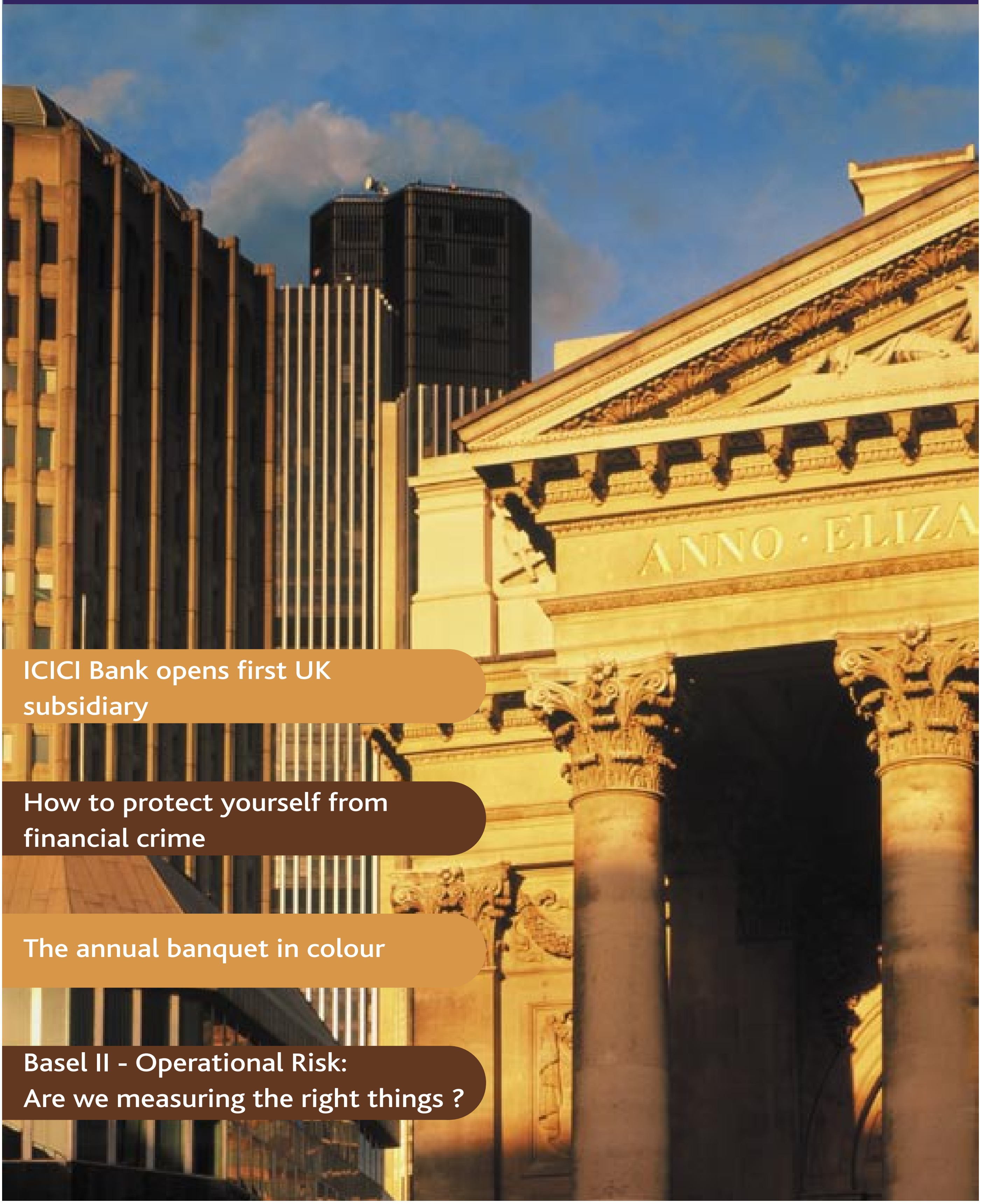
AFB

Newsletter

Association of Foreign Banks

February 2004



ICICI Bank opens first UK subsidiary

How to protect yourself from financial crime

The annual banquet in colour

Basel II - Operational Risk: Are we measuring the right things ?

NEWS ROUNDUP

This Newsletter is a quarterly journal of the
Association of Foreign Banks

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New skyscraper gets go ahead

Plans to build the tallest office block in the City of London have been approved. Developers, Minerva, have received permission to build the 217m high tower on St Botholph's Street in the eastern end of the City. It will be higher than NatWest Tower in the Square Mile, but shorter than Canary Wharf's highest tower, which is 244m high and the tallest in the capital. The 50-storey building is expected to house about 10,000 people. The tower is designed by Nicholas Grimshaw, who designed the international terminal at Waterloo Station.

Andrew Rosenfeld, chief executive of Minerva, said planning and designing the tower was one of the most difficult challenges of his career. "The City is arguably the most important financial centre in the world and this building will define its skyline," he said. Minerva expects to be on site early next year. Development is expected to cost about £500m with completion in 2007. Minerva will seek to have one-third of the building pre-let which will bring in enough money to begin development, Rosenfeld said.

The building will be energy efficient. Occupants on every floor will be able to open windows to let in fresh air through a ventilation system set between two glass skins on the outside of the building, which will save about two-thirds of the building's energy costs.

The City of London has predicted a need for an additional 10m sq ft for potential new tenants. The City forecasts job growth of at least 1.5% in the financial services industries.

Financial Times 14 January 2004

New initiatives see cash for Crossrail – if time limit is met.

Large City firms have written to the Corporation of London in support of the £10bn east-west line that would link Canary Wharf to Heathrow and Liverpool Street. A spokesperson for the Corporation said: "Top firms in the Wharf and the City have contacted us indicating they would be willing to fund Crossrail in order to get it moving. But that's dependent on a number of conditions — especially that the project stays within a time limit." The core Crossrail line would link Heathrow to Canary Wharf and Stratford via Liverpool Street.

