funding conditions for corporates are tough and indicate funding as being scarce and expensive.

Since the recession began, CFOs have become increasingly sceptical about bank finance as a source of capital for their business. These findings strengthen the assumption that national government and ECB efforts have not yet produced the desired effect on funding conditions for corporates.

**Equity is back**

While Belgian CFOs prefer corporate debt for external funding, the UK and Dutch survey results currently show that equity is emerging as a popular form of corporate financing. This is not surprising since most CFOs expect the national stock market index to be higher in a year's time.

**Sharp rise in expectations for M&A activity**

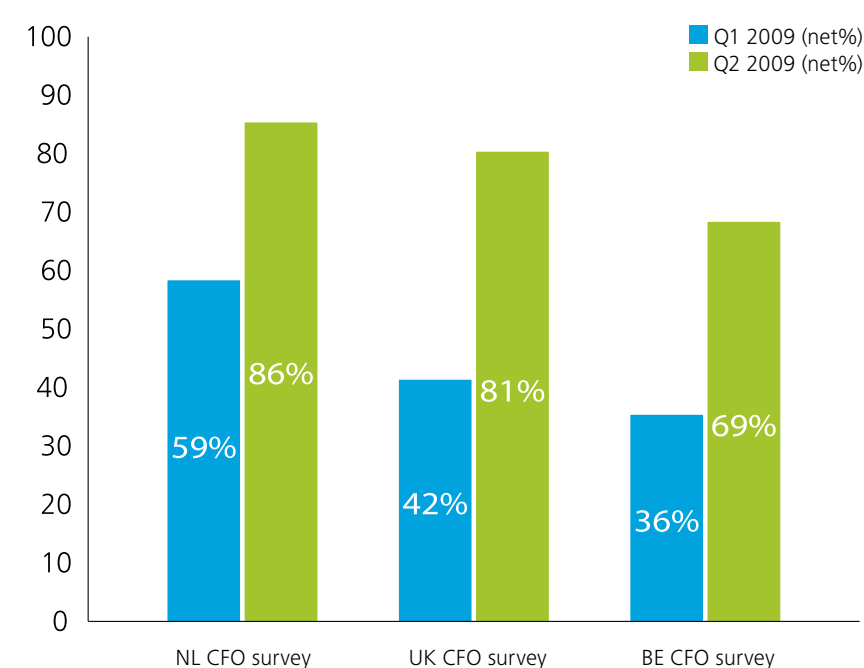
The outlook on M&A activity, one of the most cyclical elements in corporate expectations, has improved markedly in the second-quarter surveys. An overwhelming majority of the CFOs (81% in the UK, 69% in Belgium and 86% in the Netherlands) expects M&A activity to increase over the next 12 months. A significant shift that reflects the improved economic outlook and still-depressed asset valuations.

**Conclusion**

The second-quarter survey results show that CFO optimism about the business environment continued to strengthen. Furthermore, it seems CFOs are in control and have taken sufficient cost-cutting and capital-strengthening measures to slowly broaden their horizon. However, corporate CFOs remain cautious and alert, and a majority still believes now is not a good time to be taking greater risk on their balance sheet. Finally, CFOs expect recovery to be marked by sluggish growth, a strong focus on cost control and tight lending conditions – hardly a return to 'business

**Graph 3. M&A outlook**

Net % of CFOs who expect M&A activity to increase in the next 12 months.



Although overall sentiment is improving, CFOs remain cautious and alert

**About the research**

On a quarterly basis, the Deloitte CFO survey gauges attitudes to valuations, risk and financing among corporate CFOs. The participating CFOs represent both listed and large private companies, and are active in a variety of industries. The survey is individually executed by several Deloitte offices worldwide, including the UK, Belgium and the Netherlands. For further information about the individual results please visit the Deloitte country websites.

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*Jan Pieter Krahn: tackle the issue of 'too big to fail'*

# Towards a new financial order

Addressing systemic bank risk is essential for a long-term resolution to the financial crisis, argues Jan Pieter Krahn, professor of finance at the Goethe University in Frankfurt and member of the expert committee that advises German Chancellor Angela Merkel.

By Jon Eldridge

*German Chancellor Angela Merkel is flanked by German Finance Minister Peer Steinbrück (left) and economics and finance experts Otmar Issing (2nd from right) and Jan Pieter Krahn (1st from right).*

**Is this financial and economic crisis a result of a collective denial of the effects of systemic risk management, or is there more to it?**

The most important underlying problem is the interaction of these markets. And this interaction is the novel aspect of this crisis. If you don't address this issue of systemic banking risk properly, then you run the danger of the crisis repeating itself.

At some point the mechanics of this crisis turned into something we call systemic. Faulty engineering is the root cause of what went wrong. This crisis is special in that its most fundamental cause was at the level of financial engineering. Some say that macroeconomic imbalances were at the heart of this crisis, but I feel that something was out of line on the micro-banking, microeconomic level.

The first area where the crisis emerged is securities. Here, there was a huge loan book, which hitherto had been put on the balance sheets of financial institutions. They had to manage risks from the day they originated until the end of the full lending cycle; in other words, they were responsible for the monitoring of the borrower, and the redemption of the money lent. Through the securitisation process, it became possible to sell all or part of these loans to remote investors. And this 'tranching' of the loan portfolio into bonds of different quality levels is the real innovation that happened in these markets.

Investors were hungry for high-quality assets. The focus of the securitisation industry was on generating the maximum volume of AAA bonds – that was the idea of the engineering process, and loan quality maintenance got lost. You can speculate as to why it got lost: for one thing, the junior tranches, which represent most of the default risk, were apparently often sold to outsiders. The resulting loss in monitoring incentives was not picked up by analysts and investors. I think that it had a lot to do with the replacement of traditional lenders by modern financial engineers that didn't have much experience in lending. But whatever the reason, it developed in a way that shifted entire loan portfolios from the balance sheet to the investors, thereby reducing or eliminating proper incentives for lenders to monitor their borrowers and their customers. In the course of a few years – between 2003



## Create real possibilities for even large institutions to be wound down

and 2007 – the quality of the loans that were securitised fell tremendously, but this fall in quality was not noted by the official rating agencies.

At the end of this process, the market was confronted with the poor quality of bonds issued against these loan portfolios, and investors withdrew their confidence. The reason why this effect was felt across the board rather than by a few issuers is because there was no transparency regarding the true quality of any of these issues, nor on the allocation of their tranches, particularly their high-risk junior tranches. Bonds were sold throughout the world to remote investors. The reason why this went on without being detected was the complexity of the issues and the lack of transparency. Remedies should focus on exactly these areas, bringing transparency to a market that is in principle of high value to the economy.

### Was this crisis an essential event that had to happen in order for a much-needed new market order to emerge?

The way that this has happened is not an ideal way to get to a good situation. It is very costly. Many people have observed that complete disaster was only just avoided. The general perspective is that this crisis was due to an inadequacy of the information regime for dealing with the financial market. Some developments on the product side were much faster than those in the information regime. Rating agencies play a major role in communication, but they were not capable of dealing with these new instruments. Of course, if the markets are to be revived, we will need a much better information regime. Not only rating agencies, but also supervisors must have the ability to view the markets as an integrated set of relationships between intermediaries and large corporates.

We want this transparency not only for rating agencies and supervisors, but also for investors. One important aspect, a worldwide lesson from the crisis, is that oversight is no longer restricted to microeconomic supervision but must entail an element of macroeconomic supervision. It must also try to assess the interconnectedness of individual large and complex financial institutions. It's an issue that was only present in spirit before.

The modern philosophy of supervision will certainly have a big chapter on macro-prudential supervision. We will see an assessment instrument that will help us observe and analyse macroeconomic risk. It's a research exercise at this point, because people don't know how to define systemic risk, let alone how to measure it and how to manipulate it. I'm confident that over the next couple of years consistent methodologies and instruments will develop.

Another important aspect is how to deal with moral hazard risk, which is embedded in the financial system at all times. The issue of governments backing failing banks has become more prominent throughout the crisis, and we now face much more moral hazard than ever before. Many governments have proclaimed loudly that they will not let important banks fail in the future. Interventions must be avoided and we must tackle the issue of 'too big to fail'. Over the last couple of months, we have seen more and more mergers of financial institutions, so we are now getting larger financial institutions that are more likely to be bailed out by governments, and more risk for the whole system.

### How can the problem of bank bailouts be solved?

The answer is to create real possibilities for even large institutions to be wound down. So the failure of institutions, no matter how large they are, becomes a real option that managers have to be mindful of. A satisfactory strategy has to be put in place for dealing with moral hazard. It is the second most important measure after taking a systemic view of financial risk.

Typically, an individual case of bank distress gets tough on a Friday evening when the exchanges are closing. And it has to be solved before 2am on Monday morning when Tokyo's markets open. Two and a half days is really too short to close the bank without destroying its 'systemic' links to the rest of the financial system. Over and over again, we are seeing regulators taking over the institution's liabilities and basically bailing it out. What we need is a strategy of closing a bank without bailing out creditors, even if it's large, even if it's hugely interconnected.

I see two possible solutions being discussed: the first is the 'living will'. Financial institutions must have contin-

gency plans that explain to its management, as well as to the regulator, how particular parts of its balance sheet can be singled out and sold or otherwise used. Plans must demonstrate that such actions can be taken faster than in the current situation, where nobody fully understands the structure of banks.

Another condition for living wills is that institutions should be reorganised while they are still healthy. In order to be able to communicate to the regulator the strategy for winding down the business, banks may want to have the right organisational structure in the first place. This would lead to institutions that are so simple that the regulator can understand how they work. This is a very healthy and important exercise that should take place in good times and not in bad times when it's too late to change anything.

The second possible solution is what I have called the establishment of 'banking hospitals' – special institutions that can help a bank to honour its commitments that are of a systemic nature, i.e. those commitments that if they were not fulfilled would endanger the whole system, while at the same time winding down the remaining commitments. Such an 'intensive care unit' does not exist today, but it will in the future, because through such a hospital the state will be better able to hold equity holders and then debt holders liable.

### What is your view on the separation of good and bad banks, with bad banks being used as dumping sites for toxic assets?

Putting toxic assets into bad banks is a one-off solution. It cannot be a regular solution, because if it were to become regular then we would have regular deliberate generation of these toxic assets, which we don't want to see. So it can't be a long-term strategy

### How do you see the financial landscape of Europe developing after this crisis?

What we'll probably see is a drive towards much stronger harmonisation of regulatory efforts. It will not be successful everywhere, but we are already seeing harmonisation in many areas. A current example is the derivatives clearinghouse. There is a real debate between industry

and regulators in Brussels about whether or not such a clearinghouse should become mandatory for setting up contracts. The will for such a move is growing, not least because the Americans are going in a very similar direction. The US Administration view is apparently very close to the suggestions of the Commission. So it looks as if there is pretty much common ground for bringing about a standardised structure. However, if we standardise the contracts traded in this market, a new type of risk is introduced which economists call basis risk. More precisely, standardised contracts cannot be tailored to the insurance demand of the customer like over-the-counter (OTC) transactions could. Hedging will become more expensive and less precise with such standardised instruments. This trade-off is likely to have an impact on how the hedging-intensive industries, for instance the airline industry, will operate in the future.

