

Middle East

# Point of View

Published by  
Deloitte & Touche (M.E.)  
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thought leaders  
across the region.

Winter 2012

## All about the money



**There's no more money here...**  
The future of securitization

**...but there's plenty here!**  
Impact of money laundering

**Surfing the waves**  
Making sense of social data

**Your house, your rules**  
Internal audit options

**Deloitte.**

 Eighty five years  
in the Middle East

Winter 2012  
Middle East Point of View  
Published by Deloitte & Touche (M.E.)

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Having it, losing it, making it, saving it, borrowing it, lending it, spending it or even laundering it, these days “it’s all ‘bout the money” as Meja\* said.

Not that money had not always been important, but as the financial crisis bares its claws and whole countries face financial ruin, the issue of money seems to permeate our very essence of being, crawling across every newspaper page and jumping out of every television screen and over all the radio waves.

Money is certainly a central theme in this issue of the *Middle East Point of View*. On borrowing it, Musa Ramahi, Audit principal at Deloitte says, on the issue of securitization in the region, “With credit rating cuts causing spikes in credit default swaps and, ultimately, the increased cost of secured and unsecured borrowing, finding new sources of funding - or reviving old ones - has become a priority.” Mr. Ramahi argues for longer-term securities as an alternative to short-term borrowings to manage liquidity risk and stimulate the economy.

On laundering it, Nada Maalouf, Audit partner at Deloitte, discusses the risks associated with money laundering in the Middle East region and the banks’ failure to comply with anti-money laundering regulations. This issue is all the more pertinent today in view of the rapidly changing Arab political landscape and the financial sanctions imposed on governments, financial institutions and politically exposed persons. “With these financial institutions’ operations expanding globally,” notes Ms. Maalouf, “the repercussions of non-compliance with AML regulations and risk of financial sanctions is greater.”

On keeping it, David Stark, Middle East managing director of Restructuring Advisory Services at Deloitte, advises on removing the stigma associated with restructuring businesses in the Gulf, especially against the backdrop of changes in the approach of many banks in the region to lending. Restructuring, he says, should be viewed as a normal part of a business life cycle, the result of entrepreneurial risk-taking and should be embraced rather than shunned.

On making it, saving it, investing it and counting it, read the articles on making sense of social data, increasing local media revenue in a digital world, the growth of Islamic finance in Lebanon and sourcing options for Internal Audit services.

Of particular interest in this issue is an article on renewable energy taking bigger strides in the MENA region. “When encouraged and used effectively,” says Wissam Merhej, Audit principal at Deloitte, “clean sources of energy can contribute to a better preservation of our environment and even be cost-effective at times.” Saving money whilst saving the planet. Too good to be true? You decide, this is just our point of view.

\* Swedish artist, singer and songwriter.

#### **ME PoV editorial team**

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BATTERY LOW

SHAKE AGAIN  
TO TELL FUTURE

# The future of securitization - what, if any?

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Funding has become an increasingly worrying topic for banks as they themselves struggle to obtain senior secured funding at reasonable prices since the credit market dislocation. With credit rating cuts causing spikes in credit default swaps and, ultimately, the increased cost of secured and unsecured borrowing, finding new sources of funding - or reviving old ones - has become a priority.

With the start of the global credit crisis in mid-2007 that was followed by the banking sector liquidity crisis, market appetite for structured products, including Asset-Backed Securities (ABS), decreased until it almost disappeared in certain parts of the world. In the Middle East and other developing markets, securitization was one of the victims of the financial crisis. Securitization of assets was still immature in the Middle East region when the whole financial recession started, which led to this type of structured product to source funds at lower costs being the first of financial market products to fade away.

But is this demise unfair? Investors sometimes wonder what truly started the credit crisis: was it the inherent complexity of securitization, which limited investors' ability to monitor risk, or was it the many other vital factors such as the underestimation of risk undertaken by the investors, over-reliance on rating agencies, lack of data transparency, undue trust in mathematical models shadowing aggressive decisions taken by the some of the leading financial institutions?

Given the benefits of the securitization, which started a few decades ago, one can only conclude that the securitization market is a good mechanism to source low-priced funds and manage liquidity should the market participants overcome its associated challenges.

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**Given the benefits of the securitization, which started a few decades ago, one can only conclude that the securitization market is a good mechanism to source low-priced funds and manage liquidity**

### **Why securitize?**

Among all the available sources of funds to financial institutions, such as customer deposits, money markets, secured/unsecured capital markets bonds and raising capital, low-priced secured borrowing through ABS and covered bonds is always deemed favorable for both, the borrower - in terms of minimizing cost of funding and reducing liquidity risk - and the investor - in terms of achieving reasonably good returns for secured investments with senior rating.

One case in point: during the global financial crisis in 2009 - 2010, when investors' appetite for securitized products had deteriorated, the governments of larger economies bailed out some of the larger financial institutions through the acceptance to buy securitized issuance, where the underlying packaged assets met a defined criteria stipulated by the central banks.

### **Benefits of securitization for the Middle East region**

#### **Lower cost of funding with lower funding risk**

As a result of the recent liquidity pressures in the euro-zone and the Arab spring leading to political uncertainties, credit growth is expected to be limited in the Middle East in 2012, which will affect certain industry sectors such as real estate. Financial institutions will therefore continue to focus on reducing their funding cost, improving liquidity and increasing asset quality very cautiously in order to maintain profitability at high and consistent levels.

Although the banking sector in the Middle East, and particularly in the United Arab Emirates (UAE), is very well capitalized and most banks' capital adequacy ratios are well above the level required by Basel II, it has been noted that these banks' long-term loans and advances are predominantly funded by short-term borrowings



such as customer deposits and money market products, as these are better priced compared to the capital markets. However, this strategy is expected to ultimately add more pressure on the banks' liquidity management in the long run.

According to a Standard & Poor's (S&P) report published in November 2011, "the large amount of regional debt maturing between 2012 and 2014 will add to the refinancing risk facing issuers in the Gulf Cooperation Council (GCC) countries. Industry experts estimate bonds and 'sukuk' of about USD 25 billion will mature in 2012, rising to about USD 35 billion in 2014."

Taking all that into consideration, banks may need to recapitalize their balance sheet, changing their funding strategy of reliance on short-term borrowing to fund longer-term assets, in order to reduce their funding mismatch. One of the possible solutions to secure funding at a low cost, manage liquidity risk and ultimately improve profitability, could be long-term securitized issuance, which is a good alternative until unsecured borrowing from capital markets comes back at an attractive and reasonable cost.

#### **Stimulating the economy and real estate market**

To stimulate the economy, there has to be an increase in loans originated by financial institutions in the market, whence funds from such loans will be deployed in the local economy such as the real estate market and other weakening industry sectors.

As regards real estate lending products, banks are still charging considerably high interest rates and demanding higher deposits in order to reduce their funding risk (i.e. in the UAE, banks are requesting loan to value ratios of 80%). This has resulted in a very slow rate of loan originations, in particular mortgages

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## To stimulate the economy, there has to be an increase in loans originated by financial institutions in the market

origination, over the past couple of years, leading ultimately to lower demand in the real estate market and an ongoing decrease in property prices.

With banks shifting back to capital markets and secured borrowing, such as ABS and covered bonds, they will deleverage their balance sheets, improve their maturity profile, reduce their credit exposures and free up some cash for additional lending, which will eventually improve the economy, including the real estate market.

#### **No such thing as a free lunch**

The question that begs itself is: if securitization comes with all the benefits listed above, then why aren't we seeing any securitized issuances taking place in our market?

#### **Global development**

Many investors still consider securitization as a tainted product. Only those global originators that are able to sell a strong core competency and brand have consistently been able to successfully place new issuances.

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## The question that begs itself is: if securitization comes with all the benefits listed above, then why aren't we seeing any securitized issuances taking place in our market?

Critics have suggested that the complexity inherent in securitization can limit investors' ability to monitor risk and that competitive securitization markets with multiple securitizers may be particularly prone to sharp declines in underwriting standards.

In recent global securitization conferences, market participants have also been discussing the need for simple transaction structures and granular portfolios to revive investor interest in securitizations. Despite a strong desire for more detailed transaction information by market participants, there is an opposing view that too much information could be overwhelming, with small investors potentially struggling to accept it.

Since the start of 2011, the market has diverted to the issuance of covered bonds as opposed to Asset Backed Securities. With covered bonds data transparency has become less of a worry to investors, as covered bonds are considered a liability to the issuer. The investor has recourse to both, the pool of packaged loans and the issuer to recover his investment, resulting in credit risk being much less and in this type of structured products becoming more popular.

### **Market maturity and operational readiness**

The revival of securitization in the Middle East poses even greater challenges than in more developed and mature markets. The concept of securitization in the UAE market was still new at the onset of the global financial crisis. As a result, investors' and issuers' awareness of the associated risks was still not up to par, leaving all local market participants very reluctant to enter into this vague type of structured product.

Furthermore, securitization structures require ongoing operational support by various service providers normally independent of the originators, such as trustees, fund managers and servicers, in order to manage the vehicle's cash waterfall calculation, cash management, custody of collateral held and managing the investor reporting process. With the securitization process still immature in our market and the limited exposure of our local service providers, the cost associated with these services has become too expensive, as most entities seeking to securitize their assets would need to source these services from expensive international providers.

