Banking Banana Skins 2010

After the 'quake

The CSFI survey of bank risk

In association with

PRICEWATERHOUSECOOPERS

CSFI

Centre for the Study of Financial Innovation

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Preface

The CSFI has been producing its Banking Banana Skins survey almost annually since 1994, latterly with generous support from PricewaterhouseCoopers.

The intention has always been to identify those concerns that people in the financial services sector – as well as those who watch, regulate and succour them – believe are the next "banana skins" on which the industry is likely to slip. Note, therefore, that it is not *predictive*. It is not what the CSFI – or the author, David Lascelles – believes is going to happen. It is a distillation of what others (most of whom are extremely close to what is going on at the financial coalface) *expect* to happen, or *fear* may happen.

So, don't blame us that earlier surveys didn't always get it right. In particular, don't blame us that, in 2005 and 2006, pride of place at the top of the Banana Skins list went to "too much regulation". That was what the industry felt – though one can certainly make a case that what the industry really needed was either *more* regulation or, better still, *smarter* regulation.

That said, looking at the list of the most important Banana Skins since 1996 (page 10), it is significant just how close to the top credit risk, derivatives and risk management have been. It sometimes seems as though senior bankers (who are well-represented in our survey) were like compulsive shoplifters, almost begging to be caught and to be put out of their (peer pressure-induced) misery.

But those are conclusions for you, the reader, to make.

What we offer is an increasingly valuable set of multi-year data on what keeps senior City types awake at night – besides the size of their bonuses, of course. Over the next few months, we hope to work the raw data that we have accumulated a bit harder, since the science of statistics has advanced in the last decade – and that may well generate some even more fascinating findings. But, in the meantime, no surprise that bankers today put "political interference" at the top of their Banana Skins list; at least, I suppose that's better than the threat of ritual disembowelling which seemed on the cards only a few months ago.

Andrew Hilton
Director
CSFI

This report was written by **David Lascelles**
Cover by **Joe Cummings**

Foreword

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

It has been an extraordinary eighteen months for the banking industry since the last Banana Skins was published in May 2008. Back then, few thought we would see so many banks either collapse or require rescue; events since then make for a fascinating survey. This is the first economic crisis that has drawn out long enough to have two Banana Skins published (let us hope it doesn't continue for a third!). Once again a brand new banana skin – political interference – heads the list. Respondents are also beginning to focus on what comes after the crisis, although many retain fears that the worst is not yet over, hence credit risk retains its number two spot.

A worrying theme is the question of whether the crisis has taken the industry's future out of its own hands. With political interference as the top risk and too much regulation at number three there is clear sense that change may be forced onto the industry from outside. Many respondents make the point of how deeply unpopular the banks have become among the populace at large. The need to rebuild trust that the last survey highlighted has become even more acute.

It is always interesting to look back at the previous survey to see which of the top banana skins were slipped on subsequently. Liquidity was the top risk last time and came closer in the autumn of 2008 to bringing the entire system down than any previous banana skin. The survey does get it right sometimes and so this year's survey could be a well timed warning for politicians not to overreact.

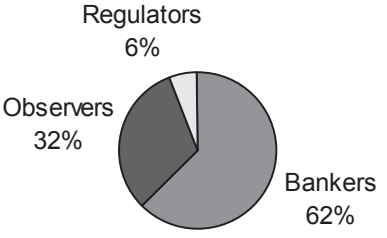
As ever there is a richness of perceptive comment threaded through the survey which repays a careful read.

John Hitchins
UK Banking Leader
PricewaterhouseCoopers (UK)

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 November and December 2009, and received 443 responses from individuals in 49 countries. The questionnaire (reproduced in the Appendix) was in three parts. In the first, respondents were asked to describe, in their own words, their main concerns about the financial system over the next 2-3 years. In the second, they were asked to rate a list of potential risks, or Banana Skins, selected by a CSFI/PwC panel, both by severity and whether they were rising, steady or falling. In the third, they were asked to rate the preparedness of financial institutions to handle the risks they identified. Replies were confidential, but respondents could choose to be named.

The breakdown of respondent by type was:



The responses by country were as follows:

Australia	11	Greece	8	Philippines	2
Austria	5	Guernsey	2	Poland	7
Bahrain	1	Hong Kong	2	Qatar	1
Belgium	3	Hungary	3	Romania	13
Bermuda	2	India	12	Russia	31
Brazil	1	Ireland	4	Serbia	1
Canada	16	Italy	2	Singapore	6
Cayman Is.	1	Japan	4	Slovakia	1
Croatia	1	Jersey	6	South Africa	6
Czech Rep.	9	Kazakhstan	5	Spain	2
Denmark	1	Kenya	1	Sweden	13
Finland	10	Luxembourg	9	Switzerland	17
France	1	Malta	1	Thailand	1
GCC	1	Mauritius	1	UK	156
Germany	17	Multinational	4	Ukraine	1
Gibraltar	1	Netherlands	7	US	29
		New Zealand	4		

Summary

The biggest Banana Skin is political interference

This report describes the risk outlook for the banking industry at the turn of the year 2010 – a time of unprecedented stress in the financial markets. The findings are based on responses from more than 400 bankers, regulators and close observers of the banking scene in 49 countries.

The dash by governments to rescue their banks from the financial crisis may have staved off a collapse of the system, but it has left the banking industry deeply politicised, a development which respondents to this survey find to be the greatest source of risk now facing the banking sector.

As a risk, **political interference** (making its first appearance as a Banana Skin this year) has many angles: it distorts commercial judgment, it creates moral hazard, and it raises uncertainty about how and when financial support will be removed. Closely linked is the risk of **too much regulation** (No. 3) from an over-reaction to the crisis.

What is striking about these Banana Skins is that they are common to all major banking regions, and are shared by bankers and non-bankers alike.

Banking Banana Skins 2010

(2008 ranking in brackets)

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

Pessimism about the global economic outlook

The dominant factor shaping risk perceptions is the state of the world economy. Respondents' comments about **macro-economic trends** (No. 4) were broadly pessimistic, viewing the recent signs of recovery as fragile and vulnerable to further shocks. This accounts for the high position occupied by **credit risk** (No. 2) where the outlook is seen to be for further losses as the true cost of the crisis is counted, and the lagging effect of the recession takes its toll on borrowers.

Although **liquidity risk** (No. 5) has slipped from the top position it occupied in the last survey in mid-2008, it remains a high level concern. Tension in other financial markets, however, is seen to be easing, notably in **derivatives** (No. 7), **credit spreads** (No. 9) and **equities** (No. 10). One market where risk is seen to be rising is **currency** (up from No. 13 to No. 11) with attention focusing particularly on the prospects for the US dollar. Concern has also eased about the outlook for **interest rates** (down from No. 9 to No. 14): although a sharp rise in rates may be imminent in an environment of dramatic monetary easing, it is also very predictable. Another notable decline is the risk associated with **hedge funds** (down from No. 10 to No.

19) with a falling off in their aggressive activity, but also an appreciation that they may be less threatening to financial stability than the banks themselves.

The availability of capital is a big worry

Making its first appearance in the Banana Skins series, the **availability of capital** (No. 6) is seen as an area of high risk as banks try to rebuild their balance sheets. Although there have been a number of large recapitalisations in the crisis, investor appetite could weaken; there will also be selling pressure as governments seek to offload their stakes in the medium term.

Big movers

RISING RISKS

Political interference: distorts commercial judgment, creates moral hazard.
Too much regulation: over-reaction to the crisis.
Capital availability: huge demands, weakening investor appetite.
Corporate governance: will banks learn lessons from the crisis?
Currencies: worries about US dollar volatility.

FALLING RISKS

Liquidity: not the problem it was a year ago.
Credit spreads, derivatives, equities, interest rates: markets getting back to normal.
Hedge funds: off the radar screen so far as risk is concerned.
Back office: has stood up well in the crisis.
Fraud and rogue trader: fewer incidents than might be expected in a crisis period.

Some of the risks facing banks are seen to be self-generated. Concern about the quality of **risk management** (No. 8) remains high following the disastrous losses suffered in the last two years. The risk of poor **corporate governance** has risen sharply (from No. 16 to No. 12), and **management incentives** (No. 16) remain a preoccupation, though opinion is divided between bankers who consider the risk to be outside interference and non-bankers who see bad incentives encouraging excessive risk-taking. Concern about **conflicts of interest** within financial institutions seems to be easing (down from No. 21 to No. 23). Many of the responses in the governance area were tinged with the worry that **banks have not learnt lessons from the crisis** and are too eager to get back to business as usual.

