Banking Banana Skins 2014

Inching towards recovery

The CSFI survey of bank risk

CSFI
Centre for the Study of Financial Innovation

In association with

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Preface

The first thing I noticed about this year's *Banana Skins* survey was David Lascelles's assertion that (as far as respondents are convinced, anyway) the post-2007 financial crisis is finally over, in that general anxiety levels in the industry have started to ease. Plus – and I think this is important – macro-economic and credit risks have been replaced at the top of the risk tree by that old favourite, regulation (or, rather, over-regulation or inappropriate regulation, since under-regulation doesn't seem to be a problem).

That is certainly significant, in that too much regulation was also perceived to be the top risk to the industry in both 2005 and 2006 – only to be replaced by fears about access to liquidity in the wake of the crisis in 2008. In that sense, we really are back to the good old days. The only question is whether bankers (and regulators) of today are like the Bourbons in 1815 – having "learned nothing and forgotten nothing" – or whether this year's concerns are reasonable and legitimate. In defence of bankers (and others who put regulation at the top of their list), the context today is rather different. In my opinion, the clue is this year's second-ranked risk – political interference. One respondent complained of a "gotcha attitude" against bankers; others highlighted "gesture politics" – and one observer (perhaps, with some justification) insisted that "politicians still do not understand how banks really work".

That, I feel, is a big problem. Bank-bashing may be emotionally satisfying, but banks are there to perform a socially useful function. And, unless they are given a bit of leeway, they cannot do what we want them to do – which is to keep the economic wheels turning.

As always, *Banana Skins* is a good read. But there are a number of complaints (by bankers or observers) that caught my eye in particular. They include the observations:

- that "regulators quite like oligopolies";
- that economic recovery may be happening "too soon", ie before deleveraging is complete;
- that we may be promoting a new class of asset bubble by jacking up the price of certain assets that banks are required by regulators to hold;
- that we still have an "inexplicable reward system for bankers that incentivises risk-taking";
- that complexity is itself a risk; and
- that bankers will inevitably be tempted to pile on more and more risk if they feel they have to generate the 15% ROE that markets seem to consider 'normal'.

There is also China – which is probably a risk unto itself. And, of course, cybercrime. I have long been a cynic about that, believing it to be more like pilferage at Woolworth's than Armageddon. However, its progress up the charts suggests the actual risk is finally starting to live up to the hype.

In other words, as always, there is a lot to think about (and to disagree with) in this year's survey. Again, as always, thanks to David Lascelles and Keyur Patel for putting together the questionnaire, for pulling together the responses, and for producing the usual heady mix of provocation, irritation and insight. And thanks (as always) to PwC for its tremendous support – and for having the great good sense to leave David and Keyur to draw their own conclusions from the data.

Andrew Hilton
CSFI Director

Sponsor's foreword

Welcome to *Banking Banana Skins 2014*, a unique survey of the risks facing the industry, which has been produced by the CSFI in association with PwC.

We are delighted to continue our support for this initiative. The *Banana Skins* reports provide highly regarded insight to the changing risk concerns of boards and senior management, and how these change over time.

For the latest rankings, it is not surprising that regulation and political interference have risen to be the top risks. However, as the industry increasingly embraces technology, with it comes other risks which must be addressed.

This is the 12th time this survey has come out, the last survey being in February 2012, when banks were focused on macro-economic risk. While there are on-going concerns on the macro-economic environment, including the impact of rising interest rates, potential asset bubbles and softness in some emerging markets, and whether banks may be tempted to misprice risk or inadvertently mis-sell products, of greater concern are technology-related risks.

As banks move towards greater digitisation, they are focusing on how to better manage technology risk and criminality as a result of concerns about the vulnerability of outdated systems to cybercrime and outages. Banks, however, need to be concerned not only with their own systems and processes but also with related reputational risks arising from third party outsourcing and off-shoring activities. Their different and possibly less stringent security standards could create the potential for data loss or leakage. The increasing need to manage the reputational risks associated with the rapid growth of social media mustn't be underestimated.

Over the past few years, banks have improved the quality of their risk management and how they manage their capital. Coupled with reduced concerns over macro-economic risks, anxiety levels in the banking industry appear to be declining after rising for seven consecutive years. Yet, with regulation and political interference continuing to impact the industry, banks will need to carefully manage these risks while ensuring they are forward looking and focused on positioning themselves for growth in the longer term.

I would like to thank the CSFI for the richness of insight in this report. I trust you will find Banking *Banana Skins 2014* useful and thought-provoking. If you have any feedback or would like to discuss any of the issues raised in more detail, please do not hesitate to contact me.

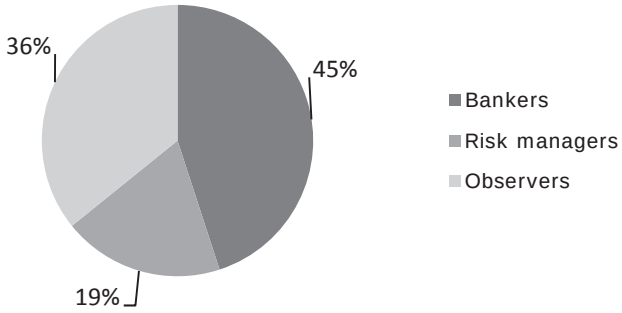
Dominic Nixon
Global FS Risk Leader, PwC (Singapore)

This report was written by **David Lascelles** and **Keyur Patel**

About this survey

This survey describes the risks currently facing the global banking industry, as seen by a wide range of bankers, banking regulators and close observers of the banking scene around the world. The survey was carried out in January and February 2014, and received 656 responses from individuals in 59 countries. The questionnaire 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 score a list of potential risks, or Banana Skins, selected by a CSFI/PwC panel. 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 named.

The breakdown of respondents by type was:



The breakdown by countries was as follows:

Argentina	1	Hungary	5	Pakistan	4
Australia	11	India	10	Philippines	12
Austria	2	Indonesia	5	Poland	14
Bahrain	1	Iran	1	Qatar	1
Barbados	1	Ireland	2	Romania	10
Belgium	14	Italy	2	Russia	16
Bosnia & Herz.	1	Japan	2	Singapore	15
Brazil	5	Kenya	1	Slovakia	12
Bulgaria	1	Kosovo	1	Slovenia	1
Cameroon	1	Latvia	14	South Africa	14
Canada	45	Lebanon	1	Spain	6
Cayman Is.	2	Liechtenstein	1	Sweden	4
China	22	Luxembourg	35	Switzerland	17
Czech Republic	4	Malaysia	10	Thailand	1
Denmark	5	Malta	8	Turkey	31
Ethiopia	1	Mexico	25	UAE	1
Finland	1	Netherlands	21	UK	186
France	4	New Zealand	6	Ukraine	2
Germany	5	Nigeria	4	USA	25
Hong Kong	2	Oman	1		

Summary

This report describes the risk outlook for the banking industry at the turn of the year 2014 – a time when the global economy and its banking system were recovering from the financial crisis. This could be described as the first post-crisis Banking Banana Skins survey because it shows, for the first time in seven years, a decline in the level of anxiety about the condition of the banking system. The risk landscape it paints therefore reflects people's risk preoccupations in a newly evolving world.

The findings are based on responses from more than 650 bankers, regulators and close observers of the banking scene in 59 countries. In the opinion of these respondents, the greatest threat to the banking industry lies in the strong **regulatory and political backlash** that has taken place against banks in reaction to the crisis. These risks were ranked No. 1 and No. 2 respectively out of a field of 28 risks in the survey. The overwhelming message in the responses is that the weight of new regulation is becoming excessive, and could well damage banks and hold up the economic recovery. This view was held both by bankers and non-bankers, and was particularly strong in Europe and North America.

Excessive regulation is seen as the severest risk facing banks

In a typical comment, a UK respondent said: "I do worry that we have gone beyond the 'tipping point' at which the costs of ever more regulation begin to exceed the benefits." A Canadian banker said that much political action in the banking field was driven by a "gotcha attitude against banks".

These concerns are set against a fragile **macro-economic environment** (No. 3). The survey reveals considerable uncertainty about the strength of the economic recovery because of the heavy debt overhang in both the private and public sectors, and the persistence of severe sovereign debt problems in a number of countries. The EU and emerging markets were singled out as potentially problematic. This risk is closely linked to

Banking Banana Skins 2014

(2012 ranking in brackets)

1	Regulation (6)
2	Political interference (5)
3	Macro-economic environment (1)
4	Technology risk (18)
5	Profitability (7)
6	Pricing of risk (11)
7	Credit risk (2)
8	Corporate governance (9)
9	Criminality (24)
10	Capital availability (4)
11	Quality of risk management (10)
12	Interest rates (17)
13	Back office (13)
14	Change management (15)
15	Liquidity (3)
16	Sales and business practices (20)
17	Emerging markets (22)
18	Derivatives (8)
19	Social media (-)
20	Shadow banking (-)
21	Management incentives (14)
22	Currency (19)
23	Human resources (28)
24	Reliance on third parties (29)
25	Social sustainability (25)
26	Equity markets (21)
27	Commodity markets (26)
28	Business continuation (12)

interest rate risk (No. 12) where the prospect is for higher financing costs as central banks phase out their quantitative easing programmes. One respondent said that borrowers "are woefully unprepared for a 'normal' rate environment".

Has credit risk really declined?

Another strong concern in this area is **bank profitability** (No. 5) both in the short term because of the legacy of bad debts, many still not fully recognised, and in the longer term as banks adjust to the costly structural and regulatory changes that have been imposed on them in the last 2-3 years. Although concern about **credit risk** has receded from the high position it occupied during the crisis (down from No. 2 to No. 7), respondents stressed that debt levels remain high in all the major categories, and could easily get worse if the economic recovery falters or interest rates rise sharply. There is also concern that bankers may be pushed to **misprice risk** (No. 6) by the pressures of competition and an abundance of central bank-provided liquidity.

Risers and fallers

The dramatic changes that are taking place in the global banking industry are reflected in equally sharp changes in risk perceptions. Here is a selection of risks whose ranking has altered markedly since our last survey in 2012.

RISING RISKS

Regulation: Concern about regulatory overkill, and potential damage to banks.
Political interference: More governments setting the rules for banks.
Technology risk: Outdated systems vulnerable to cybercrime and outages.
Pricing of risk: Temptation for banks to underprice risks because of competitive pressure and the abundance of CB liquidity.
Criminality: Strong rise in cybercrime.
Interest rates: End of quantitative easing could cause serious problems for banks.
Emerging markets: Concern about economic and financial stability, particularly in China.
Sales and business practices: Banks may not have full control over mis-selling and other abuses.

FALLING RISKS

Credit risk: Hopefully past the worst as economies recover.
Capital availability: Banks' capital ratios are improving.
Liquidity: Central banks will ensure that supply is plentiful.
Derivatives: Trading of exotic products now under tighter control.

Central banks will make sure banks have enough liquidity

Liquidity risk is one of the big movers in this survey, falling from position No. 3 in 2012 to No. 15 in this survey. One respondent said: "I can't imagine the central banks are going to stop giving liquidity assistance any time soon, including to technically insolvent banks..." There has also been a decline in concern about the banks' ability to raise fresh **capital** to meet higher regulatory requirements (down from No. 4 to No. 10), though this adjustment is also being achieved by deleveraging, which has implications for the availability of credit more widely.