### **Data transparency**

The absence of investors' required market data, such as loans delinquency level, details of the asset vintage, weighted average life of assets and collateral values, renders the quality of data below the required level of information available in mature markets. That results in higher challenges for the rating agencies to assess the associated risk appropriately and to the central bank to approve such issuances. As a result, investors will eventually lose confidence in the market and will have no appetite to invest in Asset-Backed Securities.

### Real estate market

Considering the high level of delinquent mortgages – resulting from the significant decline in demand over the past three years in the UAE real estate market and the current political unrest in the region – it is unclear whether further deterioration in property prices is yet to come. This of course leaves the current portfolio of mortgages carried by financial institutions in the region ineligible for packaging in a solid mortgage-backed securities issuance at a price that would be agreeable to investors.

### The future, or not?

Despite the positive attributes of securitization, these might still be outweighed by several challenges in the Middle East.

While some of the challenges can still be dealt with – securitized/covered bond issuers can still opt for safer asset types with more transparent market information such as auto-loans, credit cards, energy or telecom accounts receivables – there are persistent external challenges to deal with such as market immaturity and readiness, an unstable political situation and limited growth in the economy. All that will result in prolonging the recovery of the securitization market in the Middle East.

Prior to working on regaining investor interest in securitized assets or covered bonds, external challenges should be resolved and more transparent data should be made available by the originators. Without resolving these challenges, the concept of securitization will continue to fade away.

by **Musa Ramahi**, Audit principal, Deloitte in the Middle East

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#### What is securitization?

The securitization of assets is a feasible way to fund medium- to long-term assets through the issuance of secured medium to long term bonds (Asset Backed Securities or ABS) at a lower cost and still have longer maturity periods than other common funding sources such as money market borrowings and short-term deposits.

This mechanism is achieved through the pooling of diverse types of contractual debt with similar characteristics such as residential mortgages, commercial mortgages, auto loans or credit card debt obligations and funding it through the issuance of consolidated tranches of debt as bonds, pass-through securities, or collateralized mortgage obligations (CMOs), to various investors attracted by significantly reduced credit risk associated with these assets.



# Bridging the Gulf

Restructuring approaches in  
the Middle East... and what  
they mean to you

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There has been a significant amount of restructuring activity in the Gulf recently, accompanied by a change in the approach of many local banks to lending. Against this backdrop, a number of differences have emerged in the approaches to, and results from, restructuring processes in Europe and the Middle East.

Europe has been through many cycles of boom and bust and the approach to restructuring has been developed and augmented over time, both in terms of the mindset of stakeholders – both companies and banks – and in terms of legal frameworks. Restructuring is viewed as a normal part of a business life cycle, the result of entrepreneurial risk-taking. It is without stigma and is not necessarily seen as the ‘fault’ of management.

In the Middle East, the idea of restructuring is fairly new. The phenomenal growth in the local economies over the past few years has introduced businesses – and sometimes governments – to the major international debt markets and that has brought with it exposure to global macroeconomic trends. The most recent global financial crisis signaled the first instance that many businesses and lenders in the region have had to face up to the idea that their businesses may not keep growing and that their debts may not be repaid in full and on time.

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**Restructuring is viewed as a normal part of a business life cycle, the result of entrepreneurial risk-taking. It is without stigma and is not necessarily seen as the ‘fault’ of management**

With respect to the legal frameworks, many Middle Eastern jurisdictions had not previously considered the possibility that businesses would fail, or be unable to repay debts, meaning that the appropriate legislative frameworks had not, until recently, been put in place. This leads to an uncertain environment for banks with regards to their contingency and enforcement options, should consensual discussions with a struggling business not bear fruit.

The environment for restructuring in the region is less mature than it is in Europe and the United States, for example, where the Insolvency Act in the U.K. and Chapter 11 in the U.S. are well-established covenants that offer a degree of comfort that a predictable legal outcome can be expected. Comfort in the lender’s security position gives them and the company a base from which to negotiate.

#### **Lessons to learn from recent restructurings**

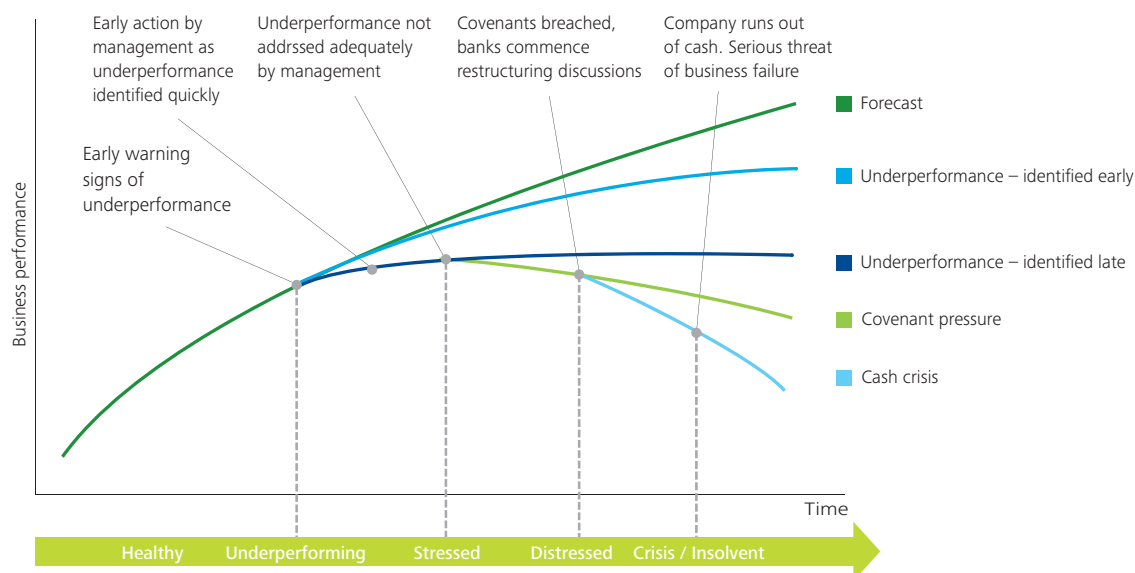
A key lesson learnt so far from restructuring activity around the region is certainly the need to act early. Companies and/or lenders can be in a state of denial about the situation their businesses face and as a result choose not to act until it’s too late.

A case in point is Dubai World, which, in November 2009, caused shockwaves throughout the financial world with the surprise announcement that it could not pay the Nakheel Sukuk amortization of \$3.5bn due in December 2009. Aidan Birkett, ex-head of Deloitte U.K. Corporate Finance, was immediately appointed as Chief Restructuring Officer (CRO) for the group, however, there remained insufficient time to pull together the crisis management plan required. The announcement was a revelation to the lending and led to a collapse of confidence in the region.

The importance of anticipating where and when problems may arise, preparing for restructuring and communicating with the lenders cannot be overstated. The primary focus should be having a robust and

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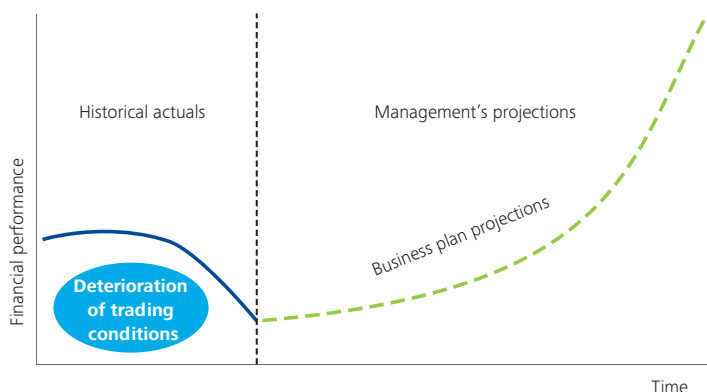
sensible business plan, supported by a proper set of processes and systems in the business. It is key to adequately forecast cash flow and covenant compliance to be able to foresee any problems with plenty of time to react appropriately. The mantra in restructuring: cash is king.



Restructuring is usually required where the continued underperformance of a once healthy business leads to a fall in shareholder value and severe and sustained pressure on debt covenants and liquidity that creates a fundamental uncertainty as to the future of a business.

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### The importance of getting the business plan right

Lenders can tell immediately when a business plan is not well thought through, achievable, or sufficiently detailed, portraying the management as lacking in credibility. Lenders may, as a result, opt out of supporting that given business. An ill-thought out business plan changes the banks' approach to any negotiations and may impair their view of the management team.

One of the main considerations in a business plan is its feasibility. There is little credibility in a business that is seen to struggle in a declining market that is showing no signs of recovery while predicting double-digit growth for the next few years, especially if this is what is required to deliver full repayment of the debt. Lenders will not be keen to refinance a clearly unachievable plan, unless it is to improve their security position when they do finally enforce over the business.

It is of course necessary to strike a balance. If a business plan shows no ambition or growth, it is unlikely to gain favor from a bank. Banks look for a combination of growth and realism, ambition and pragmatism. This may often lead to a business having two business plans – a 'banking' case and an 'equity' case. The first would be fairly prudent and something that a business will happily set covenants against, whereas the second would be used for different reasons, such as incentivizing management.



Something else to remember about the business plan is that it cannot be just a financial model, compiled once during the refinancing process, then locked away in a cupboard. It must be updated and revised on a periodic basis. It is also vital that a suitable management structure is put in place. This management team must then develop a plan that activates the financial model and sets a clear path to achieving the financials through day-to-day actions. Finally, the management team must be able to adequately measure performance against the plan through management and financial reporting of both forward - and backward - looking key performance indicators.

