Banana Skins 2003
The CSFI’s annual survey of the risks facing banks

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Centre for the Study of Financial Innovation
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Preface

The CSFI published its first Banking Banana Skins report in June 1994. It took the form of five essays by prominent practitioners and commentators, looking at perceived banking risks in the UK, the US, Japan, Germany and France. Its main concerns:

- **in the UK**, “a compulsive urge to grow”, coupled with a collective memory loss, that will lead inevitably to over-enthusiastic lending and value-destroying acquisitions (John Plender);
- **in the US**, “new kinds of risk” from the creation and trading of insurance products (ie derivatives) that will permit “the same capital to be leveraged twice, because derivative positions can be carried as off-balance sheet items” (Martin Mayer);
- **in Japan**, the “sharp deterioration in asset quality” associated with the painful recession which, even then, was proving so intractable – coupled with excessive bank investment in the stock market (Robin Monro-Davies);
- **in Germany**, the danger that “famously close banking relationships, long thought to be a source of stability”, could become a risk, because banks are too close to their customers to monitor them properly (Brooke Unger); and
- **in France**, the impact that privatisation of key players will have on capital ratios, competition and (as in Germany) the policy of directly investing in client companies (Keith Brown).

Not bad; most of that now looks pretty prescient.

Later that year, we took another look – specifically at the UK, examining the boom and bust of the late 1980s and early 1990s. Again, one important warning was “to keep the memory of past cycles alive” (Sir Nicholas Goodison) – to resist the “besetting effect” of the feel-good factor by insisting on standards during the upswing, and not just when times get bad.

For our third Banana Skins report, published in March 1996, we adopted broadly the format that we have followed ever since – a two-page questionnaire, including a (prompted) list of concerns, culled partly from our own experience and partly from previous surveys, and an (unprompted) open-ended box in which respondents could expand on their hopes and fears. Although the questionnaire has grown a bit since then (and the number of respondents has expanded from 170 to 231), that is the approach which underpinned Banking Banana Skins 1997 (April 1997), Banking Banana Skins 1998 (July 1998), Banking Banana Skins 2000 (June 2000), Banking Banana Skins 2002 (February 2002) and now Banking Banana Skins 2003.

The table on page 8 indicates, in a very summary form, how concerns have changed since we introduced the survey approach. Although one should be a bit careful not to over-interpret this (for instance, because almost everything can be boiled down to “poor management”, we dropped that particular banana skin in 1998), it is significant how complex financial instruments and derivatives have bounced back into managerial consciousness, while the risks associated with international regulation are just heaving into view. Some risks are perennials – credit risk, in particular (“we lose money the old-fashioned way; we lend it”). But others seem to have almost slipped off the radar screen – whether understandably (the internet) or not (emerging markets, rogue trader).
One final thought: a cynic might say that the risks that can bring an institution down are the ones that you don’t expect – not the ones you put at the top of your list. And there is some truth in this; after all, last year’s survey put the risk of a rogue trader at 28th (out of 30) – just two weeks before the Allied Irish/Allfirst debacle in Maryland. If that is the case, readers might want to turn this year’s list on its head – maybe the real risks are to be found in the environmental area, e-commerce or competition from new entrants.

As always, thanks to my colleague David Lascelles for putting the report together – and for coaxing so many senior City figures to respond. And to PricewaterhouseCoopers for its special support, without which it would be very hard to produce a study of this depth or quality.

Andrew Hilton
Director
CSFI

This report was written by David Lascelles
Foreword

We are delighted to continue to sponsor this fascinating survey, which has produced another set of thought-provoking responses.

While the concerns raised in last year’s survey by September 11 have not gone away entirely, it is the position of the global economy generally which continues to give most cause for concern, with the equity markets and interest rates figuring prominently in the top ten. Credit risk has also maintained its position as one of the major issues, in part due to gloom about the global economy, but also noticeably this year through worries over a lack of transparency as to where residual credit exposure lies. Particular concerns over credit derivatives took complex financial instruments to the top for the first time.

Regulation emerged last year as a key issue, although as the regulatory focus has shifted, so worries have switched from domestic to international issues. Over-regulation remains an issue, with international initiatives in particular, in the shape of Basel 2 and a large number of EU directives, being seen to be potentially damaging. The emergence of a variety of corporate governance codes has only reinforced these concerns and led to a notable new entry in this year’s survey.

It is striking that while a majority of respondents still feel that banks are better prepared to manage their risks, the figure was down on last year as a result of concerns voiced by bankers themselves, rather than regulators and observers. If bankers are becoming more sanguine about their risk management capabilities, maybe regulators are deriving additional comfort from this. Overconfidence has been behind many past banana skins.

John Hitchins
Lead partner, Banking & Capital Markets
PricewaterhouseCoopers
About this survey...

The survey was conducted in August 2003, and is based on 231 responses from 31 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 (where known) was:

<table>
<thead>
<tr>
<th>Type</th>
<th>Count</th>
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<tbody>
<tr>
<td>Bankers</td>
<td>118</td>
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<tr>
<td>Customers</td>
<td>28</td>
</tr>
<tr>
<td>Regulators</td>
<td>22</td>
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<tr>
<td>Observers</td>
<td>59</td>
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The breakdown by nationality of a respondent’s institution (where known) was:

<table>
<thead>
<tr>
<th>Country</th>
<th>Count</th>
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<tbody>
<tr>
<td>Australia</td>
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<td>Macao</td>
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<td>Belgium</td>
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<td>Malaysia</td>
<td>1</td>
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<td>Canada</td>
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<td>Morocco</td>
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<td>Channel Is.</td>
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<td>Multinational</td>
<td>12</td>
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<td>China</td>
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<td>Netherlands</td>
<td>3</td>
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<td>Czech Republic</td>
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<td>New Zealand</td>
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<td>France</td>
<td>4</td>
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<td>Portugal</td>
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<td>Germany</td>
<td>9</td>
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<td>Russia</td>
<td>1</td>
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<td>Ghana</td>
<td>1</td>
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<td>Slovenia</td>
<td>1</td>
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<tr>
<td>Greece</td>
<td>2</td>
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<td>South Africa</td>
<td>4</td>
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<td>Hong Kong</td>
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<td>Spain</td>
<td>4</td>
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<td>Ireland</td>
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<td>Sweden</td>
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<td>Isle of Man</td>
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<td>Switzerland</td>
<td>9</td>
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<td>Italy</td>
<td>3</td>
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<tr>
<td>UAE</td>
<td>1</td>
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<td>Japan</td>
<td>5</td>
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<tr>
<td>UK</td>
<td>120</td>
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<td>Luxembourg</td>
<td>1</td>
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<td>US</td>
<td>24</td>
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Introduction and summary

Banana Skins 2003 are dominated by the spectre of credit losses: the fear that banks will lose money from bad debts – but that other sectors, particularly insurance, will also suffer because of the linkages created by complex financial instruments.

This year marks the first that complex financial instruments – credit derivatives in particular – have topped the Banana Skins poll. The survey reveals widespread concern not just about the burgeoning use of credit derivatives to transfer risk, but the fact that no one really knows how much risk is being traded in this way, or where it is ending up.

International regulation also achieves its highest ever position on the back of rising worries about heavy-handed regulatory initiatives. Although the Basel 2 proposals feature strongly, various EU measures are seen to be potentially damaging as well. Domestic regulation, however, eased several places as the regulatory focus shifted to specific issues such as money laundering. Business continuation maintained a high place in the face of ever-present terrorism fears.

Corporate governance makes a first appearance in the wake of Enron, WorldCom etc, though bankers’ concerns are as much about regulatory overkill as the risk of being branded a bad corporate citizen.

The sharp rise in the position of interest rate risk shows the markets keyed up about a sudden snap back in money costs catching banks on the wrong foot, and triggering deep losses in the bond markets. Insurance companies, banks as well as pension funds are all seen to be vulnerable. But this is a double-edged sword because a sustained period of low interest rates could also damage financial institutions by squeezing margins and yields.

Other sharp risers include fraud (technology opening up ever more possibilities) and management incentives following recent rows about fat cats and “rewards for failure”.

The most noteworthy decline is emerging market risk which falls from 8th to 22nd position. The survey reveals clearly that – current problems notwithstanding – this is an area that is felt to be manageable now that banks have largely shifted these risks off their balance sheets. Of greater concern is developed market risk where Germany, Japan, the US and the EU are all seen as potentially problematic.