The institutional risks in banks show a generally easing trend. The **quality of corporate governance** continues to be the strongest concern at No. 8, driven by perceptions that boards do not have a sufficient understanding of modern banking practices, and give strong executives too much rein. The **quality of risk management** (No. 11) is a particular concern, though it is recognised that this is an area where much work has been done to raise standards. Both of these risks were a greater worry to non-bankers than to bankers. Concern about **management**

incentives is also easing (No. 21). A rising issue in this area is the **quality of sales and business practices** (up from No. 20 to No. 16), driven by the recent revelations of abuse in LIBOR setting and other markets. Interestingly, however, concerns about banking ethics and reputation rank low (**social sustainability** at No. 25), though not for very inspiring reasons: many respondents said that banks' reputations could hardly sink lower.

Very sharp rise in technology risk

Chief among the rising risks this year is **technology risk** (up from No. 18 to No. 4) because of growing concerns about the vulnerability of outdated systems to cybercrime and outages, and the low priority assigned to this risk by managements. This is a new development: technology risk has historically been seen as low order.

Another strong riser is **criminality** (up from No. 24 to No. 9) on the back of growing concern about cybercrime (hacking, identity theft and phishing) where banks have become the criminals' main targets and where the opportunities are expanding all the time.

Concern about **emerging markets** is also on the rise (up from No. 22 to No. 17) because of the growing risk of economic slowdown and financial instability, particularly in China.

Among the low ranking risks, a number are worthy of mention. **Derivatives** (down from No. 8 to No. 18) are no longer seen as the threat they once were thanks to tighter management and regulatory controls. **Social media** (appearing for the first time this year at No. 19) reflected low, though guarded, concern about the potential impact of Twitter, Facebook etc. on bank business and reputations. **Shadow banking** (No. 20) is now seen more as a potential than an actual threat, depending on how much business is driven from the regulated to the unregulated sector by the tide of new regulatory controls.

Strong consensus about regulatory risk around the world

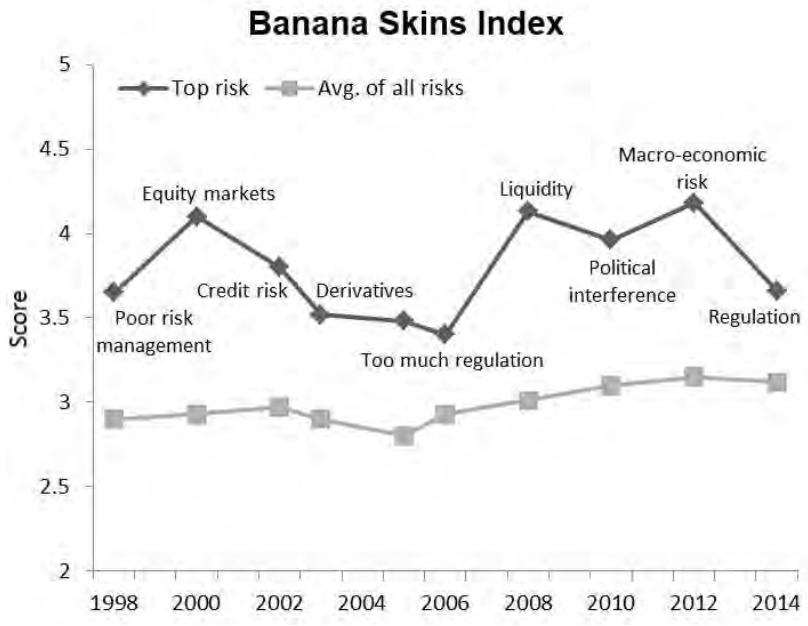
A breakdown of responses by **type** shows that all major respondent groups (bankers, observers and risk managers) are strongly concerned about regulatory excess and political interference, as well as the state of the global economy. Important points of difference come in their attitudes towards institutional risk. Non-banker respondents believe that banks are vulnerable to weak corporate governance and risk management, while bankers play these risks down. Non-bankers are also much more concerned than bankers about the rise in criminality and cybercrime.

A breakdown of responses by **region** shows that concern about excessive regulation and political interference in banking is concentrated in Europe and North America. The top concerns in the Asia Pacific region focus more on potential macro-economic disruptions, and the risk of sharp changes in interest rates. The risks which featured strongly across the board included technology risk, credit risk, banking profitability and the quality of risk management. The North American response was especially notable for high concern about criminality and the rise of the shadow banking sector.

Preparedness. We asked respondents how well prepared banks were to deal with the risks identified by the survey on a scale where 5=well prepared. The result was 3.04, slightly better than the 2.96 scored in 2012. However bankers rated their preparedness higher than non-bankers.

Banana Skins Index down for the first time in seven years

Banana Skins Index. The Banana Skins Index tracks survey responses over time and can be read as an indicator of changing anxiety levels. The upper line shows the average score (out of five) given to the top risk, and the bottom line shows the average of all the risks. This year, both indicators have come down from the record highs they reached in the 2012 survey, a sign that anxiety levels in the banking business may finally be declining after rising for seven consecutive years.



A closer look at the numbers. In our Banana Skins survey, respondents rate each risk from 1-5, where 5 is the most severe. A detailed breakdown of the ratings is revealing (see Appendix 1). We found:

1) **The severity of the top three risks is on a different level from the rest**. The difference in the average rating of risk No.1 to No.4 was greater than the difference between the next ten risks.

2) **Bankers rate institutional risks much lower than non-bankers and risk managers.** Yet there was little disagreement on the risks driven mainly by governments and global economic forces.

3) **Non-bankers are much more gloomy not only than bankers, but also risk managers** about the severity of the risks facing the industry and its preparedness to deal with them. Europe – weighed down by the UK responses – is by some way the most pessimistic region.

4) **Institutional risks dominate UK concerns**. The biggest contrast with the global ratings is around sales practices, the back office, governance, and bonuses – though regulation and political interference risks are also seen as more severe.

Who said what

A breakdown of responses by type and geography shows important differences in risk perceptions.

Bankers – commercial and investment bankers

1 Regulation
2 Political interference
3 Profitability
4 Macro-economic envt.
5 Capital availability
6 Credit risk
7 Technology risk
8 Pricing of risk
9 Interest rates
10 Change management

Bankers held the strongest views among the main respondent groups about excessive regulation, believing that it would harm their business. This was closely linked to their concern about growing political interference in the banking sector and the effect of both on banks' profitability and business. Looking ahead, bankers were also concerned about interest rate rises as quantitative easing comes to an end. They did not share other groups' strong concerns about the quality of management and governance in banks.

Observers – analysts, consultants, academics, service providers

1 Political interference
2 Corporate governance
3 Regulation
4 Technology risk
5 Macro-economic envt.
6 Credit risk
7 Pricing of risk
8 Quality of risk mgt.
9 Back office
10 Criminality

Bankers ignoring corporate governance risk?

Non-banker respondents to the survey shared bankers' concerns about the potentially harmful impact of political interference and regulation on banks. But they also stressed the risks in poor corporate governance, and risk management. They were concerned about the possibility that the economic recovery would falter, and re-open the problem of bad debts. They attached greater importance to technology risk and the associated risk of cybercrime.

Risk managers – people who work in risk management, including regulators

1 Macro-economic envt.
2 Regulation
3 Criminality
4 Political interference
5 Technology risk
6 Pricing of risk
7 Profitability
8 Quality of risk mgt.
9 Corporate governance
10 Credit risk

Respondents whose work was directly associated with risk management saw the greatest danger in the fragile state of the global economy, closely followed by concerns about inappropriate regulation. Further down the rankings, however, their concerns showed no clear pattern, covering everything from criminality to credit risk, evidence of the wide range of risks now preoccupying the banking sector.

Concern about over-regulation concentrated in Europe and North America

Europe

1 Regulation
2 Political interference
3 Macro-economic envt
4 Profitability
5 Pricing of risk
6 Credit risk
7 Corporate governance
8 Capital availability
9 Technology risk
10 Quality of risk mgt.

Europe's rankings comprised a majority of the responses we received this year, and therefore were closely aligned with the global results. The biggest perceived threats are the ones largely outside banks' control: excessive or badly targeted interference from regulators and governments, as well as concerns around the macro-economic climate and credit risk, particularly with the continued fragility of eurozone economies. But there is also seen to be scope for improvement by individual institutions in areas such as corporate governance and risk management.

Asia Pacific

1 Macro-economic envt.
2 Interest rates
3 Technology risk
4 Pricing of risk
5 Quality of risk mgt.
6 Regulation
7 Human resources
8 Profitability
9 Credit risk
10 Liquidity

The Asia Pacific response covers diverse economies – including China, Singapore, the Philippines, Malaysia and Australia – meaning the patterns are less obvious. Nevertheless, the dominant concerns are macroeconomic, particularly the effect of rewinding stimulus measures created by quantitative easing. Regulation is seen as a worry but less so than globally, perhaps because the related risk of political interference was ranked much lower than elsewhere (No. 12). On the other hand, this is the only region that sees attracting and retaining talent as a top ten risk issue.

North America

1 Regulation
2 Technology risk
3 Macro-economic envt.
4 Political interference
5 Criminality
6 Shadow banking
7 Interest rates
8 Quality of risk mgt.
9 Credit risk
10 Profitability

Regulation received a more severe rating in the US and Canada than in any other region, reflecting concerns about its compliance cost and inconsistent implementation. That had an impact on the high perceived threat of shadow banking, driven in part by concerns that regulation on mainstream banks is driving activity into the arms of shadow banks. However, the effect on profitability was seen as less of a concern than it was globally, though it is still a top ten risk. Both technology risk and criminality were also ranked top priorities, underlining fears about cyber disruption to the industry.

Preparedness

We asked respondents how well prepared they thought banks were to handle the risks that lie ahead, on a scale where 5=well prepared and 1=poorly prepared. The average score was 3.04, a slight improvement upon the 2.96 score we recorded in 2012 and a touch better than middling. However, the breakdown by type of respondent shows that bankers and risk managers rate their level of preparedness higher than observers.

Total	**3.04**
- Bankers	3.19
- Risk managers	3.16
- Observers	2.78

Banks are better prepared - say bankers

On the positive side, many respondents said that banks had made risk management an urgent priority over the last couple of years. “Banks are now devoting large scale resources to dealing with many of these risks”, said a non-executive director at a financial group in the UK, while the CFO of a major bank in Canada said: “Banks have become better at looking forward at risks to identify what is on the horizon and adjusting for those potential challenges”.

But others warned that risk managers were still too reactive and unable to cope with the unexpected: “So reliant on decision processes and systems”, as an academic from the UK put it, “that they are unable to think for themselves”. Some saw this as inevitable given the scale of the task ahead. A respondent from The Netherlands said: “Banks are too busy with compliance and clean-up of the mess from the credit crisis to spend the necessary time to look ahead at emerging risks”.

Preparedness clearly varies a great deal between institutions. But a broad theme is that banks seem to be getting better at dealing with the risks they can influence; the problem is that some of the most potent threats – such as macro-economic instability and increasingly sophisticated crime – are largely outside their control. Moreover, highly prescriptive regulation can often be a hindrance rather than a help. As one respondent in the UK put it: “Banks need to be told to improve their performance and then left to determine how to do this. If they are micromanaged by regulators and politicians, management attention might miss the big picture problems”.

1. Regulation (6)

The greatest risk facing the banking industry today is the burden of new regulation, according to the respondents to this latest Banking Banana Skins survey. This may seem a perverse result given that regulation is supposed to be about making banks more rather than less safe. But the responses clearly showed that people close to the banking scene - bankers as well as observers – see the huge wave of regulation that followed the banking crisis as excessive and potentially harmful to banks as well as to the prospects for global economic recovery.