'Green risks' are seen to be small despite climate change

On the operational risk front, there was a notable decline in concern about **fraud** (down from No. 11 to No. 15) and the **rogue trader** (down from No. 14 to No. 20) despite experience which says that both risks rise in a recession. However the ranking of these risks is closely linked to the number of recent incidents, of which there have been few (Madoff not being strictly a bank fraud). Concerns about risks in the **back office, payment systems** and **business continuation** – all of which once featured high as Banana Skins – have eased considerably. There has also been a fall in the ranking of **money laundering** (down from No. 24 to No. 27) which is now viewed as a reputational rather than financial risk. The perception of **environmental risk** (No. 25) was unchanged despite the heat generated by the Copenhagen Summit.

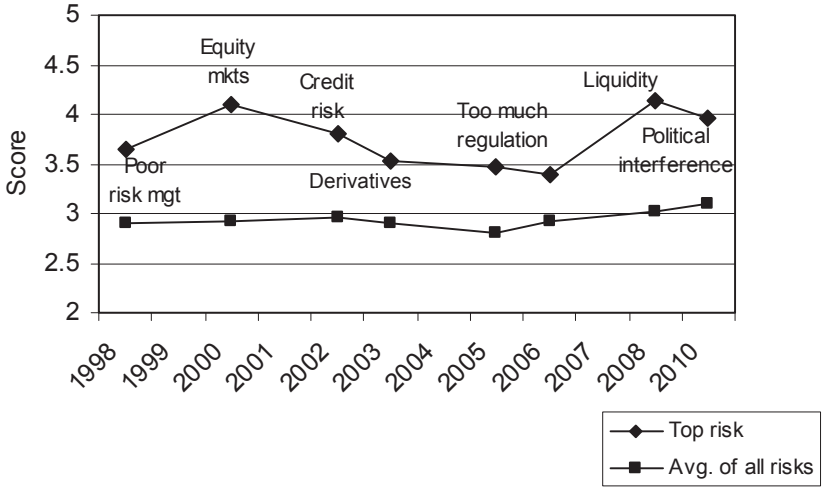
Although **competition from new entrants** (No. 30) was seen to be the least of the risks facing the industry, it generated much comment from respondents about the dangers of weakened bank competition and greater complacency due to government bail-outs and higher regulatory entry barriers. The prospects for structural change, as measured by the risk of **merger mania** (No. 28), were seen to be small.

A break-down of responses shows an unusually high level of agreement among bankers and non-bankers about the main Banana Skins. Insofar as there are nuances, **bankers** are mainly concerned with the political and regulatory fall-out from the crisis, and **non-bankers** are worried that banks will fail to reform themselves, and merely head straight into a new crisis. **Regulators** focused on the quality of balance sheets and risk management. **Geographically**, concerns were also strikingly similar in the three regions surveyed: North America, Europe and the Asia-Pacific: all considered political interference, regulatory overkill and credit risk to be among the biggest dangers facing the industry.

Only 9% of respondents think banks are well prepared to handle risk

Preparedness. We asked respondents how well prepared they thought the industry was to handle the risks they had identified. Only 9 per cent answered "well" and 11 per cent answered "poorly". The remainder gave a "mixed" reply. This is a more negative result than last time when 24 per cent said "well" and only 4 per cent said "poorly".

The Banana Skins Index



The Banana Skins Index is at an all-time high

The Banana Skins Index tracks responses over time and can be read as an indicator of anxiety levels on a scale of 1-5. The top line shows the average score given to the top risk over the last 12 years, and the bottom line the average of all the risks. Although the top risk has fallen off, the All-risk index is at an all-time high, an indication of the exceptional level of anxiety currently gripping the market.

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

Who said what

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

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

Bankers – practitioners of commercial and investment banking

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

Bankers put political interference at the top of their risk list because of the pressure it creates to override commercial judgment, e.g. by forcing them to lend in a recession. Concern about a regulatory over-reaction to the financial crisis is closely linked. Bankers' worries also include a worsening credit outlook as bad debts continue to pile up, and the availability of new capital. Their concern with liquidity risk and the derivatives market, particularly credit default swaps, remains high.

Observers – non-bankers, analysts, consultants, academics

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

Non-banker respondents share the bankers' concerns about political interference, though for different reasons: they are worried about the moral hazard created by bank rescues and wonder whether bankers have learnt lessons from the crisis. They also suspect that banks have not got to the bottom of their bad loans, and are skimping on their risk management. Non-bankers are the most pessimistic of the major respondent groups about the economic prospects, fearing a 'double dip' recession.

Regulators – supervisors, government officials

1 Credit risk
2 Political interference
3 Liquidity
4 Currencies
5 Macro-economic trends
6 Credit spreads
7 Corporate governance
8 Commodities
9 Risk management quality
10 Capital availability

The prospect of another wave of bad debts heads the concerns of regulators as recession takes its toll on borrowers – and uncertainties still cloud the financial markets. Liquidity, currency, credit spreads and commodity risk are all high on their list. Regulators also worry about political interference, in their case because of the uncertainty about how and when governments will withdraw their support. The weaknesses in bank governance exposed by the crisis are another concern.

Risks are similar across the major regions

North America

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

Government intrusion into the banking system through bail-outs and official support heads the list of risks in North America, notably in the US. Canadian banks are more concerned about the threat of regulatory over-reaction. The immediate concerns in both countries are very much with crisis fall-out: credit and liquidity risk, and the shaky prospects for economic recovery. There was less concern about the availability of capital than in Europe.

Europe

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

Europe is also deeply concerned about the consequences of government involvement with banks, notably in the UK where there is a lot of it, and where many respondents were located. Linked to this is fear of a regulatory over-reaction, particularly by Brussels. Other top concerns focus on crisis-related issues: credit risk, capital, liquidity, and the credit derivative markets. The economic mood is pessimistic, with many respondents worried that the recovery will be long and difficult.

Asia Pacific

1 Too much regulation
2 Macro-economic trends
3 Credit risk
4 Political interference
5 Currencies
6 Commodities
7 Liquidity
8 High dependence on tech.
9 Derivatives
10 Fraud

Respondents from this region included Japan, Australasia, South East Asia and India – a broad group exposed to a variety of risks. The response is notable for the strength of concern about regulatory over-reaction to the crisis, particularly in Australia, and pessimism about the economic outlook, mainly because of fears of a 'bubble' in the tiger economies and a collapse of the credit markets. The region also focused on the risks of fraud and the banking system's high technological dependence.

Industrial and emerging economies have different concerns

Industrial countries

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

The concerns of industrial countries centre on the political fall-out from the crisis: the impact of government ownership and support, and the ensuing regulatory crackdown, which is widely seen as potentially damaging to the banking system. The most pressing risks for the banks remain on the credit front, with the possibility of another wave of bad debts, and continuing liquidity difficulties, despite recent improvements. Recapitalisation could be a problem. There is caution about the economic outlook.

Emerging economies

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

The top concerns in the emerging world are all linked to financial pressures arising from the crisis: bad loans and difficult markets. The risks in the macro-economic outlook are seen to be particularly high, for example in Russia where the economy is fragile, and in the Far East where 'bubbles' are feared to be building up. On the other hand, concern about political and regulatory pressures is lower than in industrial countries. The high place taken by fraud is notable, again possibly driven by the economic downturn.

Banana Skins: The Top Ten 1996-2010

1996	1998	2000
1 Poor management	1 Poor risk management	1 Equity market crash
2 EMU turbulence	2 Y2K	2 E-commerce
3 Rogue trader	3 Poor strategy	3 Asset quality
4 Excessive competition	4 EMU turbulence	4 Grasp of new technology
5 Bad lending	5 Regulation	5 High dependence on tech.
6 Emerging markets	6 Emerging markets	6 Banking market o'-capacity
7 Fraud	7 New entrants	7 Merger mania
8 Derivatives	8 Cross-border competition	8 Economy overheating
9 New products	9 Product mis-pricing	9 Comp from new entrants
10 Technology foul-up	10 Grasp of technology	10 Complex fin. instruments

2002	2003	2005
1 Credit risk	1 Complex financial instruments	1 Too much regulation
2 Macro-economy	2 Credit risk	2 Credit risk
3 Equity markets	3 Macro economy	3 Corporate governance
4 Complex financial instruments	4 Insurance	4 Derivatives
5 Business continuation	5 Business continuation	5 Hedge funds
6 Domestic regulation	6 International regulation	6 Fraud
7 Insurance	7 Equity markets	7 Currencies
8 Emerging markets	8 Corporate governance	8 High dependence on tech.
9 Banking market over-capacity	9 Interest rates	9 Risk management
10 International regulation	10 Political shocks	10 Macro-economic trends

2006	2008	2010
1 Too much regulation	1 Liquidity	1 Political interference
2 Credit risk	2 Credit risk	2 Credit risk
3 Derivatives	3 Credit spreads	3 Too much regulation
4 Commodities	4 Derivatives	4 Macro-economic trends
5 Interest rates	5 Macro-economic trends	5 Liquidity
6 High dependence on tech.	6 Risk management	6 Capital availability
7 Hedge funds	7 Equities	7 Derivatives
8 Corporate governance	8 Too much regulation	8 Risk management quality
9 Emerging markets	9 Interest rates	9 Credit spreads
10 Risk management	10 Hedge funds	10 Equities

Some Banana Skins come and go, some are hardy perennials. The Top Ten since 1996 show how concerns have changed over more than a decade. The 1990s were dominated by strategic issues: new types of competition and technologies, dramatic developments such as EMU, the Internet and Y2K. Many of these faded, to be replaced by economic and political risks and particularly by concern over the growth of regulation. The period after 2000 also saw the rise of newfangled risks such as derivatives and hedge funds, the latter making their first appearance in 2005. The 2008 survey, conducted at the height of the 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. This year's survey shows a preoccupation with the crash aftermath: lingering debt and funding problems, but also looming questions about the state of the world economy and the intrusion of government into the banking sector.

