

Banking Banana Skins 2012

The system
in peril

The CSFI
survey of
bank risk

CSFI
Centre for the Study of
Financial Innovation

In association with



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Preface

One may carp at the predictive power of our *Banana Skins* surveys. But there is no denying that they paint a very powerful picture of what financial insiders (practitioners, regulators, jaundiced observers) believe to be the most pressing problems of the day. Two years ago, it was the threat of political interference in the business of banking, followed by credit risk (“We lose money the old-fashioned way – we lend it”) and, bizarrely, too much regulation. Now, it is:

- macro-economic risk – defined as a fragile global economy, poised yet again on the brink of recession;
- credit risk;
- liquidity – notably the difficulty that banks, particularly in Europe, are having funding themselves; and
- the availability, or not, of capital – which pretty much guarantees that banks’ response to pressure to boost their own funds (Basel 3 *et al*) will lead to a shrinking of their balance sheets and the exacerbation of the economic downturn we all seek to avoid.

It is all sad, gloomy – and predictable. As this issue of *Banana Skins* makes clear, risk in the financial system is now at a 13-year high, and anxiety levels are unprecedented. Some of this is what we economists call ‘exogenous’, i.e. out of our control. But one of the lessons that this survey teaches us, yet again, is the danger of unintended consequences. A few years ago, Basel 3 probably looked like a good idea. Now, it is clear that it is coming along at precisely the wrong time – virtually guaranteeing that big banks will not be able (even if willing) to play the role of economic locomotive that politicians demand of them. It is still heretical to say it out loud, but one wonders whether the core idea that the best way to regulate banks is through tougher capital ratios needs to be fundamentally rethought, i.e. abandoned.

This year’s *Banana Skins* survey is, as always, a good read and reflects the considered views of people who genuinely run the global financial system. Which (in my view, at least) makes it odd – and not a little disturbing – that the risk embodied in payment systems weighs in at No 30, bottom of our list. That said, I do think that the references to China are deeply significant: the problems of its banks, falling export orders, its over-dependence on the West (an interesting twist) etc. My guess is that in the next survey, China will merit a section all to itself.

In the meantime, my thanks to David Lascelles for putting together what has become the CSFI’s signature report – this time, bigger (and better) than ever. Thanks also to our friends at PwC for sponsoring it and, as important, for allowing us the editorial freedom to say whatever we like about the financial sector that succours us all. I hope that our survey helps the banks avoid some of the risks that appear to be gathering on the horizon. At the least, it should make us all question some of our most cherished assumptions about how banks are run, what their role in society should be, and how (if at all) they should be regulated.

Andrew Hilton
Director, CSFI

Foreword

Welcome to *Banking Banana Skins 2012*, a unique survey of the risks facing the industry, which has been produced by the CSFI in association with PwC.

We're delighted to be continuing our support for this initiative. The *Banana Skins* reports provide valuable insights into the risk concerns at the top of the boardroom agenda, and how these change over time. Not surprisingly, macro-economic risk heads this latest ranking, but it is worth noting that it is seen as bigger risk today than any of the top risks from past surveys.

This is the third time this survey has come out against the backdrop of a crisis for financial services, starting in May 2008 in the wake of the earlier stages of the credit crisis, then again in the post-Lehman period, and now with the world facing new uncertainties. While the latest set of risks may have the same origins as the earlier ones, this survey shows that many people view them as potentially more challenging. The move from a banking crisis to a broader set of economic, regulatory and political risks presents a new set of challenges to bank management, especially as banks must, in many cases, respond to pressures outside their immediate control.

The risks highlighted in this report are fundamental and long term in nature, and include the lack of growth in many developed economies, the eurozone crisis, the potential for some form of Tobin tax, increased costs on banks through additional capital requirements, the lack of confidence in the interbank markets, and the list goes on. And the risk is that things get worse before they get better.

While it is true that many banks have made significant changes to their organisations and the way they run their businesses since the last crisis, the fragile confidence in the sector is further underlined by the presence of credit risk, liquidity and capital availability among the top four *Banana Skins* identified by this survey. It is also clear that much work has still to be done: banks remain both unpopular and under the spotlight. As ever, there is a richness of insight and perceptive comment threaded through the report, which will repay a careful read.

Risk management is about choices and we hope that this survey helps inform the debate.

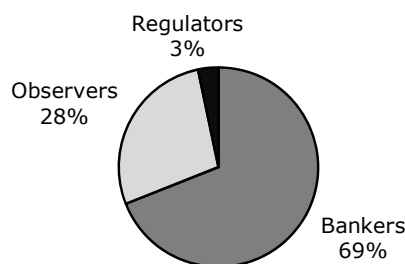
Andrew Gray
Partner, PwC

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

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 2011, and received 710 responses from individuals in 58 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 score a list of potential risks, or Banana Skins, selected by a CSFI/PwC panel. In the third, they were asked to rate the preparedness of financial institutions to handle the risks they identified. Replies were confidential, but respondents could choose to be named.

The breakdown of respondent by type was:



The responses by country were as follows:

Argentina	11	Gibraltar	1	Poland	6
Australia	13	Greece	1	Portugal	1
Austria	6	Guernsey	1	Romania	19
Bahrain	1	Hong Kong	6	Russia	13
Belgium	6	India	6	Singapore	8
Bermuda	1	Indonesia	1	Slovakia	8
Bosnia & Herz.	1	Isle of Man	5	South Africa	7
Brazil	2	Italy	7	Spain	1
Canada	41	Japan	3	Sudan	1
China	23	Jersey	9	Sweden	20
Colombia	1	Luxembourg	23	Switzerland	7
Cyprus	5	Malaysia	12	Thailand	4
Czech Rep.	10	Mauritius	1	Turkey	38
Denmark	1	Multinational	11	UAE	6
Ecuador	1	Namibia	4	Uganda	1
Finland	8	Netherlands	19	UK	245
France	1	New Zealand	22	Ukraine	4
Germany	6	Nigeria	2	USA	41
Ghana	1	Panama	1	Zambia	2
		Philippines	4		

Summary

The fragility of the world economy is the top threat to banks

This report describes the risk outlook for the banking industry at the turn of the year 2012 – a time of unprecedented stress in the financial markets. The findings are based on responses from more than 700 bankers, regulators and close observers of the banking scene in 58 countries.

In the opinion of these respondents, much the greatest threat facing the banking industry is the **fragility of the world economy**. If there is a return to recession, it is very likely that banks will suffer severe credit losses, and that more of them will fail or have to be nationalised.

“The outlook is terrible” was the comment from a director of a large UK bank, reflecting a strength of concern that was shared in all the major regions surveyed: North America, Europe and the Asia-Pacific, plus input from Latin America. The Banana Skins Index, a measure of anxiety levels in the financial sector, is at its highest since it was started 13 years ago.

The main causes are obvious: the crisis in the eurozone and **mounting debt problems in many of the world’s largest economies** (No. 2), linked to weak banking systems and a scarcity of credit.

Concern about bank funding is on the rise again

Specific banking risks lie in the area of funding. Concerns about the adequacy of **liquidity** (No. 3) and **capital** (No. 4) are on the rise again due to the low level of confidence in (and among) banks. The banking sector’s ability to sustain **profitability** (No. 7) in a difficult and changing environment is also in doubt.

Complicating the picture is the high level of **political interference** (No. 5) and **regulation** (No. 6) in the banking industry. Although these efforts are intended to bring about a solution to the banking crisis, bankers say they are also adding cost and distraction to the business, and making it harder for them to supply credit to the economy.

Banking Banana Skins 2012

(2010 ranking in brackets)

- 1 Macro-economic risk (4)
- 2 Credit risk (2)
- 3 Liquidity (5)
- 4 Capital availability (6)
- 5 Political interference (1)
- 6 Regulation (3)
- 7 Profitability (-)
- 8 Derivatives (7)
- 9 Corporate governance (12)
- 10 Quality of risk management (8)
- 11 Pricing of risk (9)
- 12 Business continuation (21)
- 13 Back office (24)
- 14 Management incentives (16)
- 15 Change management (28)
- 16 Hedge funds (19)
- 17 Interest rates (14)
- 18 High dependence on technology (18)
- 19 Currencies (11)
- 20 Business practices (22)
- 21 Equity markets (10)
- 22 Emerging markets (17)
- 23 Rogue trader (20)
- 24 Criminality (27)
- 25 Sustainability (25)
- 26 Commodities (13)
- 27 Fraud (15)
- 28 Human resources (-)
- 29 Reliance on third parties (-)
- 30 Payment systems (26)

Back offices are under strain

Concern about the ability of banks to manage the complexities of modern banking is also high: weakness in **corporate governance** (No. 9) and **risk management** (No. 10) are both seen as Top Ten risks. A fast-rising risk is **business continuation** (up from No. 21 to No. 12), i.e. the ability of the banking system to survive the failure of a major financial institution. Similarly, there is strong concern about **change management** (up from No. 28 to No. 15): the capacity of banks to handle the huge agenda of restructuring which is being imposed on them by new regulation. **Back office** risk (up from No. 24 to No. 13) has also risen sharply because of the stresses on systems created by the crisis and the heavy volume of new regulation.