#### Conclusions

It is vital not to attach a stigma to restructuring. It can be a perfectly normal course of business for healthy companies in struggling markets, or for those saddled by their owners with inappropriate capital structures. Ignoring the problem will inevitably create another and result in a worse outcome.

Prior to this, it is necessary to know if trouble is coming your way, so having a robust and regular business planning and forecasting process in place is key.

When it comes to communications with lenders, corporates will do well to recognize that there is a move away from the previous standard of lending based on name, with numerous bilateral facilities. In distressed situations it may be the case that a business faces a collective group of lenders rather than individual lenders and may not be dealing with their previous relationship manager. A robust, measured approach to negotiations must therefore be adopted involving significant preparation.

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## To enhance business value and ensure continuity, a sustainable focus on rectifying internal business performance, rather than relying on friendly banks, is crucial

It is clear that the type of restructuring solutions reached in the region will continue to develop. The 'extend and pretend' answers that we've seen in the past, where the terms of facilities are simply lengthened, will no longer address the key problems many businesses face, nor will they necessarily offer the best solution. To enhance business value and ensure continuity, a sustainable focus on rectifying internal business performance, rather than relying on friendly banks, is crucial.

by **David Stark**, managing director, Restructuring Advisory Services, Deloitte Corporate Finance Limited



# When white is too white

Money laundering, financial sanctions  
and their impact on financial institutions



**Money laundering and financial sanctions**

As money laundering schemes become more complex and sophisticated and the volume of such schemes continues to amplify, financial institutions are increasingly faced first, with the risks associated with money laundering, second, with the need to comply with anti-money laundering (AML) regulations imposed by regulatory bodies and governments across the globe and ultimately, with the risk of becoming a sanctioned entity as a result of suspected intentional participation, or unintentional facilitation of money laundering. The risks that financial institutions are facing, especially those operating in the Middle East and North Africa region (MENA), have intensified as financial sanctions are imposed on governments, financial institutions and individuals across the region, especially politically exposed persons (PEPs).

Financial institutions are particularly aware of, and are focusing on, the need for the adequate evaluation of risk of exposure to PEPs, especially in the wake of recent events and developments across the Arab world and increase in the number of firms, PEPs and governments even, that have been subject to sanctions by global authorities.

Financial institutions are now required to exercise more scrutiny over transactions made by PEPs and to assess and consider their own ability to verify the sources of funds that flow into their accounts because in many instances, these have become sanctioned parties by global authorities, sometimes overnight.

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## With these financial institutions' operations expanding globally, the repercussions of non-compliance with AML regulations and risk of financial sanctions is greater

With these financial institutions' operations expanding globally, the repercussions of non-compliance with AML regulations and risk of financial sanctions is greater – their need for continuous assessment of changes in the political and economic environment is hence crucial.

### **Impact of non-compliance**

Failure to comply with AML laws and regulations and breaches of financial sanctions can have serious consequences: punitive fines, criminal proceedings, damaged reputations and sanctioning – all crystal clear motivations to justify efforts of compliance.

All the consequences listed above can lead to serious damage to a financial institution's credibility and performance. Becoming a sanctioned party due to breaches of financial sanctions can be even more damaging.

Becoming sanctioned by one or more global bodies considerably reduces, if not halts, a financial institution's ability to provide for and cater to its international customers' needs for performing global transactions. Notwithstanding that financial sanctioning, which includes the freezing of assets by counterparties, will result in tremendous pressure on the sanctioned financial institution's liquidity.

The above consequences could and have, in some instances, led to a sanctioned financial institution's complete inability to continue operations and therefore, its demise as a viable ongoing concern.

### **Mitigating responses**

Faced with evolving and increasing AML laws and regulations and financial sanctions that impose stringent compliance requirements and impose severe repercussions in instances of non-compliance, financial institutions are increasingly aware of the need for further substantial investment in systems and human capital to assess, manage and mitigate the perils of non-compliance, whether due to intentional staff breaches, error, or a breakdown in the systems and processes implemented.

### **Investment in systems and processes**

The need to consider the solutions available, whether moving towards a single platform approach, outsourcing, or upgrading and developing the existing systems to satisfy anti-money laundering and financial sanctions needs is a major concern for senior management. These need to assess the risks and advantages of each of the available solutions and need to ensure that adequate controls and reviews are in place over the systems implemented, irrespective of the solution adopted, as responsibility for compliance with AML regulations and financial sanctions lies, ultimately, on the management, whether compliance is undertaken internally or outsourced.

In addition to investing in compliance systems and processes, financial institutions are under pressure to increase their investment in systems and resources to enable timely and adequate assessment of the impact on operations, profitability and financial position of financial sanctions being imposed on neighboring governments and other financial institutions. Financial institutions are now also investing in developing

strategies to deal with the difficulties and effects of the changes in the business environment to respond to the restrictions imposed on transacting with sanctioned parties.

**Investment in human capital**

Financial institutions need to ensure that their staff possess the appropriate knowledge, competencies, awareness and understanding of anti-money laundering regulations and financial sanctions, especially staff charged with developing and implementing compliance systems, processes and controls and internal audit staff. Spending on staff training is continuously growing as financial institutions become aware of the consequences of non-compliance arising from staff error or ignorance of procedures.

**Senior management responsibility**

Ensuring that effective and consistent systems and controls operate across the organization and that adequate resources are allocated is a crucial senior management responsibility. Senior management commitment is required to ensure that policies and procedures are developed to address money laundering issues and financial sanctions and compliance with applicable and related regulations.

Management has taken a risk-based approach towards anti-money laundering compliance and financial sanctions breaches. Without understanding the regulations and the anti-money laundering regulations and financial sanctions regimes, risk assessments undertaken by financial institutions are likely to be inaccurate and consequently, systems and controls put in place to prevent non-compliance might not be effective or efficient.

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## The above consequences could and have, in some instances, led to a sanctioned financial institution's complete inability to continue operations

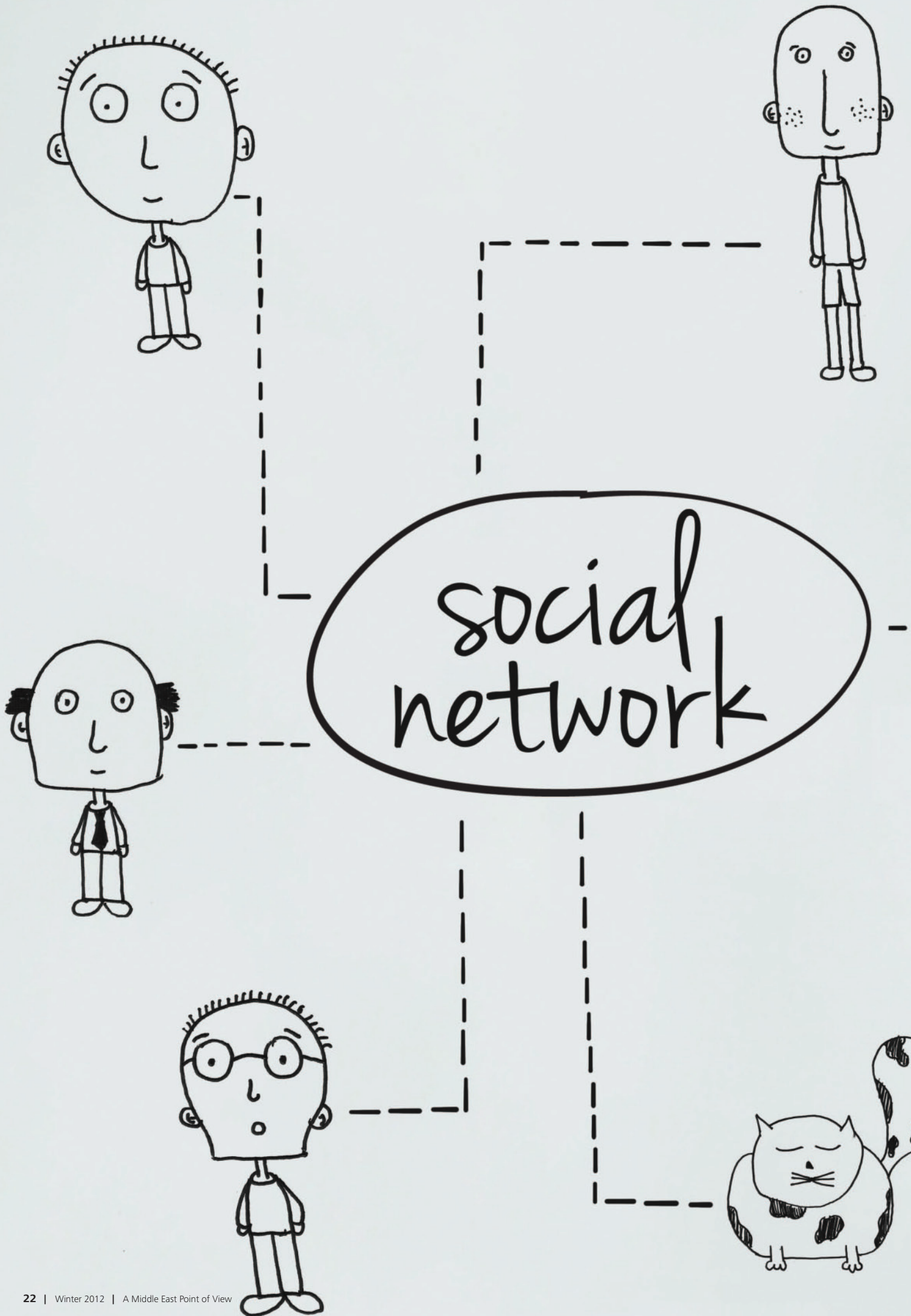
**Conclusion**


Risks associated with non-compliance with anti-money laundering laws and regulations and how to deal with financial sanctions imposed by global bodies and risks associated with ensuring compliance with them should be high on the agendas of board of directors, executive management and risk committees at financial institutions, especially those operating in the MENA region.