A number of ideas about how to raise the money have been proposed. These include a levy or rise on the business rate. No figure has yet been agreed, but rises of 1-3% are being touted.

Businesses also want a number of conditions to the extra taxes. They have indicated the money should be ring-fenced, so it does not disappear into government coffers, and that it should have a time limit on it in case Crossrail is not built. Businesses also believe that the lion's share of the money should come from Government.

The Wharf 15 January 2004

Corporation of London establishes Brussels office

The Corporation of London is setting up an office in Brussels to raise its influence on European legislation and protect the interests of the City of London and other European financial centres. David Green, international director of the FSA will run the office from April and report to an advisory board to be headed by Sir Nigel Wicks, chairman of the committee on standards in public life and former director of international finance at the Treasury.

Michael Snyder, policy chairman of the Corporation said the Brussels office would act as an "early warning radar" on European Commission regulatory issues that were likely to affect the City. "We want to further the message that we are the jewel in the crown of Europe and we can do that better by being at the table at this crucial time," Snyder said. He wants the new office to tackle issues such as European enlargement and finalisation of the financial services action plan.

The Corporation is particularly rankled by the EU's proposed investment services directive setting out the rules under which investment banks can compete with stock exchanges, over which the government has found itself outvoted.

Snyder envisaged the Brussels office helping the City build alliances with other financial centres on European-wide issues such as international accounting standards. Such issues were sometimes "decided on grubby political deals, or expediency or frankly ignorance and we've got to bring some light to that."

Financial Times 19 January 2004

AFB ANNUAL BANQUET

Drapers' Hall, November 25 2003

Angus MacLennan (right), outgoing Chairman, hands over the Chairmanship to Michael Kirkwood, CMG, a member of the Board and Managing Director, UK Citigroup.

Copies of photographs are available by contacting the AFB. Please email secretariat@foreignbanks.org.uk

BANANA SKINS

By David Lascelles

People who run banks spend a good deal of their time managing risk, which means identifying it, understanding it, and controlling it. The trick is not to eliminate risk, but to take on just the right amount to achieve desired returns.

But how do you know which risks matter?

For eight years now, our Centre has been conducting its Banana Skins survey in which we ask senior practitioners and observers of the banking scene to tell us where they see current risks, and to rank them by severity - and by whether they are getting worse or better.

We tabulate the results into a kind of spoof Top 30. It's not very scientific, but the purpose of the exercise is not to achieve statistical accuracy so much as to get people thinking and talking.

We've completed the latest survey*, and as always it produces some fascinating results.

Banana Skins 2003 (2002 ranking in brackets)	
1	Complex financial instruments (4)
2	Credit risk (1)
3	Macro economy (2)
4	Insurance (7)
5	Business continuation (5)
6	International regulation (10)
7	Equity markets (3)
8	Corporate governance (-)
9	Interest rates (21)
10	Political shocks (14)

Top of the list - for the first time - are complex financial instruments, specifically credit derivatives which people now consider the greatest danger in the system. It was only a few months ago that Warren Buffett called them fizzing time bombs, and many people clearly agree. Our respondents are worried about the huge sums involved, and the fact that most of the market is shrouded in secrecy – nobody really knows how big it is. And there are other reasons: the fact that they shunt risk to parts of the system that may not be able to handle credit losses (the insurance sector?), and the distinct lack of robustness in much of the documentation (will the holder really pay up when the borrower defaults?).

In fact, the first four items on the list are closely interwoven. They paint a picture in which economic weakness in the industrial world triggers loan losses that are transmitted by credit derivatives to weaker parts of the system. This picture includes the likelihood that yields on stocks and bonds will remain low (by historical standards) and that this will squeeze bank margins and also make it harder for the insurance sector to earn sufficient returns to meet its liabilities.

Further down the list, business continuation held on to the high place it achieved in the wake of 9/11: people clearly feel that the system is still vulnerable to terrorist attack, but this is also overlaid by anxiety that banks have still not taken sufficient precautions, e.g. by dispersing their locations and managing back-up.

One of the shock results of the survey is the high place earned by international regulation. Regulation a risk? A lot of people think so, specifically because of what they see in the Basel Capital Adequacy process. The hugely burdensome regime which is being cooked up in Basel will, in many people's view, add risk to the system in several ways: by creating cost, by deflecting management attention and - possibly worst - encouraging a mentality that focuses on process rather than substance. As one of our respondents said: "People will end up managing Basel II rather than managing risk."

Another sharp riser is corporate governance - no surprise given Enron, Higgs etc. Have banks really strengthened their internal structures, or could they still be found wanting? There's much at stake here: reputation, performance, sustainability.

Another riser is the fear of interest rate movements, though our respondents were divided over whether the risk lay in an extended period of low rates or in a snap tightening of monetary policy, particularly in the US. The first would squeeze margins

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David Lascelles is co-director of the Centre for the Study of Financial Innovation, a City think tank.

"The Banana Skins survey is very useful in the checklist sense: have you thought of all these risks, and all the angles in them? It also tends to identify risks that are squarely on the radar screen."

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and raise the threat of deflation, the second would cause havoc in the credit markets. On balance, people tended to fear the second more.

The higher position earned by political shocks is not due to Iraq-type events so much as the fear of growing political interference in the banking industry, the rising tide of anti-globalisation feeling, and the sense that the Anglo-Saxon financial model is now widely under attack. Many of our respondents were gloomy not so much about the banking industry itself as the environment in which it has to operate.

