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Increasing the chances of Success

Regulators also have a  
“duty of care”

What not to say in an Interview

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**W**ith democratic influences asserting themselves, social film-production receiving acclaim in the form of the prestigious Oscar and judiciary bringing the establishment within the line of law, the year 2012 gave Pakistan much to cherish and remember. Unfortunately, however, the economy was seen to be an underdog at best and failed to leave any triumphant imprints on the sands of the now-previous year. Malala took a bullet, and in doing so breathed life in patriotic unity, yet it was the economy which bled a little with no terrorist pressure at direct blame.

The sluggish economy was certainly not the item of priority on a governmental agenda driven by and revolving around the upcoming elections, as policy inaction emerged as the order of the day and populist measures were announced. Budget 2012-2013 remained evasive when it came to fundamental structural issues plaguing the economy such as the taxation net, RGST, energy crisis and the ill-efficient public sector. Meanwhile, the monetary directives issued by the Regulator continued to reduce the financing cost of the fiscal deficit as the discount rate was cumulatively reduced by 450 basis points over a period of 16 months, despite an inflated budget deficit of 8.5% of the GDP depicting excess demand in the economy.

For most part of the year under review, Pakistan operated in a disinclined external economic environment and failed to strike good relations with the IMF and other international financial institutions. In FY12, economic growth was recorded at a far-from-impressive 3.7% per annum, while domestic investment was witnessed at its lowest in 60 years, foreign investment plummeted and domestic saving also experienced a sharp decline. Fiscal indiscipline, escalating budget deficit and government borrowing to finance the same, has pushed the country debt to a staggering 62.60% of the GDP and the energy conundrum, ailing public sector and deficient revenue generation/taxation offer little prospect of relief to the fiscal and debt horizon.

Inflation, surprisingly, stood out as a beacon of economic hope, as it was logged at 6.9% year-on-year, and in doing so, decelerated at a rate that was faster than

projected. Despite this inflationary respite, and a relaxed interest rate regime, private sector credit remained subdued and continued to restrict economic potential, while government borrowings from the banking system augmented by 26.4% on a year-on-year basis.

As per provisional estimates, GDP growth is expected to continue in line with its current lackluster trajectory and close FY13 between 3-4%. External current account, meanwhile, is expected to close at an improved 1% GDP due to lower international oil prices and Coalition Support Fund tranche receipt; these positive developments in the external arena shall, nonetheless, not be able to prevent foreign reserves from dwindling further. Debt repayments to the IMF and the dried-up inflow of foreign investments have resulted in a decline in foreign exchange reserves of SBP, with the rupee depreciating by approximately 5% in 2012.

A few weeks into 2013, here is what hope is for: that our economy fortifies and restores investor confidence so that revived foreign capital inflows can provide stability and strength to our currency; that the private sector's credit demand picks up and takes the economy's production capacity and growth soaring with it; that the government evokes fiscal frugality by mobilizing financial resources, broadening the tax net and streamlining expenditure; that Pakistan finds within itself, that forte for which it doesn't need to go to the IMF's window.



**Sirajuddin Aziz**  
Editor-in-Chief



# IBP JOURNAL GOES DIGITAL



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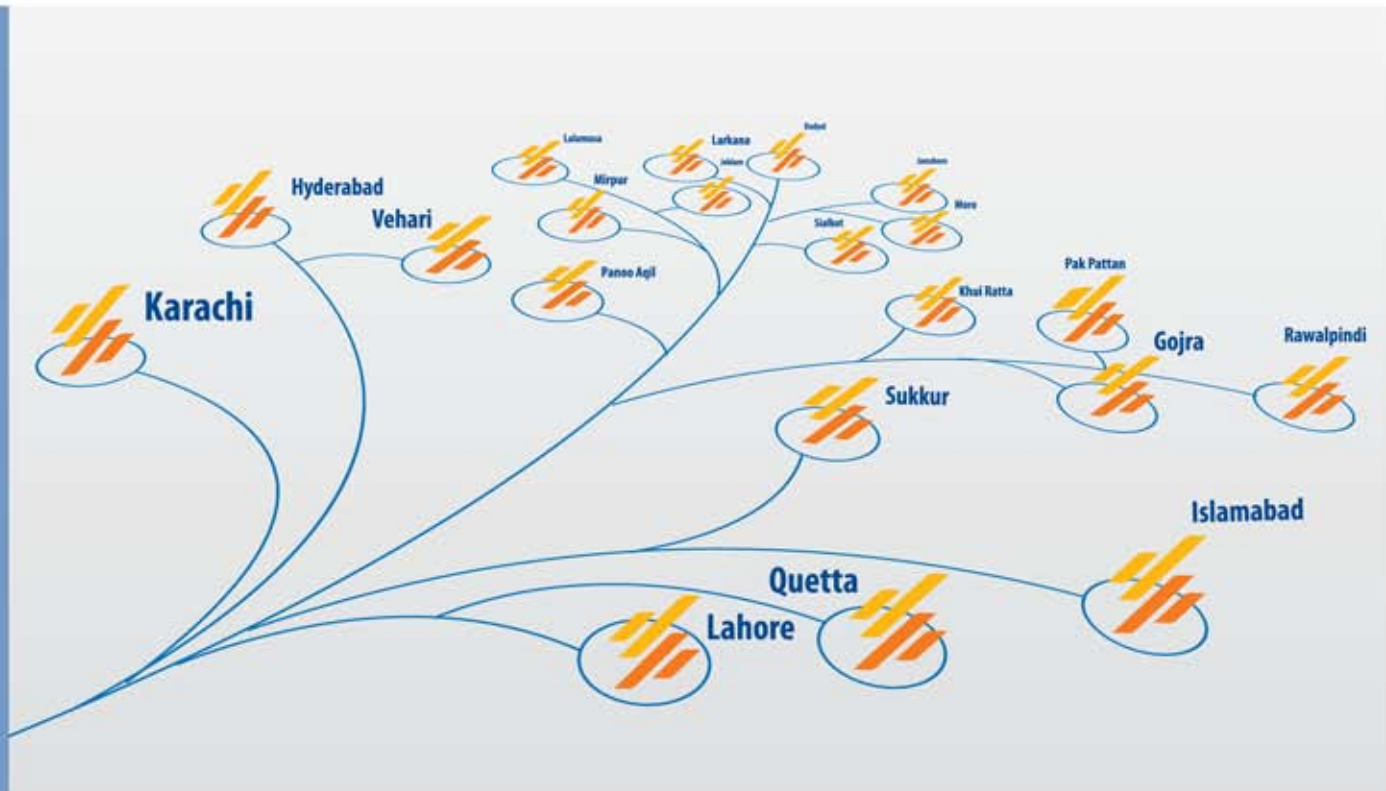
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# BASEL III is good to have, but risk culture and training will help avert the next banking crisis

By: Philip Forrest

**T**his year marks the phasing in of Basel III, a process that is expected to be completed by banks globally during the next six years.

It is designed to ensure that banks have sufficient capital, sufficient liquidity, and a sufficiently low level of leverage, to withstand economic turmoil, banking crises, and errors of judgment.

A little background: Basel I (so named because the deliberations which led to its release were held in Basel, Switzerland) was published in 1988. It focused primarily on credit risk, and it required that banks in participat-





ing countries – ultimately, most of the global financial system – set aside certain minimum levels of capital against their loan portfolios.

Before that, banks tended to hold as little capital as they could get away with. Since the ultimate goal was to maximize return on equity, it made apparent sense to minimize equity as a proportion of the overall balance sheet, provided investors didn't come to view the bank as too risky.

So Basel I was an important step towards stronger capitalization of banks. It required that capital (variously defined) equal to eight

percent of risk weighted assets be available to offset potential credit losses. It embraced operational risk and market risk, as well as a more sensitized approach to credit risk. A key change was that corporate and other loans would have different risk weightings depending on credit ratings and internal assessments.

Makes sense, provided the ratings and assessments are sound....

To quote *The Economist* (8th December 2012): But the system was soon gamed. Banks realized that they could spice up their returns by holding assets that were safe enough to require little capital, but risky enough to

collect a loan, for example by people like the geniuses who created Long Term Credit Management – the hedge fund that spectacularly crashed in 1998.

So now we move to Basel III. Certainly there are improvements, and the overall leverage restraint should help to discourage some of the more egregious practices of the past.

But history tells us very clearly that there will never be a capital ratio high enough to compensate for irresponsible or sloppy lending habits. The best protection against bank failure will always be a robust credit culture, where everyone takes personal responsibility for risk and

**“ But history tells us very clearly that there will never be a capital ratio high enough to compensate for irresponsible or sloppy lending habits. The best protection against bank failure will always be a robust credit culture, where everyone takes personal responsibility for risk and where staff are sufficiently trained to play their part. ”**

percent of risk weighted assets be available to offset potential credit losses.

The problem was that it was a rather blunt instrument. For example, all corporate loans were given the same weighting, meaning that the same level of capital would be applied to a million dollar loan to an AAA-rated company, as to an unrated startup with dubious expectations. It didn't take long for some banks to realize that they could maximize ROE by lending to such startups at high rates of interest, while foregoing opportunities with strongly rated companies who could borrow at low spreads.

The result: many banks became less safe – the exact opposite of the intended outcome.

And so we moved to Basel II, which sought to “encompass an integrated,

deliver profits. The obvious pre-crisis examples were American subprime mortgages that had been bundled up and then insured. Because risk models said that these would hardly ever produce losses, banks were able to load up on them without having to set aside much capital.

When some banks began to deliberately lend to people they knew could never meet their obligations unless property markets continued to rise, no regulatory framework was going to be strong enough to protect the system.

A prescient remark was made by the former Chairman of America's FDIC back in 2005: I have grave reservations about the proposed Basel II capital regime. I believe it carries the potential to do enormous harm to the US banking system. I'm particularly concerned that the models are created by people who have never made or

where staff is sufficiently trained to play their part.

