

# Banking Banana Skins 2008

An industry  
in turmoil



The CSFI  
survey of  
bank risk

In association with

PRICEWATERHOUSECOOPERS 

CSFI  
Centre for the Study of  
Financial Innovation



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## Preface

Welcome to the 2008 Banking Banana Skins survey - the ninth we have carried out in this format. As John Hitchins makes clear in his foreword, it is instructive to see how perceptions of risk have changed over that period. Inevitably, fears reflect the times, and this survey was carried out against the background of a global liquidity crunch following the US sub-prime debacle, and the re-emergence of the rogue trader phenomenon at Société Générale. No surprise, therefore, about the Banana Skins that have risen to the top of respondents' risk ranking – or about which are the fastest risers.

As always, David Lascelles, the CSFI's senior fellow and author of the report, offers a Rolls-Royce ride through the perils of banking. But don't let his mellifluous prose fool you. A lot of effort goes into this exercise – and the level of respondents is awesome. When David says someone is 'senior' he (or she) is very senior. We are very grateful to everyone who took the time to complete the survey – which, for the first time, was available online through SurveyMonkey.

Thanks also to PricewaterhouseCoopers for continuing to sponsor this survey, and for helping to garner responses from around the world. The responsibility is the CSFI's, but none of it could have happened without the support of PricewaterhouseCoopers. Roll on next year....

**Andrew Hilton**  
Director, CSFI

This report was written by **David Lascelles**  
Cover by **Joe Cummings**, with acknowledgements to 'Skegness is SO bracing!'

## Foreword

PricewaterhouseCoopers is delighted to sponsor another year of Banking Banana Skins.

The 2008 vintage is as thought-provoking as usual and is all the more interesting for appearing in the middle of a global crisis.

Unsurprisingly the credit crunch dominates the responses with new banana skins, liquidity and credit spread volatility, in the top three. Thoughts and insights on the credit crunch go much further than this and are threaded right through the survey. Worries that we could see the failure of another bank have been borne out with the collapse of Bear Stearns even before the CSFI could finish analysing the responses. Bank share prices remain very volatile and susceptible to market rumour.

As several respondents to the survey said, a fundamental issue is that trust has been lost across the industry, and it is likely to be a long and painful road to rebuild it.

It is interesting to look back at the 2006 survey. With no mention of liquidity as a separate banana skin the initial conclusion is that no one foresaw the scale of the risks being run. However, when you read further there are themes from 2006 that have played a significant part in the current crisis. I'd highlight three in particular:

- Part of the reason that credit risk kept its second place last time were fears that credit defaults could trigger a significant tightening of liquidity.
- There was plenty of concern about the opacity of where residual risk was ending up. Although mentioned primarily in the context of derivatives last time, opacity has clearly contributed to the loss of trust this time. As we publish this survey, a debate rages about the level of disclosures that the industry should make.
- A number of commentators worried last time that risk management was becoming too mechanistic and losing the human element. For many banks the current crisis is clearly a wake-up call that risk management needs an overhaul.

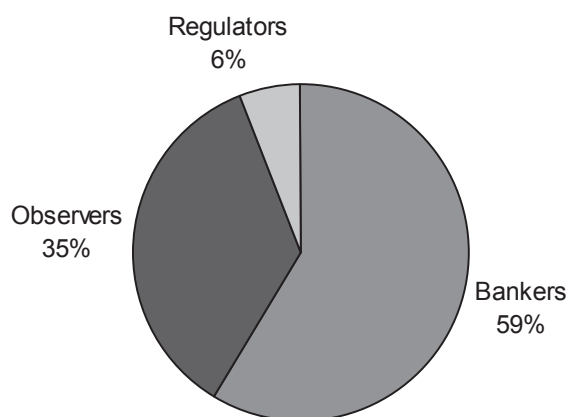
So maybe the last survey did get it right after all! I commend this survey to you for a close read as the seeds of the next big banana skin may well be buried in the detail. The role of sovereign wealth funds perhaps?

**John Hitchins**  
UK Banking Leader  
PricewaterhouseCoopers

## About this survey

This survey was designed to learn how bankers and close observers of the banking scene perceive the risks facing the industry. The questionnaire (reproduced in the Appendix) was in three parts. In the first, respondents were asked to describe, in their own words, their main concerns about the financial system over the next 2-3 years. In the second, they were asked to rate a list of potential risks, or Banana Skins, selected by a CSFI/PricewaterhouseCoopers panel, by severity on a scale of 1-5 and whether they were rising, steady or falling. In the third, they were asked to rate the preparedness of financial institutions to handle the risks they identified. Replies were confidential, but respondents could choose to be identified. The survey was conducted in February and March 2008, and received 376 responses from 38 countries.

The breakdown of respondents by type was:



The responses by country were as follows:

Australia	15	Japan	11
Austria	5	Liechtenstein	1
Belgium	2	Luxembourg	4
Bermuda	3	Malta	1
Brazil	1	Multinational	1
Canada	9	Netherlands	6
Channel Is	2	Philippines	1
Czech Rep.	5	Poland	4
Fiji	1	Portugal	1
France	2	Romania	4
Germany	5	Russia	25
Gibraltar	1	Singapore	3
Greece	8	South Africa	4
Hong Kong	1	Spain	4
Hungary	6	Sweden	4
Indonesia	4	Switzerland	9
Isle of Man	5	UAE	1
Ireland	4	UK	190
Italy	3	US	20

## Summary

### Liquidity shortage is the greatest risk facing the banking industry

This report surveys perceptions of risks in the banking industry in early 2008 – a time of unprecedented turmoil. The **overall level of risk** in the market is at an all-time high, as measured by the **Banana Skins Index** which goes back to 1998.

The most severe risk facing the industry is seen to be **liquidity**, or the lack of it. With many markets at a standstill since the collapse of the US sub-prime market in mid-2007, banks are immobilised by funding shortages and an inability to value and dispose of assets. The expectation is that these difficulties will persist and have serious knock-on effects in other markets.

In particular, they will increase **credit risk** (No 2) as banks and their customers come under strain. Within the financial services market, the soundness of banks, **hedge funds** (No 10) and private equity are key concerns. (The survey was carried out before the collapse of Bear Stearns). On the lending front, the main focus is on consumer credit because of a weak housing market and high personal debt, but corporate credit is also seen to be at risk.

Many of the market's difficulties are due to the widening of **credit spreads** (No 3) as the process of risk re-pricing continues. (Both liquidity and credit spreads make their first appearance in the Banana Skins ranking, an indication of the suddenness of the crisis' onset.)

### Is risk management working?

Many of the market's difficulties are due to **derivatives** (No 4), particularly the use of credit derivatives in structured products built on sub-prime mortgages. These are expected to be very difficult to unwind, and will add to liquidity and credit problems. Generally, the crisis has raised doubts about the effectiveness of **risk management** in banks (up from No 10 to No 6).

The burden of **too much regulation**, which topped the Banana Skins polls in the last two years, fell sharply to No 8. But this was a case of being overtaken by more

### Banking Banana Skins 2008

(2006 ranking in brackets)

- 1 Liquidity (-)
- 2 Credit risk (2)
- 3 Credit spreads (-)
- 4 Derivatives (3)
- 5 Macro-economic trends (14)
- 6 Risk management techniques (10)
- 7 Equities (12)
- 8 Too much regulation (1)
- 9 Interest rates (5)
- 10 Hedge funds (7)
- 11 Fraud (11)
- 12 Commodities (4)
- 13 Currencies (13)
- 14 Rogue trader (27)
- 15 High dependence on technology (6)
- 16 Corporate governance (8)
- 17 Management incentives (26)
- 18 Emerging markets (9)
- 19 Back office (24)
- 20 Retail sales practices (22)
- 21 Conflicts of interest (16)
- 22 Political shocks (15)
- 23 Business continuation (21)
- 24 Money laundering (18)
- 25 Environmental risk (25)
- 26 Banking market over-capacity (17)
- 27 Payment systems (29)
- 28 Merger mania (19)
- 29 Too little regulation (30)
- 30 Competition from new entrants (28)

## The threat of US recession

urgent concerns: its risk score was little changed from last time, with the focus now on the threat of a ‘knee jerk’ reaction to the crisis.

All these Banana Skins are set against a background of **macro-economic** deterioration (up from No 14 to No 5), particularly the threat of recession in the US. Although other parts of the world are seen as less vulnerable, (for example, **emerging markets** down at No 18), none is expected to remain completely untouched by trends in the US. And tough economic times will drag the **equity markets** (No 7) down with them.

Other high-ranking market risks include **interest rates** (No 9), **commodities** (No 12) and **currencies** (No 13). All are expected to show continuing volatility, particularly interest rates as central banks grapple with the conflicting pressures of slowing economies and rising inflation. Commodities slipped several places on the view that recent volatility might have peaked. The main currency concern remains the US dollar.

### Big movers

#### UP

**Liquidity:** shortage lies at the heart of the crisis

**Credit spreads:** repricing risk

**Macro-economy:** threat of recession in the US, and spill-over

**Risk management techniques:** inadequate to deal with unfamiliar risks

**Equity markets:** not pricing recession risk

**Rogue trader:** new focus post-Société Générale

**Management incentives:** badly structured and a contributor to the crisis

#### DOWN

**Too much regulation:** overtaken by more urgent concerns

**Interest rates:** the big moves may be over

**Commodities:** prices may have peaked

**High dependence on technology:** banks have no choice

**Emerging markets:** holding up

**Political shocks:** bigger things to worry about

## Management incentives are a fast-rising risk

The **rogue trader** (up from No 27 to No 14) made a strong and predictable showing in the wake of the recent Société Générale incident, though this is a risk that will always come and go. **Fraud** (No 11) held its place as a high concern, mainly because technological complexity makes it harder to detect. An associated risk is the banks’ necessary but **high dependence on technology** (No 15) and strains in the **back office** (up from No 24 to No 19).

Concerns about the quality of **corporate governance** in banks have eased considerably (down from No 8 to No 16) since the days of Sarbanes-Oxley and the Higgs report. But a fast-growing threat is the structure of **management incentives** (up from No 26 to No 17) whose focus on short-term gain is seen to be a major cause behind the crisis.

Among receding threats, the most striking is **banking market over-capacity** (down from No 17 to No 26) due to the erosion of bank capital in the crisis. For similar reasons, **competition from new entrants** (No 30) is considered very unlikely.