And that raises another point. We also asked our respondents how well prepared they thought banks were to handle the risks they identified. A high 69 per cent said moderately well or better. Although this is slightly down on last year (72 per cent), it is well up on the figures we were collecting in the 1990s. The general feeling seems to be that banks are financially strong and more adept at handling risk.

The Banana Skins survey is very useful in the checklist sense: have you thought of all these risks, and all the angles in them? It also tends to identify risks that are squarely on the radar screen. Which is why it is instructive to look at the bottom of the list because this is where you may find risks that have slipped off the screen: people don't rate them any more.

At the very bottom, Number 30, you find environmental risk. In all the years we have been doing the survey, this has never been perceived as a serious threat. But are you really sure it won't suddenly jump up and bite you? Number 29 is e-commerce strategy. In the 1990s, this was a top-level risk (remember all the internet scares?), and I find it hard to believe that it has completely gone away. We are only at the threshold of the internet era, and the huge changes it will bring are bound to sweep many financial institutions away for good.

**Obtainable (price £25) from CSFI, 5 Derby Street, London W1J 7AB. Tel (020) 7493 0173. www.csfi.org.uk.*

MANSION HOUSE LUNCH

The Association's 2003 summer lunch was held at Mansion House on Friday 18 July. Over 220 people attended the event where Sir Howard Davies, the outgoing Chairman of the Financial Services Authority (FSA) gave the keynote address.

All photos read left to right.

Sir Howard Davies, Chairman FSA, Angus MacLennan, Chairman AFB.

Roger Gifford, SEB, Alderman and Sheriff, David Brewer, CMG, Henrik Bjorn, Nordea.

John Pattison, Dresdner Kleinwort Wasserstein, Marie Claire Swinnen, ING, Robin Alington-Maguire, ING

Peter Beales, LIBA, Martin Hankey, Handelsbanken, Keith Palmer, AFB, Victoria Westley, Fortis Bank SA.

ICICI BANK

A FORCE FOR THE FUTURE

By Lucia Dore

ICICI Bank has opened its first subsidiary in the UK, recognising the huge opportunity to serve the Indian community here. What are the bank's plans and what is its heritage? Lucia Dore speaks with executives in the bank's new Knightsbridge offices.

ICICI Bank, India's largest privately owned bank, is the most recent foreign institution to be granted a full banking licence by the Financial Services Authority (FSA), allowing it to operate in the UK. Although it has had a representative office in London since 1955 it only started trading as a fully fledged bank on October 15 from its Knightsbridge headquarters. Plans for the UK include expanding its presence in the Midlands, Birmingham and Leicester.

Internationally, the bank is also expanding. On October 14 it opened a representative office in Shanghai, and follows the inauguration of its overseas offshore branch in Singapore. It also has representative offices in New York and Dubai and has received approval for opening a wholly owned banking subsidiary in Canada.

As the bank's first overseas subsidiary, the intention is to leverage its leadership in the Indian market, where it has a 29% market share in retail credit, or six million customers, and a 16% share in retail distribution (ie mutual funds and RBI bonds). By March this year retail finance constituted 18% of the balance sheet. Specifically, the bank has the largest home loan market share in India as well as the largest auto-finance business. "We want to leverage our strengths in the Indian market, targeting the Asian community in the UK who have savings in India and who also wish to repatriate funds," says Sonjoy Chaterjee, the bank's UK managing director.

With about 1.05 million people of Indian origin living in the UK, and a majority of them living in London - that's 430,000 households - demand for retail financial products specifically designed to meet the requirements of the Indian community is high. There is also increasing demand for corporate banking services by Indian companies looking to expand across Europe but there is still a great deal to be done in terms of leveraging the bank's relationships with its clients in India. Nonetheless, demand for syndicated loans is growing, as is the demand for foreign-currency products, says Chatterjee. He also sees "substantial opportunities" for growing the bank's trade finance portfolio since the UK is India's second largest trading partner

Building alliances is an important part of the bank's expansion strategy. In October ICICI entered into an alliance with Lloyds TSB for distributing its "Indian" products. This is the first strategic tie-up of its kind among major banking groups in the UK and the two banks are piloting the India Banking Service at Lloyds TSB's branches in Wembley and Harrow. This offers new and existing customers the opportunity to manage both Lloyds TSB and ICICI Bank current and savings accounts through their local Lloyds TSB branch. Using the India Banking Service, NRI (Non-Resident Indian) and PIO (Persons of Indian Origin) banking customers can transfer funds to an ICICI Bank Account in India in an efficient and cost effective manner.

And back in 2000 the bank entered into a joint venture with Prudential to provide life insurance to customers in India. The following year it entered into another joint venture with Lombard General Insurance Company Limited from Canada, one of the oldest property and casualty insurance companies in Canada.

Technology

As well as its multi-channel access network across India with a customer base of more than six million accounts, which includes 450 branches and offices and about 1700 ATMs, ICICI Bank has developed and adopted a great deal of leading-edge technology. For example, it has developed an ATM machine for the blind that uses earphones and Braille, and it uses teleconferencing technology as the

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This year the bank won The Banker's Best Multi-Channel Strategy 2003 award "for combining traditional banking channels with innovative alternative channels to overcome geographic spread and underdeveloped communications infrastructure".

(left to right) **KV Kamath, ICICI Bank's India MD and CEO, and Sonjoy Chatterjee, ICICI Bank's UK's MD and CEO.**

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core infrastructure for its "e-lobby". As well as developing these technologies for the UK market the bank will be able to offer clients the ability to track remittances on the internet.

Sending remittances to India is big business. According to figures from India's Reserve Bank, £3bn worth of remittances are sent back to the country each year, 70% of which come from the UK. Senders therefore would greatly benefit from the ability to send these remittances free-of-charge instead of having to pay the sums normally levied, typically between £25 and £45 per transaction. Not surprisingly, therefore, this is the offering that ICICI Bank is making available to its UK customers.