A strong credit culture has evolved when there is informed and professional credit input at all levels. Staff is held accountable for the quality of their recommendations. They view their signature (on credit memos) as their most important possession, for which they are personally responsible. Empowerment becomes possible, within a framework of a clearly articulated credit policy and various checks and balances. Relationship managers are always thinking about the condition of their borrowers, ensuring that the correct loan grading is applied, and that remedial measures are promptly taken when needed. People take pride in their credit skills; an increase in delegated authority is seen as a vote of confidence that means more than most promotions.

All staff, whether in Credit or Marketing, understands that they share the same



objectives. They know that bankers don't get paid for saying "no", but equally that poor credit decisions are still the greatest threat to bank profitability or even survival. Credit and Marketing work together constructively in the best interests of the bank.

Staff at all levels understands that their credibility with regard to risk assessment will have a major influence on their career prospects. Promotions and other rewards go not just to the strongest marketers, but also to those with experience in various aspects of credit and a history of demonstrating sound judgement.

As with any reference to any culture, it will exist (or be absent) in the hearts and minds of the people involved, rather than through tangible evidence such as manuals, memos and systems (although these too are important).

None of this should be taken to mean that these banks are unreasonably averse to risk. Often the banks with the strongest credit cultures are also among the more aggressive risk-takers. They can afford to be, because they understand the risks they're taking, they know how to

mitigate risk and price appropriately for it, and they know how to manage a portfolio of risks going forward.

Obviously training is crucial to building such a credit culture. It would be pointless to embark on this mission without making the commitment to provide ongoing credit training at all levels, so that senior and middle management as well as frontline staff and trainees are all subscribing to the same principles, and are all speaking a common language.

Training will cover not only the assessment of a borrower's ability to continue to meet obligations, but also how loans should be structured, and how they should be managed until repayment occurs.

Credit coaching too needs to be institutionalised as a core value, such that managers are motivated to develop and

reinforce the knowledge base of their subordinates. In a strong credit culture, managers see almost every loan proposal as a coaching opportunity. They ask the account managers to "tell me in your own words why this is a good credit, why they merit a loan from our bank, and why we should feel confident we'll get our money back".

The Basel Accords have been honest attempts by good men and women to develop some sensible safeguards for our industry. The world is better off for their efforts. But no one should think that the latest iteration will protect those banks that fail to build sturdy credit cultures. Only strong leadership and management, buttressed by training, can do that.

"The best safety device is a rear view mirror with a policeman in it. If we are looking in the rear view mirror and can see the face of our supervisor, the Basel Committee, the Central Bank, then we are likely to follow the traffic rules."

CEO, Institute of Bankers, Pakistan  
(The Asian Banker Conference, Singapore, 17th March 2005)

**“ Obviously training is crucial to building such a credit culture. ”**







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# COULD DIGITAL INNOVATION DISRUPT THE BANKING INDUSTRY?

New technologies are reshaping the financial services environment. And as CRAIG ATKINSON, Financial Services Director, PwC in Scotland, reports, these institutions will need to put a clear digital vision in place – and fast.

By: Craig Atkinson

It always struck me that digital banking was, on the whole, the preserve of the younger generation.

However, learning that a number of my more elderly relatives use online banking, with one even using a smartphone to check transactions, really opened my eyes to the digital revolution – and its coming of age.

According to recent statistics, more than 43 per cent of adults in the UK are now signed up to online banking with around 4.8 million people regularly accessing their accounts via their smartphones.

Delving deeper into the digital revolution, we carried out research<sup>1</sup> to gauge the level to which people currently use or would consider using digital banking. The results were eye-opening. As you might expect, the vast majority (68 per cent) of Generation Y (those born in the '80s and '90s) prefer mobile channels. But more mature respondents weren't that far behind at 40 per cent. And over 88 per cent of people surveyed – ranging from Generation Y to Baby Boomers and mature groups – seem to prefer online banking to more traditional routes. So the question facing the industry is: has banking reached a digital tipping point?

Banks are facing a "perfect storm" as increasing regulations and cost pressures



are compounded by the global economic crisis. Emerging banking technology continues to give new competitors entry into the traditional banking revenue pools as well as driving a change in customer expectations and behaviour.

The emergence of new technologies has undoubtedly left its mark on the industry, and it is predicted that by 2015 digital will become the primary relationship channel for banking customers.

When combined with other factors ranging from new entrants (particularly in the payment space) and enhanced customer service expectations to a general lack of trust by customers in financial services and cost pressures and margin compression, it would appear that traditional banking is now facing its steepest challenge in a generation.

In our report, *The New Digital Tipping Point*, we note that customer attitudes to using digital devices – mobiles, smartphones and the internet – are already transforming purchasing patterns in most sectors. British Airways for example rode the crest of the digital wave in 2000, launching its online sales platform. Fast forward 10 years and over 80 per cent of flights and holidays are booked directly via ba.com.

Despite customers' willingness to pay for new and innovative digital banking offerings – up to £50 a year, according to our research – it appears that some organisations are not maximising these opportunities. Digital products are a significant opportunity for banks to grow revenues and serve their customers in a way they want. Our research revealed there is a very high correlation between digital engagement and share of wallet for a customer; Generation Y cite digital as a key factor in deciding their primary bank; and those who are digitally active tend to have the largest product holdings and purchase these from their primary banking provider.

In today's market, it would appear that the argument for having a customer-

focused strategy which incorporates a sophisticated and evolving digital offering is compelling. By embracing this new world, banks can deepen relationships with customers as well as access new revenue streams.

But banks are not alone in this quest. New entrants – big and small – are also sensing opportunities, actively competing for inclusion across the banking value chain. While there is little evidence to suggest that they will be successful in taking over the entire customer relationships from banks,

It could perhaps be more effective – both in terms of cost and time – for financial services organisations to partner technology or telecommunications innovators, or even with other non-traditional banking providers.

While this may go against the grain for banks, traditionally preferring to build their own solutions, we believe a "buy" or "partner" scenario would be more advantageous and could even make it more difficult for competitors to replicate.

Creating tie-ups with the most innovative players makes it more likely that a bank can gain first-mover advantage. Failing this, it needs to become a high-quality fast follower in order to avoid being displaced or, indeed, lose market share.

In acknowledging this new digital tipping point, banks face a dilemma: focus on the traditional model that has served banks well until now but could erode value by disengaging the customer; or embrace change and serve increasingly financial and digital-savvy customers in the way they want.

Ten years ago, the language of smartphones, tablets and iPads was not even on our horizon. Now we can't imagine the world without them, as they become embedded in our day-to-day communications, shopping, and how we access information. For banks and financial services, the environment is shifting fundamentally. Customers are moving faster than organisations in terms of adopting new technologies for day-to-day services. Clear winners will emerge, but only those that set out a digital vision for securing and retaining their customers.

*Notes: The New Digital Tipping Point surveyed 3,000 banking customers.*

*This article was first published in Chartered Banker, the magazine of the Chartered Banker Institute.*

IT'S PREDICTED THAT BY 2015, DIGITAL WILL BECOME THE PRIMARY RELATIONSHIP CHANNEL FOR BANKING CUSTOMERS.

GENERATION Y CITE DIGITAL AS A KEY FACTOR IN DECIDING THEIR PRIMARY BANK.

it is important to acknowledge their role as catalysts of change. More innovative offerings such as sophisticated authentication mechanisms, location-based personalisation and Twitter/Facebook transaction notifications are evolving, not to mention the emergence of mobile payment services using mobile phones without the use of credit or debit cards.

As the battle lines are redrawn, it is crucial that banks take action now if they are to successfully fight back and secure their relationship with customers.

The development of a digital vision and strategy – with the customer at its heart – is the first step. Not only are new digital features changing the way people interact with banks, but a one-size-fits-all approach will not be effective.

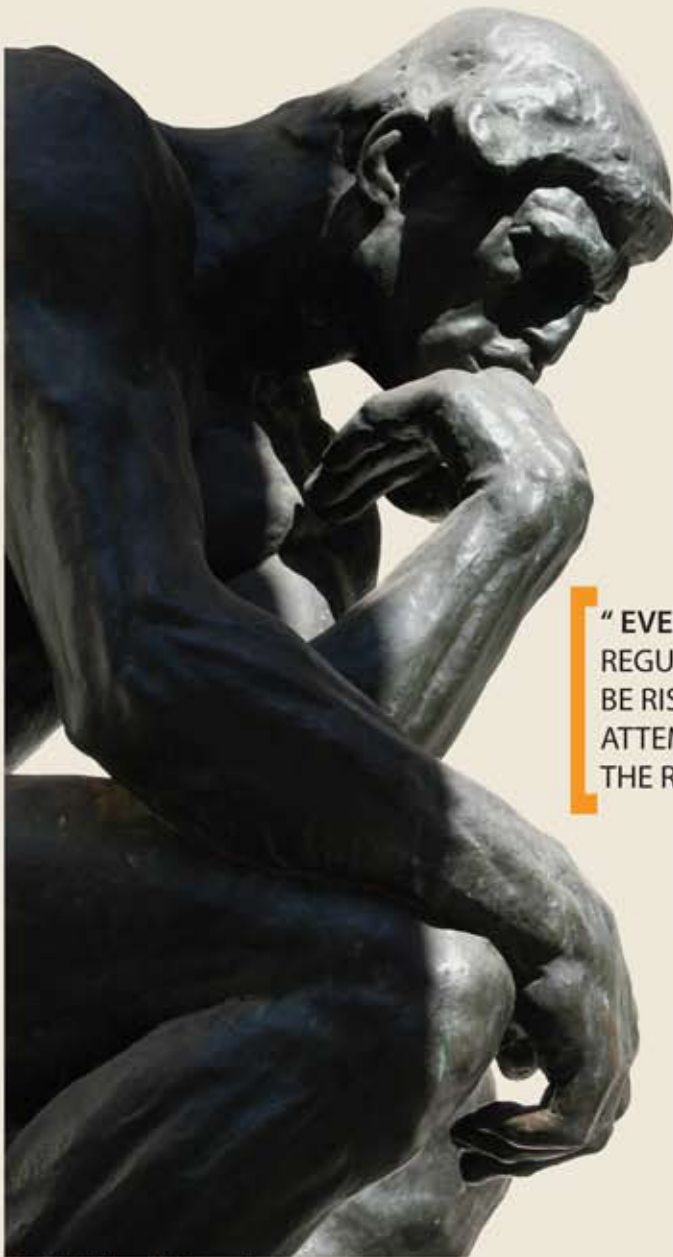




# Regulators also have a “duty of care”

At September’s annual conference of the Wolpertinger Club of university banking researchers in Valencia, Bangor University’s Professor TED GARDENER explored the latest thinking about the post-crisis corporate governance of banks.