Financial institutions have to be increasingly proactive and vigilant in their daily operations and transactions to deal with the conflicting and overlapping sanctions regimes in addition to continuous efforts to comply with anti-money laundering regulations. Regular risk assessment reviews are a priority for financial institutions that are striving to maintain operationally effective systems.


by **Nada Maalouf**, Audit partner, Deloitte in the Middle East



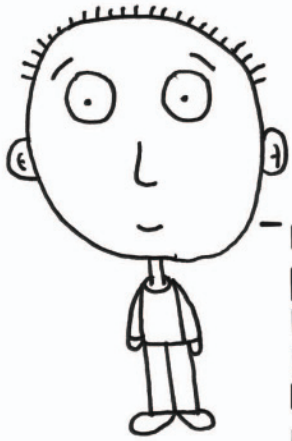




# Making sense of social data



In 2010, Google's Eric Schmidt said: "I don't believe society understands what happens when everything is available, knowable and recorded by everyone all the time."<sup>1</sup> He was referring to the fact that in the digital world, data is everywhere. We create it constantly, often without our knowledge or permission and with the bytes we leave behind, we leak information about our actions, whereabouts and characteristics.



This revolution in sensemaking – in deriving value from data – is having a profound and disruptive effect on everything from supply chains to corporate strategy. In particular, it is generally forcing executives to rethink how they understand, reach and even influence their customers. Simply put, with so much data available, especially on social networks, the ability to know the people you sell to and to monetize that knowledge has never been greater.

That said, most companies are only beginning to scratch the surface of what's possible with social data. Many are still operating in the pre-social media age, simply trying to make sense of the data they have – rather than the variety of sources that exist. But even those that are best-of-breed have only started to tap into the true potential of this information: developing an intimate and real-time knowledge of customers' relationships and behavior.

Whole new opportunities are available with these kinds of insights in hand. Banks can evaluate loan applicants based on the creditworthiness of others in their social network, the notion being that people who pay off their loans tend to group together. Telecoms can find their most influential customers – those who might switch providers and take a number of friends with them – and target them for early upgrades or deals. Even human resource departments can benefit, by understanding

which applicants are most connected, or even most passionate, in a given field. The data points have typically been limited only by technology's ability to capture and store them, a constraint that is rapidly fading away.

Still, very few companies are able to act on this kind of information, let alone accumulate it. However, as we will explore, what it takes goes beyond just an analytics solution.

### Three waves

Customer analytics is hardly news to most executives; organizations have been gradually embracing it over the last 20 years. Amazon.com was an early leader in this space, for instance, pioneering the art of using buyer behavior to personalize its site. For Amazon.com, no click goes unnoticed. Its model of the customer has very little to do with your name, age and address, and everything to do with what the company has been able to learn about you by studying your data trails.

But even some organizations that long predate the digital age are masters at analysis. Credit card issuers, for instance, have for decades used data to predict everything from spending patterns to risky behavior. Continental Airlines, which was founded in 1934 and recently merged with United, is another example. For its most profitable customers, the company tracks every kind of "flight disruption" that might lead them to switch carriers. Whenever one of them is delayed, or if the airline loses their bag, cabin crews are automatically alerted the next time they fly.<sup>2</sup>

These examples highlight what we think of as the first of three waves playing out in the space of big data. In this wave, organizations can tap an incredible amount of information – purchasing histories, demographics, measures of engagement – that make customer targeting more feasible. They can use everything from clicks and flights to credit card transactions, made on and off the Web. The key feature of this wave, however, is that the data inside it are not social – they are drawn

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There is certainly still a place for snapshot-style data, like surveys or market research, but when it comes to deeply understanding customers, the edge will likely go to those who do it in real-time



from closed or proprietary mechanisms instead of what is often stored openly on the Internet. More importantly, because these data aren't social, they lack a broader context about the relationships and behaviors of the people creating them.

The second wave gets closer to adding that color and came about with the rise of social media. As Andreas Weigend, the former chief scientist at Amazon.com explains: "Users started to actively contribute explicit data such as information about themselves, their friends or about the items they purchased. These data went far beyond the click-and-search data that characterized the first decade of the Web." Rather, they provided specific new insight into customers by putting their decisions in a social and personal context.<sup>3</sup>

Twitter, Facebook and LinkedIn are familiar platforms in this wave. Broadly speaking, their data are valuable because they tap into the voice of the consumer, telling us things like who they know and what they like. For companies looking to target ads or customize their products, this information can be incredibly powerful.

It can also drive new forms of digital listening. Many organizations, for example, are starting to build social media "command centers" to take in social data and react to them in real-time. Gatorade is one such example. Inside their mission control room, a team of five people use sophisticated sentiment analysis software to monitor and shape Internet conversations as they take place.<sup>4</sup>

However, the voice of the customer is by and large explicit. It is all tell, no show. If you have a Facebook account, for example, and visit NYTimes.com, you can see articles recommended to you by your friends. But few news sites, if any, actually analyze your behavior – or that of your network – to suggest content that is entirely new.

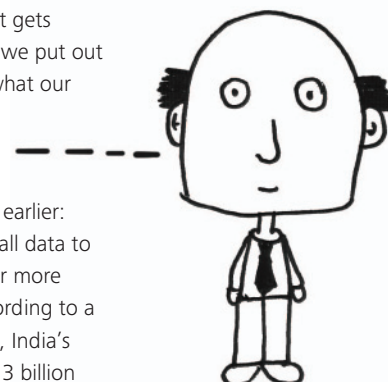
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## Twitter, Facebook and LinkedIn data are valuable because they tap into the voice of the consumer, telling us things like who they know and what they like

In fact, this kind of implicit analysis of social data is only beginning to emerge – and constitutes what we see as the third and most powerful wave of data analytics. In this wave, the focus shifts from the voice of the customer to the individual's behavior. But more importantly, it looks at that behavior in the context of who is around them and how they interact. It gets below the curated, surface-level information we put out about ourselves online, to help understand what our digital trails and network really say about us.

Early examples of this can be found in large organizations, to be sure. We alluded to one earlier: several telecommunications companies use call data to find influential customers and target them for more effective plan upgrades or special deals. According to a recent article in *The Economist*, "Bharti Airtel, India's biggest mobile operator, which handles over 3 billion calls a day, has greatly reduced customer defections by deploying [social network analysis] software ... [and] IBM, the supplier of the system used by Bharti Airtel, says its annual sales of such software, now growing at double-digit rates, will exceed USD 15 billion by 2015."<sup>5</sup>

However, many of the most interesting examples of this third wave are coming from the edge: startups in Silicon Valley; labs at the Massachusetts Institute of Technology (MIT). These players are exploring powerful new ways to help link data and identity – and in the process are redefining how companies can know and even influence who they sell to.



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## To lead beyond today, companies will likely have to develop a deep and real-time understanding of their customers through a variety of digital trails

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### The power of social data

Privacy concerns notwithstanding, these trends can be an extraordinary boon to consumers. The last decade saw the Web awash in a rapidly rising tide of information, leaving most people helpless to filter through mountains of unstructured data. Companies offered more products, advertisers pushed more messages and it simply became too difficult to manage. With social data, companies were given a powerful means to help cut through the clutter. Just as Netflix uses its Cinematch engine to find movies you might want to see, companies can personalize and tailor what they put in front of their customers – by using what they reveal about themselves online.

Partially enabling these trends is Facebook Connect, a technology that allows Facebook users to take their social networks with them around the Web. With Connect, outside developers can leverage your social data to build services and products around your social graph. Sony, for example, plans to use it to create personalized video games on the PlayStation 3 console. “We’ve pretty much opened up the entire Facebook API to our game developers,” said Eric Lempel, Sony Computer Entertainment’s vice president of Network Operations. “They’re able to pull any piece of information from Facebook, as well as push information



out to Facebook.”<sup>6</sup> With these kinds of flows, the next generation of games could very well have pictures of your friends or your tastes and interests built right in. Lempel envisions a future where “[a] music video game like Rock Band might know what music you’re a fan of on Facebook and customize your track list based on that.”

This kind of hyper-personalization gets more powerful as you start exploring the third wave. Companies like Media6Degrees, for example, are pioneering new forms of “social targeting” to help identify key influencers and focus on them for advertising campaigns. By honing in on individuals who are most likely to be receptive to messages from a brand – for instance, friends of existing customers – the company can deliver results that often outperform traditional demographic targeting. Recently, they raised an additional USD 20 million in funding and estimate that by tailoring ads based on your social graph they are two to 10 times more likely to get clicks.<sup>7</sup>

An important point about this third wave, however, is that it is hardly limited to data from social networks. In fact, some of the most compelling opportunities in social analytics lie far outside our relationships on Facebook.com. Instead, says Auren Hoffman, the CEO of Rampleaf, a leading data-mining company, “the next big data revolution will be around mobile. If you think about mobile devices as sensors, our phones know more about us than our partners do.”<sup>8</sup> In fact, they are one of the most common sensors in existence: there are already more than five billion mobile phones in use worldwide, with another billion on the way in 2012.<sup>9</sup>

More importantly, in the U.S. alone, mobiles create around 600 billion geospatially tagged transactions per day.<sup>10</sup> These data, properly harnessed, have the potential to provide a dynamic view of human behavior and activity, and dramatically augment our understanding of what takes place in the physical world.