### What areas could legislators be focusing on that they are currently overlooking?

The aspect of this crisis that they are not looking at is perhaps the most important one. They are not giving enough consideration to what one may call the bird's-eye view. We don't see a systemic approach happening at the EU level. The G-20 meeting held about a year ago in London focused on giving international institutions, such as the IMF, a particular mandate to assess systemic risk worldwide. This global approach has by and large shrunk to an 'Early Warning Exercise', using macroeconomic data. A more serious approach to systemic risk policy is being taken at EU level: the European Commission is trying to establish a European Systemic Risk board, which will be located at the ECB in Frankfurt and hopefully will have a mandate to collect data. We are not so sure whether the mandate will be strong enough to convince Western supervisors to truly share their information with this Europe-wide systemic risk observer. But this is a very important precondition for the effectiveness of the Systemic Risk Board.

We need to tear down borders and walls on the regulatory front. Politicians are fighting for this, but they face increasing opposition from the industry lobby all over the world. Regulation is typically a national issue, and many regulators think of themselves as partners to industry,

## Tear down borders and walls on the regulatory front

with a mission to help companies in their own country to achieve a good international competitive position. There is a very competitive element in the regulatory process, which I think is against the spirit of safe and healthy international financial markets.

### Is Europe likely to lag behind as North America and Asia recover at a faster rate?

The only thing that can prevent such an outcome is a level playing field, which is tantamount to bringing down borders. It means basically having the same standards. A huge effort is being made, and the permanent adoption of G-20 recognises that if strong economies are left out, they won't take on board that we need to get away from this competitive bidding in the regulatory arena. Whether this proves to be successful remains to be seen. I think we are currently seeing a step in the right direction, but several more steps are needed in order to get on safer ground. Regulation will be stronger and stricter in the old industrialised countries in Europe and perhaps the US, and some of the emerging economies may have the chance to get some business that they wouldn't have otherwise. On the other hand, much of the financial sector can't be moved so fast. For example, London and New York have a strong resilience as financial centres, and even though other centres may grow in importance, I think these two will remain at the top of the list for quite some time.



#### Jan Pieter Krahn

Jan Pieter Krahn is Professor of Finance at the Goethe University of Frankfurt and Director of the Center for Financial Studies. In October 2008, German Chancellor Angela Merkel called upon Jan Krahn to join a national committee of experts set up to advise the government on issues relating to financial crisis prevention and financial market reform. The committee's task is to explore alternative ways for increasing the efficiency of the regulatory and supervisory framework. In order to voice their suggestions on the international stage, the committee prepared reports for the international summits that followed the outbreak of the crisis, in particular the G20 meetings in Washington (November 2008), London (April 2009) and recently in Pittsburgh (September 2009).

## Column

# Getting in touch, again...

**B**anks are no longer what they once were. The 'corporate' shine of the financial services industry has become seriously tarnished. The trump cards are now soberness and smallness of scale, along, it seems, with the magic word of 'sustainability'. In times like these, when the hits are hard, everyone's trying to make sure they've still got some shots left. There is a widespread belief (at least for the time being) that the financial services sector is no good. Banks and insurance companies have come under fire, and now the campaign is spilling over into the pension and mortgage markets. Fear is the dominant emotion, with cause and effect often becoming entangled. Any bonuses paid are by definition examples of 'snouts in the trough', while the media are experiencing relatively little meaningful counter-response to their increasingly strident tone. Maybe it's a case of 'When you're in a hole, stop digging'. Suddenly politicians have become 'experts on the cause of the crisis' and are using every opportunity for visibility at the grassroots. I suspect that the current apathy and 'who's to blame' quiz still have some time to run. All in all, lots of negative energy.

Nevertheless, I would argue that it's now time for a more active policy response from the financial sector as the discrepancy between image and reality has become excessive. Financials have to accept that the market now has a structurally different view of the sector's unique selling point of 'trust'. And waiting for better times or a return to normal won't change this as doubt has now become part of the very fabric of society. Just look at the growth in blogs, Facebook, Twitter and other forms of networking in communities and, therefore, among financials' clients. I sometimes wonder whether financials are actually moni-

toring these sources structurally and learning from them. There are currently around 50 million blogs, and their number is growing by some 65,000 a month! For a long time now, image in the financial services sector has no longer been driven top-down from a corporate level. The new media have democratised that process, and image components are now being fed bottom-up.

The key to restoring confidence is, therefore, to anticipate the client experience, virtual proximity and a continuing dialogue. 'Focusing on the client' does not mean modesty and deference. As I see it, financials really need to invest far more actively in proximity to and empathy with their clients' needs. That way they can play a part in guiding clients to the clients' desired financial destinations, all in equilibrium with the mutually recognised and accepted risks.

As well as a totally different perception of financial services, this also demands in-depth investments in knowledge about the client, structurally supporting clients' experience of the many different media (especially the new ones) and ensuring ongoing joint control. As well as removing the barriers within and between their information silos, financials will also need to be transparent about the relationship between price and performance and the risks and impact of financial contracts and transactions. At the same time, clients will also have to accept some responsibility. All the arrows of blame in the current crisis are being pointed at the financials, whereas the truth is somewhere in between, and that balance needs to be restored. This is no time, therefore, for financials to sit back and wait. A complete redesign of the communications they want with their clients should be the top priority for all chief marketing officers and chief information officers in the financial services sector.



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# Reducing the administrative burdens on the FSI

In 2007, the Commission launched its Action Programme on reducing administrative burdens in the European Union. The goal

of this programme is to measure administrative costs arising from legislation in the EU and to reduce administrative burdens by 25% by 2012. The potential for reducing these burdens in the financial services industry is estimated at 15%, which would represent annual cost savings of over €141 million for financial institutions.

By Hilde Van de Velde and Tim De Meyer

Administrative costs are defined as 'costs incurred by businesses in meeting legal obligations to provide information on their action or production' and include reporting obligations for statistical purposes and obligations to cooperate with inspections such as audits of accounts.<sup>1</sup>

The fight against the administrative burdens that cause annoyance to many businesses, including financial institutions, on a daily basis is taking place all over Europe. Just recently, the Commission published the intermediate results of its Action Programme for Reducing Administrative Burdens in the EU, which made it clear that reducing these burdens will remain high on the agenda over the years to come.<sup>2</sup> Simultaneously, member states all over Europe are pursuing national reduction programmes.

By its nature, the financial services industry has traditionally been highly regulated and so subject to a range of rather complex requirements and obligations imposed by regulations. Unnecessary administrative burdens hamper growth and inhibit innovation. Removing them allows businesses to spend more time on core activities, thus increasing labour efficiency, boosting productivity and reducing production costs.

This article outlines the highlights of the reform of financial supervision being conducted at an EU level, as well as providing a state-of-play on the debate on reducing the administrative burden within the FSI and giving financial institutions some advice on coping with current and future administrative burdens.

## Deloitte's contribution to reducing the burdens on European businesses

Deloitte Belgium is the leading firm in administrative burden measurement and reduction at a European level. Over the last few years, we have assisted many European member states (Belgium, the Netherlands, Hungary, Poland, Bulgaria, Slovakia, Luxembourg, Finland and Spain) with their national reduction programmes. Over the past two years Deloitte Belgium has also been leading an EU pro-

gramme, in a consortium with Capgemini and Ramboll Management, to measure and reduce the administrative burden in the EU on behalf of the European Commission, DG Enterprise and Industry.

Deloitte has been assisting the European Commission with the programme's three key objectives:

1. To measure the administrative costs that specific legislation will cause for businesses;
2. To identify opportunities for reducing the administrative burden;
3. To prepare the Commission and member states for implementation of the reform.

The project involved analysing administrative costs for EU businesses stemming from 42 EU regulations and directives in thirteen different policy domains.<sup>3</sup> Its size

## Reinforcement of rules: additional reporting obligations?

The current crisis in the financial services industry demands further reinforcement of rules since the macro and microeconomic regulatory systems, the supervisory framework and financial institutions' internal risk assessment procedures failed to prevent the recent turmoil in the sector. On the other hand, the crisis has hit financial institutions hard, and continual efforts will be required to restore the balance within the global financial system.

Based on the report presented by the High Level Group on Financial Supervision in the EU (De Larosière Report), the Commission has initiated a reform of the institutional and regulatory frameworks governing the financial services industry. This is designed to improve the European supervisory bodies' monitoring capacity by introducing concepts such as early risk warnings that will enable proactive intervention if the financial system is in danger. However, introducing additional reporting obligations may impose yet more administrative burdens on financial institutions.

<sup>1</sup><http://www.administrative-burdens.com>

<sup>2</sup>[http://ec.europa.eu/enterprise/policies/better-regulation/files/com\\_2009\\_544\\_main\\_en.pdf](http://ec.europa.eu/enterprise/policies/better-regulation/files/com_2009_544_main_en.pdf)

<sup>3</sup>Agriculture and agricultural subsidies; Annual accounts/ Company law; Cohesion policy; Environment; Financial services; Fisheries; Food safety; Pharmaceutical legislation; Public procurement; Statistics; Tax law (VAT); Transport; Working environment/employment relations.

## EU financial services sector accounts for a total administrative burden of almost €1 billion

and complexity meant unprecedented efforts in terms of burden-reduction projects. The Deloitte team conducted over 3000 interviews and hundreds of workshops with businesses – including financial institutions – throughout Europe in order to gain insight into how businesses experience the impact of regulation in their day-to-day activities. The first phase of this programme is close to completion and our contract has been extended for additional work until mid-2010.<sup>4</sup>

The main objective of the European Council and the Commission in this project – cutting the administrative burden for businesses throughout the EU by at least 25% – has been achieved, with most of the consortium’s proposals (valued at around EUR €40 billion) being accepted.

### Measurement results for FSI

The costs for the FSI were calculated by extrapolating the results in Italy, Lithuania, Luxembourg, Poland, Spain and Slovenia for the following directives, which constitute only a fraction of the legislation applying to the financial services industry:

- Directive 2002/83/EC concerning life assurance;

- Directive 2006/48/EC relating to the taking up and pursuit of the business of credit institutions;
- Directive 2006/49/EC on the capital adequacy of investment firms and credit institutions.

The total administrative burden attributable to the selected legislation in the EU as a whole, in all the policy areas covered, is estimated at €124 billion. Almost €1 billion of this total burden is accounted for by the EU-wide costs for the financial services industry.

As the chart shows, the FSI’s share of the overall costs is relatively low. However, this underrepresentation is mainly due to the legislation selected by the Commission in the financial domain. Under no circumstances does it reflect the relative share of the burden borne by financial institutions in their day-to-day business. Indeed, interviews within the industry have revealed that the administrative obligations are commonly perceived as irritating and highly complex.