The bankers voted it their top risk; non-bankers put it at No. 3. Concern about regulatory risk was particularly high in Europe and North America, but it also scored strongly in other parts of the world, notably the Far East, the Middle East and Asia.

Richard H. Murray, chairman emeritus of the Center for Capital Markets in the US, commented: “Can the leadership and culture of the global banking sector adapt to a significantly more regulated world, where the regulation is not always wise and prudent, and the strengths of the banking sector are intertwined with practices widely perceived to be self-serving?”

Although a small number of respondents saw the growth of regulation as necessary, even beneficial given the banking horrors of the last few years, the great majority felt it had gone too far and was now loading banks with unnecessary costs and producing unintended consequences which could trigger a new wave of financial risks down the road, for example by driving financial business into the unregulated sector.

Clive Briault, a former senior UK bank supervisor and now senior adviser to KPMG UK, said: “I do worry that we have gone beyond the ‘tipping point’ at which the costs of ever more regulation begin to exceed the benefits. [British Chancellor] George Osborne's comment on the ‘stability of the graveyard’ has some truth in it.” Another banking supervisor expressed concern about “the rising cost of compliance with regulation and rising levels of capital due to ever-expanding regulation”.

Regulation going beyond 'the tipping point'

Many of the concerns expressed by respondents are familiar from earlier Banana Skins surveys where regulatory risk has long occupied a high place in the rankings: the cost and distraction of complying with new rules, inconsistent implementation across sectors and borders, and the growth of regulatory risk itself in cases of non-compliance. On top of this is the sheer volume and range of new regulation covering corporate structures, capital, liquidity, risk management, conduct of business, product development, operational risk, corporate governance, and much else besides.

There is particular concern about the motivation behind the regulatory push: to what extent is it driven by an informed understanding of how banking can be made safer, or simply by a desire to bash the banks? The huge regulatory penalties recently imposed on banks add to what a Canadian bank director called a “Gotcha attitude against banks”. The head of regulatory strategy at a large UK clearing bank said that the regulatory push was driven by “contradictory demands, gesture politics, general hostility to business, and general political ignorance of business economics”.

However the responses also revealed a deeper concern about the longer term consequences of re-regulation for the banking industry. A strong theme was the

structural impact: complex regulatory regimes of the kind now being introduced clearly favour larger banks which can absorb the cost. The resulting market concentration could have worrying competition and stability consequences by creating more banks that are too big to fail. Regulatory cost is also driving business out to less well regulated sectors, such as shadow banking and pay day lending, potentially creating new risks. A further concern was competitive equality. Would some countries or sectors benefit from lighter treatment than others? In Latvia, for example, there is concern that regulatory cost will weigh more heavily on small economies. A Latvian bank manager said that regulation was leading to "too high fixed costs and unviable business models".

Many respondents were also worried that more burdensome regulation would stifle profitability and innovation in the industry at a time when the banks' contribution to global economic recovery was most needed. In some countries like the UK this is already causing tensions between politicians who want to get the economy moving, and regulators whose priority is to make the system safe. A former senior banking supervisor said that "the main tension now will be between governments that want increased competition in the retail area and regulators who quite like oligopolies". Intrusive regulation will also weaken bank governance because, as a US risk director said, it is "hard to hold banks accountable if they are just following the regulators."

Will tougher regulation help or hinder the economic recovery?

Too much complexity

What concerns me is the risk that comes from complexity - the complexity of national and international regulation, of new regulations, of regulation which is designed to achieve a particular outcome but which fails to anticipate human and institutional behaviour and therefore fails to achieve its outcome.

There is complexity also in all the initiatives currently underway to try to restore confidence and trust in the industry. These are well-intentioned but risk diluting resources, running across each other and reducing the impact of any individual initiative. There is a risk that banks forget too quickly the cautionary lessons from the recent financial crisis and therefore fail to be robust in challenging 'clever' new ways to make profit.

Susan Rice
Managing Director
Lloyds Banking Group

Some respondents saw fresh risks emerging as banks experimented with new business models to find ones that are viable under the new regulatory regime, and would likely be tempted to exit the industry. One respondent said that the financial services sector was now "being built by regulation, and it won't work".

The broad picture that emerged from the responses was a high level of concern that regulation will leave the banking industry better capitalised, but so burdened with rules and requirements that it will be unable to generate sufficient profit to flourish, or compete with more lightly regulated parallel sectors. Meanwhile new risks are

A regulated world

Concern about the level of new regulation is global. Here is a selection of responses from around the world to illustrate this point.

Australia: We need to manage the cumulative impact of global regulatory change and its dampening impact on growth as deleveraging continues. Banks need to be able to sensibly price for risk and generate an adequate return on equity.

Brazil: Regulations are imposing capital restraints, and huge costs are arising just to comply with the requirements.

Bulgaria: There is a strong negative public sentiment towards the banks, and local lawmakers are likely to respond to [this] by increasing the regulatory burden on the banks.

China: The inconsistency of regulatory policy can result in a certain degree of unequal competition.

Denmark: Excessive regulation will spur the formation of a destabilizing shadow banking sector.

Japan: While capital seems adequate in the system, ongoing regulatory uncertainty combined with liquidity concerns could lead to a rapid decline in market stability.

Malaysia: There is tremendous pressure to comply with regulations which prove very costly to implement. Margins are falling.

Netherlands: Banks are unable to be innovative due to heavy regulatory pressure.

Singapore: The cost of doing business is becoming too high and is not easy to pass on to customers.

Slovakia. The banking system is now over-regulated which has a significant impact on competitiveness, flexibility and profitability.

South Africa: Banks are focussing significant resources on regulatory compliance. Is this diverting their attention from managing their business risks?

Turkey: There are a lot of new regulations which are aimed at the safety of the banking system but which threaten the profitability of financial institutions.

UK: Heavy/new regulation […] pushes banks to seek ways around or to minimize the effect of the regulations. This is usually inefficient, and may lead to mishaps and hits to the banks' reputation.

US: [There is an] excessive focus on trying to interpret and adhere to growing regulation and the creeping authority of various regulators.

certain to appear, for example in asset bubbles created by regulations that require banks to hold particular classes of financial instrument, in unregulated sectors, and in a regulatory system that is so complex that it will never be able to deliver the promise of banking stability.

But a number of respondents felt that new regulation, while burdensome, was beneficial. In Canada, a senior regulation adviser at one of the major banks argued that “banks that are well-diversified and that have adequate capital and liquidity should be able to easily adjust their operations to meet the changing regulatory requirements with minimal to no long-term damage”. A bank regulator in South East Asia said that “the global regulatory environment will become more challenging for financial institutions, but it should make the system as a whole safer if properly implemented across all major jurisdictions”.

2. Political interference (5)

Concern about political interference in banking is rising, driven by the wave of measures taken by governments to stabilise and reshape their banking systems in the wake of the financial crisis. To many of our respondents, these measures have become excessive, even ill-motivated, and will have unintended consequences, by handicapping banks and creating market distortions.

Political interference takes many forms: restructuring banking systems (for example by "ring fencing" activities of social and economic importance), by imposing bank-specific taxes, by introducing punitive capital and liquidity requirements, by interfering in pricing and making public attacks on banks. The growing incidence of large penalties for malpractice could also end up damaging rather than reforming banks.

Governments are taking a close interest in banks

Respondents were concerned that these actions would add costs and constraints to banks and impair their ability to function, while political grandstanding and "bank bashing" would delay the return of public trust needed for a well-functioning banking system. In Australia, the head of operational risk at a large banking group said that "in the longer term, political pressure is driving uneconomic decisions, reputational damage and exponential fines across the industry". In Canada, a bank director said that "there is not a sustainable equilibrium in political-regulatory-bank relations at this point".

Political interference was reported in most parts of the world. Some of the strongest concern is in Europe where far-reaching measures have been proposed or adopted at both the EU and national levels to make banks safer. The CEO of a Dutch bank described political risk as "the biggest threat to the system...Threats come from the ongoing lack of trust among the public at large and politicians (without trust [there can be] no sustainable healthy sector) leading to overregulation and strangulation of the sector".

There is also concern about the conflicting demands being placed on banks: to become more prudent while also taking lending initiatives to finance the recovery. A respondent from a Japanese bank in London said that "To me this is the biggest risk. Politicians still do not understand how banks really work and are introducing new perverse incentives all the time. Banks are doing a good job managing this, but can only do so much when faced with conflicting demands".

In other parts of the world, there are more specific local concerns. Abhijit Sen, chief financial officer for Citibank in India, said that "in economies with large state-owned banks there remains a risk that banks could be asked to bail out poor credits or otherwise do large scale loan forgiveness programs". Several respondents in Turkey felt that the combination of political unrest and a government tending towards "Islamisation" was leading to more unwelcome controls on banks, in the area of price regulation and capital, for example. A senior manager at a bank in Nigeria said that political interference "is a very great risk that banks face, especially in developing countries as government and regulatory changes are effected at random to the detriment of the banks".

One country where the opposite trend was reported was China where respondents saw government interference receding. Jianhua Zeng, chief risk officer at China Construction Bank said that "in the future, along with the advancement of deepening reform, government intervention will reduce gradually".

But a number of respondents said that government initiatives were resulting in stronger, better managed banks, and safer banking systems. Although bankers might lose out, there were benefits for creditors and depositors. A US regulator said that "the short term costs of reform are outweighed by the long term benefits of stability".

3. Macro-economic environment (1)

This was the top risk in the last Banking Banana Skins survey in 2012 - a time when the global economy was still in the grip of crisis. It has come down a few places indicating a slight easing of concern, but the responses revealed considerable uncertainty about the strength of the recovery.

Diane Coyle, director of Enlightenment Economics in the UK, said that “there is still significant systemic risk given the slow pace of reduction in leverage [and] increase in equity levels, combined with an uninspiring economic recovery, the debt overhang, and unresolved sovereign debt situations”.

The future of quantitative easing is key to economic prospects

Much the biggest worry is how the world gets out of the artificial interest rate regime created by quantitative easing. "The normalization of monetary policy poses uncertain consequences", said a US regulator, with some understatement. The worry is both about the impact of rising interest rates on global economic activity, and the risk management difficulties that banks will face as they adjust their balance sheets to new interest rate levels. "Asset and liability management risks may be very high if interest rates change rapidly," said the head of internal audit at a Swiss bank. (See No. 12, **Interest rates**).

Worries about the outlook were varied, reflecting the unprecedented state of the global economy. Some respondents felt that the recovery was happening too soon, before the process of deleveraging was complete, and that this would lead to renewed debt problems in both the public and private sectors when interest rates rise. The chief risk officer for Europe, the Middle East and Asia of a large US bank said that "banks have still to take pain, but [they are] holding overvalued assets in the hope that the economy improves to get them 'out the hole'".

The risk of new asset bubbles was also a worry, particularly in the property market where prices are rising on the back of new debt and government-sponsored finance

Eurozone crisis 'only in abeyance'

The eurozone still at risk

Scepticism about the strength of the global economy is rife, but it is particularly marked in the eurozone where the recent absence of bad news is widely seen to be only the calm before another storm. "The eurozone crisis is in abeyance and is likely to come back to haunt us" was one comment.

Stephen Walker, a senior investment manager at Four Capital Partners, said "I would not categorise myself as a single currency doom-monger, but we do not yet have a cure for the single currency's structural issues. And, given the outsized consequences of failure, it would remain my biggest concern..."