1. Political interference (-)

The dash by governments to rescue their banks from disaster may have staved off a collapse of the system, but it has left the banking industry deeply politicised, a development which is seen by our respondents to be the greatest risk now facing the finance sector.

Political interference on this scale being rare, it has never before appeared in 15 years of Banana Skins surveys (though "political shocks" such as revolutions and wars have). But concern about it is strong and widespread, and it includes bankers as well as non-bankers, even regulators. Geographically, it came top of the list in Europe and North America, and No. 4 in the Asia Pacific region.

Political meddling in banking is invariably 'negative'

Concern falls into three areas.

One is the **moral hazard** created by bank rescues. The managing director of risk at a large US bank said that it had already begun to breed complacent attitudes: "We'll always be bailed out". Ros Altmann, a policy adviser at the London School of Economics, said that banks now assumed that they cannot fail "which distorts their operational decisions and permits different behaviour than would otherwise be the case. They also know that governments need bank share prices to stay strong in order to offload taxpayer stakes in future which, again, gives them the one-way option of reaping the rewards of risk-taking, but not suffering the penalties of failure".

The second is the **politicisation of lending**. Having bailed the banks out, governments are pushing them to keep lending through the recession, against their better judgment. A director at a large UK bank said that "political meddling in the financial sector is almost universally contradictory and negative. One can't lend more to support the economy and build up capital bases at the same time". A credit analyst at a large Japanese bank said that "political interference in both banking and regulation is likely to lead to a mis-allocation of resources, which will probably increase, not decrease, the risk profile of the system".

The third concern is **how governments will withdraw their support** without upsetting the banking system and jeopardising the recovery**.** A respondent from Ireland, where the government is deeply involved, said: "Currently the system is extensively supported by individual states. The ability of individual banks, and the system in general, to extricate itself from such support and raise capital on a stand-alone basis is an issue". The chief risk officer of a large South African bank said: "The main immediate concerns have been alleviated through government intervention. The remaining concern is mostly around the disengagement process of governments from their intervention, and whether this would occur in an orderly way".

The future of government intervention is also a crucial question for regulators, one of whom said that "premature withdrawal of government support could leave weaker banks unable to finance their assets on a sustainable basis given their high leverage". Several respondents raised the additional worry that there was no money left to bail banks out of a new round of failures. A senior risk officer at a large US bank said that "should the 'green shoots' prove false, and these countries have exhausted their resources, no company will be 'too big to fail' - which could create a crisis deeper than any of us have seen".

There is a reason, of course, for the politicisation of banking: the need to rescue banks in the first place. This will leave a political legacy no matter how the crisis runs its course. Many respondents said that banks would have to repair their relations with governments and the public if they wanted to expunge political risk.

Here is a selection of comments on this theme.

A legacy of mistrust

> "Banks just don't get how unpopular they are and how much has to change." – *Former regulator.*

> "The banks still fail to realise the depth of public anger against them. As a result, their behaviour seems to have changed not at all. The result is likely to be a period of tension between banks and regulators, which means that banks concentrate on politics to the detriment of their ordinary banking business." – *City lawyer.*

> "The financial sector as a lobby group is not aligned with the interests of the real economy or the taxpayer." – *City trader.*

> "We need to get back to business without government support." – *UK bank chairman.*

2. Credit risk (2)

The risk of large credit losses remains a top-level Banana Skin because of fears that that banks have not got to the bottom of their existing their bad debts, and because loan problems always lag the recovery and could still increase. This was the No. 1 risk for regulators. Bankers and observers put it at No. 3. Geographically, the risk was seen to be most severe in the Asia Pacific region because of asset bubbles.

The worst yet to come on credit?

Many respondents felt that the worst was yet to come. US bank analyst Ray Soifer said: "The economy is not yet out of the woods, and credit losses are a lagging indicator. I do not believe that they have peaked." Chris Pettit, head of strategy at the Royal Bank of Scotland, said that "the economic outlook still looks miserable; credit risk remains high," while from Ireland, a respondent wrote: "A real concern would be the impact on bank balance sheets of a 'double dip' in the euro/worldwide economies."

Concerns focused particularly on **real estate**, commercial as well as domestic. A respondent from the US said that rising unemployment was a harbinger of potentially huge losses on property lending. A Nordic regulator said that "companies are only surviving due to low interest rates". On the home loan front, several respondents could see banks facing a dilemma as borrowers defaulted on their mortgages, but the political climate made it hard for them to foreclose. Adrian Coles, director-general of the UK's Building Societies Association, saw a squeeze between "rising unemployment in 2010, and a diminishing ability on the part of mortgage lenders to exercise significant forbearance policies".

Another area of concern is **consumer credit** – credit cards and car loans – where bankers said that bad debts "had not bottomed out yet". There is also the question of **leverage**: past deals built on large amounts of debt which investors cannot now service. A UK regulator saw "continuing economic weakness affecting highly leveraged borrowers, particularly commercial property lending and leveraged buy-outs".

The other major area of concern is **asset valuation**: are banks on top of their exposures, and have they valued them realistically? Many respondents felt the answer to both questions was no. Richard Farrant, chairman of the audit committee of Daiwa Securities, Europe, said that "while mark-to-market means that banks' trading portfolios are probably reasonably realistically valued, I am much more sceptical that their loan books are, and that could well become a source of pressure if the rate of economic recovery diminishes or stalls". Peter Moffatt of the Guernsey Financial Services Commission was concerned about "unexpected loss due to mispricing/misunderstanding of assets on banks' balance sheets (or clients' balance sheets)".

> **A subtle beast**
>
> Credit risk is a complex and subtle beast. Even if the upturn continues it will manifest itself in a number of different ways.
>
> UK banking consultant

Geographically, a respondent from a major banking trade association said this was a particular issue in the eurozone where, unlike the US and the UK, banks tend to use less mark to market accounting. "Failure to admit the extent of the write-downs that are necessary will prolong the period of instability in both the system and for some individual eurozone banks". A respondent from a Middle East bank said that "European banks, Middle Eastern banks and in particular Dubai banks are in denial about their exposures, which could very well set back Europe and the Middle East for about five years".

3. Too much regulation (8)

The torrent of new regulation being proposed in the wake of the crisis, however well intentioned, is seen as potentially weakening the banking industry rather than strengthening it. Many respondents described it as a dangerous over-reaction which could end up damaging not just the banks but the wider economy.

Excessive regulation may weaken rather than strengthen the banks

This concern was particularly strong among bankers, who ranked it No. 2, but also among observers of the banking industry who put it at No. 4. Regulators took a different view: they thought the problem was too little rather than too much regulation. All geographical regions gave this Banana Skin a high score: it came top in Asia Pacific.

Respondents gave many reasons for their concerns about regulation. Chief among them was that the regulatory crackdown was **politically driven** and therefore likely to be overdone. The chairman of a large UK bank was said his worry was "overbearing regulation which is not proportionate or of a level playing field character". Many respondents made the point that the risk lay in politicians and regulators going for **quantity rather than quality**. The chief auditor of a large Canadian bank said regulators took the view that "more work equals more control, when they need intelligent risk-based regulation". A particular concern for European respondents was **the EU's response**, which was likely to be particularly heavy-handed and politically driven. Sonja Lohse, head of group compliance at Nordea in Sweden, said that the EU's new regulatory proposals had not been properly evaluated, and could "squeeze out flexibility from the markets" and damage the few banks which had managed to make it through the crisis unscathed.

Too much regulation could stifle the recovery

There was also the fear that regulation would **stifle the recovery** by loading the banks with expensive capital and liquidity rules. John Hitchins, UK banking leader at PricewaterhouseCoopers, said that "the cumulative effect of all the regulatory initiatives could have an inadvertent permanently damaging effect on the industry's profitability". The chief risk officer of a large German bank warned that pressure from politicians and regulators "could lead to overregulation of banks. This may reduce banks' willingness to take further risks, and could lead in turn to a further contraction of the economy".

The sheer **volume of new regulation** was also a concern, from the point of view of cost and management distraction. Michael McKee, a partner at law firm DLA Piper said that "there has to be a limit to how much change a financial institution can safely take on board at one time". Tougher regulation may also have **unintended consequences**. The higher costs will have to be passed on to consumers, which will be unpopular. The impact on profitability could also spur banks to take more risk or abscond to more lightly regulated centres.