### Main burden-reducing recommendations for FSI

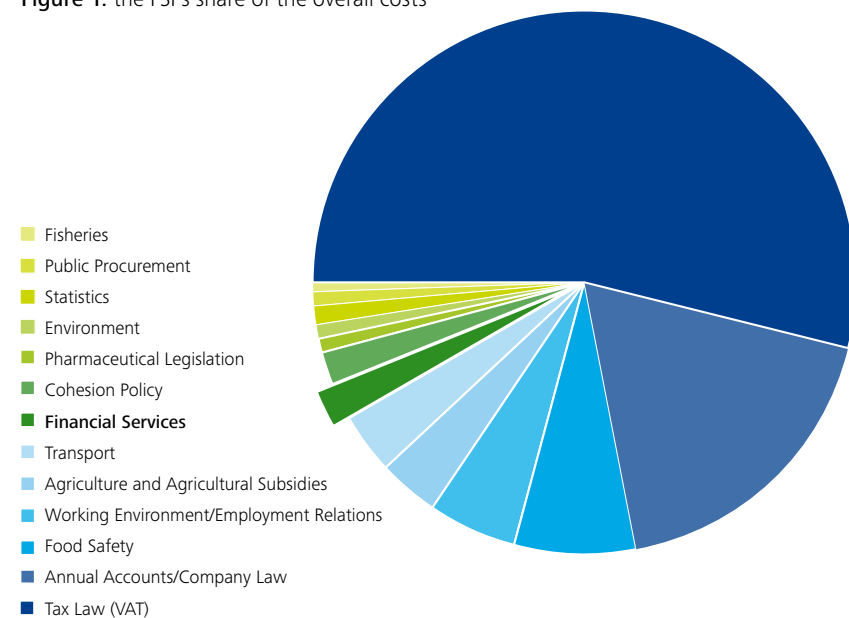
The total potential for reducing the burden in all policy areas covered by the scope of the EU measurement – if all recommendations are adopted – is estimated to be 33% of the measured burden. This amounts to a reduction of more than €40 billion in the administrative burdens on businesses, which shows that reaching the overall target of 25% is feasible.

The potential for reducing the burden in the financial services industry, both in relative terms and in respect of the specific directives, is estimated to be 15%, which would represent an annual cost saving of €141.6 million for financial institutions in Europe.

The main recommendations for reducing the administrative burden in the FSI are listed below. These include the simplification proposals generated during the EU measurement project, as well as a state-of-play of on-going initiatives at an EU level.

<sup>4</sup>[http://ec.europa.eu/enterprise/policies/better-regulation/administrative-burdens/action-programme/index\\_en.htm](http://ec.europa.eu/enterprise/policies/better-regulation/administrative-burdens/action-programme/index_en.htm).

Figure 1: the FSI’s share of the overall costs



Edmund Stoiber, Chairman of the High Level Group on Administrative Burdens Reductions

| Measure   | Change in the level of administrative burden* | Progress                                 |
|---|---|--|
| Revising capital and solvency requirements for credit institutions  | + €16.7 million<br>+ 9%                       | Adopted 06/2006                          |
| Revising mandatory and solvency capital requirements for insurance and reinsurance companies (Solvency II)                | + €0.9 million<br>+ 0.2%                      | Proposed 07/2007                         |
| Reducing administrative burdens on Undertakings for Collective Investment in Transferable Securities (UCITS)              | - €45.0 million<br>- 20%                      | Adopted 07/2009                          |
| Simplifying rules on large exposures of credit institutions   | - €105 million<br>- 32%                       | Adopted 09/2009                          |
| Abolishing the obligation to report on initial capital, own funds and investment limitation for e-money service providers | - €2.4 million<br>- 98%                       | Adopted 09/2009                          |
| Reducing reporting duties on cross-border payments  | - €6.7 million<br>- 50%                       | Adopted 09/2009                          |
| Harmonising the use of XBRL for prudential reporting  |   | Under consideration                      |
| Simplifying the provision of pre-contractual information required from insurance companies                                |   | Under consideration                      |
| Improving guidance on applications for authorisation by insurance enterprises   |   | Under consideration                      |
| Harmonising the format and frequency of reporting by credit institutions and investment firms                             |   | Under preparation<br>Target date Q4 2011 |
| Exempting unlisted insurance companies and credit institutions from annual notification of shareholdings                  |   | Under consideration                      |

(\*) Change in the level of administrative burden of EU origin: percentages relate to the administrative burden caused by the original legislation

## Harmonisation of reporting procedures and standards is likely to speed up within next few months

### Reducing internal administrative costs

As the pressure on financial institutions will remain extremely high in the aftermath of the financial crisis, banks and insurance companies will be seeking additional ways to cut internal costs. Companies often forget that, just as governments create costs by imposing administrative obligations, so, too, there is a significant cost involved in complying with internal regulations, particularly in large companies. Deloitte recently started using a highly standardised method, directly derived from the Standard Cost Model, to measure and reduce the administrative costs of complying with internal company regulations. Reducing internal administrative costs is one additional way for financial institutions to cope with high cost pressure.

### What Deloitte can do for the FSI

- Measure and reduce the real-life cost of complying with legislation
- Measure and reduce the administrative costs stemming from internal company regulations
- Examine how institutions can proactively make their business processes more efficient in the light of the ongoing/expected legislative changes
- Implement ICT tools to enhance compliancy processes within institutions, including advice on implementing open-standard-based electronic transmission

### Structural solution: towards common reporting standards within the financial services industry?

Non-harmonised reporting requirements increase administrative costs and burdens. In a globalised financial services industry, institutions incur additional costs since cross-border activities oblige them to build up knowledge on the different national regulations and to customise their IT systems accordingly.

In addition to imposing an increased burden on the industry, the lack of harmonised reporting structures also impedes the efficient exchange of information among member states. Recently, the De Larosière group specifically stated that the lack of common reporting formats was an obstacle to efficient financial supervision.

The Committee of European Banking Supervisors (CEBS)<sup>5</sup> has therefore initiated a common framework, known as COREP (COMmon solvency ratio REPorting), the aim of which is to harmonise the reporting of solvency requirements. CEBS established this framework in support of the reporting required under Basle II. As part of the process of adopting the COREP framework across the European Economic Area, some countries have decided to use XBRL (eXtensible Business Reporting Language),<sup>6</sup> a type of XML (eXtensible Markup Language). However, actual implementation of the taxonomies is not fully aligned across EU member states, as some countries have developed national extension taxonomies, and not all countries use XBRL.

COREP is an example of how the industry can significantly reduce its administrative costs, because it enables harmonised reporting templates to be used across Europe. In order to maximise the potential cost savings, a legal framework needs to exclude the possibility of adding national reporting fields to the templates. Our analysis identified XBRL as a potential technological solution to support implementation of this recommendation. As CEBS has already developed an XBRL taxonomy for the COREP templates, using XBRL for other reporting obligations may generate additional efficiency gains. Obviously, other open-standard-based electronic transmission could also be considered. The Commission is continuing to investigate opportunities for harmonising reporting standards within the FSI.

<sup>5</sup><http://www.c-eps.org>  
<sup>6</sup><http://www.xbrl.org>

### The way ahead

The European Commission has proposed a European System of Financial Supervisors (ESFS) for micro-prudential supervision, with three new European Supervisory Authorities. In this way it is seeking to establish a more harmonised set of financial rules by creating the possibility to develop draft technical standards, settle disagreements between national supervisors and facilitate the sharing of micro-prudential information.<sup>7</sup>

The ESFS will consist of a network of national financial supervisors working for the various new European Supervisory Authorities. It will be created by transforming the existing committees for the banking, securities and insurance and occupational pensions sectors. As well as a European Systemic Risk Board, there will be a European Banking Authority (EBA), a European Insurance and Occupational Pensions Authority (EIOPA) and a European Securities and Markets Authority (ESMA).<sup>8</sup>

The new Authorities in the ESFS will take over all the functions of the existing committees<sup>9</sup> and also have certain extra competences, including:

- Developing proposals for technical standards, respecting better regulation principles;
- Resolving disagreements between national supervisors if legislation requires co-operation or agreement;
- Helping ensure consistent application of technical Community rules (including through peer reviews);
- Exercising direct supervisory powers for credit rating agencies (in the case of the European Securities and Markets Authority);
- Playing a coordinating role in emergencies.

Changes to existing financial services directives will be needed if the ESFS is to work effectively. These will need to define the precise extent to which the new institutions can exercise the proposed new powers. The areas in which amendments are proposed include the development of a single book of rules. The harmonisation of reporting procedures and standards is very likely, therefore, to speed up within the next few months.

We at Deloitte are closely following the evolution at both national and European levels and will continue to keep the

FSI informed on what is happening within the context of the reform.

Financial services continue to be one of the focal areas of the Action Programme for Reducing Administrative Burdens. In its October communication, the Commission proposed conducting new measurements of the burdens attributable to legislation applying to insurance mediation<sup>10</sup> and distance marketing<sup>11</sup>.



<sup>7</sup><http://europa.eu/rapid/pressReleasesAction.do?reference=IP/09/1347>.

<sup>8</sup><http://europa.eu/rapid/pressReleasesAction.do?reference=IP/09/1582&format=HTML&aged=0>.

<sup>9</sup>The Committee of European Banking Supervisors (CEBS), Committee of European Insurance and Occupational Pensions Committee (CEIOPS) and the Committee of European Securities Regulators (CESR)

<sup>10</sup>Directive 2002/92/EC of the European Parliament and the Council of 9 December 2002 on insurance mediation.

<sup>11</sup>Directive 2002/65/EC of the European Parliament and of the Council of 23 September 2002 concerning the distance marketing of consumer financial services and amending Council Directive 90/619/EEC and Directives 97/7/EC and 98/27/EC.

### About the authors

Hilde Van de Velde (Director) and Tim De Meyer (Manager) of the Belgian Deloitte practice have been leading the large-scale European measurement of administrative burdens over the past two years. They are also advisors to several national Better Regulation authorities in Europe. Contact details: [hivandavelde@deloitte.com](mailto:hivandavelde@deloitte.com) or [tdemeyer@deloitte.com](mailto:tdemeyer@deloitte.com).

CE Top 500 report

# Stepping back from the edge of the precipice

Deloitte recently published its 2009 CE Top 500 report, a ranking of Central Europe's 500 largest companies. Below, to whet your appetite, are a few highlights from the report, which draws on the views of leading economists, academics and Deloitte experts to provide a fascinating and insightful analysis of how a region of 18 very different countries has combated the impact of a moment of shared crisis.

## The banking sector in Central Europe

Despite limited exposure to toxic assets, Central European (CE) banks have not escaped the crisis. On the contrary, they were particularly badly hit, due to the region's high levels of indebtedness, heavy reliance on exports and excessive foreign currency exposure. The situation was worst in the Baltic states, Hungary, Romania and the Ukraine, but even Poland suffered to some extent.