One of the people doing this kind of analysis is Professor Alex (Sandy) Pentland of MIT. His work – which he calls Reality Mining – aims to understand and predict human behavior by combining real-time sensing of millions of mobile phones with advanced mathematical models. So far, he can predict things like what iPhone applications you are likely to buy and even describe a city's cohesion, attitudes and behaviors by studying mobile location trails.<sup>11</sup> At a recent technology conference, he demonstrated software that he described as 95 percent accurate at determining what company you worked for, simply by analyzing your interactions and patterns of movement.<sup>12</sup>

Others are starting to expand on Pentland's work, and their findings have profound implications for both consumers and data-driven firms. A company called Sense Networks, for example, was founded by a former student of his and has developed a proprietary methodology to help extrapolate a person's lifestyle – including their estimated age, their probability of being a business traveler, how wealthy they are, and where they might go next – all from their location trails. The app, called MacroSense, can do this even if you haven't told it anything explicit about yourself. Instead, it is based on the notion that people with similar movements tend to have similar interests and demographics. By comparing where you go against billions of data points on the movements of others, the company can segment out "social tribes" and offer highly targeted opportunities.<sup>13</sup>

In general, the power of geospatial analysis is increasingly apparent, even outside of the tech world. The U.S. Court of Appeals for the District of Columbia, for instance, recently wrote: "A person who knows all of another's travels can deduce whether he is a weekly churchgoer, a heavy drinker, a regular at the gym, an

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## It's not just about technology, it's about a fundamental shift into a new age of leadership with a new type of executives who behave and operate in new ways

unfaithful husband, an outpatient receiving medical treatment, an associate of particular individuals or political groups – and not just one such fact about a person, but all such facts."<sup>14</sup>

In this sense, perhaps the most important conclusion from this and the other examples in this section is that the universe of data we can draw upon to understand our customers is almost limitless. Social data needn't be from social networks, and social analytics is much bigger than just listening to chatter on Facebook. To lead beyond today, companies will likely have to develop a deep and real-time understanding of their customers through a variety of digital trails.



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## The next big data revolution will be around mobile. If you think about mobile devices as sensors, our phones know more about us than our partners do

### Unlocking analytics in your organization

How can you start to develop these insights within your own organization? How can you finely tune your offerings or ads based on the data your customers create? A first and overarching step is to realize that “it’s not just about technology,” says Marc Benioff, chairman and CEO of Salesforce.com. Rather, “it’s about a fundamental shift into a new age of leadership with a new type of executives who behave and operate in new ways.”

This means no bolt-on solutions; no one-time customer surveys. Instead, you have to connect that technology, and data analytics as a whole, very deeply into your operating model to begin to see real results from it.

It doesn’t take all the data in the world, however. With so much data available, from so many different sources, it may actually be possible to build a 360 degree view of the customer; but for most companies, 15 degrees will do. The real challenge is making sure that you have the right 15 degrees.

At the same time, in today’s hypercompetitive, fast-moving environment, what you know about your customers is constantly diminishing in value. As the half-life of information shrinks, it is critically important not only to find the right data, but to constantly refresh what data you have. This means designing active flows of information, rather than collecting passive stocks. There is certainly still a place for snapshot-style data in this environment, like surveys or market research, but when it comes to deeply understanding customers, the edge will likely go to those who do it in real time.

The next and most difficult step relates to Benioff’s point above: building an engine to run your business on these flows. It isn’t enough to simply collect and analyze data. After all, data are only as valuable as how they are applied. Instead, companies will need to figure out not just how to extract information about their customers, but how to structure their organizations to act on it in real time; how to customize offerings on the fly; how to respond quickly to changes in consumer behavior; how to intelligently manage privacy and risk; how to segment, price and market effectively, as new information comes in. In short, the way Netflix operates – as a dynamic product, different for everyone who uses it – may foreshadow how leading firms behave down the line.

Reaching this point isn’t easy, but for those who do, the rewards can be significant. When Netflix uses your data, for instance, it isn’t just tailoring what movies you see; it is shaping behavior writ large. By serving up titles you might like but wouldn’t think to search for, the company is actively pushing you away from movies that cost it the most to license. Instead, renters find themselves

watching fewer new releases and gradually expanding their tastes.<sup>15</sup> In this sense, Netflix's much lauded effort to cater to the individual can also add directly to its bottom line. As companies improve at making sense of behavior, the ability to shape it like this may emerge as a significant, if not key differentiator. What will set firms apart, however, is how well they are able to leverage the power of data in the second and third waves. With it, they can understand things like relationships and influence that are deeply important when trying to give consumers a nudge.

However, this doesn't mean companies should marginalize the first wave or skip over the second in order to get to the third. Far from it. Instead, we think each wave reinforces and is made more powerful by the last.

Companies can achieve better results by striking the right balance among the three. And like all things data, even this will need a tailored fit.

by **Doug Palmer**, principal with Deloitte Consulting LLP, **Vikram Mahidhar**, deputy leader of Innovation, Deloitte Services LP and **Dan Elbert**, consultant with Deloitte Consulting LLP.

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## What will set firms apart, however, is how well they are able to leverage the power of data in the second and third waves





**Digital world**

# The eyes have it

How to increase the value of  
local content in a digital world

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The regional media industry remains in a phase of development, especially when considering the impact of social media during the Arab Spring. While public and private organizations have undoubtedly come a long way in the development of more sustainable media/telecommunications systems, thanks to better funding, better training and significant infrastructure investment, stimulating the production and monetization of local content in the Arab world remains a key regional challenge.

### **Monetizing the local content**

Monetization on most media platforms is largely dependent on advertising, which is currently heavily undervalued in the region. Pay models also present big opportunities for further development.

### **Increasing the value of advertising**

Based on the number of estimates, including the Arab Media Outlook 2009-2013, the total advertising market in the Arab region<sup>1</sup> in 2011 is valued at around USD 5.5 billion.<sup>2</sup> While the region is expected to experience strong growth, benchmarking the regional market against international standards suggests that its value continues to remain relatively low. Going forward, growth in advertising should be led by a strong increase in 'digital' (online and mobile) advertising and, to a lesser extent, traditional platforms.

There are many issues around advertising in the region, but it is generally agreed that the lack of measurement systems, the technical hurdle for advertisers to target national viewers on Pan-Arab satellite TV and the limited transparency in the market have been overriding factors contributing to the low value of advertising by preventing platform owners from providing provable return on investment (ROI). Thus, digital platforms, which by their nature offer advertisers a more quantifiable ROI, have a very strong future in the media industry – perhaps more so in the Middle East

North Africa (MENA) region than in other markets where traditional platforms are able to provide clearer user/ viewer statistics. As such, digital technology could present an opportunity for some media sectors, which have not proven successful on traditional platforms in the region (e.g. music) to bypass those platforms altogether.

There is also the potential in the region to leapfrog onto the digital platform from analog. Since the MENA region never really experienced the lucrative benefits of the analog industry that were witnessed elsewhere, it has an opportunity to create a new business model on digital platforms. By focusing on the new areas of value in the market, such as live programming and digital content, MENA media organizations could pave the way for a strong digital future.

### **Increasing the value of pay-TV**

The low value of pay-TV in the Arab world is the result of low penetration levels, linked to the prevalence of piracy in the region. Pay-TV adoption in the MENA region is one of the lowest in the world, in both developed and emerging economies (5% penetration in MENA vs. 53% in the U.K., 91% in the U.S. and 14% in Brazil). Although industry players are taking action to overcome the obstacles – for example, the Orbit Showtime Network (OSN) recently upgraded its decoders to High Definition (HD) to enhance Set Top Bob (STB) piracy protection – there is still a long way to go. OSN is optimistic about the results of the initiative, expecting 25% growth in subscriptions in 2011.

In this context, it is clear that piracy continues to present a major obstacle in effectively monetizing content. Indeed, the pay-TV industry in the region is, in some markets such as Lebanon, a lucrative one, with very high levels of adoption, but the money is directed at the pockets of providers of pirated services, rather than legitimate commercial players.

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**Growth in advertising should be led by a strong increase in 'digital' (online and mobile) advertising and, to a lesser extent, traditional platforms**



In spite of the challenges, many new features have been introduced to the region, such as HD channels, Video-on-Demand (VOD) services and 3-D TV. These features are all expected to enhance the value of pay-TV over free television in the eyes of consumers and contribute to the growth of the industry. Telco players also have an important role to play in the pay-TV industry through their Internet Protocol TV platforms, supported by FTTx plans in various countries. By bundling pay-TV with other services, such as broadband and fixed telephone lines, pay-TV can become a more attractive package for consumers.

#### Revenue generation through digital platforms

There is a significant role that digital platforms and new technologies can play in the development and monetization of local content in the region.

#### High demand for digital content

The MENA region displays very strong demand potential for digital content. Indeed, the entry of major international players into the region, such as Yahoo!'s acquisition of regional player Maktoob, Google's increasing presence in the United Arab Emirates, Egypt and Saudi Arabia, or the acquisition of regional player Gonabit by Livingsocial, confirm the existence of significant opportunities in the market.