The risk of excessive regulation was No. 1 in the **Asia Pacific region**. In Australia, Gary Dingley, chief operational risk officer of the Commonwealth Bank, saw the risk of a regulatory overreaction "without the necessary review, consultation and analysis of overall impact on the individual banks or the financial sectors". A banker from India commented: "The current crisis has led to all types of banks failing, large small, investment, retail, the works. Largely the common denominator is poor liquidity management. As we come out of this crisis the main threat to safety will be over-reaction from regulators which leads to a too costly system and unsustainable business models."

Regulators were not, however, blind to these dangers. Michael Lesser, managing director of supervision and authorisation in Qatar, wrote: "Regulators (and I am one) need to be careful about how new rules are written, to avoid either overly restricting the ability of banks to do business or by restricting some business lines, inadvertently encouraging firms to get involved in other, less restricted, but riskier business."

4. Macro-economic trends (5)

Fears of a 'double dip' recession

The economic outlook remains extremely uncertain, pushing this Banana Skin up a notch. Most of our respondents sounded very pessimistic. For many, the danger is not simply that there will be a "double dip" recession, but that bankers will be unprepared for it.

Broadly, non-bankers seem to be more pessimistic than bankers (No. 2 *versus* No. 6), and Asia Pacific (No. 2) more pessimistic than either Europe (No. 3) or North America (No. 5). If there is a consensus, it is that the current recovery is very weak, sustained only by low interest rates and massive fiscal and monetary support. It is also vulnerable to a reversal caused by fresh problems on the banking front: a surge in bad debts, a continuing shortage of credit, mounting pressures on government resources, and wavering investor confidence. The question is whether the global economy will somehow struggle on, suffer a setback, or even collapse into deflation.

The chief investment officer at a large UK investment group said: "I believe the actions of the authorities to guarantee depositors have significantly reduced the likelihood of a systemic wide collapse. However, the possibility of a 'W' path for the economy with a further leg down in 2010 remains significant. While not our

central scenario, such an outcome could put severe further pressure on asset prices and would clearly lead to a higher level of defaults". Elbert Pattijn, chief risk officer at DBS Bank in Singapore, saw the main risks as "double dip in terms of global GDP, leading to high inflation and interest rates that would impact property values and the ability of property owners to service their floating rate loans". A London economist wondered whether governments would be able to fine tune policy sufficiently to navigate between "the Scylla of inflation and the Charybdis of a double dip recession". Russian respondents were specially gloomy. A senior bank economist said that "significant credit risks are generated by the overall instability in the economy, and a worsening of the business climate".

A new 'asset bubble' on the way?

Many respondents felt that government actions to pump liquidity into the markets had merely inflated an **"asset bubble"** which would eventually burst with damaging consequences, as it did in 2007. This concern underlay the high risk that Asian respondents placed on the economic outlook. The chief executive of a Far Eastern bank said that liquidity "is being poured mostly into 'financial assets' such as equities and real estate, thus creating a bubble economy. More needs to be done to create jobs and boost credits and investment flows into productive industries". The chief economist at a large hedge fund said that his main concern "is that we get yet another asset bubble developing and bursting…The excess liquidity in markets means that many asset prices are already starting to look frothy".

There was also a concern that the rally had created a false sense of security, and brought a return of complacency, even recklessness to the financial markets (see box below). A respondent from a large US bank said that "risk is inadequately calibrated against an uncertain economic recovery".

The C word

Complacency may be the biggest Banana Skin of all. Many of our respondents were alarmed by the "business as usual" attitude of banks despite the huge amount of work that was still needed to clear up the mess and stabilise economies. A UK investment manager saw "the return of hubris/over-confidence and the old short term habits among investment banks, notably Wall Street ones."

Apart from exposing banks to the risk of a double dip recession, these attitudes also bode ill for the future. They imply that the lessons of the crisis may not be learnt. A regulator wondered whether "changes in behaviour will result, or whether there will be a return to the practices that led to the problems, or to new, but just as risky, behaviour." UK consultant economist David Kern saw "inadequate changes in culture and mentality within the financial system; an inability or unwillingness to learn from the crisis," and a Swiss banker observed that "product development goes ahead almost like before".

A respondent from an Australian bank said that "parts of Asia are improving rapidly and some of the issues are again emerging. Pricing for risk is being eroded, the cost of human resources is moving up. The governance framework is more bureaucratic than addressing risk".

A belief that the crisis is over may also sap the political will to reform the financial system. The director of a US project on financial reform said: "My main worry is that a good crisis will have been wasted. On Wall Street, folk are back doing business as normal. On Main Street, loans aren't getting made and a bunch more smaller banks have yet to go belly up - which they will. And on Capitol Hill, there is a real danger we will get some symbolic moving of deck chairs and nothing, *nada*, in the way of steps to reduce the chances of another $15tr dip in economic activity."

5. Liquidity (1)

A critical shortage of liquidity triggered the credit crunch two years ago, which is why this Banana Skin shot to the top of our survey last time. It remains high, not because liquidity is still such an urgent problem, but because new liquidity has been artificially created by central bank actions such as Quantitative Easing (QE) which must come to an end at some point. Then what?

Liquidity was a high level concern for all respondent categories. A Eurozone regulator said: "The current optimism on financial markets is probably overstated. Banks' liquidity and solvency position appears to be less critical for the moment, but…liquidity risk is still very much an issue. The reopening of short and long term funding markets is fragile and some firms are still overly wholesale and short term funded." Another respondent said that "QE creates an illusion which will burst".

What happens after Quantitative Easing?

The question of when and how central banks wind down their QE programmes is crucial. The finance director of a major international banking group saw banks suffering from "an excessive reliance on the huge liquidity boost that central banks have injected". A City of London economist said he feared that "QE will end before banks have been forced to refinance".

New regulations will require banks to keep higher levels of liquidity which would reduce the scale of this risk, though some respondents feared this would add to banks' funding costs, and therefore the cost of credit.

Many respondents also made the point that, until the credit crunch at least, liquidity was not viewed as a high risk area. Now, things are different, and one of the issues is whether lessons have been learnt. A German bank adviser said that "if we have learnt something from the crisis, it is that liquidity risk needs to be in the minds of authorities, boards and senior management". A UK bank chairman described liquidity as "the next problem to solve, post-central bank withdrawal".

6. Capital availability (-)

Banks have been able to raise impressive amounts of new capital in the wake of the crisis. But can this continue? Will banks be able to meet the tougher capital requirements that are on the way, and will they be able to service them?

This is a new Banana Skin: shortages of capital for the banking industry were never a problem in the boom times. But they could be now, particularly if hard economic conditions persist, and the ability/willingness of governments to support them begins to fade. This concern was strongest in Europe.

Many respondents were sceptical about the adequacy of bank capital, even after the recent round of capital-raising. A City of London economist said: "Banks have too little equity and bankers (even bankers!) know this. Until they are forced to raise large amounts, they will not lend."

And compulsion is on the way. New rules will oblige banks to hold more capital and contingency funding, and force them to salt earnings away in the good times to help pay for the bad. The head of a European banking association said: "The demands of the new Basel/EU requirements are in excess of some banks' ability to raise the necessary capital. This will mean more of them having to seek government support,

eg some Japanese banks, some eurozone banks, the mutual sector in the UK, Landesbanks in Germany, the mutuals in France and Spain."

Higher capital requirements may push banks to take greater risks

Higher capital requirements will also mean higher costs for banks, which will put a strain on profitability, and possibly create incentives to take on new risks. The director of group risk at a UK merchant bank said that "higher capital requirements and lower returns increase the relative attractions of trading activities…" while a respondent from a Japanese bank said that "as memories fade, there will be significant pressure from shareholders to boost returns, which will lead to banks taking unacceptable risks again". One banker summed up the paradox: "Regulation will increase demand for capital, whereas decreased bank profitability will reduce the supply of capital."

Some banking respondents felt that higher capital requirements were unwarranted, given the work that banks were doing to clean up their balance sheets and de-leverage. The head of government relations at a large international banking group said this was "a key issue, but driven by political and misinformed agendas".

It's not all bad

A number of respondents said there was too much pessimism around, and that we were in danger of talking ourselves into another crisis. The chief executive of a London-based bank said emphatically: "I think the global banking system and all major national banking markets are sound. Therefore I have no concerns about ongoing systemic risk."

Another respondent said that an overly pessimistic outlook would result in "regulators setting too much store by stress tests which turn out to be too severe. This constrains growth, and forces failures or consolidation which need not have happened... It also leads to pessimism amongst rating agencies who adopt an ultra cautious approach which restricts access to wholesale funding."

Susan Rice, managing director of Lloyds Banking Group Scotland, said that while there were still risks, "financial institutions and the financial system as a whole are far safer than a year ago. This is due to lessons learned, public and regulatory scrutiny, regulatory reformation, economic factors, the new Banking Act and other factors."