By: Ted Gardener



Vladimir Wrangel/Shutterstock.com

**T**he financial crisis that began in 2007 has prompted an enormous theoretical and policy debate about the post-crisis “best” future corporate governance systems and business models for banks.

A perfect corporate governance system would provide managers with the right incentives to make value-maximising decisions for owners. It would ensure that cash was paid out to investors when the company is unable to generate positive net present value investments. It would provide managers and employees with fair compensation, but would not allow excessive managerial and employee perks of any kind.

This view of corporate governance is consistent with the free market model, where investors ultimately determine the internal resource allocation decisions of firms: shareholders’ wealth maximisation is the dominant corporate objective.

**“EVER TIGHTER, MORE DETAILED REGULATIONS MAY ULTIMATELY BE RISK-PRODUCING AS BANKS ATTEMPT TO INNOVATE AROUND THE RULES”**

During the post-1970 era, deregulation moved global banking systems along this free market trajectory. Many banking and financial crises have not deflected this deregulation policy. The

latest and most severe of these crises has prompted much re-thinking, but the discipline of the free market is still the preferred policy context in countries like the US and the UK.

In the past ten years or so, corporate governance has become much more central in the debate on banking structures, strategy and regulation. The theory is that, so long as markets are provided with sufficient information, they will ultimately discipline and incentivise the required value-maximising behaviour.

The recent crisis has not interred this standard model in banking, but it has certainly raised some fundamental questions.



And, in all the post-crisis studies, the emphasis, not surprisingly, has been on risk governance. Broadly speaking, two main schools of thought can be identified: a shareholder-dominant approach (typified by the 2009 UK Walker report), and a stakeholder-based one (typified by the 2010 Basel Committee and the EU approaches).

The debate has also addressed the fact that banks are different from non-banking firms: all banking systems rest ultimately on confidence. So long as bank depositors remain confident their bank can repay its deposits on any day, banks can borrow short and lend longer. This confidence preservation always has been the bedrock of fractional reserve banking.

A raft of special banking regulations – the central bank lender of last resort function, deposit insurance and “too big to fail” regulatory interventions – all reflect the practical importance of this depositor and market confidence. The “costs” of these banking-unique regulatory interventions (especially high in a crisis) are borne ultimately by government and taxpayers because of banks’ unique importance to economic stability and growth.

These necessary interventions carry with them certain privileges and responsibilities that all banks enjoy. They enable banks to operate with higher levels of leverage and risk assumption than would otherwise be possible in a completely free market. There has to be a price and a required level of professional responsibility assumed for these economic responsibilities and privileges.

In devising an effective, post-crisis system of corporate governance for banks, I believe there are three basic

requirements:

1. The special role and unique economic position of banks must be recognised.
2. A system is needed that enables the free market model (deregulation) to work effectively and safely in disciplining the banking system and allocating resources most efficiently.
3. The most important “market failures” associated with modern banking need to be recognised and addressed. “Market failures” here refer to those regulatory interventions (like the central bank lender of last resort and “too big to fail”) that are atypical of banking and which necessarily interfere with the workings of the free market.

There are no easy solutions. Banking history appears to confirm that ever more regulations in key areas like risk, capital adequacy and liquidity are not the complete answer. So where does this lead? First, banks’ special nature means that the duty of care (so-called “fiduciary duties” to key stakeholders) is wider for bank directors. It should encompass bank depositors, especially retail depositors who do not have the expertise (or incentive, given the implied “backstop” role of the central bank and government) to assess banking risks.

In practice, bank directors must be fully cognisant of any decision that might impact badly on bank capital adequacy (solvency risk) and affect its ability to repay bank depositors.

By itself, though, this is not enough because bank regulators are also a key party in evaluating and ultimately determining capital adequacy. Their key role is

in setting (at least broadly) the level of crisis scenario for which bank capital has ultimately to be adequate. The free market is not able (or incentivised) to do this. Even supervisors, with all the information they have, cannot precisely set banks’ exact downside risk needs – but they do have the final word on what level of bank risk cushioning is adequate.

So, it follows that senior bank supervisors should have fiduciary duties of care to banks, and especially their customers, in carrying out this important and unavoidable task. This leads to a kind of tripartite system of bank corporate governance. First, it requires fiduciary duties of bank directors and the senior management team to bank depositors. Second, it requires bank supervisors also to have fiduciary duties to bank depositors. Together, this system would subject banks, thirdly, to the shareholder-based model of corporate governance. The latter might work more effectively, reducing the probability of systemic shocks and contagion risk.

These are not “easy solutions”, without some challenging practical issues. Nor would they guarantee bank safety and prudence. But they would at least address the real problem of the “market failures” which compromise an unaided free market solution to bank corporate governance. They would also surely put a premium on the professionalism demanded of supervisors, bank directors and senior managers.

*References: Jean Dermine (2011), ‘Bank corporate governance beyond the global banking crisis’, INSEAD Working Paper 2011/33/FIN (Fontainebleau: INSEAD); Jonathan R. Macy and Maureen O’Hara (2003), ‘The corporate governance of banks’, FRBNY Economic Review, April.*

*This article was first published in Chartered Banker, the magazine of the Chartered Banker Institute.*



# BASEL III

*Salient Features for  
the Layman*

By: Jhangeer Hanif

The best thing about any crisis is that it makes you learn. Experiencing crisis does have some incidental benefits, which, if tapped rightly, take us a step ahead from where we were. This is what Basel III is about.



**T**he global financial meltdown which emanated from the downfall of subprime mortgage in the US led the Basel Committee on Banking Supervision is to take a fresh perspective on the resilience of the banking institutions around the world. The meltdown signified that the banks were not adequately capitalized in order to absorb losses and also the quality of capital was of not at the desirable level. At the same time, banks were not holding sufficient liquidity cushions. The result was the severe pressure on the financial system, the spillover effect of which was felt in the real economy. The objective of

Basel III is to augment the banking institutions' ability to combat shocks, which may arise from financial and economic stress; thus limiting the risk of collateral damage to the real economy.

Although Basel III introduces a more comprehensive framework to strengthen the regulation, supervision and risk management of the banking institutions, the punch-line is Adequacy and Quality of the capital. It is here where it would make a major difference on a global scale

through its ever stricter requirements. However, the timeline for implementing Basel III stipulations varies, culminating in 2019. Before we analyze the implications of Basel III for the banking system, it seems imperative to take a bird's eye-view of the changes introduced by Basel III. The salient features of the code are as follows:

### Capital

The Total Capital Requirement has been raised from the current 8% to 10.5%-

existing 2% to 4.5% and total Tier I from 4% to 6%. Tier II capital, the gone-concern capital, comprises instruments that are subordinated, and has a minimum original maturity of at least five years. Both Tier I and II can be 8%, which essentially means that the benefit of Tier II cannot be higher than 2% (it used to be 4% previously). Tier III capital has been eliminated. In addition to CET-I, the banks would be required to maintain two buffers (i) Capital conservation Buffer (CB) and (ii) Counter Cyclical Buffer (CCB). Banks would be required

**“ DURING THE CRISIS, BANKS DESPITE SHOWING STRONG RISK-BASED CAPITAL RATIOS HAD BUILT EXCESSIVE ON AND OFF-BALANCE SHEET LEVERAGE ”**

13% for the larger universe of banks. The capital is defined as (i) Going-concern Capital and (ii) Gone-Concern Capital. The going-concern capital comprises Common Equity Tier I capital (CET-I) and Additional Tier I. The first predominantly consists of common shares, share premium, and retained earnings. Additional Tier I capital refers to such instruments which have been issued for perpetuity without any maturity and are subordinate to bank's obligations. The code seeks to enhance Tier I capital from

to build 2.5% in CB over and above 4% of CET-I. This would be done in non-stress periods so that the balance can be utilized when stress befalls. The CCB will be deployed by national jurisdictions when excess aggregate credit growth is judged to be associated with a build-up of system-wide risk to ensure the banking system has a buffer of capital to protect it against future potential losses. This buffer would be required on need basis and its range may be from 0 to 2.5% (resultantly, the total maximum CET-1: 9%, total Tier 1: 11%). Meanwhile, a further capital cushion (1%-2.5%) has been proposed in addition to CET-1, which would be required from systemically important financial institutions (SIFIs). The premise is that SIFIs, as mainstay of economic stability, should have more resilience and strength than normal institutions to manage stress periods. At max, for SIFIs, CAR would go up to 15.5 %.

Comparation of Basel II and Basel III Requirements	Basel II	Basel III
Total Capital Requirement	8%	10.5%- 13%
Common Equity Tier I Capital (CET-I)	2%	4.5%
Total Tier I	4%	6%
Tier I + Tier II	8%	8%
	Tier II ≤ 4%	Tier II ≤ 2%

## Leverage

The code prescribes that banks should observe an overall leverage ratio. During the crisis, banks despite showing strong risk-based capital ratios had built excessive on and off-balance sheet leverage. The crisis pushed the banks to reduce leveraging, creating immense pressure on asset prices. The code stipulates that, on a test basis, a minimum 3% of Tier I leverage ratio, would be observed over a period of four years beginning Jan 01, 2013.