<table>
<thead>
<tr>
<th>Banana Skins 2003</th>
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<tbody>
<tr>
<td><strong>2002 ranking in brackets</strong></td>
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<tr>
<td>1. Complex financial instruments (4)</td>
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<tr>
<td>2. Credit risk (1)</td>
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<td>3. Macro economy (2)</td>
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<td>4. Insurance (7)</td>
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<td>5. Business continuation (5)</td>
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<tr>
<td>6. International regulation (10)</td>
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<tr>
<td>7. Equity markets (3)</td>
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<tr>
<td>8. Corporate governance (-)</td>
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<td>9. Interest rates (21)</td>
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<tr>
<td>10. Political shocks (14)</td>
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<tr>
<td>11. Fraud (18)</td>
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<tr>
<td>12. High dependence on technology (13)</td>
</tr>
<tr>
<td>13. Domestic regulation (6)</td>
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<tr>
<td>14. Money laundering (11)</td>
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<tr>
<td>15. Hedge funds (16)</td>
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<tr>
<td>16. Risk management (12)</td>
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<tr>
<td>17. Banking market overcapacity (9)</td>
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<tr>
<td>18. Currencies (19)</td>
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<tr>
<td>19. Grasp of new technology (20)</td>
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<tr>
<td>20. Management incentives (28)</td>
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<tr>
<td>21. Retail sales practices (17)</td>
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<tr>
<td>22. Emerging markets (8)</td>
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<tr>
<td>23. Rogue trader (24)</td>
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<td>24. Back office (23)</td>
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<td>25. Payment systems (27)</td>
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<td>26. Commodities (22)</td>
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<td>27. Merger mania (26)</td>
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<tr>
<td>28. Competition from new entrants (30)</td>
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<tr>
<td>29. E-commerce strategy (25)</td>
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<tr>
<td>30. Environmental risk (29)</td>
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</tbody>
</table>
Worries about risk management and excess capacity in the banking market are also easing.

Most operational risks come low down the list, including back office (though outsourcing is a growing worry because of the loss of control), payment systems and grasp of new technology, reflecting the considerable work that has been done in these areas in recent years. Even the rogue trader remains little changed despite last year’s heavy losses through unauthorised trading at Allied Irish Banks.

Competition from new entrants and e-commerce strategy – both top-ranking concerns in the 1990s – have almost completely faded away, while environmental risk continues to languish near the bottom, oblivious to the dire warnings of the sustainability lobbies.

Risers and fallers

The second table looks at Banana Skins in a different way: by whether they are seen to be rising or falling in riskiness compared to the year before (though it contains a strong bias towards rising risks).

Here, complex financial instruments again emerge as the market’s top concern. The table also underscores the high risks associated with insurance, international regulation and the economic outlook. Risks which feature more strongly as risers than as absolute concerns include currencies, fraud and environmental risk, which may flag them for the future. On the other hand, business continuation emerges as a less pressing risk and so, strikingly, do the equity markets.

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 slightly less positive than in 2002. Of our respondents, 69 per cent thought institutions were moderately well prepared or better to handle the risks, down from 72 per cent the year before. The main reason was a drop in the positive responses from bankers themselves (some contained candid admissions of weakness). The other two categories of respondent, regulators and observers, both gave more positive responses than the year before.
Who said what

A breakdown by type of respondent produces some interesting variations

Bankers and financial practitioners are primarily worried about the quality of their loan portfolios, and pressures from the economy which could damage it. They are less concerned than other groups about derivatives – presumably because they feel they understand them. They also give the strongest showing to concerns about international regulation. They are less bothered than other groups about the insurance sector, and about interest rate risks.

<table>
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<tr>
<th>Bankers</th>
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<tr>
<td>1. Credit risk</td>
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<td>2. Macro-economy</td>
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<td>3. Complex financial instruments</td>
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<td>4. International regulation</td>
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<td>5. Insurance sector problems</td>
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<td>10. Interest rates</td>
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Users of banking services (e.g. corporate treasurers) are chiefly concerned with the exposures that banks have created through lending and derivatives. Interestingly, they share bankers’ concerns about the growing weight of regulation, though they also give the strongest score to the two crime elements on the list: fraud and money laundering. They share regulators’ concerns about the risks in the banking sector’s high dependence on technology.

<table>
<thead>
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<th>Customers</th>
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<td>1. Complex financial instruments</td>
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<td>2. Credit risk</td>
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<td>3. Macro-economy</td>
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<td>7. High dependence on technology</td>
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<td>8. Interest rates</td>
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<td>9. Money laundering</td>
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<td>10. Domestic regulation</td>
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</table>

Regulators focus their concerns quite clearly on two areas: derivatives and the insurance sector. Their relatively weaker concern with credit risk reflects a more relaxed view about the quality of banks’ loan portfolios. They give the highest score of the four groups to political shocks. They also acknowledge that domestic regulation might contain risks. Corporate governance and business continuation rank among lesser concerns.

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<tr>
<th>Regulators</th>
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<td>10. Business continuation</td>
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Observers of the banking industry (eg analysts, consultants, academics) have similar top level concerns to regulators: insurance, derivatives and the equity markets. But they also give the highest score of any group to corporate governance and overcapacity in the banking market. They are slightly less concerned than other groups about the macro-economic situation though they pay more attention to interest rate risk than bankers and regulators.

Some Banana Skins come and go, some are hardy perennials. The Top Ten since 1996 shows how concerns have changed over that period. The 1990s were dominated by strategic concerns: new types of competition and products, dramatic developments such as EMU, the Internet and Y2K. Many of these have faded, to be replaced with more recession-based fears about the macro economy and its impact on the banking system. Striking is the disappearance of 1990s concerns about the quality of bank management and strategy. What is also interesting about the period 2000-2003 is the way it charts the steady but strong rise of derivatives as a risk: 10th in 2000, 4th in 2002 and now No.1.
1 Complex financial instruments (4)

Complex instruments - and specifically credit derivatives - are this year’s top Banana Skin, propelled by fast-rising concern about high levels of use – and low levels of understanding.

A regulator wrote: “The revolution in credit risk transfer techniques has brought strong benefits to risk management, but gives concern that those segments of the market that have bought risk do not fully appreciate what they have taken on. If the recovery sputters and there are more corporate defaults, then these birds will come home to roost – and it is not exactly clear with whom.”

This theme struck a widespread chord. The director of a UK clearing bank said: “The concentration of insurance type risks (eg reinsurance, credit default swaps) is opaque and may turn out to be in institutions that are too weak to carry them in a stressful environment.” Michael Hamilton of Portugal’s Finantia Securities saw a market driven by “complex financial instruments that are not understood by top management”.

Others worried about the lack of information about where credit risk was ending up. “There is a daunting lack of transparency in reporting, and it is not readily apparent who holds the risk or what concentrations of risk exist”, said Charles Prescott of Fitch Ratings. Analyst Nick Antill thought that “the extent of possible systemic risk resulting from exposure to credit derivatives is unknown”.

Respondents’ concerns also focused on the concentration of derivative exposure among small groups of institutions. A central European banker said they were “reaching unbearable levels of use, concentrated on a limited number of financial institutions with risk of systemic difficulties”. A Canadian banker said that excessive concentration must give rise to concern “about future liquidity and growing counterparty risk in these instruments”. Among the sectors cited for concern were insurance companies and European banks.

David Shirreff of The Economist felt that credit derivatives created perverse pressures. “They not only neutralise the incentive of the original lender to manage the credit risk and its relationship with the borrower; they can also, perversely, give the holder of protection an incentive to see the borrower’s downfall”.

Some respondents highlighted the legal risks. Antony Thomlinson of City lawyers Eversheds said it was “very likely that banks which think they have laid off credit risk will be met, on making a claim, with the assertion that the bank did not make full disclosure, comply with agreed procedures etc., and the insurer is thus not obliged to pay”. Alan Beech and Jenny Knott of Nomura International saw “legal interpretation” as a problem for complex financial instruments.

Several respondents felt the credit derivatives market was insufficiently regulated, or “lacked controls” as one banker put it. A respondent from academia said that credit risk transfer from banks to other institutions “is not subject to the same tight banking regulations”. A pension
fund manager asked: “Has the credit derivatives market sufficient free capital to meet the cost of widespread insolvencies in the event of an economic downturn?”

A small number of respondents extended their comments to include other types of complex deals: structured finance and off-balance sheet items generally, as well as Enron-type special purpose vehicles of dubious legitimacy.

