Banking Banana Skins 2006 The CSFI's annual survey of the risks facing banks

In association with PricewaterhouseCoopers

CSFI Centre for the Study of Financial Innovation
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Preface

Banana skins are slippery things, apt to bring the unwary down to earth with a bump. But they are not unknowable. Indeed, we – or rather, my colleague David Lascelles – have been looking out for banana skins on behalf of the banks for over ten years. Since 1996, this has taken the form of a more or less annual survey which has reflected the concerns of a steadily growing number of respondents in the UK and abroad. In the last few years, the assistance given by PricewaterhouseCoopers (for which we are very grateful) has meant that we have been able to tap into US concerns, as well as those of UK respondents; now, the involvement of GARP (the Global Association of Risk Professionals) has boosted the responses from Asia in particular (for which we are also very grateful). As a result, this year’s survey is based on a record 468 responses from 60 countries.

That is particularly impressive since this year’s survey has been deliberately restricted to the banking sector. Last year’s survey, which was based on 440 responses, covered both banking and insurance. This year (at the request of PricewaterhouseCoopers), we have decided to add a companion report on insurance banana skins which will come out in due course.

The 2006 banking report makes very clear that, as last year, it is the grinding burden of over-regulation that is most on respondents’ minds. That will be no surprise to anyone with his ear to City concerns. I would, however, emphasise that this is very much a UK/European preoccupation; in the US, for instance, regulation only ranks sixth as a concern. Does that mean that the Americans do it better? Or does it mean that their worries about derivatives, hedge funds etc are just that much more pressing?

It is also worth acknowledging (as last year) that there is a body of opinion, notably among regulators, that chooses not to see over-regulation as a risk. After all, it can be said, banks don’t collapse as a result of excess regulation. That is arguably true. But regulation is not a free good; it is added to the cost of every single financial product, and if it is excessive, that excess means we will all earn less from (and pay more for) the financial services that we purchase. Over-regulation also means that another row of bricks will have been added to the barriers that keep new entrants out of the banking industry – and that, inevitably, means less competition, less innovation and generally higher charges. So, while over-regulation is seldom a catastrophe for individual institutions, it can be devastating for the system as a whole.

As always, we at the CSFI are very grateful to David for the enormous amount of work he puts into Banana Skins. In its early years, I used to resent the fact that this project is very much David’s baby; now, I am simply in awe of the amount of information he has to process and of the network of respondents he has developed. I cannot imagine anyone else (myself included) doing half as good a job as David; may he continue for many years to come.

Thanks also to PricewaterhouseCoopers for its generous support. I sometimes joke that the CSFI’s motto should be (in Latin, of course) “We bite the hand that feeds us”. PricewaterhouseCoopers’ sponsorship is very important to us – but
so is the fact that John Hitchins and his colleagues leave the editorialising to David. This is a completely independent look at where the next banking disaster is coming from – and, please, don’t forget that there will, indeed, be another banking disaster. It is the nature of the beast.

Andrew Hilton
Director, CSFI
Foreword

PricewaterhouseCoopers is delighted to sponsor this fascinating and topical survey produced by the CSFI for another year.

Banking Banana Skins 2006 has revealed yet another set of thought-provoking responses from a range of global financial institutions, regulators and observers. This year sees an increase in responses and global coverage, particularly from the emerging markets. Emerging markets also rose in profile in the survey, although more from the developed world's worries about economic stability than from concerns within the emerging markets themselves.

The main headline of this year’s survey reflects concerns around over-regulation for the second year running. At the heart of this is frustration with the growing cost and complexity and the diversion of management time to deal with this. The industry is again throwing down a challenge to the regulators as to whether they have the right balance of cost and benefit.

In addition to these worries, respondents again questioned whether too much regulation is stifling competition and driving out variety and flexibility. It is particularly notable that complaints over political interference in regulation are louder this year.

Merger mania also came out as a big mover – a potential source of trouble. A recent PricewaterhouseCoopers survey entitled “Review of and outlook for mergers and acquisitions in the European financial services market 2006” reported that European financial services deals were up 73% on the previous year, and we expect a buoyant deal market over the next 12-24 months, especially in Central and Eastern Europe. Amidst all this activity, the risk of over-ambitious deals going wrong is clearly rising.

While respondents expressed concern about the vulnerabilities of distributed processing systems to fraudulent attack, pushing high dependence on technology up to sixth, concerns about fraud itself dropped out of the top ten. This is a surprising result given concerns about the increasing sophistication of criminals. Is the industry a little complacent that it is keeping up with the fraudsters?

Hedge funds and derivatives remained high on the list as respondents worried that the quest for better returns would lead to more and more leverage. An important issue that didn’t get as much airing is the ability of hedge funds and credit derivative traders to process increasing volumes of complex trades. Growing backlogs could have a significant disruptive effect.

A final comforting thought is the striking rise in the regulators’ rating of how well banks are equipped to manage risk. Is this perhaps a dividend from all the effort going into Basel 2 preparation?

I hope you enjoy reading this year’s survey, and we very much welcome your insights and feedback on the findings.

John Hitchins
UK Banking Leader
PwC
About this survey...

This survey was conducted in April and May 2006, and is based on 468 responses from 60 countries. The questionnaire (reproduced in the Appendix) was in three parts. In the first, respondents were asked to describe, in their own words, their main concerns about the financial system over the next 2-3 years. In the second, they were asked to rate a list of potential Banana Skins, both by severity and whether they were rising, steady or falling. In the third, they were asked to rate the preparedness of financial institutions to handle the risks they identified. Replies were confidential, but respondents could choose to be identified.

The breakdown of respondent by type was:

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<tr>
<th>Type</th>
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<tr>
<td>of which</td>
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</tr>
<tr>
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<td>47</td>
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<tr>
<td>- risk officers</td>
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<td>- line managers</td>
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The breakdown by nationality of institution and respondent’s location was:

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There were also two responses from multinational institutions
Summary

The burden of excessive regulation tops the list of Banking Banana Skins for the second year running. Like last year, the reasons include cost, diversion of management time and the sheer volume of regulatory initiatives. But this year’s survey also reveals growing concern about the politicisation of regulation, and interference by governments.

Credit risk remains the No 2 Banana Skin, sharpened this year by growing worries over interest rates (up from 12 to 5). The focus is not just on loan portfolios (particularly housing and consumer debt) but also on leverage and private equity.

The size and influence of the derivatives markets continue to be a big concern, particularly credit derivatives, where there is the added worry that back offices may not be up to handling the huge trading volumes. The role of hedge funds in these markets is viewed as a potential source of trouble.

A sharp rise in concern about commodities is one of the striking findings of the survey (up from 14 to 4). Price volatility, particularly in the energy markets, is the main reason, as well as the weight of speculative exposure which could prove damaging to banks. Equity markets are a rising worry as well, (up from 18 to 12) with a growing number of people sensing that the bull market may have run its course.