Traditionally, Indian banks have not been known for being technologically savvy but ICICI Bank has certainly proved how wrong this assumption is. It has received a great number of awards, both in recognition of its advanced use of technology and for its overall banking operations. This year the bank won The Banker's Best Multi-Channel Strategy 2003 award "for combining traditional banking channels with innovative alternative channels to overcome geographic spread and underdeveloped communications infrastructure". The Banker also recognised that ICICI Bank "initiated the clicks and bricks approach in India, acknowledging varying customer needs between India's states and social strata, the bank developed the infinity banking concept as a way of making banking accessible for all". It also received the award for the Best Consumer Internet Bank in India and the Best Integrated Consumer Bank site in the Asia/Pacific region by Global Finance. The bank also won the Banker award for the Bank of the Year 2003 in India.

And these awards are only the latest in a whole line. In 1999 the bank won an award for the best IT usage by TCS and the Computer Society of India; in 2000 it featured among the best 15 bank websites in the world, reviewed by Forbes; then in 2001 it won a product innovation award for kid-e-bank account from the Asian Banker magazine along with the award for the Best Retail Bank in India. Last year, among the string of awards the bank received, were the Bank of the Year in India by the Banker, excellence in Retail Banking by The Asian Bankers Journal and Best Consumer Internet Bank in India by Global Finance.

The platform for which the bank is now receiving the greatest recognition is The Enterprise Application Integration initiative for retail and wholesale banking businesses. ICICI Bank is focusing on the integration of its various products and channel systems by effective use of technology. The EAI links various products and delivery systems across the two groups (retail and wholesale). This initiative underpins ICICI Bank's multi-channel customer service strategy and seeks to deliver customer-related information consistently across various access points.

Moving ahead

ICICI Bank has an impressive pedigree and has come a long way since it was originally formed as ICICI in 1955 at the initiative of the World Bank, the Indian government and representatives of Indian industry. The principal objective was to create a development financial institution for providing medium and long-term project financing to Indian businesses. In the 1990s, ICICI transformed its business from a development financial institution offering only project finance to a diversified financial services group offering a wide variety of products and services, both directly and through a number of subsidiaries and affiliates like ICICI Bank. In 1994, ICICI reduced its shareholding in ICICI Bank to 46% through a public offering of shares in India in fiscal 1998, an equity offering in the form of ADRs listed on the NYSE in fiscal 2000, ICICI Bank's acquisition of Bank of Mandura in an all-stock amalgamation in fiscal 2001 and secondary market sales by ICICI to institutional investors in fiscal 2001 and 2002.

In October 2001 it was decided to merge ICICI and two of its wholly owned retail finance subsidiaries - ICICI Personal Financial Services and ICICI Capital Services - with ICICI Bank, thus giving the bank a stronger base from which to extend its universal banking strategy. The merger enlarged the capital base and scale of operations; provided access to ICICI's strong corporate relationships; facilitated entry into new business segments as well as growing market share in existing ones, especially fee-based services; and provided access to a greater pool of talent. Shareholders approved the merger in March 2002 and since then ICICI group's financing and banking operations, both wholesale and retail, have been integrated in a single entity.

As a result, ICICI Bank has increased net profit 60.3% in 2002 and finished with an ROE of 17.7%. In the first quarter of 2003, net profit rose more than threefold and ROE climbed to 18.3%.

The bank also has other milestones. In 1999, ICICI was the first Indian company and the first bank or financial institution from non-Japan Asia to be listed on the New York Stock Exchange. No doubt the bank will continue to reach other milestones, especially as it expands its interests in the UK.

Rt.Honourable Paul Boateng MP, financial secretary to the Treasury (centre) opens ICICI Bank's Knightsbridge office with key bank executives.

BETWEEN A ROCK AND A HARDPLACE

By James de Jonge

Increasingly onerous anti-money laundering legislation is creating a complex business climate for banking and other industries. Are there any practical solutions that will satisfy the regulators and protect institutions from involvement with financial crime?

Complying with the increasingly onerous anti-money laundering provisions of the recently issued international standards, EU initiatives and national legislation is one of the major issues confronting all those dealing in high value transactions such as banks, law firms, accountants and estate agents.

In the UK, the Proceeds of Crime Act 2002 eventually came into effect on 24 February 2003. The long overdue money laundering regulations 2003 were recently laid before Parliament by the Financial Secretary to the Treasury, and are due to come into force on 1 March, 2004.

The challenge for the Money Laundering Reporting Officer (MLRO) continues to increase both in terms of achieving full compliance with changing obligations and in undertaking the role of nominated officer as defined in the Proceeds of Crime Act (the nominated officer being responsible for handling internal and external reports and relationships with the National Criminal Intelligence Service (NCIS).

The MLRO continues to be subject of extraordinary pressure from both internal and external forces. On the one hand, there is pressure from within the organisation to cause minimum delay to the setting up of accounts and the transaction of profitable business. On the other, there are the delays involved in completing all the necessary internal procedures and due diligence requirements before taking on new clients.

There may also be further delays in the event that suspicious transactions are noted and reported to NCIS, and in awaiting appropriate consent before allowing a transaction to proceed. The issues here are partly cultural in so far as the authorities responsible for drafting such measures appear to be neither experienced in, nor sympathetic to, commercial considerations. Nowhere is this more apparent than in the Proceeds of Crime Act 2002.

Is the system workable?