7. Derivatives (4)

This is the lowest position that derivatives have occupied in the Banana Skins table since 2000 when they were viewed as an up-and-coming risk. Is this a sign that they have lost their sting, or that people have got used to them? Interestingly, bankers ranked this risk much higher (No. 5) than non-bankers (No. 11) and even regulators (No. 13). This reverses the usual position, and may be connected with bankers' pre-occupations with credit derivatives.

The risks in derivatives are still seen to lie in their complexity, and a poor understanding of the exposures they create. One respondent said they remained "weapons of mass destruction". Consultant Andrew Leung said that, in the near future, "the risk is that the depth of toxic debt remains largely hidden under the carpet, especially with commodities and foreign exchange derivatives and credit default swaps". Some respondents thought that this risk would grow as banks

developed ever more innovative instruments to deal with tougher regulation and squeeze higher margins out of a low yield environment. Giles Vardey, consultant to institutional fund managers Babson Capital Europe, said that "any significant 'tightening' of banking regulations will only serve to create new ways to circumvent these rules and thus create even more exotic products".

Worries about derivatives are easing

But others felt there were reasons to feel more relaxed about the dangers of derivatives. One said that "simplification, reduced volumes and better transparency have made this market safer".

Others pointed out that new regulations will force Over-the-Counter derivative trading on to the open exchanges where it can be better monitored and controlled. A UK investment manager said that "the move to an exchange-traded basis will probably take at least three years. Whilst some of the work being done will reduce risks through standardisation, the resulting fragmentation between asset classes and regulatory environments may adversely impact the banks' client base".

8. Risk management quality (6)

That risk management in banks leaves much to be desired is obvious, and the bankers among our respondents ranked this Banana Skin almost as highly as non-bankers. "This is the key," said one banker. "I don't think anyone can say that it does not need improvement and attention."

But what are the issues?

Respondents identified a string of failings, including an excessive focus on short-term results, inadequate skills, a lack of rigour, poor understanding of newfangled instruments, overdependence on box-ticking and models, a failure to appreciate that risk management is not a cost but a source of value etc.. "A properly managed business should be on top of risks," said Henry Angest, Chairman/CEO of Arbuthnot Banking Group.

The question is whether banks have learnt lessons from the crisis and taken steps to correct these failings.

A tone of scepticism pervaded the responses here. One respondent feared that "board members and senior managers may not have learnt the lessons of the recent crisis and that their banks continue to take risks on their books that they don't understand". The managing director of product control at a Swiss bank worried that banks would "fail to properly and rigorously embed new control processes and cultures arising from the lessons learned during the crisis, and return to the complacency that existed before the crisis". Some respondents even felt the risks would get worse in the difficult period ahead as banks struggled to make profits and were tempted to cut corners on risk management. Stewart Fleming, research visitor London School of Economics, was concerned about "the threat of excessive speculation by financial

Is banking even a profession?

The concept of banking as 'a profession' has taken a hammering in the past 10 years with apologists arguing that there is no need for specific banking qualifications or learning. It is enough, they say, to have an 'appropriate' qualification without making clear what that means. No other 'profession' is so cavalier in its requirement for practitioners to have proper and relevant skills and knowledge.

Principal, professional institute

institutions, driven not only by extremely low (too low) interest rates and monetary easing, but also by pressures to build up profitability as quickly as possible to strengthen capital, cope with cyclical losses and raise new equity".

Many respondents commented on the need not just for stronger controls but for a change in culture to include a more positive attitude towards risk management. A Canadian consultant said that "there are few really good risk managers. Many suffer from too little independence or authority, and executive management must be attuned to their issues". A managing director in one of the leading US investment banks said he was concerned about "the loss of good people".

But not everyone saw risk management as a black spot. A managing director at a large Swiss bank said there had been "clear enhancements following the crisis" and the risk manager of a large Greek bank said that the work banks had done on risk management will "improve the efficiency of financial institutions and reduce systemic risks the coming years".

9. Credit spreads (3)

Spreads may be tightening 'too fast'

The sudden widening of credit spreads in mid-2007 was one of the triggers of the crisis, propelling this risk high up the list. Concerns on this front are now easing as markets re-price credit risk to more relaxed levels, and spreads begin to narrow. The focus of concern has shifted to whether the new spreads accurately reflect the level of risk in the system, or whether their seeming return to normality is but another symptom of unfounded optimism in the financial sector.

Many respondents noted an improvement in the credit default swaps market where different types of credit risk are priced. One of them said that "a major re-evaluation of credit risks has now been factored in". But generally the responses contained a note of caution. A European regulator said that "a reversal of the credit spreads decrease we are currently witnessing" was a "likely market risk". A German bank adviser thought that "spreads are tightening very fast, and may start, once again, not to reflect the correct balance between risk and reward".

10. Equities (7)

Equities have slipped down the risk scale, possibly because they have come back so strongly since the last Banana Skins survey when they had crashed. But the recovery is fuelling a fresh set of concerns around the sustainability of the rally, and what would happen if there was another crash.

Many respondents commented on the irrationality of markets. "If only someone could explain why equities are behaving as they are" moaned a UK consultant. The head of group risk at a UK financial group said that "equity markets could have run too far ahead if there are negative earnings surprises".

The consequences of another crash would be severe for the "real economy", probably plunging it back into recession and landing the banks with further heavy losses, and dashing their recapitalisation plans. One respondent pointed out that equities were important not just as a source of earnings and capital "but as a bellwether of confidence" in a crisis that was essentially about confidence.

11. Currencies (13)

Focus on the volatile US dollar

The currency markets are expected to remain volatile over the recovery period because of the sharp rise in government borrowing and the possibility of big interest rate movements in the next year or two. One respondent said: "The market is very volatile and subject to shifts in reaction to statements by senior financial officials".

The focus is particularly on the US with its trillion dollar debts, but also on other vulnerable countries such the UK as well as the Baltic states whose currencies are pegged to the euro, but could snap, plunging the region into economic chaos.

Question marks also hang over the US dollar in the longer term with mounting speculation that it could be toppled from its reserve currency throne. Many respondents focused on the possibility that sentiment might finally crack, leading to the dollar's collapse and a major shift in the world's reserves. A bank supervisor saw "possible market upheaval as the dollar becomes less important as a reserve currency". China, with its massive holdings of dollars, is seen as playing a central role in any scenario that develops.

But a number of respondents were more sanguine about currency risk. "I think we have learned to live with currency movements" said one banker. Another described the collapse of the dollar as "a low probability high impact event". A third said "sensible hedging helps".

12. Corporate governance (16)

This Banana Skin shows a strong rise since the last survey, reflecting mounting concern about the quality of governance within banks. No surprise, perhaps, that non-bankers and regulators saw it as a greater risk than bankers. It was also seen to be more of an issue in America than in Europe or the Asia Pacific region.

The perceived failings of corporate governance are many. Here is a selection of quotes:

Scepticism about the prospects for better governance

> There is "a lack of realism in recognising that the causes of problems lie within organisations (as opposed to pointing at external factors)". – *Managing director, US bank.*

> The risk lies in "the failure of chief executives to serve the interests of their depositors and customers rather than their own (in particular) and their shareholders' short term interests". – *London trust company.*

> There is concern about "the static and self-preserving 'buddy networks' in high management that will perpetuate incompetence, hide deficiencies, and leave urgent issue". – *Bank director, Luxembourg.*

> "Boards are still underpopulated with serious experts, and thus too subservient to management." – *Economist, New York.*

Will things get better? The responses here were notable for their scepticism, even their cynicism about the corporate governance debate. Doubts that much would change centred on banks' seeming reluctance or inability to pick up the lessons from the crisis. A senior Swiss banker said: "Firms' governance mechanisms and cultures

need to fully embed the lessons from the past 18 months. Many will struggle to do this".

Another concern was the lack of high calibre non-executive directors. Dennis Cox of bank consultancy and training firm Risk Reward, said that "the expectations of management and especially non-executive management is a major concern, and we doubt whether there is the talent required to meet these revised obligations". Another respondent put it more bluntly: "Reforms will happen – but who in their right mind would want to be a bank NED?"

But many respondents also felt that the corporate governance debate was on the wrong track. The risk was that more regulation would weaken the sense of responsibility of bank managements and directors, and that the answer lay in "removing the interference of governments and politics in management".

Trust

The damage done by the crisis to confidence in banks could be a major source of risk, and banks will have to work hard to repair it. This was a recurring theme in the responses to this survey.

A fund manager said that "the fall in confidence by the public, investors and governments has damaged credibility in the sustainability of the system. Redressing this will take years, limiting the ability of a number of banks to regain capital strength and develop."

Adrian Lloyd, enforcement and regulatory affairs director at the UK's Banking Code Standards Board, said that "confidence in banks in Europe and the USA remains fragile at best. Informed depositors are willing to leave savings in banks and mutuals only where they are secured by government-backed deposit protection schemes or by government guarantees, whether explicit or implicit ('too big to fail')."