Scepticism about emerging markets...

Emerging markets are making a comeback as a concern (up from 15 to 9). There is growing disbelief in the economic miracles of countries like India and China, and a fear that the developed world may have taken on too much finely priced exposure to them. The threat of political shocks, particularly in Asia and the Middle East, is also seen to be growing (up from 22 to 15).

Two operational risks feature strongly. One is high dependence on technology: the increasingly complex and distributed systems used by banks are vulnerable to hackers, fraudsters and terrorists. In the area of risk management, banks may be falling behind...
the rapid pace of product innovation, and relying on dubious risk models rather than on human judgment to manage their exposures.

One striking finding low down the list is the sharp rise in concern about **merger mania** (from 27 to 19). With growing activity on the banking M&A front, people’s worries about market concentration and about the creation of unwieldy structures and groups that may be “too big to fail” are resurging.

Against these gloomy findings, though, the survey also showed a declining level of concern about the **macro-economic situation** (down from 10 to 14) and a broad feeling of confidence about the economic outlook. This was reflected in declining worries about **currency volatility** (down from 7 to 13).

**Big movers**

**UP:**
1. **Commodities:** price volatility
2. **Merger mania:** sharp rise in M&A, emergence of “unwieldy” groups
3. **Emerging markets:** stability concerns
4. **Political shocks:** Iran, N. Korea, Middle East
5. **Equities:** markets looking “toppy”

**DOWN:**
1. **Fraud:** many initiatives, will never go away
2. **Money laundering:** overrated as a problem
3. **Management incentives:** better governance, less greed
4. **Currencies:** dollar worries easing; problem understood
5. **Insurance sector problems:** problems being addressed

**How well equipped are banks to handle these risks?**

We asked respondents to rank the preparedness of their own and other institutions to deal with the risks they identified. **The results were more positive than in 2005.** Of our respondents, 64 per cent thought institutions were moderately well prepared or better to handle the risks, up from 57 per cent last year. Confidence was particularly strong among bankers (73 per cent), but also among regulators (63 per cent). Outsiders were more sceptical: only 44 per cent thought banks were well prepared.

This year we include a newly formulated **Banana Skins Index** which tracks the trend in responses since 1998. This year’s average score shows the first uptick since 2002, indicating that anxiety levels are on the rise. The historical data suggest that the Index leads trends in bank profitability by up to two years.
Who said what

Bankers’ greatest worries were about excessive regulation, which they saw damaging their business without bringing net benefits. But they were also concerned about the impact of rising interest rates and strong borrowing levels on their loan books. Their high – and growing – dependence on technology is also a rising concern.

Respondents from non-banking businesses shared bankers’ concerns about excessive regulation, but were also worried about their exposure to potentially troublesome markets: derivatives, credit, commodities, emerging markets and hedge funds. They saw fraud and currencies constituting more of a threat to financial stability than bankers.

Regulators were chiefly concerned with banks’ exposure to market risks: credit, commodities, interest rates, equities, derivatives, emerging markets and currencies. They also gave a high score to insurance sector problems. They were less concerned about over-regulation and internal issues such as risk management and corporate governance.
Analysts, consultants and other observers of the financial scene focused on banks’ exposure to volatile markets such as derivatives, hedge funds, commodities and emerging markets. They were also concerned with internal issues such as risk management, corporate governance and conflicts of interest, but were less sympathetic to bankers’ concerns about over-regulation.

Top people in banks showed a clear focus on regulatory issues – though less with corporate governance which they feel they have improved. Otherwise, their concerns were very much with the risks posed by the operating environment, markets in particular. Their technological dependence and exposure to fraud were other high level concerns.

Risk officers in banks and financial institutions shared their directors’ concerns about regulation. But they also focused on operating risks such as technology and fraud. Their main market risk concerns were with rising interest rates and the impact these would have on the strength of loan portfolios and counterparties.
Line managers showed a mixed range of concerns. They were mainly worried about market developments, particularly those linked to credit, but they also showed interest in operational issues such as technology dependence, fraud and corporate governance.

**Line managers**

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

Concern about regulation dominated responses from most G7 countries. The nexus of derivatives/credit risk/hedge funds and interest rates reflected the group’s concern with the cost and availability of credit. Worries about operational risk were evident in high scores given to technology, fraud and corporate governance.

**G7**

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

The focus of US respondents was very much on markets and external events. Volatile commodities also featured strongly. In-house issues such as corporate governance and technology dependence loomed less large. American respondents were also much less concerned than their European counterparts with the problem of excessive regulation and fraud.

**US**

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

Europe much more concerned with regulation than the US
European respondents gave much the strongest score to the threats posed by excessive regulation. In the markets, they were more relaxed about the threat of rising interest rates, though market performance was reflected in their concerns about credit risk and derivatives. In terms of operating risk, their focus was on fraud, corporate governance and risk management.

The challenges of risk management featured strongly in responses from the world outside North America and Europe, with the volatility of credit, currencies, interest rates and equities high on the list. This group was also concerned with criminality: money laundering and fraud. But their worries about excessive regulation were much less marked than in other groups.

EU and Switzerland
1. Too much regulation
2. Derivatives
3. Credit risk
4. Hedge funds
5. Commodities
6. Emerging markets
7. High dependence on technology
8. Fraud
9. Corporate governance
10. Risk management techniques

Rest of the world
1. Credit risk
2. Risk management techniques
3. Currencies
4. Interest rates
5. Equities
6. Corporate governance
7. High dependence on technology
8. Money laundering
9. Too much regulation
10. Fraud
### Banana Skins: the Top Ten 1996-2005

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

Some Banana Skins come and go, some are hardy perennials. The Top Ten since 1996 shows how concerns have changed over a decade. The 1990s were dominated by strategic issues: new types of competition and technologies, dramatic developments such as EMU, the Internet and Y2K. Many of these subsequently faded, to be replaced by economic and political risks and, more recently, governance and regulation. Striking is the disappearance of 1990s concerns with infrastructure issues (eg back office). Instead, the focus has shifted to newfangled Banana Skins like derivatives and hedge funds. Notable this year is the emergence of commodities and emerging markets as Top Ten concerns.
The Banana Skins Index

What does the Banana Skins survey tell us about changing risk perceptions over time?

Fig 1

The first chart shows the score given to the top risk in each survey since 1998 and the average score for all risks. This highlights a weakening of concerns after the equity market crash of 2000. But this year’s result shows a new rise in the average score, suggesting that people are getting more worried about the risk outlook again.

