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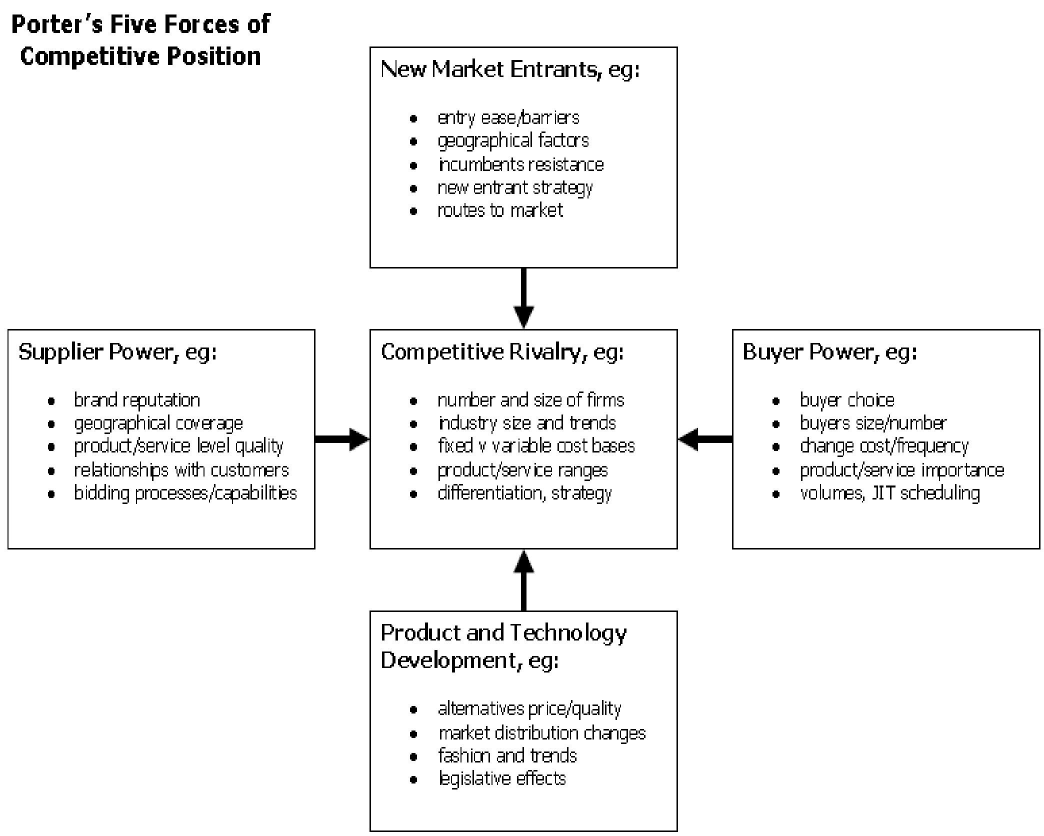
LESSON 01

CONSUMER BANKING

Objectives of Course

- To help ***Students*** gain some fundamental knowledge/information about this important component of Banking Business. As educated citizen of the country they are expected to develop a balanced perspective & establish the relevant context towards the contribution this banking practice could make in the growth/development of Economic and Social Sectors of our country
- To provide ***Students*** with an opportunity to undertake some additional/complimentary learning which could help them succeed in their work/professional lives, i.e. choosing any occupation/carrier in general or Banking/Finance in particular
- To assist ***Students*** in making better decisions in their capacity as Consumers themselves. With their educational background they represent a Key Societal Stakeholders Category and as such constitute a significant Prospective Customers Segment for the banks

Five Forces of Competitive Position



Let us take Porters Five Forces model as an example:

- Information can provide us with the details of buyers, suppliers, substitutes, competition, etc.
- Knowledge can show us how to build Porter's 5 forces mode with this information
- Understanding can explain to us why we utilized the model (objective is to determine industry attractiveness and/or use as a threat matrix)
- Wisdom enables us to discern the objective's value or relevance to us and our desired outcome
- Wisdom is about effectiveness while the rest are about efficiency

Systems Framework

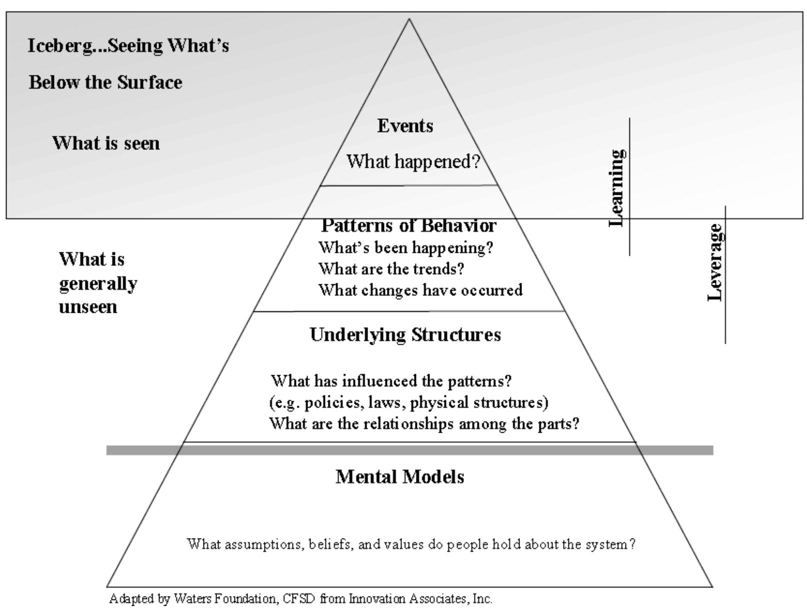
Consumer Banking is a separate course but we are not going to learn about it ***"in Isolation"***.
Our endeavors will be to understand it by applying the process of learning cycle described earlier and take a ***"Systemic View"*** of the nature & characteristics of this subject, i.e. in the wider & a macro context.

What are Systems?

- System is a group of interacting, interrelated, and interdependent components that form a complex and unified whole
- Systems are everywhere—for example, the R&D department in your organization, the circulatory system in your body, the predator/prey relationships in nature, the ignition system in your car, and so on
- A system has a purpose
- The parts combine in a particular way for the system to carry out its purpose
- Systems serve specific purposes within larger systems
- Systems seek stability
- Systems have feedback

The methods of systems thinking provide us with tools for better understanding difficult management problems. The methods have been used for around fifty years (Forrester 1961) and are now well established. However, these approaches require a shift in the way we think about the performance of an organization. In particular, they require that we move away from looking at isolated events and their causes (usually assumed to be some other events), and start to look at the organization as a system made up of interacting parts. We use the term system to mean an interdependent group of items forming a unified pattern. Since our interest here is in business processes, we will focus on systems of people and technology intended to design, market, produce, and distribute products or services. Almost everything that goes on in business is part of one or more systems. As noted above, when we face a management problem we tend to assume that some external event caused it. With a systems approach, we take an alternative viewpoint -- namely that the internal structure of the system is often more important than external events in generating the problem.

Systems Thinking is a process of discovery and diagnosis an inquiry into the governing process underlying the problems we face. It helps in building more choices not answers, into our thinking process. It creates a framework for productive dialogue.

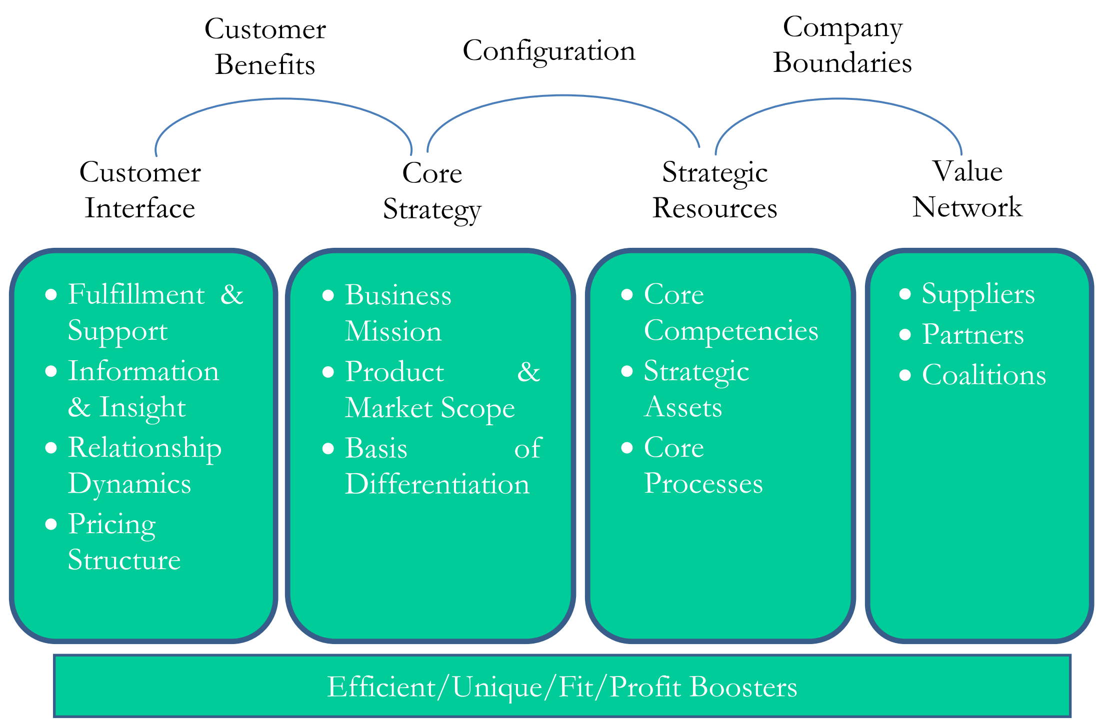


Business Model

- Can you think beyond new Products and new Services to entirely new business concepts --- ones that meet deep customer needs in ***unconventional ways?***
- Can you think of unconventional ways of recharging an existing business concept? Can you go non-linear? To be an industry revolutionary, you must develop an instinctive capacity to think about ***Business Models*** in their entirety

In order to better understand systemic behavior & dynamics ***(Linkages, Interdependencies, Interconnectedness of System's components)*** of Consumer Banking Segment within a Commercial Banking set up, let's develop a base in order to activate the learning process. One such base could be the concept of "Business Model".

Business Model



Customer Interface

Customer Interface has four elements:

1. Fulfillment and Support
2. Information and Insight
3. Relationship Dynamics
4. Pricing Structure

1. Fulfillment and Support

This refers to the way the firm "goes to the market", how it actually reaches customers ---which channels it uses, what kind of customer support it offers, and what level of service it provides.

2. Information and Insight

This refers to all the knowledge that is collected from and utilized on behalf of the customers. The information contents of the customer interface. It also refers to the ability of a company to extract insights from the information. Insights that can help it do cool new things for customers. It also covers the information that is made available to customers' pre-and post-purchase.

3. Relationship Dynamics

This element refers to the nature of the interaction between the producer and the customer. It looks at if the interaction is face to face or indirect, is it continuous or sporadic, how easy is it for the customer to interact with the producer, what feelings do these interactions invoke on the part of the customer, is there any sense of "loyalty" created by the pattern of the interactions? The notion of relationship dynamics acknowledges the fact that there are emotional, as well as transactional, elements in the interactions of the producers and consumers, and that these can be the basis for a highly differentiated business concept.

4. Pricing Structure

You have several choices in what you charge. You can charge customers for a product or for service. You can charge customers directly or indirectly through a third party. You can bundle components or price them separately. You can charge a flat rate or charge for time or distance. You can have set prices or market-based prices. Each of these choices offers the chance for business concept innovation, depending on the traditions of your industry.

Customer Benefits

Intermediating between the Core Strategy and Customer Interface is another bridge component ---the particular bundle of Benefits that is actually being offered to the customer. Benefits refer to a customer-derived definition of the basic needs and wants that are satisfied. Benefits are what link the Core Strategy to the needs of the customer. An important component of any business concept is the decision as to which benefits are or are not going to be included.

Core Strategy

Core strategy is the essence of **'how'** the firm chooses to compete. The key elements of Core Strategy include:

1. Business Mission
2. Product/Market Scope
3. Basis of Differentiation

Whatever your strategy, whether it is low prices or innovative products, it will work if it is sharply defined, clearly communicated, and well understood by employees, customers, partners, and investors. The key components:

- Build a strategy around a clear value proposition for the customer
- Develop strategy from the outside in, based on what your customers, partners, and investors have to say—and how they behave—not on gut feel or instinct
- Continually fine-tune your strategy based on changes in the marketplace—for example, a new technology, a social trend, a government regulation, or a competitor's breakaway product
- Clearly communicate your strategy within the organization and to customers and other external stakeholders
- Keep focused. Grow your core business, and beware the unfamiliar

1. The Business Mission:

This captures the overall objective of the strategy ---what the business model is designed to accomplish or deliver. The business mission encompasses things such as the **"Value Proposition", "Strategic Intent", or "Purpose"** and overall performance objectives. It implies a sense of direction and a set of criteria against which to measure progress.

2. Product/Market Scope

This captures the essence of ***where*** the firm competes ---which customers, which geographies, and what product segments ---and where, by implication, it does not compete. A company's definition of Product/Market Scope can be a source of business concept innovation when it is quite different from that of traditional competitors.

3. Basis for Differentiation

This captures the essence of *how* the firm competes and, in particular, how it competes differently than its competitors. A famous PC Company has redefined what a computer should look like. For years, the PC was the ugliest thing in your home or office. It looked like a disemboweled robot with cords & cables spilling everywhere. And it came in only one color, deadly boring beige. Why? Because most of the companies making PCs had an industrial products heritage they were filled with engineers not artists. This new design sold 400,000 units in the first month after its launch, and introduced an entirely new dimension of Differentiation i.e. Aesthetics into the computer industry.

Strategic Resources

Every competitive advantage worthy of the name rests on unique firm-specific resources. Dramatically changing the resource base for competition can be source of business concept innovation. The key components include:

1. Core Competencies
2. Strategic Assets
3. Core Processes

1. Core Competencies

This is what the firm knows. It encompasses skills & unique capabilities that enable a company to provide a particular benefit to customers. Some examples are:

- At a Japanese electronic company that benefit is "pocket ability" and the core competence is "miniaturization"
- At a global courier company the benefit is "on-time delivery", and the core competence, at a very high level, is "logistic management"
- Logistics are also central to an American retail stores giant to provide customers with the benefits of choice, availability, and value
- At one major IT company the customer benefit is seamless information flows, and one of the contributing core competencies is "systems integration"

2. Strategic Assets

These are what the firm owns. They are things, rather than know-how. They include:

- Brands
- Patents
- Infrastructure
- Proprietary Standards
- Customer Data
- And anything else that is both rare and valuable

3. Core Processes

This is what people in the firm actually **do**. Core Processes are methodologies and routines used in transforming inputs into outputs. Core Processes are **activities**, rather than "assets" or "skills". They are used in translating competencies, assets, and other inputs into value for customers. A fundamental reinvention of a Core Process can be the basis of business concept innovation.

Configuration

Intermediating between a company's Core Strategy and its Strategic Resources is a bridge component which could be called Configuration. It refers to the unique way in which Competencies, Assets, and Processes are **combined** & **interrelated** in support of a particular strategy. It refers to the **linkages** between Competencies, Assets, and Processes and how those linkages are managed. The notion of Configuration recognizes that great strategies (and great business models) rest on a unique blending of Competencies, Assets, and Processes.

Value Network

Value Network is the component that surrounds the firm, and which complements and amplifies the firm's own resources. Today many of the resources that are critical to a firm's success lie outside its direct control. The key components include:

46. Suppliers
47. Partners
48. Coalitions

1. Suppliers

Suppliers typically reside **"up the value chain"** from the producers. Privileged access to or a deep relationship with Suppliers can be a central element of a novel business model. Part of what has made a major internet plumbing company the most nimble competitor in the communication business has been its use of outside Suppliers. More than 50 per cent of its product does not touch its factory or employees. It just gets magically assembled and shipped, and the customer doesn't even know the company never touched it. Increasingly, such companies are using their Supplier network to dramatically reduce Working Capital and increase Flexibility.

2. Partners

Partners typically supply critical —compliments to a final product or "solution". Their relationship with producers is more horizontal and less vertical than that of suppliers. An imaginative use of Partners can be the key to industry revolution. The success of Windows platform is in large part due to the support the producer has lavished on its software development partners. Making it easy for Independent Software Vendors (ISVs) to write for Windows increases the numbers of applications running on Windows and further strengthens its market position. As early as 1999, the Developer Network included over 10,000 ISVs.

3. Coalitions

Business concept innovation requires a company to join together with other, like-minded competitors in a Coalition. This is particularly likely to be the case where investment or technology hurdles are high or where there is a high risk of ending up on the losing side of a winner-take-all standard battle. Coalition members are more than Partners, they share directly in the risk and rewards of industry revolution. A consortium of France, Germany, British, and Spain aerospace companies, is one of the world's most successful Coalitions.

Company Boundaries

Intermediating between a company's Strategic Resources and its Value Network are the firm's Boundaries. This bridge component refers to the decisions that have been made about what the firm does and what it contracts out to the Value Network. Again, an important aspect of any business model is the choice of what the firm will do for itself and what it will outsource to Suppliers, Partners, or Coalition Members. Changing these Boundaries is often an important contributor to business concept innovation.

Expanding the Innovation Horizon:

A Global CEO Study

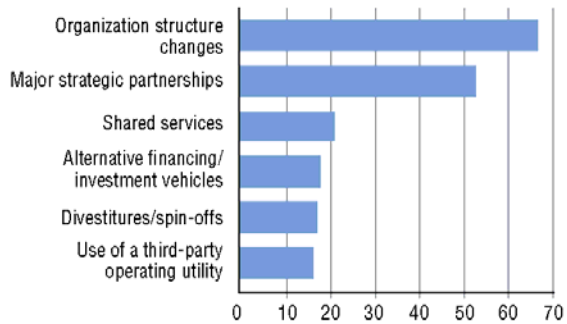
Leaders frequently define their businesses in terms of the products and services they take to market and naturally focus their innovative energy there. But with technological advances and globalization presenting so many new opportunities – and threats – CEOs are now giving business model innovation as prominent a place on their agendas as products/services/markets innovation and operational innovation. As one CEO suggested, "the three areas are essential, equally important and inseparable from each other." Some CEOs who have not focused on business model innovation in the past now believe it is time. In one CEO's words, "We are at the critical point where we should transform our business model itself." While the fact that CEOs are now focusing almost 30 percent of their innovation efforts on their business models is surprising, our financial analysis uncovered an even more interesting point. Companies that have grown their operating margins faster than their competitors were putting *twice* as much emphasis on business model innovation as underperformers. Although business model innovation is clearly important to CEOs, it is part of a combination – which makes it critical to understand more about how CEOs have been managing each type of innovation.

So, what actions are CEOs taking to adapt their business models?

Major strategic partnerships and organization structure changes topped the list of most significant business model innovations (see Figure 4).

Figure 4. Most common business model innovations.

(Percent of respondents)



Note: This question was asked of business model innovators only.

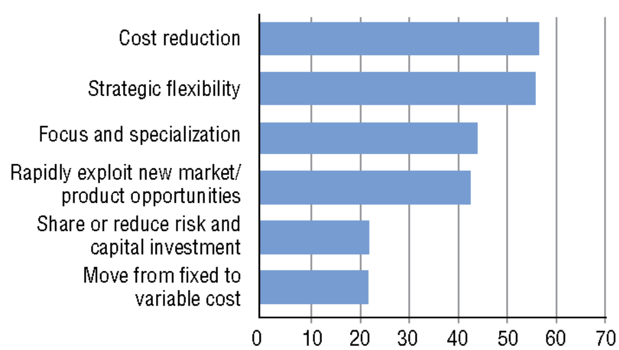
One CEO explained that the success of strategic partnerships depends heavily on a company specializing and then working toward mutually beneficial value creation. "We need to develop a business model based on strategic partnerships that creates value not just for our company, but also for the industry as a whole. We cannot do everything in this era of specialization."

Cost reduction and strategic flexibility were considered top benefits from business model innovation – reported by over half of all business model innovators (see Figure5).

Business model innovation allows companies to specialize and move more quickly to seize emerging growth opportunities. Overall, CEOs' rankings suggest that business model innovation is helping their organizations become more nimble and responsive, while at the same time lowering costs. One CEO explained: "Innovating with respect to business models and operations will not only create opportunities for cost savings, but will also lead to additional revenue generation opportunities."

Figure 5. Benefits cited by business model innovators.

(Percent of respondents)



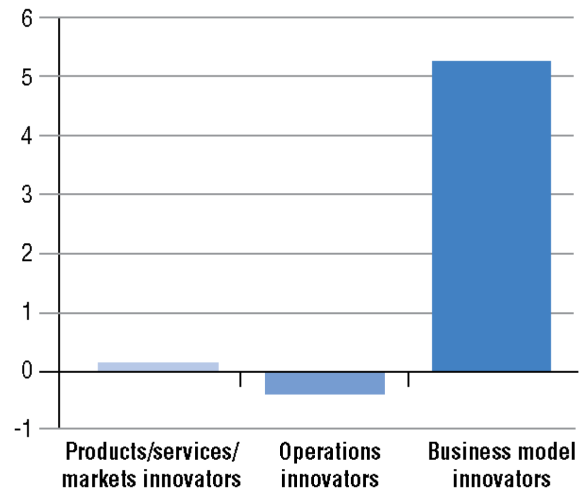
When we looked at financial performance over a five-year period, we found striking differences across the three types of innovation. Business model innovation had a much stronger correlation with operating margin growth than the other two types of innovation (see Figure 6).

Looking across the top actions business model innovators were taking, we found that companies innovating through strategic partnerships enjoyed the highest operating margin growth.

As one CEO remarked, "reducing the cost base through cooperative models is important for any growth strategy."

Figure 6. Operating margin growth in excess of competitive peers.

(Percent compound annual growth rate over 5 years)



<u>Special Note: New Ways of Thinking about Learning;</u>

An extract from the book, "Presence, Human Purpose & the Field of the Future" co-authored by Peter Senge, Otto Scharmer, Joseph Jaworski, & Betty Flowers.

QUOTE:

When any of us acts in a state of fear or anxiety, our actions are likely to revert to what is most habitual; our most instinctual behaviors dominate, ultimately reducing us to the "fight-or- flight" programming of the reptilian brain stem. Collective actions are no different. Even as conditions in the world change dramatically, most businesses, governments, schools, and other large organizations continue to take the same kinds of institutional actions that they always have.

This does not means that no learning occurs. But it is a limited type of learning; learning how best to react to circumstances we see ourselves as having had no hand in creating. Reactive learning is governed by "downloading" habitual ways of thinking, of continuing to see the world within the familiar categories we are comfortable with. We discount interpretations and options for actions that are different from those we know and trust. We act to defend our interests. In reactive learning, our actions are actually reenacted habits, and we invariably end up reinforcing pre-established Mental Models. Regardless of the outcome, we end up being "right". At best, we get better at what we have always done. We remain secure in the cocoon of our own worldview, isolated from the larger world.

But different types of learning are possible. More than five years ago, we (the authors) began interviewing leading scientists and business and social entrepreneurs.

Those interviews --- which now total more than 150 --- created the impetus for this book. We often simply began by asking each person,

"What question lies at the heart of your work?"

In our conversations with scientists, we explored emerging ideas that have the potential to shift long-established views of the separation of humanity and nature. In our interviews with entrepreneurs, we explored how new ideas and intuitive knowing are brought into reality. Together, the two groups illuminated a type of learning that could lead to the creation of a world not governed primarily by habit.

All learning integrates thinking and doing. All learning is about how we interact in the world and the types of capacities that develop from interactions. What differ are the depth of awareness and the consequent source of action. If awareness never reaches beyond superficial events and current circumstances, actions will be reactions. If, on the other hand, we penetrate more deeply to see the larger whole that generate "what is" and our connection to this wholeness, the source and effectiveness of our actions can change dramatically.

In talking with pioneering scientists, we found extraordinary insights into this capacity for deeper seeing and the effects such awareness can have on our understanding, our sense of self, and our sense of belonging in the world. In talking with entrepreneurs, we found extraordinary clarity regarding what it means to act in the service of what is emerging. But we also found that for the most part, neither of these groups talks with the other. We came to realize that both groups are really talking about the same process --- the process whereby we learn to "presence" an emerging whole, to become what George Bernard Shaw called "a force of nature."

The Field of the Future

The key to the deeper levels of learning is that the larger living wholes of which we are an active part are not inherently static. Like all living systems, they both conserve features essential to their existence and seek to evolve. When we become more aware of the dynamic whole, we also become more aware of what is emerging.

Jonas Salk, the inventor of polio vaccine, spoke of tapping into the continually unfolding "dynamism" of the universe, and experiencing its evolution as "an active process that . . . I can guide by the choices I make". He felt that this ability had enabled him to reject common wisdom and develop a vaccine that eventually saved millions of lives. Many of the entrepreneurs we interviewed had successfully created multiple businesses and organizations. Consistently, each felt that the entrepreneurial ability was an expression of the capacity to sense an emerging reality and to act in harmony with it. As W. Brian Arthur, noted economist, put it, "Every profound innovation is based on an inward- bound journey, on going to a deeper place where knowing comes to the surface".

This inward-bound journey lies at the heart of all creativity, whether in the arts, in business, or in science. Many scientists and inventors, like artists and entrepreneurs, live in a paradoxical state of great confidence --- knowing that their choices and actions really matter --- and profound humility --- feeling guided by forces beyond their making. Their work is to "release the hand from the marble that holds it prisoner," as Michelangelo put it. They know that their actions are vital to this accomplishment, but they also know that the hand "wants to be released."

Can living institutions learn to tap into a larger field to guide them toward what is healthy for the whole? What understanding and capacities will this require of people individually and collectively?

Presence

We have come to believe that the core capacity needed for accessing the field of the future is ***Presence***. We first thought of presence as being fully conscious and aware in the present moment. Then we began to appreciate presence as deep listening, of being open beyond one's preconceptions and historical ways of making sense. We came to see the importance of letting go of old identities and the need to control and, as Salk said, making choices to serve the evolution of life. Ultimately, we came to see all these aspects of presence as leading to a state of "letting come," of consciously participating in a larger field of change. When this happens, the field shifts, and the forces shaping a situation can shift from re-creating the past to manifesting or realizing an emerging future.

Through our interviews, we have discovered similarities to shifts in awareness that have recognized in spiritual traditions around the world for thousands of years. This process involves an essential quieting of the mind, where the normal flow of thoughts ceases and the normal boundaries between self and world dissolve. In the mystic traditions of Islam, such as Sufism, this shift is known simply as "opening the heart". Each religion describes this shift a little differently, but all recognize it as being central to personal cultivation or maturation.

In the end, we concluded that understanding presence and the possibilities of larger fields for change can come only from many perspectives --- from the emerging science of living systems, from the creative arts, from profound organizational change experiences --- and from directly understanding the generative capacities of Nature. ***Virtually all indigenous or native cultures have regarded Nature or Universe or Mother Earth as the ultimate teacher. At few times in history has there been a greater need to rediscover this teacher.***

Contemporary theories of change seemed, paradoxically, neither narrow enough nor broad enough. The changes in which we will be called upon to participate in the future will be both deeply personal and inherently systemic. The deeper dimensions of transformational change represent a largely unexplored territory both in current management research and in our understanding of Leadership in general. As Otto puts it, "This blind spot concerns not the what and how --- not what leaders do and how they do it --- but the who, who we are and the inner place or source from which we operate, both individually and collectively."

Source/Reference:

1) **Leading the Revolution, by Gary Hamel**
2) **IBM Global CEO Survey 2006**

LESSON 02

PROFIT BOOSTERS

Profit Boosters			
Increasing Returns	Competitor Lock-Out	Strategic Economies	Strategic Flexibility
• Network Effects • Positive Feedback Effects • Learning Effects	• Preemption • Choke Points • Customer Lock-In	• Scale • Focus • Scope	• Portfolio Breadth • Operating Agility • Lower Breakeven

The key components of profit boosters are:

- ❖ Increasing Returns
- ❖ Competitor Lock-out
- ❖ Strategic Economies
- ❖ Strategic Flexibility

Increasing Returns

This term simply refers to a competitive situation where rich tend to get richer, and the poor, poorer. It denotes a flywheel effect that tends to perpetuate early success. Those who are ahead will get further ahead, and those who are behind will fall further behind. In industries with Increasing Returns, if you win early, you're likely to get big. Economies of Scale are largely static and increasing returns are dynamics.

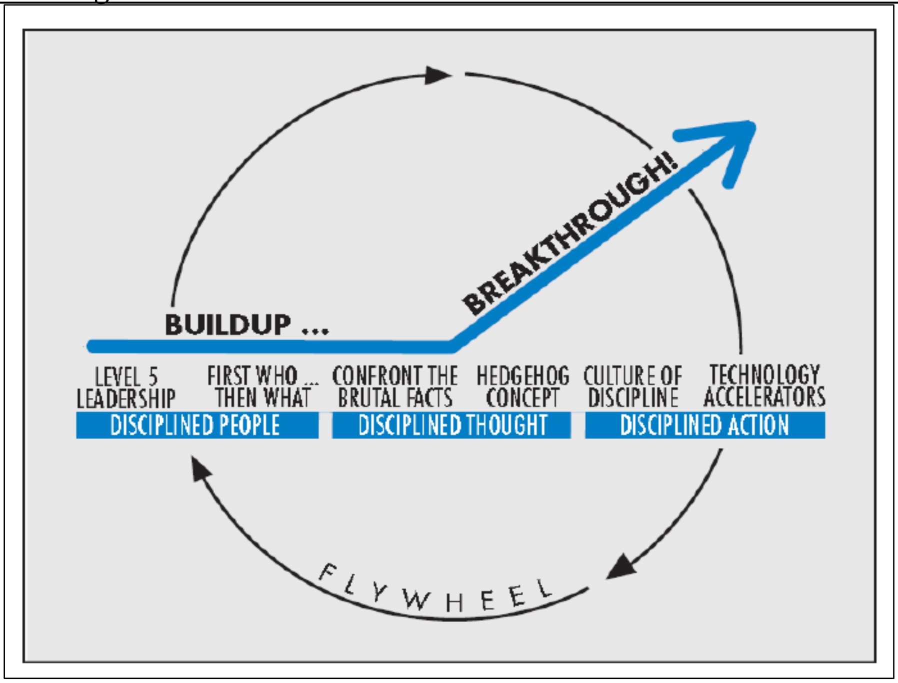
1. Network Effects

Some Business Models benefit from a strange kind of value multiplier known as "Network Effect".

In some cases, the value of a network increases as the square of the growth of "nodes", or members in the network.

2. Positive Feedback Effects

It refers specifically to the way one uses market feedback to turn an initial lead into an unbridgeable chasm for competitors. A firm with a large users' base, and a way of rapidly extracting feedback from those users, may be able to improve its products & services faster than its competitors. As a result, its offerings become better yet, and it captures even more customers. Another virtuous circle ensues.



3. Learning Effects

More & more industries are becoming knowledge-intensive. A company that gets an early start in accumulating knowledge, and then continues to learn faster than its rivals, can build an almost insurmountable lead. Knowledge accumulation is often highly correlated with experience. The notion is simple; the application of knowledge begets new knowledge. This is particularly true in cases where the critical knowledge is both complex & tacit.

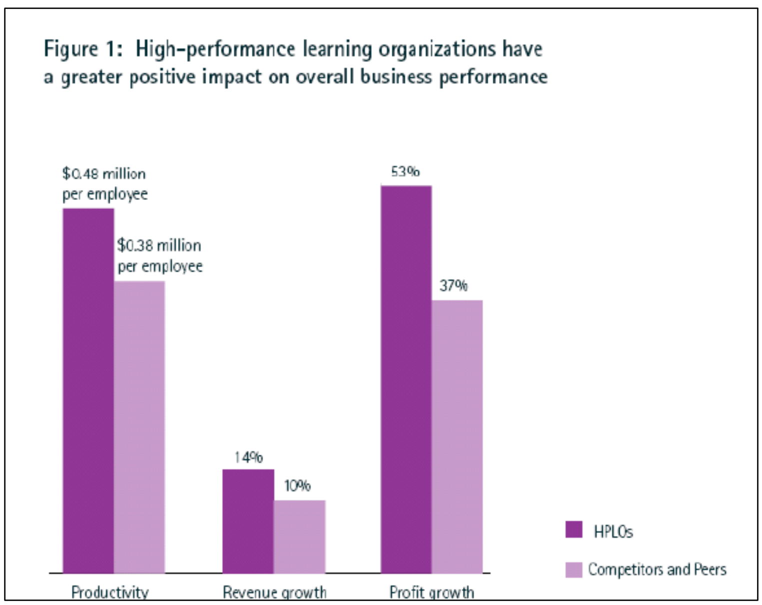


Figure 6: High-performance learning organizations are better at measuring business impact

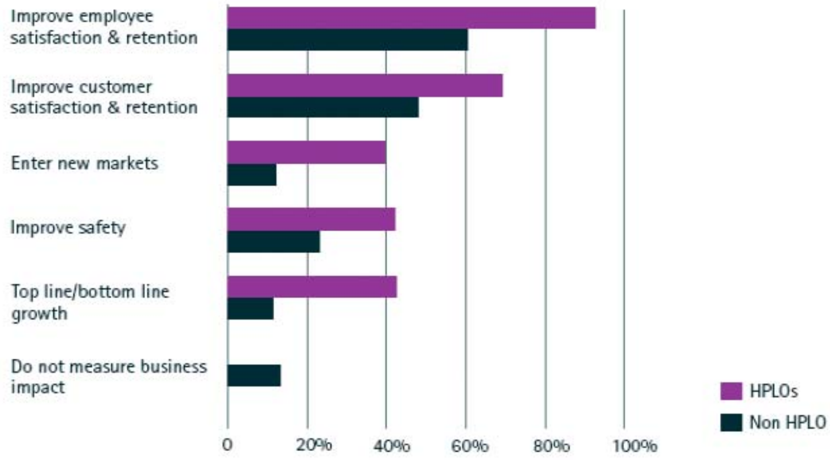


Figure 9: High-performance learning organizations are more likely to link learning content to key strategic objectives

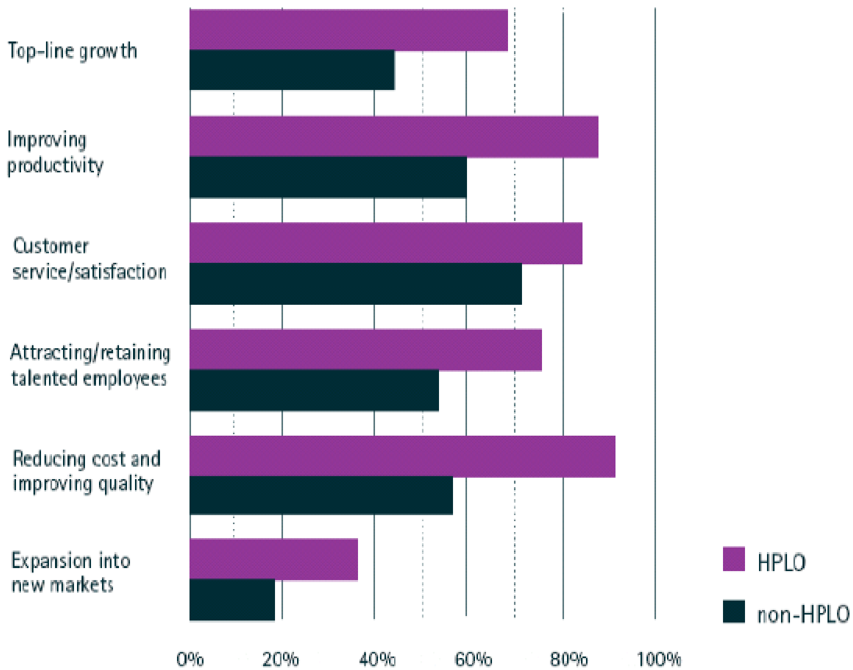
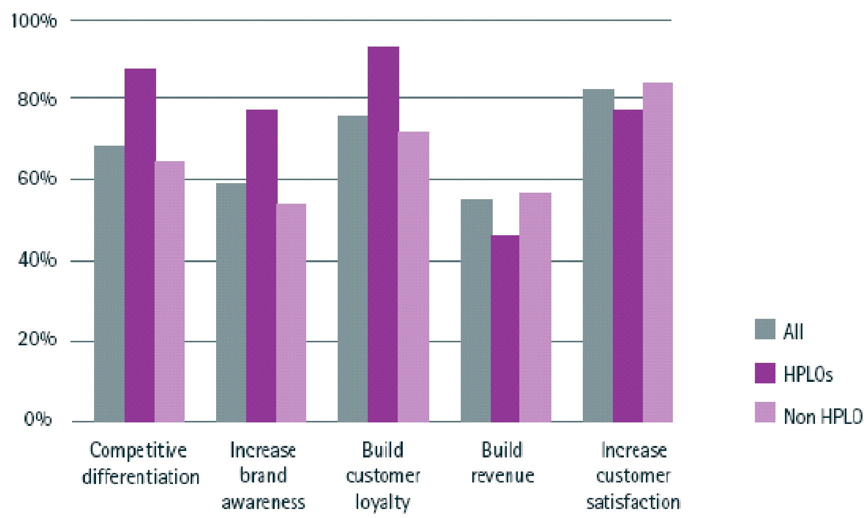


Figure 12: High-performance learning organizations recognize that customer education programs can increase loyalty and brand awareness



Competitors Lock-Out

When you find a window of opportunity, the goal is to crawl through it and lock it behind you. You want all the windfall and you don't want to have to fight for it. That's why really slick Business Model locks competitors out through:

1. Preemption
2. Choke Points
3. Customer Lock-In

1. Preemption

Where there is a great potential for increasing, merely being first may be enough to put competitors out of contention. In industries that are R&D-intensive or that have high fixed costs, there is often no second place ---you are either first or you're nowhere. First-mover advantages are never absolute, but they are often pivotal in industries with a rapid pace of technological development and relatively short product lifecycle.

2. Choke Points

Its Choke Point when in the new millennium you are trying to gain control of the cable TV Infrastructure that will allow broadband webcasting. Whoever owns the Choke Point collects the toll. If you are unwilling to pay up, you are locked-out. Window may be history's most effective Choke Point. (How & Why? Hint: IP & HTML are in public domain.) Choke Points come in many shapes & sizes; A Technical Standard, Control of some costly infrastructure, Preferential access to a government buyer, A Patent, or a Prime Location.

3. Customer Lock-In

Competitor lock-out often means Customer Lock-In. But even when you can't Lock-out all your competitors, you can Lock-In some of your customers ---through long-term supply contracts, proprietary product designs that keep them for upgrades and add-ons, or control over a local monopoly. There are many ways you can tie up your customers, but you have to be careful. A customer that feels locked in is a particularly angry beast. You got to use velvet ropes.

Strategic Economies

Unlike operational efficiencies, Strategic Economies don't drive from Operational Excellence, but from the business concept itself. Strategic Economies come in three varieties:

1. Scale
2. Focus
3. Scope

1. Scale

Scale can derive efficiencies in many ways through:

- Better Plant Utilization
- Greater Purchasing Power
- The Muscle to enforce industry wide price discipline Industries revolutionaries often consolidate fragmented industries. Any that gets caught behind the consolidation curve and misses the chance to build Scale Advantage will be left with a notable disadvantage

2. Focus

A company with a high degree of Focus & Specialization may reap economies compared with competitors with a more diffused Business Mission and a less coherent mix of products & services.

Focus is not about efficiency in a cost sense; it's about in a don't-get-distracted, get-all-the-wood-behind-one-arrow sense.

3. Scope

The idea here is almost opposite of focus. A company that can leverage resources and management talents across a broad array of opportunities may have an efficiency advantage over firms that cannot. Scope Economies come from sharing things across business units & countries; Brands, Facilities, Best Practices, Scare Talent, IT Infrastructure, and so on. Scope Economies come in a variety of flavors; Channel Power & access to distribution channels, Economies in buying ad space & running high-tech distribution centers.

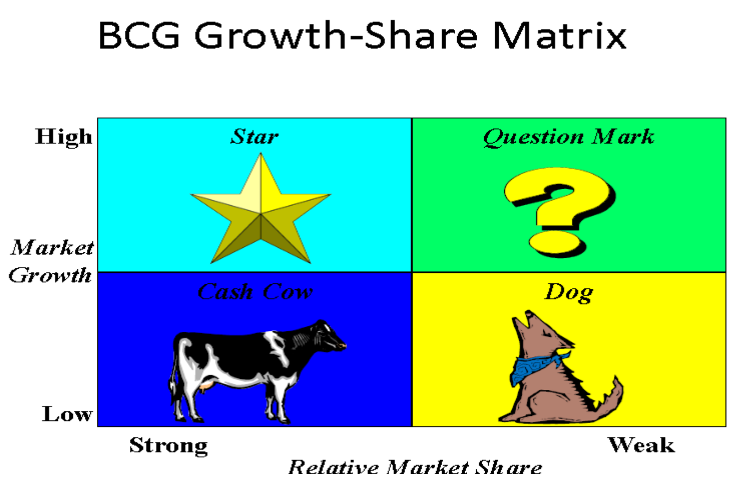
Strategic Flexibility

In a fast changing world, with unpredictable demand cycles, Strategic Flexibility can generate/sustain higher profits by helping a company stay perfectly tuned to the market and avoid getting trapped in dead-end Business Models. Strategic Flexibility comes from:

1. Portfolio Breadth
2. Operating Agility
3. Low Break-Even Point

1. Portfolio Breadth:

Focus is great, but if the world moves against you, you may lack other options. Linking the fortunes of your company to the fortunes of a single market can be a high-risk gamble. A company with a broad offering may prove more resilient in the face of rapidly shifting customer priorities than a more narrowly focused competitor. A portfolio can consist of Countries, Products, Businesses, Competencies, or Customer Types. The essential point is that it helps to hedge a company's exposure to the vagaries of one particular market niche.



2. Operating Agility

A company that is able to quickly refocus its efforts is better placed to respond to changes in demand and can thereby even out profit swings.

Given the fact that a very successful American Computer Company owns few fixed assets, it is able to quickly reconfigure its selling approach & product line to suit changing market conditions.

The emerging world of on demand:

- As the financial services industry heads toward an on demand operating environment, monolithic, vertically integrated institutions face stark new challenges
- In today's hyper-responsive marketplace, survival favors the agile; speed can be a critical differentiator; and the organizational status quo is often a liability
- An on demand business is an enterprise whose business processes –integrated end-to-end across the company and with key partners, suppliers and customers –can respond with flexibility and speed to virtually any customer demand, market opportunity or external threat.

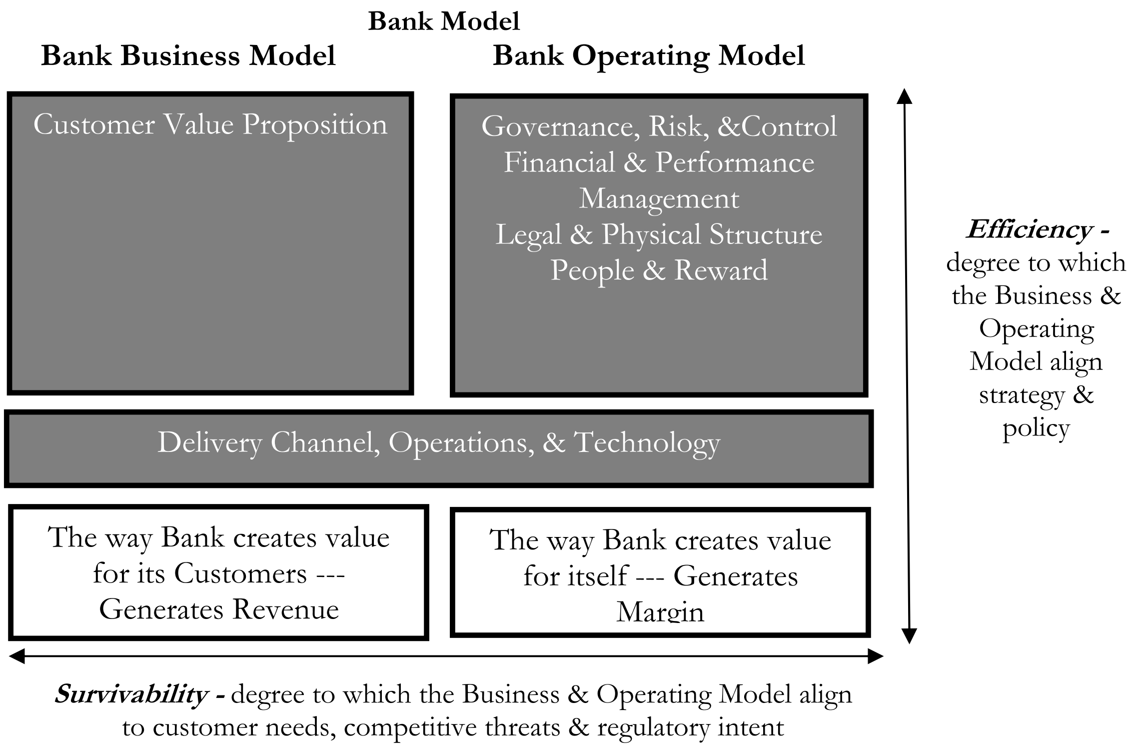
3. Lower Break Even

A business concept that carries a high breakeven point is inherently less flexible than one with a lower breakeven point. Capital intensity, a big debt load, high fixed cost ---such factors tend to reduce the financial flexibility of a Business Model. In doing so, they also reduce Strategic Flexibility, in that they make it more difficult to pay off one thing so that you can go on and do another thing.

Bank Business and Operating Model Dynamics

The business model represents the value proposition to the customer; it is made up of the products and services for which the customer will pay and success will be defined by the degree to which customer needs are met. While the business model can be configured in a number of different ways, customer segment, product and geography are typical for many banks.

The operating model is made up of the functions required to support, control and manage the delivery of the products and services that make up the customer value proposition. Typically, these functions are not directly paid for by the customer, but might be integral to the product or services offered – business support functions. Alternatively, they are functions that are required to support, control and manage value creation for the bank itself – corporate functions. While they can be grouped in a number of ways, we consider five core operating model functions: governance, risk and control; financial management; delivery (channel, operations and technology), legal and physical structure; and people and reward. (See diagram below).



Bank Business Model

It represents the ***Value Proposition*** to the customer; it is made up of the Products & Services for which the customer will pay and success will be defined by the degree to which customer needs are met.

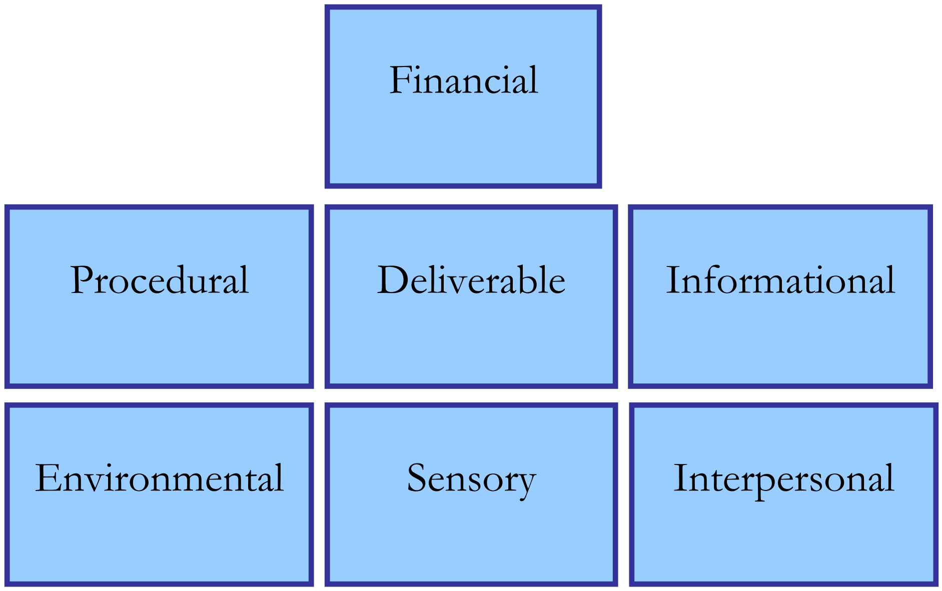
While the Business Model can be configured in a number of different ways, the typical are:

- Customer Segment
- Product Category
- Geographical Differentiation

Value Proposition

A business or marketing statement that summarizes why a consumer should buy a product or use a service. This statement should convince a potential consumer that one particular product or service will add more value or better solve a problem than other similar offerings. The ideal value proposition is concise and appeals to the customer's strongest decision-making drivers. Companies pay a high price when customers lose sight of the company's value proposition.

Seven Dimensions of the Customer Value Package



In the context of these seven dimensions let's take the example of a Bank:

Financial
This dimension concerns Returns/Profit paid on deposits or other investments products, Mark-Up charged on Loans and other credit facilities, Fees/Commission recovered for various Non-Financial Services provided to the customer. Here the concept is not only that Rates/Fees/Commission are competitive and favorable to the customer but they should have been advised/communicated to the customer in a timely, unambiguous, and transparent manner with no fine print or hidden elements. It is an observed phenomenon that a number of customers don't mind paying premium price for some products/services if they perceive having received higher value due to the overall value package.

Procedural
This refers to the various processes/steps involved while entering into/maintaining a relationship with the bank. How simple and convenient it is for a customer to deal with the bank while undertaking any transaction. To what extent bank systems are customer friendly and the bank is not a "prisoner" of its own systems.

Deliverable
Although banking is a service business with no tangible products but certain items still needs actual delivery while maintaining quality standards. Examples are Cash/Currency Notes, Check Book, Credit/ATM Card, Statements of Account, Promotional Items, and Gift Packs on various occasions.

Informational
This dimension deals with the Reliability, Timeliness, Accuracy, Authenticity, Currency, and Relevancy of various information provided to the customer. These attributes will establish the level of confidence and trust which the customer should have with its banker and will be key in the decision making process of the customer in purchasing the products/services offered by the bank. Above all, there should be the highest level of transparency in every aspect of customer information and communication processes.

Environmental
This concern with the Physical Setting, Aesthetics, Cleanliness, Hygienic Conditions of the Branch, ATM Booth, Kiosks, or any other place where customer physically experiences an interaction with his/her banker. A place with proper lighting arrangement, Air-Conditioning/Heating System, Signage, Comfortable

Waiting Area, Queuing arrangement, Public Address/Sound System are some examples of what makes a positive impression on a customer.

Sensory

This dimension deals with the human sensory attributes of Touch, Sight, Sound, and Smell. Any "Touch Point" where a customer has a pleasant sensory experience in the above mentioned attributes will add to the good image of the bank and could contribute towards its value building efforts.

Interpersonal

Attitude & Behavior of the staff members especially towards the customers is crucial in providing a higher Value Proposition. A cooperative, friendly, energetic, responsive, and empathetic staff will be a key differentiator between a bank and its competitors. Nowadays it is common for all organizations especially those having extensive customer interface to pursue the policy of "Hire for Attitude, Train for Skills."

Bank Operating Model

It is made of the Functions required to Support, Control, and Manage the Delivery of the Products & Services that make up the Customer Value Proposition.

Typically, these functions are not directly paid for by the customer, but might be integral to the Products or Services offered --- Business Support Functions. Alternatively, they are functions that are required to Support, Control, and Manage value creation for the Bank itself --- Corporate Functions.

Business Support Functions or Corporate Functions in the Operating Model usually consist of the following Core Functions:

- Governance, Risk, and Control
- Financial & Performance Management
- Delivery (Channel, Operations, and Technology)
- Legal & Physical Structure
- People & Reward

Governance, Risk and Control

Addressing the overall levers of Control and Management, governance, risk, and control are central to the decision-making required to derive Value Creation. The key components include how the Board and Non-Executive Directors (NEDs) are measured, are the Executives robustly supported and challenged, controls & policies embedded within the business, are these controls & policies adhered to when they clash with the Business Model.

Financial and Performance Management

This Function has line of sight on the overall profitability of the Bank and it needs to align costs appropriately to the Business Model. As a consequence of recent global financial crisis, expected lower returns & higher capital ratios will result in financial management having greater involvement in product design and franchise targeting. The key issues include:

- Simplification of Capital & Funding Structure
- Responding to new patterns of Supervision
- Aligning internal performance reporting and emerging external techniques for analyzing & valuing Bank performance

Delivery (Channel, Operations, Technology)

This function typically spans both Business & Operating Model in that it also encompasses the core business support functions. The key issues include:

- Platform resilience & redundancy
- Strategic Sourcing
- Managing supply chain security & scale through shared services

Legal and Physical Structure

The Structure of the Bank is under increasing review. Recent bank failures have highlighted the complex legal entities that have developed at a number of institutions, often without any alignment to Business and Operating Model efficiency. As Banks consider the best ways to ensure funding, regulatory alignment & tax efficiency, the legal and physical structure of the Bank requires realignment & simplification.

People and Reward

Reward across the Business Model needs to be reconsidered; both to ensure it is genuinely aligned to long-term sustainable value and allows the functions that determine the sustainable profit of the business to stand on equal footing to those that generate its immediate revenue. The key issues include:

- Incorporating Risk into performance measures
- Design of deferred compensation
- Remuneration governance

As banks look to the future, transitional change will probably be insufficient – structural and transformational change must be considered. Regardless of changes to the business strategy, the way that strategy is delivered will certainly change.

Transformational changes to the business and operating model are rarely undertaken, but the current environment provides a 'perfect storm' of the driving forces behind such wholesale reconstruction: dramatic adverse changes in financial performance, significant regulatory intervention and substantial changes to leadership teams.

Short-term survival is clearly critical, but, as balance sheet stability is restored, banks need to consider appropriate business and operating models that will ensure their long-term survival. The urgent need to address short-term financial considerations can lead to longer-term mistakes when assessing which assets are core and which are non-core.

Instead, these longer-term decisions on which assets are vital to the new strategy need to be derived from basic thinking around the customer value proposition and the ongoing ability of the bank to derive value from that model having regard for the appropriate levels of risk versus reward.

Banks will need to consider the appropriate mix of products and services they can deliver and manage, where they sit on the mono-line – universal bank continuum, the balance between distribution and manufacture, the ability to scale and the effectiveness of embedded control.

The future will probably bring changes to whichever part of the value chain banks choose to operate in, particularly for the universal banking model, where most will recognize they lack the scale and reach to serve fully their franchise with owned product and infrastructure.

The nimble, who have a fully developed, needs-based customer value proposition will understand that packaging an appropriate set of products and services together, some of which might be white labeled from others, adds more value than providing a limited range of fully owned products and services.

Banks need to understand clearly all the different aspects of their business and operating model because they are intertwined – decisions to change one part of the model will have significant consequences for the other aspects. This interconnectivity makes structural change highly complex and the process of change can, in itself, be a cause of operating model failure. With this in mind, banks must be wary of poorly thought through or knee-jerk reactions.

LESSON 03

BANK BUSINESS & OPERATING MODEL (BOM): AN EXTENDED CONTEXT

Where Are We Now…

The financial services sector has been blessed by a benign business and regulatory environment over the last decade, which masked a number of unsustainable business models within the industry. But a **more awkward truth for many is that the financial crisis and wider global recession** have challenged the core operating models responsible for delivering the business strategy.

As banks look to the future, **transitional change is probably insufficient – structural and transformational change must be considered.** This is not simply a case of conducting a review of the business model and reassessing the value proposition of the bank, but understanding how the future business model will be delivered. Regardless of changes to the business strategy, the way the strategy is delivered will certainly change.

This type of change is hugely complex. There are many aspects of the business and operating model to consider and these are encumbered by legacy practices, processes and systems that frequently represent the cultural core of the organization. Transformational changes to the business and operating model are rarely undertaken, but the current environment provides a 'perfect storm' of the driving forces behind such wholesale reconstruction: dramatic adverse changes in financial performance, significant regulatory intervention and substantial changes to the leadership team.

Change in Financial Performance

The period 2001–2007 was one of uninterrupted growth in financial services, underpinned by increasing gross domestic product (GDP) growth, expansion of global trade, ample wholesale funding and low inflation. Unprecedented volatility and a sharp downward trend in financial performance from 2007 onwards has prompted an urgent need to restructure balance sheets, reduce costs and improve risk management, but it has also highlighted the reality of operating performance over the last decade. The initial findings of PricewaterhouseCoopers research shows that improved operating efficiency – when measured by cost/income – has been driven by strong income growth rather than significant improvement on the cost side. Strong levels of GDP growth underpinned the expansion in income, but so too did higher levels of balance sheet leverage through increased use of wholesale funding. With liquidity risks now better understood, it is increasingly clear that apparent improvements in operating efficiency over the last decade were at least in part achieved through increased exposure to liquidity risk. **Hence, banks must consider the structures of their BOM not simply in terms of Efficiency, but the degree to which they can survive.**

Regulatory Intervention

Regulators have discovered that their rules have proved ineffective in both predicting and preventing the crisis. They have been forced to intervene where an entity is failing or at risk of failing and, naturally, they have demanded fundamental changes to the organization in return for coming to its rescue. Most of the big global banks, which have been judged too big to fail, have resorted to support from the lender of last resort – the government. The larger the intervention, the bigger the changes demanded.

Changes to Leadership

A new team at the top, whether appointed through succession, acquisition or forced change, will want to establish their own vision for the organization. This new vision then cascades down through the organization in the form of changes to the business and operating models.

These drivers, particularly when they converge, are a trigger for substantial change. Banks, however, must consider the structure of their business and operating models, not simply in terms of efficiency, but the degree to which they can survive.

Banks need to understand clearly all the different aspects of their business and operating model, because they are intertwined – decisions to change one aspect of the model will have significant consequences for the other aspects. For example, changes in liquidity regulation and strategy could require changes to the legal entity structure. Changes in risk appetite could define targeted customer segments and the use of low-cost geographies could impact on product and service performance. **This interconnectivity makes structural change highly complex and the process of change can, in itself, be a cause of operating model failure.** With this in mind, banks must be wary of poorly thought through or knee-jerk reactions. Hence, survivals more than just a short-term problem.

As discussed in the earlier section on strategy, knee-jerk reactions to the current situation can undermine both the customer and bank proposition. The new financial environment is creating both challenges and opportunities, but hasty decision-making, either in the form of disposals or acquisitions, can destroy value. Significant examples of both of these situations have been seen in the past 12 months. Short-term survival is clearly critical, but, as balance sheet stability is restored, banks need to consider appropriate business and operating models that will ensure their long-term survival. Replicating the existing model with a few bits cut away or bolted on will not prove sufficient.

Core verses Non-Core

A number of banks are considering which of their assets are core and which are non-core as part of a strategy and business model review. But the urgent need to address short-term financial considerations can lead to longer-term mistakes. Assets considered for disposal are usually identified by the ease with which they can be carved out, their distance from the centre of the organization and their immediate market value. The very nature of this decision-making process means the underlying business and operating model will probably remain unchallenged.

Longer-term core versus non-core decisions need to be derived from basic thinking around the customer value proposition and the ongoing ability of the bank to derive value from that model. **Banks will need to consider the appropriate mix of products and services they can deliver and manage, where they sit on the mono-line – universal bank continuum, the balance between distribution and manufacture, the ability to scale and the effectiveness of embedded control.**

Understanding the Customer

Banks need to go back to thinking about customer needs and the way these needs are met. **Customer segmentation models are traditionally broken down by geography, turnover or income, and industry group or demographic, but this type of segmentation originated from a credit-based relationship.**

As the cost of capital and liquidity increases, a fundamental repricing of balance sheet capital usage will occur. **Sophisticated banks, however, will think beyond repricing and look at the underlying segmentation of their customers to seek out areas of profitability that are less dependent on capital consumption.** There is a long-term trend in the industry away from net interest income (NII) to non-NII revenue sources (non-NII revenue rising from about 25% of total revenue in 1980 to 45% in 2000). This trend is likely to continue and current segmentation and relationship models should be challenged. In a recent PricewaterhouseCoopers survey[3] of corporate treasurers the primary way these key bank customers measured the value they created for their own institutions was through managing the bank relationship, and the predominant way they measured the value of that relationship was cost. This suggests that this part of the business model should have been questioned prior to the current financial crisis.

Manufacturing – Do You Need to Own it?

Banks must also consider the mechanisms through which they deliver the customer value proposition. Internet banking models have proved that the once-strong link between the size of the branch estate and market share can be challenged. White-labeling and product-aggregation models have proved that franchise ownership is not dependent on owned products and operations, while originate-and-distribute models have demonstrated that a bank need not be constrained by its own balance sheet when servicing customers' funding requirements.

The future will probably bring changes to whichever part of the value chain banks choose to operate in, particularly for the universal banking model, where most will recognize they lack the scale and reach to serve fully their franchise with owned product and infrastructure. The nimble, who have a fully developed, needs-based customer value proposition will understand that packaging an appropriate set of products and services together, some of which may be white labeled from others, adds more value than providing a limited range of fully owned products and services.

These emerging models will require a different set of skills in terms of managing the delivery components of the operating model – security of the supply chain will become increasingly central to operations, while risk management and people and reward programs will need to reflect this skill set change.

Achieving Scale

Margins in financial services will be increasingly tested. There has been a step change in the available revenue pool and while pricing and costs are being adjusted, a 300lb man that loses 30lbs is still overweight, however many notches on his belt he claims to have tightened. Banks will need to look for transformational cost reduction and this will be found through scale in all aspects of the business. Previously discrete areas will be deconstructed and synergies sought through shared services in low-cost locations. Coverage models will need aligning internally and to the customer, while historical branch and subsidiary structures will require reviewing in terms of regulatory alignment, funding requirements, tax efficiency and contract efficiency. **Every aspect of a bank's business and operating model will need to be scaled or, if it is not, have specific and clearly understood reasons why.**

Embedding Control

An essential element of the operating model is the efficiency with which it generates value for the bank. The current financial crisis has highlighted the degree to which banks' operating models failed to fully control their businesses as they developed. For example, the way business growth plans were developed and driven while disconnected from risk appetite models; how control staff was ignored by the business and boards lacked the confidence, or insight, to challenge the executive. In future, banks will need greater focus on the sustainability of their business models and that requires clear governance and embedded control.

Overall, considerations around customer value proposition, end-to-end ownership, scale and control, raise questions about the future of the universal banking model and the degree to which those institutions using that model can remain focused, scaled and controlled enough to optimize shareholder value.

Risk Management

Risk Management function has acquired a heightened importance. Valuation techniques using historical data, has proved inadequate. Substantial Improvements through multiple approaches will be required. Alongside Measurement, the remaining areas of Risk Management framework, e.g. Identification, Monitoring, and Mitigation will also be given more attention. There will be a need for renewed & greater emphasize on Liquidity & Operational Risk while making business decisions. Regulatory requirements & Regulators intervention will assume greater significance forcing Banks management to undertake major adjustments in their approach.

Complexities of Transformational Programs

The strategy section of this paper identifies the problem of institutions becoming stuck in 'panic' mode and discusses the directionless inertia that it can create. This inertia can be compounded by the scope and complexity of the change that is required. As organizations set out their plans for the future, both in terms of positioning (business model) and delivery (operating model), they need to understand the complexities of achieving their goals. We consider five complexities when undertaking transformational programs:

- **Business model complexity:** Understanding the scope of the value proposition and the way it is delivered
- **Process complexity:** Deconstructing business processes to achieve cross-process scale
- **Organizational complexity:** Realignment of the organization to new business and operating models
- **Contractual complexity:** Security and optimization of the bank's supply chain
- **Cultural complexity:** Challenging the way things are done and replacing the reference points that provide day-to-day certainty

The leadership at banks faces a considerable task in setting out their vision for the future. The first step is to define the strategic principles of the business and operating model and to understand their impact. The second step is to ensure alignment and common understanding of the principles across the leadership team, and the third is to communicate.

Over the past 18 months (since mid 2007) financial services have changed fundamentally and permanently. Before the crisis, systemic risk was a subject for abstract theoretical discussions and seen as something for others to worry about. Derivatives, securitization, risk management and the Basel banking regulations were thought to have made the world a safer place, not a more dangerous one. Then everything changed.

In a previous paper perspective was offered on the global financial crisis in order to examine how the foundations of financial service institutions have been shaken to their core. The speed and intensity, with which financial markets changed, combined with the scale and complexity of banking models exposed the structural weaknesses of major players. Some global institutions have disappeared, while only a few are able to survive on their own and gain market share. Typical reactions to the crisis have been short-term in nature, in many cases driven by the need for survival. Short-term actions alone will not suffice and fundamental questions need to be asked and issues tackled. A few leading institutions are beginning to address those fundamental issues and prepare themselves to prosper in the new world while most have not begun the process.

The Key Questions

How will institutions address risk management, capital and liquidity requirements? The need to take risks, hold capital against those risks and manage mismatches in positions through effective liquidity management is fundamental to banking. The fundamentals have not changed. Many of the assumptions that were used to model these fundamentals in the past have changed for good. Businesses that were once seen as profitable are now uneconomic; businesses once seen as safe are now seen as reckless. Institutions will need to be able to make robust decisions based on sound understanding of true profitability after having reflected the return required for the risk and the capital used.

How will Banks Make Money in the Future?

Banking is of vital importance to the global economy; therefore a successful, profitable and competitive financial system is essential. Banks must determine which customers they will serve, in which markets and with what products. There is, however, no guarantee that size will be the key to success, or that existing banks will be able to preserve their franchise. Shareholders have already penalized those banks that built up poor credit portfolios; they will soon start to reward those banks that can generate profitable revenues without taking undue risk.

What will the regulatory environment be like and how will individual institutions need to respond? High-profile regulatory action has already been taken. This process will continue and institutions will need to demonstrate a greater degree of compliance with the new regulatory requirements.

Many of the institutions that have failed had comprehensive governance structures. Were these structures fundamentally flawed? Banks must ask whether those charged with governance have the right skills, individually and collectively, to be able to challenge constructively and must ensure oversight functions have access to all the information needed to effectively analyze the risks the business faces.

Finally, how well will business models survive and will they be efficient? The changed market environment has exposed weaknesses in business models, but while no bank has the luxury of starting from a clean sheet of paper, maintaining the status quo is also out of the question. Most major banks are a complex web of geography and culture, as well as products/services. This has resulted from years of organic growth, mergers and acquisitions, as well as the organization's response to product innovation, regulatory responses, tax changes, globalization and regionalization initiatives.

The efficiency of an organization's business model will be judged by the alignment it has to the strategy and the way in which it facilitates the most productive use of unique capabilities.

It is of critical importance to address all of these key priorities, in the right order, and to ensure the responses are aligned. This is what will differentiate the leading institutions from the second-tier players in the future, and ensure survival in the new world.

Purpose of this Extended Context and Re-Emphasis on Bank Business & Operating Model is to remind you to regularly visit and re-visit the concept in order to better understand the dynamics of Consumer Banking (CB) Business.

Banks vs. Banking

- Bank is a Form, Banking is a Function (Former is a Noun, later is a Verb)
- Banks may get deconstructed, reshaped, become redundant, or disappear altogether
- Many Non-Bank entities will start providing Banking Services
- On the contrary, Banking as a Function will Survive & Thrive because people's needs for financial services & products facilitated by the Banking Function will not disappear
- Future R&D and Innovation in Financial Services Industry will be geared more towards Banking as a Function rather than on Banks as an entity
- While Banking in general has been dramatically impacted by the financial crisis, many areas of Retail Banking remain inherently highly profitable
- This fact has not gone unnoticed to Non-Financial Companies with strong brands and resources
- A number of them will enter the Banking Market/Industry looking to take market Share from traditional Banks
- In Pakistan due to Regulatory requirements/constraints this may not seem straightforward
- However, we, in Pakistan, can't afford to ignore global trends and remain marginalized in the international community
- This may soon lead to Regulators/Authorities reviewing and relaxing concerned rules

Non-Financial Companies threat to Banks: Why/How?

- Retail Banks management time & energy diverted towards issues of survival, restructuring, & reducing cost base limiting their response to such threats
- Many are capital constrained & have significant, costly & time-consuming legacy issues to overcome if they are to undertake major transformation
- Enhanced regulation resulting in lower revenues from penalty fees plus scarcity of capital leading to limiting their response
- According to a Jan '09 survey in UK, Banks reputation is at an all-time low. Some 30% of consumers are highly unsatisfied with their services

Source/Reference:

1. **The Future of Banking**
2. **PWC Briefing/Report (July 2009)**

LESSON 04

CONSUMER, CONSUMER RIGHTS & PROTECTION

Who is a Consumer?

Consumption is basic to human survival and it must be shared, strengthening, socially responsible and sustainable. Therefore, we all are consumers, whether of goods or of services, whether purchased or otherwise, and whether provided by the market or the public sector.

Consumer is somebody who uses a product or service. A consumer may not be the purchaser of a product or service and should be distinguished from a customer, who is the person or organization that purchased the product or service.

A Consumer:

- One that consumes, especially one that acquires goods or services for direct use or ownership rather than for resale or use in production and manufacturing
- One that utilizes economic goods; *specifically* **:** an individual who purchases goods for personal use as distinguished from commercial use

Consumer or Citizen

State recognizes people as citizens, whereas markets treat people as consumers and value them as customers. Even markets are located within the States. And people's status as citizens is more overarching than their status as consumers. Thus people's rights as consumers are interlinked with their rights as citizens; both need to be pro-actively promoted and protected from predatory factors in the market and the State. In particular, poorer citizen-consumers, who do not have the "dollars" to make the market respond to the "one dollar, one vote" principle, do have the right to make the state – and hence the market respond on the "one person one vote" principle. This standpoint also links up the consumer movement with other human rights movement. In the age of globalization, this realization has become more important than ever before. The former President of Consumers International, Rhoda Karpatkin, said that "Consumer activism is exercising citizenship".

Consumption is basic to human survival and it must be shared, strengthening, socially responsible and sustainable. Therefore, we are all consumers, whether of goods or of services, whether purchased or otherwise, and whether provided by the market or the public sector.

While buying in the marketplace is one important form of consumption, it is not necessary to be a customer to qualify as a consumer. However, the concept has been associated with market so closely that it has assumed a very restrictive meaning. In a country crippled with poverty, where we pay heavily but indirectly for goods and services from our State (including infrastructure development, defense, good governance, and so on), we are citizen-consumers. While the market has at least some level of self-corrective mechanisms to meet the demands of customers, the State in Pakistan does not have the most basic democratic channels to meet the demands of its citizens. Therefore, it is crucial to broaden our understanding about consumers in order to be inclusive of poor citizens and their rights as consumers whom markets can ignore but the State and the consumer movement cannot.

What are Consumer Rights?

Based on the United Nations Guidelines for Consumer Protection, 1985 (to which Pakistan is a signatory), the global umbrella body Consumers International articulated a set of eight, internationally accepted consumer rights that need to be actively protected and promoted.

The Right to Basic Needs means the right to basic goods and services which guarantee survival. It includes adequate food, clothing, shelter, health care, education and sanitation.

The Right to Safety means the right to be protected against products, production processes and services which are hazardous to health or life. It includes concern for consumer long-term interests as well as their immediate requirements.

The Right to Be Informed means the right to be given the facts needed to make an informed choice or decision. Consumers must be provided with adequate information enabling them to act wisely and responsibly. They must also be protected from misleading or inaccurate publicity material, whether included in advertising, labeling, and packaging or by any other means.

The Right to Choose means the right to have access to a variety of products and services at competitive prices and, in the case of monopolies, to have an assurance of satisfactory quality and service at a fair price.

The Right to Be Heard means the right to advocate consumers' interests with a view to their receiving full and sympathetic consideration in the formulation and execution of economic and other policies. It includes the right of representation in government and other policy-making bodies as well as in the development of products and services before they are produced or set up.

The Right of Redress means the right to a fair settlement of just claims. It includes the right to receive compensation for misrepresentation of shoddy goods or unsatisfactory services and the availability of acceptable forms of legal aid or redress for small claims where necessary.

The Right to Consumer Education means the right to acquire to knowledge and skills to be an informed consumer throughout life. The right to consumer education incorporates the right to the knowledge and skills needed for taking action to influence factors affecting decisions.

The Right to a Healthy Environment means the right to a physical environment that will enhance quality of life. It includes protection against environmental dangers over which the individual has no control. It acknowledges the need to protect and improve the environment for present and future generations.

What are Consumer Responsibilities?

Consumers International also articulated five basic responsibilities of all consumers.

- **Critical Awareness** – the responsibility to be more alert and questioning about the price and quality of goods and services we consume
- **Action** – the responsibility to assert ourselves by acting to ensure that we get a fair deal. As long as we remain passive consumers, we will continue to be exploited and manipulated
- **Social Concern** – the responsibility to consider the impacts of our consumption patterns and lifestyles on other citizens, especially the poor, disadvantaged or powerless consumers, whether they be in the local, national or international community
- **Environmental Awareness** – the responsibility to realize the environmental costs and consequences of our consumption patterns and lifestyles. We should recognize our individual and collective social responsibility conserve natural resources and to preserve earth for present and future generations
- **Solidarity** – the responsibility to come together and organize consumers in order to enhance the strength and influence required to promote and protect our interests

Why Consumer Protection?

Citizens need protection of their consumer rights in three ways:

- in the market place against problem goods and services; against bad trade practices; exploitative prices and unethical marketing;
- from governments as supplier of basic goods and services for poor and vulnerable consumers; as formulators of public polices so that they are just, equitable and protective; and as provider of good governance;
- from the State to provide reliable consumer protection structures which ensure safety against weaknesses of the market and its failures and which ensure good government.

The importance for consumer protection has assumed renewed importance today. Globalization and its various instruments have posed new challenges for consumer protection especially in poor countries.

The greatest challenge for consumer movement today is to raise cogent and effective voice for bringing fairness in free market economy at local, national and global levels.

(Note: These are the Opinions/Views/Comments as expressed by The Network for Consumer Protection, Pakistan, a not-for-profit, public interest and independent non-government organization working since 1992.)

Sectoral Challenges Facing Citizen-Consumers in Pakistan

It is well recognized that there is a general lack of awareness among consumers about their legal and civic rights, due to a number of complex and inter-related factors, including a historically unresponsive state, a regularly exploitative private sector and the failure of democratic institutions in addressing consumers day-to-day and policy related problems.

The state has in many cases not protected their right to a healthy life, as guaranteed by Article 9 of the Constitution or various United Nations declarations, including for Consumer Protection, 1985. Likewise, the private sector has proved unresponsive to complaints or to the health concerns of consumers, particularly disadvantaged consumers, making full use of the lack of literacy and awareness in the country. This is further complicated by a weak regulatory structure in the country, plagued by poor implementation of social laws even when they are drafted. In addition, most of the civic sector also does not advocate for consumer rights.

As a consequence, there is little to no demand from citizen-consumers for protection of their rights, and they have had little stake in the systems and mechanisms introduced by the state, choosing by and large not to occupy the opportunities legally offered. For example, at one level there are barely adequate statutes to facilitate redress of consumers' complaints about products and services (particularly related to government provision of basic services such as water and health) in a transparent, just and timely manner. At another level, the historically weak response to the statutes that exist have left consumers cynical, and they mostly do not appropriately lodge and follow up their complaints, accepting losses and suffering violation of their rights. As above, this affects already disadvantaged consumers the most.

A growing concern for consumers, particularly in the context of a liberalizing economy, is the information inequity in the market. The overwhelming bulk of consumers simply do not have access to independent information about: products and services, government's performance on protection of their rights, how their rights are being violated by public and private sectors, and what they themselves are already legally empowered to do to protect their rights.

Policy Challenges Facing Consumers in Pakistan:
These sectoral concerns highlight the generic, policy challenges faced by consumers particularly that affect their health.

The role of corporations, especially their lack of responsiveness and ethical behavior coupled with the inability of the state to check their functioning in Pakistan, is problematic. The fundamental issue is one of the accountability of most corporations that are primarily in place to make profits, even at the cost of consumer health. The ways in which corporations are exercising their role is now more complex than ever, not only through directly unethical and in some cases illegal marketing but also through indirectly promoting a consumer culture that values purchases more than health.

This culture is instilled in consumers from school onwards, and the role of the media itself commercialized in this regard also goes largely unchecked. The corporatization of the mind has begun in earnest in Pakistan and consumers, particularly lower middle class consumers, are increasingly under threat. While calls for corporate social responsibility abound, these have resulted in little more than "greenwash" in the country; there are no independent organizations holding corporations accountable.

However, while the problem of corporations is at one level fundamentally problematic, this is a global phenomenon which many international campaigns are targeting in different arenas. The problem is made more intense in Pakistan due to the poor state of regulation. The double whammy facing consumers in Pakistan, as above, comprises absence of appropriately motivated legislation and regulation, and poor implementation of laws where they do exist. The state of implementation of social laws has been much commented upon, and while numerous policy initiatives have been announced, none has made much difference to the fact that such regulation remains weak while at the same time there are little to no problems in implementing defense, foreign policy, or macro-finance laws. For consumer health, this situation is complicated even more because of the intensive role of the State in the provision of social services, such as drinking water, above, and justice.

This last is the final determinant of consumer welfare, since the justice system is intended to provide an independent recourse to consumers. When court procedures are lengthy and costly, and justice is neither accessible nor expected, as in most cases across the country, consumers are left to their own, weak, devices. In sum, the State problems amount to an issue of social justice.

This issue of social justice is one of democracy, in particular the absence of democratic norms in the country. From a direct consumer perspective, social justice is neither ensured nor evident in the policy processes of the country. Meaningful citizen participation in policy processes is negligible, policy processes (including implementation) are opaque, and policy makers largely unaccountable. In effect, consumers have little to no forums for raising an effective voice in matters determining their lives. They have, thus, no demand as above.

The matter of democracy is directly related to consumer rights. While Pakistan is a signatory to the UN Guidelines for Consumer Protection, 1985, it has yet to submit any report on its compliance with the Guidelines, or to be held accountable. A basic tenet of the Guidelines is that consumer rights are just that: rights, not privileges. And, therefore, the State has a basic obligation to ensure that those rights beginning with the right to satisfaction of basic needs, and moving through the right to redress. A consumer, most importantly, is not just a customer in the marketplace, but a citizen who uses goods and services not directly paid for in the marketplace.

While the Guidelines, and subsequent development of a framework by the umbrella body Consumers International, require the State to ensure these rights, they also recognize that it is unrealistic to expect the State to intervene in every case. Even a strong judicial system can act better as a deterrent that actual litigation in every matter, which would cause its own problem. In the final analysis, as understood by advocates of functional democracy, it is the demand raised by citizens themselves; in this case as consumers, that determines the efficacy of systems of protection. And for this, consumers need to be critically informed. Doubtless low literacy levels hamper mass awareness to an extent, but this barrier is neither insurmountable (given developments in electronic media) nor a deterrent to the awareness of the literate sections of the population. However, consumers in Pakistan remain unaware both of their rights, and of the increasingly insidious ways in which those rights are being violated.

These issues reflect a changed landscape since The Network last strategize its future in 1999: the previous government, the events of 9/11 and their aftermath, a vastly enhanced recognition of NGOs, a further multiplication of NGOs and donor funds, three new civil society organizations also advocating for consumer rights, growing levels of "policy advocacy", and recognition of the role of NGOs "on the table" with government but repression of a "hard" advocacy role. The Network has been a part of these trends, and derives its re-strategization from its examination of the context.

Consumer Financial Protection Agency (CFPA) of USA (Proposed)

The Consumer Financial Protection Agency, or CFPA, is a newly proposed (in Aug 2009) independent federal agency that would, if established, have single, primary authority to protect consumers with respect to financial products and services, other than investment products. It would have supervisory, examination and enforcement authority for protecting consumers with respect to credit, savings, payment and other financial products and services.

The current consumer financial protection is based on disclosure regime and is policed through supervisory feedback, enforcement actions, and occasionally prohibitions on terms, products, and practices that are deemed inherently unfair and deceptive. On the federal level, consumer protection in financial services is divided among a number of agencies. Some of these agencies have the ability to promulgate regulations, some also exercise supervisory authority over financial institutions, and some may only enforce existing regulations. Sometimes authority is over a class of institutions, and sometimes it is over a particular type of product. There are four main structural criticisms of the current regulatory structure: that consumer protection is a so-called "orphan" mission; that consumer protection conflicts with, and is subordinated to, safety-and-soundness concerns; that no agency has developed an expertise in consumer protection in financial services, and; that regulatory arbitrage of the current system fuels a regulatory race-to-the-bottom.

Consolidation of consumer financial services protection authority could: place all financial services companies, regardless of the form of their charter, under a single regulator, thus ending its orphan status; separate consumer protection from safety-and-soundness regulation, thus ending subordination; encourage the development of a deep bench of regulatory expertise and knowledge, and; end the opportunity for regulatory arbitrage and any potential race to the bottom.

There are several potential concerns about a CFPA: conflicts with prudential regulators; ambiguity with respect to Consumer Reinvestment Act authority, and; potential overregulation resulting in higher costs of financial products, less product availability, and discouragement of innovation. Still, there are compelling reasons to believe that the present regulatory architecture cannot produce the optimal consumer protection regime and will continue to fail in its task, resulting in unfair treatment of consumers and a potentially significant source of systemic risk. To this extent, consideration of a CFPA should strive to distinguish between the basic thrust of the legislation—a consolidation of the regulatory authority of—and the proposed new substantive powers granted to the agency.

CFPA Mandate is to ensure that consumers of financial products:

- Have the information they need to make wise financial decisions
- Are protected from abuse, discrimination, and unfair and deceptive practices
- Have access to financial services
- Ensure the financial services market operates fairly and efficiently

Significance of the CFPA

- Given the scope and ambition of this proposal, this is a game changer for the financial services industry
- The proposal says: consumer protection is a high priority for the federal government, and it will work in coordination with other agencies and the states to ensure that financial products that are fair, transparent, and suitable for the consumer
- Success will depend upon dedicated staff, resources, and enormous coordination throughout the federal government and the states

The Need for CFPA

- The old rules to protect consumers don't work
- Financial products are too complex
- The terms and conditions, even the disclosures, are far from clear and transparent
- The incentives of the provider and the consumer's needs may be misaligned
- Consumer often doesn't have the experience or knowledge to know where to go to get the information needed to navigate the array of product options

CFPA Authority Will

- Require that all product disclosures and communications be reasonable, balanced, and clear and conspicuous - and this would be based on significant consumer research and analysis
- Define standards for "plain vanilla" products, such as mortgages, bank accounts, and credit cards. These products would have straight forward pricing
- Have authority to place tailored restrictions on product terms and provider practices
- Enforce fair lending laws and to ensure underserved communities and consumers have access to prudent financial services

Some of the products CFPA will focus on:

Mortgages

- Consumers face an array of mortgage options that come with wide variations in rates, terms, penalties, and conditions
- In year's past, mortgages were originated by banks. But as of late, the majority of mortgages are sold by mortgage brokers
- These companies have existed largely outside of the banking regulatory system with respect to consumer protections
- Compounding the issue for the consumer is the fact that mortgage brokers have incentives -the yield spread premium -to sell the consumer a product that isn't necessarily the most suitable or lowest cost for them
- To successfully navigate this maze, consumers not only need to figure out the product options that suits their need, but also who is selling the product, what motivates that seller, and whether there are rules to ensure the seller is offering a product that is fair and non deceptive

Bank Accounts

- Even basic bank accounts are commonly fraught with unexpected costs, in the form of surcharges at ATMs, under balance fees, and the big one, overdraft charges, which cost are on average about $35 per check
- As overdrafts currently work, an accountholder is automatically over drafted, with the payment completed and the account debited for the overdraft charge
- These kinds of charges which can rack up to hundreds of dollars in the course of a month can tip a family that's just making it into serious financial hardship

Source/Reference:

1. **The Network for Consumer Protection, Pakistan, Web Page**
2. **CFPA, Official Website**

LESSON 05

KEY ISSUES IN CB --- CONSUMER'S PERSPECTIVE

When we talk about Consumer Banking, it means that we talk about facilitating the common and ordinary people of the society by providing them an opportunity to acquire the necessities and accessories of life that are needed by them to maintain/sustain an affordable, pleasurable, easy, and comfortable life.

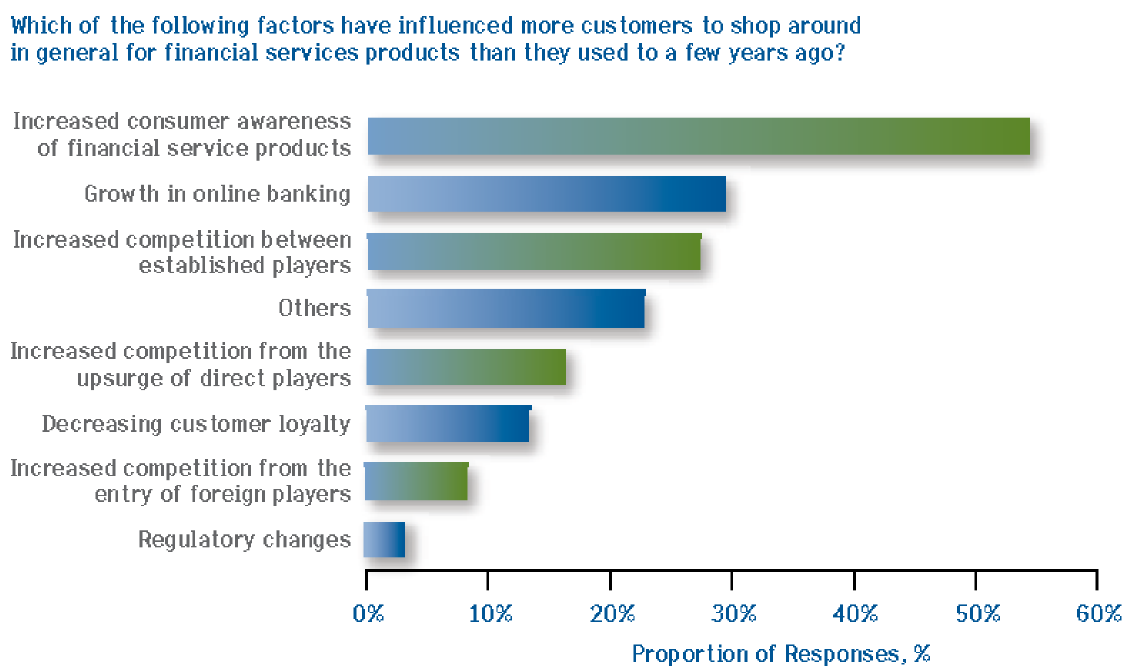
Consumer Banking: Definition
Services provided by commercial banks to individuals (as opposed to business customers) that include Current Accounts, Deposit and Savings Accounts, as well as Credit Cards, Auto Loans, House Loans (Mortgages), Personal Loans and Investments. It is also called "Retail Banking" and may be used interchangeably.

Consumer Banking is the provision of products and services to meet the financial needs of individuals in order to generate products that will boost the bank's deposit base as well as quality risk asset portfolio.

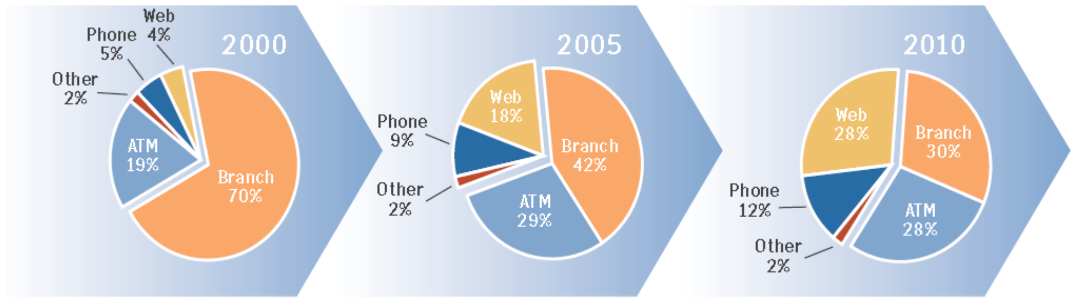
The Consumer Banking environment today is changing fast. The changing customer demographics demands to create a differentiated application based on: scalable technology, improved service and banking convenience. Higher penetration of technology and increase in global literacy levels has set up the expectations of the customer higher than never before. Increasing use of modern technology has further enhanced reach and accessibility.

The market today gives us a challenge to provide multiple and innovative contemporary services to the customer through a consolidated window as so to ensure that the bank's customer gets "Uniformity and Consistency" of service delivery across time and at every touch point across all channels. The pace of innovation is accelerating and security threat has become prime for all electronic transactions. High cost structure rendering mass-market servicing is prohibitively expensive.

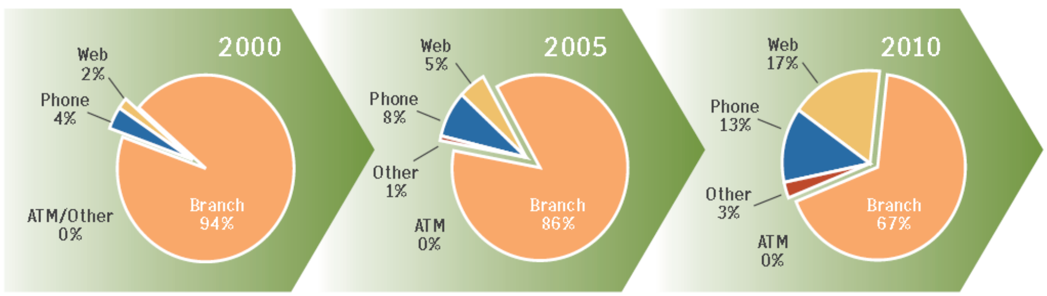
Factors That Lead Customers to Shop Around More



Distribution of Services Among Channels



Distribution of Sales Among Channels



Changing Trends

Present day bankers are now more looking at reduction in their operating costs by adopting scalable and secure technology thereby reducing the response time to their customers so as to improve their client base and economies of scale.

The solution lies to market demands and challenges lies in innovation of new offering with minimum dependence on branches, a multi-channel bank and to eliminate the disadvantage of an inadequate branch network. Generation of leads to cross sell and creating additional revenues with utmost customer satisfaction has become focal point worldwide for the success of a Bank.

Consumer Financing
Consumer financing is a type of service that is designed to provide the individuals with necessary finance for personal purchases ranging from buying a car, shopping purchases, to buying a house. The concept of consumer financing is based on the need for an institutional arrangement that provides consumers with financing support to enhance their consumption and, as a result, improve their standards of living.

Advantages of Consumer Banking
Consumer banking has inherent advantages outweighing certain disadvantages. Advantages are analyzed from the resource angle and asset angle.

The Resource/Liability Side:

- Retail deposits are stable and constitute core deposits
- They are generally insensitive to profit/return with less bargaining for higher rate
- They constitute low cost funds for the banks
- Effective customer relationship management with the retail customers build a strong customer base
- Retail banking increases the subsidiary business of the banks

The Assets Side:

- Retail banking results in better yield and improved bottom line for a bank
- Retail segment is a good avenue for funds deployment

- Consumer loans are presumed to be of lower risk and NPA perception
- Helps economic revival of the nation through increased production activity
- Improves lifestyle and fulfils aspirations of the people through affordable credit
- Innovative product development
- Retail banking involves minimum marketing efforts in a demand driven economy
- Diversified portfolio due to huge customer base enables bank to reduce their dependence on few or single borrower
- Banks can earn good profits by providing non-fund based or fee based services without deploying their funds

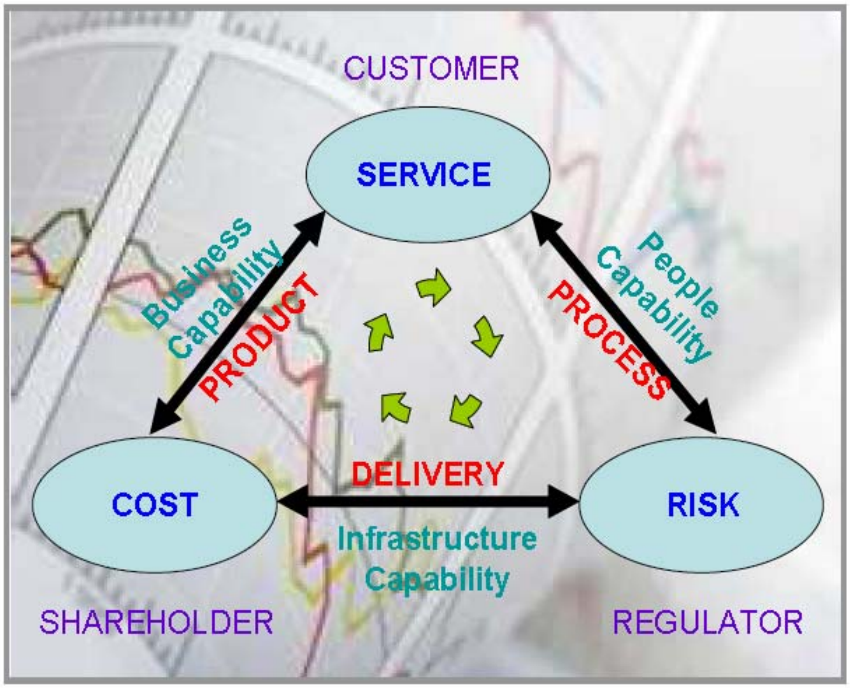
Disadvantages of Consumer Banking

- Designing own and new financial products is very costly and time consuming for the bank
- Customers now-a-days prefer net banking to branch banking. The banks that are slow in introducing technology-based products, are finding it difficult to retain the customers who wish to opt for net banking
- Customers are attracted towards other financial products like mutual funds and NSS
- Though banks are investing heavily in technology, they are not able to exploit the same to the full extent
- A major disadvantage is monitoring and follow up of huge volume of loan accounts inducing banks to spend heavily in human resource department
- Long term loans like housing loan due to its long repayment term in the absence of proper follow-up, can become NPAs
- The volume of amount borrowed by a single customer is very low as compared to wholesale banking. This does not allow banks to exploit the advantage of earning huge profits from single customer as in case of wholesale banking

Challenges to Retail Banking in Pakistan

- The issue of money laundering is very important in retail banking. This compels all the banks to scrutinize diligently all the documents which they accept while entering into a relationship
- Outsourcing has become significant in recent past because various core activities such as hardware and software maintenance, entire ATM set up and operation (including cash, refilling) etc., are being handled by outside vendors
- Banks are expected to take utmost care to retain the ongoing trust of the public
- Customer service should be at the end all in retail banking. Someone has rightly said, "It takes months to find a good customer but only seconds to lose one." Thus, strategy of Knowing Your Customer (KYC) is important
- The dependency on technology has brought IT departments' additional responsibilities and challenges in managing, maintaining and optimizing the performance of retail banking networks
- It is equally important that banks should maintain security to the advance level to keep the faith of the customer
- The efficiency of operations would provide the competitive edge for the success in retail banking in coming years
- The customer retention is of paramount important for the profitability of retail banking business & increase in the market share
- One of the crucial impediments for the growth of this sector is the shortage of manpower talent of this specific nature, a modern banking professional, for a modern banking sector

Operational Excellence in Banking



Customer Service

Customer service is perhaps the most important dimension of retail banking. While most banks offer the same range of service with similar technology/expertise, the level of customer service matters the most in bringing in more business. Perhaps more than the efficiency of service, the approach and attitude towards customers will make the difference.

Front line staffs have to be educated in this regard. A scheme of entrusting a group of important customers to the care of each employee/officer with a person to person knowledge and intimacy can be implemented all sundry advices/notices such as Dr. /Cr. advices. TDR maturity advices, etc. whether signed by employees or officers should be identifiable by the name of those signing, and inviting customers to contact them for further assistance in the matter.

A customer centered organization has to be built up, whose ultimate goal is to "own" a customer. Focused merchandizing through effective market segmentation is the need of the hour. A first step can be the organization of the various retail branches to enter for different market segments like up-market individuals, traders, common customers, etc. For the SIB (Small Industry and Business) sector banks, the focus should be on identifying efficient units and allocations of loans to these units. These banks should try Merchant Banking services on a small scale. With agricultural output growing at a fast rate and mechanization setting in, banks should try to cater to the credit needs of the people involved in this profession. A wide network is absolutely imperative for this sector.

Separate branches/divisions should be opened for traders and similar government businesses. Special facilities for cash tendered in bulk and immediate issue of drafts, by extending facilities like "guarantee bond" system, will go a long way in mitigating problems faced by traders who are the major customers for drafts issue. Provision for cash counting machines in these branches will reduce the monotony of cashiers and unnecessary delays, thus resulting in better productivity and ultimately in improved customer service.

The personal segment is however the most important one. With the urban segment moving away because of disintermediation and competition from foreign banks, retail banks should focus on the rural/semi-urban areas that hold the maximum potential. In the urban areas, private banking to affluent customers can be introduced, through which advisory and execution services could be provided for a fee. Foreign currency denominated accounts can also be introduced for them.

Technology

In the current scenario, the importance of technology cannot be understated for retail banks which entail large volumes, large queues and paperwork. But most of the banks are burdened with a large staff strength which cannot be done away with. Besides, in the rural and semi-urban areas, customers will not be at home in an automated, impersonal environment.

The objective would be to ensure faster and easier customer service and more usable information, instantly, economically and easily to all those who need it -customers as well as employees. Proper management information systems can also be implemented to aid in superior decision making.

Communication technology is especially needed for money transfer between the same city and also between cities. There are inordinate delays in our country because of geographical and other factors. Modern technology can make it possible to clear any check anywhere in Pakistan within three days. Installation of FAX facilities at all the big branches will facilitate speedy transfer of payment advices. Computerization will be of great help in improving back-office operations. At present, 60% of rural branches have PCs. These can be used for quick retrieval and report generation. This will also drastically reduce the time, bank staffs spend in filling and filing returns. Housekeeping operations can also be speeded up.

Price Bundling

Price bundling is a selling arrangement where several different products are explicitly marketed together to a price that is dependent on the offer. As banks are multi-product firms this strategy is more applicable to retail banking. Price bundling offers several economic and strategic benefits to a bank. It offers economies of, utilization of the existing capacities and reaching wider population of customers. Bank can get the benefits of information and transacting. In the process of extending variety of services, banks are acquiring enormous amount of customer information. If this information is systematically stored, banks can efficiently utilize this information in order to explore new segments and to cross-sell new services to these segments. Cross-selling opportunities and larger customer base can also be the motive for merger against usually stated advantage of cost savings. Price bundling can be used in order to lengthen the relationship with a customer. It will reduce the need of resources to be put on acquiring new customers and saves time of the bank. Among the strategic benefits, price bundling may cause less aggressive competition; it differentiates its products compared to rivals in the same market where the products are sold individually or in other kinds of bundles.

Retail banking offers many services and it gives an opportunity to the bank to combine different services in different kinds of bundles. In many cases demand for one service affects the demand for another service, for example current or savings account and payment services are highly related, and here price bundling is a better alternative than individual selling. Banks have to analyze the customer segment and bundle products before applying the pricing strategies.

The first step in price bundling decision is to select the customer segment. The bundle is targeted to choose a strategic objective. If there are two products (A and B) that are considered to be bundled together, the comprehensive strategic objectives for the different customer segments are:

- Cross-selling to customers that only buy one of the products
- Retaining customers that already buy both of the products
- Acquiring new customers when they buy neither product for the time being

Innovation

The scope for innovation in financial services is unlimited. Although banks have introduced a variety of deposit and loan products, the basic features of all these products are almost one and the same. Among the delivery channels, ATMs have emerged as ubiquitous money centers. Almost all banks have established their ATMs. For most of the banks the overhead costs on these ATMs are far higher than the revenue generated by them. ATM operation costs are largely fixed in nature - the cost of the machine, its maintenance, replenishment of currency, and the satellite (network) connection. There should be a minimum number of transactions to cover these costs. Banks have to innovate wide range of services in addition to cash withdrawals. ATMs should allow customers to buy postal and revenue stamps, payment of bills, event tickets, sports tickets, etc. Banks can offer ATM screens for slide show advertising also. However, the advantage of the ATM has always been speed and convenience, probably on introduction of these new services customer has to spend more time at a point. ATMs can guide the customer also. For example, if a customer's account balance has reached to bare minimum the ATM can give a helpful suggestion that "we notice your balance is low, can we help with a loan?" ATMs can be either within the premises of a branch or at a remote place. On premises ATMs are highly immune to competition, but branches can reduce the staff, on installation of ATM. The scope for wider services through off-premises ATMs is very high; it provides great opportunity for fee revenue. The cost of maintenance of off-premises ATMs is higher in terms of replenishment, cash couriers, armed security etc. In the US, approximately 23 percent of ATMs are offering sale of postage stamps. It is the right time for banks to question themselves whether ATM is a service channel, sales channel, or branding opportunity.

The future of retail banking lies more in mobile banking. Mobile telephone market is penetrating, and mobile phones are ideal to utilize Internet banking services without customer accesses to PC.

Smart card revolution will further change the face of retail banking. Smart cards can store information; carry out local processing on the data stored and can perform complex calculations.

Source/Reference:

www.oppapers.com/search.php

LESSON 06

EMERGING ISSUES IN RETAIL BANKING

1. Knowing Customer (Commercial/Business Perspective)

- 'Know your Customer'(KYC) has also become an important Regulatory Requirement
- In order that the product lines are targeted at the right customers-present and prospective-it is imperative that an integrated view of customers is available to the banks
- The benefits flowing out of cross-selling and up-selling require vital inputs
- What needs to be done is setting up of a robust data warehouse where from meaningful data on customers, their preferences, there spending patterns, etc. can be mined
- Cleansing of existing data is the first step in this direction

2. Technology Issues

- Retail banking calls for huge investments in technology
- Whether it is setting up of a Customer Relationship Management System or Establishing Loan Process Automation or providing anytime, anywhere convenience to the vast number of customers or establishing channel/product/customer profitability, technology plays a pivotal role
- The Issues involved include adoption of the right technology at the right time and at the same time ensuring volumes and margins to sustain the investments
- It is pertinent to remember that a large international bank, known for its deployment of technology, took quite a while to make profits in credit cards
- However, without adequate technology support it would be almost impossible to administer the growing retail portfolio without allowing its health to deteriorate
- Further, the key to reduction in transaction costs simultaneously with increase in ability to handle huge volumes of business lies only in technology adoption
- Lack of connectivity, stand alone models, concept of branch customer as against bank customer, lack of convergence amongst available channels, absence of customer profiling, lack of proper decision support systems, etc., are a few deficiencies that are being encountered
- The initiatives in this regard should include creating flexible computing architecture amenable to changes and having scalability, a futuristic approach, networking across channels, development of a strong Customer Information Systems (CIS) and adopting Customer Relationship Management (CRM) models for getting a 360 degree view of the customer

3. Organizational Alignment

- It is of utmost importance that the culture and practices of an institution support its stated goals
- Having decided to take a plunge into retail banking, banks need to have a well defined business strategy based on the competitive position of the bank and its potential
- Creation of a proper organization structure and business/operating models which would facilitate easy work flow are the needs of the hour
- The need for building the organizational capacity to achieve the desired results cannot be overstated
- This would mean a strong commitment at all levels, intensive training of the rank and file, putting in place a proper incentive scheme, etc.
- As a part of organizational alignment, there is also the need for setting up of an effective Corporate Marketing Division. Most of the banks have only publicity departments and not marketing setup
- A full fledged marketing department or division would help in evolving a brand strategy, address the issue of alienation from the upwardly mobile, high net worth customer group and improve the recall value of the institution and its products by arresting the trend of getting receded from public memory
- The much needed tie-ups with manufacturers/distributors/builders will also be facilitated smoothly
- It is time to break the myth that banks are not customer friendly. The attention is to be diverted to vast databases of customers lying with them still unexploited for marketing

4. Product Innovation

- Product innovation continues to be yet another major challenge
- What is of crucial importance is the need to understand the difference between novelty and innovation? Peter Drucker in his path breaking book: "Management Challenges for the 21st Century" has in fact sounded a word of caution: "innovation that is not in tune with the strategic realities will not work; confusing novelty with innovation should be avoided, test of innovation is that it creates value; novelty creates only amusement"
- Banks need to innovate products suiting the needs and requirements of different types of customers. Revisiting the features of the existing products to continue to keep them on demand should not also be lost sight of

5. Pricing of Product

- The next challenge is to have appropriate pricing policies in place
- The industry today is witnessing a price war, with each bank wanting to have a larger slice of the cake, without much of a scientific study into the cost of funds involved, margins, etc.
- Most of the banks that use rating models for determining the health of the retail portfolio do not use them for pricing the products. The much needed transparency in pricing is also missing, with many hidden charges and to camouflage the price
- The situation cannot remain this way for long. This will be one issue that will be gaining importance in the near future

6. Process Changes

- Business Process Re-engineering is yet another key requirement for banks to handle the growing retail portfolio
- Simplified processes and aligning them around delivery of customer service impinging on reducing customer touch-points are of essence
- A realization has to be drawn that automating the inefficiencies will not help anyone and continuing the old processes with new technology would only make the organization more inefficient
- Work flow and document management will be integral part of process changes
- The documentation issues have to remain simple both in terms of documents to be submitted by the customer at the time of loan application and those to be executed upon sanction

7. Human Resources

- While technology and product innovation are vital, the soft issues concerning the human capital of the banks are more vital
- The corporate initiatives need to focus on bringing around a frontline revolution. Though the changes envisaged are seen at the frontline, the initiatives have to really come from the 'back end'
- The top management of banks must be seen as practicing what it preaches
- The initiatives should aim at improved delivery time and methods of approach.
- There is an imperative need to create a perception that the banks are market-oriented
- This would mean a lot of proactive steps at various levels, devising appropriate tools for performance measurement bringing about a transformation ' 'can't do' to 'can do' mind-set change from restrictive practices to flexible work place:
    - By having universal tellers,
    - bringing in managerial controlling work place,
    - provision of intensive training on products and processes,
    - emphasizing coaching, etiquettes, good manners and best behavioral models, formulating objective appraisals,
    - putting in place good and acceptable reward and punishment system,
    - facilitating the placement of young /youthful staff in front-line,
    - defining a new role for front-line staff by projecting them as sellers of products rather than clerks at work,
    - changing the image of the banks from a transaction provider to a solution provider

8. Rural Orientation

- As of now, action that is taking place on the retail front is by and large confined to major cities

- There is still a vast market available in rural Pakistan, which remains to be tapped
- MNCs, as manufacturers and distributors, have already taken the lead in showing the way by coming out with exquisite products, packaging and promotions, keeping the rural customer in mind
- Some FMCGs made available through an efficient network add testimony to the determination of the MNCs to penetrate the rural market. In this scenario, banks cannot lack behind
- In particular banks having a strong rural presence, need to address the needs of rural customers in a big way. These and only these will propel retail growth that is envisaged as a key strategy for portfolio expansion by most of the banks

9. Financial Exclusion

- The scope of enhancement of Banking Business in Pakistan is considerable as the level of *Financial Exclusion* is exceptionally high despite the growth in Banking
- Penetration ratio of financial services is low judged by any measures as less than 20% of the population has access to financial services and number of borrowers are under 5 million (3% of population)
- More graphically, **there are only 171 deposit accounts per 1,000 people and 30 loan accounts per 1,000 people**
- Likewise, only 30% of adults have bank accounts
- Credit/GDP ratio at 27% is low judged by country and sector financing requirements or judged by levels prevailing in Emerging Markets
- Consumer financing penetration ratio is 3.9%

Distinguishing Features of a typical Consumer Banking (CB) Segment of a Bank in Pakistan

- CB is a Scale Sensitive, Mass Market, & Volume business
- Standardized Processes & Procedures
- Substantial upfront outlay for Designing, Developing, Marketing, Distributing, & Delivering various products
- Adherence to SBP Risk Management Guidelines
- Separate organizational setup for post-sale issues like Collection, Recovery, Litigation etc.
- Multiple Delivery Channels/Call Centers/Recorded Phone Lines
- Enhancing customer experience through effective/efficient management of "Customer Touch Points"
- Dedicated Sales & Service teams(Usually contractual)
- Hiring of external agencies for verifying & documenting details of customer profile and income source/estimation
- Professional Property Valuators
- Customer Segmentations under Life-Cycle parameters
- Adherence to Transfer Pricing regime for determining true profitability of products/services
- Innovative personal saving /investment products through Alliances with Insurance Companies & other financial service providers
- Service Level Agreements (SLA) with bank own support functions like Operations, IT, HR etc
- Brand Affiliation/Channel Partnering

New Segmentation Approaches to Drive Product Innovation

Innovation in Segmentation Strategy

Although banks have practiced customer segmentation for the past decade or so, there is room for further refinement of their strategies. Having moved from a product-centric to a customer-centric approach, banks continue to employ broad brushstrokes to segment their customer base. In doing so, the risk attributing common characteristics to a large number of customers who may have been grouped together on the basis of a single parameter, such as relationship value. More importantly, their product and service offerings are likely to be tailored to the perceived needs of these segments. At the same time, banking customers continue to demand more. They are no longer content to be viewed as faceless constituents of a large group; rather, they expect their banks to recognize their individual needs and offer custom-made solutions to help them achieve their financial goals. Against this backdrop, banks must become more innovative in the way they view their customers as well as the manner in which they serve them.