2 Credit risk (1)

Bad debts are a top-level Banana Skin for the second year running. But the story is not so much about the current condition of banks as their vulnerability to the dark forces of rising interest rates, higher unemployment and a collapse in real estate prices. The perception that credit is a problem came in from many directions: Europe, America and the Far East.

Monoline companies

Are ‘monoline companies’ - those with only one line of business - specially vulnerable in a tough environment? Some of our respondents thought so.

The head of strategic planning and development at a large international bank wrote: “Financial risks are more acute in monoline companies, especially where growth has been achieved in a rising market, such as that for mortgages. The continuing pursuit of growth in less benign market conditions may lead to weaker overall control of risk.”

A central banker believed that monoline companies could be “highly leveraged” and based on credit rating arbitrage structures that gave them the appearance of greater strength than they really had.

From Canada, a banker felt that his fellow bankers suffered from “unrealistic expectations for corporate growth recoveries” which would lead to “significant lending exposures”. The group risk director of a UK clearing bank said that a “perfect storm” of increased interest rates, lower house prices and unemployment could lead to a “serious rise in delinquencies and losses”. A South East Asian central banker worried about “the impact of prolonged slow growth on loan quality and therefore on the financial position of lending institutions”.

The biggest bad loan threat lies in burgeoning consumer debt. The chairman of a large insurance group thought banks were still being buoyed by short term lending and mortgages. “We haven’t seen the real test yet: e.g. high lending and rising unemployment. Given the high levels of consumer debt, can bad debts stay down when unemployment rises?” Alec Chryystal of London’s Cass Business School said retail banks “could be hit by problems with excessive consumer credit and housing loans”. The director of risk at a large UK bank said that the rate of personal borrowing was only sustainable at low levels of unemployment and interest rates. “Sooner or later there will be a shock to the system which causes a rise in one or both of these.”

The most frequently mentioned dodgy sector was property, specifically domestic housing with the risks this posed to the mortgage industry. An economist with a US bank said the main threat lay in a recession-induced collapse of house prices. “The most vulnerable countries are the UK, Australia, Holland - also the US, though the bubble is less.” Nancy Lui, country financial controller at Citibank, Hong Kong, thought that “as unemployment persists, the number of people walking away from their debts will increase. The biggest worry is if the mortgage portfolio is impacted and institutions are flooded with repossessed properties.” A senior official from the UK building societies feared unpleasant surprises because “we do not
yet have a full-cycle’s experience of some of the newly created markets: buy-to-let, sub-prime and equity release”.

Other problem sectors that earned mentions were energy and telecoms, and the growing extent to which private equity is financed by debt.

The big squeeze

Margin squeeze and declining profitability have the makings of a big Banana Skin. Many respondents feared that these would drive banks to take on greater risk or enter unfamiliar markets. A Swiss banker said “In their search for yield, both institutional investors and banks have significantly increased their credit risk appetite: Russia/Brazil all over again?” Another respondent saw “increasing levels of speculative commitment to high risk corporate financings of industries such as leisure, hotels, airlines, transport, telecoms ... with inadequate knowledge”.

A Swedish banker wrote: “The banks I know have been very good at cutting costs, so there is probably only the income side left if you want to deliver ‘shareholder value’. Combine this with increasing credit losses due to the business cycle, and it is easy to see a scenario where some managers start to get nervous.”

From Canada, a banker said difficult operating conditions would prompt banks to “move up the risk curve to enhance revenues without having appropriate risk models in place to handle additional risk”, while in Hong Kong, a respondent worried about hard-pressed banks seeking new profit sources in the treasury markets. Another respondent made the point that in stressful times, savers prefer plain vanilla products which carry low margins for banks.

3 Macro economy (2)

The rockiness of the global economy is a big worry. “The overriding sources of concern are global in nature”, said a US regulator. “Weak demand continues to be a problem in a world where too many countries depend too much on exporting to the US. Aside from deflationary pressures that are endemic to this situation, serious financial imbalances have arisen that threaten to induce renewed bouts of instability.” Charles Taylor of the Risk Management Association felt that the US recovery “is very vulnerable” to either a collapse in confidence or a rise in interest rates.

John Plender of the Financial Times thought it was highly unusual to experience a huge bubble without a following financial crisis. “I suspect that this economic cycle leaves unfinished financial business because the equity bubble has only partially deflated and the imbalances in the US economy have yet to be unwound.”

Many thought that an economic upturn held the key to the health of the finance sector. “The safety of the system seems to me to depend more on the recovery of economic activity than on the volatility of securities markets”, said a top investment banker. “There is as yet no evidence that monetary and fiscal action is having a significant effect on the continuing reluctance of corporate executives to increase investment or of consumers to maintain their spending enthusiasm. Consequently bad debts may start increasing pressure on banking balance sheets via credit cards and consumer/small business loans.”
Several respondents said that while they feared for individual institutions, they did not feel unduly worried about the outlook for the financial system as a whole. “I feel much more relaxed than in the period up to 2000”, said a regulator. But UK economist David Kern said the fact that many economies had escaped recession had created a sense of “dangerous complacency amongst many financial institutions in the developed world”. Kathleen Tyson Quah of KTQ Consulting said that “excessive levels of debt and over-optimism about recovery and growth prospects leave the economy in general and the banking system in particular very vulnerable to any major shocks”.

On balance, our respondents felt that we were past the worst of the economic cycle, though the road back to health could be a long one. One banker saw “a long slow ‘recovery’ leading to further decline in business activity”. Another wrote: “Coming out of a grim period of anxiety (largely self-induced), western economies could stagnate and perform well below the expectations of improvement that have been aggravated by the trough of 2001-03.”

“All banks fear deflation”

The possibility of deflation – however remote – is causing some sleepless nights.

One banker wrote: “All banks fear deflation. Deflation puts pressure on the financial system: as prices fall, the real value of debt increases, leading to difficulties in debt servicing.” Another said: “A deflationary environment would be a new experience which would be very challenging for financial institutions on top of competitive pressures.” A respondent from the insurance sector said that “we don’t know enough about deflationary risk, how to deflect it and what the consequences are for growth and the credit markets”.

The novelty of deflation was highlighted by Brandon Davies, head of Barclays Bank’s retail market risk unit, who said its effect, were it to come about, would be very significant on the structure of banking and the financial services industry in general. “This is specially so in the UK where the industry was ‘designed’ in a high inflation environment (does anyone remember the 70s and 80s?).” All banks and financial service companies should, in his view, be running scenarios for their future business plans based on 0% to 1% base rate.

4 Insurance (7)

This is a fast-rising Banana Skin. Respondents spied trouble in weak balance sheets, a difficult environment, derivative time bombs, and specific threats like another wave of asbestos claims. A senior regulator saw “continued chronic weakness, exacerbated by low yields and retail mis-selling” across the sector. Many stressed that the greatest problems lay with Continental European insurers, notably those linked to banking groups and pension funds, though another regulator commented: “Very active remedial action programmes may mean the system is structurally sound, aside from capital weakness in the short term.”

One of the biggest concerns is the damage from slumping markets. A respondent from a large UK life assurer said: “If further reductions in the stock market and other asset classes are experienced, the solvency of a large number of life assurers will be threatened. This could have a significant impact on financial stability.” The chairman of a large insurance company said: “The FTSE at 3200 was painful but not impossible. The banana skin for insurance would be if equities went down even further.”

A European central banker saw a double whammy: declining interest rates would squeeze companies exposed to defined benefit pension schemes, but rising rates would
hit those which had acquired credit risk from banks. However he noted that insurance
cOMPANY problems were not system-threatening in the same way that banks’ were
because they are not directly part of the payment system.

The black hole in pension funds

The parlous state of many pension funds attracted anxious comment. Unfunded liabilities
could send shock waves well beyond the savings sector, and the longer stock and bond
yields remain in the doldrums, the worse it would get.

A senior UK banker said: “Insurance companies and pension funds cannot operate
successfully in a low interest rate environment.” Martin Hall of the Finance and Leasing
Association felt “a lingering unease about the viability of pension providers due to past
actuarial underestimates of longevity linked to stock market doldrums”. A Swiss banker
felt the problem was more widespread: “The asset management industry is about to
disappear into a black hole: asset gatherers will absorb this function for free.”

Neil Record of Record Currency Management argued that while people now knew the
scale of pension liabilities, there was also a ‘circularity’ risk. “UK/US business pension
funds invest largely in other UK/US corporate securities, equities and bonds. Taken as
a group these holdings net out, leaving the level of ‘real’ i.e. non-circular funding very low
indeed. This presents a real risk if there were a serious squeeze on corporate profitability.”