## Liquidity

Among other sound liquidity management and supervisory matters, a Liquidity Coverage Ratio (LCR) and Net stable Funding Ratios (NSFR) have been introduced. LCR would require banks to

Requirement of Buffers as per Basel III	
Capital Conservation Buffer (CB)	2.50%
Counter Cyclical Buffer (CCB)	0 %- 2.5%
CET-I including CB and CCB – at max	9.5%
Total Tier I	11%
Tier II	2%
Max Capital for SIFIs	15.5%

risk-weighted assets and reducing its overall leverage. NSFR would push banks towards building a long term fund base, again necessitating dilution in the spread due to associated cost of funding. Fitch estimates that G-SIFIs are likely to experience a 20% decline in RoE because of Basel III. Leveraging and Capital Requirements equally imply that there would be restraint on the banks to grow their portfolio of finances and invest-

around 50% of the banks' deposits – a ratio which was only 20% in Mar 2009. Reducing this abnormal percentage to 20% would mean to release an amount of PKR 2,000bln. If this amount is deployed equally in A and AA category finances (taking a more optimistic picture), this would give rise to PKR 700bln of risk weighted assets, which would shave off 2% from the current CAR. This entails that Tier I CAR would come down to

## “THE INDUSTRY IS NOT CARRYING ANY SIGNIFICANT CUSHION, WHICH IT HAS BEEN MAINTAINING WITH REFERENCE TO THE INTERNATIONAL REQUIREMENT HISTORICALLY”

have sufficient high quality liquid assets to withstand a 30-day stressed funding scenario that is prescribed by the regulator. NSFR seeks to ensure that banks have enough liquid resources over one-year horizon to cover the expected funding needs over the same period.

Evidently, the more pronounced requirement is the capital and adequacy of capital. The question is how the banks would be able to meet this requirement. Fitch has lately published a study covering 29 Global Systemically Important Financial Institutions (G-SIFIs). As of Dec 2011, these G-SIFIs might need to raise USD 566bln in order to meet Basel III capital rules. The sheer amount of capital to be raised is going to be a daunting task. This is especially true because investors would be aware that banking as a sector would compromise on return by balancing its portfolio in terms of

ments. One of the major considerations in the regulators' sight is also the impact that Basel III would have on credit availability. This may induce the retail bond market to expand at a faster pace, given constrained liquidity in the banking system.

When we talk about Pakistan, we find that the domestic banking sector boasts a Capital Adequacy Ratio (CAR) of 15.5% as of Mar 31, 2012. This CAR is predominantly supported by Tier 1 capital (13.3%). This demonstrates that the sector is well-positioned to comply with the code. There are certain individual institutions which may find it difficult to comply (5 banks are under 10% CAR). However, when we analyze the balance sheet of the sector, we see that there has been a build-up of government securities post 2008 crisis. Currently, government securities are

approx. 11%. This percentage is exactly what is required from non-SIFIs under Basel III. This means that the industry is not carrying any significant cushion, which it has been maintaining with reference to the international requirement historically. At the same time, any imbalance in the finances portfolio may further deteriorate this ratio. The big question mark is about those banks which are finding it difficult to comply with existing requirements. This highlights the criticality of thinking through the implementation of Basel III; how it would be rolled out and what limits should be in place for SIFIs and non-SIFIs in the domestic market. The State Bank of Pakistan, while expressing satisfaction with the resilience of the overall banking sector, is evaluating transitional path that the domestic sector would have to take in order to remain aligned with the international best practices.





**A**t a time of unprecedented upheaval in the banking industry when its leaders have to contend with a series of urgent and competing issues, they may be tempted to see HR as one of their less pressing imperatives.

But it's a dangerous mistake to make, says Angela Baron, an Adviser at the Chartered Institute of Personal Development. Financial organisations that try to drive change from the centre without consulting their people will suffer for it.

"We have seen a more command and control approach to business, which is always the temptation at a time of crisis but it's outdated," says Baron. "Of course you have to command but you must also involve people and give them a voice, so they know that their views will be reflected in the action you take."

While banks seem to have heeded the lessons of the 1990s recession, when many businesses shed people only to realise they badly lacked the right skills and experience when recovery came, there is still a risk they lose sight of the need to take their people with them, says Baron.

"In retrenchments, mergers and major

# BACK UP THE CAREER LADDER

By: Andrew Stone

**2012 remains a challenging year for employers both in terms of staff cuts and staff hiring. Despite this backdrop, Andrew Stone explains why HR departments should already be planning for a healthier economic outlook ahead.**

reorganisations, the temptation is to focus on the hard things, look for efficiency savings and not think through the impact on its people strategies.

"Command and control is a big risk. You should be taking a long-term view and thinking about the implications for the brand, its ability to attract staff, and what the cost will be to staff morale. Rebuilding trust with staff takes time."

Clear leadership and communication are key, Baron says. "People are versatile and they can cope with huge changes as long as you involve them. They need to

feel part of the change process. You need leadership and a vision that says that some change is painful but that the company will be stronger and better at the end of it."

This more collegiate approach to talent will also be a source of innovation, she adds. "The people on the shop floor dealing with customers have important insights about better service and how things can change for the better."

By rebuilding trust with your staff you will also have strong advocates for your brand with new recruits, at a time when

public perceptions of the prospects for the sector are low. Using considered social media engagement in this process offers a potentially powerful engagement tool when it comes to recruiting, adds Baron.

At a time when recruitment budgets may also be tight, taking a more flexible approach to career structure and progression can be a cost-effective way to keep people engaged and to retain talent, says Sue Filmer of Mercer.

Rather than offering a fixed career ladder, she likens new career models to a climbing wall. "Different experiences are hand holds and people go about building their careers in different ways. There's more flexibility about how things are done, which can help cater for a wider array of people and it need not cost lots of money.

"More thought needs to be put into how careers might unfold. Enabling career conversations to take place helps map out how to build a successful career. It may also encourage more women to stay in the industry."

#### RESILIENCE AND ADAPTABILITY

Simon Lloyd, HR Director at Santander, agrees that developing the right career structures and progression is important. Flexible career paths that give staff the option to work across different disciplines and to use the full range of their skills and talents can keep staff engaged. He explains: "If people are prepared to move sideways at times, albeit with a long-term aim in mind, that is hugely beneficial."

Putting these issues sharply into focus for Lloyd is his immediate challenge in absorbing around 400 staff from The Royal Bank of Scotland's retail, commercial and corporate operations in England and Wales and from Natwest branches in England while ensuring the whole organisation, with 24,000 people, has harmonised terms and conditions.

"We want this to be one of the best places to work in the UK and a good place for people to pursue a career. It's about ensuring people have the right tools to do the job, the right environment, the right reward structure as well as the right values and culture in the organisation."

Communication is key in managing this process well, says Lloyd, who points to the bank's previous experience tackling these issues with the Alliance & Leicester and Bradford & Bingley acquisitions. "People



**"MORE THOUGHT NEEDS TO BE PUT INTO HOW CAREERS MIGHT UNFOLD. ENABLING CAREER CONVERSATIONS TO TAKE PLACE HELPS MAP OUT HOW TO BUILD A SUCCESSFUL CAREER. IT MAY ALSO ENCOURAGE MORE WOMEN TO STAY IN THE INDUSTRY."**

are nervous about change but they are also resilient and adaptable once they know what they have to deal with. The sooner you can bring certainty and clarity the better."

Santander is helped in part because it has a positive story to tell as a challenger bank that has been hiring staff in the UK, says Lloyd, yet continual feedback remains a vital part of the communication process, he adds. "We get an 80 per cent response from our employee opinion survey and we've seen a rising trend over the past three years on the same set of questions. I think our people genuinely believe in the plans we've set out."

#### ATTRACTIVE WORKING CULTURE

Visits by senior managers to branches starting from the Chief Executive down help the bank's board keep in touch with staff and customer concerns and aspirations, says Lloyd. "Nothing beats direct face-to-face communication and for specific topics we will organise focus groups to frame the discussion."

Positioning the organisation's composition of talent for the future means keeping it closely aligned with the strategy, as well as spotting emerging trends where new skills will be needed.

"It's a question of understanding the business strategy over the next three years and plotting the skills you've already got in

the organisation and the ones you still need. Certain skills are at a premium, like risk and compliance. As the world is changing we need new skills too. No bank has cracked the social media world, for example. Understanding the strategies needed to succeed in social media is going to be important going forward."

David Sayer, Senior Partner for banking at KPMG, agrees that hiring talent that understands social media as well as other technological drivers is going to offer a key competitive advantage.

US banks offering customers cheque-scanning applications or online sign-in using iris recognition via phone and web cams are just some examples of the emerging disruptive technologies that will offer the leading innovators vast scope for process cost savings and ways to attract and keep customers, says Sayer.

Hiring young talent that understands such technology and its effective application in innovation may also help foster a more attractive working culture. In this respect the banks have some catching up to do with other large commercial brands and professional services firms.

"There's a real opportunity here for banks to attract Generation Y and create a working environment that is non-stuffy, diverse and attractive to the new people coming into the workforce."



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# Branch Banking Problems and Possible Solutions

By: Syed Sabir Ali Jaffery

**Q.1** Mr. Sabzwari one of our valued account holders proposes to open an account in the name of his orphan minor grandson. What should be your reaction in this regard as a branch manager?

**Ans.** A minor is not competent to contract, so an account is usually opened in the name of the minor so far as the account remains in credit and as long as there is some amount in his account he is able to withdraw. But, if the account is overdrawn, banker would have no recourse to the minor account holder except for the amount received by him to meet the necessities suiting his conditions in life. In this case, the banker would be liable to be reimbursed for the amount overdrawn by the minor after he attains majority and it should be made sure that the account is not overdrawn.

In actual practice, however, banks usually discourage opening a minors' account in his single name and it is preferred is that the account is opened in the joint names of the minor and his natural guardian, with the title of the

account expressed as "A Minor, B Guardian". Minors' name is written first because it is presumed that the account is being opened for the benefit of the minor. The account is operated by the guardian, and is not allowed to be overdrawn.

Further, the account opened in the joint names of the minor and his guardian should necessarily be a savings account to ensure,

- (a) that the account is not overdrawn even inadvertently, and,
- (b) business transactions do not pass through this account.