Beyond Relationship-Value Segmentation

For a start, banks can look at refining customer segmentation by taking a multi-dimensional approach that goes beyond relationship-value. While segmentation on the basis of relationship value is important in order to recognize and reward customer loyalty, it falls short of enabling banks to identify and attract new business opportunities. It is also possible that customers with vastly different relationship-values may be connected in other ways, and therefore, could be part of the same segment from an entirely different standpoint. Hence, banks need an in-depth, well-rounded perspective of their customers before they can categorize them. This perspective must consider various factors besides relationship value including but not limited to, demography, geography, ethnicity, gender and profession. As a matter of fact, banks are well placed to do so, since most, if not all of this information would already be available within their database. Analysis of comprehensive customer data can reveal homogeneous patterns that can be used to create new and more meaningful customer segments which can be targeted for tailor-made products and services.

New Approaches to Segmentation

Customer segmentation on the basis of homogeneity of behavior, aspiration, value, culture or habit can bring to light specific opportunities which may not be visible when only relationship value is taken into consideration. It is intuitive that those who share a common geography, language, profession or social status will also have, to a certain extent, similar values or behavior. Therein lies vast, untapped opportunity – if banks can offer products and services that support such homogeneity, they are likely to reap big benefits by way of new business and cross-sales. This view is best illustrated with some examples:

- A couple of prominent U.S. banks have gone after the 37 million-strong Hispanic population, considered an unprofitable customer segment by most of their peers. This group has very specific requirements – the facility to deposit pay-checks, make money transfers and maintain a zero balance in their account being the most important. The banks have accordingly introduced innovative products tailored to these needs. One bank offers more options to move money: as cash to cash or as cash to accounts or cards, being some of them. They also allow their customers to cash pay-checks. The other bank has pioneered a special zero minimum balance account just for Hispanic clients
- Geographic segmentation is another important possibility. A physical location can be a great determinant of customer needs – for instance, while all agricultural regions have large demand for farm loans or short-term trade financing, their demand patterns differ based on the crop and harvesting cycle. Another example is that of customers on the West and East Coast of the U.S., who hold different financial aspirations which cannot be met with the same suite of products. Although regional and rural banks cater to geographic diversity to a certain extent, national banks can follow suit by creating location-based sub-segments and targeting them. With different offerings Segmentation by social strata is gaining currency riding on the concept of financial inclusion. The world over, banks are innovating their product and channel strategy to reach out to the unranked population. Going forward, they must attempt to discover subtle patterns within these segments, so that they can target smaller sections with customized offers
- Different generations display distinct behavioral patterns. Aging baby boomers may seek personal guidance while planning their retirement savings; not so the tech-savvy and self-reliant Generation X. The "digital native" Gen Y is technologically ahead of them all, and is at ease transacting over the Internet, mobile phone or even social networking platforms
- Segmentation-driven innovation need not be confined to products alone. Several Canadian banks have set up multi-lingual branches, where employees speak up to eight languages, to cater to the vast expatriate community in that country. ATMs in rural India offer screens in vernacular languages to encourage usage among the resident population
- Banks can also benefit by segmenting their customer base along unconventional dimensions. An Australian bank offered a utility bill payment service in the form of a specialized loan to those customers who had difficulty keeping up with their monthly payments. By doing so, they earned interest from their customers and commission from the service providers. New methods of segmentation have also been considered within niche areas such as wealth management, with sub-segments being formed on the basis of source of wealth, customer sophistication, life stage and geography
- Another approach advocates the formation of customer groups depending on their banking behavior – which is either investment or borrowing/transaction oriented. Typically investors

comprise older, more affluent clients who maintain high balances and are primarily concerned with growing their wealth for the future. Since this group is not focused on deposit products, it is not very sensitive to interest rates

- ❖ On the other hand, lower-balance transactions are young and just starting to accumulate wealth through employer plans, IRAs or similar avenues. Mostly, their needs are immediate – and hence, they lay greater emphasis on checking, saving and loan products and the interest rates associated with each
- ❖ Not surprisingly, their channel preferences also differ. High-balance customers want experienced branch staffers to whom they can turn in case of need. Their low-balance counterparts are happy using self-assisted channels such as PC/Internet banking, ATMs and call centers
- ❖ Clearly, banks need very different strategies to tackle each of these groups. At the same time, they must recognize the interplay of multiple factors within each segment – for instance, some members of the Hispanic segment may have similar social, linguistic and economic characteristics. Another example of this is evident in the case of the high-balance investors discussed earlier, who, apart from having common financial goals, may also be at a similar life-stage. Thus, going forward, banks' segmentation strategy must create finer "sub- segments" which are homogenous along different dimensions. This will lead them from customer-centricity to the more desirable state of customer-specificity or "segment of one". For instance, of the three broad customer segments, namely corporate, small business and retail, the latter can be grouped by generation, which in turn may be segmented according to geography, income, behavior and so on. The corporate and small business client base can be similarly broken down

Innovating to Create Relevant Products and Services

That being said, a sophisticated segmentation strategy will achieve little unless it is backed up by innovative products and services relevant to the needs of different groups. Hence, banks need to map their "offerings" defined by a combination of product, price, channel, timing and human resources to various customer segments. For instance, they can bundle a set of investment products for their Gen X customers and train a team of relationship managers to deliver them. Another example is the creation of small savings products to cater to the new savings consciousness emerging in the aftermath of the global crisis. Banks must also give due weightage to pricing to ensure that small- ticket vanilla products are not perceived as being expensive by the target segments. Timing is equally important – Gen Y customers have simpler, frequent needs and expect instant fulfillment, whereas mature clients are likely to have significant requirements at different life-stages, such as marriage, parenthood or retirement. A well-rounded segmentation approach must take all this and more into consideration.

Aligning the Organization with a Robust Segmentation Strategy

While all of this is good wisdom, it is only part of the story. The goal of true segmentation is not merely to offer innovative products and services, but to ensure that the customer experience is raised to a different level. Hence, the entire banking organization, including its policies, processes and people must be aligned with the segmentation strategy. KYC norms are a good example of how policies can be "turned on their heads" to support segmentation – rather than following these norms purely as a compliance practice, banks can use the information to strengthen their understanding of various customer segments.

It goes without saying that banks will need resources as well as infrastructure to effect these changes. A sound technology platform is a necessary enabler at every stage – from segmentation to product innovation to customer experience delivery. To start with, banks need a 360 degree unified view of their customers across the organization – only integrated core systems have the capability to consistently deliver this information, no matter how large the scale. Technology is required to analyze huge volumes of customer data, discover patterns within them and engender the progression of broad-based segmentation to a "segment of one". Again, quick roll-out of new products and services is only possible with the support of modern core banking systems. The same systems enable banks to optimize their channels and processes, making them more efficient but not less personalized, all of which contribute to the delivery of good customer experience. For instance, technology can be used to trigger an investment recommendation whenever a customer's account receives sizeable inflows as well as alert the concerned relationship manager so that he may follow it up.

Summary

Banking customers' demands have kept pace with the rising complexity of their needs. They expect banks to address their individual requirements with relevant products and services. This implies that banking institutions must acquire a deeper understanding of their customers at a one-to-one level, and deploy that insight into product and service innovation. Customer segmentation is central to this objective.

Current segmentation practices are mostly uni-dimensional and based on a single parameter such as relationship value. Although the relevance of relationship value as a measure of customer loyalty is beyond doubt, it cannot be the sole criterion for segmentation. Going forward, banks must refine their segmentation strategy by taking into account a combination of demographic, social, economic, geographic and linguistic factors. Other innovative approaches to segmentation include grouping customers on the basis of financial behavior, customer sophistication or life-stage.

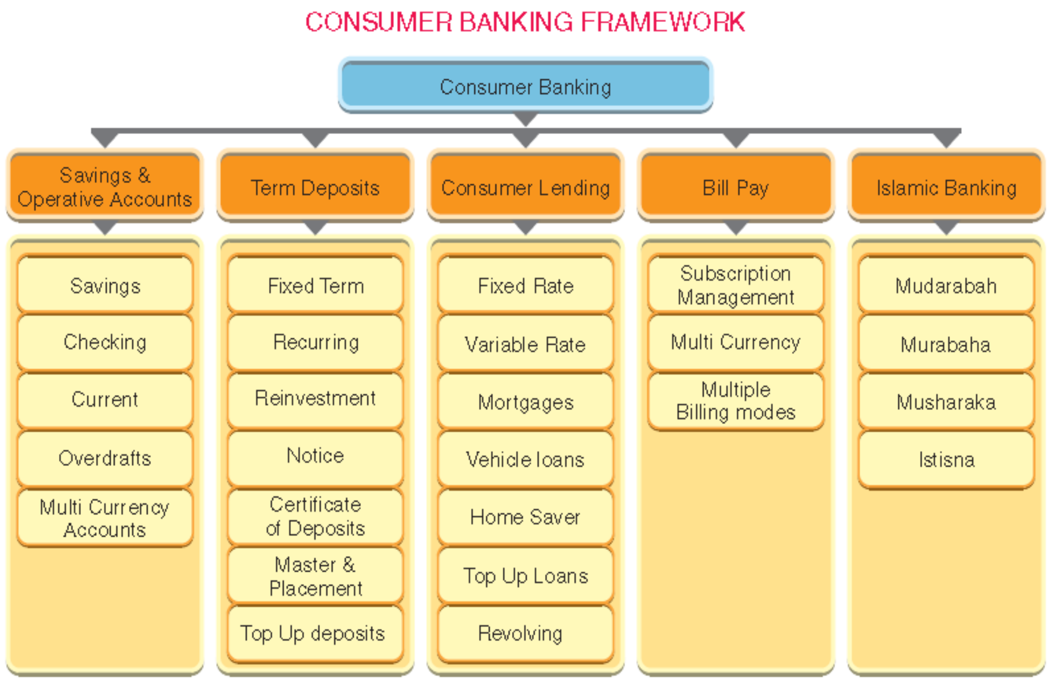
As broad customer segments are broken down into finer sub-groups, segmentation strategy shifts from customer-centricity towards customer- specificity. New business opportunities can be created by offering tailor-made products to each customer sub-segment. However, none of this is possible without the support of a strong technology backbone at every stage – whether it is the creation of new customer segments, roll-out of innovative offers or the alignment of processes and channels to provide a great banking experience across all segments.

Source/Reference:

1. **www.oppapers.com/search.php**
2. **Finacle Product Strategy, Infosys Technologies Limited**

LESSON 07

STRUCTURE OF BANK CREDIT RISK --- AN OVERVIEW

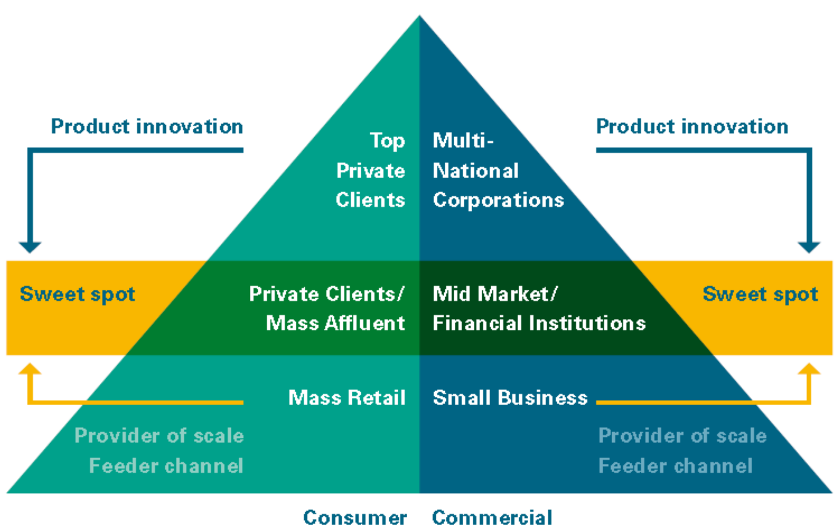


Bank Structure: A Successful Approach

Managers spend hours agonizing over how to structure their organizations (by product, geography, customer, and so on). Winners show that what really counts is whether structure reduces bureaucracy and simplifies work.

- Simplify. Make your organization easy to work in and work with
- Promote cooperation and the exchange of information across the whole company
- Put your best people closest to the action
- Establish systems for the seamless sharing of knowledge

Client Pyramid



Targeting 'Sweet Spot':

- In putting this strategy into effect, a Bank serves mid market consumer and commercial clients – whom it calls the bank's 'sweet spot' client segments
- The Consumer mid-market segment includes mass affluent customers– retail clients with healthy finances as well as most of higher-end private banking clients
- Commercial mid-market clients include many medium-to-large companies and financial institutions

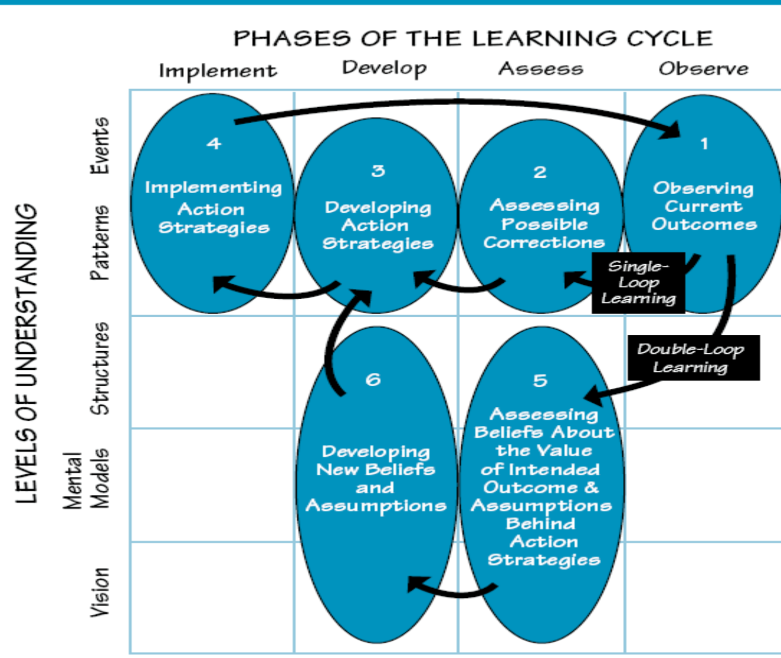
Serving the Whole Client Pyramid:

- Client base can be represented through the 'Client Pyramid' shown in the accompanying illustration
- The strategy identifies sweet spot as being mainly located around the middle of this pyramid
- However, this does not reduce the importance of the top and bottom end of the pyramid
- For example, serving top private banking clients helps to develop innovative investment products that can later be offered to mid market consumer clients as well
- Similarly, serving large multinational corporations enables to strengthen industry knowledge and product innovation, both of which will eventually benefit mid market commercial clients
- Both the mass retail segment and the small business segment deliver the scale Bank needs and act as a feeder channel for future mid-market clients

Strategy, another Perspective:

- Your strategy should be sharply defined, clearly communicated, and well understood by employees, customers, partners, and investors
- Build a strategy around a clear value proposition for the customer
- Develop strategy from the outside in, based on what your customers, partners, and investors have to say—and how they behave—not on gut feel or instinct
- Continually fine-tune your strategy based on changes in the marketplace— for example, a new technology, a social trend, a government regulation, or a competitor's breakaway product
- Clearly communicate your strategy within the organization and to customers and other external stakeholders
- Keep focused. Grow your core business, and beware the unfamiliar

DOUBLE-LOOP LEARNING MATRIX



For developing quick fixes for simple problems, it is appropriate to work in the low-leverage "action zones" (Zones 1–4). Moving down to the high-leverage "reflection zones" (Zones 5 and 6) increases our ability to develop fundamental solutions for difficult problems.

In the Single -Loop learning we apply habitual way of thinking and doing, i.e. re-enacting the past or what is called "Downloading". But in Double-Loop learning we reflect and ask the "why not" questions which could lead to a paradigm shift.

Double loop theory is based upon a "theory of action" perspective outlined by Argyris & Schon (1974). This perspective examines reality from the point of view of human beings as actors. Changes in values, behavior, leadership, and helping others, are all part of, and informed by, the actors' theory of action. An important aspect of the theory is the distinction between an individual's espoused theory and their "theory-in-use" (what they actually do); bringing these two into congruence is a primary concern of double loop learning. Typically, interaction with others is necessary to identify the conflict.

There are four basic steps in the action theory learning process: (1) discovery of espoused and theory-in-use, (2) invention of new meanings, (3) production of new actions, and (4) generalization of results. Double loop learning involves applying each of these steps to itself. In double loop learning, assumptions underlying current views are questioned and hypotheses about behavior tested publicly. The end result of double loop learning should be increased effectiveness in decision-making and better acceptance of failures and mistakes.

In recent years, Argyris has focused on a methodology for implementing action theory on a broad scale called "action science" and the role of learning at the organizational level.

Key Regulatory Requirements:

- Know-Your-Customer (KYC) System
- Anti-Money Laundering (AML) Policy
- Audit & Compliance Setup

SBP PRUDENTIAL REGULATION XI --- KNOW YOUR CUSTOMER (KYC)

- In view of heightened global efforts to prevent the possible use of the banking sector for money laundering, terrorist financing, transfer of illegal/ill-gotten monies and as a conduit for white collar crime etc., the importance of 'Know Your Customer (KYC)'/"customer due diligence" has increased
- To reinforce the checks and controls already developed by banks as also to ensure due diligence is done while starting relationship with a new customer and maintaining and continuing relationship with existing customers

GUIDELINES

All reasonable efforts shall be made to determine true identity of every prospective customer. The following minimum set of documents must be obtained from various types of customers/ account holder(s).

Nature of Account	Documents/Papers to be Obtained
Individuals	i. Attested photocopy of national identity card or passport of the individual. ii. In case the NIC does not contain a photograph, the bank should also obtain, in addition to NIC, any other document such as driver's license etc that contains a photograph. iii. In case of a salaried person, attested copy of his service card, or any other acceptable evidence of service, including, but not limited to a certificate from the employer. iv. In case of illiterate person, a passport size photograph of the new account holder besides taking his right and left thumb impression on the specimen signature card.

The Banks shall obtain **"Introduction"** on the new account to assess the prospective customer's/account holder's integrity, respectability and the nature of business etc. Any laxity in this regard may result in serious consequences for the banker.

The following guidelines are to be followed in this regard:

i. Where the introducer is an existing account holder of the same branch, his introduction should be accepted, after due verification of signature by the official of the branch. In case the introducer is an account holder of another branch of the same bank, the account
ii. should only be opened after proper verification of the signature from the concerned branch
iii. Where the introducer happens to be an account holder of another bank, the introduction should be accepted after complete verification of the signature and other particulars of the introducer from that bank
iv. The introduction by the employees of the bank may also be acceptable. However, he or she will have to establish that sufficient information has been collected on the new account holder for making the introduction and that they believe that "Introduction" from a person other than the bank's employee is not necessary
(The introduction of a person other than by the branch employee is being stressed to ensure maximum authenticity on the status of the would-be accountholder/customer, beside minimizing the chances of undesirable accounts which may be opened on the introduction of the bank employees in their pursuit to achieve targets of opening maximum number of accounts and treating the "Introduction" a mere formality in the process).

- The Bank/branch shall obtain satisfactory evidence duly verified/authenticated by the branch manager and shall be placed on record in respect of:
  i. the true identity of the **beneficial owners** of all accounts opened by a person, entity etc,
  ii. the real party in interest or controlling person/entity of the account(s) in case of nominee or minors account
- The Banks are also advised that KYC/customer due diligence is not a one time exercise to be conducted at the time of entering into a formal relationship with customer/account holder. KYC/Customer due diligence is an on-going process for prudent banking practices, therefore the banks are encouraged to: -
  i. Set up a compliance unit with a full time Head
  ii. Put in place a system to monitor the accounts and transactions on a regular basis
  iii. Update customer information and records, if any, at reasonable intervals
  iv. Install an effective MIS to monitor the activity of the customers' accounts
  v. Chalk out plan of imparting suitable training to the staff of bank periodically
  vi. Maintain proper records of customer identifications and clearly indicate, in writing, if any exception is made in fulfilling the due diligence procedure
  vii. Monitor and check unusually large cash transactions, especially those which are out of character/ inconsistent with the history, pattern etc of the individual account(s)
- The banks shall develop guidelines for customer due diligence, including a description of the types of customers that are likely to pose a higher than average risk to a bank
- In preparing such policies, factors such as customers' background, country of origin, public or high profile position, nature of business etc should be considered
- Each Bank shall formulate and keep in place, in writing, a comprehensive Know- Your-Customer policy duly approved by their Board of Directors and in case of branches of foreign banks, approved by their head office, and cascade the same down the line to each and every branch/office/ concerned officers for strict compliance
- State Bank of Pakistan, during the course of inspection, would particularly check the efficacy of the KYC system put in place by the banks and its compliance by all the branches and the staff
- Appropriate action shall be taken against the bank and the concerned staff members for non-compliance and negligence in this area under the provisions of Banking Companies Ordinance 1962

A Typical KYC System/Framework (An Example)

Documentary Requirements

1.1 Identification of Client
1.2 Verification of Client's Name (NADRA's Verification)
1.3 Verification of Client's Address (registered and if applicable operational)
1.4 Identification of Ultimate Beneficial Owners with a Controlling Interest of 20% or more (neutral risk client)
1.5 Identification of Ultimate Beneficial Owners with a Controlling Interest of 10% or more (increased risk client)
1.6 Verification of Controlling UBOs
1.7 Evidence that Legal Rep is Authorized to Act on Behalf of and Bind the Client in the manner proposed
1.8 Identification and Verification of the Legal Rep's Identity
1.9 Identification of Company Director(s)
1.10 Verification of 1 (or 2) Company Director(s)
1.11 Evidence of Sanctions Check
1.12 Evidence of PEP (Politically Exposed Person) Search
1.13 Evidence of Bad Press Search
1.14 Evidence of publicly traded and/or regulated status (directly or indirectly)
1.15 Verification of Business Activity

LESSON 08

STRUCTURE OF BANK CREDIT RISK --- AN OVERVIEW (CONTD…)

AML: Some Thoughts

- Money laundering, in general, is the name given to the process by which the origin of illicit funds is disguised
- The need to indulge in money laundering is primarily to cover up the means by which such funds have been acquired with the aim of legitimizing them
- According to the United Nations, the term Money Laundering is defined as "Any act or attempted act to disguise the source of money or assets derived from criminal activity
- It is the process whereby "dirty money", produced through criminal activity, is transformed into clean money"

According to Section # 3 of Ant- Money Laundering Ordinance 2007, Government of Pakistan, and Offence of money laundering:

A person shall be guilty of offence of money laundering, if the person:

a) acquires, converts, possesses or transfers property, knowing or having reason to believe that such property is proceeds of crime; or
b) Renders assistance to another person for the acquisition, conversion, possession or transfer of, or for concealing or disguising the true nature, origin, location, disposition, movement or ownership of property, knowing or having reason to believe that such property is proceeds of crime

According to Section # 4 of the Ordinance:

Punishment for money laundering:

Whoever commits the offence of money laundering shall be punishable with rigorous imprisonment for a term which shall not be less than one year but may extend to ten years and shall also be liable to fine which may extend to one million rupees and shall also be liable to forfeiture of property involved in the money laundering.

Client Acceptance and Anti-Money Laundering Policy (CAAML):

- Standard for Risk Assessment and Client Acceptance
- Standard for Client Identification and Verification
- Standard for Money Laundering Detection
- Standard for Rejection of Clients/Ending Relationships
- Standard for AML Awareness and Training
- Procedures for Identification and Verification
- Procedures for Transaction Filtering
- Lists of Legal Persons and Groups
- Procedures for Handling Suspicious or
- Unusual Activity Details
- Procedures for Waivers

An Example from a Bank Manual on AML Policy:

It is a Policy of the Bank that,

- Statutory and regulatory obligations to prevent ML and TF are to be met in full
- Systems and controls will be implemented in order to minimize the risk of the Bank's services being abused for the purposes of ML and TF
- A money laundering risk assessment of the Bank's services and customer base including correspondent banks and MSBs (Money Service Businesses) will be undertaken and appropriate policies, procedures and due diligence controls will be applied proportionate to that risk
- Any customer relationship where the customer's conduct gives the Bank reasonable cause to believe or suspect involvement with illegal activities will be reported to Regulators or relevant

authorities. Thereafter action will be undertaken in conjunction with the relevant authorities and in accordance with local practice to avoid any risk of the Bank committing a 'tip-off' offence. Wherever possible, the relationship will be terminated

- In countries where local regulators call for a money laundering compliance reports, respective country MLRO would be responsible for preparation and submission of these reports. CCO would submit a quarterly compliance report to Audit Committee and an annually to the Board, as required under the Compliance Policy

Internal Controls and Communication

It is a Policy of the Bank:

- To institute controls which comply fully with all applicable anti-money laundering laws and regulations
- To conduct risk assessment and develop risk profiles of the Bank's products, services and customers and to apply appropriate policies and procedures to manage such risks. Undertaking enhanced due diligence for 'High Risk' products, services and customers
- To communicate Bank's policies to management and staff and provide them with written procedures and control requirements to ensure ongoing compliance with AML laws and regulatory requirements

Recognition and Reporting of Suspicion

It is a Policy of the Bank:

- To establish and follow procedures that requires employees to refer promptly any suspicious activity to GCG or respective country MLRO who will review the transaction to determine whether a report should be filed with the Regulators
- To be alert to unusual or suspicious transactions or other activities that appear not to make good business or investment sense, or activities that appear to be inconsistent with the counterparty or customer's expected activity, including activities that may be indicative of criminal conduct, terrorism or corruption
- To act competently and honestly when assessing information and circumstances that might give reasonable grounds to suspect ML or TF
- To provide GCG or respective country MLRO (at request) access to all customers, correspondents or counterparties information within the Bank
- To co-operate fully with law enforcement authorities in investigations concerning possible ML or TF within the confines of applicable laws, and in consultation with GCG or respective country MLRO
- Not to alert or provide any information to any person suspected of illegal activity regarding suspicion or inquiry on his or her account or transactional activities or any indication of being reported to Regulators

Awareness Raising and Training

It is a Policy of the Bank:

- To make all management and staff aware of what is expected of them to prevent money laundering or terrorist financing and to advise them of the consequences for them and for the Bank if they fall short of that expectation
- To provide initial and annual update training for all appropriate personnel, including all personnel who set up and manage customer account opening or transactions, correspondent relationships, and/or are involved in trade finance activity
- That management and staff will be required to sign a memorandum confirming they have read and understood the Bank's AML/KYC policies and procedures

Record Keeping

It is a Policy of the Bank:

- To retain identification and transaction documentation for the minimum period required by applicable Laws and Regulations

- To retain records of all reports made by staff to GCG or respective country MLRO and all suspicious activity reports made by MLRO to Regulators for an indefinite period unless advised by the Regulator otherwise
- To be in a position to retrieve, in a timely fashion, records that are required by law enforcement agencies as part of their investigations
- To keep records of dates when anti-money laundering training was given, the nature of the training and the names of staff who received such training

Bank's Policy on Politically Exposed Persons (PEPs) Policy Rationale

PEPs and related individuals can pose unique reputation and other risks, in particular:

- Some corrupt PEPs around the globe have used traditional banking products and services as safe havens for misuse of funds, illegal activities and associated practices, including money laundering;
- PEPs enjoy prominence and are therefore under continuous public spotlight. Their financial affairs are highly magnified and could easily trigger adverse publicity and franchise risks for the Bank;
- There is a growing attention worldwide to the misuse of public funds and increased reaction against corruption at high government levels;
- There is increasing responsibility and liability for banks and bank personnel to undertake due diligence for establishing source of wealth and investigate fund flows of PEPs

Definition

PEPs are individuals who are or have been entrusted with prominent public functions, for example Heads of State or of Government, senior politicians, senior government, judicial or military officials. Senior executives of state owned corporations, important political party officials, business relationships with family members or close associates of PEPs involve reputation risks similar to those with PEPs themselves. The definition is not intended to cover middle ranking or more junior individuals in the foregoing categories.

Reputational Risk:

- Reputation is a key business asset, however intangible. Risks that negatively affect the reputation and standing of banks have increased considerably in the last decade
- One of the key risks to the bank's reputation is the risk of the bank becoming involved in, or becoming a vehicle for, criminal activities, such as money laundering, terrorism, fraud and corruption
- Many products and services offered by the Bank are attractive to those who would use the financial services industry and financial systems for criminal purposes
- One important way of mitigating these risks is ensuring that the bank conducts business with acceptable clients and has adequate policies and procedures to deter criminal activities
- The Client Acceptance and Anti-Money Laundering (CAAML) policy ensures required attention is paid to a client, in order to establish whether or not the bank wants to do business with the client and that the bank's clients are of good reputation
- It should be noted that client acceptance includes aspects not covered in the stated policy, particularly sustainability

Money Laundering and Terrorist Financing:

- Generally speaking, "Money Laundering" is the introduction of illegally gained assets into the legal financial system with the aim of concealing or disguising their true origin
- The source of illegally obtained funds is obscured through a succession of transfers and transactions in order that those same funds can eventually be made to reappear as legitimate income. Terrorist financing is the financial support, in any form, of terrorism or those who encourage, plan or engage in it
- The common trait between money laundering and terrorist financing is concealment

Anti-Money Laundering Questionnaire

Section I - General AML Policies, Practices and Procedures:

1	Does the AML compliance program require approval of the FI's Board or a senior committee thereof?	☑ Yes ☐ No
2	Does the FI have a legal and regulatory compliance program that includes a designated Compliance officer that is responsible for coordinating and overseeing the AML program on a day-to-day basis, which has been approved by senior management of the FI?	☑ Yes ☐ No
3	Has the FI developed written policies documenting the processes that they have in place to prevent, detect and report suspicious transactions that has been approved by senior management?	☑ Yes ☐ No
4	In addition to inspections by the government supervisors/regulators, does the FI Customer have an internal audit function or other independent third party that assesses AML policies and practices on a regular basis?	☑ Yes ☐ No
5	Does the FI have policies covering relationships with politically exposed persons consistent with industry best practices?	☑ Yes ☐ No
6	Does the FI have appropriate record retention procedures pursuant to applicable law?	☑ Yes ☐ No
7	Does the FI require that its AML policies and practices be applied to all branches and subsidiaries of the FI both in the home country and in locations outside of the home country?	☑ Yes ☐ No
8	Does your institution provide training to employees regarding KYC/AML/CTF?	☑ Yes ☐ No
9	Is the FI fully compliant with the FATF 49 recommendations?	☑ Yes ☐ No

What is 'Compliance'?
Audit & Compliance function's role is:
To independently oversee the core processes, and their related policies and procedures, that seek to ensure that the bank is conforming to industry-specific laws and regulations in letter and spirit, thereby maintaining the bank's reputation.

SBP PRUDENTIAL REGULATION NO. XXIX – RESPONSIBILITIES OF BOARD OF DIRECTORS

- The State Bank attaches a great importance to effective corporate governance, clear lines of responsibility, elaborate mechanism of accountability, and existence of proper checks and balances in each bank/financial institution
- The corporate governance means the way in which business and affairs of each institution is directed and managed by their 'Board of Directors' and the 'Management'
- To promote safe and sound banking practices, it is imperative that the 'Board of Directors' assumes its role independent of the influence of the Management
- Members of the Board should know their responsibilities and powers in clear terms
- Further, it should be ensured that the Board of Directors focus on policy making and general direction, oversight and supervision of the affairs and business of the bank/DFI and does not play any role in the day-to-day operations, as that is the role of the 'Management

The Compliance Officers will primarily be responsible for Bank's / DFI's effective compliance relating to:

a) SBP Prudential Regulations
b) Relevant provisions of existing laws and regulations
c) Guidelines for KYC
d) Anti money laundering laws and regulations
e) Timely submission of accurate data / returns to regulator and other agencies
f) Monitor and report suspicious transactions to President / Chief Executive Officer of the bank / DFI and other related agencies

LESSON 09

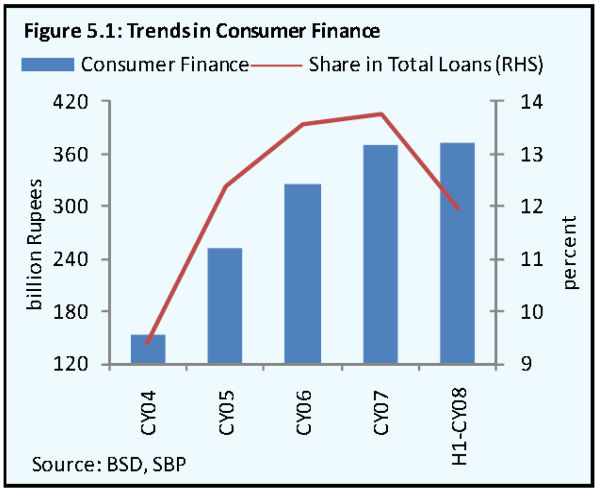
CONSUMER FINANCING IN PAKISTAN AN OVERVIEW

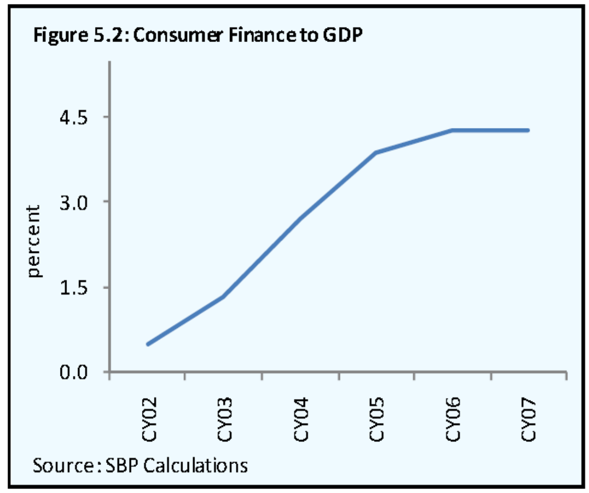
SBP Financial Stability Report 2007- 08:

- Consumer finance is an established financial product across the globe, particularly in mature economies, where it constitutes a significant portion of banks' lending portfolios
- In the Pakistani banking sector, however, the evolution of the consumer financing portfolio is a more recent phenomenon, as banks have traditionally focused on lending to the corporate sector and public sector entities
- While two prominent foreign banks took the lead in introducing credit cards in the banking sector in the mid '90s, their outreach was limited to the top tier of salaried customers and businessmen
- Emulating the experience of various foreign banks who had a head start in this area, domestic private banks have exhibited remarkable adeptness in adopting new procedures for credit risk assessment, setting up the requisite policy and collections units, and upgrading the scope of their IT based systems
- In doing so, they successfully introduced several innovative products for the individual consumer segment
- On the demand side, the consumer, who previously did not have access to bank credit without sufficient liquid collateral, responded well to these initiatives?

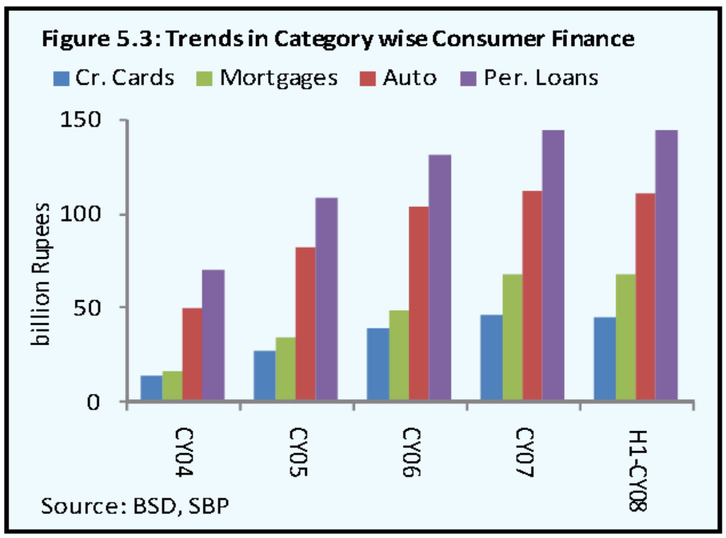
Factors responsible for the widespread popularity of consumer finance in recent years:

- The financial liberalization process over the last decade or so, has led to the creation of a banking system which is largely owned and operated by the private sector, and is free to allocate resources in response to the demands of a market based mechanism,
- Secondly, the influx of liquidity in the banking sector since FY02 motivated banks to diversify and expand their earnings base by venturing into previously untapped areas,
- Thirdly, the easy monetary policy stance of the central bank from FY02 to FY05 provided eligible customers with financing options at historically low rates to meet their consumption demand. In this backdrop, consumer finance has emerged as one of the most promising asset products for banks
- Providing access to purchasing power to the middle class consumer has been the most significant achievement of this product class
- Not only have people been able to raise their standard of living by purchasing various consumption goods which were previously treated as luxuries in reach of only a few, demand for these goods has also led the manufacturing sector to expand its capacity, such that both backward and forward linkages have contributed to the expansion in economic activities
- Hence, in promoting their consumer financing products, banks have played their due role in promoting economic development in the country





Warning Signals:
Abuse in Credit Cards Usage



A FOOD FOR THOUGHT
The Nature of Modern Finance
Is modern finance more like electricity or junk food?

This is, of course, the big question of the day.

If most of finance as currently organized is a form of electricity, then we obviously cannot run our globalized economy without it. We may worry about adverse consequences and potential network disruptions from operating this technology, but this is the cost of living in the modern world.

On the other hand, there is growing evidence that the vast majority of what happens in and around modern financial markets is much more like junk food – ***little nutritional value, bad for your health, and a hard habit to kick.***

The issue is not finance per se, i.e., the process of intermediation between savings and investment. This we obviously need to some degree.

But do we need a financial sector that now accounts 7 or 8 percent of GDP?

Table 5.1: Credit to Households in Emerging Asia

percent of total credit to private sector

	1999	2000	2001	2002	2003	2004	2005
Singapore	38.6	41.1	42.6	44.9	49.5	51.1	51.6
China	1.5	4.3	6.2	8.1	9.9	11.2	11.3
Indonesia	21.5	25.9	31.9	36.7	40.5	44.3	45.5
Malaysia	22.9	23.7	26.0	29.9	31.6	31.0	30.4
Philippines	15.1	14.2	14.4	14.3	13.9	16.0	16.5
Thailand	23.3	31.8	38.2	35.3	40.0	43.5	48.1
Pakistan				2.1	5.6	9.4	12.4

Sources: IMF's Asia & Pacific Regional Outlook; CEIC Data Company Ltd; and IMF, APD country desks.

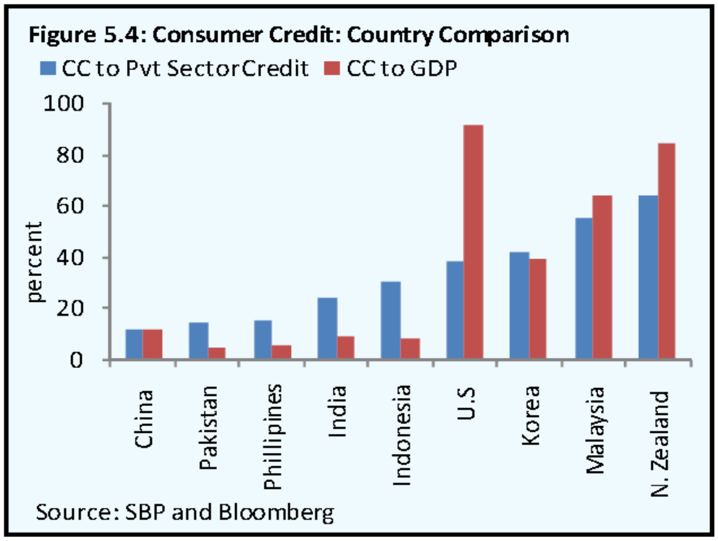


Figure 5.4: Consumer Credit: Country Comparison

Source: SBP and Bloomberg

CONSUMER FINANCE IN PAKISTAN:
Some Myths and Facts

- Access to, and growth in, consumer finance carries both social and economic significance for the society
- In the absence of such products from the formal banking sector, people used to borrow from money lenders in the informal sector at exorbitantly high interest rates
- Banks have now facilitated them in acquiring the necessities of life by providing credit against their future incomes and cash flows, at rates far lower than those demanded by players in the informal sector
- Since the consumer finance function in itself is quite labor intensive, demand for this product has led the banking sector to employ a significant segment of the active workforce both on full time and part time basis
- Banks themselves have also benefited from the diversification of their credit portfolio, as well as capital savings under the Basel II regime, and consumer finance has brought higher returns and stability in earnings

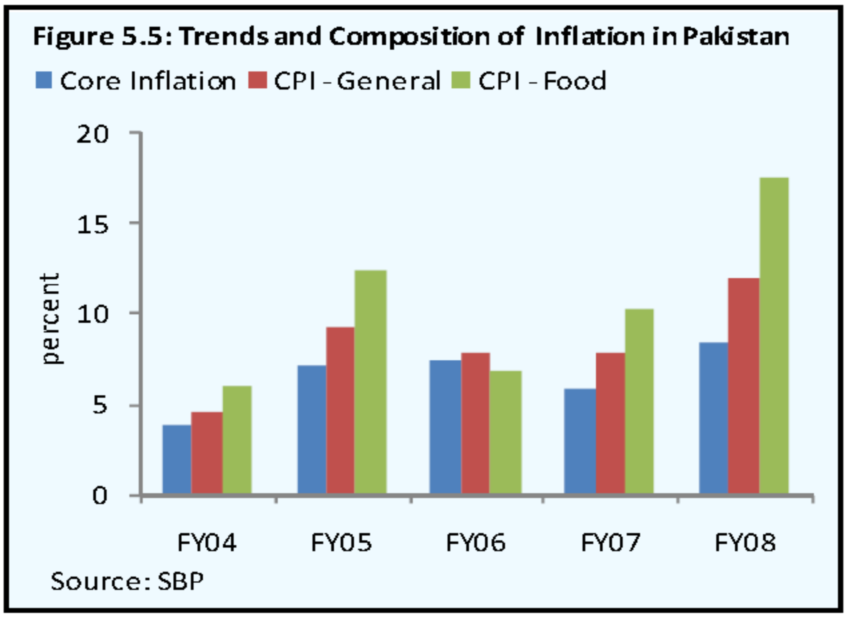
The phenomenal growth in consumer finance has also raised a debate regarding its downside risks and implications.

It is generally perceived that this particular asset product has:

i. Given rise to consumerism in Pakistan, this has contributed to the low level of national savings;
ii. Fueled inflation; and
iii. Led to the rise in speculative activities in asset markets

An analysis of actual facts and figures, however, dispels these notions

- Consumer Finance has certainly met the individual consumer's needs for personal expenditures, but in doing so, it has also generated demand for consumer durables and other goods and services which have in turn translated into a chain of economic activities
- For the consumer, monthly payments for servicing the loan are a form of forced savings
- Rather than promoting consumerism, this product has contributed in enhancing the standard of living of the middle class, which is the back bone of any economy
- Moreover, trends in savings of the household sector also do not support the perception of consumerism, as the average saving rate of the household sector is higher in the post 2000 period as compared with the '90s
- An analysis of inflation dynamics does not support the claim that consumer finance is the reason for the build up of inflationary pressures in the economy
- Core inflation, which is more sensitive to the level of credit and associated increase in demand, has shown quite contained growth over the last few years (Figure 5.5)
- The recent rise in overall inflation is attributable to factors such as international price shocks, and anomalies in administrative and fiscal policies



Personal loan is the only product which is not tied to a specific purpose, and thus could potentially be utilized for speculative transactions in asset markets.

However, its potential for spurring speculative activities is limited because of the fact that:

(a) given its unsecured nature, this loan is priced competitively and is not an attractive funding option for speculators;

(b) its main target market is mainly the fixed income / salaried segment of individual customers who are generally risk averse and are not known to indulge in speculative activities;

(c) such loans are relatively smaller in amount (average loan size Rs. 20,000) than other categories of consumer finance, whereas speculative transactions in asset markets generally require larger sums of money;

(d) the level and annual growth of this particular portfolio is quite small in comparison with other possible contributory factors such as the liquidity generated by increased foreign remittances and reverse capital flight, as well as the easy interest rate regime that prevailed up until a few years back, where disbursed loans for even small corporate entities and businesses could potentially have been miss-utilized

  - Essentially, consumer finance, if utilized judiciously and within prudent limits, is a handy tool for propelling economic growth, ensuring smooth consumption patterns and improving credit risk diversification

- That said, indiscriminate growth in this asset class in an unstable macroeconomic environment, without a corresponding strengthening of risk management systems, could potentially create systemic vulnerabilities (Recall Bank Business & Operating Model)

Because the financial system is so integrated — financial institutions borrow and lend large sums with each other every day in normal times—problems in a few banks can create a systemic risk for the financial system as a whole.

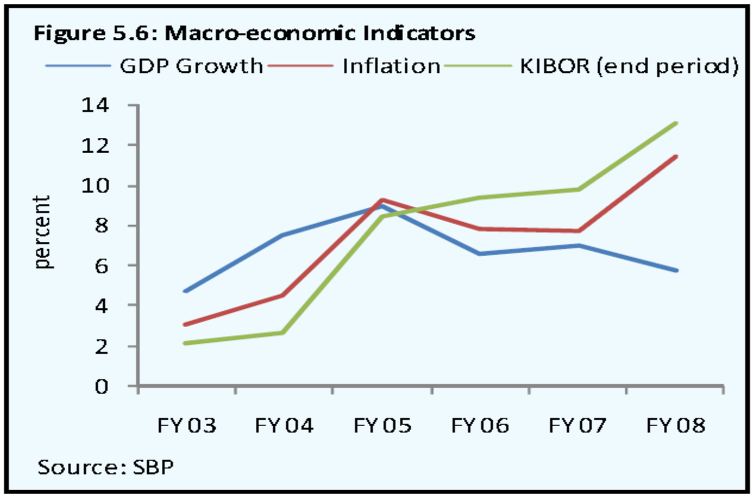
Paul O'Neill, a former Treasury secretary under President Bush, summarized this risk with a nice analogy:
"If you have ten bottles of water and one is poisoned, but you don't know which, no one drinks water".

LESSON 10

COSTING /PRICING OF CB PRODUCTS

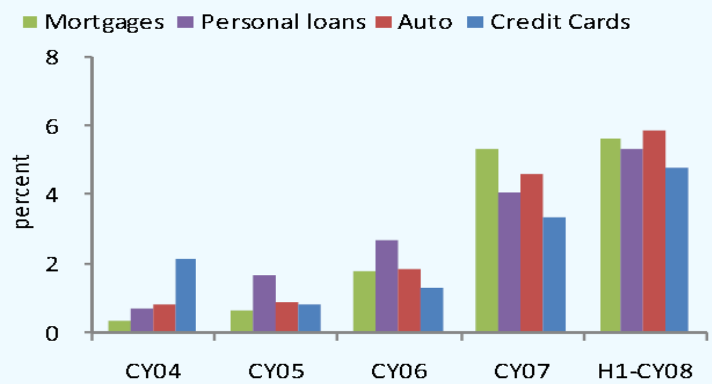
Major Issues and Challenges:

Bank's efforts to expand their consumer finance portfolio are mainly faced with challenges emanating from the less than favorable macroeconomic environment. Emerging deterioration in economic fundamentals i.e. rising inflation rate, a certain degree of slowdown in economic activities, etc. has constrained the consumer's debt servicing capacity (Figure 5.6).



- This weakness is further intensified by rising interest rates as a consequence of monetary tightening by the central bank which, besides dissuading new customers, have also made the existing debt servicing more costly, given that most of the loans under this asset class are made on a variable or floating rate basis
- An indication of the manifestation of the macroeconomic environment on consumer finance has already started to reflect in the deceleration in its growth rate, and a relative increase in nonperforming loans
- The infection ratio has gradually risen to 5.5 percent of the total outstanding credit in H1 CY08, though it is still lower than that for the corporate sector at 7.6 and the overall infection ratio of the credit portfolio at 7.7
- The performance of the different components however varies in this regard (Figure 5.7)
- Mortgage loans, with the lowest infection ratio, have shown relative improvement in disbursements over the last few quarters, while the biggest impact of the macroeconomic environment has been observed on the Credit Card, Personal and Auto loans' portfolio
- Bank wise data shows that consumer loans are more concentrated in around 10 banks
- Notwithstanding, since consumer credit is spread over a large number of borrowers, such risks are widely dispersed
- Results of a stress testing exercise (based on end June CY08 data) conducted on banks' consumer finance portfolio show that even a rise of 10.0 percentage points in the infection ratio will only reduce the Capital Adequacy Ratio (CAR) of banks by 90 bps
- This is because the share of consumer finance in the overall credit extended by banks is still rather low at 12.0 percent

Figure 5.7: NPLs to Loans Ratio of Consumer Sector



Source: BSD, SBP

In recognition of the underlying risks, SBP continues to make concerted efforts to strengthen the regulatory regime, as well as the risk management capacities of banks. The introduction of Prudential Regulations specifically designed to address the risk factors in the consumer finance portfolio in CY03, and enhancing the scope of the Credit Information Bureau (CIB) which was first launched in 1992 are some important measures implemented to ensure prudent growth of the portfolio. The enhancement in scope of the e-CIB database now gives a comprehensive coverage of all borrowers of the banking sector (and some non-bank financial institutions) which has helped banks in ensuring that customers are not over-leveraged, and that the loan to income ratios are managed more prudently. Furthermore, SBP's regulations and guidelines on risk management and internal controls effectively delineate the desirable level of internal controls and risk management capacities which the banks have started to implement for their consumer finance operations. Banks are building upon the existing capacities and rapidly improving their risk management expertise in response to regulatory requirements. Their progress along the learning curve suggests that they are now better placed to handle the challenges related to the operations of the consumer finance business.

Future Outlook

Given that the total consumer financing portfolio currently forms around 12.0 percent of the total loans and advances of the banking sector in comparison with substantially larger portfolios in peer countries, and its conducive role in promoting economic development, concerns about the potential risks of this product need to be viewed in perspective. This is particularly so because the household sector in Pakistan, from where the demand for consumer finance is generated, is financially sound and under leveraged by international standards.

Notwithstanding, given the pace of growth of this particular asset class and its increasing popularity, financial institutions need to carefully plan the expansion of their respective portfolios by minimizing the impact of the potential risks with adequate systems and resource support, in order to be able to sustain and positively avail the benefits of its growth.

Notwithstanding these developments, a few initiatives are still crucially needed for maintaining the stability of the consumer finance portfolio in coming years:

- With the growing exposure against consumer finance, banks would need to implement specific credit scoring models. These can be based on the information derived from credit history databases, such as the turnaround time of monthly repayments, level of income and type of debt, length of credit relationship, in addition to other key pieces of information on social and demographic factors which help in establishing borrower profiles. The model will help banks in objectively identifying the credit worthiness of a borrower and the likely credit behavior. However, for building an effective credit scoring model, the existing databases on the consumer's credit history would need significant enhancements;
- The prevailing regime for enforcement of security liquidation and collection of debts needs to be rationalized in terms of effectiveness and fairness to both banks as well as consumers;

- Considering the low level of financial literacy of the average consumer, mainly due to the low level of awareness and the prevailing literacy rate in the country, banks would need to review the transparency of the pricing mechanism, and offer a choice between fixed and floating rates to the customers, while informing them of the pros and cons associated with each option. Such initiatives will also help in improving the ethical standards of banks' dealing with their customers

Financial Position of the Household Sector:

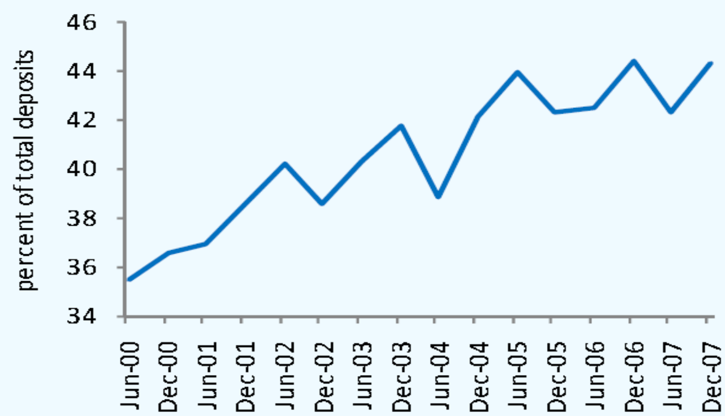
The household sector is the single largest provider of funding (in terms of personal deposits) to the banking system. In aggregate terms, it holds 46.0 percent of banking system deposits, while it borrows only 12.0 percent of the total loan portfolio. National Income Accounts also reinforces this assessment, as the share of personal savings in total national savings is over 80 percent.

While all these figures clearly indicate the household sector's significant contribution to the financial sector, a detailed analysis in the context of financial stability is heavily constrained by the lack of appropriate data. The net wealth, or financial position, of the household sector is therefore estimated on the basis of selected indicators including trends in personal deposits of the banking system, individual investments in the stock market, and growth in personal investments in National savings Schemes (NSS). Changes in the consumer loan portfolio of the banking sector are used as the only available indicator of outstanding debt.

Personal Deposits

Personal deposits of the banking sector registered a YoY increase of 19.9 percent during CY07, compared to 18.2 percent in CY06, to reach Rs 1.6 trillion. Strong growth in personal deposits in recent years is also visible from its increasing share in the overall deposits of the banking system. Specifically, the share of personal deposits in total deposits increased to 45.0 percent by end June CY08, in comparison with 42.3 percent at end June CY07, and 40.3 percent as of end June CY03 (Figure 1). This is an encouraging development as the overall deposits of the banking system in recent years have also recorded an average growth of over 18.0 percent during CY03-07. The steady growth in personal deposits is largely attributed to: (i) record inflows of remittances; and (ii) a sharp increase in per capita income in the wake of strong economic growth in recent years.

Figure 1: Trends in Personal Deposits

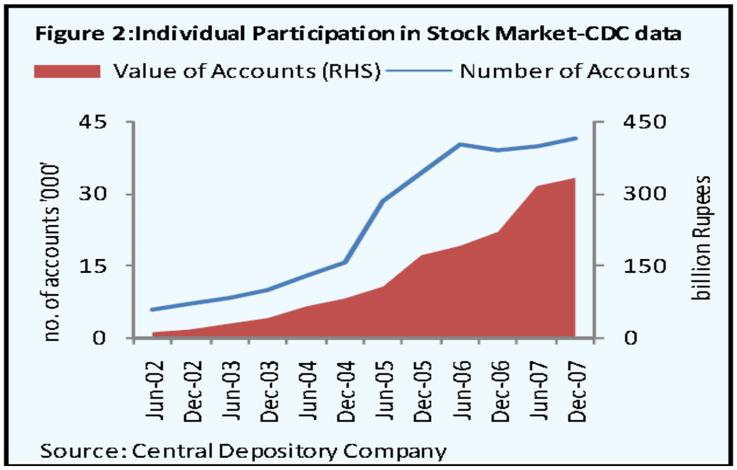


Source: Statistical Bulletin, SBP

Investments in Equity Market

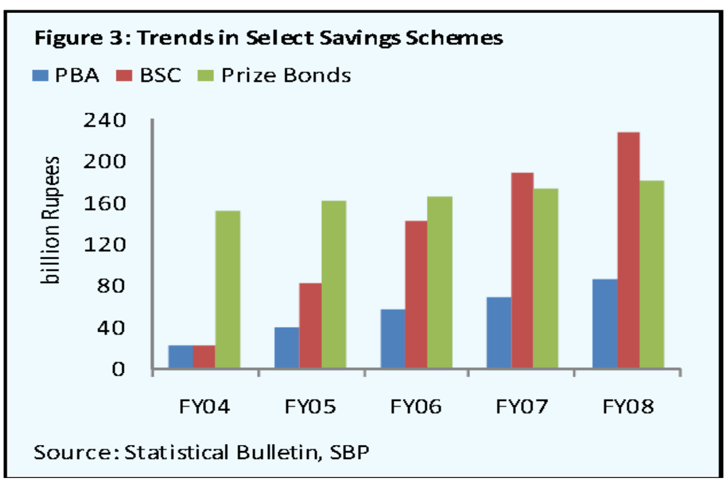
Another indicator of financial health of the household sector is the individual customer's investments in the stock market. According to statistics from the Central Depository Company (CDC), the number of individual account holders investing in the stock market has reached 41,700 accounts by end CY07, compared to 10,000 at end CY03. The total value of these individual accounts has also grown significantly to reach Rs. 331.7 billion inCY07 against Rs 39.9 billion in CY03 (Figure 2). However, the pace of growth in new individual accounts at CDC has slowed down markedly in CY07, at 6.3 percent in comparison with 13.2 percent in CY06, 121.1 percent in CY05 and 57.0 percent during CY04. Interestingly, despite the lower growth in the number of accounts during CY07, the volume of accounts grew by 51.3 percent against 28.6

percent in CY06; showing increased transactional activities in both new and existing accounts, due to both higher stock prices and increased volume of transactions.



Investments in NSS

The Central Directorate of National Savings (CDNS) offers various types of saving schemes for individuals and institutional investors. While all the schemes are open to individual investors, statistics on the proportion of individual investments are not available from CDNS. In order to estimate the growth of personal investments in these instruments, investments in those savings schemes which are offered to individuals investors only are taken into account. These schemes are: Bahbood Saving Certificates (BSC), Pensioner's Benefit Account (PBA) and Prize Bonds. The outstanding amount in these schemes reached Rs 498.0 billion by end June 08, which constitutes 45.9 percent of the outstanding amount in all NSS, instruments i.e. Rs 1,084.0 billion. In aggregate, these schemes increased by Rs 64.3 billion during FY08, which was slightly lower than the increase of Rs 67.7 billion in FY07 (Figure 3). In terms of growth rates, the outstanding amount grew by 14.8 percent during FY08, compared to 18.5 percent in FY07. This slight decline during FY08 is primarily attributed to the fact that the substantial growth in these schemes when they were relatively new is now at more sustainable levels. Also, individuals also invest in other schemes, as BSC and PBA are in particular available for senior citizens/widows/pensioners only. Recent upward revisions of the rate of return on these schemes are likely to attract more investments into these instruments.



Following to be discussed in detail in the next lessons

Regulatory Framework for Consumer Financing:

1) Prudential Regulations for Consumer Financing
2) Guidelines for Standardization of ATM Operations
3) Guidelines for Dealing with Customer Complaints
4) Credit Information Bureau

5) Redress Mechanisms for Consumer Complaints
    i. Internal Complaint Units/Sections of Banks
    ii. Banking Ombudsman
    iii. Consumer Protection Department
    iv. Banking Courts for Recovery of Loans
6) The Financial Institutions (Recovery of Finances) Ordinance, 2001
7) The Payment Systems and Electronic Fund Transfers Act, 2007
8) The Competition Ordinance, 2007

Box 5.1: Regulatory Requirements for Consumer Financing

SBP has issued separate Prudential Regulations for Consumer Financing, and continues to issue directives in response to the changing market dynamics, to ensure the prudent risk management of banks' consumer finance portfolio.

Some of the safeguards laid out in the regulations are :

1. Prior to offering consumer finance as a product, banks/DFIs are required to establish appropriate risk management systems, in addition to strong internal audit and control functions. They have to ensure that the staff involved in dealing with customers and processing these applications are adequately equipped and trained.
2. Banks/DFIs are required to ensure the implementation of effective collections procedures and mechanisms to efficiently obtain repayment of monthly loan installments, while also dealing appropriately with delinquent customers.
3. Banks are required to obtain the e-CIB Credit information report prior to approval of a loan to ensure that the customer has a clean credit history and is not over-leveraged.
4. Banks are advised to institute necessary checks to ensure that clean loans are not used to participate in Initial Public Offerings (IPOs).
5. Specified limits on the exposure against total consumer financing as well as percentage of classified consumer financing, both in terms of capital, are laid out in the Prudential Regulations.
6. Banks are required to ensure that total financing facilities are commensurate with the borrower's income.
7. Banks are required to maintain a general reserve at least equivalent to 1.5 percent of the consumer portfolio which is fully secured, and 5 percent of the unsecured portfolio, to protect themselves from the pro-cyclical nature of this business.
8. Banks follow stringent provisioning requirements against classified loans, which protect them from potential erosion in asset quality.

Source: Banking Policy and Regulations Department (BPRD), State Bank of Pakistan

LESSON 11

COSTING / PRICING OF CB PRODUCTS (CONTD…)

SBP PRUDENTIAL REGULATIONS FOR CONSUMER FINANCING APPLICABLE TO ALL BANKS/DFI'S

MINIMUM REQUIREMENTS FOR CONSUMER FINANCING:

- General requirements laid down here should be followed by while undertaking consumer financing
- These minimum requirements should not in any way be construed to restrict the role of the management to further strengthen the risk management processes through establishing comprehensive credit risk management systems appropriate to their type, scope, sophistication and scale of operations
- The Boards of Directors are required to establish policies, procedures and practices to define risks, stipulate responsibilities, specify security requirements, design internal controls and then ensure strict compliance with them

Banking Characteristics	Risk Class	Risk Category
Environment	Environmental Risks	Legislative Economic Competitive Regulatory
Human Resource	Management Risks	Defalcation Organizational Ability Compensation
Financial Services	Delivery Risks	Operational Technological New Products Strategic
Balance Sheet	Financials Risks	Credit Liquidity Market Leverage

- Risk is defined as the volatility of a corporation's market value. The definition that has been selected is as broad as possible. What is of interest is all decisions that may impact on a change in market value
- This is consistent with the view that risk management is about optimizing the risk-reward tradeoff– not about minimizing the absolute level of risk
- SBP guidelines define financial risk in a banking organization as the possibility that the outcome of an action or event could bring up adverse impacts
- Such outcomes could either result in a direct loss of earnings / capital or may result in imposition of constraints on bank's ability to meet its business objectives
- Such constraints pose a risk as these could hinder a bank's ability to conduct its ongoing business or to take benefit of opportunities to enhance its business

Figure 3: Three Main Types of Risk

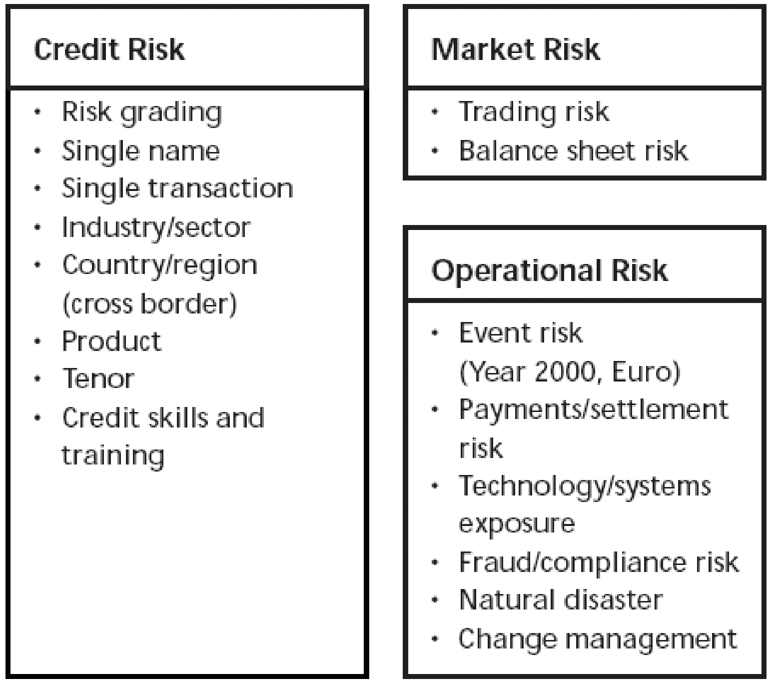
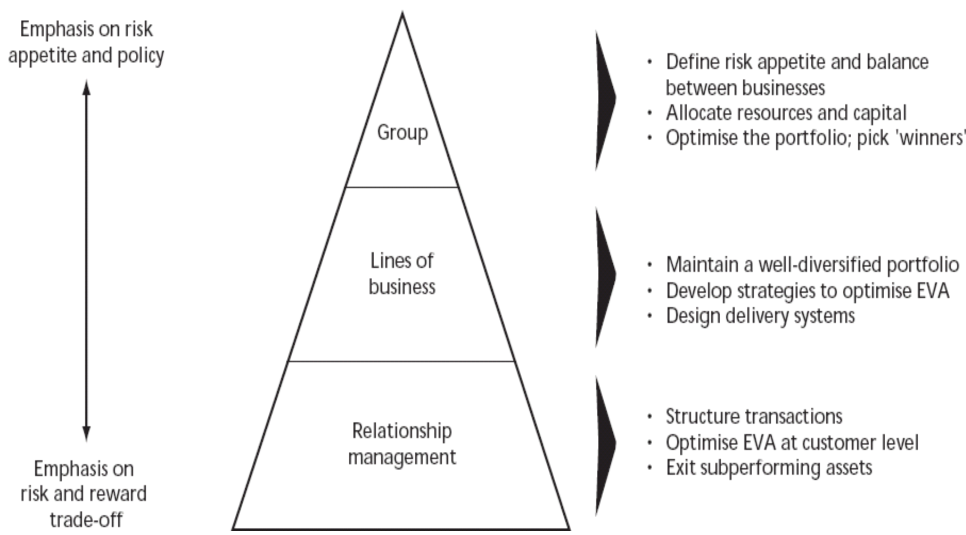


Figure 11: Roles in the Risk Management Process



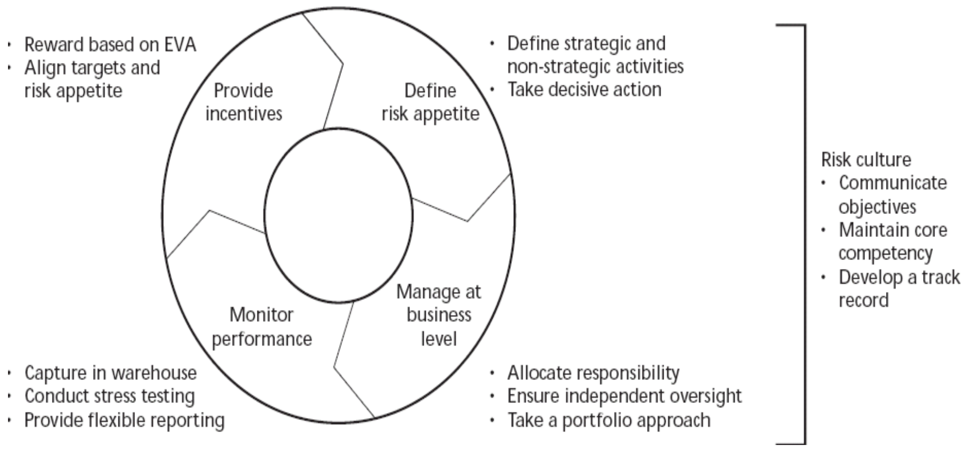
PRE-OPERATIONS:

Before embarking upon or undertaking consumer financing, the banks / DFIs shall implement / follow the guidelines given below:

1) The banks / DFIs already involved in the consumer financing will ensure compliance with these guidelines within six months of the date of issuance of Prudential Regulations for Consumer Financing
2) Banks / DFIs shall establish separate Risk Management capacity for the purpose of consumer financing, which will be suitably staffed by personnel having sufficient expertise and experience in the field of consumer finance / business
3) They shall prepare comprehensive consumer credit policy duly approved by their BOD (in case of foreign banks, by Country Head and Executive / Management Committee), which shall interlay cover loan administration, including documentation, disbursement and appropriate monitoring

mechanism. The policy shall explicitly specify the functions, responsibilities and various staff positions' powers / authority relating to approval / sanction of consumer financing facility

Figure 10: Making Consistent Risk Management Decisions



4) For every type of consumer finance activity, the bank / DFI shall develop a specific program. The program shall include the objective / quantitative parameters for the eligibility of the borrower and determining the maximum permissible limit per borrower
   - They shall put in place an efficient computer based MIS for the purpose of consumer finance, which should be able to effectively cater to the needs of consumer financing portfolio and should be flexible enough to generate necessary information reports used by the management for effective monitoring of the their exposure in the area. The MIS is expected to generate the following periodical reports:
     - Delinquency reports (for 30, 60, and 90, 180 & 360 days and above) on monthly basis
     - Reports interrelating delinquencies with various types of customers or various attributes of the customers to enable the management to take important policy decisions and make appropriate modifications in the lending program
     - Quarterly product wise P/L account duly adjusted with the provisions on account of classified accounts. These P/L statements should be placed before the BOD in the immediate next Board Meeting. The branches of foreign banks in order to comply with this condition shall place the reports before a committee comprising of CEO / Country Manager, CFO and Head of Consumer Business
5) The banks / DFIs shall develop comprehensive recovery procedures for the delinquent consumer loans. The recovery procedures may vary from product to product. However, distinct and objective triggers should be prescribed for taking pre-planned enforcement / recovery measures
6) The banks / DFIs desirous of undertaking consumer finance will become a member of at least one Consumer Credit Information Bureau. Moreover, the banks / DFIs may share information / data among themselves or subscribe to other databases as they deem fit and appropriate
7) The financial institutions starting consumer financing are encouraged to impart sufficient training on an ongoing basis to their staff to raise their capability regarding various aspects of consumer finance
8) The banks / DFIs shall prepare standardized set of borrowing and recourse documents (duly cleared by their legal counsels) for each type of consumer financing

OPERATIONS:

1. Consumer financing, like other credit facilities, must be subject to the Bank's / DFI's risk management process setup for this particular business. The process may include, identifying source of repayment and assessing customers' ability to repay, his / her past dealings with the bank / DFI, the net worth and information obtained from a Consumer Credit Information Bureau
2. At the time of granting facility under various modes of consumer financing, banks / DFIs shall obtain a written declaration from the borrower divulging details of various facilities already

obtained from other financial institutions. They should allow fresh finance / limit only after ensuring that the total exposure in relation to the repayment capacity of the customer does not exceed the reasonable limits as laid down in their approved policies. The declaration will also help them to avoid exposure against a person having multiple facilities from different financial institutions on the strength of an individual source of repayment

3. Before allowing any facility, the banks / DFIs shall preferably obtain credit report from the Consumer Credit Information Bureau of which they are a member. The report will be given due weightage while making credit decision
4. Internal audit and control function of the bank / DFI, apart from other things, should be designed and strengthened so that it can efficiently undertake an objective review of the consumer finance portfolio from time to time to assess various risks and possible weaknesses. The internal audit should also assess the adequacy of the internal controls and ensure that the required policies and standards are developed and practiced. Internal audit should also comment on the steps taken by the management to rectify the weaknesses pointed out by them in their previous reports for reducing the level of risk
5. The banks / DFIs shall ensure that their accounting and computer systems are well equipped to avoid charging of mark-up on mark-up. For this purpose, it should be ensured that the mark-up charged on the outstanding amount is kept separate from the principal
6. The banks / DFIs shall ensure that any repayment made by the borrower is accounted for before applying mark-up on the outstanding amount

DISCLOSURE / ETHICS:

The banks / DFIs must clearly disclose, all the important terms, conditions, fees, charges and penalties, which interalia include Annualized Percentage Rate, pre-payment penalties and the conditions under which they apply. For ease of reference and guidance of their customers, banks / DFIs are encouraged to publish brochures regarding frequently asked questions.

For the purposes of this regulation, Annualized Percentage Rate means as follows:

$$\frac{\text{Mark-up paid for the period}}{\text{Outstanding Principal Amount}} \times \frac{360}{\text{No. of Days}} \times 100$$

REGULATION R-1

FACILITIES TO RELATED PERSONS:

- The consumer finance facilities extended by banks / DFIs to their directors, major shareholders, employees and family members of these persons shall be at arms length basis and on normal terms and conditions applicable for other customers of the banks / DFIs
- The banks / DFIs shall ensure that the appraisal standards are not compromised in such cases and market rates are used for these persons
- The facilities extended to their employees as a part of their compensation package under Employees Service Rules shall not fall in this category

Utilization of Clean Loans for Initial Public Offerings IPOs:

While the State Bank's intent is not to create any undue hindrance in the smooth flow of consumer financing to the borrowers, the banks /DFIs are, however, advised to institute necessary checks, so that clean loans are not used for subscription in Initial Public Offerings (IPOs). In this connection, SBP suggests the following two minimum requirements:

(a) At the time of sanction of a clean consumer loan / credit line, they should obtain an undertaking from the client, that the drawings from the loan account will not be used for subscription in an IPO

(b) They should introduce an internal system, whereby, no cheques, drafts and / or payment instructions will be made for an IPO subscription account from a clean personal loan / credit line account

REGULATION R-2
LIMIT ON EXPOSURE AGAINST TOTAL CONSUMER FINANCING:
Banks / DFIs shall ensure that the aggregate exposure under all consumer financing facilities at the end of first year and second year of the start of their consumer financing does not exceed 2 times and 4 times of their equity respectively. For subsequent years, following limits are placed on the total consumer financing facilities:

PERCENTAGE OF CLASSIFIED CONSUMER FINANCING TO TOTAL CONSUMER FINANCING	MAXIMUM LIMIT
a) Below 3%	10 times of the equity
b) Below 5%	6 times of the equity
c) Below 10%	4 times of the equity
d) Upto and above 10%	2 times of the equity

REGULATION R-3
TOTAL FINANCING FACILITIES TO BE COMMENSURATE WITH THE INCOME:
While extending financing facilities to their customers, the banks / DFIs should ensure that the total installment of the loans extended by them is commensurate with monthly income and repayment capacity of the borrower. This measure would be in addition to their usual evaluations of each proposal concerning credit worthiness of the borrowers, to ensure that their portfolio under consumer finance fulfills the prudential norms and instructions issued by the SBP and does not impair the soundness and safety of the bank / DFI itself.

REGULATION R- 4
GENERAL RESERVE AGAINST CONSUMER FINANCE:
The banks / DFIs shall maintain a general reserve at least equivalent to 1.5% of the consumer portfolio which is fully secured and 5% of the consumer portfolio which is unsecured, to protect them from the risks associated with the economic cyclical nature of this business.

The above reserve requirement will, however, be maintained for the performing portion only of consumer portfolio.

REGULATION R-5
BAR ON TRANSFER OF FACILITIES FROM ONE CATEGORY TO ANOTHER TO AVOID CLASSIFICATION:
The banks / DFIs shall not transfer any loan or facility to be classified, from one category of consumer finance to another, to avoid classification.

REGULATION R-6
MARGIN REQUIREMENTS:
Banks / DFIs are free to determine the margin requirements on consumer facilities provided by them to their clients taking into account the risk profile of the borrower(s) in order to secure their interests. However, this relaxation shall not apply in case of items, import of which is banned by the Government.

- Banks / DFIs will continue to observe margin restrictions on shares / TFCs as per existing instructions under Prudential Regulations for Corporate / Commercial Banking (R-6). Further, the restrictions prescribed under paragraph 1.A of Regulation R-6 of the Prudential Regulations for Corporate / Commercial Banking will also be applicable in case of Consumer Financing
- State Bank of Pakistan shall continue to exercise its powers for fixation / reinstatement of margin requirements on consumer facilities being provided by banks/DFIs for various purposes, as and when required

LESSON 12

BANK SCHEDULE OF CHARGES

Guidelines for Standardization of ATM Operations

ATM is among the most important e-banking delivery channels in Pakistan. It is becoming increasingly popular, as it facilitates accountholders to withdraw fast cash anytime, inquire balance, and transfer funds throughout the year. The SBP has issued separate guidelines for all the commercial banks and switch operators in order to curtail any inconvenience to the users of ATM services. The guidelines require the banks having ATMs to carry out cash balancing and reconciliation on every working day at the time fixed by their Head Office, other than the peak hours.

According to the guidelines, a process of "automatic credit" is to be carried out on the basis of verified individual transactions in which a customer's account has been debited without any cash disbursement.

Moreover, the process of "automatic credit" is to be completed within the timeframe ranging from one to seven business days, depending on the manner of execution of transaction by a cardholder of a bank. In order to facilitate the customers and meet the objectives of the ATM, banks are also required to develop a detailed documented procedure for automatic credit and carry out training of relevant staff members. The guidelines necessitate Card Facilitation Centre (CFC) in every bank. CFC is a unit responsible for managing e-banking channels and maintaining database of cases (resolved/unresolved) of its own customers and balance in suspense account. In this regard, every branch ought to report to CFC the details of claims settled, outstanding claims and balance suspense account on daily basis, to enable quick response of queries.

It is mandatory for all the banks to identify at least two key personnel of CFC, who would be responsible for responding to the queries of customers, and their contact details are to be made available on website of the bank. Furthermore, customer must be informed in writing about the amount credited to his/her account by the issuing bank. Besides, the customers are not to be charged for minimum balance when their account has been debited without cash disbursement and time for which the amount remains payable. For providing secondary evidence to satisfy the customer against cash claims, banks are required to install external camera in ATM cabins in a way that PIN may not be captured.

Moreover, the guidelines obligate all banks to report details regarding the nature of transactions (automatic credit, claims processed or outstanding balance (suspense ATM cash), and total number and amount of actual transactions to the SBP's Payment Systems Department (PSD). In addition, every bank is required to develop a numbering sequence for complaints and every complainant is to be issued a reference number.

These guidelines are applicable only on cards used on ATM machines for local currency transactions, which are carried out in Pakistan.

Guidelines for Dealing with Customer Complaints:

Keeping in view the complaints received by the SBP regarding financial losses, damage to the businesses, and delayed response of banks, the SBP has issued guidelines for dealing with the customer complaints. SBP observed that due to absence of proper mechanism for resolution of public grievances, the banks are unable to respond to the customer complaints promptly and efficiently. Therefore, these minimum guidelines require every bank and financial institution to designate a senior officer to deal with all sorts of complaints, whether they are received directly by the bank or referred to by other institutions including the SBP. All banks are obligated to provide contact details of such designated officials or any change with this reference to the SBP.

According to the guidelines, the person and the unit/section appointed for this purpose is responsible for acknowledging, addressing, handling and investigating all the complaints in a fair and prompt manner. The reply to the complaints ought to be clear and indicate the reasons of the decisions taken. The complaint unit is also required to identify complaints of recurring nature for taking immediate corrective measures in the related area. In addition, the unit has been guided to monitor and analyze the status and data of complaints for improving the system. Every bank or financial institution is also required by the guidelines to submit a regular report about the complaints to the management of the bank or financial institution for review.

The response time for the complaints has been fixed at 10 days under the guidelines. However, an interim reply can also be sent to the complainant explaining the reasons for delay, but the final reply is to be transmitted within 45 working days. Like other departments of the bank, the complaints department/unit is also required to be regularly audited by internal auditors to check the effectiveness and performance of the unit.

For raising awareness among the customers about the grievance redress procedure and complaint unit, the banks and DFIs are required to prepare a leaflet indicating the procedure for lodging a complaint and its resolution, and post the same on the notice boards at each of their branch/office and on the website. Besides, a copy of the leaflet is to be supplied to customer upon request. Moreover, the bank staff is to be provided appropriate training to enhance their skills so that an employee who is not directly involved with the complaint unit may investigate a complaint, if required.

The guidelines specify that the complaints forwarded by the SBP would be handled by the person who is the contact person for SBP in this regard. Whereas, the SBP would check the performance, effectiveness and function of the complaint section and strict actions would be taken against the bank or DFI and the concerned staff members for noncompliance with the procedures or mishandling of complaints.

What is a Grievance?

'Grievance' may be defined as a formal statement of complaint generally against an authority, or an institution. Most often, organizations establish a body or designate an officer who deals with complaints of the clients. Such a body plays important role for identification, intervention and resolution of issues that have the potential of becoming a grievance. When the circumstances do not allow prior resolution of issues and a grievance takes place, the redress forum is responsible for initiating a grievance redress process. The aim is to protect the citizens' right to raise a genuine issue, lodge a complaint for a grievance, and have the grievance redressed in a timely manner.

On line Credit Information Bureau (e-CIB)

While developed countries have a long tradition of maintaining a centralized database of credit history of all borrowers, in many developing countries it is a relatively new development, given the scope and size of their lending activities. State Bank considers the functioning of an effective credit information bureau integral in promoting financial discipline and an essential tool for credit risk management by financial institutions. In its endeavor to facilitate financial institutions in making prudent lending decisions, the Credit Information Bureau (CIB) was established in 1992. Due to the rather small and largely secured lending extended to individual customers at that time, the initial focus of the CIB database was on capturing the *negative history* of large and medium sized borrowers, with outstanding loans equal to and above Rs 500,000 only. Over the years, SBP has significantly enhanced the scope of CIB operations. In April 2003, SBP enhanced the coverage and effectiveness of CIB by introducing e-CIB online facilities, becoming in the process, the first credit history database of the region to introduce online access to its member financial institutions. This development enabled financial institutions to upload their data on loans directly into the CIB database and readily generate customer reports for their credit assessment purposes.

In response to the rapid growth in banks' credit portfolio, e-CIB's reporting requirements and operational and IT platforms have been significantly upgraded. The scope of the CIB database was further enhanced during early 2004 when SBP launched a new project called the "e-CIB data lowering limit" with the collaboration of Pakistan Banks Association (PBA) to achieve the following objectives:

- Abolishing the minimum limit of Rs 0.5 million and above for credit reporting and to expand the database to cover all loans of member financial institutions
- Changing the composition of the information to include more financial and non-financial details of the borrowers
- Improve the overall operational efficiency of e-CIB by upgrading the communication infrastructure, hardware and software, etc

The project aimed at transforming CIB into a state-of-the-art credit information database with the ability to minimize the turnaround time of queries from financial institutions and providing a quick source of information. The project was successfully completed in June 2006 and brought significant improvements in the overall operational and technological infrastructure of the CIB. The key improved features of the new e-CIB system over the old CIB system are summarized below:

- Existing credit reporting limits of Rs 0.5 million has been eliminated. Under the new reporting system, all outstanding fund and non-fund based credit facilities, irrespective of the amount, are being reported to SBP
- Besides Banks and DFIs, for whom membership in e-CIB is mandatory, a large number of NBFCs are also members of this database
- Product-wise availability of loan information. Before implementation of the new system, such information was available in aggregate form only
- Improved efficiency in terms of speed, reliability and security of CIB data
- Deployment of high capacity servers, security firewalls, broader bandwidth, point-to-point data encryption
- Multi-user and multi-tiered Rich Client Data using latest programming tools, provided to 100 financial institutions. The software has been designed keeping in view the data collection requirements of all financial institutions and can be customized according to the needs of specific financial institutions. It can be deployed in both centralized and decentralized environments. The software is capable to efficiently collect, consolidate and report thousands of records from all branches of a large bank
- Highly sophisticated and completely automated Back Office (BO) system for processing data. With the implementation of the BO system the task of data processing has been reduced from 15 days to 3 days only
- Web based interactive data inquiry systems to provide online Credit Information Reports to financial institutions, and allow online amendment and updates
- Replaced the previous dial-up system with a scalable Virtual Private Network (VPN) that allows financial institutions to connect to the e-CIB more quickly and efficiently
- Comprehensive data validation rules implemented to ensure correct entry of records. A validation rule engine has also been developed for creating and implementing new data validation rules
- A new separate reporting system has been introduced for consumer and commercial borrowers. The CIB will collect consumer and corporate credit data on two separate specified formats and provides separate credit information reports for the consumer and corporate borrowers
- The credit report of the consumer also reflects the repayment history for the last twelve months
- Record of last four credit inquiries from the financial institutions has also been made part of the respective borrower’s credit report

Redress Mechanisms for Consumer Complaints:

Banking Ombudsman

The Federal Government established the Banking Ombudsman in 2005. The principal responsibility of the Ombudsman is to resolve the complaints through mediation and provide an amicable and acceptable solution where conciliation is not possible.

Jurisdiction

The Banking Ombudsman has been entrusted with the powers and responsibilities to entertain complaints lodged by the customer against the scheduled banks or by a scheduled bank against another bank, and provide the basis for an amicable and acceptable solution after giving hearings to the complainant and the concerned bank. Moreover, Banking Ombudsman has been given authority to make recommendations, to be communicated to the concerned bank for considering the issue, and in some cases to pass an order against the concerned bank. To improve the service standards and effectiveness, and remove the generalized systematic deficiencies, the Banking Ombudsman can recommend procedural improvements. SBP can inquire the banks involved in violation of laws and regulations on recommendation of the Ombudsman.

The authority and powers of Banking Ombudsman have been specified for private and public sector banks. In relation to all banks, Banking Ombudsman has been given the authority to entertain the complaints regarding bank’s failure to act in accordance with the laws, regulations, policy directives and guidelines, which are time to time issued by SBP and inquire the delays or fraud in relation to the payment or collection of cheques, drafts or transfer of funds. Moreover, the Banking Ombudsman has also been allowed to consider the complaints regarding fraudulent or unauthorized withdrawal or debit entries in accounts, complaints from exporters or importers, complaints related to banking services and obligations including letters of credit, complaints from holders of foreign currency accounts, whether maintained by residents or non-residents, complaints relating to remittances to or from abroad and relating to payment of utility bills.

A noteworthy characteristic of the Baking Ombudsman is that it has some special powers, which do not apply to the private banks. The responsibilities of entertaining the complaints pertaining to corruption, negligence of duties by bank officers in dealing with customer and excessive delay in taking decisions can be exercised only in respect of public sector banks.

In addition, Banking Ombudsman has the authority to call for relevant information necessary for disposal of complaints, receiving evidence on affidavit and issuing commission for examination of witness, given that confidentiality would not be violated.

Bar on Jurisdiction

However, there are some matters which are outside the jurisdiction of Banking Ombudsman including the power to direct banks for giving loans and advances to a complainant. Similarly, the Banking Ombudsman has no authority to consider the complaints regarding the schedule of charges and any other policy matter of banks. Likewise, complaints pertaining to terms and conditions of service of the bank are not accepted by the Banking Ombudsman. Moreover, awarding the damages against banks is not within the jurisdiction of Banking Ombudsman. However, the authority for the compensation of loss suffered by aggrieved persons in pursuit of justice lies with him.

Complaint Procedure

The complaint handling process of Banking Ombudsman is centralized at the Karachi Secretariat. The complainant is required to file a complaint to the bank in writing stating the intention to refer the matter to the Banking Ombudsman if matter would not be resolved satisfactorily. The bank is required to resolve the complaint within 45 days, otherwise the complainant can file the case to Banking Ombudsman on the complaint form duly completed, signed and attested by an Oath Commissioner, attached to the letter of complaint. Moreover, the complainants are required to make sure that copies of all documents and relevant correspondence with the bank are also attached along with the form and letter of complaint.

The Banking Ombudsman entertains those complaints, which are filed by a customer against scheduled bank or by a scheduled bank against any other bank. Further, the rejected complaints, which have not been barred by time or have not been destroyed by the bank, are also entertained by the Banking Ombudsman. In this regard, the complainant has to send all related correspondence along with the complaint form without giving 45 days notice to the concerned bank.

When a complaint is lodged to the Banking Ombudsman, first all procedural requirements are confirmed and both parties may be required to provide additional information, if necessary. Informal complaints (i.e. walk in, e-mail, copies of letters or via telephone) are resolved by providing procedural guidance to complainant. In case of formal complaints, the banks are formally informed where necessary. Regarding informal complaints, the law allows to entertain only those complaints, which have been filed directly to Banking Ombudsman and made under oath.

The Banking Ombudsman may also visit the concerned bank to examine their books, procedures and processes relating to complaints. The case is closed if found unjustified. However, if a case is found to be genuine, then it would be resolved through mediation. The situation where conciliation is not possible, the Banking Ombudsman passes an order asking the bank to rectify the situation or compensate the loss of aggrieved.

The Banking Ombudsman solves the complaint within two months. However, some complaints may take longer to resolve if they are complex or information and copies of documents are not provided by the complainant. Therefore, a complainant is required to make sure that the complaint form has been filled in with clarity and copies of all the relevant documents are attached.

The Right to Appeal

The law provides the right to appeal to parties, the complainant and the bank. A complainant, dissatisfied with the decision of Banking Ombudsman, has the right to appeal to the Governor SBP within 30 days from the date of order of the Ombudsman. Moreover, a complainant, dissatisfied with the decision of SBP, has also been given the right to go to a court of law. However, the Ombudsman's decision would be final, operative and binding upon the bank, if no appeal is filed or SBP does not uphold the appeal.

Several changes have been made in the Banking Companies Ordinance, 1962 through the Finance Act, 2007 empowering the Banking Ombudsman to issue commission for the examination of witnesses. In consideration of the changes, Banking Ombudsman does not entertain those cases, which have already been decided or handled by the SBP.

The time allowed to banks, to send the complaint to the Banking Ombudsman if not resolved, is reduced to 45 days from three months. Earlier, there was no time limit for disposal of an appeal filed with SBP against any order by the Banking Ombudsman, which has now been limited to 60 days. Unless an appeal is referred to the Governor SBP, the time limit for implementation of an order passed by the Banking Ombudsman has been increased to 40 days and submission of compliance report is compulsory, which was not required previously.

Consumer Protection Department:

- Keeping in view the growth in consumer banking and related consumer complaints, SBP has issued a circular on January 30, 2008 for the establishment of new department, namely Consumer Protection Department (CPD)
- The Department would resolve consumer complaints dealing with banks
- All banks and financial institutions would submit complaints and appeals against the orders passed by the Banking Ombudsman to the Consumer Protection Department

Banking Courts for Recovery of Loans:

- Under the Recovery of Finances Ordinance, 2001, the Federal Government has been entrusted with the authority to establish banking courts, appoint judges for each of such courts, and specify the territorial limits to exercise its jurisdiction
- Federal Government has established 29 banking courts throughout Pakistan for quick recovery of bank loans from defaulters
- The order of banking court would be final and no other court or authority would have power to revise, review or call, into question any proceeding, judgment, decree or order of banking court

The Financial Institutions (Recovery of Finances) Ordinance, 2001:

- The new recovery law provided a mechanism for expeditious recovery of stuck up loans, e.g., the law provided a comprehensive procedure for the foreclosure and sale of mortgaged property without the interventions of a court of law, and automatic transfer of all cases pending in any other courts to the banking courts for their early resolution
- Under the new legislation, banks may recover debt through summary procedure, and sell mortgaged property without intervention of the court

The Payment Systems and Electronic Fund Transfers Act, 2007

With the rapid development in technology, like other spheres of human life business and trade are also no more limited to traditional modes of delivery of products and services, as well as, purchase and payments in cash. A person sitting at one place can buy any product from another place through internet and can pay through secured online electronic channels like credit cards. Many countries around the world have formulated laws, rules and documentation procedures for secure fund transfer through electronic means.
The Government of Pakistan promulgated the Payment Systems and Electronic Fund Transfers Act, 2007 in order to encourage documentation of economy, supervise and regulate such payments and fund transfers, provide standards for protection of the consumer and to determine respective rights and liabilities of the financial institutions and other services providers, and their consumers and participants. The Act is aimed at providing regulatory framework for the electronic fund transfer services. Under the Act, the SBP has the

authority to designate a payment system as a designated a payment system and/or revoke designation of a designated payment system.

Under the Act, the SBP is also empowered to issue rules, guide lines, circulars, by-laws or directions as it may consider appropriate. A bank, financial institution, clearing house, service provider or any person authorized by the SBP to transact business under the Act and providing funds transfer facility is required to retain complete record of electronic transactions in electronic form and ensure secure means of transfer consistent with international standards. Clause 8 and 9 of the Act describe the reasons for disqualification of staff of a designated payment system and its effects respectively. According to the Act, the operator of a designated payment system is obligated to establish adequate governance arrangements which are effective, accountable and transparent or which may be required by the SBP to ensure the continued integrity of such system.

The SBP is empowered under the Act to nominate one or more clearing house to provide clearing or settlement services for a payment system and to formulate 'settlement rules' relating thereto. Besides, certain conditions have been imposed in the Act for the issuance of a designated payment instrument. The financial institutions and other institutions providing Electronic Funds Transfer (EFT) facilities are required to ensure that secure means are used for transfer of funds which are compliant with current international standards. In respect of each EFT initiated by a consumer, the financial institution holding such consumer's account is required to provide documentary proof to the consumer of such transfer.

The Act further requires the financial institution to provide periodic statement of account to each consumer in respect of each electronically accessible account. It also lays down the procedures to be followed in case of errors or omission in electronic fund transfer (EFT) and the respective liabilities of the financial institutions and consumers in such circumstances. Under the Act, a consumer may also complain to the SBP regarding EFT in case of not being satisfied with the outcome of a complaint made to financial institution without prejudice to any right to seek any other remedy under the law.

The Competition Ordinance, 2007

The Government of Pakistan, in a bid to strengthen the competition policy and law, constituted Competition Commission of Pakistan. The Commission is responsible for promotion of competition and fair trade practices. The legal mandate comes from the Competition Ordinance, 2007. All regulated sectors, including the banking sector, fall within the purview of the Ordinance.

Section 4 and 10 of the Ordinance are particularly relevant in the context of banking sector, as they deal with prohibited agreements and deceptive market practices. Section 4 lays down that no undertaking or association of undertaking shall enter into any agreements or, in the case of an association of undertakings, shall make a decision in respect of the production, supply, distribution, acquisition or control of goods or the provision of services which have the object or effect of preventing, restricting or reducing competition within the relevant market unless exempted under the ordinance. Such agreements includes, but are not limited to fixing the purchase or selling price or imposing any other restrictive trading conditions with regard to the sale or distribution or any goods or the provision of any services.

Such agreements also include those, which involve dividing or sharing of markets for goods or services, whether by territories, by volume of sales or purchases, by type of goods or services sold or by any other means; fixing or setting the quantity of production, distribution or sale with regard to any goods or the manner or means of providing any services; limiting technical development or investment with regard to the production, distribution or sale of any goods or the provision of any service; or collusive tendering or bidding for sale, purchase or procurement of any goods or services; applying dissimilar conditions to equivalent transactions with other trading parties, thereby placing them at a disadvantage; and make the conclusion of contractors subject to acceptance by the other parties of supplementary obligations which, by their nature or according to commercial usages, have no connection with the subject of such contract.

Section 10 of the Competition Ordinance 2007 prohibits deceptive marketing practices (which are common in the banking sector). The law provides that no undertaking shall enter into deceptive marketing practices. The deceptive marketing practices shall be deemed to have been restored to or continued to or continued if an undertake restores to the distribution of false or misleading information that is capable of harming the business interests of another undertaking; the distribution of false or misleading information to consumers, including the distribution of information lacking a reasonable basis, related to the price, character, method or place of production, properties, suitability for use, or quality of goods; false or misleading comparison of goods in the process of advertising or packing; fraudulent use of another's trademark, firm name, or product labeling or packing.

The above review indicates that a number of mechanisms exist for dealing with public complaints and concerns that are associated with consumer financing. Still, the number of complaints is rising every year.

While this trend can be measured in proportion to the increasing number of borrowers and overall consumer financing portfolio, lack of consumer education and weaknesses in the grievance redress mechanism are among the major reasons for rising customer dissatisfaction. The Banking Ombudsman is a case in point. The complex complaint procedure and limited powers of the Ombudsman do not provide an incentive to many aggrieved customers to approach this forum against banks. The regulatory framework needs to be reformed keeping in view the emerging issues and challenges in consumer financing.

LESSON 13

CONSUMER FINANCING IN PAKISTAN ISSUES, CHALLENGES AND WAY FORWARD STUDY / REPORT

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Pakistan Consumer Banking Landscape

Issues/Concerns from *Consumers Perspective:*

1. High Interest Rate Spread
2. Variable Interest Rate
3. Increasing Inflationary Impact
4. Deteriorating Quality of Services
5. Unsolicited Financing
6. Lack of Consumer Education
7. Poor Information Disclosure Practices
8. Loosing Competitiveness in International Trade
9. Intimidating Recovery Practices
10. Weaknesses in Regulatory Framework

1. High Interest Rate Spread:

Low interest rate spread is an important indicator of the efficiency and competition in the financial systems and helps in economic growth through increased investments. In the national context, the most important issue in consumer financing from the standpoint of national economy as well as individual consumers is that Pakistan has one of the highest interest rate spread in the world.

An analysis of the interest rate behavior in Pakistan reveals that the spread has vacillated between 5.95% and 9.58% during the period from 1990 to 2005. This indicates that average deposit rates have been very low, as compared to average lending rates. One could have expected a decrease in spread as a potential gain of competition among the increasing number of banks in the post-2001 period. However, little change has been observed in average spread, which points towards a cartel-like behavior of the banking sector.

If we look at the nominal and real interest rates, it becomes evident that consumers have had suffered a great deal at the hands of banks. From 1990 to 2004, the nominal weighted average lending rate has always been higher than inflation rate. The real lending rates averaged between 1.98% and 9.69%, which means that the banks earned net profits on lending in all these years. In contrast, the average deposit rate was slightly higher than inflation rate in four years only (1999-2002). The real deposit rates were negative in 11 years. It partly explains the impact of inflation on interest rate spread. The banks keep the lending rate high enough to ensure that the real lending rate is almost always positive.

In recent years, the spread has exceeded 7% on the average. The high difference between lending and deposit rates indicates that the depositors are not getting due returns, as compared to huge profits being earned by the banks. Indeed, the lending rates have increased and deposit rates have decreased over the last few years.

In February 2008, the weighted average lending rate was 11.23% whereas the weighted average deposit rate was 4.17% resulting in high interest rate spread to the tone of 7.04%. In terms of average interest rate spread of banks in South Asia, Pakistan has the highest spread. From 2003 to 2005, its average spread has remained between 6.33% and 7.79%. Whereas, during the same period, it ranged between 4.50% and 6.9% in India, 4.34% and 5.99% in Sri Lanka, and between 5.27% and 6.11% in Bangladesh (Table 4).

While the spread is higher in South Asian as compared to other regions, Pakistan stands out distinctively due to huge difference between lending rate and rate of return on deposits. The spread in Pakistan is much higher than average rates in many countries around the world. Chart 2 shows average interest rate spread in 13 countries, which ranges between minimum 1.71% (Japan) and maximum 4.5% (Italy). This is evident from these statistics that average interest rate spread in Pakistan exceeds the regional as well as international average rates.

Table 3: Interest Rate Behaviour in Pakistan

Year	Inflation Rate	Weighted average Lending Rate		Weighted average Deposit Rate		Interest Rate Spread	
		Nominal	Real	Nominal	Real	Nominal	Real
1990-95	10.57	12.55	1.98	6.53	-4.05	6.02	5.95
1996	10.8	14.4	3.6	6.4	-4.4	8.00	8.00
1997	11.8	14.6	2.8	6.8	-5.0	7.8	7.8
1998	7.8	15.6	7.8	6.8	-1.0	8.8	8.8
1999	5.7	14.8	9.1	6.5	0.8	8.3	8.3
2000	3.6	13.52	10.9	5.47	1.9	8.05	9.00
2001	4.4	13.61	9.21	5.27	0.87	8.34	8.34
2002	3.5	13.19	9.69	3.61	0.11	9.58	9.58
2003	3.1	9.40	6.3	1.61	-1.49	7.79	7.79
2004	4.6	7.28	2.68	0.95	-3.65	6.33	6.33
2005	9.3	8.81	-0.49	1.37	-7.93	7.44	7.44

Chart 3: Weighted Average Lending and Deposit Rates in February 2008[15]

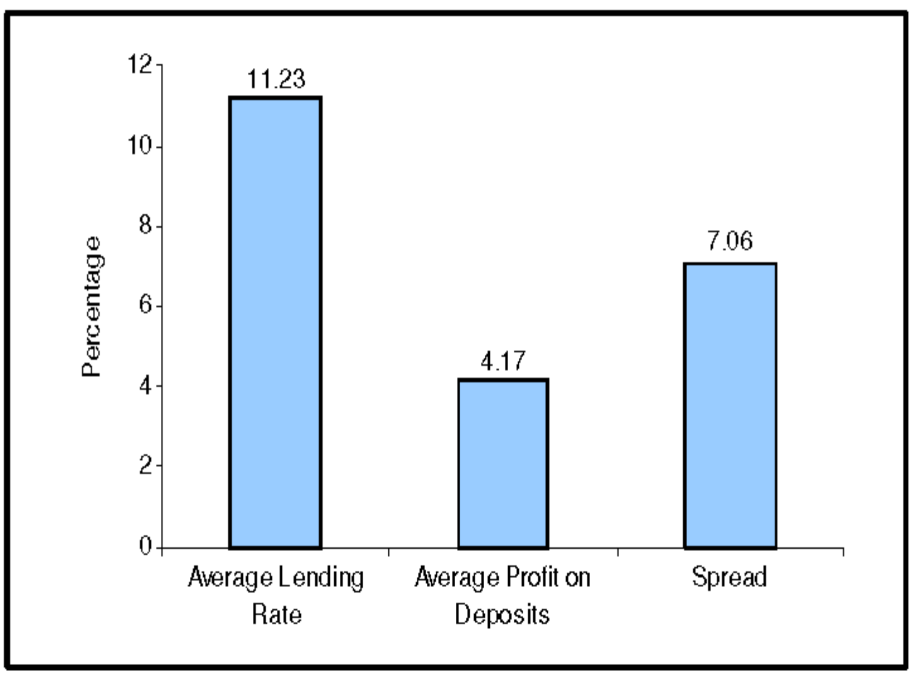
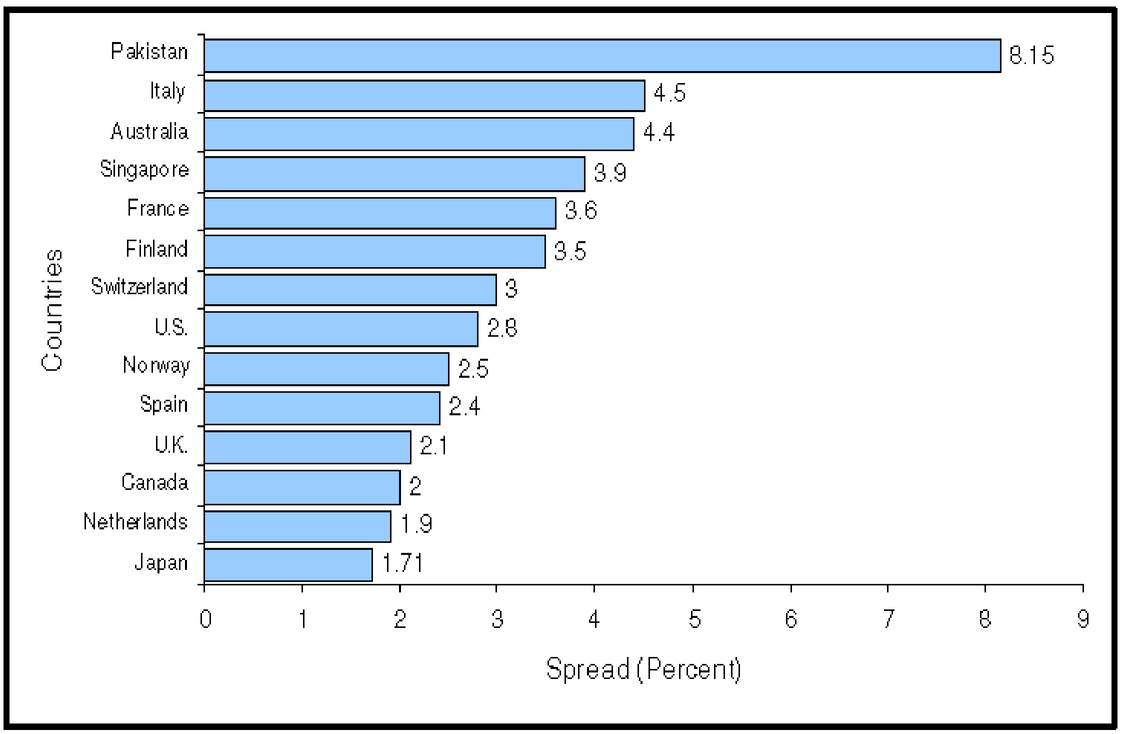


Table 4: Average Interest Rate Spread in South Asia (2003-05) [16]

Year	Pakistan	India	Sri Lanka	Bangladesh
2003	7.79	6.09	4.34	6.11
2004	6.33	5.17	4.4	5.27
2005	7.44	4.50	5.99	5.38

Chart 4: Nine Year Average Interest Rate Spread of 14 Countries[19]



High interest rate spread indicates that competitiveness in the banking sector in Pakistan is either absent or is very poor. A cartel-like behavior in banks appears to have taken place within the policy space provided by SBP. In April 2006, the present Governor of the SBP had said that banking spread was very high in the county and termed it an inefficiency of banks. In December 2006, she said that spreads were high because the sector was not facing competition and it was hurting the economy. However, she said that time was yet to come when SBP should exercise its powers.

This issue is largely attributable to weak SBP regulation of interest rates despite that it has the powers to bring down the spread through monetary policy. While non-operating loans and high administrative costs could be considered as the major reasons in countries where spread is high. These reasons cannot be said true of Pakistan because banks are earning huge profits at the cost of savings of the depositors.

2. Variable Interest Rate:

A variable interest rate moves up and down based on factors including changes in the rate paid on bank certificates of deposit or treasury bills. From a consumer's standpoint, it makes a huge difference whether the bank is charging variable or fixed rate on credit. If a consumer enters into an agreement with the bank on the basis of fixed interest rate, the bank cannot change the overall payable interest during the entire tenure even if interest rates go up in the market. In contrast, when the interest rate is variable, the bank ties the rate with an index. The interest payable by the consumer varies as the index changes.

In Pakistan, almost all consumer loans are on the basis of variable mark up rates. This policy is attributed to two reasons. First, variable rates are in the larger interest of banks due to high probabilities of increase in rates in the future. Second, a long term debt market has yet to be developed to provide term funding to the banks. However, banks also offer loans in which borrowers are given the choice of fixed or variable mark up. If the borrower chooses fixed mark up, the rate offered is generally higher than the variable mark up rate at the time of the contract. Therefore, borrowers most often choose variable mark up, without realizing their future financial liability, in the hope that the rates will fall in the future. This has seriously affected the loan servicing capacity of the borrowers with deleterious effects on their savings.

Some countries have determined fixed or variable interest rate for each sector depending on specific needs. In the United States, for example, the interest rates on education loans were changed from variable rates to fixed rates in 2002. In addition, there are examples of discount periods for variable interest rates. Such practices need to be introduced and scaled up in Pakistan in order to serve the interests of small borrowers.

3. Increasing Inflationary Impact:

- Easy bank credit by the household consumers has spurred the demand for many essential and luxury items
- Ultimately, the increase in demand has not only escalated the prices of essential items, but has also stimulated hoarding and black-marketing thus multiplying the problems for poor consumers. *(Un-intended Consequences)*
- Similarly, the demand for road networks and fuel imports has increased due to growth in auto financing
- These developments have an overall inflation impact, which is affecting the purchasing capacities of the poor

4. Deteriorating Quality of Services:

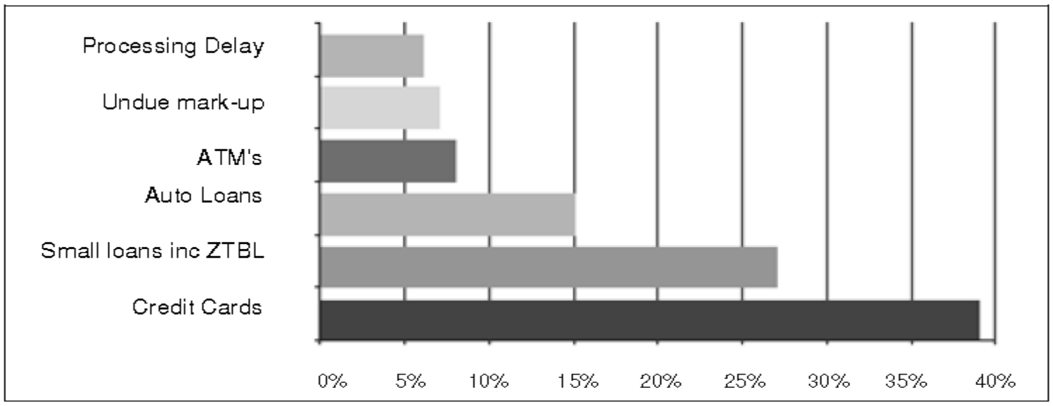
As the consumer financing portfolio is increasing, quality of related banking services is becoming a serious issue. Processing delays, service inefficiencies, unauthorized debits and non-compliance with requirement of providing monthly bank statements are few examples of poor quality of banking services. Other issues such as non-transparent advertisements, violation of agreed terms and conditions, levy of unjustifiable charges, and arduous complaint redress mechanism, etc. also reflect upon the poor quality of consumer services.

The press frequently reports such complaints, which speak of the issues in quality of banking services. For example, some banks are involved in charging late payments penalties despite payment on time. Similarly, many credit card users complain about service charges appearing on their credit statements, which make no sense to anybody. The number of complaints is increasing every year. For example, in the first eight months of the operation of Banking Ombudsman in 2005, about 40 per cent complaints filed with the Ombudsman were related to consumer products, and among these complaints, 30 per cent were related to credit cards alone.

In 2006, Banking Ombudsman received 215 complaints out of which 18 were rejected, 71 were declined and 90 complaints were granted. There were 36 complaints related to internal banking fraud scam, still being investigated by the Banking Ombudsman. The complaints received at Banking Ombudsman were related to service rules, service inefficiency, and loan remission of mark-up waiver, frauds and consumer products. However, it is observed that percentage of complaints received regarding consumer products was 46%, much higher than other type of complaints received.

The complaints related to consumer products included credit cards, small loans, auto loans, undertake mark up, processing delays and ATM's complaints. Magnitude of credit card complaints was much more than all other complaints, nearly 40% of total complaints.