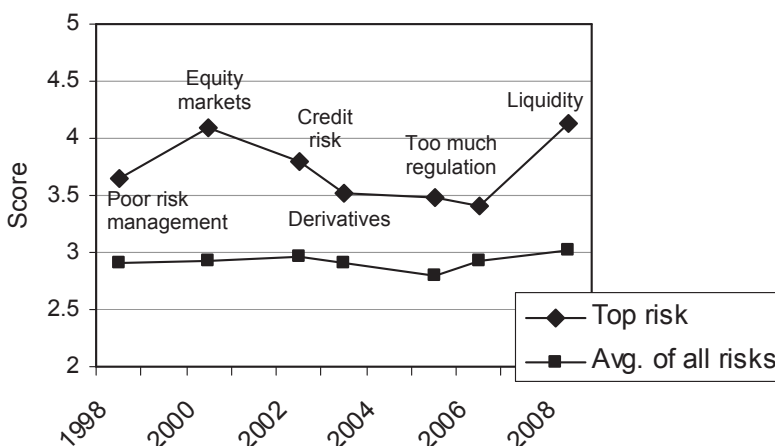
A breakdown of responses shows **bankers** putting greater emphasis on market risks, and **non-bankers** on weaknesses in bank management and controls. Geographically, there was a strong consensus on the major risks: liquidity, credit and derivatives, though **industrial countries** focused more on the risks of recession and regulatory over-reaction while **emerging economies** were concerned about access to funding.

## How well prepared are banks to handle these risks?

**Few think that banks are 'well prepared' to handle risk**

We asked respondents to rank the preparedness of their own and other institutions to handle the risks they identified. Only a quarter of them said they were “well” prepared, down from nearly two thirds in the previous survey. However only four per cent said “poorly”, down from 14 per cent before. The majority of respondents said “mixed”. Bankers were more bullish than non-bankers and regulators.

## The Banana Skins Index



**The Banana Skins Index is at a record high**

The Banana Skins Index tracks responses over time and can be read as an indicator of anxiety levels. The top line shows the average score given to the top risk over the last ten years, and the bottom line the average of all the risks. Both lines hit all-time highs in the current survey, an indication of the exceptional level of anxiety currently gripping the markets.

The course of the index over the last decade shows the finance sector emerging in a bullish mood from the late 1990s but running into the frenzy of the dot com crash in the early 2000s. Although the top risk peaked in 2000, the overall anxiety level continued to rise for two years in the messy aftermath. The risk level then subsided as stability returned to the markets. However the first indications of anxiety about the soundness of the bull run appeared in the 2006 survey with a sharp rise in the all-risk index, which has continued with the present poll.

## Who said what

A breakdown of the top ten responses by type shows different levels of concern.

### Bankers

- 1 Liquidity
- 2 Credit risk
- 3 Credit spreads
- 4 Derivatives
- 5 Macro-economic trends
- 6 Risk mgt techniques
- 7 Equities
- 8 Too much regulation
- 9 Interest rates
- 10 Fraud

Bankers were mainly concerned with market risks: liquidity, spreads, derivatives, equities, interest rates etc. They were also the most concerned among respondent groups with over-regulation, particularly a “knee-jerk” response to the crisis. They were less inclined than other groups to see poor risk management as a contributory cause of the turmoil. They expected fraud to rise as conditions worsened. Looking ahead, their greatest worry was credit risk in what they saw as a difficult period for the global economy.

**Bankers, observers and regulators agree on the big risks, but differ on the detail**

### Observers

- 1 Credit risk
- 2 Liquidity
- 3 Credit spreads
- 4 Risk mgt techniques
- 5 Derivatives
- 6 Macro-economic trends
- 7 Equities
- 8 Commodities
- 9 Hedge funds
- 10 Management incentives

Observers of the banking scene differed from bankers by putting credit risk at the top of their list, reflecting their concern that the legacy of the crisis will be loan losses and damaged banks. They were also more inclined to see internal bank failings as causes of the crisis, such as poor risk management and perverse incentives, and were therefore less worried than bankers about the threat of over-regulation. But they shared bankers’ concerns about the poor economic outlook, and its implications for markets.

### Regulators

- 1 Liquidity
- 2 Credit risk
- 3 Derivatives
- 4 Macro-economic trends
- 5 Risk mgt techniques
- 6 Credit spreads
- 7 Equities
- 8 Hedge funds
- 9 Fraud
- 10 Management incentives

Regulators’ top concerns were similar to those of bankers and observers of the banking scene: liquidity, credit risk, derivatives, and a difficult economic outlook. They also gave a high score to internal bank weaknesses such as the quality of risk management and incentive structures. They were the most concerned of the three groups about the position of hedge funds and the threat of fraud post-Société Générale. But they saw less risk of over-regulation, which they placed 13<sup>th</sup>.

## North America

- 1 Credit risk
- 2 Liquidity
- 3 Derivatives
- 4 Risk mgt techniques
- 5 Credit spreads
- 6 Commodities
- 7 Macro-economic trends
- 8 Emerging markets
- 9 High dep on technology
- 10 Too much regulation

Respondents from North America ranked the worsening credit outlook as their top concern, though worries about liquidity were not far behind. Other market risks included derivatives, particularly structured products, and commodities where they expected more volatility in oil and gold. They also saw risk management as a weakness. Although much of the rest of the world feared a US recession, North Americans scored macro-economic risk lower than other geographical areas. They were also less worried about over-regulation.

## America seems less worried about recession than other regions

## Europe

- 1 Liquidity
- 2 Credit risk
- 3 Credit spreads
- 4 Derivatives
- 5 Macro-economic trends
- 6 Risk mgt techniques
- 7 Equities
- 8 Too much regulation
- 9 Commodities
- 10 Interest rates

Eight of the European respondents' top ten were market or credit risks where they saw considerable volatility ahead. This was linked to their strong concern about gridlock in the financial markets and the likelihood of a US recession with spillover in Europe. They were also concerned about poor risk management in banks, and expected to see strong regulatory comeback as a consequence of the crisis. East European and Russian banks were particularly concerned about access to funding, and its cost.

## Asia Pacific

- 1 Credit spreads
- 2 Liquidity
- 3 Too much regulation
- 4 Equities
- 5 Credit risk
- 6 Macro-economic trends
- 7 Risk mgt techniques
- 8 Derivatives
- 9 Interest rates
- 10 High dep on technology

The Asia Pacific region reflected less concern about the economic effects of the crisis than North America and Europe: their markets seemed to be in better shape, though respondents did not expect them to escape unharmed. Access to funding was a major concern, particularly among emerging economy banks. Concern about derivatives and structured products was relatively lower. Japanese and Australian banks expected to see more regulation in response to the crisis.

## Industrial and emerging economies share concerns about the outlook

### Industrial countries

- 1 Liquidity
- 2 Credit risk
- 3 Credit spreads
- 4 Derivatives
- 5 Macro-economic trends
- 6 Risk mgt techniques
- 7 Equities
- 8 Too much regulation
- 9 Hedge funds
- 10 Commodities

The interests of industrial and emerging economies show more convergence in this survey than in previous ones, mainly because the crisis provides a strong focus for both groups. Both are concerned with the condition of the financial markets and the prospects for the world economy. Among the main differences is a higher concern in industrialised countries about over-regulation and the quality of risk management. Commodities also featured strongly since this group included Canada and Australia.

### Emerging economies

- 1 Liquidity
- 2 Credit risk
- 3 Derivatives
- 4 Macro-economic trends
- 5 Equities
- 6 Credit spreads
- 7 Interest rates
- 8 Risk mgt techniques
- 9 Fraud
- 10 Currencies

Emerging economies shared industrial countries' concerns about the state of the financial markets and the economic outlook. In particular, they focused on what it might mean for their access to funding and its cost; there was a fear that they would be shut out. Their concern with currency risk reflected the fact that banks are forced by the shortage of local funding sources to use foreign markets. This group also saw fraud as a rising risk. Over-regulation was less of a concern.

## The Top Ten Banana Skins 1996-2008

<b>1996</b>			<b>1997</b>			<b>1998</b>		
1	Poor management		1	Poor management		1	Poor risk management	
2	Bad lending		2	EMU turbulence		2	Y2K	
3	Derivatives		3	Rogue trader		3	Poor strategy	
4	Rogue trader		4	Excessive competition		4	EMU turbulence	
5	Excessive competition		5	Bad lending		5	Regulation	
6	Emerging markets		6	Emerging markets		6	Emerging markets	
7	Macro-economic threats		7	Fraud		7	New entrants	
8	Back office failure		8	Derivatives		8	Cross-border competition	
9	Technology foul-up		9	New products		9	Product mis-pricing	
10	Fraud		10	Technology foul-up		10	Grasp of technology	
<b>2000</b>			<b>2002</b>			<b>2003</b>		
1	Equity market crash		1	Credit risk		1	Complex financial instruments	
2	E-commerce		2	Macro-economy		2	Credit risk	
3	Asset quality		3	Equity markets		3	Macro economy	
4	Grasp of new technology		4	Complex financial instruments		4	Insurance	
5	High dependence on tech.		5	Business continuation		5	Business continuation	
6	Banking market o'-capacity		6	Domestic regulation		6	International regulation	
7	Merger mania		7	Insurance		7	Equity markets	
8	Economy overheating		8	Emerging markets		8	Corporate governance	
9	Comp from new entrants		9	Banking market over-capacity		9	Interest rates	
10	Complex fin. instruments		10	International regulation		10	Political shocks	
<b>2005</b>			<b>2006</b>			<b>2008</b>		
1	Too much regulation		1	Too much regulation		1	Liquidity	
2	Credit risk		2	Credit risk		2	Credit risk	
3	Corporate governance		3	Derivatives		3	Credit spreads	
4	Derivatives		4	Commodities		4	Derivatives	
5	Hedge funds		5	Interest rates		5	Macro-economic trends	
6	Fraud		6	High dependence on tech.		6	Risk management	
7	Currencies		7	Hedge funds		7	Equities	
8	High dependence on tech.		8	Corporate governance		8	Too much regulation	
9	Risk management techniques		9	Emerging markets		9	Interest rates	
10	Macro-economic trends		10	Risk management		10	Hedge funds	

Some Banana Skins come and go, some are hardy perennials. The Top Ten since 1996 show how concerns have changed over more than a decade. The 1990s were dominated by strategic issues: new types of competition and technologies, dramatic developments such as EMU, the Internet and Y2K. Many of these faded, to be replaced by economic and political risks and particularly by concern over the growth of regulation. The period after 2000 also saw the rise of newfangled risks such as derivatives and hedge funds, the latter making their first appearance in 2005. This year's survey brought the focus sharply onto credit and market risks, and propelled two new entrants to the top of the charts: liquidity and credit spreads.



## 1. Liquidity (-)

### Bewilderment at the sudden crisis onset

The critical shortage of liquidity in the financial markets emerges as the top risk facing the banking industry in this year's Banana Skins survey. A measure of its dramatic rise is that it did not even rank in the last survey undertaken in 2006.

The director of international operations at a major US bank said: "This is the number one problem. Banks fail from liquidity...everything else is a share price problem." James Prichard, head of market risk at WestLB's London branch, said: "Injections of cash have not re-enabled liquidity in the markets...Markets will remain inefficient and prices distorted until new capital is raised."