A member of a UK banking group with large insurance interests even raised doubts
about the longer term viability of the sector. “There is a question mark over the
profitability of the business model which could make some insurers vulnerable due to
a decline in new business. It will be interesting to see if, as equity markets settle down,
there is greater consolidation, particularly in Europe. This may be a bigger issue than
concerns over safety.”

5 Business continuation (5)

This Banana Skin has held its high position because of the continuing threat of terrorist
attacks. A UK banker wrote: “While the probability of such an event is very low,
geopolitical developments suggest that it is likely to increase.” Catriona Shaw of the
Association of Private Client Investment Managers and Stockbrokers said: “There is
a high risk of a major terrorist attack on a western European capital, and this will have
a devastating impact on markets and financial institutions.”

Several also warned against complacency. John Trundle, head of the Bank of England’s
market infrastructure division, said: “Low probability/high impact risks are always the
most difficult to assess and mitigate. The current critical example is business
continuation risk where the probability, although still low, has risen and we have to
plan for potentially bigger impacts than we previously thought realistic. This requires
detailed work and extensive cooperation within the financial sector. Much is in train,
but more needs to be done.”

A US respondent also stressed the need for more work: “Although many key financial
institutions are addressing business continuity planning and are decentralising,
they are not there yet. An attack on a key site or firm (physical or electronic) could have
serious consequences worldwide.” A respondent from the technology sector thought
“it still does not appear to be generating the level of activity one would expect"
Jeremy Robinson of Champion Consulting thought that ostentatious groupings of financial might like London’s Canary Wharf were asking for trouble. “This seems to me a highly visible example (almost a metaphor) of yesterday’s corporate models promulgating themselves for a better tomorrow, with all the business risk this entails.”

But some thought anti-terrorism measures could get out of hand. “This will use up much time and resource”, said a US banker.

6 International regulation (10)

This Banana Skin has risen strongly, mainly on the back of Basel 2 (see box).

As they look at the international regulatory scene, many of our respondents see an ill-coordinated mish-mash of regulatory initiatives, often working at cross-purposes, and producing inappropriate results (though whether their responses were intended to identify risks or merely give vent to frustration was not always clear).

A senior investment banker said “insufficient progress is being made by regulators in working together to focus on cross-border risks”. A UK clearing banker thought that “conflicting EU and US regulatory requirements add to compliance issues”. Another banker said that “growing regulation in US and Europe is an increasing cost and distraction, especially when it is not coordinated”. This is not to say that bankers do not want international regulation, they just want it better, like the derivatives marketer who asked that more be done “to link sources of information at national and international levels to have an ‘early warning’ system in the case of major meltdowns”.

“Banks will end up managing Basel 2 rather than managing risk”

For many of our respondents, the Basel 2 capital regime embodies all that is most threatening about regulation: they see it as ill-thought out and costly, as creating perverse incentives and encouraging market concentration, and blunting the competitive edge of many banks, particularly in Europe.

One banker wrote: “Basel 2 will have a considerable and often negative effect on banks. It is said to affect 30,000 of them and will cost $15bn to implement. At what point does regulation become cost effective? It will stifle the growth of new, smaller banks and leave the system exposed to a cabal of giant international monoliths. It will impose huge costs on those developing economies which can least afford it by raising their cost of funding considerably. Banks will end up managing Basel 2 rather than managing risk.”

Another banker said: “Banks will focus too much attention and risk resources on Basel 2 and take their eye off the ball elsewhere.”

Even a favourably disposed respondent could see Basel’s problems: “The move to risk-based capital should eventually be positive as it will force everyone to hold capital appropriate to the risks inherent in their business. However there is no perfect market for many risks and therefore no way of establishing the ‘right’ price for that risk. There is likely to be a big time lag between theory and good working practice which might only become widespread after some major corporate failures that have the potential to destabilise the entire system.”
Several Europeans focused their concerns on EU regulatory initiatives such as the capital adequacy, savings and credit directives which they found flawed in various ways. One City respondent wrote: “It is extremely hard to forecast the likely repercussions of some of what is going on in Brussels.” Some also took a swipe at international accounting standards, particularly IAS 39 which requires banks to mark their assets to market values. This was “forcing banks to give up some of their prudent practices of the past, eg holding cushions of general provision. The tail is increasingly wagging the dog,” said a banker. A UK clearing banker said international accounting standards and Basel 2 were like “shifting sands - it is not clear exactly where they are going and how they will end up”.

7 Equity markets (3)

Worries on this front have eased somewhat since last time: “Equity risk has bottomed out” according to Jonathan Howitt, director of operational risk at Dresdner Kleinwort Wasserstein. Still, some respondents felt that stock market weakness would persist, and make life difficult for financial institutions.

Economist Andrew Smithers wrote: “Wall St is still massively overvalued and has, in the past, always become extremely cheap during the post-bubble phase, and further falls pose huge risks both directly and indirectly. Insurance companies and pensions funds are particularly exposed to direct risks, as their assets will fall faster than their liabilities.”

Hendrik du Toit, chief executive of Investec Asset Management, wondered how insurance companies would sustain themselves amid declining equity prices and a falling yield environment, though he added: “Perversely banks may benefit from the initial phases of this.”

8 Corporate governance (-)

A newcomer to the charts - and no surprise given recent scandals.

A German banker said: “Integrity has given way to greed and this leads to decision-making that is not transparent to those outside a given institution. This has been manifest in obvious ways such as Enron, Worldcom and the corporate practices of pension accounting. But other more subtle manifestations are undoubtedly also occurring, and until this tendency is squashed the financial system remains at risk.”

A financial consultant thought the problem was not awareness of the risk, but a belief that it didn’t matter. “European financial institutions carry on as if the statist, post-war models of governance and operation will continue, and that Enron et al ‘couldn’t happen here’. Equally, I don’t believe Wall Street has changed its spots, and regulators may overreact to another error.”

The leadership challenge

“Accounting issues and corporate governance in their widest sense continue to detract from public confidence in the markets and the banks. Senior executives need to show continued leadership to put things right, and to ensure that they take real accountability for their responsibilities. In recent history too many people have focused on generating revenue at any cost and have forgotten the responsibility for managing their businesses. Get this right and much else follows (and at a lower opportunity cost).”

Financial consultant
Other respondents pointed up risks arising from internal conflicts, reputational damage and a desire for revenue at any cost. But a sizeable segment of our respondents felt the real risk in this area lay from over-reaction. The chairman of a City finance group said: “A deterioration of integrity and probity by certain banking managements and boards, motivated by ambition and greed, partly induced from the US, will provide the excuse for already overly zealous regulators to go into overdrive, with all the negative consequences for the industry.” Investment banker David Potter said boards were being discredited “largely due to the greedy and insensitive actions of relatively few directors and chairmen”. Philippa Foster Back of the Institute of Business Ethics also worried about the extraterritorial effect of Sarbanes-Oxley “which is wholly inappropriate and has the effect of limiting banking activities”.

From Japan, Noriko Hama of the Doshisha Management School, saw banks threatened by “the absence (or the impossibility of creating) a structure of global governance that works and makes sense”. George Graham, editor of the FT’s Lex column, thought that “misdirected corporate governance concerns will curb corporate risk appetite: government regulation will exacerbate this”.

What’s in a name?

Reputation risk was cited by many respondents – but what does it really mean? Some linked it to corporate governance, others to social responsibility and the environment, yet others to money laundering and unfair selling practices. All this made it rather hard to “rank” as a Banana Skin.

Phil Rivett, global leader of PricewaterhouseCoopers’ banking and capital markets practice, said that financial services organisations “that fail to recognise and close the gap between the box-ticking approach to compliance and the totality of risks they run are extremely vulnerable to reputational risk”.

A senior regulator saw the danger of “further reputational damage and costs from mis-selling retail investment products”. A Greek banker thought that cost-cutting in banks would reduce service quality and damage reputations. A City respondent saw money laundering “undermining the credibility of otherwise reputable institutions”.

A variation on the theme was that low yields on investment and savings products would damage banks in the eyes of customers accustomed to more generous returns. A respondent from the insurance sector said: “On the reputational side, retail institutions face public disillusion with low returns and disappointed expectations.”

9 Interest rates (21)

A strongly rising risk – and double-edged because it could hurt banks if rates go up or if they go down – though a snap back in rates is seen as the more vicious of the two.