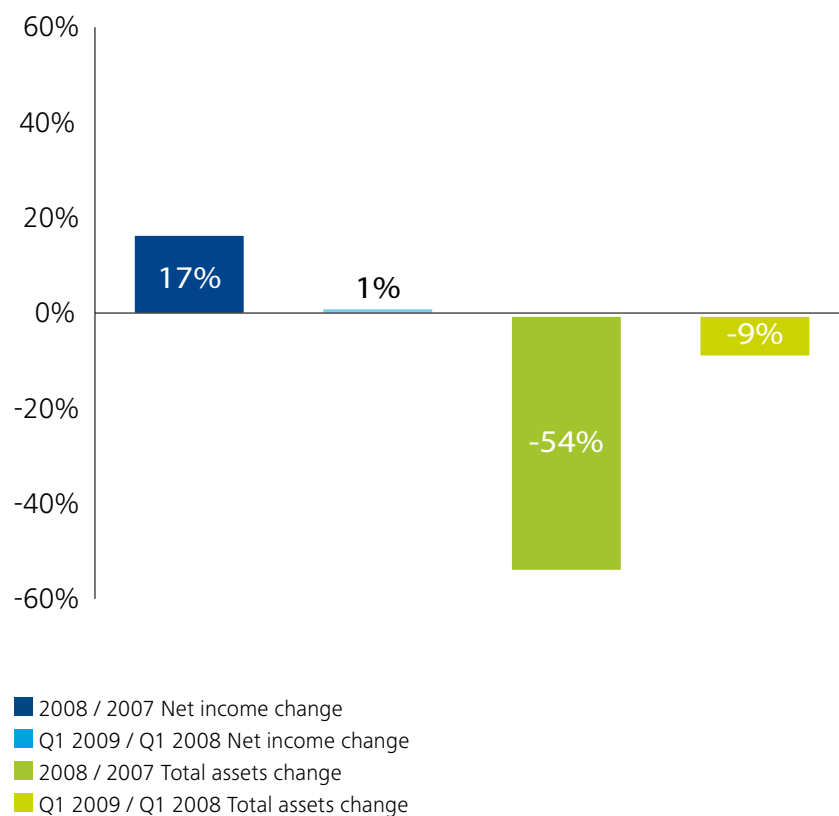
The 2009 CE Top 500 report compares results from the first quarter of 2008 with the first quarter of 2009. It was in the latter quarter, the findings indicate, that the effects of the global crisis became obvious. While during 2008 the assets of the top ten banks increased slightly (by 1%) and profitability by almost 17% year-on-year compared to 2007, in the first quarter of 2009 total assets shrank by 9% (excluding NLB Group) and profitability by 54% (excluding BCR) year-on-year. This was mainly due to the risk provision charges on growing portfolios of non-performing loans. The crisis sent valuations of Central European banks plummeting to all-time lows, reflecting investors' views of the inherent risks in the region and the sector itself. Banks with significant exposure to Ukraine, Romania, Russia and the Baltic states were shunned by equity investors. Their P/TBV (Price to Tangible Book Value of Equity) in December 2008 decreased even below 1.0x in some cases compared to historical figures of 3.0x to 5.0x. On the other hand, banks with balanced loan-to-deposit ratios and no goodwill on their balance sheets are still valued at around 1.5x in P/TBV terms. Although valuations have improved amid the stock market rally in the late spring and summer of 2009, they are still substantially below historical levels.

With finance from Western banks drying up, lending in Central Europe has effectively ground to a halt. New investment loan or project finance placements are scarce or even non-existent in CE countries, and debtors are struggling even to renew their working capital financing. This lack of finance has further deepened the recession, stifling both corporate investment and private consumption. The focus in banks has shifted to the management of existing portfolios. Most decisions on new lending have been centralised at the headquarters of the parent banks. Meanwhile, reward for local management is now based



not on profitability or growth but on decreasing the loan-to-deposit ratio. As a result, we are seeing unchanged or even decreasing banking assets, growing non-performing loan portfolios, improving loan-to-deposit ratios and higher interest margins and fee income. However, overall profitability will remain modest during 2009, and even into 2010, due to increased risk costs.

The figure below shows the change in net income and total assets of the top 10 banks in Central Europe, setting 2008 against 2007 and Q1 2009 against Q1 2008. The 54% fall in quarterly comparative net income and the 9% decline in total assets are a dramatic departure from earlier trends.



#### The insurance sector in Central Europe

The unprecedented depth of the economic crisis made the past year a very challenging one for the Central European insurance sector. The effects vary from country to country, and stakeholders of all kinds have concerns. Customers, firstly, are worried about whether insurers can fulfil their promises regarding investment guarantees and insurance benefits. Foreign shareholders, in their turn, are concerned about collapsed share prices, exposure to bad assets, reduced return on equity and increased levels of commercial risk, for example in connection with counter-party defaults and credit spreads. Finally, regulatory authorities and governments are uncertain about the financial soundness of the whole insurance sector.

Across Central Europe, we have observed rapid growth in direct insurance, especially in the motor sector, although the overall market share is still very small. We believe that the direct channel may be the right choice for players in markets where insurance is considered to be a commodity, with many customers regarding price as their main priority rather than the quality of cover or service levels. Currently, the most successful players within the direct insurance channel are registering double-digit growth in written premiums. In the past year, we have seen several product innovations in both life and non-life insurance, with some – notably unemployment insurance, which complements credit, mortgage or life insurance – generating successful sales. Others, though, such as variable annuities, have not generated significant premium income, and several such projects across the region have been cancelled or put on hold. Despite the current gloomy outlook, we believe that this once-in-a-generation crisis will trigger some significant transformations in the near future, as insurers across the sector grasp the opportunity to improve efficiency. Initiatives may vary from cost optimisation programmes to complete business-model redefinition. We see a number of M&A opportunities in the region that may be suitable both for ‘insiders’ and companies which are as yet not present in Central Europe. The coming 6 to 18 months may reshape the CE insurance market for the next decade.

| Rank | Company name         | Country        |
|------|----------------------|----------------|
| 1    | OTP Bank             | Hungary        |
| 2    | PKA BP               | Poland         |
| 3    | Česká spořitelna     | Czech Republic |
| 4    | Pekao                | Poland         |
| 5    | ČSOB                 | Czech Republic |
| 6    | Komerční banka       | Czech Republic |
| 7    | Swedbank             | Estonia        |
| 8    | BRE                  | Poland         |
| 9    | NLB Group            | Slovenia       |
| 10   | BCR                  | Romania        |
| 11   | ING                  | Poland         |
| 12   | ZABA                 | Croatia        |
| 13   | BZWBK                | Poland         |
| 14   | BRD                  | Romania        |
| 15   | Slovenská sporiteľňa | Slovakia       |

Banking

| Rank | Company name                  | Country        |
|------|-------------------------------|----------------|
| 1    | PZU                           | Poland         |
| 2    | Česká pojišťovna              | Czech Republic |
| 3    | Warta                         | Poland         |
| 4    | Kooperativa pojišťovna        | Czech Republic |
| 5    | Commercial Union Polska       | Poland         |
| 6    | ING Polska                    | Poland         |
| 7    | Allianz Polska                | Poland         |
| 8    | Zavarovalnica Triglav         | Slovenia       |
| 9    | Allianz Hungaria              | Hungary        |
| 10   | Generali-Providencia          | Hungary        |
| 11   | Uniq Polska                   | Poland         |
| 12   | STU Ergo Hestia               | Poland         |
| 13   | Allianz - Slovenská poisťovňa | Slovakia       |
| 14   | Croatia osiguranje            | Croatia        |
| 15   | AIG Amplico Life              | Poland         |

Insurance

## The coming 6 to 18 months may reshape the CE insurance market for the next decade

#### About the CE Top 500

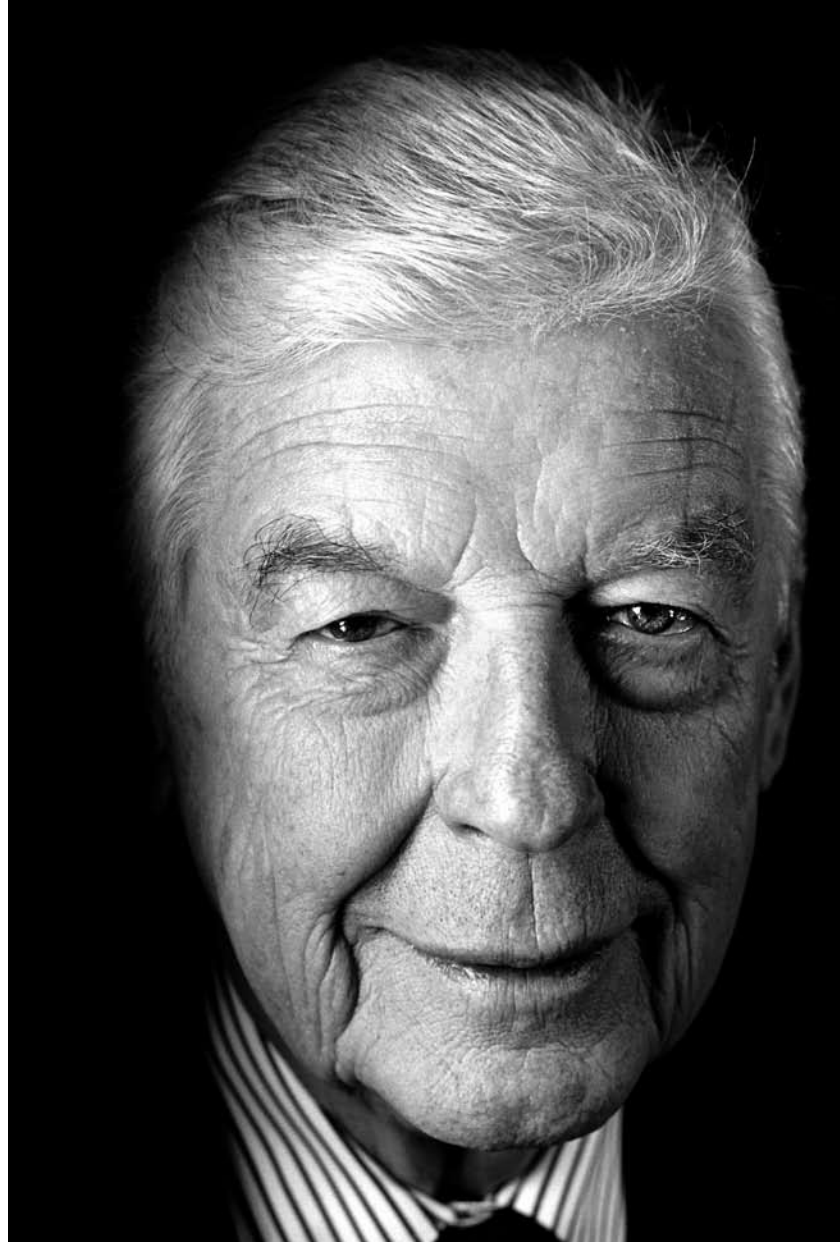
The Central Europe (CE) Top 500 ranks the region's 500 largest companies, including banks and insurers. It draws on the knowledge and insights of Deloitte's own professionals as well as renowned economists and academics to provide a valuable commentary on the CE markets and current trends. With individual country reports, a special focus on seven industry sectors and analysis of the dramatically differing corporate results seen between Q1 2008 and Q1 2009, it provides an in-depth and wide-ranging view of the latest Central European developments.

For more information please go to [www.deloitte.com/cetop500](http://www.deloitte.com/cetop500) or contact Matthew Howell, CE Clients and Markets Director ([mathowell@deloitte.com](mailto:mathowell@deloitte.com)).

# Beyond rules



Although the causes of the present financial and economic crisis may be complex, a lack of integrity in certain quarters has clearly been one of its main catalysts. We approached the Dutch FSI's finest with some searching questions: Was the crisis a matter of a personal failure on the part of a few high-profile individuals? Or of an inherently defective system? And what exactly is integrity? Wim Kok, former Dutch Prime Minister, former supervisory board member at ING and now President of the Club of Madrid: 'This is not a soft issue.'



### Personal integrity

Regardless of how much policy is thrown at integrity, it begins with the individual. Gilles Izeboud, member of the supervisory board of Robeco and former member of the Dutch Corporate Governance Committee, identifies independence as one of the key qualities the modern supervisory board member needs in order to add significant value to the company. 'To me, independence (if I may define it in terms of its opposite) is not wanting to be a member of the "club" so much that you're forever trying to please those in power. In fact, I actually think it's a good thing when people don't feel they have to be nice to each other in a company. There should be scope to "tell it like you see it". Bad news should travel fast.' Kees Storm, former CEO of Aegon and now serving various companies in a non-executive role, including Aegon, Unilever and KLM, also emphasises the personal nature of integrity: 'Daring to look yourself in the eye stands for integrity, decency and reliability. I think that it's a test many people might find difficult. Or, in any event, they should find it difficult, given the financial crisis we're fac-

ing.' Arnold Schilder, chair of the IAASB and formerly director in charge of supervision at De Nederlandsche Bank, puts it like this: 'In essence, you want to be accountable for behaving in line with reasonable social standards. You need to understand what's expected of you in terms of fair dealing, and you have to make sure that you stick to that.' But, he adds, operating with integrity is 'a vague, open and broad field: maybe we shouldn't want to say too much about it.'