Much of the commentary reflected the bewilderment that the liquidity crunch has caused throughout the industry: the suddenness of its onset, the shock waves, the feeling of helplessness etc...The vice-chairman of a London fund management group described it as "a desperate problem". He said: "It may feel as though it is confined to the money and debt markets now, but the risk is that it will climb out into other areas too." The head of risk at a large UK financial group said: "The entire financial system is now much more vulnerable to further shocks, eg a deep US recession with large scale credit defaults or a major geopolitical event."

The responses touched on many aspects of the crunch.

**Lack of risk focus.** Risk management systems and banking regulations failed to anticipate the devastating effect of the loss of market liquidity. Capital adequacy rules did not take sufficient account of liquidity risk, and few banks had adequate defences in place. One respondent said this was an issue which had been "overlooked by the industry until recently", and another described it as "a forgotten classic". (See also No 29, **Too little regulation**).

### The perils of growth

The current credit crisis emphasises the vulnerability of the banking system to prolonged periods of growth well in excess of overall GDP.

**Chief financial officer**  
US money centre bank

### Markets stifled by lack of trust

**Collapse of trust.** Respondents described the psychological effects: the loss of trust among banks and customers, the tendency for fears to become self-fulfilling, the comfort taken from general ignorance - all potentially leading to a downward spiral of confidence. A senior executive with a large Swiss financial group said: "It's the fear of its loss rather than the actual loss that we need to manage." An Irish respondent said that economic growth would be stifled by "a lack of trust between financial institutions and an unwillingness to enter into complex financial arrangements in the future".

**Funding.** The crunch has made funding harder, even for healthy banks, and raised the possibility of bank failure. (The survey was carried out before the collapse of Bear Stearns.) The head of market risk at a large Australian bank said: "Not only are increasing costs playing out, but the fundamental issue of access to funds could be jeopardised by single name events and/or systemic perceptions. The likelihood of bank failures (or bail-outs) is high. This issue is set to persist as the credit crunch widens." The funding issue is particularly acute for smaller banks and those in outlying markets. A respondent from a small UK bank said that "many banks are still struggling". Banks from East Europe and Russia feared for the availability and cost of funding. A Polish bank president faced "difficulties acquiring medium

and long term financing in an environment of high risk premiums due to the global financial situation.” A Russian bank examiner said that “banks from Russia and countries of the former USSR have problems refunding bonds and syndicated loans”.

**Valuation.** The absence of free-flowing markets has made it hard if not impossible to value and unwind the complex deals lying at the heart of the crisis. A risk officer at a large German bank highlighted “the cost of the ‘unwind’/work-out of the risk on bank books...(i.e. leveraged loan inventory, CMBS\* inventory, real estate loans, SIV assets etc.)” A UK banker said that “the greatest risk felt by financial institutions remains losses associated with SIVs/CDOs where forced sales of the underlying assets are creating a ‘snowball’ effect”. The director of regulatory affairs at a large UK bank predicted “continued capital markets dislocation through 2008, with further losses on structured financial products and spillover effects into other sectors and markets.” Many respondents thought the progress of the unwind, or lack of it, would determine how long the crisis lasted, and how deep its effect would be. In any case, the value of many of these securities could not be determined until the fate of the monoline insurers was known.

## Fear of the unknown

I am concerned about the unknown. The growth in the finance industry has been enormous in comparison to the ‘real’ economy. I think we don’t understand the ramifications of this. As a result, there is a sense of foreboding which will have an impact on liquidity in the markets.

**Michael Hamilton**  
Managing director  
Finantia Securities

Some respondents felt that strong central bank intervention may have averted a melt-down. “I don’t think it will get any worse” said the head of group risk at a large London financial group. But others urged caution. John Plender, a columnist on the *Financial Times*, said that the immediate concern “is that the efforts of the central banks fail to arrest the loss of confidence, and that there are further failures of financial institutions with systemic consequences.” Many said that while banking markets had stabilised a bit, the knock-on effects in areas like credit, structured deals, property finance and the wider economy were still potentially very damaging and long-lasting. The director of credit risk

management at a US money centre bank said “We are at a critical juncture with no improvement in sight.” Some respondents predicted that the crunch could spring back if there were further bank failures.



## 2. Credit risk (2)

The risk of heavy credit losses came second but was ranked the fastest-rising risk as respondents tried to look beyond the liquidity crunch for its consequences. What they saw was an extended period of deteriorating credit quality with overstretched borrowers, weakened banks and a worsening economic environment.

Concern about credit weakness covered a broad front. Economic consultant David Kern said that “swelling bad debts could unleash a vicious circle as ballooning losses destroy bank capital, limit the banks’ ability to lend, and worsen the credit crunch. This in turn will cause new and bigger losses, and could trigger a massive

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\* A glossary of abbreviations is on page 38.

## The bursting of the global credit bubble

slump.” A senior economist at a large German bank said that “the bursting of the transatlantic housing and the global credit bubbles will remain the key threat to financial institutions. After recent events in the US, UK and Germany, I expect problems now to increase in Spain, Italy and France.” Respondents from East Europe, Russia, the Far East and Australia all anticipated trouble.

Some of the strongest concern was about **consumer indebtedness**: the overheated housing market and sub-prime woes, as well as soaring credit card debt. A senior US banker said: “Consumers are in worse shape than most observers appreciate and will keep increasing their debt load until they literally ‘can borrow no more’. Then their failure rate will look like a tsunami to those lolly-gagging on the financial beaches.” Matthew Elderfield, chief executive of the Bermuda Monetary Authority, said: “The central concern must be that sub-prime problems extend to consumer credit generally in a severe manner and that corporate credit risk also increases, with chickens coming home to roost in highly leveraged private equity transactions.”

Many respondents challenged the view that **corporate borrowers** were better placed to withstand a credit crunch than consumers. Michael Feeny of the Society of Technical Analysts in London said that linkages between credit markets were stronger than people realised. “More of the bodies floating to the surface may turn out to be corporates than is currently generally expected.” In fact linkage was a widely-cited concern, particularly where it had not been spotted. A senior executive of a large Swiss financial group warned of “unexpected interdependencies.”

**Corporates are more at risk than is generally thought**

**Property** was a big worry in most markets, particularly the “Anglo-Saxon”. The director of regulatory affairs at a UK clearing bank said that “commercial and residential property markets are at best stagnating, weakening the ability to borrow and reducing the quality and quantity of collateral.” Speaking for many UK mortgage lenders, Adrian Coles, director-general of the Building Societies Association, was concerned about “credit quality in a deteriorating housing and commercial property market.” Andrei Stepanenko, chief risk officer of Raiffeisen Bank in Russia, said that “many banks have a significant exposure to residential real estate under weak loan structures.”

## The new uncertainty

The continued impact of the unwinding of structured financings and the lack of pricing knowledge of these and derivatives; the reassessment of the use of complex derivatives by unsophisticated people. All these will breed uncertainty where there has been brash and unfounded certainty until now.

**Chris Prior-Willeard**  
Vice-president  
The Bank of New York Mellon

Then there are the **banks** themselves where further large write-downs are still possible. Diane Coyle of Enlightenment Economics asked: “Have banks yet written down all they will need to? Will this be on a sufficiently large scale to pose a systemic threat?” A related problem is **counterparty risk** which has become particularly hard to assess amid all the turmoil. A New York investment banker was concerned about the “continued impact on markets from credit constraints and lack of information about counterparty positions and off balance sheet exposures.”



## 3. Credit spreads (-)

Like liquidity, this is a risk which came out of nowhere and caught many people unawares.

Credit spreads – variations in the cost of credit to different classes of borrower – create opportunities for banks to trade one class against another. The sub-prime bubble compressed these spreads as the market increasingly ignored the extra risk in low class credits. But with the crunch, they all sprang apart again, throwing price calculations into disarray and hammering the value of assets structured around them. Spreads have now become a measure of mistrust.

Much of this mistrust focuses on the banks themselves, and on other types of financial institutions such as hedge funds and private equity houses. A UK banker said that the cost of credit “will rise at a time of more challenging economic conditions. The main impact will be on refinancings and M&A, creating further strain on some financial institutions as their stock of lending becomes less attractive and more difficult to distribute.” Many respondents expected to see financial institutions fail.

**Risk re-pricing is a new challenge for banks**

### An end to O&D?

The “originate and distribute” business model is bust; a new one needs to be found.

The practice of packaging deals with the sole purpose of selling them on to other, possibly less sophisticated, banks was widely identified as a central cause of the crash. Respondents described it as irresponsible, intentionally confusing, and non-productive. One said that while it had the benefit of diffusing risk, it also “makes it very hard to distinguish clearly where and how risks have been carved up, reallocated, brought back together; and, by the same token, makes it impossible to predict what will happen in moments of stress.”

A senior European regulator said there was now “a challenge to the industry to re-engineer their business models in response to pressure on the originate and distribute concept,” a view which was echoed by a Japanese bank supervisor who said the objective now was “to develop a new business model in order to cope with accelerated innovation.”

Philip Middleton, a partner of Ernst & Young, foresaw an end to O&D. “This will probably lead financial services into one of its periodic bouts of introspection and as a result probably towards a period of greater stability.”

Part of the difficulty lies in putting a realistic value on credit assets. A respondent from a large US bank said that accounting standards were demonstrating that “too many institutions don’t know what they have. Inexperienced seniors, panicking politicians and pressured regulators may cause financial institutions to make injudicious firesale decisions.”

The question is whether this process of repricing is over, or whether there are more shocks to come. Most respondents thought that spreads would remain volatile for some time. A German bank adviser said: “Credit was too cheap and until its cost reaches reasonable levels, spread volatility is a major risk. There is too much credit risk on the balance sheets to hedge”. A respondent from London said there was

**‘Too many institutions don’t know what they have’**

“more widening to come, followed at some point by a sharp reversal.” A respondent from a large Swiss bank said that “volatility will continue to be high as investors reprice risk.”

Some respondents thought the worst was past. A risk officer at a large German bank said “much of the move has already happened”. Others saw volatility presenting opportunities for banks, at least for those with the capital to take advantage of them.

## An obscure art

Banking has become the art of increasing returns whilst obscuring risks. The realignment of these factors has begun in a tempestuous fashion and will continue. But in what form?

**Richard Sayer**  
Risk manager  
Santander Global Markets  
Spain



## 4. Derivatives (3)

The potential for derivatives to cause trouble, particularly in the credit default market, remains high.

There were several worries: the banks’ exposure, the potential for non-performance by weakened counterparties, turmoil in back offices, and the sheer complexity of unresolved deals based on derivatives.

Collateralised debt obligations (CDOs) built on sub-prime mortgages loomed large as a concern, along with credit default swaps which are supposed to offer protection in a credit crisis. But the director of compliance at a large UK bank asked: “Will credit derivatives work when they are needed?”