In the banking markets, **derivatives** (No. 8) continue to be seen as a high risk area, though activity is expected to decline. **Hedge funds** (No. 16), another earlier whipping boy, come out as a middling risk. By contrast, market-related risks are seen to be relatively moderate: little potentially damaging movement is seen in **currencies**, despite the euro, (No.19), **interest rates** (No. 17), and **equity markets** (No. 21) because banks have the means to protect themselves against volatility.

Big movers

RISING RISKS

Macro-economic risk: worries about a new global recession
Liquidity: resurgent fears of a liquidity crunch
Capital availability: risks of a shortage
Corporate governance: ability to manage risk
Business continuation: inadequacy of crisis recovery plans
Back office: systems could be overwhelmed

FALLING RISKS

Interest rates: little volatility foreseen
Emerging markets: in better shape than developed markets
Payment systems: standing up well to the stresses

Despite the strength of anti-bank feeling generated by the crisis, reputational issues and wider questions about the social **sustainability** of banks come low down the list (No. 25). The risks associated with **management incentives** are only seen as middling (No. 14), with banking respondents describing concerns as “wildly exaggerated”. Although the need for banks to rebuild trust is widely recognised, the risks to bank survival in this area are seen to be low. The risk that the low reputation of banks will drive away talented **human resources** is also low (No. 28). **Criminality risks** (fraud, data theft, rogue traders, cyber attack) are seen as manageable, though they may rise in difficult economic conditions.

Certain operational risks such as **reliance on third parties** (i.e. offshoring) and **payment systems** come at the bottom of the list. Although always a potential source of trouble, the prevailing view is that these have stood up well in the crisis.

Emerging market risks are among the few that are falling

The risks in **emerging markets** are seen to be falling (down from No. 17 to No. 22) mainly because the sector is seen to be in better shape than industrial countries (though there are worries about China). Emerging markets do, however, have concerns of their own about global economic prospects, and, for the first time in this survey, we include a view of the world from their perspective.

A breakdown of **responses by type** shows a high level of agreement among bankers, non-bankers and regulators about the risks facing banks: all three put the

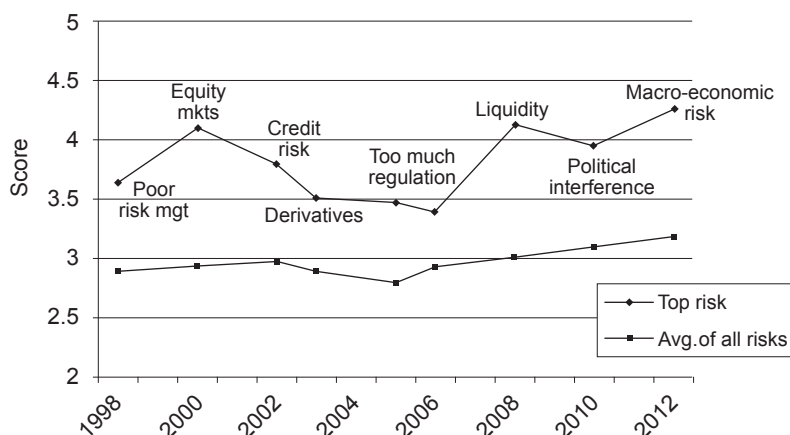
macro-economic situation, credit risk and liquidity risk in their top three. The availability of capital, the volatility of derivative markets and the outlook for banking profitability are also common top level concerns. The big difference between them is the perception of regulatory and political risk: the bankers rate this very high, while non-bankers put it at the middle and regulators at the bottom of their lists.

The risks are global

Geographically, concerns are also strikingly similar in the main regions surveyed. All of them view the macro-economy, credit and liquidity as major risks. Concern about regulatory risk is strongest in North America followed by Asia Pacific and Europe. There is also little to distinguish the types of risk identified by industrial and emerging countries, underlining the global nature of the dangers currently facing banks, though emerging markets are more confident than industrial countries about their economic prospects.

Preparedness. We asked respondents how well prepared they thought the banking industry was to handle the risks they had identified. On a scale of 1 (poorly) to 5 (well) they gave a score of 2.96, slightly above middling, the broad message being that “banks are trying but could do better”.

Banana Skins Index



The Banana Skins Index is at an all-time high

The Banana Skins Index tracks survey responses over time and can be read as an indicator of changing anxiety levels. The upper line shows the average score (out of 5) given to the top risk, and the bottom line shows the average of all the risks. This year, both indicators are at record highs, a clear sign of the unprecedented level of anxiety in the market.

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 – commercial and investment bankers

1	Macro-economic risk	The bankers' chief concerns centre on the operating environment: the state of the global economy, rising debt, particularly on the sovereign front, and the possibility of a new liquidity crunch. The availability of capital and profit prospects are also high on the list. The bankers' response is especially notable for its concern with the negative impact of regulation, and growing political interference in the business. But they also recognise the need for stronger governance and risk management.
2	Liquidity	
3	Credit risk	
4	Capital availability	
5	Regulation	
6	Profitability	
7	Political interference	
8	Derivatives	
9	Corporate governance	
10	Quality of risk management	

Observers – non-bankers, analysts, consultants, academics

1	Credit risk	Observers of the banking industry are the only group which puts credit risk at the top of the list, believing that banks are acutely vulnerable to the sovereign debt, housing and consumer loan markets. They also share bankers' concerns with funding issues. But they are more worried than bankers about potential losses from derivative products and the mispricing of risk. While they also see political interference as a risk, they do not share bankers' intense concern about excessive regulation.
2	Macro-economic risk	
3	Liquidity	
4	Derivatives	
5	Capital availability	
6	Political interference	
7	Quality of risk management	
8	Corporate governance	
9	Profitability	
10	Pricing of risk	

Regulators – supervisors, government officials

1	Macro-economic risk	The regulators' top three concerns are identical to the bankers', showing a strong alignment of views on the near-term risk outlook. They are also concerned about the operating strength of banks: capital, profitability and back office management. But high on their list is the institutional strength of banks, and their plans for business continuation (crisis recovery). Regulators also show more concern than other groups about the economic outlook for emerging markets.
2	Credit risk	
3	Liquidity	
4	Business continuation	
5	Capital availability	
6	Profitability	
7	Corporate governance	
8	Quality of risk management	
9	Derivatives	
10	Emerging markets	

Risks are remarkably similar across the regions

North America

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

The top concern in the US and Canada is the state of the world economy, in particular the risk of contagion from the eurozone debt crisis. But the response is notable for the intense focus on the negative impact of regulation and growing political interference in the banking business. Although this is largely a US preoccupation, it is also present in Canada. Credit risk is a generally lower concern, with both economies feeling that they may be past the worst on domestic bad debts.

Europe

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

Concern about the sovereign debt crisis dominates the responses from Europe, both as to its scale and poor handling. Fears of a renewed recession are strong, with bank funding a big issue in several countries, particularly those at the eye of the debt storm. Europeans share North American concerns about the growth of regulation and political interference in banking, though not as intensely. This is the only geographical group which sees the quality of corporate governance as a Top Ten issue.

Asia Pacific

- 1 Macro-economic risk
- 2 Credit risk
- 3 Liquidity
- 4 Regulation
- 5 Capital availability
- 6 Political interference
- 7 Profitability
- 8 Quality of risk management
- 9 High dep. on technology
- 10 Derivatives

The Asia Pacific response covers a wide variety of economies, including Japan, China, Malaysia and Australia, and therefore displays less obvious patterns. However concern about the economic outlook is strong, particularly the risk of contagion from the eurozone crisis. There are also worries about the prospects for the region if China slows down. The growth of banking regulation and political interference is a concern in many countries, as is the high technological dependence of banks.

Countries at different levels of development share the same risk outlook

Industrial countries

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

There is little surprise in the industrial countries' top worries: the state of the global economy and the risk of a major credit crisis. Concern about funding issues and profitability is also strong. Bankers in all the countries in this group are concerned about the strong growth of regulation, believing that it is adding unnecessary cost and distraction, and holding back growth. However they also recognise that the quality of their risk management and governance needs attention.

Emerging economies

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

Although the emerging economies are broadly in a stronger position than the industrial countries, their concern about the debt problems of the developed world is intense. The risk of a collapse in global demand and of a parallel crisis in the banking markets is currently their greatest worry; none of them, even China, would be insulated from the shocks. Banks in this group are also concerned about the strength of their management, with the growth of political interference a new worry.

Preparedness

We asked respondents how well prepared they thought banks were to handle the risks that lie ahead, on a scale where 5=well prepared and 1=poorly prepared. The average score of more than 700 responses was 2.96, which is slightly better than middling.

However the result was strongly weighted by bankers who had a higher opinion of their preparedness than their observers and regulators (though regulators were slightly more positive than observers).

Bankers	3.13
Regulators	2.92
Observers	2.62
Total	2.96

On the positive side, many respondents said that banks had put a lot of work into risk management, and were better prepared for what were likely to be very difficult conditions over the next few years. For example, the executive vice-president of risk services at a large Canadian bank said that “banks have lived through and survived the recent recession, so are well prepared to handle risks. The recent recession has also increased the profile of risk management, in turn, increasing oversight/risk mitigation”.