### Integrity in the organisation

Integrity at organisational level goes further than personal morality, and is broader, too, according to Wim Kok, former Dutch Prime Minister and former supervisory board member at ING. 'It also encompasses business principles and codes of conduct. Many companies, in the oil and energy sector for example, make use of the concept of asset integrity.' In the wake of the crisis, public pressure for corporate transparency has become greater than ever. But does more transparency automatically lead to greater integrity? 'I don't think that we should go back to the days when we hid everything away. Indeed, I don't think we could go back even if we wanted to,' says Kok. 'But transparency must be an obligation on all parties. Other sections of society, from shareholders to other stakeholders and authorities, are going to have to deal with the fact that more and more information is being made available. Having the information is only the first part of the process: once you've got it, you need to be able to understand it and interpret it.' André Olijslager, who is on the supervisory board of several companies, including ABN AMRO, does not believe that everything should always be made public. 'I always ask, "Who needs my organisation to be transparent?" Those recent calls for transparency about remuneration, for instance, are just curiosity. It doesn't serve any purpose, either in business or politics.'

### Principles and freedom

Society also has a clear interest in businesses acting with integrity. Objective, non-culture-specific standards are therefore needed to measure to what extent integrity is, or is not, present in a company's behaviour. Morris Tabaksblat, who chaired the Dutch Committee on Corporate Governance, sees clarity as an effective ingredient of integrity. 'Integrity is monitoring that the

## 'Don't view integrity as a necessary evil'

goal that you've agreed with each other can be reached in the agreed manner. You have to make sure that you keep moving towards that goal under all circumstances. Of course, integrity is an ethical concept, but it's also, in essence, a management tool.' Schilder points to the advantage of taking a pragmatic view: 'You just need to agree some common-sense rules about that. And don't carve them in stone, because you may want to do things differently in a couple of years' time. If you know how things work, and you're prepared to listen to each other, then you'll often find a solution.'

### Tone at the top

Executive directors play an important part in safeguarding integrity, Wim Kok observes. 'The tone at the top is very important: it's essential that management and the supervisory board make it clear, from the top down, what is permissible and what is not. They need to establish clearly what standards people will be judged by, and must insist that these standards be strictly maintained. At the end of the day, it's part of your licence to operate. The credibility that companies need in order to do their work properly depends in large measure on how good they are at handling such things.' Olijslager agrees. 'Rules are fine,' he says, 'but what's much more important is the way the board deals with them. A higher standard of behaviour is required from those at the top. Sometimes people forget this, but the truth is that there aren't fewer rules for people at the top, there are more!' Kees Storm is able to comment from two angles. 'When I started as an assistant bookkeeper at the age of 17,' he recalls, 'I thought the bosses were a long way away and actually did nothing. Only later did I come to understand that, after all, those bosses actually had a lot of influence, particularly on the atmosphere in the company. And I'm still impressed by the great influence that executives can exert throughout an organisation with regard to integrity.' A cautionary note is added by Schilder, however. He points out that maintaining the highest levels of quality under all circumstances is no easy task. 'People are under more and more pressure. If they're not to succumb to it, they need to keep telling the truth and saying what they think. People have to take decisions in tense circumstances. Not everyone is able to maintain their integrity under those conditions.'

### Role of the CFO

In my experience,' says Izeboud, 'when organising management of a large internationally operating company you need to manage two matters centrally: accounting and IT. The CFO needs to determine what goes in the accounts, so that the figures can't be influenced by local management. That's standard practice in most American corporations, but is very rarely found in Dutch companies. The CFO must prevent any juggling with figures by local or intermediate levels of management. If judgements and estimates have to be made, they should be made at the top – nowhere else. It's an important part of the CFO's job to make sure this is organised properly and kept under control.' The CFO also has a special responsibility in encouraging desired behaviour. Says Hans Hoogervorst, chair of AFM, the Dutch financial services regulator. 'My message to CFOs regarding both integrity and the interest of the company is this: don't view integrity as a necessary evil that you have to watch out for; see it instead as a core value of the company, one that does not detract from commercial profitability but is in fact one of the most important conditions for the long-term commercial profitability of the organisation.'

### Watch out for hubris

One of the biggest dangers facing executive directors is that of overestimating their abilities. Olijslager believes that managers must dare to put themselves in vulnerable positions, and be prepared to admit mistakes honestly. 'Policy gets support if it's open to discussion, and if people dare to question ridiculous directives or guidelines.' Supervisory board members can play a key role in reining in overambitious CEOs. 'I'm a hands-on type,' says Olijslager. 'If anything goes wrong, I'll be there, alongside the board of management... When problems arise, I'm there to ask them all the questions I think I should ask.' Kees Storm, for his part, receives help from the home front on keeping both feet firmly on the ground. 'I talk over many things about my work with my wife. Over the years, she's helped me a great deal by telling me when I hadn't listened or looked into something properly: "You need to look at that again."'

### Integrity deficit behind the crisis

Kees Storm, points to the many examples of execu-



F.l.t.r.: André Olijslager, Arnold Schilder, Kees Storm

F.l.t.r.: Hans Hoogervorst, Gilles Izeboud, Morris Tabaksblat

tives lacking integrity that the crisis has turned up. 'For instance, the crazy remuneration being given in America is so clearly at odds with the reality of the situation that you can no longer respect such people.' Hoogervorst is also shocked that the financial system could go off the rails like this. 'I know many of these top people,' he says, 'and I've no doubt that, in general, they're respectable people with integrity. And yet things happen in the market that make us ask ourselves: "Was that really an example of integrity?"' Morris Tabaksblat similarly expresses his disbelief: 'Somehow or other, people managed to circumvent the checks and balances in the system,' he says, describing the enormous scale on which that happened as 'astounding'. Banks, he says, made and sold products that were too complex. 'That was encouraged, and led to irresponsible behaviour.' Those who sold more were rewarded with big bonuses, sending all the wrong messages, he says. 'As a result, people started selling products they didn't understand – which was totally scandalous. They failed to foresee the effect that this would have.' That in itself, he describes as 'absolutely reprehensible'. 'It's not that they deliberately acted badly; they simply forgot about the risks. That in itself shows a lack of integrity.' As Arnold Schilder succinctly puts it, 'The level of reliability that we could once expect of risk management at a bank has been lost.'

#### Lessons of the past

The next question is, naturally, 'what now?' How can we best react to the crisis without making the mistakes of the past? In the first instance, Hoogervorst appeals to the financial sector to put its own house in order. 'I'd hope that the trauma of this crisis will have impressed upon every bank at least one principle: that they should sell only those things that they understand. It's a simple principle that, in the euphoric financial atmosphere of the past few years, has been forgotten. As regulators, we should require banks to be able to explain their products... This should not require complicated regulation.'

#### Legislation and regulations

The current legislation and system of regulation is due for renewal, concludes Storm. 'What is required now is coordination on a global scale,' he says. 'People need to work in close cooperation on an international level, and

with a strengthened IMF. The regulators and the central banks must obtain more authority and greater independence.' Tabaksblat, for his part, is very clear about this. 'The whole regulatory system needs to be overhauled,' he says. 'We need to go back to the rules of post-1929; they worked well for a very long time. We now need to ask ourselves how it was possible that things still managed to go wrong, and then make sure that those rules work better.' Tabaksblat fears, though, that the government will not have sufficient time (or will not grant itself enough time) to make these sorts of analyses. 'So the sector will need to do the job itself. Unless the banks themselves come up with ideas and solutions, you won't get fewer, more efficient rules; you'll just get more and more rules.'

#### Remuneration

The bonus system also needs to be changed, says Hans Hoogervorst. 'Let's hope, for instance, that a quite different climate will develop regarding the remuneration structure in the financial sector, because that's not being tackled with integrity – that's crystal-clear.' He points to the fact that it is not uncommon for more than half a company's profits to be paid out in the form of bonuses. 'But what happens when those bonuses turn out to have been earned by taking undue risks, and there's no way you can get the bonuses back? Then you're faced with a system without integrity,' he says. 'I hope that people will take notice of the public anger that has quite rightly arisen about this.'

#### And when it's all over?

Finally, we must not forget, says Wim Kok, to think about what will happen after the crisis has passed. 'We should work to turn our present vulnerability into future strength,' he says. 'This means that, while fighting the crisis in the short term, we also need to keep in mind those questions that we were discussing when the crisis broke – questions about tomorrow.' The crisis, he suggests, is an ideal stimulus to get us to rethink things in greater depth and change what needs to be changed. Whatever we do, he says, 'we mustn't miss the boat to the future.'

*For a copy of the publication 'Beyond rules. Integrity as the basis of sustainable business success' please visit [www.deloitte.nl](http://www.deloitte.nl) and search for 'beyond rules'.*

The new 'F' word – Forensic Services explained

# The 'must knows' to survive



The key to success, especially in tough times, is having the right information so that the right people can make the right decisions. This means executives need to ask the “what if” questions before a crisis hits. Forensic services and professional advisors can assist by implementing measures, both traditional and technological, to help prevent, detect and assess abnormal behaviour.

By Steven York

The current economic crisis has arguably been exacerbated by a lack of precise information, caused in no small part by technological complexity and global interconnectivity in both business and personal networks. Obviously we can only manage risks on the basis of information that we have. Ironically, however, the very information we need is often in the hands and heads of people who may be at risk of losing their jobs. Twenty years ago no-one could have imagined that inexpensive, easily obtainable equipment could shut down government departments and incapacitate corporates<sup>1</sup>. But this has happened, and on many occasions<sup>2</sup>.

Risk management and analysis are claimed<sup>3</sup> to be no more mysterious than any other form of management and to be inter-linked with other management functions. If so, we should be able to examine the functions, procedures and responses and expose the vulnerabilities so that we can learn from each other's mistakes. The difficulty in learning from each other's mistakes (isomorphic learning) is that it does not come naturally. We tend to view the world through the lens of our own experience, rather than taking the advice of others. There are, however, four essential things that every business needs to know. And forensic services can help them understand these four 'must knows'.

## What are Forensic Services?

This all-encompassing term essentially means using scientific techniques to resolve questions in criminal and other investigations. Forensic specialists provide independence and objectivity, as well as specialised technical skills and expertise in performing forensic investigations and using data analysis and retrieval tools.

Forensic investigations seek to answer the following questions, with the most important criterion being that every answer must stand up in court:

- What happened and when?
- Who was involved?
- Why and how did it happen?
- What was the result?

The following table lists some differences between auditors and forensic investigators.

Traditionally, forensics specialists have been called in after an event, but these services now need to be part of an organisation's operational risk management fabric. The need to streamline organisations and reduce staff costs means that whereas risk control and supervision were previously done by people, they are now done by technology. And this fact in itself gives rise to new risks.

<sup>1</sup>Pellegrino, G and McAllum, G (2009) Cybersecurity: Everybody's Imperative. Protecting our economies, governments and citizens, Deloitte Global Public Sector, 6 May 2009.