The absence of liquidity in many areas of the market including Over The Counter (OTC) made it impossible to value deals and therefore calculate exposures. This meant that banks could not unwind their positions, or would be forced to mark them down. Many values depended on risk insurance provided by monoline insurers who were themselves under stress. One respondent said that the markets were “snookered” by the monoline problem. Another said that “the receding tide will leave a lot of naked swimmers.”

There were chinks of light. One London-based respondent saw “more market liquidity moving into derivative instruments. On the plus side, they have kept trading, on the minus side they build long-tail counterparty risk and the CDS market in particular has not gone through a downturn yet.” But the chief risk officer of a large Japanese bank said that the markets “face a long adjustment process because of the sub-prime issue.”

Many respondents said that few people really understood how these markets worked. They were “difficult to value, account for and understand. Buffett and Henry Kaufman may be right,” said one. Another described them as “weapons of mass financial destruction.”

There was a different story from Russia where bankers said that the absence of derivative markets spared banks these risks, though that also prevented them from hedging exposures.

**‘Will credit derivatives work when they are needed?’**

## Mark-to-market

Valuation rules which oblige banks to price their positions at their current market value rather than at their book value were seen as a major part of the problem. Respondents said the rules created a “downward spiral” which only made a bad situation worse. One observed that this was “causing significant pricing errors and leeching market confidence”, another that “there is nowhere to hide, and little or no chance of respite.”

UK accountant Richard Clarke described the knock-on effect. “A monoline credit rating is reduced, mark-to-market models reduce the values of all the securities supported by the monoline ‘guarantee’, the value of all the investors’ equities are marked down, the recoverability of all the investors’ debts are marked down, the monoline risk increases, the monoline is downgraded etc. Add on the impact on pension deficits, political/media headlines and there is a general collapse.”

John Hitchins, partner in PricewaterhouseCoopers, said that the immediate issue “is restoring confidence in bank balance sheets as we are in danger of talking ourselves into a downward spiral. There needs to be a lot more focus by senior management on the robustness of valuation processes and risk exposure.”

David Rule, chief executive of the International Securities Lending Association, said this was “the first time that credit losses have been primarily mark-to-market losses. It remains to be seen what relation these losses will bear to actual realised losses in future. My guess is that mark-to-market losses exhibit excess volatility, perhaps meaning that firms are more likely to fail.”



## 5. Macro-economic trends (14)

### ‘A vicious cycle of financial and industrial failure’

The world faces tough economic times. Respondents see a slowdown, led by the US, possibly heading to a recession. A few even used the word depression. The head of risk at a UK financial group said there was “a real risk that the US will get significantly worse with consequent effect on the global economy.” Another respondent saw “a vicious cycle of financial and industrial failures.” Banks would be both the cause of the downturn through tighter lending and the victims through worsening credit conditions.

The other big threat is inflation following massive central bank intervention. The head of market risk at a major Australian bank said this would “create the need to address the inflation issue further down the track. This may result in a poor credit environment that persists over the next few years.” Some respondents coupled the threat of a recession to the risk of rising prices, and came up with stagflation. Prof. Charles Goodhart of the London School of Economics said: “We are suspended between the dangers of output deflation and price inflation. The main danger is that the monetary authorities fail to walk this tightrope skilfully enough”.

Difficult economic conditions were bound to harm banks by driving up loan losses, cutting profitability and forcing cutbacks, respondents said. A senior UK banker saw “a general slowdown in economic activity leading to redundancies and lower profits”.

The hope that the global economy could be decoupled from that of the US was widely pooh-poohed. Respondents from Europe, Asia, Africa and the Far East all

expected to feel the downdraft. In Europe, a senior bank economist said that “given the ECB’s hands-off approach to interest rate policy, the Euroland economy is set for a major slow-down, which will weaken financial institutions.” In Australia, the chief financial officer of a large bank said that “although the Australian economy remains healthy, there is clear contagion risk from global capital markets or a global ‘domino effect’ recession”. In Russia, a banker said that the price the country would have to pay for its closer integration into the world economy was greater exposure to foreign shocks.

Not everybody was full of doom and gloom. One respondent said: “I am not falling into line with conventional wisdom. I think that the economies will find themselves surprisingly resilient over time.”



## 6. Risk management techniques (10)

Poor risk management clearly made a major contribution to the credit crunch, hence the rise in concern about this Banana Skin. Roger Kubarych, chief US economist of UniCredit Markets and Investment Banking in New York, said: “Risk-taking is out of control. Guardians of the system (boards of directors, official financial regulators, rating agencies, auditors, legal advisers) lack the tools or the authority to do their jobs. Investors are lazy and/or cheap, refusing to do their own due diligence.”

The responses threw up many themes.

**Controls.** The sense that banking is losing its grip is strong. Philip Warland of Halsey Consulting said that recent events “reinforce concerns of how any CEO/board can be satisfied that an institution is being run appropriately from top to bottom”. Another respondent said that the bigger banks were, the worse their controls.

From Canada, an operational risk executive said that “whenever we touch our complex ‘house of cards’ we risk upsetting the balance of control embedded in the process or system...Given that we change things all the time, we are constantly faced with this exposure.”

**Authority.** The people overseeing risk management are not sufficiently senior. Ernest Patrikis, partner of Pillsbury Winthrop Shaw Pittman in New York, said there was a need for “top tier comprehensive risk management...The CEO, COO, and CFO need to be an active part of the process. Without that level of oversight, the organization is at risk.” Another respondent said that too many CEOs and CFOs at global institutions “have demonstrated in recent months an appalling ignorance of the risks implicitly assumed by their institutions”. A banker said: “We need to get some real experience back in the saddle.”

**‘The bigger banks are, the worse their controls’**

### Look ‘above the trees’

Although all major financial institutions have sophisticated risk management systems and processes, what seems to be missing is an “above the trees” oversight and understanding of the risks being taken. There seems to be a particular need for thoughtful stress testing, both at an enterprise level and on specific positions or exposures.

**Paul Huyer**  
Senior vice-president  
TD Bank Financial Group  
Canada

**Investment.** Although banks have invested heavily in risk management, they may be tempted to cut back in a downturn. From a large rating agency a respondent said that banks “may now take their foot off the gas. In reality they should be building on and consolidating the previous investment with a view to getting payback, but other priorities will distract them from this.” Fenner Christian, a director of Credit Suisse in Switzerland, said that banks face conflicting pressures “to reduce cost while maintaining and improving the control environment.”

**Stress testing.** While banks have risk management procedures in place, they do not stress test them against sufficiently challenging scenarios. John Tattersall, a partner of PricewaterhouseCoopers in the UK, said that “institutions need to be capable of adapting their risk management and stress testing processes regularly to anticipate and reflect changes in the markets as they occur: those that fail to do so may suffer in difficult times.” Paul Domjan, a director of consultants John Howell and Co, said that weakness on this front was due in part to regulators’ failure “to ensure meaningful compliance with stress-testing requirements”.

**Catch up.** Respondents said that risk management had a tendency to lag market developments, and was therefore bound to be caught on the hop. From the Channel Islands a banker said that “it has been made abundantly clear that risk management systems have fallen behind the complexity of trading”. Several respondents in Japan said that innovation was undermining risk management in their country.

**Models.** Over-reliance on risk models which are inadequate, insufficiently rigorous or out-of-date is a problem. The finance director of a large UK bank singled out models “which offer only expected value to a confidence level without highlighting

## The shortcomings...

Recent events have exposed serious shortcomings in bank risk management models and processes. Unquestioning reliance on secondary market liquidity turns out to have been misplaced. The securitization of loans and the creation of complex derivative and synthetic instruments, formerly sources of liquidity, are now sources of uncertainty that is proving difficult to resolve. Ambiguity in the transference of risk, which banks formerly used to their advantage, is now also being punished by the markets.

US regulator

## Managing information

The crisis has exposed weaknesses in managing information, particularly about risk exposures. The chief auditor of a major US bank said: “The complexity of products, risk interdependencies and market volatility require ‘just in time’ digestible and predictive risk indicators. Many firms don’t have this capability, and this can inject credit, market and liquidity risk into the system.”

The chief risk officer of a large Australian bank said that data integrity was a key issue. “Of primary concern is how risk is recorded and taken into account when calculating client exposure records.” Nicholas Hayes, senior consultant for Europe to Automated Financial Systems, said that “decision-oriented data must be made available to management at all levels. Data quality remains poor and accessible only with difficulty”.

**Risk models are almost impossible for staff and regulators to understand**

the extent of ‘tail risk’”. A Dutch bank director said that Basel 2 allowed banks to make their own risk calculations, and the temptation was to choose a risk model that was “too optimistic”. In any case, he added, risk models were only understood by a small number of staff “and almost impossible for regulators to understand”.

However some bankers saw these risks receding because banks were certain to give risk management a thorough going-over post-crisis. Others felt that banks’ risk management had shown encouraging resilience in many cases.



## 7. Equities (12)

Are the buoyant equity markets living in Wonderland? The sharp rise in concern on this front suggests that the answer may be yes. The head of risk at a UK financial group said that the markets “have remained remarkably sanguine to the risk of recession”.

Many respondents expected to see equity markets become more volatile as the credit crunch fed through to the real world. A banker said that the equity market was “still heavily overvalued vs the debt markets”. Others questioned whether the equity markets had priced in the risk of recession, even depression, or were braced for a collapse in stock markets in emerging economies.

How badly would banks suffer if there was a crash? Some respondents thought this was a specific rather than generalised market risk, and would only affect banks with proprietary trading books. But others saw a crash having a wide impact on banks and throwing up “massive correlation”, quite apart from adding to the sense of economic gloom and making it harder for them to raise new capital.



## 8. Too much regulation (1)

Regulatory excess, which topped the polls in the two previous Banana Skins surveys, yields first place this year to more urgent concerns about the health of the financial system.

But only relatively. In absolute terms, excessive regulation scored nearly as much as in the previous survey (3.3 on a scale of 1-5 vs 3.5 last time), and the responses showed that regulatory overload is still a huge concern in most parts of the world. But the focus has shifted from the volume of regulation already in place to the threat of extra regulation “to put things right”.

Many respondents feared that there would be a “knee jerk” reaction to the crisis. The director of international operations at a leading US bank thought the authorities “will over-react to the embarrassing failures of the financial systems, and put in place

### The urge to regulate

In the light of what has happened on sub-prime and associated problems, there will be a strong temptation to have more regulation. It is difficult to argue against it in the circumstances, but questionable as to whether it will, if introduced, be effective.

**Chairman**  
US money centre bank

**Fears of a ‘knee jerk’ reaction by politicians and regulators**

remedies that will take an already bad situation and make it worse.” In the Netherlands, Gilbert Plum, chief financial officer of Delta Lloyd Bankengroep, warned of the prospect of “strangling regulation”.