Several respondents raised the possibility of more bank failures, particularly where governments can no longer afford to bail them out. A UK respondent asked: "If there is another significant bank that fails during this recovery process, what would the public and government reaction be? Has all the stress testing dealt with this issue?"

Mistrust is not just about the soundness of banks but about the quality of their accounts. Many respondents felt that "accounting fudges" were being used to conceal the worst of bank exposures, and that sophisticated trading techniques were being deployed to move risk out of sight. A US banker feared that "financial-economic pressures may lead to 'creative' accounting practices becoming more widespread".

13. Commodities (12)

Concern about the risks in commodity markets has changed little during the course of the crisis. They are still seen as volatile and unpredictable, with oil and gold heading the list, and China's voracious appetite and US energy profligacy the causes. Concern about this risk was strongest in the Asia Pacific region (No. 6).

Respondents made the point that commodity volatility should not pose a major risk to banks because these markets are well understood, and there are plenty of ways banks can protect themselves against them.

In some ways the greater risks lie in the political consequences: what will unstable oil do to the Middle East and Russia, how will China react if it cannot gain access to the resources it needs?

“Still volatile – and still prone to over-reaction”, said one respondent.

14. Interest rates (9)

A surge in interest rates is inevitable, but also predictable

Concern about interest rates has eased – at least for the time being. The medium term outlook (up to a year?) is for low and relatively stable interest rates. The fun comes later, when central banks have to extricate themselves from the markets and governments begin to address their mounting debts. At that point, inflation may also begin to rear its ugly head, and a rise in rates looks inevitable.

But while the rate outlook is alarming, it is also to some extent predictable. One respondent asked: “What happens when the 'punch bowl' is removed. Will we have a series of rate rises similar to 1994?”

The impact could be severe. Michael Taylor, adviser to the Central Bank of Bahrain, warned that changes in interest rates would hit asset values and bond prices. “So far the extraordinary measures have worked in the sense that they have averted something far worse, but have we thereby already laid the foundations for the next crisis?”

Rising rates would put a strain on borrowers and produce a surge in bad debts. A shift in the yield curve could also cause problems. John Grout, policy and technical director at the Association of Corporate Treasurers, said that “big movements up must be expected at some point. The biggest risk for banks is a flattening of the yield curve”.

Meanwhile, low interest rates can bring problems of their own. Some respondents saw them providing a spur to greater risk-taking to earn profits. Consultant Paul Hattori said that “long term interest rates at low levels will only encourage investors to do more stupid things in search of yield as they come to believe the worst is over”. They also squeeze profitability. A Luxembourg banker feared that “the negative impact to the P&L of the banks may occur before balance sheets are restored from the impact of the current crisis”. A divisional director of one of the large UK building societies was concerned about “ongoing super low interest rates which suppress margins”.

The caution factor

The biggest problem now is the combination of the following factors distracting management from doing their job: government regulation in the widest sense; fear of repeating the mistakes of the past; uncertainty about the ability of counterparties to stay solvent; uncertainty about central bank policy; impact of central bank policies on the future value of currencies, and on the re-emergence of inflation; uncertainty about the inevitability of the latter and the timing thereof.

All these lead to excessive caution, inhibiting the extending of credit to the productive sector, and correspondingly the increasing risk of mispricing of asset values.

City chairman

15. Fraud (11)

One reason why fraud has slipped down the ranking is that there have been few recent headline-grabbing cases. In fact, many respondents commented on the surprising scarcity of frauds during a time of recession, which is usually when they come to light, Madoff being a case in point, though that was not exactly bank fraud. The incidence of fraud "has not yet risen by as much as one would expect given the state of the tide," said one respondent. "I am convinced more serious frauds will be exposed before economic recovery arrives," said another.

The main variation in this risk was geographical: it scored higher in the Asia Pacific region (No. 10) and among emerging economies (No. 6).

The concern is both about internal and external fraud as systems become more complex and vulnerable. Advances in electronic technology are always widening the scope for intrusion and data manipulation, according to Topi Manner, executive vice-president at Nordea Bank in Finland. A Russian respondent said that information security was probably the greatest risk that Russian banks faced over the next 2-3 years.

A concern among banking respondents was the effect that a big bank fraud might have on banking confidence at a time when the system is so fragile. The head of regulatory strategy at a large US bank said that "fraud may undermine investor confidence resulting in excessive caution".

16. Management incentives (17)

The row over bonuses and incentives has pushed this Banana Skin up a place. But what is the risk: that perverse incentives will destroy banks, or that new regulation/tax will kill the golden goose? Respondents were sharply divided on this question.

What is worse: paying bonuses or banning them?

Non-bankers tended towards the first of these views. The bonus culture was not only out of control but dangerous: it was creating the wrong incentives, and dulling bankers' sense of risk. Moreover, banks were failing to take on board that something needed to be done about it. Martin Hall, a non-executive director of Broadcastle Bank, said that "banks do not appear to have got the message and are likely to remain in the political doghouse". A London consultant said that the situation was "gradually improving – but the need for reform is not yet fully 'owned' by the firms". A banker added that "perverse incentives (not necessarily the level of incentives) are the core of our industry's problems, at all levels of significant management and risk taking. These have not been solved".

The opposing view holds that remuneration should not be a political issue, and that attempts to regulate it could end up damaging the business, specially if it is done on a country-by-country basis rather than through international agreement. A London investment banker asked: "Will remuneration be sorted out on a level playing field basis so that there is not a run on talent to other markets, leaving some markets vulnerable to a shortage of talent, leading to decline in market position?" This was not merely an Anglo-Saxon preoccupation. A German bank respondent warned that tax and regulatory interference in bonuses "could lead to a deterioration in morale".

A US bank risk manager even argued that, with banks now holding billions of dollars of taxpayers' money, it was in the public interest to have compensation schemes that attracted the best talent to manage it. "If these firms are not permitted to pay competitively, we will find that those who remain in employment there will not be the brightest and best, and hence not the best stewards to turn these firms around and return the government/taxpayers funds."

But others felt the steam was going out of the issue. A regulator said that there was "more awareness and concern about perverse incentives, hence a lowering of the risk level". A Swiss banker saw this risk "falling due to compensation rules".

17. Emerging markets (18)

Are emerging markets a risky bet or, in today's environment, a better prospect than the developed world?

Clearly, it is hard to generalise, but the tone of many responses was cautious. Concern about the macro-economic outlook was stronger among respondents from emerging countries (No. 3) than industrial countries (No. 5), mainly because of the dangers over-hasty recovery producing asset bubbles.. There was "overconfidence in the safety of emerging markets", according to Sheila Page, senior research associate at the UK's Overseas Development Institute. "Vulnerabilities remain", according to the director of risk management at one of the large regional development banks.

A better prospect, or a risky bet?

Some of the caution has to do with uncertainty over China's prospects, the opaque political situation in Russia, and the growing assertiveness of leaders in Latin America. Ioannis Gousios, director of banking supervision at the Bank of Greece, was particularly concerned about emerging European economies where, he said, there was a risk that "loans that were restructured to avoid default become non-performing anyway, that collateral pledged proves to be worth less than initially thought and that rising unemployment and corporate insolvencies in the region create more bad debts". The chief risk officer at a bank in India said there was "a general perception that the country is either fairly immune to economic activity elsewhere, or is already benefiting from an economic recovery, both of which points of view might be over-optimistic".

But other respondents were more upbeat. James Prichard, an emerging markets trader at WestLB in London, said that worries about emerging market exposure meant that "many banks are pulling back, leaving just a few players to benefit".

18. High dependence on technology (15)

The high dependence on technology that banks have built up over the years is no longer the critical issue that it once was (this Banana Skin was consistently in the Top Ten in earlier times – see page 10). The problems are better understood, the pace of change has slowed, and in some areas such as the customer interface it has even been pushed back a bit with the drive to deliver a more personalised service.

But issues remain. This was ranked a Top Ten risk in the Asia Pacific region, particularly among emerging economies. The chief executive of an Indian bank said that "operational and reputational risks from increasing dependence on technology and payment systems are among the risks that banks face currently."

Bottom line worries

Ultimately, all Banana Skins are risks to the bottom line. Here is a selection comments on that theme.

The prospects for banking profitability are not great, thanks to a raft of factors including general economic weakness, low interest rates, political pressure on banks to engage in low-profit activities for the good of the economy, and tighter regulatory constraints.
Executive director, banking trade group

There must be concern about whether financial services firms will be able to generate sufficient profit to remain viable.
Chief executive, UK building society

Lack of profitability is going to be a drain on the vitality of the system going forward, all the more so in Europe if leverage is capped with relatively little regard for the quality of what is being leveraged.
Credit strategist, multinational development bank

High capital requirements will reduce return on equity, which will lead to lower equity prices and more problems raising new capital.
Board member, German bank

The management of online systems is a big problem, as is data security. A Russian respondent said that "as internet banking develops, attacks on client bank accounts will increase". The upcoming migration of Over-the-Counter derivatives to public exchanges will increase technology risk, according to one respondent. New York economist Roger Kubarych said that firms and regulators take for granted that information technology is well run. "What if it isn't? It has been starved of resources in many financial institutions for short-sighted, near-term budgetary concerns."