Chart 5: Types of Consumer Complaints in 2006



5. Unsolicited Financing:
- Aggressive marketing campaigns launched by the banks are targeting the consumers and repeatedly encouraging them to purchase a loan or credit card
- Misleading phone calls are made to the consumers with false promises
- The supply driven approach is creating artificial consumerism on one hand, and is limiting the choices for consumers, on the other
- For example, auto leasing makes a fit case of banking sector's dominance over customers
- A car lessee, for instance, is bound to insure the car from an insurance company of the bank's choice

6. Lack of Consumer Education:
- Most of the consumers do not have enough understanding of the very basic rules and terms and conditions
- Documents prepared by banks are usually technical and the information which may affect financial rights of the consumers is never stated clearly and plainly in these documents
- Need to focus on public awareness about the financial rights of the citizens, and the forums available to them for accessing justice, if these rights are violated (Example; Proposed CFPA in USA)

7. Poor Information Disclosure Practices:
- Access to information related to consumer financing remains a critical issue
- A strong culture of secrecy prevails in the banks, as they avoid providing even ordinary and insensitive data
- Apart from reporting requirements laid down in the SBP regulations and contracts, there is no law in Pakistan, which entitles the consumers to access information from private banks as a legal right
- The existing freedom of information laws are applicable to only public sector banks, and do not extend to private banks and DFIs

8. Loosing Competitiveness in International Trade:
Banking sector has assumed greater importance due to liberalization of trade under the General Agreement on Trade in Services (GATS). Pakistan has opened up the financial sector and made a number of commitments under GATS without performing any Economic Needs Test (ENT). The impact of such decisions needs to be ascertained keeping in view the contribution of financial services in services trade.

The imports of financial services have remained substantially higher than exports. Estimates suggest that the imports in financial services were US$ 77 million in 2003-04 and 2004-05, and US$133 million in 2005- 06. In comparison, exports in financial services stood at US $21 million, US$ 39 million, and US$ 70 million during the same years.

The challenge for Pakistan is to increase exports in financial services in a manner that has least impact on low income customers. Given the huge spread in interest rates, the local banks have no incentive to improve internal efficiencies to become competitive in the international market. Therefore, urgent steps including reduction in spread need to be taken to create competitive financial environment in Pakistan.

9. Intimidating Recovery Practices:

Recovery of dues from borrowers is the responsibility of the 'collection department'. However, when a borrower does not clear all his dues, the case is transferred to the loan recovery department. Legally, under Section 15 (sub-section 2) of the Financial Institutions (Recovery of Finances) Ordinance, 2001, the banks are required to send three legal notices to the borrowers for payment of dues within the specified time periods. If the borrower fails to pay the dues even after third legal notice, only then the bank has the authority (under sub-section 4 of section 15) to sell the property of the mortgagor, without the intervention of any court, which was kept on mortgage as a security for the bank.

Keeping aside the law, the banks have constituted recovery teams who use strong-arm tactics to harass the borrower and make threatening calls. Despite the fact that bank's recovery teams have no legal authority to visit the borrower's residence; sometimes, recovery teams reach the borrower's house to intimidate and pressurize them for payment of dues. In some instances, they illegally coerce and misbehave the borrowers, and, in desire of earning more commission, cross the limits by abusing, brutally beating, showing guns, locking in the house and threatening to dreadful consequences.

Second annual report (2006) of the Banking Ombudsman stated a rise in the unrestrained action by the debt collectors; cases have also come to light where innocent people have been accost and maltreated as well as cases where borrowers with up-to-date payment record have been needlessly harassed. The report mentioned that in most countries, debt collection is regulated by the law. In the US, to prohibit certain methods of debt collection and treat borrowers fairly, the "Fair Debt Collection Practices Act" was incorporated in the "Consumer Credit Protection Act" in 1977. According to Banking Ombudsman Report (2006), some banks in Pakistan have developed guidelines applicable to debt collection but these are not strictly followed by external recovery agencies engaged for the purpose. To protect consumers from abuse by debt collectors, it was recommended that Pakistan Banks Association be asked by SBP to draft suitable set of instruction for compliance by external debt collection agencies.

10. Weaknesses in Regulatory Framework:

The frequent violation of financial rights of the consumers is attributed, mainly, to weaknesses in the regulatory framework governing the banking sector, and low level of consumer education about the relevant policies and rules. The existing regulations do not capture the full range of problems being faced by the users of consumer financing services. For example, the regulations do not restrict the banks to levy unjustified service charges such as high fee on depositing cash in one's own account. Another case in point is the Credit Worthiness Reports maintained by the Credit Information Bureau (CIB). According to the rules, these reports are confidential documents for the borrowers, and amount to denial of the right to one's own personal information.

On the top of it, whatever regulations exist, they are yet to be fully implemented. As a matter of fact, the banks enjoy a great degree of freedom for formulating their own policies and procedures regarding credit cards, automated services, loans, interest rates, etc., which suit their interests best. These missing links, if not abridged adequately, would continue to harm the interest of the consumers on one hand, and affect the potential of banks to serve as a strong base of economy in the longer term, on the other hand.

LESSON 14

CODE OF CONSUMER BANKING PRACTICE: THE ASSOCIATION OF BANKS IN SINGAPORE

- This Code of Consumer Banking Practice represents the collective and concerted effort of banks in Singapore in reaching out to their customers
- The Association of Banks in Singapore has spearheaded this voluntary initiative and has worked with member banks with retail customers to crystallize for the first time, and on an industry wide basis, *the minimum standards of service and conduct*, which you, the customer can expect in dealing with your bank
- Like other organizations and corporations, banks in Singapore face some challenging times ahead
- Foremost is the preservation and enhancement of the banks' relationship with their customers
- We believe that the four principles on which this Code is premised:
  - ✓ Fairness
  - ✓ Transparency
  - ✓ Accountability
  - ✓ Reliability
- Will establish the bedrock for building a trusting and open relationship between you and your bank

Objectives:
The Code of Consumer Banking Practice for retail banking customers has been developed to:

1. Promote good banking practices by setting minimum standards in dealing with you;
2. Increase transparency so that you can have a better understanding of what you can reasonably expect of the services;
3. Promote a fair and cordial relationship between you and your bank;
4. Foster confidence in the banking system

Key Commitments:
Your bank's relationship with you will be guided by four key principles:
Fairness:
Your bank commits that it will:

- act fairly and reasonably in all its dealings with you;
- ensure that all the products and services offered are in line with the Code;
- establish a clear and common set of procedures to ensure that any disputes between you and your bank will be resolved fairly and quickly

Transparency:
Your bank commits that it will:

- Provide you with relevant and useful information that will help you arrive at informed decisions about its products and services;
- Provide clarification, highlighting major points that impact the products and services that you are interested in buying;
- Inform you of the range of products and services offered through various delivery channels (e.g. over the Internet, telephone or in branches)

Accountability:
Your bank commits that it will:

- Explain and help you understand the financial benefits of its products and services that you are interested in buying, how they work and the risks involved;
- Ensure that the procedures laid down for the bank's staff reflect the commitments set out in the Code;
- Ensure that all products and services meet relevant laws and regulations of Singapore

Reliability:

Your bank commits that it will:

- Have a secure and reliable banking system;
- Ensure your records and transactions are kept confidential and accurate;
- Maintain a reliable system of security controls for the bank's self-service banking channels;
- Ensure that the information provided is up-to-date

Service Standards:

Your bank will ensure that:

- Its staff are trained to provide prompt and efficient service, so that your transactions will be handled promptly and your queuing time minimized;
- ATMs and other self-service banking channels, if offered, will be available both day and night to serve you; however, please note that the machines maybe temporarily inaccessible when they undergo regular servicing and maintenance;
- Information on its products and services will be updated and current. It will be made easily available at bank branches, through your bank's website and other appropriate channels;
- Its internet banking and e-banking services will comply at all times with the MAS guidelines issued on 12 Nov 2001 on "Responsibility for Internet Banking Security";
- You will be informed 30 days in advance before implementation of any changes to the Terms and Conditions, fees and charges and discontinuation of services/relocation of premises. Its officers will handle and respond to your feedback;
- Your complaint will be acknowledged within 2 business days of receipt and will be investigated;
- We will respond to you on the status of the investigation within 14 business days. (For complaints requiring investigation by a third party this may take more than 14 days.)

Marketing and Promotions:

a) Your bank will exercise care in the use of direct mail:
   i. where customers are less than 16 years of age;
   ii. when promoting loans, overdrafts and other credit facilities
b) The bank will also ensure all advertising and promotional materials are not misleading and comply with all relevant and applicable legislation, codes and rules
c) Plain language will be used to the extent that it is consistent with the need for legal certainty. Legal and technical language will be used only where necessary
d) All printed advertising and promotional materials for banking services which include a reference to an interest rate, will include the Effective Interest Rate (EIR), other relevant fees and charges

Complaints - Dispute Resolution Process:

Your bank is committed to providing you with a high level of service. However there may be occasions when complaints and disputes arise. In this instance, the Code specifies a structured process for your complaint to be dealt with.

Principles:

- ✓ Sincerity - your complaint is important feedback and the bank will treat it seriously
- ✓ Transparency - the procedures for handling complaints are documented and apply to all customers
- ✓ Effectiveness - the procedures will provide for a speedy resolution

Components of Value Proposition in Service Industry

Quality	Timeliness	Reliability	Cooperativeness	Communication
▪Accuracy ▪Clarity ▪Meaningfulness ▪Relevancy ▪Completeness	▪On-Time Delivery ▪Solution Speed ▪Short Cycle Time	▪Consistency ▪Promises Kept ▪Creditability ▪Trust worthiness ▪Problem Solving Ability ▪Service Longevity & Reputation	▪Responsiveness ▪Flexibility ▪Customer Sensitivity ▪Courtesy ▪Ability to Diffuse Anger ▪Compensation Authority	▪Sympathetic Listening ▪Feed Forward Information ▪Handling Emergencies ▪Easy to Contact ▪Non-Verbal Skills ▪Making Customer Feel Important

The Geography of Trust:
The most successful leaders understand that trust is a function of relationships as well as integrity and expertise. And they know that relationship-based, "structural" trust changes depending on where people stand on the organizational map.

Personal Trust:

- Based on faith in a person's integrity, is trust at its most fundamental and widely understood
- It is the trust of confidences shared without thought of betrayal, ideas revealed without fear of appropriation, and tasks doled out to teammates with the assurance that they will try hard not to let you down
- Personal trust develops in the workplace through shared experiences and knowledge of colleagues' characters. From such crucibles as impossibly tight deadlines or shop-floor emergencies, we quickly learn on whom we can rely

High Personal Trust exists when we answer yes to the following questions:

- Is this person honest and ethical?
- Will she/he make good on her/his word?
- Is she/he basically well intentioned?
- Will he/she handle confidential information with care and discretion?
- Will he/she be straightforward about what he/she doesn't know?
- Leaders may persevere in relationships based on personal trust no matter how exalted they become in their leadership roles
- But such relationships are unlikely to remain static
- They are also unlikely to provide the kinds of deep, often specialized knowledge leaders need
- In circumstances where advisers' competence matters as much as their character, *expertise trust* enters the picture

Expertise Trust:

- It is reliance on an adviser's ability in a specific subject area
- In our daily lives we show expertise trust every time we board a plane or schedule surgery
- In organizations, leaders develop expertise trust by working closely with people who consistently demonstrate their mastery of particular subjects or processes
- Or, lacking personal experience with qualified people, leaders seek out those with the strongest reputations
- Unlike with personal trust, the parameters of expertise trust tend to be limited to a particular content area

High Expertise Trust exists when we answer yes to the following questions:

- Is this person expert in her field?
- Is her knowledge up-to-date?
- Does she present credible information to support her positions?
- Is she able to apply her expertise to our specific situation?
- Can she offer sage advice on risks, options, and trade-offs?

Structural Trust:

- It reflects how roles and ambition color insight and spin information
- High structural trust provides leaders with a channel for pure insight and information
- Advisers in positions of the highest structural trust generally reside outside organizations to prevent not only self-interest and self-serving agendas but also cultural assumptions from tinting their views
- Of course, externality doesn't automatically translate into objectivity: Not all outside advisers are in positions of high structural trust
- But strong outside advisers provide leaders with a resource that their organizations cannot

High Structural Trust exists when we answer yes to the following questions:

- Given this person's role and responsibilities, can he offer judgment untainted by his goals or interests?
- Is he in a position to be fully loyal?
- Is he unlikely to spin or filter information?
- Is it reasonable to assume he will not move into a role that places structural constraints on our level of trust (for example, will we someday compete for the same position or for the same client)?

Consulting and Professional-Service Firms:

What they offer:

Lawyers, accountants, management consultants, and other professional-service providers promise a very high level of expertise trust; otherwise, you wouldn't be paying them. They also possess experience with many companies and consequently have a broad frame of reference.

What to consider:

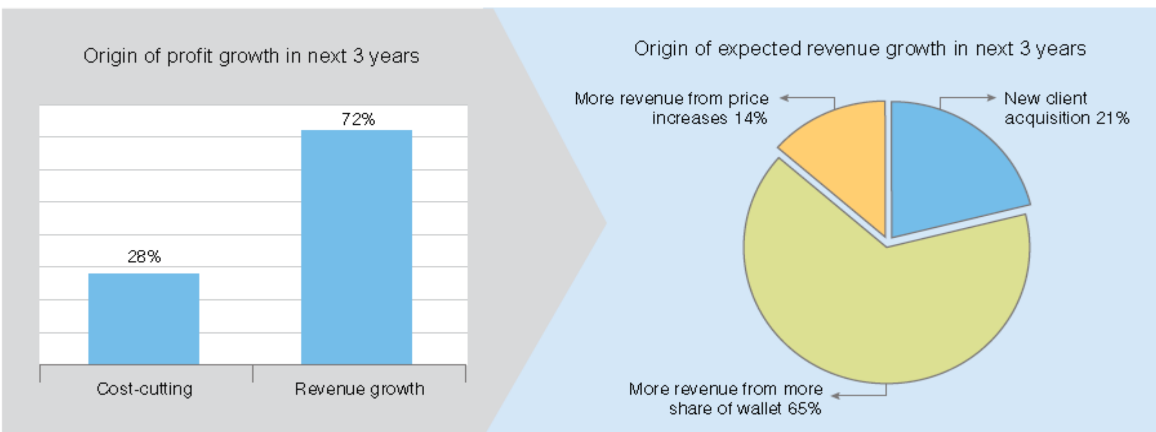
Many firms generally offer reliable, replicable products and services. But their ability to offer structural trust is limited to the two to three ranges by their business models, which require them to leverage their senior people and continue to increase their work for you. For high structural trust, look for firms that don't rely on these models.

LESSON 15

GROWTH STRATEGY IN RETAIL BANKING STRUCTURED RELATIONSHIP APPROACH

- After an early part of the decade focused on cost-cutting, retail banks have reaped most of the easy wins and adapted their organizations to a faster pace of change
- Most banks now feel that while continuing to monitor costs closely to avoid any slippage, they now need to concentrate on growth
- We interviewed twenty-three banks in mature banking markets, as well as four Chinese banks
- The four Chinese institutions were predominantly focused on growing through client acquisition
- For the twenty-three other banks, revenue growth was the focus: those institutions estimate that 72 of their profit growth in the next three years will come from revenue growth, and only 28% from cost-cutting (see Figure 10)

Figure 10. | INCREASING SHARE OF WALLET TO GROW PROFITS



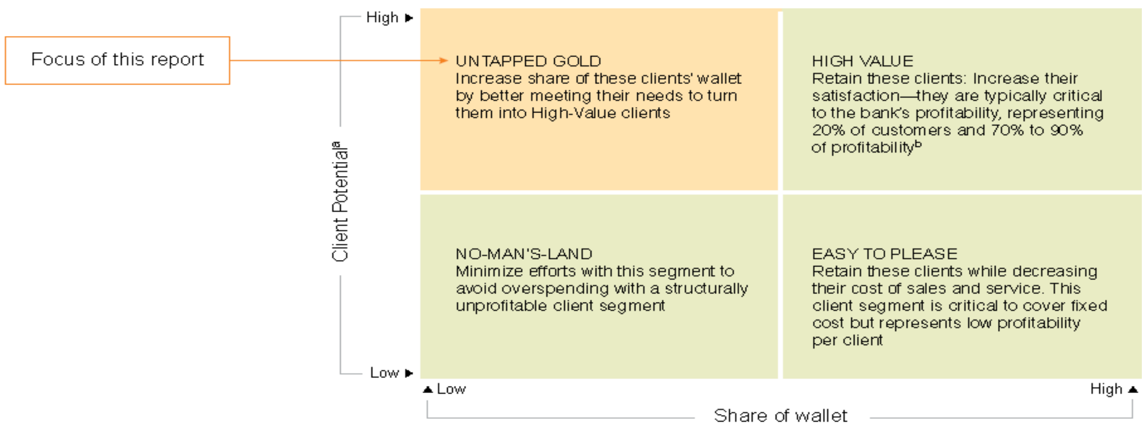
- In mature markets, excluding mergers, 80% of future revenue is expected to come from existing clients, and only 20% from new client acquisition
- Banks can generate more value from existing customers by raising prices, expanding product lines, or increasing ***share of wallet.***
- In mature markets, therefore, most well-established banks recognize that growing share of wallet is their primary objective
- As a result of this finding, spotlight falls on how banks
- Can extract more value from existing customers by increasing share of wallet
- After interviews with bank executives and industry experts
- We concluded that a relationship approach is critical to meeting this goal
- Our interviews focused on their institutions' experience with the relationship approach
- This helped us determine where banks stand in implementing such an approach, recognize the difficulties they encounter in implementing it profitably, and identify best practices and lessons learned from those experiences

Beyond "Product Push":

- Conventional banking wisdom holds that a relationship strategy that goes beyond a traditional product-push approach can capture untapped client potential
- Banks have successfully leveraged push approaches to increase sales effectiveness
- As ***Figure 11*** suggests, this push approach was successful in capturing market share of high-value and easy-to-please customers

- These segments are currently either very or somewhat profitable to the banks, so there is no reason to change approaches with them

Figure 11. | TARGET SEGMENT
Low-share-of-wallet, high-potential clients represent an "untapped gold" segment.



- Some clients, however, are unreceptive to the product-based push approach commonly used by retail banks, because their needs are not fully identified in that way
- They feel they receive low value, and finally end up making themselves unavailable to their banks' advisors
- This group represents an ***"untapped gold"*** client segment
- Despite computing advances, complex customer needs cannot be well predicted by automated systems
- Understanding client needs requires a perspective no automated solution can offer
- Client needs frequently originate with events that systems cannot predict (weddings, major purchase decisions, deaths of relatives, divorces)
- Because sales forces are often compensated on the basis of number of products sold, and because advisors are too often unprepared to give advice that goes beyond a product's generic benefits, advisors typically seek out easy-to-sell-to clients rather than clients with more complex needs
- Ignored clients soon begin to distrust their bank, and do not maintain contact with their advisors
- The traditional product-push approach is ineffective with this group, because they often regard such efforts as "pushy," and it is inadequate in meeting their more complex needs

A relationship-based approach for these high-potential clients—who may not yet qualify for private banking services— could create a virtuous circle through a win-win relationship in which the customer's perception of increased value generates more share of wallet, which gives the bank a better view of the client's needs, resulting in better advice, which increases still further the customer's perception of value.

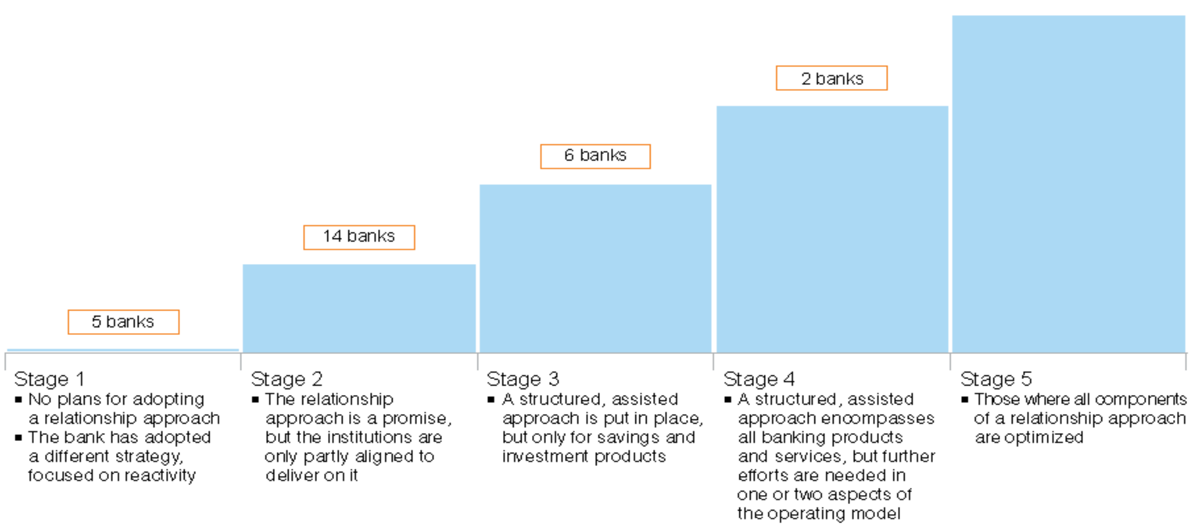
- A survey indicated that 70% of clients would want to use a single institution if it were able to serve all their financial needs well
- Another survey found that 64% feel that having companies collect information on their individual interests and lifestyle in order to better personalize services is a good thing
- A relationship approach is one where the bank "invests in obtaining customer-specific information, often proprietary in nature, and evaluates the profitability of these investments through multiple interactions with the same customer over time and/or across products"
- The objective of a relationship approach is to understand client needs and meet them, and ***to develop such strong trust*** that the client does not even consider moving to another provider

- Creating such a relationship is an iterative and progressive process, is long-term, is personalized, and requires the client to share information with the advisor
- A relationship approach only matters to clients who are either expert comparatists or loyal-to-a-brand, and will recognize the value of the bank's efforts
- The alternative to a relationship model for capturing the untapped potential is to satisfy price-focused customers by adopting the lowest price position
- In banking, self-service is a good option for many people not wanting a relationship: their expectation is seamless transactions that can be carried out at low cost
- Capturing those clients requires a well-thought-out multi-channel customer experience, and robust and cost-efficient systems to meet service-level expectations at minimum cost

A Structured Approach:

- Many banks are attempting to implement relationship strategies, but few are adopting structured approaches covering the full scope of retail banking
- Of the twenty-seven banks we interviewed for this study, twenty-two had adopted or were adopting a relationship approach
- After developing a framework with the essential components of such a strategy, we mapped the components in each bank's approach, gained in the interviews, against our framework (see Figure 12)

Figure 12 | MATURITY STAGES, RELATIONSHIP APPROACH[a]



Five levels of maturity in the relationship approach emerged from our interviews:
Stage 1: No relationship approach strategy
Stage 2: The relationship approach is a promise, but the institutions are only partly aligned to deliver on it
Stage 3: A structured, assisted approach is in place, but only for savings and investment products
Stage 4: A structured, assisted approach encompasses all banking products and services, but further efforts are needed in one or two aspects of the operating model
Stage 5: All components of a relationship approach are optimized

Stage 1 banks

Five of the banks we surveyed, representing approximately 20% of the sample, did not have any component of a relationship approach in place. Their perspective was different in that they were either targeting price-focused or transaction-oriented clients, or did not feel the market situation required them to adopt such an approach yet. One bank said it did not believe in a relationship approach and thought its success factor of the future was self-service and reactivity.

Stage 2 banks

Just over half of the banks we surveyed were in Stage 2, promising a relationship approach but only partly aligned to deliver it. These banks have developed a relationship approach as a reaction to the trend of weakening relationships with clients due to branch automation, deskilling of bank manager tasks, and quality issues arising from multiple channels. These banks recognized that they needed to take better care of their most important clients, and launched relationship programs, typically adapting the elements of segmentation, organization structure, some tools supporting the advisors, and marketing planning, but too often neglecting changing ways of working, performance management, and processes.

Banks segmented their clients according to a mix of present and potential value and established levels of service, including frequency of client contact, depending on client segment. For those clients identified as high-potential, they have assigned specific advisors and reduced the number of clients per advisor to improve availability. In terms of tools, a few banks have given their advisors an extended view of their clients, developed automated ways to identify product opportunities, and created contextual scripts to help them present product benefits to clients. Marketing plans have been adapted by segment, and multi-channel customer solicitation has been developed to generate opportunities for advisor contact with clients.

In the process, however, many banks have neglected key aspects necessary to move toward a more relationship-based approach, especially in the ways their advisors work and are managed. Available tools have failed to provide holistic advice or establish a diagnosis of each client's situation and needs .As a consequence, retail advisors still often lack the ability to give substance to their client relationships and lack good reasons to call clients. Without this necessary advice-product architecture, advisors find it difficult to recognize client needs. And they are encouraged to stay product-and campaign-centered because their performance is still measured by number of products sold. Having only partly aligned the organization to a relationship approach, success remains out of reach.

Stage 3 banks

A smaller proportion of the banks we interviewed—approximately 20%—have developed a structured relationship management approach, but only for their savings and investment products. These banks believe that cross-selling savings and investment products to banking clients will generate significant profits. This is especially true in such countries as the Netherlands and Sweden, where day-to-day banking is a loss-leader, with profit made on savings and lending products.

The European banks that have universal banking models have traditionally excelled in delivering savings products to their clients. As customers became more sophisticated and the number of products expanded, a need for better advice emerged that some banks chose to address with a structured advisory process, especially in Belgium, the Netherlands, and Sweden.

Establishing a structured process for savings and investment products can deliver excellent results, as specialized institutions in wealth management have shown. Yet the downside of having a structured approach limited to savings and investment products (or other specific products) includes the inability to gain a complete understanding of a client's overall needs and financial situation. It can also cause client frustration if it involves a very professional but unstructured process, and can translate into the client perceiving the bank as a partial solution provider. Our research indicates, therefore, that only a structured relationship covering the complete set of retail banking products and services can generate a strong increase in client satisfaction and a bank's share of wallet.

Stage 4 banks

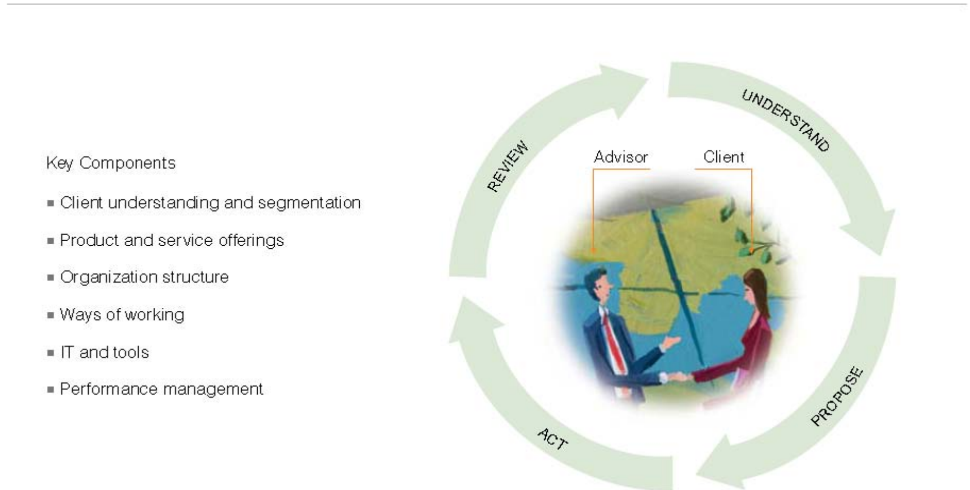
Only two banks, in our survey, one in North America and the other in Europe, representing less than 10% of the sample, have implemented a robust relationship approach. Our interviews revealed that executives at both banks believe they have not yet achieved Stage 5 status, and have further improvements in the pipeline. As noted previously, these banks have already benefited from a very positive impact on their share price, having increased both revenue growth and profitability by adopting a structured relationship approach.

LESSON 16

GROWTH STRATEGY IN RETAIL BANKING STRUCTURED RELATIONSHIP APPROACH (CONTD…)

- Interviews with executives in these top banks also identified several best practices involved in implementing and growing a relationship approach that increases revenue and improves the profit margin
- These managers have repeatedly reaffirmed their commitment to a comprehensive relationship approach, and have implemented it over time; progressively aligning its key components (see Figure 13)

Figure 13. | KEY COMPONENTS OF A RELATIONSHIP APPROACH



1. **Client Understanding and Segmentation:**

Measuring client potential

Potential includes all assets and debts. Most banks have developed measures of potential, but many banks are not yet comfortable that their measure is accurate enough. Methods used to assess potential include compiling data on average assets of inhabitants of neighborhoods, employing statistical methods based on similar client profiles, and offering sales force incentives to capture and update client potential. In Germany, more and more banks are using external providers to establish accurate figures of client potential. In France, one bank decided to provide a better base for analysis by paying its advisors a bonus based on their completing client data in the information system.

Understanding client trigger points

There are right and wrong moments to start a relationship with a client. And once the relationship is going, there are key points in this relationship when the advisor—and the bank in supporting him or her—has to take special care to avoid client disappointment and seize a development opportunity. One North American bank we surveyed has focused substantial energy on better meeting its clients' needs by identifying "reasons for defection" and ensuring their advisors and the institution succeed in what that bank calls "the moments of truth." It has established a customer service blueprint to capture the emotional responses of clients to rational experiences with the bank. Advisors are trained to identify those moments of truth and react appropriately.

Building loyalty through trust

Clients are looking for advisors they can trust, and banks should also be looking for their advisors to be trusted. A recent Forrester study demonstrated that customer loyalty was most correlated to trusting one's advisors, and that trust resulted from clients feeling that their advisor was honest and open and an advocate of their interests. Good relationship advisors understand clients' desire for these traits, and do everything they can to ensure they adopt them.

Advisor/client dialogue

The prerequisite for an effective advisor/client dialogue lies in the advisor's ability to frame a holistic view of the client's situation. The client will soon be aware of whether the advisor has such a view, and will make critical relationship decisions based on this perception.

Clients know themselves better than strangers or systems do, especially when it comes to assets they hold outside the bank. Once an advisor wins the client's trust, it becomes much easier to ask the key questions about the client's current situation and understand his or her needs. It is also the most effective way to establish a client's true potential.

Clients have expectations and preferences, which advisors should learn. There is no point in repeatedly telephoning someone who does not like to be called. However, that same client may be comfortable exchanging emails. The best advisors ask clients at the outset what their expectations and preferences are.

2. **Product and Service Offerings**

A needs-advice-product architecture

A critical component of a relationship approach is the matching of client needs with advice and finally with products. To help ensure they fully capture client needs, advisors often develop and administer questionnaires.

At one European financial institution, advisors are trained to identify and work into predefined scenarios based on combinations of client needs, and to suggest solutions that bundle products to meet those needs. Another European bank has created packaged products to fit points in the client life cycle, so advisors can readily match their clients' needs. Some banks have experimented with a central support center to assist advisors in customizing their proposals.

3. **Organization Structure:**

Sales force specialization and branch sizing

A single bank employee cannot operate effectively in two different modes, applying a relationship approach to some clients and a push-based approach to others. Too many differences in terms of time allocated yearly to a client, performance management, tools to be used, and so on, can make it a no-win situation.

In a Benelux financial institution, for example, two categories of customer are recognized, each with a specific approach and type of advisor. Mass consumers are offered an event-driven push approach. Affluent customers are offered a financial advice approach managed by a financial advisor. Relationship managers usually handle from 100 to 300 clients, and this bank has merged some branches so each has over 100 affluent customers. This ensures that the presence of a financial advisor is profitable.

4. **Ways of Working:**

The people factor

Ensuring that people change their ways of working and managing, and fully adhere to the relationship approach, is essential. Our interviews suggest that change involved in implementing a relationship approach faces some resistance at all levels, from central teams, to branch management, to the advisors themselves. Central teams sometimes resist changing their management style from measuring performance based on campaigns and product sales objectives. Advisors might not believe the institution will provide an approach to help them better understand their clients, could worry about the amount of time and effort required to learn the new way, and are often very cautious about the impact on their compensation. Approaching the move to a relationship approach as a major change program is the most effective way to overcome this potential resistance.

At a large European financial institution, for example, the most critical success factor identified was "the attitude of the branch manager." During the change process, 25% of the branch management work force was progressively replaced to enable the necessary change in culture.

Other methods used by banks include identifying specific employee concerns and addressing them, rolling out a comprehensive communication plan to alleviate fears and align employees, identifying change agents at all levels that are willing to endorse the change, lead by example, and conduct pilots to obtain positive results. Pilot programs can both motivate others and help gain a better grasp on potential implementation issues, which can be mitigated when the program is rolled out later across the branch system.

Developing an entrepreneurial culture at the branch level can also generate positive results. Encouraging and rewarding employees for teamwork and for going the extra mile to satisfy their clients' needs is a proven way to change mindsets. Top banks use these incentives to motivate their branch managers, and make sure they recognize high-performing branches that accept change and adopt a client-focused relationship approach.

A rigorous, iterative, standardized process

The structured process should be geared toward a recurring effort to match client needs and build a positive customer experience. From the client perspective, as illustrated earlier in Figure 13, it can be a four-step process: (1) understand; (2) propose; (3) act; (4) review. This process begins with a dialogue between the client and the advisor to ensure the client's overall situation, needs, and preferences are understood. Second, the advisor develops a proposal and discusses it with the client to ensure the proposed solution addresses those needs. Third, the client lets the bank act on the agreed solution. Then, after some time, comes the review to ensure the solution is serving the client's evolving needs.

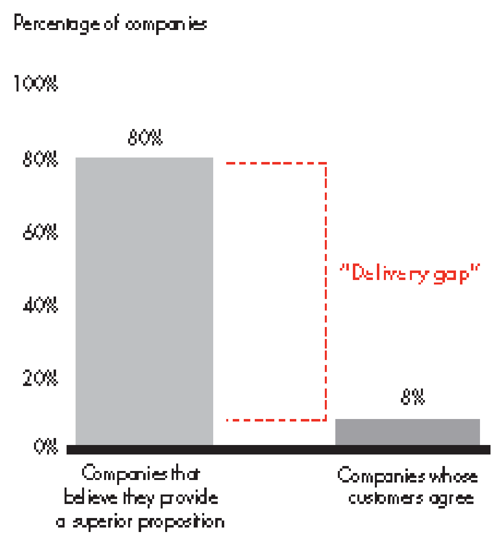
A few banks interviewed in Europe are currently rolling out such advice-oriented processes. Their purpose is to ensure clients receive high-quality service and advice while the banks' commercial efficiency improves. Such guidance and support brought to the advisor is key to maximizing the bank's profitability.

Internal recruiting and competence management

These new ways of working need to be learned. Most banks recruit their relationship managers from the existing sales force based on their ability to listen, react, and have a broad perspective on customers' financial needs. Even then, strong training efforts are a must. Both of the top-performing banks in our survey relied on excellent training programs to ensure their personnel developed a complete understanding of the portfolio of products and services and the structured advisory process.

Some Additional Thoughts on Customer-Led Growth:

Figure 1: Identifying the delivery gap



How to pinpoint your problem

Where are your most profitable customers and how can you deepen your relationship with them? Where are your problem customers? The chart shows the level of customer advocacy as measured by Net Promoter Score on the horizontal axis, and the level of customer profitability on the vertical.

Let's consider the key boxes:

- Beginning in the upper right, this group of customers is a company's natural design target, its core, the segment that should be the prime focus of the Three D's described in this brief. You want to keep them, find more like them and explore what additional products or services they need. They are your prime source of new innovation, so listen to them
- In the upper left box are the "false profits," customers who are "buying but mad"— they are profitable right now but in fact are sticking around only because they have no good alternative. You must address this group urgently, either by moving them to the right set of products or by fixing delivery issues. They are turning the market against you
- In the lower left are the "unhappy and unprofitable"—the buyers who are not a natural fit with the company and who are not happy anyway. Helping them migrate to other providers makes sense
- We have found companies routinely surprised by which customers are high-profit promoters, how much potential for cross-sell exists among low-profit promoters and how many detractors lurk in their portfolio

Figure 2: Where are your customers on this relationship matrix? What actions should you take?

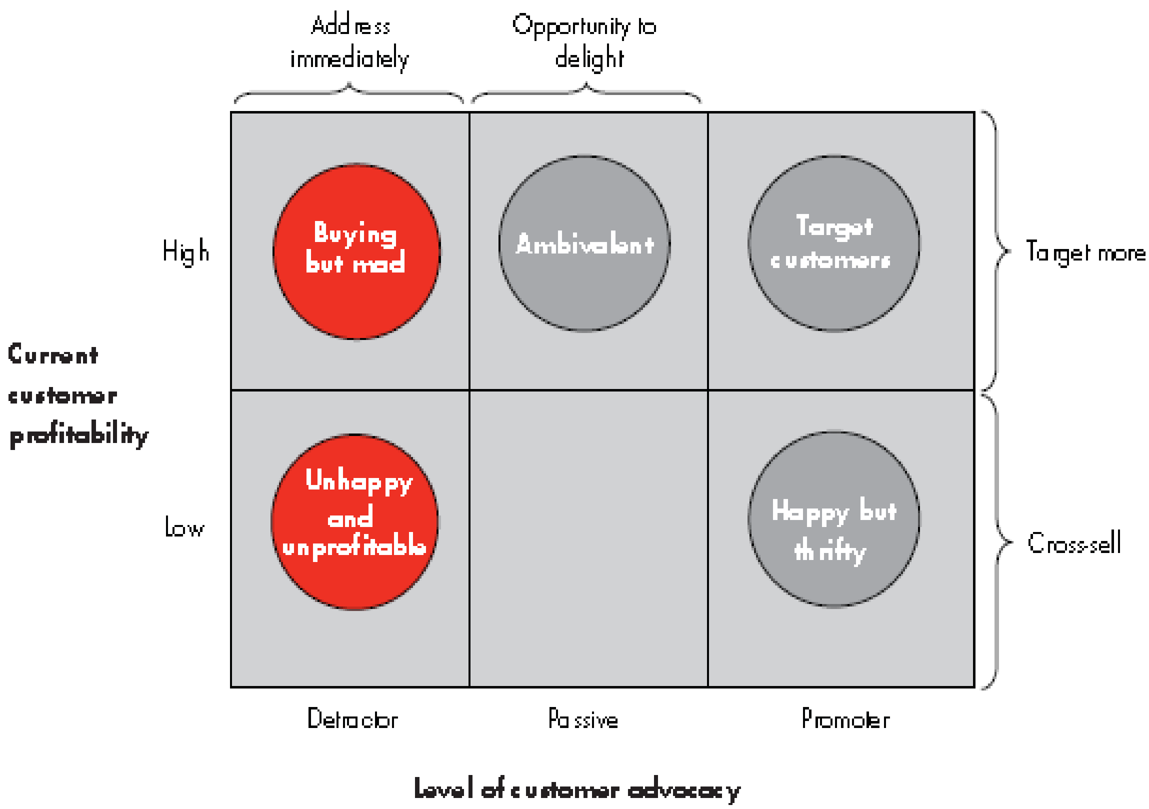
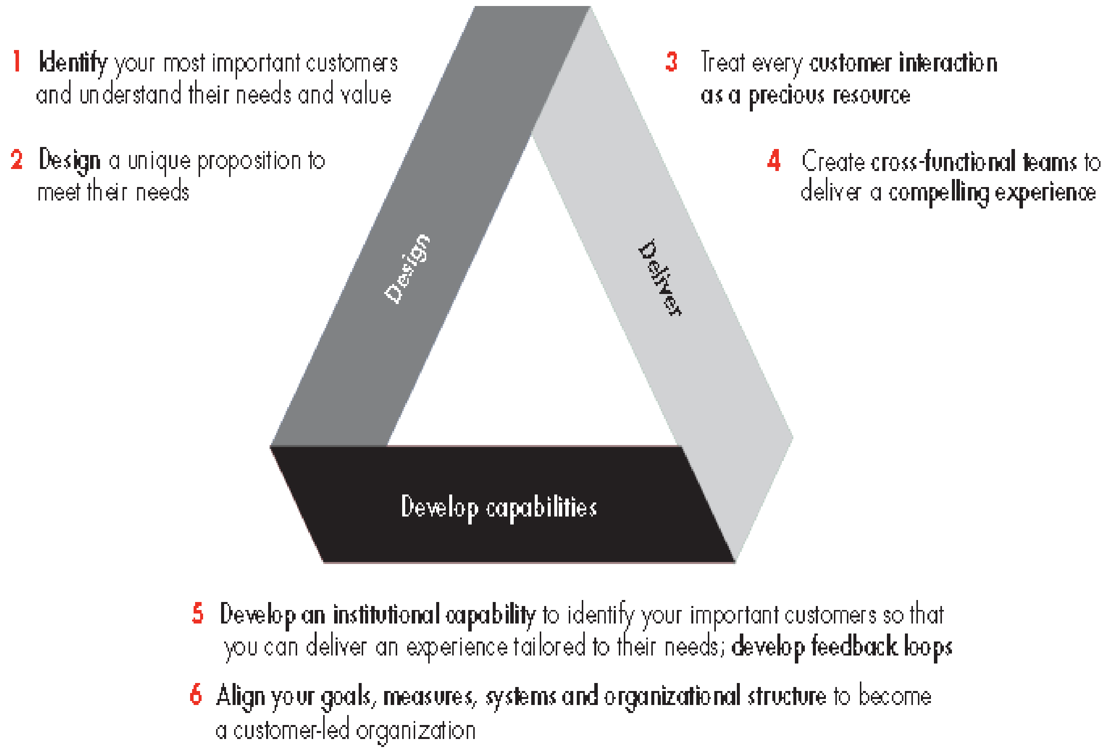


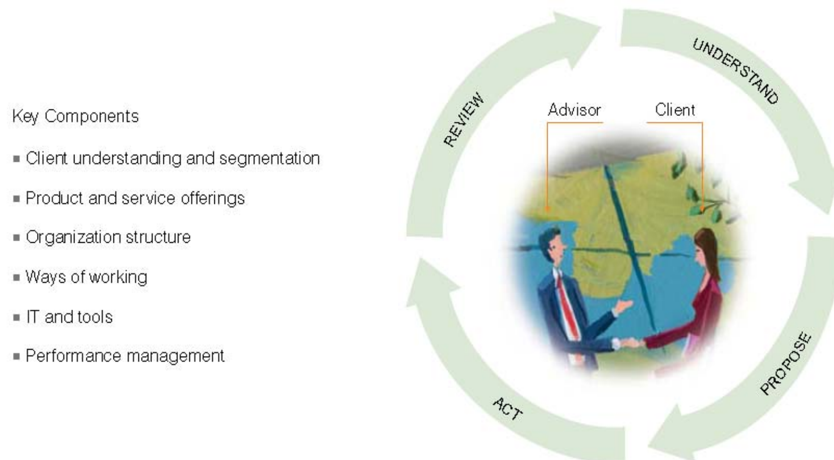
Figure 3: Six actions you can take to deliver the Three D's



LESSON 17

GROWTH STRATEGY IN RETAIL BANKING STRUCTURED RELATIONSHIP APPROACH (CONTD….)

Figure 13. | KEY COMPONENTS OF A RELATIONSHIP APPROACH



5. IT and tools:

Adapting tools to a relationship approach

To provide effective advice, advisors need a complete, integrated view of the client's situation, a good measure of client potential, and an accurate record of the client's past interactions with the bank, including through other channels.

Advisors also need tools supporting the structured process to guide dialogue, enable rapid advice-generation, and develop customized solutions. Questionnaires can help guide dialogue. For rapid advice, tools replicating the need-advice-product architecture are very helpful. To customize solutions, advisors should be able to group products and be guided through the pricing process so they can adjust the price based on the value perceived by the client, within acceptable boundaries of profitability for the bank.

Managers also need monitoring tools to help them know where to direct their efforts and whom to coach. The best tools provide an aggregated and detailed view of how advisors follow the structured process as well as the benefits obtained.

An adaptive IT architecture

In a client-needs-driven relationship, flexibility and a holistic view are essential. Flexibility is necessary to enable customization of product bundling and pricing, and to allow for accessing products across all product lines based on identified client needs.

A holistic customer experience is a key concept. It refers to customers having access to online channels, which empowers them to get advice and act on their own. This requires an adaptive architecture for synchronized data exchange. Advisors also need a readily accessible view of all the client's interactions with the bank (including self-service). In this way the advisor can ensure the client does not become frustrated with the bank's service, and instead gives the client the feeling that the advisor has a firm grip on his or her banking matters.

Developing customer insight and "institutional memory" is also critical. This includes records of processes executed for the client, and a record of client preferences and past interactions through all channels. The prerequisite is an advice-offering database architecture that enables advisors to react to client needs quickly and effectively, and to conduct analyses that produce better targeted offerings.

A Multi-Channel Customer Experience: (See Figure 14)

A relationship is about the bank viewing the customer as an individual (and the customer perceiving it that way) with a specific situation and needs, and how to meet those needs with a broad spectrum of offers—not by pushing products in campaigns or boxing them into a segment category, even a small one. The bank can be represented by a human advisor or a technology interface. In Nordic countries we found the concept of a relationship through technology interfaces more advanced than elsewhere.

A multi-channel focus can help considerably by:

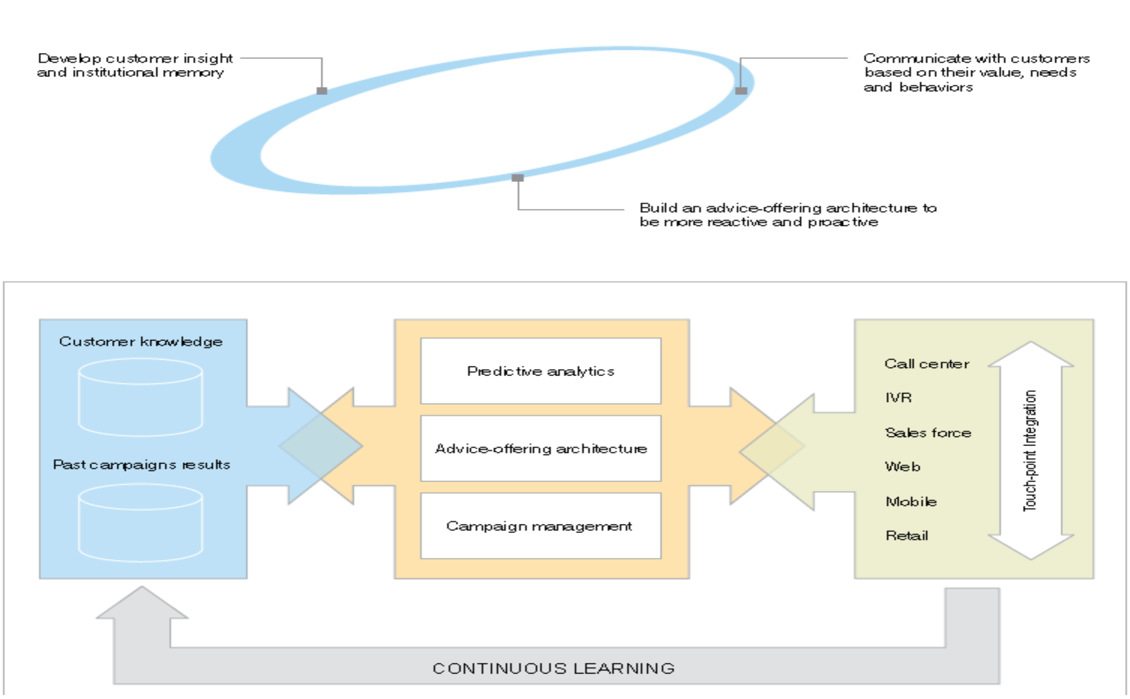
1. Lowering the cost of providing a relationship approach, albeit through technological means, to satisfy lower segments of revenues
2. Providing a multi-channel relationship that enhances the customer experience to satisfy higher standards of more affluent client segments that either prefer self-service to people-based service or are very active users of all channels

As a Nordic banker we interviewed put it, "This personalized approach can be achieved through people, or systems, or a combination." His bank has decided to drive up its share of wallet by lowering the cost of personal service. Its goal is to provide relationship-based approaches to less-affluent segments, and offer its affluent clients a multi-channel relationship that includes self-service, not one restricted to the branch advisor. This approach recognizes that self-service is as much a part of the relationship approach for affluent clients as it is for the less-affluent segments.

The bank's key objective is that every customer be treated on an individual basis. All activities toward a customer, in whatever segment, are generated on an event basis, so people in the branch have a stack of activities toward customers every day, with individual assignments of bank employees for each customer. Events are logged in all channels. Records, or institutional memory, are the key; systems can help organize it and leverage it through analysis for human-machine interaction, or provide the information in an organized way for an advisor to be more effective.

However, this same leading Nordic bank recognizes its human advisors are still the critical success factor. Despite its efforts with technology, it insists that clients with a contact person are distinctly more satisfied and more loyal; hence clients have a named contact person they can reach out to when they want and most of the time they do so by email or chat.

Figure 14. | CLOSED-LOOP MULTICHANNEL EXPERIENCE



6. Performance management:

Alignment with a relationship approach:

- The relationship approach's objective is to match each client's needs with the bank's products, and thereby increase the bank's revenue stream
- Unlike a product-push approach, where employees' performance is measured by the number of products they sell, a relationship approach takes a broader view
- It encompasses all revenue generated for the bank and also a view over time of the revenue/profit contributed by the client accounts
- A large part of the relationship approach's success is based on advisors' efforts to be close to their clients
- Advisors' efforts are, therefore, broken down by steps in the process and tracked, including number of first-step meetings with clients, number of proposals submitted, number of proposals accepted, timeliness of review meetings, and so on
- A good example is the performance measurement approach of the European bank in our sample that we judged to represent best practice
- It tracks its advisors' efforts against short-term and long-term profitability metrics
- All employees in the branch are assigned personal objectives in terms of number of specific interactions, depending on their role
- Profitability performance is measured by a mix of financial results, customer satisfaction, quality of credit portfolio, and volume of long-term savings and lending products

Benefits tracking through internal benchmarking

- The best benefits-measurement programs track benefits at the branch level and fine-tune them through internal benchmarking
- Such programs focus on measurable results
- A good way to stimulate change is to compare these results between branches to highlight best practice, recognize top performers, and motivate laggards to catch up

Key learning points on the relationship approach:

- Measuring client potential accurately to focus the relationship effort and ensure its profitability

- Recognizing the client's trigger points in his or her relationship to the bank in light of the multi-channel customer experience, so the advisor can provide informed support at those critical times
- Building customer loyalty through trust that the advisor is the client's advocate and that the bank offers clear pricing and excellent service
- A relationship is a two-way dialogue: listening to what customers have to say about themselves, their objectives, their preferences, and their needs, and taking it truly into account when proposing a solution

Developing a specialized sales force for the relationship approach through internal recruiting, appropriate training, ongoing competence management, and a long-term effort to ensure people change and adhere to the new approach:

- Aligning performance measurement and incentives with the relationship approach
- Establishing a rigorous, iterative, standardized relationship process—one supported with tools that develop a holistic view of clients, while providing guidance in the diagnostic and solution phases of the relationship (through an architecture encompassing situation, needs, and products)
- Establishing an IT architecture reflecting the business architecture of a closed-loop relationship approach

Growth Agenda in Financial Services Industry
Are Surveys relevant to our study?

- Some findings from another survey ***(Conducted prior to Mid-2007 Financial Crisis)*** by a leading International Consulting/Accounting Firm
- Executives from 201 institutions in Asia, Europe & North America participated in the survey
- Opportunities & Challenges
- Six Imperatives

Growth stands high on the financial services agenda. After a period of conserving and building their resources and boosting returns to shareholders, financial services institutions around the world are shifting up a gear. From insurance to banking and asset management, companies are eyeing opportunities inside and outside their existing sectors, overseas as well as at home. No fewer than 65% of the 201 financial services executives surveyed for this briefing agreed that managing for growth had become a higher priority over the last 12 months.

Economic growth is expected to drive much of this expansion. Interest rates are still low by historical standards and the world economy is growing at a reasonable pace. Demography is providing a following wind, at least in terms of retail savings. As baby boomers in developed countries near retirement, demand for wealth management and investment advice is expected to surge. At the same time rising standards of living are leading to faster rates of growth in both savings and consumer lending in developing countries too.

It will not all be plain sailing, however: a third of survey respondents believe that the growth targets they have been set are optimistic as opposed to realistic or conservative. Challenges to the agenda for growth vary from region to region, sector to sector. But three stand out:

- Asked to identify the principal impediments to the growth strategies that their organizations will face this year, the survey respondents put **competition** top. Despite respondents' expectations that organic growth will be the primary driver of expansion at their organization, new business models

And products are required to break the mould in many saturated, mature markets. In emerging markets, although growth is relatively easy to come by, the smartest organizations will work both to carve out a place in the market and then to erect barriers to entry around it so that, as competition intensifies, the benefits of fast-growing economies continue to flow.

- **Risk, both economic and political**, casts a shadow over growth prospects in several markets. The sliding dollar, rising interest rates and the possibility of a sharp reduction in China's rate of growth all have the capacity to undermine the macroeconomic balance. The possible impact of a slowdown in consumer spending in the US and the UK is also a worry. West European economies will continue to disappoint

- Mounting **regulation**, and the fear of failing to comply fully, could distract management, complicate acquisitions and stifle entrepreneurialism. For institutions operating in multiple territories, putting in place local and regional governance structures to meet the wishes of various regulators can add additional costs and soak up senior management time. A majority of respondents also agree that a sharper accent on compliance, governance and risk management is dampening the appetite for risk at their organizations. Creating an entrepreneurial culture is seen as one of the key challenges of moving from a focus on value to one on growth

Faced with these challenges, institutions are not about to spend massively on strategies for growth. In line with their emphasis on organic growth, sales, marketing and customer-service capabilities are regarded as the most critical enablers by survey respondents. Whether developing new products or building on existing ones, whether seeking out new customers or selling more to existing ones, growth will largely depend on an organization's people. From improving the skills of customer-facing staff to nurturing risk appetite, the quality of management and of employees will be critical in determining success.

A tight focus on costs and efficiencies will also be essential. It is striking that performance improvement comes high in the hierarchy of drivers for growth identified by respondents to the survey, and that two-thirds rate cost efficiencies as either critical or very important in driving growth over the next 12 months.

'Successful firms will not abandon cost control as a way of creating value'. 'But the income side of the equation will definitely become more important during the coming months as companies get closer to their customers and look for ways of growing in innovative ways.'

No fewer than 65% of the 201 financial services executives surveyed for this briefing agreed that managing for growth had become a higher priority over the past 12 months, and the majority is expecting revenue growth this year of more than 10%.

The reasons for this shift in emphasis from cutting costs towards growth are not hard to find. Though rising, interest rates are still low by historical standards and the outlook for the world economy remains relatively bright. By and large, provisions for bad debt are down and interest income remains strong. The increasing use of derivatives is spreading risk and making capital more mobile. Asked to identify the most significant drivers of growth at their institution this year, more respondents pick economic growth than any other option.

Demographic forces – particularly the graying of the baby boomer generation – will also fashion significant opportunities for growth in wealth and investment management over the coming years. In the US alone, an estimated US$10trn or so in funds could flow into the investment management industry as baby boomers approach retirement (although in the longer term, of course, they will run down these savings to provide retirement income). This is equivalent to about half the amount currently managed by the top five investment managers in the US.

LESSON 18

GROWTH AGENDA IN FINANCIAL INDUSTRY

Not only is the number of people nearing retirement starting to swell, but governments are also starting to push the responsibility for providing pensions back to individuals. As a result, the amount of money going into savings schemes in the private sector is likely to grow significantly.

Which of the following will be most responsible for driving growth at your organisation this year? Please choose and rank the top three from the following list.

	Ranked 1	Ranked 2	Ranked 3
Economic growth	52%	17%	11%
Performance improvement	28%	15%	15%
Changing customer behaviour	7%	13%	35%
Innovation	6%	17%	13%
Demographics	1%	31%	12%
New technologies	1%	7%	10%

The growing cost of healthcare is likely to have a similar effect. The more the state steps back from providing universal healthcare, the more individuals will be forced to take out insurance, in both developed and developing markets. In the US, for example, financial institutions in all sectors are exploring the potential impact of the expansion of Health Savings Accounts, investment vehicles which are designed to help individuals save for future qualified medical and retiree health expenses on a tax-free basis.

To take another example, China's central government now covers only 10% of the operating costs of urban hospitals there. The rest comes from patients drawing on savings to pay their bills and from rising levels of health insurance, opening up a fast-growing new area for insurers. The pay-off could be twofold: as insurance replaces bank savings as a means of covering the costs of healthcare, then a proportion of these savings can be directed into other forms of more sophisticated investment or into higher spending on consumer goods and the like.

The premium end of retail banking, where margins are greatest, will also benefit from more active wealth management on the part of individuals. As baby boomers help to swell the number of people in this category, so the business will grow. CIBC, the largest issuer of credit cards in Canada, has built a successful business around its 'Imperial Service' brand which is aimed at the country's growing population of mass affluent, for example.

European banks are also in good shape and ready to grow if the right conditions materialize. With their revenues rising faster than their costs, many have posted double-digit increases in operating income for 2004. As a result, says Standard & Poor's, a rating agency, the average cost of generating revenues for Europe's 50 largest banks is close to a 10-year low. This bodes well for future profits if the economies in which they operate continue to expand and if the lurking threat of windfall taxes on hefty profits comes to nothing.

The pressure on banks to expand will intensify, especially for second-tier institutions in the US and Europe. But the potential for explosive growth is most obvious in emerging markets.

Asia grabs most of the headlines: China is where survey respondents expect to see most growth this year, though the pace of expansion may be tempered by restrictions on the ground. Regulators there take the view that there are already enough national banks in the market and international banks are restricted at the moment to buying only minority stakes. So, high hopes of growth may prove illusory, at least for the time being. Other growth markets, such as India, are also attracting keen interest, though similar constraints apply there too.

One area that is set to keep expanding in both markets is wealth management. As the middle class swells, Justin one expects to see more acquisitions of companies in this sector in India, South Korea and China. Lending to consumers in these markets is also expected to pick up significantly.

As developing economies grow, demand for ordinary non-life insurance also tends to grow disproportionately faster. This is because insurance awareness and the rapid acquisition of new assets drives demand to protect both cash flow and lifestyle from unexpected events.

China's non-life market grew at an average rate of 16% over the past five years against a backdrop of GDP growth of around half that level.

Other regions beyond Asia are also alluring. Take Mexico, a market that has been rocked by more than one crisis over the past couple of decades. After years in the doldrums, the banking market there has suddenly begun to grow again as the necessary ingredients – economic expansion, financial stability and a stronger regulatory framework – have fallen into place. The result was a 15% rise in corporate lending in 2004 and a 30% increase in the number of mortgages created. An analyst with Moody's Investors Service, reckons that growth is starting from such a low base that lending could continue to expand at a similar rate for several years before credit worries began to surface.

What do you regard as the principal challenges that your organisation will face over the coming year in your key growth markets?

	Global	Americas	Asia	Europe
Levels of competition	71%	71%	73%	65%
Macroeconomic conditions	60%	64%	63%	57%
Compliance and regulatory requirements	58%	69%	52%	59%
Maturity of the market	41%	45%	32%	44%
Political risk	37%	33%	45%	31%

Asia figures are key for our purposes

Six imperatives for the growth-orientated institution:

For their strategies to succeed, financial services firms cannot sit back and wait for the pie to grow. Leading institutions can improve their chances of sustainable growth through the following courses of action:

1. **Invest time in careful planning and communication of strategies.**

The fact that a substantial minority of survey respondents said their targets for growth is optimistic suggests that executives at many institutions are not fully convinced of the strategies they are expected to execute. Proper quantification of risks and financial outcomes, and the use of a range of analytical techniques, are essential in formulating strategy. In emerging markets in particular, this means selecting the right geography or segment to achieve and sustain profitable growth. Proper planning does not mean slow execution, however: successful institutions are capable of testing new ideas and adjusting to market feedback at speed.

2. **Be realistic about where and how you want to grow.**

Growth can be defined in a number of ways: respondents to our survey mainly target revenue, followed by operating income and assets under management. Managers must consider the impact that rapid growth can have on the quality of customer service, on performance levels and on profits. Reputational issues also need to be considered, particularly as institutions expand into markets where business practices may differ from those at home.

3. Get close to the customer.

Survey respondents place great emphasis on the performance and quality of front-office functions, not just in applying local knowledge to service customers but also in leveraging their insights into customer needs and behaviors in order to improve their products and services. They also recognize the value that high satisfaction levels among existing customers can bring as a source of referrals and of opportunities to extend sales. Closeness to the customer also implies the flexibility to change offerings to suit local market conditions: what works in, say, the Netherlands may or may not work in India. Sometimes it also means learning from successful business models employed by other highly responsive industries.

4. Use technology appropriately.

If people are critical to growth, technology is close behind. Electronic distribution channels can be a significant enabler of cost-effective growth, as ING has proved in Europe and elsewhere with its one-size-fits-all IT model; they can also help international firms vault barriers to entry in new markets. Technology is critical to the effective management of customer relationships and to the measurement of companies' performance. Whether, integrating legacy systems or simply updating their own applications and infrastructure, controlling the cost of IT can also make a material contribution to the bottom line. But the value of technology will vary between markets and customer segments: CRM in some emerging markets is more likely to depend more on personal relationships than data analysis, for example.

5. Innovate in areas of strength.

When asked to assess their own capabilities with regard to an array of growth enablers, survey respondents ranked innovation bottom of the pile. Yet whether they are dealing with new products or old, virgin markets or existing ones, institutions must be prepared to innovate, not just to grow but also to create and raise barriers to entry. Many global companies have achieved growth in markets such as China, for example, but have neither innovated nor distinguished themselves significantly from their local competitors. The key is leveraging those skills and technologies in which the organization is best-in-class in order to build a differentiated platform for growth. In mature markets, too, an enterprise-wide culture of innovation is essential to unlock pockets of growth – witness the huge success that Canada's CIBC has enjoyed by offering Aeroplan frequent flyer miles on its credit cards.

6. Invest in, develop and reward the right talent.

When asked to identify the biggest challenges associated with the shift from focusing on value to focusing on growth, survey respondents plump first for finding the right people and, second, for creating a more entrepreneurial culture. Growth strategies will require greater numbers of talented people with a global mindset, a relentless focus on the customer and innovative skills, as well as flat decision making structures that are capable of incentivising staff and enabling innovation.

Enablers of Growth:

Given your expected sources of growth this year, which of the following enablers of growth will be most important to your organisation over the next 12 months? (respondents rating each option as critical)

Sales, marketing and customer service capabilities	42%
Human resources	36%
Brand, reputation and customer satisfaction	35%
IT/technology enablers	23%
Cost-efficiency	23%
Entrepreneurialism and risk appetite	21%
Innovation	20%
Negotiating and integrating acquisitions	10%

The survey shows that firms are ruling out nothing when it comes to identifying where the growth is most likely to come from. Over a third of respondents to our survey expected new geographical markets to be their primary sources of growth, and more than half (53% and 60% respectively) thought that attracting new customers and launching new products would be the main engines of expansion. But whether branching out into new areas or consolidating positions of strength, the firms that will successfully deliver on their growth targets will share a number of attributes.

Be Prepared

The first is proper planning. The survey evidenced poor planning of growth strategies at a number of institutions. A sizeable minority of respondents, the overwhelming majority of them at smaller institutions, admitted to using no formal model for measuring the risks and possible outcomes of various strategies for growth. Curiously, too, a surprising number of those questioned said they did not quantify the likely financial outcomes of growth strategies.

At leading institutions, by contrast, the accent is on striking the right balance between risk and reward. In Canada, CIBC has taken steps to tilt its business more towards its retail operations, which now account for 72% of its economic capital. Having been stung by the fallout from Enron, among others, it is keen not to expose itself in future to the possibility of large losses from wholesale lending. For this reason, CIBC is in no hurry to expand either geographically or into new sectors. Any expansion in investment banking, for instance, would have to reinforce specific business lines.

In the investment management sector, the expected influx of money and assets into the private sector is likely to create a greater degree of specialism and more alliances within the industry. Firms that lack expertise in, say, real estate investment may team up with one that does, and investment managers will become more willing to outsource those functions that are neither crucial to their business nor add any value to the proposition they make to customers.

In the insurance sector, too, following a raft of new regulations as well as changes to the way insurance companies report, most insurers are also taking a more systematic approach to risk and the allocation of capital than they did, say, five years ago. Insurers are gradually beginning to integrate techniques such as enterprise-wide risk management into their businesses. This is expected to promote a better understanding of the trade-off between risk and reward and therefore of the speed with which they can grow. The more sophisticated such models become and the more that regulators allow their use in allocating capital, the faster insurers are likely to be able to grow.

Customers Come First

Assuming that a realistic growth strategy is in place, what are the enablers that will help organizations to act on it? Perhaps the biggest challenge for financial services organizations, particularly those in mature markets, is delivering a good enough level of service to satisfy customers, be they wholesale or retail. Even in developed markets in Europe, customers are still getting poor service. Until the standard improves across a range of channels, from call centers to physical branches, many firms will continue to see customers desert them for competitors.

Survey respondents are under no illusion that their capability to service customers, as well as sales and marketing skills, will be among the most important ingredients in delivering growth in the future. Asked to identify which enablers of growth will be most important over the next 12 months, these capabilities rank top. Human resources, whose most important facets include the quality of customer-facing staff, comes next, while brand, reputation and customer satisfaction, rank third.

Retail banks in North America are stepping up their efforts to segment their customers. Being able to identify customers with a higher net worth and doing a better job to keep them and expand the amount of business done with them is critical. Many retail banks are also thinking harder about ways to integrate their systems to enable them to respond more quickly to marketing opportunities and to be on target when they do so. Speed to market and speed in reacting to feedback from the market are both vital – something that retailers in other industries, such as fashion and music, have long known.

What works in one country will not necessarily work in another, of course. Simply transferring customer facing techniques that have been tried in the West to emerging markets is rarely straightforward.

The distribution of non-life insurance products in China through direct sales over the telephone and the Internet is one example. China's consumers are certainly price-conscious enough and the market is poorly segmented when it comes to price. Yet the limited awareness of such an approach among consumers, weaknesses in payment systems and limited credit-card use, which restrict efficient premium collection, and regulatory hurdles have so far prevented firms from exploiting the market. In time, however, it is likely to take off, at which point the limited number of companies around the world who have perfected this technique in other markets (such as Directline in the UK) will be able to establish a position and secure sustainable growth provided they can adapt their business models to local culture and consumer preferences.

Employees Come Close Behind

People remain critical in underpinning successful growth strategies. Asked to identify the biggest challenges associated with the shift from focusing on value to focusing on growth, people to deliver growth and, second, for changing the culture of their organization to one that was more entrepreneurial.

Forward-thinking firms are beginning to think differently about people – asking not how they can prune more costs but whether they should be investing more in their people, and particularly their client-facing staff, in order to get a better return.

No One said it was Easy

Of the growth enablers that respondents were asked to rank in order of importance, only negotiating and integrating acquisitions came lower than innovation. And asked to assess their own capabilities with regard to each enabler, respondents ranked innovation bottom of the pile.

It may be that respondents are simply conceiving innovation in narrow terms. Innovation is not only about new products and services but also about new ways of marketing, of organizing, of distributing, and so on. From Barclaycard's use of CRM systems to ING Direct's virtual business model, the institutions that achieve the highest growth are the ones that are prepared to think and act differently. The fact that even established companies, such as ING and CIBC – through its alliance with Aeroplan, Canada's leading frequent-flyer program – have had such an impact in developed markets by doing something quite different and supporting their activities with clever marketing shows the potential of innovation. At the same time, new business models and the application of leading-edge capabilities will always need to be adapted to local environments – to the state of market readiness and to the availability of appropriately skilled people.

To build and sustain a growing business in financial services, institutions need a combination of vision and pragmatism. They must have the courage to expand but clearly define the perimeters of sustainable growth. They must grasp opportunities but have a sophisticated appreciation of the risks involved in establishing a new venture. They must encourage entrepreneurialism but focus on areas of existing excellence. And they must be able to identify areas of high potential but also choose a market niche, a means of distribution or some other differentiator which insulates them from the competition.

LESSON 19

CAPTURING CONSUMER FINANCE OPPORTUNITIES IN EMERGING MARKETS

NOTE:
This article was published in Dec 1998. As such numbers/data may not be relevant.
However, the purpose of sharing its contents is to undertake a comparison with current situation in the Emerging Markets (especially concerning Pakistan) and to learn about some basic themes & concepts as well as the evolving trends/patterns.

For most banks, selling consumer finance products in emerging markets has seemed like more trouble than it's worth. In these markets, incomes are low, transactions are small, and relatively few people use banking services of any kind. Add to that the recent economic weakness in Asia, Africa, and Latin America, and the prospect of making money on consumer finance in emerging markets seems doubtful at best.

In reality, the opportunity to create profitable consumer-finance businesses in emerging markets is much more attractive than it appears. But to take advantage of that opportunity, banks and other financial services institutions must develop new business models and find ways to team up with new partners.

Sizing Up the Market:
Although the volume of consumer finance business in emerging markets is extremely low, the population's appetite for debt to enable purchases of common items such as televisions, refrigerators, and motor scooters is growing fast. In Mexico, for example, consumer finance assets, at around U.S. $1.5 billion, represent about 1 percent of the country's total loan portfolio. These loans, however, are projected to increase 10 to 15 percent per year for at least the next five years. And even at the current level, consumer finance loans provide approximately 8 percent of Mexico's total net-interest margin because of the wide spread—up to 10,000 basis points—between consumer interest rates and the cost of capital to financial institutions.

What's more, operating costs and default rates for consumer finance loans in emerging markets are generally low, making these loans extremely profitable. In Latin America as a whole, for instance, the operating costs on the roughly U.S.$6 billion in consumer finance loans account for only 50 percent of the net interest margin of U.S.$4.2 billion—a considerably lower percentage than that in most other finance businesses. With default rates a surprisingly low 3 to 5 percent of total assets, net profits before tax total approximately U.S.$1.8 billion—a profit margin of 36 percent.

The trends are similar in Asian emerging markets, despite the recent downturn in many of those economies. Thailand, Malaysia, and Indonesia, for example, consumer credit volumes are still likely to triple over the next ten years. And in India, which has yet to be affected by the economic crisis, the annual net-interest margin from consumer credit is expected to grow from U.S.$630 million to as much as U.S.$3.2 billion by the year 2010. Although net interest margins in Asian emerging markets tend to be lower than those in Latin America (in the neighborhood of 15 to 20 percent), operating costs are lower as well (roughly 30 percent of net interest margin). Estimates put current net profits before tax for India, Malaysia, Thailand, and Indonesia combined at U.S. $530 million. Those profits should continue to grow at double digit rates.

Where's the Catch?
Despite the expanding opportunity, however, few of the existing players—whether banks, local moneylenders, or retailers—are well positioned to exploit it. Traditional banks are significantly over engineered for the needs of consumers in emerging markets. Their methods for assessing credit, approving loans, and collecting payments are costly and ill suited to populations lacking traditional credit information. In addition, low-income consumers are often intimidated by the procedures of the typical bank branch. Independent moneylenders are generally more accessible, but they have their own liabilities. Their cost of funds is high, and they do not have easy ways of identifying prospective customers or an economic means of leveraging their credit experience beyond their narrow customer base. In theory, retailers are well positioned to address consumers' credit needs, since they "own" customers at the point of sale. However, only the large chains have the scale to justify investing in the necessary credit-appraisal and loan-processing systems.

What's needed is a new approach to consumer finance that draws on the financial and distribution strengths of different types of players in emerging markets and delivers credit economically, efficiently, and in ways that are acceptable to consumers.

- Because many of their customers have no banking relationships, retailers could be a steady, low-cost of new consumer-finance clients. Retailers could work closely with banks, other financial companies, and manufacturers of big-ticket items such as appliances to originate installment loans
- Credit assessment in emerging markets must rely on the available consumer data. In markets where standard information, such as salary documentation and utility bills, does not exist or is difficult to obtain, credit officers must be prepared to make lending decisions on the basis of less tangible information, such as a consumer's standing in the community and personal guarantees
- Local stores are well suited to be loan-payment locations in emerging markets. When consumers are delinquent on payments, however, the best method of collection will be door to door. Whereas approach is too expensive to pursue in developed countries, it is much less costly in emerging markets. Moreover, it is extremely effective with low-income consumers, who don't want to jeopardize their ability to borrow in the future. In fact, if the collection process is managed properly, default rates can be held to less than 5 percent

Assembling the Right Lending Capabilities

Banks and other financial-services companies that wish to pursue consumer finance opportunities in emerging markets can consider a variety of approaches.

Some banks will enter the business by adjusting their existing systems, cost structures, and cultures. However, most will find it easier to create a separate company or to team up with finance companies that already have low-cost systems for acquiring customers, assessing credit, and collecting payments. That approach enables banks with high credit ratings to take advantage of the efficiencies of finance companies while capitalizing on their own ability to access funds at competitive rates.

ICICI, one of India's largest banks, recently adopted this strategy with its acquisition of Anagram Finance, a domestic finance company with 60 branches. And in Brazil, Unibanco has joined forces with Fininvest, a leading Brazilian finance company with receivables of roughly U.S.$1 billion and a client base of several million. Fininvest targets low-income consumers by financing specific items in stores through agreements with retailers. The company has developed sophisticated systems for risk assessment and customer management: Credit assessment is centralized, closely controlled by the corporate center, and completed before any loan is approved. The company also regularly screens transaction histories, purchasing patterns, and payment records in order to identify cross-selling opportunities.

Banks that join forces with finance companies may reap other benefits as well. As finance-company customers become more affluent, banks can provide them with accounts and other financial products.

Large retailers may establish their own consumer credit businesses to increase their customers' purchasing power and generate additional profits for themselves. For example, Elektra, a major retailer of furniture and appliances in Mexico, is also the country's leading consumer lender: some 60 percent of its profit in the year came from its finance activities. However, developing the necessary capabilities for credit assessment, loan underwriting, and collections is not for everyone. Many retailers will opt in favor of negotiating partnerships with manufacturers and finance companies that already have the required skills.

Even global finance companies are identifying opportunities to leverage their product and credit knowledge in emerging markets. Rather than venturing on their own, though, some elect to team up with local lenders and retailers. GE Capital, for example, has recently purchased several local finance companies in Asia and has acquired controlling stakes in the private-label credit-card business of Thailand's largest retailer and in a new credit-card venture of State Bank of India.

As long as the demand for consumer finance was barely measurable in emerging markets, most traditional financial players were content to wait on the sidelines. As the potential for the business comes into focus, however, those hoping to participate must begin to determine precisely what kind of role they want to play. Companies that act early have an opportunity to lay the foundation for an exciting—and profitable— future.

2009: A year in Emerging Markets

The problems facing the global economy emanate from the developed markets, not the emerging world. Although the news from emerging market economies has deteriorated – like everywhere else – they will withstand the global recession better than developed markets, and much better than they would have done themselves in the past. Yet this is not yet reflected in markets, which appear too cheap.

The 'credit crunch' – the virtual freezing up of lending by banks – is primarily a developed market problem, created in the developed world. In the last six years, for example, personal debt in the US grew by as much as it had in the previous forty years. Too much cheap lending has now resulted in a complete and dramatic reversal of this trend, with banks unwilling to lend to other banks, unsure of their financial solvency.

The upshot is that expectations for global economic growth have deteriorated sharply in recent months. In this environment, growth in the emerging world will also slow next year. Just like everywhere else in the world, more difficult times are ahead.

The only place to go for growth

Newspapers are filled with stories every day now about the slowdown in economic activity in countries around the world. India and China – where manufacturing activity has slowed, along with other emerging markets, have been no exception. The difference is, we believe, that overall economic growth will remain in positive territory – unlike the US, UK and Europe, where the process of debt reduction is likely to be protracted and will dampen spending and investment.

Schroders is forecasting economic growth at 3.5% in emerging economies in aggregate next year, versus a fall of 1% in the OECD. In fact, emerging market economies should be at the forefront of global economic recovery when it comes – albeit gradually – in 2010.

Economic decoupling

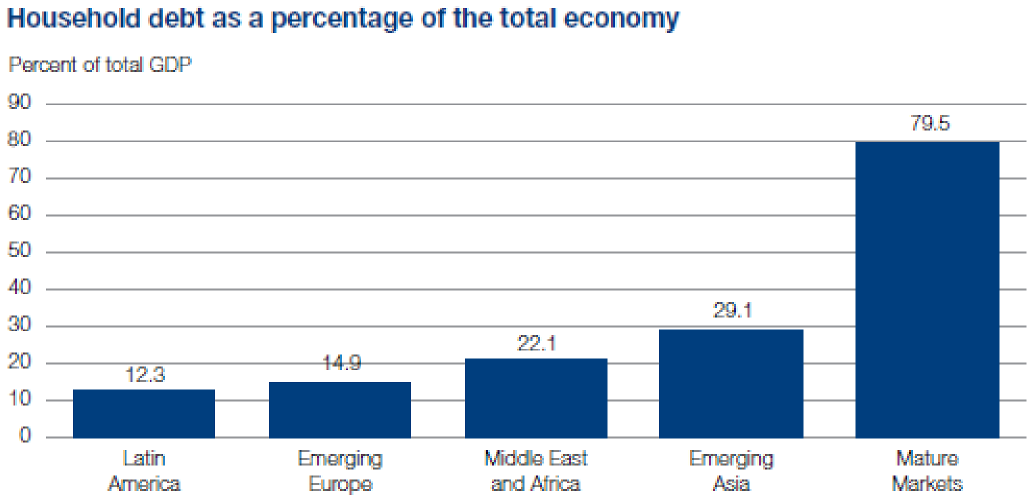
Emerging economies are less dependent on the developed world for growth than they were a few years ago. Strong demand from within their own growing economies, and trade with other growing emerging market countries (particularly China and India), make these economies much more self-sufficient. Once they would have been the worse hit in a global recession; now they are able to withstand a US-led downturn better than markets like the UK.

Across the region, revenues from exports to other emerging markets have now overtaken exports to the industrial nations, and domestic demand in many countries is growing at a very fast pace. This is particularly the case in China, where demand for Chinese products provided around four times more contribution to its domestic economic growth than total exports did in 2007. That trend is expected to continue. Of course, exports from China to the developed world will inevitably slow, but planned increases in Chinese government spending should help to offset this: the government announced a national stimulus package, totaling $586 billion, this November, which should see more infrastructure spending on roads and other projects.

Emerging markets are not borrowed up to the hilt

Local banks have little exposure to the toxic assets that have been part of the reason for the meltdown in the global financial system. Furthermore, debt levels in these economies are generally modest. While emerging markets will suffer in the short-term from the global liquidity squeeze, they will not suffer the same issues that developed markets are currently going through in terms of long and painful period of reducing debt.

The chart below shows household debt as a percentage of the total economies in emerging market regions compared to the developed world.



In fact, there is actually potential in emerging markets for household debt to rise further, which will support future growth in consumption. Public sector debt in emerging markets is also low compared to developed markets.

Other economic fundamentals are good compared to developed markets. Foreign reserves are at a record high and foreign debt has declined sharply – resulting in a dramatic turnaround in the net trade balance.

Markets are cheap relative to developed markets

Despite the extent of economic decoupling, these stock markets have been at the sharp end of the sell off in global equities this year. As investors have reacted to a more gloomy global environment, they have written off emerging markets as too risky and taken profits on extremely good returns in the previous few years. Record inflows from foreign investors in 2005, 2006 and 2007 became record outflows this year.

This can have some knock-on effect on economies themselves, of course, as large outflows of foreign investment takes its toll on companies.

But this does not reflect the underlying economic picture relative to the developed world. Recent under-performance does not mean that emerging market economies and developed economies have re-coupled, it simply means that investors' perceptions of what is 'risky' and what is not have yet to catch up.

There could continue to be more volatility and disappointments in the short term as more companies issue results; investors are arguably still a little unrealistic in their company profit expectations. Even so, the current price/earnings ratio across emerging markets is 7.5 times next year's corporate earnings. This compares to a longer-term average of around 13 times for the region. The p/e of the US market and the average p/e for global markets are now both over 9 times. Valuations may be flattered by overly optimistic company earnings forecasts, but even if downgrades are factored in and the 'e' part of the p/e equation falls, these markets are still likely to offer much better value.

The best place to be

Of course, uncertainty on a global basis is dominating stock markets at the moment – no one is sure how long before we see the shoots of economic recovery, or how many more bank bailouts there will be. This means we are seeing sharp swings in markets on a daily basis everywhere, but also that investors have lost their sense of perspective on emerging markets' prospects for the longer term. But given that economic fundamentals in these markets are stronger and that they will be able to withstand the global economic downturn, yet still offer more attractive valuations, we think they are the best place to be.

A Food for Thought:

There is a great deal of research that finds finance is positively correlated with growth, but this work has a couple of serious limitations – if you want to derive any robust implications for policy.

First, it is about the amount of financial aggregates (e.g., money or credit, relative to GDP) rather than the share of financial sector GDP in total GDP. I, (The Author), know of no evidence that says you are better off with a financial sector at 8% rather than, say, 4% of GDP.

Second, the research shows correlations not causation. So all we really know is that richer countries have more financial flows relative to GDP, not that more finance raises GDP in any linear fashion.

Attempts to dig into causation tend to show that financial development is not the bonanza that it is cracked up to be.

Third, we know finance can become "too big" relative to an economy. The work in this area is still at any early stage. Given what we've seen since Mid-2007 crisis, which way should we lean: towards believing in the positive power of finance, until the opposite is proven; or towards being skeptical of finance in its modern form, until we see evidence that this actually makes sense?

Surely our skepticism should extend to financial innovation. Show me the evidence that this kind of innovation really adds value, socially speaking – rather than providing a very modern way to extract amazing "rents"

An Alternate View on Financial Innovation:

- Even if financial innovation does not boost growth, it is a good thing if it improves welfare
- Modern finance improved people's access to credit
- Computers enabled lenders to use standardized credit scores, and the risk-spreading from securitization made it safer to lend to less creditworthy borrowers
- This "democratization of credit" let more people own homes (and even after 1&1/2 year post Mid-2007 financial crisis, it is worth remembering that most subprime borrowers are keeping up with their payments)
- It enabled more households to smooth their consumption over time, reducing their financial hardship in lean times
- Studies show that consumers in Anglo-Saxon economies cut their spending by less when they suffer temporary shocks to their income than those in countries with less sophisticated financial systems
- Smoother household consumption often means a smoother economic cycle, too
- Many economists believe that financial innovation, including easier access to credit, is one reason for the "Great Moderation" in the business cycle in the past few decades

LESSON 20

INDIA CONSUMER BANKING LANDSCAPE

India: Credit where it's due

Emerging markets often offer greater growth potential than developed markets but they also pose a different set of challenges. Take India, where the burgeoning middle class, especially the young, is rapidly becoming accustomed to credit and to replacing bank notes with plastic. 'People used to say 'save now buy later'. Now it's all about affordable indulgence,' says Chanda Kochhar, head of consumer banking at ICICI Bank, one of the country's largest banking groups.

'Until three or four years ago, the 25-30 age group of young working couples with no kids wasn't taking out loans. Now they are behaving differently from their parents and earlier age groups,' says Rajiv Jamkhedkar, head of Citibank's personal loans business in India. It is not just televisions, scooters and cars that such people are buying on credit. They are also borrowing to pay for such things as holidays, marriage celebrations (which couples sometimes help their parents to finance) and homes (as upwardly mobile couples break with tradition and move away from their parents).

All this is helping India's market for consumer finance to grow at an annual rate of 40%. Social change is not the only thing that is driving the market. There has been a rapid growth in incomes too: the number of households earning over Rs 80,000 a year (US$1,860 at current values) has raised by 20 million since 1996 to a current figure of 60 million.

Yet consumer loans worth US$15 billion (excluding secured mortgages) still account for only 3.5%-4% of India's gross domestic product. Government-owned banks tend to lend only to existing retail customers, so those in the private sector, which market aggressively to new customers, account for most of the expansion. The market leader is ICICI, which offers consumer finance in 1,000 cities, up from as few as 15 as recently as 2000. This is followed by foreign banks such as Citibank, HSBC and Standard Chartered, which face no barriers to entering the market but which tend to focus on the large metropolitan areas where credit risks are lower.

Despite recent growth, credit and debit cards still account for only about 0.6% of consumer spending. From three million credit cards in 1998, the market has grown to a combined total of 44 million credit and debit cards in 2004, worth around US$23bn, according to a study by Visa International and India's National Council of Applied Economic Research.

Competition for market share is intense. Consumers are offered a range of inducements including interest rates on credit cards as low as 0.99% and free holidays as rewards for accumulated points. Standard Chartered has broken new ground with a card called Manhattan that offers 'lifestyle' packages, allowing users to redeem points against activities that range from a visit to an Indian vineyard or a spa to white water rafting and previews of films.

An impediment to growth in both consumer loans and cards is the lack of credit bureaux, identity cards or a social security system that would enable applicants' identities and creditworthiness to be checked. Understandably, this makes most foreign banks concentrate on the safer end of the market. 'We currently focus on self-employed professionals and salaried individuals who make up 80% of our customers, so there is still a big untapped market among self-employed proprietors and small businesses,' says Citibank's Mr Jamkhedkar. A list of defaulters, started by MasterCard in the late 1990s, now covers all banks and cards. Rival banks are also beginning to co-operate more on defaults, partly through CIBIL, a credit bureau set up in 2000.

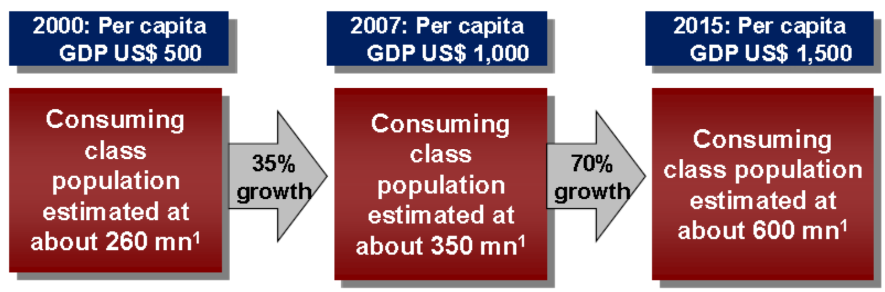
Another obstacle to growth is a resistance to the use of credit and debit cards by merchants such as shopkeepers, and from self-employed professionals like doctors. Even the owners of schools are reluctant to accept cards. Like others, they baulk not just at the cost of merchant fees and card-processing equipment but also at anything that would involve them in having to add sales tax and so helping the authorities to track the flow of money. Government departments and public utilities are even more resistant to change because it would mean abandoning hand-written or typed files that provide employment for clerks.

Changing Consumer Demographics....

Consumer Demographics of India

- Increasingly affluent, with a bulging middle class
- The youngest population in the world
  - 65% of population below 35 years of age
- Increasing literacy levels
- Higher adaptability to technology
- Urbanisation is a continuing trend
- Increasing "consumption" mindset in India

...driven by a growing consuming class...



- From per capita GDP of US$ 1,000 to US$ 1,500: consuming population to grow manifold

...with an upward migration of incomes..

(households in million)

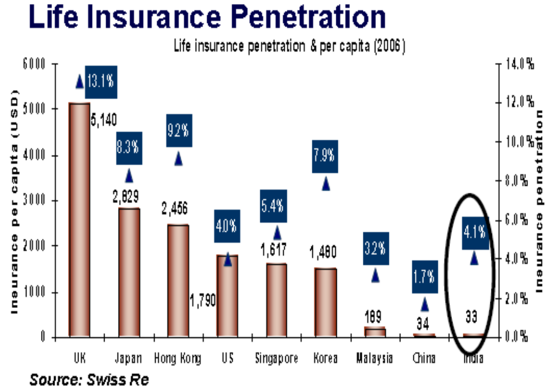
	FY1996	FY2002	FY2010 Estimate
Middle income	33	50	98
High income	1	3	10

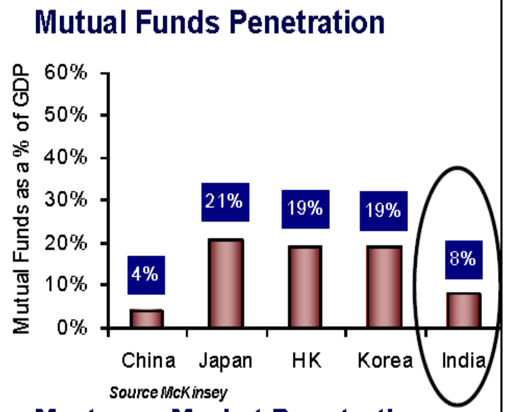
Middle income : US$ 2,100 - 11,670 per household p.a.

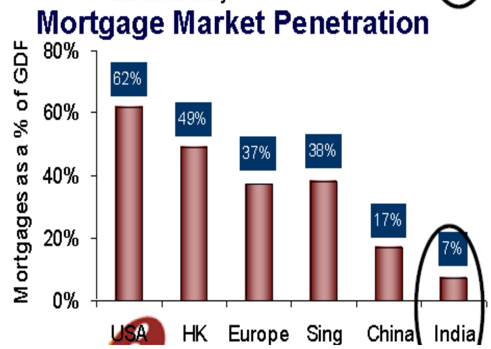
High income : > US$ 11,670 per household p.a.

- Rising affluence and growth of the consuming class
  - NCAER data for top 24 cities in India shows migration to higher income levels growing at over 40% per annum

..and low market penetration..

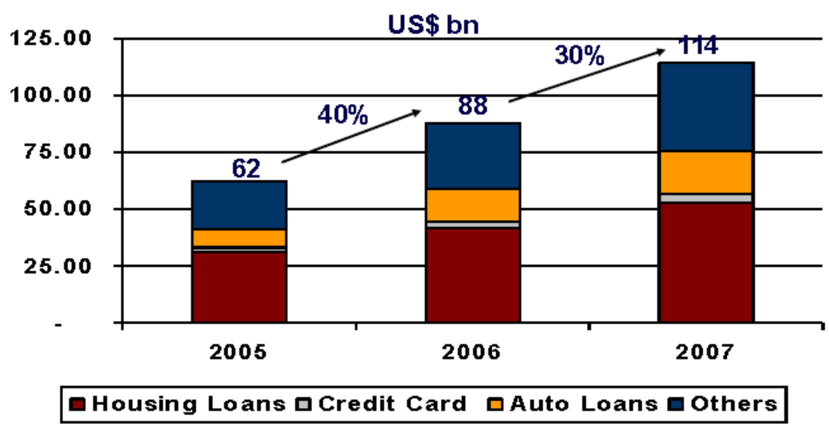






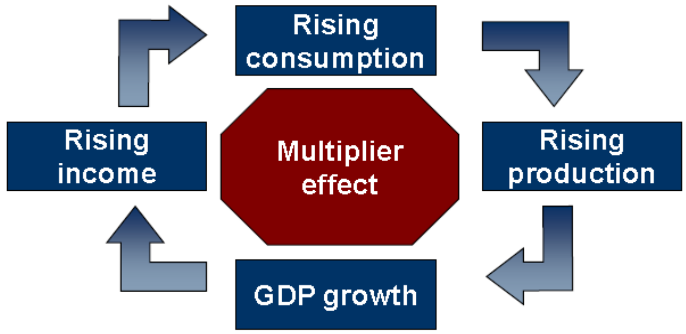
- Retail Credit / GDP at 13% as compared to 60%* in Malaysia & 90%* in the US
- 113 mn people are likely to retire by 2016
  - Need for retirement planning now

..offering banks a huge opportunity..



- Robust growth in consumer credit in India
  - Across product segments
- Growth to moderate to 12-15% due to the large base effect

..and resultant Economic growth…



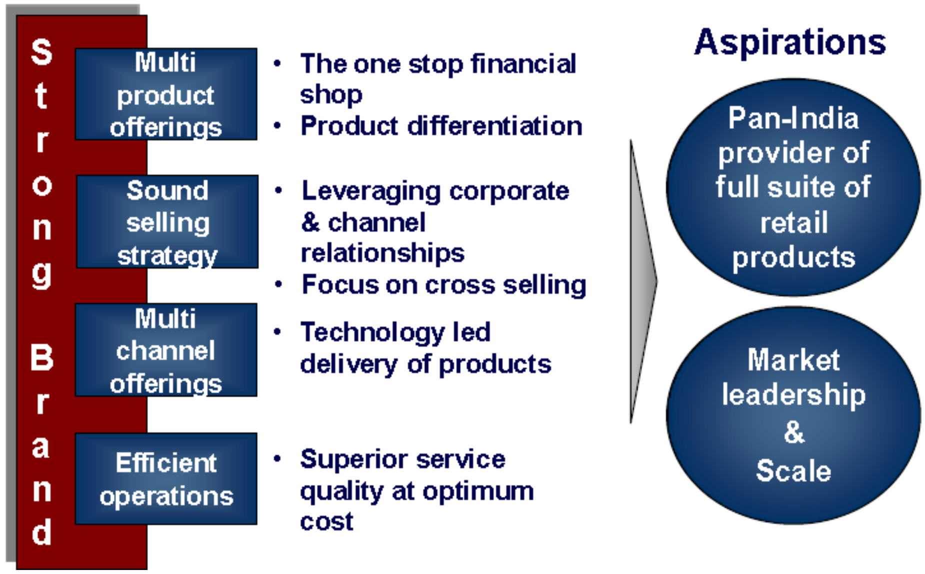
- India on a high growth trajectory with an average GDP growth rate of 8.7% over the last four years
- Expected growth rate of 8-8.5% during FY 09

India's Leading Bank

Key challenges at the time of entry into consumer finance

- Well entrenched competition
- Change in mindset required
  - Focus on decentralisation & empowerment
- No experience in consumer finance
  - Finding the right way to approach the market was a key challenge
- Lack of scale
  - Low relevance for intermediaries and vendors
- High cost of funds
- Creating a retail organisation

India's Leading Bank
Consumer Finance Strategy



Establishing new paradigm in consumer credit distribution…

Doorstep delivery	Point-of-sale delivery
• Agents taking product to the customer • Availability of credit at the customer's home or office	• Strong channel partner network • Manufacturers, dealers, realtors • Availability of credit at point-of-sale of product

"Enhanced customer convenience" the key selling proposition

…and achieving economies of scale….

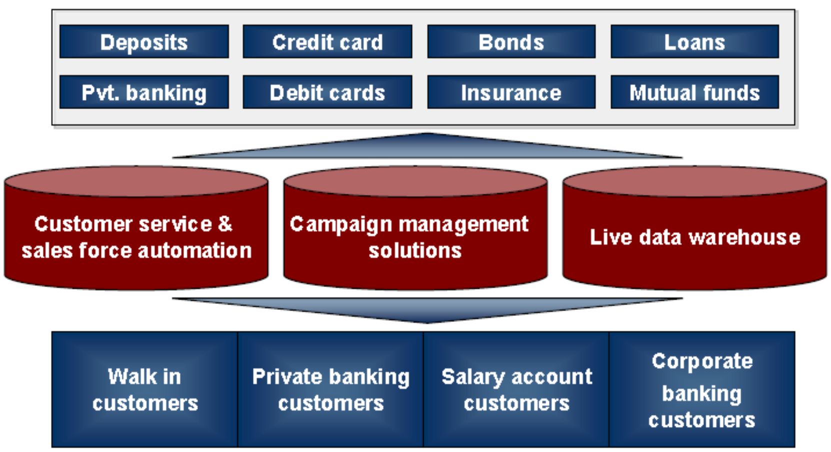
Particulars	Before 1995	Now
Product Portfolio	Single product	complex retail & corporate finance products
Branches/ Offices	6	>1,300
ATMs	-	~4,000
Employee Base	1,000	>40,000
Customer Base	3,000	31 Mn
Internet customers	-	18.3 Mn

…by leveraging technology channels…

Channel	Usage 2000[1]	Usage 2008[1,2]
Branches[2]	94%	7%
ATMs & POS terminals	3%	37%
Internet	2%	21%
Call centre & mobile banking	1%	30%

The Online trading platform caters to more than 1.4 million customers handling about 350,000 trades a day

… with a focus on cross-sell…



To achieve market leadership in consumer finance in India

International Opportunity : Key Drivers

- ***Do these details/facts about Indian Consumer Finance Industry have any Relevance/Significance for our purposes in the context of Pakistan?***

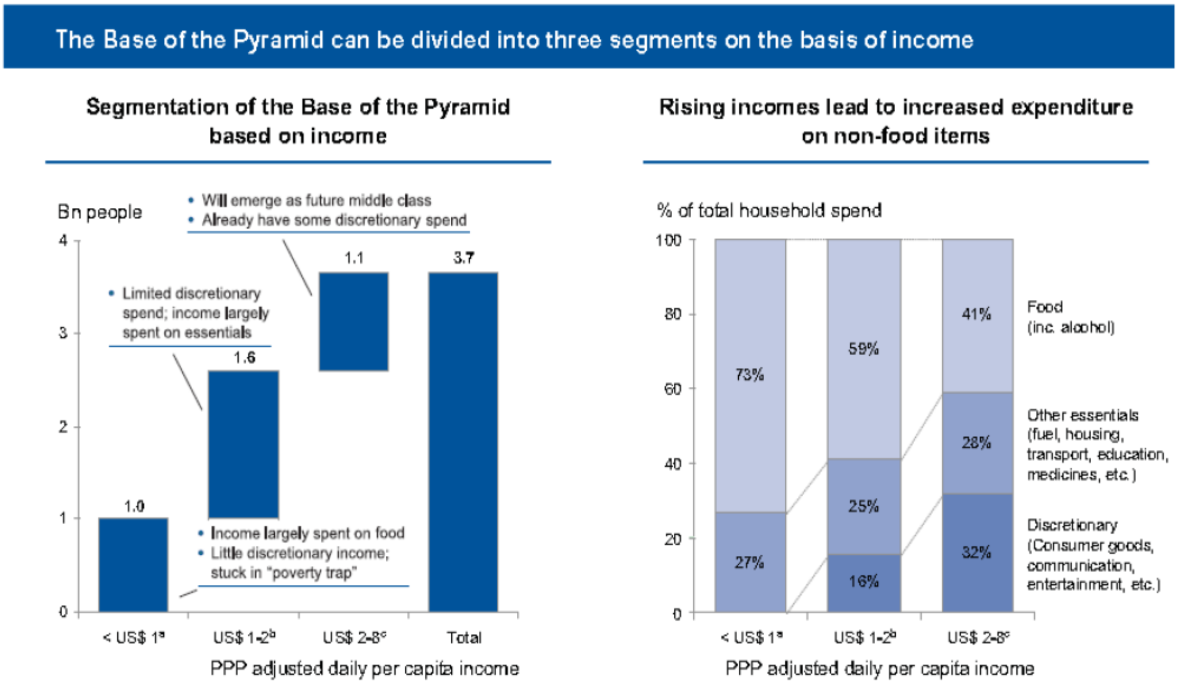
- ***Can we put these details/facts into some perspective by applying the "Learning Process" we discussed in our first lecture?***
- ***Let's try by considering yet another analogy!***

Learning is the acquisition of data, information, knowledge, understanding, and wisdom.
And what are those things?

- ***Data*** consists of symbols that represent objects, events, and their properties. For example, the speedometer in a car presents data
- ***Information*** is data that has been made useful. Information answers who, what, where, when, and how many questions. Information is helpful in deciding what to do, not how to do it. For example, the information that you are driving at 120 mph will help you decide whether to speed up or slow down. But information won't tell you how to do it
- ***Knowledge*** consists of instructions and know-how. Knowledge answers how questions. For example, your driving knowledge tells you how to control the car's speed
- ***Understanding*** consists of explanations. Understanding answers why questions. For example, you understand why you are in the car in the first place: because you are driving your kids to school
- ***Wisdom*** is the ability to perceive outcomes and determine their value. It is useful for deciding what should be done. For example, the wise may decide that driving recklessly may lead their children to do the same in the future

LESSON 21

THE NEXT 4 BILLION MARKET SIZE & BUSINESS STRATEGY AT THE BASE OF THE PYRAMID AN IFC/WORLD RESOURCES INSTITUTE REPORT (2007)



Four billion low-income people, a majority of the world's population, constitute the base of the economic pyramid. New empirical measures of their behavior as consumers and their aggregate purchasing power suggest significant opportunities for market-based approaches to better meet their needs, increase their productivity and incomes, and empower their entry into the formal economy.

The 4 billion people at the base of the economic pyramid (BOP)—all those with incomes below $3,000 in local purchasing power—live in relative poverty. Their incomes in current U.S. dollars are less than $3.35 a day in Brazil, $2.11 in China, $1.89 in Ghana, and $1.56 in India. Yet together they have substantial purchasing power: the BOP constitutes a $5 trillion global consumer market.

The wealthier mid-market population segment, the 1.4 billion people with per capita incomes between $3,000 and $20,000, represents a $12.5 trillion market globally. This market is largely urban, already relatively well served, and extremely competitive.

In contrast, BOP markets are often rural—especially in rapidly growing Asia—very poorly served, dominated by the informal economy, and, as a result, relatively inefficient and uncompetitive. Yet these markets represent a substantial share of the world's population. Data from national household surveys in 110 countries show that the BOP makes up 72% of the 5,575 million people recorded by the surveys and an overwhelming majority of the population in Africa, Asia, Eastern Europe, and Latin America and the Caribbean—home to nearly all the BOP.

Analysis of the survey data—the latest available on incomes, expenditures, and access to services—shows marked differences across countries in the composition of these BOP markets. Some, like Nigeria's, are concentrated in the lowest income segments of the BOP; others, like those in Ukraine, are concentrated in the upper income segments. Regional differences are also apparent. Rural areas dominate most BOP markets in Africa and Asia; urban areas dominate most in Eastern Europe and Latin America.

Striking patterns also emerge in spending. Not surprisingly, food dominates BOP household budgets. As incomes rise, however, the share spent on food declines, while the share for housing remains relatively constant—and the shares for transportation and telecommunications grow rapidly. In all regions half of

BOP household spending on health goes to pharmaceuticals. And in all except Eastern Europe the lower income segments of the BOP depend mainly on firewood as a cooking fuel, the higher segments on propane or other modern fuels.

That these substantial markets remain under-served is to the detriment of BOP households. Business is also missing out. But there is now enough information about these markets, and enough experience with viable business strategies, to justify far closer business attention to the opportunities they represent. Market-based approaches also warrant far more attention in the development community, for the potential benefits they offer in bringing more of the BOP into the formal economy and in improving the delivery of essential services to this large population segment.

A BOP Portrait

The development community has tended to focus on meeting the needs of the poorest of the poor—the 1 billion people with incomes below $1 a day in local purchasing power. But a much larger segment of the low income population—the 4 billion people of the BOP, all with incomes well below any Western poverty line—both deserves attention and is the appropriate focus of a market-oriented approach.

The starting point for this argument is not the BOP's poverty. Instead, it is the fact that BOP population segments for the most part are not integrated into the global market economy and do not benefit from it. They also share other characteristics:

- **Significant unmet needs**
  Most people in the BOP have no bank account and no access to modern financial services. Most do not own a phone. Many live in informal settlements, with no formal title to their dwelling. And many lack access to water and sanitation services, electricity, and basic health care.
- **Dependence on informal or subsistence livelihoods**
  Most in the BOP lack good access to markets to sell their labor, handicrafts, or crops and have no choice but to sell to local employers or to middlemen who exploit them. As subsistence and small-scale farmers and fishermen, they are uniquely vulnerable to destruction of the natural resources they depend on but are powerless to protect (World Resources Institute and others 2005). In effect, informality and subsistence are poverty traps.
- **Impacted by a BOP penalty**
  Many in the BOP, and perhaps most, pay higher prices for basic goods and services than do wealthier consumers—either in cash or in the effort they must expend to obtain them—and they often receive lower quality as well. This high cost of being poor is widely shared: it is not just the very poor who often pay more for the transportation to reach a distant hospital or clinic than for the treatment, or who face exorbitant fees for loans or for transfers of remittances from relatives abroad.

Addressing the unmet needs of the BOP is essential to raising welfare, productivity, and income—to enabling BOP households to find their own route out of poverty. Engaging the BOP in the formal economy must be a critical part of any wealth-generating and inclusive growth strategy. And eliminating BOP penalties will increase effective income for the BOP. Moreover, to the extent that unmet needs, informality traps, and BOP penalties arise from inefficient or monopolistic markets or lack of attention and investment, addressing these barriers may also create significant market opportunities for businesses.

Perhaps most important, it is the entire BOP and not just the very poor who constitute the low-income market—and it is the entire market that must be analyzed and addressed for private sector strategies to be effective, even if there are segments of that market for which market-based solutions are not available or not sufficient.

Some Additional Comments on BOP by World Economic Forum:

Although individual incomes of the BOP are low, the aggregate market is large: in 2008, their income pool totaled slightly more than US$ 2.3 trillion. Since some of them have already begun to accumulate disposable incomes to spend on goods beyond basic necessities, they present an attractive opportunity for market-based interventions.

Incomes for the BOP have been growing rapidly at around 8% per annum. Even in the context of a global economic downturn, this market is likely to see some continued growth. If growth was to continue at the rate of 8% per year seen in recent years, by 2015 the aggregate income pool of today's BOP could increase to approximately US$ 4 trillion.

The BOP can be divided into three income segments – lowest, middle and top. The lowest level consists of about 1 billion people who live below the poverty lined and struggle to make ends meet. The middle segment constitutes the largest group, with approximately 1.6 billion people. Although they have little discretionary spending power, they are generally able to support their basic needs and will require intervention only to improve the level and consistency of their existing incomes.

The top segment – which comprises around 1.1 billion people – has sufficient disposable income to purchase nonessential products, yet they receive little attention from most businesses, because their incomes are still relatively low and tend to fluctuate.

This group may be easiest to engage with, since they have surplus incomes and already spend on discretionary items. However, engaging the lower income ranges of the BOP is also feasible and important. If businesses and organizations help to increase capacity and income among all ranks of the BOP, they will foster broad-based growth throughout the market.

In many countries, women undertake most of the farm labour, as well as food collection or purchasing and preparation. Yet, women often have less access to information, credit and services than men do, which constrains their capacity as producers and consumers. Companies could pay special attention to women as an under-served segment and address their needs, preferences and constraints in the design of products and services. For example, micro-farm equipment can be designed to be affordable and require less intense manual labour, and food products can be targeted to household nutritional needs. Since women reinvest most of their income into the family, they are a powerful avenue for value creation at the household and community level. Companies that recognize and invest in this opportunity could help strengthen community-level productivity and enhance long-term market growth.

Where does the BOP live?
People living at the BOP can be found all over the world, yet they are particularly concentrated in a few areas. India and China alone account for 60%. Asia, Africa and Latin America together account for 94% of the total BOP population. Africa has the highest share of the poorest segment – only 65% of Africa's BOP population is above the World Bank's US$ 1 a day poverty line, compared with more than 86% in Latin America. The majority of the BOP live in rural areas (68% globally), which adds to the complexity and costs of reaching them.

Some salient characteristics
Although it is difficult to generalize about a group as varied as the BOP, it is important to understand the characteristics that distinguish them from other groups.

They manage low and fluctuating incomes
The burden of low incomes is compounded by the fact that income streams for BOP households are unpredictable. As customers, therefore, they resist large up-front outlays and recurring expenses in the form of installments. In addition, most lack access to affordable credit which would enable essential purchases or business investments. Therefore, companies might look for ways to align their prices and financing for consumers with incomes that ebb and flow. They might also design financial incentives that provide a stable income and encourage entrepreneurship when engaging with the BOP as producers.

They cope with domestic constraints and difficult living conditions
The living spaces of BOP households are typically quite small. Furthermore, conveniences that more affluent households take for granted – such as uninterrupted electricity and clean running water – have yet to reach many BOP households. These conditions impose constraints on both the type of products that the BOP can produce and consume and their level of productivity. Companies engaging with the poor could strive to deliver business and product solutions that address these constraints.

They are smart shoppers and investors

Since every cent counts for low-income households, they are unlikely to spend money on products they don't understand or trust. However, they don't necessarily prefer cheaper or stripped-down versions of more expensive offerings. They want high-quality products, even if they have to ration their use.

Therefore, they prefer products that are known to be reliable or are demonstrably superior. For example, despite cash constraints, farmers will often pay a premium for high productivity seeds that other farmers have used and profited from.

They are unfamiliar with many products, technologies and procedures

At the BOP, communication channels are scarce, literacy rates are low, and many consumers are often first-time users. These factors increase the need for consumer education, product trials and demonstrations to explain product benefits and usage. Producers and entrepreneurs also lack crucial information. Therefore, companies sourcing from the BOP must be willing to invest in educating their suppliers as well.