Some feared that over-reaction would take regulation back to what a Japanese respondent called “a command and control environment” and scupper attempts to make regulation more principles-driven. Sebastian Schich, principal economist at the OECD in Paris, said that post-crisis measures could mark “a step back towards the more traditional banking model in which institutions have less scope for diversifying their risks.” In Australia, a senior banker warned that over-regulation would encourage a “compliance as opposed to risk management mindset” and make banks question the value of their investment in programmes like Basel. “This will lead to a sustained anti-risk management backlash when the current crisis is over,” he warned.

And so it went on, from many countries.

But to be fair on the regulators, a number of them also saw a risk of over-reaction, including a top European regulatory official who warned against “a knee jerk response to recent failures in the industry”. Andrew Poprawa, president of the Deposit Insurance Corporation of Ontario, blamed “the overconfidence displayed by major participants in the markets that regulators and central banks can control the situation if a major loss of confidence in the system occurs.”

Beyond these fears, the concerns expressed about over-regulation in earlier Banana Skins surveys remain strong: its cost and clumsiness, the growth of compliance risk, the impact on competition and innovation, the fact that those who create regulation tend to measure it by size rather than quality, the moral hazard that transfers management responsibility from bank to regulator... A senior vice-president in a

## Capital problems

Capital is under stress. “Commercial banks and most investment banks will suffer heavy losses and will need significant new capital,” said Prof. Willem Buiter of the London School of Economics. But what to do about it? New capital is expensive because the banks’ ratings are low, and if they do manage to raise it, their rates of return will fall.

Andrew Mills, director of Insight Research in the UK, said that “the banks’ assumptions about their ability to raise capital could be severely tested”. Aaron Brown, risk manager at AQR Capital Management in the US, said that while some banks were raising equity, “it seems to be the minimum necessary to keep their ratings, rather than an amount that would reassure customers.”

An analyst with a global investment management firm said that “banks’ capital ratios (particularly in the UK) are not high and some may need recapitalisation. If they do not recapitalise, then deleveraging will slow lending growth and exacerbate a weak economic environment. It is unclear what will break this downward spiral other than central bank support or liquidity injections from cash-rich Asian economies.”

However a US regulator was more upbeat. “US banks entered this challenging period with generally strong capital positions. Banks are moving quickly to recognize losses and raise capital, which bodes well for their ability to overcome these challenges over the intermediate term.”

## The fall-out from the Northern Rock fiasco

major Canadian bank said that “increasing regulatory oversight continues to cost financial institutions hundreds of millions of dollars, i.e. Basel, anti-money laundering and anti- terrorist financing.”

**Basel 2** was a strong focus of concern, particularly for its perceived “pro-cyclicality” - making bad worse. A respondent from a large Swiss bank said this tendency “could cause the credit crunch to continue”. A bank chairman said that “Basel 2 may have to be revisited”.

British respondents were concerned about fall-out from the **Northern Rock** fiasco. The director of regulatory affairs at a large UK clearing bank said that events would trigger “regulatory overkill and erroneous regulatory targeting...in an attempt to make up for the regulatory failings of 2007.” Alexander Hoare, chief executive of C. Hoare & Co, saw “regulatory knees jerking, being caught by systemic failure.” The managing director of a private bank said that the knock-on effect could “materially change the retail element of the banking sector” by encouraging depositors to spread their funds around up to the limit of the compensation scheme, and allowing nationalised Northern Rock to offer peak prices.

The failure of the tripartite supervisory agreement between the Treasury, the Bank of England and the FSA to avert Northern Rock was also a concern. A professor of banking said that if it was impossible to get three UK institutions to act quickly, such arrangements “are not worth the paper they are written on.” Bank director David Potter feared that the government would compound the disaster “by giving more responsibility to the wrong leg, i.e. the FSA.”

Reflecting on recent events, the head of risk management at a leading Australian banking group said that “international regulators have so far done an acceptable job, but it is hard to be completely confident in the regulatory response to such novel changes.”



## 9. Interest rates (5)

There was a marked fall in the ranking of this Banana Skin, despite unprecedented central bank activity on the monetary front.

Many respondents felt that interest rate volatility had peaked. “Quite a lot of this has already happened,” said a London banker. A US respondent said that it was “hard to see the volatility trend here rising much after the last six months, so I rate this steady only in relation to recent history.”

But many respondents felt that even if the immediate outlook was steadier, renewed turbulence could not be far away as inflation began to bite. A Swiss respondent said inflation would be “a cataclysmic shock to balance sheets. The system would struggle to survive if interest rates rise to double digits – yet that would be the politically acceptable fix to debt.”

Another respondent said that “interest rates mismatches are riskier because the changes of monetary policy required to deal with the dual problem of slow growth and inflation will result in interest rate volatility.”

There was also anxiety from markets which had so far been spared direct shocks, for example East Europe, emerging markets and the Far East. Tim Foster, chief financial officer of HBOS in Australia, saw the Australian market “moving out of a

## Inflation would be ‘a cataclysmic shock to balance sheets’

benign environment” with “rising interest rates and increasing credit risk”. Bankers in Hungary, Russia and Romania listed rising interest rates among their top concerns.



## 10. Hedge funds (7)

Although hedge funds slipped a few places, this was because they were overtaken by more pressing matters. Their overall score was almost identical to the previous year (3.14 vs 3.15 on a scale of 1-5) and the comments showed that they still rank high as a concern. These “could be the next problem”, said a bank chairman.

**‘These could be the next problem’**

Respondents pointed to their high leverage and opacity, their “unregulated” status and their growing shareholder activism. Many wondered how safely hedge funds would be able to unwind their deals if the crisis continued, and what wider damage they might cause in the process, particularly to investment banks with prime brokerage relationships and counterparty risk. One respondent warned that it might take some time for the full picture to emerge “due to extended redemption periods”.

Even so, some responses sounded a less anxious note. The chief risk officer of a large German bank said this was “still a specific individual fund risk” rather than a generalised problem. A London banker said that while they might contribute to volatility, hedge funds “have something of an eye for absolute value”. Other respondents said that they were “a source of stability rather than volatility” and were “curiously well managed compared to the big houses.”

### The “shadow banks”

Despite their importance for market liquidity, hedge funds and other unregulated entities are drivers behind the so-called “shadow banking system” whose unwinding is impacting the real economy. In some parts of the financial system, hedge funds have taken the role of banks while not having the same experience as traditional banks or the regulation that banks have to face. A higher degree of regulation for hedge funds might be an answer for the future.

**Marco Feiten**  
Business Development  
Dresdner Bank  
Luxembourg



## 11. Fraud (11)

Recent events have sustained the risk of fraud, or at least its discovery. For desperate people there is less to lose, more to conceal...

Many respondents said that a pressured environment increased the incidence of fraud both within a bank (traders needing to sustain performance) and outside (customers needing to sustain credit). “Tough times breed fraud” said a respondent from a large Swiss bank. The director of compliance at a large UK bank said that “more existing frauds will come to light ‘as the tide goes out’”.

But fraudsters are also becoming more clever. Financial complexity is on their side, as are the ever-swelling sums passing through the system. Controls are often poor and “still not joined up enough to combat fraud” said a respondent from the payment systems industry. John Bullard of IdenTrust, the identity security service, said that banks were not sufficiently equipped to combat the growing incidence of cross-border fraud “in a patchwork of nation-state-based infrastructure.” Growing fraud was a particular problem in Russia. E.Y. Rozanova, chief risk officer of Energy Consulting, said that increasing dependence on technology was “heightening the risk of theft and business security.”

One of the risks is the sheer cost of fighting fraud. A risk executive from a South African bank said that “the cost of implementing new technology to counter fraud in electronic payments and thus present safe payments infrastructure will become substantial”. A Japanese banker pointed to the added regulatory costs of crime prevention. But is this a battle the banks can win? Fraud was always around “even in the best families”, said one respondent.

## Fighting the bad guys

The ‘bad guys’ keep getting smarter and better equipped. We need constant diligence and investment in people and solutions to fight all kinds of fraud and threats to our data and our funds. I’m not sure we can invest equal time and money to make progress commensurate with the growth of the threat.

### Vice-president

Operational risk management  
Canadian bank



## 12. Commodities (4)

The sense that volatility in the commodity markets may have peaked lay behind the sharp fall in this Banana Skin.

The question is what happens next. Several respondents expected commodity prices to fall as steeply as they had risen. “The flood of hot money into commodities during the recent boom could be setting up a bigger than usual bust,” said one. The commodities most mentioned as potentially volatile included gold, oil and agricultural produce.

Sharp falls would damage banks which had exposure to commodity markets. Richard Farrant, non-executive director of Daiwa SMBC Europe, said that “peak oil is a more immediate challenge than seems to be generally recognised. When that recognition comes, it may act as another disruptive influence on markets”. Some respondents thought the impact on banks would be limited because many of them acted as traders and advisers rather than investors. Most of the shock would be borne by speculators and hedge funds, and “inexperienced players” lured by the prospect of easy gains. If banks did suffer, it was likely to be indirectly, through the inflation pressures that surging commodity prices had created.

Strongest concern about falling commodity prices came from banks in Russia where a banker said this risk was “not only to the banking system, but to the economy which is oriented to the export of raw materials. Falling commodity prices could hurt exports and currency earnings, putting pressure on bank liquidity and interest rates.”

**A ‘bigger than usual bust’ on the way?**



## 13. Currencies (13)

The US dollar continues to be the worry here, particularly with the divergence in interest rates in the main currency blocs. Many respondents felt that volatility would continue for some time given the uncertain political outlook in the US and, as one respondent put it, “a new Administration with promises to keep.” In the Doomsday scenario, “dollar hegemony is imperilled and will end if either the Middle East or China grows weary of financing US deficits and militarism,” said Kathleen Tyson-Quah, chief executive Granularity Ltd. And as the dollar collapses, other currency pegs could snap and cause wider havoc.

But the dollar was not the only focus of concern. Canadians and Australians worried about the strength of their dollars hurting exports. In the EU, Neil Record, chairman of Record plc, a currency management firm, warned of a possible break-up of the Euro. “The very strong Euro is making this ever more likely (or rather the certainty of break-up a little nearer),” he said. East Europeans feared for the stability of their currencies because shortages of domestic funding meant that banks had become increasingly exposed to currency risk by borrowing abroad.

### Litigation risk

The messy aftermath of the credit crunch increases the risk of expensive litigation and class actions. A senior Swiss banker saw the prospect of “legal pressures” and the finance director of a large UK group warned of “litigation from badly originated, inadequately described securities”. Settlement disputes in the securitised debt markets were also expected.

Some respondents predicted more litigation on the consumer front. Ioannis Alexopoulos, a partner in DLA Piper, saw “increased awareness by investors/consumers of their rights and problems with products or practices leading to increased litigation.” Another respondent warned of “consumer action while bank reputations are weak”.

Paul Hattori of Principal Consultancy in the UK said the risk was not just legal costs but “diversion of management time as sub-prime related litigation arises.”



## 14. Rogue trader (27)

This one was bound to shoot up the rankings, but did Soc Gen throw up anything new?