Fig 2

The second chart shows the link between the Banana Skins Index and bank profitability. The dark line shows the trend in top risk scores, and the lighter one the percentage return on equity earned by banks in the UK. The Banana Skins Index appears to lead the trend in bank profitability.
1. Too much regulation (1)

For the second year running, excessive regulation is seen by our respondents as the biggest risk facing the financial sector. The cost, the distraction, problems of compliance and growing political pressure formed part of a catalogue of concerns – and often bitter complaints.

The cost of regulation was much the most frequently mentioned risk, particularly since few bankers saw a compensating benefit. This view was expressed from many quarters. In the US, a respondent said that “the explosion” of laws and regulations had made regulators much more aggressive. “All these changes have made doing business in the US far more complicated and costly. This may be particularly troublesome for foreign entities with operations in the US.” An Australian banker complained of “compliance costs particularly as a result of anti-money laundering initiatives and Basel 2 obligations which may be of little or no benefit to the organisations bearing the cost of the initiatives”. From Uruguay a banker wrote: “The cost of increased regulation, while not fully impacting on the safety of financial institutions, is surely a big concern for its impact on processes, reputation and expenses.”

The distractions caused by a constant flow of new regulations were also seen as potentially damaging. In London, a large banking group said that “investment banks are subject to significant changes brought about by EU legislation which will divert management attention and stretch legal and compliance teams”. From the US, respondents from the Depository Trust & Clearing Corp. said that the heavy emphasis on operational risk “puts a drain on resources, taking them away from other important areas...and could cause firms to take their eye off the ball and miss something important”.

The anti-competitive aspects of regulation were also highlighted, particularly by smaller banks for which the costs were proportionally higher. “It is killing us slowly”, said the chairman of one City-based financial group. Another respondent pointed out that regulation ensured that large banking groups were “too big to fail”, and that smaller groups were relegated to competing “in limited private banking territories”.

The inappropriateness of regulation was remarked upon. The deputy chairman of a large European financial group was concerned about “the drip drip of regulation - both new rules and the intensity with which they are applied...” There was a risk, he said, that micro-regulation would not pick up the “big risks and the big market shifts”. Others described regulation as prescriptive, ineffective, lacking in commercial sense and confusing. The head of compliance at a large US investment bank said: “The increasing focus on industry conduct by regulators such as the FSA, while simultaneously moving towards a principles-based regulatory regime, may result in difficulty in firms’ ability to identify issues.” The further problem of compliance risk was helping to breed bad business practices: a passive, box-ticking attitude, and a reluctance to give customers advice. The prescriptive character of much regulation removed diversity and human judgment, and imposed the use of risk models with similar characteristics.

A growing concern is that regulation seems to be driven by politics rather than a desire to promote healthy banking systems. Several top bankers complained of government interference, particularly in the UK. Philip Middleton of consultants Ernst & Young
said: “In the UK the big risk to the industry is the apparent desire of the current government, aided by regulators and consumer bodies, to turn retail financial services into a regulated utility, thereby stifling the very diversity, choice and innovation for consumers that it is desired to promote.”

Brussels was widely blamed for much of the burden and cost. One respondent described EU regulation as “an imposition”. Another said that the introduction of the new directive on markets in financial instruments (MiFID) “will cause turmoil in 2007”. One banking economist wrote: “Politicians assume that all risks can be regulated away, so they keep demanding extra rules. The EU is just the vehicle for this misguided political opportunism.”

Basel 2: The new international capital regime was criticised for its complexity and the stresses that implementation will impose on banks which are obliged to adopt it. Craig Pickering of the Finance and Leasing Association said it was “a novel and complex system, and nobody really knows in detail how it will work”. A Spanish banker saw it having “negative effects” in his country. Some even thought that Basel would create new problems by introducing inappropriate rules. The chief credit officer at a UK bank said that far from encouraging banks to focus on the quality of risk management, as had been intended, it had made regulators more prescriptive and mechanistic. “Sound judgment is not acceptable.” Others criticised Basel for encouraging a confusing proliferation of risk models.

Against this welter of complaint, however, many respondents from emerging markets said that while Basel was a burden, it was forcing through better management practices and controls.

2. Credit risk (2)

With interest rates rising and liquidity ebbing, the fear of a damaging wave of loan defaults continues to run high. The focal points are consumer debt and leveraged borrowing, both areas where bad lending decisions and over-geared balance sheets could be exposed by deteriorating markets. Generally, banks are thought to have been too liberal in their lending while the good times lasted.

On the consumer side, high levels of personal debt attracted much anxious comment. In the UK, a regulator said: “Rising bad debts and reputational damage over irresponsible lending could well be major features of the next two to three years.” Many respondents pointed to housing bubbles as potential sources of trouble. One US mortgage lender said: “If the stock market continues to rise, it will draw money out of the real estate market and ‘challenge’ banks with big real estate portfolios.” A US bank economist said that banks “have amassed huge holdings of mortgage-backed securities, other collateralised debt obligations supported by real estate loans and home equity loans…many will face some nasty losses”.

Losing money the old-fashioned way – lending it...
The leverage problem centred on private equity firms and hedge funds that would be vulnerable to sharp interest rate movements and could drag others down with them. “Rising interest rates coupled with increasing leverage (LBOs, M&A) and a deteriorating credit environment are the biggest risks faced by individual institutions” said a bank analyst with one of the large rating agencies. An Irish banker was concerned about the fashion for short-term recapitalisation. “Businesses are now nearly always fully geared. Any rise in earnings that reduces financial risk is nearly immediately released in the form of a recapitalisation.” The chief executive of a UK bank said he was concerned about “equity masquerading as debt on bank balance sheets”.

Although many respondents did not foresee imminent crisis, they felt that the good times were sowing the seeds of bad by encouraging slacker credit standards. An Australian banker saw “a reduction in credit underwriting standards after a period of 15 years of continuous growth in the economy”. Thomas Butler, chief executive of the Anglo-Romanian Bank, saw declining credit standards reflected in “weakening loan covenants and banks going downmarket to capture yield”. Looking ahead, a consultant predicted that banks “will need to make tough choices between growing their customer base and lending responsibly to avoid ever increasing bad debt”. Another respondent thought banks placed “excessive reliance on ratings agencies”.

But while credit risk ranked high as a Banana Skin, a number of respondents felt that credit worries were overdone, that the credit environment was not bad considering. Susan Rice, chief executive of Lloyds TSB Scotland, wrote: “The over-indebtedness of consumers may yet turn into a problem and bears close watching, although it is probably more of a horizon risk at the moment. Conversely, however, companies are for the most part managing their debt levels prudently.”