Moreover it is only the natural guardian who has the authority to deal with the minors' money, enter into contract on his behalf and give valid discharge or receipt for money. The position should be tactfully explained to Mr. Sabzwari and he may be persuaded to include the minors' mother or father, as the case maybe, as joint accountholder with the minor.

**Q.2** Through operational oversight, an overdraft is created in a minor's saving account. The guardian account holder-Mr. Umer turns a deaf ear towards all reminders from the bank to adjust the account. Mr. Umer also has a fixed deposit in his single name with the bank which has matured and he has come to the bank to get the FDR encashed.

Can the bank set-off the amount of the fixed deposit against the overdraft in the savings account?

**Ans.** The right of set-off can be invoked against a debt which is valid and enforceable by law. Since a loan to the minor is void to begin with, the right of set-off cannot be exercised against it.

**Q.3** A cheque of Rs. 1,000/- is presented for payment by a minor drawn on his father's account. The head teller is reluctant to honour the cheque and the case is referred to you as the branch operations manager. What will you advise?



**Ans.** Apparently, there is no harm in making payment of the cheque to the minor, particularly as the amount is small. However, the age of the minor presenting the cheque should also be taken into consideration. If he is old enough to comprehend the nature of transaction, payment maybe made. At the most he should be asked during a friendly conversation as to what the cheque was given to him by his father. His answer, his body language in giving the answer, and the level of his confidence in facing the question should help the concerned officer make a viable decision.

**Q.4** Mrs. Tehniat Suleman Siddiqui maintained a current account with the branch. She was a known philanthropist and renowned social worker. Her husband was a business tycoon who also maintained handsome deposits at the same branch in his business and personal accounts, as well as accounts of several family members. Keeping all these things in view, and expecting much more business through her illustrious husband, the branch manager allowed Mrs. Tehniat Siddiqui to overdraw her account to the extent of Rs. 10,000/- after obtaining permission from the Zonal Branch Head on the telephone. Subsequently, she paid no heed to several letters and personal requests by the branch manager to repay the amount. Surprisingly enough she had no property in her personal name, and her extravagant life style was entirely on her husband's resources. Ultimately after being disappointed by her, the branch manager approached her husband with a request to pay the overdraft amount. To the branch manager's disappointment, the husband refused to be of any help. What recourse does the bank have, if any, in these circumstances?

**Ans.** A married woman cannot make her husband accountable for her liabilities except under following circumstances:

- When she acts on behalf of her husband as his authorized agent.

- Living with her husband, she has implied power to pledge the credit of her husband for necessities of life; or
- The husband expressly guarantees repayment of any particular debt. This need not always be in writing, but in that case the onus proof that the husband had consented wife's request for the debt would be on the lender. Bankers do not reckon on this exemption.

Hence a prudent banker would never accommodate a married woman unless she has adequate resources in her own right or her debt is guaranteed by her husband or by any other sound party acceptable to the bank.

In the given case, the bank cannot successfully proceed against the lady. The only remedy available to the branch manager is to exert moral pressure on Mr. Siddiqui to get the overdraft adjusted.

**Q.5** Miss Aisha Ahmed has a savings account. She has now approached the bank to change title of her account as Aisha Malik since she has been married to Mr. Saeed Malik. Please suggest the line of for the bank.

**Ans.** The bank should simply open a fresh account with the proposed title of account after taking all necessary precautions needed to open an account.

## TRADE RELATED QUESTIONS

**Q.1** What is the basic difference between purchase and negotiation as per UP 600?

**Ans.** There is no term as "purchase" under Article 2 of UCP 600. The Article defines negotiation as purchase by the nominated bank of drafts and/or compliant documents. In other words, negotiation is the giving of value to the beneficiary for drafts and/or compliant documents, which is tantamount to "purchase".

In negotiating credit, the issuing bank arranges for the beneficiary to obtain from the negotiating bank immediate value for his usance bill. Having given value, i.e. on purchasing the bill, the negotiating bank will forward the document to the issuing bank for payment.

The issuing bank will direct the negotiating bank to reimburse itself upon negotiation, or, at the maturity of the bill, as per arrangement. This constitutes "purchase" of draft by the negotiating bank.

The essence of this type of term of payment is that it provides credit to the applicant and simultaneously provides immediate value to the beneficiary.

**Q.2** What is deferred payment letter of credit?

**Ans.** Deferred Payment Credit serves the same purpose as an Acceptance Credit but without a usance bill of exchange. Under this term of payment, credit period is determined by stipulation in the credit, specifying payment after certain number of days after the date of bill of lading.

The nominated bank acknowledges receipt of documents to the beneficiary and forwards the documents to the issuing bank for payment on maturity. On receipt of documents, the issuing bank acknowledges receipt to the nominated bank instructing it to make payment on the due date.

The documents are released to the applicant under Trust Receipt; undertaking to make payment on the due date.

**Q.3** Article 30 of UCP 500 regarding forwarder bill of lading is not reflected in UCP 600. What is its position?

**Ans.** Basic principle of law is that if an article is neither abrogated, nor amended, nor replaced, then it holds good.



A man in a dark pinstripe suit is seen from behind, placing a white puzzle piece into the word 'SUCCESS'. The word is formed by large white puzzle pieces on a textured grey background. The man is holding a piece that fits into the 'C' of the word.

# SUCCESS

## INCREASING THE CHANCES FOR *Success*

By: Hansruedi Schütter

In our fast-paced world, decisions need to be made on daily basis. Some of these decisions affect our daily work and some have a much broader effect on the long-term sustainability of our activities. How are decisions made? Is it experience or gut feeling or is it assumptions or data that give the ultimate impulse and add enough weight to, either yes or no?

“**T**raining and good preparation are half the victory”, my coach in my younger and more sportive years used to say. I heard this phrase again in my professional life. Any project which is not well planned will run into problems if not failure. And for sure, all of us have heard similar phrases in various situations over time.

Back to decisions, how many decisions have you made in life which you regretted later on? Did you make them because they seemed right at the time or based on solid arguments? Did you wait long enough until you had all the facts or were you missing some crucial information? Is not one of the most unethical sales tricks putting time pressure on the prospective buyer, thus





preventing him from checking out alternatives and making a comparison?

Obviously, information is an advantage, it is power. It lets you act and exploit opportunities before anyone else does and therefore ultimately, information is worth money. For a business, managing based on the right information is one of the most crucial elements to ensure success but it is also one of the biggest challenges to deal with.

### Common Language

According to the Book of Genesis, a united humanity of the generations following the Great Flood, speaking a single language, started building the Tower of Babel. Good progress was made until God confounded their speech and they were unable to understand each other. As a result, they were forced to abandon the project.

A similar pattern can be observed in modern day projects. 'Misunderstandings' lead to planning or implementation of

mistakes, delays and cost overruns. Whereas everybody is aware of and accepts different human languages and deals with it in one way or another, many firms ignore the problem of company internal language barriers, where terminology is applied differently by different departments or business lines. Or as a client of mine lamented once: "We waste so much time trying to figure out the meaning of the data we receive because trading and finance departments speak a different language."

### Data Collection

As time progresses, more and more banks, insurers and, to some extent, Corporates invest in building loss event data bases, storage and reporting capabilities to satisfy regulatory requirements without thinking much about the way they could utilise the data to better manage their business, products or services offered and/or to support decisions on which risks could be transferred or insured.

At the same time, whenever a firm suffers a loss, it is often faced with a significant dilemma in how to classify the event. Take, for example, the recent case of UBS and Kweku Adoboli – in many instances, the resulting loss is automatically classified as the consequence of a "rogue trader" – however, an in-depth analysis of the event will show that many things went wrong before Mr. Adoboli entered into any unauthorised trades or positions. How can any firm, often operating in multiple and distant centres ensure that each loss event it experiences is consistently and correctly classified? To make things worse, ambiguous definitions and multiple possible correct classifications often cause loss events to fall into potential "gaps" or "puddles" between different event categories.

This is further compounded by the fact that often firms use a classification that makes sense to its business and facilitates good risk management, but need to report or disclose information to the regulator in a totally different, non-business oriented structure.

### Taxonomy

Solid information is based on timely, accurate and complete data. But this is not enough. The data must be properly structured, allowing the analyst to unambiguously identify the underlying issue. This is the only chance we have to collect data from various sources and ensure a correct aggregation without undue distortions.

The way about this requires the use of a well-designed and proven taxonomy. The word "taxonomy" finds its roots in the Greek *τάξις* (taxis), meaning 'order', 'arrangement', and *νόμος* (nomos), meaning 'law' or 'science'. Taxonomy can thus be defined as the science of arrangement or ordering of data according to specific laws or rules for classification – vital for good record keeping and risk management.



**“Is not one of the most unethical sales tricks putting time pressure on the prospective buyer, thus preventing him from checking out alternatives and making a comparison?”**

Firms vary in the extent to which they have focused on taxonomy as a key element of value generation. Many use unmodified high-level Basel II categories, while some have adopted different hierarchies for specific initiatives. It is possible to live with a quick formulation early on. Yet, in the long term, a program with an ill-designed taxonomy is likely to fare little better in practice than an athlete entering the Olympics with a strong set of muscles but soft bones.

An effective taxonomy framework may contain a variety of specific data elements. The ideal number and composition of these elements depends on the organisation's specific business needs and its management culture. Some components are core data elements, likely to be included by virtually all organisations (risk category, line of business, etc.). Others are best described as supplemental, or specialised variables that a firm may use to its advantage, but only if suitable.

### Data as a Management Tool

With properly classified and reliable data, it is now possible to make informed decisions. Sources of such data may be loss events, as used in the example above, but ideally include data collected through performance and/or risk indicators. If regularly analysed, such data may show first signs of undesirable developments, providing the organisation with an opportunity to make a corrective move at an early stage.

I often get asked about predictive indicators. Well, data requires a brain to do the rest of the job. Indicators are not the solution, they are merely objective data that need to be interpreted and worked with. Often enough it is difficult to see beyond the trees that make up the forest, or beyond the data which in combination describe a situation.

Successful analysts therefore try to identify things that belong together, that influence each other. Combining such data in an index is a smart way of being alerted of problems where the individual components may not have provided sufficient reason to worry. To be true, though, not many organisations have gone beyond the individual indicator monitoring stage.