Many respondents thought not. Here was a classic case of management neglecting back office controls, failing to understand the complexities of the derivatives market, allowing the sight of profits to cloud judgment. The director of international operations at a large US bank said that “almost always the rogue trader becomes a mega-problem because of a greedy management that turns a blind eye on bad practices.”

Those who saw the risk rising noted that the sums involved grow with each rogue trading incident, and that the ever-increasing complexity of finance makes rogue traders that much harder to detect. One respondent wondered: “How many people will be inspired by Kerviel rather than deterred by the fact that ultimately he was caught?”

**Did Soc Gen throw up anything new?**

But a number of respondents thought that the risk level had not changed. They said that the rogue trader “will always be with us”, will always try to hoodwink the system, will always be able to exploit management’s lack of interest in the back office. “I would have given the same rating pre-Soc Gen” said Paul Smee, chief executive of the UK’s Payments Council. A German IT consultant thought that “recent events don’t make it more likely, but I don’t see much evidence that gaps are being plugged in banks other than Soc Gen, so the risk still seems to be there.”

Some even thought the risk level would fall because of the increased attention that management would now give to this area – for a time at least. One said: “Soc Gen was a wake up call which will tighten controls for a while”. And some regretted the consequences: “This will lead to more regulation and cost”, according to a respondent from Luxembourg.

## The old banger

The system is in a mess. Banks have been over-leveraged with off-balance sheet items such as conduits and SIVs at a time when sub-prime mortgages have been done to excess. We also have undercapitalised insurers of such debts. With a prospect of recession, we can expect the financial sector to behave like an old car engine which is short of oil for at least a couple of years.

### Sir Malcolm Williamson

Chairman

National Australia Bank UK and Clydesdale Bank



## 15. High dependence on technology (6)

Banks are highly dependent on IT systems, that is clear. But what are the risks?

Respondents gave varied answers. One was simply the risk of failure “leading to inability to process, monitor, report or control,” said a UK respondent.

Another risk lay not in technology itself, but what it cut out. “When management tries to substitute technology for experience they will fail,” said a respondent from a large US bank. But a London banker thought the human being was making a comeback. “If anything, people’s reliance on quantitative assessments of risk and value has reduced as a result of the last year.”

Another was scale. A respondent said: “I believe this risk will increase as banks upgrade systems and create points where transactions become highly concentrated. When something fails, the impacts are more visible, eg HSBC’s recent problems with its payment systems.”

And then there was management comprehension. A UK respondent said: “The strategic implications of technology are not well understood at CEO level. I presume Terry Leahy understands the technology implications for Tesco’s business. I’m not sure how many financial services CEOs I can presume the same for.”

But at the end of the day, do banks have any alternative? One respondent said that “the market currently divides into two critical groups: those that have invested in technology and those that have not and will be adversely selected as market disruptions continue to occur.” Another said that this had “nowhere to go but up. They cannot go back to paper. I’m not sure this is a negative thing, however...”

## Is the human being making a comeback?

## People

There just aren't enough experienced bankers around. The good times have lasted so long that few people have any memory of the bad ones.

Philip Wessels, chief risk officer of Nedbank in South Africa, said that the main risk "is not the changed cycle *per se* but the fact that the favourable conditions have lasted for a long period, resulting in many managers not having seen or managed a negative cycle."

A consultant said there was "a lack of anybody with experience of even moderately recent crises. UBS worldwide employs but 108 people aged 50 or more. Banks will be exposed as they navigate through the next 2/3 years." Some respondents said this was because banks got rid of older people, but banking respondents blamed a tight skills market, at least until recently. There was a shortage of people who understood "advanced derivative instruments, valuation methodologies and exception markers", according to a respondent from a large US investment bank.

An Australian banker said that "having the right people in risk, compliance and ORM is essential and competition for quality staff is of concern." Staffing problems were particularly rife in outlying markets such as East Europe and the emerging world.

Some respondents feared that banks would now repeat their mistakes by letting go people who understood complex products and had acquired crisis experience.



## 16. Corporate governance (8)

Concern about corporate governance has fallen sharply since the bad old days which led to Sarbanes-Oxley and the Higgs Report. In 2005, this Banana Skin ranked No 3.

But in 2008, responses were mixed. Many felt that good work had been done. A UK banker described this as a "fairly well ploughed furrow already." The chief risk officer of a Polish bank said the issue was "well embedded", and in Geneva, Paul Dembinski, director of the Observatoire de la Finance, thought that concern was "just noise".

But others felt there was still work to be done in some areas. One was raising the quality of boards to ensure that directors were appropriately qualified. Brandon Davies, a director of Gatehouse Capital in the UK, said that "bank boards don't have the skills in a very challenging environment." A respondent from a large Australian bank said that "the current environment requires strong board oversight." Other areas of concern included the need for more transparency and better checks and balances in the corporate power structure.

This Banana Skin also attracted comment from the regulatory community. One EU regulator was concerned about "the adequacy of board oversight on risk positions by management", Another said there should be more focus on "fraud and corruption by managers".

**The quality of boards is still a worry**

Some respondents pointed to a looming problem: sovereign wealth funds. How would they fit into the western corporate governance structure? One respondent felt that problems “could be magnified” by their growing presence, another that structures might be weakened.



## 17. Management incentives (26)

This risk is up sharply on the view that ill-structured reward packages contributed heavily to the credit crunch.

**‘Too many pigs at the trough’**

The responses were colourful. “Today’s crisis is yesterday’s bonus.” “Greed, greed, greed...too many pigs at the trough.” “A cancer in the system.” “The rotten heart of finance.” All made essentially the same point: one-way incentives push bankers to take short-term risks, ignoring real profits and sustained growth. Many also said that nothing ever changed here, despite regular outcries and promises to do better.

Andrew Freeman, senior expert in McKinsey’s risk practice, said this was “the industry’s biggest problem and should be the principal focus of risk management efforts.” The chairman of a large banking group agreed. “A new ‘pay for performance’ philosophy is needed,” he said. Some saw the risk in the form of further political/regulatory interference to “fix” the problem. Others thought it

### The curse of complexity

If one theme ran through the survey, it was complexity: of products, of systems, markets, regulations. Complexity is hampering people’s ability to understand events, to track and handle risk, to value deals - and, at the end of the day, to manage. Complexity is wonderful on the way up because it bamboozles markets, but terrible on the way down because it obscures the dangers.

These concerns were expressed with special force by non-bankers who saw a lack of transparency in banks, low levels of understanding, and regulators being left behind by over-innovative markets.

A UK consultant said: “There is a looseness of terminology hiding lack of understanding of the fundamental facts involved. This is exacerbated by misunderstanding of credit/risk gradings by agencies, particularly of complex and multilayered SIVs, and credit vehicles.” A respondent in Germany said that complexity “results in poor controls, increased likelihood of fraud, and of data protection breaches”.

But many bankers also deplored complexity. Philippe Moreels, a director of CSOB, the largest bank in the Czech Republic, said: “Banking is becoming so complex that we do not understand it and its risks any more, nor is any board member able to actually understand the whole business and therefore the risks associated with it...Even though there may be better systems, controls etc. for small parts of the business, the sum total has become too complex to follow and the necessary know-how too specialised, unless we want all bankers to be quantum physics graduates.”

A respondent from Singapore said that organisationally most banks now consisted of multiple fiefdoms rather than a coherent whole, which created confusion and a “disconnect” between the bank and what was really going on in the market.

would be self-correcting. A London banker said that “poor performance focuses attention, in pretty short order, on perverse incentives and the market sorts them out.”

Only a small number of respondents felt this Banana Skin was overdone. A senior Swiss financial executive said this was “an image issue rather than real”, and the chief executive of a UK bank said that “a lot of focus on this area means there is more transparency/fairness”.



## 18. Emerging markets (9)

### **A sharp fall in concern about emerging markets**

Well, are they coupled or not? The sharp fall in this Banana Skin suggests a lowering of concern about the health of emerging markets relative to other risks. The chief economist of a leading international bank said: “The low risk associated with emerging markets shows how much the world has changed. Even though emerging markets are not decoupled, they are better able to cope.”

But there was scepticism among respondents about the ability of emerging economies to ride the storm unharmed.

There is “a risk of complacency here”, according to one. Emerging markets “will be impacted as a result of wider market movements,” said the head of risk at an international fund management company. Some went further. The head of operational risk at a UK financial group forecast “an emerging markets crash within a two year time frame”. Many saw China taking a tumble. “It can't keep on growing at 8 per cent a year for ever,” according to a partner at a leading consultancy.

Reasons for scepticism included the lack of transparency in local markets (what is really going on there?), a collapse in commodity prices, and a greater exposure than is generally realised to real world developments.

Sheila Page, senior research associate at the UK's Overseas Development Institute, said there was “a lack of good risk information in the case of lending to developing countries, and over-confidence about prospects for China and for commodity prices.” The deputy director of a large international financial institution said he hoped banks “are not taking comfort from the ‘decoupling’ theory, and are watchful.” Jitan Patel, an analyst with Royal Bank of Scotland Group in the UK, said that Asia had become “an oasis in the midst of slowing growth in the western markets. The fear is that these two are more interdependent than many realise and the pool of water will begin to dry up.”

Some respondents feared that banks might still be lured to emerging markets by their relative stability, or by a continuing desire to diversify risk. A partner at a large London law firm said that “difficulties in mature markets will attract banks to higher risk emerging market business.”

Emerging markets themselves were generally more optimistic about the outlook, feeling that they might be spared the worst of global shocks, though access to funding was a big concern.



## 19. Back office (24)

### The 'Cinderella department'

Concern about back office risk is rising because of the volatility of markets and the Soc Gen rogue trader incident.

Huge trading volumes and the greater complexity of transactions were seen to be straining settlement systems and creating lengthy backlogs. Greatest concern focused on the derivatives markets where, in the words of a senior US banker, "settlement capability is appalling".

Some respondents said these risks would increase because the back office did not receive the same investment or talent as the front office. The chief executive of an Internet-based trading facility said: "The infrastructure of our industry (the 'plumbing') seems impervious to the competitive forces for improvement that drive, say, the retail and motor industries. 'Paper-based' seems good enough, and lobbying to protect legacy systems seems easy." Alan Peachey, author of a book on banking disasters, described the back office as "the Cinderella department" which senior management considered to be "below their dignity".

But others felt that many of these weaknesses were being dealt with, and that Soc Gen had given a spur to improvement. A German consultant said that "the middle and back office are getting focus and investment (incl. STP) in banks where there has been nearly ten years of under-investment." A London banker said that "volumes are reducing and backlog levels are being overcome."



## 20. Retail sales practices (22)

### MiFID is sorting out the mis-selling problem

A clear division of view on this one between bankers ("it's getting better") and non-bankers ("no it isn't!").