They look for trusted advice

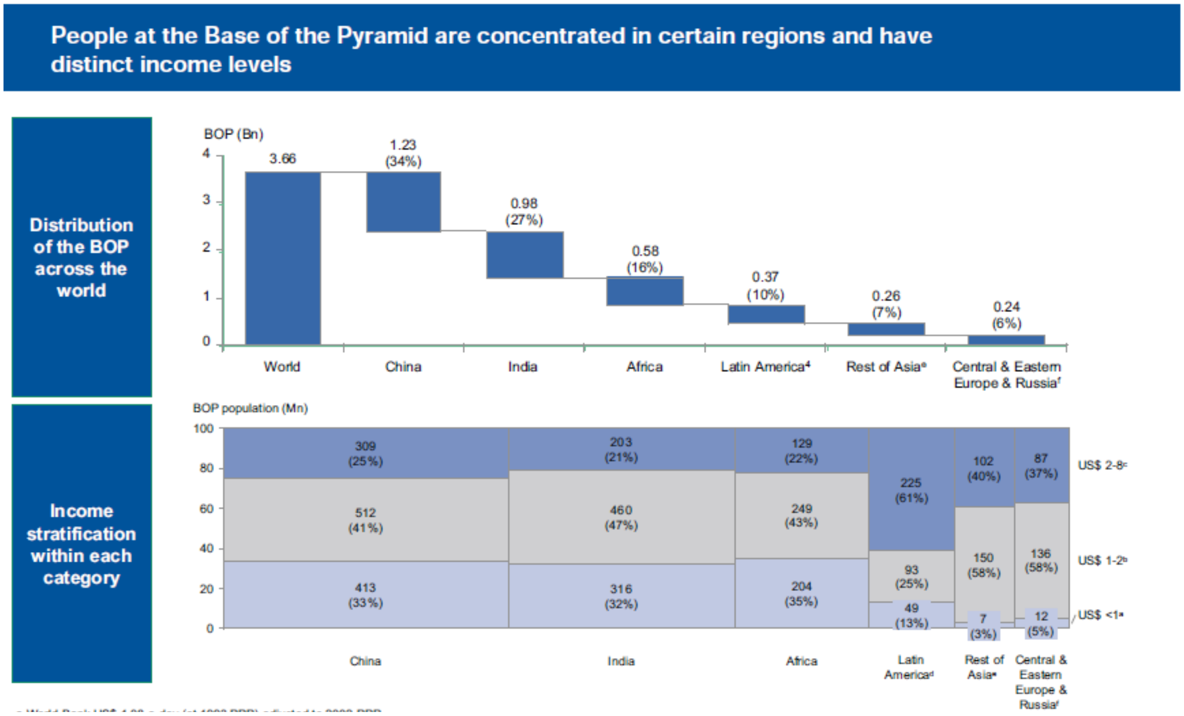
Because the BOP are new to many products and have limited access to information sources, they are more likely to rely on the opinions of people they know and trust. Advertisements can help raise awareness, but they seldom address all the barriers to purchasing a product. The experiences of friends and relatives – good and bad – as well as direct experience through product testing and demonstrations, strongly influence the BOP's choice of products and brands. For that reason, encouraging local groups to advocate products and services to friends and creating networks for educating first-time users is a valuable tool in many business models.

They demand respect

Surveys of low-income households elicited statements such as: "We need to be well dressed and look good. Otherwise, people will not take us seriously. And at school, the teachers will write my children off as poor and not deserving of a good education." Being treated equitably and with dignity also influences where the BOP shops. They often prefer neighborhood shops– which are familiar and offer personalized service – over supermarkets, which may require more travel time and seem intimidating. Companies should consider such sensitivities and treat the BOP – whether as consumers or employees – with respect.

They face disadvantages in the market

Because BOP consumers' spending power is limited, and the costs to reach them are high, they tend to be served by inefficient supply chains. That often results in their paying higher prices for inferior goods, compared to wealthier members of their societies – an inequity often referred to as the "BOP penalty". This cost dynamic presents a tremendous opportunity for organizations and businesses to offer better quality and more affordable options to the poor. But realizing that opportunity will require: uprooting entrenched stereotypes and being open to new ways of engaging with this segment.


People at the Base of the Pyramid are concentrated in certain regions and have distinct income levels
Distribution of the BOP across the world
BOP (Bn)
3.66
1.23 (34%)
0.98 (27%)
0.58 (16%)
0.37 (10%)
0.26 (7%)
0.24 (6%)
World
China
India
Africa
Latin America
Rest of Asia
Central & Eastern Europe & Russia
Income stratification within each category
BOP population (Mn)
309 (25%)
512 (41%)
413 (33%)
203 (21%)
460 (47%)
316 (32%)
129 (22%)
249 (43%)
204 (35%)
225 (61%)
93 (25%)
49 (13%)
102 (40%)
150 (58%)
7 (3%)
87 (37%)
136 (58%)
12 (5%)
US$ 2-8
US$ 1-2
US$ <1

LESSON 22

MARKET-BASED APPROACH FOR POVERTY REDUCTION

HIDDEN PURCHASING POWER, DEAD CAPITAL

The income and spending patterns of the BOP, made explicit in this report's analysis, have for too long been hidden from business by lack of data on the informal economy and the perception of the purchasing power of the poor as insignificant. As Hernando De Soto (2003) has pointed out, this purchasing power could be substantially increased if the BOP could leverage the wealth trapped in the assets of the informal economy. A recent study showed, for example, that the "dead capital" represented by informal properties and businesses in 12 Latin American countries is worth as much as US$1.2 trillion (ILD 2006; IDB 2006). Unlocking these assets, by providing land titles and lowering barriers to formal registration of small businesses, could greatly expand BOP markets.

Analysis of BOP markets can help businesses and governments think more creatively about new products and services that meet BOP needs and about opportunities for market-based solutions to achieve them.

For businesses, it is an important first step toward identifying business opportunities, considering business models, developing products, and expanding investment in bop markets. For governments, it can help focus attention on reforms needed in the business environment to allow a larger role for the private sector.

BOP market analysis, and the market-based approach to poverty reduction on which it is based, are equally important for the development community. This approach can help frame the debate on poverty reduction more in terms of enabling opportunity and less in terms of aid. A successful market-based approach would bring significant new private sector resources into play, allowing development assistance to be more targeted to the segments and sectors for which no viable market solutions can presently be found.

There are distinct differences between a market-based approach to poverty reduction and more traditional approaches. Traditional approaches often focus on the very poor, proceeding from the assumption that they are unable to help themselves and thus need charity or public assistance. A market-based approach starts from the recognition that being poor does not eliminate commerce and market processes: virtually all poor households trade cash or labor to meet much of their basic needs. A market-based approach thus focuses on people as consumers and producers and on solutions that can make markets more efficient, competitive, and inclusive—so that the BOP can benefit from them.

Traditional approaches tend to address unmet needs for health care, clean water or other basic necessities by setting targets for meeting those needs through direct public investments, subsidies, or other handouts. The goals may be worthy, but the results have not been strikingly successful. A market-based approach recognizes that it is not just the very poor who have unmet needs—and asks about willingness to pay across market segments. It looks for solutions in the form of new products and new business models that can provide goods and services at affordable prices.

Those solutions may involve market development efforts with elements similar to traditional development tools—hybrid business strategies that incorporate consumer education; micro loans, consumer finance, or cross-subsidies among different income groups; franchise or retail agent strategies that create jobs and raise incomes; partnerships with the public sector or with nongovernmental organizations (NGOs). Yet the solutions are ultimately market oriented and demand driven— and many successful companies are adopting such strategies.

Perhaps most important, traditional approaches do not point toward sustainable solutions—while a market-oriented approach recognizes that only sustainable solutions can scale to meet the needs of 4 billion people.

Growing Interest, Growing Success in BOP Markets:
Business interest in BOP markets is rising. Multinational companies have been pioneers, especially in food and consumer products. Large national companies have proved to be among the most innovative in meeting the needs of BOP consumers and producers, especially in such sectors as housing, agriculture, consumer goods, and financial services. And small start-ups and social entrepreneurs focusing on BOP markets are rapidly growing in number. But perhaps the strongest and most dramatic BOP success story is mobile telephony.

Between 2000 and 2005 the number of mobile subscribers in developing countries grew more than fivefold—to nearly 1.4 billion. Growth was rapid in all regions, but fastest in sub-Saharan Africa—Nigeria's subscriber base grew from 370,000 to 16.8 million in just four years (World Bank 2006b). Household surveys confirm substantial and growing mobile phone use in the BOP population, which has clearly benefited from the access mobile phones provide to jobs, to medical care, to market prices, to family members working away from home and the remittances they can send, and, increasingly, to financial services (Vodafone 2005).

A strong value proposition for low-income consumers has translated into financial success for mobile companies. Celtel, an entrepreneurial company operating in some of the poorest and least stable countries in Africa, went from start-up to telecom giant in just seven years. Acquired for US$3.4 billion in 2005, the company now has operations in 15 African countries and licenses covering more than 30% of the continent.

Not all sectors have found their footing in BOP markets yet. Privatized urban water systems, for example, have encountered financial and political difficulties in developing countries, and the result has been neither better service for low-income communities nor success for the companies. The energy sector has similarly had only limited success in providing affordable off-grid electricity or clean cooking fuels to rural BOP communities. But even these sectors have seen encouraging new ventures, and further development of technology and business models may expand BOP markets.

Moving towards a more hospitable environment for business:
The operating and regulatory environments in developing countries can be challenging. Micro and small businesses especially face disadvantages. If they are informal, they cannot get investment finance, participate in value chains of larger companies, or sometimes even legally receive services from utilities. Condemned to remain small, they cannot generate wealth or many jobs. Nor do they contribute to the broader economy by paying taxes.

Most, face barriers to joining the formal economy in the form of antiquated regulations and prohibitive requirements—dozens of steps, delays of many months, capital requirements beyond attainment for most of the BOP. In El Salvador, for example, starting a legitimate business used to take 115 days and many separate procedures—until recent reforms reduced the effort to 26 days and allowed registration with four separate agencies in a single visit. But even for legitimate small businesses, investment capital is generally unavailable and supporting services scarce.

Fortunately, there is growing recognition of the importance of removing barriers to small and medium-size businesses and a growing toolbox for moving firms into the formal economy and creating more efficient markets. And as the World Bank and International Finance Corporation (IFC) show, in their annual Doing Business reports, there is also mounting evidence that the tools work. In El Salvador five times as many businesses register annually since its reforms. Many countries, including China, have dropped minimum capital requirements. The pace of reform is accelerating, with more than 40 countries making changes in the most recent year surveyed. Coupled with reform is growing attention to enterprise development initiatives focusing on BOP markets and investment capital for small and medium-size businesses. Several international and bilateral development agencies are launching investment funds to support the growth of small and medium-size enterprises across the developing world. These efforts, and the growing private sector interest in investing in such enterprises in developing countries, explicitly recognize that an expanded private sector role and a bottom-up market approach are essential development strategies.

What BOP markets look like?

Total household income of $5 trillion a year establishes the BOP as a potentially important global market. Within that market are large variations across regions, countries, and sectors in size and other characteristics.

Asia (including the Middle East) has by far the largest BOP market: 2.86 billion people with income of $3.47 trillion. This BOP market represents 83% of the region's population and 42% of the purchasing power—a significant share of Asia's rapidly growing consumer market.

Eastern Europe's $458 billion BOP market includes 254 million people, 64% of the region's population, with 36% of the income.

In Latin America the BOP market of $509 billion includes 360 million people, representing 70% of the region's population but only 28% of total household income, a smaller share than in other developing regions.

Africa has a slightly smaller BOP market, at $429 billion. But the BOP is by far the region's dominant consumer market, with 71% of purchasing power. It includes 486 million people—95% of the surveyed population.

Sector markets for the 4 billion BOP consumers range widely in size. Some are relatively small, such as water ($20 billion) and information and communication technology, or ICT ($51 billion as measured, but probably twice that now as a result of rapid growth). Some are medium scale, such as health ($158 billion), transportation ($179 billion), housing ($332 billion), and energy ($433 billion). And some are truly large, such as food ($2,895 billion).

Evidence of BOP penalties emerges in several sectors. Wealthier mid-market households are seven times as likely as BOP households to have access to piped water. Some 24% of BOP households lack access to electricity, while only 1% of mid-market households do. Rural BOP households have significantly lower ICT spending and are significantly less likely to own a phone than rural mid-market households or even urban BOP households—consistent with the broad lack of access to ICT services in rural areas.

BOP business strategies that work:

Why are some enterprises succeeding in meeting BOP needs, and others are not? Successful enterprises operating in these markets use four broad strategies that appear to be critical:

1. **Focusing on the BOP** with unique products, unique services, or unique technologies that are appropriate to BOP needs and that require completely re-imagining the business, often through significant investment of money and management talent. Examples are found in such sectors as water (point-of-use systems), food (healthier products), finance (micro-finance and low-cost remittance systems), housing, and energy.
2. **Localizing value creation** through franchising, through agent strategies that involve building local ecosystems of vendors or suppliers, or by treating the community as the customer, all of which usually involve substantial investment in capacity building and training. Examples can be seen in health care (franchise and agent-based direct marketing), ICT (local phone entrepreneurs and resellers), food (agent-based distribution systems), water (community-based treatment systems), and energy (mini-hydropower systems).
3. **Enabling access** to goods or services—financially (through single- use or other packaging strategies that lower purchase barriers, prepaid or other innovative business models that achieve the same result, or financing approaches) or physically (through novel distribution strategies or deployment of low-cost technologies). Examples occur in food, ICT, and consumer products (in packaging goods and services in small unit sizes, or "sachets") and in health care (such as cross-subsidies and community-based health insurance). And cutting across many sectors are financing strategies that range from micro loans to mortgages.
4. **Unconventional partnering** with governments, NGOs, or groups of multiple stakeholders to bring the necessary capabilities to the table. Examples are found in energy, transportation, health care, financial services, and food and consumer goods.
5. Enterprises may—and often do—use more than one of these strategies serially or in combination.

New Perspectives --- Challenging Deep-Seated Beliefs:

Much of the conventional wisdom about business operations in emerging economies stands in the way of further growth and opportunity among the BOP.

There could be five ways of reframing the problems that have challenged conventional solutions:

- Affording access rather than ownership
- Monetizing hidden assets
- Bridging the gap in public goods through private enterprise
- Scaling out versus scaling up
- Governing through influence rather than authority

Affording Access Rather than Ownership:

A person doesn't have to own a product in order to benefit from it – he or she just has to use it. Yet, companies tend to measure a product's market potential in terms of the number of people who can afford to buy it. Given the relatively low and volatile incomes of the BOP, this mindset severely restricts the perceived potential of these markets. If organizations think about "who can use the product" rather than "who can buy it," they will find a much larger and potentially profitable opportunity.

Reframing this problem requires new kinds of metrics to measure market potential and affordability. What if companies were to measure "access" to their products rather than ownership? Such access could be provided through a shared-usage model or through an entrepreneur who "leases" the product to customers. This way of thinking has opened up valuable markets for a number of companies.

In Bangladesh, for example, Grameen Telecom equipped village women with mobile handsets and, for a small fee, the women make the handsets available to others for both incoming and outgoing calls. Over time, many of these customers have bought their own mobile handsets – often choosing a Grameen phone; since it is the brand they have become familiar with and have grown to trust. As a result, the mobile phone sector in Bangladesh has been growing rapidly: from only 200,000 subscribers in 2001 to more than 42 million at the end of May, 2008. Nearly half of those 42 million subscribers use Grameen Phone. At the same time, numerous women have become entrepreneurs and improved their incomes, thereby reducing poverty and expanding opportunities. Other organizations around the world have adopted and extended the Grameen shared-access model for mobile phone usage, including offering additional services Kenya Agricultural Commodity Exchange (KACE) and Safaricom Ltd combined the shared-access model with a new application that offers a valuable information service to farmers and traders. The service provides information on the prices of specific commodities via SMS messages – by typing in "beans", or "maize", for example, to find the going price in the capital. As a result, farmers can access vital pricing information to target their sales to the best buyers, and improve their negotiating position with traders and middlemen. It costs only 15 shillings (20 cents) per use, and the costs can be shared among the farmers.

To challenge conventional wisdom about product ownership, consider the following questions:

- **"**How can a company change from a "selling" mode to one that "deploys" products for use without requiring ownership?
- How would this new approach affect its revenues?
- Does such an approach change how the company thinks about realizing further value from existing assets and customers?
- What new business models might this new approach require?"

Monetizing Hidden Assets:

There is a wealth of potential capital residing within BOP communities, but these assets are often hidden from formal markets. The term "assets" refers to a broad array of resources that can generate economic value. This includes undocumented capital, which is capital that individuals have used historically or traditionally, but for which they do not have formal ownership rights.

Undocumented capital could include property for which a family has tenancy rights but no legal title; or unincorporated businesses that aren't funded by a bank or other traditional investors. The second type of capital is personal and community resources that can be leveraged to enable business transactions produce or sell goods. It includes the collective power of a community, which is often informally used for contract enforcement. Even a good personal reputation – a prized asset that allows access to local credit – could be considered a source of capital. The third kind of capital is underutilized assets, such as civil society organizations and small and medium enterprises (SMEs). Many of these entities already have strong networks within the community and a deep knowledge of where their untapped sources of value are. It also includes people with entrepreneurial or other skills that have yet to be developed.

Leveraging the economic value of these hidden assets can potentially unlock significant market growth.
Indeed, the aggregate value of such capital is potentially enormous. Consider the money that Mexican immigrants earn in the United States and send back to families in Mexico through informal remittance channels, or the extraordinarily high interest rates charged by village money lenders in India for low-income people with no access to formal credit. Companies should look beyond the official models to learn how local communities bring capital into the system "unofficially", and seek to leverage that capital to catalyze further value creation.

In fact, mobilizing the community is a good entry point for identifying hidden assets, since the BOP maintain strong community ties. For that reason, companies have integrated local community entrepreneurs into their value chains, in addition to serving them as customers. Not only does this broaden the customer base for these companies, it can also generate higher profits, since the local entrepreneurs are willing to pay more for resources they had no access to previously. Lastly, it removes market inefficiencies and thus creates an economic multiplier. For example, Mibanco (Banco de la Microempresa S.A.) in Peru has loaned more than US$ 1.6 billion in amounts ranging from US$ 100 to US$ 1,500 to low-income households and their micro and small enterprises. Mibanco's innovation was to design special banking products to be used for the purposes of housing, agriculture, working capital, and other necessities. To ensure that the loans would be paid back, they instituted personal incentives, such as awards and public recognition.

As a result, they were able to offer credit to people who never had access to the formal banking system in Peru. Human resources, which include the large pools of people who might become producers or entrepreneurs with adequate training, are another form of hidden assets. Yet, conventional methods of developing their skills and collecting the goods they produce in distant villages are expensive. Another deterrent is the reluctance of many businesses to invest in training when the benefits might be shared by competitors. For example, companies often need raw materials from farmers in a particular region, but they avoid sourcing from them because the products are often poor in quality. Although the company and the farmers would both benefit if the company would help to improve the quality of produce, the company is reluctant to make such investments because it has no way of ensuring that the farmers won't begin selling to other companies as well.

Uncovering hidden community resources will require companies to collaborate with other organizations and possibly even competitors to share community skills, knowledge and training. But the benefits of gaining a more skilled, productive and accessible workforce often justify the effort and cost.

The potential for companies to unlock hidden assets by collaborating with local communities and integrating new models with their current ways of doing business is substantial. To challenge conventional wisdom about capital assets, consider the following questions:

1. What hidden assets does the target community have, and how does the community leverage their value?
2. How could the hidden capital that exists in informal arrangements be brought into formal systems?

Bridging the Gap in Public Goods through Private Enterprise:
Developing nations face major infrastructure gaps. Organizations that set out to engage low-income groups as customers or producers are often constrained by the lack of basic infrastructure they take for granted when serving current mass markets. This greatly increases the costs of engaging with the poor, designing products for them, and collaborating with them for the purposes of production and sourcing. The missing infrastructure can include "hard" infrastructure, such as roads, warehousing, logistics facilities and public utilities for water and electricity.

It can also include "soft" infrastructure, such as producer organizations, educational and training programs, and basic information on consumers, including individual identification and credit histories that allow companies to target them for specific products and services.

Hard and soft infrastructures enable market activity and value creation, and they are largely considered the responsibility of the public sector (such as governments or development agencies). Organizations that seek to do business with the BOP overcome infrastructure constraints in two ways: they can form active partnerships with the public sector to improve the circumstance of the BOP, or they can find innovative ways – often in collaboration with others – to bridge the gap in public goods.

Consider the example of Pésinet Health Care, which funded an innovative initiative to reduce infant mortality in Mali. Instead of setting up clinics in rural locations, the company trained qualified local representatives to perform basic check-ups and communicate the information electronically to doctors in the cities. Patients visited doctors only when they needed hands-on attention. That made the service more affordable for patients and helped to reduce the country's infant mortality rate. For the program to become self-financing, the company needed to achieve economies of scale that required treating 1,200 to 1,500 children. The costs of the project were recovered by revenues generated by subscription charges, which were US$ 1.05 a month per child and included visits to the doctor and basic medicines. In a similar project rolled out in Saint-Louis, Senegal, the infant mortality rate fell from 120 per thousand to only 8 per thousand. The new model has made basic healthcare more accessible to low-income people and, because it generates sufficient revenues in subscriptions, its operations are sustainable.

Another obstacle, companies face is a lack of information about the choices and constraints in the daily lives of the BOP. Indeed, some companies even find it difficult to identify which groups of consumers belong to this segment. Government data is often inaccurate or nonexistent, and many workers lack official salary records. This can be a particular challenge for banks. By insisting on official records, banks lose not only potential customers, but also the opportunity to catalyze growth and reduce poverty by providing essential financial services.

Organizations could work towards improving financial information systems through tools such as credit bureaus and smart cards. Better, more accurate ways of identifying low-income consumers and determining their qualifications and needs could be achieved through a consortium of companies that stand to benefit from this effort, rather than a stand-alone organization. For example, A Little World, a technology company based in Mumbai, India, launched a project in which a consortium of six banks provide biometrics-based identification cards and RFID smart cards and near-field-communication mobile phones to people without bank accounts. Not only has the consortium made it possible to offer banking services without the expense of building branches, it has also built some invaluable soft infrastructure in the form of credit information that can be used by many other industries over time to accurately identify and track their customers. That allows companies to expand their boundaries and partner with companies in other industries to share investments and returns.

Private intervention can support the creation of public goods – not just for philanthropic reasons, but also to ensure long-term profitability in low-income markets. Interventions in the public domain by many companies around the world have demonstrated that they can add value for customers as well as producers. To challenge conventional wisdom about investing in public goods, consider the following questions:

1) Will investing in a public good that also benefits competitors actually improve near-term profits?
2) Who will decide how much each partner will gain from opportunities and how much each could invest?
3) How can the organization create an open partnership model to facilitate entry and exit of partners over time?

Scaling Out versus Scaling Up:

To serve customers efficiently, companies often work to reduce the unit costs of products and achieve economies of scale through centralized production in large factories. But this model has two problems when it comes to the low-income market. First, it increases the costs of serving and sourcing (warehousing and distribution) since producers and customers live far from central factories. Second, centralized factories often produce standardized products for global or regional markets, which is often not what low-income consumers need or want. The BOP's requirements for locally-targeted products often cannot be met with standard low cost production models. Companies therefore need to rethink strategies or scaling in this market.

What's more, companies often attach hierarchical structure to large-scale operations. As they seek to "scale up" an innovation, they standardize structures in the forms of decision rules, measurement systems, and organizational models. While these can boost efficiency in large-scale standardized markets, they can also limit innovation – a key quality for success in diversified BOP markets. Companies should instead seek to replicate innovation, constantly adapting it along the way, in order to expand their market and offer a new pathway to growth.

One of the problems with large-scale sourcing and production schemes is that they are designed for high-density areas. The traditional concept of economies of scale often fails when it comes to serving the low-income markets. Although demand and supply in this market is potentially very large in the aggregate, these consumers buy and sell locally because they live primarily in small, scattered groups. The alternative to scaling up is to scale out: create experiments that can be adapted and rolled out to increasing numbers of markets. That involves the low-income people as producers and distributors, as well as consumers, and it minimizes overhead.

Yet, scaling up and scaling out are not mutually exclusive. Instead, organizations need to balance scaling up (through centralization) with scaling out (through localization) to achieve the right combination of low costs and customized solutions. To accomplish this, organizations could deconstruct their value chains and for each step consider the trade-off between centralization and localization. The resulting model could reduce costs and enhance customer appeal, reach, and credibility.

Aravind Eye Care in India exemplifies such a model in using metrics in initial examinations to triage patient needs. Its staff of local entrepreneurs examines patients at low-cost community centres, which are located in remote towns and villages. Basic examination, screening and preliminary diagnostic procedures can be carried out by these entrepreneurs with minimum training. Cases requiring consultation with an expert are dealt with by e-mailing patient-exam reports to doctors in cities. These doctors are highly trained and form a costly resource in the treatment chain. Only patients that need hands-on treatment are referred on to select hospitals. Each small community centre is self-sustaining, because it uses local resources and inexpensive basic instruments. The organization has grown by leaps and bounds and that has given many more people access to good eye-care services. It has also made Aravind a huge success.

A recent study conducted by a hospital showed that after treatment, 85% of the men and 58% of the women who had lost their jobs due to sight impairment were reintegrated into the workforce. Rethinking business models can create considerable benefits not only for companies, but also for individuals. By starting with a few trials, then replicating the innovation and adapting it along the way, companies can eventually reach markets sufficiently large to ensure profits. In traditional large-scale production models, everything from procurement to production, processing, packaging and marketing is standardized. That works efficiently when companies can use established channels for supply and sourcing, and they are targeting middle- and high-income consumers.

However, production costs increase when demand is broadly dispersed and volumes vary, as is the case at the BOP. In these settings, localized production centres can be a more effective approach. The French company Nutriset S.A., which manufactures Plumpy'Nut, a fortified food for extremely malnourished children, has adopted such a strategy. The company sought to lower manufacturing and delivery costs, allow flexible production schedules, and maintain high quality standards by introducing a tailored licensing system. It outsources production to local franchisees, some of which operate as mini manufacturing units, in Malawi, Niger, Ethiopia and the Democratic Republic of Congo, and plans expansion to other regions. Nutriset works intensively with franchisees on quality control and monitoring. This makes it possible for local production to significantly reduce delivery costs, while creating jobs and capacity.

Although the pursuit of economies of scale has been a central tenet of conventional business models for a long time, the means to achieve it are different for BOP markets, where scale is often better understood and evaluated at the micro, rather than the macro, level. To challenge the conventional wisdom of economies of scale, consider the following questions:

1. Where should the company scale up and where should it scale out?

2. Can the company balance both kinds of scale simultaneously?
3. How will the company adopt a decentralized system, encourage innovation, and still ensure product quality and effective management?

Governing through Influence Rather than Authority:

As companies grow, the natural inclination is to exert more control on decision-making and tighten monitoring and audit systems. Yet, at the BOP, information gathering and control has to happen through collaboration and with local partners. Given the wide dispersion of villages and communities in emerging markets, it is crucial to retain a high degree of flexibility and decentralization, in order to adapt to local changes and control costs. To reduce the overall costs of monitoring when enlisting the BOP as consumers and co-producers, companies must first align their goals with the community's interests and then introduce local checkpoints. Organizations that have managed to link their interests to those of their local partners have found that they can deliver more value at significantly lower cost. This is also true for partnerships with different organizations.

When considering doing business with BOP communities, companies are often concerned about the substantial monitoring costs that might be required to ensure compliance with quality standards. A better approach is to reduce the need for monitoring by aligning the interests of the employees with those of the company so that employees are motivated to deliver better results. This can be achieved by developing shared aspirations and values, leveraging incentives such as profits so that employees benefit when the organization benefits. In order for this to work, however, companies will need to rethink their business models and current shareholders will need to relinquish some rights in exchange for broadening the range of benefits.

One organization that has succeeded with such a partnership approach is Child and Family Wellness Shops in Kenya. They have adopted a franchise model to deliver healthcare, and offered the nurses who run their local clinics shares in the company. That motivates the nurse-owners to provide high quality healthcare and reach out to the community with information and education. Not only has providing nurses with better remuneration improved health in the community, it has also helped to retain local talent, which addresses the problem of "brain drain" – the out migration of skilled professionals – that affects many developing countries.

Even after aligning with the interests of local partners, companies will still need to ensure that standards, payments and other requirements are met. Some companies appoint an "aggregator", who serves as a point of contact for accountability and fee collection from the community. For instance, rather than trying to collect money from individual customers in a village for using its services, a company could consolidate payments using a commission-based local entrepreneur who collects payments from individuals, thereby reducing the collection costs for the company and ensuring timely payments.
Some companies partner with communities for the purposes of governance. That's what the Manila Water Company Inc. did when it established a community-based collection program for water consumption. To assess and collect fees, it installed a "mother" meter for the whole community, which was responsible for jointly paying the bill. The community now employs local checkers to ensure individual payment, which saves the company from having to employ additional resources. As a result, the program has become a source of local employment, generating more than 10,000 jobs since it started operations in 1997.

Besides working with local players, businesses can partner with other organizations to create and share assets. But these organizations should be viewed more as a network of peers, rather than vendors. One of the main challenges with such arrangements is the establishment of clear governance standards. Often partnerships have broken down because the partners didn't share common goals. Even when aspirations and values are shared, the partnership must still create an open architecture for organizations to enter and exit on the basis of their capacity to operate in the market. For example, if there is an arrangement among financial sector companies to create a common customer-credit database, each of the players ought to be able to contribute and benefit. There should be clear guidelines for how various organizations will participate and how their contribution will be valued, if they choose to exit.

There is authoritative power in the social forces that bind communities together, and the key to success among the BOP is to tap into it. Companies that have aligned the interests of communities, and then allowed individuals and other partner organizations to manage them, have unlocked great potential, while reducing the overhead costs of monitoring.

The key to making partnerships work lies in aligning the interests of all stakeholders towards a common goal. That calls for viewing community members as partners, not just salaried employees. To ensure quality control, companies can engage managers at the community level and design incentives for the communities to manage themselves. To challenge conventional wisdom about governance, consider the following questions:

- What partners – with whom the company might share responsibilities and profits – can help it achieve its goals? Will the organization be willing to relinquish its power in order to lower monitoring costs?
- How can the company align incentives to reinforce accountability and trust with the community?
- How can the company establish clear governance standards and an open architecture where partners can enter and exit freely?
- How will the company value their contributions despite its focus on long-term profits?

LESSON 23

FINANCIAL SERVICES MARKET WITHIN BOP

Microcredit pioneer Muhammad Yunus received the Nobel Peace Prize in 2006, a milestone in public attention to the financial needs of the BOP. Until recently the main focus has been microcredit, historically the domain of nonprofits. Now the focus is changing—as new players and new products enters the market and new technologies transform services. A dynamic financial services sector is emerging—moving toward financial access for all.

Many microfinance institutions now offer savings as well as microcredit. Commercial banks are becoming active in the BOP market and bringing a still broader range of services, including insurance. Mobile phone banking, still at an early stage, promises to dramatically broaden access and lower transaction costs. Remittances to BOP households from family members overseas have emerged as a significant cross-border financial flow, bringing new attention and new ways to promote economic growth.

As these changes expand access to financial services for the BOP, the effects can be measured in many ways, not just in the volume or dollar value of transactions:

- **New jobs and income**. New types of financial services, provided through mobile phone systems, are generating new jobs and income for millions of small entrepreneurs who sell over-the-air credit.
- **Formal identity.** Establishing a banking relationship gives people a formal identity they often lacked before, contributing to the process of political and social inclusion critical to development.
- **Greater personal safety**. Cash is a burden for the poor, making them vulnerable to crime. By doing away with the need to carry a lot of cash, such services as debit cards and mobile phone–based access to cash and bill-paying facilities enhance personal safety and the quality of life.
- **More education for children**. In Bangladeshi families that are clients of Grameen Bank, nearly all girls are in school, compared with only 60% in nonclient families.
- **More timely health care**. In Uganda the Foundation for Credit and Community Assistance (FOCCAS) links its microloans to participation in child health education programs and has doubled the share of its clients using practices to prevent the transmission of HIV. In Bolivia microcredit clients of Crédito con Educación Rural (Crecer) had higher rates of child immunization in their families than did nonclients.
- **Economic empowerment of women**. In Indonesia women who are clients of Bank Rakyat Indonesia (BRI) are more likely than other women to participate in family financial decisions. In India borrowers from SEWA Bank have organized unions to lobby for higher wages and more rights as members of the associated Self- Employed Women's Association.

Through these effects and many more, financial services play a critical part in reducing poverty and improving the access of the BOP to goods and services.

How large is the market?

National household surveys capture extensive data on financial matters, but little on actual spending for financial services. Moreover, the costs of these services are often not fully transparent to BOP customers, who may not know or understand the actual costs of transferring remittances from sender to recipient, for example, or the true interest rate paid to an informal village lender.

As a result, robust data on spending for financial services are not available in sufficient detail for meaningful analysis.

What is known, however, clearly indicates that the financial services sector is changing—and doing so in ways that are moving it toward broad access for the BOP.

Three factors are powering this transformation:

- The microfinance sector is growing up, attracting new participants and creating new services.
- Rapid changes in technology are reducing the transaction costs in financial services, expanding markets, and interesting large financial institutions in markets previously ignored.

- Remittances are approaching an estimated US$350 billion a year, and recipients, businesses, and national governments are learning how to leverage these "BOP to BOP" financial flows.

The following analysis briefly explores the financial services sector through these three lenses.

The changing banking landscape

Several strategies are at work to bring financial services further into the BOP. One is to expand the microfinance institutions. A growing number of traditional microcredit banks—such as the Cooperative Bank of Kenya, Financiera Compartamos in Mexico, and BRI in Indonesia have become profitable on a fully commercial basis, with sustainable microlending now just a part of their core business. And one relative newcomer, SKS Microfinance in India, has relied on operational efficiency to power rapid growth in lending.

By the industry's own estimate, however, microcredit had reached only 82 million households by the end of 2006. Even the industry's new target for 2015, 175 million households, would represent only 31.5% of today's 556 million BOP households.

Clearly, other strategies are needed to reach scale. Some are already in play. Major financial institutions are discovering that they can go "down-market" profitably, leveraging their capital, their expertise, and their back-office systems. In one of many examples, Citi in late 2006 announced plans to expand into low-income neighborhoods of India with automated teller machines (ATMs) using thumbprints to identify customers. Banks also are beginning to view those receiving remittances as potential customers for a range of financial services.

Nontraditional players are entering the BOP market. Retail giant Wal-Mart has received regulatory approval in Mexico to create its own bank, Banco Wal-Mart, co-located with its stores. If the venture is successful, other Wal-Mart banks will follow elsewhere.

Some microfinance institutions and big commercial banks are meeting in the middle. Grameen Foundation USA and India's largest private sector bank, ICICI Bank, have formed Grameen Capital India to assist microfinance institutions in raising funds. The joint venture will help microfinance institutions access primary and secondary debt markets and sell portfolios of microloans to other banks—and will also supply guarantees and credit enhancements for these portfolios where appropriate.

ICICI has many similar ventures in the pipeline aimed at reaching the BOP. One is a partnership with microfinance institutions and technology provider n-Logue to harness thousands of entrepreneur-run Internet kiosks as the first touch point for savings accounts, mutual fund purchases, insurance, and even equity loans—and to provide branches, franchise operators, and ATMs throughout rural India. Partnerships like these are spreading across the financial sector as a way to broaden access to services for the BOP.

Steady growth of savings accounts in the BOP provides compelling evidence of its appetite for more than microcredit. Savings accounts for low-income customers in developing and transition economies are estimated to number more than a billion. Indeed, for BRI and Financiera Compartamos, savings accounts represent a much larger part of their BOP portfolio than do microloans. Savings vehicles are often hampered by outdated laws and regulations. But where permitted, they can play a powerful new role in deepening the financial sector for the BOP.

Finance for small and medium-size enterprises is growing. While this development does not bring financial services to the BOP, it does expand opportunity by creating jobs and services. The financing comes in the form of loans and equity investment beyond the limits of microfinance but too small for the traditional lending windows of large banks. The Asian Development Bank is developing a series of investment funds for small and medium-size enterprises in Asia, and the Japan Bank for International Cooperation has increased by several million dollars its pledge for private sector investment in Africa, including money for small and medium enterprises. Shell Foundation has helped launch several investment funds in Africa that focus on small enterprises, bringing in local financial institutions as co-investors. The most effective new models combine the provision of capital with mentoring, business education, and skills training.

Commercial banks are seeking new ways to participate in small and medium-size enterprise finance, driven by such structural factors as low rates of return on government debt in much of the developed world and stiff competition among banks at the high end of the market. The global banks usually partner with local banks, able to provide the risk assessment and community relationships critical to success. Meanwhile, the availability of capital and the support of big money-center banks are driving local banks to better serve local small and medium-size enterprises, a market many have long ignored.

Technology as a driver

Technology does two key things that help drive the development of financial services: it cuts costs, and it bridges physical distance. For BOP customers, technology in financial services can address four important concerns: convenience, accessibility, safety, and transferability. A mobile phone–based transaction system offers far more convenience and accessibility than a traditional financial institution, whose use may require that clients find a bank branch or attend a weekly microfinance group meeting. Electronic forms of money, less prone to theft, are safer than cash. They also are more easily transferred, especially overseas.

Technology is bringing nontraditional players into the financial services market. Most notably, mobile phone operators are introducing new products and services over their networks that look and feel like traditional financial services. Start-ups are finding ways to combine mobile networks and traditional banks.

The resulting hybrids—banks partnered with mobile phone operators, or companies that market both financial and mobile phone services— pose issues for banking and telecommunications regulators. But the benefits seem so great as to demand solutions, and ***Pakistan***, for example, has instructed the two sets of regulators to work out effective solutions.

The emerging technology-driven financial services include bank-centric models, electronic currency, and mobile commerce systems. The services are being provided through a range of technologies: ATMs, mobile phones, handheld computers, and credit, debit, and smart cards.

In Kenya, Vodafone is partnering with local mobile operator Safaricom and local microfinance institutions to roll out a financial transaction system called M-Pesa. The system is based on a new mobile phone card, developed for the purpose that enables microfinance clients to make deposits, check balances, and fully manage their accounts. Neighborhood banking agents can turn electronic transactions into cash and take deposits and payments on behalf of clients, earning commissions along the way. Vodafone has plans to rapidly add more countries.

Prodem FFP in Bolivia is a sector-leading example in the advanced use of ATMs to provide savings accounts to low-income, illiterate customers in rural areas. Technology, it understood, would be the key to providing affordable service. Unable to find the low-cost, high-quality technology it sought, Prodem partnered with a local firm to create it. The result: an ATM that uses visual and audio prompts in four languages, including three indigenous ones, and a smart card that captures and stores account information and biometric identification. ATMs aimed at the BOP are now being taken up by big banks, such as Citi in its ATM venture in India.

Visa International has partnered with FINCA International, a microfinance institution in Latin America, in a retail banking program for FINCA's BOP microfinance clients. The program automatically deposits loans into a savings account opened by the client at a retail bank and issues the client a Visa debit card and a personal identification number (PIN) to access the funds. Visa and FINCA have found that the program makes clients more inclined to save now that their money is in a secure place. The program also increases security by eliminating the need for a loan check, which could be lost or stolen. And it gives clients a feeling of prestige associated with carrying a Visa card.

Remittances as a new tool for promoting growth

At the same time that banks are discovering that the BOP want and need full access to financial services, financial sector analysts are discovering that the funds flowing in and out of the BOP are much greater than previously thought. The Multilateral Investment Fund of the Inter-American Development Bank took the lead in tracking remittances to Latin America and the Caribbean, and now others are adding to the data.

The new understanding of the size of remittances brought policy and commercial attention. Reforms were launched to bring more of the flows into official channels, and new competition emerged among transfer services (Orozco 2006). With competition have come better service and lower cost. The results have been especially noticeable in Latin America, where the reported flows from the United States have risen every year, reaching US$53.6 billion in 2005.12 Worldwide the total is now thought to approach US$350 billion, with significant flows to every developing region. Indeed, reported remittances doubled between 1999 and 2004.

This stable flow of funds provides a large share of income for many in the BOP as well as a direct "BOP to BOP" financing mechanism that helps pay for new houses, new businesses, and children's educations. But governments and development agencies are only beginning to understand the national and local effects of remittance flows—and to find ways to increase the benefits from them.

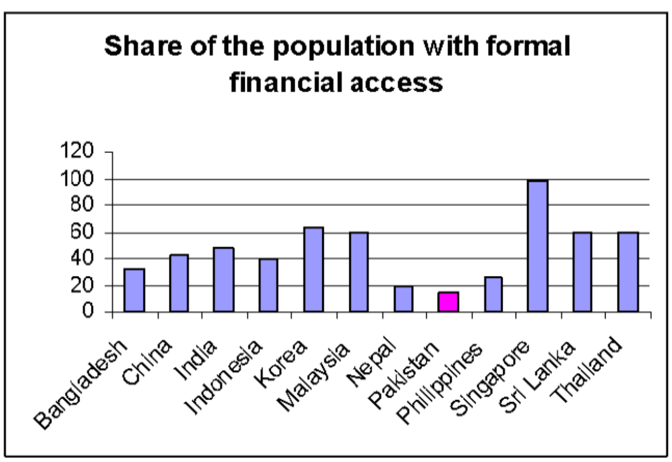
One benefit: at the national level remittances significantly improve country risk ratings, as recent research by World Bank economist Dilip Ratha (2005) shows. Higher ratings encourage more private sector investment, which can help create jobs and fuel growth. Another benefit: several banks in developing countries have been able to "securitize" remittance flows—that is, use these dependable flows to back a financial instrument sold in international capital markets—and thereby lower their cost of borrowing. Both these benefits mean greater national financial capacity for domestic investment, increasing the growth effect of remittances beyond their impact at the household level.

Recognizing the potential in transferring remittances, businesses are launching new services. At the 3GSM World Congress in Barcelona in February 2007, a consortium of 19 mobile operators, serving more than 600 million customers in 100 countries, announced a system that will transfer remittances entirely through their mobile phone systems, radically reducing cost. The consortium predicts global remittances of more than $1 trillion a year by 2012.

These developments notwithstanding, there is still a serious shortage of infrastructure on the ground to provide financial services to the BOP. Carefully mapping where remittances are sent in Mexico and where formal banking institutions exist, the Inter-American Development Bank has identified many locations with substantial remittances but no banking services.

This lack of presence represents a lost opportunity for traditional financial institutions and a barrier to full financial citizenship for the BOP. It also creates a significant opening to this unserved market for non-traditional players and branchless banking enterprises.

The Pakistan Context ......



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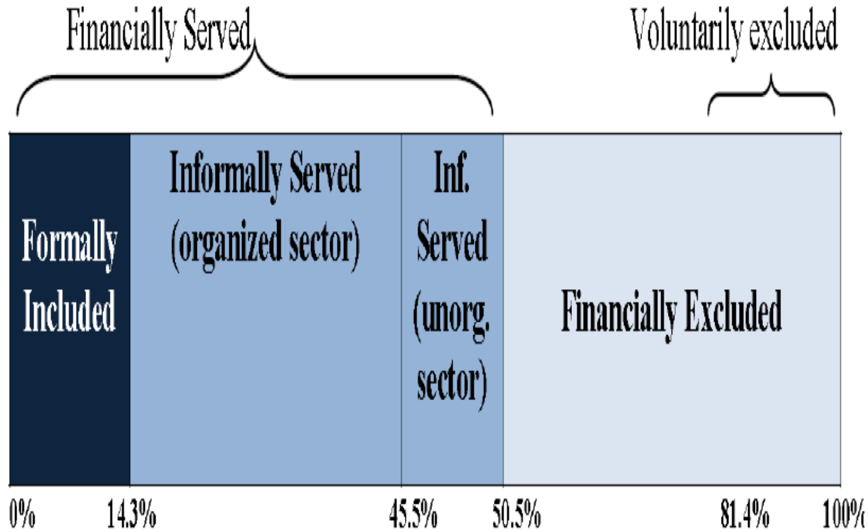

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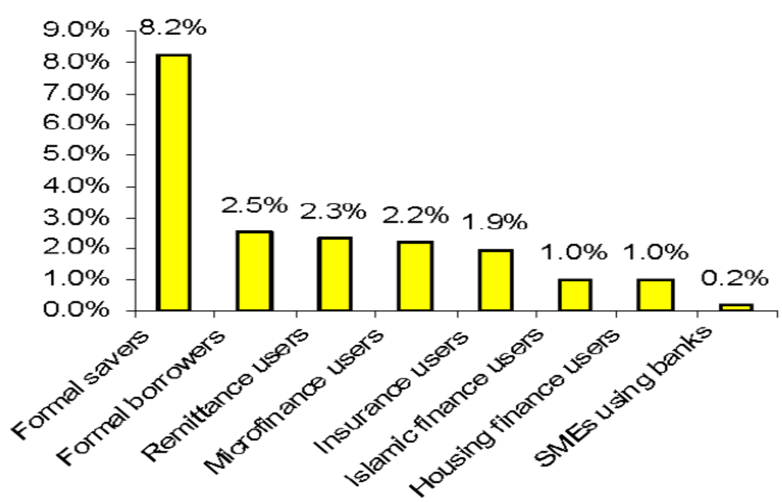
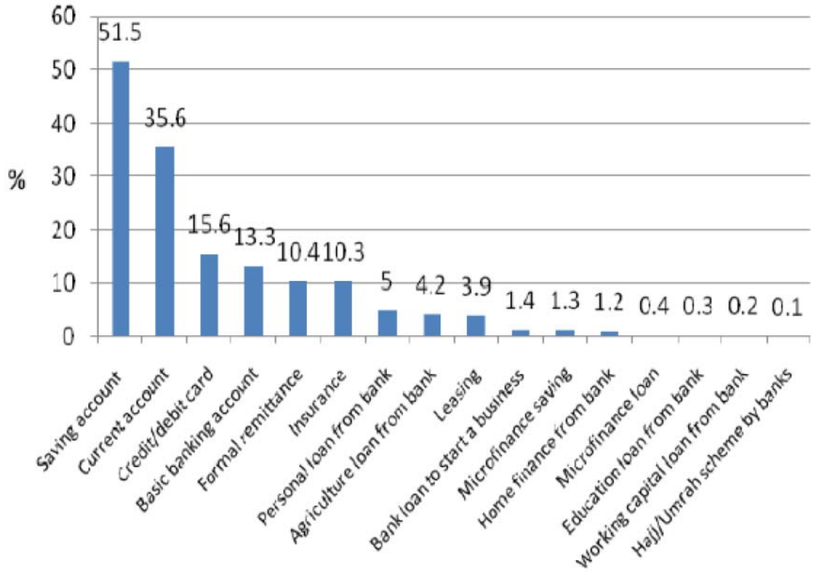


Product Penetration (as % of banked)



Source/Reference:

IFC/World Resources Institute Publication, 2007

Titled, "The Next 4 Billion, Market Size & Business Strategy at the Base of the Pyramid (BOP)"

LESSON 24

REFLECTION TIME!

Following is an extract from an article by Prof. Dilworth

Robert L. (Lex) Dilworth is an Associate Professor Emeritus of Virginia Commonwealth University in Richmond, Virginia, USA. He has a doctorate from Columbia University in Adult and Continuing Education. His specialties are human resource development (HRD), action learning, and organization development (OD).

The Nature of Reflection!

If you ask someone to define reflection, you are liable to receive widely varied responses. In the simplest form, mention may be made of stopping to think, a momentary pause in the activities tied to living (e.g., stopping briefly to reflect on what is needed on entering a grocery store). When it comes to reflecting on your life and critical decisions that need to be made, it becomes much more difficult.

For some, stopping to reflect on their existence can seem too painful. It can bring to mind memories of failure or life tragedies. I had a student about four years ago who told me that she simply could not do any deep reflection. She said, "I am afraid of what I may see". Part of her memory was in effect off limits. Protection of her self-image and self-esteem required that she stay clear of certain sensitive subjects.

While there can be obvious psychological blockages to reflection, the more common reasons for finding it difficult to reflect are much more basic. First, opportunities to reflect are driven out by the frenzy of life activity and day in and day out crises. Therefore, the ability to reflect lies undeveloped, and when one attempts it, reflection can seem extremely awkward--like a right-handed person trying to sign their name using their left hand. Business executives can be especially resistant to reflection because it can seem a needless detour from current business activity.

It takes time and practice to unlock the ability to reflect. The art of critical reflection takes even longer, and some never get there. However, once the impasse is breached and reflection starts to occur naturally and routinely, the individual can feel empowered and in control of their own life. That can be a liberating experience. When the reflection pushes to the deeper levels of self, it becomes possible to jettison dysfunctional assumptions and behaviors. Deep learning can then occur. It can become transformative learning. The individual is elevated to a new plateau of self-awareness. At this point, it becomes what can be called emancipatory learning--throwing off the self-imposed, and frequently externally imposed, chains that have been constraining clear thinking and advance.

Reflection in the end is a dialogue with self. It can lead to a form of self-catharsis, where we find ourselves listening to our inner feelings. I remember a person in one of my action learning sets in 1996 in England who reached a point where she could hardly wait to get back to her room at night to reflect on events of the day and their meaning. She indicated that she found herself good company and had meaningful conversations with herself as part of the act of reflecting.

Jack Mezirow, who has written on transformative learning and reflection, says this:

> Reflective learning involves assessment or reassessment of assumptions. Reflective learning becomes transformative whenever assumptions or premises are found to be distorting, inauthentic, or otherwise invalid.

In discussing "reflection and making meaning", Mezirow indicates:

> Much of what we learn involves new interpretations that enable us to elaborate, further differentiate, and reinforce our long established frames of reference to create new meaning schemes. Perhaps even more central to adult learning than elaborating established meaning schemes is the process of reflecting back on prior learning to determine whether what we have learned is justified under current circumstances .What this all leads back to and places in focus is the Learning Equation of Revans.

Here it is the reflective process (the questioning insight, or Q) that confirms or disaffirms what is currently in the inventory (the programmed instruction, or "P") from the standpoint of true relevance to what is being dealt with first hand. What Mezirow is saying in so many words is that reflection enables you to judge the relevancy and appropriateness of prior learning to the situation that now confronts you.

Are you a knower or a learner?

Knower

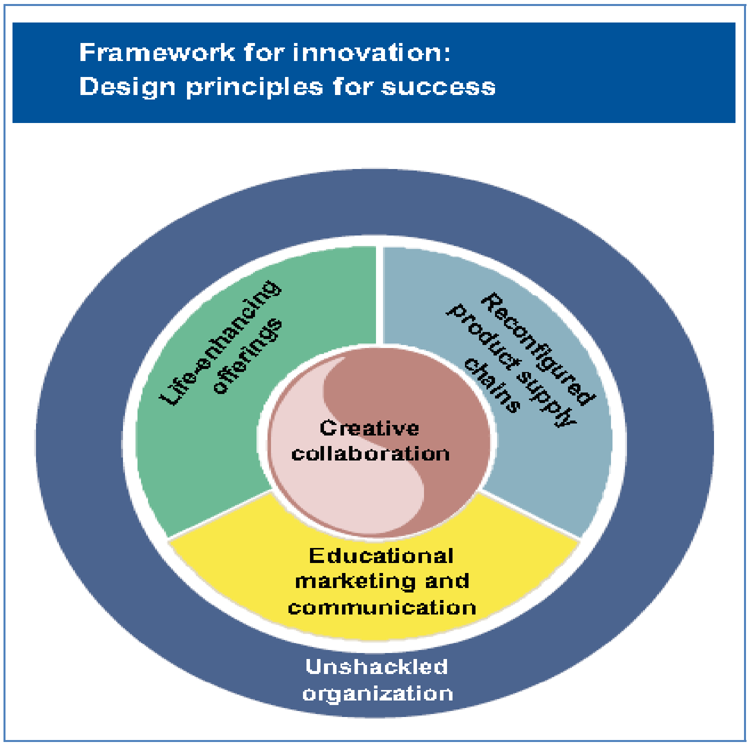
- Someone who obtains his self-esteem from appearing to be right. He is not willing to admit, "I don't know" and is not willing to be influenced.
- Knowers believe they know all that they need to know in order to address the situations that they are responsible for.
- Knowing is so central to knowers' identities that it causes them to sometimes pretend that they know, even when they don't.
- Knowers can easily become defensive. They hide their lack of knowledge.

Learners

- Learners are players in the game of life and understand they are there to have an impact on the game's outcome.
- The main focus of learners is on increasing their abilities to respond to the challenges around them and inside of them.
- They are willing to be influenced. They consider what other have to offer.
- They admit their ignorance and then offer their knowledge. They seek communication through dialogue, i.e. balancing advocacy with enquiry.

BOP Market New Approaches & Design Principles for Success (World Economic Forum Report)

This Framework is based on an analysis of more than 200 Case Studies.



The BOP often find themselves having to make difficult compromises: their incomes are limited, yet they desire products and services that are suited to their needs; they require information, yet they have difficulty accessing it; they live in scattered towns and rural villages, yet they must deliver their wares to distant markets. Companies first need to invest in developing a comprehensive understanding of the BOP and the constraints they face. The next step is to create new business models that break these compromises and give low-income people a sustainable foothold in a market that allows them to thrive.

This chapter addresses what it will take to convert the BOP into the next billions. It presents a set of design principles for developing new business models that are based on an analysis of more than 200 case studies and numerous discussions with companies planning on or currently engaging with the next billions as consumers, producers or entrepreneurs. The design principles are structured along four parts of a typical business model: product innovation, supply chains, marketing and partnerships. They apply specifically to the circumstances of the next billions and together present a framework for innovation. The five principles, seen in Exhibit, are:

1. Create life-enhancing offerings
2. Reconfigure the product supply chain
3. Educate through marketing and communication
4. Collaborate to form non-traditional partnerships
5. Unshackle the organization.

The chapter concludes with a discussion of how companies can help new business models succeed by unshackling the organization. It should be noted, however, that these principles are given as suggestions rather than prescriptive solutions. There is no silver bullet in this market. Organizations will need to be prepared to consider many kinds of innovations on several fronts.

Create Life-enhancing Offerings

Life-enhancing means offering products and services that improve livelihoods and trigger the economic multipliers that allow the next billions to overcome their constraints. Rather than offer the same products they sell in the mass markets of developed economies, companies need to adapt their products and prices to the specific needs of the next billions.

A farmer in a rural area, for example, may want a rugged mobile handset with a data feed that provides wholesale prices at nearby markets, whereas a day laborer in a city may care more about how the handset looks and feels and its ability to take pictures. Therefore, mobile operators and handset manufacturers need to design products and services that deliver both aspirational and pragmatic value. Research suggests the following practical guidelines:

Price for the budgets of the next billions

Because the next billions have low incomes and little savings, large up-front purchases are often out of their reach. For many products, pricing will involve some consideration of credit terms. Producers and retailers of large-ticket items, such as durable goods, for example, could offer financing tailored to the next billions' budgets in order to increase sales. Service providers, such as mobile operators, could "fit the pocket" of consumers by lowering recharge amounts, offering flexible terms, and encouraging free or low-cost trial use.

One of the best ways to make products available is to offer less expensive and smaller packages. For example, a BOP customer may need a small loan for a one-time purchase of inputs for a business operation or for an emergency. Yet, many institutionalized credit offerings are expensive and available only for large amounts. With a minimal investment in restructuring, a financial institution might offer small-size loans with flexible repayment terms. Since families tend to pool their funds for expensive purchases, certain products should appeal to all family members. One possibility would be prepaid family plans for mobile handsets because family members tend to share them.

Tailor products to address local constraints and emphasize quality

Developing low-cost products shouldn't mean sacrificing quality. In fact, because the BOP can't afford products that break down, they will often pay a premium for quality they can trust – even if they have to use credit or trade down to less expensive products in other categories. Some companies have demonstrated successful examples of assuring quality for locally tailored products and in turn earning the loyalty of the consumers. Take the example of International Development Enterprises India (IDE India) which is a social enterprise that engages actively with small scale farmers by supplying manually operated treadle pumps. As uninterrupted power supply is rarely available to these small landholders, they could not use electrical pumps. IDE India designed pumps which required no power supply and enabled farmers to trade up from manual methods of drawing and transporting water to the treadle pumps. In order to keep retail prices low, product manufacturing is outsourced to local manufacturers, who follow a stringent quality assurance program and participate in IDE India's warranty scheme. The enterprise has also facilitated partnerships in service hubs that provide processing facilities and allow for intermediary sales of produce. This provided broad based support to farmers and convinced them to pay money for the product as it's easy to use and of high quality. IDE India has successfully helped farmers to increase their productivity and in many cases they have doubled their income, often within two years of purchase.

Develop environmentally sustainable approaches

Raising the income and consumption level of the BOP will place immense pressure on already-stretched resources such as land, water, energy and ecosystems. Therefore companies should explore economically sustainable solutions that have a minimal impact on the environment.

Products and services offered to low-income populations should aim for innovative and eco-friendly methods of production and consumption. Goods marketed to the next billions should utilize packaging that minimizes environmentally harmful wastes. Farming techniques and inputs should be developed to address environmental concerns while also enhancing farmers' incomes.

Reconfigure the Product Supply Chain

Of the BOP, 68% reside in rural areas, where physical access – for both distribution and sourcing – is a challenge. Even in urban areas, distribution requires a network of micro-traders. Companies often wrestle with tradeoffs between cost, coverage and control. Distribution networks need to reach disparate neighborhoods and villages, while remaining viable at low volumes and prices.

Manufacturers need to ensure that they have adequate oversight of pricing, stocking, and service throughout the distribution chain to fulfill quality requirements. The following recommendations could guide the design of effective distribution networks:

Source from local producers

The potential for increased agricultural production is one of the "hidden assets" that often lies untapped in BOP communities. Companies can develop this value by working with local producers to improve the quality and volume of their output for a specific market.

Sourcing locally can reduce the cost that companies incur to reach and serve the next billions, enable provision of customized products for local preferences, and build trust and credibility for the company's brand. Most importantly, it can provide a sustainable source of local income, which is vital to BOP farmers facing volatile markets. Companies might offer mechanisms such as forward contracting or guaranteed purchasing to reduce risk and uncertainty for farmer incomes. Local sourcing, however, often requires companies to expand their traditional role and actively coordinate the full supply chain, often enough by cooperating with several partners.

One of the most prominent examples of local production is Shokti Doi yoghurt, which was introduced by Grameen Danone Foods Ltd in Bangladesh. Shokti Doi is sourced from, partly processed by, and distributed and consumed by the local low-income segment. Once a coordinated supply chain is established, it will grow into a platform that can facilitate other benefits to producer, consumer and company.

Another successful example in this domain is Fair Winds Trading Inc., who partners with Gahaya Links, a Rwandan woman owned firm that manages a network of 3,000 Rwandan women who weave baskets sold through an exclusive agreement with Macy's in the US.

Broaden reach and save costs by leveraging local distribution channels

Service providers can work with local entrepreneurs to leverage existing low-cost distribution channels. In Brazil, Nestlé outsources the "last mile" of its distribution network to women entrepreneurs in small villages. They receive the company's products through the mail and sell them door to door throughout the neighborhood, thus increasing the company's reach and brand credibility. Another company in India gives its salespeople bicycles to reach villages with populations of less than 5,000.

Companies could also cooperate to bundle product distribution in BOP regions, thus reducing costs for all involved. Small product manufacturers in Brazil partner with international retailers such as Carrefour and Wal-Mart to supply private-label products, thereby reducing retailers' supply-chain costs, as well as manufacturers' marketing costs. As a result, nearly 33% of the population is now buying private label products. In South America, S.A.C.I. Falabella started providing financial services to unserved segments as a way to drive retail sales; the services now generate at least 50% of the company's bottom line. In another example from Brazil, banks have offered their products and services through lottery shops and post offices. As a result, 28% of unserved municipalities and 98% of Brazilian towns now have banking services.

In addition, companies can capture discretionary retail spending by combining distribution efforts. Agricultural retail centres in Indian rural areas offer a one-stop shopping service, providing small-scale farmers with a range of products and services.

Find creative ways to overcome infrastructure constraints

A key constraint in sourcing goods from BOP producers is the risk of loss or damage of agricultural products due to poor storage and transport infrastructure. Companies buying from the poor have been addressing this by establishing "scaled out" local processing and collection centres.

Training producers and handlers can also help reduce these losses. Sometimes, it doesn't take a lot to realize significant improvements. Metro, a cash and carry outlet in India, suffered losses in its tomato supply as high as 40%. It turned out that during their breaks, handlers sat or slept on top of bagged tomatoes. By changing its packaging to crates on which they could sleep, Metro was able to reduce waste to 15%. Companies can also turn the lack of infrastructure into a business opportunity.

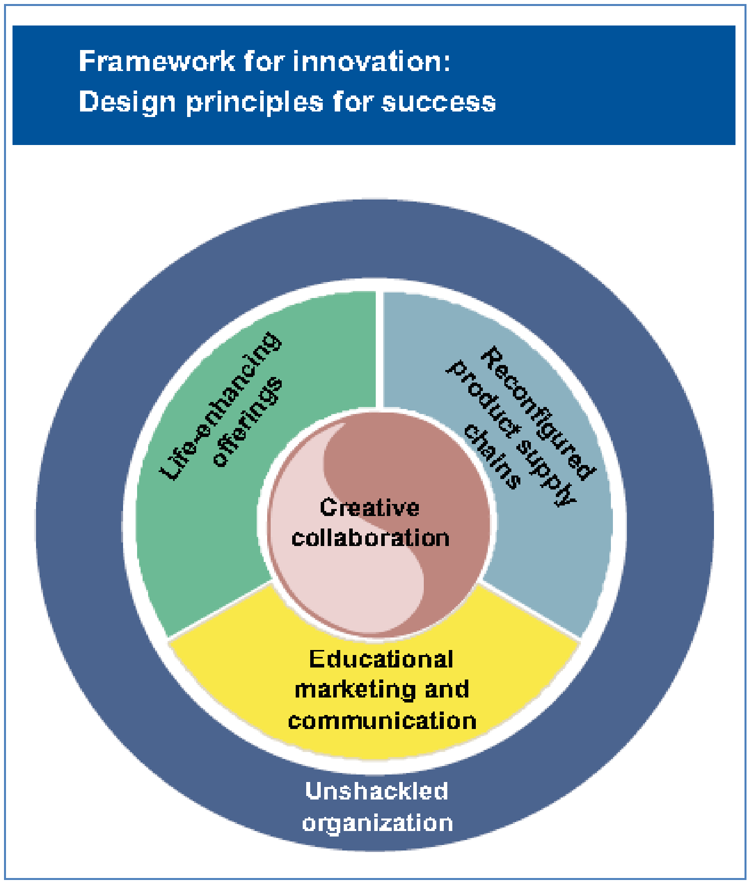
The MPESA service by Safaricom in Kenya, for example, allows individuals to transfer money via mobile phones. Cash can be deposited or redeemed at local shops that are licensed as agents. By converting small-scale local retailers into a distribution network for the service, the company is overcoming the lack of more established service channels.

Source/Reference:

The Next Billions: Unleashing Business Potential in Untapped Markets,
Study/Report prepared by World Economic Forum in collaboration with The Boston Consulting Group

REFLECTION TIME (CONTD…)

This Framework is based on an analysis of more than 200 Case Studies.



Educate through Marketing and Communication

Given low literacy levels and lack of access to mass communication, BOP consumers are often unfamiliar with new products and their intended benefits. As a result, companies need to create marketing programs that are as educational as they are persuasive, and they must establish strong credibility and recognition for their brands.

Educate about product benefits

Once BOP consumers are convinced of the value of a new product, they are often eager to invest in it. Unilever's successful hygiene promotion campaigns in India involved product promoters visiting villages to educate consumers on the health benefits of its soap. In a similar manner, agricultural input companies have used farmer training programs, agro-dealer certification, and model farms to train farmers on the use and benefit of specific products.

Companies can create opportunities for new customers to experience their products firsthand through displays, guided product trials, or explanations by trusted advocates. This approach is especially necessary for complicated products such as electronic equipment, as well as for products that might be perceived as potentially harmful, such as fertilizers and other agricultural inputs. In India, Hindustan Unilever's Project Shakti – a distribution network of village women – is a good example of explanation by trusted advocates. The women educate their neighbors about the need for personal hygiene and demonstrate the effectiveness of the company's products.

Create word-of-mouth advocacy

Consumers in this market are more likely to trust a friend or family member than a salesperson they don't know. Leveraging such informal communication networks can become a powerful sales tool. That insight led a Brazilian retailer to hire salespeople from the same neighbourhoods where its customers lived and thereby increase its sales significantly. One consumer-goods company in India identified key opinion makers in several communities and developed a partnership with them to market products in the neighbourhood. The company's offerings now reach 80,000 villages, which account for about 15% of its rural sales. Intel Corporation partnered with the Vietnamese government to advocate its low-price Thánh Gióng personal computers in rural community centres; the company now sells over 3,000 systems a month to small business owners in Vietnam.

Aim for trust and identity in branding.
Low income consumers are generally more willing to accept an unfamiliar product if it carries a well-known brand or is endorsed by a trustworthy institution. Companies with strong brand recognition can leverage that asset by launching additional products and brand extensions.

However, because many companies have yet to access BOP markets, relatively few brands are widely recognized. New entrants to the market can overcome this obstacle by partnering with established brands in another industry – for example, a financial services firm could collaborate with a trusted consumer products brand to promote its services. A number of Latin American companies have successfully used this model – for example, the arrangement between the Brazilian retailer Magazine Luiza S.A. and Unibanco (União de Bancos Brasileiros S.A.) to offer consumer credit for shopping.

Once a company has secured customer loyalty, it is important to preserve that trust. Many BOP regions have few or poorly-enforced consumer-protection regulations for truth in advertising or labeling. Consumers therefore rely on direct experience or inter-personal communication to form an opinion about a brand. Building and preserving a strong reputation therefore becomes a key for companies seeking long-term success in the BOP market. Consumer trust must be secured through consistently delivered quality and reliability.

Collaborate to form Nontraditional Partnerships
As noted earlier, mass production is often ineffective in the BOP market. Serving this segment requires companies to go beyond traditional "we-make-it and-you-buy-it" relationships to include the BOP in the actual production of the offer, as well as its distribution. By engaging with the BOP as a market of producers as well as consumers, companies can substantially lower the cost to serve, since the local communities have established networks and deeper reach. This includes collaboration on two levels: partnering with local communities and collaborating with organizations. Such arrangements are a good way to reduce production costs. Collaboration also captures "hidden" assets – in the form of untapped resources and local knowledge – while increasing local incomes. That enhances the BOP's ability to purchase more goods and services and generates a virtuous economic cycle for long-term sustainability.

Unlock local potential by engaging with communities
By employing hidden assets in local communities, companies can reduce overall cost to serve, customize local offerings, improve delivery, and penetrate deeper into markets to fill gaps.

Partner with communities rather than individuals
One of the biggest challenges in using local resources is the cost and complexity of sourcing from small-scale producers. A potential solution is to involve community aggregators, often village leaders, who can serve as focal point for a group of producers.

PepsiCo in India uses such an approach in its contract farming program for high quality potatoes. PepsiCo signs contracts with group of farmers in a village and empowers a village coordinator who enjoys the confidence of the farming community. The coordinator aggregates supply, disseminates information on farming practices and technologies, and plays a role in setting mutually agreed and pre-announced prices.

Not only do such aggregation schemes make it easier for companies to source in this market, they also make sourcing from the BOP easier for the local community. Most families who supply to companies aren't able to guarantee a consistent flow of goods because they have other constraints. For instance, women who weave high-quality carpets also need to take care of their families. Since they work on varied schedules, they can't deliver fixed volumes directly to the companies who buy their goods. But when village women work together collectively, they can organize their work flow so that the company can receive regular shipments of goods in required volumes.

Invest in talent and expertise building
Another problem with integrating local producers is that they often don't have the necessary skills to meet a company's quality standards. Most companies are reluctant to invest in workers' skill base when that may also benefit its competitors. Furthermore, the investments required are substantial and often entail building missing infrastructure, so they can be unprofitable for single players. One solution is to set up consortiums with other companies interested in the market and work collectively towards creating a talent pool. Another option is to deconstruct the value chain and "de-skill" activities performed in the field or at the point of service delivery. The Aravind Eye Care model in India and the Pesinet healthcare model in Mali are two examples of this. In both cases, specialist doctors remain in cities, while field staffs who have received basic training perform the first level of patient screening and information collection for diagnosis.

Create incentives that encourage self-governance
Most organizations are reluctant to source from the BOP because they believe quality will be poor, and monitoring for quality control is costly. Yet, it is possible to establish low-cost local checkpoints to ensure that quality standards are met by aligning the interests of the co-producers.

Coca- Cola innovated along these lines in developing countries in Asia and Africa, where it established "manual distribution centres" (MDC) staffed by local entrepreneurs. Originally developed in East Africa by its bottling partner Coca-Cola Sabco (CCS), the distribution system is built around thousands of small, independent distributors. Coca-Cola bottlers actively manage MDC owners as third parties, supporting them to establish their operations, secure microfinancing, and design effective delivery operations to keep customers in stock.

Form deep collaborations with unconventional partners
To succeed in this challenging market, companies need to work with other players to develop the right products, services, and delivery mechanisms. But serving the next billions will require them to go beyond traditional forms of partnership, to include civil society organizations and even competitors. In doing so, they will be able to share costs, as well as capabilities and knowledge. And they can enhance current offers through bundling and convenient access, and fill the gaps in market infrastructure.

Share products and assets
Companies can partner to bundle several products and services together, often making those products more affordable. In Brazil, Telefónica S.A.'s partnership with Abril S.A. to offer Internet services over the television network is one such example. Companies can also share distribution and retail networks, and leverage common logistics and facilities. Consider the partnership of IFFCO, a fertilizer company in India, and Airtel, a telecommunications company. Airtel realized that IFFCO had an established and efficient sales channel to widely disperse rural farmers, so Airtel used it to market and distribute its own products for farmers.

Channel sharing might also involve a global medical company providing local drug companies in emerging markets with licenses to produce lifesaving drugs. The local companies bring to the table a deeper reach and more efficient sales force, while the global company brings superior capacity in research and development systems. The global company might also be able to receive benefits from the government for such initiatives.

Share capabilities and knowledge
Organizations can also collaborate in deeper ways to distribute or process information, share knowledge for product innovation, or improve efficiency. For example, the records that telecommunications operators have on individual payment histories could be used by a finance company as a proxy to establish their credit worthiness. Financial service companies are exploring ways to use this information to provide micro-insurance and other financial products. Or an insurance company might enter the low-income market by having the local postman help to market its products door-to-door and return with feedback on product satisfaction. Such collaboration practices give companies rapid access to critical knowledge on market

movements and local consumer behaviour, and they help to eliminate the market inefficiencies of reaching the BOP.

Make Partnerships Work

The pay-off for nontraditional partnerships is the development of valuable skills in producers, partners, and consumers that will provide long-term profits. They will also help to build mutually beneficial infrastructure for all stakeholders, including governments. To make such partnerships work, companies should assess their capabilities, assets, and knowledge base – then identify other partners who have the additional resources they need. Next, they should analyse the pros and cons of collaborating, with a long-term view of profits. In initiating a partnership, they should establish clear governance structures, clearly outline roles, and agree on how the outcomes will be distributed for mutual benefit. Finally, before work begins, they need to make sure their systems and performance metrics are aligned.

One of the most important things for companies to keep in mind when partnering in the BOP market is that some companies have a head start. These leaders can serve as active drivers or facilitators, and not merely participators. That means orchestrating an arrangement in which it is easy for new players to enter and old ones to leave in order to maximize adaptability to changing conditions.

Unshackle the Organization to Help New Business Models Succeed

Most organizations – even those well established in emerging markets – focus primarily on serving mass and affluent markets. As a result their cultures, organization structures, and metrics are likely to be out of step with the demands of BOP markets.

Companies might consider the following remedies:

Demonstrate senior level commitment

Success in next billions markets requires strong commitment from the leadership team and active advocacy within the organization. These initiatives should be on senior management's radar and receive special recognition, in order to motivate employees to be a part of the effort.

Create focus and accountability

An exclusively top-down approach can limit the innovation required to develop effective ways of serving this market. Companies also need champions within the organization. Barclays and Citigroup for example, both have departments focused on micro credit, to develop opportunities for low-income customers.

Provide decision rights and autonomy

The separate departments and champions need to be empowered so that they are not constrained by the norms and processes that govern corporate activity in developed markets – such as standard cost saving and revenue goals. These often need to be adapted to allow for the up-front investments or longer pay-back horizons required for developing BOP business models.

Establish objective metrics

New metrics help to strengthen accountability and track results.

Companies also need to rethink the metrics they use to make go/no-go decisions. Return on capital, for example, is a better metric than the more traditional "operating margin" when serving high-volume, low priced markets. A low-priced brand of detergent in India, for example, has an advantage over higher priced brands due to lower investments in product development and marketing, giving it superior returns on capital.

Create lean and agile structures

BOP business units need to minimize costs and stay flexible. They should avoid duplication and create shared assets and services rather than loading on large overheads.

Provide access to capabilities and knowledge

Many organizations create functions that are responsible for transferring best practices across business divisions. These "success agents" are essentially managers who translate learning from business models into pointers that other divisions can use for entering a new market. Some companies also acquire local companies to accelerate the process of understanding the BOP market and developing appropriate brands and business models.

A market of 3.7 billion people spending US$ 2.3 trillion per annum remains largely excluded from formal markets. This is a growing population, living in expanding economies worldwide. While there are numerous challenges involved in reaching them effectively as consumers or business partners, they provide significant opportunities for companies that find successful approaches.

The Next Billion Banking Consumers
The Challenges & Proposed Responses/Solutions especially in Pakistan's Context

1) Who are the "Next Billion"?
2) What do the Next Billion need?
3) Developing Financial Products to Reach the Next Billion
4) Distributing Financial Products to Reach the Next Billion
5) Marketing to Reach the Next Billion
6) Redefining a Bank's Organization Structure to Reach the Next Billion
7) Collaborating to Reach the Next Billion

The problem of financial exclusion—individuals' limited access to or use of formal banking services—looms large around the world. It both reflects and contributes to the stark socioeconomic divide that pervades many emerging markets. In China and India, for example, only about one-third of the population participates in the formal banking sector. Among the excluded are a distinct and huge group of consumers—the *next billion*—whose potential to become viable banking customers has been greatly underestimated. Categorized by income, this group sits just above the poorest of the poor and just below those who are currently targeted by most banks.

Governments and microfinance institutions have made some headway in alleviating financial exclusion, but banks have lacked a clear commercial impetus to do so, stifling the development of business models that have the reach required to confront this problem. By embracing innovative business models, however, banks can upend the economics of reaching consumers long considered impossible or unattractive to serve. This approach would open up unparalleled opportunities for profitable expansion in some of the world's most rapidly growing economies.

Who Are the Next Billion?
The next billion consumers can be found largely in Brazil, China, and India, but the group also spreads across Africa and other parts of Asia. If the next billion constituted a nation by itself, it would be the tenth-largest economy in terms of GDP, ranking after Spain but ahead of Brazil, Russia, India, South Korea, and Mexico. In its development, the next billion "nation" stands today where India stood in the 1990s and China stood in the 1980s: on the cusp of high growth and voracious consumption.

The next billion consumers have no lack of interest in banking. Their demand is so strong, in fact, that they routinely en-dure the trying, sometimes oppressive conditions that plague the informal sector, including limited choice, usurious rates, and exploitative terms. It is not unheard of for loans in the informal sector to be repaid through lifelong indentured service.

Rather than having opted out of the formal banking sector, most of the next billion have been excluded from participating by financial institutions unable or unwilling to invest in understanding their needs and in adapting business models to serve them profitably. Our definition of the next billion consumers also includes people whom banks are compelled to serve but who cannot be served profitably through conventional business models—for example, individuals in government-mandated priority sectors (such as low-income consumers) and employees of corporate clients. Banks believe they have little economic incentive to serve such consumers. Some even prefer to incur penalties rather than make the investments necessary to comply with government mandates. As a result, these consumers are chronically underserved.

In several emerging economies, however, a few financial institutions have recognized the potential of the next billion and are introducing innovative products and distribution methods in order to carve out broad avenues for reaching this segment.

What Do the Next Billion Need?
To field an offering that resonates with the next billion consumers, banks must first understand the barriers to participation in the formal sector.

The leading, if obvious, reason for financial exclusion is a lack of steady, substantial income. It is compounded by the cumbersome mechanics of cash-based economies, which circumvent financial institutions, making a relationship with a bank unnecessary and preventing individuals from building a credit history. This one-two punch minimizes the incentive to maintain a savings account and makes it difficult to qualify for a formal loan.

Poor proximity to banking services is another reason for exclusion. A study by The Boston Consulting Group in late 2006 and early 2007 found that in India, the rate of financial inclusion among urban households was more than double that of rural households—57 percent versus 26 percent—in part because banking outlets are typically located far from rural areas, and people there often lack the means to make the trip.

Financial exclusion also stems from a scarcity of suitable products. The next billion consumers would like flexibility, especially the option to skip or make additional payments on a loan. Because many in this segment do not have steady incomes, such flexibility is a common feature in products available in the informal sector. Simplicity is also important. In our work in Brazil and India, we found that the next billion consumers are generally more concerned about manageable monthly installments than they are about interest rates.

Many of the next billion also desire easy access to small personal loans, but most banks find the expense of providing small-ticket financial products prohibitive. In addition, banks won't lend to individuals lacking collateral, a verifiable source of stable income, or a documented credit history. Moreover, in some emerging markets, banks in the formal sector can take up to six months to approve a loan—but a villager can meet with and secure a loan from a local moneylender virtually anytime.

Financial exclusion is exacerbated by poor relationships between banks and communities. Low-income people, particularly in rural areas, are often wary of banks and find branches intimidating. A profound lack of financial literacy only reinforces this sense of alienation.

Overcoming these barriers and altering the economics of serving the next billion require banks to pursue a variety of innovations—in product development, distribution, marketing, and organization structure. Innovations in marketing, for example, will play a critical role in engaging this untapped group. New approaches to distribution will be crucial in serving the segment profitably.

Developing Financial Products to Reach the Next Billion
Banks can address many of the problems that cause financial exclusion by developing products that are simple, flexible, and accessible. For example, offering a loan with a higher number of installment payments— and allowing the customer to increase or postpone payments with little or no penalty—would attract many of the next billion.

Also, linking products directly to individuals' sources of income could mitigate the risk that banks assume and thereby help make products more accessible to consumers. Banks in Brazil have adopted this approach, developing payroll- and pension-backed loans that have opened the credit market to many new consumers. These products now account for about half of all personal loans in Brazil, according to Banco Central do Brasil.

Unfortunately, regulations sometimes make it difficult— if not impossible—to offer products that suit the financial means of the next billion consumers. Our analysis shows, for example, that Indian banks would need to charge a 32 percent interest rate just to break even on the kind of small, short-term personal loan that the next billion consumers would want. Yet national regulations prohibit banks from charging interest rates to priority sectors that exceed the prime lending rate, which currently stands at about 12 percent. This problem underscores the need for regulatory reform that complements initiatives to reach the next billion consumers.

Distributing Financial Products to Reach the Next Billion
Banks that already have extensive physical networks should try to maximize the revenue per square foot of their branches by offering products in addition to financial services, provided that regulations will allow for this shift. Banks could, for example, set up local communications centers—public pay phones, fax machines, and Internet access—at rural branches to help make the outlets economically viable, and therefore more attractive to open and operate with a fully committed, sales-oriented level of service. They could also use the rural branches to disseminate commodity information and provide access to commodity exchanges.

At the same time, when one considers the physical and emotional barriers that prevent the next billion from using branches, it becomes clear that banks seeking to foster inclusion must also employ alternatives to their traditional outlets. Some banks in emerging markets have already begun to forgo branches, instead reaching underserved segments through nonbank channels. In Brazil, banks have added nearly 100,000 point-of-sale (POS) locations by striking deals with post offices, pharmacies, & supermarkets. These channels, which have operating costs 12 times, lower than those incurred by branches, are more convenient for consumers and help engage them in the formal banking sector. They now account for more than half of all bill-payment activity in Brazil.

South Africa's Mzansi account, launched in 2004, illustrates the appeal of nontraditional channels. This card-based product, which can be used in branches and ATMs but also in post offices and retail stores' POS locations, now has more than 4 million subscribers. Self-help groups represent still another viable channel—and perhaps even a partner—for banks. In a typical self-help group in India, village women save money to underwrite loans to one another. Through the groups, money from the community is used in the community, creating a strong moral obligation for borrowers to repay their loans. By drawing on its personal connections, a self-help group can verify its borrowers' creditworthiness. If they also collaborated with banks by directing individuals to tailored commercial products, self-help groups could offer consumers a familiar path to the formal sector.

Marketing to Reach the Next Billion
Given the uneasy relationship that many low-income consumers have with banks, it is essential that the financial establishment foster trust among the next billion. Toward this end, expanding inclusion will require marketing through community-level partnerships—not just through radio, television, and print media. Moreover, by becoming a partner in a community's prosperity, a bank could forge bonds that would be difficult for new financial players to break or replicate. Beyond promoting products and services, marketing campaigns will need to enhance financial literacy among the next billion. The most effective marketing campaigns could wind up being equal parts education and sales pitch. As an illustrative example, consider a leading public-sector bank in India that is currently promoting its credit-counseling services.

These services include free advice on how consumers outside the formal sector can gain access to the bank's financial products.

Redefining a Bank's Organization Structure to Reach the Next Billion
Although all banks in emerging markets should have the next billion consumers on their radar screen, most of them are not yet ready to undertake the transformation required to serve this segment. In many larger institutions, a centralized, top-down approach to decision making discourages the types of initiatives needed to push the boundaries of product offerings. Their metrics and incentives also threaten to inhibit next billion initiatives in two major ways. First, performance targets, frequently measured by the volume of loans or savings and applied the same way to both rural and urban branches, motivate the sales force to court big-ticket customers. Second, many banks lack incentives to attract or retain staff in rural areas—a fact sometimes reflected in poorer levels of service in those locations and a disdain among workers there for low-income customers.

To overcome their own impediments to serving the next billion, banks must develop separate organizations dedicated to tapping this opportunity. These units' performance metrics and incentives should be aligned with the priorities for serving such customers. For example, banks could measure performance by the number of customers served, rather than the size of their wallets. Similarly, these units could be allowed to emphasize growth over profitability in the short term. To reinforce the importance of this opportunity, banks should create an executive-level position that focuses on the initiatives and reports directly to the CEO. One private sector bank in India is leading the way by entrusting to a board-level executive its efforts to boost financial inclusion of the next billion.

Collaborating to Reach the Next Billion

The next billion consumers will not be constrained by traditional industry boundaries, and this factor, among others, will help set the stage for new players to encroach on what has been a stronghold of banks: basic payment and deposit transactions. When it comes to those services, the next billion won't necessarily distinguish between telecom providers and banks, for example, and they'll opt to use whichever providers offer the least cumbersome and lowest-cost offerings. Consequently, if regulators in emerging markets allow telecom operators to straddle industry boundaries, these players could mount a strong challenge to banks.

In some rapidly developing economies, new mobile phone customers are being added more quickly than new banking customers, and mobile phone services, in general, boast a significant cost advantage over branch based banking. Yet the relationship between the banking and telecom industries need not be adversarial. Before telecom players lay claim to traditional banking strongholds, banks should explore opportunities for collaboration, identifying ways to cross-sell their products by leveraging the ease of use, low cost to serve, and accessibility offered by mobile phones. Players from both industries can share elements of their offerings and value chains in ways that provide mutual benefits, including more attractive, targeted products. Banks in particular stand to benefit from a steep reduction in transaction costs, because transactions executed by mobile phones could cost as little as 10 percent of those executed at bank branches.

Mobile phone networks are already being used as effective channels for financial services in emerging economies. In Kenya, telecom customers can deposit money into an account on their mobile phones and transfer the funds to other mobile-phone users— even in remote areas. The telecom operator's local agent can then convert the money into cash, allowing people to avoid cumbersome and costly dealings with banks. In Zambia, telecom company Celtel introduced Celpay, a service that allows customers to make purchases, pay bills, and transfer funds through their mobile phones. Two percent of Zambia's GDP was transferred through Celpay in 2006, and even those Zambian communities that have little or no financial services infrastructure can now participate in the banking system.

Laying the Groundwork

The breadth of actions required to reach the next billion consumers may seem daunting, but banks can take several immediate steps to begin the process of unlocking this opportunity:

- *Understand the needs of the next billion consumers.*
  Which features do they value? What barriers prevent them from engaging in the formal sector?
- *Analyze product and channel economics.*
  For each element of the value chain, what are the opportunities to reduce the cost of serving the next billion?
- *Develop new marketing campaigns.*
  How can marketing improve financial literacy among the next billion consumers while promoting the benefits and simplicity of basic products and services?
- *Design a new organization model.*
  Which organization structure would best foster experimentation, including collaboration with other industries?
- *Create an empowered executive position.*
  Who will oversee the strategy for tapping the next billion opportunities?
- *Begin adapting the value chain.*
  Can the bank focus on core activities and use low-cost partners for all other activities, especially distribution?

Boosting financial inclusion will no doubt create economic opportunities for an overlooked and underserved segment. Socioeconomic imperatives aside, however, the prospect of reducing financial exclusion represents a significant business opportunity for banks. Conventional banks that act in unconventional ways can transform the next billion consumers—the tenth-largest economy—into a source of profitable growth.

Source/Reference:

1. **The Next Billions: Unleashing Business Potential in Untapped Markets, Study/Report prepared by World Economic Forum in collaboration with The Boston Consulting Group**
2. **The Next Billion Banking Consumers, An Study by The Boston Consulting Group**

LESSON 26

SBP RISK MANAGEMENT GUIDELINES

A Brief Re-Cap:

1. Defining Risk
2. Risk Management (Strategic/Macro/Micro Levels)
3. Board & Senior Management Oversight
4. Risk Management Framework (RMC, MIS, Review etc.)
5. Integration of Risk
6. Business Line Accountability
7. Risk Evaluation/Measurement
8. Independent Review
9. Contingency Planning

1. Defining Risk:

- For the purpose of these guidelines financial risk in banking organization is possibility that the outcome of an action or event could bring up adverse impacts
- Such outcomes could either result in a direct loss of earnings/capital or may result in imposition of constraints on bank's ability to meet its business objectives
- Such constraints pose a risk as these could hinder a bank's ability to conduct its ongoing business or to take benefit of opportunities to enhance its business
- Regardless of the sophistication of the measures, banks often distinguish between expected and unexpected losses
- ***Expected losses are those that the*** bank knows with reasonable certainty will occur (e.g., the expected default rate of corporate loan portfolio or credit card portfolio) and are typically reserved for in some manner
- ***Unexpected losses are those associated with unforeseen*** events (e.g. losses experienced by banks in the aftermath of nuclear tests, losses due to a sudden down turn in economy or falling interest rates)
- Banks rely on their capital as a buffer to absorb such losses
- Risks are usually defined by the adverse impact on profitability of several distinct sources of uncertainty
- While the types and degree of risks an organization may be exposed to depend upon a number of factors such as its size, complex business activities, volume etc, it is believed that generally the banks face following "Risks"
  - ✓ Credit
  - ✓ Market
  - ✓ Liquidity
  - ✓ Operational
  - ✓ Compliance/Legal/Regulatory
  - ✓ Reputational

2. Risk Management

Risk Management is a discipline at the core of every financial institution and encompasses all the activities that affect its risk profile. It involves identification, measurement, monitoring and controlling risks to ensure that:

i. The individuals who take or manage risks clearly understand them.
ii. The organization's Risk exposure is within the limits established by Board of Directors.
iii. Risk taking decisions are in line with the business strategy and objectives set by BOD.
iv. The expected payoffs compensate for the risks taken.
v. Risk taking decisions are explicit and clear.
   - Sufficient capital as a buffer is available to take risk.
   - The acceptance and management of financial risk is inherent to the business of banking and banks' roles as financial intermediaries.

- Risk management as commonly perceived does not mean minimizing risk; rather the goal of risk management is to optimize risk-reward trade -off.
- Notwithstanding the fact that banks are in the business of taking risk, it should be recognized that an institution need not engage in business in a manner that unnecessarily imposes risk upon it: nor it should absorb risk that can be transferred to other participants.
- Rather it should accept those risks that are uniquely part of the array of bank's services.

In every financial institution, risk management activities broadly take place simultaneously at following different hierarchy levels.

a. **Strategic level:** It encompasses risk management functions performed by senior management and BOD. For instance definition of risks, ascertaining institutions risk appetite, formulating strategy and policies for managing risks and establish adequate systems and controls to ensure that overall risk remain within acceptable level and the reward compensate for the risk taken.
b. **Macro Level:** It encompasses risk management within a business area or across business lines. Generally the risk management activities performed by middle management or units devoted to risk reviews fall into this category.
c. **Micro Level:** It involves 'On-the-line' risk management where risks are actually created. This is the risk management activities performed by individuals who take risk on organization's behalf such as front office and loan origination functions. The risk management in those areas is confined to operational procedures and guidelines set by management.
   - Expanding business arenas, deregulation and globalization of financial activities, emergence of new financial products and increased level of competition has necessitated a need for an effective and structured risk management in financial institutions.
   - A bank's ability to measure, monitor, and steer risks comprehensively is becoming a decisive parameter for its strategic positioning.
   - The risk management framework and sophistication of the process, and internal controls, used to manage risks, depends on the nature, size and complexity of institutions activities.
   - Nevertheless, there are some basic principles that apply to all financial institutions irrespective of their size and complexity of business and are reflective of the strength of an individual bank's risk management practices.

3. Board and Senior Management Oversight

a) To be effective, the concern and tone for risk management must start at the top. While the overall responsibility of risk management rests with the BOD, it is the duty of senior management to transform strategic direction set by board in the shape of policies and procedures and to institute an effective hierarchy to execute and implement those policies. To ensure that the policies are consistent with the risk tolerances of shareholders the same should be approved from board.

b) The formulation of policies relating to risk management only would not solve the purpose unless these are clear and communicated down the line. Senior management has to ensure that these policies are embedded in the culture of organization. Risk tolerances relating to quantifiable risks are generally communicated as limits or sub-limits to those who accept risks on behalf of organization. However not all risks are quantifiable. Qualitative risk measures could be communicated as guidelines and inferred from management business decisions.

c) To ensure that risk taking remains within limits set by senior management/BOD, any material exception to the risk management policies and tolerances should be reported to the senior management/board that in turn must trigger appropriate corrective measures.

d) These exceptions also serve as an input to judge the appropriateness of systems and procedures relating to risk management.

e) To keep these policies in line with significant changes in internal and external environment, BOD is expected to review these policies and make appropriate changes as and when deemed necessary.

f) While a major change in internal or external factor may require frequent review, in absence of any uneven circumstances it is expected that BOD re-evaluate these policies every year.

4. Risk Management Framework:

- A Risk Management Framework encompasses the scope of risks to be managed, the process/systems and procedures to manage risk and the roles and responsibilities of individuals involved in risk management.
- The framework should be comprehensive enough to capture all risks a bank is exposed to and have flexibility to accommodate any change in business activities.
- An effective risk management framework includes:
  a. Clearly defined risk management policies and procedures covering risk identification, acceptance, measurement, monitoring, reporting and control.
  b.
    - ✓ A well constituted organizational structure defining clearly roles and responsibilities of individuals involved in risk taking as well as managing it.
    - ✓ Banks, in addition to risk management functions for various risk categories may institute a setup that supervises overall risk management at the bank.
    - ✓ Such a setup could be in the form of a separate department or bank's Risk Management Committee (RMC) could perform such function.
    - ✓ The structure should be such that ensures effective monitoring and control over risks being taken.
    - ✓ The individuals responsible for review function (Risk review, internal audit, compliance etc) should be independent from risk taking units and report directly to board or senior management who are also not involved in risk taking.

  c. There should be an effective management information system that ensures flow of information from operational level to top management and a system to address any exceptions observed. There should be an explicit procedure regarding measures to be taken to address such deviations.
  d. The framework should have a mechanism to ensure an ongoing review of systems, policies and procedures for risk management and procedure to adopt changes.

5. Integration of Risk Management:

- Risks must not be viewed and assessed in isolation, not only because a single transaction might have a number of risks but also one type of risk can trigger other risks.
- Since interaction of various risks could result in diminution or increase in risk, the risk management process should recognize and reflect risk interactions in all business activities as appropriate.
- While assessing and managing risk the management should have an overall view of risks the institution is exposed to.
- This requires having a structure in place to look at risk interrelationships across the organization.

6. Business Line Accountability:

- In every banking organization there are people who are dedicated to risk management activities, such as risk review, internal audit etc.
- It must not be construed that risk management is something to be performed by a few individuals or a department.
- Business lines are equally responsible for the risks they are taking.
- Because line personnel, more than anyone else, understand the risks of the business, such a lack of accountability can lead to problems.

7. Risk Evaluation/Measurement:

- Until and unless risks are not assessed and measured it will not be possible to control risks.
- Further a true assessment of risk gives management a clear view of institution's standing and helps in deciding future action plan.
- To adequately capture institutions risk exposure, risk measurement should represent aggregate exposure of institution both risk type and business line and encompass short run as well as long run impact on institution.

- To the maximum possible extent institutions should establish systems/models that quantify their risk profile.
- However, in some risk categories such as operational risk, quantification is quite difficult and complex.
- Wherever it is not possible to quantify risks, qualitative measures should be adopted to capture those risks.
- Whilst quantitative measurement systems support effective decision-making, better measurement does not obviate the need for well-informed, qualitative judgment.
- Consequently the importance of staff having relevant knowledge and expertise cannot be undermined.
- Finally any risk measurement framework, especially those which employ quantitative techniques/model, is only as good as its underlying assumptions, the rigor and robustness of its analytical methodologies, the controls surrounding data inputs and its appropriate application.

8. Independent Review:

- One of the most important aspects in risk management philosophy is to make sure that those who take or accept risk on behalf of the institution are not the ones who measure, monitor and evaluate the risks.
- Again the managerial structure and hierarchy of risk review function may vary across banks depending upon their size and nature of the business, the key is independence.
- To be effective the review functions should have sufficient authority, expertise and corporate stature so that the identification and reporting of their findings could be accomplished without any hindrance.
- The findings of their reviews should be reported to business units, Senior Management and, where appropriate, the Board.

9. Contingency Planning:

- Institutions should have a mechanism to identify stress situations ahead of time and plans to deal with such unusual situations in a timely and effective manner.
- Stress situations to which this principle applies include all risks of all types.
- For instance contingency planning activities include disaster recovery planning, public relations damage control, litigation strategy, responding to regulatory requirements etc.
- Contingency plans should be reviewed regularly to ensure they encompass reasonably probable events that could impact the organization.
- Plans should be tested as to the appropriateness of responses, escalation and communication channels and the impact on other parts of the institution.

Uncertainty Tamed?
The Evolution of Risk Management in the Financial Services Industry

A Global Survey/Study identifies:

- Four Reasons why Risk Management remains primarily focused on meeting regulatory requirements & only secondarily on protecting and enhancing the value of the franchise.
- Ten attributes that would help companies create a world-class culture of Risk Management.

Four Reasons:

- A culture of risk awareness has yet to emerge.
- Compliance is not being turned into competitive advantage.
- The importance of governance is underestimated.
- Quantifiable risks are still absorbing too much attention.

For financial institutions, risk lies around every corner. With little or no warning businesses can stumble and even collapse because of unexpected events. Growing risk management departments and sophisticated technology have helped companies in financial services to combat many of the more quantifiable dangers, from credit and market risk to such things as regulatory and IT risks. But what about those areas, like reputational risk, that are both harder to measure and more sudden and severe in their impact?

As, Sir John Bond, Chairman of HSBC, told a conference recently: 'It used to take years of dedicated bad management to destroy a company. Now it can be done almost overnight.'

Two years ago, PricewaterhouseCoopers carried out a survey of financial services institutions Worldwide. The results showed that, while senior executives were keenly aware of the credit and market risks they faced and were doing more to address them, they tended to pay comparatively little attention to less visible, equally menacing dangers. Two years on, a fresh survey of more than 130 senior executives in financial services institutions, carried out by the Economist Intelligence Unit on behalf of PricewaterhouseCoopers for this briefing, indicates that risk management in general has climbed higher up the corporate agenda and that an awareness of unquantifiable risks in particular has grown markedly: reputational risk is now regarded as the greatest threat to an organization's market value.

Yet significant concerns remain. Many financial services institutions are still failing to think proactively about unseen and emerging risks. There is evidence that much of the impetus for change in risk management priorities is coming not from self-assessment but rather from pressure from regulators, rating agencies and the like. Some 72% of those questioned in the survey said that regulatory pressures were either an extremely significant or a major driver for changes in the priority of their organization's risk management over the past two years.

The evidence of the survey and our interviews suggests four main reasons why risk management remains primarily focused on meeting regulatory requirements and only secondarily on protecting and enhancing the value of the franchise:

A culture of risk awareness has yet to emerge.
Risk management has climbed the boardroom agenda since the previous survey: expenditure on risk management as a percentage of its overall expenses is on an upward trajectory, and more organizations have a senior risk management executive and committee at the group level. But spending more on risk management on its own is no guarantee that a company will become better at it. In only 31% of respondent companies do all major decisions require interaction with, or some form of approval from, the group risk management committee (that number rises to a still low 47% for larger institutions with total gross income of $1bn or more). There is a big difference between talking about steps to integrate risk management and actually taking them. Too often a company's head of risk is not at the same table as the chief executive officer or other executive directors when important decisions are being made. A company needs to inculcate an appreciation of risk that goes beyond the risk management department and permeates the whole organization.

Compliance is not being turned to competitive advantage.
Too little emphasis on compliance can, of course, expose an organization to regulatory sanction, litigation and damage to its reputation. But too much emphasis on box-ticking can also distract a company from using risk management to create value – by reassessing its investment strategies, making better operational decisions in areas such as pricing and capital allocation, and by gauging its own appetite for risk. True, almost 70% of survey respondents assess their performance on some measure of risk-adjusted capital. Yet many are failing to turn this fully to their advantage, by setting more appropriate product pricing, for example.

The importance of governance is underestimated.
Robust risk management and sound corporate governance invariably make good bedfellows. Indeed, some argue that it is impossible to get one without the other. But few survey respondents seem to have acted on the logic of this argument. When asked in which business processes their organization had a structured approach to assessing risk, only 43% ticked M&A activity and just 17% pointed to the setting of compensation policies for directors and recruitment policies as a whole. It is accepted that paying executives too generously for failing to do their jobs competently or ethically raises questions about governance but it ought to be a major focus of risk management too.

Quantifiable risks are still absorbing too much attention.

Asked to rate the effectiveness of their organization's risk management capabilities, survey respondents had most confidence in their ability to manage data-rich areas such as credit risk, liquidity risk and market risk. No one disputes the importance of managing these types of risk effectively – respondents still rate these as the principal threats to earnings, but they are not necessarily the main threat to the health of the franchise upon which sustainable earnings depend.

Too many organizations are still concentrating on calculating market and credit risk to a further order of accuracy and too few on understanding the totality of the risks they face in order to give themselves a competitive advantage.

The tendency for financial institutions to focus on areas of risk that are most familiar and where data and techniques are most developed is natural, of course. But in an environment where new and potentially lethal risks can suddenly emerge, the leading institutions consciously and continually look at the bigger picture. They seek to anticipate and avoid the submerged risks that can abruptly sink an enterprise. And they have both the crisis management processes and the underlying standards of behavior that are likely to soften the impact of such risks when they do come to pass. Such institutions accept that uncertainty cannot be tamed; only mitigated.

Ten Attributes

1. Pay equal attention to quantifiable and unquantifiable risks.

Institutions are increasingly attuned to the dangers posed by less quantifiable risks, particularly with regard to their market value. That awareness stretches right to the top of the organization.

In a survey of global CEOs, 28% of financial services bosses felt that reputational risk was a significant threat and 13% felt that it was one of the biggest threats they face.

2. Identify, report and quantify all possible risks.

Despite a growing awareness of unquantifiable risks, there remains a danger that some organizations will take no action if they cannot find the numbers with which to measure a risk or set of risks. As one respondent to survey tellingly replied, 'for some risks, the data is insufficient to construct a strategy.'

3. Let an awareness of risk pervade the enterprise.

Everything from performance to pricing and pay should be adjusted for risk. Too few institutions currently obey that imperative. Of the 69% of survey respondents to assess their performance on a measure of risk-adjusted capital, fewer than one in five use this information to pay bonuses or set remuneration for senior executives.

4. Make risk management everybody's responsibility.

In the past, financial institutions have tended to look outside their own walls when assessing risks. But issues of governance, culture and integrity are arguably more critical in protecting firms from unseen dangers – and should be made the explicit responsibility of all members of staff.

'All 20,000 employees have the potential to do something to enhance or destroy our reputation,' says Chief Risk and Compliance Officer of a global financial services provider.

5. Risk managers should have teeth.

Everybody involved in monitoring risk of all kinds should have a genuine influence over decision- making. Independent risk assessments of a new product or transaction should be made before the CEO and senior management have approved it in principle. Is it realistic to go back to the drawing board afterwards?

6. Avoid products and businesses the enterprise does not understand.

If you don't understand the business, you cannot understand the risks facing it. Encouragingly, 77% of respondents now include a structured assessment of risk in their product development processes. Less happily, only 43% said they did so when it came to mergers and acquisitions.

7. Accept that uncertainty exists.

More than two in five respondents to the survey believe that the greatest risks to the organization's market value are 'unknown' sources of risk. Workshops, scenario planning and cross-industry reviews are among the techniques that leading institutions are using to assess the potential impact of, and response to, these future sources of danger.

8. Monitor your risk managers.

The amount of attention being paid to risk at board level still leaves much to be desired. In less than a third of surveyed institutions are risks and risk management discussed in detail at all main board meetings. And although awareness of risk has grown in over 80% of institutions, in fewer than half is responsibility for enterprise-wide risk management higher up the organization than it was two years ago.

9. Good risk management delivers value.

Loss avoidance remains the staple means of demonstrating the value of risk management, but 50% of survey respondents also look to risk management to contribute to improved shareholder value.

10. Define and enshrine your company's risk culture.

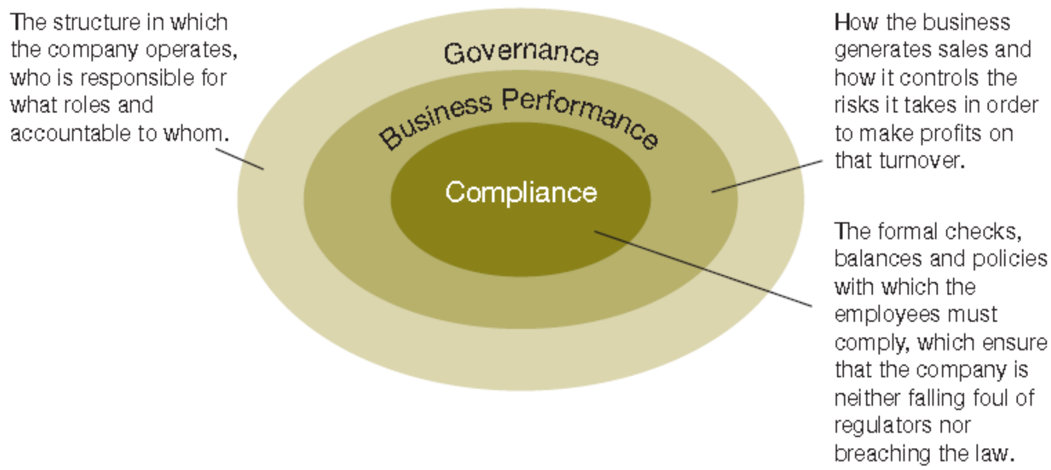
The enterprise's appetite for risk should be clearly and widely understood. 'We have a very clear risk appetite for certain events,' says the MD, Credit Risk Management of an international group. The institution's senior leadership should set a tone at the top that creates a behavioral and ethical benchmark for the entire organization. Given the inherent vagaries of human behavior, however, process controls also need to be put in place to reinforce cultural norms and compensate for any lapses.

Which areas of risk represent the greatest potential threat to your organisation's market value and earnings? (% of respondents rating as top area of focus; rank in brackets)

	Market value	Earnings
Reputational risk	34% (1)	22% (6)
Credit risk	25% (2)	37% (1)
Market risk	25% (3)	31% (2)
Regulatory risk	18% (4)	25% (3)
Business/strategic risk	16% (5)	23% (4=)
Operational risk	14% (6)	23% (4=)
Business continuity risk	13% (7=)	13% (8=)
IT/technology risk	13% (7=)	8% (10=)
Treasury/liquidity planning	10% (9)	19% (6)
Governance risk	7% (10=)	13% (8=)
Sovereign/political risk	7% (10=)	8% (10=)

The sources of reputational risk

Reputational risk arises from failures of process, failures of strategy and failures of corporate governance. Companies must manage and monitor all these risks to protect their reputations.

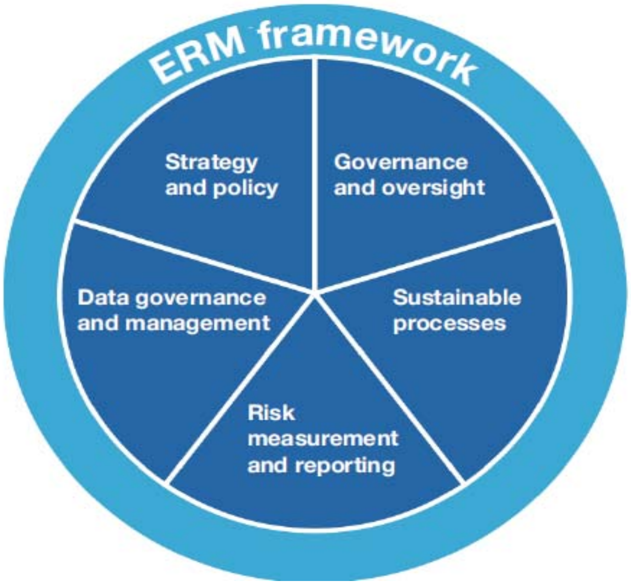


Source/Reference:

1. **SBP Website**
2. **PWC Survey/Study**

LESSON 27

ERM: DEVELOPMENT & IMPLEMENTATION OF _"INTEGRATED APPROACHES"_ TO MEASURE AND MANAGE RISKS ACROSS THE ENTERPRISE



Classification of Banking Risks

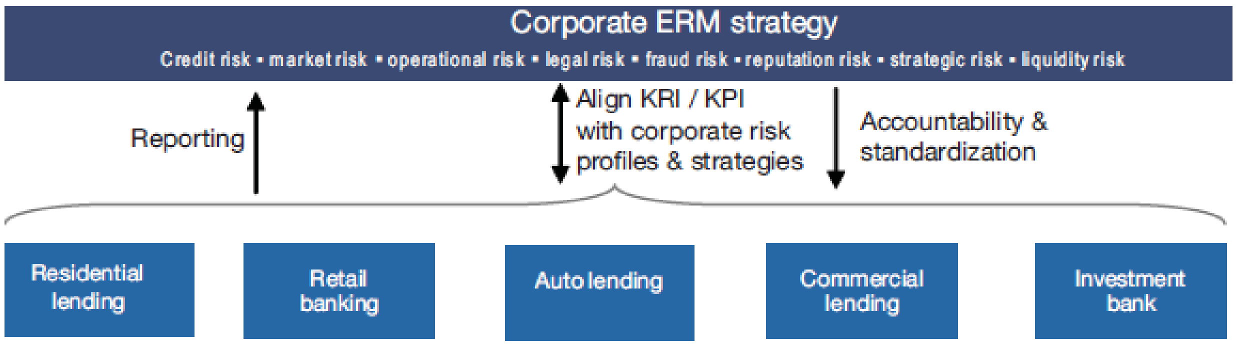
Banking Characteristics	**Risk Class**	**Risk Category**
Environment	Environmental Risks	Legislative
		Economic
		Competitive
		Regulatory
Human Resource	Management Risks	Defalcation
		Organizational
		Ability
		Compensation
Financial Services	Delivery Risks	Operational
		Technological
		New Products
		Strategic
Balance Sheet	Financials Risks	Credit
		Liquidity
		Market
		Leverage

Risk management has never been more critical for mortgage companies. The secondary market continues to tighten, the financial system is under unprecedented duress, and more regulatory requirements are on the horizon. To succeed in this environment—to effectively price products based on constantly changing market dynamics, reassure investors and shareholders, and grow strategically while adhering to regulatory requirements—it is essential to reevaluate and modify the mortgage risk management and measurement framework to align with today's new risks and ensure an appropriate control structure.

Establishing a clearly defined enterprise risk management (ERM) framework begins with an understanding of the corporate ERM program and establishment of a line of business ERM vision that supports that broader program. This vision defines the operating model for how risks will be managed and is mutually reinforcing, achieving short-term business goals and long-term corporate strategies. While important in driving the macro approach to risk management, the articulation of the ERM vision also drives role clarity, consistency, and accountability throughout the organization.

ERM success requires linkage between line of business and corporate risk strategies:
For mortgage lenders, which is often a line of business or separate legal entity within a larger financial institution, achieving a risk management?

Vision requires lining up the line of business risks with the corporate risk management philosophy and framework.



For each line of business, the specific measurement process may vary, but the standards must be consistent and critically assessed for how well they conform to the corporate ERM strategy. However, risk measurement cannot be determined in a silo—the interrelatedness of the risks defines the overall corporate exposure. An effective ERM framework is able to aggregate business unit risk exposures across all business units.