Consultant Steve Dyson said that "the sector needs to invest a huge amount in new technology to keep pace with the monitoring and management of risk. This, allied with the need to invest in upgrading/replacing legacy systems, will place a huge burden on budgets over the next 2-3 years".

Some respondents made the point that risk not only lies with the systems but in managing – and retaining – the people who run them and understand them. A banker in Luxembourg said banks depended "on particular individuals with a monopoly".

19. Hedge funds (10)

A dramatic drop in concern here, in line with the generally lower profile taken by hedge funds during the crisis.

A sharp drop in concern about hedge funds

The funds are not attracting the level of attention they did earlier through their aggressive position taking, short selling and shareholder activism. Some respondents pointed out that they were actually better managed than banks. Regulatory moves are also afoot to put them on a shorter leash. "The once dominant sector is no longer in charge. Real money investors make longer term decisions with their own money", said one respondent.

But the funds are still making their presence felt. An investment banker said that while hedge funds "are not now a concern with respect to driving up leverage in

buy-outs etc., they are making work-outs more volatile/uncertain as they are purchasing distressed debt at significant discounts and acting with a very different agenda to banks within work-outs". Many respondents said that banks' exposure to hedge funds needed to be "well-managed".

Referring to regulatory initiatives in this area, one respondent said that "at present there is more risk *to* the funds than *from* them". However some respondents feared that tougher controls would merely drive the sector to less well regulated centres. "Many hedge funds will relocate outside the EU", said one. In Hong Kong, Paul Lejot of the Asian Institute of International Financial Law said that "a loss of business is likely from the regulated sector".

20. Rogue trader (14)

This Banana Skin goes up and down in line with recent history. The last survey (in 2008) followed the discovery of Jérôme Kerviel's massive fraud at Société Générale. Since then, there have been no major incidents, and so the risk of rogue trading is seen to have eased.

The question is whether the pressures of recession make a rogue trader more likely. The answer seems to be yes. A regulator said: "The risk is always there. They tend to be discovered in falling markets."

A consultant observed that there are "fewer traders. But those that are left may be under more pressure to save their jobs (which is a more powerful encouragement to fraud than getting a bonus)". Since major incidents tend to occur every 3-4 years, the time for another one must be approaching.

21. Business continuation (23)

Little change in the perceived risk here: the Banana Skin that shot high up the list in the wake of 9/11 has eased off sharply.

Although terrorist attacks continue to earn mentions as potential sources of risk, pandemics such as swine 'flu are there too, as are crashes in the system.

However, the broader feeling is that banks have put a lot of work into this area, and are less vulnerable, though this could also lead to complacency. "Some danger of this falling off the radar", said one consultant.

22. Retail sales practices (20)

The mistreatment of retail clients continues to be a source of risk to banks, even though the worst of the mis-selling abuses may now be behind us. Some of the risk is of a reputational kind, some financial. In the words of a Canadian banker, the risk is "over-promising in a competitive market fuelled by bonus objectives". New regulation proposed through initiatives like the FSA's Retail Distribution Review to separate the sales and advice functions in financial products should help contain some of this risk, though some respondents felt that mis-selling is now so deeply ingrained in banks that they will have trouble adjusting. Regulation will be "a huge shock" said one UK respondent.

There is also the wider question of how the crisis will affect banking relationships at the retail end. Some respondents feared that it may aggravate them by forcing banks to pass on the costs of additional regulation, and to take a tougher line with delinquent customers. There is also the opposite risk: that bank customers, having been rescued from the banks' mistakes, will start "mistreating" the banks. A group strategist at one of the large UK banks foresaw "a further erosion of any sense of personal responsibility by consumers".

Richard Higham of sales training consultancy Mercuri International said the objective for banks should be to make their sales and risk cultures more consistent. This would help them "retain good customers who feel abused by their treatment over the past year".

23. Conflicts of interest (21)

Conflicts are becoming more complicated

This is one of those Banana Skins (like corporate governance and management incentives) on which bankers and non-bankers take sharply different views, for fairly obvious reasons. The bankers think they understand the risk and play it down, the non-bankers think the bankers are ignoring it, wilfully or otherwise.

The risk is that banks will damage confidence by placing their own interests above those of their clients, a risk that has grown with the emergence of "universal banks" combining many different functions. The bankers' viewpoint was summed up by a respondent from a Channel Islands bank: "This is always an issue, but well managed in our business". Others said that the perception of conflicts, if not the conflicts themselves, was rising.

But with the intrusion of state ownership during the crisis, these conflicts have also become more complex. Who are bankers now supposed to be serving: their customers, their shareholders or the taxpayers? One respondent saw the risk increasing "as the oligopoly shrinks and governments get more entwined with the financial services industry".

However a number of respondents felt that banks and regulators were addressing these conflicts and reducing the scale of the risk.

24. Back office (19)

The risks in the back office usually arise because of cost cutting. Many of our respondents said that back office budgets had been trimmed as part of recession-driven cutbacks, and that these were false savings. Even though business volumes are down, the complexity of the current environment – plus panics and failures – means that banks need to have very robust back offices. It is not only a matter of processing business, but documenting collateral and guarantees, tracking defaults and ensuring contract enforceability.

"Cost cutting and consolidation strains are impacting the ability [of banks] to strengthen processes and controls around new product offerings at a time when they are already struggling to provide an adequate service for existing clients for products", said a London investment manager.

On the other hand, much work has also been done to improve this side of banks' operations through greater automation and the resolution of specific problems like derivatives settlement. And they have held up well in the crisis. One banker said that this was "always a risk area, but becoming less so with established systems and processes".

A looming issue is how back offices will cope with a growing regulatory and compliance workload. A respondent from a large Swiss bank said that "pressures on back offices seem to be easing, however the spectre of new regulations and accounting standards will add new demands". Looking at the budgetary implications of this workload, another Swiss banker admitted to a dilemma over "the implementation of regulations *versus* cost control pressure".

25. Environmental risk (25)

No change here despite the growing pressures of climate change and the recent prominence of the Copenhagen Summit.

Bankers are not known for giving a high ranking to environmental risk. The highest position this Banana Skin has reached in more than 15 years of surveys is No. 25, reflecting a belief that the risk to profits is political rather than financial, and even where it is financial, the exposures are not critical or near term.

At the same time, though, the environment has always earned a high place as a rising risk: No. 10 this year, on a par with concern about the global economy, so it is obviously on the radar screen.

This is a risk with many angles: reputation, litigation (banks are "deep pockets"), pollution liability, cost and direct financial exposure. One respondent listed climate change as an issue that could complicate the economic recovery and make life difficult for banks as well.

But it was hard to ignore a tone of dismissiveness, even impatience, in the responses. "Overstated" was one comment. "At the moment, who cares?" was another.

26. Payment systems (27)

Like the back office, this is an area where much work has been done to improve speed and reliability, notably the move to real-time payment and settlement at both the wholesale and retail levels. And these have stood up well during the crisis. But more could always be done in what is, after all, "the key to financial stability" in the words of one respondent.

An area facing competition from non-banks

One risk that was mentioned was that banks may not make the most of the investment they have put into this area. Payment systems consultant Nick Collin said that "the piecemeal deployment of Faster Payments [the UK electronic payments system] has meant that the banking industry has not made as much out of this huge leap forward in near-real-time payments as they might have done, and have so far not been in a position to build on the relatively rich FPS infrastructure with added value applications".

27. Money laundering (24)

Once high on the risk agenda (it was No. 11 in 2002), this Banana Skin is slipping fast with the easing of concern. It has to be said that bankers have never taken this risk as seriously as non-bankers, believing it to be "got up" politically. But now, non-bankers too are less worried, and this year they put it almost at the very bottom of their list.

Many of the respondents' comments focused on the risk of regulatory overkill, and the fact that banks are more vulnerable to this Banana Skin from a reputational than a financial standpoint. "There is plenty of regulation in place" said the chairman of a London banking group.

But regulators are still focusing on it. One said: "During a prudential crisis, this area gets less attention, hence it is a high risk." A Russian banker said there was a temptation for banks to turn a blind eye to money flows during recession when deposits and profits were under pressure.

28. Merger mania (28)

This may not be the time to embark on a major acquisition spree, and some of our respondents even scoffed at the idea. Many even pointed out that the trend was now towards demerger as combinations forged in the heat of the crisis had to be unwound for competition or other reasons.