In terms of consumption, the region is showing some impressive fundamentals. Saudi Arabia, for instance, is one of the largest markets for YouTube playbacks on mobile worldwide. Recent research across four leading regional areas confirms that even before the Arab Spring, the usage of social media was already particularly high in the region, with nearly 70% of consumers in key Arab markets using social networking sites.

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## There is a significant role that digital platforms and new technologies can play in the development and monetization of local content in the region

Not only social media, but the wider digital space, offers plentiful opportunities for media players in the region to extend their existing content to new platforms and to develop new content for these platforms.

#### Opportunities for local players

The online world has historically, been fuelled by entrepreneurs in many international markets and the MENA region also boasts some examples of successful online start-ups. These success stories present a good opportunity to draw valuable lessons from the regional online market. Localizing the content as much as possible and having an open environment to operate in are two of the key success factors for the rise of successful online companies in the region.

Furthermore, online and mobile devices can provide new platforms for the exploitation of existing content owned by producers and broadcasters. Hulu in the U.S. is a case in point. The joint venture between NBC Universal, Fox and ABC is the most successful example of a collaborative online VOD concept, boasting nearly half a billion U.S. Dollars in revenues in 2011 as well as advertising revenues per TV series episodes higher than on American cable TV. Hulu has further grown its top-line by developing a hybrid 'freemium' model, with a mix of free and paid content, including a USD10 subscription, in order to maximize its returns on the site.

## There exists a strong debate over whether consumers in this region are indeed willing to pay for content and whether a 'Hulu-type' model could work

In the region, a number of media players, either start-ups or established players, are embracing the trend in online VOD as shown in the exhibit below.

In this context, there exists a strong debate over whether consumers in this region are indeed willing to pay for content and whether a 'Hulu-type' model could work. On one hand, there has always been a sense of entitlement to content, largely due to the abundance of piracy; on the other hand, there is an urgent need to find the right content that consumers will be willing to pay for – that is, providing a premium to the consumer that is worth the extra money. By this token, a 'freemium' model could work well in the region and the industry could benefit from players experimenting with this model further on digital platforms.

There is also support from regional government initiatives in providing funds for digital entrepreneurs, as for twofour54 and Ibtikar in the UAE, Oasis 500 in Jordan, and the digital cluster of iCTQATAR among others.

**Sample of regional online video offerings (partial list)**

Name	Language	Model	Genre	Ownership
Istikana	Arabic only	Free	Drama, cartoon, theatre, comedy, religion	Arab media network
Forga	Arabic only	Free	Movies, series, trailers, video clips	Active digital development
Shofha	Arabic and English	Paid	Movies, live TV, series	Linkeddott net, DVD quality
Shahid	Arabic only	Free	MBC content: movies, series, TV shows	MBC
Aljazeera	Arabic and English	Free	Live TV, news and sports broadcasts	Aljazeera
TE live: cinema	Arabic and English	Various	Movies and series	TE data

- Both rights owners and content aggregators are increasingly offering online video to consumers in the Middle East.
- Business models are so far mostly advertising-based, but if international trends are to be replicated, freemium models could soon be introduced.

Source: Informa, company websites, Deloitte

### The battle for mobile content revenues and possible cooperation models

The region is witnessing strong growth in mobile broadband. This is confirmed by the launch of the LTE standards commercial services in the region (UAE, KSA) and the increasing number of smartphones and now, tablets.

The adoption of these broadband mobile devices is accelerating the all-digital media consumption transformation. In fact, in mature markets today, users spend 50% more of their time browsing mobile broadband than reading newspapers. As mobile broadband penetration increases in the region, revenues from mobile content look set to rise.

In theory, with better devices, new services such as 'augmented reality' and the increasing penetration of mobile broadband, mobile advertising has the potential to grow substantially and become viable competition for advertising dollars. In practice however, the battle for funding digital content (both online and mobile) remains a tough one between rights owners and network providers. Telecom operators are urgently looking for broadcasters to partner with on digital content, as seen with the successful case of the Emirati telecoms company du and Eurosport on Eurosport Arabia. Most telco players currently lack the skills, not only to produce content themselves, but to market that content effectively. They have a strong need to partner with broadcasters and producers on digital content.

There is an increasing number of government-sponsored initiatives in the Arab market in this space, including AppsArabia of twofour54, Mobily Developer's Community in the KSA and Itida in Egypt.

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## There seems to be a strong opportunity for partnerships between content providers and telco operators, but it is not one without risk

Meanwhile, broadcasters feel that, given market conditions and the balance of power between themselves and the operators, they are in a difficult position to be taking risks to invest in digital content.

Although there are some strong differences in perspectives between various players in the value chain, there seems to be a strong opportunity for partnerships between content providers and telco operators, but it is not one without risk. If the region is to increase the revenues generated from mobile content and identify the best model for revenue sharing, it may require some initial 'experimentation' by innovative players, as has been seen in other markets.


by **Santino Saguto**, Telecommunications, Media and Technology (TMT) leader, Deloitte in the Middle East

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### Endnotes

1. Includes 15 key Arab markets (Bahrain, Egypt, Jordan, Kuwait, Lebanon, Morocco, Oman, Palestine, Qatar, Saudi Arabia, Sudan, Syria, Tunisia, UAE, Yemen) and pan-Arab advertising
2. All advertising figures represent net revenues after discounts and are based on a combination of external sources (e.g. Zenith Optimedia), industry interviews and internal analysis



A man in a light-colored shirt and dark suit jacket is running towards the right. He is carrying a black briefcase in his right hand. The background shows a modern building with many windows. The overall scene suggests a sense of urgency or a transition.

# Renewable energies: a reality, not just an idea

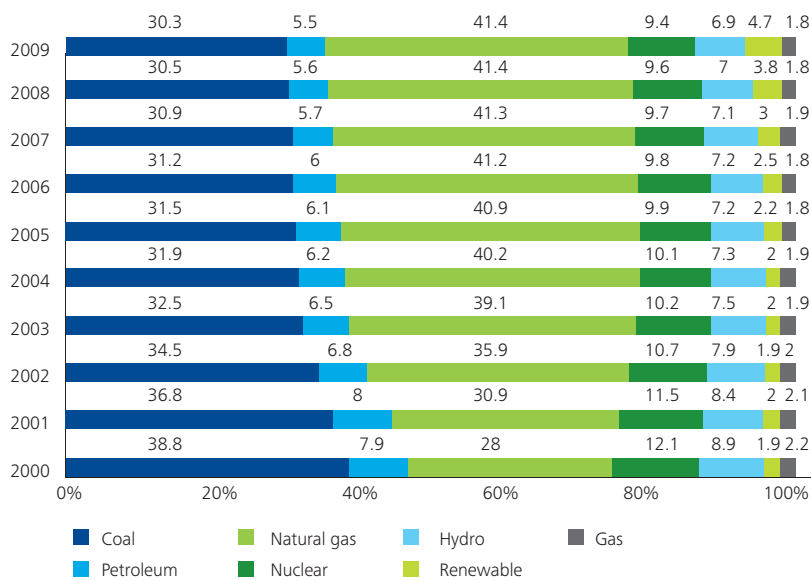
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Recent discoveries of oil and gas fields in areas deemed as unconventional - such as the Mediterranean coast for example - have added impetus to the energy sector. However, traditional energy resources remain both, depleting and polluting and new sources of power generation that already exist, must be further developed. Alternative energy sources such as nuclear and renewable energies are the two probable solutions to our increasing energy needs.

### Evolution of renewable energy

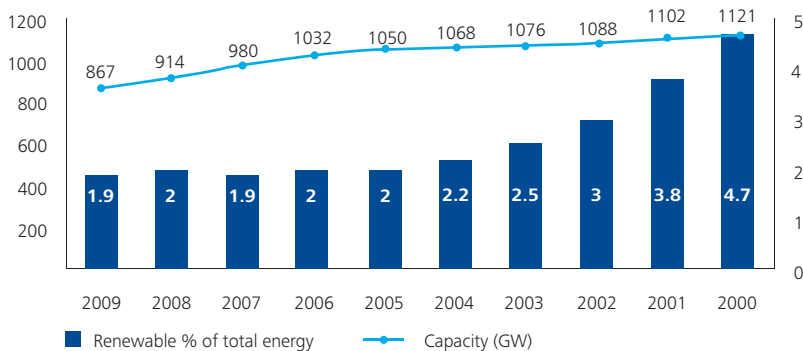
Despite considerable investment cost, renewable energy is safe – production wise – and environmentally friendly – excepting the issue of nuclear wastes and the unusual occurrence of disasters such as Chernobyl and Fukushima – and requires no fuel. Numerous techniques of production have been developed, that are more or less lucrative depending on location, weather and other factors.

**Table 1: U.S. Electric net generation (2000-2009)**



Source: EIA, AWEA, SEIA, GEA

**Table 2: Renewable energy as a function of capacity**



Source: EIA, AWEA, SEIA, GEA

Capacity is also growing. Despite its relatively small contribution to overall electricity production (see Table 1), renewable energy usage is increasing considerably year on year in terms of total capacity (see Table 2): "Although renewable energy (excluding hydropower) is a relatively small portion of total energy supply both globally and in the United States, the installed renewable energy capacity in both the world and in the United States has more than tripled between 2000 and 2009," according to the U.S. Department of Energy.

As other energy resources decrease, it seems renewable energy will be the ultimate long-term power generation resource. Governments are increasingly getting engaged in projects by investing capital and labor to help promote and advance clean power generation more efficiently.