Despite the hooah that always accompanies this Banana Skin, it has to be said that it has never featured high on the list and, this year at any rate, is not seen as a strong riser. The comments from banking respondents included: "Standards are tightening at last" (Swiss bank), "post-Spitzer, mutual funds cleaned up their acts" (New York bank), and a respondent from a large German bank who said there was "more scouting" and the risk was "therefore falling". A European regulator said that these issues were "now covered by MiFID" and getting closer regulatory attention. The chief executive of a UK bank said that "regulation and systems have gone a long way to reduce this risk."

#### The dream machine 1

At the end of the day, the financial services industry has been in the "dreams" business, i.e. financing dreams of residences, vacation homes, secure retirement. But watch-out when broken dreams happen in social democracies.

Former US regulator

But outsiders pointed out that the sub-prime crisis was caused largely by questionable selling practices, and that the prospect was for more rather than less of that sort of activity. "The 'retailisation' of complex products is only just beginning," said a partner at one of the large UK law firms. The head of risk policy at a Swiss bank said that the retailing "of complex structures by sellers who

do not understand and communicate the real risk of products could have a deep reputational impact on the bank.” Another said it “will catch up with them sooner or later” as more regulation or reputation damage.



## 21. Conflicts of interest (16)

Conflicts of interest between banks and their customers always increase when times are tough, as now. “When profits and people are under pressure, conflicts of interest get sharper and more difficult to manage”, said a London banker. The head of risk at a UK financial group said: “Risks increase with complex structures where products are showing losses.”

These conflicts were seen to be sharpest in investment banks because of the multiplicity of their client relationships. A financial analyst thought that “more skeletons” would emerge from such institutions. But some respondents also saw conflicts among retail banks, between their duty to their customers and their quest for profit. Some attributed the Northern Rock fiasco to conflicting governance loyalties.



## 22. Political shocks (15)

The threat of political shocks is seen to have receded since the last survey, mainly because wars in Iraq and Afghanistan have been pushed out of the headlines by more urgent crises closer to home. But many issues remain.

Jens Tholstrup, executive director of political analysts Oxford Analytica, said that this “remains a high (but unpredictable) risk area. Economic nationalism, food and energy scarcities may cause particular problems”. The head of risk at a UK financial group said that “the financial system and market sentiment are both fragile; political shocks can have a big impact.” Another thought that the emergence of large new players like India, China and Russia raised the likelihood of clashes.

While many respondents cited the risk of unrest in places like the Middle East, Turkey and Pakistan, most comment focused on the political outlook in the US which had become “a bit of a wild card” in the words of a UK banker. Prof. Ryo Watabe of Hosei University in Japan saw “a weak US government” posing a threat. One respondent pointed out that in a year’s time, many of the major countries of the West would be under new leadership, which created a wider prospect of uncertainty. Russian bankers felt vulnerable to political risk, from internal shocks and from the possible deterioration of Russia’s relations with the West. A banking risk economist said that “all this could lead to an outflow of capital from Russia, to a crisis of bank liquidity, and to depreciation of bank capital.”

Generally respondents felt that the uncertain political and economic climate could lead to greater protectionism and tougher regulatory controls. In the UK, respondents saw the government’s clumsy handling of sensitive tax issues amounting to a political threat. Roger Gifford, UK country manager of Sweden’s SEB, feared that proposals for tougher taxation of non-domiciled resident foreigners would lead to “a loss of foreign staff.” Another respondent saw the finance sector being hit by “many poorly thought through 'sound bite' initiatives.”

## Rating agencies are seen to be part of the problem

### Rating the raters

Rating agencies are seen to be part of the problem, or at least over-reliance by others on their ratings is.

Respondents saw failings both in the quality of agencies' ratings and in the comfort that others took from them. This was particularly the case with structured securities where poor ratings had ramifications throughout the credit markets. "Rating agencies have limited insights and don't provide a particularly dynamic view", said one. There was "inadequate risk assessment [by market users] due to over-reliance on rating agencies" said another. The problem of rating agencies' loyalties was also raised: to the market or to the client? A consultant said: "Not only must the agencies be reformed to reduce conflicts, but banks must reform their credit assessment processes."

One respondent said "I cannot see the current rating agency model continuing into the future."



## 23. Business continuation (21)

This risk has been slipping steadily down the charts since 9/11 when it was ranked No 5. So much work has been done to prevent business disruption that the perception, at any rate, of the threat has eased, though terrorist attack featured in many responses.

However the term has acquired a wider meaning in a time of financial turmoil. A UK respondent said: "The risks are moving from disruption through external agency (terrorism, bird 'flu) to failure of market systems or major counterparties." A consultant said that the risk was now "from the effects of financial crisis rather than physical disruption". Another said that "many cheap money business models will fail in an era of dear money."



## 24. Money laundering (18)

### A 'got-up' risk?

This Banana Skin has fallen steeply, mainly because many bankers view this risk as "got up" by regulators and politicians to demonstrate their toughness on terrorism and crime, rather than as a genuine problem. A member of the executive committee of a large Swiss financial group said this was "high profile but only material as respects regulation." Although bank reputations are at stake, the amounts involved are small relative to total transactions passing through the system. A UK bank director said the problem "always was overhyped".

Many respondents saw this risk as part of the wider problem of over-regulation. A UK bank director said: "My main concern is the apparent inability of the Bank of England and the FSA to understand and manage the systemic risks, principally of liquidity, while they give undue attention to Treating Customers Fairly and Money Laundering Procedures." The senior vice-president of a large Canadian bank said that AML regulation was imposing "significant costs" and "continued pressure to

## Profitability: where next?

Banks profits are heading down, but how severe will this be?

A bank chairman said that the financial system will have to “adapt to lower profitability since some of the more profitable income streams will no longer exist. It will also have to adapt to generally lower RoEs because of [regulatory requirements for] more capital.” A senior regulator saw banks facing “a challenge to profitability through pressures from slowing growth rates in the real economy.”

Michael Foot, chairman of Promontory Financial (UK), said that “frantic short term US interest rate cuts and fiscal stimuli from governments that can’t afford them” would offset some of the pressures on banks. “But not enough. Underlying bank profitability will fall in most areas, a few weak banks will fail, more will get ushered into arranged mergers.”

Respondents said it was difficult to see where the next big source of profits would come from, and some feared that banks would be driven back into risky markets in search of yield.

meet short term deadlines”, and the chairman of a large US bank thought the problem “will not go away as long as regulators worry”.

But some respondents thought there was a real issue here. A Canadian banker said “the risk is still high and the consequence of an incident severe.”



## 25. Environmental risk (25)

This is as high as environmental risk has come in more than ten years of Banana Skin surveys, i.e. not very, and the tone of the comment has not changed much: potentially very important, but distant and hard to quantify. It was, however, seen as rising strongly, particularly in North America and the Asia Pacific.

Climate change was much cited as a risk, financially if losses materialise and reputationally if banks fail to be seen to be doing something about it. The head of corporate citizenship at a large Canadian bank said there were now “expectations that banks should control the activities of their clients and client industries”. Peter Hughes, director of corporate citizenship at The Smart Company, said that banks “must be seen to be concerned in today’s world, focused on climate change challenges.”

However some respondents were dismissive. “It’s getting enough attention” said one, “An easy stick with which to beat the banks” said another. A number made the point that if climate change responsibility lay with banks, it was more a matter for those in India and China.



## 26. Banking market overcapacity (17)

**But will banking capacity be allowed to shrink?**

The crisis will squeeze a lot of capacity out of the market through funding difficulties, pressure on capital and profits, banks exiting unprofitable lines, poor prospects for market growth - which is why the Banana Skin has fallen. “What overcapacity?” asked a UK bank director. But a number of respondents saw reasons why overcapacity might persist, even grow.

### No time for nemesis

Hubris. If they manage to get themselves out of the present mess, they will pat themselves on the back and rush into the next one.

**David Shirreff**  
Business & Finance correspondent  
The Economist  
Frankfurt

Despite capital constraints, the banking industry is unlikely to shrink much because of the public interest in keeping banks going, through guarantees, subsidy and even nationalisation, viz Northern Rock. A bank economist said that sovereign wealth fund support “has prevented a consolidation of the banking sector in the West” and a US banker said that technology “keeps making it easier and easier to enter the market”.

Europeans saw banks fighting to hold on to their market shares, engaging in aggressive marketing and pricing, even moving in to neighbouring countries to find new customers. A German banker saw his notoriously fragmented banking industry failing to consolidate, resulting in surplus capacity. In East Europe, banks expected to see an influx of foreign institutions eager to take advantage of their relatively undeveloped markets.



## 27. Payment systems (29)

**Global payment systems are coming together: is that good or bad?**

Concerns about financial “plumbing” have usually been low order in Banana Skins surveys, and that remains the case in the absence of major disasters, even in a time of crisis.

But the fear of breakdown never goes away. A UK respondent said this was “potentially a big source of risk, particularly when liquidity is tight. Uncomfortably binary in outcome.” Others highlighted the additional stresses created by derivative markets and hedge funds with their high and volatile trading volumes.

Many respondents focused on the coming together, globally, of payment systems, and next year’s launch of the Single Euro Payments Area in the EU. Would these narrow the risks or merely enlarge the scope for disaster?

The compliance officer of a major French bank said: “As the European market undergoes changes and world payment volumes rapidly increase, the risk of operational failures or inefficiencies is likely to rise, particularly as new cross-border commercial arrangements and new providers go through a learning phase”.

The chief executive of a large EU payments system said that “efficient systems will transmit bad news faster” and a respondent from a major US bank saw possible difficulties in “greater interdependence between securities and payment settlement systems around the world.”



## 28. Merger mania (19)

### Mergers 'of the damned'

Respondents expect banks to shy away from mergers during the current turmoil - too risky - reducing the rank of this Banana Skin by a long way. One respondent said that mergers would be “defensive now, rather than aggressive, which is probably better.”

Merger in present conditions would also be a sign of weakness, “mergers of the damned”, as one respondent put it. Several respondents from Germany expected to see mergers there as the fragmented banking system and the Landesbanken sought consolidation.

But some looked further ahead to a time when stronger banks might try to take advantage of the weaker. A US bank chairman saw the current turmoil leading to “merger and concentration with associated risks of complexity and poor execution.” A respondent from Switzerland also expected to see an acceleration in mergers because “growth is hard to find and prices are low.”

### Thank heaven for SWFs

What would happen if securities pledged as collateral for emergency loans from central banks were to default, or be downgraded, resulting in the collateral no longer being eligible? Would central banks be allowed to continue lending? Can the Bank of England bail out a further Northern Rock (or several of them)? Effectively, the lenders of last resort today are ADIA, GIC and the other funds of wealthy countries. For the time being, they are providing, but what would happen if they stopped?

**Rick Sopher**  
Managing Director  
LCF Edmond de Rothschild Asset Management  
UK



## 29. Too little regulation (30)

This remains a low order Banana Skin, though it has crept up one place since the last survey.