Some also commented that banks had done a good job of managing their credit exposure, particularly through the derivatives market. But that raised a separate question: how will institutions who bought credit exposure through derivatives cope if there is a serious downturn? A UK regulator said: “At some point the corporate credit cycle will turn. While the banks have off-loaded credit risk, hedge funds and insurance companies will hurt, and liquidity markets will suffer as a result.” And even if banks have built up their capital, what about their clients? “Most banks are capital strong, but some of their clients (private equity, hedge funds and the high yield sector) may be at risk if interest rates rise and equity market valuations fade”, said a senior London banker.

The geographical spread of credit concerns was very wide – as strong in the emerging economies as in the developed. A Chinese respondent for example wrote: “Banks have provided too many loans to too few industries or companies; if China suffers a recession, credit risk will break out.” From India, another wrote: “Although most banks are under the impression that they have conquered this risk, still each default is a new lesson.”
The tipping point

Interest rates and credit spreads have fallen to new lows, and stock markets were (at least until very recently) on a steady rising trend. However, the real economy is showing signs of a turn with rising unemployment and high oil prices. Against this background, LBOs are being financed at debt/EBITDA levels last seen in 1990, and we know how that unwound. Some time in the next two to three years we will see a sharp reverse in the credit cycle.

Graham Allatt
Chief credit officer
Abbey

We are seeing very aggressive pricing of credit – particularly property related – and there is clearly a lot of leverage supporting markets generally. An interest rate or geo-political shock would have a significant impact on asset prices. The first of these is a relatively moderate risk at present; the second is perhaps more concerning.

Chief executive
International private bank

We are moving to the end of the stock market cycle when capacity constraints will start to lead to inflation, but money expansion will prove difficult to curb and the excesses will lead to the usual pattern of credit failures which will show up weaknesses throughout the system, particularly in the areas of innovation in the current cycle.

Kevin Pakenham
Managing director
Putnam Lovell

Exotic mortgage products may come back to haunt us in an increasing interest environment. When the bankruptcies in both borrowers and lenders reach certain critical mass, the financial system’s capacity (including psychological appetite) to absorb the loss may collapse. If that happens, the shock may spill over into wider markets and the economy via two paths: a domino effect through the highly leveraged derivatives market, and a collapse of the housing market which is the main driver of the economy now, and with a heavy debt burden.

US bank examiner

3. Derivatives (4)

Derivatives, in particular credit derivatives, continue to be a strong source of concern - time bombs ticking away in the depths of the market. A senior UK banker said that if the benign decade comes to an end “derivatives will be the Achilles heel”. The potential for destabilisation “remains high” according to the chief executive of a large UK bank. Leveraged instruments, and collateralised debt obligations in particular, were frequently mentioned.
The trigger could be a default by a large issuer, with credit derivatives magnifying the impact. A US respondent pointed to GM’s well-known credit problems as a potential “nasty lesson”. A default by one of the large investment banks or hedge funds was an added risk, particularly if a collapse caused liquidity in the markets to dry up. “The next downturn will seriously test this market”, said the senior vice-president of risk management at a large US financial group.

The opacity of the derivatives market was widely cited. Michael Mainelli of risk consultants Z/Yen said that the complexities of credit derivative products “make us realise that it is almost impossible to keep an overview of this immature market”. Another respondent said that main board directors still did not understand the detailed workings of “esoteric financial instruments”.

Several respondents saw problems springing from related settlement log jams in back offices. Paolo Fegatelli, product manager with Clearstream Banking in Luxembourg, said: “Credit derivatives are certainly an area where there are some potential risks; both from a front-office point of view (i.e. credit risk) and from a back-office point of view (operational risk).” The collateralised debt obligation markets lack “industrial strength” back office support, said another.

This was an area that drew concerned comment from emerging market respondents. One spoke of the “alarming” use of derivatives in Pakistan, for example. But some respondents also felt that concerns were overdone because of the greater amount of information and understanding that now surrounded these markets.

**4. Commodities (14)**

Fear of disruption to the commodity markets is one of the strong findings of this survey. Only two years ago, this risk lay at No 26.

The reasons are almost entirely energy-linked: soaring oil prices, terrorism, political unrest in the Middle East, and China’s voracious appetite for oil. The fears were particularly strong in G7 countries, notably North America. Regulators also singled out this risk (it came 2nd on their list). Although most respondents saw markets reacting to short term events, one bank chairman expected more lasting problems: “I think the pricing of commodities (not just oil) is an issue with China distorting the market on perhaps a more permanent basis than is thought.”

But will disruption come from continuing price rises, or a collapse? Some commentators thought the greatest dangers lay in a market correction, possibly triggered by rising interest rates, and widespread losses which extended beyond the community of speculators. One Russian respondent pointed out that a fall in the oil price would be very damaging for Russian banks. A similar comment came from Bahrain.

**5. Interest rates (12)**

Although the upward trend in interest rates is now well established, there is a fear that these could rise much more sharply than markets expect, triggering problems for the credit markets and leveraged players. One respondent saw the possibility of “a shift in currencies/interest rates to an area well outside market expectations – eg another
1994”. A senior German banking economist thought that banks were vulnerable to “an unexpected rise in interest rates plus a fall in the real estate market”.

Although concern focused mainly on the US, and a continued rise in the Fed funds rate, other areas showed anxiety too. In the eurozone, an Irish banker said: “Asset value reductions in stock markets, commodities and property markets as interest rates rise will impact banks’ loan books.” A Spanish banker foresaw a rise in loan defaults as rates continued upwards.

In the UK, there was greater confidence that rates would be relatively stable, though if they did rise sharply, there would be casualties in the personal loan market.

6. High dependence on technology (8)

This is an area where concern is rising with increasingly complex and distributed systems seen to be vulnerable to hackers, fraudsters and terrorists. “The attackers are likely to understand the environment better than the defenders in banking institutions”, said an operational risk specialist at a large UK bank. From the US, one bank said: “Technology seems to be moving further and further away from mainframe processing to distributed systems which require different forms of security. The security seems to be more vulnerable to penetration.”

But there was a clear line between responses from industrial countries where IT was seen, on balance, as a good and manageable thing, and those from the emerging world where it created problems of management and risk control. In some regions, it was linked to the migration from manual to automated systems, as in Russia and Asia. Many respondents in these countries also saw this risk in terms of threats to customer confidentiality. The head of audit at a Malaysian life assurance company said: “As the banks in my country move towards e-banking, there are high concerns over the safety of using such facilities especially on issues relating to confidentiality of customers’ information etc.”

7. Hedge funds (5)

Worries about hedge funds continue to run high because of their size and opaque character, and their heavy use of leverage. But to this has been added the worry that overcapacity in the sector may drive hedge funds to take greater risks to sustain returns. As one respondent put it: “As competition becomes more severe, the cowboys of the industry may take increasingly risky positions on a scale eventually capable of having threatening knock-on effects in difficult markets.”