Assessing these risks is an ongoing, continually updated process as changes to the business model and market conditions occur. Developing a flexible program is critical to a successful risk management strategy— especially in today's market. Effectively measuring and modeling risks helps companies more accurately estimate their risk exposure and develop a plan to manage it.

Developing a plan to manage the risk is where many mortgage companies today are struggling. From this perspective, companies can focus their energies on two main areas today to have an immediate impact.

Specifically, a strong focus on governance and an overhaul of key risk indicators will help companies lay the groundwork for an enterprise risk management platform that grows the business while managing risk exposure.

A focus on governance lays the groundwork for a reliable ERM strategy

A focus on governance begins with determining the top-level risk management vision and objectives consistent with long-term strategic goals and risk tolerances. The entire risk management function needs to be evaluated, and the importance of business risk managers must be emphasized through their appropriate placement throughout the organizational structure and governance framework. This reorganization supports a culture where risk management is institutionalized by all management and staff. These risk managers, reporting up through the ranks and to the board, are responsible for creating a consistent process for measuring and reporting risk, documenting compliance with risk management plans, and developing a risk response.

As risks escalate in one area or line of the business, the governance structure ensures that the risks are assessed with regard to other risks and other lines of business and a response is developed accordingly. Because the governance structure is enterprise-wide, risks that fall under one line of business but affect the whole company are appropriately considered at the corporate level. This linkage is a critical component of a transparent risk management strategy.

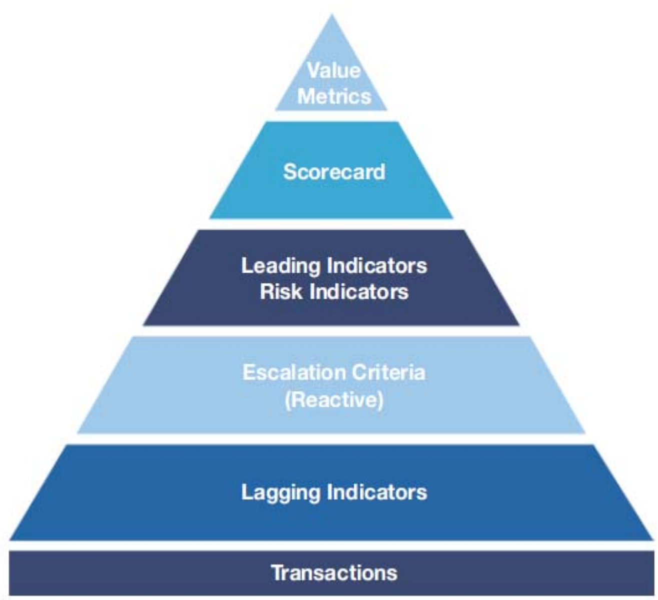
Accurate key risk indicators allow accurate risk measurement

Developing an effective risk response relies on accurate risk measurement. Key risk indicators (KRIs) are a baseline for effective risk measurement; yet for many mortgage companies, the KRIs and related tolerances/triggers are not assessed frequently enough to capture changes in the industry or environment. A comprehensive, ongoing program to review the relevance of KRIs (including data quality) and tolerances will help ensure adequate risk measurement.

Across the lines of business, there must be ownership of these risks and accountability for the numbers. For example, management should be expected to manage the risks identified by monitoring KRIs, not merely reporting the numbers.

As depicted in the diagram, several concurrent phases of risk management activity overlay business transactions:

- Lagging indicators, as the name suggests, are indicators that provide data only after the fact. Their usefulness arises when viewing trends over time, and they are a key input into future modeling and developing of the escalation criteria
- Escalation triggers drive the notification of increased risk throughout the management team and are reported to management after a specific trigger— determined by the risk governance oversight team— has been tripped. Vigilance regarding these criteria facilitates management intervention prior to a risk manifesting beyond an expected or acceptable tolerance or controls failing to effectively mitigate a risk
- The leading indicators can be collected at any time, for any period, and identify systemic issues or causal factors, in a tactical and proactive way. These indicators are reported and reviewed on a regular basis and can be available as requested to understand risks in a rapidly changing environment
- The scorecard provides management and any risk oversight structures with insight into current risk exposure, trends, and actions that need to be taken to remain consistent with the corporate ERM strategy
- The value metrics encompass both financial and non-financial measures that can help to demonstrate value creation for the investment community



Effective use of these KRIs requires developing procedures and processes to continually analyze and update the KRIs as the market or business strategy changes. However, while creating a mortgage risk management strategy that aligns with corporate ERM expectations is important, it is equally important to confirm KRIs are consistently tracked and monitored across lines of business.

For example, if one of the leading KRIs for the mortgage business is customer FICO score, with the score being refreshed on a quarterly basis to observe trends, the effect of declining FICOs may not be felt solely within the mortgage unit, but within credit card and auto finance units as well. Similarly, when looking at KRIs for operational or financial data, similar KRIs should use consistent periods (for instance, quarterly vs. monthly), calculations (such as actual vs. 30-day-average month) and data sources (such as general ledger vs. production data for certain measurements).

Successfully monitoring risk at the corporate level will take involvement from corporate to work with the lines of business and establishment of a consistent process for measuring, reporting, and monitoring KRIs. In some cases, for example when measuring delinquency rates, there may be different calculations or accounting policies associated with the KRIs. Continually reviewing the KRIs with regard to internal and external benchmarks will allow identification of variances in a timely fashion so the risk committee or other oversight governance structure can mitigate risks with the risk response plan.

A strong ERM platform will help position organizations for success

Focusing on the governance structure and KRIs are actionable steps that companies can take now to start developing a stronger and more adaptive enterprise risk management platform. A strong enterprise risk management platform will help mitigate risk, improve transparency of risk profiles across the organization, and position organizations for success.

The effective risk indicators, analysis, event modeling, and tolerances will help to demonstrate full comprehension of the risk profile at the line of business and enterprise levels. This will provide corporate risk managers with confidence that the lines of business are taking risks consistent with corporate policy. Senior management and the board will also have visibility into the risk management plan to be able to understand risk management procedures and provide top-level support for risk management decision-making.

ERM --- Key Drivers and Trends:

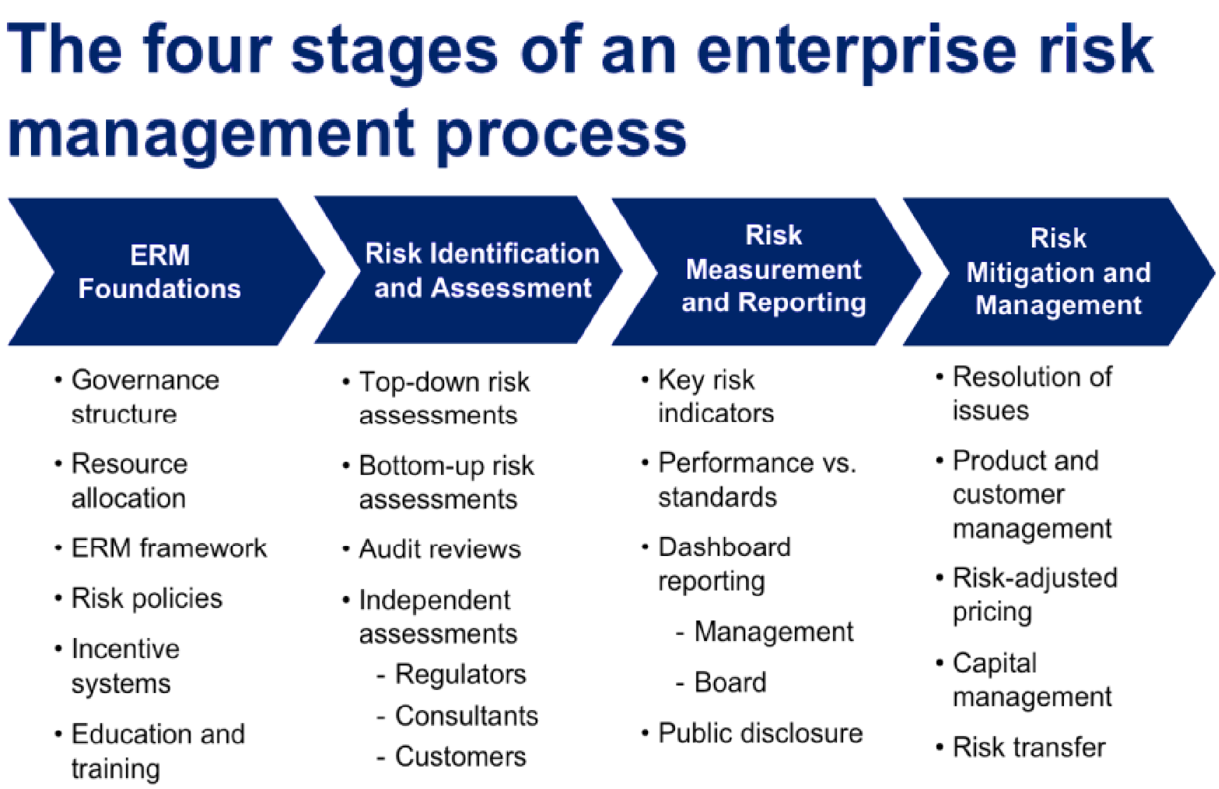
Why are companies adopting an ERM approach?

Currently, there are four key forces driving the growth in, and acceptance of, ERM:

- **Wake-up calls from corporate disasters.**
  More than ever, board members and corporate executives realize the consequences of ineffective risk management. Notable disasters include companies such as Enron and WorldCom, as well as industry-wide problems such as market-timing and late-trading in the mutual funds industry and bid-rigging in the insurance brokerage industry. In the aftermath of these corporate disasters, board members and executives realize that the only alternative to risk management is crisis management, which can do much more damage to a company's financial and reputational assets.
- **New stringent regulatory requirements.**
  In response to these events, regulators such as the SEC and the Federal Reserve have increased their examination and enforcement standards. The *Sarbanes-Oxley Act* requires enterprise-wide documentation and testing of controls over financial reporting. Amendments to the NYSE listing standards require audit committees to discuss risk monitoring and control activities with internal and external auditors. Basel II and Solvency II will establish a direct linkage between minimum regulatory capital and the underlying credit risk, market risk, and operational risk exposures of banks and insurance companies, respectively. In the new business environment, there are clear incentives for best-practice risk management, while wrongdoers face financial penalties as well as potential criminal charges and jail time.
- **Global initiatives on corporate governance and risk management.**
  A number of industry initiatives have been organized around the world to establish frameworks and standards for corporate governance and risk management. The *Treadway Report* (United States, 1992) produced the Committee of Sponsoring Organizations (COSO) framework of internal control, while the *Turnbull Report* (United Kingdom, 1999) and the *Dey Report* (Canada, 1994) developed similar guidelines. In September of 2004, the COSO *Enterprise Risk Management – Integrated Framework and Application Techniques* was published. This framework incorporates corporate governance and internal controls as part of an overall ERM structure. These industry initiatives have clearly established the role of the board and senior management in risk management.

- **Early ERM adopters are reporting tangible benefits.**
  Companies have reported significant benefits from their ERM programs, including stock price improvement, debt-rating upgrades, early warning of risks, loss reduction, and regulatory capital relief. As well, given the significant costs that companies have incurred to comply with Sarbanes-Oxley, there is an opportunity to convert this "compliance cost" into a "business benefit" by implementing an ERM program.

Benefit	Company	Actual Results
Shareholder value improvement	Global bank	Outperformed S&P 500 banks by 58%
Early warning of risks	Investment bank	Global risk limits cut by 1/3 prior to Russian crisis
Loss reduction	Asset management company	Loss-to-revenue ratio declined by 30%
Regulatory capital relief	Commercial bank	$1 billion regulatory capital relief
Insurance cost reduction	Manufacturing company	20-25% reduction in insurance premium



Role of Risk Management & Reporting in ERM

One of the key objectives of ERM is to promote risk transparency, both in terms of internal risk reporting and external public disclosure. Establishing a robust risk measurement and reporting system is therefore critical to ERM success. The old adage "what gets measured gets managed" holds true in risk management.

The above illustration shows how risk measurement and reporting fits into the overall ERM process. The implementation of ERM as a management process involves four stages:

Stage 1: ERM foundation setting

In the first stage, a company must establish a sound foundation for the overall ERM program. The board and senior management provide what is often referred to as "tone from the top." This includes developing the ERM framework, allocating sufficient resources, and engaging in risk policy discussions. The company's risk appetite is also clearly defined in risk policies and limits. Education and learning is another key component, which includes training programs and organizational processes that share best practices and lessons learned. To motivate desired behavior, incentive systems should incorporate risk management effectiveness and risk-adjusted profitability measurement.

Stage 2: Risk identification and assessment

An ERM process should integrate various risk assessments to develop a comprehensive inventory. Top down risk assessments of strategic and business risks can be gathered from the executive team through one-on-one interviews and/or facilitated group discussions. Bottom-up risk assessments of financial and operational risks can be developed through standardized templates or software applications. In addition, risk assessments from independent sources – auditors and regulators – should be incorporated into the overall inventory. Note that the information developed in this stage is largely subjective and qualitative in nature.

Stage 3: Risk measurement and reporting

In this stage, more objective and quantitative information is developed. This information includes key risk indicators (KRIs) for business risk, credit risk, market risk, and operational risk. To evaluate trends and levels, these KRIs are tracked against policy limits (e.g., market and credit risk exposure limits) or performance standards (e.g., tolerance for error rates or system downtime). External data should also be integrated to provide additional context for internal KRIs. External data can include interest rate trends, industry credit default rates, or competitive or industry benchmark data. Finally, risk reporting is provided to management and the board, as well as outside stakeholders through regulatory filings and public documents.

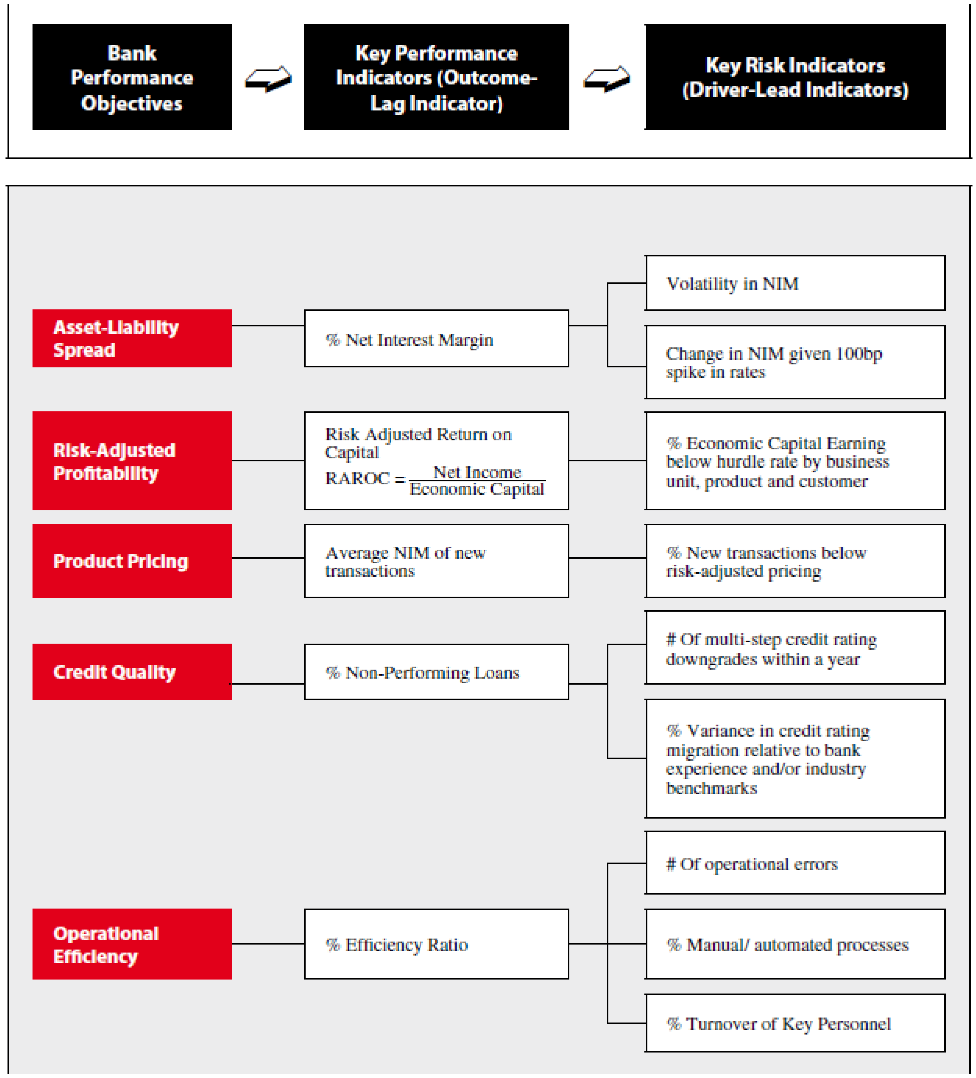
Stage 4: Risk mitigation and management

The most important stage of ERM is risk mitigation and management. This includes resolution of outstanding issues. Moreover, to be a value-added function, ERM must impact decisions that increase the risk-adjusted profitability of the company. ERM applications – including product pricing, customer management, business development, capital management, and risk transfer – integrate risk management and the key drivers of corporate performance. The overall objective is to make more informed business decisions based on risk management. These decisions may include reducing risk limits during stressed market conditions, implementing an exit strategy to minimize losses on a bad investment, or allocating more capital to grow a business with attractive risk-adjusted profitability.

These four stages of the ERM process should not be implemented in a sequential manner for the overall company. A sequential approach, in which a company spends the first year establishing the ERM foundation, the second year identifying and assessing risks, and so forth, is both unproductive and cumbersome. For example, some companies spend a year or more in conducting risk assessments before developing KRIs. In the meantime, the qualitative risk assessments cannot be validated with quantitative data, and the task of designing KRIs for hundreds of identified risks and processes is daunting.

Management should instead focus on the company's most critical risks and apply the overall ERM process to them. Another approach is to start with the end, and first determine the types of management decisions and actions that the ERM process must support. From there, management can work backwards and develop the appropriate KRIs and risk reporting, risk assessment processes, and ERM foundation.

Integration of Key Performance Indicators & Key Risk Indicators



Source/Reference:

1. **Rebuilding toward the future: A Consumer Finance view on managing risk PWC Consumer Finance Group**
2. **Emerging Best Practices in Developing Key Risk Indicators and ERM Reporting, An Executive White Paper by James Lam & Associate**

LESSON 28

ERM: DEVELOPMENT & IMPLEMENTATION OF "INTEGRATED APPROACHES" TO MEASURE AND MANAGE RISKS ACROSS THE ENTERPRISE (CONTD…)

Sources for KRI's:

The development of effective KRIs is a key challenge for most companies. Financial institutions usually have an abundance of credit risk and market risk indicators, but they are challenged in aggregating this data as well as developing operational risk indicators. On the other hand, non-financial institutions may have significant business and quality information, derived from balanced scorecard and quality initiatives, but they are challenged to develop KRIs for financial risk or technology risk. All companies face the challenge of developing leading indicators that can effectively provide early warnings of potential future losses.

While the development of effective KRIs is a significant challenge, there are some readily available sources from which KRIs can be derived.

These sources include:

- **Policies and regulations.**
  Regulations that govern the business activities of the company, as well as the corporate policies and limits established by management and the board, provide useful compliance KRIs. These KRIs may include risk exposures against limits or compliance with regulatory requirements and standards.
- **Strategies and objectives.**
  The corporate and business strategies established by senior management, and their associated performance metrics, are another good source. Note that performance metrics are designed to measure expected performance, whereas KRIs should be designed to measure downside risk or volatility of performance.
- **Previous losses and incidents.**
  Many companies have compiled loss/event databases that capture historical losses and incidents. These databases, or even anecdotic evidence, can provide useful input on what processes or events can cause financial or reputational loss. KRIs can then be developed for these processes and events.
- **Stakeholder requirements**.
  Beyond regulators, the expectations and requirements of other stakeholders – customers, rating agencies, stock analysts, business partners – can help in the development of KRIs based on variables that are important to these key groups.
- **Risk assessments**. Risk assessments performed by the company--including audit assessments, control self assessments, and Sarbanes-Oxley tests--can provide valuable input on the business entities, processes, or risks where KRIs are needed.
  Given the various sources for KRIs, the objective should be to develop a high-quality set of KRIs, rather than high quantity.

Ten key characteristics of effective KRIs:

1. Based on consistent methodologies and standards.
2. Incorporate risk drivers: exposure, probability, severity, and correlation e.g. VaR, Economic Capital.
3. Be quantifiable: PKR/$, %, or #.
4. Track in time series against standards or limits.
5. Tie to objectives, risk owners, and standard risk categories.
6. Balance of leading and lagging indicators.
7. Be useful in supporting management decisions and actions.
8. Can be benchmarked internally and externally.
9. Timely and cost effective.
10. Simplify risk, without being simplistic.

ERM Reporting --- Key Questions & Attributes:

Over time, a company may develop hundreds or even thousands of KRIs and risk assessments. Then the company faces a different challenge – the development of an effective ERM report. When designing the format and content of an ERM report, and the functionality of an ERM reporting system, it is important to start by looking at the five basic questions that an ERM reporting system should address:

1. **Are any of our business objectives at risk?**
2. **Are we in compliance with policies and regulations?**
3. **What risk incidents have been escalated?**
4. **What KRIs and trends require immediate attention?**
5. **What risk assessments need to be reviewed?**

For a typical company, it might take days, weeks, or even months to answer these questions on an enterprise-wide basis. The fundamental problem is that current approaches to risk reporting can be described as "risk measurement by silos," in which management is provided with static reports that provide risk information for different risks separately. Moreover, static reports require significant manual work, resulting in more data problems and less time for risk analysis and strategies.

With an effective ERM reporting system, management should be able to answer all five of these questions in fifteen minutes. An ERM reporting system should provide executive reporting of enterprise-wide risks and drilldown capabilities so that all key risks can be monitored simultaneously.

The key attributes of an ERM reporting system include:

- Provides a single point of access to all critical risk information that may reside in disparate risk systems and data sources.
- Combines executive reporting of enterprise-wide risks with drill-down capabilities to more detailed risk data.
- Delivers "just-in-time" risk information, from real-time risk alerts to monthly credit reports to quarterly risk assessments.
- Integrates quantitative KRIs, qualitative risk assessments, policy documents, and external market data.
- Allows users to provide commentary or analysis to the risk information presented by the ERM reporting system.

The following illustration provides a schematic of an ERM reporting system:

ERM Implementation – Avoiding Common Pitfalls

Early on, the key questions business executives asked about ERM began with *what*. What is enterprise risk management? What are emerging best practices? What are specific industry requirements? Today, the key questions begin with *how*. How to implement an ERM program? How to develop specific ERM tools? How to integrate ERM into business processes?

With respect to ERM implementation, there are five common pitfalls that companies should avoid. These pitfalls, and strategies to overcome them, are as follows:

- ***Don't let the regulatory tail wag the dog – ERM is about management, not simply compliance.***
  Companies face an influx of regulatory requirements that they must comply with, such as Sarbanes-Oxley for public traded companies, Basel II for banks, and Solvency II for insurance companies. However, compliance with these and other regulatory requirements represents a necessary but insufficient condition for success. Companies should go beyond compliance and leverage their ERM programs to realize tangible business benefits. For example, Basel II establishes bank regulatory capital requirements only for credit risk, market risk, and operational risk. In addition to these risk categories, leading companies also consider strategic risk and business risk in their capital management frameworks. A more comprehensive capital management framework would enable a company to improve profitability and shareholder value by making better risk-based product pricing, resource allocation, and business development decisions.
- ***Don't just integrate risks – break down organizational silos.***
  ERM is not just about integrating the key risks – strategic, business, credit, market, and operational – into a common framework. It is also about breaking down organizational silos in order to identify interdependencies and make trade-off decisions. Most companies have established oversight functions as part of their governance, risk, and compliance activities. These functions generally include risk management, audit, compliance, legal, treasury, and other oversight groups. Leading companies have broken down these silos by establishing organizational structures, processes, and incentives. These initiatives include establishing risk committees at the board and executive levels, appointing chief risk officers, and aligning the interests of individual oversight functions through common objectives, performance measurement, and incentives.
- ***Don't boil the ocean – focus the ERM process on what is most important.***
  Given the wide scope of ERM, many companies are overwhelmed with their risk identification, assessment, documentation, and reporting processes. The objective of ERM should not be to address all of the risks faced by the company. In fact, it would be impossible to identify *all* of the company's risks because that list is infinite. The objective of ERM should be to support decisions on the critical risks and opportunities for the board of directors, executive management, and business and operational units. An effective ERM program should prioritize risk information for the company's key decision makers. As such, an indication of ERM success is not to say "We have identified 720 risks across the company, and fully documented related controls and risk assessments," but to say "We have identified the major risks that require the attention of various management groups, and supported their decisions for these major risks." As an example, some companies find it useful to maintain a "top 10 risks" list for the company.
- ***Don't just tell me, show me – quantify risks through effective key risk indicators.***
  Many ERM programs produce large volumes of qualitative information (e.g., risk and control assessments, process maps, policies and procedures) that are not conducive to board and management decision making. In order to support policy and business decisions, critical risks must be quantified and reported in a concise and effective manner. That is not to say that quantitative information is more valuable than qualitative data, but there should be a balance in ERM reporting. For the company's most critical risks, quantitative analysis can be used to show trends, risk-adjusted metrics, compliance with policy limits, and performance against established standards. For the same risks, qualitative analysis can be used to provide expert risk assessments, alternative strategies and actions, management recommendations, and other contextual information.
- ***Don't produce volumes of data and reports – develop an ERM dashboard.***
  An ERM report should not be a 50-page report that takes the risk committee two hours to simply walk through. A common complaint from board members and senior executives is that they cannot see "the forest from the trees." Companies should develop an ERM dashboard that provides role

based information to key decision makers. During a board or management risk committee meeting, the ERM dashboard would enable board members and senior executives to first see high-level risk information. In addition, it would allow them to drilldown to more granular data if they want to see more details. An exciting possibility is to develop the ERM dashboard so that it not only provides dynamic access to risk information, but also to risk analytical models. As such, it would also enable board members and senior executives to perform real-time scenario analysis, such as "How would a 30% increase in cruel oil price impact our quarterly earnings, as well as market risk and credit risk exposures?"

An example of an ERM dashboard is given below.

Summary

In the past 10 years, technology applications were focused on risk *quantification* in terms of analytical models, such as asset/liability models, VaR models, credit default models, and so forth. Over the next 10 years, technology will focus on risk *communication* in terms of ERM reporting systems. An ERM reporting system will provide board members, corporate executives, and risk professionals with a single point of access to all critical risk information – including objectives-at-risk, early warning indicators, KRIs against policy limits or performance standards, risk assessments and audit findings, escalations of issues and incidents, and risk-adjusted return performance. The time interval for enterprise-wide risk measurement and reporting will move from monthly to weekly to daily and ultimately to real-time.

The value of risk information is not in its development, but in its application. As such, to realize the full potential of ERM, risk professionals must deliver the right information, to the right decision makers, at the right time.

Case Studies

The following case studies showcase real-life situations where ERM has provided significant and tangible benefits.

JP Morgan Chase

In 1994, JP Morgan Chase received an inexpensive lesson in the need to manage aggregate market risk exposures. Previously, the bank had focused its market risk oversight mainly on its trading businesses. In 1994, the Federal Reserve raised interest rates repeatedly, one result being a significant disruption in the mortgage markets. While the trading businesses performed well, the bank suffered an unexpected, albeit small, loss in a small S&L that it owned.

According to Leslie Daniels-Webster, chief market risk officer, the bank realized from this experience that it needed to manage aggregate market risk exposures across three dimensions – trading portfolios, asset/liability mismatch, and basis risk. The bank further developed its market risk staff and analytical resources, including VaR and stress testing models. This experience has served the bank well. In 1998, it weathered the Russian crisis, and it reported earnings of $4 billion (up 4.4 percent) while its peers suffered significant earnings declines due to market losses.

CIBC

In December 1994, the Toronto Stock Exchange published the *Dey Report,* which recommended that the board of every firm listed on the exchange take direct responsibility for risk management efforts within the firm, and report on these efforts in its annual report. At about the same time, CIBC was expanding globally in the capital markets business. So the Canadian bank had both regulatory and business reasons to invest in ERM. That same year, Bob Mark was hired to build an ERM program, including firm-wide market risk, operational risk, and counterparty credit risk.

The ERM initiative paid off four years later. In the middle of 1998, CIBC was concerned with three early warning indicators in the capital markets – widening credit spreads, increasing actual and implied volatility, and the breakdown of historical price relationships. The bank promptly cut global risk limits by one-third prior to the Russian crisis and market drop later that year, thus avoiding significant losses.

Heller Financial

On May 1, 1998, Heller Financial returned to the NewYork Stock Exchange as a public company. The commercial finance company aimed to be "world class" in its industry, and realized that it needed to establish an ERM program. While Heller was confident in its credit risk and market risk functions, it was missing a formal operational risk methodology and an overall ERM framework.

In September 1999, Mike Litwin, the company's chief credit officer (who was later promoted to chief risk officer) led the development of an operational risk methodology and ERM framework. A critical insight gained during this initiative was that nearly one-third of what Heller had classified as credit losses were in fact operational losses (e.g., inadequate loan documentation). The ERM program was well underway, and then on July 30, 2001, GE Capital announced that it was acquiring Heller for $5.3 billion in a cash transaction, a 48 percent premium. In its press announcement, GE Capital noted that Heller's risk management was one of the company's key assets.

Duke Energy

In July 2000, Duke Energy's senior executives gathered for a two-day strategy meeting to discuss the future of the energy business. They reviewed three possible scenarios:

"Economic Treadmill" in which U.S. economic growth slips to 1% per year, "Market.com" in which the Internet revolutionalizes the relationships between buyers and sellers, and "Flawed Competition" in which uneven deregulation will continue in the energy industry, resulting in significant price volatility.

To help manage the company's business uncertainty, Duke Energy appointed Richard Osborne as its first CRO earlier that year. As early warning indicators for these three scenarios, management established specific "signposts," including macroeconomic indicators, regulatory trends, technology changes, environmental issues, competitive moves and patterns of consolidation in the energy industry. Today, Duke Energy has performed well relative to its competitors. As of November 2004, the company achieved year-over-year revenue growth of 41percent, compared to 11percent for the industry. The company's stock has increased 45percent in one year, outperforming the S&P 500 by 28 percent.

Rockwell Collins

In July 2001, Rockwell Collins went public. Following the events of 9/11, the supplier of military and commercial aircraft parts faced hundreds of millions in lost sales and the collapse of its commercial market. Yet the company responded quickly and put in place a contingency plan within 10 days. Management credits its ERM program in terms of its preparedness and resiliency.

The company's ERM program had an interesting start. Several years earlier, project manager John-Paul Besong applied ERM to support the implementation of a critical SAP system. The project went so smoothly that he was promoted to chief information officer a short time later. Since that time, ERM has been integrated into other business processes of the company. The results have been impressive. For the company's fiscal year ending September 2004, it reported record sales of $2.9 billion (up 15 percent) and net income of $301 million (up 17 percent). In January 2004, Forbes called Rockwell Collins the best-managed aerospace company in America.

Source/Reference:

1. **Emerging Best Practices in Developing Key Risk Indicators and ERM Reporting**
2. **An Executive White Paper by James Lam & Associates**

LESSON 29

RISK APPETITE: HOW HUNGRY ARE YOU?

Regulatory pressures, such as Basel II and a greater focus on corporate governance, have been a stimulus for many changes in the industry – one of these has been the recognition of the need to articulate risk appetite more clearly. On the face of it, this may seem easy to do. After all, is it not simply a combination of an institution's desired credit rating, regulatory capital structure and the relevant solvency needs which set the ability of the institution to withstand shocks and therefore represent its risk appetite? For some smaller firms this approach may well be enough, but for others risk appetite is a more complicated affair at the heart of risk management strategy and indeed the business strategy.

Defined well, risk appetite translates risk metrics and methods into business decisions, reporting and day-to-day business discussions. It sets the boundaries which form a dynamic link between strategy, target setting and risk management.

Risk appetite is of course in the eye of the beholder (if the reader will excuse a mixed metaphor!). Different parts of the organization and external stakeholders have different perspectives. Equity investors' appetite for risk will differ from that of the rating agencies. Equity investors want to see a return; rating agencies want to minimize risk of default. The regulator's perspective differs from management's which differs from that of customers, employees, bondholders etc. Consequently, articulating risk appetite is a complex task which requires the balancing of many views. Some elements can be quantified but ultimately it is a question of judgment. All too often many parties take false comfort from purely quantitative risk measures which, if they were actually attained, would in practice result in huge reputational damage and job losses for the CEO and the chief risk officer (CRO).

In a corporate context, what do we mean by risk appetite?

At its simplest, risk appetite can be defined as the amount of risk, on a broad level, that an organization is willing to take on in pursuit of value. Or, in other words, the total impact of risk an organization is prepared to accept in the pursuit of its strategic objectives.

Risk appetite therefore goes to the heart of how a company does business. How an organization wishes to be perceived by key stakeholders such as shareholders, employees, regulators, rating agencies and customers is a function of that company's risk appetite.

The amount of risk an organization accepts will vary from organization to organization depending on circumstances unique to each. Factors such as the external environment, people, business systems and policies will all influence an organization's risk appetite.

Just as organizational risk appetites vary, so too can risk appetites vary across business units and risk types. For example a bank's appetite for risk in mature lending activities may be quite different from its appetite for risk in an emerging business.

From another perspective, we have seen that smaller losses incurred as a consequence of fraudulent activity can have a more adverse impact on a bank's reputation than much larger lending losses incurred in the normal course of business. Consequently, financial institutions often set a much lower risk appetite for fraudulent or unethical activity which could damage reputation.

Organizations use different ways to measure risk, ranging from simple qualitative measures such as defining risk categories and setting target levels around these, to developing complex quantitative models of economic capital and earnings volatility.

Whichever approach is adopted, risk appetite, if properly articulated, should provide a cornerstone for the organization's risk management framework.

Benefits to the Organization and the CRO

There are considerable benefits in taking the time to articulate risk appetite properly. If a financial institution (or indeed any corporate) has arrived at a crisp definition of its risk appetite it will have achieved:

- Clarity over the risks that the organization wishes to assume;
- The basis for consistent communication to different stakeholders; and
- Explicit articulation of the attitudes to risk of the senior management.

As CROs play a fuller role at board level1, initiating a risk appetite discussion can be an ideal way to engage senior colleagues and the board on risk issues and strategy.

In our experience, a top-down approach is usually the best way to begin to tackle the problem of defining risk appetite. A top-down approach makes the requirements of the various external stakeholders explicit and stimulates debate in the executive team. The process can also be used to engage board and non-executive directors on the subject. The result is a robust framework that can be used to articulate appetite throughout the group and to external stakeholders.

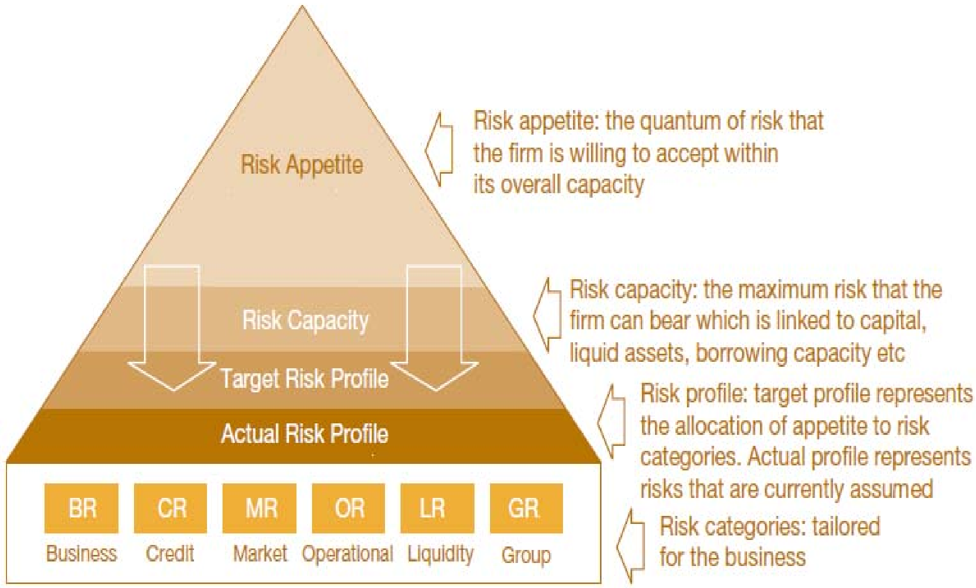
Following figure conveys an overall approach which involves assessing risk appetite from different stakeholder perspectives and risk types. The top down view of risk appetite leads typically into an assessment of the desired risk profile and an action plan to achieve it.

PricewaterhouseCoopers has developed a number of tools and concepts to help clients cut through the complexities of this multi-dimensional problem. For example, we have found it helpful to introduce the concept of risk capacity. An organization's risk capacity is the maximum amount of risk that it can assume. This is an important concept because risk appetite must be set at a level within the capacity limit. Capacity needs to be considered before appetite. Stakeholder views will differ on the desired safety margin and it is crucial to understand this in setting and understanding appetite. It is also necessary to assess other factors such as the potential impact of a risk incident, as well as the ability of the organization to control the activity and the market's perception of the 'fit' with the institution's other activities. These qualitative factors, when combined with risk capacity and risk measures, enable a balanced appetite to be articulated and monitored.

A top-down approach works better than a detailed bottom-up assessment. The reason for this is that it is really the only way to bring in the views of external stakeholders and to create a proactive statement of what management believes its risk appetite should be. In our experience, bottom-up approaches tend to endorse the status quo and the existing risk profile. They do not take the thinking forward. The result is often a passive description of risk appetite today rather than a proactive view of where management wants to take the organization. Another benefit of the top-down approach is that it ensures that senior management are 'on the same page' on risk appetite. This may require more investment at the start but it pays dividends by making subsequent roll-out much easier.

At one client the first appointee to the newly created role of CRO has used risk appetite discussions to engage the business unit heads in defining the links between risk and strategy. This is the first time that risk has been considered as an integral part of the business agenda. Previously risk was treated primarily as a compliance issue to be monitored by internal audit.

Approach to Risk Appetite



What does it look like?

A well-defined risk appetite should have the following characteristics:

- ✓ Reflective of strategy, including organizational objectives, business plans, and stakeholder expectations.
- ✓ Reflective of all key aspects of the business (B/Model).
- ✓ Acknowledges a willingness and capacity to take on risk.
- ✓ Is documented as a formal risk appetite statement.
- ✓ Considers the skills, resources and technology required to manage and monitor risk exposures in the context of risk appetite.
- ✓ Is inclusive of a tolerance for loss or negative events that can be reasonably quantified.
- ✓ Is periodically reviewed and reconsidered with reference to evolving industry and market conditions.
- ✓ Has been approved by the Board.

In order to ensure effective monitoring and governance, the risk appetite will incorporate a balanced mix of both quantitative and qualitative measures. Quantitative measures may include financial targets (e.g. capital adequacy, target debt rating, earnings volatility, credit or other external ratings). Qualitative measures may refer to reputational impact, management effort and regulatory compliance.

These qualitative aspects of risk appetite are more difficult to quantify. However, organizations that choose to measure risk more precisely are modeling these risks to determine their risk appetite on a quantified basis.

Once an organization's risk appetite is defined, the challenge is to implement robust governance and reporting framework that ensures day-to-day decisions are made in line with the organization's risk appetite.

In analyzing the risk appetite statements of our client organizations, the following measures were found to be the most commonly used: earnings volatility (80 percent); economic capital requirements (60 percent); reputation (60 percent); external credit/debt ratings (40 percent) and regulatory standing (40 percent).

Following figure provides an example of how an organization may rate its Risk Appetite across major risk types:

	Willingness to accept risk				
	Low		Medium		High
	1	2	3	4	5
Earnings volatility					
Capital requirements					
Reputation					
Credit ratings					
Regulatory standing					

How does Risk Appetite fit into the Risk Management Framework?

Framework element	Linkage to risk appetite
Risk governance	Clear risk appetite statement approved by board and embodied in risk policy and delegated authorities. This sets the 'tone from the top' and a foundation for the risk culture.
Risk assessment	Frequent risk assessment process to identify new and changing risk landscape in context of risk appetite.
Risk quantification and aggregation	Regular quantification and aggregation of risk to prioritize focus of risk management and control.
Monitoring and reporting	Monitoring and reporting of performance against risk based limits based on risk appetite.
Risk and control optimization	Framework of controls calibrated in line with risk appetite to optimize cost/benefit.

Risk culture

Remember various stages of ERM Process (Lecture # 27)?

Risk, Return and Reputation

It is also important to look at other aspects of risk. For example, it is essential to discuss risk in the context of a company's desired levels of return and growth. At corporate level in a quoted company this might involve a Total Shareholder Return (TSR) target.

Many companies set targets for these and publicize them – usually in terms of outperforming a peer group. If we turn this around and look at it from the risk perspective, it could be interpreted that management wishes to outperform its peers in assuming risk! We have yet to see a company set risk-adjusted TSR targets.

If management, however, is clear about its risk appetite and develops a core competence in risk management it should, everything else being equal, be able to deliver superior returns to its shareholders. Similar arguments apply to unquoted companies such as mutual institutions and cooperative banks. By building a risk management competence, returns to members should improve.

Hunger for returns without a defined appetite for risk can lead to disaster. Many apparent risk management failures have been caused by profits being chased and risks being assumed that were poorly understood. Often management makes the mistake of focusing on the appetite of one group of stakeholders without giving sufficient weight to the appetites of others.

Experience shows that reputation can be damaged even if the firm survives. Sometimes severe reputational damage can be caused by an incident in one part of the group leading to contagion and damage elsewhere. This can be particularly acute in financial institutions which require the trust of their depositors or policyholders to remain solvent. Without a top-down perspective, such risks can be missed.

It is essential to take a multi-dimensional and balanced view of risk appetite and periodically to refresh it. Admittedly this can be difficult, as it is often very hard for management to be objective about how others see the institution.

Risk Appetite and Culture

One of the more interesting internal challenges in financial services organizations, which often tend to be risk averse and conservative, is to ensure that business unit management is assuming sufficient risk!

Retail banks in mature markets must rise to this challenge as they strive to find new growth opportunities. Incumbent management teams, who are often very good at maintaining the existing machine, find they need new skills to tune up the engine and go faster. Without a change in risk appetite, these companies can find themselves underperforming in terms of returns.

Culture, strategy, and competitive position all influence risk appetite. Different firms will have different tolerances for different risk types. Furthermore, within a firm, appetite should differ between business units. A bank's appetite for credit risk in consumer lending might be quite different to its appetite for market risk in its investment banking operation. Management's appetite for risk will differ in a start-up operation in a new market compared to maintaining an established business in a mature market – and so on.

A major benefit of defining risk appetite is that it forces the debate and helps ensure that risks are made explicit. To change behaviors in relation to risk, interventions through additional training or changing personnel may be needed, but in most organizations the tone set by senior management tends to have by far the greatest impact.

The Role of Economic Capital

From a group perspective, risk appetite is an important input to determining economic capital which, in turn, influences overall capital requirements. Economic capital usually has a key role to play in the quantification of risk and in embedding risk appetite in the operational infrastructure of the business. These methodologies give business management a tool to quantify risk and to understand much better the relationship between risk and return.

There are justifiable concerns, however, about relying entirely on bottom-up economic capital models. Management needs a top-down view as a cross-check. For example, the problems encountered measuring diversification benefits or determining capital requirements for 'difficult to quantify' risks such as strategic risk mean that bottom-up views may not reflect the true position. Indeed many companies face major difficulties in quantifying the capital associated with operational risk.

A top-down view of risk appetite informs a top-down view of capital requirements. The imminent arrival of Pillar 2 means that some banks are developing such a view for the first time. Without a clear position, an institution is likely to be at a disadvantage with its supervisor.

'Difficult to Quantify' Risks

Naturally enough, if some elements of risk appetite cannot be measured they could be more difficult to manage. Examples might include business risk or reputational risk. Arguably these are the risks that can benefit most from being articulated more clearly, even if it is in qualitative terms. Nevertheless, quantitative techniques are improving all the time.

The implication for management is clear: identify the risks that the organization faces, measure them and articulate the appetite for them. This needs to be done in a comprehensive and balanced way where quantitative measures are combined with qualitative measures, as well as those for which the institution may have zero tolerance. These three key components of a group-level risk appetite definition are shown in Figure 2.

Figure 2: Risk appetite

Quantitative measures	• Hard measures of risk • Describe the type and quantum of risk the business wants to and is willing to take • Relate directly to business plans and risk measurement processes • E.g. appetite for earnings volatility
Qualitative measures	• Recognise that not all risk is measurable but can affect business performance • E.g. appetite for business activities outside core competencies
Zero tolerance risks	• A subset of the above - identify the categories of risk we wish to avoid • E.g. appetite for regulatory mis-compliance

Linking Risk Appetite to the Business

To embed risk appetite effectively in the business requires management to establish limits for each risk type and cascade them to lower levels in the organization. Establishing a clearer statement of risk appetite has important consequences in terms of management information and performance management requirements. There are also likely to be implications for risk assessment, measurement and reporting. New management information may be required to monitor risks and the consumption of appetite across a group. In some cases, this will involve new cuts on existing data; in others it will require new information feeds (which could be as straightforward as monitoring certain risk concentrations on a group-wide basis). In most cases, it will require harmonization of existing limit structures and clarification of roles and responsibilities.

A critical issue is to gather sufficient leading indicator data that allows management to take pre-emptive action before appetite is exceeded or limits are breached. It is of little value to report passively at the end of the month that appetite has been exceeded. It is of greater value to take preventive action. Provided the information is available, management will have a range of options to choose from. These might include risk transfer (for example, the use of derivatives and swaps); unwinding of positions; deceleration of growth etc. Furthermore, risk information needs to be interpreted dynamically. As credit risk exposures increase, appetite for market risk may decrease. The degree of flexibility granted to particular managers to adjust the dials on the risk management dashboard, however, will clearly depend on the firm's risk governance approach.

Do you need to take action?

Ask yourself three questions to see if you need to take action:

- Has your senior team recently debated its view of the organization's risk appetite?
- Can you describe the appetites of all of your main stakeholder groups: supervisor, rating agencies, investors and customers?
- Can you populate Figure 2 with the key metrics and values for your organization?

If the answer to any of these questions is ‘no’, the chances are that your firm could benefit from re-defining its risk appetite.

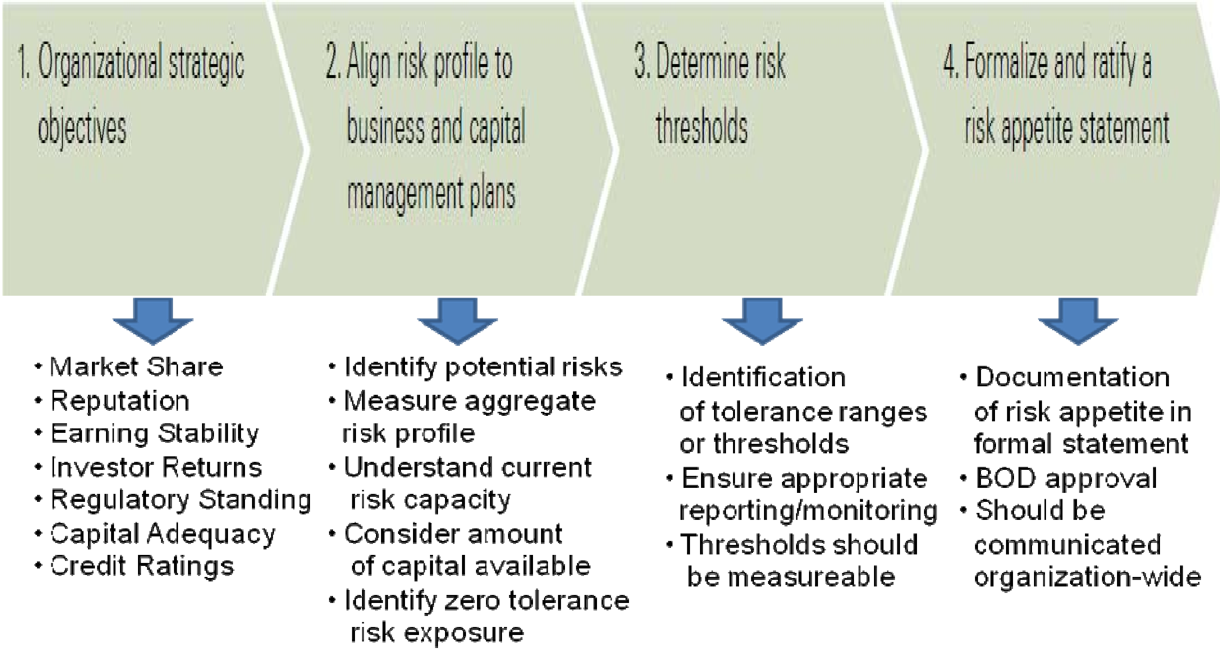
Risk is good but it needs to be understood. That understanding begins with the board and senior management. Risk appetite definition is often the first step to deepening and broadening that understanding and shaping risk management strategy.

Source/Reference:

1. **Risk Appetite --- How Hungry are you? By, Richard Barfield, Pricewaterhousecooper, The Journal, Special Risk Management Edition**
2. **Understanding and Articulating Risk Appetite, KPMG**

LESSON 30

A STRUCTURED APPROACH TO ESTABLISHING A RISK APPETITE STATEMENT



1. Organizational strategic objectives may include:

- Market share
- Reputation
- Earning stability/growth
- Investor returns
- Regulatory standing
- Capital adequacy/external credit ratings.

A key component of understanding organizational objectives is to understand the drivers of these objectives (e.g. the key stakeholders and, more specifically, their expectations).

Depending on the nature of the organization key stakeholders may include shareholders, board of directors, management, employees, regulators, etc. Expectations of these groups may differ significantly but often include maintaining business growth, profitability and earnings stability, ensuring regulatory compliance, being an employer of choice and a good corporate citizen.

Objectives are driven by a combination of short term return expectations of stakeholders such as profitability, and longer term corporate targets such as debt rating and growth.

As the strategy of the organization changes, its appetite for risk must be revisited to confirm that it will support the achievement of its objectives.

For example, should an organization's growth targets double, the organization's risk appetite would need to be reconsidered to reflect the increased risk taking and capital requirements needed for such a target to be achieved.

An extension to an organization's strategic objectives is its business plan, which outlines how the business intends to meet its objectives and stakeholder expectations. Many companies within the financial services sector will also have comprehensive capital management plans outlining capital requirements for achieving strategic objectives. Both of these documents need to reflect and inform the risk appetite statement.

2. Align risk profile to business and capital management plans

The next step involves determining how much risk is currently being taken in the context of the organization's capacity to take risk (e.g. its current and planned capital and business position as expressed in the respective plans). To align the risk profile to the capital management/business plan an organization should undertake the following steps:

- Identify potential risks the organization is exposed to that may prevent achieving the organization's strategic objectives.
- Measure the aggregate risk profile and the level of unexpected losses that the organization is willing to accept in the event a risk eventuates.
- Understand the current risk taking capacity (e.g. the capital management plan and business plan and the degree to which these allow a buffer for future risks).
- Consider the amount of capital available (the buffer) between the risk taking capacity and the aggregate risk profile, including provision for unexpected losses. The risk appetite of the organization will determine the size of the buffer required. The organization has to strike a balance between its competing strategic objectives (e.g. availability of capital versus cost of capital). The strategic objectives, if clearly articulated, should provide a strong guideline for the level of anticipated risk appetite.
- Finally, identify zero tolerance risk exposures (e.g. compliance or safety breaches) for reputational purposes.

3. Determine risk thresholds

Having determined the capital available to withstand risks and the current level of risk exposure, the next step is the identification of tolerance ranges for specific risks (to ensure the appetite remains within the bounds of the capital management and/or business plan).

Risk thresholds, or risk tolerances, are the typical measures of risk used to monitor exposure compared with the stated risk appetite. In practice, they enable the high-level risk appetite to be broken down and communicated into measures that are actionable at the business unit level.

Developing risk thresholds helps to ensure that appropriate reporting and monitoring processes can be put in place for the effective management of these risks. As such, these thresholds should be clearly articulated and measurable.

4. Formalize and ratify a risk appetite statement

Finally the organization will need to formalize the results of the above process through the documentation of the organization's risk appetite in a formal risk appetite statement. The risk appetite statement should then be approved by the board prior to communicating the document to the wider organization.

Key Components of a Risk Appetite definition

Quantitative measures	• Hard measures of risk • Describe the type and quantum of risk the business wants to and is willing to take • Relate directly to business plans and risk measurement processes • E.g. appetite for earnings volatility
Qualitative measures	• Recognise that not all risk is measurable but can affect business performance • E.g. appetite for business activities outside core competencies
Zero tolerance risks	• A subset of the above - identify the categories of risk we wish to avoid • E.g. appetite for regulatory mis-compliance

Linking risk appetite to performance monitoring and reporting

As business strategy is linked to performance management, risk monitoring and reporting should be linked to risk appetite—as both contribute to the quality of business performance.

It is important that performance is assessed in terms of its compliance with the organization's risk appetite. Strong financial performance can often mask the risks that are actually being taken to achieve that performance. It is one thing to make risk/ reward trade-offs; it is another to understand exactly what they are.

Standard risk and incident reporting methodologies should be used to monitor breaches of risk appetite and tolerance levels. This monitoring and reporting is fundamental. Risk appetite loses its value if departures from it are not promptly identified and followed up on.

An effective risk appetite needs to be integrated into the enterprise-wide decision making process at all levels. Integration into robust governance and reporting framework should also include the development of policies and procedures, escalation/delegations of authority matrices and appropriate mitigation strategies in the event that tolerance limits are exceeded.

The other critical role of the risk appetite is the tone it sets for the risk culture across the organization. The importance of risk culture can never be underestimated. Most major contemporary examples of company fraud and financial failure over the past 20 years were related to instances of flawed or ambiguous risk cultures.

To reinforce risk culture, the organization's risk appetite should be integrated into the performance management framework at the individual level to ensure consistent application. At the company level risk appetite should be expressed through risk based performance targets measured against actual results. These may be set and managed at the business unit, sub-business unit, product, customer and/or transactional level. Similar measures should be included in the scorecards for individuals with accountability for the profit centers identified at the company level.

A clearly articulated risk philosophy and statement unlocks value

We (The KPMG) believe that there are significant advantages to include a well defined risk appetite statement within the formal governance documentation. The definition and articulation of risk appetite has a positive influence on organizational culture and behavior. It gives managers an improved understanding of what risk management means to their roles and helps them to apply effective risk management practices. Risk appetite is the foundation of an effective risk management system. In turn, such a system can generate the following business benefits.

Linking business decisions to business strategy

Understanding risk appetite helps the board and management teams to make better strategic and tactical decisions. It enhances understanding of board and stakeholder expectations and enables risk-reward decision making. It reduces the likelihood of unpleasant surprises.

Encouraging consistent behaviors

Our research strongly suggests that the effective communication of risk appetite sharpens the overall risk management effort. Internal communication of risk appetite provides the business with a clear mandate for the amount and type of risk to accept and manage and the risks to avoid. It facilitates a more considered risk taking culture in which decisions about taking on risks reflect the capacity to manage those risks. External communication of risk appetite assists in shaping realistic expectations on the part of investors and other external stakeholders and promotes transparency and accountability.

Increasing the capacity to take on risk

The ability to take on risk is determined by more than just a capacity to absorb losses. The ability to manage risks based on skill sets and experience, systems, controls and infrastructure is also crucial. Understanding risk appetite helps an organization in the efficient allocation of risk management resources across a risk portfolio, and may enable the pursuit of business opportunities that, without an understanding of the appetite, would otherwise be rejected. Furthermore, a clearly defined risk appetite takes much of the guesswork out of putting limits on new business.

Developing sharper, more intelligent risk reporting

Reporting frameworks are more sensitive to risk tolerance levels allowing more meaningful early warning indicators and risk limits.

Providing the value of actually doing it

The process of putting together a risk appetite statement has provided immediate benefits to many organizations.

- **How banks in Pakistan addressing issues of Risk Appetite/ERM?**

- **ARMI study on Asian Banks**

Economic Capital is the amount of capital estimated by the bank's management that is required to cover and protect the shareholder from potential economic losses (unexpected negative changes in economic value) within a given confidence level, over a given time horizon, consistent with a certain target or standard (such as a debt rating or solvency standard).

- ***Economic capital*** provides management with a standardized unit, a Rupee of economic capital, for comparing and discussing opportunities and threats.
- ***Economic capital*** numbers can also be multiplied by an institution's equity hurdle rate (the minimum acceptable rate of return on equity) to offer a 'cost of risk' number that is comparable to other kinds of bank expense.
- ***Economic capital*** differs from both regulatory and accounting capital.
- It focuses directly on risk as perceived and measured by the firm bearing the risk.
- It is not based on accounting measures, funding strategy, or balance-sheet composition.
- It is based on holding enough equity-like claims to meet the chance of loss due to the risks the firm assumes.
- Regardless of accounting or regulatory definitions, economic capital serves to underpin all the actual risks borne by the firm.
- Think of it as the "true" capital required for running the business.

What's wrong with Regulatory Capital?

To get a better grasp on the concept of ***economic capital,*** we can look at what it is ***not***. Start by considering the three main flaws of ***regulatory capital***:

✓ It is one-size-fits-all, inflexible, and rules-based.
✓ It does not consider a bank's unique strengths, positions, and niches.
✓ It does not account for the shareholders' perceptions of and tolerance for risk.

Relative to regulatory capital, an ***economic capital*** process:

✓ Creates a **standard, consistent measure** across the organization (can use it to compare different types of risk)
✓ Reflects the **economic realities** of the business (measures the **true risks**)
✓ Focuses on changes in **true, fair-market, economic value** (**not earnings** or any other accounting-based measure)

- ✓ Covers **all forms of risk** (credit, market and operational, but should cover other forms as well)
- ✓ Relates strictly to a **corporate goal or standard** (such as target debt rating or comfort level)
- ✓ Is **forward looking**, with a standard time horizon and a confidence level
- ✓ Has a **high degree of accuracy** (**tailored** to the bank's unique risk profile and goals)

The Key Distinctions Between Regulatory Capital and Economic Capital

	Regulatory Capital	**Economic Capital**
Process and Environment	Political / Government	Market Sector / Individual Bank
Based on	Rules	Discretion
Presumption	Minimum capital is required to protect banks from failure, thus the banking system from systemic risk	Bank holds capital to protect shareholders against excess volatility of returns, as well as bank failure.
From Risk Perspective of	Regulators	Shareholders
Balance sheet focus	Accounting assets, risk weighted	Every economic asset and liability (on- and off-balance sheet), based on market values
Risk Focus	Systemic risk / externalities Overall capital Composition of capital instruments	Firm risk / Private risk Overall volatility
Risk scope	Market, Credit, Operational	All risks, or at least those quantifiable
Risk management scope	Identification, Measurement, and Control	Identification and Measurement
Risk Drivers	Accounting data, "worst-case" parameters	Market data, actual performance
Risk concept	Limited – Risk as defined by regulators	Unlimited – Every real economic risk
Value concept	Low, weak Focus on accounting asset "valuation"	High, strong Focus on true, economic value
Approach / Driver	Risk-weighted assets Particularly accounting "value"	Volatility of returns, i.e., changes in pure economic value
Consistency of model and results with business purpose	Low – Little connection to concept of shareholder value	High – Designed to align with goal of maximizing shareholder value, subject to desired risk level

Consistency across business units	Low / Partial	High / Complete
Angle	Bottom-Up	Top-Down and bottom-up, reconciled
Benchmark or standard used across all risks	Determined by national regulators (*i.e.*, 99.9%)	Determined by institution (*e.g.*, confidence level consistent with target debt rating or solvency standard)
Level of prescription	High	Low
Flexibility / Dynamism / Adaptability *(Freedom to innovate, design, calculate, & revise your approaches, models, parameters)*	Low Many parameters are prescribed, especially for credit and market risk	High All parameters are flexible
Consistency across banks	High – "cookie cutter"	Low – customized, tailored
Bias	Compliance	Risk Measurement, Allocation
Relative magnitude	Expected for most banks to be higher than economic capital	Expected for most banks to be lower than regulatory capital
Quality / clarity of disclosure	Low, less meaningful, due to one-size-fits-all	Potentially high – bank can customize its disclosures, tailor them to each audience
Usability	Low. For compliance	High. Can be used for 1) performance measurement, 2) budgeting, 3) planning, 4) allocation, 5) pricing, *etc.*
Satisfies "Best Practices" (e.g., RMA)	No	Yes

Source/Reference:

1. **Understanding and Articulating Risk Appetite**
2. **KPMG Advisory Services**

LESSON 31

ERM AT ASIAN BANKS FROM CHALLENGES TO STRATEGIES A STUDY BY ASIA RISK MANAGEMENT INSTITUTE (ARMI)

Bank executives and board members in Asia, with lessons learned from the 1997 Asian Crisis still fresh on their minds, are now facing unprecedented business opportunities and risk management challenges. On the one hand, economic growth rates are strong, foreign direct investments are high, and future business prospects are indeed bright.

On the other hand, Asian banks operate in more volatile financial markets, and they are undergoing significant structural changes with respect to deregulation, privatization, and consolidation. Moreover, Asian banks face complex organizational and technical challenges in meeting new regulatory requirements from their central banks and the Basel II framework.

Asian Banking Context

Risk management at Asian banks should be discussed in the context of the overall business and regulatory environment. While risk management practices and issues vary significantly across different countries and individual banks, the ARMI Research Team has identified several common themes.
These themes include:

Economic and Financial Uncertainties

Relative to banks in Europe and North America, banks in Asia face higher economic and financial uncertainties. The ARMI Research Team analyzed the historical volatility of key economic and financial indicators, and found that volatilities in gross national income, housing prices, equity prices, and foreign exchange (FX) rates are higher at Asian countries. For example, over the past ten years annualized equity price volatility was 17.9% in the US and 18.6% in the UK. In comparison, equity price volatility in Asian countries ranged from 22.7% in China to 30.9% in Thailand. Moreover, despite balance sheet restructuring and government bailouts, Asian banks still have higher non-performing loan (NPL) levels.

Banking Reforms and Structural Changes

In the aftermath of the 1997 Asian Crisis, the Asian banking industry is undergoing dramatic structural changes. These changes include:

- **a.** recapitalization of troubled banks – hardest hit were Indonesia and Thailand, where bank recapitalization exceeded 50% of GDP,
- **b.** strategic investments by foreign institutions – for example between 2001 and 2005 foreign banks invested about US$20.9 billion in Chinese banks, with US$17.6 billion invested in 2005 alone, and
- **c.** rapid consolidation as Asian banks attempt to increase scale and competitiveness – in Indonesia, for example, the number of banks fell from a peak of 240 in the mid 1990s to 133 at the end of 2004.

Asian banks also face increased foreign competition as competitive barriers are removed to conform to requirements for entering the World Trade Organization (WTO). Ownership structure is also changing as banks privatize from government to private ownership.

Significant Gaps in Risk Management Capabilities

Banks in Europe and North America are relatively confident in their capabilities for credit risk, market risk, and asset-liability management (ALM) since they have made significant improvements over the past decade. Their key risk management challenges include Basel II compliance, operational risk, and enterprise risk management (ERM). In comparison, most Asian banks need to improve all of their risk management capabilities, yet they lack critical human, data, and modeling resources. When asked to conduct a self-assessment against the ERM Maturity Model, CROs in China, Indonesia, Malaysia, and Thailand rated their banks at Stage 1 or 2 (out of a scale of 1-5, with 5 being the most advanced). These CROs estimated that it will take 5-10 years for their banks to catch up to current international standards in risk management. CROs in Singapore rated their banks at Stage 2 or 3, and estimated that it will take 3-5 years to reach international standards.

New Regulatory Requirements

Bank regulators in Asia are establishing new standards for risk and capital management, including financial examination and reporting requirements. In preparation for Basel II, most banks in Asia have established program management offices (PMOs) to address the complex data and modeling requirements. However, as shown in the following exhibit, the Basel II timetables vary significantly across Asian countries, with Singapore and Hong Kong being ahead of the other countries. As a group, they lag behind top tier banks in the EU and US. Moreover, publicly-traded banks in Asia must deal with SOX-based financial controls documentation and testing standards, as well as stock exchange corporate governance and listing requirements.

Basel II Implementation Schedule for Top Tier Banks

	2007	2008	2009	2010	2011	2012
Singapore	★★	★★★ ★★				★★★
Hong Kong	★★ ★★	★★★				
Malaysia		★ ★		★★		
Thailand		★★ ★★	★★★			
Indonesia		★ ★		★★		
China		★ ★	★★ ★★			★★★ ★★★
US		★★★ ★★★				
EU	★★ ★★	★★★ ★★★				
KEY	Credit Risk Operational Risk	*★ Standardised* *★ Basic Indicator*	*★★ Foundation IRB* *★★ Standardised*	*★★★ Advanced IRB* *★★★ AMA*		

Business and Competitive Mandates

Asian bankers recognize that risk management must go beyond regulatory compliance, and create business value through better risk-based pricing, risk limit systems, portfolio management techniques, and capital management decisions. Additionally, key stakeholders such as institutional investors, rating agencies, and business partners will increasingly demand enhanced risk disclosure. The risk professionals who participated in this research study noted that they have seen a significant increase in attention to risk management from key stakeholders such as strategic investors and rating agencies. They also face pressure from senior management to create business value through improved risk management.

Research Methodology

Most research surveys focus on describing the current state of risk management practices at banks across the globe or within a specific region. In contrast, this research project was focused on providing in-depth analysis of key risk management challenges at Asian banks, as well as formulating practical recommendations to address these challenges. As such, the research methodology was designed to be both descriptive in terms of specific risk management issues and prescriptive in terms of specific recommendations.

The research was conducted between March 2006 and September 2006, and consisted of a comprehensive review of existing research studies and surveys, an analysis of bank regulatory requirements, and on-site interviews with over 30 risk management professionals across China, Indonesia, Malaysia, Singapore, and Thailand. These five countries were selected because the ARMI Research Team determined that they provide a good representation of the range of risk management practices across Asian banks. The banks ranged from US$3 billion to over US$85 billion in assets. The risk management professionals interviewed included chief risk officers and their direct reports. In an effort to facilitate candid and honest discussions, the ARMI Research Team agreed to the requests by the banks to remain anonymous.

In addition, the ARMI Research Team conducted dozens of interviews, by phone and in person, with bank regulators, directors, consultants, and other analysts with in-depth knowledge of Asian bank risk management issues.

The Business Case for Enterprise Risk Management

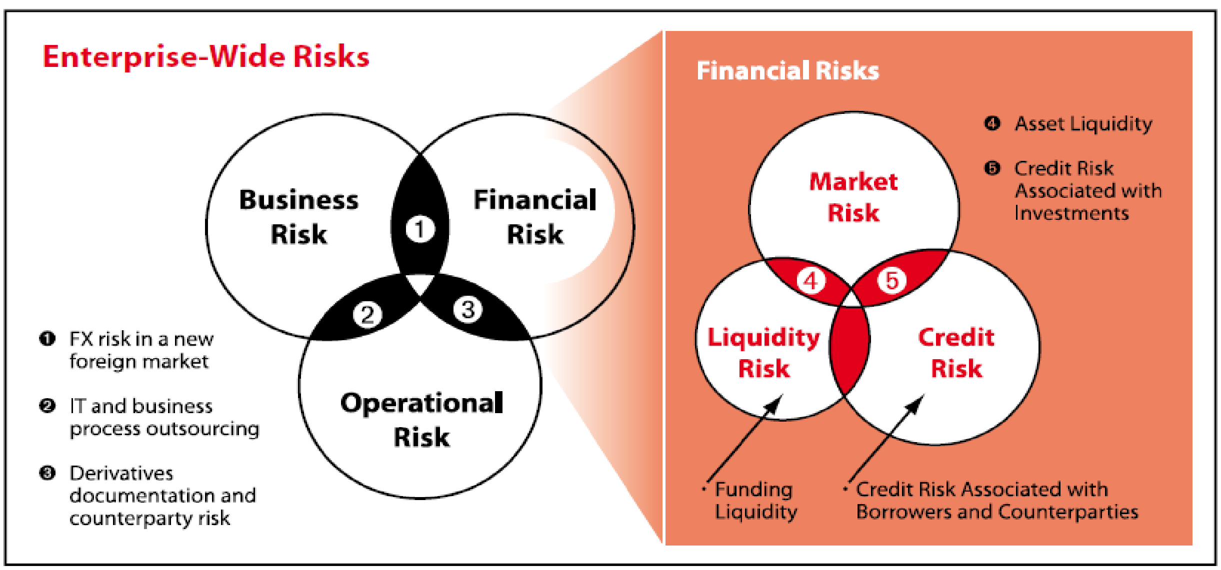
Why should Asian banks adopt an ERM program? While most risk professionals interviewed said that they are planning to implement an ERM program, others felt that they are "not ready" for ERM as they should first develop core capabilities in market risk, credit risk, and operational risk. However, ERM should not be viewed only as the integration layer for the bank's risk management processes. Rather, ERM should be viewed holistically as the overall risk management process, inclusive of core capabilities in market risk, credit risk, and operational risk.

A strong business case can be made that all banks should adopt an ERM program regardless of their level of sophistication in risk management. There are three key reasons why Asian banks should adopt ERM without delay:

1. Banks face complex risks that are highly interdependent, and an ERM framework enables a bank to manage all major risks and their interdependencies.
2. An ERM framework provides the overall architecture for a bank's risk management program.
3. Empirical research and industry surveys have indicated that there are clear business benefits for adopting an ERM program.

Risk Interdependencies

The key risks faced by banks are highly interdependent (the exhibit below illustrates examples of such independencies). In the past, banks managed different risks through separate organizational units, an approach known as "managing risk by silos". Over time, banks realized that there are important relationships between these risks. For example, inadequate documentation for loans or derivatives (an operational risk) would likely result in higher loss severities in the event of default (a credit risk). Today, banks and bank regulators have adopted ERM as a global standard for effective risk management.



Overall Risk Architecture

An ERM framework provides the overall architecture for a bank's risk management processes. As such, it is valuable to establish an integrated ERM framework for a bank to identify critical gaps and improvement opportunities. Key components of an ERM framework include:

- **Corporate governance** to ensure that the board of directors and management have established the appropriate organizational processes and corporate controls to measure and manage risk across the bank;
- **Line management** to integrate risk management into the revenue generating activities of the bank, including business development, product and relationship management, pricing and so on;

- **Portfolio management** to aggregate risk exposures, incorporate diversification effects and monitor risk concentrations against established risk limits;
- **Risk transfer** to mitigate risk exposures that are deemed too high, or are more cost effective to transfer out to a third party than to hold in the bank's risk portfolio;
- **Risk modeling** to provide the risk measurement, analysis, and reporting tools to quantify the bank's risk exposures as well as track external variables;
- **Data and technology** resources to provide the data management and systems capabilities; and
- **Stakeholder management** to communicate and report the bank's risk information to its key stakeholders, such as investors, rating agencies, and regulators.

ERM Benefits

There is a growing body of research and survey data that would indicate effective ERM practices lead to significant business benefits. Notable studies include:

- The Conference Board and Mercer Oliver Wyman (2005)5 conducted an ERM survey among 271 executives at global companies with over US $1 billion in sales. The survey found that 91% of the respondents were either positively disposed toward or have adopted ERM. While only 11% have fully implemented their ERM programs, they reported significant benefits – 86% cited better informed business decisions, 83% cited greater consensus on key risks, and 79% cited increased management accountability.
- Cheng and Wu (2005) at Institutional Shareholder Services (ISS) examined the correlation between the ISS' Corporate Governance Quotient ratings and 16 financial performance metrics for more than 5,200 U.S. companies in the 2002-2004 period. They found that companies with better corporate governance have lower risk, better profitability and higher valuation. For example, they found that the top decile companies performed significantly better than the bottom decile companies, including 3-to-10% versus negative return on assets; 8-to-15% versus 0.3% return on equity; and 16-to-20% versus 10-to-15% stock price to earnings ratio.
- McKinsey and Company (2000)7 surveyed over 200 institutional investors in 22 different countries with a combined US$3.25 trillion in assets under management. They found that the large majority of investors were willing to pay a premium for companies with effective corporate governance practices. For example, in the U.S. 84% of investors were willing to pay an average premium of 18.3%.

Following exhibit shows the tangible and significant benefits reported by early ERM adopters (Also shown in lecture # 27)

Benefit	Company	Actual Results
Shareholder value improvement	Global bank	Outperformed S&P 500 banks by 58%
Early warning of risks	Investment bank	Global risk limits cut by 1/3 prior to Russian crisis
Loss reduction	Asset management company	Loss-to-revenue ratio declined by 30%
Regulatory capital relief	Commercial bank	$1 billion regulatory capital relief
Insurance cost reduction	Manufacturing company	20-25% reduction in insurance premium

Source/Reference:

Enterprise Risk Management at Asian Banks from Challenges to Strategies an Executive White Paper by James Lam, Senior Advisor, Asia Risk Management Institute (ARMI)

LESSON 32

ERM AT ASIAN BANKS FROM CHALLENGES TO STRATEGIES A STUDY BY ASIA RISK MANAGEMENT INSTITUTE (ARMI) (CONTD…)

The ARMI Research Team identified five key challenges faced by Asian banks with respect to their risk management programs, as well as 15 specific recommendations for addressing these challenges.

People and Skills

There is a critical shortage of risk management talent in Asia. Every banker who participated in this research project has indicated that their number one issue is the ability to hire and retain risk management professionals with the appropriate experience and skills.

For example, the Chief Risk Officer of an Indonesian bank obtained a headcount budget increase from 8 to 32 in February 2006. By August 2006, only 11 out of the 24 new positions were filled due to a shortage of qualified candidates. For Asian banks, the most critical shortage seems to be with senior-level experienced hires.

To address this overall issue, Asian Banks should implement the following strategies:

1. Hire a Risk Expert

For Asian banks, hiring a world-class risk expert can make a significant difference to overall risk performance. While an effective ERM program requires a team of qualified risk professionals, it is essential that Asian banks first hire a risk expert. Asian banks should:

- Engage an executive search firm to hire a risk expert as CRO, board member, or senior advisor to the bank. The risk expert should have practical ERM experience, as well as deep credit risk, market risk, and operational risk management skills. In addition to strong risk management skills, the risk expert should understand local business customs and the culture of the bank.
- Clearly define the role and expectations for the risk expert. Otherwise, organisational issues may prevent the risk expert from being effective. For example, one of the "big four" banks in China hired two risk experts – one as a board member and the other as a risk executive. In less than two years, both experts resigned after experiences that bank officials described as "difficult".
- Engage and empower the risk expert in key risk management decisions, such as developing the appropriate ERM framework and policies, hiring other qualified risk professionals, and acquiring the necessary data and technology solutions. At one bank in China, the ARMI Research Team noted that a risk expert seconded from a foreign bank made a significant contribution to the development of that bank's risk management capabilities.

2. Establish a Training and Certification Program

Training and certification programs in risk management provide a long-term solution to the development of human capital. The ARMI Research Team discussed this approach with senior officials at Bank Indonesia, which in August 2005 made it compulsory for all bank managers, executives, and board members to go through a formal training and certification program. To ensure that the appropriate risk management skills are developed at all levels of the organization, Asian banks should:

- Enroll risk management staff in training and certification programs offered by the professional associations. These programs are generally focused on financial markets and products, credit risk, market risk, actuary methods, and risk modeling skills.
- Provide customized in-house training for board members and senior corporate and business unit executives. These programs should be designed to review practical business applications of risk management.
- Apply advanced learning technologies, such as e-learning and video-conferencing, to provide cost-effective training to a larger group of bank employees.

3. Increase Compensation of Risk Personnel

In order to retain talented risk professionals, as well as attract business executives onto the risk management career track, the compensation levels for risk professionals must be attractive. The ARMI Research Team noted that the salary levels for risk professionals at European and North American banks have increased significantly over the past decade, and thus narrowing the compensation gap between line managers and risk managers. As such, it is not unusual to find senior loan officers, traders, and even CFOs who had moved into risk management positions. Asian banks should:

- Conduct a salary survey to ensure that the bank's compensation packages for risk professionals are competitive from both a regional and global perspective.
- Increase compensation levels for all risk professionals so that compensation packages are attractive.
- Link performance incentives for risk professionals to specific milestones in developing the bank's risk management infrastructure, as well as to improvements in key risk indicators.

4. Conduct Industry Benchmarking Exercises

A common practice among European and North American banks is industry benchmarking, whereby risk professionals from different banks interact and learn about each other's risk management practices. These benchmarking exercises are often facilitated by consultants, professional associations or organized through industry contacts. Participants in benchmarking exercises benefit from lessons learned and best practices of other banks.

The ARMI Research Team noted that industry benchmarking is not a common practice among Asian banks today. Asian banks should:

- Conduct international benchmarking exercises through global risk management associations and/or international banking contacts.
- Participate in, or help set up, Asia-based risk management associations that would organize and facilitate regional benchmarking exercises.
- Capture and distribute the benchmarking data so lessons learned and best practices can be shared across the bank.

Change Management

Risk management means different things to different people. A key objective for ERM is to establish a common framework. Asian banks should incorporate change management strategies as part of their ERM programs to ensure that key risk management policies and processes are fully adopted by the organization.
These strategies include:

5. Set the Tone at the Top

Any enterprise-wide initiative requires the support from senior management in order to be successful. The "tone at the top" should be set not only through words, but actions. Asian banks should:

- Provide sufficient human capital and budgetary resources to support the development of ERM and other risk management capabilities.
- Communicate the board and management's commitment to establishing an effective risk management program. Specifically, risk management should be one of the "top 5" corporate priorities.
- Ensure that board members and senior executives play an active role in risk management, especially in the development of risk policies and limits, recruiting senior risk staff, and formulating risk management strategies.

6. Develop the Business Case

The business case for ERM provides the business and economic rationale for the initiative. For most Asian Banks, risk management is still viewed as a compliance function as opposed to a value-added function. CROs interviewed by the ARMI Research Team see this as one of their key challenges.

In order to develop the business case for ERM, Asian banks should:

- Conduct a formal cost-benefit analysis for ERM, including specific cost estimates for the ERM program and expected benefits. Key benefits may include regulatory and policy compliance, improved risk reporting, reduction in losses and incidents, and improved debt rating and shareholder value.
- Develop risk management applications that would benefit business units directly, such as risk-based product pricing, customer relationship management, and early detection and resolution of operational issues.

- Monitor the realized benefits from the ERM program against the expected benefits. While some of the benefits of ERM are not quantifiable (e.g., enhanced risk awareness), the bank should nonetheless consider these benefits as part of its overall evaluation.

7. Revise performance measurement and incentives.

A critical component of the change management program is to ensure that performance measurement and incentives are aligned with ERM goals and desired behavior. Asian banks should:

- Incorporate specific milestones into performance measurement and incentives in the early stages of ERM. Performance criteria may include the development of an ERM framework, completion of a training and certification program, and the implementation of a board level risk report.
- Reinforce business unit cooperation through their incentive programs. Performance criteria may include participation in bank-wide risk assessment and reporting initiatives, or timely resolution of outstanding issues or policy exceptions.
- Link incentive programs with risk-adjusted profitability as the bank's ERM program becomes more advanced. Performance criteria may include risk-adjusted return on capital (RAROC), net income after capital charge (NIACC), and shareholder value added (SVA).

Data and Modeling

What gets measured gets managed! Asian banks lack critical data resources and risk models for risk quantification, including the regulatory capital calculations required by the Basel II framework. While the Asian banks interviewed by the ARMI Research Team have conducted gap analyses and developed plans for Basel II, they lack data and modeling resources to implement such plans. Asian banks should implement the following strategies to enhance their data and modeling capabilities:

8. Establish Country or Regional Data Bureaus

Asian banks lack risk data because they previously did not have specific risk or business applications that would utilize such data. In addition, disparate systems and manual processes prevalent at Asian banks hinder the systematic collection of such data. Moreover, in order to have sufficient and meaningful data for modeling purposes, many years of data (at least 3-5 years) must be collected. It would be extremely difficult for any individual Asian bank to address these issues independently.

Therefore, Asian banks should:

- Organize, perhaps with the assistance from central banks and risk associations, country or regional data bureaus. The purpose of these data bureaus is to create a critical mass of quality risk data that can be shared by bank participants. The costs, benefits, and "ground rules" for participating banks should be clearly defined at the onset.
- Collect credit risk data through the data bureau as an early initiative in order to support probability of default (PD) and loss given default (LGD) calculations needed for credit risk capital calculations. This would be critical for Basel II compliance, as well as internal credit risk management processes.
- Collect operational risk data (e.g., losses, events) and market risk data (e.g., valuations and VaR calculations by instrument) once the data bureau concept is proven and accepted.

9. Apply Industry Benchmarks

Even if data bureaus are organized by Asian banks as suggested above, it will take years before useful data can be developed. Meanwhile, Asian banks should:

- Apply industry benchmarks or proxies. For credit risk, internal credit ratings should be mapped to public debt ratings (e.g., Moody's or S&P ratings) so that bond default, loss severity, and rating migration data can be utilized. Such data, or similar databases, should be adjusted for country-specific and bank-specific characteristics.
- Leverage the industry benchmarks to develop and test risk models, as well as prototype management and board risk reporting. As a conservative measure, Asian banks may also consider applying a "surcharge" or gross-up factor to external data until internal data is made available.

10. Acquire Vendor-Based Models

Nearly all of the Asian banks interviewed by the ARMI Research Team; use internally-developed Excel-based analytical models for risk quantification. These models are generally less sophisticated and less reliable than vendor models that are commercially available. A corollary issue is that the risk management staff spends too much time on maintaining these risk models, and not enough time interpreting the results or developing risk management strategies. Other than those with simple risk profiles and basic modeling requirements, Asian banks should:

- Acquire vendor-based models for risk measurement applications that are well established, such as ALM, market risk, and credit risk modeling.
- Only develop specific risk management models that would give the bank a competitive advantage, such as proprietary trading models or valuation models.

Reporting and Disclosure

A key tenet of sound risk management is risk transparency, both in terms of internal risk reporting as well as external disclosure. The availability, quality, and timeliness of useful risk information need significant improvements at Asian banks. Currently, a typical Asian bank would provide monthly risk reporting to management and quarterly risk reporting to the board. However, due to data and systems constraints, these reports lack timeliness and usefulness. To enhance the effectiveness of risk reporting, Asian banks should implement the following strategies:

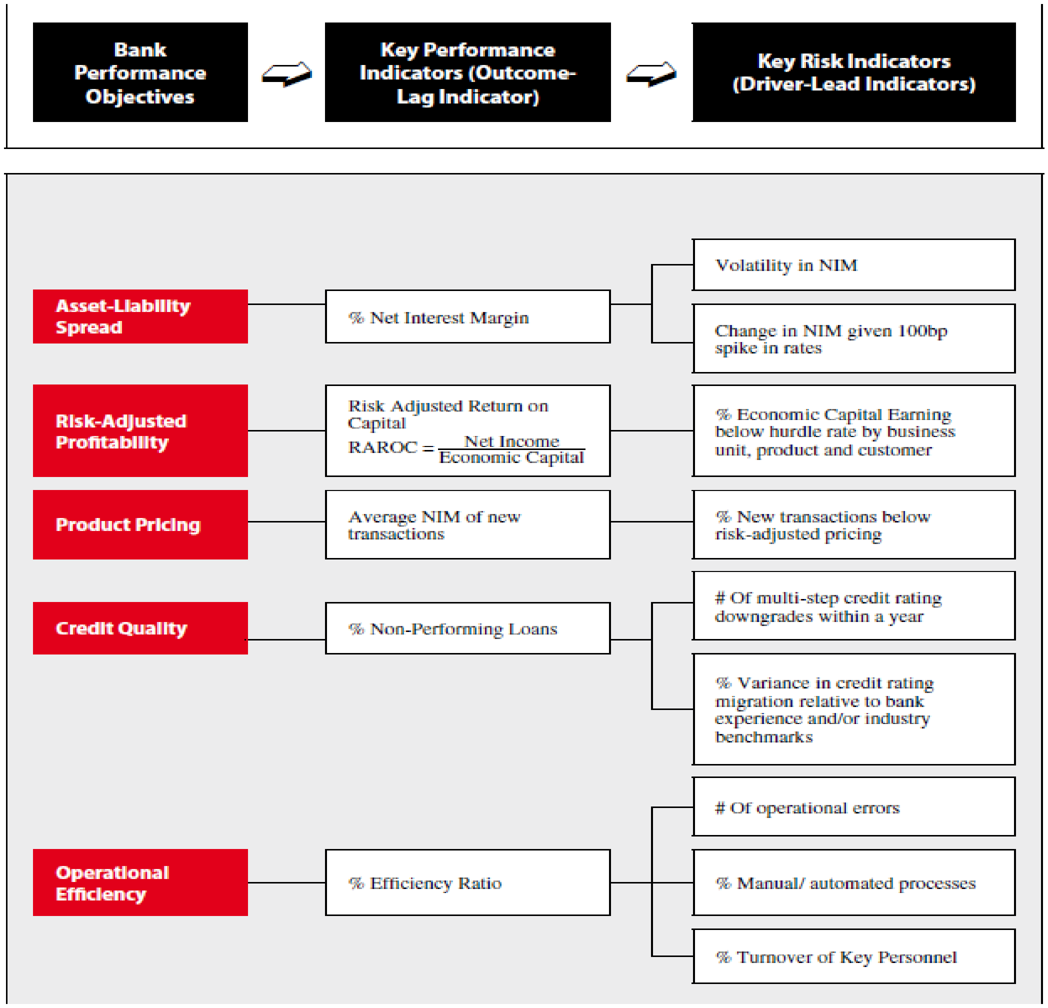
11. Integrate Key Performance and Risk Indicators

Key performance indicators (KPIs) are designed to measure and track the primary success factors for a bank, such as profitability, credit quality, and operational efficiency. On the other hand, key risk indicators (KRIs) are designed to measure the business variables and risk factors that may prevent the bank from achieving its objectives. From a management perspective, they are both important and one can argue that they are two sides of the same coin.

To enhance risk reporting, Asian banks should:

Develop and report on KPIs and KRIs on an integrated basis. The combined reporting of KPIs and KRIs provides significantly more value and insights than if KPIs and KRIs are reported separately (Appendix below provides examples of the integration of KPIs and KRIs for bank profitability, pricing, credit quality, and operational efficiency).

This chart was also discussed in lecture # 27



- Develop risk-based performance indicators such as risk-adjusted return on capital (RAROC), net income after capital charge (NIACC), and shareholder value added (SVA).
- Establish "early warning indicators" for performance and risk indicators to enable the board and management to anticipate potential changes to the bank's risk-return profile.

12. Develop Dashboard Reporting

As more performance and risk information are made available, Asian banks should develop dashboard reporting to enhance the delivery of such information to key decision makers. To support executive and board decision making, dashboard reporting combines quantitative data (e.g., KPIs and KRIs), qualitative data (e.g., risk assessments and audit issues), external market data (e.g., interest rates, economic data), and management strategies and alternatives. In other words, the purpose of dashboard reporting is to enhance the "risk intelligence" of the bank. Asian banks should:

- Design a paper-based dashboard report as a means to organizing existing data and identify data gaps, as well as function as a prototype for an electronic dashboard system.
- Develop an electronic dashboard reporting system to automate the development and delivery of role-based risk information, including drill-down analysis. As such, the first generation of the dashboard system will provide web-based dynamic access to performance and risk data.
- Incorporate modeling capabilities to the dashboard system so that the board and management can ask "what if" questions or test specific business scenarios on a real-time enterprise-wide basis. As such, the second generation of the dashboard system will also provide access to performance and risk modeling capabilities.

13. Enhance Disclosure and Risk Transparency

The development of internal risk reporting is not enough, Asian banks should also enhance risk disclosure and transparency to outside stakeholders, including regulators, stock analysts, and rating agencies. To enhance disclosure and risk transparency, Asian banks should:

- Incorporate more risk management information into annual reports and other disclosure documents. The ARMI Research Team analyzed the annual reports of publicly-traded global banks, and noted that there is a direct relationship between the quality of risk management and the quality of disclosure. For example, the number of pages devoted to risk management in JP Morgan Chase's annual report increased from 12 pages in 1998 to 24 pages in 2005, a period in which the global bank made significant improvements in its highly-regarded ERM program. In contrast, Asian banks only devoted between 3 to 8 pages to risk management in their 2005 annual reports.
- Evolve earnings disclosure from earnings variance analysis (ex-post analysis of actual versus expected earnings) to earnings guidance or forecast (ex-ante analysis of projected future earnings) to earnings-at-risk analysis (ex-ante analysis of key drivers of future earnings volatility). For Asian banks with superior risk management, improved risk transparency should lead to improved investor relations, and even improved stock valuation and debt rating as a result of lower "risk premiums".

Strategy and Execution

The key question on risk management is not what, but how. Asian bankers are generally aware of what is the gap between their risk management capabilities against industry best practices. They are uncertain as to how to develop and execute the appropriate strategies to close that gap. Asian banks should implement the following strategies to enhance the strategy development and execution of their ERM programs:

14. Develop an ERM Roadmap

One of the most important success factors in the implementation of an ERM program is to develop a clear long-term plan. The ERM roadmap should include a clear vision of the "goal state" of risk management at the bank, as well as specific milestones ("what"), dates ("when"), and accountabilities ("by whom"). It should also include resource requirements, change management plans, and measures of success for the ERM program. Asian banks should:

- Establish an ERM roadmap and ensure consensus among bank directors, executives, and business unit managers.
- Conduct quarterly performance reviews in terms of progress against specific milestones and measures of success.
- Conduct annual reviews on the ERM roadmap to ensure that it continues to be appropriate for the bank.

15. Focus on the "Low Hanging Fruits"

In the implementation plan for the ERM program, Asian banks should focus on "low hanging fruits" or initiatives that will provide the most immediate and tangible value relative to cost and effort. For example, in operational risk management, a short-term achievable goal may be establishing a loss-event database, whereas conducting bank-wide risk assessments would require much more time and resources. Successful implementation of ERM requires a balance between quick wins and long-term initiatives. As such, Asian banks should:

- Identify "low hanging fruits" in the early stages of ERM, and allocate appropriate resources to successfully implement such initiatives.
- Document and communicate these early wins to maintain momentum for the ERM program, as well as demonstrate the tangible benefits that the bank can derive from improved risk management practices.

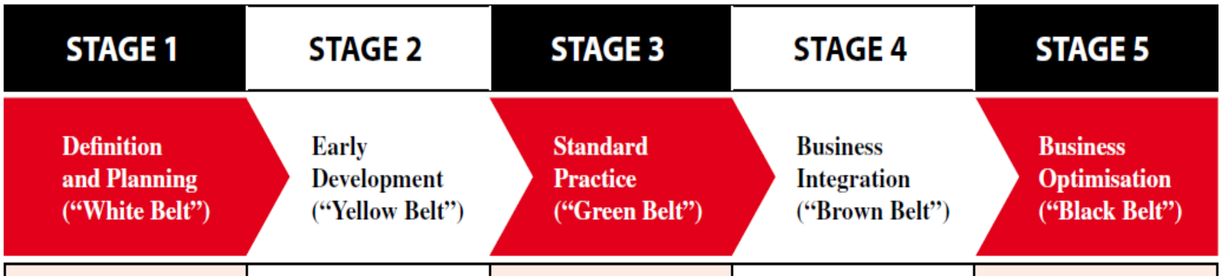
A Call to Action

As part of this research initiative, the ARMI Research Team has identified 15 specific recommendations for the key risk management challenges faced by Asian Banks. Collectively, these recommendations represent a "call to action" to improve risk management at Asian banks.

However, Asian banks should not attempt to implement all of these 15 recommendations at once. Rather, they should implement those recommendations that are most logical and value-added relative to their stage of development in risk management.

Asian banks can use the ERM Maturity Model to conduct a self-assessment of their stage of development. While the specific requirements for each bank are unique, the ARMI Research Team would suggest the following approach to prioritizing the implementation of the 15 recommendations:

The ERM Maturity Model
For Asian Banks



A Call for Action:

Asian banks can use the ERM Maturity Model to conduct a self-assessment of their stage of development. While the specific requirements for each bank are unique, the ARMI Research Team would suggest the following approach to prioritizing the implementation of the 15 recommendations:

Stage 1
Definition and Planning (White Belt):
Banks at this stage are in the initial phase of scoping and planning for ERM.
Key initiatives should include:

- Hire a risk expert (Recommendation #1)
- Establish a training and certification program (#2)
- Conduct industry benchmarking exercises (#4)
- Set the tone at the top (#5)
- Develop the business case (#6)
- Develop an ERM roadmap (#14)

Stage 2
Early Development (Yellow Belt):
Banks at this stage are in the early development phase of ERM.
Key initiatives should include:

- Increase compensation of risk personnel (#3)
- Establish country or regional data bureaus (#8)
- Focus on the "low hanging fruits (#15)

Stage 3
Standard Practice (Green Belt):
Banks at this stage are focused on developing KRIs and reporting.
Key initiatives should include:

- Revise performance measure and incentives (#7)
- Apply industry benchmarks (#9)
- Acquire vendor-based risk models (#10)
- Integrate key performance and risk indicators (#11)

Stage 4
Business Integration (Brown Belt)
Banks at this stage are focused on integrating ERM into business processes.

Key initiatives should include:

- Develop dashboard reporting (#12)

Stage 5
Business Optimization (Black Belt)

Banks at this stage are applying ERM to optimize business performance.
Key initiatives should include:

- Enhance disclosure and risk transparency (#13)

Summary

Indeed, it is the best and worst of times for banks in Asia. On the one hand, the Asian banking systems are being transformed and modernized at a rapid pace. As a result of these changes and high economic growth, Asian banks face unprecedented business and profit opportunities. On the other hand, they must improve risk management to ensure long-term success and survival. However, they face significant challenges in people and skills, change management, data and modeling, reporting and disclosure, as well as strategy and execution.

These risk management challenges are not insurmountable. As part of this research effort, the ARMI Research Team has identified 15 practical recommendations to address these challenges. We hope that the research and recommendations contained in this white paper will lead to more in-depth discussions, and more importantly, specific actions on the part of Asian banks. Only through improved risk management can Asian banks be assured that the future will in fact bring the best of times.

STAGE 1	STAGE 2	STAGE 3	STAGE 4	STAGE 5
Definition and Planning ("White Belt")	**Early Development ("Yellow Belt")**	**Standard Practice ("Green Belt")**	**Business Integration ("Brown Belt")**	**Business Optimisation ("Black Belt")**
• Researching regulatory requirements and industry practices • Appointing a chief risk officer and/or ERM project leader • Organising an ERM task force and/or ERM committee • Conducting a benchmarking exercise with other companies • Providing risk education for senior executives • Defining the scope for ERM (including credit, market, and operational risks) and developing an overall ERM plan • Establishing an ERM framework, including a risk taxonomy	• Establishing an ERM Policy, including roles and responsibilities • Performing annual control self-assessments across business units • Integrating risk identification processes across risk management, audit, compliance, and other oversight activities • Providing risk education for the board of directors, as well as risk training for a wider group of employees • Establishing risk functions across the business units	• Developing risk measurement models and databases • Developing KRIs and reporting on enterprise-wide risks on a monthly basis • Integrating credit risk and market risk models, and building operational risk models • Developing risk-adjusted performance measurement methodologies • Updating control self assessments on a quarterly or monthly basis	• Expanding the scope of ERM to include business risk (and possibly reputational risk) • Allocating economic capital to underlying market, credit, operational, and business risks • Incorporating the cost of risk into product and relationship pricing, as well as portfolio management and risk transfer strategies • Integrating risk reviews into business development and product approval processes • Automating ERM reporting from monthly reports to electronic dashboards, including customised queries and real-time escalations	• Expanding the scope of ERM to include strategic risk • Integrating ERM into strategic planning processes • Maximising shareholder value by actively allocating organisational resources at the "efficient frontier" • Providing risk transparency to key stakeholders – regulators, investors, rating agencies – with respect to current risk exposures and future risk drivers • Leveraging risk management skills, tools, and information to deepen customer relationships by helping them manage their risks

Source/Reference:

Enterprise Risk Management at Asian Banks From Challenges to Strategies an Executive White Paper by James Lam, Senior Advisor, Asia Risk Management Institute (ARMI)

LESSON 33

SERVICE MANAGEMENT BREAKING THE TRADE-OFF BETWEEN EFFICIENCY AND SERVICE

Note of Acknowledgement:
This lecture is based on an article by Professor Frances X. Frei published in HBR.
Frances X. Frei is an Associate Professor of Business Administration in the Technology and Operations Management (TOM) unit at the Harvard Business School. At HBS, Professor Frei has developed a second year elective on Managing Service Operations, which focuses on tools and frameworks to drive performance for service firms and service aspects of product firms.

Components of Value Proposition in Service Industry

Quality	Timeliness	Reliability	Cooperativeness	Communication
▪Accuracy ▪Clarity ▪Meaningfulness ▪Relevancy ▪Completeness	▪On-Time Delivery ▪Solution Speed ▪Short Cycle Time	▪Consistency ▪Promises Kept ▪Creditability ▪Trust worthiness ▪Problem Solving Ability ▪Service Longevity & Reputation	▪Responsiveness ▪Flexibility ▪Customer Sensitivity ▪Courtesy ▪Ability to Diffuse Anger ▪Compensation Authority	▪Sympathetic Listening ▪Feed Forward Information ▪Handling Emergencies ▪Easy to Contact ▪Non-Verbal Skills ▪Making Customer Feel Important

Service businesses struggle with a reality that is foreign to manufacturers: Customers "interfere" with their operations. To deliver consistent quality at sustainable cost, companies must learn to manage that involvement.

What if a manufacturer had to deal with customers waltzing around its shop floor? What if they showed up, intermittently and unannounced and proceeded to muck up the manufacturers carefully designed processes left and right? For most service businesses, that's business as usual. In a restaurant or a rental car agency or most of the other service companies that make up the bulk of mature economies today, customers aren't simply the open wallets at the end of an efficient supply chain. They're directly involved in ongoing operations. The fact that they introduce tremendous variability – but complain about any lack of consistency – is an everyday reality.

Dealing with that variability is a central challenge in making a service offering profitable. But little in managers' conventional training or tool kits equips them to deal with it effectively. Operations management theory, rooted in the manufacturing context, typically has only one thing to say about variability: It must be eliminated. Any educated manager learns to recognize it as the enemy of quality.

In the service context, the challenge is far more subtle. First, it wouldn't be wise to drive out all variability; customers judge the quality of their experience in large part by how much of the variability they introduce is accommodated, not how sternly it is denied. Second, it wouldn't be possible to do so. While manufacturers have virtually complete control over the cost and quality of their production inputs, service companies face this one, huge exception: Their customers are themselves key inputs to the production process. That form of input is, by its nature, capricious, emotional, and adamantly disinterested in the company's profit agenda. My (The Author) research over the past several years has been aimed at helping service organizations overcome the challenge of customer-introduced variability. I've studied a wide variety of service companies, some of which prospered while others experienced escalating costs in the face of eroding customer satisfaction. The framework that has emerged from that study can help managers make better decisions about how and how much to reduce or accommodate the variability customers introduce.

As the stories in the following pages make clear, there are multiple ways to combat the effects of any type of variability, and the best solution is not always immediately apparent. But by using a systematic process to diagnose problems and design and fine tune interventions, managers can reduce the impact of variability and enhance the competitiveness of their service.

Five Types of Variability

The first step in managing the variability introduced by customers is to understand the forms it can take. Customers introduce variability to operations in no fewer than five ways, so it is critical to sort out which type is causing mischief before designing interventions.

Arrival Variability

The first type of variability that creates challenges for service companies is an obvious one: Customers do not all want service at the same time or at times necessarily convenient for the company. Many a grocery store manager has bemoaned shoppers' inability to space their transactions such that checkout clerks remain busy and lines do not form at the registers. The classic way to address arrival variability is to require appointments or reservations, but that makes sense only in certain situations. In many service environments, such as retail stores, call centers, or emergency rooms, the customers themselves cannot foresee or delay their needs. The resulting inefficiencies have inspired a large body of work in what's known as queuing theory and many solutions

Request Variability

Film buffs will recall the diner scene in the movie Five Easy Pieces, in which actor Jack Nicholson asks for a side order of wheat toast. The rule the waitress invokes – no substitutions – is a time-honored way to limit request variability, or the range of what customers ask for in a service environment. While it's hard to imagine operations grinding to a halt over an order of toast, the fact that customers' desires don't emerge along standard lines poses real challenges for virtually every kind of service business. At an advertising agency, each client is executing a unique marketing strategy. At a resort, vacationers want different amenities. Even at a single-service business like Jiffy Lube, customers show up with different makes and models of automobiles.

Capability Variability

Perhaps less obviously, service businesses must also work with customers whose own capabilities differ. Whether because of greater knowledge, skill, physical abilities, or resources, some customers perform tasks easily and others require hand-holding. This capability variability clearly becomes more important when customers are active participants in the production and delivery of a service. A cleaning service may arrive, do its work, and leave, having had no real interaction with the customer. The customer's particular capabilities make little difference to how well the crew does its job. In a medical setting, by contrast, a patient may be more or less able to describe his symptoms, and that will affect the quality of the health care he receives.

Effort Variability

When customers must perform a role in a service interaction, it's up to them how much effort they apply to the task. An internal accountant may or may not take care to hand over well-organized files to her company's independent auditor. A shopper at a warehouse club may or may not have the remaining energy to return his massive shopping cart to one of the corrals in the parking lot. Such effort variability has an impact on service quality and cost, either directly for the engagement at hand or indirectly for other patrons.

Subjective Preference Variability

Customers also vary in their opinions about what it means to be treated well in a service environment. One diner appreciates the warmth of a waiter's first-name introduction; another resents his presumption of intimacy. When a top partner in a law firm lavishes attention on engagements, some clients will be gratified by the proof of their cases' importance. Others will think those expensive billable hours could be doled out more judiciously. These are personal preferences, but they introduce as much unpredictability as any other variable and make it that much harder to serve a broad base of customers.

It's possible to think of these five forms of variability sequentially because they reflect the process by which many service transactions unfold. The customer arrives, makes a request, plays a part in the process requiring some level of capability and effort, and assesses the experience according to personal preferences. At any of these points, life is easier for a service provider if it is dealing with a narrow band of variability. Where the band is wide, service quality and efficiency are at risk.

The taxonomy above is important because operational issues in a service business can often be traced to problems created by customer-introduced variability. But the right strategies to manage, say, effort variability (often involving incentives) can be completely different from the strategies for dealing with capability variability (typically some sort of training). Before managers can draft an appropriate response, they must diagnose which variability is at issue.

A Classic Trade-Off

Wherever customer-introduced variability creates operational issues for a company, managers face a choice: Do they want to accommodate that variability or reduce it? Generally, companies that emphasize the service experience tend toward accommodation, and those that emphasize operational simplicity – usually as a means to keep costs low – tend toward reduction. The two approaches are in constant tension.

Consider a classic illustration of a reduction strategy: the restaurant menu. Menus, by their nature, are a way to constrain request variability. They put a limit on what would otherwise be an infinite number of potential orders and therefore make it possible for a restaurant to offer meals of consistent quality at a reasonable cost. But customers chafe under too many constraints (again, recall Jack Nicholson's rage in Five Easy Pieces). For them, the ability to request variations in preparation, ingredients, and side dishes – or to order off the menu entirely – is part of a premier dining experience. When restaurants do not accommodate special orders, they reduce the complexity of the operating environment but also may diminish service quality. Companies that use reduction strategies tend to attract price-conscious customers who are willing to trade off an excellent service experience for low prices. People who choose discount airlines, bulk retailers, movie matinees, and off-peak travel options essentially reduce their collective variability by conforming to a company's operational needs, even at the risk of an inferior service experience.

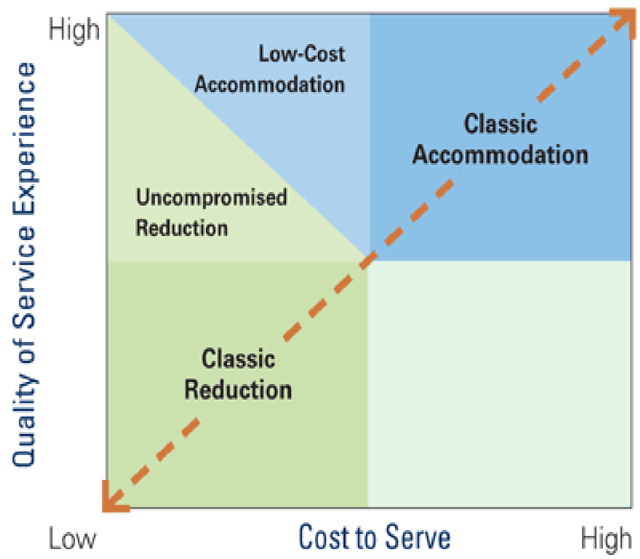
Accommodation strategies take different forms, depending on the business and type of customer-introduced variability. Very often, accommodation involves asking experienced employees to compensate for the variations among customers. For example, in a business where customers have divergent views of how service should be delivered (a business, that is, with high subjective-preference variability), a veteran employee learns to diagnose customer types. By making on-the-fly adaptations to suit their preferences, he essentially "protects" the customers from having to make many adjustments of their own.

It costs more, of course, to hire, train, and keep employees who can compensate for customers. Like most accommodation strategies, this one forces the company to bear the brunt of the variability. Therefore, the success of an accommodation strategy usually hinges on a company's ability to persuade customers to pay more to cover the added expense. Generally, only companies at the high end of their competitive landscape can command such a premium. Those at the low end must rely on strategies to reduce variability.

But managing customer-introduced variability does not have to come down to a stark trade-off between cost and quality. Some companies have met the challenge without damaging either the service experiences they provide or their operating environments. In a matrix representing the classic trade-off as a linear function of cost to serve versus the quality of the service experience; these companies have gone "above the diagonal."

The matrix shows possibilities beyond classic reduction and classic accommodation strategies: the potential for what can be termed uncompromised reduction and low-cost accommodation.

Overcoming the Trade-Off



Here's an example of an uncompromised reduction approach. A company can greatly reduce the impact of variability on its operating environment without compromising the service experience by targeting customers on the basis of variability type. If, for example, a college fears that admitting students of varying intellectual capabilities will complicate its operations, it can choose only students whose standardized test scores fall within a narrow band. The students get the benefit of a tailored curriculum without the schools having to support more than one. Likewise, a company faced with subjective preference variability can target customers who are predisposed to want service to be delivered the same way. It isn't always easy to know where customers fall on the relevant spectrum of variability, and there isn't always sufficient demand within a given band of customers to sustain a business. However, companies that find such a niche can benefit from reduced variability without requiring customers to adjust.

Companies that achieve low-cost accommodation most often do it by persuading customers to serve themselves. This strategy is very effective for high arrival or request variability, both of which complicate labor scheduling. Obviously, when the customer is responsible for much of the labor, the right labor is provided at the right moment.

Further, by having customers serve themselves, companies are allowing the service experience to vary with customers' capability and effort (accommodating capability and effort variability) and giving customers control of the service environment (accommodating subjective preference variability). The online auction house eBay shows how far this model can be taken: Virtually all the labor of selling and buying on the site is performed by customers, not by eBay employees.

The problem is that many companies, unlike eBay, have established precedents whereby employees perform certain tasks for customers. For those companies to succeed with a low-cost accommodation approach, they must persuade customers to do the work. This "persuasion" is typically achieved through some redefinition of the customer value proposition. That is, customers need to feel compensated in some way – whether through lower prices, greater customization, or other benefits of being in control – in order to feel good about doing work they think the company should be doing.

Solutions in Practice

Once a management team understands the types of variability customers introduce, and the possibilities for reducing or accommodating variability, the challenge of managing service operations becomes more tractable.

Let's revisit the four strategic responses discussed above: classic accommodation, classic reduction, low cost accommodation, and uncompromised reduction.

Strategies for Managing Customer-Introduced Variability

Once a company has determined which type of customer-introduced variability is creating operational difficulties, it must choose which of four basic strategies to pursue. The chart outlines tactics that have proven to be effective in each category.

	Classic Accommodation	Low-Cost Accommodation	Classic Reduction	Uncompromised Reduction
Arrival	• Make sure plenty of employees are on hand	• Hire lower-cost labor • Automate tasks • Outsource customer contact • Create self-service options	• Require reservations • Provide off-peak pricing • Limit service availability	• Create complementary demand to smooth arrivals without requiring customers to change their behavior
Request	• Make sure many employees with specialized skills are on hand • Train employees to handle many kinds of requests	• Hire lower-costspecialized labor • Automate tasks • Create self-service options	• Require customers to make reservations for specific types of service • Persuade customers to compromise their requests • Limit service breadth	• Limit service breadth • Target customers on the basis of their requests
Capability	• Make sure employees are on hand who can adapt to customers' varied skill levels • Do work for customers	• Hire lower-cost labor • Create self-service options that require no special skills	• Require customers to increase their level of capability before they use the service	• Target customers on the basis of their capability
Effort	• Make sure employees are on hand who can compensate for customers' lack of effort • Do work for customers	• Hire lower-cost labor • Create self-service options with extensive automation	• Use rewards and penalties to get customers to increase their effort	• Target customers on the basis of motivation • Use a normative approach to get customers to increase their effort
Subjective Preference	• Make sure employees are on hand who can diagnose differences in expectations and adapt accordingly	• Create self-service options that permit customization	• Persuade customers to adjust their expectations to match the value proposition	• Target customers on the basis of their subjective preferences

The history of successful service companies reveals that they've used every one of these strategies at one time or another.