Much of the focus is on the parlous state of the eurozone economy which is "still fragile and will not be able to stand another shock or crisis" according to the chief compliance officer of a bank in Luxembourg. A Scandinavian bank regulator said that the banks in his country were strong. "However, if structural problems in several countries in the eurozone are not rectified, resulting in a sharp downturn in this area affecting its already weak banking sector, this could also, in the long run, have a negative impact [on the economy and the banking system]".

The likelihood of further sovereign debt problems is seen to be high, both as existing work-out countries fail to make it, and others are forced to ask for help. The chief risk officer of a bank in France said there was a risk of "another eurozone crisis triggered by a 'large' country like France, generating doubts about its growth capacity and lack of structural reforms".

Questions were also asked about the effectiveness of banking regulation in the eurozone, in particular the enormously complex plans being assembled for banking union. One respondent from Brussels doubted that there was "preparedness for bad news" out of the Asset Quality Review being conducted by the European Central Bank. Another eurozone banker said that a dangerous "'government debt bubble' had been created out of the regulatory requirement for eurozone banks to hold sovereign debt.

From outside the eurozone, a Russian banker put "public debt crises in Europe" at the top of his worry list. A US banking professor said that "Europe's banks are deeply under-capitalized and at risk from a variety of perspectives: loan risk, sovereign debts, implosion of the eurozone, failure to coordinate the regulatory process effectively..." and the chief risk officer at a large Australian bank said that "transition to the European Banking Union and recapitalization of their banks is a big watch area with many economies still very fragile".

programmes. A South African respondent said that "the risks of diminished liquidity, rising interest rates and a stalled economic recovery, combined with certain assets prices being unjustifiably high present some significant challenges".

But others feared that the recovery was too weak and was liable to be thrown into reverse. The ability of the banks to finance strong growth was widely doubted because of their parlous state and the weight of new regulation. A Canadian respondent said that "banks are somewhat at risk from the current macro-economic environment to the extent they may suffer losses from slower than anticipated economic recovery (in the form of consumer loan defaults, inability to lend at higher interest rates, a decline in the housing market, etc)..."

Uncertainty about conditions in emerging markets was also high on the list. "Economic growth is not improving as expected", said a respondent from Malaysia. The outlook in China was a particular concern. The chief financial officer of a large Chinese bank said that given "the adjustment of the economic structure and the slowdown of the growth rate in the economy, some industries and businesses will be in trouble, and financial institutions may face the risk of decreasing asset quality". (See No. 17, **Emerging markets**).

However a small number of respondents commented positively on the outlook, stressing that growth, however uncertain, was better than none at all, and that there were reasons for expecting the global economic rebalancing to be successful. One of them commented: "The downside (and indeed upside) risks look less pronounced this year than in any year since about 2007".

4. Technology risk (18)

One of the most striking results in this year's survey is the big jump in concern about technology failure.

Very striking rise in concern about technology risk

Two themes ran through the responses. The first is the perception that there has been a huge escalation in the frequency and sophistication of cyber-attacks, (which also drove a sharp rise in the ranking of **Criminality** risk this year. See No. 9). The chief risk officer of a bank in Australia said: "the fastest increasing risk revolves around a range of threats categorised as cybercrime coupled with the broadcasting of the event through social media".

Allied to this a growing reliance on old and overly complicated IT systems (see also **Back office risk**, No.13) which are susceptible to security breaches and unpredictable outages that can cause widespread disruption. One respondent from a Japanese bank gave a scathing assessment: "Only going to get worse. Ancient systems stuck together with sticky tape. Long lead time to replace them. Too expensive to replace them. Management have head in the sand about the scale of the problem".

A major challenge is that banks are already playing catch up in a technology environment that continues to evolve rapidly. Graham Smith, director of the technology consultancy Certeco, said that "legacy systems will still be a major problem for financial institutions. Updating these systems whilst trying to adopt a more fleet of foot, customer centric approach through mobile technology will present a massive risk to these organisations".

That makes disruption almost inevitable. Taking the prospect of cyber-attack and internal technology issues together, Chris Dunne, payment services director at the UK payments systems company Vocalink, said: “It is a near-certainty that institutions will suffer outages in the next few years; the critical issue is how they recover”.

As many respondents pointed out, the potential rewards to the banking industry are high if the risks around upgrading technologies are successfully overcome. But one problem – particularly in emerging markets – is that the cost of implementing secure systems could lead to innovation being shunned. A banker in Mexico said that security issues meant that “cash continues to be widely used and the lack of trust in technology could imply a regression towards further cash usage”.

5. Profitability (7)

Although banks are now in recovery phase, concern about their profitability persists. This reflects a number of factors, many of them specific to particular markets such as the level of competition, low interest rates and the volume of non-performing loans. But the broad theme is that banks have moved into a new era where profitability is unlikely to return to earlier levels because of the structural and regulatory changes that have been imposed on them in the last few years. This raises difficult questions about the ability of banks and their shareholders to adjust to changed expectations.

A credit analyst said that "the erosion of profitability, leading to lower ROEs, […] will constrain internal capital generation and may create difficulty in raising capital externally".

Bank profitability may never recover earlier levels

Most respondents saw regulatory change, particularly higher capital requirements, having the biggest impact. Guy Harding, chief risk officer at Commonwealth Bank of Australia said that “increasing capital will inevitably lead to lower returns”. The head of regulatory developments at a large UK clearing bank saw “growing challenges to the viability of existing banking models and the profitability of the western banking sector as the re-regulation wave moves from policy development to implementation”. A finance director from a large German bank even warned that “a number of banks are likely to close due to their inability to generate profits due to the introduction by regulators of onerous and misguided capital requirements”.

Other negative influences on profitability that were mentioned included pressures of low interest rates (Japan, Europe and North America), competition (Argentina, Malaysia), regulatory penalties (UK, Switzerland, US), political instability (Hungary, Turkey), government interference in pricing and loan allocation (India) and market liberalisation (China).

The question is how banks will respond to a world where high returns are no longer achievable. A worrying possibility is that they will turn to riskier business in search of higher returns. Clifford Dammers, a former City of London trade group director, said that “no established industry can achieve returns on equity in excess of 15%, the target of most large banks. The risk is that banks will engage in risky and/or improper behaviour to achieve unrealistic returns”.

This concern was widely shared. A eurozone central banker said that “banks need to increase profitability without increasing risks”. Ludovit Gerec, head of the work-out

department at Sberbank Slovensko in Slovakia, said that "in order to fulfil their goals, banks have to undertake higher risks on an ongoing basis" and in Mexico, Patricio Villarreal, chief executive of Alivio Capital, said that profit pressure in banks "will make them continue to find ways to risk their own equity (trading) and making them less stable".

However some respondents were more bullish about the profit outlook, arguing that banks were now in better shape and that central banks would ensure they had sufficient liquidity to cope with changes in the interest rate structure.

6. Pricing of risk (11)

The mispricing of risk, one of the major causes of the financial crisis, continues to be seen as a problem, even though banking reform is supposed to make it harder.

The pressures to misprice risk (i.e. underprice it) which were identified by respondents included sluggish credit markets and a growth in post-crisis competition, both of them driving banks to do business below its true cost, especially in conditions of abundant liquidity. The chief risk officer of a bank in Australia said that mispricing "is beginning to happen due to low credit growth and … other pressures to have earnings against growing capital requirements". A US regulator said that "banks, in the current environment, are not being compensated for risks".

Risk mis-pricing could be on the way back

Competitive pressures are strong in many markets. The director of compliance and legal affairs at a Dutch merchant bank said that "in an increasingly transparent environment, you need to compete on service and pricing...." and a respondent from the Philippines reported that "credit spreads are at all time lows due to abundant liquidity and competitive pressures". A Polish banker said that "even risk-based pricing is not implemented in many banks in our region".

A particular problem is the artificiality of the price of assets which banks are required to hold to meet capital and liquidity requirements. A senior director at a credit rating agency said that "the main risk is in mispricing regulatorily 'favoured' asset classes such as government bonds and legislative covered bonds". Some respondents also blamed government pressure on banks to increase lending on favourable terms to politically targeted borrowers such as small businesses.

However some respondents felt more relaxed about this risk, arguing that banks should know what they are doing. The chief risk officer of a bank in New Zealand said that mispricing risk was unlikely "given banks' core expertise in this area". In China, a bank chief financial officer said his bank's risk pricing "is based mainly on market pricing, profits and costs and so forth, and these determine the price floor".

7. Credit risk (2)

The economic recovery has led to some easing in concern about credit risk, but we are not out of the woods. Many respondents stressed that debt levels remain high in all the major categories: household, business and sovereign, and that a change for the worse in the economic climate could easily trigger a fresh wave of problems. A senior director at a leading credit rating agency said that "at the highly leveraged status at which the global financial market is currently maintained, any liquidity risk is likely to transform into credit risk by one means or another".

The biggest threat to credit quality lies in quantitative easing, and the prospect of "tapering" of central bank intervention. Rising interest rates would not only cause fresh problems but expose others which are currently hidden or disguised by the economic recovery. Paul Hattori, director of Practical Financial Engineers, said that "if interest rates go back to historic levels, this is a big risk area."

On the household side, there are the twin problems of consumer debt and mortgages where doubtful loan levels remain high in many countries. Tony Greenham, head of finance and business at the UK think tank New Economics Foundation, said that "the fundamental bias toward credit secured on assets, particularly property, has not really been addressed by any of the regulatory or institutional reforms since the crisis…Hold your hats for another credit rollercoaster ride?" Another consultant said that "consumers are hopelessly unready for interest rate rises".

Some of the strongest concern was reserved for sovereign risk, particularly in Europe where the UK and the eurozone remain fragile. Other respondents pointed out that the preference given by regulators to sovereign asset classes could easily backfire unless public debt problems are resolved.

Credit risk is seen to be declining

An additional concern is that the pace of banking competition is growing in parallel with the economic recovery and that this is leading to a decline in lending standards. The chief auditor of a large Canadian bank said that credit risk "would be lower if not for the competitive pressures to accept more risk at lower prices". Others said that "'covenant lite' is returning", i.e. loan terms are being softened.

Some respondents also wondered whether banks had upgraded their credit risk management systems in anticipation of a new round of loan defaults. In the US, Robert Bench, a former Deputy Comptroller of the Currency, said that "there are always credit losses. The challenge is early recognition of the problems and provisioning for them." However others feared the problem was the opposite: that risk averse banks would be reluctant to lend, and would snuff out the recovery.

Credit risk was a widespread concern geographically. Outside Europe and North America, there were many localised concerns. In China, respondents said that the easing of growth had left industries with excess capacity and debt financing difficulties. Zheng Jie, vice-president of Kunshan Rural Commercial Bank, said that "the economic downturn has led to a decline in many small and medium-sized enterprises [and their] reimbursement ability, thus affecting the quality of credit assets of the bank". Credit risks were reported from Nigeria, Singapore, India, South Africa, Australia, Russia and Mexico. In the Philippines, the chief risk officer of a bank said that "the recent super typhoon highlighted the vulnerability of institutions in terms of business continuity planning and loan exposures in affected areas".

However some respondents felt that the improving economic climate boded well for credit risk and, anyway, managing it was supposed to be part of banks' competence. The managing director of risk management at a large US bank said he was seeing "normal expected losses for this stage of the cycle". The chief executive of a Dutch bank said credit problems were "high at the moment but gradually becoming better". A US bank regulator agreed that credit quality was improving but warned: "Risk appetite is also growing".