The risks lie in the ‘unknown unknowns’

A bank economist in the UK put in a special plea: “The trouble is that there is a wide disparity between the capabilities of different banks. Increasingly banks and bankers are referred to as homogenous groupings; there is very little recognition of how well some banks have performed despite the turbulence”.

Many respondents were also sympathetic to the fact that present conditions are unprecedented, and that banks are snowed under with risks, many of them outside their control: the state of the global economy, the possible collapse of the eurozone, and heavy political interference. As one consultant said: “The risks lie in the unknown unknowns”.

But many respondents felt that the banks had been slow to respond to their difficulties, be it for reasons of complacency, incompetence, or the view that prudence stood in the way of profits. They therefore remained vulnerable to shocks. One respondent said that having abandoned the culture of prudence during the good times, banks were now “re-rigging at sea” which was “not an easy exercise, and surely not necessarily an effective one”.



1. Macro-economic risk (4)

The fragility of the world economy with the possibility of a return to recession poses the greatest risk to the banking industry in these turbulent times, according to this poll of bankers and close observers of the banking scene in 58 countries.

No surprise in this finding, perhaps. But the picture painted by this survey is unquestionably the bleakest we have seen in more than 15 years of *Banking Banana Skins* reports, with huge uncertainty over the near-term prospects, but also the certainty that wrenching changes will be needed to restore stability and growth in the longer term. “The outlook is terrible” was the blunt comment from a UK bank director, words which reflected a level of concern that was shared in most parts of the world.

The main causes are obvious: crisis in the eurozone and mounting debt problems in many of the world’s largest economies, linked to low banking confidence and a scarcity of credit. A period of financial disruption could severely damage the global economy, and smother the prospect of growth for many years. Another banker said that “European recession seems certain, US recession likely and a significant slowing of growth in Asia and Brazil is also likely”.

Sir Brian Pearse, former chief executive of the Midland Bank and chairman of the CSFI, said: “The biggest risk of all is that it will not prove possible to bring about an orderly reduction of borrowing by nations, banks and commercial and individual customers resulting in a major recession”. The head of stress testing at a large Swiss bank, said his two main concerns were: “Firstly that the eurozone shatters and, conversely, that due to massive printing of money, inflation rises to well above comfortable levels.”

The impact on banks would be severe. Despite all the measures that have been taken to bolster banking systems, the fear is that there will be considerable retrenchment in the sector, and possibly failures that financially stressed governments will find it hard to prevent.

With financial markets tightly linked, any local crisis would spread quickly through the global banking system, affecting even countries which have so far been in good economic health. City of London economist Andrew Smithers said that “excess debt means that defaults are likely to be well above historic levels in the years ahead, and this will be exacerbated by slow growth and even more by recession”.

All the major regions in this survey showed a high level of concern with the growing financial strains. The chairman of the risk committee of a large Canadian bank said that “progress on fundamental imbalances has been not enough and too slow”, and Gary Dingley, chief operational risk officer at the Commonwealth Bank of Australia, said that “from my own institution’s perspective, the outlook for the next 2-3 years will be challenging due to the external environment”. The head of country risk of a bank in Brazil said his top concern was the ability of banks “to cover losses if the European sovereign crisis spreads or results in a new financial crisis”.

A new global recession ‘could cause more bank failures’

China: handle with care

China's prospects were central to respondents' assessments of many of the key risks in this survey: the global economic outlook, the stability of financial markets, the resolution of sovereign debt problems, and the safety of the banking system. Providing, as it does, a counterbalance to the West's economic weakness and fiscal deficits, China could have a devastating effect if it started to go wrong.

The overall tone of comment about China was cautious, even sceptical. Many respondents noted that economic growth was slowing, and that China was building up internal strains which could lead to political and economic turbulence. One of them said: "China is slowing and very few banks are really prepared for this; their business plans all call for big expansion in Asia".

A particular worry is China's banking system which is seen to be undercapitalised and threatened by inflated asset prices. It also has a "shadow" banking system which is poorly understood. The head of treasury at one of China's largest banks said that the finance industry faced risks from many directions. "The pace of profit growth will slow down, and it is worth noting that the banking industry will increasingly encounter risks in liquidity which result from credit-related risks. Nonetheless, the overall risks are relatively manageable in our view".

Giles Chance, professor at the Guanghai School of Management at Peking University, said the government needed to liberalise the banking system to increase transparency and confidence. "But it's not clear that China will go down this route any time soon because it will undermine the CCP's control of China which it exercises through the large banks and state-owned enterprises".

In South Africa, the chief risk officer of a large South African bank commented: "My principal concern centres on the stability of the European banking system and the systemic risk that could ensue if one of the banks exposed to euro sovereign debt actually fails. Moreover, this risk is prevalent at a time when sovereigns themselves will find it difficult to support the banking sector and when banks' access to new capital and term liquidity is restricted and/or prohibitively expensive."



Can the global banking system absorb all the likely losses?

2. Credit risk (2)

The concerns of respondents about credit risk focused less on the likelihood of loss, which most of them took as read, than on the scale of likely losses, and their impact. How big will they be, and will the system be able to absorb them? The head of prudential policy at a large UK bank said: "[Loss is] a certainty. More relevant is whether this can be covered by existing capital". The fear among many respondents was that the answer is "no", the obvious consequence being the likelihood of bank failures and/or nationalisations. "The risk of financial institutions defaulting has increased drastically", said the head of credit control at a large Scandinavian bank.

As might be expected, by far the biggest concern is **sovereign debt**, both in the industrialised world and emerging countries. One respondent foresaw "a sovereign default domino. Most developed nations are insolvent, and it's only collective disbelief in the markets that keeps them from dumping sovereign debt *en masse*".

Top of the list is the **eurozone**, both for the scale of the risk and the hesitancy of the political response. Although the banks most immediately under threat are European,

the effects could be global. A European financial regulator saw “a spillover of the eurozone sovereign crisis into a full blown banking crisis driving an unsustainable rise in funding costs and the possible freezing of the banking system”. The director of regulatory affairs at a large UK bank saw “the potential for a vicious circle of contagion from impaired sovereigns to the financial sector back to sovereigns that might not otherwise be credit-impaired – and the impact of this on macroeconomic performance”.

Other potential sources of credit risk include **housing finance**. A senior regulator’s top concerns included “debt deflation, leading to falling property values in Europe, the US and China against which banks have large residential and commercial mortgage exposures”.

Consumer debt is a growing concern, and not just in the advanced economies. A banker in Turkey said that “credit card and consumer loan exposure, which is growing worldwide, especially in the developing and emerging markets, should be given greater attention”. China is also a worry. A bank auditor there was concerned about “the deteriorating credit environment amidst the slowdown/recession of the world economy (e.g. US slowdown, Eurozone debt and the property bubble in Asia) which will create threats to the credit quality of financial institutions”.

The level of anxiety was somewhat lower in North America, partly reflecting the generally healthier state of the Canadian economy, but also a sense in the American banking community that they may be past the worst. However regulators there expressed concern about the high levels of consumer and housing debt, with a US official predicting that “mortgage write-downs, write-offs, and short sales will continue to plague the banking sector for the next 2-3 years, and remain a drag on the economy”.



3. Liquidity (5)

Concerns about liquidity are on the rise again. They topped the Banana Skins poll in 2008 and eased off to 5th place in 2010 as the financial crisis appeared to recede. But now people are worried about a re-run of 2008, with the banks’ funding markets seizing up once more and causing havoc.

As respondents pointed out, a liquidity crisis is not a threat but a fact for many banks, notably in the eurozone, which can no longer fund themselves in the markets, and have been forced to turn to their central banks. The question, really, is how much worse this is likely to get, and what impact it will have.

John Hitchins, banking partner at PwC, said that “in the short term the biggest threat to the banking system is the impact on wholesale funding markets of a failure to solve the Eurozone crisis, and a disorderly default by one or more countries. This could cause a funding freeze worse than 2008”.

Some respondents said that the risk was being made worse by the tougher liquidity standards now being imposed by regulators. These are creating a shortage of suitable assets, and even encouraging greater risk-taking by banks. The chief financial officer of a large South East Asian bank said that “liquidity risk management is a key concern. As financial institutions are pressured to reduce their risk-weighted assets, they will be forced to take more interest rate risk and funding risk to increase returns on their capital”. James Prichard, a swaps specialist at Crédit Agricole CIB,

Concerns about liquidity are on the rise again

said that banks could find themselves in a liquidity trap “competing for deposits to stay in existence, but then struggling to find opportunities to lend or invest”.

Although liquidity risk has its roots in the euro crisis and the fear of collapsing banks, its repercussions could be far-reaching. Respondents from all major banking regions mentioned the danger of contagion. The head of market funding at a New Zealand bank said there was “massive concern about the true position of many banks, especially those with exposure to European sovereign debt. Another liquidity squeeze seems inevitable unless this problem is addressed with proper mark-to-market valuation followed by recapitalisation of those that require it”.