### Data Sharing

An important element in a comprehensive decision making structure is the ability to benchmark your own data against those of your peers. In our advisory work we came across a client who recorded a fair amount of internal fraud. Management was concerned but for lack of better knowledge accepted the numbers as a cost of doing business. It was only after they joined a loss data consortium and got hold of their anonymous peers' respective numbers that they

bank in Indonesia, but without knowing the bank or the client, and use the amounts involved for inclusion in their own scenarios or capital models.

All too often, data sharing initiatives fail because someone internally refuses permission to anonymously contribute the firm's own data. Indonesia's success to establish the External Loss Data Consortium is largely attributable to member banks' senior management embracing of a fresh idea, with a bit of encouragement from Bank Indonesia's publicly stated support for the initiative. Pakistani banks, unfortunately, have not taken that support hurdle yet, despite considering the establishment of such a consortium from time to time.

### Conclusion

As the Indonesian example shows, success is the result of a number of factors:

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**“Often enough it is difficult to see beyond the trees that make up the forest, or beyond the data which in combination describe a situation”**

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realised that their concerns were more than justified: Losses due to internal fraud were way above everybody else's.

As nicely proven in this example, external data can be vital to the overall picture, one of the reasons why Basel II made external data analysis a requirement to qualify for the Advanced Measurement Approaches to calibrate Operational Risk Capital. The Basel Committee on Banking Supervision supports the idea of Loss Data sharing but wants to see such activities as private sector initiatives.

Following the Basel suggestion and supporting their banks in their need to obtain external data, a Loss Data Consortium was recently established in Indonesia under the auspices of the Indonesian Banking Development Institute. Participating Indonesian banks will forthwith be able to read up on descriptions of Loss Events that happened to another

1. Determination – the will to do some thing.
2. Planning – preparation for an accurate budget and internal sales campaign.
3. Courage – proposing an initiative with initially unlikely approval chances.
4. Management Support – senior managers taking the time to look at initiatives with an open mind.
5. Discipline – implementation as per plan
6. Data Quality – timely, accurate, complete and well structured data.
7. Follow-up – applying one's know-how to professionally and sometimes inquisitively work with data .
8. External Data – benchmarking and learning from/getting warned by peer data.



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# INTERVIEW

## *What NOT to Say* in an **INTERVIEW**

By: Mansoor Murad

In a job interview, much like everywhere else in life, first impressions count a lot. However, even the most positive of first impressions cannot save you if you manage to undo it by an acute case of foot-in-mouth disease. In other words, what you say (or don't say) in an interview will easily outweigh any positive impression you make through good eye contact, body language, etc.

In order to ensure that you maximise your chances of landing that dream job, here is a list of what not to say in an interview:

### 1. Saying Too Little:

There is nothing worse than to be interviewing someone whose responses consistently comprise of single sentences. It sends the message that you either are very nervous and therefore may not be able to perform under pressure or that you have nothing to say and therefore your achievements on the CV are likely to be overinflated. In either case, by not giving well-rounded responses, you are missing out on a key opportunity to showcase your suitability for the role.

### 2. Talking Too Much:

The exact opposite of the former, this is often the natural result of trying to appear relaxed and confident. Candidates tend to go on and on, without having nothing of substance to add. Interviewers tend to lose interest, and it is likely that you will not be called back. Whenever responding, keep the question in mind and ensure that your response is always targeted at the question. It is better to have the interviewer ask a follow up question (indicating that they were paying attention) than to have them zone out. At times, you may genuinely have a lot to say regarding an accomplishment or a project. The interviewer is rarely interested in the project but wants to gauge your understanding and exper-



tise which is evidenced through your response. It becomes difficult in such situations to curtail your response. The best way is to give some details and invite the interviewer to ask more questions citing that you can probably talk about the matter for hours and perhaps bore the audience with lengthy details.

### 3. Stretching The Truth:

This is critical. Never, ever, lie in an interview. Any experienced interviewer will catch you out right away. It is very common to have candidates who place things on their CV, especially in terms of their personal interests which are not true; that they think will impress potential employers. Trust me, it will not impress if it is untrue.

**“KEEP THE QUESTION IN MIND AND ENSURE THAT YOUR RESPONSE IS ALWAYS TARGETED AT THE QUESTION.”**

It is quite common for an interviewer to start off by asking about an interest stated in the CV that they know something about. There is nothing worse than going through the motions of an interview with someone when you know you have already rejected them, and the number one reason for this is usually when the first question you ask them is about an interest that appears on their CV, about which they clearly know nothing. Remember, a made up interest can only trip you up; someone who knows little about the interest is unlikely to ask about it or be impressed by it, and when someone who knows a bit about the topic asks you a question and you come up blank, you have sealed your fate.

### 4. Ask About Salary:

You don't want to come across as a mercenary. All prospective employers

will ask about your current salary package, and many will ask your salary expectations. The moment you start to ask about money, the conversation moves from revolving around your skills and potential contribution to the employer to your cost of employment. This is a mistake that many mid-career professionals tend to make. Remember, if you are good enough for the job, then you will be offered the appropriate compensation.

This doesn't mean that you should refuse to answer if asked your salary expectations but simply that the interviewer should be given the chance to bring up the subject. If it does come up, be honest but realistic about your expectations.



### 5. Volunteering a Pay Cut:

This is a big no-no. It sends the signal that you think you are overpaid in your current role, or that you are not worthy of the position you are being interviewed for. In either case, employers will see it as a red flag. If an employer thinks you are good enough, they will either pay you the right salary, or will try to convince you to take a cut due to the other benefits being offered by the job.

If you are applying for a job where you do not wish to give out a salary expectation, then simply state that you do not have a figure in mind, as the overall package in terms of the job dimensions, potential for growth, etc. is what you would be considering, and that the salary would only be one of several factors, and is not the primary one. This is a clever way of saying that you would consider a

**“It is always a good idea to spend a few minutes on the company website the day before the interview.”**

pay cut if the rest of the variables are in place.

### 6. “Actually, I didn't have the Time to Look at Your Website”:

If you were too busy to spend ten minutes on the prospective employer's

website, then why should the interviewer spend any time on you? It is always a good idea to spend a few minutes on the company website the day before the interview, and ideally it will give you some fodder to ask an intelligent and well-informed question towards the end of the interview, that will show that you have taken the time to visit the website. This is as true for mid-career moves as is for entry level roles, something that mid-career professionals tend to ignore.

**“Be honest but realistic about your Salary expectations.”**



# *Why* PAKISTAN *Needs* a LEGAL FRAMEWORK for SMALL OFFICE HOME OFFICES (SOHOS)

By: Nida Naqvi



**SOHO or Small Office Home Offices have become increasingly prevalent in the modern economy as technology such as the computer, internet, email and video conferencing allows the SOHO owner to be completely plugged in and connected to the world without having to operate out of a traditional office.**

Pakistan has a flourishing economy in a shadow sector – the small office home office (SOHO). The SOHO is defined as a business operated out of the business owner's residence. It has anywhere from one to fifty employees, and is a notch below the Small to Medium Enterprise or SME. Moreover, the start-up cost of office infrastructure can be daunting and at times simply not required. Thus the SOHO presents itself as a low-cost, efficient, and effective option for an individual seeking to start up his or her own business enterprise.

People living in Pakistan regularly interact with the SOHO sector, as it provides many of the services that the population needs. As an example – when I got married, I consulted the designer of my clothes in his home office/studio, I met with the one-woman team doing my invitations at her home, in her drawing room, and I selected my tablecloths at the home of a woman who ran a thriving business producing everything from bed sheets to couch upholstery out of her living room. The entire room was papered, end to end, in samples, and we sat and negotiated our prices sitting right there on her couch. When I went to buy clothes for my wedding party, for every



boutique I went to, I also went to someone who was selling clothes from her house, using a room in the home to display her entire collection and letting me try things on in the bathroom. Indeed, the wedding industry stands and thrives on SOHOs, and the wedding industry is big business.

Beauty salons, tailors, interior decorators, artisans, craftsmen – many of these services are run from the home. However this is just a slice of the SOHO sector. Lawyers, accountants, consultants, real estate agents, stockbrokers, financial analysts – these professionals also will often run their business from their home, meeting clients in a room made into an office within the home and using the internet and at home office supplies to run an entirely functional and successful home business. Also, many tech-related businesses are run from the home – web designing, email marketing services, and the like.

Unfortunately, these businesses are largely operating under the radar. This has several key repercussions. First, it means that their activity is undocumented, and does not contribute to the calculations regarding Pakistan's overall economic health, particularly GDP, which directly influences the level of foreign investment in the country. Second, it means that the workers in the sector are not regulated, and thus are not able to take advantage of labor laws. Third, since SOHOs do not have a legal identity, they are unable to access finance from the formal sector as a business. Finally, and perhaps most significantly from a macroeconomic perspective, the sector remains an untapped source of tax revenue for the government. Pakistan's tax-to-GDP ratio is one of the world's lowest, at a paltry 8.6 % (most developing economies have a ratio of 13 % – 18 %).

Naween A. Mangi is of the view that the underground economy in Pakistan employs over three quarters of the nation's 54 million workers and is worth as much as 50 % of Pakistan's 18 trillion rupee (\$200 billion) official Gross

Domestic Product. While "underground economy" includes sectors outside of the SOHO, the SOHO comprises a significant share of this shadow economy. According to Sayem Ali, country economist at Standard Chartered Bank in Pakistan, "Everything from auto parts to sports goods, knitwear, clinics and beauty salons fall into the informal economy. All these make a significant contribution to

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**“The banking sector is thus looking at a large prosperous section of the economy, which has borrowing and other transaction banking needs which are being fulfilled by the informal sector. The current legal infrastructure is not conducive to the registration of this sector and the fear of getting in the tax ambit keeps many away. The lack of legal entity becomes prohibitive for banks to lend and deal with this sector as a business entity resulting in a large opportunity loss.”**

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employment and income, and that's one reason why the economy is still growing. But since Pakistan has one of the worst tax structures of the world, these fall under the radar.” (“The Secret Strength of Pakistan's Economy”). The untaxed “shadow” economy as a share of GDP is approximated to be 36 % (Data from the Asian Development Bank).