<sup>2</sup>The press recently reported a virulent 'botnet' attack in which criminals infiltrated over one million computers worldwide. The attack was enabled by vulnerabilities in social networking sites used by younger people for communicating and downloading information. 'Major cyber spy network uncovered', BBC News Americas, 29 March 2009.

<sup>3</sup>Toft, B. and Reynolds, S., 1999, Learning from Disasters: A Management Approach. Leicester, Perpetuity Press.

|                 | Forensic Investigation   | Audit   |
|-----------------|--|---|
| Mindset         | All cases end in litigation  | Professional scepticism   |
| Frequency       | Non-recurring; random  | Recurring; scheduled  |
| Approach        | No management planning session; limited notification   | Meet management to determine nature of audit; all employees notified of audit         |
| Relationship    | Potentially adversarial  | Non-adversarial   |
| Scope           | Document examination of particular issue; review of outside data; interviews of people of potential interest | Analysis of financial statements and other financial data; interviews with management |
| Work programmes | Programmes developed and amended as needed   | Standard audit programme  |
| Employer        | Client's attorney, in-house counsel, special committee   | Audit Committee/client's management   |
| Objective       | Identify responsible parties; quantify damages   | Issue opinion on client's financial statements and related disclosures                |
| Report audience | Report presented to counsel  | Findings presented to directors/Audit Committee                                       |

# The four 'must knows' to survive: know your business, people, customers and suppliers

## Gen-Risk Gap

This gen(eration)-risk gap is the gap between two sides of an organisation. On the one side are senior managers, with their concept of how to manage the external perceptions of the business and how the business is to be managed internally. These people are generally older and have no in-depth understanding of technology. On the other side, we have the technology specialists, who are employed to implement company imperatives via technological innovation. These people are generally from a different generation and do not have an in-depth understanding of the business model. They do have in-depth technological skills and education, but – unlike younger generations in previous eras – are not trained and closely supervised by senior managers who really understand what the younger generation does or can do in a business that may have been operating for many years.

This seemingly innocuous gap has opened up in corporate structures and is causing risks so immense that what we are now seeing in the financial crisis is just the tip of the iceberg. And in my view this risk is growing faster than we can imagine. The essential question for all organisations is: how much information has leaked outside via the internet or other social networking technology?

## Four 'must knows' to survive

We need no reminding that advances in communications and technology mean we are all now closely and continuously linked. In recent years, businesses have launched into many new areas, whether by selling and doing business on-line or by physically entering new and emerging markets. However these new environments are highly complex and lack historical data. Recent dealings with large global organisations that have been the victim of fraud or other financial crimes have highlighted four aspects that determine business survival and where lack of knowledge among business leaders can be disastrous. These four "must knows" are: know your business, know your people, know your customers and know your suppliers.

## Know your business

In my work as a professional risk consultant, the answer I get to the question, 'Why are you in this particular

business lines?' is all too often, 'I don't really know. I inherited it.'

In a push for revenue, many corporations have moved into markets and business lines that are not core business. Senior managers often have little practical knowledge of what is happening on the ground or of the right benchmarks. We have recently seen major companies that had entered the banking sector withdraw from the more risky, non-secured loans previously seen as highly profitable.

Knowing your business and markets is ultimately a matter for senior and executive management. Well-managed businesses can enter new areas or acquire new businesses, but they must be able to manage the associated risks. Using external risk experts with an in-depth understanding of what may be behind the possible opportunity is vital. The results of not doing so can be seen in news reports on a daily basis.

Specific forensic analytical tools can be used to identify anomalies or unnecessary expenditure among millions of transactions, either before a merger or acquisition or by analysing procurement, ledger or sales data. Indeed the tools can be used on data anywhere as a quick way of analysing or highlighting outlying or unusual events. And the cost savings achieved for our clients by reducing mistakes, double payments and fraud can save peoples' jobs.

## Know your people

In my experience as a forensics partner, management all too often waits to conduct background checks until after recruiting people. There can be many reasons for the post-enquiry, including unexplained or anomalous transactions or behaviour costing the company money or reputational loss. The key is knowing exactly who you are going to employ before the employment contract goes out. Using professionals to conduct background checks before you offer employment will save you money in the long run.

In their efforts to streamline activities and reduce costs, many companies are focusing on their poor performers. Their high performers however, have in some cases gained that status by selling products or services to

people who cannot afford them. In the past, sales staff were remunerated on the basis of their sales, but perhaps they should in future be paid on the basis of maturity or conversion.

## Know your customers

The Australian government's ads in newspapers and magazines in March 2009 reminded directors and company boards that the country's anti-money laundering legislation (AML) requires them to 'know their customers', while also reminding them of the penalties of not doing so. The third European anti-money laundering directive has largely been translated into country-specific AML legislation. However, companies doing business in several countries are subject to the law in all those countries, while internet transfers may mean companies are unaware of where a customer actually conducts business, as in the much-publicised case of a bank that had to forfeit USD 175 million to the United States and USD 175 million to New York County as a penalty for allowing Iranian and Sudanese clients to access the US banking system<sup>4</sup>.

Not only banks are subject to AML legislation. So, too, are accountants, bullion dealers, law firms and parties making money transfers in related industries. The belief that regulators took their 'eye off the ball' in the run-up to the current crisis will put increasing pressure on regulators to fund their increased activities through such fines.

How secure are your customers? Can they pay their bills? Are they exposed to currency fluctuations? Not only does knowing your customers, their habits, likes and dislikes make good business sense, it is also key to survival.

## Know your suppliers

Getting close to your suppliers is as important as knowing your customers. Supply chains are now highly complex and cross many national boundaries. Your service may depend on an item that, if lost, can completely stop your ability to supply. One of our many services involves analysing links in supply chains and advising on risk management. Having up-to-date business intelligence is now essential to survive and thrive in the new climate.

Recent closures of outsourcing operations remind us how interlinked we are. Although businesses appear to be supplying one client or industry, their activities may have a far wider knock-on effect. The shockwave created by the 21.9% fall in UK new car registrations in February, for example, rippled through small towns like a plague of locusts. The motor industry is rapidly going from bad to bleak, and industry suppliers are increasingly worried about their receivables and people about their jobs. Yet an automobile client told me in May 2009 that his company is running at nearly 100% capacity and has increased its market share because of an early move into popular, low-cost small cars. This is the upside of a crisis.

If you find yourself in a rising receivables cycle, don't just wait and see what happens. Get the right professional advice and ensure you are appropriately protected. In a recent case, receivables were found to be false invoices generated through conspiratorial action within a business.

Another example of risk is a possible failure of third parties holding businesses' documentation or supporting their technology networks and back-up data. Closure of a warehouse may appear innocuous, but not if it holds your documents. And you can be assured that this will not reduce your legal obligation to maintain records for tax and other purposes.

## Conclusion

The key to success is having the right information so that the right people can make the right decisions. This means executives need to ask the 'what if' questions before a crisis hits. Forensic services and professional advisors can assist by implementing measures, both traditional and technological, to help prevent, detect and assess abnormal behaviour. There is no time to lose. Seize the day and review the four factors for your business now. Then make sure you get the right advice and look for the upside in the current crisis.

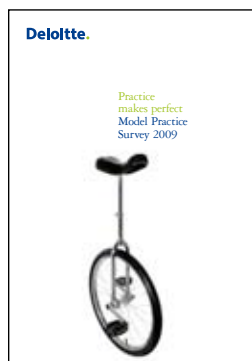
<sup>4</sup>Freshfields Bruckhaus Deringer LLP, (May 2009) US criminal liability for non-US corporations and financial institutions. The long arm of US law, Briefing Paper, May 2009.

## About the author

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*Deloitte Model Practice Survey*

## Model practice needs further improvement



Although models play a major part in the risk management of financial institutions, model practice is not yet fully mature.

It is specifically in respect of its integration into business decision-making and data quality that current practice falls short of what is needed. Improvements are, however, likely, thanks to the optimised application of Basle II and the implementation of Solvency II. Supervisory frameworks such as Basle II and Solvency II mean that the role of models in financial risk management has become increasingly important over the past few years. Models provide a powerful tool for risk managers to quantify and control risks. Both internal and external stakeholders rely heavily on information provided by models. Therefore, models should be transparent, of high quality, reliable and integrated into the business. Such elements should be safeguarded by a proper model practice. The Deloitte Model Practice Survey set out to obtain insight into the quality of current model practice within financial institutions (banks and insurance companies).

### Governance and model quality

The governance element of models was found to be the most mature. At most organisations the governance structure creates clear accountability and transparency for all stakeholders, with more than half of the respondents (55 per cent) indicating advanced implementation. According to 70 per cent of respondents, the approval level of authorities is consistent for all models and in line with strategic business decisions. Improvements are needed, however, in the standards set for the general level of knowledge about models among users and management, with more than 40 per cent of respondents indicating that such standards hardly existed.

The quality of models used is also relatively mature. For example, 97 per cent of respondents indicated that they were compliant with supervisory and accounting requirements. Respondents also indicated that the risk models for different risk types were consistent with respect to assumptions, time horizons, double counting and conservatism. On the other hand independence between model development and validation was not generally safeguarded, with 34 per cent of respondents indicating

that this was not yet mature. Training programs on model usage were also largely absent in 60 per cent of the companies surveyed.

### Integration and data quality

Less mature are the extent to which model outputs are integrated into business decision-making and the quality of data used. These model practice elements have an average maturity below the level of basic implementation. Only 8 per cent of respondents indicated that the reporting and calculation systems were optimised and integrated into strategic business decision-making. On top of that, reporting and calculation systems were said not to be very flexible. Most organisations seem to have reporting and calculation systems that can only partially adapt to organisational changes and new supervisory regimes. The fourth element of model practice – the quality of data used – was shown to be least advanced. Almost all respondents scored very low on aspects such as source database consistency, audit trails of data history, sufficiently long data history, reporting of data quality to senior management and senior management's responsibility and accountability for the quality of data.

### Improvements expected

Although the Deloitte Model Practice Survey shows that current model practice within financial institutions is not yet of the quality that these institutions themselves and external stakeholders such as regulators and investors are entitled to expect, the results of the survey nevertheless indicate that improvements can be expected over the next couple of years. On average banks score better than insurers on all model practice aspects. This can probably be explained by the greater model use resulting from the Basle II (banking industry) and Solvency II (insurance industry) supervisory frameworks. Whereas Basle II is already fully implemented, Solvency II is still in development. For this reason it is not only expected that the banks will start optimising the use of models they developed while implementing Basle II, but also that, by implementing Solvency II, the insurance industry will start closing the gap that now exists in proper model practice.

To download the full report, please visit [www.deloitte.com](http://www.deloitte.com) and search for 'Model practice'.

*Deloitte Global Risk Management Survey*

## An opportunity to emerge more resilient



Risk management is in the spotlight. On the one hand it has been tested by an unprecedented confluence of events, and has proved to be inadequate to deal with (let alone prevent) the recent turbulence in the financial markets. On the other hand, these same events have also demonstrated the need for enhanced risk management capabilities.

Unsurprisingly, given the recent turmoil on the financial markets, the sixth Deloitte Global Risk Management Survey shows that risk management practices have evolved in many aspects since the previous report in early 2007. This latest report provides insight into: risk governance, enterprise risk management, Basle II, management of key risks (including credit, market, liquidity and operational risks), risk management systems and technology infrastructure.