But there is more to it than that. The banking system will clearly have to undergo some restructuring as the dust settles: rationalisation, consolidation, a shrinkage of capacity, and this is bound to require deals to be struck, with the risk that some of them will not work.

Merger mania "could be induced by the crisis", said a Swiss banker. It might even be healthy. A Luxembourg banker said that "as long as the excess capacity in our industry is not reduced and more closely adapted to client-driven earnings potential, we will see continued risk-taking drawing upon market volatile earnings sources".

29. Too little regulation (29)

Plenty of 'blind spots' on the regulatory map

The persistently low position of this Banana Skin over the years suggests that the risk in regulation is seen to be too much of it rather than too little. That remains the case, despite the obvious regulatory failures that led to the crisis. While bankers and non-bankers put this low on their list, regulators placed it higher, at No. 21.

Yet there is a vocal minority which asserts – with understandable reasons – that we need more regulation, or at least better regulation which often amounts to the same thing. A UK banking consultant who has responded to the CSFI's Banana Skins survey for many years, had the following to say: "Yes, there will be an over-reaction, but from a starting point that was manifestly too low. Those who listed [too much regulation] as the top Banana Skin in 2004-6, just as the banking system piled into toxic assets funded by cheap wholesale money and with pressure to show that capital was being used 'economically', now look absurd. The problem was that there was too much regulation in places, but too little of it centred on prudential issues."

Other comments included: “More regulation will come and rightly so”, and “Only a banker would argue there's too much”. Many emphasised the need for better regulation (more professional, better informed), and for gaps to be plugged in a string of areas: disclosure, risk management, governance, international coordination, and specific functions such as derivatives, hedge funds and credit rating agencies.

A strong concern was that the regulatory reform effort would flag, leaving necessary work undone. One respondent feared that risky deal-making would get going again “before new regulations and controls can be introduced, together with a failure of regulators to agree on how to reduce moral hazard across the industry. This means that a second melt-down cannot yet be ruled out”. Canadian banking consultant John Pattison feared that governments “will not act to put in place appropriately tighter regulation in a number of areas. Financial institutions do not like some of these proposals but for the sector as a whole and institutions of all sizes they are desirable”.

A number of respondents wanted to see a split created between safe “utility banks” serving the high street, and “casino banks” dealing in markets. But they feared that this wouldn’t happen. Andrew Cornford, senior adviser to the Observatoire de la Finance, a Swiss think tank, said that “regulatory reform will concentrate on prudential and transactional problems revealed by the crisis, rather than on structural reforms, in particular the separation of traditional commercial and investment banking and insurance”.

London’s position at risk

A regulatory over-reaction could damage financial centres, particularly London.

The group corporate strategist of a large City-based institution said his concern was that “[FSA chairman Lord] Turner's thrashing of the banking sector will reduce London's position on the global stage to the detriment of the entire UK economy.”

Some also saw the City vulnerable to a crackdown from Brussels. A respondent from one of the large UK banks said that EU regulations would “force financial institutions outside the UK, either to become concentrated in the US and Caribbean, or increasing activity on continental Europe.” A specific concern is the EU’s proposal to regulate hedge funds and bonuses. A respondent said that “volume and expertise may be lost from London markets as hedge funds relocate to Zug thanks to EU rules, and traders move to avoid UK bonus rules.”

Antony Elliott, director of FairBanking in the UK, said that “clear thinking will be needed to separate the issue of safety for UK banks from that of allowing the City to flourish.”

30. Competition from new entrants (30)

Although this Banana Skin is at the bottom of the pile, it contains the important issue of how you stop banks becoming “too big to fail” and make markets more competitive.

Yes, there are new entrants: supermarket giant Tesco announced plans to step up its banking presence in the UK as this survey got under way, and at a different level, Chinese banks are emerging as a force on the world stage.

'Too small to survive'

The crisis has shown that many banks are too big to fail. But the opposite is also true. Many respondents felt that one outcome will be a loss of banking capacity, particularly at the small end where banks have been left to sink or swim, and where survivors now face competition from state-supported behemoths. This concern showed up in many markets, including specialised ones like Luxembourg where small banks feel particularly threatened.

The chief executive of a Luxembourg bank feared that "many small banks in the private banking business will disappear...because clients will have to go to safer banks. Small credit providers will also suffer due to liquidity issues. These trends will encourage consolidation from which big institutions will benefit". In Australia, a respondent saw heavier regulation "causing the demise of marginal players".

New regulatory costs will also fall heavily on small banks. Antony Thomlinson of City lawyers Eversheds said that new funding requirements penalised small banks "to the detriment of competition in the banking sector". David Colvin, executive director of Jordan International Bank, said there was a risk that remedial measures "will place a disproportionate burden on smaller banks and financial institutions. The counterpart to 'too big to fail' is 'too small to survive' which will be the result if the sins of the mega-banks are visited on the small".

But while this might be a good moment for new competitors to launch business models untainted by the crisis, respondents doubted that they would have the stomach for it. "My concern is there will not be real new entrants," said one. Another said bitterly: "The real issue is unfair competition from state-owned businesses".

As regulation gets tighter, the barriers to entry will get higher. There were "few candidates for entry – and those there are will find it difficult to get established in the face of market and regulatory scepticism", said a respondent. Another observed that it was large, failed banks that attracted capital, not exciting new ones.

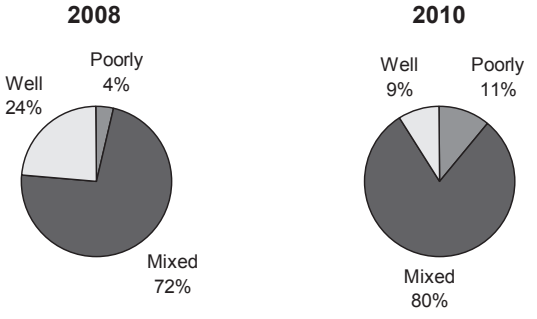
Prof. Michael Mainelli of Z/Yen Group said the key was not to reform regulation but to toughen up monopoly rules to encourage more small banks that were not "too big to fail". He said: "The debate should be about 'open' markets rather than dogmas of 'free' or 'regulated' markets – breaking up oligopolies, not saving institutions." A US respondent agreed, but was not hopeful. "It would be a very good thing to make financial activity more contestable. Smaller institutions, more entry and exit ... ahh that would be wonderful!"

The seeds of the next crisis 'may already have been sown'

Jonathan Howitt, head of group risk at Man Group, said that increased protectionism and regulation would "stifle the market and product innovation that we need to pull out of the crisis. Worse still, with fewer banks and higher barriers to entry, the financial system is far more concentrated than it was before the crisis. Hence the seeds of the next crisis, even if it is a few decades away, may already have been sown".

Preparedness

We asked respondents: **How well prepared do you think the sector is to handle the risks you have identified?**



Only 9 per cent of respondents thought banks were well prepared, and 11 per cent thought them poorly prepared. The remainder gave a mixed response. This was a considerably more negative result than last time when 24 per cent said "Well" and 4 per cent said "Poorly". In our 2006 survey, 64 per cent answered "Well".

%	Well	Mixed	Poorly
Bankers	12	81	7
Observers	4	79	17
Regulators	0	90	10

Bankers are the most positive about their ability to handle risk

A breakdown of the responses shows bankers to be the most positive about their ability to handle risk, and non-bankers the most negative. Although no regulators thought banks were well prepared to handle risk, most of them gave a mixed response.

Those who answered "Well" emphasised the amount of work that had been done to strengthen banks and develop better risk controls. A typical comment was: "The recent crisis has heightened the sense of awareness of, and appreciation for, various risks. This, coupled with active regulatory oversight, ought to enable the sector with the necessary mindset to manage the key risks faced by the industry." Those who answered "Poorly" said that banks had not learned the lessons from the crisis and, if anything, had become complacent. A UK respondent said: "The fundamental discipline of fearing bankruptcy is now severely diminished for large institutions, leaving regulation and political pressure to fill the gap. This is not a viable way forward."

The "Mixed" responses stressed the difficulty of generalising about a sector which had been so sharply split into winners and losers, to the point where it was now possible to differentiate very clearly between well and badly run banks. One senior banker said: "My impression is that many banks have learned the lesson and are focusing and improving risk management, and are ready to accept lower profitability and RoE. Unfortunately there are still many banks, probably one third of the ones I have talked to, that believe that they did nothing wrong and that it is business as usual."

CSFI

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Banking Banana Skins 2010

Each year we ask senior bankers and close observers of the financial scene to describe their main worries about the banking industry as they look ahead. We'd be very grateful if you would take a few minutes to fill out this form, and return it to us by December 19th

CSFI, 5 Derby Street, London W1J 7AB, UK
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Email: info@csfi.org.uk

Name _____ **Position** _____

Institution _____ **Country** _____

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

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

Please turn over

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

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

Question 3. How well prepared do you think the sector is to handle the risks you have identified?

Poorly ☐ Mixed ☐ Well ☐

Comment:

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