The banking sector is thus looking at a large prosperous section of the economy, which has borrowing and other transaction banking needs which are being fulfilled by the informal sector. The current legal infrastructure is not conducive

to the registration of this sector and the fear of getting in the tax ambit keeps many away. The lack of legal entity becomes prohibitive for banks to lend and deal with this sector as a business entity resulting in a large opportunity loss.

The pervasive issue preventing large scale tax reform, particularly in the SOHO sector, is that many business owners are averse to the idea of a tax system. Thus they try to avoid taxes at all costs – of around 50,000 businesses have National Tax Numbers (NTNs) issued to them, only 40% actually file their annual tax returns. This harms the entire system, for many reasons, as it is unjust for the business owners who do decide to pay their taxes, and it fuels the vicious cycle eroding tax compliance.

Most significantly however, tax evasion fundamentally cripples the economy. National governments sustain themselves and provide the functions that a society needs based on tax revenue. Since the government does not collect nearly enough tax revenue to sustain itself and service its debt, it borrows from the banks, who in turn are therefore not lending to the private sector. The private sector must be able to borrow to invest and stimulate widespread growth – but it cannot, because the government is crowding out the sector with its own borrowing. The net flow of credit to private sector was Rs 18.3 billion in FY12, which is a drastic decline compared to a net flow of Rs 173.2 billion in FY11 and total investment as a percentage of GDP is a paltry 12.5 % for FY12. As a direct result of the restricted flow of investment from the private sector, national economic growth is projected at 3% - 4 % – well below the target for the year and considerably below the country's actual economic potential. Further, the government does not have the revenue to sustain the key functions that a government must perform – including security, social, economic and political functions. Without revenue, the government cannot provide the public with the services that are needed to create a stable national environment. Indeed, for all these



reasons, any successful, functioning national economy must have as part of its structure a healthy tax system – because far from taking money away from businesses, taxes actually empower businesses to be a part of an economy that is functioning well and operating at potential.

The cancerous issue of taxation might be the single most fundamental factor hindering Pakistan from utilizing its vast potential and growing alongside the other developing economies. To get an idea of the potential – estimates indicate that if participants in Pakistan's underground economy paid their taxes, the government would collect a whopping 800 billion rupees a year.

As part of tax reform, Pakistan can create a system where SOHOs are brought into the tax fold, but are done so in a way that encourages their growth. These systems exist in the US, the UK, and certain emerging markets. In the US, after demonstrating that one's home office qualifies for exemption under the tax code, an individual has at his disposal a bevy of tax deductions that ease the burden of setting up shop from home. Some common tax deductible exceptions under the tax code include – rent, mortgage, property taxes, insurance, internet and phone, transportation (including car and gas), travel and self-employed retirement plans (as long

as these expenses are related to the line of business). Similarly, in the UK, there are a host of business and home working expenses one can deduct from the HRMC when working from home.

Developed countries are not the only examples of regimes where SOHOs are brought into the tax-fold productively. Turkey underwent a significant, progressive and well-planned tax reform program in 2007 which has proved very successful for the country, thus far, in generating revenue for the state and in attracting foreign investment. As part of this program, Turkey created a system whereby many of the tax deductions available to corporations are also available to individuals operating businesses from home. This policy is part and parcel of the larger tax reform program and it successfully brings the large segment of home business operators into the tax fold by treating them as micro-corporate entities and giving them many of the same breaks that corporations receive (See "Investment in Turkey", KPMG, February 2011).

Pakistan simply cannot afford to wait any longer to reform and revamp the tax system. The Federal Board of Revenue

**“ Since SOHOs do not have a legal identity, they are unable to access finance from the formal sector as a business.”**

(FBR) must be empowered into a judicious, efficient and effective agency by proactively adopting the best practices of modern tax administrations in developed countries and in emerging markets. The SOHO sector drives growth, remains an untapped source of revenue and must be regulated to protect labor rights. If brought into the system in a productive way, it has the potential for even more growth and sustainability.







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# Outsourcing: IT GOVERNANCE

By: Zahir Ali Quettawala

**I**T governance is a subset of corporate governance. It refers to how well an organization governs or controls those of its activities that involve the use of information technology. IT governance refers to how the entire activity using IT is controlled—not just the IT department, but the business knowledge and information that the activity requires for its successful operation.

Outsourcing, in its most common form, involves the contracting out of one or more of an organization's activities to an enterprise outside the corporate or government bounds. The perspective of executives or directors toward the need for effective IT governance depends on how important the activity or resource provision outsourced is, in the context of achieving the organization's strategies. If what is outsourced is a replaceable commodity or service, then problems can be overcome by going to an alternative supplier with low transfer risks. However, if what is outsourced is vital for the organization's ability to operate, then IT governance considerations and the frequency of reporting on service delivery and effectiveness of associated performance become of high importance.

The table below sets out types of activities that can be outsourced, the risks associated with outsourcing such activities and what IT governance issues should be considered.

IT governance refers to how the entire activity using IT is controlled - not just the IT department, but the business knowledge and information that the activity requires for its successful operation.



Outsourced Activities	Risks From Outsourcing and Possible Consequences	IT Governance Considerations for Executives and Boards
<p>Outsourced information management and storage (all value stored, databases, customer files, key parameters, etc.)</p>	<p>Very high risk - Depending on how critical the information stored with the outsourcer is:</p> <ul style="list-style-type: none"> <li>• Consequences of loss or unauthorised access via penetration or poor security.</li> <li>• Immediate impact, meaning this instant.</li> <li>• Exposure to a wide spectrum of risks, e.g., loss, theft, integrity corruption, competitor access.</li> <li>• Outsourcer negotiating power through organisation dependence on continuing access.</li> </ul>	<ul style="list-style-type: none"> <li>• Ensure the outsourcing contract covers acceptable access rights and clear ownership of information.</li> <li>• Ensure adequate backup and disaster recovery arrangements have been made. Executives should cite specific evidence of successful recovery testing. Directors should request from CEO written confirmation that this test has taken place.</li> <li>• Inquire as to security over information stored and communications channels with access to the information.</li> <li>• Ensure that the cost of outsourced service and the level of service received meet strategic needs.</li> </ul>
<p>Outsourced core knowledge systems and development of new, or maintenance of existing, systems (corporate memory, key knowledge elements, activity processes, executive preferences, etc.)</p>	<p>High to very high risk—Depending on how critical the outsourced knowledge systems are to the organization's strategic operations:</p> <ul style="list-style-type: none"> <li>• Exposure to a wide spectrum of risks, including intellectual property theft, process integrity corruption and competitor access.</li> <li>• Dependence on an outsourcer to develop new systems and/or associated intellectual property can mean extreme vulnerability or loss of credibility.</li> </ul>	<ul style="list-style-type: none"> <li>• Ensure adequate backup and disaster recovery arrangements have been made.</li> <li>• Inquire as to security over system stored on the outsourcer's servers or in its computer installation.</li> <li>• Inquire into how systems access information is stored by outsourcers and the security of associated communication channels.</li> <li>• Inquire as to the level of the organization's dependency on the outsourcer for development or maintenance of new or existing software; understand where knowledge and necessary competencies covering systems now reside.</li> <li>• Inquire as to project delivery management for new systems.</li> <li>• Inquire as to system uptime and maintenance performance.</li> <li>• Ask if the contracted service and uptime operational commitments are being met by the outsourcer.</li> </ul>

Outsourced Activities	Risks From Outsourcing and Possible Consequences	IT Governance Considerations for Executives and Boards
Outsourced major computer installation and ancillary support services	<p>Medium to high risk</p> <ul style="list-style-type: none"> <li>Establishing major data centres run by major outsourcers should lower risk via economies of scale, experience, sound data centre procedures, and depth of supporting services.</li> <li>Organization outsourcing needs to ensure that outsourcer's installation is soundly run and contractually arrange access rights and verification arrangements (possibly via a third party such as a competent assurance provider).</li> <li>Risks arise where outsourcing organization does not monitor the service received or the ongoing condition of the computer installation on which it depends.</li> </ul>	<ul style="list-style-type: none"> <li>Ensure adequate backup and disaster recovery arrangements have been made and tested (as noted previously) with participation or observers from the organization onsite.</li> <li>Inquire as to assurance reports on installation service and uptime performance.</li> <li>Ask if the contracted service and uptime operational commitments are being met by the outsourcer.</li> </ul>
Outsourced networks or communications	<p>Medium to high risk</p> <ul style="list-style-type: none"> <li>Risks include illegal or malicious penetration (hacking), denial-of-service attacks, information or system corruption, intellectual property theft, viruses, worms and Trojan horse attacks.</li> <li>Alternate network routing capabilities must exist and have been tested for major networks so single point of failure dependency (bottleneck risk) is overcome.</li> <li>Insufficient communications capacity slows processing or lengthens customer service centre response times.</li> </ul>	<ul style="list-style-type: none"> <li>Ensure adequate backup and disaster recovery arrangements have been made and tested.</li> <li>Inquire deeply as to security at all points of the network, extranets and intranets, as well as over links to the Internet, to Internet service providers (ISPs) and to the organization's web site.</li> <li>Inquire as to the adequacy of bandwidth or communication network capacity to the organization, e.g., does it meet strategic needs?</li> <li>Ask if the contracted service and uptime operational commitments for networks and communication channels are being met by the outsourcer.</li> </ul>
Provision of computer equipment, replacement of network PCs and servers, network devices	<p>Usually low risk</p> <ul style="list-style-type: none"> <li>Alternate suppliers available.</li> <li>Contract does not meet commercial/entity needs over time.</li> <li>Poor service is received leading to lower productivity or higher downtime.</li> <li>Outsourced service provider does not keep equipment current.</li> </ul>	<ul style="list-style-type: none"> <li>Comply with terms of outsourcing agreement (service received/payments made).</li> <li>Bring to executive or directors' attention only if a disaster occurs, probably to seek recovery fund.</li> </ul>





By: M.A Khan

# Indicators of Suspicious Transactions

The age old saying that "Crime is always a step ahead of the law" is equally relevant to the financial world. One does not need to look far to notice that globally orchestrated efforts to combat terrorism financing and financial crimes are relentlessly being matched by the criminals through innovation and diversity in their operations.