### Room for improvement

The report also shows that there is still plenty of room for improvement. A few of its key findings:

- Only 36 per cent of the institutions surveyed had an enterprise risk management (ERM) programme, although a further 23 per cent were in the process of creating one.
- For a long time, Value at Risk (VaR) has been the industry-accepted methodology for assessing market risk, but its limitations in assessing the risks of extremely rare events (tail risks) and the degree of correlation across asset classes, risk categories and geographies have become apparent. Institutions are supplementing the use of the VaR with other methodologies, such as stress tests.
- Regulatory authorities have been encouraging financial institutions to independently validate their risk-related models, but action to date in response to this guidance has not been uniform. While 53 per

cent of the participating institutions indicated that they had an independent model-validation function, almost two thirds of the remaining respondents reported having no plans to create such a function.

- Many institutions may have significant work to do to upgrade their IT risk management infrastructure. Roughly half of the executives were extremely or very satisfied with their risk systems' capabilities to provide the information needed to manage market and credit risks. In other areas, such as liquidity and operational risk management, 40 per cent or fewer rated their systems this highly.

### Strong leadership

The report expresses the expectation that financial institutions will now more than ever be looking to their boards of directors, and specifically a CRO or a similar senior-level executive position, to provide strong leadership in risk management, including enhancing and approving the risk appetite statement, if this has not already been done. More and more institutions will be implementing ERM programmes to obtain a comprehensive view of all the risks they face, the linkages between these risks and how they are managed. Many companies need to improve their ability to manage emerging risk types, such as reputation and liquidity risks. Risk management programmes may also require more sophisticated methodologies to reflect the increasing complexity of financial products and interdependence of financial markets. In particular, the VaR may need to be supplemented by additional methodologies.

Beyond specific metrics and tools, however, successful risk management will also rely on the creation of a culture of risk awareness. Senior management may need to provide additional communications to reinforce the belief that managing risk is part of every employee's job, and to take steps to incorporate risk management goals into performance objectives across the organisation. Continuing to strengthen the risk management function will allow institutions to emerge more resilient and better able to meet the competitive challenges ahead.

To download the full report, visit [www.deloitte.com](http://www.deloitte.com) > Industries > Financial services > Investment management.

# Poland's banks heading in the right direction



Polish banks have a lot of catching up to do where back office organisation is concerned. But the changes being made by individual banks are the right ones, and are leading the Polish market towards efficient, low-cost and high-quality service.

By Agnieszka Nurska

**W**ith the dynamic growth of the Polish retail loan market in recent years, the country's banks had to first of all expand their capabilities to be able to handle a vastly greater volume of transactions, and second, make the most of opportunities to increase their market share and generate extra revenue. To achieve these goals, banks had to improve sales effectiveness and, at the same time, improve the efficiency of their administrative units. Lately, uncertain market conditions have increased the focus on cost cutting and efficiency measures, and reorganising the back office has more than ever become the obvious way forward.

The back offices had to be transformed from outdated 'manufactories', where most operations were performed manually, to modern 'industrial plants' with human activities limited to management of systems and making of complex decisions. Some banks responded early on and began reorganising their units to keep pace with market developments. Others, despite problems resulting from having to perform costly processes on a large scale, have been reluctant to act.

#### Young enough to learn from mature markets

Available statistics show that the Polish banking market is still in its initial development stage. A comparison of the mortgage loan to GDP ratio in various countries shows that Poland is still well behind other European countries (the ratio in Poland is around 7.5%, against an EU average of around 49%). Similarly, the consumer loan penetration ratio (the value of loans granted compared to GDP) in Poland is a mere 6%, still far behind the level of 14-16% characteristic of developed EU countries. On a positive note, this means Poland can still learn from the experiences of more mature markets. The first step to effective implementation of solutions proven abroad, however, is to determine the position of the Polish market on the development curve. Therefore, Deloitte, the financial monthly BANK and Harvard Business Review Polska, supported by the Polish Bank Association, launched the first research ever into the loan back office function in Polish banks. The initiative was welcomed by market players and

financial institutions alike. Of the latter, over twenty commercial and nearly fifty cooperative banks participated in the study. The combined assets of surveyed entities exceeded 50% of those owned by all banks operating in Poland.

#### Varying approach to back office tasks

For the purpose of the study, we needed to determine the definition of back office used by banks. The survey covered both commercial and cooperative banks, and because the nature of their operations differs significantly, their view of back office processes differs as well. Within the commercial bank category, we observed another distinction between those with predominantly consumer loans in their portfolios, and those where mortgage loans prevail.

In commercial banks predominantly active in mortgage loans, back offices often perform not only typical administrative tasks (monitoring of contractual terms and collateral, archiving documentation, introducing changes to systems, annexing, closing loans), but also additional activities pertaining to the selling stage (loan contract recording, loan disbursement). In banks where consumer loans prevail, back offices carry out typical post-sales tasks, including monitoring of payments, introducing changes to systems and archiving documents.

The centralisation issue looks quite different in cooperative banks. These entities are characterised by a small scale of operations and territorial coverage, so they do not need centralised administration and specialisation of jobs. Therefore, the threshold between the front and back office is usually fluid.

#### Three classes

Analysis of the current status of organisational changes implemented by banks within their administrative function shows that progress varies. There are three clear categories of banks in the Polish banking market:

1. **"Fast and modern"** - Nineteen percent of the market<sup>1</sup> (36% in terms of assets<sup>2</sup>) is made up of the most advanced banks, where administrative functions are centralised, and both processes and workflow management are supported by IT solutions.

<sup>1</sup>Commercial banks operating in the Polish market

<sup>2</sup>Market measured by value of assets of commercial banks operating in the Polish market

2. **“On the way”** - Sixty-two percent of banks (30% in terms of assets) have achieved medium level process reorganising and automating.
3. **“Latecomers”** - The last group – 19% of banks (34% in terms of assets) is in the stage of planning or just initiating organisational changes.

#### Progress of change translates into efficiency

The survey results prove that the higher the organisational development level is, the greater the efficiency. In centralised back offices that have applications to maintain loan processes and to process documents in the form of computer files, an employee is able to service a portfolio of nearly 6,000 loans (banks with majority share of mortgage loans in their portfolios) or even over 10,000 loans (for banks with portfolios dominated by consumer loans). By contrast, in banks that have just initiated the change, an administrative employee is able to support 953 and 117 loans a year, respectively.

#### Lack of dedicated support systems

The difference stems from back offices in many banks lacking support of dedicated IT systems. In such banks, many tasks that otherwise could be automated and mass-processed are carried out manually. Most commercial banks (70% of these with portfolios dominated by mortgage loans and 50% of those where consumer loans prevail) have indicated that the entire loan service and administration process is system-supported. Other banks indicate that their automation level is just slightly lower. When analyzed for quality, however, the situation is not quite as favourable, since only 19% of banks are using dedicated workflow applications for comprehensive support of loan processes. Most banks use a number of simple tools that support individual activities or stages of the process. Since capabilities of individual applications are limited, some parts of the process remain unsupported. Lack of interfaces between the systems necessitates manual completion of information, resulting in reduced consistency of data among the systems. Such practices contribute little to organisational efficiency.

#### Still much room for improvement

The problem of inefficiency, though, requires a different approach, which takes account of the development level and progress of change in an organisation. All banks indicate areas in need of improvement, but being in various stages of change implementation, each of them has individual needs. Based on inefficiencies observed by banks in each category (advanced, in process of change, prior to change), the researchers were able to get an idea of the problems faced by institutions at each particular development level.

Commercial banks in the initial stages of implementing organisational and technological changes, as well as the group of cooperative banks, have a long list of inefficiencies to struggle with. Lack of system support and varying competencies of employees involved in loan processing are considered the key reasons for these inefficiencies. Most frequently mentioned by participants in our survey were:

- lack of automated interfaces between systems
- lack of ability to track work progress in process
- lack of lead-time standards to finalise each process stage

- too many roles involved in the process
- lack of internal communication rules
- informal workflow

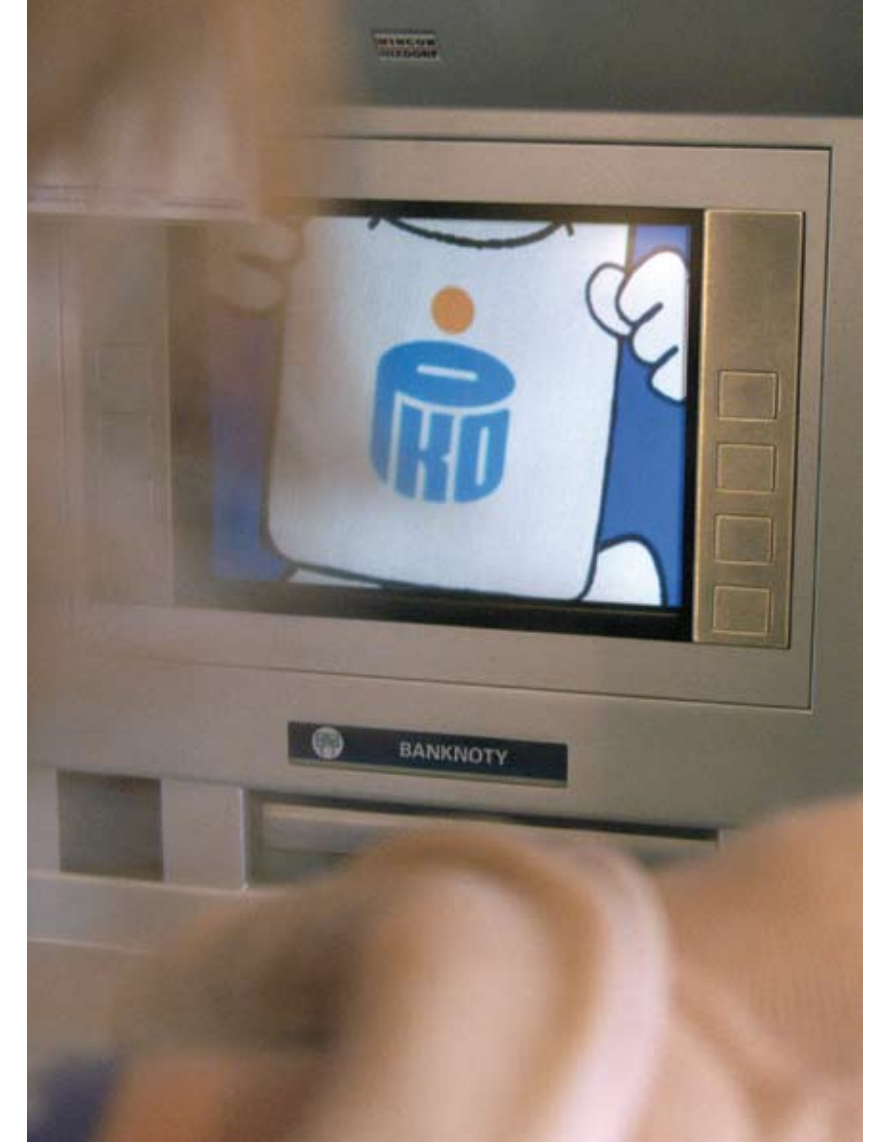
All these inefficiencies may not only unnecessarily extend the loan service and administration processes, but also compromise the quality of data and completeness of documents, resulting in duplication or omission of certain activities. Additionally, all these issues grow in importance when the volume of transactions increases. Problems like these may have triggered these banks to talk about necessary changes and take the first steps toward implementing them.