But though fears of a liquidity crunch are widespread, many individual banks said they were currently in a good liquidity position, and a US regulator commented that the risk was “low in the US with liquidity nearing 20 year highs, but high in Europe and potentially elsewhere.” Professor Charles Goodhart of the London School of Economics agreed that “the risks are quite high, but central banks are on the case”.



4. Capital availability (6)

The availability of capital at the right price is becoming an issue

With banks under pressure from regulators to strengthen their balance sheets, the availability of capital at the right price is becoming a key issue, even a matter of survival for some banks, though this is a risk with strong geographical variations. It was clear from the responses that the greatest problems lie in Europe where many banks have already been effectively shut out of the funding markets.

Capital-raising will be difficult: competition for funding is strong, and the banking sector is not in favour. A UK institutional fund manager asked: “If banks can't make good profits, why would investors want to assign capital to the sector? Even where it is available, there is a question of price”. A banking consultant said: “Capital will always be available for important essential organisations such as banks. The question rests on ‘affordability’. I think banks and investors will need to revise expectations on returns. This is an essential part of the changes required to make the industry safer and more appropriate to retail deposit taking”.

Banks that cannot raise capital will have to reduce assets (“deleverage”), consolidate, or turn to public funding. But all of these routes have their risks, both for the banks themselves and the wider economy. James Ferguson, head of strategy at Arbuthnot Banking Group, warned that, in trying to shrink their balance sheets, banks will only be able to shed “good quality assets because they don't have the latitude with their capital to shift the poor quality, illiquid ones. The quality of banks' remaining assets deteriorates and the workout gets extended some years into the future”. Another unintended consequence could be that banks feel compelled to take on more risk to compensate for lost revenue.

Asset reduction, as many respondents pointed out, is politically unpopular at a time of economic recession, which adds to the conflicting pressures on the banking industry. The CEO of a UK bank said: “There is a real mixing of messages between government pressure to lend and regulators' pressure to build up capital buffers”. Consolidation, particularly under duress, can be disruptive, and the availability of public funding has shrunk drastically.

But other respondents were more sanguine. The more hard-nosed said that a tougher capital market would impose a healthy discipline on banks, and force them to think more carefully about how they manage their resources. Some felt the situation was

US banks are seen to be better capitalised than the Europeans

better than it looked. Andrew Cornford, counsellor at the Observatoire de la Finance in Switzerland, said that “the problem is probably overrated, particularly in view of the transition periods to apply the new financial regulatory architecture.”

The picture also varies from one region to another. There was less concern in North America and in emerging markets which have a lower dependence on international funding sources. Respondents from countries like Australia and Canada also reported that funding conditions were good, and in the US a banking regulator said the situation there was improving: “US institutions have already recapitalized and are currently near 20-year highs in liquidity.”



5. Political interference (1)

Concern about the growth of political interference in the banking industry has come down from the top position it occupied in the last survey – but only because it is no longer a threat but a reality. Intrusion by politicians and governments in banking is now a fact of life, be it in the form of nationalisation, tougher regulation, new taxes, pressure on business decisions or simple “bank bashing”.

For most of our respondents (but not all) this was a worrying development which endangered the health of the banks by distorting business judgment and, perversely, forcing them to take risks they might otherwise have avoided.

Increasingly, it is putting banks in a bind. Sir Adam Ridley, chairman of Equitas Trust, said that “further political interference is a certainty, much of it extremely ignorant, aggravated by the lack of public sympathy or understanding for the position of the banks, and the inability of bank leadership to explain or defend rational behaviour on their part. The biggest risk for the outside world is that the banks are overwhelmed with restrictive pressures which prevent them from sustaining, let alone increasing, their lending to the real economy”.

While a lot of the concern came from London-based respondents, this was by no means a British obsession. It was echoed in responses from Switzerland, Germany,

History tells us that when things get desperate, politicians resort to higher taxation, suspension of convertibility or transferability, confiscation, and changing coupons on outstanding debt (all of which have happened in living memory).

David Potter, investment banker

the Netherlands, Central Europe, the US, China, South Africa and Australasia. A credit risk manager at one of the large Swiss banks said that “politicians have the ability to severely damage the whole sector (more than they already have) e.g. Tobin tax, Basel 3 etc”. The chief financial officer of one of the large regional US banks said: “You only

have to look at what has happened in the past 10 years to see the damage, and we have a major election headed our way in 2012 with both political parties and the media wanting to beat the industry”.

But a number of respondents did not see political interference in such a negative light: they said it was a necessary step to reform banks and restore public confidence. A banking consultant said: “I think the current progress and direction of focus – financial stability, prudential regulation, greater challenge and critical thinking – is all appropriate and will lead to a safer system. The problem is getting there”.

Banks are simultaneously being told to be more prudent and to lend more



6. Regulation (3)

Even though regulation is supposed to make banks safer, it continues to be seen by the majority of our respondents (particularly bankers) as excessive, and therefore a potential risk to the banking system and to the wider economy. The risks include higher costs, management distraction, constraints on profitability, and reduced capacity to lend. And these assume that regulation is well-intentioned; many respondents felt that recent regulatory initiatives were a form of political retribution, intended to teach the banks a lesson.

The director of regulatory affairs at a large British clearing bank said that the “extreme risk aversion of the authorities” was “leading to an inability of banks to make sufficient returns, either by raising the cost of equity or by constraining their ability to raise prices. The resulting inability to monetise the franchise while being required to generate equity internally could result in damaging de-leveraging that nobody intends”.

The culture of blame

There seems to be a relentless ‘blame’ culture which shows no sign of abating. While this may not drive the profound change in leadership some might like, it will inevitably be a barrier to entry for the new entrants that are needed to create the lifeblood. There is widespread confusion on what the role of banks should be, with terms such as ‘socially useless’ persisting. There is a balance to be had between social and economic concerns: both are legitimate and need to be addressed. But not all that is wrong with society can be left at the door of the banks.

Director, group risk, UK clearer

The weight of regulation is seen to be choking lending capacity

A director of government affairs at a large US bank said his concern was that “as a result of regulatory overload, the banking industry will become un-investable. Many banks will then fail to attract private sector capital to meet Basel 3 or EU stress test requirements, and will need to be nationalised or recapitalised by public intervention”.

Bankers might be expected to say this, but similar views emerged from non-bankers. A respondent from one of the large credit rating agencies said: “Basel 3 implementation will make earnings stability a major challenge for all affected banks.” He feared that new funding requirements “will make loans both more scarce and much more expensive with the implications that has for the macro-economy”.

Even regulators had some sympathy with these views. A US regulator said that “financial regulatory reform has overshot the mark and will be a drain on economic growth and the soundness of the banking sector”, and a British regulator agreed that there was a risk of “management distraction”. Marcus Killick, chief executive of Gibraltar’s Financial Services Commission, said that “more regulation will not mean better regulation”.

But at the end of the day, the sector rankings speak for themselves: for bankers, this was the No. 5 risk, for non-bankers No. 12 and for regulators No. 24.

One thread of concern was the lack of international coordination on new banking regulation. The risk of divergence was seen to be particularly strong between the EU and the US. A US-based banker said that differences “will force a change in the

business model of global banking, reduce market liquidity and result in very heavy implementation and maintenance costs”.

Although most of the comments about regulation came from the international financial centres of London and New York, there was plenty of input from other territories. A senior banker in Canada said that “regulatory risk is a huge issue”, a

The risk of increasing capital to a level which stops banks paying an adequate return to equity investors is huge and avoidable. When the history of the 2020 banking crisis is written, Basel 3 capital requirements will be seen as the main cause.

Corporate banker

view echoed by respondents in Switzerland, Continental Europe, South East Asia, and Latin America. The chief risk officer of a Czech bank said that regulators were “forgetting that banking is also a business”, and a banker in China said that regulatory cost “may overtake the benefits that regulators expect to bring to the public”.

However, a sizeable minority of respondents applauded regulatory initiatives as well-intentioned and necessary. Philip Warland, head of public policy at Fidelity Worldwide Investment, said that “most of the current wave [of regulation] is good for banks, but maybe not for their current business models”. Some respondents felt that the reforms did not go far enough. Diane Coyle, director of Enlightenment Economics, said: “None of the reforms since late 2008 have tackled the main vulnerability of the financial system, namely the vast multiplicity of links between very large and complicated institutions. The big global banks need to be broken up into smaller and simpler entities, or the crisis could continue to spiral into its next phase, just as it has now on its euro leg.”



7. Profitability (-)

In these stressful times, profitability has become a long-term issue for banks rather than just a matter of the next quarterly earnings report. So we added it to the list in this survey to learn what people had to say about the risks to banks’ ability to maintain “adequate” profitability in the current environment.

It emerged as a high risk, with the great majority of our respondents believing that the sector was undergoing a fundamental shift in profit expectations. Higher capital requirements, greater regulatory and compliance costs, curbs on banking activities, higher “stable funding” costs, political pressure to hold down prices – all of these are impacting bank profits, and are likely to be around for a while. A UK bank chief executive said that “every aspect of the P&L is under pressure”.

Andrew Gray, banking partner at PwC, said that “managing in a low growth, low interest rate environment will challenge many banks. Profitability will be hard to achieve, particularly as capital levels required by international regulators rise. The ability to attract funds and generate sufficient returns will test even the strongest banks”.