Many respondents commented on the vulnerability of hedge funds to sudden market movements. “Thoughts of a systemic meltdown are probably overplayed, but stronger analysis and supervision is needed,” said the director of a bank on the Isle of Man. A UK economist wrote: “The idea that in the long run hedge funds can deliver above average returns to savers and hugely above average returns to fund managers, and yet not suffer occasional severe reverses because of excessive risk, is obviously untenable.”
Other respondents made the point that hedge funds, once considered to be mavericks, are now right at the heart of the financial system, and that problems in the sector could have severe knock-on effects. One said: “$1 trillion cannot continue as an alternative asset class.” Another commented that the threats posed by hedge funds “are now mainstream”.

Several respondents thought that hedge funds should be more tightly regulated. “The hedge fund market remains lightly regulated, but is little understood by the majority. The potential for a sudden loss of confidence or another mis-selling scandal exists and is rising,” said a UK banker. The prospect of hedge funds being marketed to retail investors in the UK was also a cause for some alarm. One respondent said there would be “scandals”, and another saw the “risk of large losses, huge compensation bills and even more regulation as a result”.

The huge experiment of the last ten years has been to use institutional and wealthy individual capital mediated by hedge funds and derivatives traders to re-engineer the system for allocating economic risk. It has worked very well so far, but has not been tested since 1998. I’d sleep better after seeing a few successful tests.

Aaron Brown
Executive director
Morgan Stanley

8. Corporate governance (3)

This risk has eased somewhat since the heady times which produced Sarbanes-Oxley and the Higgs Report. Many of our respondents felt that corrective action had been effective and that this risk was now “overdone”. Corporate governance is “improving” said Howard Flight, a director of Investec Asset Management. If there was a risk, it lay in over-regulation. Richard Norgate, head of risk measurement at Barclays Group, said: “Post-Enron governance isn’t answering the questions; but is costing a huge amount - and keeping thousands of not-very-good consultants in their jobs.” A large Scandinavian banking group complained that the burden of corporate governance regulation and compliance is “taking the focus off developing the business”.

But a minority still felt that boards were weak in certain areas, such as their understanding of derivatives or their determination to combat fraud. A respondent from one of the large US credit rating agencies said: “Corporate governance is still not fully and effectively adopted. Greed and fraud are still around the corner, due to a corporate environment where we still have large inequalities in salaries… and ineffective controls due to conflict of interests.” A Swiss respondent said this was “a top concern - greedy wolves supervising greedy wolves”.

Despite the importance often attached to it, the risk to corporate reputations was little mentioned.

Much less of a concern this year...
9. Emerging markets (15)

Concern about the stability of emerging markets is on the rise again. Respondents feel that industrial world exposure is too large and too finely priced, and that comfortable recent experience has made people slack. One spoke of a mix of “euphoria and complacency.” A US respondent wrote: “I see overheated expansion into emerging markets without adequate risk assessment being a very real risk, especially as opportunities in US and Europe diminish.” Millen L. Simpson, market risk and liquidity coordinator at the Federal Reserve Bank of San Francisco, said: “Emerging markets have been well-behaved for quite some time, but imbalances seem to be forming as investors chase yields.”

Two countries prompted particular concerns. One was China, where a respondent felt that the risks, including corruption, were “readily glossed over by commentators focusing on its economic miracle”. He wondered: “Could we see a China crisis in 2007?” The head of international operations at a large US bank commented: “Everyone is convinced China cannot fail: history is not so kind.”

The other was Russia, where the uncertain political and economic situation was underlined by both outside commentators and Russian respondents, many of whom felt the banking system there was undercapitalised and weakly managed. Pavel Samiev, head of bank ratings at Expert RA rating agency, saw “inefficient management and information systems, particularly in the sphere of the analysis of risk, and complex risk management”. The head of risk analysis at a private sector bank saw the prospect of rising bad debts, greater competition and a shortage of qualified personnel.

Other countries that earned mentions as potential sources of trouble included India, Iran, Taiwan and North Korea.

But respondents from emerging markets were less concerned. Mark Gunton, chief risk officer with HSBC Mexico, saw “generally improving macro economic trends; however political shifts will test recent stability”. Michael Ogunbiyi, head of group risk management at Nigeria’s Asset and Resource Management Company, said: “Markets are becoming more sophisticated and catching up with developing markets.”

10. Risk management techniques (9)

Generally, banks are seen to have improved their risk management skills, though some product areas were singled out by respondents as still worrisome.

One said that while good times have bred complacency, “against that, I am convinced that risk management skills, awareness and experience are much improved compared to, say, five years ago”. A central banker in Europe agreed: “They are better than before.” “The level of financial risks and the professionalism with which they are addressed increases year by year”, said Martin Owen, vice-president of product design at Haydrian Corp., a US financial crime detection company.

Others were not so sure. A UK consultant thought that “exposures in innovative credit instruments are increasing at an incredible pace. I am concerned about risk management given the high level of expertise required in these products.” Simon
Franklin, director of risk management at Big 4 Banks and Financial Services in Australia, saw “complete incohesion of risk management approaches. Multiple disciplines pulling in different directions and ivory towers of risk; compliance, legal and audit not sharing information and building empires. This all results in poor understanding of real risk issues and misleading reports to management.” A London respondent agreed: “Much so-called risk management is still very amateur.”

Areas where skills were seen to be either poor or lacking included asset management (which uses complex derivatives without the experience of the trading desks) proprietary trading, and credit derivatives.

The growing reliance on risk models was also a cause for concern. These could be faulty, or provide false comfort. The head of international operations at a large US bank saw “a lack of experience in industry seniors which leads them to have too much confidence in the accuracy and predictive power of their ‘risk models’ – the bankers’ Maginot Line”. Stani Yassukovich, deputy chairman of ABC International Bank, thought that risk management was becoming formula-based and eroding the commonsense approach.

11. Fraud (6)

Surprisingly, worries about criminality seem to be easing, probably because of what one Australian banker termed the number of “ongoing initiatives”. US respondents, in particular, marked fraud down as a risk. Those respondents who gave this Banana Skin a high score were concerned about the growing sophistication of fraud, particularly organized gangs, and the new opportunities opened up by technology, such as phishing and the use of the internet for trading and payments. An Irish banker said it was “always a threat”. Others saw this as one of the main risks to bank reputations.

One Chinese respondent was particularly concerned about collusion between bank officers and outsiders in his country.

12. Equities (18)

A widespread feeling that equities have had a very good run brought this risk back up the scale. “Markets looking toppy”, “riding for a fall”, “correction overdue” were typical of the comments. However, some people made the point that the banking system is, for the most part, only indirectly exposed to the stock market, and a sharp correction would not be disastrous. A Chinese respondent pointed out that equities are “a prohibited investment vehicle in the Chinese banking system”. But a City economist wrote: “Growth prospects cannot justify current ratings, and specially the low dividend yields at a time of rising short term rates. A crack in equities would ricochet through defined benefit pension funds and insurance, and on to company balance sheets and profitability, thus completing a nasty vicious circle.”