8. Corporate governance (9)

The intense scrutiny that corporate governance has come under since the crisis has done little to reduce the level of concern about this risk, particularly among respondents to this survey who were non-bankers: this was their No. 2 risk, compared to bankers who ranked it No. 11.

The comments were broadly of two types. One bemoaned a lack of resolve and talent in boardrooms. A widely echoed view was that board members do not do enough to exert their authority and challenge senior management. A risk management director in the UK warned: "Overly strong CEOs can still dominate direction and strategy". Less charitably, another respondent said: "Too many boards are made up of 'friends' and clapped out brains".

The composition of boardrooms was a strong theme. A US consultant pointed out that some multinational banks still have no bankers on their board. A banking non-executive director in the UK said: "I still question the ability of boards to understand the complexities of the businesses for which they are responsible". In the Middle East/Asia region, where this risk came in the top 3, the chief risk officer of a banking group in Pakistan said: "Regretfully, it looks like people want to be on bank boards mainly for prestige reasons".

Can directors be expected to understand complex modern banks?

A second group of respondents was more sympathetic to board members, stressing the enormity of their challenge – particularly when faced with rapidly changing regulatory regimes. Edward Sankey, partner at Larocourt Risk in the UK, said: "Irrespective of the abilities of the people, 'too big to manage' is a real issue". An observer of the industry argued that it was "not so much weakness [in corporate governance] as the sheer impossibility of boards to effectively oversee the largest, most complex institutions".

Some respondents saw regulators, rather than boardrooms, as the culprits in this area. The director of a consultancy in the UK noted that "banks are facing an avalanche of ill-thought out, hastily executed and overlapping regulation which no-one, neither supervisors nor banks, understands." Others bemoaned the impact of changing regulatory requirements on the recruitment of non-executive directors and executives. A banker in Sweden argued that: "new EU rules […] make it difficult to attract the right board members".

But a minority of respondents did recognise improvements as a result of crisis. A respondent in India said: "The lessons of 2008-9 have driven very strong oversight and control processes, and most boards are now enlightened and accountable". In the Far East Pacific region, where this banana skin ranked well down the list, a risk management banker from Australia said failures in corporate governance were less likely now than five years ago because "boards and regulators are much more attuned to this risk".

9. Criminality (24)

The risks around fraud, rogue trading, money laundering and other forms of criminality are seen to be rising fast. Concerns in this area were among the top five risks identified by North American respondents.

The focus of comments was particularly on the growing threat of cybercrime, such as hacking, identity theft and phishing. Andrew Wingfield, partner at King & Wood Mallesons LLP, said: "I think the risk of cyber-attack is very much underrated. As consumers trend onto mobile phone payment systems, this risk will only increase". Another respondent said "the growth of cybercrime is the only reason other forms of crime are falling in the UK. Banks remain the number one target".

Cyber crime 'can only get worse'

The risk is sharpened by the fact that criminals are often more technically savvy than the banks – and, as one respondent put it, they "only need to get through once" to cause significant disruption. A senior regulator in Canada warned what even in financial institutions which devote considerable resources to fighting cybercrime, the growing sophistication of perpetrators and the ease and speed with which information can be transmitted electronically makes it very difficult to foresee all the avenues that can be exploited, and to develop appropriate safeguards.

The global rise in cybercrime

South Africa: "Cybercrime has increased significantly in recent years and now poses a meaningful threat to the banks and their reputation."

Canada: "Risk is rising due to potential hacking and denial of service attacks."

Russia: "Development of IT systems is just keeping up with hacking and fraudulent practices."

China: "IT security management of rural financial institutions is weak, in view of increasingly high-tech cybercrime."

Nigeria: "Main concern is over cybercrime or internet fraud which has become rampant in Nigeria."

Netherlands: "The key issues are around cybercrime and identity theft."

The threat from other kinds of crime seems to be a lower order priority. Although there has not been a massive rogue trade scandal since 2011, a few respondents highlighted the lingering threat: "The insider will always be able to circumvent controls longer than the outsider", noted one respondent from Russia. In Pakistan, the chief risk officer at a bank said: "Regretfully, these days most bankers change jobs every few years. This is a potential source of fraud risk and criminality in the consumer banking area".

A handful of respondents made the point that the actual disruption caused by criminal acts is typically less damaging than the resulting fines by regulators and reputational fallout. Mark Hannam, a board member at the Institutional Money Market Fund Association, said: "The biggest risk here is punitive fines by regulators". Another commentator from the UK wondered whether pre-emptive measures to prevent crime were proportional to the potential risk, arguing: "compliance costs are more of a threat than genuine losses".

10. Capital availability (4)

Although risks associated with banks' need to rebuild their capital appear to be receding with the improved financial climate, this is still widely viewed as a problematic area, both as to the amount of capital available, and the impact of rising capital requirements on bank behaviour.

A number of respondents said that a better capitalised banking system was to be welcomed, but many also thought that capital requirements were in danger of getting out of hand, what with the implementation of Basel 3, the eurozone's Asset Quality Review (AQR) and pressure for additional "capital buffers". Would sufficient capital be available, especially given the changing economics of banking from a lucrative business to one more akin to a utility and the increasing fashion for "bail-in" rather than "bail-out" which puts funders of all types at risk?

The director of compliance at a large UK bank asked "Why would anyone want to invest in bank capital?" given the compression of bank margins and ever rising regulatory costs. Many respondents feared there was no convincing answer to this question. One of them saw "a growing realisation that capital rules mean that banks are a poor investment class" and this would prevent banks being able to raise the required capital.

Several respondents said that banks would be left with little option but to deleverage: to shrink their balance sheets around what capital they had in order to raise their capital ratios. The head of regulatory strategy at a large UK bank said that "regulators' demands continue to rise. Given shrinking revenue pools, the logical response is massive deleveraging". This could have a number unwelcome wider consequences: banks might embark on riskier strategies to generate new sources of profit, in the area of investment banking for example, and there would be less credit available to support the economic recovery. A UK banking consultant said that "the need (ultimately) to make sensible returns on much greater (and seemingly ever increasing) capital requirements will inevitably lead to more risk being taken…"

Heavy impact of rising capital requirements

Some respondents saw a strategic risk looming here: could conventional banking models survive with the weight of today's capital requirements; would there be a concentration of the banking industry around a smaller number of large players who could afford the regulatory costs, and how would licensed banks meet growing competition from more lightly regulated non-banking entities? On the theme of competitive equality, many bankers were also concerned that capital requirements were being implemented unevenly across borders, and that some countries' banks would obtain a competitive advantage in international markets.

However a number of respondents felt that fears about capital shortage were overdone. The director of risk management at a large US bank said that "bank capital is available to meet their needs and meet the Basel 3 requirements" and a manager of a large bank in Nigeria said that "regulators especially in the developing economies have ensured that adequate capital is in place for all the practitioners". The chief financial officer of a Luxembourg bank thought that "capital is always available to profitable and secure institutions" and a UK consultant added that "a shortage of capital stops banks doing silly things".

11. Quality of risk management (10)

This banana skin was ranked No. 6 in the immediate aftermath of the financial crisis. Since then, banks have devoted a great deal of resources to developing better systems to identify and negate emerging risks. Yet though the perceived threat has fallen a little in our rankings, the comments we received suggest more needs to be done.

A striking point in the results is that non-bankers rank this risk higher than practising bankers (No. 8 versus No. 13). Could this indicate a degree of complacency on the part of bankers? As one respondent in the UK put it, "Risk managers are not given the resources or the power to do their job properly". The chief audit executive of a bank in Malaysia said: "Risk managers are often ineffective because they lack influence and authority. Most risk managers give management the [benefit of the] doubt because management pays the salary".

Has risk management become too mechanical?

Some respondents felt that regulators had not helped by being overly prescriptive in their demands. "Over-regulation is leading to risk management by force, and losing the incentive to proactively manage risks", said a risk officer at a bank in the Netherlands. But others warned that authorities lacked the technical expertise to prevent exploitation of the rules they themselves had put in place. Duncan Alford, Professor of Law at the University of South Carolina, said: "Regulators do not fully understand internal risk models which allows banks to 'push the envelope' on regulatory limitations on these models".

A number of respondents thought risk management processes had improved because of the sheer amount of resources devoted to them since the crisis. The CFO of a bank in India said: "The extreme focus on risk management has mitigated the exposure here". Others talked about "a massive amount of investment in compliance" leading to the implementation of increasingly sophisticated systems.

The worry is that this could mean little – or be reduced to a robotic box-ticking process – if not accompanied by a change of culture throughout the bank, not just the risk management division. The chief risk officer at a global investment management company said: "I should emphasise that it's the management of risk through the first line that needs to improve – not a shift into risk management and compliance". In the UK, a senior director at a ratings agency said: "The risk management departments are well equipped. But board member skills and incentives may be another story". Perhaps the key issue, as one respondent put it, is ultimately that "greed is stronger than fear".

12. Interest rates (17)

The current uncertainty about interest rates has heightened this risk. Many respondents wondered how banks and borrowers would cope with a rise in interest rates as quantitative easing ends, and what the impact would be on the global economy.

The main concern was that the unusual and extended period of low interest rates will have encouraged complacency among banks and introduced distortions into the banking market which will be hard to eradicate. Banks have become accustomed to low funding costs and central bank support, and borrowers are unprepared for a rise in loan costs.

Are borrowers ready for a rise in interest rates?

The vice-president of risk at a Canadian bank said that “the consequences from the end of an unusually long low interest rate environment are a risk that is not well understood. Rates will undoubtedly increase. Institutions are increasingly dependent on sales of products and liquidity strategies that are highly rate sensitive without fully appreciating how they will react under stress. Consumers are addicted to low rates and are woefully unprepared for a 'normal' rate environment”. Respondents pointed to the potential mismatch in bank books between long term fixed rate loans and short term deposits where a sharp change could be very painful. Tim Dawson, chief financial officer at Helvea Group in Switzerland, wondered “Is the banking sector fully protected against the balance sheet impact of rising interest rates?”

The strongest concern was that rising rates would trigger a wave of bad loans. Emanuel Åkerlind, business controller at Landshypotek Bank in Sweden, said that “higher interest rates ... will create credit losses”. A senior director at a credit rating agency warned of “the potential for a rebound in non-performing loans as we return to a more normal interest rate environment”.

Concern was particularly high in China where the authorities are in the middle of a major interest rate liberalisation programme. Loan rates were freed last year, and deposit rates may be liberalised this year. Shourong Xu, president of the risk management department at Huishang Bank, said that the acceleration of interest rate liberalisation “will lead to bank spreads narrowing, affecting the profitability of the banks; overall risk in the financial system will increase”. A number of other countries such as India were also concerned about the rise in interest rates that has become necessary to protect their currencies and hold back inflation.

However there is an opposite view: that a rise in interest rates will restore a yield curve that will enable banks to widen margins and improve their profits. But this depends on their having sufficient flexibility on both sides of their balance sheets to take advantage of such a change.

13. Back office (13)

The risks associated with the back office – which include systems, data management, custody and technical controls – retain a mid-table ranking.

A prominent theme in the responses was the complexity and disjointedness of many back offices, exacerbated by “years of bank consolidation with little focus on consolidating and adopting single IT systems”, as one US consultant put it.