Rising rates: Chris Ellerton, banking analyst at UBS, thought “the main risk for the bank sector is a change in direction from the Fed and a mad rush for the exit by bond and credit speculators. Like 1994 but worse.” A senior US respondent saw a related problem: “Banks may borrow short-term to fill up long-term lending arrangements. If rates spike and the banks lack a proper hedge, this could pose a major risk.”
And assets would shrink. A senior City banker wrote: “Investors have switched in a substantial way from equities to bonds, arguing safety and yield. These arguments are fine so long as interest rates remain low - and I think they will. If the unexpected does happen and if inflation and therefore interest rates edge upwards one could see bond prices declining very sharply, resulting in enormous capital losses, eg 33 %.”

Banks playing the yield curve could be specially at risk if they gear up their positions with derivatives. Consultant Steve Davis wrote: “The dash for yield and performance and the widespread assumption of a favourable yield curve have significantly increased the risk of serious damage to individual banks, and possibly to the system.” A respondent from one of the large Chicago exchanges said his main concern was an upward shift in the yield curve. “Financial institutions thrive on low and falling rates and are severely hurt by rising rates, steepening curves. Given the barely adequate capitalisation of the financial sector, a sharp uptick in rates could be very damaging.”

Low rates: But many respondents saw the reverse picture: a persistent low interest rate environment squeezing banks and making it difficult for them to earn a living. A senior regulator put “a low inflation/low yield world” on his list of top risks. An Asian central banker worried about “a false sense of comfort rendered by the prevailing low interest rate environment”.

Low interest rates would also make it harder for banks to sell interest-bearing products. A respondent from one of the large UK-based banks said: “There is a danger within some personal sectors that activity will decline markedly due to a mixture of apathy and disillusionment, the first caused by low returns and a tendency to spend rather than save, and the second because of constantly negative feedback by the press and to an extent government.”

10 Political shocks (14)

Turbulent international events have sharpened perceptions of political risk. A central European respondent said the major concern for financial institutions over the next couple of years would be “political tensions between the USA and countries linked up with terrorist organisations”, a view that was widely shared.

However many of our respondents saw political risk of a different nature: the anti-business, anti-globalisation movements that increasingly shape government stances.

A US banker feared the future held “further deterioration in support for globalisation and market economics; a return to outdated populist statist development models; growing disenchantment with the responsibilities of global citizenship”. A director of a large UK clearing bank saw “further disenchantment with the Anglo-Saxon model of capitalism leading to wealth-destroying market interventions by regulators and governments”.

The chairman of a City banking group proclaimed: “Political dogma, enforced by socialist governments in Europe and the UK, is increasingly damaging the commercial viability of the banking industry, particularly smaller banks (eg hidden price controls, high labour costs, high cost of compliance, high indirect taxes etc.).” A South African banker said that his country’s new Financial Services Charter created “expectations to provide banking services at lower than acceptable margins to cover cost and risk”.

Again in the UK, a clearing bank director said: “Consumerism and muddled government policy towards pensions and savings are eroding confidence in the financial system.”
11 Fraud (18)

A rising risk, and one which many respondents said would be “ever-present”. A UK executive feared “criminal access to technology and increased levels of organised crime expertise”, while a Portuguese banker highlighted “the ever-increasing degree to which institutions are exposed to fraud and the need to be super-vigilant”. A regulator worried that banks “will be threatened by the increasing expectations on them to carry cost burdens designed to combat financial fraud”. But a Czech banker thought auditors “have a limited chance of discovering uncharted activities”.

Identified areas of high risk include Internet banking, custodianship and credit cards. On the latter, consultant Nick Collin warned that the massive global migration to Europay Mastercard Visa (EMV) chip cards over the next couple of years contained high impact, though low probability, risks.

Electronic identity theft also earned several mentions. John Bullard of Identrus said this was “a high-growth, high profile area for direct and high speed losses to a bank’s bottom line. It is often hushed up, and therefore the full extent is not known as yet.” David Birch of Consult Hyperion warned: “If it keeps rising it will add big costs.”

Malpractice risk

“Over the next two-three years, we believe the safety and stability of financial institutions is likely to be threatened most by large scale money laundering, fraud or corporate governance scandals and the inevitable litigation that would follow. Scandals such as Enron and split capital investment trusts are indicative of the sort of exposures of possible malpractice in the financial services arena that usually accompany a downturn. It is likely that there are more to come.”

City lawyer

12 High dependence on technology (13)

The financial world’s dependence on technology is a middling risk, both in terms of vulnerability to failure, and the need to keep up with change.

A Swiss banker wondered whether banks’ IT infrastructure “can deal with the complexity and the shortened innovation cycle of financial products?” A central banker said that high technology dependence placed a heavy burden on banks to build and maintain strong databases, and to ensure they had adequate backup to meet disasters.

A respondent from a Middle East bank thought banks were trapped by the complexity of hardware and software, and by the need to have globally integrated systems. “The alternative is the opportunity lost to competitors”, he said resignedly. Some equated rising technological dependence with the loss of personal skills, with all that might imply for the future quality of bank operations. From Australia, a banker said: “The complexity and speed of transactions is making the system less dependent on human judgment – which is both an asset and a liability.”

13 Domestic regulation (6)

Although the rising tide of regulation is still seen - as in previous surveys - as posing a threat to financial services, the domestic variety has yielded place in the charts to more pressing concerns. Yet this remained the area which attracted the greatest number of comments.
John Langton, chief executive of the International Securities Market Association, said that regulatory initiatives at both the international and domestic levels “are often inappropriate for the smooth functioning of markets in a sensible, pragmatic manner”.

George Cardona of fund managers Cardona Lloyd saw an industry suffering “slow strangulation”. Regulations were “raising costs and causing financial intermediation activities to bypass the banking sector and flow through other channels. Those other channels (currently insurers or informal credit suppliers in emerging markets, for example) may have to re-learn painfully the lessons learnt by banks over a long period”.

Specific points made by respondents were that regulation imposed a tax on financial services, that the cost would force more consolidation on the sector, and that it was becoming too tilted towards the consumer. An Australian banker pointed out that the increasing complexity of regulation raised the risk of non-compliance, which in turn would lead to costly compensation claims and reputational damage.

Bankers also said that the regulatory response to pretty much any type of event was now to pile on more rules. A respondent from one of the large UK building societies felt that if the present credit boom produced a hard landing “there are consequential risks of regulatory over-reaction on lending institutions”. Mark Boleat of Boleat Consulting saw the regulatory system being driven by “attempts to match public expectations of what regulation can do”.

14 Money laundering (11)

Down from last time, despite all the fuss. While many respondents saw this as a rising risk - often for reputational reasons - a large number thought the real danger lay in regulatory overkill – like the US banker who said: “The big focus on money laundering continues to utilise huge amounts of IT resource and management time, and prosecutions/benefits are not in balance.” A UK respondent thought that anti-money laundering regulation was “a considerable block on establishing good relations with customers”.

Why London is attracting criminals

“It has been my impression for some time that organised crime is trying to penetrate the financial system in London. The reason is that offshore centres, long used for illicit transactions, are today under close scrutiny. But probably more important, the size of illicit transactions has also grown so much that they have become too noticeable in small centres. This makes London interesting to illegal operators because of the sheer volumes transacted in its markets.

“Supervisors are rightly demanding that banks establish controls to detect these operations and report them to the police. At some point, there will be enough experience to determine more precisely what activities need to be reported by banks, and avoid overburdening the police. For the time being, though, I prefer too much reporting to too little.”

Latin American central banker
15 Hedge funds (16)

Little changed from last year. Although the number of hedge funds is up, they are generally smaller and therefore less of an LTCM-type risk to the system. Nonetheless, a proportion of the survey’s respondents saw them as fizzing time bombs because of their association with derivatives and the lack of information about them.

Richard Heis, a partner at KPMG, saw “hedge funds taking large risks with imperfect hedging and sensitivity to market changes”. Another respondent believed that “the opaque nature of hedge funds may still obscure risks”. Several more made the point that hedge funds are insufficiently regulated.

16 Risk management (12)

The broad perception seems to be that banks are getting better at risk management, hence a slight easing in the position of this Banana Skin. “There has been a clear improvement here”, said a credit analyst.

Nonetheless, many respondents still saw plenty of weak links in the chain, particularly with risk management becoming increasingly driven by process rather than substance.