In the late 1990s, for example, Dell faced the challenge of high arrival and request variability in its customer service operations as the company considered adding large servers to its product array. It knew that these high end servers, and the corporate customers who bought them, would create significant new demands for responsive service. Given the competitive context, Dell would have to be prepared to satisfy these demands around the clock and across a broad spectrum of possible malfunctions. As a new entrant in the market, lacking scale in its service operations, the company faced a trade-off between maintaining an underutilized and expensive service operation (accommodation of variability) and achieving higher predictability and utilization by, for instance, asking customers to schedule appointments (reduction of variability). Dell understood that, from its customers' perspective, accommodation was the only alternative, so the company set out to find a way to insulate itself from the effects of variability without compromising customers' service experiences.

Dell's solution was to outsource on-site customer service to third-party providers, who served more than one client and thus were less disrupted by the variability imposed by Dell's customers than Dell would have been had it acted alone. The move posed some risk: By giving up this customer contact in exchange for lower costs, Dell could have lost control of its customer relationships. The company prevented that through strict vigilance, staying in close touch with customers to discuss their needs and to assess their experiences with the third-party providers. By maintaining this contact, Dell effectively made the providers' role less prominent. In the end, the company achieved a low-cost accommodation of the variability its customers brought to the service relationship.

Starbucks provides an excellent example of the deft handling of capability variability. The coffee shop chain allows customers to choose among many permutations of sizes, flavors, and preparation techniques in its beverages. In the interests of filling orders accurately and efficiently, Starbucks trains its counter clerks to call out orders to beverage makers in a particular sequence. It is all the better when customers themselves can do so. Therefore, Starbucks attempts to teach customers its ordering protocol in at least two ways. It produces a "guide to ordering" pamphlet for customers to peruse, and it instructs clerks to repeat the order to the customer not in the way it was presented but in the correct way. The tone is not one of rebuke, but nevertheless most customers learn to avoid the implied correction by stating their order in the way that helps Starbucks's operations – with no hit to the service experience. Indeed, for some customers, getting the order right is an aspiration, a small victory on the way to the office. It's a clever solution, achieving an uncompromised reduction of variability.

Companies facing issues relating to effort variability often resort to the classic accommodation approach: They simply require employees to do the work for the lazier customers, with an obvious impact on operating costs. Some companies, however, try to compel those customers to work a little harder. As decades of research on employee motivation have emphasized, there are two ways to change behavior: instrumental means and normative means. Instrumental means are formal rewards and penalties for specified behaviors – the basic carrots and sticks of discipline. Normative means rely more subtly but often more effectively on shame, blame, and pride. In the case of Zipcar, an auto-sharing service, motivating customers to make the effort asked of them is particularly important because their actions influence not only themselves but also other customers. A car returned to its parking space late by one user spells real inconvenience for the next. While late fees are a common instrumental control for this type of situation, they risk being perceived by the customer as a license to be late. Indeed, late fees often help compensate a business for customers' costly choices, but they are not always effective in changing their behavior.

Normative controls, which make customers want to behave, can be far more successful, but these incentives are difficult to craft. Why would one customer necessarily care about the inconvenience suffered by another? To use normative controls effectively, companies need to create an environment in which customers care about the impact of their behavior on others. Such an environment exists on eBay, where customers serve one another with great care, in large part because of the customer-to-customer commitment the company has built through tools such as feedback stars, which publicize buyers' and sellers' past behavior. Normative controls can be particularly important when instrumental incentives have failed. (As Steven Levitt and Stephen Dubner relate in Freakonomics, when a day care center instituted late fees for parents who were not on time to pick up their children, lateness got worse.

The fee reduced the parents' guilt, which had been a powerful normative incentive.) Companies like Zipcar must not only determine how they need customers to behave but also come up with effective ways to promote that behavior.

The best strategy for changing customers' behavior is not always obvious, nor is the best strategy for managing a specific type of variability. Tiffany & Company, the luxury jeweler, suffered from missteps in 2001, when it failed to anticipate how customers would react to what seemed like a logical solution. Its problem was one that many retailers would like to have: The brand's popularity was soaring among the so-called mass affluent segment – a fast-growing market of moneyed consumers.

Consider that Tiffany's hallmark had long been the graciousness of its service. As customers began crowding into its stores, this traditional service experience was being undermined. In particular, management noticed, with so many people milling around the floor it was hard for employees to uphold the first-come-first-served norm.

Tiffany dealt with this arrival variability with a tried-and-true device: the beeper. Upon arrival in the shop, customers were given a beeper and told they would be buzzed as soon as a service person was available. Unfortunately, the reaction of the customers Tiffany most wanted to protect – its most wealthy and loyal ones – was outrage. Management had failed to recognize that a more problematic form of variability – subjective preference variability – had disrupted the business. While the mass-market customer arriving in the store was well acquainted with beepers, and even felt well served by them, the more demanding luxury customer found them to be inconsistent with Tiffany's historic commitment to white-glove service. Only after the company saw a dramatic plunge in satisfaction among the latter group did it confront its fundamental managerial challenge: whether (and how) to serve two distinct segments of customers through a single retail channel. Tiffany's challenge was complicated by the fact that the less expensive silver jewelry was popular with both segments, which made it difficult to come up with a solution that segmented service on the basis of product type.

Gateway's attempt to manage customer variability failed for different reasons. Since its inception, the personal-computer maker had sold its products solely through direct channels. But faced with eroding market share, management decided to address the capability variability common in high-tech markets. It knew that it would be able to sell more PCs if it provided more hand-holding to consumers who lacked technical knowledge and confidence. This meant entering the retail market – and more, it meant creating exceptional retail environments that enabled deep customer learning.

When Gateway's new stores opened in 1996, they were undeniably impressive. Employees were experienced, helpful, and abundant (the employee-to-customer ratio was unusually high). Excellent educational materials were on hand, and the stores were conveniently located to ensure heavy foot traffic. Gateway succeeded spectacularly at bringing customers with all levels of expertise through the doors.

Fast-forward to April 2004, when the company was shuttering the last of more than 300 storefronts. How could this have happened? It wasn't that the strategy was ludicrous. The company had accurately diagnosed a problematic form of customer variability, and it had devised a way to manage its impact. Unfortunately, that way was expensive, and Gateway hadn't guaranteed that the people receiving the benefits of all that pre-purchase accommodation would also bear the costs. Far too often, customers took their newly acquired understanding of what they needed and how it worked and then placed an order with one of Gateway's low-price competitors.

Managing the Operational Behavior of Customers

It's clear from the examples above that the effective management of variability in service operations often requires a company to influence customers' behavior. That can be a hard goal to achieve; given that a company's operational concerns are not usually foremost in its customers' minds. Managers attempting this kind of intervention should plan their actions carefully in a three-step process.

Diagnose the problem

The operational problems caused by customers' discretionary behavior can range from the seemingly minor – some customers are late to their appointments – to issues that can have a large impact on profitability. As a first step, managers must understand the root causes of problematic customer behavior. Unless the behavioral problem is accurately diagnosed, no subsequent action to correct it will be effective.

The experience of **retail bank First Union** in the late 1990s makes this point dramatically. Because the bank misdiagnosed the type of customer variability it faced, it took actions that were inappropriate to the situation. First Union had created many self service options for customers – primarily through ATMs, voice response units, and Web pages – and hoped that the cost of the innovations would be more than recouped by lower costs in branch operations. However, when customers continued to visit the branches to transact business in person with tellers, the investment in self-service technology failed to meet expectations. Management concluded that the problem was, in essence, one of capability variability: Not all customers had learned what the technology could do and how to use it. To address this problem, First Union stationed greeters at the doors of its branches to ask customers the nature of their business with the bank that day. If the transaction could easily be accomplished through an ATM (as was usually the case); the greeter would recommend the self-service technology and offer guidance on how to use it. Within months of this management intervention, First Union had lost roughly 20% of its most recently acquired accounts. Not long after, First Union merged with Wachovia and dropped its name.

The cause for the loss was not hard to trace: It came down to a misunderstanding of why the self-service options had not caught on among all customers. The variability that was actually at issue was not capability variability but effort variability. Customers with time on their hands preferred to wait in line to have the teller do all the work.

Managers can avoid that kind of misdiagnosis by conducting a thorough analysis guided by some straightforward questions:

- What is problematic about customers' current behavior? What is the danger of leaving the behavior unchanged?
- What are the hypotheses of the cause of the behavior? In determining the hypotheses, consider the role of the five types of customer-introduced variability and state hypotheses for each as the cause.
- Which hypotheses make the most sense? Which are less plausible? Is management invested in a particular outcome? What assumptions is the company making about what customers value?
- How will these hypotheses be tested? Who will be responsible for the data they produce? If the outcome has significant implications for strategy or operations, who will lead the change process?

Had First Union (or Tiffany, drawing on an earlier example) gone through this kind of exercise, the ineffectiveness of the solution would have been identified well before it was rolled out in a full-scale, live operating environment. First Union hypothesized that customers' resistance to self-service technologies reflected a gap in their capabilities, so the bank jumped directly to training them (using greeters) without sufficiently testing the hypothesis. Acting on untested hypotheses is a common mistake when the logic of what is (presumably) good for customers is widely accepted. First Union reasoned that if customers only knew how much better off they would be using ATMs, they would surely choose to serve themselves.

Had the bank tested this assumption – by, say, asking customers why they used particular channels and what they thought of alternative channels – it would have exposed the flaws in its thinking. Managers often confuse capability and effort variability because their symptoms can be identical.

At Tiffany, the company observed overcrowding, hypothesized that arrival variability was the issue, and designed a store-level solution. Had the company been more thorough in exploring the problem – particularly in analyzing the differences in subjective preferences between customer segments – it could have learned about the potential incompatibility of the two segments and designed a company-level solution.

Design a mutually beneficial operating role for customers

With the appropriate diagnosis, companies can design an operating role for customers that creates explicit value for both parties. As in step one, a set of questions can guide the creation of this mutually beneficial role:

- What do customers gain from their new role? Are they better off than before? Are they still better off than they would be in the hands of competitors?
- What does the company gain from customers' new role? What is the intended impact of their new behavior on the company's performance?
- Is it realistic that customers will behave the way the company wants them to? What assumptions are managers making about human motivation?

The difficulty in creating value for customers often comes from untested assumptions about their behavior and perceptions, like the ones made by management at First Union. Usually there are many ways to create value for customers – but one of them is not to make customers feel they are worse off than they were before the change.

The difficulty in creating value for service companies is that revenue and cost are often not tightly linked in such businesses. This isn't the case in product-based businesses, where each transaction can be evaluated according to the clear associated revenue minus the cost of production. Service businesses often use a model more akin to buffet pricing: Customers, having paid a fee, can conduct as many transactions as they desire. This makes it difficult to understand the value being created at different points in the relationship and allows such mistakes as Gateway's foray into high-touch retailing. Indeed, the free riding the company suffered is a major risk for any business in which customers need expensive pre purchase service and rivals offer easy substitutions.

Test and improve the solution

Because of the inherently complicated nature of customer behavior, it is useful to test approaches to influencing behavior before rolling them out on a broad scale. However, while pilot tests can reveal critical system flaws at a limited cost, such tests are often executed incorrectly. The three most common mistakes are as follows:

- Creating testing environments that are substantially different from the real environment. Sometimes pilots take place in a better climate than customers will actually experience. The most common differences in a testing environment are more experienced employees, artificially ample resources, and limited exposure to variability.
- Creating incentives – whether implicit or explicit – for the test to have a positive outcome. This often comes in the form of a promise that the test manager will be responsible for the full-scale rollout if the test has a positive outcome (regardless of whether the company learned anything).
- Designing a test that has no controls. If customers change their behavior following a test, it is difficult to know whether the change should be attributed to the test or to other external factors if the test had no controls.

One way to overcome the last mistake is to use what Wells Fargo refers to as the "challenger-champion" model. For every new initiative, the company selects a sample to test the new initiative (the challenger sample) and a similar, matched sample (the champion sample). After the initiative is tested on only the challenger sample, the company tracks differences in behavior between the two samples.

More generally, we have found that pilot tests are effective when managers can affirmatively answer the following questions:

- Is the pilot program being tested under typical circumstances? Are the employees, customers, and resources consistent with the company's real operating environment?
- Is the goal of the pilot to learn as much as possible (rather than to demonstrate the value of the new system)? Is this goal clear to both employees and managers?
- Is it clear that managers' performance is not based on a positive outcome of the pilot?
- Are customers and frontline employees involved in evaluating the circumstances of the test and in assessing results?
- Can managers articulate the explicit changes made as a result of the pilot test? (If relatively few changes are made, that should be a red flag that the primary motivation of the test was proof-of-concept, not learning.)

Throwing a Customer in the Works

Profitably managing the variability implicit in customer heterogeneity, and developing effective levers to influence it, is a central challenge for service businesses. By extension, it is also a central challenge for developed economies. In the typical mature economy, service providers conduct more than 70% of commerce – yet the frameworks and tools for managing these businesses lag significantly behind those developed for manufacturing environments.

Understanding the workings of service businesses more thoroughly begins with identifying the things that make them different from manufacturers. Chief among these is the presence of the customer in operations. Customers perform roles that are either well or poorly designed for them and engage in behaviors that either benefit or harm the company. They make it nearly impossible to manage production in isolation from consumption. Companies that learn to manage the variability customers bring to the works will find that customers are the key to competitive advantage.

Netflix is an example of a company that capitalized on incumbents' mishandling of customer variability. When customers rent DVDs, late returns are a major source of tension for both rental companies and customers. Companies have charged late fees – which customers often perceive to be draconian – in order to encourage people to return movies on time. But late fees have not only failed to change customers' behavior but also have been a significant source of customer dissatisfaction. Enter Netflix and its subscription model, which makes late fees obsolete by allowing people to keep movies for as long as they want. The customer's incentive to return a movie is being able to get the next movie on her request list.

Netflix saw an opportunity in the tension over late fees. The company knew from its research what its competitors didn't: Some customers' value having control over how long they keep movies, but not at the high cost (and anxiety) of late fees. This left room for a middle ground, a premium subscription service that guarantees revenues while accommodating variability in usage time. While incumbents were trying to strong-arm their customers into "behaving," Netflix built a winning business model based on a deeper understanding of the true drivers of customer behavior.

LESSON 34

SERVICE MANAGEMENT BREAKING THE TRADE-OFF BETWEEN EFFICIENCY AND SERVICE (CONTD…)

Note of Acknowledgement:
This lecture is based on another article by Professor Frances X. Frei published in HBR.
Frances X. Frei is an Associate Professor of Business Administration in the Technology and Operations Management (TOM) unit at the Harvard Business School. At HBS, Professor Frei has developed a second year elective on Managing Service Operations, which focuses on tools and frameworks to drive performance for service firms and service aspects of product firms.

The Four Things a Service Business Must Get Right

Extensive study of the world's best service companies reveals the principles on which they're built. As the world's major economies have matured, they have become dominated by service-focused businesses. But many of the management tools and techniques that service managers use were designed to tackle the challenges of product companies. Are these sufficient, or do we need new ones?

Let me (The Author) submit that some new tools are necessary. When a business takes a product to market, whether it's a basic commodity like corn or a highly engineered offering like a digital camera, the company must make the product itself compelling and also field a workforce capable of producing it at an attractive price. To be sure, neither job is easy to do well; enormous amounts of management attention and academic research have been devoted to these challenges. But delivering a service entails something else as well: the management of customers, who are not simply consumers of the service but can also be integral to its production. And because customers' involvement as producers can wreak havoc on costs, service companies must also develop creative ways to fund their distinctive advantages.

Any of these four elements:

- ✓ The offering
- ✓ Its funding mechanism
- ✓ The employee management system
- ✓ The customer management system can be the undoing of a service business. This is amply demonstrated by my analysis of service companies that have struggled over the past decade. What is just as clear, however, is that there is no "right" way to combine the elements. The appropriate design of any one of them depends upon the other three. When we look at service businesses that have grown and prospered—**companies like Wal-Mart in retail, Commerce Bank in banking, and the Cleveland Clinic in health care**—it is their effective integration of the elements that stands out more than the cleverness of any element in isolation.

This article outlines an approach for crafting a profitable service business based on these four critical elements (collectively called the "service model"). Developed as a core teaching module at Harvard Business School, this approach recognizes the differences between service businesses and product businesses. Students in my course learn to think about those differences and their implications for management practice. Above all, they learn that to build a great service business, managers must get the core elements of service design pulling together or else risk pulling the business apart.

1. The Offering

The challenge of service-business management begins with design. As with product companies, a service business can't last long if the offering itself is fatally flawed. It must effectively meet the needs and desires of an attractive group of customers. In thinking about the design of a service, however, managers must undergo an important shift in perspective: Whereas product designers' focus on the characteristics buyers will value, service designers do better to focus on the experiences customers want to have. For example, customers may attribute convenience or friendly interaction to your service brand. They may compare your offering favorably with competitors "because of extended hours, closer proximity, greater scope, or lower prices. Your management team must be absolutely clear about which attributes of service the business will compete on.

Strategy is often defined as what a business chooses not to do. Similarly, service excellence can be defined as what a business chooses not to do well. If this sounds odd, it should. Rarely do we advise that the path to excellence is through inferior performance. But since service businesses usually don't have the luxury of simply failing to deliver some aspects of their service—every physical store must have employees on-site, for example, even if they're not particularly skilled or plentiful—most successful companies choose to deliver a subset of that package poorly. They don't make this choice casually. Instead, my research has shown, they perform badly at some things in order to excel at others. This can be considered a hard-coded trade-off. Think about the company that can afford to stay open for longer hours because it charges more than the competition. This business is excelling on convenience and has relatively inferior performance on price. The price dimension fuels the service dimension.

To create a successful service offering, managers need to determine which attributes to target for excellence and which to target for inferior performance. These choices should be heavily informed by the needs of customers. Managers should discover the relative importance customers place on attributes and then match the investment in excellence with those priorities. At Wal-Mart, for example, ambience and sales help are least valued by its customers, low prices and wide selection are most valued, and several other attributes rank at points in between. The trade-offs Wal-Mart makes are deliberately informed by these preferences. The company optimizes specific aspects of its service offering to cater to its customers "priorities, and it refuses to over invest in underappreciated attributes. The fact that it takes a drubbing from competitors on things its customers care less about drives its overall performance.

The phenomenon, of course, has a circular aspect. Shoppers whose preferences match Wal-Mart's strengths self-select into its customer base. Meanwhile, those who don't prefer Wal-Mart's attributes buy elsewhere. It is important therefore to identify customer segments in terms of attribute preferences—or as some marketers prefer, in terms of customer needs. Identifying what might be called customer operating segments is not the same exercise as traditional psychographic segmentation. Rather than stressing differences that enable increasingly targeted and potent messaging, this type of segmentation aims to find populations of customers who share a notion of what constitutes excellent service.

Once an attractive customer operating segment is found, the mission is clear: Management should design a new offering or tweak an existing one to line up with that segment's preferences. Look, for example, at the fit achieved by Commerce Bank, which has been able to grow its retail customer base dramatically even though its rates are among the worst in its markets and it has made limited acquisitions. Commerce Bank focuses on the set of customers who care about the experience of visiting a physical branch. These customers come in all shapes and sizes—from young, first-time banking clients to time-strapped urban professionals to elderly retirees. As an operating segment, however, they all believe that convenience is a bank's most important attribute and choose Commerce Bank because of its evening and weekend hours. Second most important to them is the friendliness of interactions with employees, and so the promise of a cheerful, familiar teller has become part of the bank's core offering. Commerce has added to its branch ambience with interior elements both lovely (high ceilings and natural light) and funs (an amusing contraption for redeeming loose change). When it comes to attributes less important to the bank's customers—price and product range—management is willing to cede the battle to competitors.

It is tempting to think, "If I'm a really good manager, then I don't have to cede anything to the competition." This well-intentioned logic can lead, ironically, to not excelling at anything. The only organizations I have seen that are superior at most service attributes demand a price premium of 50% over their competitors. Most industries don't support this type of premium, and so trade-offs are necessary. I like to tell managers that they are choosing between excellence paired with inferior performance on one hand and mediocrity across all dimensions on the other. When managers understand that inferior performance in one dimension fuels superior performance in another, the design of excellent service is not far behind.

2. The Funding Mechanism

All managers, and even most customers, agree that there is no such thing as a free lunch. Excellence comes at a cost, and the cost must ultimately be covered. With a tangible product, a company's mechanism for funding superior performance is usually relatively simple: the price tag. Only the customers who forfeit the extra cash can avail themselves of the premium offering.

In a service business, developing a way to fund excellence can be more complicated. Many times, pricing is not transaction based but involves the bundling of various elements of value or entails some kind of subscription, such as a monthly fee. In these cases, buyers can extract uneven amounts of value for their money. Indeed, even non-buyers may derive value in certain service environments. For example, a shopper might spend time learning from a knowledgeable salesperson, only to leave the store empty-handed.

In a service business, therefore, management must give careful thought to how excellence will be paid for. There must be a funding mechanism in place to allow the company to outshine competitors in the attributes it has chosen.

In my study of successful service businesses, I've seen the **funding mechanism take four basic forms.** Two are ways of having the customer pay, and two cover the cost of excellence with operational savings.

Charge the customer in a palatable way

The classic approach to funding something of value is simply to have the customer pay for it, but often it is possible to make the form that payment takes less objectionable to customers. Rarely is that done with à la carte pricing for the niceties. A large part of Starbucks's appeal is that a customer can linger almost indefinitely in a coffeehouse setting. It's unthinkable that Starbucks would place meters next to its overstuffed chairs; a better way to fund the atmosphere is to charge more for the coffee.

Commerce Bank is open late and on weekends—earning it high marks on extended hours—and it pays for that service by giving a half percentage point less in interest on deposits. Could it fund the extra labor hours by charging for evening and weekend visits? Perhaps, but a slightly lower interest rate is more palatable. Management in any setting would do well to creatively consider what feels fair to its customers. Often, the least creative solution is to charge more for the particular service feature you are funding.

Create a win-win between operational savings and value-added services

Very clever management teams discover ways to enhance the customer experience even while spending less (finding, in other words, that there can be such a thing as a free lunch). Many of these innovations provide only a temporary competitive advantage, as they are quickly recognized and copied. Some are surprisingly durable, however.

An example is the immediate-response service provided by Progressive Casualty Insurance. When someone insured by Progressive is involved in an auto accident, the company immediately sends out a van to assist that person and to assess the damage on the spot—often arriving on the scene before the police or tow trucks. Customers love this level of responsiveness and give the company high marks for service. But in anticipation of such a need someday, would they pay more in insurance premiums? Unfortunately, no People are pathologically price sensitive about car insurance and almost never select anything but the rock-bottom quote. The key to Progressive's ability to fund this service is the cost savings it ultimately yields. Normally insurance providers are subject to fraud, with criminals making claims for accidents that were staged or never happened. Because of these and other types of disputed claims, firms also incur high legal fees—which, combined with the other costs of fraud, add up to some $15 out of every $100 in insurance premiums across the industry. Since deploying its vans, Progressive has seen costs in both categories plummet. Sending a company representative to the scene pays for itself.

Progressive offers another customer convenience that many competitors have so far shied away from: giving quotes from other providers alongside its own when a potential buyer inquires about the cost of insurance. It's not that Progressive is determined to go one better than rivals to win the business. In fact, Progressive's is the lowest quote only about half the time. What Progressive does believe is that its quote is the right one given the probability of that person's getting into an accident—a probability that the insurer is best in class at determining. If indeed its quote is spot-on, then allowing a competitor to insure the customer at a lower rate is doubly effective: It frees Progressive from a money-losing proposition while burdening its competitor with the unprofitable account. Thus a level of service that looks downright altruistic to the customer actually benefits the company. This is an example of leveraging operations into a value-added service.

How can your management team find win-win solutions of its own? When I pose this question to managers, their impulse is to imagine what new value could be created for customers and then to ponder how that could be funded through cost savings. I suggest beginning instead by asking, "Where are our biggest cost buckets?" With these in mind, managers can then simultaneously determine how to reduce costs and create a value-added service. A good first place to look? Anywhere that time is a large component of cost. Removing time is often fruitful, since it can directly improve service even as it cuts costs.

Spend now to save later
Often it is possible, if somewhat painful, to make operational investments that will pay off eventually by reducing customers "needs for auxiliary service in the future. A classic example is Intuit's decision to provide free customer support, in defiance of the software industry norm. Call centers are expensive to staff because of the combination of technical knowledge and sociability required to field inquiries effectively. Customers meanwhile are extremely uneven in their neediness vis-à-vis information technology. For most software makers this adds up to the obvious conclusion that customers should be charged for support. Intuit founder Scott Cook sees the matter differently. Those needy calls, he believes, are a useful form of input to continued product development—the engine of future revenues—and that justifies an even greater expense outlay. Intuit has its higher salaried product-development people, not solely customer service people, fielding calls so that subsequent versions of its offerings will be informed by direct knowledge of what users are trying to accomplish and how they are being frustrated.

This is part of a broader commitment to feedback-driven improvement that Cook refers to as "DIRST"—for "do it right the second time." The investment has paid off in better software, which means a lower call volume.

"Our competition thinks we're crazy," Cook says, and he understands why. "If we got as many calls as they do, we'd be out of business."

Have the customer do the work
One other type of funding mechanism for enhanced service puts the cost back in the customer's court, but in the form of labor. Offering self-service, from pump-your-own gas to self-managed brokerage accounts, is a well-established way to keep costs low. If the goal is service excellence, though, you must create a situation in which the customer will prefer the do-it-yourself capability over a readily available full-service alternative. Airlines have achieved this, at last, with flight check-in kiosks, although the value proposition they initially presented was dubious. At first, passengers felt compelled to use the relatively unappealing kiosks only because carriers had allowed the lines in front of manned desks to become intolerable. Today, however, frequent fliers prefer the kiosks because they provide readier access to useful tools like seat maps. Businesses looking to achieve service excellence in other settings should not take such an indirect route. They should set themselves the challenge of creating self-service capabilities that customers will welcome. Indeed, if a self-service option is truly preferable, customers should be willing to take on the work for nothing or even pay for the privilege. When managers designing self-service solutions are not permitted to add the inducement of price discounts, they are forced to focus on improving the customer experience. Whatever funding mechanism is used to cover the costs of excellence, it is best thought out as thoroughly as possible prior to the launch of a new service, rather than amended in light of experience afterward. When a service that's been perceived as free suddenly has fees associated with it, customers tend to react with disproportionate displeasure. And since companies cannot thrive by offering service gratis, it is vital that they not set expectations that can't be sustained. With careful analysis and design, a company can offer and fund a better service experience than its customers would enjoy elsewhere.

3. The Employee Management System
Companies often live or die on the quality of their workforces, but because service businesses are typically people intensive, a relative advantage in employee management has all the more impact there. Top management must give careful attention to recruiting and selection processes, training, job design, performance management, and other components that make up the employee management system. More to the point, the decisions made in these areas should reflect the service attributes the company aims to be known for.

To design a well-integrated employee management system, start with **two simple diagnostic questions.**

First: What makes our employees reasonably able to achieve excellence?
Second: What makes our employees reasonably motivated to achieve excellence?

Thoughtfully considered, the answers will translate into company-specific policies and programs. Companies that neglect to connect the dots between their employee management approaches and customers "service preferences will find it very hard to honor their service promises.

At one large international retail bank I studied, a senior manager had come to a depressing realization. "Our service stinks," she told me. Under her guidance the bank took various measures, mainly centering on incentives and training, but the problem persisted. Customer experience in the branch did not improve. Perplexed but determined, the executive decided to become a frontline employee herself for a month. She thought it would take that much time to experience a typical range of service interactions and see the roots of the problem. In fact, it took one day. "From the time the doors opened, customers were yelling at me," she reported. "By the end of the day, I was yelling back." What became clear was that employees were set up to fail. Recent cross-selling initiatives had created a set of customers with more complex needs and higher expectations for their relationship with the bank, but employees had not been equipped to respond. As a result of decisions made by the management team (all individually sensible), the typical employee did not have a reasonable chance of succeeding. The bank's employee management system was broken.

If your business requires heroism of your employees to keep customers happy, then you have bad service by design. Employee self-sacrifice is rarely a sustainable resource. Instead, design a system that allows the average employee to thrive. This is part of Commerce Bank's competitive formula. Recall that the bank chooses to compete on extended hours and friendly interactions and not on low price and product breadth. Now think how that strategy could inform employee management; the implications are not hard to imagine. For instance, Commerce concluded that it didn't require straight-A students to master its limited product set; it could hire for attitude and train for service. In job interviews, its managers could use simple weed-out criteria—like "Does this person smile in a resting state?"—rather than trying to maximize across a wide range of positive characteristics. The bank's current employees could be deployed as talent scouts, on the principle that it takes one to know one. (When people from Commerce see someone providing great service in another setting, whether at a restaurant or at a gas station, they hand out a card printed with a compliment and a suggestion to consider working for Commerce.)

It's a simple reality that employees who are above average in both attitude and aptitude are expensive to employ. They are not only attractive to you but also attractive to your competitors, which drive up wages. A business that wants to maintain a competitive cost structure will probably need to compromise on one quality or the other (or, if it insists on having both, find a way to fund that luxury). If, as Commerce Bank does, you choose to hire for attitude, then you must engineer things so that even lower-aptitude employees will reliably deliver great service. Like managers who don't want to admit that their service is designed to be inferior on some attributes, many people are reluctant to acknowledge a trade-off between aptitude and attitude. But failure to accommodate this economic reality in the design of the employee management system is a common culprit in flawed service.

4. The Customer Management System

In a service environment, employees aren't the only people affecting the cost and quality of service delivered. The customers themselves can be involved in operational processes, sometimes to a very large extent, and their input influences their experiences (and often other customers "too). For example, an architectural firm's client may explain the purpose of a new facility well or poorly, and that will affect the efficiency of the design process and the quality of the end product. A customer who dithers at a fast-food counter makes the service less fast for everyone behind him.

Customer involvement in operations has profound implications for management because it alters the traditional role of the business in value creation. The classic product-based business buys materials and adds value to them in some way. The enhanced-value product is then delivered to customers, who pay to receive it. In a service business, however, employees and customers are both part of the value-creation process. A main benefit is that customer labor can be far less expensive than employee labor. It can also lead to better service experiences. When students participate more in a classroom environment, for example, they learn more. But there are challenges, as well. Designing a system that explicitly manages these challenges is essential to service success.

Consider the issue of customer selection. Service designs may call for customers to perform important tasks, but for the most part customers have no interview, no background check, and no personality profile. As a former senior executive from Nestlé now working in financial services put it, "I could control who was in my factory at Nestlé; I have no such control over the customers in my bank's branches."

In addition, despite many organizations' best efforts, customers are not as easy to train as employees. There are usually many times more customers than employees, and creating effective training materials for such a large, dispersed, unpaid, and often irrelevantly skilled workforce is difficult. When this holds true, firms must accommodate the limited training in the design of the service experience. If tasks are shifted from employees to customers—from higher-skilled to lower-skilled people—then they must be adjusted accordingly.

Airlines seem to get this right. Recall (if you can) the last time you checked in with an agent at the full-service counter. Chances are you witnessed the agent complete a dizzying sequence of keystrokes. It would not seem reasonable to expect customers to perform these same steps, and so when the check-in role was transferred to customers, it was dramatically simplified. By contrast, think of the self-service supermarket checkout. Here customers are asked not only to do what trained employees have done previously but also to shoulder the additional responsibility of fraud prevention through a complicated process of weighing bags. Asking customers to perform more-complicated tasks than higher-skilled employees contributes to the disarray and anxiety that surrounds these checkout lines.

Customers also have a great deal of discretion in their operational activities, usually far more than employees. When a company introduces a new process that it wants employees to use, it can simply issue a mandate. When customers are involved, transitions like this can be significantly more complicated. Look at Zipcar, the popular car-sharing service. To keep costs low, its service model depends on customers to clean, refuel, and return cars in time for the next user. Motivating employees to perform these tasks would be routine; motivating customer-operators has required a complex, evolving mix of rewards and penalties.

In managing customers in your operations, then, you'll need to address a **few key questions**:

- Which customers are you focusing on?
- Which behaviors do you want?
- And which techniques will most effectively influence behavior?

For example, a company whose business model depends on customers "timeliness—whether it's a dental office packing its appointment calendar or a video store circulating hit films—may use more- or less-heavy-handed tactics to ensure compliance. In a previous article for Harvard Business Review ("Breaking the Trade-Off Between Efficiency and Service," November 2006), I related lessons from several companies that have used a range of techniques to modify customer behavior. These techniques can be divided into **two basic categories:**

- ✓ Instrumental (the carrots and sticks we commonly see play out as discounts and late fees)
- ✓ Normative (the use of shame, blame, and pride to motivate us to return shopping carts and pick up trash even when no one is looking).

The important thing is to manage customers in a way that is consistent with the service attributes you've chosen to emphasize overall.

Integrating the Elements

Successful service companies have a working plan that incorporates all four elements of service design. Within each of those areas, however, it is hard to spot any best practice. This is because the whole business depends more on the interconnection of the four than on any one element.

A standout example of effective overall integration is the Cleveland Clinic, which is consistently ranked among America's most eminent hospitals and has been a leader in pioneering cardiac care for decades. It's hard to put a finger on the source of that advantage. The fact that the clinic has specialty centers focusing on diabetes, for example, or cardiac care is not exceptional in itself. Its refusal to attach financial rewards to doctors "productivity is unusual but might not be effective elsewhere. Step back from the details, however, and the bigger picture emerges. Attracting the highest-severity patients means that doctors will always face a challenging environment in need of innovative solutions. Organizing into disease centers rather than narrower, more traditional lines of specialization (such as kidneys or blood) sets the stage for cross-disciplinary collaboration—and thus for novel perspectives—within those centers. Removing productivity incentives gives doctors license to spend time on innovation, which is enhanced by their close work with specialists from other fields. The particular choices made on methods, processes, and personnel are the right ones for the Cleveland Clinic because they complement one another and come together in a smoothly operating system. Any service company, no matter how long established, can benefit from a review of its operations using the framework laid out in this article.

Bringing the four elements of service design into tighter alignment can be an ongoing process of small tweaks and experiments in change, inspired by the kinds of questions included in the sidebar "Diagnosing Service Design." A management team planning to launch a new service will find the framework particularly helpful. It flags the decisions that should be made early and in tandem so that they don't clash down the road. And at the highest level, it underscores two very important principles of service design.

First, there is no such thing as a good idea in isolation; there is only a good idea in the context of a specific service model.
Second, it is folly to attempt to be all things to all customers.

The Management-Practice Frontier
Management scholars, and not a few practitioners, have taken up an interesting debate in recent years: Is the discipline of management fundamentally different in service businesses than in product businesses? The way in which management is studied and taught in graduate business schools was forged in the context of the industrial economy.

Are the approaches that worked for manufacturing companies equally applicable to services? As service businesses continue to innovate, succeed, and be studied, the answers are becoming clearer. The framework presented here suggests why the traditional techniques have proved as durable as they have and why they still leave sophisticated managers wanting more. Much of what determines the health of a product business—the soundness of its offering and the management of its people—is just as indispensable in a service business and can be addressed with a similar tool kit. But whole new areas involving the roles of customers have opened up, and their tool kits are only now being assembled.

Diagnosing Service Design
The success or failure of a service business comes down to whether it gets four things right or wrong—and whether it balances them effectively.

Here are some questions that will sharpen managers "thinking along each dimension and help companies gauge how well their service models are integrated.

The Offering
- Which service attributes (convenience? friendliness?) does the firm target for excellence?
- Which ones does it compromise in order to achieve excellence in other areas?
- How does its service' attributes match up with targeted customers "priorities?

The Funding Mechanism
- Are customers paying as palatably as possible?
- Can operational benefits be reaped from service features?
- Are there longer-term benefits to current service features?
- Are customers happily choosing to perform work (without the lure of a discount) or just trying to avoid more-miserable alternatives?

The Employee Management System

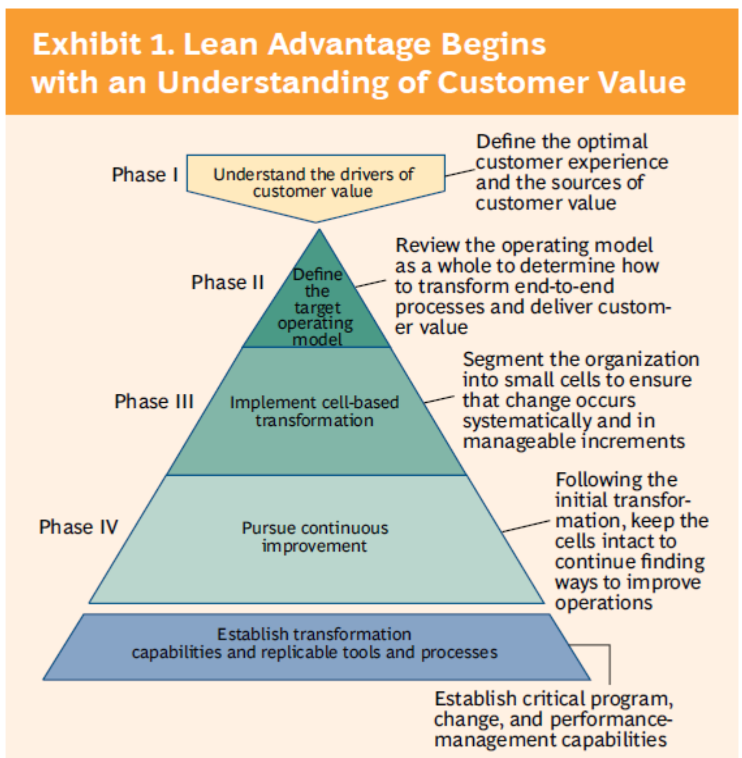
- What makes employees reasonably able to produce excellence?
- What makes them reasonably motivated to produce excellence?
- Have jobs been designed realistically, given employee selection, training, and motivation challenges?

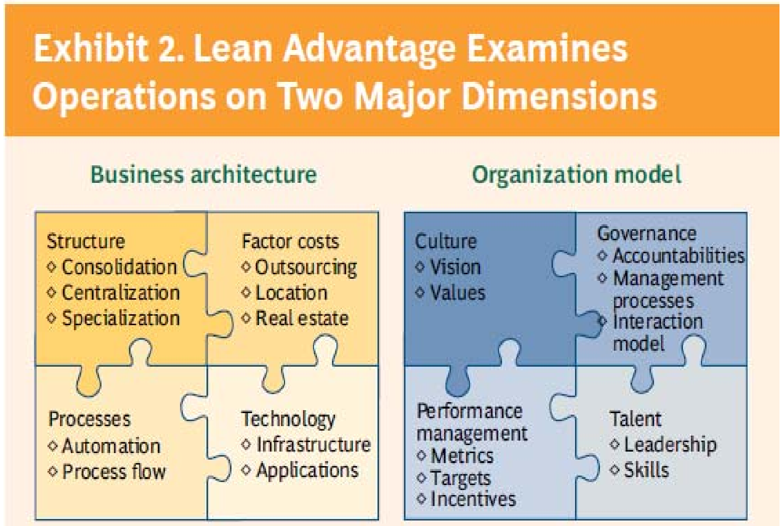
The Customer Management System

- Which customers are you incorporating into your operations?
- What is their job design? What have you done to ensure they have the skills to do the job?
- What have you done to ensure they want to do the job?
- How will you manage any gaps in their performance?

Banking on Lean
Advantage:

- Given the influence operations has on the way a customer views a bank, banks should view it as a strategic asset to be leveraged rather than a source of costs to be managed.
- An approach called lean advantage looks at operations holistically instead of through a one-dimensional, cost-oriented lens.
- Lean advantage searches for opportunities to improve end-to-end processes and build strategic advantage by transforming operations and instilling cultural and organizational change.
- The lean-advantage approach has helped banks around the world complement strong efficiency improvements with impressive gains in customer satisfaction and loyalty.





Source/Reference:

1. **Banking on Lean Advantage**
2. **Boston Consulting Group**

LESSON 35

WHY BANK CUSTOMER EXPERIENCE MATTERS?

The customer experience is the impact that certain interactions make that create a lasting feeling or attitude toward a bank.

Creating a 20/20 customer experience: From customers to advocates

Top banks are topping out at finding new ways to build competitive differentiation through conventional customer relationship management (CRM) plays. Are they missing part of the picture? By understanding the entire customer experience, banks can explore a new frontier of true customer advocacy.

The customer is on to you

Although many in the industry suspected it, recent IBM research on banking consumers confirmed it: the customer is on to you. Customers know about loyalty and retention programs, especially at big banks, so they expect big banks to be customer-loyalty focused. They have grown accustomed to "the customer is always right" slogans and to hearing how important they are.

It's little wonder. Banks have been working hard to improve CRM operations over the past decade and have been letting customers know it. Billions of dollars continue to be spent annually on CRM initiatives. The years of investment have made an impact on the customer operations of banks: they have successfully delivered account transactions over the Web, improved how call centers operate, optimized customer databases and equipped front-line personnel with torrents of customer information.

Little room for differentiation

Now, when most banks have made significant improvements in customer operations, it becomes more difficult to differentiate themselves simply by focusing on incremental improvements. With banking products often viewed by customers as a commodity, service and treatment have become key differentiators. When these levers also become commodities, competitive advantage can be lost.

Real innovation and value rarely come from deeper exploration of a single, maturing field – such as CRM – but rather from the exploration and integration of related fields. This is often referred to as the "white space," or, more literally, "the new frontier." As CRM is a maturing discipline, with well-established boundaries, technologies and value propositions, finding new frontiers for improvement must happen beyond the historic purview.

Building advocacy

Banks need to elevate their aim beyond traditional CRM goals such as cross-sell, retention or satisfaction, and focus on building customer advocacy. By understanding the discrete stages of the customer experience, and by including emotional attributes, banks will be able to achieve advocacy, which in turn can more consistently deliver against base CRM objectives, such as more revenue with less cost.

Based upon the customer's feelings, or attitudes, toward a company, they can be described along a behavioral continuum that ranges from advocate to antagonist, (see Figure 1).

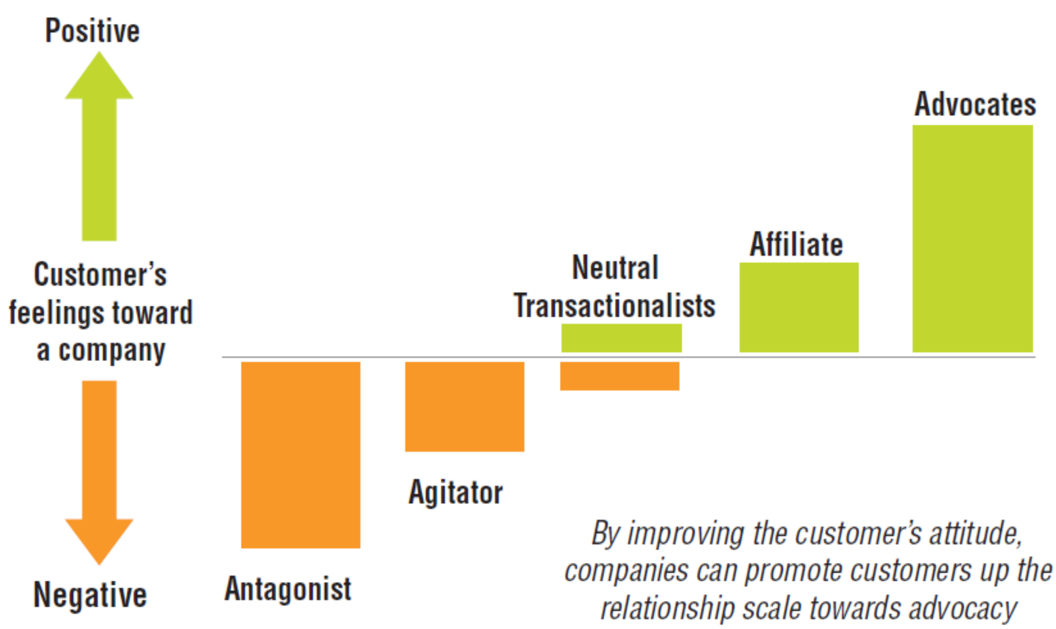
Building advocates, or at least moving customers toward advocacy, should be the goal of banks. Additionally, companies must think about becoming advocates on behalf of their customers. For example, when banks have information on a customer's credit rating, or other information about his or her total financial picture, that information should be used to demonstrate the bank is looking out for the customer's interests.

Are emotional connections being promised?

Brand promises are also what set customer expectations of the brand. Banks are frequently using marketing to establish an emotional connection with their customers, and to communicate that they are dedicated to attributes such as trust, caring, respect and dignity. Their operations, though, typically focus on functional delivery and operational metrics.

When banks promise emotional connections but deliver poorly against satisfaction indices, a rift can happen in their relationships with customers. An emotional connection may imply that a bank needs to be sensitive to the customer's true state, such as understanding when the customer is in a state of "buying" versus an active service mode. It may also mean that banks must respond emotively to customers, understanding what's important to them and delivering beyond operational proxies and metrics.

Figure 1. The goal: Create advocate-level feelings



New Challenges

These new customer expectations present several key challenges for major banks today:

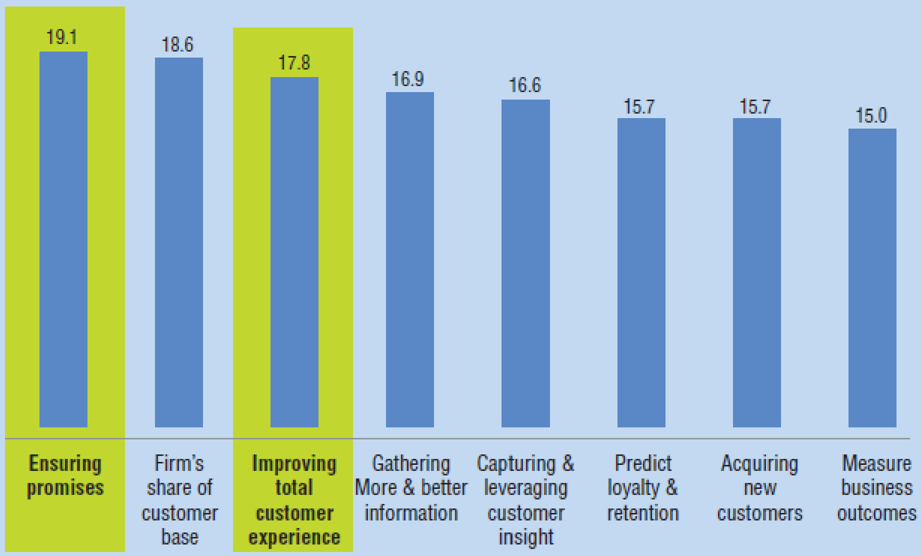
- How do banks differentiate their customer experiences when the customer already assumes competitive sameness?
- How do banks formalize and operationalize the advocacy- building, higher-order emotive attributes, such as dignity or empathy, as promised by their brands?
- How can banks transform ordinary experiences so they are consistently received by customers as positive experiences?

Customer experience tops business leaders' CRM priorities

It may not be a surprise that business leaders consider the customer experience a top priority (see Figure 2). What is surprising is that they find customer experience issues, including delivering on brand promises, a higher priority (cited by 19.1 percent) than acquiring customers (15.7 percent) or gathering customer information (16.9 percent).

Trying to "ensure promises" has profound effects on the customer experience, as promises set experience expectations.

Figure 2. Decision-makers' top CRM concerns



Customer attitude = customer expectations +/- experience delivery

A customer's attitude is the result of how experience delivery fulfills, exceeds or falls short of customer expectations. The result is the customer's attitude or feeling for the company.

Important considerations on customer's expectation and attitude

The customer's attitude is created out of a complex mix of different components, with most of them outside of any one bank's control. The customer's mindset can be described as a combination of interaction expectations and importance and relevance (See Figure of Five Dimensions).

Interaction expectations are what the customer expects when communicating or interacting with the bank, its products and service providers.

There are two primary types:

- Brand-specific delivery expectations are attributes that customers expect because of what they know about that specific bank. They can be created by brand promises, reputation and past experience. These expectations might be about quality, service level or value. For example, a national bank will be expected to offer a broad array of products and have a transactional Web site. A specific bank might run commercials that say "free checking and attentive service," both of which may set brand-specific expectations.
- Baselines expectations are what customers expect automatically in dealing with any bank, and in most cases, any business. Simply put, customers expect the branch to be open during the day and they expect polite service from tellers. Although these are obvious, baseline expectations increase daily, with such once futuristic features, such as integrated online statements and electronic bill-pay, now becoming part of the baseline.

Importance and relevance weigh each interaction in the minds of the customer, answering the customer question "This is how much I care about how the interaction happens".

IBM views importance and relevance in three, co-mingled categories:

- Interaction criticality measures how important it is that the interaction be completed or completed in a certain fashion. For example, it may be critical for a customer to transfer funds to cover a check, but not critical that it be done online.
- Intrusiveness of interaction measures how difficult, complicated or significant the interaction is. Completing a mortgage application is intrusive because it takes a lot of time, a lot of personal information, the interaction is critical (the customer must borrow money), and the result (approval or rejection) may have significant emotional relevance. Non-intrusive interactions may include receiving a mailed statement or hearing an advertisement on the radio.
- Emotional relevance and personal importance describes the emotional impact the customer perceives the interaction to hold. For example, a customer may respond emotionally to personal information being collected, find it extremely important to be treated with respect or find a loan application rejection very emotionally jarring. On the other hand, a customer may find a misspelled name on a bank statement emotionally irrelevant, or may even find access to a live teller unimportant if that customer only interacts via the ATM

Moments of truth

The importance and relevance of an interaction is often the sole reason why an interaction may leave a lasting impact and change a particular customer's attitude toward the company. Interactions that do this are called moments of truth.

Understanding moments of truth is vital toward the success of banks' customer experience initiatives. From a customer point of view, they are the most critical interactions when it comes to creating advocates or antagonists. From an operational point of view, they allow a company to prioritize investment and resources on interactions that really matter. For example, if the loan application process is a moment of truth, then that should be the process the bank focuses on improving, to meet customer expectations and fine-tune emotive delivery attributes. This understanding also allows the bank to determine which interactions not to prioritize. The best-designed and most elaborate mailed statements are non-events if the customer throws them away before opening the envelope. Over-delivering on emotionally irrelevant events will not make any advocates and is a waste of resources.

A note of caution: focus on the basics
Moments of truth can and are generated by brand specific or baseline expectations, but only when the delivery is botched enough to disrupt the customer's attitude. Even the most unimportant or emotionally irrelevant interaction can be soured into a disaster if there is unexpected rude treatment or a fundamental breakdown in delivery against the rational attributes of the relationship. For this reason, basic delivery against brand-specific and baseline exceptions is absolutely critical. Most banks still must make this a consistent priority. This point is understated in this document, and many banks would be vastly improved by making progress on just baseline and brand specific delivery. However, progress can and should be made on the delivery of the emotive attributes, even while pursuing delivery excellence against the rational relationship attributes.

A 20/20 customer experience from banks
"20/20" means "with sharpness of vision," or as IBM defines in this study, "with clear understanding of the customer." Providing a 20/20 customer experience creates an opportunity for differentiation. While delivering quality products, helpful services and multiple, functionally-rich channels is still critical, these offerings have become commonplace.

The new view of 20/20 customer experience includes:

- Addressing the entire customer experience, including its emotive attributes, and applying a cognitive science mindset toward understanding what truly motivates customer behavior.
- Going beyond understanding customer expectations to discover which events have a lasting impact.
- Focusing investment on those moments that have a lasting impact (moments of truth).
- Transforming the bank organization to deliver these customer experiences by raising operations to meet the brand promise.

This view presents a new frontier for improving customer experiences. New IBM research into customer experience delivery and design shows that some experiences are more important to customers, or have a higher emotional relevance. There are emotional attributes to experience delivery that become critical for companies to recognize and act upon.

A New Perspective
IBM has developed a new view that involves all aspects of customer experience delivery. A more complete vision of customer experience and design, it fully addresses both the emotive and rational attributes. The 20/20 customer experience delivery framework for banking has six dimensions (See figure).

1. Emotive attributes are the intangible, subjective dimensions that make up the relationship between the bank and the customer, such as being perceived as trustworthy, genuine or empathetic. These attributes present the greatest opportunity for differentiation in the marketplace, largely due to their lack of operational attention by most banks. According to the 2005 research, banking customers experience and respond to a broad array of emotive attributes when interacting with the bank (See figure)

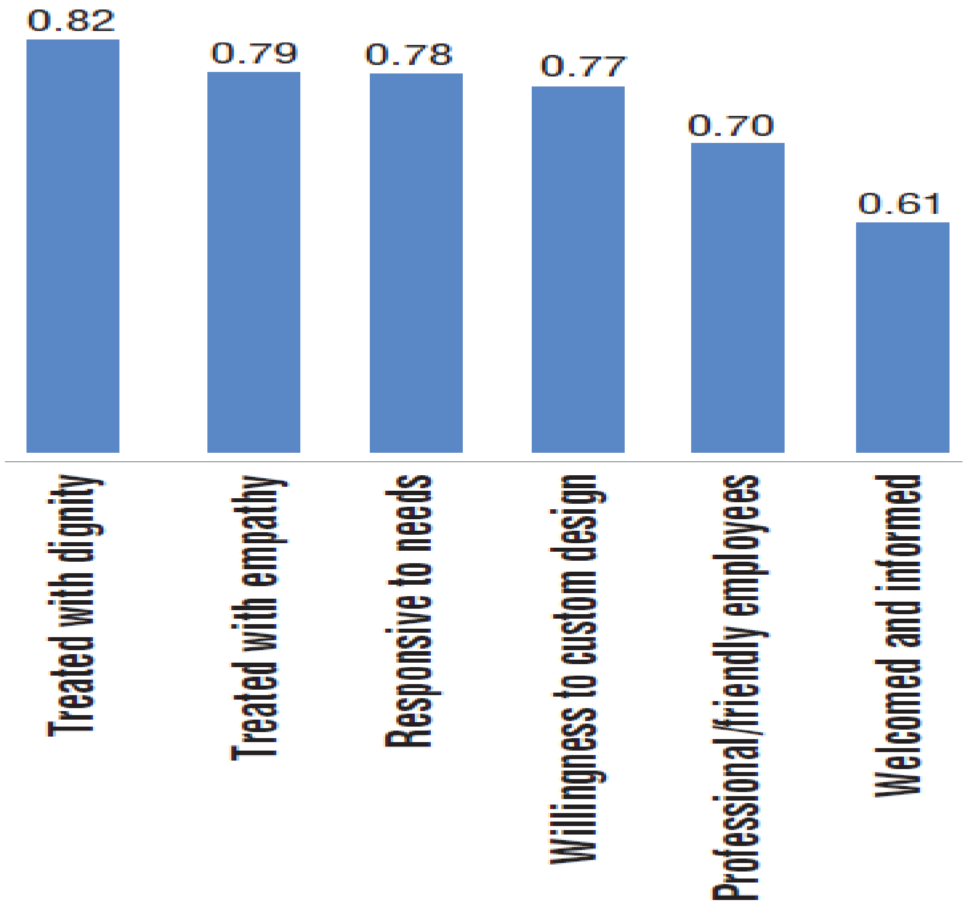
Customers cite higher-order emotive characteristics, such as dignity and empathy, as top preferences Characteristics such as friendly and informed are less important. This may suggest that customers believe qualities like friendliness, professionalism and being informed are baseline characteristics, or automatic.

Interestingly, the more sophisticated, emotive attributes have traditionally been ignored by bank CRM initiatives, despite being more important to the customer.

2. Rational attributes are the tactical qualities of the customer interaction, such as consistency, speed or completeness. These attributes are often easily measured and have been the focus of CRM engagements over the past decade. While these attributes are critical, there is increasingly less opportunity for banks to differentiate in these areas because of long-standing focus on improving them.

Research showed that although dignity, empathy and responsiveness were most important, less than half of customers had experiences that exceeded their expectations for the delivery of these attributes. This could be a natural result of many banks' inability to operationalize or purposefully deliver on these attributes, instead being forced to leave it up to chance and the character of branch staff (See Figure).

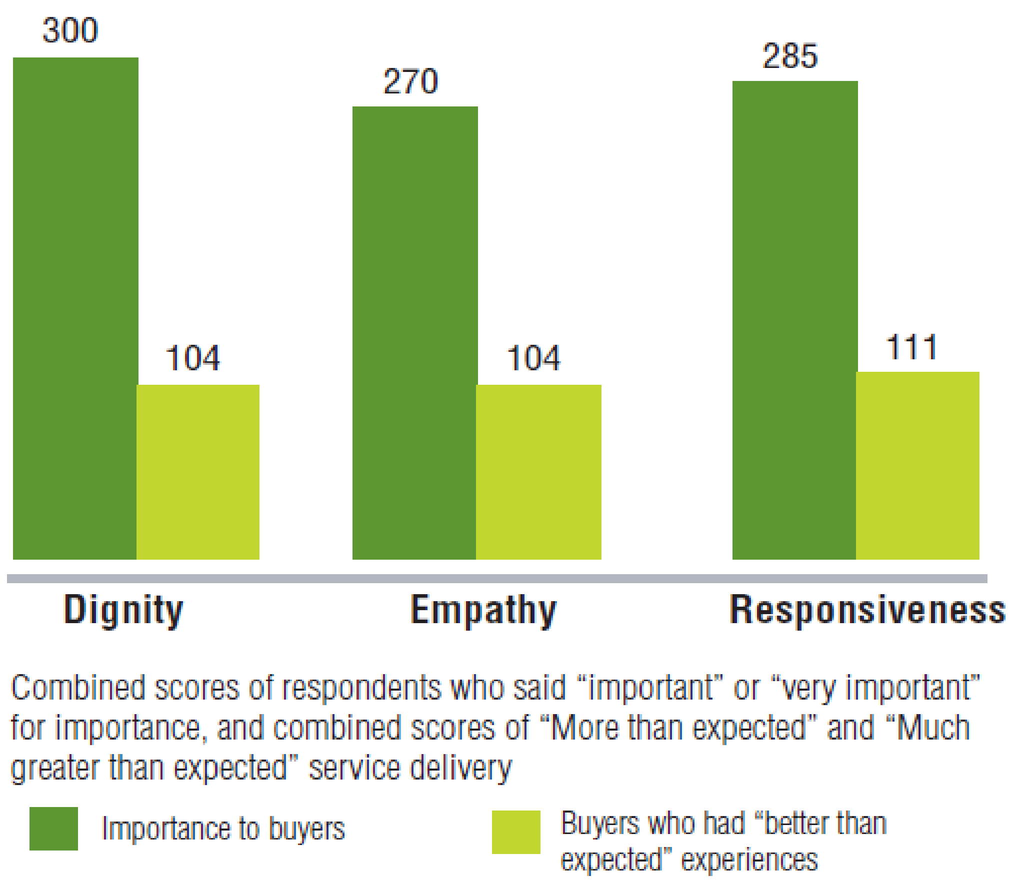
Figure 4. Customer preferences during banking purchase decision



Six Dimensions of 20/20 Customer Experience Delivery

1. Emotive Attributes
2. Rational Attributes
3. Customer Segments
4. Interactions
5. Channels & Touchpoints
6. Products & Services

Figure 6: Importance of emotive need versus expectations in Banking buyers



Understanding the difference between emotive and rational attributes is essential to delivering the right customer experience. When banks are able to operationalize both types of attributes, they will then be better able to elicit the higher-order emotive responses from bank employees, such as dignity or empathy, and have a higher probability of achieving customer advocacy.

Understanding the proper mix of emotive and rational attributes changes the way banks should handle various dimensions of the traditional customer experience, such as interactions, channels or products. Listed below are the traditional elements of experience design that should be viewed under this new lens.

3. Customer segments represent different types of customers. They may be treated differently based on their value, preferences and emotional profiles. In the past, two customers may have seemed the same because of their demographics or purchase history, but they may be wildly different in terms of what is important to them or which emotive attributes most strongly influence their banking behavior patterns.

4. Interactions are the individual events that a customer has with the company. Some are critically important, such as opening an account or receiving a fraud notice. Others are less so, like getting a credit card offer. Interactions are central to understanding the customer experience.

5. Channels and touch-points are where interactions take place and how they are executed and enabled through the specifics of the medium. There has been much focus on the rational attributes of customer experiences, but new channel competencies require delivery to also extend to the emotive attributes.
6. Products and services are the tangible goods or saleable services provided to the customer. Traditionally, companies focused on products and services as the core of their business and competitiveness. In banking, many products – such as accounts, CDs, insurance or basic investment products – have become commoditized. Product experiences then become secondary to other factors when considering the customer experience.

Raising Operations to Meet the Brand Promise
Raising operations to meet the brand promise requires that a company that understands the 20/20 customer experience and delivers against it to build customer advocates, while deploying resources effectively and smartly. New competencies and practices into the bank that make leading-edge customer experience strategies viable and operational are required.

The competencies that a company must focus on include:

- End-to-end customer design: A consumer-driven, "outside in" approach to design customer interactions that delivers against the specific emotive attributes that drive optimal customer banking behavior.
- Threaded channels: Channels support specific steps in the customer life cycle. Channels are integrated to support a consistent experience, and allow intelligent, cross-channel execution of customer interactions.
- Event driven communications: Capture discrete behavioral triggers, secondary events and patterns, and generate specific communication. Then route interactions in a seamless multichannel fashion based upon complex business rules, channel capacity and customer preference rules.
- Human performance: An approach to sustaining employee commitment and engagement that stimulates attitudinal change to allow knowledge workers to better meet personal and organizational objectives. Cognitive and behavioral science is used to assess and deploy staff against customer experience objectives and initiatives.
- Segment influenced operating model: Transform from product to customer-oriented P&Ls that support a focus on managing the business by customer segment; includes customer governance and ownership models, new metrics and organization design.
- Distributed delivery (virtualization): Create an environment and business model where business activity can be completed with less or no physicality, creating new interaction modes for customers and more effective resource delivery for banks.
- Innovation and collaboration – both company and customer: Establish an environment that promotes new ideas by combining insight with invention. By embracing these characteristics, leading banks can develop into customer-centric organizations that strive to deliver 20/20 customer experiences.

Conclusion

By addressing the entire customer experience, there is a new frontier for companies to create profitable customer advocacy, differentiation and competitive leadership. This new approach can be described as the 20/20 customer experience, which takes into account emotive attributes and focuses on key moments of truth – the interactions that will have a lasting impact on the customer's attitude toward the company.

IBM believes that companies should act on customer experience strategies. Beyond delivering against baseline expectations, being able to operationalize customer experiences by raising operations to meet the brand promise is essential to finding success. Companies who successfully transform their operations toward creating 20/20 customer experiences should find advantages in building customer advocacy, and ultimately, greater returns on their customer investments.

Source/Reference:

IBM Business Consulting Services

LESSON 36

MOMENTS OF TRUTH IN RETAIL BANKING……MANAGING CUSTOMER INTERACTIONS TO ENHANCE LOYALTY, SATISFACTION & SHARE OF THE WALLET

What is a Moment of Truth?

In recent years, considerable focus has been given to the concept of Moments of Truth. Whilst there are different interpretations of what this means, a Moment of Truth can be described as:

"An interaction with the customer that can cause a significant impact (positive or negative) on the attitudes of the customer to the bank."

Therefore, if Moments of Truth are understood and managed correctly, the result will be an increase in satisfaction, loyalty and, hopefully, increased business with the customer. Equally, poor handling of the interaction is likely to lead to dissatisfaction and defection.

For many banks the concept has been primarily applied to unique interactions of high emotional impact to the customer: how the bank handles fraudulent transactions, lost or stolen cards or bereavement, for example. However, a number of banks have moved the concept further.

Firstly, the research of many banks has indicated the importance of key sales and advisory transactions in the development of the relationship with the customer. The customer feeling that her needs have been understood and met by a meeting with a bank advisor has a different perception of the bank than the one that feels the advice given has been for the purpose of increasing the bank's fees and commissions.

Secondly, it has been noted that whilst events such as excessive queuing for counter service are not individually significant, if it happens frequently the cumulative impact can cause an equally negative reaction as the poor handling of a single major issue – the last time it happens can be the straw that breaks the camel's back.

Banks have moved to recognize that for different customers many different types of interaction can have a major impact on their relationship with the bank. This leads to the problem that if any interaction may have a serious consequence for the customer, what should a bank focus on improving? Is it possible to ensure that any interaction will be dealt with effectively and will lead to increased satisfaction or should banks play the percentage game and concentrate on certain types of interaction or, indeed, certain customer groups?

Briefing Objectives

The purpose of this briefing is to understand the use (or not) of the Moments of Truth concept within banks today. It is based upon specific interviews with 14 banks supplemented by Finalta's ongoing work on retail management best practices with over 30 banks across Europe.

Firstly, we provide the business background to the importance of customer interactions. Then we look at what banks actually perceive as Moments of Truth and, more specifically, which areas is the present focus for attention.

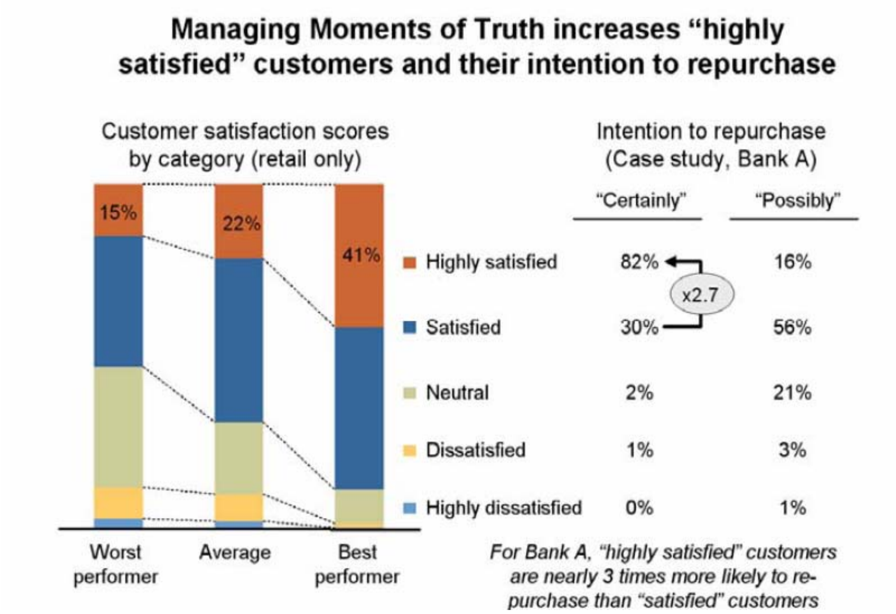
From this we offer a model that describes the different methods banks are using to address the issue and provide a framework for helping to think through a practical approach to improving customer interactions to increase satisfaction and deepen relationships.

Finally, we describe our perception of the state of play in European banking today and provide a view of the potential future for the management of customer interactions.

The Business Case

Using a standard five point scale, the overall level of customer satisfaction varies materially within different banks and across Europe. For some banks, over 40% of customers are highly satisfied with the service they receive. Other banks only receive this feedback from 15% of customers.

The implications for future sales, retention and share of wallet are material. The figure below provides some research from Bank A which indicates that that those customers who are highly satisfied are significantly more likely to repurchase than those customers who are satisfied, let alone those who are neutral or dissatisfied. Across various banks similar research backs this up.



Clearly moving customers to highly satisfy is a priority, a desirable objective. The question is how to achieve this and what the cost would be. If regular mass market customers were to receive the quality of service and advice normally reserved for high net worth individuals at very competitive prices, high satisfaction would result. Increased profitability would not.

Thus banks need a framework to trade-off the relative impact of different types of customer interaction, their frequency and the cost of meeting or exceeding customer expectations.

The Universe of Customer Interactions

Through the research, banks made the point that almost any type of interaction, for different customers at different times depending upon their service history with the bank, could have a high emotional impact. Figure 2 provides some examples of the different events that can be considered.

Routine Events

Ideally these events should be performed efficiently with limited impact on customer attitudes. However, a number of banks have identified issues with counter service – in particular queue lengths – or with the customer's reception in the bank branch as major areas of dissatisfaction. Whilst occasional break downs in service quality may be acceptable, frequent problems may escalate the emotional impact.

Advisory Events

Events relating to purchases of services (especially first time) often have a high impact on the customer. Major decisions such as mortgage purchase, especially given the complexity of the process in most countries, have a high emotional effect. In addition, advisory events are most closely linked to sales opportunities increasing the benefit of managerial focus.

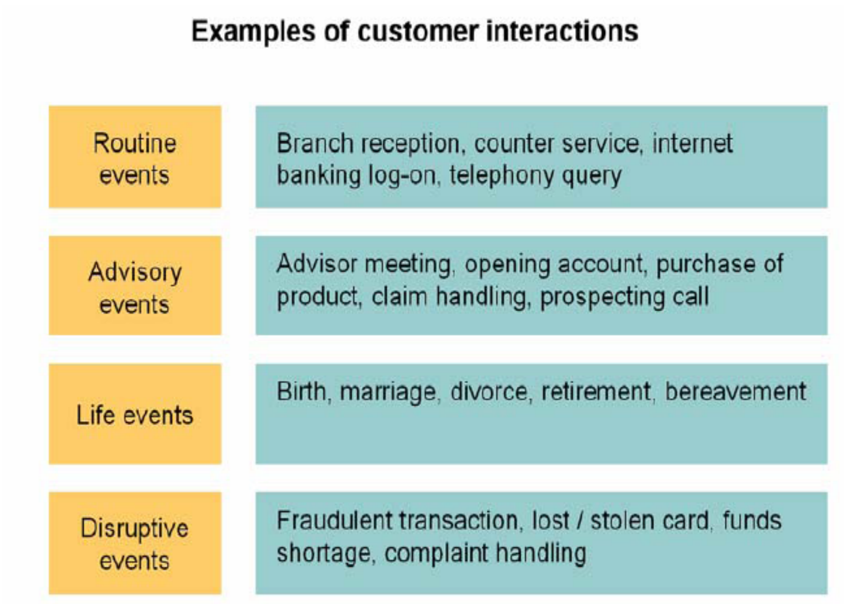
Life Events

Some banks have placed emphasis on managing major events in the customer's life to ensure that a relationship is gained, enhanced or retained. They perceive these interactions as offering substantial positive upside if pro-actively addressed and resolved for the customer.

Disruptive Events

These are unplanned events (either by the bank or the customer) that often have a high emotional impact. If the event is handled well by the bank, the relationship can be saved or strengthen. Poor handling will almost certainly lead to dissatisfaction and likely defection.

This segmentation provides a way of classifying different types of interaction. The next step is to identify, in general and for the specific bank, the major areas to focus upon.



Prioritizing Moments of Truth

Most banks have undertaken research to understand which interactions are of most importance to the customer and how well the bank is performing. This is the first stage in focusing attention and effort.

Finalta believes that a more sophisticated model is required than simply the degree of emotional impact on a customer of a particular event. It must include:

- The frequency of a given event;
- The times that the event is handled above, at or below customer expectation;
- The impact of these outcomes on customer satisfaction and loyalty; and
- The potential for improvement in performance and the likely cost.

For instance, Bank B surveys customers that have made a complaint and asks whether it was handled well, satisfactorily or badly. It then correlates this with their level of satisfaction and intention to repurchase. It has found that if a complaint is handled well, the impact on customer loyalty is minimal. Poor complaint handling almost certainly will reduce or end the customer relationship (if not immediately then in the near future).

The main techniques used are:

- General customer satisfaction surveys;
- Specific surveys or focus groups on particular aspects of service;
- Internal measurement of performance on KPIs;
- Complaints analysis and exit interviews;
- External benchmarking against competitors.

General customer surveys are most useful to try to measure the impact of regular events (reception, counter service, advisor meetings). In the main, disruptive or product purchase events are too infrequent to feature on large-scale surveys. Focus groups and specific surveys are used for less frequent event analysis.

Collection and analysis of complaints can also provide insight. However, many banks have limited central visibility of the type and volume of complaints as these are dealt with and not recorded in the branch. Some banks have reached close to 100% complaint recording by combining centralization of complaints resolution with incentives to branch staff to actually record locally handled issues (one insists on two complaints recorded per month per branch FTE).

External benchmarking is often used to provide some degree of objectivity to the problem. For instance, customers may complain about queue lengths but, compared to competition, is there something that can be done to improve the interaction? If it is understood that, on average, competitor customers do queue less (and how much less) then this provides a benchmark, perhaps a solution and the basis of the business case for change. Alternatively, recognizing that competition is as bad or worse may provide the impetus to positively differentiate on these interactions.

Banks also use exit interviews to understand the reasons for customer loss. What is interesting is how infrequently they interview delighted customers or customers that have increased their relationship. What was it about the relationship with the bank that caused high satisfaction? Is this something that could be exploited or built upon?

Core Moments of Truth

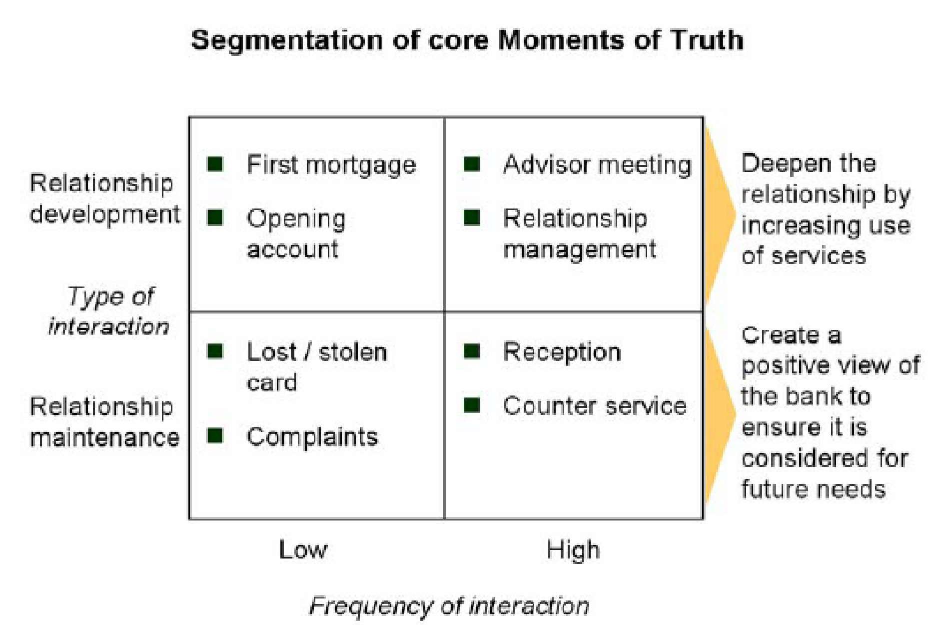
Based on Finalta's survey, it is possible to identify those interactions which, across the industry, are generally perceived to have a high impact on customer satisfaction and occur with sufficient regularity to make a material impact on the overall customer base of the bank (See Figure below).

This is not to say that others may not be important to individual banks (or that these will all be important to every bank). Individual banks noted events such as fraudulent interactions, claims handling, bereavement and refusing credit as important Moments of Truth for them.

Whilst most of the core Moments of Truth relate to "one-off" events (lost card, account opening), it is important to note the importance of "cumulative" interactions such as counter service and branch reception.

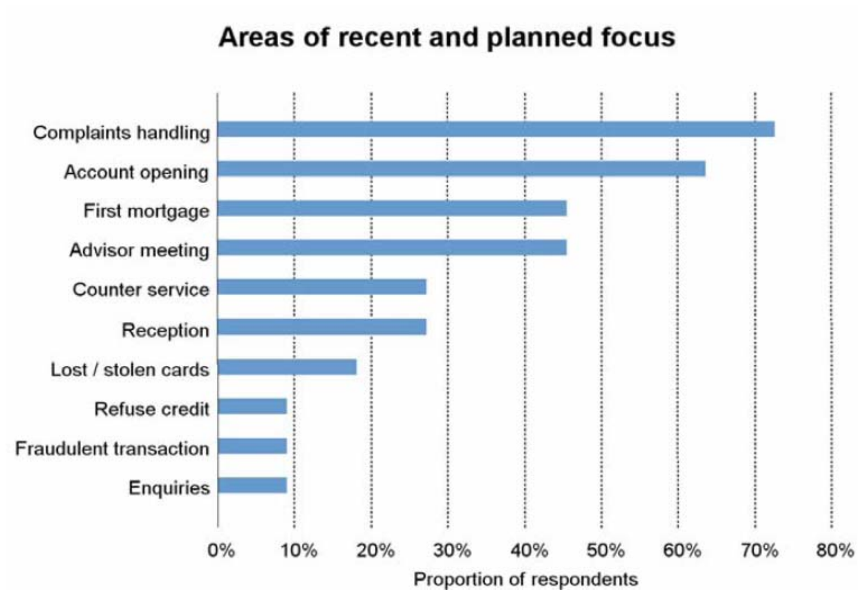
It is useful to consider the nature of the interactions from a relationship perspective. What we see is that half of the events are largely around relationship development – communicating to, meeting with and selling products. This is driven by the proximity of revenue increase to the impact of the event.

The other half can be described as relationship maintenance. The objective is not immediately to increase the customer relationship but to ensure loyalty and receptiveness to offers at a later date.



That said, one of the reasons why branch welcome and counter service are perceived as core Moments of Truth is the possibility of using these service interactions to immediately generate sales leads.

Of equal interest is to understand what are the areas that banks have either worked on recently or are presently focusing on (See Figure below). This is not quite the same as their perceived importance as Moments of Truth – it also indicates where banks in the research feel there is room for improvement in their own performance. Nevertheless, it gives a picture of where the focus of the banking market, in general, is.



Methods of improvement

Having gone through the process of identifying core Moments of Truth and opportunities for improvement, the next step is to take action.

First of all, one of the core messages from the group was the need to select a relatively small number of Moments of Truth and focus on these until performance meets targets, after this, move onto the next most important and so forth.

The approach that banks take will clearly be defined by those Moments of Truth identified. If the issues are around particular processes, the initiative is largely process centered – re-vamping the complaints process, reducing the time and complexity of account opening, etc.

Other core interactions are around staff behaviors – welcoming, advisor meetings and so forth. In this case the activity is based primarily on changing behaviors for all or part of the organization (though process improvement can be an important facilitator).

More generally, Finalta has identified two distinct strategies to improve the customer experience.

The process approach

One of the key trends across European retail banking is the adoption of total quality management ideas and practices from other industries. In part, this is a reaction to the fragmented processes typical of large banks. For many banks key processes such as account opening or mortgages cut through many departments, have no overall owner and are difficult to measure and manage holistically. This leads to some banks requiring many minutes to open accounts, with up to 12 signatures required and several days to complete the process.

To overcome this problem, banks use techniques such as Six Sigma and ideas from lean manufacturing (or even "Lean Sigma"). Typically starting with the most important (or most problematic processes) some banks have systematically re-engineered these activities.

Bank C, strewn with process problems, identified those with the most impact and causing the greatest number of complaints. It introduced process owning teams and used Six Sigma methodologies to tackle these processes. Over a 24 month period, the volume of complaints regarding these processes was reduced by over 50%.

Further, some banks have now moved to certification of the quality of these processes through achieving international standards such as ISO 9001 or comparable local equivalents.

Bank D has taken this approach even further. Working with a local quality certification body, it defined a program for quality excellence across the whole of the bank – a complete operating model based on quality standards.

The process started in 2004 with the support of the CEO who had identified service quality as the key differentiating strategy for the bank. This lead to an exercise to identify and fix key processes. A suite of internal applications were developed to collect, publish and monitor quality of service across the whole organization. At the end of 2005, the bank became, it is believed, the first bank to have its whole operation certified. This is now being rolled out as a "norm" for the rest of its market.

This holistic approach is based upon the view that a Moment of Truth is any interaction that, if done correctly, increases the trust of the customer for the bank. Nevertheless, for specific implementation, it believes that there is a maximum number of interaction types (probably five) that can be tackled at one time.

The Behavioral Approach

The process approach can be spread wider than classic operational activities such as the mortgage application process. The technique can be used to address counter service or advisor meetings. However, it can be characterized by a focus on the systems used to deliver a specific output.

Other banks have taken what Finalta would term a behavioral approach. This typically occurs when the customer experience issues are related to interactions with front line personnel or where there are major issues with back office customer focus – be the customer the consumer or the front line staff.

An example of this is Bank E which traditionally had an extremely sales-oriented approach to its customer base. It had excellent customer acquisition rates and sales productivity. Over time, it recognized it had an increasing attrition and dormancy problem. Through management example, behavioral coaching and reward system adjustment, it is attempting to move to a more balanced approach to the customer. The objective of the customer interaction is not solely to "sell" but to "service".

Frequent users of the behavioral approach to effective customer interaction are de-centralized banks with local branch autonomy. Without the systems and the culture to drive through "top-down" process improvements, banks concentrate on building a service ethos amongst front line (and support) staff.
Bank F attempted to re-invigorate its service culture through the implementation of a major cultural change program. It attempted to change the passive behaviors of its branch staff through reinforcing its core values (meeting customer needs and integrity) as well as changing their understanding of and attitudes to the role. The branch hall became the "stage", the customers were the audience and the interaction with them a form of choreography. (The implementation of branch choreography is the subject of another Finalta briefing).

As well as large scale cultural change programs, the behavioral approach can also be used for specific issues or specific staff groups. Bank G, for example, felt that its advisors had too little customer understanding. Meetings were "product push" rather than "satisfying needs". It determined to change behaviors by implementing strict measurement of the advisor's understanding of the customer. This was achieved by analyzing the inputs in the computerized interview report card to ensure that relevant information about the customer's circumstances and needs had been gathered at the advisor meeting. The degree of completeness is measured and the results impact remuneration.
The behavioral approach focuses on changing the attitude and actions of bank staff rather than defining and improving systems. It too can be measured, though this focuses on outputs ("Was your greeting friendly?

Did the service representative make eye contact and call you by name?). Process re-design is frequently a component of the approach but is often based on removing inhibitors (or excuses) to desired behaviors.

Framework for Action
All banks that have considered and embarked upon programs for improving customer satisfaction are clear that once the core Moments of Truth are identified, implementation requires focus on a handful of initiatives at a time – be this process or behavior.

The relative merits of the different approaches depend upon the nature of the objectives and the culture of the bank (the process focus is more common in centralized banks, behaviors in de-centralized banks).

Equally banks can change approach through their evolution. Bank A, for example, had very successfully engineered high customer satisfaction through managing the behaviors of its front-line staff, to the extent that it was difficult to get further improvement. However, its back office systems had seen under-investment and front line staff was increasingly covering for error-prone and inefficient processes. In 2005, it adjusted course and embarked upon a systematic program of process improvement and certification.

Clearly both approaches have their benefits. Equally both approaches must be mindful of the impact and the need for supportive actions on the other dimension.

Figure below outlines a high level framework for considering the actions required in the short term but also a "road map" for longer term planning and objectives.

Key Processes
Once core Moments of Truth for a bank are identified, these can be worked on in a systematic fashion with those of greatest impact first. Increasingly there is a recognition that a standardized approach, be it Six Sigma or others, provides a framework for analysis and helps change the operational culture as well as, hopefully, improving the efficiency of process improvement as the bank learns.

The end objective, as suggested in the case of Bank D, is to move the whole organization to a high-quality operating model, inculcating a performance culture within the bank.

Senior Management
The importance of senior management actions and support is critical for improving customer interaction. As the financial results normally take longer than a few quarters, program managers programs must have explicit support, especially in the period where change is high and financial impact is still to come.

Whilst a CEO's time is limited, actions can have significant symbolic impact. The CEO of Bank B, as part of its service improvement program, personally contacted two customers who had made complaints every month. The seriousness with which the rest of the organization took complaints resolution can be imagined. A harder case than senior management is line management. Area and regional managers have often seen several initiatives to improve the customer experience in their careers. In all probability they have also noted the reduction in senior focus when sales targets looked challenging. Bank H has looked to address this by:

- Getting their buy-in and input into the objectives to create ownership of the issue;
- Adjusting bonuses ahead of the front-line staff to reward service enhancement;
- Intense communication from senior management.

Back Office Operations

Whilst this group is most obviously impacted by process initiatives, there is often a need for behavioral change as well. Most banks have attempted to address this issue by initiating Service Level Agreements with the front office as well as front office satisfaction surveys impacting reward systems.

Front Line Staff

Most behavioral initiatives are aimed at this group. Critical aspects to consider include appropriate role definitions, reward systems, training, measurement and feedback system.

Bank I, in looking to increase the quality of service delivered and change the culture brought in individual quality certification for its counter and service staff. This meant training and examination on various protocols and choreographies for customer interaction. To incentivising take up, it became mandatory to be certified to reach a higher grade and salary.

(Further analysis on front line staff measurement, motivation and reward practices can be found in previous Finalta briefings).

Customer Expectation Management

Finalta believes that customer satisfaction is driven by the comparison of expectation and actual experience. In general terms, banks that present a high service proposition to the customer have higher expectations to live up to than those that emphasize other qualities (such as value for money).

Some banks are sufficiently confident in their capabilities to meet this challenge. Bank D, for example, perceives its unique quality certification as a means to "prove" its service differentiation to the market place. Other banks have suffered greatly when marketing messages have conflicted with operational realities.

Bank J made a major push to gain new current account customers, supported by enhanced account opening processes. This was keenly pursued by the branch staff. However, what had not been communicated to the customers (or staff) was the time and effort that was still required to move existing standing orders from their previous bank. The result was press headlines and reduced satisfaction.

More positively, enhancements to specific Moments of Truth can be used as marketing tools. Bank H introduced a new system for lost or stolen cards. Its customers can immediately go to the nearest branch and pick up a "temporary" card which will work until the new one is sent to them. So effective (and different) was this strategy that it became a major part of the product proposition.

Summary

Finalta believes that the concept of Moments of Truth is a useful operational tool for management. However, a number of banks have moved from this to a systematic approach to managing the customer experience across all interactions.

On the basis of our survey, we would classify banks into three camps.

Reactive

Whilst (nearly) all banks pay lip service to improving customer satisfaction and the customer experience, a few have a limited strategy in place to actually manage this. Interestingly, a number of mutual could be characterized in this fashion. Whilst service is expounded, the delivery of effective customer interactions relies on the behaviors of front line staff, often covering for inadequate systems. This behavioral approach can work for a long time, especially if it is built on a long tradition of service. However, it is often not supported by systematic protocols, procedures and training to ensure adherence. It relies on recruiting the right kind of staff and transplanting the culture. This relies on finding and paying for staff able and willing to do so. As service skills increase their value in the banking sector, this may prove an expensive solution.

Fragmented

The majority of banks have taken steps to identify and address what they perceive as the most important customer interactions. Depending upon their strategy these may be focused towards either relationship development or maintenance. However, they typically lack a coherent framework to prioritize actions and to ensure that process and behavioral actions are congruent.

Depending upon their service position, this may be sufficient for the present. If there are major and clear failings in particular interactions, taking these piecemeal and fixing them is probably adding value and an appropriate use of resources.

Systematic

A few banks, however, have moved to a complete quality of interaction model. Bank D has decided upon this as its key strategic thrust, systematically worked through its issues and developed a coherent (and certified) approach to the whole range of interactions that it has with the customer.

Having worked through the major interactions, systematic banks can continually improve quality in a structured, prioritized fashion – they have in place the operating model and the culture to achieve this.

Importantly, most banks typically focus on problems and fixing issues that cause dissatisfaction and attrition. Little attention is paid to the other side of the equation – exceeding expectations. As noted earlier, banks interview leavers, few focuses on what has made their customers delighted.

Banks with a systematic approach to customer interaction management should be moving into a position where they focus their resources on this aspect, create processes to delight their customers and raise customer expectations for everyone else.

To use a manufacturing analogy, Toyota started by fixing problems and, in doing so, developed the processes and behaviors to continually improve quality beyond existing customer expectations – to the detriment of its rivals. Perhaps banking will see a similar pattern.

Beyond Moments of Truth

The concept of Moments of Truth today has considerable value. It:

- Captures the fact that some interactions are more important than others;
- Provides a framework for prioritization; and
- Can give a language to cultural change.

Moving from this, the process and behavior framework is useful in thinking about the actions and the implications of enhancing each year a handful of critical interaction types.

However, the next stage is to create a business operating model – both processes and behaviors - where the norm is dealing with all important customer interactions at least to customer expectations and possibly beyond them.

Some of the more advanced banks don't actually use the concept of Moments of Truth. Instead they consider each interaction that can influence the trust of the customer as important. They have moved from managing Moments of Truth to ensuring a quality interaction in every aspect of the customer relationship.

Source/Reference:

Moments of Truth in Retail Banking
Finalta Briefing
Finalta Financial Services Benchmarking

LESSON 37

FOOD FOR THOUGHT……

- Why short-selling is Haram in Islamic Finance?
- Amid the financial crisis, the US stock market regulator SEC temporarily banned short selling on September 24, 2008.
- ***In Islamic Finance, however, 'to go short' will always be Haram.***
- In order to protect the stock markets from sliding further the Securities and Exchange Commission (SEC) saw no way out other than banning short-selling.
- Short selling occurs when stock market participants sell stocks or commodities they do not own in order to profit later from an anticipated fall in prices.
- It is a strategy widely used by hedge funds, which often are blamed for contributing to the fall of market instruments.

Shariah against Short-Selling……

- Because of the latter phenomenon, short selling is considered as haram under Shariah.
- "In Islamic Finance, we deny the conventional way of thinking, which aims of creating a new dollar out of every dollar", says renowned Pakistani Shariah scholar Sheikh Dr. Taqi Usmani.
- "By selling a stock short, the 'investor' may gain while the underlying company loses value – a clear violation of the ban of unjust deeds, stated in the ***Holy Quran, Sure Al Baqara, 2, 278 - 279: 'Deal not unjustly, and ye shall not be dealt unjustly".***
- Islamic Finance is about serving society.
- By selling a stock short, an avalanche of more short sellers might be triggered, leading the firm to expensive stock buy-back initiatives or in the worst case to bankruptcy.
- As well as short selling, day trading is labeled as speculation and therefore is counted as haram as well.
- Market participants are certainly allowed to profit, but this should add value to the entire economic system.

Shariah Banking's Moral Stance……

- The aspect of Tauhid, or unity, is also core in Islamic Finance.
- It is not only about investing in 'pure' stocks or avoiding interest. It is about protecting society from trickery, fraud and social tensions.
- Furthermore, Shariah banking bans sector which allegedly hurt Muslim society and family values as well.
- Sectors which are unacceptable or haram under Islamic Law (Shariah) are well-known.
- An Islamic Fund manager is not allowed to invest in stocks pertaining to alcohol, tobacco, entertainment, defense and the conventional banking and insurance sector.
- With the temporary ban of short-selling, Western financial regulators adapted for the first time a core principle of Islamic Finance.
- ***Will they now look at the Quran more closely in order to avoid another Black Monday?***
- Remember, most Islamic Banks in the GCC have achieved double-digit gains in 2008 while conventional banks currently recount their biggest losses in history.

MEASURING AND MONITORING BRANCH SERVICE QUALITY……

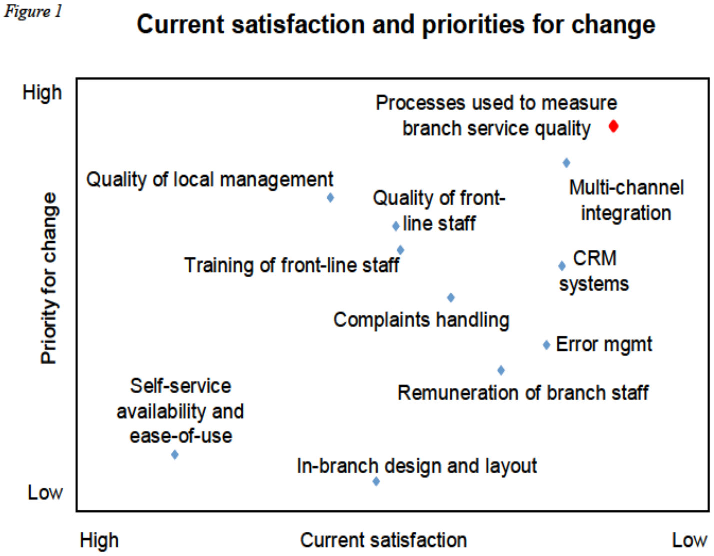
"What gets measured gets done". It might be a cliché, but analysis of branch service quality demonstrates that for service improvement, this rule holds true.

Why Measure Branch Service Quality?

- Banks recognize that service quality is critical to retain customers, increase referrals and improve cross-sell ratios.
- Branch service is both the most important part of the average customer service experience and also the most problematic with lower satisfaction levels than other distribution channels.

- Banks have made public commitments to build deeper and better customer relationships.
- However, without appropriate measurement it is impossible to effectively manage service improvement programs.
- Consequently, branch service measurement and monitoring is becoming a major area of management focus.
- Indeed, it has the highest priority for change to enhance branch service according to recent research (See Slide).

Figure 1



Service Measurement 'Rules of Thumb'……

The principles of service measurement can be summarized by the acronym ***RADAR***. Service measurement must be:

- **Rapid.** Service measurement data must be collected, analyzed, distributed and acted upon as quickly as possible to ensure immediate response and correction.
- **Accurate**. Data must be statistically robust and coherent to gain acceptance with staff and management especially when used for remuneration programs.
- **Detailed**. Data must focus on those aspects of most importance to the bank to improve overall service performance, and must be tracked on a branch by branch level.
- **Actionable**. Staff, within branches or management, should only be measured on what they can influence and improve.
- **Rewarded**. Measurement system results must be incorporated into remuneration systems for all relevant staff. Staff attitudes can be the largest barrier to service improvement.

Which Metrics Best Represent Service Quality?

There is a strong correlation between branch service capability and customer satisfaction, but not all customer service experiences have an equal impact on satisfaction.

Service experience can be influenced by:

- ✓ **Environmental Factors**
- ✓ **Hygiene Factors**
- ✓ **Critical Factors or "Moments of Truth"**

Environmental Factors

- This is the experience of visiting a branch rather than conducting a specific interaction or process.
- Factors include the look and feel of the branch and the welcome extended by branch staff.
- The most critical factor is often queue length.
- Associated service metrics could include average queue length, measures of branch presentation, literature availability or staff pro-activity.

Hygiene Factors

- For high volume transaction such as payments or deposits.
- Customers expect these processes to be completed quickly and without errors.
- There is no opportunity to exceed expectations, but bank errors have a negative impact on experience.
- Process error rates and self-service machine availability are metrics commonly used to measure this type of service experience.

Critical Factors or 'Moments of Truth'

- These are interactions which are highly emotive or important for the customer.
- Examples include: reporting a lost or stolen card, first mortgage application or first overdraft.
- The Bank should identify those events which have the largest impact on customer satisfaction, and prioritize measurement of these.

Which Techniques are best for Measuring Service?

- Environmental factors can be best measured using customer satisfaction surveys, mystery shopping and emerging Point of Sale technology.
- Customer satisfaction surveys are the most commonly used measure of service quality.
- However, question design must reflect the specific metrics required and measurement must be at the branch level.
- Hygiene factors are best measured using MIS data which is captured for operational purposes.
- Such measures are accurate and their collection is low cost, with the majority of investment required in upfront design rather than ongoing monitoring.
- Despite having the greatest impact on satisfaction, critical factors are least commonly measured, largely because of the difficulty in identifying an appropriate measurement technique.
- 'Moment of truth' service quality is best measured via targeted customer satisfaction surveys.
- For problem identification, focus groups or ad hoc surveys can also be valuable.

Whilst MIS-based metrics can be collected at relatively low cost, other techniques are more expensive. Thus measurement budget must be focused on delivering accurate data on the highest priority metrics. For banks which are overhauling an existing measurement system, concurrent cost savings can be achieved through:

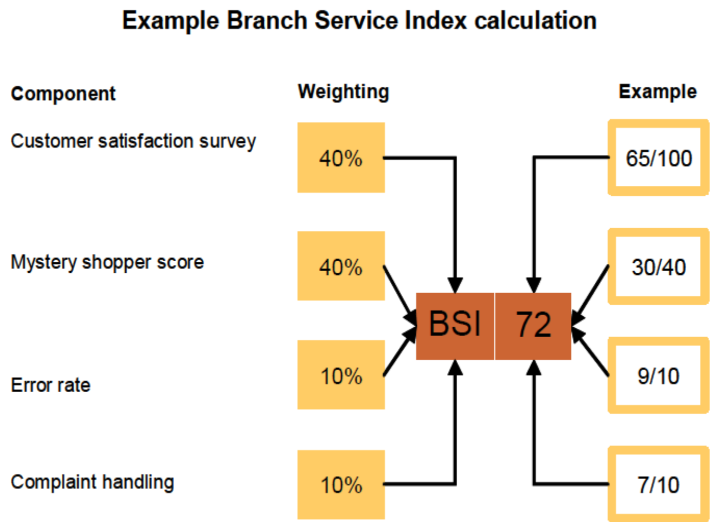
- Eliminating the collection of unused or unimportant service measurement statistics;
- Pruning customer satisfaction surveys to the core, essential questions;
- Streamlining the distribution of service measurement information to focus on delivering the key data to the right levels of the organization.

Cost constraints can make it tempting to make short cuts that compromise the accuracy and reliability of data. However, data reliability is critical if staff is to accept the measurement system.

How can Service Measurement be used?

To make these measures easily understandable and actionable, best practice banks use a composite branch service index, calculated by weighting all service metrics collected by their relative impact on customers' perception of branch service quality. Figure 2 provides illustrates how a branch service index score might be calculated.

Service measurement data has a number of different 'audiences' and the type of data provided needs to be tailored to the needs to each. To make data easy to use, getting the correct level of granularity is critical. For most members of the senior management, the composite index score alone may be sufficient. Rather than creating multiple reports for these audiences, the data should be integrated with the standard MIS reports used as an operational tool by these groups. Conversely, the outputs of the service measurement system should be exploited to set Bank-level targets for service quality, and cascaded to allow regional and branch management to create local action plans to deliver these targets.



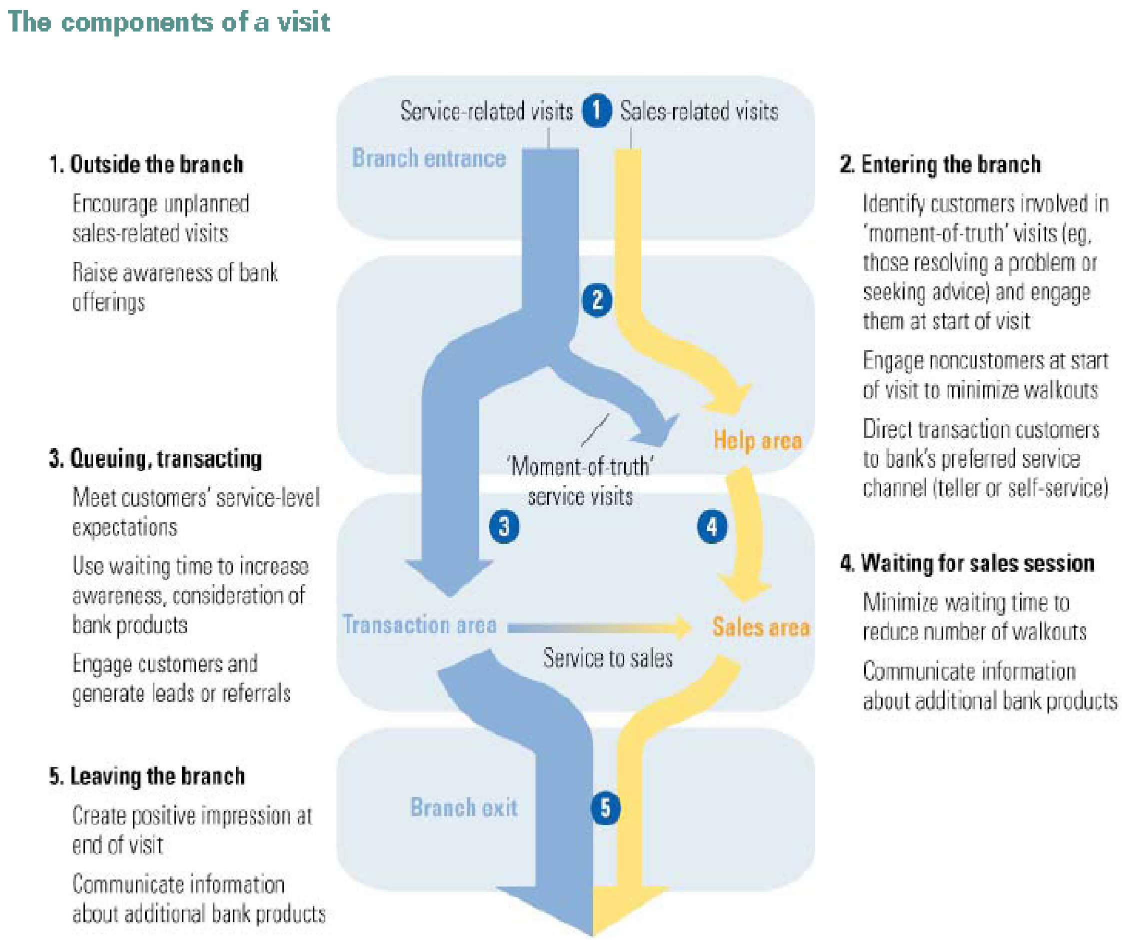
Measurement data is primarily used to set remunerated performance targets. Finalta found that in best practice organizations, up to 20% of branch manager variable remuneration is related to service, whilst for tellers variable remuneration is based on team service goals, and is worth between 5% and 15% of variable remuneration. Remuneration linked to service performance should not be restricted to branch staff, branch network management at all levels should also have a service element to their reward, and functional units should be rewarded based on the service quality provided to the front line.

Bank Branches that Meet Customer Needs

Break down visits into their components Putting looks before utility is a common pitfall in branch renewal programs. To avoid it, banks must first decide how to shape the flow of visits from customers (for instance, by having staff members approach them as they enter the branch) and then design the environment accordingly. To be effective, the changes will probably have to go far beyond the physical formats of branches.

A typical customer visit has five key components—outside the branch, entering, queuing and transacting, waiting for sales, and leaving—corresponding to distinct physical areas. Banks should have different objectives for each component (exhibit), taking into account the different needs (and income-generating potential) of service and sales-related visits. At the entering stage, for instance, a key objective will be to segment customers into people on simple transactional errands (who should be directed to a teller or a self-service desk) and those on "moment-of-truth" missions (such as resolving problems or seeking advice), which shape customer perceptions of the bank.

Clear signage can be very effective, particularly combined with the physical separation of the transaction area (teller counters and ATMs) from the help-and-advice area (the service desk and the sales section). Placing a meeter-greeter desk directly in the line of incoming customers can be a good idea under some circumstances but may be ill advised in others. In our experience this approach often works well in large branches with complex traffic patterns: different customer segments requiring specialized personnel to handle their various requests. But it can be needlessly expensive in smaller, transaction-oriented outlets and is positively self-defeating if, as frequently happens, the desk is there but left unstaffed.



Source/Reference:

1. **Measuring & Monitoring Branch Service Quality Finalta Briefing**
2. **McKinsey Quarterly, Financial Services**

LESSON 38

HOUSING/MORTGAGE FINANCE IN PAKISTAN

SBP PRUDENTIAL REGULATIONS FOR HOUSING FINANCE

REGULATION R-15

- Banks/DFIs shall determine the housing finance limit, both in urban and rural areas, in accordance with their internal credit policy, credit worthiness and loan repayment capacity of the borrowers.
- At the same time, while determining the credit worthiness and repayment capacity of the prospective borrower, banks/DFIs shall ensure that the total monthly amortization payments of consumer loans, inclusive of housing loan, should not exceed 50% of the net disposable income of the prospective borrower.
- Banks/DFIs will not allow housing finance purely for the purchase of land/plots; rather, such financing would be extended for the purchase of land/plot and construction on it.
- Accordingly, the sanctioned loan limit, assessed on the basis of repayment capacity of the borrower, value of land/plot and cost of construction on it etc., should be disbursed in tranches, i.e. up to a maximum of 50% of the loan limit can be disbursed for the purchase of land/plot, and the remaining amount be disbursed for construction there-upon.
- Lending bank/DFI will take a realistic construction schedule from the borrower before allowing disbursement of the initial loan limit for the purchase of land/plot.
- Banks/DFIs may allow housing finance facility for construction of houses against the security of land/plot already owned by their customers.
- However, the lending bank/DFI will ensure that the loan amount is utilized strictly for the construction purpose and loan is disbursed in tranches as per construction schedule.
- Loans against the security of existing land/plot, or for the purchase of new piece of land/plot, for commercial and industrial purposes may be allowed.
- But such loans will be treated as Commercial Loans, which will be covered either under Prudential Regulations for Corporate/Commercial Banking or Prudential Regulations for SMEs Financing.
- Banks/DFIs may allow Housing Loans in the rural areas provided all relevant guidelines/regulations on the subject are complied with by them.

REGULATION R-16

The housing finance facility shall be provided at a maximum debt-equity ratio of 85:15.

REGULATION R-17

Banks/DFIs are free to extend mortgage loans for housing, for a period not exceeding twenty years. Banks/DFIs should be mindful of adequate asset liability matching.

REGULATION R-18

The house financed by the bank/DFI shall be mortgaged in banks/DFI’s favor by way of equitable or registered mortgage.

REGULATION R-19

Banks/DFIs shall either engage professional expertise or arrange sufficient training for their concerned officials to evaluate the property, assess the genuineness and integrity of the title documents, etc.

It may, however, be noted that the requirement of full-scope and desk-top evaluation, as required under R-8 and R-11 of Prudential Regulations for Corporate/Commercial Banking and SMEs Financing respectively, will not be applicable on housing finance.

REGULATION R-20

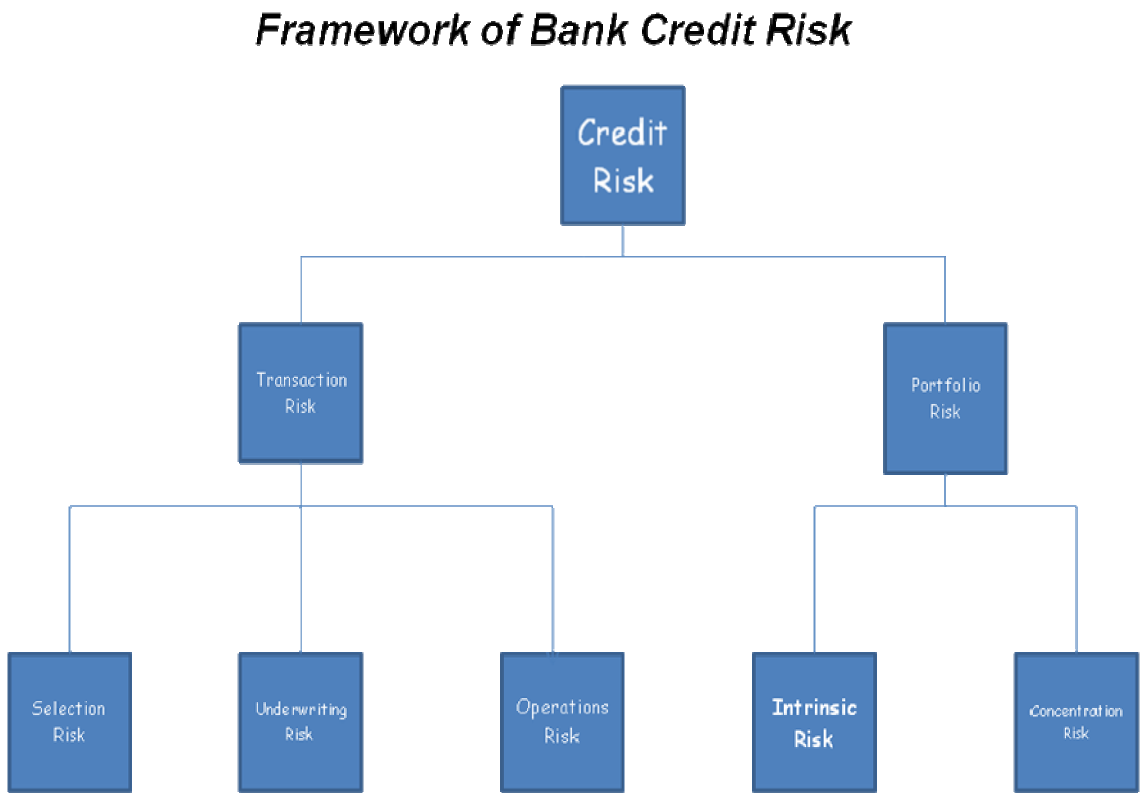
The bank’s/DFI’s management should put in place a mechanism to monitor conditions in the real estate market (or other product market) at least on quarterly basis to ensure that its policies are aligned to current market conditions.