Many respondents focused their comments on the banks’ rates of return. Traditionally a high return on equity (ROE) business, banking is now heading down, but how far? Bob Masi, a risk manager at Citigroup, said that “increased capital requirements, not to mention bits of legislation like Dodd-Frank, have transformed what was once an 18% ROE industry into a 12% ROE at best.” Current return expectations, respondents said, were “fanciful” and needed to be “managed down”.

Banks’ earnings expectations have to be ‘managed down’

This would, however, be difficult at a time when the banks are also under pressure to increase their capital, and there is always a danger that they will take on more risk to keep up their earnings.

Looking further ahead, banks may have to adapt to an environment of low growth and low returns, where regulation demands greater simplicity, and where public opinion is ready pounce on any sign of excess. The head of strategy development at a large UK bank said that “massive restructuring, re-pricing and cost-cutting will be required to reach a model delivering adequate returns”.

In the short term, though, some respondents thought banks should do quite well out of the present environment, with its cheap money, state subsidies and constraints on competition. A couple of respondents even described banks as “rent gougers”.



8. Derivatives (7)

Derivatives and complex instruments are still seen as potential sources of risk, but the strength of concern seems to be moderating, and is certainly not at the level it was a few years ago when it topped the *Banana Skins* poll.

The bad things that respondents say about them centre mostly on their opacity: the fact that few people really understand them and that true exposures are hard to measure. A respondent from one of the large financial trade associations spoke of “sprawling OTC derivative positions creating unmappable potential liability patterns”, and a managing director at a major US investment bank said that “derivative exposures dwarf pure balance sheet risk”. Currently, credit default swaps are important links in the chain of bank exposure to major risks such as sovereign debt, and newer derivatives such as Exchange Traded Funds and “NewCITS” could be a source of future trouble.

But many respondents who offered comments on this risk stressed that derivative volumes were easing off, and that deals were becoming less complex. This is partly because banks have introduced better controls since the financial crisis, and partly the consequence of tougher regulation which makes derivative dealing less attractive than it was previously. A US regulator said that the risks were “significantly lower in the US today due to the Dodd-Frank impact on swaps margins and securitizations”.



9. Corporate governance (12)

Although corporate governance has received a huge amount of attention since the onset of the crisis, there is still a feeling that banks are not getting it right: the effectiveness of boards, their control over management, the qualifications of directors, and the impact of regulation – concerns abound in all these areas.

One of the biggest problems remains the complexity of large banking organisations, requiring boards with levels of knowledge, control and foresight at the extremes of human capacity. John Plender, banking commentator at the *Financial Times*, said that “there has not been as much clearing out of boards as would have been justified by the crisis. But there is also a shortage of people adequately qualified to play the directors' role in unwieldy organisations of huge complexity”.

**Derivatives
risk may be
easing off**

Despite a lot of work, corporate governance remains an issue...

There is also the problem of bank boards being pressured or second guessed by the regulators. Some respondents felt that regulators were becoming “shadow directors” and undermining directors’ accountability. One bank CEO thought that “regulatory pressure will lead companies to be so risk averse that they will not go for sound business opportunities”.

A number of respondents made the point that the skills required in times of stress were different from those in good times. The risk manager at a UK bank said that “anyone can make money in good times. Not losing money in bad times takes skill that I think very few have”. Other respondents said that the industry needed more

Corporate governance sounds great, but all of the measures proposed since the BIS document of 2006 have totally failed to prevent disasters. One has to conclude that such governance in banking is the triumph of hope over experience!

Steve Davis, Banking consultant

board members with knowledge of IT, risk, geo-politics – even finance – to help them get on top of the business’ complexities. Some felt that the more gung-ho investment banking culture was, in the words of one, “still the dominant force in the management of the sector”.

Our respondents included bank directors who described the daunting nature of the task before them, among them Richard Farrant of Daiwa Capital Markets, Europe, who said: “Experience makes one very unconfident about one’s ability to oversee and control what is really going on.” Another said: “In the light of events in 2007/8 [corporate governance] must always be a significant risk”.

But even though this emerged as a high ranking risk, some respondents thought that it was overrated. It was easy to criticise corporate governance with hindsight, they said, and things were getting better. A US bank regulator said that “significant weaknesses exposed during the crisis are gradually being addressed”.



...so does risk management

10. Quality of risk management (8)

Much is being done by the banks to improve their risk management after the stresses of the last few years. But there are still doubts about their capabilities in this area. Why?

Much of it has to do with the position of the risk management function inside banks: it is seen to be second order, lacking independence, underfunded, too reliant on

Risk management systems are becoming more robust, but still lack the ability to understand what trouble the human brain can create.

Nick Hungerford, CEO, Nutmeg

mechanistic devices like checklists and models. And so long as banks have generous bonus schemes, there will always be an encouragement to excessive risk-taking.

Charles Stewart, senior director at Moody’s Analytics, observed that “risk management teams generally strive to do their best with the resources that they have available. But as long as the activity is treated as a necessary evil rather than as a core strategic cost of doing business (with the need for appropriate and strategic long-term investment in human capital, technology and resources), the poor management of operational, market and credit risks will continue to be the downfall of many a bank”. One bank risk manager with an obvious interest in the matter said that “the quality is eroded through poor reward structures for risk personnel”.

This Banana Skin would have come higher up the ranking but for the view that, for all their shortcomings, banks are at least trying. Susan Rice, managing director, Scotland, of Lloyds Banking Group, said that “most banks have significantly strengthened this function in recent years”.



11. Pricing of risk (9)

It was the gross underpricing of risk by banks that contributed to the 2008 crisis. Have times changed?

Some respondents felt that banks had “learned the lessons of 2008” and were taking a much more conservative view of risk – even overpricing it. A UK banker said: “I think this issue is now well understood and unlikely to recur for a long time”.

Banks may now be over-pricing risk

But others believed that the quest for profit and the investment banks’ innate risk culture were still leading them to underprice their risks. A regulator said that this risk “had abated coming out of the financial crisis and is now increasing due to a lack of attractive asset opportunities”. Another problem is that asset prices have been so distorted by government and central bank support that accurate risk pricing has become much more difficult. Some respondents also said that risk asset weightings and capital adequacy requirements set by regulators were adding to these distortions.



12. Business continuation (21)

Regulators are counting on recovery and resolution plans (RRPs) to mitigate future banking crises: banks will have to have pre-approved plans to protect the system if they run into trouble. But will these plans be effective?

There was a sharp divergence of views among respondents. Many felt that this risk got to the heart of the problem: the interconnectedness of banks, the vulnerability of the system to a single failure, and the fact that most governments no longer have the resources to rescue banks. A regulator said that “with governments unable to stand behind banks, any bank failure would have contagious effects”.

Will resolution plans stave off a crisis?

The robustness of RRP was therefore key. David Grace, associate director at UBS, said that “business continuation management (BCM) is huge. Any issue/default or BCM event would have a huge knock-on impact on other participants”.

Many respondents saw RRP as a point of strength in the system. The vice-chairman of a multinational bank said that “if anything, this is one of the few areas where risk is moderating”, and a US bank regulator said that “new SIFI [systemically important financial institutions] regulations and resolution regimes will eventually help mitigate this risk”.

But other respondents feared that RRP missed the point. A banking consultant said that “plans alone are not going to make the industry safer. Structural change is required and a better prudential understanding of the networks and dependencies between banks. RRP should help with this – but there needs to be the recognition that they are a tool, and that more fundamental change is required”.

RRPs might even be counter-productive in providing a false sense of security. Few countries have formally adopted them (only the UK and Switzerland according to one respondent) and the area is rife with legal uncertainty over bankruptcy laws. Clive Briault, formerly a senior UK banking regulator, now adviser to KPMG, said that “given the under-developed state of resolution planning, it would be foolish to rely yet on these plans acting as a defence barrier”.



13. Back office (24)

The risks in the back office (systems, data management, custody, technical controls etc.) have risen sharply up the ranking, for two reasons: the stresses of the crisis and the extra demands imposed by new regulation. As one respondent said, the less banks trust each other, like now, the more important it is that back office systems should not fail.

For many respondents, this was still a “Cinderella” area which managements preferred not to get involved with, or allocate the necessary investment despite the

We seem to make life overly complicated by having the processing of transactions travel all around the world, sometimes on several occasions.

Project manager, German bank

obvious risks, viz. the recent rogue trading incident at UBS. The head of operational risk at a large UK bank saw revenue pressures creating “an endless cycle of cost-cutting in an environment of heightened operational risk”.

“Complexity” was a word that cropped up in many responses: back office systems are now so complicated that they are beyond the comprehension of all but a few key staff. Alasdair Steele, partner at City law firm Nabarro, said that “the ability of senior management to understand all the complex areas in sufficient detail to allow them to challenge the assessment of the operating managers becomes considerably greater when there are multiple complex business lines”. Complexity may also grow if, as many expect, the banking industry now goes through a phase of restructuring.

The regulatory tsunami is also having an impact. A respondent from Japan said that systems risked being overwhelmed by “the rushed implementation of Dodd-Frank, Basel 3, MiFID 2 etc.” and a risk director at a large Swiss bank said: “Complexity is not the issue; it’s the level of regulation being layered onto banks to track it”.