How workable is the system that is developing out of government strategy? A glance at the figures released in a recently published KPMG report reveals that there is a backlog of approximately 58,000 suspicious transaction reports waiting to be processed before being passed on to the appropriate law enforcement agencies. With such a backlog the overall system is unworkable and there is an urgent requirement for the government to increase the investment in NCIS to address the problem. In such an environment the key strategy for MLROs is to develop good working relationships with their contacts at NCIS, and to make it clear when a disclosure is really urgent or whether there are other serious issues involved. To assist in this regard, NCIS has introduced a "fast track" reporting system.

Developing confidence in the system is crucial to its overall effectiveness for once companies are confident with it institutions might develop the courage to submit only "quality" disclosures. But this seems unlikely with the introduction of the objective test in the failure to report offence under the Proceeds of Crime Act.

So the question arises, what is the best possible means of continuing to develop new business on a secure foundation, without either running into trouble with the regulators or risking involvement with organised criminal structures which may pose serious security and reputational risks to the banks and other institutions concerned?

The only practical answer is to undertake appropriate and effective due diligence on all new clients. Obviously the amount of due diligence undertaken must reflect the inherent risk of the type of customer or business being undertaken. For example, retail banks will have a different approach to private banks and investment banks dealing with high net worth individuals who would like to open private client accounts, or to develop investment portfolios in an international financial centre such as London.

Subscriptions to information databases can be a useful weapon in the battle against financial crime. However, it is important to bear in mind that experienced criminals often take elaborate steps to construct false identities to overcome database checking, or use other individuals (known as "clean skins") to act on their behalf. Another issue is the global nature of business and finance. Numerous banks, corporations and law firms are increasingly looking for business opportunities in emerging markets with underdeveloped economies and poor state infrastructure, where little reliable information may be available about local personalities and companies. There is quite simply no substitute for sound business intelligence from a provider that understands both the regulatory climate and the internal constraints faced by financial and commercial entities.

Anti money-laundering regulatory compliance reviews are also to be recommended. These reviews can take the form of an annual "healthcheck" or a more fundamental examination of existing policy and procedures. The result is that clients are assured that they are up to date with all the legislative requirements, and that their systems are operating effectively. In particular, a review before an inspection by the regulatory authorities can ensure that any particular problems in record keeping, reporting systems or staff training programmes are rectified well in advance.

Beware the perils

This may be a good point at which to re-emphasise the perils entailed in banks, corporate entities and individuals entering into business ventures without the full facts of the relevant parties. In almost all cases,

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discreet enquiries at the outset would have flagged up any serious concerns about the past conduct or reputation of the individuals and/or companies concerned. In budgetary terms this can often be the difference between expenditure of a couple of thousand pounds, compared with losses running into several millions. Similarly on the security/ political risk aspects, modest expenditure can greatly reduce the risk of exposure.

In a recent case, individuals applying for a licence to incorporate an insurance company in an offshore jurisdiction were initially considered to be entirely legitimate as all details submitted to the regulator (passports, addresses etc) could be verified. However, on further local investigation in one of the countries of the former Soviet Union, it was quickly established that the applicants were acting as front men for a leading member of an organised crime syndicate. The proposed "insurance company" was to be used as a vehicle for laundering the proceeds of the illegal sale of arms.

Another case involved an individual making an application to open a bank account with a branch of a foreign bank in London. The person concerned ran a series of successful businesses in the currency exchange and insurance sectors, and had good references provided by local referees. During the course of due diligence enquiries he was found to be under investigation in Central America for laundering funds derived from the illegal trafficking in narcotics. No information about this had been available in the public domain, but the local intelligence and law enforcement bodies were able to advise that investigation of the subject was in progress and likely to lead to prosecution in due course.

It is confidently expected that there will be a continual broadening of the scope of the regulatory framework to include the majority of commercial and financial entities that are involved in high value transactions. These organisations will have to increase their level of compliance to the high standards currently employed by most banks and building societies. This, together with a growing acceptance by all concerned that properly conducted due diligence enquiries on the principal individual(s) and entities in any business situation, as well as the associated costs, is the safest way to proceed and is an integral part of doing good business in the modern global marketplace.

Due diligence should be viewed as a positive exercise. Of all the checks conducted by Risk Analysis for banking clients over the years, less than 10% turned out to be negative. Without thorough and reassuring due diligence enquiries, many of these banks may have turned away valuable new business as appearing to offer too high a risk.

James de Jonge is an associate director of Risk Analysis (UK) Ltd (www.risk-analysis.org), providers of global business intelligence and protective security services to clients around the world.

COMPANY MOVES: CHANGING FACES

- **Alpha Bank AE**
  The bank has made the following appointments: Emmanuel P Zuridis is general manager. Martin J Waghorn is deputy general manager. John Coxon is financial controller.

- **Banco Espirito Santo London Branch**
  Ricardo Pires replaces Tom Hoffman as general manager.

- **Fortis Bank S.A./N.V. UK**
  Paul Schuilwerve replaces David de Buck as head of the commodities team.

- **Jordan International Bank plc**
  Roger Smithyes replaces John Clouting as general manager.

- **HSH Nordbank.**
  Following the merger between Hamburgische Landesbank and Landesbank Schleswig-Holstein on June 1 2003 the following appointments took effect:
  Andreas Duden became general manager, following the retirement of Jens Mumme.
  Torsten Kordt became deputy general manager, following the retirement of Jim Gill.
  Joachim Lorenz, formerly head of corporate lending, became deputy general manager.

- **State Bank of India**
  Bal Chandra Achary is appointed manager (financial services) and compliance coordinating officer. Mr Achary replaces Rajiv Agarwal.
  Rajesh Chandra Verma is appointed manager (systems). He replaces Mr. B. S. Subhas.

  Mr.K.P. Sivasankaran becomes manager (investments & syndications). He replaces Mr. R.K. Ahuja)

- **Norinchukin Bank London Branch**
  The bank appointed Chris Riley as senior internal auditor in August 2003. Riley joined from Mizuho Corporate Bank and has wide Japanese banking and securities experience.