Compared to today, the life during the decades of the fifties and mid-sixties, seems much simpler and as do the threats to the global financial systems. A simple third-party introduction was good enough to open a bank account and walk-in customers were entertained on the basis of prima-facie evidence or simple verbal or written statement. Then came the drug culture which in its wake brought politicking by corrupt leadership backed by the so-called drug lords. Over time the menace has assumed monstrous proportion with devastating economic and geopolitical ramifications at global as well as country level.

Gone are the days when suspicious transactions were scrutinized only within the perspective of frauds or theft, given the elements of money laundering and terrorism financing, the present-day definition of suspicious transaction, also known as 'Red alerts' or 'Red flag indicators' embraces a much broader range of illegal activities.

The U.S. Treasury Department's Financial Crimes Enforcement Network (FinCEN) defines suspicious transactions, as any transaction in which the financial institution knows, suspects, or has reason to suspect that it:

- a) Involves funds derived from illegal activities or is intended or conducted in order to hide or disguise funds or assets derived from illegal activities (including, without limitation, the ownership, nature, source, location, or control of such funds or assets) as part of a plan to violate or evade any law or regulation or to avoid any transaction reporting requirement under federal law.
- b) Aims to evade any regulations promulgated under the Bank Secrecy Act.
- c) Has no business or apparent lawful purpose or is not the sort in which the particular customer would normally be



expected to engage, and the financial institution knows of no reasonable explanation for the transaction after examining the available facts, including the background and possible purpose of the transaction.

There are several precursors to identify potential suspicious activity and while the existence of a single indicator does not necessarily warrant raising the flag it should however warrant further monitoring & examination. Usually it is the existence of multiple indicators that raises a suspicion of potential criminal activity prompting a response to the situation; such practices should be discouraged if a fiasco in transaction monitoring process is to be avoided.

According to the prevailing best practices, the genesis of a routine suspicious transaction can possibly be traced in any of the following categories:

- **Cash Transactions.** Unusually large cash payments in circumstances where payment would normally be made by cheque, bank draft, etc., soiled notes and/or small denominations, cash deposits followed by further transfer of funds to other person on the same or next day.
- **Customer Profile.** It covers factors such as size or frequency of the transaction(s) that is inconsistent with the normal activities of the customer, the goods/currencies purchased, and/or the payment arrangements are inconsistent with normal practice for the type of business concerned, customer's address is a post office box or C/O a third party.

“The existence of multiple indicators that raises a suspicion of potential criminal activity prompting a response to the situation.”

- **Customer Behaviour.** This may include situations when the customer is unwilling to provide details of identity and references, customer needs information on what has been deposited in the account before a large cash withdrawal or transfer to abroad, use of false identity documents to send money.
- **Transaction Surveillance.** The transaction may involve unnecessary complexity, use of front men and/or shell companies, transactions in a series structured just below the regulatory threshold for due diligence identity checks.

The examples given above are just for citation purpose; within each category numerous transaction scenarios are possible depending on the type and location of a business. Nature and frequency of suspicious transactions are often reflective of local financial and regulatory framework as well as business culture; hence Red flag indicators may vary from location to location.

For the sake of effective monitoring the red flag mechanism should be defined keeping in view the business realities, for instance, in wholesale vegetable markets it is likely that almost all transactions are cash-based, so allowances in such situations must be given in transaction evaluation. Needless to say, business dynamics must be properly understood before raising a Red flag.

Responding to the ever-growing challenges faced by country's financial system, State bank of Pakistan have recently revised the existing regulations M-1 to M-5 of Prudential Regulations on Corporate/ Commercial Banking (BPRD circular # 02 dated September 13, 2012) to bring the same in line with Basel Core Principles, Recommendations of the Financial Action Task Force and other AML/CFT standards.

For ready reference, annexure II of the circular contains examples of possible suspicious transactions which are divided into following four categories.

“For the sake of effective monitoring the red flag mechanism should be defined keeping in view the business realities, for instance, in wholesale vegetable markets it is likely that almost all transactions are cash-based, so allowances in such situations must be given.”

- Transactions which do not make economic sense or inconsistent with customer's business or profile.
- Transactions involving large amounts of cash.
- Transactions involving locations of concern & wire transfers.
- Transactions involving unidentified parties.

(For details refer Annexure- II of the said circular)

It is widely acknowledged that the on-going crusade against financial crime network has helped the global financial watch-dogs tighten the noose around the criminals; however the fight against money laundering and terrorism financing is a long-haul battle which is not likely to be over any time soon, it is nightmarish to imagine the plight of global financial systems if the existing AML / CFT regulations were not in place.

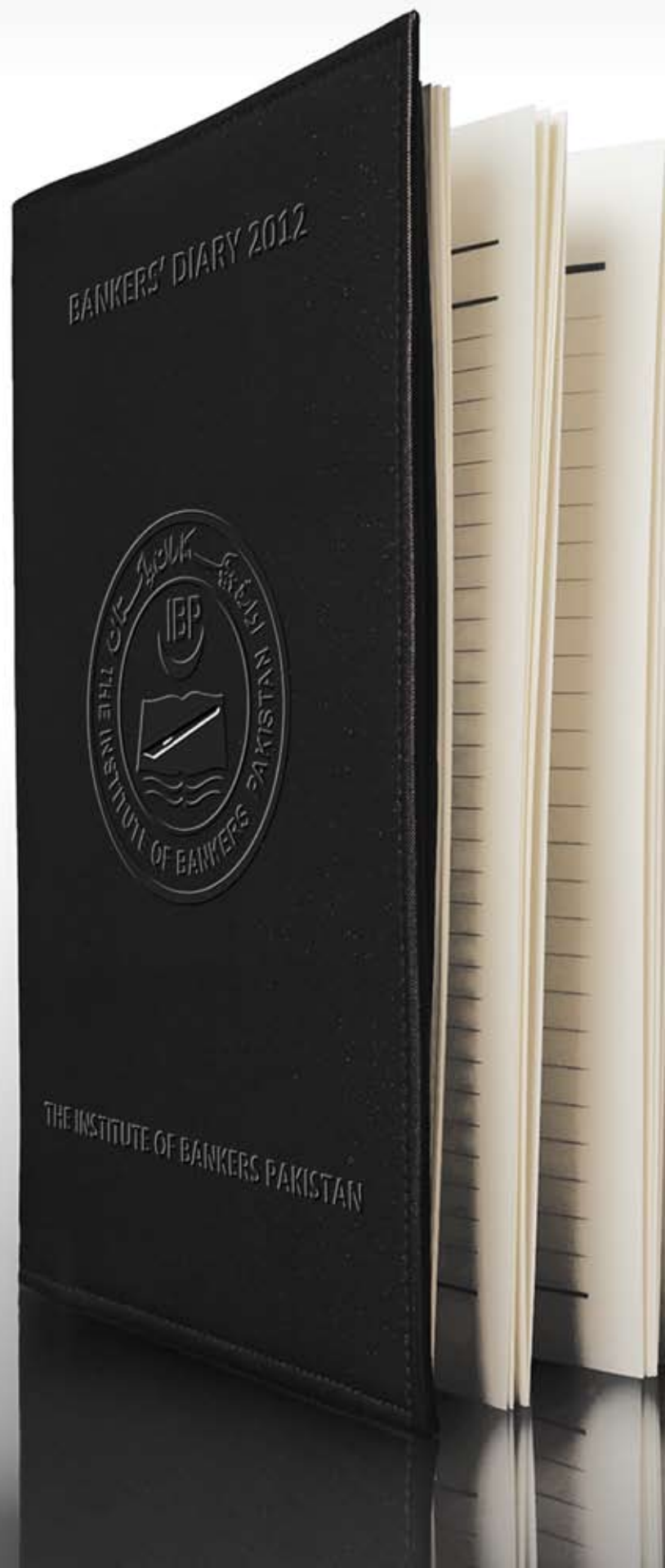


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*Some one struck Zoyd a hard blow from behind. He was about to retaliate,*

*When his assailant cried, 'Let me ask you a question: first answer it, then strike me.*

*I struck the nape of your neck, and there was the sound of a slap. Now I ask you in a friendly way -*

*"Was the sound caused by my hand or by your neck, O pride of the nobel?" "*

*Zoyd said, 'The pain I am suffering leaves me no time to reflect on this problem.*

*Ponder it yourself: he who feels the pain cannot think of things like this.'*

*Rumi*



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► The process by which banks create money is so simple that the mind is repelled. **John Kenneth Galbraith**

► Business is the art of extracting money from another man's pocket without resorting to violence. **Max Amsterdam**

► Money is the opposite of the weather. Nobody talks about it, but everybody does something about it. **Rebecca Johnson**

► Money can't buy friends, but it can get you a better class of enemies. **Spike Milligan**

► The pen is mightier than the sword, but no match for the accountant. **Jonathan Glancey**

## Interesting Quotes

► Whenever you find yourself on the side of the majority, it is time to pause and reflect - **Mark Twain**

► We are what we pretend to be, so we must be careful about what we pretend to be - **Kurt Vonnegut**

► Success is not final, failure is not fatal: it is the courage to continue that counts - **Winston Churchill**

► Have no fear of perfection - you'll never reach it - **Salvador Dali**

► Be yourself ; everyone else is already taken - **Oscar Wilde**





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*"We ... in general and youngmen in particular do not know the value of money. A paisa saved today is two paisa tomorrow, four paisa after that and so on and so forth. Because of our addiction to living beyond means and borrowing money we lost our sovereignty over this Sub-continent."*

**Mohammad Ali Jinnah**  
**Founder of Pakistan**  
(Ziarat, 1948)



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