A big worry in this space was over the private equity sector: its huge size and leverage, and the potential for trouble if markets start heading downwards. There was an expectation that regulators would take a tougher line with private equity funds, and inhibit their growth.
13. Currencies (7)

The US dollar’s refusal to self-destruct has convinced some of the sceptics who put this risk high on their list last time but low this time. But while currency concerns are waning, they have not gone away. Many respondents still think a disruptive realignment is in the offing, the only uncertainty being when. The president of a US Federal funding corporation said a sudden drop in the dollar “would cause a dramatic increase in 10-year bond rates regardless of Fed policy. The results would harm the US economy and financial institutions that bet on a flat yield curve.”

But the US dollar was not the sole focus of concern. Some respondents felt the euro was at risk because of what one of them described as “the internal contradictions at the heart of EMU”. A realignment of the renminbi was also mentioned, as was the unwinding of the carry trades.

The reserve management policy of central banks was another concern. One City-based respondent said that a “politically motivated restructuring of reserve portfolios is an unquantifiable risk”. A respondent from India said: “If the dollar fails to remain the de facto payment currency for oil, central banks which hold most of their reserves in dollars will be hit. Moving away from the dollar as a reserve currency will only precipitate the situation.”

14. Macro-economic trends (10)

Economic conditions are exceptionally benign – of that there seemed little doubt among our respondents. But can it last?

Many saw clouds on the horizon: rising interest rates, energy prices, bubbles in places like China, and of course the famous imbalances overhanging the US economy. A UK economist warned that while ample liquidity had staved off worldwide recession after the shocks of 2000-2001, it had only postponed rather than cured problems. As a result “asset prices are out of line with incomes. This can be rectified by falling nominal asset prices or inflation of incomes. Neither will be easy to manage without recession and financial turmoil.” Others saw the spectre of inflation rising from the large amount of money sloshing about.

Many expressed concern about the outlook in the US because of the trade and budget gaps, and the effect of rising interest rates. A US respondent warned that “the long period of price stability may be over”. Some also saw clouds looming over the UK. A consultant wrote: “Even though the global economic outlook is healthy, I am concerned about the economic resilience of the UK and the impact of this on the overextended retail market. In addition, the personal loan market is increasingly a cause for concern.”

My main concern is the interaction between global macroeconomic imbalances and herd behaviour in financial markets and institutions. If the imbalances start to crack, the herding behaviour could easily over-react, leading to big market movements, a drying up of liquidity and great stress on financial firms and the infrastructure of the financial system, eg payment systems.

Non-executive director
London investment bank
But at the end of the day, the bulk of our respondents had difficulty coming up with horror scenarios – which may be why we hear so much about complacency. A senior executive from a large UK bank said: “The global economy is generally healthy, providing a positive backdrop for all our businesses this year. The risks identified [by Banana Skins] are risks to earnings rather than the safety of financial institutions individually or systemically.”

15. Political shocks (22)

This Banana Skin is always sensitive to recent events. It came bouncing back this year because of rising tension in the Middle East, continued violence in Iraq, the Iranian nuclear question, North Korea etc. Richard Farrant, a member of the UK’s Competition Commission, blamed “the disastrous Middle East policies of the western world”, and another respondent referenced “the clash of civilizations”. Many respondents cautioned that this was one direction from which the market could expect the unexpected shocks for which no one could plan. The nationalisation by Bolivia of its gasfields led a number of respondents to talk of expropriation risk and rising populism in the third world.

One respondent said his main concern about US financial institutions “is the concentration of investments in them from foreign, potentially politically unstable governments. For example, if the monarchy of Saudi Arabia were to be overthrown by internal political forces, the US economy would suffer substantially.”

Some respondents referred to political shocks of a different kind. A number of UK respondents felt that the Labour government was administering unwelcome shocks to the banking industry through its persistent criticism of banks. The chairman of a large clearing bank gave “UK government interference in the market” as his reason why he saw this risk on the rise.

16. Conflicts of interest (-)

We included this Banana Skin for the first time this year to see how seriously it was rated in the wake of recent corporate scandals. The answer was not a lot. Although many respondents identified the problem as specific to investment banks in their multiple and often conflicting roles, few considered it to be serious or life-threatening. A senior US banker said it was “driven more by litigious fervour than fact”. But a small minority felt this could become “a big issue”, citing recent cases such as the fine on Deutsche Bank for market manipulation, and the growing complexity of financial groups resulting from mergers. Another respondent described conflicts as “endemic”.

It was also linked to concerns about the appropriateness of management incentives.

17. Banking market overcapacity (20)

The abundance of financial liquidity and the arrival of new entrants are adding to concerns about overcapacity in the banking sector, and contributing to pressure on margins. These concerns were voiced from a wide range of countries, including the UK, Australia, Ireland, Spain, Russia and the US. A senior manager with one of Canada’s largest banks saw “excessive competition in most markets resulting in unhealthy competition for market share”.
Generally this was more of a concern in developed than developing economies, where growth in demand for banking services is seen to be keeping a check on overcapacity. Satya Mogalapalli, manager with Qatar’s Ahli Bank, said there was “still room for banking capacity particularly in countries like India, China etc. where the number of banks per million is less compared with developed countries”.

In any case, many people thought that the problem of overcapacity would be reduced by consolidation in the coming years.

Capacity, liquidity, and asset prices

Excess capacity and liquidity contain many potential Banana Skins: cut-throat pricing, aggressive risk-taking and leverage. A senior regulator said the main financial risk currently “is probably one of overheating of asset prices reflecting the excess available liquidity. This has particularly affected emerging markets and the price of credit.” Economist David Kern said that a combination of good growth forecasts and low bond yields has engendered “a complacent attitude to risk-taking” in the corporate and sovereign risk markets, as well as the commodity markets.

Many of our respondents felt that assets were aggressively – even unrealistically – priced, as a result. A manager with one of the large UK banking groups, said markets were “pricing in a long period of benign economic conditions which I do not believe to be correct. Spreads are too tight, long end yields too low, and volatilities are minimal.” Many felt it could all end in tears. A central banker foresaw “a rapid implosion of this liquidity in the next couple of years as some shock causes investors to reassess future required returns upwards and to want to deleverage.”

18. Money laundering (13)

Much of the comment here focused on the risks created by anti-money laundering initiatives rather than the threats posed by money laundering activities themselves. This was particularly the case in developed economies where respondents thought the risk was exaggerated – and belonged more to emerging markets. Several respondents said the initiatives “did not work” and would merely drive legitimate business offshore. In the meantime, however, it created new costs and compliance risks for banks. A US respondent thought “banks have overinvested in [anti-money laundering] compliance.” One respondent from the UK gave this as a declining risk because of “the commonsense approach now evident in the UK”, with recent initiatives to reduce paperwork.