A risk management specialist wrote: “My biggest concern is the lack of risk awareness in (and throughout) firms. Insofar as the regulators are driving change, firms appear to be doing what they are told and spending money on measuring rather than assessing and managing risk.” Another respondent saw danger in “an over reliance on formal or standardised estimates of risk” and internal systems that were “used unquestioned”. Wall Street banking analyst Ray Soifer said: “Eventually, the composition of boards will evolve to reflect the complexity in the business of banking. But over the next several years many banks will be operating, quite literally, out of their directors’ control.”

Some respondents saw this as a constant uphill task. Colin Smith, head of credit and risk at HSBC, worried about “increased product complexity running ahead of risk measurement methodology and control procedures”. Another saw “failure to implement and keep risk management and internal control tools efficient and up-to-date in a very volatile environment”. A third thought “technology will continue to progress in risk management but the ‘jargon’ and training and understanding will not move on as fast (does it ever?)”.

17 Banking market overcapacity (9)

This is a perennial Banana Skin, though the recent shake-out has pushed it down the charts.

Several respondents thought that overcapacity was increasingly a problem of rigid economies, particularly Germany and Japan, and less of the more liberal ones. But some
also made the point that the shake-out itself could be a source of trouble. For example, a banker thought “consolidation in the system could trigger short/medium term disruptions”.

Robert McCracken of Ernst & Young said there were still too many banks chasing too little business in areas like private banking and investment banking. Cuts had been made, but were they enough? He warned: “If markets stay depressed for a while longer, we may see further cuts in staff, banks disposing of, or closing, unprofitable units, and further industry consolidation in order to achieve cost reductions.” A UK investment banker saw trouble in the fact that some marginal players were reacting to a tough market “by trying to compete rather than withdraw”.

**Initiative overload**

“The drive for growth, the pace of regulatory change, the need to react quickly to changes in the market - all these may be too much for banks to handle. The big Banana Skin ahead is not the presence of risk but banks having their resources stretched so thinly that they ‘drop a ball’.

“For example:
- the quest for tactical solutions undermines banks’ ability to maintain operation stability;
- regulatory investment means that money is not available to grow the business;
- the focus on the ‘measurement of risk’ means they do not concentrate on the ‘management of risk’.”

Management consultant

**18 Currencies (19)**

Not a high risk in most people’s books - and little changed from last time. The main concern is the vulnerability of the dollar to shocks from mounting US deficits. A UK bank director said he feared “an abrupt unwinding of the imbalances in the world economy, particularly if this involves the US $”. A US regulator saw currency risk rising because of “poor policy coordination”, and a UK respondent saw risk in the high – and rising - central bank reserves of Asian economies.

Not really a currency risk - but some respondents focused on the UK’s looming euro decision. Sir Brian Pearse, CSFI chairman and former chief executive of the Midland Bank, thought “shocks might emerge from uncertainty concerning UK relationships with the euro”. A financial consultant felt many UK banks had “a head-in-the-sand attitude to the potentially significant conversion costs” to the euro which would cost them dear later.

**19 Grasp of new technology (20)**

This has been a low ranked risk for some time, extending the feeling that banks have strengthened their technological grasp. “I feel we are on top of this now”, said a UK clearing banker. But some were not so sure, mainly because of the constant pressure to move ahead and update systems, though one jaundiced respondent asked: “What new technology?”
20 Management incentives (28)

This risk has risen some distance, with the focus shifting from traders’ bonuses – the source of much *angst* in the past – to recent rows over executive compensation schemes, and therefore has a closer link with corporate governance than with concerns about trading behaviour.

“A bloody mess” and “fat cattery” were some of the more scathing comments we received. A Hong Kong-based respondent said “share incentives force short term actions”. Diane Coyle of Enlightenment Economics thought “an opportunity for a serious review of incentives has been missed”.

21 Retail sales practices (17)

This Banana Skin has fallen a few places, but there is a marked shift of focus away from the mis-selling issues of the past to matters of service quality. A lot of respondents felt that banks were putting their future at risk by failing to meet the expectations of consumers and governments as to products and service.

The interesting thing was that this view was put forward by bankers themselves. Susan Rice, chief executive of Lloyds TSB Scotland said: “Most banks are at the stage of saying that they are doing business in the ‘customer’s interest’ but few actually do business that way - yet. Those that put themselves in the customer’s shoes soonest will have a competitive advantage. Those that don’t will find that, even with the most sophisticated systems in the world, they are not growing the business in line with their projections. The industry needs to move from the mindset of ‘sell to’ to an invitation to ‘purchase from’.” A UK clearing banker saw a “vicious circle” in which a difficult trading environment led to “worse credit decisions, cost cutting, and worse customer service”.

Ruwan Weerasekera of Accenture saw a “failure to create ‘better’ propositions for the end customer rather than just ‘new’ as happened in the internet era”, and a City lawyer thought the “lack of service by high street banks is likely to lead to new institutions with a service culture. Conventional high street banks seem to have a limited future.” A respondent from the investment management sector saw “further declines in consumer confidence in financial services (eg when the value of big-selling bond funds falls)”.

On the product front, several respondents felt there was an innovation challenge here that banks were not rising to. John Tattersall of PricewaterhouseCoopers said one of the main tasks facing banks was “targeting the right sectors with the right product”. Richard O’Brien of Outsights said the development of appropriate long term savings products was “a big challenge as neither providers nor users know how to tackle the problem”. But a respondent from a major UK savings institution felt that the drive by the finance industry to become more innovative would lead to “selling without customers having full awareness of what they are investing their money in”.

The feeling that government – and regulators - were partly to blame for poor selling practices appeared in several responses. In a caustic aside, one respondent said: “In the UK, I find it unbelievable that the Financial Services Authority allows projection rates of 9% in retail sales literature.”
On the more conventional mis-selling front, concerns focused on pensions, predatory lending and endowment mortgages, with an analyst noting “an increase in regulation worldwide”. Philip Middleton of Ernst & Young said that “the drift from caveat emptor to caveat vendor emanating from Westminster, Brussels and Canary Wharf raises profound strategic risk questions. We are faced with the prospect of retrospective blackmail for ‘mis-selling’ which will prove disruptive and expensive, and will undoubtedly see a ‘dumbing down’ of retail financial services markets.”

But Mick McAteer from the UK’s Consumers Association saw an opposite risk. “The industry will dig its own grave by lobbying for more ‘liberal’ definition of caveat emptor (i.e. one which demands greater personal responsibility). The regulatory system will have to protect – and be seen to protect – consumers. Industry might not like it, but that will be the reality they will have to accept.”

The consumerist threat

“Accusations of mis-selling in a consumerist environment, reputational risks arising from complaints to the Ombudsman and increased uncertainty as to whether today’s business decisions may be unravelled in the future: these are core risks which firms face day-to-day in the current environment. They have to be conservative in response. How will this impact on innovation and competition in the future?”

Michael Coogan
UK Council of Mortgage Lenders

22 Emerging markets (8)

Well down on last time, despite Brazil, Turkey etc. In fact most of the geographic risk now seems to lie in first world rather than third world economies (see box on p24).

Charles Prescott of Fitch Ratings summed up the long term, though currently low profile, nature of this risk: “Crises in Russia, Asia, Turkey and Argentina have occurred one after the other with remarkable rapidity over recent years. Brazil is not out of the woods yet, and emerging market crises may continue to occur every few years.” However a City chairman felt that Latin America was not a threat. “The banks have squared off against it”, he said.

A respondent from Morocco put a different slant on these risks. The forthcoming opening up of the Moroccan economy as a result of international agreements “could have a high impact on relatively badly prepared companies. Competition from countries like China, or India could significantly hurt sectors of the economy and therefore threatens bank loans to those sectors.”

23 Rogue trader (24)

Our last Banana Skins survey - in which rogue trader also appeared well down the list - came out only a few days before Allied Irish Banks lost $700m through unauthorised trading in Baltimore. But this has little altered the perception of the rogue trader as a low order Banana Skin, even if one against whom vigilance should constantly be maintained. “Always a risk” was a comment from several respondents.
First world headaches

Our respondents were much more worried about first world than third world risk.

**Germany**

The travails of the German banking system headed the list. An economist saw German banks suffering from “macro-economic stagnation/deflation, exacerbated by the end of public guarantees to the remaining state-supported segments of the banking system”. A (British) politician saw “a risk of German banking collapse as they struggle to adjust to a euro rate of interest and monetary policy that is not suited to German conditions”. A central banker feared that the German banking system’s problems would lead to “the withdrawal of capital from the wholesale market”.