REGULATION R-21

- ✓ Banks/DFIs are encouraged to develop floating rate products for extending housing finance, thereby managing interest rate risk to avoid its adverse effects.
- ✓ Banks/DFIs are also encouraged to develop in-house system to stress test their housing portfolio against adverse movements in interest rates as also maturity mismatches.

REGULATION R-22

It covers Classification & Provisioning for non-performing loans.



Standard Operating Procedure (SOP) Manual for Housing Finance

A Typical Sample of a Bank in Pakistan

- ✓ Policy
- ✓ Procedures

Policy Highlights:

1. Introduction
2. Customer Type
3. Product Features & Eligibility Criteria
4. Income Requirements (Source of Repayment)
5. Responsibilities & Authorities
6. Delinquency
7. Insurance
8. Re-Scheduling & Change in Facility Terms
9. Provisioning
10. Termination
11. Litigation
12. Commission
13. External Agencies
14. Reporting
15. Annual Review/Industry Survey/Budgets
16. Deviation Matrix

NOTE:

Following is a sample of a typical Housing Finance Manual from a Bank operating in Pakistan. This is not a standard format as a number of features/contents may vary from Bank to Bank

1. Policy

1.1 INTRODUCTION

1.1.1 Purpose of the Manual

Standard Operating Procedures (SOP) Manual (herein referred to as the manual) is to provide the personnel of the concerned department with a standard document to serve as a guideline in carrying out their responsibilities.

1.1.2 Responsibility of Implementation

It shall be the responsibility of the General Manager – Consumer Finance (GM-CF) to implement the policies and procedures presented in this manual and this responsibility shall be delegated to the regional heads.

1.1.3 Clarification

Request for clarification or explanation of the material present in this manual shall be addressed to the GM-CF.

1.1.4 Manual Holder

The following shall be authorized to keep a copy of the manual at all times to ensure proper delegation and segregation of duties and implementation of the policies and procedures prescribed therein:

- CEO
- GM-CF
- Divisions/Functional Heads

1.1.5 Updating and Revision

These policies and procedures shall be reviewed and revised from time-to-time, as deemed necessary.

1.1.6 Changes in SBP and other Regulatory Regulations

Changes in relevant laws and regulations such as SBP PR's shall be automatically applicable and would override any clause in this manual and SOP's should be updated to reflect the change.

1.1.7 Risk Management Function

A separate risk management framework for the purpose of Consumer Financing shall be established which will be suitably staffed by the personnel having sufficient expertise and experience in the field of consumer finance. This capacity shall operate completely independence of business and report to Country Risk Office.

1.2 CUSTOMER TYPE

The customers applying for the housing finance shall be classified under Consumer Finance.

1. **Applicant-** whose income is being taken into consideration; may be a:
   a. Salaried Individuals
   b. Self-Employed Businessmen (SEB)
   c. Self-Employed Professionals(SEP)
2. **Co-borrowers-** individual who owns the property or has right therein. Further it also includes a person whose income is clubbed with main applicant. These may compromise of the following:
   a. Spouse
   b. Blood relatives (parents, siblings and children)

1.2 PRODUCT FEATURES AND ELIGIBILITY CRITERIA

This will be explained / described in Lecture # 39.

1.4 INCOME REQUIREMENTS

While computing the monthly income the following will be included:

Salaried Individuals

- Basic salary.
- Rent allowance.
- Conveyance allowances.
- Other remuneration which is part of the package, such as guaranteed bonus or LFA.
- Other verifiable regular income.

The following shall be considered as per the share mentioned below and subject to documented proof available:

- Rent income (90% of the average of last 2 years).
- Performance bonuses (90% of the average of last 2 years).
- Commissions (90% of the average of last 2 years).

The following shall be excluded:

- Taxes.
- Provident fund payments.
- Any other deductions at source (including other financing facility taken by the customer).

Other than Salaried Individuals

Income estimation of the above will primarily be based on either one of the following. CM/CRM should specifically mention which source document is used for income calculation:

- Bank statements (average credits or average balances)
- Tax returns or
- Income estimation from an approved agency on Bank's panel or
- Audited financial statements for facilities above Rs 5m.
- Other documents provided by the customer. This could include partnership documents, annual accounts, bank statements of business etc.

For a facility Rs. 5 million and above, income estimation shall also be performed by an outside agency. However for such cases the requirement of income estimation may be waived subject to the approval of GM-CF. In case of such waiver, Manager – HF shall consider the income from any above-mentioned sources.

Income to installments ratio will be calculated by comparing customer's net disposable income against his credit commitments (including applied facility). This shall be within 60:40.

The ratio can be extended upto50% of the disposable income. However this would require deviation approval of GM-CF.

1.4.1 LOAN DOCUMENTATION, DISBURSEMENT COLLECTION AND MONITORING

These are covered in Procedures Section of the manual.

1.5 HOUSE FINANCE TEAM, RESPONSIBILITIES AND AUTHORITIES

Consumer House Finance shall comprise of sales team, processing team and collection team. The individual teams shall be headed by the House Product Manager who would be responsible for looking the entire affairs of this product.

1.5.1 RESPONSIBILITES AND AUTHORITIES

Sales team shall bring the lead and will coordinate with the processing team for completion of required documents. The functions and procedures are further defined in part 2 of this manual. Sales, processing and collection team shall have no right over approval or rejection of the case which strictly rests with credit committee. Credit committee powers and authorities and limits are defined in table below:

1.5.2 SANCTIONING AUTHORITIES AND LIMITS OF CREDIT COMMITTEE

Members of HFCC: Manager –HF, Regional Manager – CF, GM-CF.

Financing Amount	Approving Authority
• HF cases up to Rs. 20	• GM-CF plus 2 HFCC members
• HF cases up to Rs. 30	• GM-CF, any 2 HFCC members and Risk Manager-CF
• HF cases up to Rs. 50	• GM-CF, any 2 HFCC members, Country Risk Manager and CEO

1.6 DELINQUENCY

The responsibility of collection rests with the CF. All the installments will be due on the first of every month. The procedure for handling delinquency is covered in 2.3.5.

1.7 INSURANCE

The property financed by the Bank shall be protected with full coverage (comprehensive) insurance plan for the complete period of financing. The insurance company providing the plan shall be on Bank's panel.

Insurance premium will be charged on an annual basis in advance.
The value insured shall be:

- 125% of the facility amount in case of an apartment; and
- 125% of the facility amount or structural value, whichever is lower, incase of a house. In construction cases it should be 125% of trenches released value.

The customer shall also be required to obtain a life insurance policy from an insurance company, Bank's panel at least equal to the facility amount, with Bank as the beneficiary.

1.8 RESCHEDULING/CHANGE IN FACILITY TERMS

The request for rescheduling/change in terms of the facility shall be approved by the GM-CF. Rescheduling charges shall be obtained from the customer as per Bank policy as applicable from time to time. Reduction in rates shall be as per the rate limits of relevant sanctioning authority. Age of loan shall no exceed the maximum loan term as prescribed by Prudential Regulations. Change in tenor can be approved by GM-CF.

Facility terms to be changed in following situations:

ENHANCEMENT OF THE FACILITY/TENOR

- Enhancement will be treated as a new facility and relevant documents shall be obtained for approval.
- Loan tenor for facilities extended including enhancement, to a maximum of 20 years from the date of first disbursement.

1.9 PROVISIONING

Bank shall follow the Prudential Regulations (PRs) pertaining to provisioning, issued by SBP from time to time.

1.10 TERMINATION

The customers may be allowed premature termination of the financing obtained; however, a 5% charge on the outstanding principal shall be imposed or as may be decided by management from time to time. These charges or part there of, may be waived subject to the approval of GM-CF.

Where the customer requests a partial prepayment towards a facility, it shall be ensured that the customer meets the following pre-requisites:

- A partial prepayment charge shall be obtained from the regular customer as per Bank policy (as applicable from time to time). These charges may be waived subject to the approval of the GM-CF.
- Partial prepayment shall be allowed twice a year. However, the GM-CF may allow more than two partial prepayments in a year.

Minimum payment under this option shall not be less than six monthly installments.

1.11 LITIGATION

Any account due to collection issues or any other reason as deems fit by the GM-CF can be forwarded to legal advisors for resolution (for seeking legal opinion, initiating legal proceedings etc).

1.12 COMMISSION

Commission policy to sales staff, free lancers, referees, collection staff etc shall be applicable as approved by GM-CF from time to time.

1.13 EXTERNAL AGENCIES

CFD shall use the following regulatory authority/approved external agencies for verification and other outsourced work:

a. **SBP**
Services of SBP shall be utilized for the purpose of obtaining ECIB report of customers.

b. **Data Check-Private credit information bureau**
The data check website shall be utilized for the purpose of checking the credit worthiness of the customer for all transactions.

c. **Approved Verification Agencies**
Physical verification of the residential and business/employer addressed of the customers, their references and guarantors shall be processed through an approved agency that shall on behalf of the Bank conduct verification of all customers applying for financing.

d. **Approved Income Estimation Agencies**
Income estimation of the customer shall be processed through an approved agency that shall on behalf of the Bank conduct income estimation (if required) of the customers applying for financing.

e. **Approved Valuation Agencies**
Valuation of the property being financed shall be done in all the cases and shall be processed through Bank approved agencies.

f. **Approved Legal Advisors**
The original documents of properties to be financed by the Bank shall be verified by the Legal Advisor on Bank panel before disbursement of the finance facility.

1.14 REPORTING

Consumer Finance Division (CFD) and Credit Administration Department (CAD) shall perform the following internal and external reporting with respect to housing finance:

Overdue payments

CAD shall inform on a regular basis, regarding any unsuccessful collection of any dues such as insurance, documentation charges, rentals, legal fees etc or insufficient balance in the customer account on the rental due date.

Performance Report (Sales Report)

CF shall on a monthly basis prepare a performance report giving details of the cases finalized during the month. The report shall be forwarded to RM-CF and GM-CF for onward submission to the CEO.

Executive Summary

The report shall be prepared a month basis by the CF Coordinator and shall be forwarded to the CEO through the GM-CF. The report shall contain;

- Pan Pakistan disbursement report
- An overdue report for classified portfolio
- Head Count report

Interrelated delinquencies

Reports shall be prepared and reviewed to monitor delinquencies across various products.

Commission Report

CF shall prepare a report pertaining to commissions due during the month, which shall be forwarded, to the RM-CF and the GM-CF for payment of commission to sales staff. The report shall also highlight the sales target for each sales personnel and the actual sales made by them.

B Quarterly report

a. **Profit and Loss Consumer Finance**
   The report shall be prepared on a quarterly basis by the CF Coordinator and shall be forwarded to the FCU/CEO through the GM-CF. The report shall contain a pan Pakistan Profit and Loss analysis for all the three products of consumer financing.
b. **SBP-Quarterly Report**
   CF shall prepare a quarterly performance report for SBP, on the format prescribed by SBP.

1.15 ANNUAL HOUSE FINANCE PRODUCT PROGRAM

Product program comprising of objective/quantitative parameters for the eligibility of borrowers and determining the maximum permissible limit per borrower as required by Part B (Minimum Requirements for consumer financing) Prudential Regulations shall be annually prepared. The document shall also cover industry survey, competitor analysis, budget for current year, and performance in prior year etc. this document shall be approved by CEO.

1.16 DEVIATION MATRIX- HOUSE FINANCE

Deviations/waivers may be considered while sanctioning approval for processing of applications. The senior member of sanctioning authority is to approve deviation/waivers. Particular deviations are mentioned in relevant paragraphs of SOP.

Major deviations allowed are mentioned below. No deviations from Prudential Regulations requirements are allowed.

Type of Deviation	Approving Committee
	GM-CF
Debt Burden Ratio up to 50%	✓
Age Relaxation	✓
Employment Period	✓
Verification of customer	✓
Bank Statement	✓
Proof of Business	✓
Tax Returns	✓
Financing below the minimum financing amount	✓
CIB over dues- up to 120 days	✓
Date Check Default	✓
Life Insurance	✓
Processing charges Waiver or Reduction	✓
Termination Charges Waiver or Reduction	✓
Partial Pre payments more than twice a year	✓
Partial Pre payment charges Waiver or Reduction	✓

Property Age	✓
Major and Minor Structural Violation in valuation report	✓
Income Estimation in certain cases	✓
Reschedule/Change in Facility	✓

LESSON 39

HOUSING/MORTGAGE FINANCE IN PAKISTAN (CONTD…)

PRODUCT FEATURES AND ELIGIBILITY CRITERIA

Housing finance shall comprise of Financing of residential properties (in the form of a self standing house, semi detached house or an apartment).

The following table shows the key features of housing finance products:

Features	Buy a land + Construction	Build a house	Buy a home	Home renovation	Balance Transfer Facility
Facility Tenure(1)	1 to 20 years	1 to 20 years	1 to 20 years	1 to 20 years	1 to 20 years
Minimum Facility Amount	Bank's Discretion	Bank's Discretion	Bank's Discretion	Bank's Discretion	Bank's Discretion
Maximum Facility Amount(2)	Bank's Discretion	Bank's Discretion	Bank's Discretion	Bank's Discretion	Bank's Discretion
Collateral(3)	Residential land + construction value	Residential land + construction value	Residential property	Residential property	Residential property
Maximum Property Age(5)	N/A	N/A	50 yrs at maturity of the facility	50 yrs at maturity of the facility	50 yrs at maturity of the facility
Debt Equity Ratio	80:20	80:20	80:20	50:50	80:20
Profit Rate – variable(6)	12 month KIBOR+ Spread (as per policy)	12 month KIBOR+ Spread (as per policy)	12 month KIBOR+ Spread (as per policy)	12 month KIBOR+ Spread (as per policy)	12 month KIBOR+ Spread (as per policy)
Disbursement Mode	Stage Wise(7)	Stage Wise	One Time	One Time/Stage Wise(8)	One Time/Stage Wise
Property and Life Insurance(9)	Mandatory	Mandatory	Mandatory	Mandatory	Mandatory
Residency	Pakistani/ NRPs	Pakistani/ NRPs	Pakistani/ NRPs	Pakistani/ NRPs	Pakistani/ NRPs
Minimum Age of Applicant	21 years	21 years	21 years	21 years	21 years
Maximum Age of Applicant on completion of facility term	60 or the retirement age as per the company/ employer for Salaried Individuals and 65 for SEB/SEP/ NRP(10)	60 or the retirement age as per the company/ employer for Salaried Individuals and 65 for SEB/SEP/ NRP	60 or the retirement age as per the company/ employer for Salaried Individuals and 65 for SEB/SEP/ NRP	60 or the retirement age as per the company/ employer for Salaried Individuals and 65 for SEB/SEP/ NRP	60 or the retirement age as per the company/ employer for Salaried Individuals and 65 for SEB/SEP/ NRP
Employment Period/Years in Business	2 years(11)	2 years	2 years	2 years	2 years

Additional Security	PG(12)	PG(12)	PG(12)	PG(12)	PG(12)
Rental Collection	Equal Monthly installment/ staggered	Equal Monthly installment/staggered	Equal Monthly installment/ staggered	Equal Monthly installment/ staggered	Equal Monthly installment/ staggered

1) The facility tenure should not exceed the customer's retirement age. The requirement may be waived subject to the approval of GM-CF.
2) Please refer "Sanctioning Authority/Limit" part of the Manual. Loan facility above these limits referred to CEO for approval.
3) To finance a transaction the bank shall obtain the property financed as security under a registered (token) mortgage except where equitable mortgage is specifically mentioned in credit memorandum and approved by GM-CF. Amount of the token mortgage should be defined in RA/Credit memorandum. All properties accepted as collateral shall strictly confirm to the relevant building regulations. However, the discretionary authority to approve all types of major or minor structural violations (including sub-standard construction) shall be with the GM-CF.
5) This requirement may be waived subject to the approval of the GM-CF.
6) The rate may be reduced by the GM-CF depending upon the authority delegated to him by the CEO from time to time.
7) **<u>BUY A LAND PLUS CONSTRUCTION POLICY</u>**
   In order to comply with the requirement of the PRs, CFD shall ensure that facility is disbursed in trenches as follows:
   - Property value= Cost of land + construction as per the BOQ obtained (the combined value to be taken as assessed by the approved valuation agency
   - Maximum 80% of property value to be financed
   - Facility should not be in excess of 50% of net disposable income
   - The first trench cannot be more than 50% of the sanctioned facility limit or 50% of land value whichever is lower. Subsequent trenches to be made as in revised valuation report/BOQ.
8) **<u>HOME RENOVATION POLICY</u>**
   Renovation loan should not exceed 50% of property value or Rs 20 million which ever is lower.
   Maximum loan size under Renovation is Rs 20m.

   In order to comply with the requirements of the PRs, CFD shall ensure that the facility is disbursed as follows:
   - Maximum 50% of property value to be financed or 100% of estimate value (whichever is lower) however loan amount should not exceed the set limit of Rs. 20M.
   - Facility should not be in excess of 50% of net disposable income.
   - Trenches to be disbursed as per estimate obtained and amount utilization.
   - Realistic estimates for renovation to be obtained from the customer.
   - Undertaking to be obtained from the customer for utilization of loan that the funds would be utilized for said purposes.
   - Physical visit by bank official (RM or RO) after disbursement to verify the utilization and a document should be prepared and field in loan file confirming the use of funds for renovation purposes. The form should be sent for review to GM-CF.
   - Customer has to qualify for subsequent trenches before the amount can be released. This is assessed by revised valuation report. The eligibility assessment is done by CF and it retained the right to cancel the original approved limit incase customer does not qualify for disbursement.
9) Life insurance may be waived by relevant sanctioning authorities.
10) Age criteria may be relaxed subject to the approval of GM-CF.
11) Salaried Individuals
   - Total service to be at least two years, out of which one year employment with current employer is mandatory.

   SEP
   - They must be practicing professionals with at least 2 years of continuous practice.
   - They must have a valid membership with their respective institutions.

SEB

- They must be engaged in the current field of business for at least 2 years.

The criteria for employment period/years in business may be relaxed subject to the approval of GM-CF

12) Whenever necessary, the customer should furnish a personal guarantee of, at least, one guarantor*.

***Guarantor**

These shall comprise of individuals, companies etc. extending personal/corporate guarantees on behalf of the customer.

Procedures

A Common Approach

1. Initial Processing (Sales Unit)
2. Evaluation, Approval & Disbursement
3. Balance Transfer Facility (BTF)
4. Collection Procedure for Delinquent Customers
5. Insurance
6. Revision
7. Provisioning
8. Re-Scheduling
9. Termination
10. Litigation
11. External Agencies

CREDIT ADMINISTRATION – A SAMPLE FROM A LOCAL BANK

Credit Administration (CAD) is an essential part of the Credit Process. CAD is responsible to provide administrative support for the lending activities of the Bank and arrange day to day monitoring of credit exposure.

PURPOSE:

The purpose of establishment of CAD is to ensure that:

- Administrative assistance is provided to marketing staff allowing them to concentrate on credit and marketing affairs to increase revenues.
- Loan Documentation is scrutinized, verified to be legally enforceable.
- Collateral securities are effectively controlled and monitored.
- Credit disbursement is made in accordance with credit approval.
- Proper checks and balances are in place as per the terms and conditions of Credit Approval.
- An effective follow-up system is in place for generating timely reminders and reporting of exceptions.

SCOPE:

CAD is responsible to provide administrative support to all credit extending units of the bank i.e.:

- Corporate
- Commercial
- SME
- Islamic
- Consumer
- Agriculture

STRUCTURE:

Credit Administration Division (CAD) provides administrative support services through a network of Regional Credit Administration Departments (RCADs) established in selected locations on the basis of business volumes. The Heads of RCADs report to the Country Head CAD.

FUNCTIONS/RESPONSIBILITIES:

CREDIT ADMINISTRATION DIVISION (CAD):

- To ensure implementation of SBP Regulations and Bank's Credit Policy.
- To arrange Consolidation/Circulation of CAD related Monthly/Quarterly Reports received from RCADs.
- To prepare/review Credit Administration Procedures and ensure implementation at RCADs.
- To interact and resolve issues with Credit Extending Units (SME/ Commercial/Corporate/Islamic/Consumer/Agriculture).
- To interact with various Head Office Divisions (i.e. Legal, Credit, Risk Management etc.) on matters relating to CAD.
- To attend/resolve issues relating to Internal/External/SBP Audit.
- To handle matters relating to appointment of Valuers, Muccaddams on Banks Approved List.
- To provide support and guidance to RCADs.

REGIONAL CREDIT ADMINISTRATION DEPARTMENTS (RCADs):

PRE-APPROVAL

PROCUREMENT OF CHARGE DOCUMENTS:

- RCAD will arrange procurement of adequate stock of Printed Charge Documents from Central Stationery Cell.
- On receipt of stock, RCAD will utilize the services of Stamp Vendor for the purpose of affixing Revenue/Adhesive Stamps under Stamp Duty Act, in accordance with the rates prescribed by the concerned Government Authorities.
- Upon receipt of stamped documents, RCAD will authorize the Branch to make payment to the Stamp Vendor.
- Branch will debit RCAD Stamps on Hand Account and make payment to the Vendor through Pay Order.
- RCAD will maintain proper record of Stamps on Hand and arrange monthly reconciliation/balancing of Physical Stock with the balance appearing in Stamps on Hand A/C. RCAD Head will nominate a staff member who will perform the functions of custodian of existing stock. It will be the responsibility of custodian to maintain adequate stock and arrange monthly reconciliation/ balancing. The custodian will release required quantity of stock on receipt of IBCA from the Branch.

LATEST CIB REPORT OF THE BORROWER:

- Relationship Manager (RM) will provide required information of the Borrower to RCAD with the request to provide Latest CIB Report. It is the responsibility of RM to recover charges from the customer as per Banks Schedule of Charges.
- RCAD will provide Latest CIB Report of the Borrower to RM.

LEGAL OPINION:

- RM will provide photocopies of property documents to RCAD.
- RCAD will send the documents to Banks Legal Advisor for initial opinion to confirm whether the property offered as collateral would be acceptable to the Bank. Legal Opinion must cover the following:

(a) Establishment of ownership of the mortgagor.
(b) Verification of title documents/genuineness of the title documents from concerned authorities.
(c) Competence with respect to creation of mortgage in favour of the bank.
(d) Identification of any additional documents required for creation of effective and enforceable mortgage.
(e) Confirmation from the Legal Advisor that effective and enforceable mortgage can be created.
(f) Any other legal requirements for perfection/enforcement of security.

  - On receipt of Initial Legal Opinion, RCAD will forward the same to RM.

VALUATION OF FIXED ASSETS:

- RM will provide photocopies of property documents to RCAD.
- RCAD will send the documents to one of the Banks Approved Valuers for the purpose of independent valuation of collateral being offered.
- RCAD will ensure that the Valuers should verify and take into consideration the following minimum relevant factors to determine the Forced Sale Value (FSV) and not merely apply the discount factor:

1. Nature of locality
2. Saleability
3. Encroachment
4. Illegal occupation (if any)
5. Title of ownership
6. Encumbrance (if any)
7. Prevailing economic conditions in the relevant sector, business or industry
8. Any difficulty in obtaining possession
   - RCAD has to ensure that Valuation Reports do not contain any disclaimer clauses e.g.
     (a) Original title/ownership documents have neither been sighted nor searched.
     (b) We have relied fully on the information supplied in good faith and accept no responsibility etc.

Valuation reports containing above disclaimers/exceptions (if any) should immediately be taken up with concerned Valuers.

- RCAD has to further ensure that photographs attached must cover all the four sides of the location as well as road access and inside conditions.
- On receipt of Valuation Report, RCAD will forward the same to RM.
- Valuation reports will be duly supported by the Visit Report of Relationship Managers (RM)/Branch Manager(s) BM/Unit Heads (UHs). In this regard, they will visit the site and confirm:
  - ➢ Location of the property/assets from the title deeds wherein boundaries have been mentioned i.e. North, South, East & West with narration of surrounding properties and will submit visit reports accordingly (as per Banks prescribed format).
  - ➢ Properly document the investigation in visit report.
  - ➢ The approximate value of property is to be verified from at least two estate agents, besides estimation of surveyors, to arrive at a reasonable and realizable value of the property.
  - ➢ As per Banks Policy, RMs/BMs/UHs will visit the properties mortgaged with the bank in all existing relationships at least once in a year to confirm that there are no illegal occupation/encroachment issues.

DOCUMENTATION:

- It is the Bank's policy to obtain complete, legally enforceable documentation from customers, prior to extension of credit. RCAD will ensure that all required documentation is in place, prior to extension of credit.
- On receipt of Credit Approval, RCAD is to ensure that it is in conformity with SBP Regulations and Bank's Credit Policy.
- In case Credit Approval contains deferral of some documents, RCAD will allow disbursement of credit facility, maintain record of approved deferrals and follow up with credit extending units for regularization/rectification.

PREPARATION:

- It is the responsibility of RCAD to arrange preparation of Loan Documentation including Facility Offer Letter (FOL), in accordance with the terms and conditions of Credit Approval. RCAD is to provide the first signature on the FOL. If for any reason RCAD cannot provide the first signature (due to non-availability of an Authorized Signatory), RCAD shall initial the documents to signify preparation, review and concurrence.

STANDARD DOCUMENTATION:

- On receipt of Credit Approval, RCAD is to ensure that the prescribed complete set of legal documents is prepared in coordination with credit extending unit.
- RCAD will utilize the services of Legal Advisor/Law Firm on Banks Approved list for creation of Equitable/Legal Mortgage and Perfection of Documentation/Securities.

NON-STANDARD DOCUMENTATION:

- Where non-standard documentation is to govern credit facilities, RCAD will seek appropriate legal advice from a reputable Legal Advisor on the Bank's Approved list and/or Legal Affairs Department of

the bank.
- If the Bank is to participate in a syndicated facility and the arranger is employing a Legal Counsel, RCAD will consult a reputable Legal Advisor/ Law Firm on the Bank's approved list and arrange to obtain legal vetting/clearance.

DOCUMENTATION PROCESS FLOW:

- Once the Credit Approval (CA) in original is received by RCAD, the same is entered in the DAC register.
- CA is examined to ensure that: Credit Approval is within the discretionary powers of the Credit Committee, and all prescribed documents are received alongwith the CA as per Credit Approval Package Check-Off List.
- RCAD will prepare a Checklist relating to Loan & Security documents required for the approved credit facilities. RCAD will prepare Draft FOL in accordance with the terms and conditions of CA. RCAD will forward Checklist and Draft FOL to RM by email.
- RM will review Draft FOL and provide input (if required) and email concurrence of Draft FOL to RCAD.
- RCAD will prepare FOL. RCAD is to provide first signature on the FOL.
- On receipt of request from RM, RCAD will arrange preparation of Loan and Security Documents.
- RCAD will nominate Legal Advisor/Law Firm on Banks Approved List for creation of Equitable/Registered Mortgage and perfection of Documentation/Securities.
- RCAD will forward the Loan & Security Documents (including FOL) to RM for execution (signing) by the customer.
- RM will arrange attested copies of CNICs Borrower(s)/ Mortgagor(s)/ Witnesses.
- Banks Lawyer alongwith an officer from Branch shall be required to personally visit concerned authorities maintaining property ownership for title verification and confirmation of the authenticity of all documents.
- RM will coordinate with the Banks Lawyers for completion of all mortgage formalities.
- Once the documents are signed by the customer and properly witnessed, RM will return completed documents to RCAD.

RCAD will review the documents received from RM to ensure that:

- All documents executed by the customer have been received and are in good order.
- Documents on behalf of the Bank are signed by staff holding Bank's Power of Attorney.
- Documents show the correct amount of approved facility.
- Amount stated in figures and words are consistent with each other.
- Each document must be dated and blank spaces, if any, must be completed.
- Date of the document should essentially be a working day.
- In case of a Partnership concern, all Charge/Legal/Security Documents must be signed by all Partners, irrespective of the fact that the account is operated by any one of the partners. Joint and several guarantees signed by all partners in their personal capacity should also be obtained.
- In case of a Limited Company, all signatories have legal authority to sign and that all related documents such as Memorandum & Articles of Association, Board Resolution, etc. are in place.
- Documents have been properly witnessed.
- Appropriate signature verification has taken place.
- Multi-page documents are signed on each page by the customer.
- Corrections, errors, over-writing, alterations, etc., in a document, are signed by the customer.
- RCAD will update the Checklist to confirm that all required documents under the approved credit facility(ies) have been received. In case any document is missing or a discrepancy is identified, RCAD will take up the matter with RM and ensure rectification.

PERFECTION OF SECURITY/DOCUMENTATION:

- Legal opinions/vetting certificates should not contain remarks such as:
  - On face of it documents seem to be genuine.
  - Prima facie appears to be owner of subject property.

- Upon examination of the above documents it appears that XXX is the owner of subject property.

- RCAD will obtain a certificate from the Legal Advisor confirming the following:
  - Creation of effective/enforceable mortgage/charge on assets in favor of the bank.
  - Certified copy of the "title documents" in support of verification has been obtained.
  - Confirmation towards obtaining of the requisite documents to cover the bank's security aspects with respect to its validity/ enforceability.
  - Complete/correct, enforceable and effective mortgage has been created and security/support documentation stands perfect in all respects.

DISBURSEMENT AUTHORIZATION:

- After obtaining Perfection Certificate from the Banks Lawyer, RCAD will arrange Completion/Updation of Checklist. The Checklist is to be signed by (Documentation Officer and Team Leader).
- Upon completion of Checklist and after obtaining Perfection Certificate from the Banks Lawyer, RCAD will arrange issuance of Disbursement Authorization (DAC) which is to be signed by Documentation Officer/Team Leader and Head RCAD.
- Copy of Disbursement Authorization Certificate will be sent to RM for information and record.

CUSTODY:

- RCAD is responsible for lodgment and control of borrowing documents.
- All Loan & Security Documents are to be recorded in the Safe In/Out Register.
- After recording details in Safe In/Out Register, the documents are lodged in the vault under dual custody.
- RCAD is responsible for maintaining custody of all Loan and Security Documents. It must ensure that all required documents are in custody prior to disbursement.
- RCAD will keep track of expiry of Loan Documents.

RELEASE OF SECURITY DOCUMENTS:

- On receipt of customer request, Relationship Manager (RM) will arrange approval of appropriate Credit Committee for release of security documents.
- RCAD will release security documents upon adjustment of credit facility (ies).

MAINTENANCE OF CREDIT FILE:

RCAD maintains Credit File for each customer. Credit File contains the following:

- Original Credit Approval
- Trade/Market Checking's
- CIB report of the borrower.
- Basic Borrower Fact Sheet (BBFS)
- Call/Visit Reports

COLLATERAL AND SECURITY:

Collateral is taken for one or more of the following reasons:

- To improve bank's rights with respect to other lenders.
- To gain financial and psychological leverage in negotiations with the customer.

CREDIT DISBURSEMENT:

Once all required documentation, securities/collaterals are in place as per Credit Approval (Disbursement Authorization i.e. DAC has been issued), RCAD will input credit facility in the Core Banking System. RCAD has to ensure:

- Facility set-up loaded in the Core Banking System is in line with the approved credit proposal and Facility Offer Letter/Documentation executed by the customer.
- There must be segregation between "IN-PUTTER" and "AUTHORISER" with respect to the Bank's systems, i.e. no staff member can have both options. Country Head CAD will nominate "IN-PUTTER" and "AUTHORISER" in the system.
- Post input check procedure through system generated reports to be in place to ensure accuracy and dual control.

Availment Procedure:

- Availment Tickets under the Approved Lines of Credit will be initiated by Branch (Relationship Manager and Incharge Credit/Branch Manager), provided that sufficient cushion is available under the valid approved lines.
- RCAD will review the Availment Ticket and authorize availment, provided the proposed transaction is within the approved limit, documentation is in order or deferral is in place.

CREDIT MONITORING:

After the loan is approved and draw down allowed, the loan is continuously watched over. This includes keeping track of borrowers compliance with credit terms, identifying early signs of irregularity, conducting periodic valuation of collateral and monitoring timely repayments.
This is undertaken in the following manner:

(i) Monitoring of Exceptions:

- RCAD will arrange monthly reporting to Branches/Area Offices/Regional Office/CBUs. of the following:
  (i) Excess Over Limit
  (ii) Security Shortfall
  (iii) Expired Limits (CAs)
  (iv) Missing/Discrepant/Expired Documents
  (v) Expired Deferrals
  (vi) Missing/Discrepant/Expired Insurance(s)
  (vii) Missing Stock Reports
  (viii) Missing Stock Inspections
  (ix) Expired Valuations
  (x) Missing Financials
  (xi) Miscellaneous Items

(ii) Monitoring of Overdue Loans & Advances/Mark-up:

- RCAD will arrange monthly reporting of Overdue Loans & Advances/Mark-up to Area/Regional Offices/CBUs.

(iii) Preparation of Reports required by Credit Administration Division (CAD).

Consumer Rights Commission of Pakistan (CRCP) Survey
Some Findings

Chart 1: Patterns of Access to House Financing

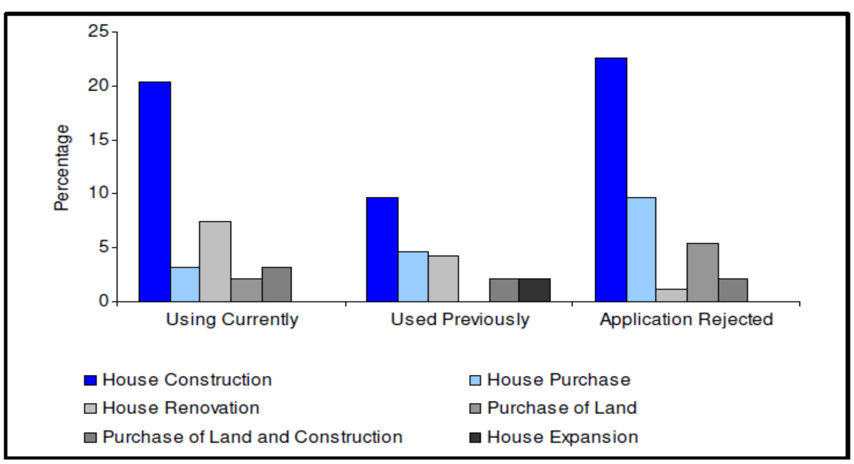


Table 1: Reasons for Rejection of House Financing Applications

No.	Reasons	% of Borrowers
1	I could not give all required documents	48.6
2	My income was below the bank's mandatory limit	39.5
3	Bank gave no reason for rejection of application	38.9
4	My credit worthiness was not favourable	35.3
5	Other reasons	26.5

Chart 2: Factors Affecting the Choice of Bank for Housing Finance

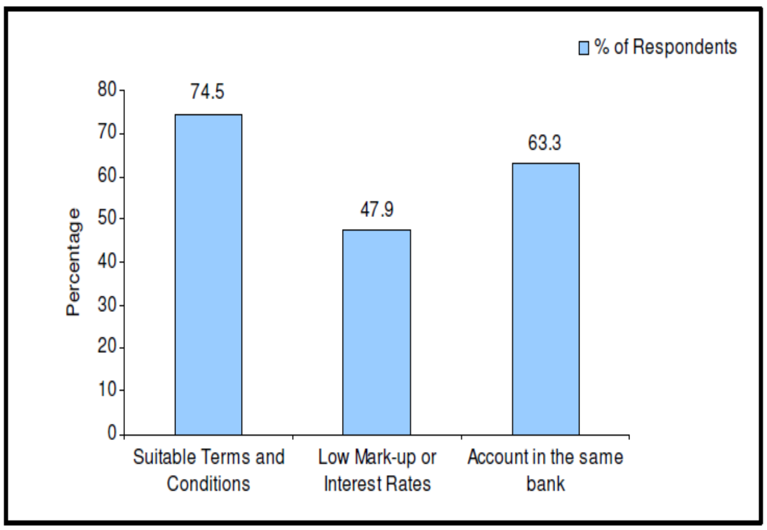


Chart 4: Processing of Loan Applications within Stipulated Timeframe

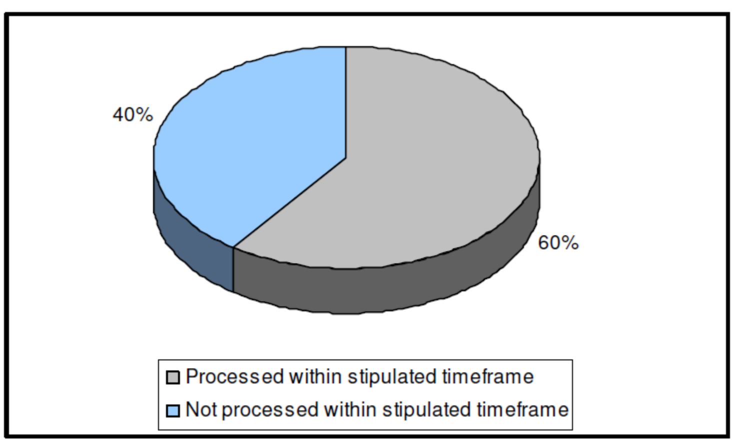


Chart 5: Time Taken for Loan Application Process

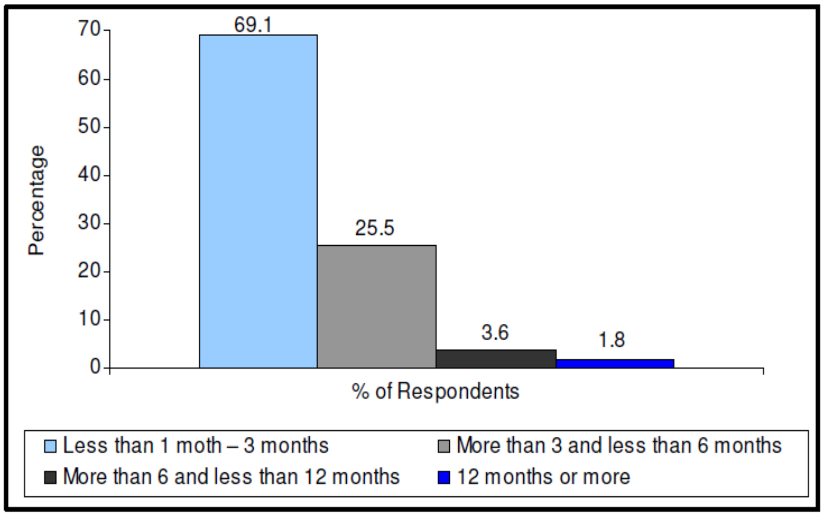
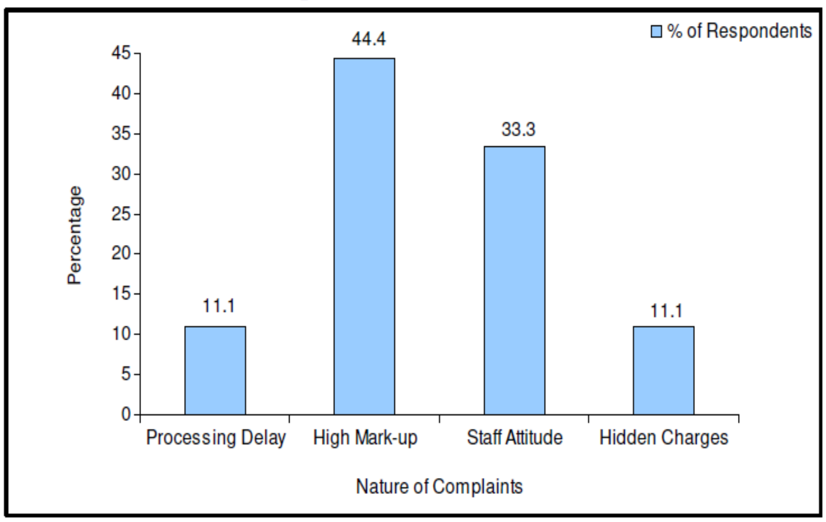


Chart 6: Nature of Complaints



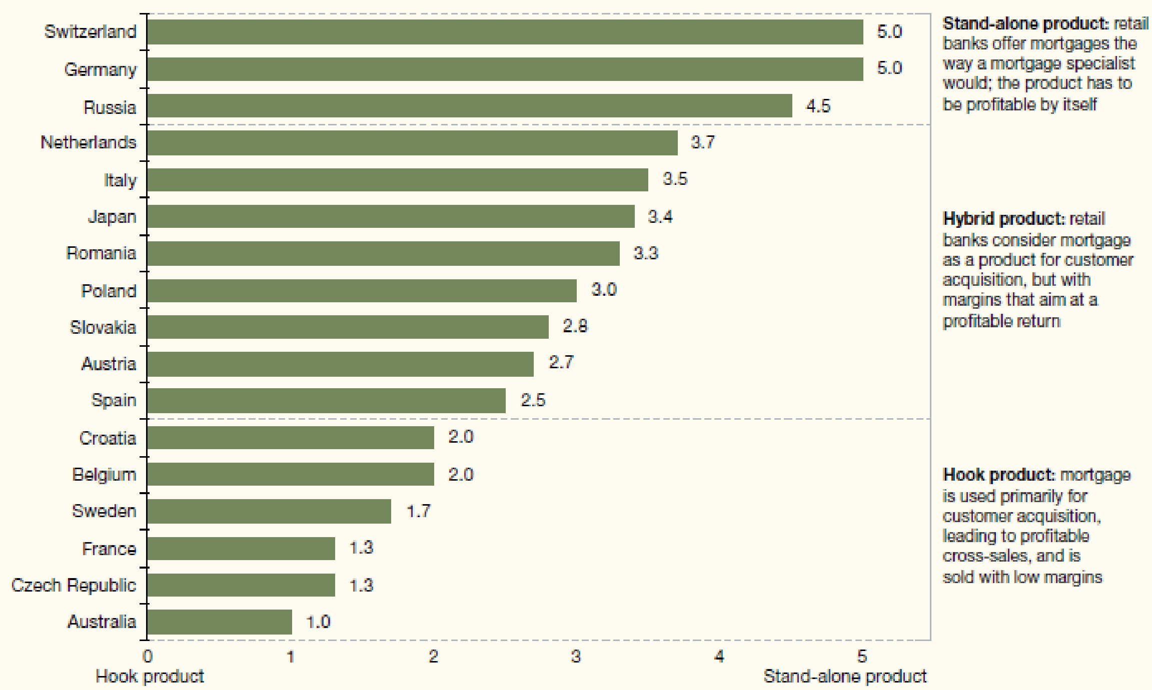
LESSON 40

GLOBAL PERSPECTIVE ON MANAGING MORTGAGE PROFITABILITY RETAIL BANKS AT A CROSSROAD IN 2009 PRINCIPAL FINDINGS

The Booming Mortgage Market, 2001-2007

- Mortgage was a growth engine for retail banks worldwide from 2001 through 2007, with some markets exceeding reasonable limits, especially in the ratio of mortgage debt to gross domestic product.
- Although most mortgage markets experienced this boom, huge discrepancies could be observed between these markets.
- Depending on the country, mortgage was used either as a *stand-alone product (it has to be profitable by itself), a hook* product (it is used primarily for customer acquisition and is sold with low margins), or a *hybrid product (it* serves customer acquisition objectives, but with margins that aim at a profitable return).

FIGURE 2.7 Mortgage Strategies, by Country



Source: Capgemini interviews with 54 surveyed retail banks, 2009.
Note: Respondents were asked to assign a number from 1 to 5 to characterise the role of mortgages in their institutions, with 1 meaning they treat mortgages solely as hook products, and 5 meaning they treat them solely as stand-alone products.

Mortgage Unit Profitability: A Widespread Decline until 2007, Partly Mitigated by Growth

- Unit profitability declined from 2003 through 2007, primarily as a result of the decrease in net interest income (down by around 50 basis points [bps] in major markets) due to intense competition between retail banks.
- Initiatives to generate additional revenues and reduce costs could not compensate for the loss in interest revenues.
- This decline in global unit profitability was partly mitigated by the rise in volume during this period, but value creation remained questionable.

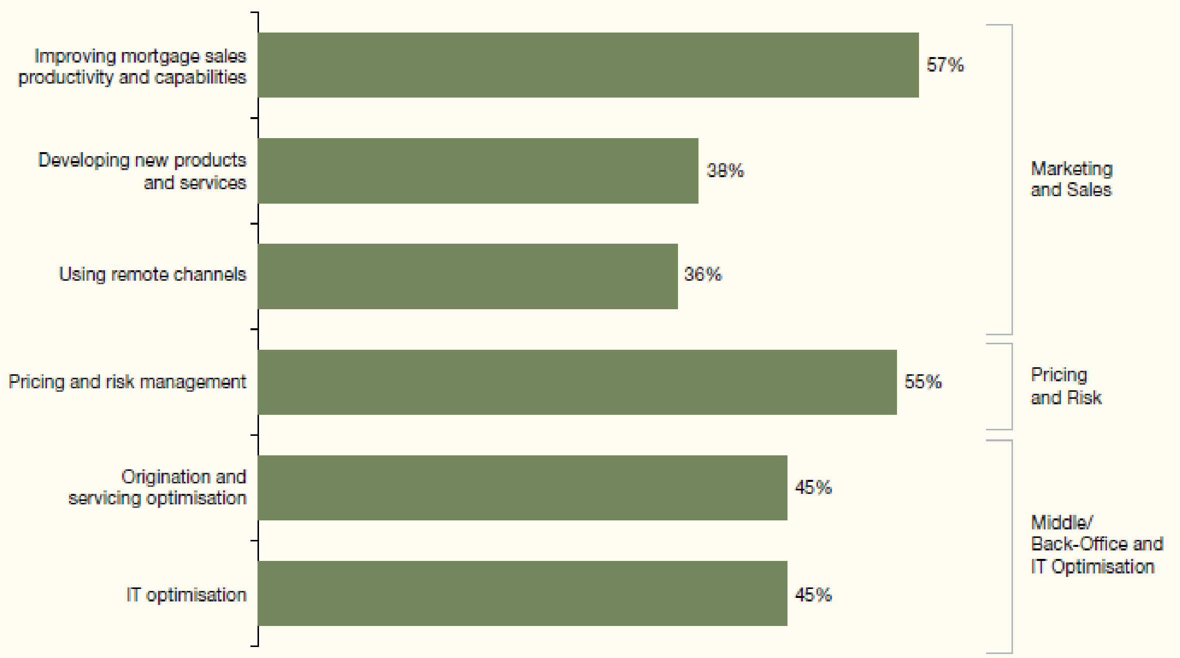
The Year 2008: A Downward Turning Point in the Mortgage Market

- In 2008 the subprime crisis marked a clear stop to positive trends in the mortgage market, with an explosion in funding costs having a dramatic impact on mortgage profitability.
- In the five years to come, retail banks will need to prepare for a significant decline in mortgage activities due to three main factors:
  - ✓ ***the general slowdown of the world economy,***
  - ✓ ***the asset crisis with its impact on the cost of funding,***

- ✓ ***And the threat of an increasing cost of risk.***
- The general trend towards regulations protecting consumers (for example, limits on loan prepayment penalties and ceilings on total customer rates) is likely to continue, and will have an impact on mortgage unit profitability.

How Can Retail Banks Respond to the New Market Situation?
Banks are looking for key opportunities and activities to address the challenges related to new market situation over the ***next five years.***

FIGURE 2.17 Key Opportunities to Address the New Mortgage Market Situation (% Respondents)



Source: Capgemini interviews with 54 surveyed retail banks, 2009.

Banks are looking for key opportunities and activities to address the challenges related to this new market situation over the next five years.

We asked surveyed banks to name their top opportunities for addressing the challenges related to this new market situation over the next five years.

As Figure 2.17 indicates, they identified six key opportunities:

- **Three in marketing and sales:**
  - ✓ Improving mortgage sales productivity and capabilities
  - ✓ Developing new products and services
  - ✓ Using remote channels
- **One in pricing and risk:**
  - ✓ Pricing and risk management
- **Two in middle/back office and IT:**
  - ✓ Origination and servicing optimisation
  - ✓ IT optimisation

Among them, the Improving mortgage sales productivity and capabilities opportunity, and the Pricing and risk management opportunity, are the most important, having been cited by over half the surveyed banks (see Figure 2.17).

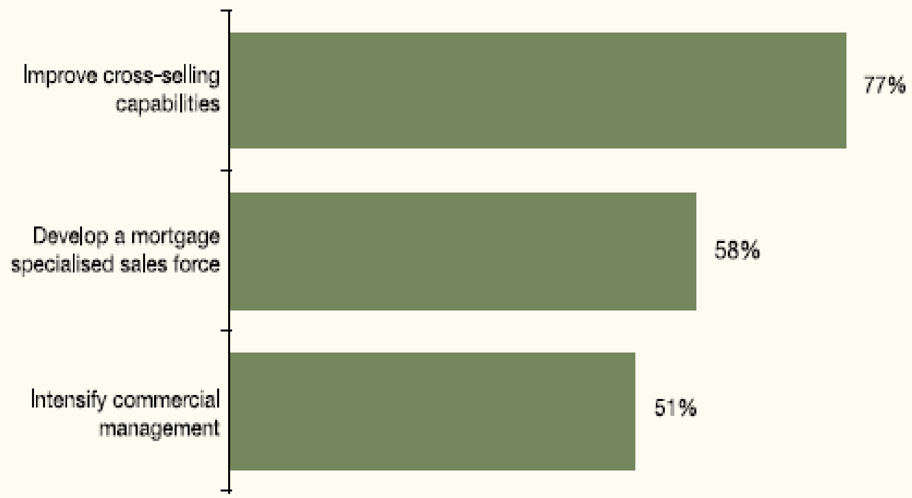
Other opportunities were proposed, such as developing intermediary channels and cross-border distribution, but these were not viewed as significant enough to warrant in-depth study here.

Marketing and Sales

Improving mortgage sales productivity and capabilities is the first overall and is considered a key opportunity in all regions. To capitalize on this major opportunity, retail banks saw the need to initiate three critical activities (see Figure 2.18):

- Improve cross-selling capabilities
- Develop a mortgage specialized sales force
- Intensify commercial management

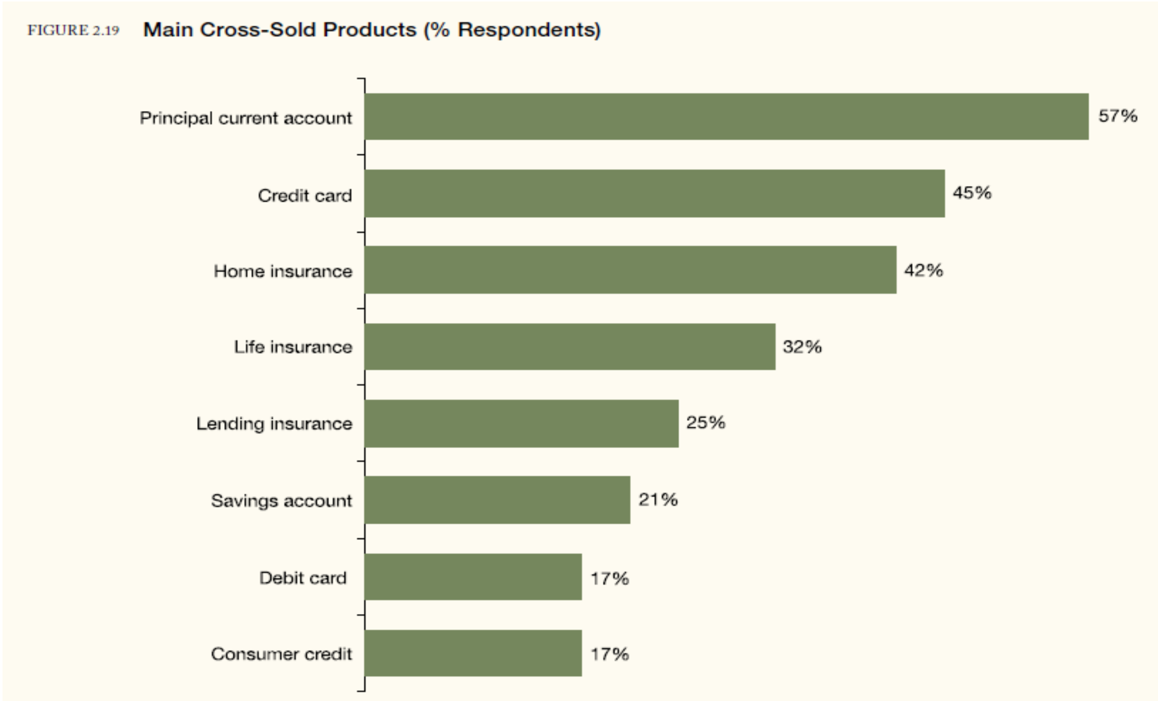
FIGURE 2.18 Activities to Improve Sales Productivity and Capabilities over the Next 5 Years (% Respondents)



Source: Capgemini interviews with 54 surveyed retail banks, 2009.

Improving cross-selling capabilities is the most critical approach to improving sales productivity. A large majority of retail banks (nearly 80% of our respondents) aim to develop the cross-selling capabilities of their sales forces over the next five years. This is particularly notable because cross-selling policies related to mortgages are already widespread today.

Most responding banks have already developed cross selling policies in the mortgage area. The main cross-sold products were principal current accounts and credit cards (see Figure 2.19). Insurance products (home insurance, life insurance, and lending insurance) were also often mentioned as cross-sold products. Intensifying commercial management through planning and reporting processes and tools is a global lever for all retail banking activities, not just mortgage.



Executives in nearly 60% of the banks surveyed reported that sales force specialization (with mortgage specialists) is important, and most have already initiated the process. This specialization can be accomplished either by developing a specific sales force, or by implementing specialized call centres accessible both by customers (in addition to the Internet) and by the retail banking sales force (as an additional source of mortgage expertise).

Nevertheless, some banks surveyed reported that in today's context of crisis, investing in new sales forces, with its additional costs, might not be relevant.

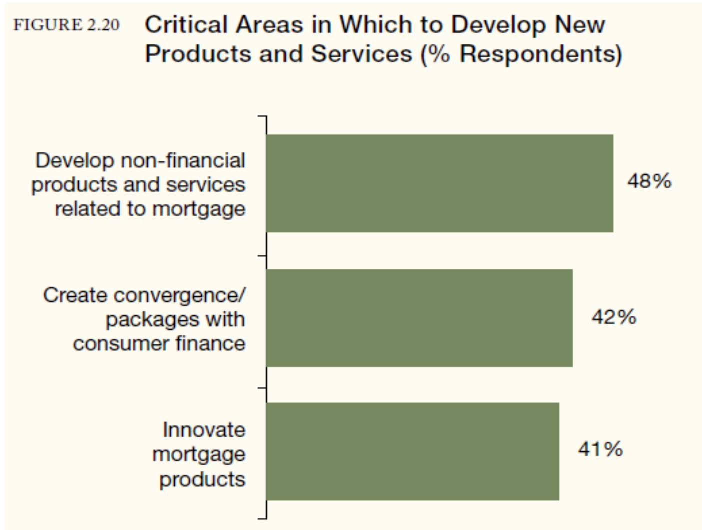
Developing New Products & Services
This activity was seen by many respondents as less important for the coming years than it has been for the past five, but it still remains a key opportunity in 38% of the banks where we interviewed (see Figure 2.17, above). To capitalize on this opportunity, retail banks are focusing on three areas (see Figure 2.20):

- Develop non-financial products and services related to mortgage
- Create convergence/packages with consumer finance
- Innovate mortgage products

Developing non-financial products and services related to mortgages (such as home services and surveillance services) was viewed as an important activity in nearly half the banks we interviewed, with the objective of generating new revenues with higher margins than those offered by mortgages.

Creating packages with other financial products is another crucial area for this opportunity. Bank executives we interviewed cited consumer finance, as well as payment cards and insurance, as key products for packaging.

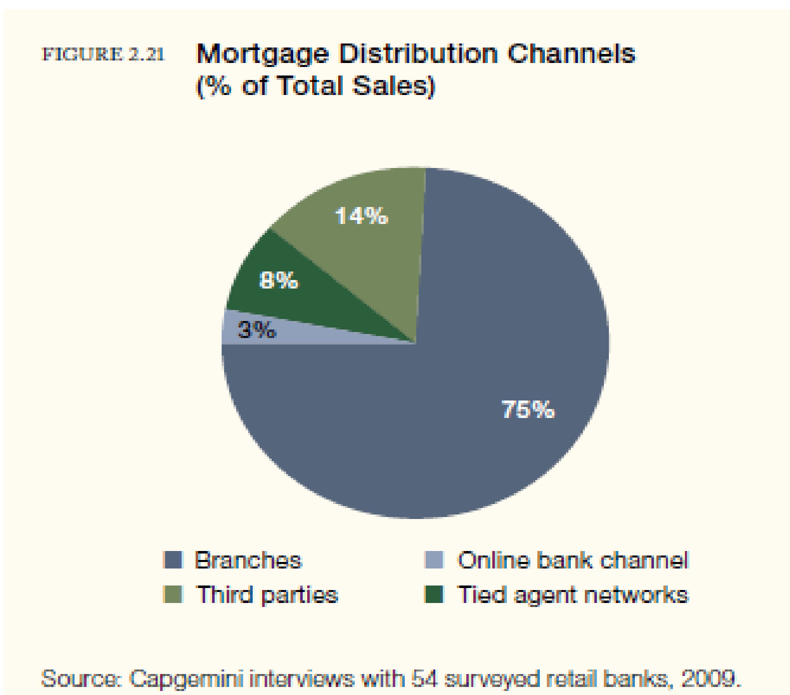
Mortgage product innovation is not considered to be as important as it has been for the past five years. Most retail banks believe that existing products respond to their customer needs. Yet some innovation will be done by simplifying or customising existing products, for example by increasing their flexibility (loan maturity, repayment policy, etc). Additionally, innovation will be used for niche products ("Senior" Mortgages, for instances)



Using Remote Channels

Using remote channels (such as the Internet and call centres) was the sixth opportunity overall, mentioned by 36% of the banks we surveyed. This opportunity has grown the most, with only 13% of banks we surveyed saying they had considered it important for the past five years.

Remote channels are used today in the mortgage sales process, but principally as information channels. Sales through remote channels accounted for only 3% of mortgage sales in the banks we surveyed (see Figure 2.21).



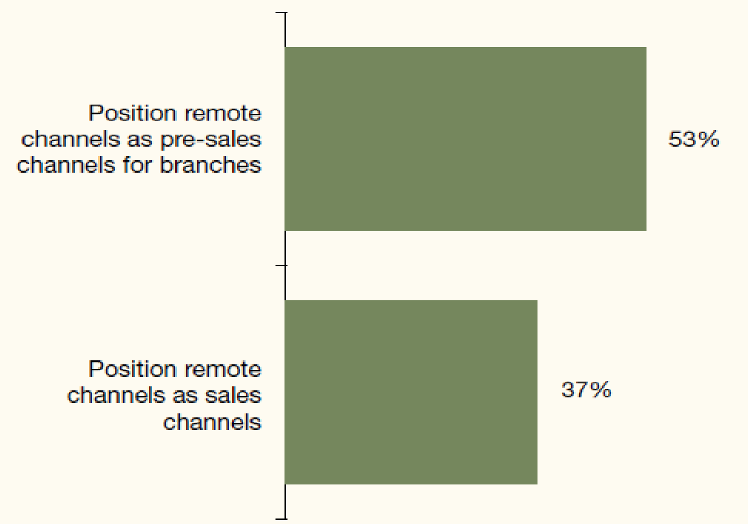
To capitalize on this opportunity, retail banks are considering two critical means (see Figure 2.22):

- Position remote channels as pre-sales channels for branches
- Position remote channels as sales channels

Executives in more than half the retail banks surveyed said they want to develop remote channels as pre-sales channels for branches. They would use these remote channels to achieve the first steps of the sales process—identify and select customers, and understand their needs. The sale itself would take place at the branch level, so that the bank could capitalize on the customer relationship at a key commercial moment.

Nearly 40% said they intend to develop remote channels as complementary sales channels to branches. In this case, the declared ambition is to sell 5%-10% of products through the Internet or call centres. This will be linked to the introduction of simplified offers.

FIGURE 2.22 **Critical Means to Use Remote Channels in the Next 5 Years (% Respondents)**



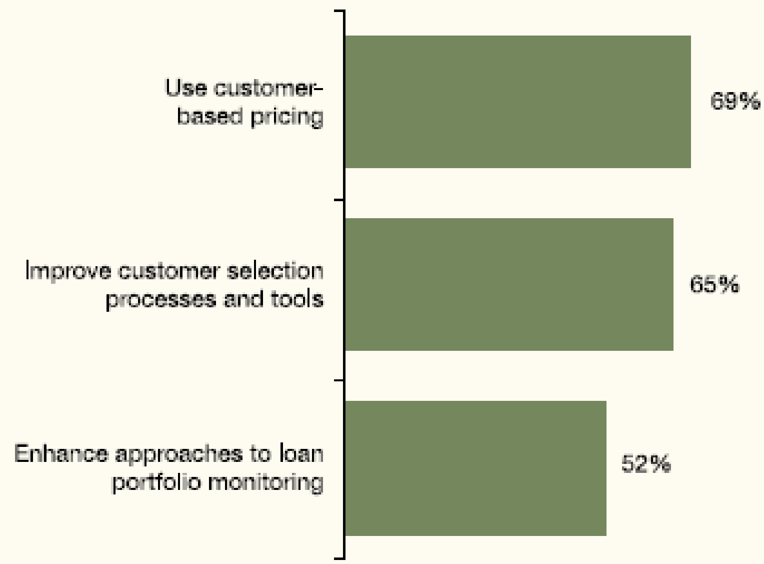
Pricing and Risk Management

Pricing and risk management is the second opportunity overall, and respondents in over half the banks surveyed cited this area as one of their top six opportunities over the next five years. They were keenly aware that any of today's customer spreads would not even cover the cost of funding. They intend to take three primary actions to maximize the benefits from this opportunity (see Figure 2.23):

- Use customer-based pricing
- Improve customer selection processes and tools
- Enhance approaches to loan portfolio monitoring

Successful retail banks will develop customer-based pricing while improving customer selection. Already, many banks often price their mortgage products using a mix of practices, including interest margin-based pricing, competition-based pricing, and customer based pricing. Nearly 70% of responding banks told us that customer-based pricing is increasingly important in the context of Basel II, the capital squeeze, and increasing client risk. Retail banks intend to differentiate their pricing even more according to client risk and potential.

FIGURE 2.23 Activities to Maximise Pricing and Risk Management over the Next 5 Years (% Respondents)



A Note on Customer-Based Pricing:
By Ronen Vengosh

Many managers use the cost-plus method of pricing. This method is attractive for its deceptive simplicity: to obtain the price, managers simply calculate their costs and mark up these costs by a certain percentage. The resulting figure is the price.

The use of the cost-plus model is extremely widespread and I have witnessed its use in everything from everyday consumer products to complex software packages. Often the managers who utilize this model do not even make a conscious decision to do so, but rather achieve the same result intuitively, by setting the price according to the profit they would like to make on the product or service.

Despite its attractive simplicity, the cost-plus model can lead your company down a very dangerous path. Using this model, your company may lose sales revenue, lose market share, or even price itself out of the market. Consider this: do your customers really care about your costs or do they care about the value you bring them? This article describes the dangers of cost-plus pricing and offers a simple, workable alternative. This alternative, the Economic Value to the Customer (EVC) model, can help you avoid these pitfalls, and also help you to strategically grow your business by allowing you to understand what it is that your customers really care about.

THE SIMPLICITY TRAP

Simplicity is the biggest advantage offered by the cost-plus pricing model. The model also offers the often irresistible mirage of guaranteed profits. However, the model's biggest drawback is that it completely ignores demand for the product as a factor in the pricing process. For example, a company that decides on a certain markup for its products may find itself under pricing products for which there is high demand (thus leaving money on the table), and overpricing products for which demand is weak (thus losing sales and market share).

Additionally, the cost-plus model assumes that per-unit costs are known prior to pricing. Actually, it is a widely known fact that costs change with the number of units produced or sold, and the number of units sold is highly dependant on the price. Thus cost-plus pricing suffers from a circular-logic problem.

Nevertheless, cost-plus pricing is not always wrong. In fact, companies vying for government contracts are often required to use cost-plus pricing (for example, some Iraq reconstruction contracts). Cost-plus pricing may also be appropriate in cases where large numbers of individual product prices need to be constantly updated (for example, in a supermarket). However, these exceptions only emphasize the rule: Cost-plus pricing is very often a bad idea.

ECONOMIC VALUE TO THE CUSTOMER: A WORKABLE ALTERNATIVE

Now that I have, hopefully, convinced you that cost-plus pricing has serious drawbacks, it is time to present the alternative: Economic Value to the Customer or EVC. This method of pricing is customer-centric, i.e., the price is based on the value generated for the customer rather than on the costs incurred by the supplier. Here's how to implement this pricing strategy:

- Identify all the features that differentiate your product from competing products.
- Quantify how these differences impact the economic value the customer generates from your product.
- After quantifying the surplus (or shortfall) in value the customer gets from your product compared with available alternatives, price your product in a way that will create an economic incentive for the customer to adopt your product over those offered by the competition.

The following simple example illustrates the application of the EVC method:
Company A is in the process of introducing a new machine, identical in all but size and reliability to other machines available from the company's competitors. The new machine is bigger than competing machines, but is more reliable. After conducting some market research, the company comes to the conclusion that the added size of the machine will cost the average customer about $200 over the life of the unit (in transportation and storage space costs, for example), while the added reliability will translate into savings of approximately $600 (in reduced maintenance and down time). This means that, everything else being equal, the unit will produce an EVC of $400 over competing products. Of course, the company should not charge a premium of $400 over the competition, since this would eliminate any benefit to the customer.

In fact, the company must leave a lot of the surplus created to the customer, so that the customer is motivated to choose this product over the available alternatives. For example, if the company chooses a price which is $200 higher than that of the competition, customers will still consider the new product a great value. You must remember, however, that customers often do not look beyond the sticker price, and your marketing efforts must effectively educate your customers as the true nature of the value created by the product.

In many cases, calculating the EVC can be much more complicated. In the real world, not all product features are identical, and similar product features generate different economic value for different customers. There are statistical tools and methods designed to cope with such problems, however, in most cases, employing the logic and process of the EVC method even without these sophisticated tools will generate results that are far superior to those achieved through the cost-plus method of pricing.

WHAT ABOUT COSTS?

As your accountant or board of directors may have stubbornly pointed out, costs matter. What should your company do in the event that the price developed through the EVC model does not cover your costs or does not meet your company's profitability requirements? The answer to that question is simple: If you have correctly completed your EVC analysis and discovered that there is no way to achieve profitability at the resulting price, you need to reduce your costs or else not sell the product.

This answer should make intuitive sense. Increasing the price to the point at which there is negative value created for the customer means that the customer is losing money by doing business with you. Obviously, most such clients would turn to other products available on the market or would completely forego purchasing any product. Of course, you could try to rely on the old adage that there's a sucker born every minute, but this would not be advisable for most legitimate businesses.

Under such circumstances, you would be well advised to either find a way to cut your costs or to redesign the product to offer more economic value to the customer.

BOTTOM LINE: THE CLIENT COUNTS!

As do most other marketing activities, pricing starts with the client. To effectively price your products you need to understand the value that they create for your customers. You also need to have a good understanding of alternative products or solutions that your clients are considering. By understanding these factors, you will be able to price your product in a way that leaves a large portion of the value created by the product to your customers. This will create a powerful economic incentive for clients to buy your products and, ultimately, increase your profits.

If you choose to price your products using the cost-plus method or any other method that disregards the customer in the pricing process, you are voluntarily disregarding the most crucial piece of the puzzle, and such oversights rarely have good results.

To Summarize:

- In most cases, your customers don't care about your costs. They will make their decision to buy your product or service based on the value that you are creating for them.
- Variable pricing models, such as volume discounts and bundling are a great way to create different economic benefits for different customer segments.
- If you cannot sell your products or services at a price that offers an economic value to your customers, and still cover your costs, you should change the product or service, or exit that market segment.

Risk management will remain a core mortgage practice and will be reinforced by the new market situation. Improving the customer selection processes and tools was cited as a primary lever in two-thirds of the banks surveyed, and credit risk management/ monitoring (such as probability of default [PD], loss given default [LGD], internal ratings-based [IRB], and internal ratings-based approach [IRBA]) was viewed as essential by half of them.

Enhancing approaches to loan portfolio monitoring is also considered critical. The rising cost of risk, combined with greater difficulty in externalizing risk through securitization, poses new challenges for retail banks. Banks will need to remain vigilant concerning loan quality degradation on the balance sheet, avoiding the toxic combination of acquiring low-margin, high-risk ("bad") loans, and losing more profitable ("good") loans.

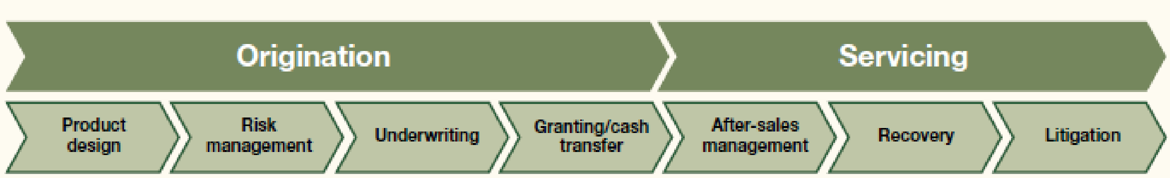
Banks will have to develop early-warning and watch-portfolio approaches to identify risky loans before they become non-performing. They will need to define and implement specific actions for each customer category to avoid degradation of the credit portfolio. Another way to address this new risk management challenge will be to mutualise it through specialized institutions, as is done today in some countries.

Middle/Back-Office and IT Optimization

Origination and servicing optimization. This is the third opportunity overall, cited in 45% of the banks in our survey.

We focused on each part of the mortgage value chain, as shown in Figure 2.24:

FIGURE 2.24 Mortgage Origination and Servicing Value Chain

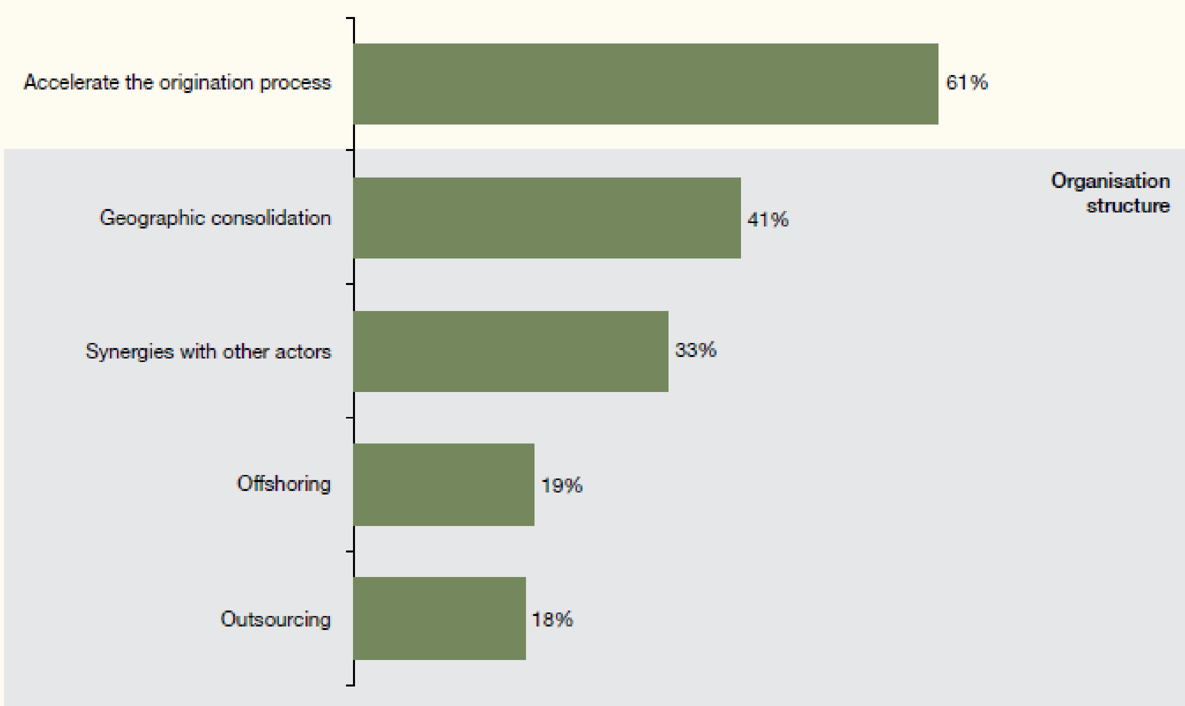


Source: Capgemini analysis, 2009.

- We divided the origination process into four parts: product design, risk management, underwriting, and granting/cash transfer.
- We divided the servicing process into three parts: after-sales management, recovery, and litigation.

In 61% of surveyed banks, respondents considered the acceleration of the origination process as a major challenge that had to be met. They believe the capacity to make a loan quickly (e.g. two days) is a key success factor for sales. Accordingly, many banks have either already changed or aim to change tools in their front office (and often in their middle and back offices) to gain efficiency and speed.

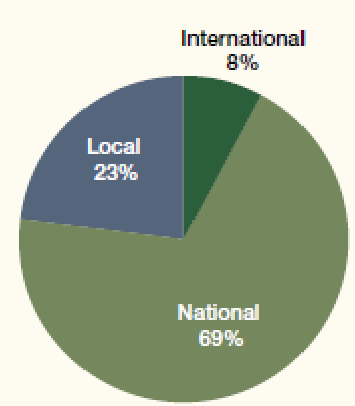
FIGURE 2.25 Ways to Optimise Origination and Servicing over the Next 5 Years (% Respondents)



As Figure 2.25 indicates, respondents also cited actions to reduce operating costs and lower the breakeven point through organization structure— geographic consolidation, synergies with other actors, off shoring, and outsourcing.

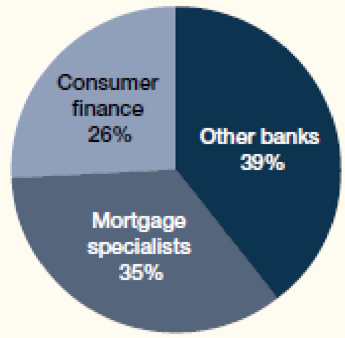
Geographic consolidation was the most cited lever, as it was for IT optimization. Almost one out of every ten banks aims to develop multi-country middle and back offices over the next five years (see Figure 2.26).

FIGURE 2.26 Levels of Origination and Servicing Geographic Consolidation for the Next 5 Years (%)



One-third of retail banks surveyed said they hope to develop synergies with other institutions, mainly with other banks and mortgage specialists, but also with consumer finance institutions (see Figure 2.27).

FIGURE 2.27 **Origination and Servicing Synergies with Others (% Respondents)**



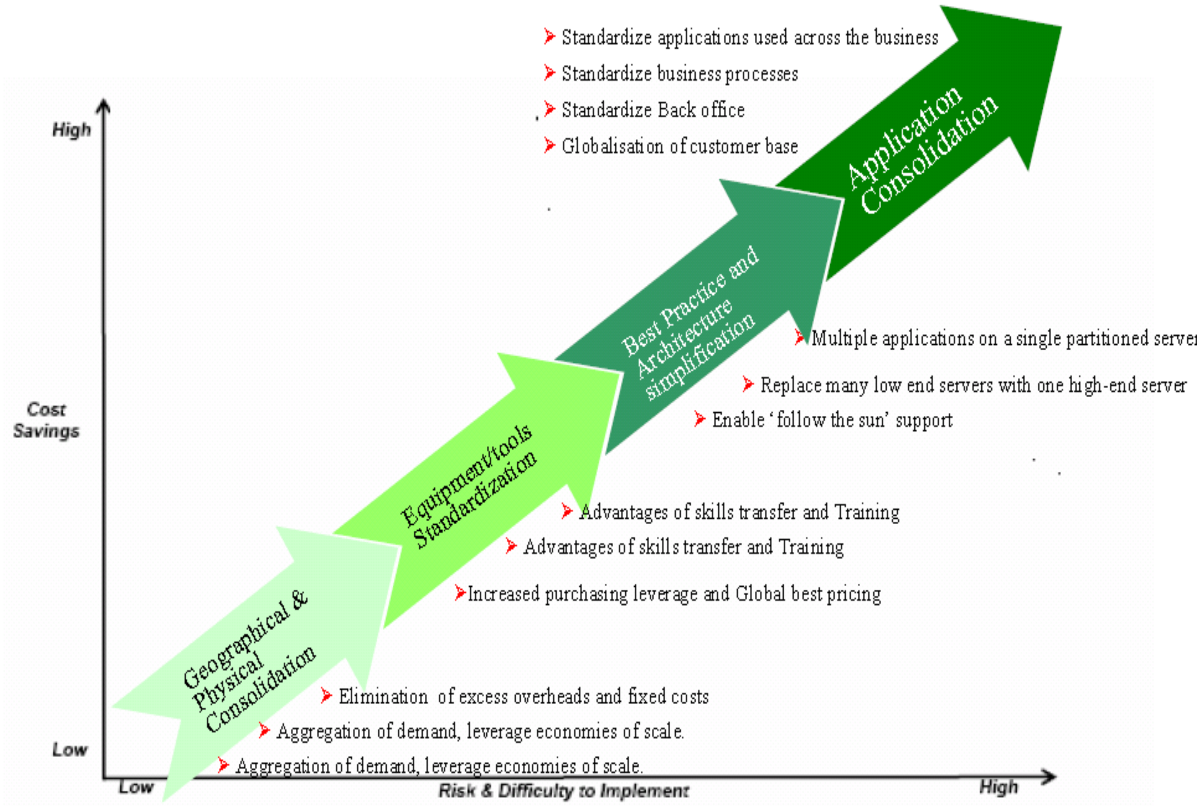
They would accomplish this either by sharing tools or even origination and servicing platforms, including human resources. Outsourcing and off shoring were identified by only a few surveyed banks' respondents as areas where they thought their banks should take action (see Figure 2.25).

While some leading retail banks have already capitalized in this area and will continue to do so, most consider the barriers to implementation, such as regulation and social and political issues, as simply too high.

Altogether, organization structure will affect all parts of the mortgage origination and servicing value chain IT optimization. IT optimization is often a prerequisite for optimizing origination and servicing, especially when considering organization restructuring. For this opportunity, more than one-third of banks surveyed considered the optimization of their IT on a geographic basis as critical. Banks will strongly consider developing international IT systems (note the expected rise from 6% to 31%) in the five years to come. They expect this rise despite the fact that the national level will remain the primary consolidation level for mortgage IT over the next five years. To manage mortgages, most banks surveyed (77%) said they have an IT system at the national level, either for a part or all of their operations.

As for origination and servicing optimization, other levers identified for IT optimization are synergies with other actors (cited by one out of four banks), IT outsourcing, and IT off shoring (about one out of five banks).

Role of the Centre – Driving IT efficiencies from scale



Moving Forward over the Next Five Years

In 2009, retail banks are at a crossroad, and they will have to implement significant changes to remain successful over the next five years.

Rather than relying exclusively on cost reduction, retail banks should continue to develop sales. Reducing cost, primarily through geographic consolidation of middle and back offices as well as IT systems, should undoubtedly be a top priority for retail banks. Nevertheless, in the context of the current financial crisis, cutting costs is not a sufficient measure by itself, due to high fixed costs and uncertain revenue streams.

Banks should give equal priority to the development of their sales, particularly by improving cross-selling capabilities, product bundling, and customer-based pricing. Retail banks might also have to find and attract new, lower-net-worth clients to increase volume. To safeguard against increased risk, the challenge will be to invent a new approach to customer selection adapted to this clientele.

Top-performing retail banks that once relied on *hook* or *stand-alone* strategies will have to rethink their approaches in favor of the *hybrid* strategy. Two key drivers will force this convergence of mortgage strategies. First, the increased importance of cross selling will push banks to abandon the *stand-alone* strategy, as the decline in volume will force them to cross-sell more products. Second, heightened regulatory restrictions on some packages (such as mortgage plus lending insurance) will threaten those banks relying exclusively on *hook* strategies.

Retail banks will also have to rethink their business models and revert to their historic deposit-based approach, leaving behind the credit-based model they have relied on over the past few years. For several years, credit, and notably mortgage, drove retail bank growth.

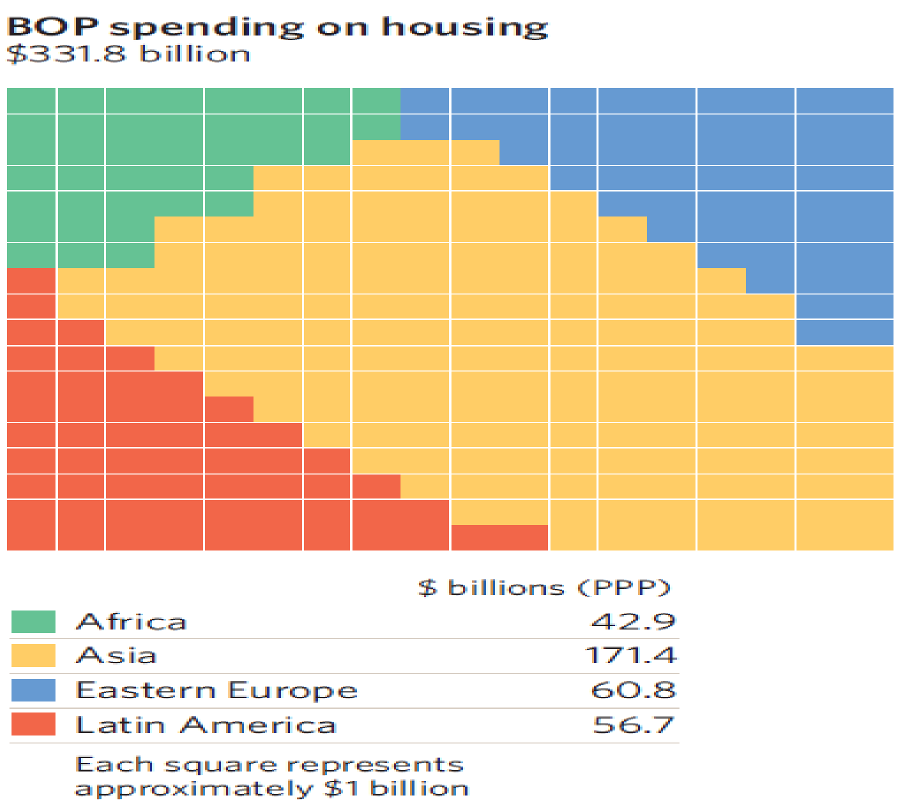
Today, the new market conditions are dramatically different: a declining economy, heightened funding requirements (Basel II constraints, limited access through securitization), and the increasing cost of client risk are all jeopardizing the old credit-based model. A new deposit-based approach appears to be inevitable. Successful banks of tomorrow will be those with the most deposits and therefore the highest capability to fund and transform those deposits into credits.

In this crisis context, mortgage specialists' ability to survive on their own is weak. With no access to deposits and no direct cross-selling opportunities, mortgage specialists will have to lean on diversified retail banks to get through the crisis. This would help mortgages become profitable again in the medium term, as the result of a lower supply.

Over 80% of the banks reported they concentrate their profitability analyses exclusively on net interest margin, with some also taking into account other revenues (fees, insurance margins) in the mix.

But only a few do what is needed to succeed today: develop a complete vision of mortgage profitability, including revenues, cost of risk, operating costs (distribution, origination, servicing, and IT), and costs of capital employed; and use the key profitability indicators: net operating profit after tax, economic value added, and return on assets.

Managing mortgage profitability by developing excellent profitability models is the clear way forward, although today it is an under-used practice. We believe it is the best way for retail banks to ensure they are prepared for the daunting challenges they will face in the years ahead.



- Housing is one of the larger BOP markets—larger than transportation, smaller than energy.
- The market encompasses major spending items—rent, mortgage payments (or imputed rents), and repairs and other services.
- But the BOP housing market is perhaps uniquely handicapped by informality.
- Both lack of legal title to housing in squatter settlements—Hernando De Soto's "dead capital"—and lack of access to mortgage financing for the BOP limit its potential size.

- Despite these barriers, both private sector approaches and policy reforms—sometimes catalyzed by NGOs—are showing how to tap this market in ways that provide significant benefits for BOP households.
- In Asia especially, where mortgage markets are undeveloped and land prices high relative to income, the market potential— and the need—is huge.

Source/Reference:
Retail Banking Report (By Capgemini)/IFC Report on BOP

LESSON 41

AUTO FINANCING/LEASING IN PAKISTAN

AUTO INDUSTRY OF PAKISTAN
OVERVIEW

CONTRIBUTION TO GDP

- The total contribution of Auto Industry to GDP is 2.8%
- Auto sector contributes USD 3.6 billion annually in GDP
- Auto sector contributes 16% to manufacturing sector

PRODUCTION

- There are 39 automobiles and 55 motorcycle manufacturing units involved in the assembling & manufacturing business
- Vehicle manufacturing directly employs 192,000 of workforce
- Auto parts manufacturing output is approx. USD 1.0 billion per annum

MARKET POTENTIAL

- The total vehicle population of Pakistan is 5.4 million units
- 78% of auto part demand is met by imports

Key Players in the Pakistan Auto Industry

1. Auto Manufacturers
2. Car Dealers/Distributors
3. Auto Parts Manufacturers
4. Auto Parts Dealers/Importers
5. Repairs/Service Shops & Garages
6. Insurance Companies

Point to Ponder

- In a country like Pakistan, are Prices of Standard Passenger Cars (Upto1000 cc) on the higher side?
- Any Causes?
- Against installed annual capacity of around 150,000 units, the production in 2009 (up to Nov) was ***only*** around 47,000 units.

SBP PRUDENTIAL REGULATIONS FOR AUTO LOANS

REGULATION R-9

- The vehicles to be utilized for commercial purposes shall not be covered under the Prudential Regulations for Consumer Financing.
- Any such financing shall ensure compliance with Prudential Regulations for Corporate/Commercial Banking or Prudential Regulations for SMEs.
- These regulations shall only apply for financing vehicles for personal use including light commercial vehicles also used for personal purposes.

REGULATION R-10

The maximum tenure of the auto loan finance shall not exceed seven years.

REGULATION R-11

- While allowing auto loans, the banks/DFIs shall ensure that the minimum down payment does not fall below 10% of the value of vehicle.
- Further, banks/DFIs shall extend auto loans only for the ex-factory tax paid price fixed by the car manufacturers.

- In other words, banks/DFIs cannot finance the premium charged by the dealers and/or investors over and above the ex-factory tax paid price of cars, fixed by the manufacturers.

REGULATION R-12

- In addition to any other security arrangement on the discretion of the banks/DFIs, the vehicle financed by the banks /DFIs shall be properly secured by way of hypothecation.
- Payments against the sale orders issued by the manufacturers are allowed till the time of delivery of the vehicle subject to the condition that payment will directly be made to the manufacturer/authorized dealer by the bank/DFI and upon delivery, the vehicle will immediately be hypothecated to the bank/DFI.

REGULATION R-13

The banks/DFIs shall ensure that the vehicle remains properly insured at all times during the tenure of the loan.

REGULATION O-6

- The clause of repossession in case of default should be clearly stated in the loan agreement mentioning specific default period after which the repossession can be initiated.
- The repossession expenses charged to the borrower shall not be more than the actual incurred by the Bank/DFI.
- However, the maximum amount of repossession charges shall be listed in the schedule of charges provided to customers.
- The banks/DFIs shall develop an appropriate procedure for repossession of the vehicles and shall ensure that the procedure is strictly in accordance with law.

REGULATION O-7

- A detailed repayment schedule should be provided to the borrower at the outset.
- Where alterations become imminent because of late payments or prepayments and the installment amount or period changes significantly, the revised schedule should be provided to the borrower at the earliest convenience of the bank/DFI but not later than 15 days of the change.
- Further, even in case of insignificant changes, upon the request of the customer, the bank/DFI shall provide him/her revised repayment schedule free of cost.

REGULATION O-8

The banks/DFIs desirous of financing the purchase of used cars shall prepare uniform guidelines for determining the value of the used vehicles. However, in no case the bank/DFI shall finance the cars older than five years.

REGULATION O-9

The banks/DFIs should ensure that a good number of authorized auto dealers are placed at their panel to eliminate the chances of collusion or other unethical practices.

REGULATION R-14

The auto loans shall be classified and provided for in the manner already specified for Housing Finance.

Auto Finance & Leasing

Purpose: To provide financial assistance to individual customers to enable them own a car of their choice at affordable installments and easy repayment terms & conditions.

This product could be classified into derivatives as follows:

- Standard Product Offering (SPO)
- Balance Transfer Facility (BTF)
- Other Assets Customers (OAC)
- Branch Preferred Customers
- No Documents Category (NDC)

- Loan Top Up (Enhancement)
- Collateral Replacement

Eligible Vehicles

- Local assembled brand new vehicles
- Foreign assembled (new and used) vehicles (Unregistered only)
- Imported vehicles marketed by OEMs
- Semi/Light Commercial vehicles assembled in Pakistan or imported/marketed by OEMs as per banks approved list of vehicles.

Mode of Financing

The product will be marketed as:

- Markup based financing &
- Lease financing

Mark up:

Variable mark-up rate

Tenure:

Finance	Min 1 Year	Max 7 Years
Lease	Min 3 Years	Max 7 Years

SECURITY

Finance:

The vehicle will be registered in the name of the Customer under Hire Purchase Agreement with the Bank.

Lease:

The vehicle will be registered in the name of the Bank.

Minimum Income Requirement

❖ This will not include any commission income. Allowances being received on regular basis may be included in the income.

❖ Rental income can be considered income if the rent is reflected in Bank Statement as per terms of the rent agreement.

❖ Where the customer has additional verifiable source of income, his/her monthly take home salary/income should be at least Rs. 10,000 per month to qualify.

❖ Income of any immediate blood relative or spouse may be added to enhance the loan eligibility, which will be treated as a co-borrower.

❖ Minimum take home monthly income/salary: Rs. 12,000 per month

Length of Occupation

SALARIED

FOR CONTRACTUAL EMPLOYEES

✓ Min 1 yr continuous service with current employer OR

✓ Total work experience of 2 yrs with maximum of 2 employers

FOR PERMANENT EMPLOYEES

✓ Min 6 months permanent employment required in case of first job

✓ No minimum employment period required if previous job history as permanent employment exists

BUSINESSMEN/SELF-EMPLOYED PROFESSIONALS

✓ Min1 yr (continuous) in the same business or profession

✓ If less than 1 year, prior work experience may be considered if nature and line/nature of business is the same

Debt Burden

- Credit Criteria to assess repayment capacity of borrower by deriving installment percentage to his/her take home income.
- Total monthly payment shall not exceed 50% of Take Home Income of customer.
- Debt Burden shall be mandatory for following categories:
  1. Salaried individuals with no other verifiable source of income.
  2. Customers paying less than 15% equity.
  3. Customers availing 2nd car facility.
  4. Customers whose total exposure in autos equals or exceeds Rs. 2.0 Million.

Pakistan Auto Industry
Some Recent Observations

- As per Industry sources, car sales went up in July-September 2009 despite premature repayments of auto loans as declining income levels shifted people's spending priorities—and the repayments were in excess of disbursements of fresh auto loans.
- Data for auto loans till September 2009 is not available but a declining trend in the stock of these loans between July 2008 and July 2009 indicates that retirement of auto loans outpaced release of fresh loans.
- Outstanding auto loans stood at Rs105 billion in July 2008 which declined progressively to Rs77 billion in July 2009.
- Bankers say, the government's inability to increase more of domestic debt from non-bank sources and banks' reluctance to make significant increase in deposits rates have left huge liquidity outside the banking system.
- "This also has a hand in enhanced sales of automobiles, which for many people have become a mode of investment," remarked a banker.
- Part of increased inflow of workers' remittances, which used to be parked earlier in the real estate and in stock market, has also found its way in auto investment, he said.

Credit Cards Business in Pakistan

SBP PRUDENTIAL REGULATIONS FOR CREDIT CARDS

REGULATION O-1

- The banks/DFIs should take reasonable steps to satisfy themselves that cardholders have received the cards, whether personally or by mail.
- The banks/DFIs should advise the card holders of the need to take reasonable steps to keep the card safe and the PIN secret so that frauds are avoided.

REGULATION O-2

Banks/DFIs shall provide to the credit card holders, the statement of account at monthly intervals, unless there has been no transaction or no outstanding balance on the account since last statement.

REGULATION O-3

- Banks/DFIs shall be liable for all transactions not authorized by the credit card holders after they have been properly served with a notice that the card has been lost/stolen.
- However, the bank's/DFI's liability shall be limited to those amounts wrongly charged to the credit card holder's account.
- In order to mitigate the risks in this respect, the banks/DFIs are encouraged to take insurance cover against wrongly charged amounts, frauds, etc.

Regulation O-3 Continued

- The bank/DFI shall, however, not charge the borrowers' account with any amount under the head of "insurance premium" (by what so ever name called) without obtaining consent of each existing & prospective customer in writing.

- In addition to obtaining consent in writing, the banks/DFIs may also use the following modes for obtaining prior consent of their customers provided proper record is maintained by banks/DFIs:-
  i. Customer's consent on recorded lines via out bound/in bound call center (after due verification)
  ii. ATM screens – screen pop up before conducting transaction and after inputting pin code
  iii. Signed consent acquired with credit card application or as separate form
  iv. IVR (Integrated Voice Recording)

REGULATION O-4

In case the cardholders make partial payment, the banks/DFIs should take into account the partial payment before charging service fee/mark-up amount on the outstanding/billed amount so that the possibility of charging excess amount of mark-up could be avoided.

REGULATION O-5

- Due date for payment must be specifically mentioned on the accounts statement.
- If fine/penalty is agreed to be charged in case the payment is not made by the due date, it should be clearly mentioned in the agreement.

REGULATION R-7

MAXIMUM CARD LIMIT

- Maximum unsecured limit under credit card to a borrower (supplementary cards shall be considered part of the principal borrower) shall generally not exceed Rs 500,000/.
- Banks/DFIs may, however, assign a clean limit beyond Rs 500,000 but not in excess of Rs 2 million to their prime customers who have extraordinary strong repayment capacity, moderate debt burden and a clean track record.
- But the aggregate limits in this respect should not exceed 10% of the total credit card portfolio at any point in time.
- However, while availing benefit of this provision, banks/DFIs would place on record well defined criteria for terms "Prime Customers"and "Moderate Debt Burden" approved by their Board of Directors/Chief Executive.
- Banks/DFIs may also allow financing under the credit card scheme in excess of Rs 500,000/- (up to Rs 2 million) to other customers as well, provided the excess amount is appropriately secured.
- The loan secured against liquid securities shall, however, be exempted from the above limit.
- The loans against the securities issued by Central Directorate of National Savings (CDNS) shall be subject to such limits as are prescribed by CDNS/Federal Government/State Bank of Pakistan from time to time.
- For Charge Cards, pre-set spending limits generated by the standardized systems, as is the global practice, shall be allowed.

REGULATION R-8

CLASSIFICATION AND PROVISIONING

The credit card advances shall be classified and provided for in the following manner:

CLASSIFICATION	DETERMINANT	TREATMENT OF INCOME	PROVISION TO BE MADE*
(1)	(2)	(3)	(4)
Loss.	Where mark-up / interest or principal is overdue by 180 days or more from the due date.	Unrealized mark-up / interest to be put in Suspense Account and not to be credited to Income Account except when realized in cash.	Provision of 100% of the difference resulting from the outstanding balance of principal less the amount of liquid securities with the bank / DFI.

It is clarified that the lenders are allowed to follow more conservative policies. Further, provisioning may be created and maintained by the bank / DFI on a portfolio basis provided that the provision maintained by the bank / DFI shall not be less than the level required under this Regulation.

Source/Reference:

1. **SBP Website**
2. **A Local Bank Auto Loans Manual**

LESSON 42

SBP OPERATIONAL GUIDELINES FOR CREDIT CARDS BUSINESS IN PAKISTAN

1. Marketing of Credit Cards
2. Credit Card Application Process
3. Information on Interest Rates and other Charges
4. Billing Process
5. Collection/Recovery Process
6. Complaint Resolution Process
7. Merchant Relationship

1. Marketing of Credit Cards

1.1 Banks/DFIs should follow the Code of Conduct for marketing of Credit Cards which will be issued by Pakistan Banks' Association (PBA) in consultation with SBP.

1.2 Banks/DFIs should discourage aggressive and hard selling & marketing practices during working/office hours; except with prior appointment of the prospective customer. In case a customer is called during office hours for seeking appointment, he/she should be first asked for the option to continue with the call or not.

1.3 Banks/DFIs should seek prior consent of their customers/account holders for informing them on new products and services on telephone as and when introduced. In this regard, banks should maintain a "Don't call list" comprising the contact details of those customers who do not want to be contacted. The list should be accessible to all marketing staff and they should be advised not to contact such customers /account holders for introducing or offering new banking products. In this connection, banks should update the database of existing customers within three months from the date of issue of these guidelines.

1.4 Marketing staff must disclose their official identity before or during meeting with prospective customer.

1.5 Banks/DFIs should conduct regular training and awareness sessions of their marketing personnel covering all aspects of Credit Card operations including charges to be paid by the customers, safety measures, complaints resolution mechanism etc.

1.6 Marketing personnel and/or third party of the Banks/DFIs should provide complete information on the Credit Cards to the prospective customer and should not make false claims on any feature which the Bank/DFI does not offer. In this connection, Banks/DFIs should conduct Surprise Checks; at least once in every quarter, to verify the marketing approach used by their marketing personnel or third party. If some one found involved in making false claims and/or contacting customers included in "Don't call list"; then Banks/ DFIs should immediately take remedial steps and take disciplinary action against the concerned staff, in order to prevent such tendency in future and also immediately inform the customer accordingly.

2 Credit Card Application Process

2.1 Credit Card may only be issued by the Banks/DFIs, pursuant to a written application duly filled and signed by the prospective customer. However, in order to reward and retain high-end existing customers, pre-embossed cards may be issued after a proper acceptance by the customer, which may be in the form of any verifiable mode such as recorded phone call. Nevertheless, these pre-embossed Credit Cards should be activated only after receiving complete application form from high-end customers and criteria for selecting high end customers must be defined in the bank policy.

2.2 Keeping in view the complex nature of Credit Cards, the Banks/DFIS are advised to simplify the Credit Card Terms & Conditions, and keep them clear and understandable both in English and Urdu languages.

The marketing staff should ask customers about the choice of language and provide the Terms & Conditions accordingly. Font size of Terms & Conditions should not be below 11. In addition to the Application Form, following information should also be provided to the customer either in Urdu or English:

I Procedures of using Credit Card

II Facilities included in Credit Card

III Risks which may arise from the use of the Credit Card on different channels and the mechanism of mitigating these risks
IV Rights and obligations of Credit Card holder
V Liabilities of all parties in case of Credit Card loss/fraud
VI Complaint procedure and estimated time for dealing with complaints
VII Procedure of calculating interest with two practical examples
VIII Different types of charges, Bank/DFI may charge to card holder under various circumstances

2.3 Banks/DFIs should not include any stipulation, caveat, clause or provision in Terms and Condition of the contract, which may result in curtailment of rights of customers.

2.4 Banks/DFIs should put in place a well structured procedure of verifying Credit Card applicant information. Before issuing the Credit Card, Banks/DFIs must establish true identity of the applicant and verify the same preferably from references and from NADRA database; provided that the applicant is not an existing account holder of the Bank/DFI.

2.5 Banks/DFIs should properly assess the credit risk before issuing Credit Card to any applicant and apply more Prudent Risk Management checks as they deem necessary, in addition to complying with the SBP's Prudential Regulations (PR) for consumers finance.

2.6 In order to mitigate fraudulent use of Credit Cards, Banks/DFIs should have built in functionality in their systems to monitor the usage of Credit Card. Additionally, it should also promptly identify unusual or out of pattern transactions. In this connection, Banks/DFIs may introduce checks or limits on certain category of transactions, customers, merchants etc.

2.7 Banks/DFIs must ensure confidentiality of their customers' data/information and should not divulge, share or sell customers' data/information to any body or institute. This restriction, however, shall not apply providing customers' credit information to e-CIB at SBP and/or any approved credit bureau of which the Bank/DFI is a member and/or to the companies who have agreement with the Banks/DFIs for data sharing because of outsourcing arrangements. Nevertheless, the outsourcing agreement must enforce the confidentiality clause for the third party.

2.8 Supplementary, Add-on or Subsidiary Credit Cards may be issued with clear understanding that the liability for payment rests with the principal card holder.

3 Information on Interest Rates and Other Charges

3.1 Banks/DFIs shall quote interest rate and service charges on annual basis. If different, the separate interest rate or service charges for retail purchases and for cash advance shall be quoted. Banks/DFIs are free to set the aforesaid rates, but, they are required to set well defined service level for each of the product/service; whether charged or free.

3.2 Banks/DFIs should inform the Credit Card holder on the interest rate or services charges through advertisement and/or sending information to cardholders on their addresses.

3.3 Banks/DFIs should not levy any charge (s) that was not explicitly mentioned either in the User Guide or Application Form or Schedule of Charges provided to the customer at the time of selling Credit Card, without the prior consent of the cardholder. However, this would not be applicable to excise duty or other charges which may be levied by the Provincial or Federal Government or any other statutory authority from time to time. Banks/DFIs should however, timely update the customers on the imposition of such levies.

3.4 Banks/DFIs should get prior approval from the existing Credit Card holders before offering any new but charged service to them.

3.5 Any change in Schedule of Charges, revision in the agreed terms and conditions or removal/withdrawal of an incentive should be communicated to all active Credit Card holders, at least, 30 days before the actual effective date, unless it was communicated at the time of agreement/ offer.

3.6 Banks/DFIs should clearly mention the charges, fees, commissions, selling exchange rate of transaction and settlement date, for executing foreign currency transactions.

3.7 Interest amount should be charged on net credit i.e. after deducting the amount paid by the cardholder. The outstanding amount due to rounding-off of paisas, should not be considered as partial payment and interest amount should not be charged on it.

4 Billing Process

4.1 Banks/DFIs are required to dispatch monthly Statement of Account to Credit Card holders at least 15 days before the due date. Towards this end, Banks/DFIs may offer Online, Email or IVR billing facility, with appropriate security measures.

4.2 If the customer lodges complaint regarding non-receipt of monthly Statement of Account, the statement should be dispatched to him/her free of cost, within 2 working days from the date of complaint.

4.3 Banks/ DFIs must send bills on monthly basis to all active Credit Card holders even in case of zero billing.

4.4 Banks/DFIs are required to send monthly Statement of Account to Credit Card holders which must contain following minimum information:

I Breakup of Total Amount Due and the Minimum Amount Payable

II Annualized rate of Interest and interest amount along with the method of calculation for purchase of goods or services, cash advances, and other benefits of the Credit Card if different

III Acceptable modes of payment (i.e. through cash, direct debit, cheque, Balance Transfer Facility-BTF etc.), expected number of days a particular mode of payment may take in clearing, and handling charges if any. For instance, number of days required for clearing when Credit Card holder of city "A", drops a cheque of the bank located in city "B" in the drop box placed in city "C"

IV Due date for payment

4.5 Banks/DFIs should make comprehensive arrangements commensurate with the present & future business plan and needs of the Credit Card holders for the collection of bills either through designated branches, collection centers or through drop boxes. In this connection, Banks/DFIs offering internet banking may allow payment of Credit Card bill to Credit Card holders both through his/her own secured internet account or through other person's internet account.

4.6 In order to facilitate customers, Banks/ DFIs must: I. Collect cheques from drop boxes on daily basis and on every drop box the collection time must be written thereon. II. Maintain an effective Inward Mail System so that cheques dropped in drop boxes should easily be traced in the event of their loss at some later stage.

4.7 Banks/DFIs should inform the Credit Card holders about the fate of the "Unpaid Cheques" within 2 working days from the date of receipt of unpaid cheques. Cheques submitted within the time prescribed by the Bank/DFI but cleared after due date must be reported to the customer along with genuine reason (s). Banks/ DFIs should not charge late payment fees to customers in case Banks/ DFIs fail to inform the customers on returned cheques within the prescribed timeframe.

4.8 Banks/DFIs should ensure that "due date" for payment does not fall on Sunday or any other public holiday(s). If technically possible, Banks/DFIs must accrue benefit of public holiday(s) to the customer due to sighting of moon. Bank/DFI should clarify in the Terms and Conditions that whether their system support holidays due to sighting of moon.

5 Collection/Recovery Process

5.1 Banks/DFIs need to ensure that recovery letters issued to Credit Card holders bear the Designation, Contact Number (s) and Office Address of the concerned official(s).

5.2 Banks/DFIs should respond to the queries arising out of the recovery letters within a reasonable time period. The time period must be specifically defined in Banks/DFIs public policy and should be communicated properly to the customers.

5.3 Banks/DFIs must ensure that their recovery/collection officers should not resort to any verbal or physical harassment of the delinquent Credit Card holder, their family members, referees and friends during recovery/collection efforts. Recovery/Collection officers should also not humiliate publicly or in private or intrude the privacy of the Credit Card holder's family members, referees and friends.

5.4 Telephone calls and visits to Credit Card holders for recovery of unpaid dues should be restricted to a convenient time and the same may be defined in the Bank/DFIs public policy and should be properly communicated to customers at the time of issuance of Credit Card.

5.5 Recovery should only be made from principal cardholder and in no case supplementary cardholders shall be resorted to any sort of pressure to pay the unpaid amount. However, supplementary cardholders may be contacted only to enquire about the whereabouts of the principal cardholder.

5.6 Banks/DFIs should not start recovery process for reported disputed transactions until the investigation carried out by Card Issuing Bank/DFI/Banking Ombudsman/State Bank of Pakistan is completed. In case of wrong/ inappropriate basis of rejection of customer claim, Bank/ DFI would be liable for penalty.

6 Complaint Resolution Process

6.1 Banks/DFIs should have an appropriate complaint resolution structure in place commensurate with the volume of complaints and better service consideration.

6.2 Credit Card complaints resolution mechanism must be prominently disclosed on the official website of the Bank/DFI. The Bank/DFI may also arrange online complaint registration on their websites. Complaint number should be provided to each complaint submitted to Bank/DFI and same should be communicated to the Credit Card holder.

6.3 Bank/ DFI should prepare MIS on complaints received against Credit Card operations and it should be submitted to Board of Directors or to the Country Management team, in case of branches of foreign banks, on quarterly basis for taking necessary action.

6.4 Banks/DFIs must resolve the disputed Transactions/complaint of the Credit Card holder promptly and as per the franchise rules of VISA, MasterCard, AMEX or any other international card association, taking into account nature of the transaction, distances, time zones, etc. However, in no case complaint resolution time should exceed 45 days from the date of complaint for the transaction(s) under dispute originated within Pakistan.

6.5 Banks/DFIs should clearly communicate to Credit Card holders that in case of any dispute, whether they will get temporary credit during investigation period.

6.6 Interest amount should not be charged to customer during investigation period. Bank/DFI will recover interest amount accumulated during investigation period only when the dispute is settled in favor of Bank/DFI. If decision turns in favor of the customer, the bank/DFI needs to refund the amount of disputed transactions, even to those customers who had made the payment of disputed transaction and cancelled the card after lodging complaint.

6.7 Bank/ DFI should provide related evidence to customer without any charges, if complaint turns to be in favor of Bank /DFI.

6.8 Banks/DFIs will be responsible to get reversed the erroneous information provided to e-CIB or any other approved credit bureau, within reasonable time period.

7 Merchant Relationship

7.1 Role of merchants is very important in executing any transaction and in the growth of safe and secured electronic banking, particularly in Credit / Debit Cards. Therefore, Banks/DFIs are advised to develop sound risk evaluation procedures for enlisting /registration of merchants keeping in view the franchise rules of their respective franchiser. The enlistment/registration process may inter-alia include proper identification, verification and good credit history, clean track record in VISA NMAS (National Merchant Alert Service) and / or Master Card MATCH (Member Alert to Control High Risk Merchants) etc.

7.2 Banks/DFIs providing "Acquiring Services" need to educate their merchants about the use of Point of Sale (POS) Machine, Genuineness of Credit Cards, Signature Verification, their rights and responsibilities under the agreement. Acquirer Banks/DFIs are required to facilitate merchants by providing prompt payments and timely maintenance/service of POS machines.

7.3 Acquirer Banks/DFIs should maintain track record of merchant's performance and categorize them, based on risks, involvement in frauds & disputed transactions etc. and develop a data base of negative list of merchants involved in fraudulent activities. The merchants involved in Credit Card related frauds should be delisted and their particulars should be shared with other Banks/DFIs through PBA. Banks/DFIs may also take legal action against such merchants under the relevant laws.

The Story of Visa International

Visa International espouses no political, economic, social or legal theory, thus transcending language, custom, politics and culture **to successfully connect** a bewildering variety of more than ***16,200 financial institutions, 29 million merchant's outlets, and 1.7 billion cardholders in 200 countries and territories. Annual payment volume of $2.7 trillion continues to grow in excess of twenty percent compounded annually.*** A staff of about three thousand people scattered in twenty-one offices in thirteen countries on four continents provides ... around-the-clock operation of two global electronic communication systems with thousands of data centers communicating through nine million miles of fiber-optic cable. Its electronic systems clear more transactions in one week than the Federal Reserve System does in a year.