Banks already in the process of implementing the changes face other problems that seem typical of their development stage. They indicate inefficiencies regarding:

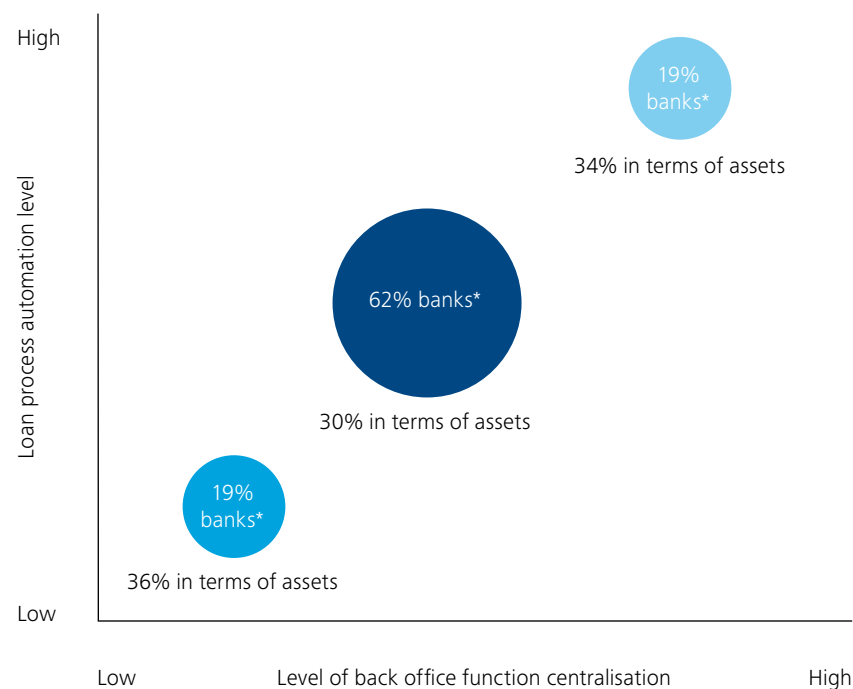
- underdeveloped system environment (lack of automated interfaces between applications, necessity to manually prepare standard loan documentation, absence of document digitising systems)
- unclear scope of duties and inefficient communication between front and back office employees (and the resulting low quality of documentation completed by front office, lack of communication procedures between front and back office)
- non-regulated loan process (absence of mechanisms allowing early check for document completeness in process, lack of time standards for individual process stages and too many control points)

Apparently, the problems at 'on the way' banks are mostly related to the implementation of organisational changes. This group of banks, though, manages to avoid having to increase back office headcount, since gradually implemented changes seem to balance the demand for additional resources to carry out certain activities.

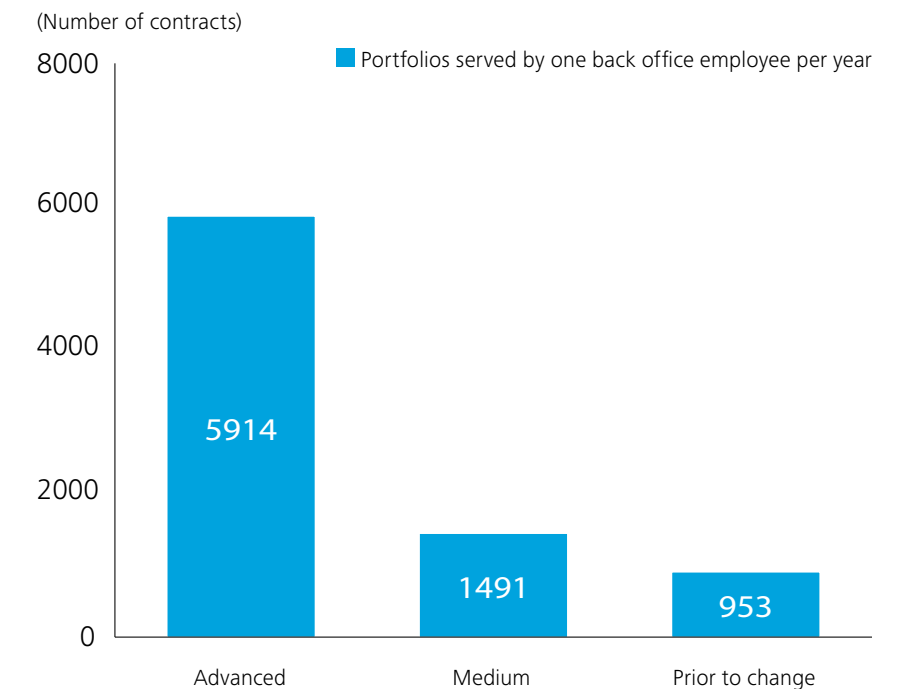
Following successful implementation of all planned changes, the banks will enter the subsequent stage of development. At that moment, they will face quite different issues to be solved. They can expect to experience problems similar to the ones that the most advanced banks face now.



**Figure 1**  
Classes of banks by change advancement level

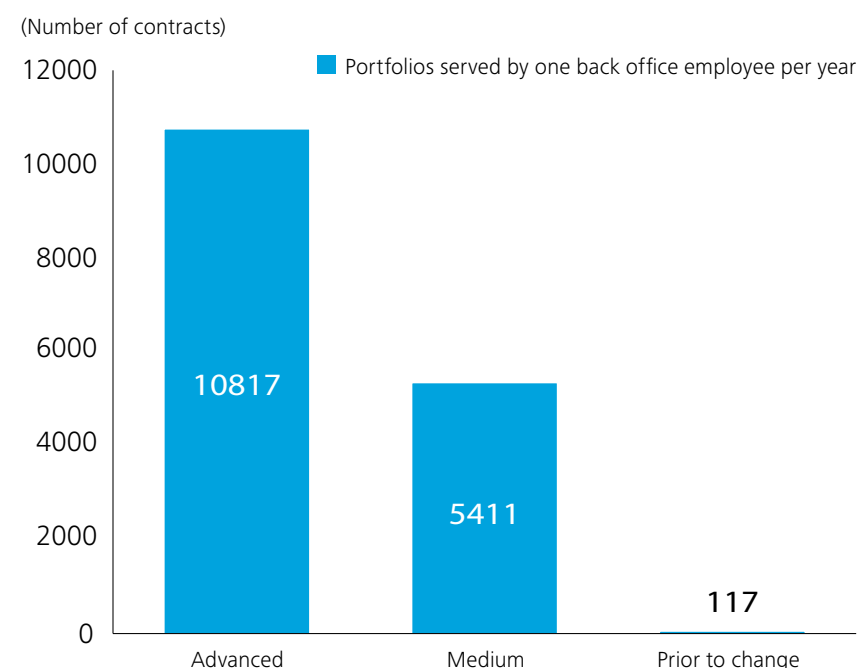


**Figure 2**  
Back office efficiency in banks with mortgage loans prevailing in their portfolios



# Increasingly optimistic outlook for Adriatic economy

**Figure 3**  
Back office efficiency in banks with consumer loans prevailing in their portfolios



Banks from the most advanced group pointed out the following inefficiencies:

- incomplete integration of their systems
- inability to automatically generate loan documentation
- need for more automation of collateral monitoring processes

Importantly, most surveyed banks declare that they are planning further improvements and developing applications. Such an approach seems very positive, meaning that even the most advanced banks want to push ahead to develop organisational and system solutions of maximum efficiency. Indeed, this is the only way to:

- **reduce costs of processes**, for example through advantages of scale, less spending on maintenance of multiple applications and documents archiving
- **reduce process lead-time** through automation of activities, elimination of process redundancies, deeper knowledge and broader decision-making competencies of process participants
- **reduce operating risk**, and indirectly, **credit risk**, for example through elimination of manual work, reduction of client data storage systems and complex integration of data across systems
- **maintain high quality** of loan service and administration processes, mainly through unification of individual activity performance standards, ability to identify inefficiencies in process management, fast response to changes in transaction volume or product construction

Benchmarking of the back office organisation in the Polish market to trends observed in more mature financial markets shows that Polish banks have a long way to go in order to reach the relevant standards. Still, the direction taken is clearly right and will result in efficient, low-cost and high-quality service for clients.

#### About the author

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The Adriatic region's average GDP seems likely to contract by between 5% and 6% in 2009, by far the worst annual performance since the early 1990s. In the longer term, however, once the immediate crisis passes, the region will remain an attractive place to invest in. >>

By Ivica Kresic

*Many young Belgrade professionals do not yet have a mortgage.*

## No significant bank failure or run on a bank in the region

**T**he repercussions of the global financial storm started being felt strongly in the Adriatic economies during the final quarter of 2008. Prior to the collapse of Lehman Brothers, these economies had all been expected to continue growing healthily. Since then, however, all the growth revisions have trended sharply downwards. The magnitude of these falls in GDP will be similar in all the region's economies, despite their differing structures.

Given this sharp and sudden contraction in economic activity, and the even faster spread of illiquidity, cash flow management has become increasingly important for all Adriatic companies (and even governments). To complicate matters further, the costs for the region of obtaining financing abroad have risen significantly (with the partial exception of Slovenia).

Since all the Adriatic economies had recorded large current-account deficits in recent years, the abrupt drying-up of cheap foreign finance resulted in a significant fall in investments, while the accompanying higher interest rates also led to a sharp retreat in consumer spending. Large increases in government deficits, due to underperformance in tax collection, are being addressed through a combination of tax increases, deficit financing and spending cuts (especially investment deferrals).

Each country in the region is trying to mitigate the effects of the crisis by leveraging its particular strengths. Slovenia, a stable member of the euro zone, can still borrow relatively cheaply abroad, and so its government and large companies such as NLB have repeatedly tapped the European credit markets. Croatia and Montenegro meanwhile have pinned their hopes on the success of this year's tourist season, which has turned out quite well, whereas Serbia and Bosnia-Herzegovina have each secured standby agreements with the IMF that will provide support during the crisis.

As the worst of the global crisis now seems to be behind us, with Asia leading the way and both the US and the EU also expected to achieve significant growth in the third quarter of 2009, Adriatic policymakers are hoping that

the rising global tide will lift their boats as well before any significant damage is done to the real economy. While this may well happen, it is also true that the onset of the crisis in the Adriatic region lagged several quarters behind the rest of the world, and so it may take the better part of a year for the region to turn the economic corner. And before that happens, many of the companies that over-invested in dubious projects based on rosy assumptions may yet find out that this crisis was their last one.

While the pain felt in the region has certainly been significant and real – and will continue for a few more months at least – not everything is gloomy. There has been no real panic in any country. The banking sector also remains well capitalised, and there has been no significant bank failure or run on a bank in the region. Increasing optimism that the region's economies would soon pick up started being felt during summer 2009, and this is bound to have a positive effect on consumer spending in the coming months. Meanwhile the region's consumers are still not deeply indebted by Western standards. Indeed a large majority of young Belgrade professionals, for example, do not yet even have a mortgage, although many of them will increasingly be able to afford one.

In the longer term, once the immediate crisis passes, the Adriatic region will remain an attractive place to invest in. Situated close to the heart of the EU – between Italy, Austria and Hungary on one side, and Romania, Bulgaria and Greece on the other – countries in the Adriatic region have been repeatedly assured of their long-term future in the EU and are taking significant strides along the path towards it. Assuming continued political stability, the process of catching up with the more prosperous EU members could on its own be the driver behind growth in the Adriatic region for decades to come.

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