However, respondents also felt that back offices were standing up well, considering, and that the risks were exaggerated. Paul Smee, director general of the UK’s Council of Mortgage Lenders, said that “bank systems seem remarkably robust”.



14. Management incentives (16)

Concern about bankers’ bonuses has risen since the last survey because they are such a visible part of the problem, and not much seems to have been done about them despite a number of regulatory initiatives. But having said that, many respondents thought that the risks were reputational rather than financial.

The case against incentives is familiar: they encourage short-termism and excessive risk-taking, and are mostly upside. Alan Peachey, a banker who compiled *Great Financial Disasters of our Time*, said that most of the hundreds of incidents listed in the book “were caused by dealers taking unacceptable risks in order to create

Regulatory change is adding to the stresses on the back office

The debate about bankers’ bonuses continues

sufficient profits to generate bonuses. These comments apply not only to treasury operations but also to other areas of an institution such as customer business and investments”.

Nor, judging by the responses, was this just a problem in the developed world’s “greedy” banks. The chief auditor of a large Malaysian bank said that “insufficient attention and resources are given to good governance because most senior executives think that it impedes growth, which in turns impedes their bonuses”.

The real cause for concern for many respondents was whether bankers propose to do anything about them. Christopher O’Brien, director of the Centre for Risk and Insurance Studies at the University of Nottingham, said that “bankers just haven’t learned the lessons on this, and don’t seem to care”, and a central banker said he had no problem with incentive pay so long as it was based on reality. “But the senior management of banks and their boards have got completely out of touch with the rest of society when it comes to remuneration, and for no good reason.”

But the counter view was that the bonus issue is, in the words of one of the respondents, “massively overrated”. A director of prudential regulation said that “the level of bank pay is offensive and unjustified. However, the role of remuneration in encouraging risky behaviour is hopelessly exaggerated”. Many respondents pointed out that, faced with political and regulatory pressure, banks are trying to curb bonuses and link them to more fundamental measures of performance. The chief financial officer of a large Canadian bank said that while the issue of bankers’ pay was overblown from the soundness perspective, “it can become a reputational issue for banks, especially where they are bailed out”.



15. Change management (28)

In earlier *Banana Skin* surveys, we asked respondents to rank the risk of “merger mania”, which usually came out low on the scale. But with a lot of restructuring, deleveraging, downsizing and general strategic rethinking going on, we thought it more instructive to probe the risks in the wider process of crisis-driven change.

And clearly, there are causes for concern. Philip Middleton, head of central banking at Ernst & Young, said that current problems were likely to lead to “severe uncertainty...and the most fundamental restructuring in European financial services in a generation”. But the banking industry has a mixed record when it comes to big strategic moves, and our respondents were quick to remind us of the sorry examples of Royal Bank of Scotland’s acquisition of ABN Amro, and Lloyds Banking Group’s politically enforced merger with HBOS.

Much of the structural change that lies ahead will be driven by regulatory pressure to reduce the size of banks that are “too big to fail”, and, as one respondent pointed out: “Changes resulting from regulatory requirements are particularly difficult to manage efficiently”. A further problem is that a lot of change will be taking place at once, adding to the uncertainty and affecting prices. A banking consultant foresaw a situation “where many banks are seeking to divest at the same time. Who and where are the buyers?” All this could bring on “restructuring fatigue”.

Nonetheless, many respondents thought restructuring was a necessary step to restore health to a bloated and over-complex banking system. A central banker said that “short term losses will quickly turn into longer term strengths and sustainability. All diets have short term costs but a slim waistline provides a new lease of life”.

**A lot of
restructuring
lies ahead**



16. Hedge funds (19)

Although hedge funds continue to be seen as a middling risk, the responses reflected a growing sense of unease about the wider “shadow” banking sector: its size and opacity, and the lack of regulation.

Stewart Fleming, a financial commentator and associate fellow at Chatham House, said: “I continue to worry about the unexpected... There are too many areas of the global financial system about which we know far too little.”

One risk is that the regulatory squeeze now being applied to banks will drive business into the shadow banking sector where their activities will be less closely scrutinised. Morten N. Friis, chief risk officer at the Royal Bank of Canada, said that “regulatory changes are causing renewed growth of the unregulated shadow banking system”.

But there was also a lot of sympathy for hedge funds: respondents pointed out that, contrary to the popular view, particularly on the Continent, many of them did not engage in short-selling, that they were a source of liquidity, and that they provided services that mainstream banks no longer wanted to or could. Stuart Trow, credit strategist at the European Bank for Reconstruction and Development, pointed out that hedge funds “might help in terms of being among the few buyers of assets the banks need to unload”.

**The ‘shadow’
banking sector
could benefit from
current trends**



17. Interest rates (14)

The outlook seen by most respondents is for a long period of low interest rates, and little volatility. The risks lie less in uncertainty about rate movements than in the persistence of low yields and a flat yield curve, both of which complicate the job of making banking profits.

Peter Hahn of London’s Cass Business School said that “the risk is that income generation will be weak in a low rate, low demand environment”. A regulator said that “current low rates are squeezing bank margins and contributing to lower earnings. Any rate shock up would lead to immediate losses on investment portfolios. Double jeopardy for interest rates makes this a certain high risk”.

Aaron Brown, a risk manager at AQR Capital Management in the US, made the point that since interest rates are being manipulated for the benefit of banks “this is likely to be a source of support, not a source of risk”. But the chief executive of a UK building society pointed up the other side to this coin: “By assisting the banks, the government are making life more difficult for building societies. Interest rates need to be increased to assist margins in the sector”.

Some respondents also wondered whether the concept of a “risk-free rate of return” could still be said to exist, given that so many sovereign borrowers had now lost their triple A status. David Shirreff, European business correspondent of *The Economist*, said that “even if the euro is saved, the banks face a revolution in the concept of what is risk-free. Where do they stash capital if not in high-grade sovereign bonds?”

**Steady outlook for
interest rates**

Banking technology is undergoing a tough test



18. High dependence on technology (18)

This is not the high profile end of the risk business, but a key one nonetheless as banking becomes more technology driven. As a Japanese respondent said: “The banking industry is effectively a technology industry”. Geographically, this was a conspicuous concern in the Far East, notably China.

The concerns are twofold. One is the adequacy of banks’ plans to deal with failure in a high impact, albeit low probability, area. Worries centred on the level of management understanding of technology, and banks’ high dependence on a few key people. One respondent said that “too many process critical IT staff are being fired – short term focused management decisions”.

Many respondents expected that the robustness of bank technology would be severely tested by the current banking conditions. There was “an increased risk at present due to a nervous and volatile market background amplifying the consequences, though not the probability, of failure”, said a respondent from one of the German Landesbanks.

The other concern is vulnerability to hacking. A respondent from a large US clearing house said: “I think this risk is much underrated. Dependence on technology is huge, and there has been a sharp increase in cyber crime which can cause damage. Witness Sony, which isn’t a bank obviously, but the principle is established”. A US regulator said that the real worry is “the increasing sophistication of hackers”.

Some respondents felt that these risks were manageable. A Swiss banker said that “the complexity of the business is decreasing following regulatory reform”.



19. Currencies (11)

A surprise, perhaps, to see this risk so lowly rated given the crisis in the eurozone. But there is clearly a distinction to be made between the macro-economic risks associated with a troubled currency union (which are seen to be huge), and the more specific risks in currency trading. Here, as many respondents pointed out, the banks have a lot of experience – and might even see currency upheaval as an important source of business.

Nonetheless, the euro was the focus of most responses, partly because of potential turbulence, but also because it could throw up some unfamiliar risks. One said that “a euro meltdown seems almost certain. Any break-up of such a system of fixed exchange rates will be loss making for some”.

If it occurs, fragmentation of the eurozone would almost certainly result in currency redenomination, with a tangle of difficult legal issues. One respondent said: “Look at Greek euros. What would happen to all sorts of contracts in the event of exit / enforced exchange to new currency / devaluation / effect of exchange controls / investment currency premium etc.?”

But some respondents felt that banks might even profit from a break-up: the volatility would generate a lot of business, and if the crisis resulted in more currencies to trade, bully for the banks. The risk director of a Finnish bank said that “the dismantling of the euro might bring in new risks, but on the other hand also opportunities”.

Currency is seen as a low risk despite the euro

For once in this long-running survey, the dollar and the renminbi earned scarcely a mention, and the phrase “currency wars” did not appear at all, suggesting that the focus of currency risk has undergone a major shift.



20. Business practices (22)

With all the scandals over mis-selling in recent years, banking business practices should be improving. Many respondents thought that the banks understood the problem and were responding to regulatory pressure. A senior Canadian banker said that “this is a risk, but the industry is more aware of it, and applies more rigour”.

Conduct of business needs to improve

In the US, the creation of the Consumer Financial Protection Bureau will lead to much closer regulation of bank practices in consumer financial products, including mortgages and credit cards. Similarly, in the UK, the arrival of the new Financial Conduct Authority is expected to have a powerful effect. One head of regulatory and operational risk said that “conduct of business is the greatest risk with the FCA the spectre at the gate”.