Nonetheless, several respondents made the point that banks’ reputations are at risk if they find themselves involved with money launderers – and this can happen unwittingly if they are part of a transaction chain where one bank’s deficiency lets the criminals into the loop. The head of internal audit at a large Swedish bank said that the “reputational risk associated with not having due diligence controls to protect against illegal customer activities is a major regulatory concern”.

Is money laundering a risk? Or just the efforts to stamp it out?
19. Merger mania (27)

Worries about merger mania in the banking sector have come storming back. Although consolidation is seen as a healthy trend, many people also view it as a potential source of trouble: mergers add to market concentration, stretch management structures, create uncontrollable entities and drive out smaller players. A US respondent said consolidation had “narrowed the number of organisations available to sustain impacts from a disturbance in the marketplace”.

This view was echoed by a South African respondent who feared that concentration of banking activity in a few global banks “increases the risk to the safety of financial institutions or the system because of the significant impact that problems at such institutions may cause to the system as a whole”. A Malaysian respondent said that consolidation was producing “oligopolistic behaviour” which was “not beneficial to the public at large”. A Taiwanese respondent said: “In my country, banking mergers are proceeding too fast.” Several Russian respondents said that consolidation was inevitable in their country because of capital shortages in the banking sector, though it would be disruptive.

But there was also an opposing view: that there is not enough consolidation. One respondent from a large US bank saw considerable opportunity for prudent consolidation in Europe and in emerging markets as well. A respondent from the European Central Bank said that consolidation was “proceeding too slowly in Europe.” From the UK, a respondent saw the need for more mergers to permit the emergence of big high street players and stave off foreign domination.

20. Legal risk (17)

The banks’ main vulnerability to this Banana Skin is that they are seen as “deep pockets” by the litigiously-minded and the compensation-seeking. Specific problem areas could include litigation arising out of a debacle in the credit derivatives market, or geographically from the more volatile markets of Asia. Multinationals face increasing jurisdiction conflicts in the many markets in which they operate.


This Banana Skin has eased greatly since it occupied fifth place after the 9/11 attacks. Most respondents felt that banks had done a lot to anticipate and cope with disruption, though they would never be able to cover all the bases. The biggest current worry is bird ‘flu, which got many anxious mentions. “A worst case avian ‘flu epidemic will defeat most people”, said a London-based banker.

Terrorist attacks are also in people’s minds, with some respondents feeling that this risk was not being taken seriously enough. Catriona Shaw, of the Association of Private Client and Investment Managers, said: “There is no doubt whatsoever that the July 7 bombings in London in 2005 were the tip of a very large iceberg, and more and more serious attacks are only a matter of time.” The chief executive of a large UK bank also put terrorist attack at the top of his list of concerns. Others felt that banks needed to keep up the good work in this area in order to retain public trust. From Germany, Guido Becker, managing partner of OperaConsult, said his main concern was “the
inability of current management to deal with all kinds of security or safety issues especially in the field of op risk.”

### Staffing risk

Should staff availability be classed as a risk? Several of our respondents thought so. They also wondered how banks might mitigate this risk: by bidding for talent in the labour market, or developing it internally?

A UK consultant said: “The people who are leaving the industry are those with experience and breadth who can act as an early warning of an impending problem and who may have the independence and voice to express their misgivings. They are being replaced by specialists who are content to operate within their allocated areas and terms. The result is an ever shallower pool of enterprise general managers who act as the industry’s shock absorbers.”

The head of integrated risk at a large Australian bank listed among his main concerns: “Attracting and retaining good staff.” The director of operational risk at a large UK clearing bank saw the problem in terms of business continuity: “As firms move towards increasing automation, they are tending to reduce headcount to the extent that they will not be able to perform functions in the event of a major system failure.”

Many respondents from emerging markets felt that lack of qualified personnel in their banks and regulatory agencies was a big weakness of their banking systems.

### 22. Retail sales practices (23)

Although this remains a low order risk, many respondents felt that banks were exposed to long term damage if they failed to pull their socks up. The risks could include loss of customer confidence – and regulatory crackdown. “UK institutions still need to work at this, or new mis-selling problems will lead to an increase in regulation”, warned a UK regulator. Others pointed to the rise of consumerism, and the need for banks to respond. John Tattersall, a partner of PricewaterhouseCoopers, said that retail sales practices were one area where banks would have to “adapt to changing regulatory expectations”.

US respondents felt that fresh problems would loom with what one of them called, “the increasing issue of esoteric products being introduced to the retail space”. Another said: “This will become trendy after a few hedge funds go pear shaped.”

In emerging markets, many of the comments focused on the need to preserve client confidentiality. In Russia, a respondent saw “rocketing risks due to market growth”.

### 23. Insurance sector problems (11)

Last year saw a marked easing of concerns about the insurance sector. Although it is still considered to be dogged by problems of pension liabilities, weak management and overcapacity, the various actions taken to deal with them have made them less pressing.
But concerns have not gone away. One consultant likened the sector to an inverted pyramid which could easily be toppled by catastrophes, “with consequent effects on the support which banks can reasonably expect from their insurers”. Willi Brammertz, director of Iris Integrated Risk Management in Switzerland, said: “The insurance industry will continue to be the critical part of the financial system. [EU directive] Solvency 2 will fix good parts of it; but it will take a long time.” Several respondents stressed the sector’s exposure to natural calamities, rising environmental risks and epidemics.

24 Back office (26)

Although the back office continues to rank low as a source of concern, a small number of respondents gave this a high score because they were worried that burgeoning business volumes would overwhelm processing capacity. A senior regulator pointed to back office hold-ups in the settlement of credit derivative trades as an example. A Russian respondent said that the rapid growth of consumer lending was creating “a huge flow of paperwork” in his country. Others felt that outsourcing and offshoring of back office operations to unreliable centres held the seeds of future trouble.

Benign conditions cause memory loss

“The generation in charge of many banks hasn’t really been through a tough recession with all the risk issues that brings. In this benign period, derivatives and hedge fund activity have expanded so much, a recession would involve a new set of problems with possible instability of large institutions.”
UK banker

“The very stability of the macro-economy means that increasingly traders/loan originators learn about risks and losses from text books not from bitter personal experience.”
Central banker

“Many of our young industry leaders have not experienced a rising rate environment. Their reaction will be key to the future success of our industry.”
US banker

“We have been in an economic expansion for many years and are losing institutional memory”.
Australian banker

25. Environmental risk (28)

This risk continues to edge its way up the list, but not very fast despite the prominence of climate change as a public concern. Some saw the risk more in terms of the increasing regulatory costs than of direct damage. Others stressed that it could become more of a concern in the long term.