- **RZB Austria AG**
  David Cahill replaces Maarten van den Belt as general manager. The deputy general manager is Dr. Wladimir Ledochowski.

- **Sabanci Bank**
  Fiona Pandit has taken up the position of human resources manager.

- **Sanpaulo IMI**
  The bank has appointed Vincenzo Petraroli as head of administration. Thomas Baumeister has become head of credit analysis.

- **Société Général**
  Yves Blavet replaces Stuart Chandler as chief operating officer.

- **United National Bank Limited**
  Abid Mufti replaces Robert Wild as chief executive officer.

BASEL II - OPERATIONAL RISK

ARE WE MEASURING THE RIGHT THINGS?

By Peter Hughes

Peter Hughes examines the suitability of operational loss event data as a basis for risk measurement.

"Instilling discipline in operations personnel to report loss events is a daunting enough task. But training them to include them correctly, consistently and coherently moves it into the realms of the infeasible."

In June 1999, Basel first challenged the industry, "to devote the necessary resources to quantify the level of such (operational) risks and to incorporate them into their assessment of their overall capital adequacy". The only guidance offered by Basel at that time was that sophisticated approaches would lead to lower capital charges. The rest was a blank sheet of paper.

The response in most bank boardrooms was to hand this challenge to the areas that already had experience of building and implementing sophisticated risk modelling techniques, credit risk and market risk. Thus, the operational risk space was initially occupied by migrant modellers from credit and market risk who soon realised that the measurement of operational risk would demand significant judgmental input. Nevertheless, they proceeded with their task in the absolute conviction that only through rigorous mathematics could judgmental factors be considered in a systematic, coherent and consistent manner.

Data and measurement

But rigorous mathematics applied to what? The accounts did not provide a ready source of operational loss event data so the risk modellers had to create their own. This resulted in calls going out to all departments that operational loss events needed to be captured and logged in loss event databases.

In March 2003 Basel published its paper *"The 2002 Loss Data Collection Exercise for Operational Risk: Summary of the Data Collected"*. Basel needed to know what progress was being made on this front. Eighty-nine banks submitted information concerning 47,269 individual loss events. This effort wasn't entirely conclusive as is evident in the comment, "... even this very large database almost certainly fails to provide a fully comprehensive sense of the range of potential operational risk loss events experienced by banks, because of gaps in data collection". The troubling aspect here is that it is impossible either to know, or independently determine, how large these data collection gaps are and, unless accounting fundamentals are radically altered, nobody ever will.

Accounting for operational risks

Generally accepted accounting principles relative to credit and market risk require that the economic value of risk asset or trading positions be reflected in the accounts. A similar accounting framework for operational risk simply doesn't exist. There is no requirement to account for the economic value of technology, systems applications, internal controls and people that constitute operational infrastructures. Likewise, there are no accounting principles that govern the recording of the financial impact of operational loss events. Indeed, loss events can be found in almost any general ledger account.

It is the interaction of internal controls with generally accepted accounting principles that bank reporting is built upon. Today, loss event databases sit outside this control and accounting framework. If we wished to integrate them then appropriate accounting principles would first need to be formulated which, at a minimum, would require an "operational loss" to be defined in accounting terms for posting to specifically designated profit and loss accounts in a way that facilitates reconciliation with the loss event database. In the absence of this, the completeness of operational loss event data is dependent on staff voluntarily advising and reporting all such events.

Recording loss events

It is an inescapable fact that an operational loss event is bad news for somebody and the first instinct when dealing with bad news is to bury it. A bank is an operating entity and the accounts reflect its operations in the form of debits and credits. Differentiation is generally not made between an "in-the-normal-course-of-business" debit and an "operational-loss" debit. Thus, if you want to leave bad news buried in a bank's accounts it's easy since, in most cases, the only action required is to do nothing.

Instilling discipline in operations personnel to report loss events is a daunting enough task. But training them to include them correctly, consistently and coherently moves it into the realms of the infeasible. If it is concluded that an event qualifies for inclusion in the loss event database most operations managers will intuitively believe that no good can come of it. The first challenge they face is to describe the event in a way that it doesn't become an admission of stupidity, carelessness or lack of control. Even operations managers should be allowed the right not to incriminate themselves.

Operational environments

Mergers, acquisitions and investment in technology have caused operational risks in the industry to go through massive consolidation. Operational infrastructures are constantly changing. In this scenario

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operational loss events that occurred five years, three years or even one year ago may have little bearing on the robustness of today's operational infrastructures.

Real-time risk monitoring, which includes loss event reporting and analysis, is an essential ingredient in operations and technology management. Banks that support more advanced operations and technology hubs generally employ highly sophisticated risk monitoring programs that form an integral part of the production environment. The further these risk-monitoring programs are removed from the environments for which they were designed the less meaningful they become. This is certainly the case if granular risk monitoring data is filtered and used as a basis for enterprise level risk measurement and capital calibration.

Impact on the operations managers

The day has to be anticipated when operational risk capital in some banks will be allocated to businesses with an actuarial methodology at the core. When this day comes, business managers will begin to include measures in their strategic plans aimed at reducing costly operational risk capital charges. Operations managers are likely to bear the brunt of this pressure and will be expected to provide some answers. The likely reaction will be twofold: firstly, to discredit loss history as a basis for the measurement of operational risks; secondly, they will see the link between loss history and capital allocations and find ways not to report loss events.

It is questionable whether the "gaps in data collection" referred to in Basel's *Loss Data Collection Exercise* paper will ever be closed which begs the question: "Is there a better way to measure operational risks?". Yes, there probably is, but why doesn't somebody ask the operations managers what they think?