But others were less optimistic, which may be why this risk has risen up the rankings a bit. Has there really been much change? A central banker thought the risk was “quite high, as for most customers the banks seem to be operating in another space-time dimension – hence the Occupy movement. They do need to think and act differently”. Also, the risk of legal action for past misdeeds remains.

Some respondents felt that, as the banks came under profit pressure, this was an area where standards could easily slip. One of them said: “Using the UK as an example, it appears that banks have not learned their lesson from past mis-selling scandals. Banks must improve their act in this area, but in reality they are being pushed to find abnormal profits at the expense of their weakest retail clients by the need to boost earnings to generate the new higher levels of capital required by Basel 3”.

One problem highlighted by respondents was that this was more of a reputational than a financial risk, and had little material impact on banks’ performance, so banks could take calculated risks if they chose to. One of them said: “It is a peculiarity of banking that major banks can be involved in repeated mis-selling scandals without going out of business. Maybe reputations in banking are now so low that it is hard to incur reputational loss”.



21. Equity markets (10)

The risk that banks will lose money through the equity markets is not seen to be high: direct exposure is limited and proprietary trading is being discouraged by the regulators. However an equity market collapse would have consequences that would affect banks through a fall in general economic growth and in the value of their collateral – and in lower financial confidence.

If there are direct risks, they lie more in the loss of revenue from brokerage activities on behalf of clients, or through losses suffered by the clients themselves. A regulator said that this was “a modest risk. But, as seen from the internet bubble equity correction, not nearly as impactful as a debt driven crisis”, and a Swiss banker said it was “moderate as a risk and comparatively easy to manage and hedge”.

Developed countries are 'a powder keg waiting to explode'

The view from the flip side

While bankers in industrial countries weigh the risks in developing markets, there is a flip side to this: the emerging markets' concerns that the troubles of industrial economies will hit their own growth prospects. A US regulator said that "given the dependence of the western world on growth from emerging markets, this is a much more material issue today".

The chief financial officer of a large Chinese development bank said that the uncertainties about the world economy plus upward pressure on the renminbi "have led to a sharp drop in export orders" in China, while the growing sense of risk in banking markets was causing "funds to flow increasingly out of emerging market countries, including China, [leading to a] shrinking of domestic market liquidity and surging inter-bank interest rates".

These concerns were echoed by respondents in many parts of the world. The chief economist of a bank in Namibia said that "the biggest challenge is how the current sovereign debt crisis will unfold over the next three years and impact the global growth outlook and in turn affect the operating environment". The executive vice-president of a large bank in the Philippines was worried that "over the next two to three years, the industry will not be able to absorb the shockwaves from the geo-political arena where the US, China and Europe are a virtual powder keg that may explode if not managed well".

In several countries, there is concern about the knock-on effect of a collapse in banking confidence. In Romania, a senior banker's top worry was "the lack of trust in banks and excessive coverage of bad news about banks", and a Turkish banker said that the "lack of confidence on the international markets is making it hard to raise needed capital". In Malaysia, Ashok Ramamurthy, deputy CEO of the AMM banking group, said that financial institutions "are facing unprecedented pressures that require dynamic and clever handling. Not all FI's are equipped to deal with these issues correctly!"

In Russia, bankers felt more insulated from global trends because of the size of the economy and its relatively small banking exposure to sovereign debt. However there was concern there, too, about the country's sluggish economy and the growth in credit risk. The head of risk analysis at one of the country's leading banks said that credit was "one of the main risks due to the deteriorating economic environment".

This survey also drew several responses from the microfinance industry which has found that it is not immune to global pressures, and where concern about the overindebtedness of low income borrowers is growing.

In a separate context, banks need healthy equity demand if they are to raise the large amounts of new capital demanded by regulators, and persistent weakness in these markets would be a hindrance.



22. Emerging markets (17)

Views about the risks in emerging markets were very divided.

Many respondents said that, whatever their prospects, the risks in these countries were minimal compared to those in developed markets. More than that: many of these markets were, relatively speaking, strong, and a source of stability for the world economy. They also had governments which could respond much more effectively to global shocks than those of mature markets. Alexander Hoare, managing partner of C. Hoare & Co in the UK, said: "I regard Africa as less risky

Emerging markets look in better shape than developed markets

than Europe in some senses”, and Gerard Lyons, chief economist at Standard Chartered, said that in contrast to the debt and deleveraging of the West, “the economic environment in the East is a big opportunity”.

Nonetheless, there was a strong current of concern in the responses about emerging markets’ ability to spring nasty surprises. The big uncertainty is China which many respondents said was becoming a worry (See box p12).

The increasing unemployment in people under the age of 35 and the resultant lack of acceptable living standards and access to basic services is leading to social unrest that will spread, especially in developing countries. This threatens to destabilise countries where financial institutions will be severely affected.
Philip Wessels, chief risk officer, Nedbank, South Africa

Elsewhere, a respondent warned that “over-rapid growth in the BRICS and Turkey is a threat, and when this slows, I believe banks in those countries will turn out to be sitting on significant asset quality problems”. A respondent from South Asia said that “growth in India has already declined dramatically, and growth in

Bangladesh and Nepal has been galloping ahead too quickly. We’ll see more consolidation in the sector, which is not necessarily a bad thing in the long run. But in the short term, it means less access to finance. We’re certainly seeing this in India”. There was also concern about funding and credit quality in responses from Latin America.



23. Rogue trader (20)

Despite the incident at UBS a few months ago, rogue trader risk is little changed from last time, with most respondents seeing it as an ongoing business hazard which seldom has more than local implications. A senior investment banker said this was “always a risk but unlikely to be as material as other areas”.

Nonetheless, the UBS case accelerated management and strategic changes at the bank and will doubtless have prompted risk reviews at all its competitors – as well as closer regulatory scrutiny. A Swiss trust banker said: “One would hope other banks have heard the footsteps post UBS”. Also, tougher economic times, along with cuts in bonuses and volatile markets, may create a breeding ground for more unauthorised trading.

One question is whether the size and complexity of financial institutions makes them, in the words of a respondent, “the perfect adventure playground for rogue traders” which no amount of control will correct, or whether the downsizing and tougher regulation that banks are now going through will make it harder for rogue traders to get away with it. If there’s one thing rogue traders are good at, it is finding new ways to crack the system.



24. Criminality (27)

The risks of fraud, hacking, cyber attack, theft of confidential information etc. are seen to be low order, at least compared to all the other risks around. Many respondents said that banks have strong controls in place, that regulators are keeping a close eye on problems like money laundering, and that, as one risk manager said, “while a constant threat, it will not bring down many banks without insider involvement”. Ian Bancroft, a managing director of the Cayman National Bank and

Cyber attacks on banks are growing

Trust Company, said he didn't see "any pressing concerns in this area over and above those that have arisen over the past few years".

But there are risks. One is that crime tends to rise during a recession. Another is the growing sophistication of criminals, especially in the electronic world at a time when more financial business is being digitised. The director of legal and compliance at a Dutch bank said that "criminals get smarter by the week. This is a huge risk to banks". A third is bank vulnerability to tougher tax disclosure requirements, such as the US' FATCA, and the general push by cash-strapped governments to pursue tax evaders.

Many respondents made the point that the real risk is not monetary loss or destabilisation, but reputation. The head of operational risk at a large UK bank said that "the exposure is principally a reputational risk. It is unlikely to be life-threatening in the short-term".



25. Sustainability (25)

Some respondents wondered why we bothered to ask a question about the risks to the long-term sustainability of the banking business: its reputation, its ethics, its social utility. It was hard, they replied, to see things getting any worse. But if so, why does this risk come so far down the list?

Here, opinions were divided. The more generous-minded felt that the banks were trying to do better, partly out of self-interest, partly under intense political and regulatory pressure. Bankers understood that the lack of confidence in their industry was not just a moral question but a matter of business survival. It was therefore unfair that they should continue to be assailed by popular "Occupy" movements and daily bashing by the media and politicians. A banking consultant said that "this risk would be higher except for the current regulatory pressure which is forcing the banking industry to respond and make changes in this area".

Reputation risk has had little impact on bank earnings

The bail-out of banks through the TARP funds has already created a lack of trust and faith in financial institutions with the general public. The financial industry must do a better job of explaining how they have repaid these funds, and are now better positioned to help the economy recover. Financial institutions must lend money in such a way as to create domestic jobs, or we will continue fighting this reputational / lack of trust issue.

Edwin A. Link, senior vice president, Wells Fargo Bank, US

The less charitable felt that little had changed. The reputational damage that the banks have suffered seems to have had relatively little impact on their behaviour. A banking consultant said that "it's hard to see that this state of affairs has done much to undermine their profits". Michael Mainelli, executive chairman of Z/Yen Group, said that "banks have lost public support but don't seem to have noticed. A combination of a few disasters requiring more bail-outs could lead to complete nationalisation".

An Australian banker also addressed the more specific concern about the evaporation of trust in the banking markets. "The fundamental concern for me is the restoration of confidence that financial institutions have in each other. Without this, I see a very slow, protracted return to health for the global economy." Some

respondents saw a longer term risk that the banking industry would become complacent behind its protective barriers of regulation and state guarantees, and that this would delay the recovery of public trust.