A number of our respondents linked it with bird ‘flu, though most saw that more as a business continuation issue than as one linked to the environment. A regulator saw environmental problems impacting the insurance sector in particular.
26. Management incentives (21)

Once highly controversial, the form and amount of executive pay continues to recede as a concern. Tougher monitoring by regulators and the press have played their part. “Much more visibility is improving control”, said John Hitchins, a partner of PricewaterhouseCoopers.

But a City bank chairman still saw this as a rising problem: “Bad for the shareholders” he said. Another City respondent felt that publicity was itself damaging. “Putting everything in the public eye is deterring good managers”, he said. The risk manager of a large Swiss bank said this was “an issue for newspapers, not for markets”.

27. Rogue trader (24)

The absence of recent major rogue trader incidents brought this risk down a few notches. But as several respondents noted, here is a Banana Skin that will never go away, and indeed will flourish in an environment where financial innovation keeps throwing up new opportunities. Leverage could also accentuate the impact.

28. Competition from new entrants (29)

New entrants into the banking arena, both the bank and non-bank variety, are back in the news. In Australia, the arrival of foreign banks is viewed with concern; in South Africa, banks are facing new competition from non-banks such as retailers. In the developed world, a recurrent theme was the threat posed by entrants from emerging markets that might not operate to the same standards as local banks. But in the emerging world and East Europe, there was concern about the arrival of powerful new outsiders. For example, some Russian bankers are worried about the impact of foreign bank arrivals on a banking system that has yet to find a solid footing – as well as what they see as unfair competition from state banks. Similar messages came from Saudi Arabia and Chile.

But generally, the risks here were seen to be low. As several respondents noted, the rise in regulation has raised entry barriers to the banking sector, and given it some protection from outside competition.

29. Payment systems (25)

The safety of payment systems remains a low order concern. “Payment and settlement systems are generally resilient…and are being comprehensively tested and trialled”, said Alex Merriman, a director of the British Bankers Association. But Merriman noted that big structural changes are planned in the coming years, particularly in Europe, which could be testing for banks and systems managers alike.

Several respondents wondered whether the technology could keep pace with the speed of change, particularly in emerging markets, or high growth markets such as derivatives. Others worried about terrorist attack and physical disruption. In Australia, there was concern about the admission of non-banks to the payment system, and the risk of contagion from outside.
Bernhard Schmid, corporate client advisor at Credit Suisse, warned against complacency: “Since payment systems are only looked at as a cost factor, they get worse with time instead of better.”

How safe is electronic money?

Electronic security consultant Nick Collin said: “Many banks, certainly in the UK, are using card authentication methods based on Static Data Authentication (SDA) which carries a small risk of a catastrophic security breach, but is cheaper than the more secure Dynamic Data Authentication (DDA).” Collin felt there was a disaster waiting to happen in this “classic security/cost trade-off”. From Germany, a respondent said that the rapid spread of electronic money posed a severe threat. “It is already very difficult to identify the initiators of a lot of payments inside the banking system, so the door for professional money laundering is much more open now.”

30. Too little regulation (30)

Although concern on the regulatory front lies overwhelmingly with too much of it rather than too little, a lot of people felt that under-regulation was a problem in specific areas like hedge funds, derivatives and asset management, and over matters like regulatory co-ordination between national authorities. The senior economist of a large European bank thought that the “uncoordinated approach between the EU and the US, and within the EU” was creating excessive regulatory costs. Another respondent felt that better coordination was needed to ensure consistent worldwide implementation of the Basel 2 rules.

Some respondents also warned that many of the world’s fastest growing economies were not properly regulated, and their expansion could pose a threat to better regulated economies.

Some respondents also used this opportunity to appeal for a qualitative rather than quantitative view of regulation. Andrew Cornford, research fellow of the Financial Markets Research Center, felt that industry norms and regulation were increasingly seen as “obstacles to the pursuit of profitability rather than as having a broader social and economic rationale”. Karel Volckaert, senior consultant at Strategus in Belgium, felt this was “not a question of too much or too little; but of consistent and up-to-date regulation.”
Preparedness

<table>
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<tr>
<th>How well prepared do you think your own and other financial institutions are to handle the risks you identify? (%)</th>
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Banks’ readiness to deal with Banana Skins – or at least the perception of their readiness – has improved. Nearly two thirds of our respondents felt that banks were moderately well prepared or better to deal with risk, while only 22 per cent gave a mixed answer and 14 per cent said poorly or worse. Bankers, as is customary, gave much the most upbeat answer: nearly three quarters of them put themselves in the top category and only eight per cent in the worst. The striking finding though is that regulators sharply increased their rating of bank preparedness as well: 63 per cent put banks in the top category, the highest since we started asking this question in 2000. Just under half of non-bankers thought banks were doing well – little changed from previous years.
Appendix 1: The questionnaire

CSFI
CENTRE FOR THE STUDY OF FINANCIAL INNOVATION

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TEL: +44 (0)20 7493 0173  FAX: +44 (0)20 7493 0190
www.csfi.org.uk

Banking Banana Skins 2006

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 mail it to CSFI, 5 Derby Street, London W1J 7AB, UK or fax it to +44 (0) 20 7493 0190 or email it to info@csfi.org.uk by April 17th.

Question 1. Please describe your main concerns about the safety of financial institutions (both individual institutions and the system as a whole) as you look ahead over the next two to three years.
Question 2. Here are some of the areas of banking risk which have been attracting attention. How do you rate their severity, and how do they compare with last year? Use the right hand column to specify particular risks, eg markets or countries which you think are specially vulnerable. Please add more risks at the bottom if you wish.

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<td>Rogue trader</td>
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How well prepared do you think your own and other institutions are to handle the main risks you have identified?

Name: .................................. Position: ..................................
Institution: ..................................
Country in which you are located: ..................................

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

...
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<tr>
<th>Title</th>
<th>Author</th>
<th>Publication Date</th>
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<td>Waiting for Ariadne: A suggestion for reforming financial services</td>
<td>Kevin James</td>
<td>July 2002</td>
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<td>Capitalism without owners will fail: A policymaker’s guide to reform</td>
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<td>Thinking not ticking: Bringing competition to the public interest audit</td>
<td>Jonathan Hayward</td>
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<td>Christopher Swann</td>
<td>May 2003</td>
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<td>Companies cannot do it alone: An investigation into UK management attitudes to Company Voluntary Arrangements</td>
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<td>Michael Mainelli and Sam Dibb</td>
<td>December 2004</td>
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<td>John Godfrey (with an appendix by Graham Cox)</td>
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Mr. Peter Roth
Soifer Consulting