During his career in banking, Peter Hughes occupied senior positions in audit, operations, finance and risk management. He has now formed his own company, OpRAss, which specialises in operational risk management solutions

BOOK REVIEWS

Decentralisation - why and how to make it work. The Handelsbanken Way, by Jan Wallander (SNS Forlag 2003)

In this book Jan Wallander, former CEO and chairman of Handelsbanken, at the time the largest bank in Scandinavia, describes how he applied the fundamental principle of decentralisation to the bank which was completely reorganised 33 years ago. The head office was cut down by a third and, among other things, all budgeting and long-term planning work was abandoned. And analysts no longer received forecasts. Advertising was stopped and the central marketing department was virtually closed.

Since developing real power to its frontline people over 30 years ago, the bank has outperformed its Nordic rivals on just about every measure one can think of including, return on equity, total shareholder return, earnings per share, cost to income ratio and consumer satisfaction.

This book describes the ideas behind the principles and gives a detailed account of how such a different organisation functions.

Think globally, spend globally. The illustrated guide to globalization by Christopher Arnander (Profile Books), Price: £8.99

In this book about globalization Christopher Arnander has selected 125 cartoons from both sides of the Atlantic to deftly and wittily illustrate key themes in the progress of globalization. With an entertaining year-by-year summary of economic and political events over the last 50 years, and a fascinating chronology of globalization's milestones from Columbus onwards, this deceptively light-hearted guide is also a fact-packed work of reference.

Who Really Matters, The Core Group: Theory of power, privilege and success, by Art Kleiner (Nicholas Brealey Publishing, London, 2003) Price: £19.99

According to Art Kleiner, whose book, **The Age of the Heretics**, was a runner up for the Edgar G Booz Award for the most innovative business book of 1996, the energy propelling every organisation is the desire to satisfy a core group and understanding the expectations of this group is the key to success. He argues that all organisations have one motive in common: everything they do - choosing which projects to back, who to promote, where to spend the money is affected by the perceived wants and needs of a core group of people.

The composition of the core group can differ from organisation to organisation. Kleiner gives readers the key to reading a core group's real mission by observing its day-to-day actions, including what its fundamental message to employees is and how it gets that message across; how it manages the energy of new members; what basic ideas shape its policies about management, money and the way the world works; and what taboos govern the way it operates.

Who really matters is a deft, engaging blend of argument and observation, anecdotes and management theory. It is the ultimate guide to navigating the hidden pathways in any organisation and to achieving one's own career goals and aspirations.

THE GUILD OF INTERNATIONAL BANKERS

THE CITY'S NEWEST LIVERY COMPANY

By Edmund Conway

There are more than 100 livery companies in the City of London and more than half have been around since the Middle Ages. What need, you might be excused for asking, do we have of a fresh one?

The story of the Guild of International Bankers, founded just two years ago and on its way to becoming the City's 105th livery company, provides more than enough answers.

In the entire City's history, there has never been a livery company representing members of the financial services and banking community. In medieval times, when London started to gain eminence as a city, the companies were originally established as associations for members of their trades. In this way, the painters, goldsmiths, tailors and salters grouped together for representation and to set up trade rules to regulate their respective businesses.

The companies were set up not only to provide a forum to meet others from within the same profession, but they also played a key part in encouraging the young to become apprentices and follow their fathers' line of work. They built halls in which to meet, do business and act as embassies for the trade.

Over time, the majority of the companies ceased to have a real business function, as the sweeping changes set in place by the Industrial Revolution made their skills and trades redundant. While some fell by the wayside, most of the others abandoned their original trade purpose and positioned themselves as charitable and social associations. However, much like private clubs, the companies are sometimes regarded as closed bodies with complicated, intimidating membership conditions and mysterious, ritualistic histories. A certain amount of ritualism is understandable - and indeed welcome - within the confines of the Corporation of London, which is itself an older institution than Parliament.

The Guild of International Bankers, though one of the youngest guilds, holds the same values and a loyalty to the core purposes of the livery. Like the more ancient companies and their now defunct trades, its ties remain with its trade, and it sets out to encourage others - particularly those from backgrounds and education who would not normally aspire to a career in financial services - to enter into the trade. It is in this area of offering inner-city youngsters training, work experience and then career opportunities that the Guild has decided to put at the very center of its charitable purpose.

Although all Guild members are individual members, many have persuaded their employers to participate in the Guild's programme. This gives the sponsoring members a real sense of personal involvement in the charitable aims of the Guild. With members being employed at over 100 different banks and institutions, the potential supply of training positions is high.

Under this programme, the Guild provides youngsters from disadvantaged backgrounds with internships at banks and city firms, and training through the Brokerage Citylink. Last year 30 students were given placements by Guild members. Six of them were taken up by the banks and offered jobs in what might otherwise have remained a closed world.

Like other companies, the Guild of International Banker's purpose is twofold: to provide charity and to organise meetings and social functions for its membership. Its privileges as a company and - hopefully within a short space of time - as a livery company, connect bankers and the world of financial services with the Corporation of London. Members of a livery company can also become Freemen of the City - a position of eminence, if of little tangible gain.

Anyone in financial services looking at the Guild for the first time cannot help but notice that the illustrious list of Guild members is its most overwhelming aspect. Its founder-master was the former Lord Mayor, Sir Paul Newall. He was succeeded by Sir Brian Pitman - the former head of Lloyds - and the master-in-waiting is none other than Sir Edward George, former governor of the Bank of England. With such illustrious leaders, it is no surprise that the Guild's membership has been so highly prized.