A related concern was about “legacy” systems in need of substantial investment. Yet several respondents warned that rather than addressing this, senior management too often treated the back office as an area ripe for cost cutting in a challenging climate – either because the problems are not understood, or are ignored because they are not glamorous. In the UK, one commentator said that back offices have “long been considered an unsexy area of banking, but the potential for huge mistakes and losses is significant.” Another argued that risks were increasing due to short term cost cutting rather than a focus on strategic long term goals.

Not everyone, though, saw complexity in back offices as necessarily a bad thing. One corporate risk manager in the UK said: “complexity gives diversity, and so robustness. And this is a core skill with no obvious financial drivers to put it at risk”.

In New Zealand, the chief risk officer of one bank said that “systems and processes to manage operational risk are well developed” – but warned that “cultural practices can defeat these if allowed to develop inappropriately”.

14. Change management (15)

We included a question about the risks in change management because so much of the industry is being forced by market and regulatory pressure to restructure itself, be it by acquisition, ring fencing, divestiture, downsizing, deleveraging etc. Could an industry with a poor record of change management do the job without courting disaster?

Opinion was evenly divided. Those who were sceptical felt that change driven by regulation ended up badly because the pace was forced and the logic was not always commercial. One respondent said that “regulatory pressure for accelerated divestments will inevitably lead to value destruction” and another said that "as banks get re-structured post-Vickers, Volker etc., someone, somewhere will drop the ball."

Systems were often mentioned as a potentially vulnerable area. There was also the problem of “fatigue” – too much change causing minds to wander.

And there was the market impact to consider. A respondent from Canada said that “in certain circumstances, institutions will most certainly incur losses to meet new regulatory requirements as the timing of those actions (i.e. divestiture or modifications to a particular business) will not always occur when market conditions are optimal”.

Much structural change on the way

But others felt that this was “business as usual”. Mark Paskowitz, deputy chief risk officer at OneSavings Bank in the UK, said that “almost certain there will be more losses than gains from this - there always are - but nothing to threaten viability”, and the chief risk officer at bank in New Zealand asserted that “change is always high risk, but usually well managed”. Dr Simon Ashby, professor of risk management at Plymouth University, said that “this is a common issue, but I do not see the risk increasing”. A consultant in the Netherlands went a step further and stated that “the new regulations make fewer demands than a prudent banker would/should impose on himself/herself”.

15. Liquidity (3)

There has been a sharp decline in concern about the liquidity problems of banks, mainly because the markets expect central banks to make sure that they do not happen again.

Philip Warland, head of public policy at Fidelity Worldwide Investment UK, said “I can't imagine the central banks are going to stop giving liquidity assistance any time soon, including to technically insolvent banks...” Jeroen Drost, chief executive of NIBC Bank in the Netherlands, said he did not expect to see liquidity problems “in the next two years as the ECB and other CBs keep providing cash to the system”. Other respondents also made the point that the banks’ management of liquidity has been tightened up and is now the subject of much closer regulation.

However a sizeable minority of respondents felt this was an area that was vulnerable to complacency. Liquidity, though currently abundant in many parts of the world, was a fickle and unpredictable beast: it could vanish overnight and cause untold damage. The senior director of a rating agency said that "seemingly abundant liquidity in the global financial market (mainly government bonds) will become illiquid before bank balance sheets and government finances have recovered to levels where they can weather such hiccups". Alan Peachey, author of a compendium on bank crises *Great Financial Disasters of our Time*, feared that "when the Bank of England starts to wind down quantitative easing, the banks may well find that a lot of their stable deposits have melted away as customers find more profitable homes for their money, or simply spend it".

Liquidity is a matter for the central banks

A further concern is that recent regulatory moves such as ring fencing, as well as differences in national rules could fragment the global liquidity market, making it harder for banks to obtain the liquidity they need, particularly between the US and Europe. The managing director of risk management at a large US bank was concerned about "the trend toward ring fencing of local liquidity risks in response to concerns by the host regulators that the home regulators will place their interests in a junior position in a financial crisis (e.g. Lehman)".

Geographically, awareness of liquidity risk was high in all the countries surveyed, though the level of concern varied. In Japan it seemed to be high, but in China low because liquidity management is now a priority. A US regulator said that "banks are flush with liquidity, but overnight funding is still a concern".

16. Sales and business practices (20)

Memories of scandals that brought mis-selling to the forefront of the banking industry – most famously the debacle around Payment Protection Insurance in Britain – are still fresh. Indeed, respondents in the UK rated this banana skin No. 7. Globally it has gained a few places on 2012 but remains a mid-table risk.

Many feel that the fundamental problem is that banks haven't improved their sales culture. A retail banking specialist from a UK government body said that "abysmal banking practices and behaviours" stemmed from a failure at the top levels of financial institutions to drive change. "CEOs have to realise that they are responsible for their employees' behaviour and actions. I see no material change in the behaviour of CEOs," he said. A respondent from Belgium, who also gave this a maximum severity rating, described the risk as "huge: ask anyone who works on the front line about pressure to meet targets with which they do not agree".

The risk is sharpened by a widespread view that banks will now be held to higher standards than they have been in the past – "particularly as regulators and courts will judge the sales practices with the benefit of hindsight, making banks very wary", as the chief executive of a bank in the Netherlands put it. A regulator in Canada said: "Given the increasing prevalence of social media, companies today are at even higher risk of suffering reputational harm from poor business conduct or customer relations, even in cases where these are isolated events".

A few respondents argued that the perceived prevalence of bad business practices had been overblown. Dick Bell, formerly of Royal Bank of Scotland, said: "Sadly the banks have just given in to customers as *caveat emptor* seems to have gone out of the window. PPI, derivatives, what next?" Another banker in the UK

acknowledged that product offerings need to be simplified to radically reduce mis-selling risk – but added that "until some degree of *caveat emptor* is restored, the risk will remain high".

On a positive note, quite a few commentators did see lessons being learned from past debacles and painful punishments. The investment director of a leading wealth management firm in the UK said: "I believe a lot of poor sales practices have been altered following the fines over the past few years", while the CRO of a bank in New Zealand noted that "conduct risk is the new focus of regulation".

17. Emerging markets (22)

The recent turbulence in the financial world has led to a resurgence of concern about the prospects for emerging markets.

One reason is China. Many respondents took the view that a macroeconomic reversal in the country would be a game changer for the global banking industry (See box).

Concern about emerging markets is on the rise again

More widely across the world, a big concern is the transition to post-crisis normalcy: the unwinding of stimulus measures that were put in place to stabilise the global financial system. Rick Sopher, managing director at Edmond de Rothschild Capital Holdings, said: "As a result of the manipulation of interest to such low levels, investors have sought higher yielding investments, resulting in very large inflows into emerging markets and high yield credit. At the same time, the banks have withdrawn capacity from market-making in those areas. As a result, there is unlikely to be an orderly market in those areas should investors wish to exit".

Others warned that emerging market banks are even less ready to absorb the regulatory overhaul than their counterparts in developed economies – exacerbated by political instability and interference in the financial sector. A respondent in Singapore warned that new regulatory requirements in some emerging markets are not as clear as they should be, saying "there is a risk that banks operate in the grey areas that may pose a regulatory breach in future when the requirements get crystallised".

Yet as one UK respondent put it, volatility in emerging markets is "a source of risk but that is kind of the point. With that comes investment opportunity and growth potential". In Russia, a respondent said: "The exposures to these markets are not significant for the global players – the upside and diversification is more than worth the risk", while several others emphasised that though individual institutions might suffer losses, the threat is not systemic. The point was also made that the rise of emerging markets in recent years means they are more closely linked to developed markets, leading to a shrinking of volatility spreads.

BRICS

The BRICS are not what they used to be. Many respondents were worried about potential volatility in countries that, until recently, ranked high on the financial pick list. A US banking professor said: "China's financial reforms are not reliable, and have broad political ramifications. India's opening is a further source of major uncertainty for capital flows. Brazil's tenuous macroeconomic situation and political outlook could provoke high capital flow volatility."

If there is a single big worry it is China where a fragile banking system could run into a crisis which would have global ramifications. Stewart Fleming, a banking expert at St Antony's College, Oxford, said: "My main concern is that China has reached an inflection point in which its ill-regulated 'shadow banking' financial institutions, and the difficulty of reforming the sector, coupled with financially overextended local governments interact to damage the domestic and world economies."

A senior executive at a bank in Australia, which is closely linked economically to China, said: "The growth in cross-border exposures to Chinese banks and state-owned enterprises has risen significantly, creating a potential systemic risk."

There are also rising concerns in India about the level of non-performing assets on banks' balance sheets. The CEO of one bank said he was worried about "credit issues deriving from the rapid growth in non-performing infrastructure investments. [There is] a lack of credit discipline and willingness to enforce on the part of lenders".

Nishi Agrawal, CEO of Clock Tower International, a financial consultancy to emerging economies, said that by leapfrogging into mobile banking, emerging country banks had bypassed traditional banking credit check processes which provided a safety net. "The process of credit checks and its infrastructure need extensive development especially with the growth of the middle classes. The investment for this development will run into millions and hence, is still not high on the list of priorities."

18. Derivatives (8)

Since topping these rankings in the run up to the crisis, the risk around derivatives has lost much of its urgency and this year drops another ten places.

Derivative risk is receding

Three main reasons were given: more caution and less appetite for exotic products among financial institutions, better internal controls, and tighter regulation. In the UK, views on the impact of regulation on the market were mixed. One bank's head of European Regulatory Affairs said: "There may be teething problems under the new EMIR/DFA[1] regimes. Also, there is vulnerability to any CCP[2] problems. However, the new structures should lead to less risk than in the past in this area". Another respondent agreed that more restrictive rules did reduce risk, but potentially at the cost of innovation and liquidity in markets.

[1] European Market Infrastructure Regulation/Dodd-Frank Act
[2] Central counterparties

Rigorous regulatory scrutiny was also applied more widely. The country head of a bank in Romania said: “Derivatives were the focus of almost all recent prudential approaches. I see limited risks over the next 2-3 years”. In India, executives at two large international banks pointed to “very prescriptive” regulations and “intense oversight” by the authorities. Coupled with still fresh memories of heavy derivatives losses after the crisis, this means “a lot of banks have shrunk their exposure dramatically”, said a respondent in Italy.

Yet there was the lingering sense that it may only be a matter of time before banks revert to the bad old days, accompanied by the impression that senior management – and regulators – have still not acquired a sufficient understanding of the complex products on the market. The chairman of a trust services group in Switzerland warned that banks would continue to expose themselves to the risks, the fines and the reputational damage arising from a derivatives failure because the market is so potentially lucrative.

19. Social media (-)

We included a question for the first time this year about the risks associated with the rapid growth of social media: Facebook, Twitter etc. and their potential to do harm to banks. The low ranking it received suggests that these media are not a matter of urgent concern, though the comments made clear that people are giving them a lot of thought.

Social networks amplify and accelerate reputational risk in the banking sector, with the added unpredictability about which stories will catch fire. The question is how much of a material impact this actually has. Are social media influential as well as being noisy?

In the short run, is the general consensus. In India, the CFO of a global bank said: “Potential for short term damage through episodic occurrences is high but not likely to be sustained as memories have become short”. The regional CRO of a bank in Singapore went further, saying: “because of social media, people's attention span gets so short that yesterday's news is not only irrelevant, it is actually forgotten”.

Social media risk is downplayed

Others argued that claims made through the channel of social media are treated with more scepticism – “not sure how seriously people take the opinions of trolls” – especially as high-profile examples of false accusations emerge. One banker in the UK opined that institutions which are targeted for criticism generally have done something wrong. “Malicious campaigns with no real basis still seem rare”, he said.