Also, it depends on what you mean by reputation risk. By one definition, the huge increase in regulation and political interference suffered by the banks is a direct consequence of the poor reputation they have acquired for themselves.



26. Commodities (13)

The risks in commodities are seen to be slight so far as banks are concerned. Few are large players in these markets, and there are well-trying means of hedging price volatility.

Nonetheless, commodity price movements are closely linked to the fortunes of the macro-economy, and uncertainty about the prospects both for the developed world and the BRICS could produce some unwelcome surprises. One respondent said: “Prices can move very fast here – fortunately positions are typically small”.

Banks also have business exposure to companies and dealers who are direct dealers in these markets.



27. Fraud (15)

The consensus is that fraud is a permanent but manageable risk, even if it may be rising now because of the difficult economic climate. The chief executive of a UK bank said: “Economic hardship usually leads to higher fraud. Insider fraud and account takeover are the two most likely areas of exposure”. A US banker said that “we will continue to have incidents of fraud, as financial institutions are combating crime rings that are well-organized, well-funded, disciplined and focused. Better cooperation between the public and private sectors going forward is critical in fighting these crime rings”.

But the chance of a large life-threatening fraud is seen to be low and certainly less costly than bank losses resulting from poor decisions at the top. “This will always be an issue, but will never match losses from credit or bad management”, said the chief investment officer at a large UK institutional investor. But the chief financial officer of a US bank said that “it is still an expense to keep up with security measures to avoid a loss of confidence in the market”.



28. Human resources (-)

We included a question on human resources for the first time this year because there seemed to be rising concern about banks losing “talent” since the crisis, for a number of reasons: bonuses are being cut, bankers are becoming social outcasts, the business is being regulated to death.

The position of this risk in the rankings speaks for itself: it is not perceived to be a large one. People still want to be bankers because they see it as an interesting and rewarding career. As one respondent said: “It’s losing the glitz factor, but it’s still attractive”.

Fraud risk is seen to be manageable

People still want to be bankers, despite the crisis

Part of the reason for job demand, of course, is that banks are downsizing and good banking jobs are scarce. A respondent from one of the large Swiss banks said that “in spite of the anti-banker sentiment, numbers applying to join the industry have not declined noticeably”. Also, the pay continues to be good.

But there are worries. A senior UK clearing banker wrote: “Against [the economic] backdrop, and continuing vilification of the industry by media and politicians, allied to a squeeze on remuneration (in mainstream financial services, not just investment banking), the recruitment and retention of high quality staff, and encouragement of a flow of young talent into the industry risks becoming a systemic issue.”

Another concern is that as mainstream banking becomes more heavily regulated and “boring”, the creative talent will seek better opportunities in the “shadow” banking sector, which many see as a bad thing. According to one London-based respondent: “Bankers are seen as pariahs and the constant and misguided blame attached to them by the real culprits (politicians) will drive the best ones into greater remunerated areas such as hedge funds, private equity funds, asset management etc”.



29. Reliance on third parties (-)

Although the advantages of outsourcing are much-debated, this did not emerge as a high risk issue. Most respondents thought that outsourcing was worthwhile and generally well-managed by the banks, though recession may make that more difficult. A risk manager at one of the large Swiss banks said banks were now quite reliant on third parties, “but generally governance of these is well policed”.

If there was a concern, it lay in the area of reputation. Banks with distant call centres risked alienating their customers – and some were already repatriating them for that reason. Stefan Wasilewski, managing partner of FinaXiom Services, said that “outsourcing carries all of the reputation risks, but none of the real management control and should only be done with care”, and a central banker said that “weakening their link to customers is not a good way to run a sustainable business”.

A regulator warned that “concentration of risk in India for call centre and software development has become an issue for banks and service industries, just as concentration of manufacturing has occurred in China. Such concentrations typically backfire at some point in time”.

Outsourcing is a well managed risk



30. Payment systems (29)

Payment systems are the boring part of banking, and long may they stay that way. This lowest of banking risks has caused little trouble in recent years, and is not expected to, though one can never be sure.

“There is no reason to think payment systems are a vector for spreading instability. They have performed well through the crisis so far,” said Kathleen Tyson Quah, managing director of Absalon Project, and a specialist in financial market infrastructure. Even so, respondents had their worries. One was the impact of a eurozone break-up on the Single Euro Payments Area (SEPA), something for which there was no precedent. How would the markets manage if the system had to be shut down for several days to allow currency realignments to take place?

The financial plumbing has stood up well – so far

Another is the growing concentration of business through the centralised counter parties (CCPs) that guarantee trades on derivative exchanges. Although CCPs have also held up well, many respondents saw them as potential weak links in a stressed system. Dennis Cox, CEO of Risk Reward Limited, said that the development of central counterparties “creates a concentration of risk which runs exactly counter to everything else that we are hearing the regulators want to achieve – and will result in increased unhedged risk and systemic weakness”.

Generally, counterparty risk is perceived to be growing – a natural consequence of weakened banks. One banker said that “the introduction of more centralised clearing has simply transferred the risk of counterparty loss to a new risk node. I would not be surprised to see a clearing house need government support at some stage”.

Banana Skins: The Top Ten since 1996

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 o'-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 15 years. The 1990s were dominated by strategic issues: new types of competition and technologies, dramatic developments such as EMU, the Internet and Y2K. Many of these faded, to be replaced by economic and political risks and particularly by concern over the growth of regulation. The period after 2000 also saw the rise of newfangled risks such as derivatives and hedge funds, the latter making their first appearance in 2005.

The 2008 survey, conducted at the height of the financial crisis, brought the focus sharply onto credit and market risks, and propelled two new entrants to the top of the charts: liquidity and credit spreads. The 2010 survey showed a preoccupation with the crash aftermath: lingering debt and funding problems, but also new concerns about the fragility of the world economy and the intrusion of government into the banking sector, many of which have materialised in the present survey.

APPENDIX: The questionnaire

CSFI

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Banking Banana Skins 2011

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 12th

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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 2-3 years.

Please turn over

CSFI / New York CSFI

Question 2. Here are some areas of risk which have been attracting attention. Please score them on a scale of 5 to 1 where 5 means you see a high risk to banks and 1 a low risk. Use the column on the right to add comments. Add more risks at the bottom if you wish.

	Risk 5=high 1=low	Comment
Back office: How big a source of risk are banks' operations, for example the complexity of their footprints, their operating models, or their ability to introduce new products?		
Business continuation: How likely is it that inadequate recovery and resolution plans will put banks at risk?		
Capital availability: To what extent is the availability of affordable capital a potential source of risk to banks?		
Corporate governance: How likely is it that weakness at board level will lead to poor oversight and control?		
Credit risk: How great is the risk that banks will suffer losses through loan default by sovereign borrowers, companies and consumers?		
Criminality: How exposed are banks to risk in areas such as money laundering, tax evasion and theft of confidential information?		
Derivatives: What is the potential for banks to suffer losses through their dealings in derivatives and other exotic products?		
Emerging markets: How big a source of risk is potential volatility in emerging markets?		
Fraud: What is the risk of banks being defrauded by clients or staff, other than rogue traders?		
Hedge funds: How strong a threat do hedge funds and other "shadow" banking institutions pose to banks, for example as competition or sources of volatility?		

Please turn over

CSFI / New York CSFI

High dependence on technology: How likely is it that banks could be damaged by internal technology failure?		
Human resources: How likely is that banks will have difficulty attracting and retaining talent in the present environment?		
Liquidity: What is the risk that banks will encounter liquidity problems?		
Macro-economic environment: To what extent does the current macro-economic environment present a threat to the banking sector?		
Management incentives: How big a source of risk are incentive structures to banking soundness and reputation?		
Markets: How likely is it that banks will lose money because of turbulence in the following key markets:		
- Equities?		
- Currencies?		
- Commodities?		
- Interest rates?		
Payment systems: How likely is a major failure in bank payment systems?		
Political interference: How great is the risk that political pressure will damage banks, for example through interference in management and lending policies, or by imposing additional mandates and costs?		

Please turn over

CSFI / New York CSFI

Pricing of risk: How likely are banks to misprice risk due to competitive or other pressures?		
Profitability: What is the risk that banks will be unable to maintain adequate profitability in current operating conditions?		
Reliance on third parties: To what extent is the outsourcing or off-shoring of activities a potential source of risk to banks?		
Quality of risk management: How likely is it that banks will incur losses as a result of inadequate risk management?		
Regulation: To what extent could the current wave of regulation have damaging effects on banks?		
Restructuring and change management: How likely is it that banks will incur losses as they shed, divide or acquire businesses to meet the new economic and regulatory environment?		
Rogue trader: How likely are banks to be hit by unauthorised trading?		
Sales and business practices: How strong is the risk that banks will incur losses as a result of poor sales, customer servicing and other conduct of business practices?		
Sustainability: How likely is it that banks will suffer from weaknesses in the area of the environment, ethics, reputation etc.?		

Question 3. How well prepared do you think banks are to handle the risks you have identified, where 5 = well and 1 = poorly?		
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Thank you

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