### Types of renewable energies

One of the most commercially used sources of energy is biomass, produced from organic material such as plants and animals. In the U.S. alone, the use of biodiesel has multiplied by a factor of 100 during the period 2000-2009, according to the U.S. Department of Energy. The advantage of biomass energy relative to its peers is that it does not depend on variables (i.e. radiant light and heat of the sun, flow of water) consequently, it guarantees, to a certain extent, continuous power generation. Wood is considered to be the most widely used electric resource generation among all solid biomass since it has the highest calorific value (a thermal unit representing the amount of heat produced by complete combustion of a given mass). Additionally, wood is abundant so it can be used to a large extent.

Other energy sources have witnessed large growth such as wind, solar and geothermal energies, with wind turbines scoring the highest growth among all renewable energies (a factor of 9 between 2000-2009). Wind power creates energy by transforming kinetic energy into mechanical energy. Geothermal energy originates from the Earth, it is considered among the few resources that can continuously supply power. Nevertheless, the full potential of geothermal energy is yet to be reached.

Hydraulic energy has had a commercial presence since a long time with dams producing electricity for decades. It was first used for irrigation and the operation of several mechanical devices and has ultimately developed into a more effective and efficient source of power generation.

### Green taxes

Governmental fiscal policies such as tax reductions on green products also contribute to the expansion of these alternate sources of energy. Adversely, green tax programs have been established to minimize the usage of harmful resources: tax levies, also referred to as “green taxes” or “environmental taxes” are high on products with considerable density of detrimental materials (such as Polyvinyl Chloride or PVC).

### Future opportunities and new solutions

Unlike what is commonly thought, renewable energy does not actually work well alone: the sun is not always shining, wind speed fluctuates, even lakes behind dams get larger or smaller depending on the time of year. These factors make renewable energy an unreliable source at times, but when functioning properly, they can reduce the dependence on carbon or uranium and supply part of our needs with clean energy.

Consequently, many studies have elaborated methods and techniques to reduce air-polluting emissions resulting from transportation. Among the most recent discoveries are the Electric and the plug-in hybrid electric vehicles (EV and PHEV). The latter consume both gasoline and electricity (greenhouse gas GHG), which ultimately reduces emission of pollutants (i.e. CO<sub>2</sub>).

Other scientists have discovered ways to significantly increase storage capacity by keeping hydrogen, which is then used in fuel cells or internal combustion engines, to produce electricity.

When encouraged and used effectively, clean sources of energy can contribute to a better preservation of our environment and even be cost effective at times (especially the running cost since no fuel is required).

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## Unlike what is commonly thought, renewable energy does not actually work well alone

In the Middle East region in particular, wind speeds are more consistent, particularly on the Saudi side of the Suez Canal and the in the Empty Quarter (Rub Al Khali). In addition, there is guaranteed high intensity sunlight for far longer, especially in the Sahara Desert, where covering a minimal percentage of the land with solar panels is thought to provide enough power to cover the planet (a plan that is not without its own set of inherent problems.) Nevertheless, from a regional perspective, this natural resource should be invested in rather than ignored.

### Success stories

The most high-profile renewable energies projects have been undertaken in Egypt: from developing selective wind turbine by manufacturing turbine towers and blade facilities for the local market to supplying products to emerging North African and Middle Eastern markets.

Another project is the Global El Zeit Project Wind Park. Worth USD 880 million, it is to be developed on the Red Sea coast. When fully operational, the plant will generate an output of 350 GWh per year and will cut carbon dioxide emissions by 500,000 tons per year. The plant is expected to employ up to 40 workers for plant maintenance, in addition to more than 100 workers in the construction of the wind farm.

One more project is the Zaafarana Wind Park Project which is a German, Danish, Spanish and Egyptian joint venture. This wind park will be delivering a total output of 160 MW after its completion.

Relying totally on renewable energy is still a bit controversial for the time being, yet with better techniques to store energy, we may be able one day to see these sources as our main supply of energy.

by **Wissam Merhej**, Audit partner, Deloitte in the Middle East





# Lebanon: a veteran regional center for Islamic finance

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The country has seen rapid and positive expansion of the Islamic banking sector. However, political unrest may reduce the flow of foreign investment and could affect the expansion of Islamic banking. Dr. Hatim El-Tahir shares his insight into the development of Islamic finance in the country.

In recent years, Lebanon has increasingly focused on efforts to promote Islamic finance. The government, represented by Banque du Liban (BDL), the central bank of Lebanon, has introduced several regulatory and practice-related policies including Law No.575 of 2004, which regulates the industry.

In September this year, the International Monetary Fund (IMF) reported that Lebanon's real GDP growth for 2011 will remain low at 1.5%. Inflation is estimated at 5.9%, which remains in line with inflation rates in the MENA region. It should be noted that economic growth has remained positive despite the regional unrest and Lebanon's domestic political issues.

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## It should be noted that economic growth has remained positive despite the regional unrest and Lebanon's domestic political issues

The country's competitive edge as a leading business and tourism hub rests mainly on its banking sector. This has been further enhanced by the introduction of Islamic banking services. The country hosts four fully-fledged Islamic banks: the Arab Finance House, Al Baraka Bank Lebanon, Lebanese Islamic Bank and Blom Development. BDL does not allow conventional banks to offer Islamic windows. The country's consistent efforts to introduce a sound and prudential regulatory environment, coupled with the introduction of internationally-accepted best practices, will boost the flow of investments into the country.

Over the past year, the service-based economy enjoyed growth in almost all sectors and industries. The services sector, which accounts for two thirds of the country's GDP, led the growth engine. This growth was driven by three main sectors: trade, tourism and banking. Other sectors that contributed to growth were agriculture, education and health services. In effect, the growth was largely driven by the private sector.

The government's management of the economy can perhaps best be measured by the level of success in meeting targets set by the IMF's Emergency Post-Conflict Assistance program. Key to these was the overarching goal to reduce the debt-to-GDP ratio, which was successfully cut to about 130% in 2011 from 150% in 2009. Each year, about 10% of the annual GDP - currently estimated at USD 40 billion - goes to service the country's debts.

In September, 2011, the total assets of the banking sector reached USD154 billion: an increase of 7% from the same period last year, when they totaled USD143.8 billion. In contrast, the capitalization of the Beirut Stock Exchange recorded a slight drop to USD12.8 billion in April 2011, according to BDL.

### Islamic banking

In general Islamic banking grew steadily over the past year, with more bank branches opening across the country and an increase in the customer base, which expanded to include small and medium-sized enterprises in several sectors of the economy. This trend is likely to continue in the years to come.

The outlook for Islamic banking is optimistic and Islamic banks operating in Lebanon will likely take the lead in financing service sectors and investment projects. Projections for GDP growth, estimated at 4% for 2012, boost confidence in the economy and the banking

sector in particular. Government support for Islamic banking is paramount and will give more assurance to potential investors in this important emerging sector. One area of industry growth potential lies in leveraging the country's reputation as a fiduciary service center and developing Shariah-compliant asset and wealth management services.

However, this growth cannot take place without challenges and, needless to say, will hinge on domestic and regional political stability. Lebanon offers a viable investment growth opportunity for bigger Islamic banks with bigger balance sheets to invest. In its favor, the country offers an abundance of professional talent and reasonable operational costs. This is crucial for a competitive and efficient Islamic financial sector.

The current regulation of Islamic banks stipulates that: "Investments and placements in Lebanon must account [for] at least 50% of assets and rights included in the balance sheet items in each Islamic bank." This guidance will ensure that Islamic banks operating in Lebanon will continue to invest and finance local industries and play an important role in economic growth.

#### **Restriction on Islamic windows**

Nevertheless, the restriction on conventional banks preventing them from offering Islamic windows poses challenges and may impede the growth of Shariah-compliant banking services in the country. This means that licensed Islamic banks will have to expand efficiently to accommodate the rising demand for Islamic financing. Similar regulatory changes have been made in Qatar, which also restricted conventional banks from operating Islamic windows, effective 2012.

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## The broader global economic and political unrest may reduce the flow of foreign investment in the country and delay the Gulf-led initiatives of Islamic banking expansion into Lebanon

#### **Conclusion**

The broader global economic and political unrest may reduce the flow of foreign investment in the country and delay the Gulf-led initiatives for Islamic banking expansion into Lebanon. However, the government should continue its support of this emerging sector in the country and nurture its growth. Regulatory reforms should provide a level playing field for Islamic banks. Issues such as double taxation, Zakat, land registry, tax incentives for foreign investors in the sector and the establishment of leading practices in arbitration and business disputes, to name just a few, should be tackled.

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by **Dr. Hatim El Tahir**, director of the Islamic Finance Knowledge Center (IFKC), Deloitte in the Middle East



MY HOUSE

# Sourcing options for Internal Audit services: your house, your rules

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Today's dynamic business environment requires internal auditors to wear many hats and change them often. For internal auditors to deliver on their mandate and meet the expectations of oversight bodies, they need broader skill sets, the ability to add the most value and the flexibility to properly respond to changes caused by internal and external factors.

# MY RULES

Internal audit activities should, ideally, be strategically aligned with the overall organizational goals and should help in improving the organization's operations by evaluating and improving the effectiveness of risk management, control and governance processes.

To enable the internal audit function to achieve these objectives, it needs to have leading edge technology, tools and a constantly updated arsenal of specialized skill sets, techniques and leading practices. Acquiring and retaining the necessary and often specialized capabilities internally can pose quite a challenge, particularly in light of changing priorities and the costs involved.