Statistical Overview

Visa Inc. is the world's largest retail electronic payments network, with nearly US$4.3 trillion transacted on our payment products over the four quarters ended June 30, 2009.

VISA INC. OPERATES THE WORLD'S LARGEST RETAIL ELECTRONIC PAYMENTS NETWORK*	
16,200	Financial institution customers
1.7 billion	Visa cards
US$4.3 trillion	Total volume*
US$2.7 trillion	Payments volume
29 million	Merchant outlets**
1.5 million	ATMs***
59 billion	Total transactions***

Dee Hock, a Banker, actually conceived the idea of VISA. How it all happened is explained in his book, "Birth of the Chaordic Age".

What is more interesting about **VISA** is not its phenomenal success but its design. **VISA** is a network, and, how it functions starts with its formal governance system. VISA International operated (At least Up to Jan 2008 i.e. Pre IPO Period) under a constitution that stipulates how governing boards are elected, the rights & obligations of members, how new members are admitted, and how members can be disqualified. In short, one of the world's largest corporations operates as a self-governing democracy.

Most pragmatic managers cannot conceive of democratic principles governing a successful organization because they equate democracy with voting. But voting is just a mechanism, not the essence of democratic self-governance. A system of self-governance originates with governing ideas from which power flows: 'We hold these truths to be self-evident …'

For **Dee Hock**, these are ***Purpose*** ---- 'a clear, simple statement of intent that identifies and binds the community together as worthy of pursuit'---- and ***Principles*** ---- 'a clear, unambiguous statement of fundamental beliefs about how the whole and all the parts intend to conduct themselves in pursuit of the purpose'. **Dee Hock** believes deeply that rules & regulations, laws & contracts can never replace clarity of shared purpose and deeply held principles. But he also knows that purpose & principles cannot be imposed; they must be 'evoked from the minds and hearts of members of the community.' It took two years of intense work to determine **VISA**'s statement of purpose --- 'to create the world's premier system for the exchange of value' --- and principles.

VISA was born out of deep immersion in the chaos of the early days of the credit card industry. That chaos ultimately gave way to a sense of the unique opportunity that was available --- if people could suspend their established assumptions about banking, set aside their self-interest, and truly see what was needed to serve an emergent whole.

In late 60's and early 70's credit cards industry was in such chaos that it attracted criminals like bees to honey. Millions of fake credit cards appeared. Sham merchants deposited millions of fake sale drafts and collected payment during the time it took to process them by hand. One has to remember that at that point electronic data entry did not even exist.
The losses must have been in the hundreds of millions by 1968, and as happens when a massive collapse is in the making, denial pervaded the industry. Most people kept their heads down and hoped someone else would figure out the problems.

Dee Hock, who was then a vice president of the credit card department at a small bank in Washington, attended a licensee meeting called by Bank of America to discuss 'operating problems.' Recognizing that no management response was likely to be forthcoming commensurate with the scale of the problems, he spoke up and soon found himself invited to head a committee of licensees to review the situation and make recommendations to the bank. Eventually, he orchestrated an extraordinary process of immersion in the realities of the industry and the possibilities for radical transformation they presented. People saw that the problems were enormously greater than anyone imagined. But there was no place to hide or to lay blame. The system they had all created could simply never solve the problems to which it had given rise. They had 'met the enemy' and they were it.

Seeing this, **Dee**'s sense of possibility grew. For years, he had been intensely interested in living systems and self-governance. He saw managers' addiction to command and control as a logical by-product of seeing organizations as machines, rather than as human communities. Now he saw a setting in which a leap to another way of organizing might be possible. Gradually, he helped his group see that much of what they had taken for granted as professionals --- the nature of banking, lending, and even money itself --- had to be rethought. Their problems were only symptomatically about managing credit cards as a new business.
His account of this awakening is fascinating. Listen to this;

> "As we abandoned our old perspective and challenged our mechanistic model of reality, we ceased thinking of the jargon of banking and payment systems. We thought in a more holistic way and another change in consciousness occurred. It seems ordinary and obvious now. It was a revelation then. We were not in the credit card business …. We were really in the business of the exchange of monetary value."

In a wonderful articulation of 'surrendering into commitment,' **Dee** accepted that he had little idea of what was emerging. But he knew what was required of him: 'I suppressed my perspective of what the future might be and tried to create the conditions by which concepts could emerge. How that might happen, I did not know.'

In a weeklong meeting with three others drawn from his committee, the broad outlines of the vision began to crystallize. He said, 'Laying awake the fourth night. . . I knew that no bank could create the world's premier system for the exchange of value. No hierarchical stock corporation could do it. No nation-state could do it. But what if a fraction of the resources of all financial institutions in the world and a fraction of the ingenuity of all people who worked for them could be applied?

"It was beyond the power of reason to design such an organization … yet, lying there,[I was reminded] how evolution routinely, effortlessly tossed off countless varieties of much more complex organisms and organizations --- rain forests, marine systems, weather systems, cheetahs, whales, human body, brain, immune systems --- with seeming ease. The puzzle gradually dissolved my brain, and I fell into a deep sleep."

"In the morning, half-awake and surfing the shores of consciousness came a fascinating question. Could such an organization be patterned on biological concepts and methods? … Such an organization would have to evolve, in fact, to [continually] organize and invent itself … What if we quit arguing about the structure of a new institution and tried to think of it as having some sort of genetic code?

"The genetic code, he realized, was the governing idea, the purpose and principles of the organization,"
In the conversation that ensued, the group began to articulate the principles that eventually described the governance system that became **VISA**. Altogether, the subsequent journey of prototyping and institutionalizing took more than two years, followed by another two until **VISA International** was formed. Along the way there were much iteration of suspending assumptions and seeing current reality, connecting to purpose, and trying something new."

Source/Reference:

1. **SBP Website**
2. **Presence, Human Purpose & the Field of the Future, by Peter Senge, C. Otto Scharmer, Joseph Jaworski, & Betty Sue Flowers.**

LESSON 43

BUILDING CONSUMER TRUST IN RETAIL PAYMENTS

In retail payments, trust is fundamental. Consumers need to know that their payments providers (usually a financial institution) are handling their transactions with speed and accuracy, while keeping their private data safe and secure. But trust runs deeper and relies on both broad marketplace perceptions and personal customer experiences. Despite its importance, financial institutions typically do not measure consumer trust; therefore, they fail to fully understand a critical determinant in how consumers select, and choose to remain with, a payments provider. With a better grasp of the underpinnings of trust, financial institutions can focus on the attributes that matter most to customers.

To gain insight into the key components of trust, and how financial institutions can better manage this central element in the customer relationship, Deloitte surveyed consumers with credit, debit, and stored-value cards. Due to the growing frequency and visibility of consumer fraud and identity theft events, and their potentially significant impact on consumer trust, we made sure the survey was divided evenly between consumers who had experienced fraud on at least one of their credit, debit, or stored-value cards ("fraud victims") and those who had not ("non-fraud victims"). Our objective was to measure the impacts on consumer trust that resulted from how the financial institutions (the card issuers) handled the fraud event.

The survey examined consumers' levels of confidence and the elements that go into building trust with payments providers. The results — combined with Deloitte's experience in working with major payments providers — have broad implications beyond fraud, demonstrating both the critical importance of trust and the opportunity to manage it more effectively.

The presence, or lack of, consumer trust in a payment provider's ability to manage financial transactions can have broad impacts on financial performance. Consumer confidence in a financial institution can be colored by everything from the accuracy of transactions, to how disputes with merchants are handled, to the ability to honor credit limits and authorize transactions to how widely a credit card is accepted, and to whether credit limits or interest rates are changed. Trust can directly affect customer loyalty, including whether consumers remain with an institution and the ability to cross-sell additional products to them. Where institutions maintain high levels of trust, they are much more likely to receive referrals from existing customers and far less likely to suffer from dissatisfied customers recounting unhappy experiences to friends and coworkers.

But trust has even wider implications. Financial institutions that lose customer trust by failing to manage payments transactions will face substantially greater operational risks: They can suffer damage to their brand and reputation, as well as become the target of regulatory action or class-action lawsuits. At the same time, the erosion of trust can lead to higher operating costs, as institutions must respond to a higher volume of customer service calls and disputes. They also bear higher customer acquisition costs because they must market more intensively and offer greater incentives to attract new customers.

To manage and build trust, financial institutions need to understand its components. Deloitte's experience suggests that trust has three key attributes:

- **Tolerated vulnerability:** Consumers' perceptions of the ability of their financial institutions to protect them against potential problems.
- **Financial protection:** Protection levels provided to consumers once a financial impact event has occurred, such as liability coverage offered in cases of fraud.
- **Impact management:** A financial institution's ability to manage the customer experience after a problem has been detected/suspected. This can include problem resolution, customer inconvenience during the process, and more.

While all three attributes are important, it appears that the greatest room for improvement for most institutions lies in implementing processes, policies, and tools to address the third factor — managing the impact of an event that might damage consumer trust. For example, consider the critical high-asset customer segment when a fraud incident occurs. These customers face significant and unique challenges because of the volume and types of transactions they execute. Resolving fraud may require them to pore over several hundred transactions — a task that is manual, tedious, and time-consuming. As a result, to maintain or strengthen trust with these key customers, institutions may need to offer special impact management policies and processes.

Because consumer trust is such an important asset to financial institutions, we recommend that an explicit focus be placed on establishing and maintaining consumer trust at the overall enterprise level since it likely spans multiple lines of business and is impacted by almost all functions. Consumer trust is established initially through branding, marketing, and customer-facing employees at the time the customer buys their first product. Then, it is maintained and reinforced through subsequent customer experiences shaped by marketing, operations, products, and customer service. First, we recommend establishing consumer trust governance and performance metrics (see Exhibit 1).

Exhibit 1. Establish governance and metrics

	Key Tactics	Description
Establish governance and metrics	Create a formal discipline around consumer trust	• Designate one executive to own organizational trust, loyalty, and customer experience centrally. • Identify those who will have responsibility for customer experience, data security, analytics, setting policies, monitoring and assessing current state, and identifying and implementing improvements (Responsible staff may reside within instrument or business silos and might include: marketing, brand, product, operational and brand risk, and operations personnel.). • Develop enterprise-wide agreement on the drivers of consumer trust and the events that impact consumer trust. • Train all staff on the importance of consumer trust, the main drivers of consumer trust, and how their job impacts consumer trust.
	Measure consumer trust	• Develop "consumer trust" metrics and reporting (e.g., time to resolve a trust impacting event, customer satisfaction post event, customer attrition post-event). • Align organizational incentives with "consumer trust" performance.
	Develop standard policies across the organization	• Assess current policies that impact trust: chargebacks, investigations, disputes, collections, fraud, privacy, etc. • Clearly address how and when to side with different parties. • Assess competitor policies (both traditional and non-traditional). • Determine true cost/business case around policies. • Set standard policies for all instruments.

Improving an organization-wide variable like consumer trust requires senior level executive accountability and specific metrics that are tracked and linked to incentives across the organization. (Consumer trust is one major component of the customer experience and could be wrapped into overall customer experience governance.) Governance might take the shape of a consumer trust council, chaired by the accountable executive and comprised of representatives from different business units and functional areas across the organization. The council's responsibilities might include:

- Setting consistent bank-wide policies that impact consumer trust on topics such as information usage, privacy, data security, the handling of identity theft, when to side with which party in disputes, investments in customer facing tools and channel infrastructure.
- Developing organizational incentives to promote consumer trust.
- Developing and tracking consumer trust related metrics (time to resolve disputes, customer survey results, etc.).

Second, we recommend infrastructure be evaluated to determine how it can positively or negatively impacts consumer trust (see Exhibit 2). Selective infrastructure should be made to enhance the customer experience and promote consumer trust. Examples of infrastructure considerations include:

- How can existing channels be enhanced to address consumer trust (e.g., customizable and system generated alerts provided through customer's preferred channel)?

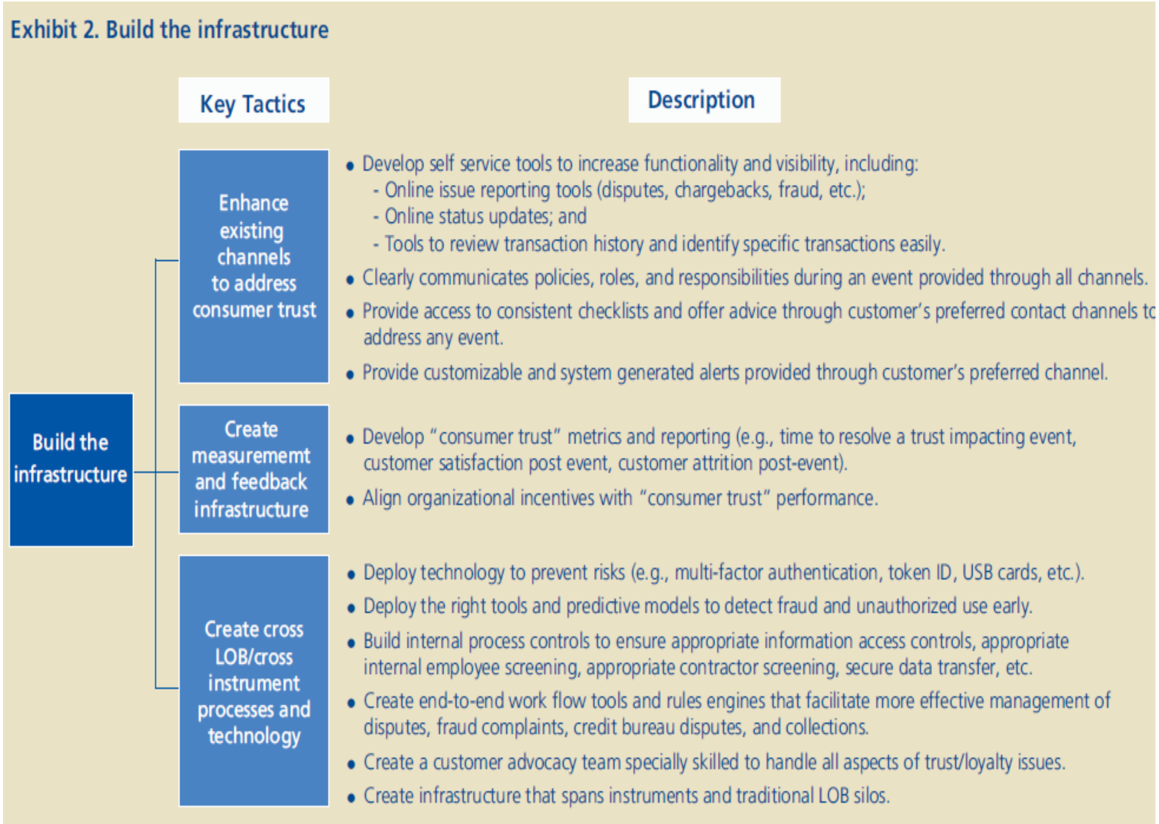


Exhibit 2. Build the infrastructure

Selective infrastructure should be made to enhance the customer experience and promote consumer trust. Examples of infrastructure considerations include:

- How can existing channels be enhanced to address consumer trust (e.g., customizable and system generated alerts provided through customer's preferred channel)?
- How can we better measure and track consumer trust (e.g., customer service metrics, customer survey questions, etc.)?
- How can we create cross LOB/instrument processes and technologies that enhance consumer trust (e.g., automated end-to-end workflow tools and rules engines that facilitate more effective management of disputes, fraud complaints, credit bureau disputes, collections, etc.)?

Finally, once consumer trust governance and measurement is in place and infrastructure has been designed to maintain and enhance consumer trust, the challenge becomes one of execution (see Exhibit 3). Unfortunately, consumer trust can be considered a basic requirement for a financial institution, so customers rarely notice good execution until something goes wrong. When a customer's identity is stolen, they have a dispute, or they want to investigate a questionable transaction on their account, how well does their financial institution execute? These are all questions to address when building consumer trust, so we recommend taking a consumer trust lens to operations and execution around consumer trust-impacting events:

- How well is the customer experience managed?
- How was the customer's experience relative to event prevention, detection, and customer notification?
- How is the customer experience during event resolution?
- How well did operations perform to quickly and efficiently resolve the event and serve the customer?

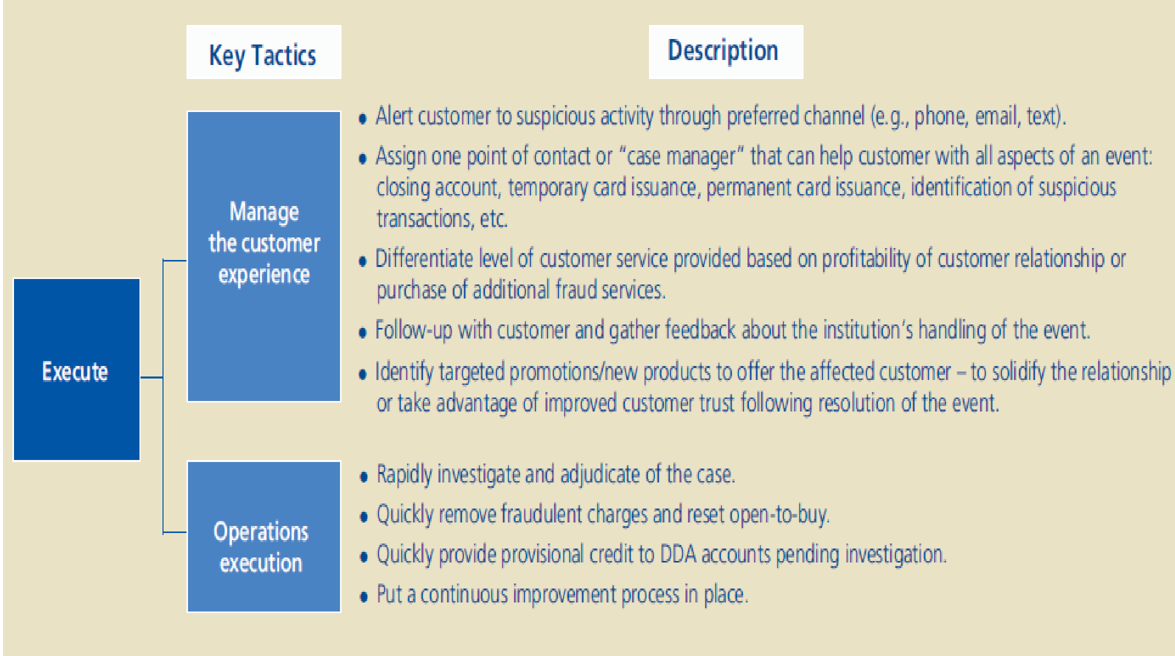


Exhibit 3. Execute

Key Drivers of Trust

When a trust-impacting event such as fraud occurs, it can have a significant negative effect on consumer behavior. How an issuer handles such events can determine whether it maintains a consumer's trust and retains the customer's business. Consumers who experience fraud find it disruptive to their lives, and a significant portion of fraud victims reduce or cancel their relationships with their issuers, leading to lost revenue. On the other hand, issuers that manage such events well can turn these threats into opportunities and strengthen consumer trust.

Our survey examined eight key attributes that contribute to trust in retail payments, asking consumers about their confidence in their providers in terms of:

- Overall reputation
- Accuracy in recording financial information
- Ability to protect against fraud
- Ability to easily resolve an instance of fraud
- Honesty and integrity of employees
- Ability to quickly fix any problems that may arise
- Willingness to take the consumer's side in a dispute
- Skills and competence of employees

Significant performance gap on key trust drivers

What emerged from our findings was a significant performance gap between the highest- and lowest-rated issuers for these factors that drive trust. Across these eight attributes, the highest-rated issuer was rated an average of 22% higher than the lowest-rated issuer. For example, while 93% of fraud victims were very confident in the overall reputation and ability to quickly fix problems of the highest-rated issuer for this attribute, only about 65% had this level of confidence for the lowest-rated issuer. Similarly, only 55% of consumers were very confident in the lowest-rated issuer, far behind the 85% rating received by the highest-rated issuer for this attribute (see Exhibit 4).

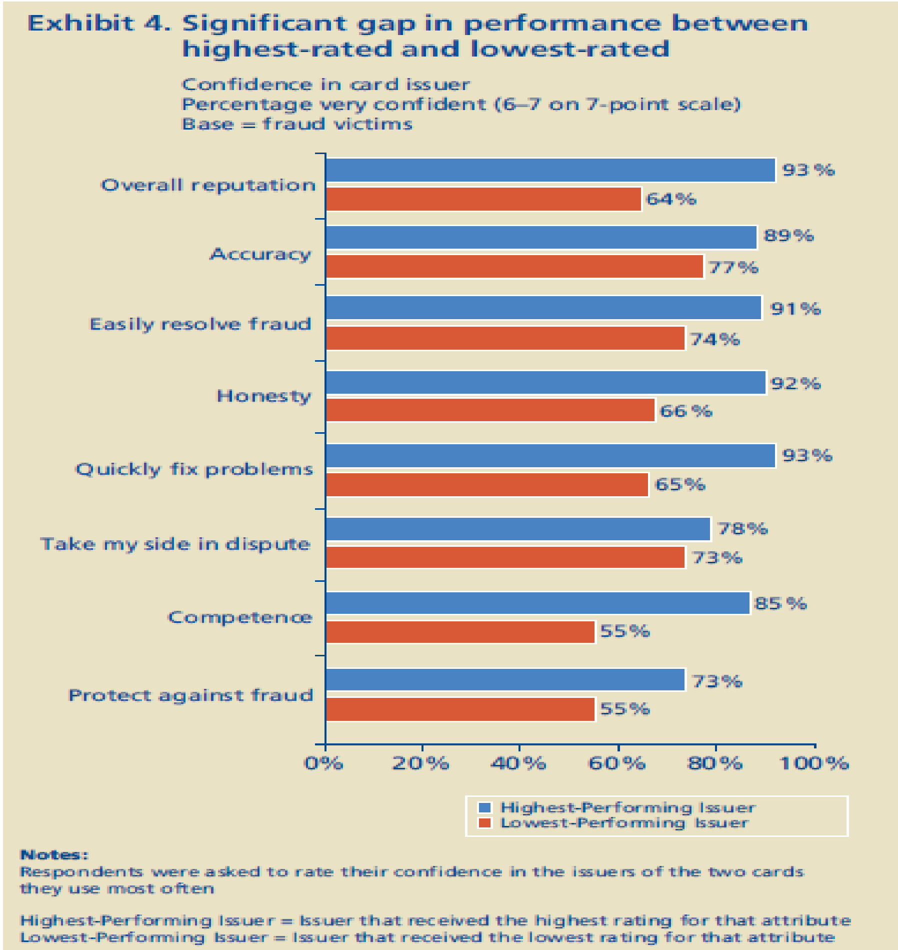
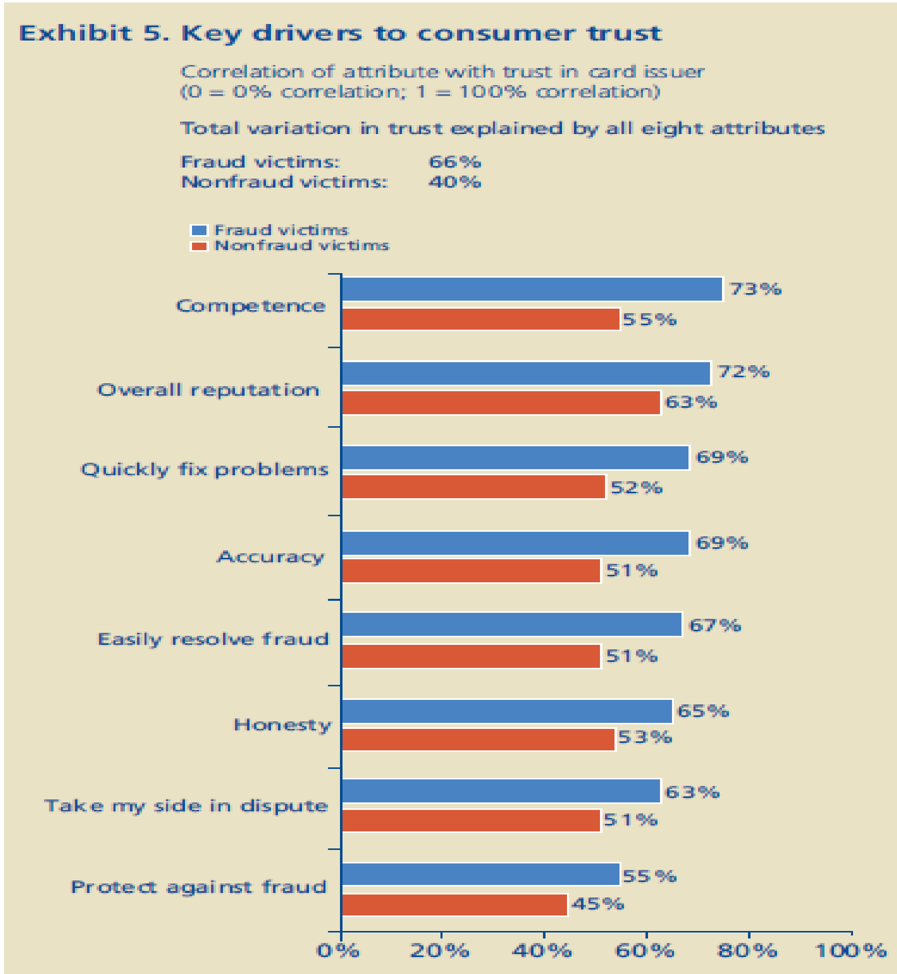


Exhibit 4. Significant gap in performance between highest-rated and lowest-rated

Clearly, some issuers need significant improvement in their performance on these key trust drivers.

Companies that perform well on these eight attributes are quite likely to enjoy high levels of consumer trust. To measure the influence of these attributes on consumer trust, we analyzed the correlation between the reported satisfaction ratings of each attribute and the reported levels of trust. The analysis found that there were strong correlations between the ratings of these individual attributes and overall trust levels, especially for fraud victims. The attributes showing the highest correlations with trust were *competence* and *overall reputation*, with all eight attributes having correlations ranging from 0.55 to 0.73.1 As a group, ratings on these eight attributes explained 66% of a consumer's reported level of trust, while they explained 40% of the trust level for the non-fraud group2 (see Exhibit 5).



Many of these attributes have wide applicability across the entire customer payments relationship. Qualities such as competence, accuracy, and the ability to quickly fix problems are important to customer satisfaction, whether in setting up a new account, managing merchant disputes, or providing additional services.

Overall, financial institutions understand the value of building trust, but they are not managing it with the same rigor that they apply to areas such as customer satisfaction, customer retention, and customer advocacy. Trust is not well understood and largely unmeasured in the industry, which limits institutions' ability to manage and build it — all at a time when it is becoming an increasingly important asset.

Taking Action

Many financial institutions do not take advantage of the "moment of truth" that a fraud incident presents. As a result, those that are able to excel at managing the impact of a fraud event have the opportunity to gain a competitive edge. Designing a fraud-resolution process that effectively addresses areas where an institution ranks behind its competitors can yield substantial benefits.

Financial institutions should consider actions such as:

- Use intelligent call routing to route calls about fraud incidents to service personnel with the right skills to handle that type of fraud. Systems can be designed to more accurately segment customers based on their profitability and the aspects of the fraud resolution process that are most important to each customer segment. For example, when a high-asset customer calls for the second time about a fraud incident, such systems can be programmed to automatically route them to the same customer service representative with whom they spoke previously.
- Share appropriate information with customers and keep them informed throughout the fraud investigation and dispute-resolution process. Institutions have traditionally been concerned that they

may inadvertently provide information to consumers who are perpetrating fraud themselves, rather than being innocent victims. Yet, executed with care, providing additional information during fraud resolution can cement customer relationships at a time when they are most vulnerable. For example, consumers could be given an online interface to receive assistance in identifying suspicious transactions by accessing some of the information contained in the institution's fraud work station, which is typically only available to employees. This could be an attractive element of the additional services offered to affluent or more profitable customers.

- Differentiate offerings through additional fraud resolution services, such as "white-glove" treatment in the case of fraud. Such services could include assigning a customer service representative to help the customer through the entire process. This could include assisting in identifying suspicious transactions and providing the required documentation. In fact, financial institutions that fail to provide enhanced services to their more affluent, high-volume customers may lose them to other institutions that offer these services. In attracting new affluent customers, one feature could be assistance in decoupling their accounts and automatic debit arrangements with their existing financial services provider and transferring customers seamlessly.
- Offer a guarantee to customers that the financial institution will go beyond the legal requirements. For example, while a credit card issuer may be required by law to respond to a customer notification about a fraudulent item within 30 days and to resolve the issue within two billing cycles, the issuer may in fact commit to its customers that it would respond and resolve the issue much earlier than legally required. This will clearly indicate that the institution will go the extra mile to serve and please its customers and will do it not purely because it is mandated by industry regulations to do so.
- Enhance the ability to allow consumers to conduct online the overall communications process regarding fraud or trust-damaging events. Much of the communication between the customer and the financial institution after a trust-damaging event is still conducted the old-fashioned way (e.g., forms need to be faxed or mailed), which is time-consuming and frustrating for most customers. However, much of the required documentation could instead be e-mailed or uploaded, streamlining the process and making it more convenient for the customer. It is not only the final resolution that determines overall satisfaction, but also whether the resolution process itself was convenient and simple.

Clearly, the issue of trust looms large for the retail payments industry. Companies can apply greater discipline to the management of trust — just as they have to customer relationship management as a whole. In particular, they can augment fraud-reduction efforts with a more fact-based and systematic approach to the fraud resolution process, focusing on the factors that matter the most to customers. Payment providers that mismanage fraud resolution can quickly erode trust and lose customers. On the other hand, financial institutions that meet this challenge effectively will build trust and profitable, enduring consumer relationships.

Using Financial Innovation to Support Savers:
From Coercion to Excitement

- Household Savings are generally low in most countries.
- Any potential to address this problem?
- Do limited profit opportunities restrain private entities from helping people save?
- The recent economic crisis has prompted households to revisit savings behavior, at least temporarily.
- Let's identify savings innovations that work, laying out a range of options currently offered by stakeholders in the United States and abroad.
- These solutions can be distinguished as either *Process Innovations OR Product innovations.*

Process Innovations

- Process innovations change the ability or motivation to save.
- At one extreme are measures that take away the savings decision, either through outright transfers or through government-mandated savings.
- One could say, for example, that by mandating payroll tax deductions and contributions, Social Security coerces individual savings.
- Other process innovations leave the savings decision in consumers' hands but change the process with respect to the time and place of savings.

- One such set of strategies attempts to make it hard *not to save.*
- For example, employers may encourage retirement savings by having participation be the default setting for new employees' 401(k) enrollment.
- Those who do not wish to save must opt out.
- A related strategy bundle saving with something consumers already does, such as shopping, using a credit or debit card, or borrowing.
- The bundling of lending and saving meets customers' short term needs while helping them to accumulate sufficient savings to break the payday loan cycle.
- Other innovations require a conscious, unbundled savings decision but reduce impediments and make it easier to save—for example, by making savings products available when and where people can save, and by opening up convenient distribution channels like workplaces and retail stores.

Product Innovations

- Product innovations reengineer the cost benefit calculation of saving by adding financial, social, or psychological incentives.
- Individual development accounts (IDAs) encourage savings among the poor by providing grants that match what the savers deposit in bank accounts (so long as the funds are used for home ownership, education, or business development).
- Financial mutuals are products that leverage the social power of groups to support saving.
- They take different forms but share a fundamental behavioral logic featuring peer pressure and peer support.
- Although the most prominent form is the microfinance lending circle popularized by Muhammad Yunus, the rotating savings and credit associations (ROSCAs) operate on similar principles around the world.
- Members meet regularly, and each member contributes funds that are then aggregated and presented to one member.
- The meetings continue until everyone has been awarded the pooled sums.
- Social bonds encourage participation and keep defaults down.
- In developed countries, mutuals are seen among immigrant entrepreneurs.
- Prize-linked investment products manipulate psychological incentives to increase saving.
- First introduced in the United Kingdom in 1694, prize-linked savings products have now settled on a fairly simple construction.
- Investors purchase a savings product with no risk of losing the principal; they either forfeit interest payments or accept reduced ones in exchange for the chance to win large prizes allocated randomly among account holders.
- Prize linked savings products have been offered in many countries.

From Ideas to Action

- All too often, we focus on one type of savings (usually long-horizon goals like retirement or education) or one type of program (such as tax credits or a default scheme) without acknowledging the breadth of families' savings goals or the range of available mechanisms.
- A consideration of the alternatives quickly leads to the observation that some solutions are best suited to government action (savings bonds at tax time), others to the private sector (bundled or point-of-sale savings), and others to social groups or nongovernmental organizations (social network savings).
- Additionally, some solutions might appeal to "analytic types" (inflation indexed savings bonds) and others to savers with different preferences (prize-linked savings.)
- Some might require government subsidies.

The Mind of Low- to Moderate-Income (LMI) Savers Some thoughts from Credit Union Industry

- LMI families find it difficult to save money.
- For many, day-to-day needs like housing, food, and commuting to work consume the vast majority of their incomes.
- The threat of financial crisis—brought on, for example, by a job loss, illness, or essential car repair—hangs over them and colors their daily financial choices.
- A lack of savings undermines their efforts to build a more promising future for themselves.
- This reality raises important questions relevant to the Credit Union Industry as well Retail Banking
  - ✓ *How can LMI families be helped and encouraged to save?*
  - ✓ *How might Credit Unions or Retail Banks best reach potential LMI savers?*
- Zaltman Metaphor Elicitation Technique (ZMET) is an innovative research methodology that elicits insights about human decision making through metaphors and storytelling.
- Using a sophisticated interview technique, researchers encourage consumers to create stories and identify images about their feelings related to a topic of study.
- From these stories emerge metaphors, messages, and imagery that professional marketers use to build brands and products.
- The ZMET tool can deepen our understanding of how to increase saving activity among LMI households.
- ZMET applies lessons from psychotherapy, cognitive neuroscience, psychology, and sociology to discern consumers' unconscious feelings about products, brands, institutions, and the concepts on which products are based.
- The technique recognizes that 95% of human decision making and thinking occurs in the unconscious mind.
- With traditional consumer research tools like surveys and focus groups, most people are unable to articulate what genuinely motivates their behavior—what lies beyond or beneath rational thought.
- Equally important, human beings are primarily visual and nonverbal communicators, meaning consumer marketing is most effective when it is framed in the images and symbols that resonate deeply and cue customer action.

Figure 2: Emotional Continuum Framework

Customer emotional involvement	Metaphors	Subcategories	Estimated % of ads	Images
Low	Utilitarian		30%	Bills, coins, piggybanks, people working at computers
	Growth	Compound interest	13%	Plants, water-ing, seedlings, acorns, trees
		Planted money		
		Abstract		
	Games, journey, protection		17%	Sporting events, galoshes
	Aspirations/ attainment	Short-term satisfaction	40%	Shiny, happy people, proud graduates, close families
		Education		
		Calm, cool, control		
		Physical closeness		
High		Retirement		

Thoughts and Feelings about Money

- Studies found that money, like water, is both a resource and a destructive force for LMI families.
- Images of boats in a calm inlet and waves crashing against rocks exemplify this idea.

Participants articulate a number of barriers to saving

- First, the process of saving is not a lesson learned during childhood in many LMI families. Many individuals have simply never saved money before.
- Second, those heading LMI households are overwhelmed by life and by living paycheck to paycheck. Their precarious financial situation leads to a constant state of anxiety, clouding judgment and creating powerful incentives to avoid facing financial problems or planning for the future.
- Third, with checkered and sometimes tragic histories, participants are wary of planning for an uncertain and seemingly distant future. Long-term goals seem unattainable, rendering saving behavior futile.
- Finally, atop all this sits a social stigma around saving; in many low income social networks, strong pressure exists to share any resources and lend savings to those in need, especially family.
- Further complicating the task facing financial services marketers is the success of retailers and consumer product marketers in framing spending as a form of saving.
- Billions of advertising and marketing dollars have effectively persuaded many consumers that buying items on sale is a shrewd form of saving.
- With a pervasive consumerist culture, LMI consumers face omnipresent and tempting spending options.
- Understanding the degree to which consumption undermines saving, several interviewees express feelings of guilt about their personal spending behavior.

Source/Reference:

1. **Building Consumer Trust in Retail Payments Produced by Deloitte Center for Banking Solutions.**
2. **Using Financial Innovation to Support Savers by Prof. Peter Tufano, HBS.**
3. **The Mind of Low-to-Moderate-Income (LMI) Savers by Filene Research Institute.**

LESSON 44

EVOLVING MODELS OF RETAIL BANKING DISTRIBUTION CAPITALIZING ON CHANGES IN CHANNEL USAGE

Banks as retailers

Over the last decade, retail banks operating in the U.S. have generated significant revenue and profit growth; however, when their track record is examined in terms of cross-sell rates and customer retention, they continue to deliver inconsistent results. If these banks are essentially major retailers — after all, many banks have as many financial centers as some of the largest super-retailers — why haven't they been more successful by traditional retail metrics? Why has creating a consistently high-quality customer experience continued to elude them? Even though they are increasingly being drawn to the retailer's blueprint, which has been demonstrated to facilitate astute and nimble responses to customers' needs, they are still slow to adopt the strategies that could allow them to capitalize on the tremendous additional potential for growth and profitability that a customer-centric retail orientation brings. Can banks evolve to a more customer-centric state? What opportunities should they pursue to realize a dramatically different customer experience?

Many banks have made strong progress in improving their customer experiences, particularly in the following areas: customer data and segmentation; leveraging data to deliver a better product mix; creating a distinct brand image; and improving service operations. Deloitte believes the banks' challenge is to improve and integrate their multiple distribution channels to consistently deliver an enhanced experience and foster better customer relationships. As the primary means of customer service and sales interaction, distribution channels play a central role in the customer relationship process, which fuels growth.

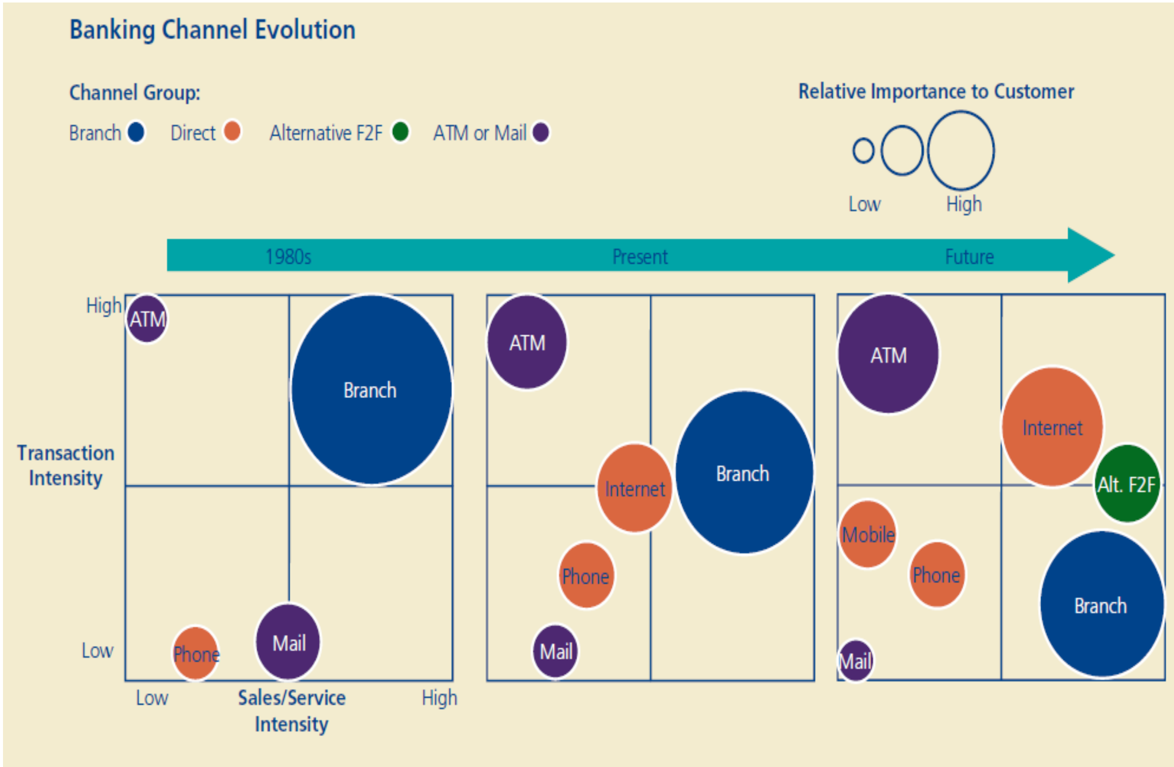
That's why retailers place great importance on the look, feel, layout, and customer convenience of distribution channels, whether they comprise physical locations, Web sites, kiosks, or interactions with sales professionals. For the same reason, they make attracting and retaining customers within and across these channels a top priority. Banks must do the same.

For most banks, the branch presently dominates their distribution approach, while other methods of interaction such as direct channels and alternative face-to-face (F2F) outlets are less important and not well integrated. But this situation appears to be changing fast. Research by the Deloitte Center for Banking Solutions has identified six converging market dynamics, which are creating an inflection point in the evolution of retail channels for banks. These market drivers are rapidly transforming the retail distribution landscape for banking services from a branch-dominated paradigm to one of integration and balance among multiple channels.

Branches will still play a vital part in this new equilibrium, but they will be very different. As transactions begin to take place via other channels, banks will increasingly behave like traditional retailers, focusing more on sales and complex service opportunities. Meanwhile, technological advances can enhance the ability for direct channels to fulfill their potential as a source of banking sales and service with higher convenience at lower costs. Alternative F2F channels will also emerge as strong, viable distribution options in this new landscape because people will still value personal interactions. An integrated customer focus will become critical across these channels as demographic shifts usher in a new — and highly discriminating — breed of customer.

Financial institutions will be faced with some tough strategic decisions in adapting to this new environment. At a minimum, they will want to determine how and when to revitalize the branch, the existing primary channel for most, to draw customers in and to address their changing expectations. They will also want to consider how to develop and expand non-branch channels to be competitive in attracting, serving and retaining customers. In addition, they should look for cost-effective ways to make their channels more integrated and customer focused.

Should financial institutions address these challenges through small incremental improvements or major leaps of change? The research findings, potential projects, and strategic possibilities presented here are intended for banks to consider as they develop a solid framework for navigating the sea change that lies ahead.



Six Converging Market Dynamics……

1. Branch-generated revenue growth is becoming more challenging.
2. Transaction processing & Customer service are becoming increasingly independent of branch channel.
3. Customer demographics are shifting, making Generation Y & ethnic groups vitally important.
4. New technologies are gaining widespread adoption, allowing CRM to become channel independent.
5. Changes in regulatory environment are altering the playing field.
6. Banks should prepare for overlapping competitive dynamics in Retail Financial Services.

The research by the Deloitte Center for Banking Solutions has identified six market dynamics, the convergence of which has created the inflection point banks face today in the evolution of retail distribution channels for banking services. We believe understanding these dynamics is critical to developing effective customer-focused strategies and to determining the roles that existing and nascent channels could play in them.

Trend 1:
Branch-generated revenue growth is becoming more challenging.
While growth at existing branches continues to be strong, this is not the case at many new branches. Growth at branches outside of a bank's existing footprint is uneven and weak. From 2000 to 2006, U.S. bank deposits grew by 61 percent, while the number of branches grew only 11 percent. Since deposits grew faster than branches, revenue per branch logically increased — fueling the push among banks to build more outlets. Although the Unites States is the only industrialized country in the world to have significantly increased the number of branches per million residents since 2001, it still remains behind many countries in branches per capita. Despite this gap, the era of rapid branch expansion in the United States may be coming to an end. Of the branches built in 2001, 60 percent have not yet reached a break-even level of deposits.

Simultaneously, it is becoming increasingly expensive to acquire existing branches. As a natural consequence of the continual stream of acquisitions over the past decade, our observations suggest the number of attractive and willing sellers of retail banks is dwindling, thereby raising the effective cost of acquiring additional branch capacity. In addition, the quality of smaller bank branch networks is highly variable, with many fast-growing, newer community banks, being no more than real estate-loan production offices funded by high-rate deposit bases, presenting a less-than-attractive book of business for expanding a traditional branch network and acquiring core customers.

Trend 2:

Transactions processing and customer service are becoming increasingly independent of the branch channel.

Why visit a bank branch? For decades, most people visited the branch for credit approval, to conduct transactions, learn about products and services, and for customer service. However, most credit approval processes moved out of branch networks over a decade ago. Today, many of the core transactions that were once conducted in branches are shifting to electronic forms or are being captured elsewhere. While this phenomenon has been under way for some time, its momentum is rapidly accelerating. Today, remote deposit capture (RDC), a service that allows users to scan checks and transmit the scanned images and/or ACH-data to a bank for posting and clearing, is already demonstrating its potential to substantially reduce the volume of payments processed at branches. In 2007, over 3.8 billion items, worth more than $7.6 trillion, were handled by RDC in the United States, with volumes expected to grow more than four-fold by 2010 as the number of RDC users' increases dramatically. Although this still represents a small portion of total checks, use of RDC has expanded significantly with many major banks rolling out RDC-capable ATMs. Now that RDC can be done via a common scanner, its growth will continue to accelerate, particularly as an offering for small business customers. Some banks are even testing the feasibility of using mobile phone cameras to do RDC.

In addition to its many customer advantages, RDC can also benefit banks, particularly community banks, by allowing them to expand beyond their current geographic footprints and reduce the number of full-time equivalent (FTE) staff members committed to handling branch transactions. For instance, 46 percent of community banks expect to offer RDC to their small business clients over the next 12-18 months, according to a recent survey by *Independent Banker*.

Lagging the global shift to electronic payments, the United States continues to complete proportionately more paper transactions than the rest of the world. This further suggests that the U.S. banking industry may be on the cusp of a significant payments transformation. While the United States has historically been out of sync with other countries' payment practices, it is now becoming more aligned in order to stay competitive and to facilitate global commerce. The emergence of widely available and accepted mWallets for electronic and contact-less payment will likely aid this alignment, accelerating the already substantial movement of transactions away from branch networks.

Trend 3:

Customer demographics are shifting, making Generation Y and ethnic groups vitally important.

More than 75 million strong, the Gen Y customer segment (born between 1982 and 1995) is second in numbers only to the 80 million Baby Boomers. Furthermore, Gen Y is positioned to become the wealthiest generation to date, with a collective income that is expected to grow to $3.5 trillion over the next 10 years. Yet recent research conducted by the Deloitte Center for Banking Solutions and Harris Interactive reveals that members of Gen Y have individual characteristics that make them a different breed of bank customer, requiring banks to employ different kinds of channel strategies to attract and retain them.

Practicality is among the most important of these characteristics. Gen Y prefers affordable, accessible banking and appears more prone than other generations to consider options from other institutions, especially relating to fees, convenience, and online capabilities. Younger respondents (both Gen Y and Gen X) were more likely to switch banks for lower fees, more convenient locations and banking hours, and the ability to conduct more activities online.

Another characteristic of Gen Y consumers is that they view technology as a way of life, an extension of themselves. At the same time, they value direct interaction with people for some types of banking transactions such as answering questions, resolving issues, and opening an account. They also like to do their own research before making buying decisions, but they look to family and friends to support their conclusions, a tendency reinforced by their participation in social networking Web sites.

These characteristics suggest that Gen Y consumers are well connected, multi-channel buyers who have high expectations for convenience, information, and service. To attract and retain them, banks must offer channels that are easy to navigate, that provide a consistent customer experience, and integrate seamlessly.
Another source of demographic change and population growth is from ethnic groups in the United States. Multicultural and new immigrant customers have a series of financial needs and preferences that are slightly different from those of traditional retail banking customers. The ability to access basic banking services, credit, the remittance system, and customer sales and service in their native languages will influence where they become customers as has been the case in mature banking markets such as Australia, Canada, and the United Kingdom.

Trend 4:
New technologies are gaining widespread adoption, allowing customer relationship management to become channel independent.
Internet banking has received the most coverage in the past decade, however, the adoption of new technologies may profoundly influence the distribution of retail banking services. One area of impact may be the movement toward greater mobility as mobile phones become more sophisticated and, therefore, more capable of handling advanced applications and services. Banking via mobile phones appeals to consumers on multiple fronts. Customers may not know the location of their closest branch or even where their credit or debit cards are, but they always have their mobile phones nearby. Mobile phones also serve as an efficient vehicle for making contact-less payments or person-to-person transfers, providing greater security protocols and storing in-depth preference information. This is efficiently accomplished via an existing device, without the need to load an extra smart card. Various software platforms for mobile phones and other devices will allow consumers to use the Web through their handhelds as easily as they do through their computers. It is anticipated that this will spur rapid demand for mobile-banking services over the next decade.

Other technology developments are also poised to affect the distribution of retail banking services. For instance, growing broadband internet penetration and wider use of low-cost, high-quality webcams will allow banks to use Web 2.0 or other collaborative tools to reach customers at their homes offices, in branches and at ATMs. This capability is providing banks with fresh alternatives for customer interaction such as video conferencing or co-browsing to support dynamic consultations at convenient locations.

One Australian bank has a VoIP (Voice over Internet Protocol) network with enough bandwidth to handle video streams so that remote relationship managers, loan officers and insurance professionals can advise and serve clients at a distance. Additionally, the growing use of instant messaging as a business tool, the expanded use of social networking sites, and increasing consumer acceptance of self-service kiosks are likely to influence consumer preferences for banking delivery channels going forward. Dramatic improvements in security and authentication are addressing the concerns of those customers who have been hesitant so far to use mobile technologies or to bank online as well.

Meanwhile, technological progress is also providing the means for banks to operate more efficiently and cost-effectively. Advances in network capabilities and "thin client" computing are enabling banks to deploy different IT configurations in branches and remote offices, thereby reducing the cost and complexity per outlet while providing more functionality to staff and customers. Other developments, such as Radio Frequency Identification (RFID), can be used to provide increased security and better risk management while enabling banks to more rapidly access customer information. Web-based approaches, such as online assistance, can enable banks to provide person-to-person assistance more productively than branch-based staff, while also allowing them to employ leading off-shoring techniques at a far lower cost per interaction. Finally, the growth in aggregate knowledge sources and tools will likely enable banks to better merchandise and respond to their potential customers, tailored by distribution channel.

Trend 5:
Changes in the regulatory environment are altering the playing field.
Many recent regulatory changes were designed to foster innovation and enhance efficiency in the payments system. The Check Clearing for the 21st Century Act (Check 21), for instance, has paved the way for remote deposit capture, which is demonstrating the potential to displace a large portion of branch-based

transactions. While Check 21 to date has had the biggest impact upon retail distribution of banking services, other regulatory trends will also be important in shaping the channels of the future. These include:

- *Increased customer goodwill policies*: Already a significant trend in European retail banking and U.S. retail insurance and investment businesses, this movement to provide greater protection and information to consumers is starting to influence U.S. retail banking. Stipulations associated with increased customer goodwill often include more transparency on pricing and fees; stricter requirements to supply consumers with real-time information so they can make better-informed choices (such as whether or not a non-sufficient funds fee will be incurred on a transaction); and the ability to produce an audit trail that demonstrates that the bank acted in the customer's best interest, which is similar to the requirements imposed upon the insurance and securities industries.
- *Implementation of Basel II in the United States*: While focused primarily on capital adequacy, this development will likely lead to differential pricing by product and channels as a result of explicit strategies to attract certain segments of customers. Additionally, the infrastructure created by banks to comply with Basel II will provide retail banks with enriched insights into their books of business and customers' behaviors.
- *Enhanced security and privacy regulations*: More stringent requirements in these areas will make it more costly and complicated to share information about a customer across legal entities. They will also necessitate more complex and expensive means of ID and access management for both customers and bank staff. Ongoing pressures related to anti–money laundering (AML) regulations will continue to make account-opening and money transfer processes complex and cumbersome as well.

A recent survey by the Deloitte Center for Banking Solutions found that the cost of compliance with the enhanced security and privacy regulations at major U.S. banks has grown from 2.8 percent of banks' net income in 2002 to 3.7 percent by 2006. These regulatory changes both increase the cost and complexity for existing banks and open the playing field for non-traditional competitors.

Trend 6:
Banks should prepare for overlapping competitive dynamics in retail financial services.
In the United States, retail banking offers a bigger profit pool, more stable returns, and a more fragmented industry structure than many other types of businesses. While scale is important at the micro-market level or in selected product lines, newcomers can sometimes achieve the volumes necessary to be competitive without taking a leading market share position. As a result, non-banking financial services companies are increasingly entering the retail and small business banking space, competing for customers and their balances.

With the competitive door continually ajar, existing banks are constantly under threat. Several other industries have chosen to enter banking services including, but not limited to, retail brokerage firms; life insurance companies; property and casualty insurance companies; health care insurance companies; and retailers and e-commerce companies. Banks should be on alert and planning for the inevitability of multiple, non-bank entrants for a number of reasons. First, the erosion of branch-based transactions may significantly reduce the natural advantage retail banks have had for decades to blunt the invasion of new bank entrants. Second, several non-bank companies have stronger sales cultures, higher customer service approval ratings, and more formidable brand equity than many U.S.-based banks. Third, each type of non-bank competitor offers customers an individual value proposition that may include, for example, bundled insurance and deposit or savings products, one-stop shopping with a single financial institution, convenient store locations, or innovative products such as mobile payments. Finally, some non-banks such as online retailers or search firms may bring approaches and a set of economics that envelope and overwhelm the traditional economics of the "old retail banking payment systems," making banks little more than commodity vendors of a low-cost banking service within these emerging customer paradigms.

An inflection point for banking
These six market dynamics are creating a dramatic inflection point for retail banking. The needs and expectations of bank customers are changing as quickly as the competitive landscape. Customers are demanding seamless, multi-channel sales and service experiences. Simultaneously, other financial institutions are either looking for opportunities to invade this attractive space or to redefine it through disruptive innovation. These trends, including the evolution and diminution of the branch and the rising

influence of alternative face-to-face and direct channels, are causing banks to examine a more balanced channel approach. It is anticipated that all channels will become more customer-focused, integrated, and interdependent. Many retailers and technology firms have long recognized these trends. Taking their cue, banks will still maintain branches as a vital part of this new equilibrium, but the branches will look very different and play a very different role in meeting customers' needs.

Taking Action to Transform the Branch Network

Converging market dynamics are driving banks to revitalize their branch networks despite cost pressures. In formulating a renewal strategy, your bank will likely need to find creative and cost-effective ways to:

- Design and test next-generation format models that are efficient and sufficiently advanced to address evolving customer preferences.
- Rebalance staff and branch processes to focus more on complex service issues and on the necessary sales opportunities to continue deposit and investment growth in existing branches despite declining customer traffic.
- Invest in advanced technology – especially communications related to enable real-time delivery of face-to-face expertise at dispersed branches.
- Develop revised network models that reflect the changed roles of branches, automated banking machines, and alternative outlet types within a market.
- Actively manage the migration of transactions away from branches by implementing various projects simultaneously to move payment transactions away from expensive branches and into other channels that are lower in cost.
- Outline an economically viable means of modifying existing branch approaches, while maintaining or increasing de novo growth to improve customer convenience in select markets.

Responding to Increasing Alternative F2F Activity
Alternative F2F channels present both an opportunity (to connect with customers outside the branch) and a threat (non-banks can enter the retail banking space). To respond to this challenge, banks can take several actions:

- **Expand alternative mobile sales force capabilities:** Attract experienced sales people or transition existing staff to become mobile bank relationship managers. Equip managers with mobile technology to execute and fulfill sales transactions remotely and provide simple service activities.

- **Explore franchise branch networks:** Change branch management from employed staff to independent operators who share in the economics of the branch. Give these owner-operators some flexibility to offer more customized staffing and sales and service, while centrally retaining product pricing, credit authority, and back-office operations.

- **Convert agent/advisor brick-and-mortar offices into banking outlets:** Grow the number of physical customer touch points by providing sales and service through new locations such as brokerages or agent outlets. Banks could co-locate with non-banks or non-banks could collaborate with banks to offer their own branded services. Non-banks could cross-sell financial services offerings with their own products at shared sites or even co-locate at retail banking malls such as exist in Dubai.

Responding to the Rapid Evolution of Direct Channels
Shifting customer preferences and behaviors are accelerating the expansion of direct banking, which is developing in many forms. To respond to the rapid evolution of direct channels, banks may want to take several actions:

- **Upgrade the service attributes of their existing direct channels:** While Web site availability, page-load speed, call wait time, and drop rates all need to be improved at most banks, the majority of effort should be devoted to better navigation and usability of existing sites, improved access and linkage to account data (within and across institutions), and the provision of richer content.

- **Improve the ability to convert remote service interactions into relationship building and sales opportunities:** Traditional direct players and recently some banks, have been very good at making this conversion, but banks need to enhance their customer tracking, predictive quantitative tools, on-line chat capabilities, and the supporting human capital initiatives to capture this category of near-term improvements.

- **Invest to create greater sales capabilities and capacities on Web sites:** There is a significant gap between what can be executed today on a robust financial-services Web site and what can be done on a typical bank site. We anticipate that enhancing customer-facing site attributes, as well as aligning the supporting operations and IT applications to execute more kinds of sales, will consume the time and energy of most banks over the next three to five years.

- **Take a proactive approach to direct aggregators:** Banks will need to refine their cooperate-compete approaches with aggregators and put the tools and skills in place to effectively pursue the opportunities and manage the risks related to attracting and serving customers through these two different direct methods.

- **Experiment with select mass collaboration models:** Given the disintermediation potential of these approaches, banks should begin to selectively experiment with different models that are consistent with their customer bases, brands and operating skills.

Channel Integration and Improvement: Bringing It Together ……

In the future, customer needs and preferences will increasingly drive the integration of all types of banking channels. Generational preferences suggest that tech-savvy Gen Y and Gen X customers will demand the ability to fluidly switch back and forth among channels, using a mix for interactions around the same sales or service event. They also expect improved cross-channel experiences similar to the ones already offered by retailers. For instance, consumers today can get a coupon in the mail from Best Buy, research the product online, purchase it online, pick it up at a store the same day, and get after sales service by phone or e-mail. Few, if any, banks can deliver that kind of cross-channel experience today if a customer, for instance, would want to purchase a prepaid debit card for a trip.

Thus banks should be seeking to accelerate their steady progress toward greater levels of integration and more proactive approaches to meet customers' cross-channel needs. The situation can be framed better in terms of **four levels** of engagement with customers.

The first, service-level integration, is where most banks are today. This level is almost entirely reactive, where a customer phones a call center and inquires about her account. Today, customers minimally expect that bank employees have at least the same level of information as they can access online themselves.

The second level of integration adds a proactive behavior to the customer experience. The customer-service representative offers customers an additional product or service while assisting them with their initial inquiries. For example, financial institutions are finding that proactively chatting with customers while they are researching online drives value.

The third level involves totally integrated channels, resembling the models employed by retailers such as L.L. Bean. With total channel integration, customers can research a product or service online or in a catalog and then phone in the order to a call center that has the customer's preferences and buying habits stored in a database. In an integrated model, customers can easily skip from one channel to another to make their purchases.

The final, or fourth, level integrates and organizes the channels and business systems around specific customer segments. This level is reflected in the operations of Best Buy, which has not only fully integrated its online call center and store operations but also has designed its Web sites and stores around specific customer segments. For example, a customer can phone a call center to obtain product information, order a product online, and then pick it up in the store. Within the stores, there are sections dedicated to different types of customers such as computer novices and audio gurus. The company's Web site also has pages that are tailored to customers' varying needs for education and information, ranging from in-depth product specs aimed at videophiles to helpful buying guides targeted toward the average consumer, which explain an entire category of products such as DVD players and DVRs.

While difficult and costly to achieve due to system integration challenges, many progressive institutions have launched initiatives to improve channel integration and to become more proactively customer-focused by investing in infrastructure, applications, and talent necessary as well as training customers to encourage their adoption.

Some potential developments in channel integration include Internet and telephone banking kiosks that facilitate routine transactions and demonstrate online banking functionality; webcams and interactive televisions that connect branch customers in real time to product specialists in central locations; and next-generation integrated CRM software and shared customer data, similar to call center applications and databases, with prompting and scripting functionality to support face-to-face branch sales interactions. Banks are also starting to take advantage of standardized workflow technology that supports the integration of Web, phone, mail, and branch sales and service events by capturing various customer interactions wherever they occur.

Banks can gain a lot from improving their channel-integration capabilities, which often requires integrating their back- and front office systems. Transitioning to more seamless IT platforms can provide banks with the highly vaunted "single view of the customer," which holds the key to enhanced customer service and improving the effectiveness of cross-selling activities. Many of the major international banks are already moving in this direction while many U.S. banks are hesitating because of the "hermit crab" dilemma: while they know they need to move to a new shell, or core IT systems, they also know that they are most vulnerable — at risk of losing customers, missing revenue growth, and profit targets — when they leave the old one and head out across the sand. But customer and competitive pressures are intense and many banks may be forced to make a dash for it, whether or not they are comfortable with the prospect.

Implications for Banks: Good News or Bad News?

Banks can take advantage of the current inflection point in the evolving distribution landscape by pursuing certain opportunities and projects before their competitors do. Like Toyota's growth from being an early distributor of hybrid cars, enterprising banks and non-banks alike have an opportunity to capture a whole generation of consumers as the game changes irrevocably.

Yet most institutions today are underestimating the magnitude and timing of the impending shift and are acting slowly, if at all. A common conundrum for many is determining when and how to make their moves. Should it be done in small incremental improvements or via major leaps of change? There is also the challenge of balancing the need to improve all three channels with the need to integrate them. While cost is an obvious inhibitor, a main constraint is lack of human resources to envision and execute the change. Also, the major players perceive themselves to be winning under the rules of the old game; therefore, they see very little reason to accelerate the shift to cannibalize their existing retail banking franchises.

The future will require the continuation of incremental progress on multiple fronts but it will also require some bold strokes and actions. Which routes to take and how a bank might assess its potential depend upon its present market position and current set of assets. Clearly a national bank with thousands of branches will react differently than a national bank that has a strong brand but limited branch network. Similarly, a community bank will respond differently than a non-bank competitor that is seeking to take away market share from existing banks. While the options may seem overwhelming at first, the basic course of action is straightforward: start somewhere in each of the three channels type and do it sooner rather than later. Those that react too slowly to this inflection point will fail to attract the attention and the assets of the next generation of bank customers, which is poised to be the wealthiest in history.

The situation is akin to turning an aircraft carrier. The decision to head in a particular direction must be made several miles ahead of the actual turning point because of the ship's mass and momentum. While you probably don't have to do something immediately, the size and scale of most retail banking institutions demands considerable forethought if the company is to alter its course in time to respond wisely to the compounding influences of these powerful market forces. Fortunately, the game isn't about precision this time. Simply setting a reasonable course and heading in the right direction on any one of these trends can go a long way toward positioning your organization to capitalize on the approaching waves of change in retail distribution rather than getting overturned by them.

Source/Reference:
Evolving Models of Retail Banking Distribution,
Produced by Deloitte Center for Banking Solutions

LESSON 45

FIT, FOCUSED AND READY TO FIGHT HOW BANKS CAN GET IN SHAPE FOR THE BATTLE AHEAD……

Many banks appear unhealthy and out of shape as they emerge from the global financial crisis. As they recover from this experience, they must embark on a new fitness regimen that includes a diet restricted by tighter regulations. Battling toward a healthy future, banks must act today to redefine their business models, restore client trust and understanding, and reform their risk management culture.

As the world recuperates from its recent economic malaise, bankers face a host of questions as they seek to improve the industry's health and foster long-term growth. In addition to determining how to strengthen their financial fundamentals and create new avenues for sustainable revenue and profit growth, banking leaders need to address client trust and insight while simultaneously developing strategies to better manage risk.

With many economies moving toward recovery, now is the time for banks to chart their course to a new reality. **Where should they begin?** Managing future growth while, at the same time, strengthening the balance sheet is one of the most important immediate challenges for banks. Cutting costs alone will not suffice. Banks should find new, sustainable sources of revenue and profit.

To drive long-term success, today's banks need to **focus on their business models** and make changes that enable growth, reduce costs and concentrate on those areas in which the organization wishes to excel. Each bank should determine its own specialization strategy and build the business model to support it. Banks must concentrate on decreasing complexity and increasing efficiency. Along the way, some banks will become candidates for mergers and acquisitions, such as smaller banks that lack economies of scale. At the same time, some larger banks, whose size has created extreme complexity, will divest divisions. While some of these divestitures will be required by regulators, large banks should consider divesting low performing divisions to maintain their focus and fitness.

In addition to business model health, banks must address the declining **health of their client relationships**. Our research indicates a clear trust gap between banks and their clients. Clients overwhelmingly believe banks operate primarily in their own interests rather than those of their clients – and, surprisingly enough, many bankers agree! To rebuild client relationships and reestablish trust, banks must understand what clients want, what they need and for what they are willing to pay. One way to do this is by employing a new approach to client segmentation – one based on what clients value rather than on traditional attributes like age, health, stage of life, etc. Such segmentation will lead to a healthier, more sustainable relationship with clients and, in turn, a more profitable one.

Finally, the recent economic crisis has underscored the need for banks to become more astute in their approach to risk. Historically, banks' risk management techniques have been implemented in silos aligned along individual lines of business or regions of operations. These silos hinder an essential **enterprise-wide view of risk**. Banks should move toward an integrated risk management framework that transcends silos and cohesively addresses financial risk, compliance and governance, and fraud and financial crimes.

At the same time, banks must work with regulators to create a financial architecture that improves stability and allows insight into systemic risk.

Based on extensive industry research and surveys and interviews with industry executives worldwide, we have identified the areas we believe banks should focus on as they fight to overcome their challenges and thrive in this new environment.

To get into shape and maintain fitness, banks must make a significant transformation to redefine their business models, restore their client relationships and reform the risk management culture.

The battle ahead

With the majority of dust having settled from a disruption in the financial services sector, many organizations are moving forward, taking with them lessons learned as they get in fighting shape to prepare for future growth and success. The good news is that several parts of the world appear to be on a road to recovery. However, many economists speculate there are still major bumps ahead.

As banks venture down this road – bumps or not – they will find new opportunities, as well as some challenging realities. Since the start of the crisis, banks across the world, particularly those in the United States and Western Europe, have made significant write-downs. In fact, from July 2007 to March 2009, asset write-downs exceeded capital raised worldwide by more than 16 percent. In particular, European banks are likely to face further write downs.

Banks must now focus on raising capital, improving asset quality and increasing profits. No doubt, this is a multiyear journey. New and proposed regulations all point to additional requirements for greater capital. Further complicating matters, banks' access to capital from equity markets is constrained by existing loans, an overall decline in public wealth and low current performance. And, having already spent more than US$10 trillion on banks, governments will be hard pressed to assist any further.
With all this in mind:

- ✓ How does the banking industry move from peaked to prosperous?
- ✓ How can the industry grow amid increased regulations and capital requirements?
- ✓ Where must banks focus today as they fight for a healthy future?

We believe the answers involve a commitment to fitness in the areas of business model innovation, client insight and risk management.

The financial ecosystem
For the purposes of this study, we have classified institutions in the financial ecosystem into three domains outlined below. This paper focuses on institutions in the traditional banking domain, which has been further segmented into three categories: universal banks, national and multinational banks, and specialized and regional banks.

- ***Traditional banking:*** Deposit-taking institutions that provide financial services to retail and institutional clients.
  - ***Universal banks*** are large global banks that typically have significant operations in 12 or more countries and generate a minimum of 2 percent of their revenues from each of these countries. These banks have assets of US$800 billion or more.
  - ***Multinational and national banks*** include banks with significant operations in 11 or fewer countries with an asset base between US$250 billion and US$800 billion that receive 50 percent of their revenue from their home base. They typically rely on both their deposit base and the capital markets as funding sources.
  - ***Specialized banks and regional banks*** include specialized banks that operate in one or more countries, have an asset base of less than US$250 billion and gain 75 percent of their revenue from one or two major countries or lines of business.
- ***Customer intimacy:*** Financial institutions or organizations specializing in the distribution of one or more product groups or firms providing business information/customer data to financial institutions. Included in this group are integrated mono-lines, niche and cross-product distributors, and insight specialists.
- ***Operational excellence:*** Businesses that provide operations or operational support to other banks, with business operations as their main revenue source. This group is further broken down into hybrid manufacturers and processors, processing specialists and networks.

Business model innovation
Data from this study confirms what numerous IBM Institute for Business Value studies have indicated: that specialization is a winning theme within the financial ecosystem. While pre-tax profits were down 9 percent from 2003 to 2008 (compounded annual growth rates) for traditional banks, customer intimacy firms' pre-tax profits declined only 1 percent and operational excellence firms saw growth of 12 percent.

To capitalize on this specialization theme and compete in the post-crisis environment, banks need to rethink their business models – and they are aware of this need. In fact, 75 percent of executives interviewed point to business model uncertainty as the issue that keeps them "awake at night."

Many banks, universals included, face lower income levels for a number of reasons, including lines of business that suffered during the crisis, lower levels of economic activity, higher loan losses and provisions, increased customer resistance to fees and greater pressure on margins. Overall, this has resulted in reduced profit pools. Furthermore, banks face increasing competitive pressure for deposit funding and difficulty in raising additional capital. Some also face pressures from regulators to downsize.

What can bank executives do to alleviate uncertainty so they can sleep better at night? The answer begins with a critical look at their business models. Specifically, banks need to nail down their areas of specialization – or, more simply, determine who they want to be – and build a supporting business model.

They should seek sustainable new sources of revenue and focus on the markets and customer segments that will reap the most profits while reassessing less profitable markets. At the same time, they need to improve scale advantage – via mergers, acquisitions, divestitures, collaboration or other means – and lower costs by improving long-term efficiencies.

Change is in the air

Profit pools are shifting – and many predict the returns of the past are over. The universals have seen the most drastic decrease in profits **(see Figure 1).**

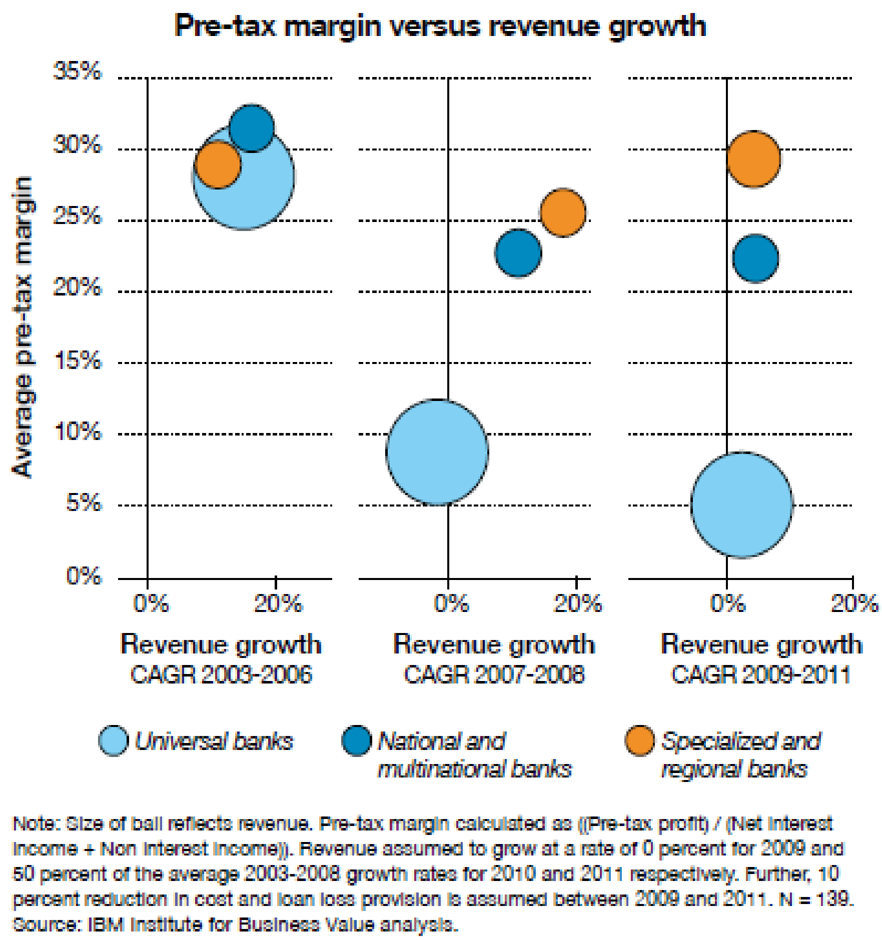


Figure 1: Shifting profit pools.

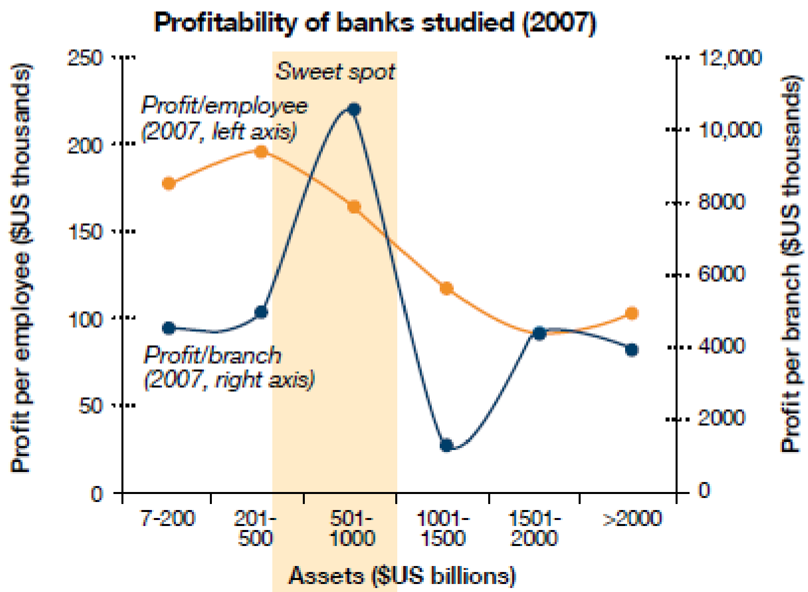
Other banks have been better able to endure the changes, with the national and multinational banks expected to recover fairly well going forward despite the dip their profits took during the height of the financial crisis in the 2007 to 2008 timeframe. However, they too face economic challenges and cost pressures and must make lifestyle changes for improved fitness and growth.

With such dramatic shifts in profits and growth, many bankers have begun to doubt their business models. As banks take a critical look at their strategies, they should consider the pitfalls associated with trying to be all things to all people.

In summary, banks must determine their areas of specialization and expertise. They should focus their efforts on those customers, markets, products and distribution channels they can manage effectively and efficiently and consider extending the business only when economies of scale and scope are clearly present. To fill gaps in product range, market reach and distribution, banks should consider strategic alliances with other banks or organizations.

Finding the sweet spot

When analyzing the profitability of the banks in our study, there appears to be an optimal size – or a "sweet spot" – at which a bank is large enough to achieve economies of scale but not so large that it suffers from the adverse effects of complexity and inefficiencies **(see Figure 2).**



Branches per bank ('00s)	8	32	56	139	64	56
Employees per bank ('000s)	15	40	92	152	190	196

Source: The Banker. Top 1000 World Banks. July 2009; IBM Institute for Business Value analysis.

Figure 2: Profitability and asset size.

On one end of the size spectrum are small banks, many of which are successful due to their focus on specialization. However, the profit levels of a number of the small banks suffer because these banks are unable to achieve economies of scale. On the other end of the spectrum are very large banks, some of which also do not achieve economies of scale – but for different reasons. For these banks, the complexities of managing a large bank with numerous branches and businesses in varying geographies has nearly nullified the potential for economies of scale and scope – a phenomenon we have dubbed "scale squander."

As banks seek to achieve scale advantage and improve return on assets (ROA), we will see an acceleration of mergers, acquisitions and divestitures. For example, a small bank with below average ROA might be acquired by a bank seeking to achieve better operational efficiencies, better economies of scale and higher profits. Other smaller banks might elect to collaborate on certain functions to enable those economies of scale they lack. On the other side of the coin, those large banks suffering scale squander might elect to divest poor performing business units **(see Figure 3).**

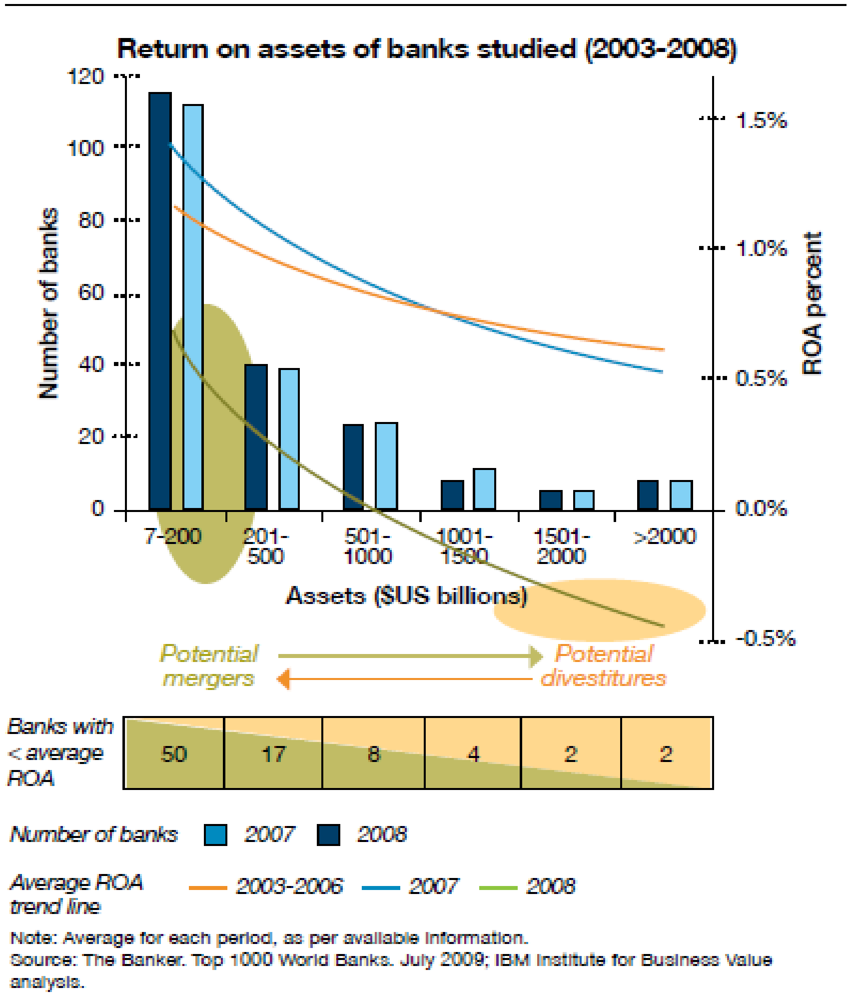


Figure 3: Opportunities for mergers/acquisitions and divestitures.

Lowering costs, increasing efficiency

Banks' total cost structures remain high despite the recent declines in revenue and profit. Across all three categories of banks (universals, nationals and multinationals, and specialized and regional banks) from 2006 to 2008, staff costs decreased slightly – *but all other costs continued to increase.* All three bank categories also experienced reduced profitability by 2008 – with the universals declining the most.

Banks will have to service future growth from radically lower cost structures. Most banks in Europe and the Americas would have to undertake very steep cost cuts to restore the profit levels of 2003 to 2006 (**see Figure 4).**

Emerging market banks are an exception, as many of them are likely to achieve past profits level through growth in revenues. Further, many of these banks already enjoy significant cost advantages in comparison to the banks in mature markets.

In particular, many universals, nationals and multinationals must focus on new business models, since cost cutting alone will not return them to past levels of profitability. These banks are faced with structurally lower revenues, as revenues from some businesses are likely to remain poor for the near future.

Hence, these banks will have to emphasize conventional revenue sources, such as interest generated from loans and fees from deposit accounts, as well as revenue from new sources. With the exception of the emerging markets, the return to previous levels of profit will be a journey spanning multiple years.

All banks must look at longer-term structural efficiencies to increase agility and integration and to reduce costs based around their chosen strategic focus. This will enable them to design an efficient platform for growth.

	Average pre-tax profit margin (2003-2006)	Pre-tax profit margin (2007)	Pre-tax profit margin (2008)	Staff costs and administrative costs as percentage of total income (2008)	Reduction in costs over 2008 required to reach historic (2003-2006) profit margins in one year		
					Americas	Europe	Emerging markets
Universal banks	35%	26%	-21%	67%	40% – 55%		NA
Mulitnational and national banks	38%	41%	32%	43%	30% - 40%		0% - 10%
Specialized and regional banks	30%	25%	6%	64%	15% - 20%	25% - 30%	0% - 10%

Note: Revenue growth is assumed to be 0 percent in 2009. For projection, depreciation and amortization and loan loss provisions are assumed to remain at 2008 levels; one-off costs are assumed to be zero.
Source: IBM Institute for Business Value analysis.

Figure 4: Required cost reductions to reach 2003-2006 profit levels.

Many banks have already implemented simple initiatives to drive near-term savings via reduced capacity, such as staff reductions, management de-layering, project and service streamlining, etc. However, to drive long-term savings, sustained growth and greater agility, they must shift the entire cost curve downward through transformation initiatives in areas such as IT, shared services and front/back office integration.

For example, by optimizing IT resources, banks can reduce complexity and increase efficiency. They could similarly optimize shared services in enterprise data management, enterprise content management, call centers, human resources and finance. Finally, banks could better integrate front and back office functions, particularly in the areas of collections and recovery, the lending process, transaction processing and core banking system transformation, and account opening and client data management.

In essence, banks must make substantial changes to their business models to facilitate long-term health, fitness and growth. They must determine their areas of specialization and design their business models to support them. Concurrently, they must respond to opportunities for mergers and divestitures in the ecosystem, as well as make organizational adjustments to simplify operations and eliminate complexity.

While these changes associated with business models are important – and indeed imperative – to the future of banks, they are only one piece of the puzzle. Such changes will be meaningless if banks do not simultaneously take a deeper look at their client relationships.

Client insight

The banking industry has some serious work to do in terms of reestablishing trust in client relationships. Our research indicates a large trust gap between banks and their clients across all geographies **(see Figure 5).** Clients do not trust banks to offer products and services that are in the clients' best interests.

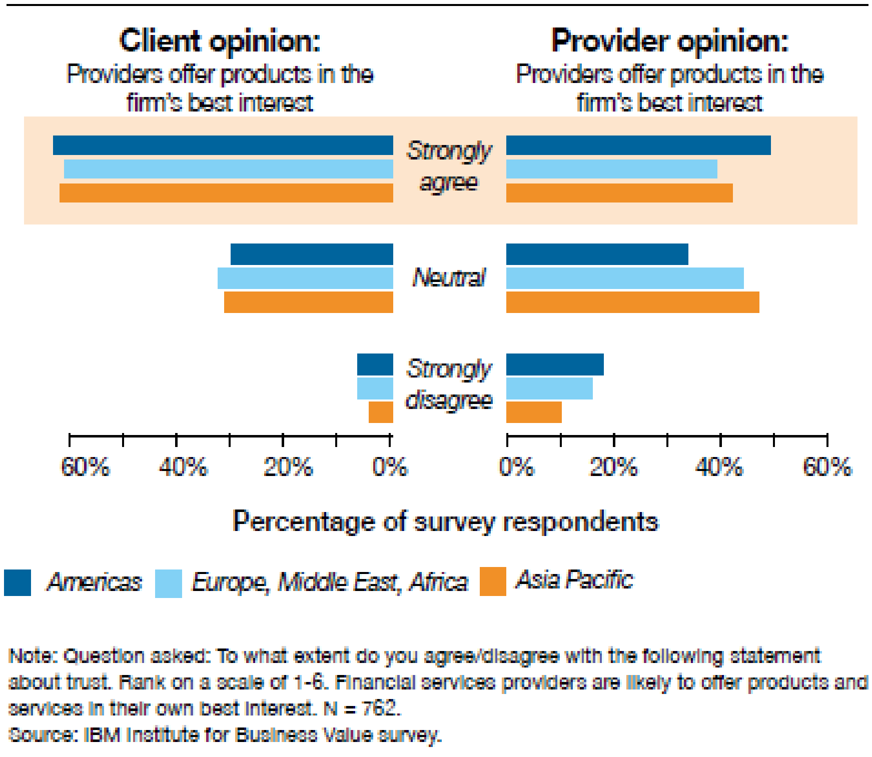
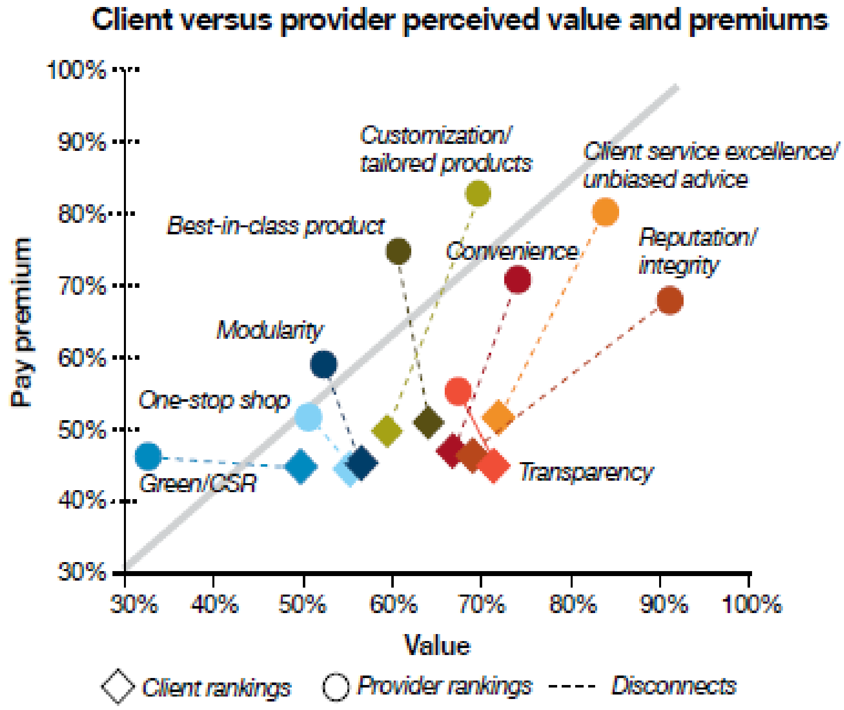


Figure 5: The trust gap.

The unknown client

To close the trust gap, banks must gain a deeper understanding of their clients – what they value, what they need and what they expect. Today's clients are more active and enabled, and many are willing to look outside their banks to meet their needs. As such, banks must find a way to reconnect with their ever-evolving clients.

We surveyed over 7,000 clients in 13 countries and asked what attributes of banking products and services they value most and what additional premium they would be prepared to pay for each of these attributes. We also asked providers the same questions about their clients (i.e., what providers believed their clients valued and for what they would pay). The results reveal huge disconnects, indicating banks do not know their clients nearly as well as they should **(see Figure 6).**



Note: Questions asked: 1) Which financial services capabilities become more/less important to you/your clients in the next 3-5 years? Rank 1-6. 2) How much would you/your clients be willing to pay over existing rates to ensure delivery on specific factors? Select 0%, 5%, 10%, 15% or more, don't know. For customers, N = 7454; for providers, N = 226.
Source: IBM Institute for Business Value survey.

Figure 6: Disconnects between clients and providers.

Among the items rated high in value by clients are client service excellence/unbiased advice, transparency and reputation/ integrity. Some that are relatively less important include modularity, one-stop shop and green/corporate social responsibility (CSR). Bankers somewhat underestimate the value clients place on green/CSR and overestimate the value clients place on client service excellence/unbiased advice and reputation/integrity.

Bankers overestimate what clients are willing to pay for across the board with the biggest gaps for customization/tailored products, client service excellence/unbiased advice and reputation/integrity. As such, typical banks are inclined to charge premiums that are in excess of levels clients are willing to pay. On average, there seems to be little difference in the readiness of clients to pay more for various attributes, though they are slightly more willing to pay for client service excellence/ unbiased advice, best-in-class products and customization/ tailored products.

Overall, clients indicate variance as to which factors drive value in their eyes. However, there is a much narrower band of variance in the amount of premium they will pay. Banks were off the mark across the board in both respects.

Client segmentation
Segmentation can reveal what clients value, how they behave and for what they are willing to pay a premium. By segmenting clients based on attitudes and values, banks can more effectively determine price sensitivity and potential for premiums.

Using advanced clustering and statistical methods, we segmented the client survey population into six segments based on attitudes and values **(see Figure 7).** Convenience desirers want easy-to-configure products, prefer to receive advice and service online, and may be open to value pricing.

The price-sensitive analyzers desire accessible information, easy-to-compare products and transparency/comparability in pricing. The active demanders also appreciate accessible information – but value customizable services when it comes to products. The uninvolved minimalists seek flexibility, convenience, and ease of use and understanding. Some of the more challenging customers are the traditional service expectants, who have "special needs." They want customizable services – but at low prices. Their preferred channel of interaction is often a branch.

Segment	Convenience desirers	Price-sensitive analyzers	Active demanders	Uninvolved minimalists	Traditional service expectants	Ethics seekers
Percent	21.9%	21.4%	20.6%	19.1%	9.2%	7.9%
Key theme	"Make it easy for me at whatever cost."	"I want the best bargain."	"I want it all, and I want it now."	"Finances are important, but I don't know how."	"I have special needs, and I want you to take care of them."	"I want a smarter, more responsible provider."
Defining characteristics	Convenience, simple, easy to use	Service, best value for money, transparency	Tailor-made products, product quality, brand integrity, best value	Convenience, service excellence, transparency, reputation	High-quality and individual products, one-stop shop, advice	Reputation, green, transparency, service, unbiased advice

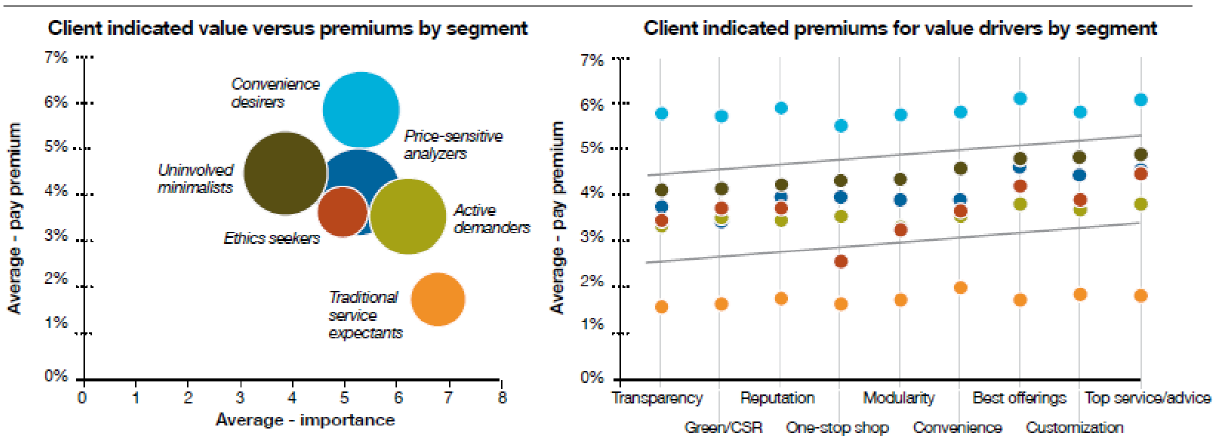
Source: IBM Institute for Business Value surveys and analysis.

Figure 7: Client segments.

The smallest group is the ethics seekers, who want a responsible provider with a good – and green – reputation that can provide service, unbiased advice and transparency.

As we saw previously, when the survey population is grouped as a whole, there is little variance in overall willingness to pay premiums for various services. However, once clients are segmented, a clearer picture emerges of which clients are willing to pay more for which services or offerings **(see Figure 8).**

For example, traditional service expectants, who tend to rate all attributes higher, are also less inclined to pay a premium for bank products and services. They have high expectations but are not willing to pay more – which makes them a somewhat challenging group. Convenience desirers, on the other hand, are more willing to pay a premium than the other groups for various products and services.

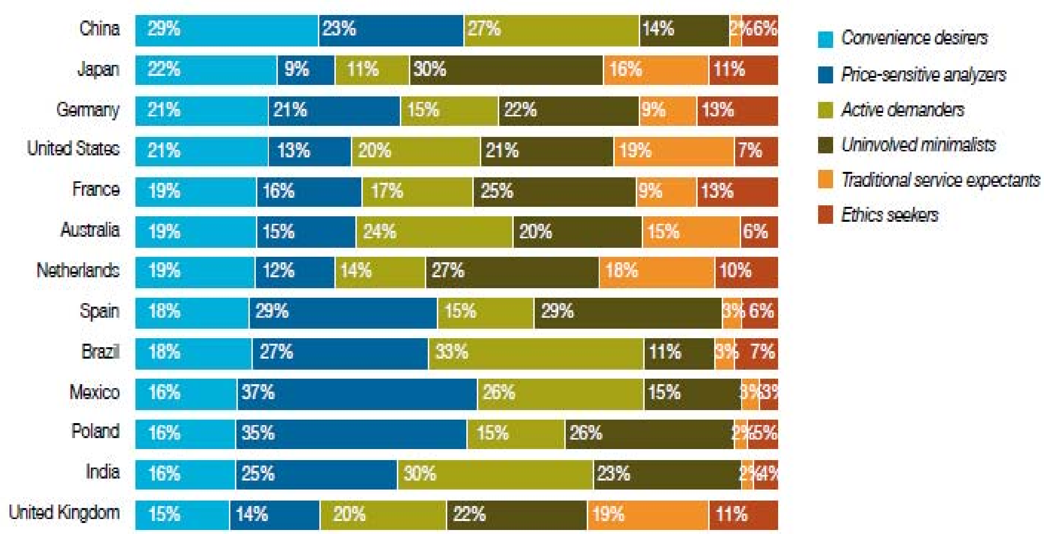


Note: Questions asked: Which financial services capabilities become more/less important to you in the next 3-5 years? Rank 1-6. How much would you be willing to pay over existing rates to ensure that you deliver on specific factors? Select 0%, 5%, 10%, 15% or more, don't know. N = 7454.
Source: IBM Institute for Business Value.

Figure 8: Value and premiums by client segment.

We also found that the client segments vary by country **(see Figure 9).** Countries with developed, saturated markets, such as Japan, Spain and the Netherlands, tend to have a higher proportion of uninvolved minimalists, while markets such as Mexico and Poland have a much higher percentage of price sensitive analyzers and active demanders.

Smart banks will invest in customer analytics to gain new customer insights and effectively segment their clients. This will help them determine pricing, new products and services, the right customer approaches and marketing methods, which channels customers are most likely to use and how likely customers are to change providers or have more than one provider. By segmenting customers to gain deeper insights regarding their values and behavior patterns, banks can begin to close the trust gap and build a healthy mutually-beneficial relationship with their clients.



Note: N = 7454.
Source: IBM Institute for Business Value survey.

Figure 9: Segment distribution by country.

Risk management

Risk management is the last piece of the puzzle for banks as they consider their regimen for success. Recent failures in the banking industry have underscored the need for improved risk management techniques.

As professional risk managers know, traditional models tend to discount the frequent occurrence of extreme events and hence underestimate risk. However, we believe these models are but one of several problems. The difficulty in forming good judgments and making decisions based on the information that is available is another significant area of concern. We believe two main issues contribute to this difficulty – silo implementation of risk management techniques and a weak systemic view of risks across the banking ecosystem. To combat this, banks must implement an integrated, enterprise-wide risk management framework.

Beyond financial risk…

In addition to traditional financial risks such as credit and market risks, banks also face risks associated with financial crime, operations, and governance and compliance. And in each of these areas, the same two themes of silo implementation and lack of a systemic view emerge.

Financial risk:

Current risk models have limitations in coping with today's realities. Furthermore, a weak risk culture and a tendency to implement systems and processes departmentally make it difficult for many banks to gain sufficient insight into risks. The result is an inability to assess risks accurately.

Financial crime:

The fraud aimed at banks is becoming more and more sophisticated – and more and more prevalent. Although many banks gather incident information from across the organization, their success is limited by systems that have been organized by business lines or departments. In addition, there is little sharing of data between banks, making it difficult to combat fraud across the ecosystem.

Operational risk:

Expanding globalization and rising numbers of financial transactions have brought with them increases in operational risks. In addition, the growing demand for processing capacity has led to mounting costs. Banks are increasingly dependent on external information sources to evaluate operational risks. Some banks are forming consortiums to pool data and better understand the occurrences and associated potential losses. However, this fragmented approach to risk – both internally and externally – remains a handicap.

Governance and compliance:

To react rapidly and effectively to changing events, banks need accurate, real-time information. Reliable and easily-accessible financial information enables timely responses to external demands and effective internal business insight.

Banks are challenged by the absence of consistent, complete data and by the lack of common enterprise-wide frameworks and methods for analyzing risk. This information challenge is further exacerbated by poor communication between departments, a weak organizational risk culture and data being defined and understood differently by different departments within the overall enterprise.

Integrated approach

An industry report indicates only 17 percent of firms surveyed have completely integrated their governance, risk and compliance processes. Today's firms cannot continue using piecemeal approaches to risk and compliance management. To move away from silo implementation and gain a holistic, systemic view of risk, financial institutions must embrace enterprise-wide risk management.

To address the various areas of risk, banks should:

- Interconnect the numerous risk silos to better comprehend the bank's full set of risks and opportunities.
- Instrument the organization – i.e., provide it with the sensors it needs – to detect and intercept risky events.
- Intelligently anticipate and mitigate potential risk from failed internal processes, people or systems.
- Be smart in complying with regulations and build competitive positioning of the bank.

By employing an integrated risk management system across all functions and across the entire organization, banks can move beyond regulatory reporting – and move toward better and more complete management information. Once this is achieved, banks could move beyond organizational boundaries toward integration across the banking ecosystem and, ultimately, co-create a new financial architecture with governments and regulators.

So, yes, banks need to recast models and analytics to understand risk. However, above and beyond that, they need to look toward an integrated risk management framework that transcends silos and addresses financial risk, fraud, compliance reporting and financial crimes.

Are you fit, focused and ready to fight?

To flourish in the "new normal," banks must redefine their business models, rebuild customer trust and understanding, and reform the risk management culture. In addition to an ability to adapt, success requires decisive action:

- Revitalize the balance sheet and restore shareholder value.
- Rethink strategic focus areas and build a business model to support them.
- Refresh processes to eliminate complexity.
- Rebuild customer intimacy to help close the trust gap.

- Recast existing and invest in new customer analytics to segment customers based on values and behavior patterns.
- Reevaluate analytics for risk and intelligence.
- Reform the corporate culture to enable effective risk-based decisions, while integrating risk and compliance management holistically.

There are great opportunities ahead for the banking industry. To seize them, banking executives must begin a transformation today to help ensure they are fit, focused and ready to fight any challenges standing between them and success. By working toward improved fitness in their business models and renewed focus on customer insight and risk management, banks can help secure a strong and healthy future.

Integrity ……
Without It Nothing Works
A Conversation with
MICHAEL C. JENSEN
Professor Emeritus of Business Administration
Harvard Business School
Chairman, Managing Director and Integrity Czar, Social Science Research Network

There is some confusion between the terms *integrity*, *morality* and *ethics*. How do you differentiate them?
These three phenomena are widely understood to provide standards of 'correct' behavior, but people generally get them mixed up. The primary differentiation I make between them is to distinguish integrity from morality and ethics. Integrity is a purely positive proposition. It has nothing to do with good vs. bad. Think for a moment about the Law of Gravity: there is no such thing as 'good' or 'bad' gravity; like integrity, it just 'is'.

Morality and ethics, on the other hand, are normative concepts in that they deal with matters of good or bad, right vs. wrong. Morality refers to a society's standards of right and wrong behavior for individuals and groups within that society, while ethics refers to the normative set of values that apply to all members of a group or organization. Thus, both morality and ethics relate to desirable vs. undesirable behavior.

You define integrity as "what it takes for a person to be whole and complete." What does this look like in daily life?
An individual is whole and complete when their *word* is whole and complete, and their word is whole and complete when they *honor* their word. We can honor our word in one of two ways: first, by keeping our word, and on time as promised; or second, as soon as we know that we won't keep our word, we inform all parties involved and clean up any mess that we've caused in their lives. When we do this, we are honoring our word despite having not kept it, and we have maintained our integrity.

If you are serious about being a person of integrity, you will think very carefully before giving your word to anyone or any-thing and you will never give your word to two or more things that are mutually inconsistent. As they should, many people focus on the importance of *keeping* their word; however, if one does not consider how to maintain integrity when one *cannot* keep one's word, this is sure to lead to out-of-integrity behavior at some point. If you're up to anything important in life, you will not always be able to keep your word, and that's alright, but if you are a person of integrity, you will always honor your word.

Integrity is important to individuals, groups, organizations and society because it creates *workability*. Without integrity, the workability of any object, system, person, group or organization declines; and as workability declines, the opportunity for performance declines. Therefore, integrity is a necessary condition for maximum performance. As an added benefit, honoring one's word is also an actionable pathway to being trusted by others.

You believe that a key aspect of integrity involves the relationship one has with oneself. Please explain the importance of this.

One's word to one's self is a critical part of integrity. By not being serious when we give our word to ourselves, we forfeit the opportunity to maintain our integrity by honoring our word to ourselves.

For example, think of occasions when the issue of self-discipline comes up, and the ease with which we often dismiss it. It may be something trivial like, 'I'm going to work out tomorrow at nine o'clock', or something serious like, 'I will never cheat on my friends/colleagues'. By failing to honor our word to ourselves, we undermine ourselves as persons of integrity. If we aren't serious about this aspect of integrity, it will create 'un-workability' in our life: we will appear to others as inconsistent, unreliable or unpredictable. You simply cannot be a whole and complete person if you don't honor your word to yourself. Unfortunately, people almost universally ascribe the mess in their lives resulting from out-of-integrity behavior to some justification or rationalization.

Your Ontological Law of Integrity says that integrity has a critical effect on business: increased performance. How does integrity translate into performance?
As I've said, integrity is a necessary condition for maximum performance. That is, if something is in integrity – is whole, complete, unbroken – it has maximum workability. But because it takes more than workability (a product of integrity) alone to realize maximum performance, integrity is not a *sufficient* condition for maximum performance. The proposition is that if you violate the Law of Integrity, the opportunity-set for your performance will shrink and therefore your actual performance is likely to suffer. As with the gravity analogy, this is just a plain fact: if you violate the Law of Gravity without a parachute, you will suffer severe consequences. We argue that if you respect the Law of Integrity you will experience enormous increases in performance, both in your organization and in your life.

You believe that the effects of out-of-integrity behavior are significantly more damaging than most people believe. Please discuss.
People tend to view integrity as a virtue that is 'nice to have', but not as something that is directly related to performance. They fail to link the difficulties in their lives or in their organizations to out-of- integrity behavior. But the increases in performance that are possible by focusing on integrity are huge: I'm not talking about a 10 per cent increase in output or productivity – it's more like 100 to 500 per cent. At my organization [the **Social Science Research Network** (SSRN)] after a year and a half of implementing these notions, our CEO **Greg Gordon** will tell you that we've seen in excess of a 300 per cent increase in output, with essentially no increase in inputs. And our people are happier.

Objects and systems can also have integrity. Please explain.
Integrity for objects and systems is a matter of the components that make up the object or system and the relationship between those components. Three critical aspects are their design, the implementation of the design and the use to which the object or system is put. If an object or system is to have maximum opportunity for performance, it must have integrity in each of these aspects. The design must be capable of fulfilling the purpose for which it was designed – for example, to provide transportation or flotation. In addition, to have integrity the implementation of the design must be whole and complete; and finally the use of the object or system must have integrity. If any of these three aspects is not present, the object or system will be 'out-of-integrity', its workability will be compromised and its opportunity for performance will be reduced. For example, if a 300-pound man attempts to use a life preserver designed for a 50-pound child, he is in big trouble.

This distinction – between the integrity of design, the integrity of implementation and the integrity of use – has proven to be of enormous value to me and my colleagues in running SSRN. Of course, any large computer system is going to have issues, and thinking about the source of problems as due to potential failures of integrity of design, integrity of implementation or integrity of use has resulted in enormous increases in productivity for us.

What are the costs of dealing with an object, person or entity that is out-of-integrity?
Consider the experience of dealing with an object that lacks integrity, such as a car. When one or more of its components is missing or malfunctioning, it becomes unreliable and unpredictable, and it creates those same characteristics in our lives: the car fails in traffic; we inadvertently create a traffic jam; we are late for our appointment; and we disappoint our colleagues. In effect, the out-of-integrity car has created a lack of integrity in our life, with all sorts of fallout and repercussions that reduce workability. The same thing is true

of our associations with persons, groups or organizations that are out-of-integrity. These effects generally go unrecognized, but they are significant.

How does 'cost-benefit analysis' affect integrity?
This is a great failure of the curriculum of every business school I know: we teach our students the importance of conducting a cost/benefit analysis in everything they do. In most cases, this is useful – but not when it comes to behaving with integrity. In fact, treating integrity (i.e. honoring your word) as a matter of cost/benefit analysis virtually guarantees that you will *not* be a person of integrity. When not keeping my word, if I apply a cost/benefit analysis to honoring my word, I am either out-of-integrity to start with – because I have not stated the cost/benefit contingency that is in fact part of my word when I give it, or to have integrity I must say something like the following: "I will honor my word when it comes time to do so if the costs of doing so are less than the benefits." Such a statement, while technically leaving me with integrity, is unlikely to engender trust. Indeed, I have just told you that my word means nothing.

If I had one recommendation for improvement to the curriculum of every business school, it would be to make it very clear to students that cost/benefit analysis is very important almost everywhere in life – *but not with respect to honoring one's word*. In my view, this is a major root cause of the current economic crisis.

Trust in the business community has plummeted in recent months. What has to happen for it to be restored?
Out-of-integrity behavior has been pervasive, both on an organizational and an individual basis. Recall that the integrity of an object or system depends on the integrity of the design of that object or system, the integrity of the implementation of that design and the integrity of the use of that object or system.

Looking at the sub-prime mortgage crisis, each element of the system evolved in a way that left it out-of-integrity: the system ended up such that people were rewarded for creating and selling mortgages and mortgage-backed securities, but not mortgages and mortgage-backed securities that would be paid. Obviously such a system lacked integrity, and we are paying a very steep price. Moreover, the politics of the situation is now encouraging homeowners (who gave their word to paying back the money they borrowed to purchase their homes) that it is OK to quit paying one's mortgage in the case where the homeowner is 'under water' – that is, where the value of the home is now less than the mortgage on the home.

Putting the system back in order is deceptively simple: people have to start honoring their word. If they do, trust will materialize almost instantly. The interesting thing about it is that you actually create trust more rapidly if you fail to keep your word but you honor it, because this is always so surprising to people. If you're straight with people – "I told you that I'd have this report done a month from now, but I know now that I'm not going to be able to and I apologize, but I'll get it to you in a month and a half. Let's have a talk about what I can do to clean up the mess I have caused for you." If I then get the report to you in a month and a half, our relationship will be strengthened; but if I simply don't keep my original word, trust will be lost.

There are great examples of service failures that have turned out positive. In one study by **Bitner**, **Booms** and **Tetrault** [published in *The Journal of Marketing*], a husband and wife had a reservation for a hotel room. They arrived at the hotel, it was completely filled through no fault of the hotel – people just hadn't checked out as planned. Unfortunately, the front desk staff wasn't able to find the couple another room in the city, so they failed to keep their word. But they did honor it: they took a small dining room in the hotel, put in some cots and pillows and bedding and made a bedroom out of it. In the end, the family rated this as one of their outstanding service experiences.

Honoring one's word is truly an amazing phenomenon, and my colleagues and I are eager for people to implement it in their lives and in their organizations. As with the Law of Gravity, the end result is guaranteed.

'One's Word', Defined
A person's word consists of each of the following:
1. **What you said:** whatever you have said you will do or will not do, and in the case of do, doing it on time.

2. **What you know:** whatever you know to do or know not to do, and in the case of do, doing it as you know it is meant to be done and doing it on time, unless you have explicitly said to the contrary.
3. **What is expected:** whatever you are expected to do or not do (even when not explicitly expressed), and in the case of do, doing it on time, unless you have explicitly said to the contrary.
4. **What you say is so:** whenever you have given your word to others as to the existence of something or some state of the world, your word includes being willing to be held accountable that the others would find your evidence for what you have asserted.
5. **What you say you stand for:** What you stand for, whether expressed in the form of a declaration made to one or more people, or even to yourself, as well as what you hold yourself out to others as standing for (formally declared or not), is a part of your word.
6. **The social moral standards, the group ethical standards and the governmental legal standards of right and wrong, good and bad behavior**, in the society, groups and state in which one enjoys the benefits of membership are also part of one's word unless a) one has explicitly and publicly expressed an intention to not keep one or more of these standards, and b) one is willing to bear the costs of refusing to conform to these standards.

Source/Reference:

1. **IBM Institute of Business Value**
2. **Rotman Magazine, Fall 2009**