**Japan**

As one respondent sighed: “The woes of Japan seem endless.”

Rei Masunaga, chairman of Japan’s Central Council for Financial Services Information, said: “The biggest concern for me is how quickly Japanese banks and insurance companies can muddle through and finally get out of the various troubles they face now. It is crucial for the world financial system that they re-establish their past strength under a new strategy to compete with their peers in the international arena.”

A regulator said: “I don’t much worry that Chinese and Japanese banks are probably bust by best western standards, but the lack of a clear exit strategy to get them back to health is more concerning because of the drag on economic growth it is creating for Japan and may create for China.”

A Tokyo-based European banker feared a Japanese government bond bubble: “When it bursts, global interest rates will definitely go up. Does it matter if Japanese banks blow up again?” A UK-based academic added that the Japanese banking system’s problems were “a good example of how risk asset ratios are not necessarily linked to sound banking”.

**UK**

The UK political and economic scene was seen as sufficiently uncertain to warrant comment. The chairman of a City insurance company felt that “UK political shocks are possible if Blair has to step down”. Craig Pickering of Money On-line Education said: “We may escape recession but we’re not safe yet”.

The view from a German Landesbank was that an economic slowdown “would be particularly toxic in the UK, given the trend for increased gearing in the personal sector and the current refusal to look the economics of retirement in the eye. These present the UK government with problems of economic and expectations management, with knock-on consequences and opportunities for UK banks. At a guess, banks will have the problems to deal with first, and may struggle to capitalise on the opportunities”.

A respondent from the London branch of a large Japanese bank raised the threat that “overseas banks in the City of London will start moving out when they find they can’t make a decent return here, with consequential trickle-down effect (or lack of it) on the rest of the economy in London, leading to huge property devaluations and further losses to banks.”
US
Apart from the strains arising from the general economic situation, some respondents saw US financial institutions facing a difficult time if interest rates rise sharply, and generate a wave of bad loans or funding problems.

One specific concern was the difficulties facing the government sponsored financing agencies. A City-based analyst said that Freddie Mac and Fannie Mae were now so large that they had a major impact on the whole US capital market, mainly through their hedging operations. Yet there was “great opaqueness” about their affairs. “When a party is so large, normally small problems can be magnified out of proportion.” A British financial journalist thought the “regulatory anomaly of Fannie Mae and Freddie Mac could wreak havoc with the US mortgage market were interest rates suddenly to rise”.

European Union
The EU threw up a number of potential risks.

Enlargement:
The accession of a large number of new countries could put strains on the EU banking system. Adjustment shocks “could not be excluded”, said one respondent. Swiss banker Rudi Boggi thought the implications were “insufficiently analysed and understood”.

Rigidity:
Several respondents saw the EU getting bogged down in regulation and protectionism, and blunting its banks’ competitive edge. One saw “a reduction in flexibility as a result of employment law changes, averaging down to produce an EU single market rather than a global market. More rigidity imposed by a mercantilist rather than a free market approach”. Another saw the EU becoming over-banked, confused between EU-level and domestic regulation, and unable to create much needed cross-border payment systems. “This requires co-ordination across the industry where they have traditionally competed.”

Single market:
Several respondents saw downside for banks in the EU’s failure to break through national barriers and deliver its Financial Services Action Plan. Mario Cotto of Sanpaolo IMI felt that, despite the euro, banking markets remained regional “with no movement towards a European model”. A City lobbyist wrote: “Goodwill is ebbing away partly because of repeatedly colliding with the submerged rocks of nationalism and protectionism”. Recognising this mood, a UK regulator wrote: “I am concerned that disenchantment with Brussels and the FSAP (well deserved in some cases) will lead to an unwillingness to engage pro-actively on European regulation, and encourage a defensive attitude that undermines UK influence”.

The euro:
The survey also drew out a eurosceptic streak among our respondents. Several felt that the single currency would be a source of trouble over the coming years. A financial analyst thought that “conflict between the European Central Bank and governments is going to cause instability for industry, and therefore potentially bankruptcies and bad debts”. Robin Roberts of Egon Zender International saw strains arising from euroland’s “one size fits all interest rate”. Another made the candid admission: “I am concerned - though this may be wishful thinking - that the internal strains of the euro project will have unforeseen consequences”. Richard O’Brien of Outsights expected that “credit markets in Europe will face rising sovereign risk concerns when the first EU country seriously breaks the Stability Pact (and/or the Pact is abandoned)”.
24 Back office (23)

The main concern here is that swinging cutbacks may have impaired the safety and efficiency of bank back offices at a time when complex deals are growing. The increasing resort to outsourcing is another concern (see box).

One banker warned that there had been “overemphasis on cost saving to the detriment of business risk”, while a top investment banker said there had been “too much reduction in headcount in control, compliance and audit functions to meet cost pressures”.

Scott Moeller of the Cass Business School wondered: “Will the large banks have adequate staff to deal with the expected upturn in the next 2-3 years? Will those staff be properly trained? If a major market event occurs (e.g. a large credit default) will banks/investment banks have the staff to deal with it, or have they cut too much?”

Getting someone else to do it

The growing practice of outsourcing emerged for the first time in our survey - as a prominent Banana Skin. Many respondents felt that shifting operations to contractors or to cheaper locations implied a loss of control that carried big risks.

A respondent from one of the large US banks saw dangers in “increased use of outside service providers, and the management challenges of providing effective oversight of an OSP”. He also warned of “the trend towards relocating functions from developed high cost business centres to less developed low-cost locations around the world”. Michael Mainelli of Z/Yen thought that offshoring “is likely to lead to a major control failure”.

A financial consultant, however, saw the risk the other way round: could banks “meet the offshore challenge and realise the cost benefits of lower cost locations?”

25 Payment systems (27)

This has been a low order Banana Skin for some years, and is little changed from last time - a credit, no doubt, to the work that has been done on the “plumbing” of the global financial system. But it still bothers some people.

A respondent from one of the large clearing houses said “Concerns arise over the terrorist threat to the global financial plumbing as it becomes more interdependent, vide the intimate relationships between securities and payments, with the expansion of ‘delivery versus payment’, and now the interlinking between payment systems through use of ‘continuous linked settlement’. Disruption of one element could have unpredictable consequences on the system as a whole - and who has both understanding and power to solve problems?”

Another respondent said it was a matter of balancing impact with likelihood. “My main concerns are with large scale - but inherently unlikely - risks such as collapses in the plumbing which may be caused either by technology problems or by terrorist attack. Overall however risks should be manageable and I am not seriously concerned about either the bulk of the market or significant individual firms.”
Rick Sopher, managing director of L.C.F. Rothschild Asset Management, saw risks in the fact that many participants in the equity and fixed interest markets, including proprietary desks and hedge funds, depend on the clearing and lending services of a small number of counterparties/prime brokers. “The disruption to markets if any one of these was to falter would be very significant.”

A regulator raised a different angle: “Legal risk is often overlooked. There can be significant consequences from an unexpected court decision (Hammersmith, Equitable), and it is very hard to hedge. In the rush to create cross-border clearing and settlement infrastructure in particular, it is important that the legal risks are not fudged.”

26 Commodities (22)
Lower than last year. The only risk that got any mention was oil, and then only sparsely.

27 Merger mania (26)
Insufficient activity in the merger market to warrant a big Banana Skin here. “What mania, what mergers?” asked a financial analyst. Yet this was still an area which attracted comment, much of it driven by concern over the giant size of some institutions:

Market power: A Continental banker saw risk in “the concentration of market power in the hands of fewer very large institutions”. Brian Hagger of Ghana International Bank worried about “the escalation in the number of multi-faceted financial institution giants”.

In praise of older bankers

Declining staff quality because of early retirement, greater specialisation and faster job rotation is getting more attention. A consultant said that “people with longevity and experience of different market conditions are giving way to less mature, more specialised and less confident people”.

Joe de Feo, president of CLS Bank International, wrote:
“One of the key and as yet unrecognised risks over the next 2-3 years is the diminution in the number of bank executives with ‘whole bank’ knowledge. Increased specialisation has led to a ‘silo’ knowledge base that, in my view, negatively complements silo organisation structures.

“There are two negative outcomes from this:
- if a crisis arises in the enterprise, the skills to judge and deal with the impacts will not be there;
- customers do not care about internal silos, and opportunities to take advantage of cross-business line requirements will be missed.”