One reason is that the banking crisis has exposed the need for more – or at least better – regulation in a number of areas. A respondent in London said it had “focused the banking authorities on how little of the credit markets they are currently able to influence, which some would say is a key source of today's problems.” A management consultant thought there was “too little of the right kind of regulation. Banks cope well with the steady state, but regulators need to help them prepare for when things change rapidly, as they may well do soon.” But the head of financial services at a leading public relations consultancy saw the opposite problem: banking innovation was “outpacing supervisors/regulators' ability to understand what is taking place and where the risks lie.”

## Plenty of 'blind spots' on the regulatory map

The most pressing area for regulatory attention is liquidity which has been largely overlooked by the capital adequacy rules. Antony Thomlinson, a partner at Eversheds, said it was clear “that the prudential requirements applying to financial institutions are deeply flawed. They concentrate on capital to the exclusion of liquidity, and, at least in their old form, actively encouraged risky lending.”

Other regulatory “blind spots” included hedge funds, structured products, risk management, incentive schemes, cross-border activities, rating agencies, even sovereign wealth funds, not a bad list for an area that most bankers already consider to be over-regulated. But as many pointed out, it was not a question of blanketing the world with regulation, but directing it at the right targets.

Several respondents also said that regulation outside the main industrial countries was still poor even though many emerging economies had become very large indeed. Respondents from emerging economies tended to share this view, saying that local regulators were unsophisticated and bureaucratic. Russian bankers saw themselves being hampered by heavy-handed regulation and a growing emphasis on consumer rights. A respondent in Indonesia said that the authorities’ efforts to create a stable financial system “have yet to bear fruit”, and regulations were “ineffective, inhibiting and inappropriate”.

### The dream machine 2

As long as the industry keeps on investing in things that sound too good to be true, there will be instances of loss-making activity.

**Head of product development**  
London-based international bank

Russian bankers saw themselves being hampered by heavy-handed regulation and a growing emphasis on consumer rights. A respondent in Indonesia said that the authorities’ efforts to create a stable financial system “have yet to bear fruit”, and regulations were “ineffective, inhibiting and inappropriate”.

Even so, many respondents feared that the crisis would give regulators their head. From the UK one asked: “Will regulators focus on the key issues or the easy, bureaucratic wins?” and a US respondent said that the fear of too little regulation existed only in the minds of the regulators.



## 30. Competition from new entrants (28)

## Who will take advantage of weakened banks?

With the banking industry in a febrile state, this may not be the moment for new competitors to make their move. Or is it?

The head of finance at a large UK bank said that current conditions were “a barrier to entry” – a view which was widely echoed. But others took a different view. The capital constraints faced by major banks could create entry opportunities for well-funded outsiders like sovereign wealth funds, even hedge funds. The chief economist of a major international bank said that “regional banks from the emerging world will become stronger and bigger.” A US official predicted that “unregulated entities will reap the benefits of today’s market uncertainty and the likely increase in financial regulation.”

This prospect posed threats. A Japanese banker thought that new entrants “would decrease the banks’ role and bring disintermediation,” and the chief executive of a UK bank said that newcomers’ strategies would be “based on share or price, rather than a longer-term relationship strategy”. East European respondents were concerned about the encroachment of foreign institutions and, in Russia, by the predations of state-owned banks.

But some respondents welcomed the prospect of more competition. One said that the “lack of genuine competition is one of the roots of current financial instability,” and another wished there were more new entrants, “especially in monoline insurance.”

### The big question

Does the credit crunch pose a threat to the system, or is it only a problem for particular markets and institutions? Respondents were divided.

Those who thought it was systemic saw events spiralling downwards: losses causing bank failures leading to more losses and failures. The risk director of a London merchant bank said: “As I write, the safety of many financial institutions is in doubt and the contagion is spreading from banks and insurance companies to specialist funds and other parts of the financial sector. My main concerns therefore relate to the risks of recession which will further undermine confidence in the financial sector and increase the risk of systemic failure.” Richard McManus, a partner at PA Consulting Group, said that “we are in a situation where enthusiasm for off-balance sheet vehicles has resulted in an underestimate of risk and unpriced risk. In consequence the spectre of systemic risk is real.”

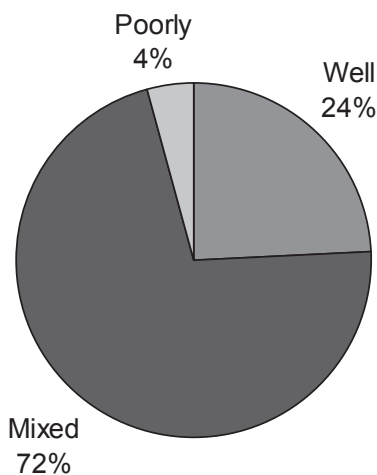
But many respondents were more sanguine, believing that the system had greater resilience than the doom mongers gave it credit for – and that if a crash did come it would be because of over-reaction rather than fundamental weakness.

A capital markets consultant said his main concern was “overreaction of policy makers. Yes, there will be some FS institutions who get into trouble, but it is not a systemic problem which requires populist solutions.” The chief financial officer of a Hungarian bank said that declining profitability “will lead to further casualties but does not threaten the stability of the financial intermediation system”, and Beat Hodel, chief risk officer at the Raiffeisen Group in Switzerland, thought that “overall, the stability of the financial sector is higher than the actual turmoil suggests”.

## Preparedness

We asked respondents: **How well prepared do you think your own and other institutions are to handle the risks you have identified?**

**A cautious response on bank preparedness**



Just under a quarter of them thought banks were well prepared for difficult times, and only four per cent thought they weren't. The rest gave a mixed response, usually differentiating between "us" (good) and "them" (poor), or between different operating environments. This was a significantly more cautious response than the last survey where "Well" scored 64%, "Mixed" 22% and "Poorly" 14%.

A breakdown of the responses by type shows bankers giving the most optimistic response, observers the most cautious, and regulators in between, though none of them casting a "Poorly" vote.

%	Total	Bankers	Observers	Regulators
<b>Well</b>	24	28	16	19
<b>Mixed</b>	72	68	77	81
<b>Poorly</b>	4	4	7	0

## Glossary

ADIA: Abu Dhabi Investment Authority, a sovereign wealth fund.  
AML: Anti-money laundering  
CDO: Collateralised debt obligation  
CDS: Collateralised debt security  
CLO: Collateralised loan obligation  
CMBS: Collateralised mortgage-backed security  
Conduit: An off-balance sheet business vehicle  
GIC: Government Investment Corporation, a Singapore wealth fund  
MiFID: EU Markets in Financial Instruments Directive  
ORM: Operational Risk Management  
OTC: Over the Counter  
SIV: Structured Investment Vehicle, an off-balance sheet business vehicle  
STP: Straight Through Processing

} Structured  
products

# CSFI

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## Banking Banana Skins 2008

Each year we ask senior bankers and close observers of the financial scene to describe their main worries about the banking industry as they look ahead. We'd be very grateful if you would take a few minutes to fill out this form, and return it to us by February 29th.

CSFI, 5 Derby Street, London W1J 7AB, UK

Fax: +44 (0) 20 7493 0190

Email: [info@csfi.org.uk](mailto:info@csfi.org.uk)

Name \_\_\_\_\_ Position \_\_\_\_\_

Institution \_\_\_\_\_ Country \_\_\_\_\_

Replies are in confidence, but if you are willing to be quoted in our report, please tick

**Question 1.** Please describe your main concerns about the safety of financial institutions (both individual institutions and the system as a whole) as you look ahead over the next two to three years.

Please turn over

# CSFI / New York CSFI

**Question 2.** Here are some areas of risk which have been attracting attention. How do you rate their severity, and what is their trend: rising, steady or falling? Use the right hand column to add comments. Insert more risks at the bottom if you wish.

	Severity 1=low 5=high	Trend Rising Steady Falling	Comment
1 Back office	<input type="text"/>	<input type="text"/>	<hr/>
2 Banking market over-capacity	<input type="text"/>	<input type="text"/>	<hr/>
Big market movements:			
3 - commodities	<input type="text"/>	<input type="text"/>	<hr/>
4 - credit spreads	<input type="text"/>	<input type="text"/>	<hr/>
5 - currencies	<input type="text"/>	<input type="text"/>	<hr/>
6 - equities	<input type="text"/>	<input type="text"/>	<hr/>
7 - interest rates	<input type="text"/>	<input type="text"/>	<hr/>
8 Business continuation	<input type="text"/>	<input type="text"/>	<hr/>
9 Competition from new entrants	<input type="text"/>	<input type="text"/>	<hr/>
10 Conflicts of interest	<input type="text"/>	<input type="text"/>	<hr/>
11 Corporate governance	<input type="text"/>	<input type="text"/>	<hr/>
12 Credit risk	<input type="text"/>	<input type="text"/>	<hr/>
13 Derivatives	<input type="text"/>	<input type="text"/>	<hr/>
14 Emerging markets	<input type="text"/>	<input type="text"/>	<hr/>
15 Environmental risk	<input type="text"/>	<input type="text"/>	<hr/>
16 Fraud	<input type="text"/>	<input type="text"/>	<hr/>
17 Hedge funds	<input type="text"/>	<input type="text"/>	<hr/>
18 High dependence on technology	<input type="text"/>	<input type="text"/>	<hr/>
19 Liquidity	<input type="text"/>	<input type="text"/>	<hr/>
20 Macro-economic trends	<input type="text"/>	<input type="text"/>	<hr/>
21 Management incentives	<input type="text"/>	<input type="text"/>	<hr/>
22 Merger mania	<input type="text"/>	<input type="text"/>	<hr/>
23 Money laundering	<input type="text"/>	<input type="text"/>	<hr/>
24 Payment systems	<input type="text"/>	<input type="text"/>	<hr/>
25 Political shocks	<input type="text"/>	<input type="text"/>	<hr/>
Regulation:			
26 - too much	<input type="text"/>	<input type="text"/>	<hr/>
27 - too little	<input type="text"/>	<input type="text"/>	<hr/>
28 Retail sales practices	<input type="text"/>	<input type="text"/>	<hr/>
29 Risk management techniques	<input type="text"/>	<input type="text"/>	<hr/>
30 Rogue trader	<input type="text"/>	<input type="text"/>	<hr/>
31	<input type="text"/>	<input type="text"/>	<hr/>

**Question 3.** How well prepared do you think your own and other institutions are to handle the risks you have identified?

Poorly  Mixed  Well

### CSFI PUBLICATIONS

1. **“Financing the Russian safety net”**: A proposal for Western funding of social security in Russia, coupled with guarantee fund for Western investors.  
By Peter Ackerman/Edward Balls. September 1993 £40/\$65
2. **“Derivatives for the retail client”**: A proposal to permit retail investors access to the risk management aspects of financial derivatives, currently available only at the wholesale level.  
By Andrew Dobson. Nov 1993 (Only photostat available) £10/\$15
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