Perhaps another reason this risk ranks low down the list is that social media are also seen as an opportunity for banks for marketing purposes and crisis management. “I think that when it comes to social media, you're better in than out”, said Philippa Kelly, manager at the Institute of Chartered Accountants of England and Wales. “This is a new form of dialogue that is increasingly important to consumers and banks need to be a part of that. There is reputational risk, but also the opportunity for customers to champion you for doing a good job. The greater harm is to ignore social media”.

20. Shadow banking (-)

This year, we broadened the 'hedge funds' category to encompass the wider shadow banking sector (i.e. non-bank banks, lightly regulated financial vehicles, etc.). Its low position reflects a perceived lack of urgency about shadow banking risk, as well as the view that shadow banks may play a healthy role. However, many of the comments suggested that shadow banks had serious long term potential to damage the banking business both as competitors and sources of instability. This risk was also likely to grow as business migrated to it to escape banking regulation.

A number of respondents described the potential threat as "systemic". In Luxembourg, the country CEO of a global bank said shadow banking institutions "are significant potential competitors given lower regulatory costs, but more importantly they are a major risk to the system in some areas due to lower regulatory standards".

China's continued dependence on its informal banking system was seen as a particular cause for concern. John Plender, columnist at the *Financial Times*, warned that "shadow banks are both a competitive threat to conventional banks and a potential systemic threat. This is especially true in China". But he also said: "It is too easily forgotten that in credit constrained economies shadow banks can be part of the solution rather than the problem".

The perception that it is 'part of the solution' may help explain this risk's low ranking. Although some respondents bemoaned the looser regulatory requirements as unfair, others welcomed a "useful complement to mainstream banking", as one put it. "If banks did what they do properly, a little competition would only be healthy", said Cormac Petit, a strategy consultant from the Netherlands. The vice chairman of a consulting group in the UK said: "Banks have it within their own power to limit the threats here. Many of the risks the shadow banks are willing to take should be risks the banking sector is willing to pass on".

Into the shadows

As certain requirements tighten for mainstream financial service providers, activities that become highly regulated or restricted (for example, proprietary trading in the US), or too expensive for companies to maintain, will now shift to shadow banking institutions. This poses increasing risk to the economy in the form of lost capital and liquidity, and to consumers who may no longer be protected.

Banker
Canada

21. Management incentives (14)

It will surprise few people that concerns around bonuses rank much higher among non-bankers (at No. 11) than bankers (at No. 23). But though this is a perennially headline-grabbing topic, the perceived risks overall have come down quite a few places since 2012.

Most respondents agreed that the concern was not bonuses *per se*, but badly designed remuneration systems. Daniel Martineau, executive chairman at Summit Trust International in Switzerland, warned that though there had been improvements, "there is still is an inexplicable reward system for bankers that incentivises risk-taking". An observer of the industry from the UK said: "The complexity of incentives is a risk – incentives are not *a priori* a bad thing, but they need to be transparently and fairly structured".

The row over bonuses is a risk to reputation rather than soundness

The main threat for many is seen to be "more to reputation than soundness", as one respondent put it. "Until the industry jettisons outmoded bonus models, it will not begin to regain public trust," said the head of regulation at a UK financial group. Yet some felt the popular view on bankers' bonuses did not reflect the real picture. Barry Livett, chief executive of Abacus Corporate Finance Limited, said: "Given the thousands of staff employed by banks who are not on huge salary packages, the problem may be more one of perception than reality when it comes to reputational damage".

Regulators' recent efforts to crack down on excessive pay, such as the EU's cap on bonuses, may be part of the reason this banana skin has come down – though some thought these were ill-directed. The chief operating officer of a bank in Luxembourg said: "Remuneration policies are a weak attempt by policymakers to curb excessive risk taking, particularly at more junior levels in investment banking, where risk management and compliance controls to identify big bets and concentration risk do not appear to be fail-safe to fraudulent behaviour". Quite a few comments we received identified the alternative to bonuses – raising base pay – as the riskier option by diminishing individual accountability.

That said, there was the feeling that while regulators don't always get their methods right, they are driven by valid concerns – which banks too readily play down. Paul Smee, director general of the UK's Council of Mortgage Lenders, said: "too much effort is expended on finding ways round rules rather than creating a sustainable system". The director of a professional body in the UK warned of a "danger that banks plead international competitiveness reasons for a quick return to unsustainable incentives, which in turn drives a return to poor culture".

22. Currency (19)

Concern about currency risk is low, despite some big market movements in recent months.

Currency risk under control

Andrew Cornford, counsellor to the Observatoire de la Finance in Switzerland, said "my assumption is that financial institutions are reasonably well hedged for everything but extreme events". Other bankers said they felt confident about their ability to manage this risk.

However a number of respondents said that it was precisely the likelihood of extreme events that could cause problems. A Canadian banker said he feared there would be "significant currency devaluation", and another respondent said that currencies were "unpredictable and therefore risky in the current global environment".

Some of the focus was on emerging market risk as the phasing out of quantitative easing made the US dollar and other major currencies more attractive. One respondent said that "repatriation flows to USD away from EM may cause unforeseen correlation problems". In China, a chief risk officer feared that "banks' direct involvement in the money market will bring turmoil". On a different note, some respondents said that the currency markets now carried the risk of manipulation and regulatory fines, which could alter the economics of the currency trading business.

The new vulnerabilities

Regulatory reforms have improved the stability of the system and strengthened the capital and liquidity positions of individual banks. Banks are better positioned to understand known risks and to absorb moderate to severe shocks from external influences. The main concerns are that emerging risks are taking shape in non-traditional unknown forms with increased frequency. Threats to information security, structural breaks in macro-prudential factors (PPP, currency pegs), and dependencies created from single commodity-led economies, vulnerabilities to the price of oil/gas.

Banker
Qatar

23. Human resources (28)

Though still seen as a low order priority, concern about the ability of banks to attract and retain talent has moved up a few places since 2012. In fact, in the Far East/Pacific region, this banana skin comes No.7. The level of concern is also higher among bankers than non-bankers who ranked this risk second from bottom.

The 'battle for talent'

Two opposing themes ran though the comments. One group took the view that despite cutbacks and tighter regulations, banks still pay more than other sectors competing for the same talent. Pete Hahn, Senior Fellow at London's Cass Business School, said: "Pay is going from the stratosphere to Mount Everest, but is still a long way above those other industries at sea level". The CFO of a banking group in Switzerland agreed. "Try applying for an internship programme at a bank and you will see that they remain a top sought-after destination," he said.

In fact, contrary to the idea of banks losing talent, a senior analyst at a UK professional body said: "My worry is that they will keep attracting all the best engineers and programmers just when we need them to rebuild other sectors".

On the other hand, there was a widespread feeling that the industry has lost a lot of its sexiness because of "banker bashing" and the regulatory squeeze. In the UK, a respondent said: "The disdain young people hold for the banking sector will have an impact here. Banks must adapt their public style or lose out". Other comments of this type were that banks "lack credibility for people motivated by values rather than money" and were "definitely less attractive to top calibre new recruits".

Part of the reason this risk remains low was shown by the dismissive attitude of quite a few respondents to the so-called “battle for talent”. One called it “a myth to keep rewards high”; others argued that persistently difficult economic conditions meant that banks could have their pick of high quality recruits. “It's always quite easy to attract talented people”, said an observer of the industry from Poland. “Much higher risk stems from wrong motivation schemes”.

In the Far East and Pacific, the region which rated this risk the most severely, a banker from Singapore said the problem was more about the cost of recruitment than attracting talent. “Restrictions to visas in Hong Kong and Singapore may become a real handicap”, he said.

24. Reliance on third parties (29)

The risks around outsourcing and the off-shoring of activities remain low order.

John Hitchins, partner at PwC, reckoned that though not a high risk today, it is one to watch – “growing because outsourcers are starting to outsource themselves as the industry gradually specialises. This increases the risk of a bank losing control of parts of its operations as supply chains get longer and more complex”. A respondent from Luxembourg pointed out that “a major 'supply chain' failure has not really been tested yet”.

There are also concerns about the reliability of third parties: lax security standards and the potential for data loss or leakage. Edith Rigler of Homburg Associates in Germany warned: “Internet payments pose significant security risks. Particularly third party providers which are currently not regulated must be brought under the regulatory umbrella”. In the UK, the deputy head of credit at one bank said: “I think we are understanding just how big a risk this is – a process outsourced is a process that senior management inadequately controls, inadequately understands and makes inadequate new investment in”.

Otherwise, the main issues in this area seem to be reputational – the frustration to customers caused by call centres thousands of miles away, and so on. One respondent in the UK noted that off-shoring in particular has become politically controversial in some jurisdictions due to the perception that such activity takes jobs away from the domestic labour market.

25. Social sustainability (25)

This risk covers the areas of ethics, reputation, the environment and other value-driven risks that might affect a banking business.

Ethical risks rank low despite the banks' bad press

Its low ranking is, frankly, a puzzle given the pounding that banks have taken from public opinion for many years. The comments we received made clear that public trust in banks has never been lower. Yet the industry’s weaknesses in this area continue to rate well down the list of risks in every region and among every type of respondent surveyed.

How can this be explained? One answer may lie in another question: “How much lower can banks’ reputation go?” If customers have not already deserted beleaguered banks, they are probably unlikely to now. From the UK, a respondent

who gave this risk the lowest severity rating said: “The banks will continue to suffer hits, but their reputation is already very low and they continue to hold customers”.

A few respondents argued that banks had more pressing issues to worry about. “These seem minor risks compared to debt defaults”, noted the chairman of an asset management company in the UK, while a banker from the Netherlands said: “Unfortunately clients are uninterested in this topic”.

In general, commentators were worried about reputation but wondered how much of a material impact it had on individual institutions, particularly when the whole industry is under the cosh. The executive director of a UK trade association said: “Failing to deliver on reputation or trust promises is a high risk, but is measured in customer popularity, not commercials, so not systemic”. Independent consultant James Prichard said it was "100% certain that individuals at banks will tarnish some brands, but the much admired 'Vampire Squid' [i.e Goldman Sachs] seems a sustainable model for a bank even if it is perceived as exploitative and unethical."

Others took a harder line. Philippa Foster Back, director of the Institute of Business Ethics, warned: “In a 24/7 world the level of distrust in the system means there is no hiding place and no tolerance of failure. Banks will not be given the benefit of doubt any more”.

26. Equity markets (21)

The risk of banks courting trouble in the equity markets is considered to be very low, mainly because of increasing regulatory curbs on speculative activity by banks, such as proprietary trading. Adalberto Palma, chairman/CEO of Unión de Instituciones Financieras Mexicanas in Mexico, summed it up succinctly: “Volcker rules *dixit*”. Many countries also have specific rules limiting bank exposure to the equity markets.

There were, however, concerns about a possible setback in the burgeoning equity rally which could cause indirect damage to banks and the economy. As one of the respondents said: “We are in the early stages of an asset bubble” and a Canadian banker warned that there was “a correction on the way”.

27. Commodity markets (26)

Banks, on the whole, have a small exposure to the commodities markets, and this risk therefore ranks low. However, it is worth highlighting a couple of concerns.

One is that risk can be very localised. For example the chief risk officer of a bank in Malaysia gave this risk a high score, saying that “I’m considering crude oil and palm oil” and a respondent from a credit union in a mid-west province in Canada was concerned about local exposure “to agricultural commodities and oil drilling”.