Too big to manage: A banker saw “deficiencies in effective management/supervision of emerging very large institutions: eg Citigroup, Mizuho, etc.” Another believed that the US big bank model “is wrong in the UK. Small boutiques with very low overheads will undermine these banks.”
Too big to regulate: Here, an investment banker worried that the concentration of market share and infrastructure into fewer institutions “would increase systemic risk”. Another said consolidation “could trigger short/medium term disruptions”.

A financial consultant took a more reflective position. “With any upturn”, he wondered, “can banks resist the herd challenge of mergers and focus on their core businesses?”

28 Competition from new entrants (30)

A few respondents saw threats from this quarter (eg from cellphone operators, supermarkets). From the UK, one said: “New entrants continue to offer loss-leading products, eg ING Direct in the deposit market. There will also be more severe competition from National Savings as the government deficit grows.” But most saw these risks declining. “More regulation means less competition”, was one wry comment. Some respondents even turned the risk on its head: “Low risk, sadly” said one; “overdue” muttered another.

29 E-commerce strategy (25)

This really is a sign of the times. E-strategies were a top Banana Skin in the late 1990s as banks wrestled with the Internet. Now, few people give a damn. “Part of everyday strategy”, said a banker. But for some that was a problem. A Scandinavian banker thought one of the biggest risks facing banks was “a slow response to their role in e-business”. Jeremy Smith of Z/Yen thought that “the growth of e-trading may disintermediate areas of staff, eg brokers”.

30 Environmental risk (29)

This Banana Skin has never really got off the ground, so to speak. A few respondents pointed to the associated reputational risks. Franz Knecht of Swiss sustainability consultants Connexis thought that Basel 2 would expose how different banking communities dealt with “soft” issues such as their clients/borrowers’ exposure to social and environmental risks, and their long term sustainability. But despite all the talk of pollution, disease (Aids, Sars), climate change and sustainability, the finance sector seems broadly unmoved. Is this realism or madness?

Preparedness

Financial institutions appear to be slightly less well equipped to handle Banana Skins than they were last year. In 2002, 72 per cent of respondents thought banks were ‘moderately well prepared or better’ to handle the risks they identified; this year that number has fallen to 69 per cent. The main reason is a drop in the positive responses given by bankers from 81 per cent to 74 per cent. The two other categories – regulators and observers – both gave more positive responses than last year.

Maybe this reflects a greater realism among bankers. More of them were prepared to qualify a positive response with some candid admission of weakness (surely itself a healthy sign?). A German Landesbank said: “We are very good in some areas, but relatively weak at the high technology end.” A Czech bank said: “We are relatively well prepared; however we need to be very well prepared – which we are not.” A UK clearing bank worried that “recently announced cutbacks may reduce our ability to respond to changes in risk”. One Channel Island banker admitted he was “not well” prepared. “Cost pressures, resource pressures and regulatory pressures are major
negative factors”, he said. But many also made the point that while individual institutions might suffer, the system as a whole looked quite strong.

The confident tone of many responses was reflected in the comments of a mortgage lender: “The main issue facing my organisation’s key area of business could be the possible downturn in the housing market. This would lead to increased arrears and higher levels of re-possessions. However this would not put us at too much risk as we are very strongly capitalised and we would be able to widen our margins to generate increased profit to cover increased losses.”

<table>
<thead>
<tr>
<th>How well prepared do you think your own and other financial institutions are to handle the risks you identify?</th>
<th>2003</th>
<th>2002</th>
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<td>Overall</td>
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<tr>
<td>Moderately well prepared or better</td>
<td>69</td>
<td>72</td>
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<td>Mixed</td>
<td>24</td>
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<tr>
<td>Poorly or worse</td>
<td>7</td>
<td>9</td>
<td>13</td>
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| Of which: Bankers                                              |      |      |      |
| Moderately well prepared or better                            | 74   | 81   | 60   |
| Mixed                                                         | 22   | 17   | 37   |
| Poorly or worse                                               | 4    | 2    | 3    |

| Of which: Regulators                                           |      |      |      |
| Moderately well prepared or better                            | 57   | 50   | 36   |
| Mixed                                                         | 29   | 33   | 45   |
| Poorly or worse                                               | 14   | 17   | 19   |

| Of which: Observers                                           |      |      |      |
| Moderately well prepared or better                            | 50   | 43   | 42   |
| Mixed                                                         | 35   | 35   | 32   |
| Poorly or worse                                               | 15   | 22   | 26   |

The pessimists focused on what they saw as complacency in the banking system – or a reluctance to face up to financial realities. A fund manager saw “a lack of willingness by certain institutions to take the required write-downs on assets”.

A senior investment banker wrote: “Provisioning in both the retail and wholesale banking sectors, analytically and bank by bank, seems reasonable despite the risks at this point in, for example, residential housing markets and some corporate sectors. But for the system as a whole - and by comparison with experience at the beginning of the 1990s - it’s just so flimsy that I wonder whether something isn’t bound to come out of left field and blow a hole - possibly below the waterline - in an awful lot of balance sheets.”
View from the regulators

“Financial institutions have been tested in recent years by financial market instability, economic slowdown, terrorism and war. For the most part, US financial institutions have weathered the storm in solid shape. While risk management weaknesses have been identified, the system as a whole appears strong and resilient.”

US regulator

“The relatively strong resilience of financial institutions to a whole series of risks/challenges in the last few years (severe market falls, market volatility, new wholesale products, consolidation, TMT collapses, Enron and similar failures) makes one suspect that the main threats to the system as a whole, and to the very biggest institutions, will come from unconventional, difficult-to-predict sources: Californian earthquake, terrorism of a dislocatory nature or scale, collapse of some vital communications/energy source, war (Kashmir or Middle East), nuclear power station blow-up in a first world country – some such.”

Martin Owen
Financial Services Authority
UK
Appendix: Banana Skins questionnaire

CSFI
CENTRE FOR THE STUDY OF FINANCIAL INNOVATION

Banking Banana Skins 2003

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 or fax it to +44 (0) 20 7493 0190 or email it to info@csfi.org.uk.

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

Please turn over
Question 2. Here are some 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 third 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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<th>Risk Category</th>
<th>Severity</th>
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<td>Banking market over-capacity</td>
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<td>Business continuation</td>
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<td>Risk management techniques</td>
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<td>Rogue trader</td>
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<td>How well prepared do you think your own and other institutions are to handle the main risks you have identified?</td>
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Replies are in confidence, but if you are willing to be quoted in our report, please tick □
CSFI PUBLICATIONS

1. “Financing the Russian safety net”: A proposal for Western funding of social security in Russia, coupled with guarantee fund for Western investors. By Peter Ackerman/Edward Bails. September 1993 £40/$65

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3. “Rating environmental risk”: A proposal for a new rating scheme that would assess a company’s environmental exposure against its financial ability to manage that exposure. By David Lascelles. December 1993 £25/$40

4. “Electronic share dealing for the private investor”: An examination of new ways to broaden retail share ownership, inter alia, by utilising ATM networks, PCs, etc. By Paul Laird. January 1994 £25/$40

5. “The IBM dollar”: A proposal for the wider use of “target” currencies, i.e. forms of public or private money that can be used only for specific purposes. By Edward de Bono. March 1994 £15/$25


7. “Banking banana skins”: The first in a periodic series of papers looking at where the next financial crisis is likely to spring from. June 1994 £25/$40


10. “Banking banana skins II”: Four leading UK bankers and a senior corporate treasurer discuss lessons for the future from the last banking crisis. November 1994 £25/$40


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53. “Harvesting Technology: Financing technology-based SMEs in the UK” DTI Foresight sponsored report, which examines what has been done (and what will be done) on the financing tech-based SMEs. By Craig Pickering. April 2002 £25/$40


60. “Thinking not ticking: Bringing competition to the public interest audit” A paper discussing how the system for auditing large company financial statements can be made better. By Jonathan Hayward. April 2003. ISBN 0-9543145-6-5. £25/$40


**REGULATORY PAPERS**

1. “Accepting failure”: A brief paper from the CSFI’s regulatory working group on the need for the new FSA explicitly to accept the likelihood that banks will fail. By David Lascelles. February 1998 £6/$10


4. “Embracing smoke: The Internet and financial services regulation” A new regulatory framework is necessary for the Internet, most important ‘lose the paper’. By Joanna Benjamin and Deborah Sabalot. June 1999 £6/$10

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Internet and Financial Services: a CSFI report. In-depth analysis of the industry’s key sectors. Please order through City & Financial Publishing. Tel: 01483-720707 Fax: 01483 740603. £45/$75

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