The current Institute of Internal Auditors' International Standards for the Professional Practice of Internal Auditing ("IIA Standards") reflects the following changes in the definition of internal audit (see table below):

## Former standards

Independent function established within an organization

Appraisal function

Examine and evaluate the organization's activities as a service to the company

Assist members of the organization in the effective discharge of their responsibilities

Analyses, appraisals, recommendations, counsel and information concerning the activities reviewed and promoting effective control at reasonable cost

## Current standards

Independent, objective activity performed by Internal Audit

Assurance and consulting activity

Designed to add value and improve organization's operations

Help a company achieve its objectives

Bring a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes

## Sourcing options

Below are several internal audit sourcing strategies that organizations have at their disposal to build their arsenal of internal audit expertise, transfer knowledge and build the capabilities of their internal audit functions.

Organisations have three main internal audit sourcing strategies to choose from. The selection of a sourcing strategy will be driven by the model that best fits the organization's requirements and meets its objectives. The models presented below are based on leading corporate governance practices. Central to leading corporate governance practices is the requirement that management must retain responsibility for the system of internal controls and that the Board, through the Audit Committee, must retain oversight of the internal audit function. This includes approval of the vision, values, strategic objectives, internal audit delivery structure, allocation of financial resources and the respective performance measurements.

The alternative sourcing strategies are:

- **Internal Sourcing:** Resources\* are provided by the organization to achieve the strategic objectives of the Internal Audit Function.
- **Co-sourcing:** A blend of resources from within the organization and a third party provider of services. Resources\* are developed and provided based on the organization's unique needs in order to achieve the strategic objectives of the Internal Audit Function.
- **Outsourcing:** Resources\* are entirely provided by a third party provider of services to the organization in order to achieve the strategic objectives of the Internal Audit Function.

\*The term "resources" as used within the above context, is defined as the people, processes, methodologies, technologies and tools required to carry out the internal audit activities.

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## Organisations should set the specific criteria for the selection of the internal audit service providers that will form the basis of the organization's sourcing selection strategy

### Advantages and disadvantages of sourcing options

#### Internal sourcing

A key advantage of the Internal Sourcing model is that it provides the arena for developing future leaders within the organization. Members of the Internal audit department are trained on various functions within the organization and obtain a comprehensive understanding of the key risks and challenges that face the organization, enabling individuals to enhance their decision-making process. Other advantages include a higher level of ownership of the internal audit function and a better understanding of the organization's culture that permits internal auditors to master the relationship with various process owners.

The key disadvantage of the Internal Sourcing strategy or model is the difficulty internal auditors face in acquiring or maintaining the depth and breadth of specialized skills due to the high cost associated in investing in the skills required. Another drawback is the lack of flexibility to accommodate the increasing demands from oversight bodies to provide control assurance on certain areas due to the lack of resources available.

#### Co-sourcing

In an Internal Audit Co-sourcing model, management retains control over the internal audit function while at the same time leveraging the internal audit resources of the third party service provider, which provides access to valuable and diverse specialised skills as needed. The organization will have access to leading practices as well as the Intellectual Capital of world-class Internal Auditors resulting in a higher return on investment. A co-sourcing model is usually accompanied by a knowledge transfer framework through which the in-house internal audit skills and expertise are augmented by the knowledge and leading practices introduced by the third party service provider.

One of the key deficiencies of the Internal Audit Co-sourcing model is that it requires continuous coordination from the organization to ensure seamless delivery of the internal audit services, as the responsibility of managing the internal audit function remains with the organization. Also, continuous investment in the in-house internal audit department is required with respect to training, recruitment and the technology used.

#### Outsourcing

The key benefit of a fully outsourced internal audit service model is that the service provider is ultimately responsible for the internal audit function; management direction is limited but still required. The organization has the ability to request proficient and qualified staff with core competencies from the service provider in the pursuit of adding value to the organization. The service provider bears the investment costs for training, tools, technology and the Intellectual Capital required and internal auditors are able to maintain financial independence.

The main drawback of this option is that expertise does not reside in-house and accordingly, there is an evident limitation on the ability to transfer knowledge and build the capabilities of the internal audit function within the organization.

**Selection criteria of service providers**

Organisations should set the specific criteria for the selection of the internal audit service providers that will form the basis of the organization’s sourcing selection strategy. Individual criteria will not have equal importance thus requiring organisations to apply respective weights based on their vision of the organization’s internal audit function.

Diagram 1 presents the key sourcing options criteria organizations should consider when assessing respective sourcing options.

**Summary**

When considering different sourcing options, organizations must consider which model best addresses their organization’s needs. As with all strategies, there is no “one size fits all” solution, and the aforementioned sourcing option criteria only provides organizations with a starting point on what key issues need to be analyzed, as these will need to be tailored depending on the organization’s requirements. The underlying principle guiding organizations to re-evaluate their internal audit functions is the need to enhance the value that internal auditors provide, and the fact that the internal audit function is increasingly becoming an advisor to the business and an example of leading practices.

by **Hisham H. Zeitouny**, partner, Enterprise Risk Services, Deloitte in the Middle East

**Key sourcing option criteria**



Source: 2011. Deloitte & Touche

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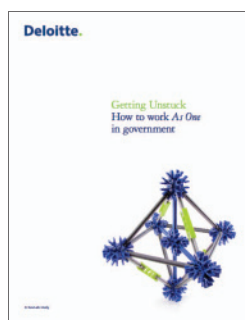
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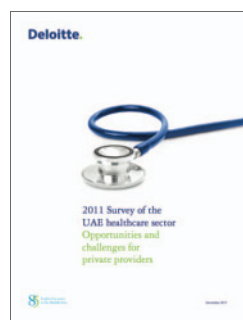
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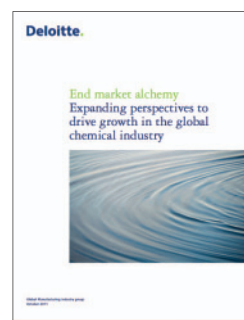
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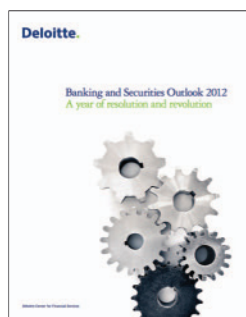
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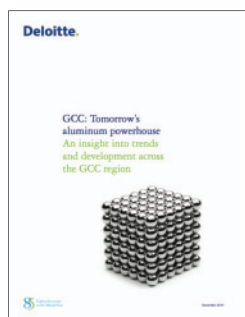
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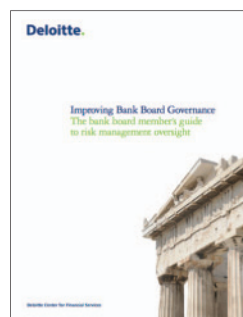
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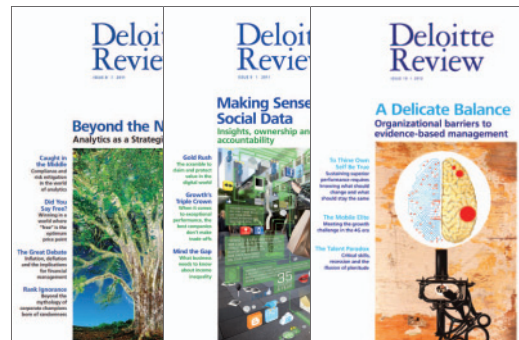
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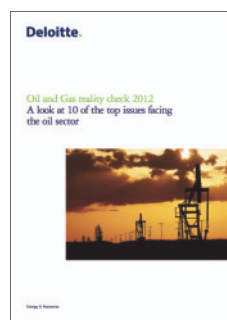
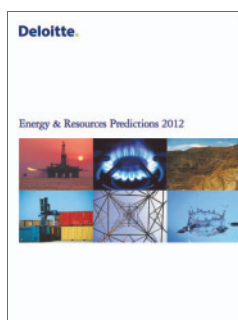
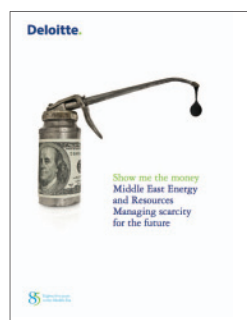
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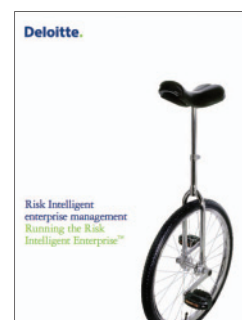
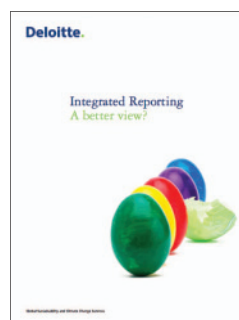
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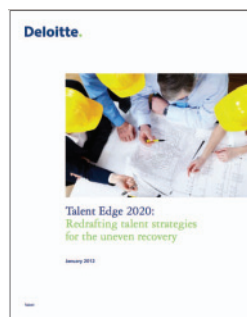
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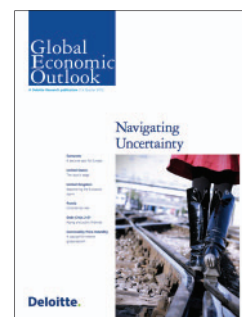
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