The current master, Sir Willie Purves, was the man who turned HSBC into one of

"Anyone in financial services looking at the Guild for the first time cannot help but notice that the illustrious list of Guild members is its most overwhelming aspect."

the world's biggest banks and played a key role in the handover of Hong Kong to the Chinese. Legend has it that when driving in the city he had a switch in his limousine which turned all the lights in his path to green. Now retired and living in London, the Guild is his one official association with his former trade.

"It has always seemed bizarre to me," he says, "that the bankers did not have a guild in their own name particularly given London's position as the largest financial center in the world." Sir Willie adds that: "Our purposes are charity and fun, fun being a key feature of the Guild and which takes all forms, from the formal occasion to the very informal networking event. When the old Bankers' Club became extinct we took its most venerable tradition, the Bankers' Banquet, which we now celebrate in the Guildhall every year."

The banquet is a key event in the city diary for all bankers and financiers. Last year's keynote speech was delivered by the former chairman of the US Federal Reserve, Paul Volcker, who gave a widely-reported speech on finance and accounting standards in the wake of the Enron scandal.

The continuing importance of the banquet is clearly demonstrated by the 2004 banquet, held on 2 February, which was addressed by the new governor of the European Central Bank, Jean-Claude Trichet.

Membership of the Guild is open to all in the banking profession - as well as to

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THE SECRETARY HAS HIS SAY

By James Tree

In this, our first electronic newsletter, I am pleased to give you a few ideas of what we have been up to recently, and what we shall be rolling out in the near future.

The most significant event in the last few months has obviously been the retirement as AFB chairman of Angus MacLennan. Angus's stewardship over the past four years has been outstanding. Although his contributions are far too numerous to list here, there is no doubt in my mind that the increased profile of the Association has been mostly due to his personal efforts. The AFB might have a small Secretariat, but our strength lies in the way we are perceived by the community. Of course our profile has been steadily improving over the years. Our 50th anniversary in 1997 under Peter Bürger's chairmanship was doubtless the beginnings of our progress, and although Art Brown's term was rather short as he was recalled "mid-term'' to Australia, the first of our regular meetings with the Bank of England commenced with Art at the helm. Angus has built on those foundations and has effectively made our Association part of the City fabric, with the merger of the old FBSA with AFSA in late 2002 his single most important achievement.

So on behalf of us all, and from the Secretariat especially, "Thank you Angus!"

Turning to other matters, last year's planning has turned into this year's action. And at this point I should like you know that we now have available to us the services of two highly qualified consultants, Keith Palmer and Michael Blane. Keith and Michael were both compliance directors in AFB member institutions and are doubtless well known to many of you. Keith will continue as chairman of our very active Legal & Regulatory Committee and will also assist with FSA liaison. Michael has taken over from Alan Ashworth, the former Secretary of AFSA who has now retired and heads up our Anti-Money Laundering Special Interest Group. Anti-money laundering is still very much at the top of all members' in-trays, and for as long as this will be the case we can be sure there are few more qualified than Michael to head up our supporting role.

Next on the list of our activity is doubtless Basel! I am very pleased to let you know that we have reached agreement with three very friendly consultancy firms to assist us in bringing members the information you will need in London to support your organisation's actions in the preparation that Basel will require. We shall do this in three ways; a series of focused seminars; a regular bulletin designed especially for our members, and the establishment of a "help-desk", which will answer specific questions from the membership. We shall be letting you know about this project shortly. We are very grateful to Deloitte, to KPMG, and to Mercer Oliver Wyman for agreeing to help us roll out this new programme.

Other issues continue to percolate in the background, Business Continuity Management being one excellent example where a small number of dedicated individuals are considering various issues from a number of points of view. Another is the release of our *Good Practice Guide to Archiving & Document Retention*. And there are some interesting initiatives to follow. A regulatory "Health Check" guide for example.

Finally, but certainly not reluctantly, I turn to our social activities. I'm constantly reminded that as an international fraternity we are a remarkably gregarious group of individuals. Our member institutions come from around 50 different countries and we probably have even more nationalities than that working in our organisations - or TCNs as this class was once rather unkindly referred to. TCN stands for Third Country Nationals. An example might be where the London branch of a bank from Country A employs staff from Country B, and perhaps C and D as well!

Here are the dates of four important events.

30 April - Golf at Wentworth
18 May - Lunch at Mansion House
23 May - Charity Shoot at Bisley
30 November - Annual Banquet at Drapers' Hall

With best wishes from all at the Secretariat,

James

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others in the city. Members range from the old to the young, for whom membership fees are reduced, and all are welcome to come along not just to big annual celebrations such as the banquet but all its other social events. The Guild holds regular dinners, drinks and wine-tasting events, as well as informal dinners.

The Guild is also home to the Overseas Bankers' Club Golf Club Society, which has a 42-year tradition as the city's most exclusive golf society.

The Guild will soon have achieved all the distinctions necessary to qualify as an official livery company, subject to the approval of the Corporation of London. But being such a young company it has, as yet, no hall of its own so it enjoys the hospitality provided by fellow guilds and has held events at other halls, such as the Painters' and Merchant Taylors'. In the long term, the Guild intends to find itself premises - either sharing with an existing company, or its own hall.

Any article about the Guild must be crowned by a contribution from the Bank of England's recently retired governor. Speaking at the Guild's inaugural dinner at the Mansion House in July 2001, he showed the nickname "Steady Eddie" could as easily refer to his grasp of poetic rhythm as his hold on the economy:

"Now let us give thanks
For international banks
And the role that they play in the world;
Though misunderstood, and sometimes abused,
They channel resources to where they're best used,
So the banner of growth is unfurled.
And let us tonight
Take pride and delight
In the City's most novel creation,
That strengthens the unity
Of our world financial community
Surrounding Bank Underground station.
So please be upstanding, with the glasses filled,
Let's toast the International Bankers Guild."