More generally, respondents associated this risk with the recent stresses in emerging markets, including China, and the secondary impact reaching banks through other markets, such as credit.

28. Business continuation (12)

Concerns about business continuation rank very low, despite some high profile outages at major banks in recent months. Many banking respondents said they had robust business continuation planning (BCP) and had explored the risks pretty thoroughly.

Banks confident they can manage business shocks

The biggest worry is hacking and cyber crime (see No. 9). The managing director of risk at a major US bank said that "I have been involved in cyber warfare games, and must say I am concerned", and a senior banking consultant said that "the cyber war can only get more dangerous". But even here, the risk was not always seen as fatal. The chief auditor of a large Canadian bank said there was "a heightened likelihood when you factor in cyber-terrorism. The impact could be material but not necessarily life-threatening".

Respondents mentioned other categories of external risk such as terrorism and natural catastrophe, both of which were seen to have a geographical dimension. The chief executive officer of a bank in India said that business continuation was "definitely a challenge in India given issues with terrorism", and the chief risk officer of a bank in the Philippines said problems were "very likely, especially with our most recent experience". Such risks would be severe if they hit many banks rather than individual institutions.

Some respondents felt the issues were internal rather than external: in particular the failure of systems where the damage will hit reputations as well as the bottom line. But the majority of respondents felt these risks were under control. A respondent from a bank in Hungary said that "yearly BCP re-planning and testing [have] demonstrated our readiness to handle these kind of issues", and a banker in Luxembourg commented that "institutions will generally technically be able to continue/resume activity better than ever, but public and press pressure is so much more intense it could cause failure unwittingly".

Central counterparties (CCPs)

Although disruption to payments systems has historically ranked low as a banana skin, there is mounting concern about the growth of centralised counterparties (CCPs) who guarantee derivatives trades through organised markets. A number of respondents singled these out as potential flashpoints because the represent a concentration of risk and have a heavy dependence on IT. One of them said that CCPs "are now too big to fail and do not have much capital and, while supervised I am not sure anybody really knows how to supervise them".

Appendix 1

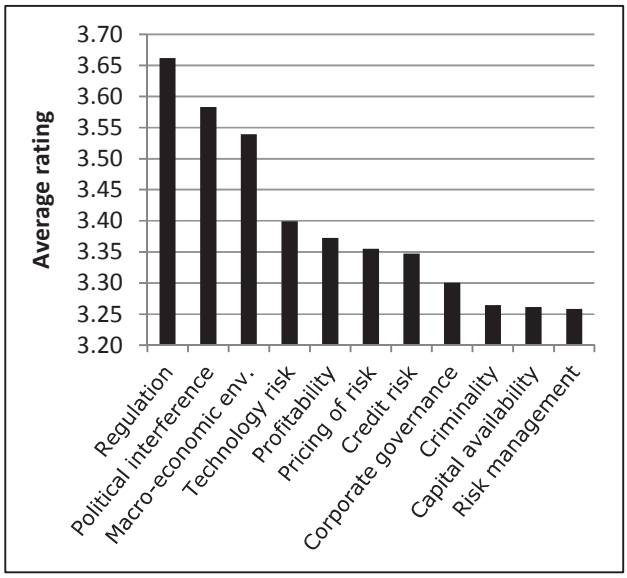
A closer look at the numbers

In our Banana Skins survey, respondents rate each risk from 1-5, where 5 is the most severe. We take an average across each risk to produce a final list. The section below should be treated with caution: different respondents may have a different conception of what level of severity is required to merit a 5, for example. But a breakdown of the figures yields some intriguing results:

1) The severity of the top three risks is on a different level from the rest

The chart shows strikingly how the top-3 risks this year stand out from the rest of the crowd. Indeed, the difference between the average rating of No.1, regulation, and No.4, technology, is greater the difference between No.4 and No.14, change management.

Descending the list, every risk down to No.18 is ascribed more than a middling average rating (i.e. more than 3). At the bottom, the difference between No. 27, commodity markets, and No. 28, business continuation is 0.28 – twice the next biggest gap between consecutive risks.



2) Are bankers complacent about the risks they face?

…Or are others exaggerating the threat? What is clear from the table is that there are several risks on which bankers and the rest of our respondents do not see eye to eye – and most of these are in the areas that individual institutions have the ability to influence most: bonuses, governance, business practices, risk management, the back office, etc.

What makes this result more striking is that the risks which are driven mainly by governments and global economic forces – regulation and political interference, the macroeconomic climate and interest rates, liquidity, currency and equity markets, and so on – showed very little disagreement in the corresponding figures.

Non-bankers and risk managers vs commercial and investment bankers

Biggest difference in average rating

Management incentives	0.42
Business continuation	0.38
Corporate governance	0.36
Criminality	0.32
Derivatives	0.28
Sales and business practices	0.27
Quality of risk management	0.26
Back Office	0.25
Sustainability	0.24
Technology	0.23

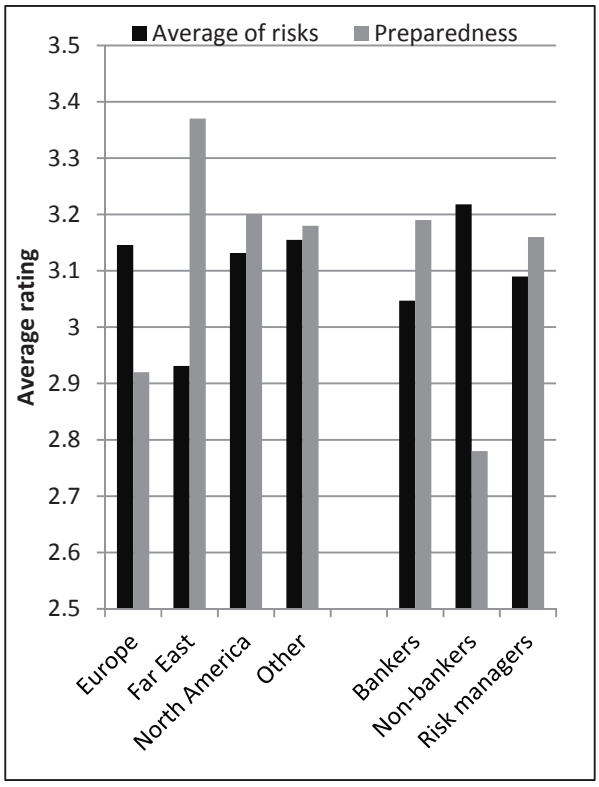
Average of risks: bankers: 3.05; others: 3.19

Preparedness: bankers: 3.30; others: 2.91

3) Non-bankers are much more pessimistic not only than bankers, but also risk managers

Of any group in this chart, non-bankers saw by far the biggest gap between the severity of the risks facing the industry and its preparedness to deal with them. Interestingly, however, the outlook of risk managers was much closer to the more sanguine picture painted by commercial and investment bankers.

Geographically, Europe was the most pessimistic region, weighed down in particular by the UK's response. But there was much more confidence about the industry's ability to face impending challenges in the Far East and, to a lesser extent, in North America. The combined response from elsewhere – Africa, Asia, the Middle East and Latin America – saw the risks as more severe than any other region, but still felt considerably better placed to manage them than respondents from Europe.



4) Institutional risks dominate UK concerns

Nearly 30 per cent of our responses this year came from the UK. The reputation of the country's banking industry has taken a pounding in recent years, with British banks incurring huge fines as a result of mis-selling scandals and the LIBOR revelations. It is therefore no surprise the institutional risks – sales practices, the back office, governance, bonuses and risk management – are rated much higher than in the rest of the world. Yet the authorities' attempts to tackle these problems are also seen as unsatisfactory, with political interference and regulation both seen as considerably more severe than the global average.

UK vs all other respondents

Biggest difference in average rating

Sales and business practices	0.53
Back office	0.48
Corporate governance	0.47
Management incentives	0.42
Political interference	0.31
Technology risk	0.27
Quality of risk management	0.24
Regulation	0.21
Change management	0.18
Criminality	0.18

Avg of risks: UK: 3.20; non-UK: 3.08

Preparedness: UK: 2.70; non-UK: 3.17

Appendix 2

Banking Banana Skins: The Top Ten since 1996

1996
1 Poor management
2 EMU turbulence
3 Rogue trader
4 Excessive competition
5 Bad lending
6 Emerging markets
7 Fraud
8 Derivatives
9 New products
10 Technology foul-up

1998
1 Poor risk management
2 Y2K
3 Poor strategy
4 EMU turbulence
5 Regulation
6 Emerging markets
7 New entrants
8 Cross-border competition
9 Product mis-pricing
10 Grasp of technology

2000
1 Equity market crash
2 E-commerce
3 Asset quality
4 Grasp of new technology
5 High dependence on tech.
6 Banking market o'-capacity
7 Merger mania
8 Economy overheating
9 Comp. from new entrants
10 Complex fin. instruments

2002
1 Credit risk
2 Macro-economy
3 Equity markets
4 Complex financial instruments
5 Business continuation
6 Domestic regulation
7 Insurance
8 Emerging markets
9 Banking market o'-capacity
10 International regulation

2003
1 Complex financial instruments
2 Credit risk
3 Macro economy
4 Insurance
5 Business continuation
6 International regulation
7 Equity markets
8 Corporate governance
9 Interest rates
10 Political shocks

2005
1 Too much regulation
2 Credit risk
3 Corporate governance
4 Derivatives
5 Hedge funds
6 Fraud
7 Currencies
8 High dependence on tech.
9 Risk management
10 Macro-economic trends

2006
1 Too much regulation
2 Credit risk
3 Derivatives
4 Commodities
5 Interest rates
6 High dependence on tech.
7 Hedge funds
8 Corporate governance
9 Emerging markets
10 Risk management

2008
1 Liquidity
2 Credit risk
3 Credit spreads
4 Derivatives
5 Macro-economic trends
6 Risk management
7 Equities
8 Too much regulation
9 Interest rates
10 Hedge funds

2010
1 Political interference
2 Credit risk
3 Too much regulation
4 Macro-economic trends
5 Liquidity
6 Capital availability
7 Derivatives
8 Risk management quality
9 Credit spreads
10 Equities

2012
1 Macro-economic risk
2 Credit risk
3 Liquidity
4 Capital availability
5 Political interference
6 Regulation
7 Profitability
8 Derivatives
9 Corporate governance
10 Quality of risk management

2014
1 Regulation
2 Political interference
3 Macro-economic envt.
4 Technology risk
5 Profitability
6 Pricing of risk
7 Credit risk
8 Corporate governance
9 Criminality
10 Capital availability

See over

The changing face of risk

Some Banana Skins come and go, some are hardy perennials.

The Top Ten since 1996 show how concerns have changed over 18 years. 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.

The 2008 survey, conducted at the height of the financial crisis, brought the focus sharply onto credit and market risks, and propelled two new entrants to the top of the charts: liquidity and credit spreads. The next two surveys, conducted at a time of great turmoil in the financial sector, showed a twin preoccupation with financial dangers (credit, derivatives, liquidity, capital) and the growing backlash against banks seen in the sharp growth in regulation and political interference.

The present survey, which can be described as the first in the post-crisis era, shows a hardening of the view that regulatory and political interference in the industry can be damaging, but also declining concern with crisis-critical issues such as credit risk, capital adequacy and liquidity (which disappears from the top ten for the first time since the crisis began). But ominous new risks are also appearing, in particular a rise in technology risk and criminality as banks discover their vulnerability to cyber crime and ageing systems.

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