Banana Skins 2002
A CSFI survey of the risks facing banks

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**CSFI:** Chairman of the Trustees, Minos Zombanakis; Chairman of the Governing Council, Sir Brian Pearse; Chairman of the Advisory Council, John Plender; Director, Andrew Hilton; Co-director, David Lascelles.
Preface  Andrew Hilton, director, CSFI.

This report, written by my colleague David Lascelles, is the seventh Banana Skins paper that the CSFI has put out – and the fifth that has been based on a fairly standard questionnaire, enabling us to produce comparable survey data going back to 1996. It is also the second Banana Skins report that has benefited from the special support of PricewaterhouseCoopers, for which we are very grateful.

What are the main lessons of this year’s survey? Three come immediately to mind:
- the virtual disappearance of concern about e-commerce and about new technology in general;
- the emergence of broader concerns related to the economic cycle – notably fears about credit risk; and
- the re-emergence (post-Enron) of worries about complex financial instruments

As one would expect, given that the survey was conducted fairly soon after September 11, business continuation/disaster recovery has also shot up the list of worries – as has concern about the ability of the insurance industry to cope with disasters on this scale. Perhaps more surprising – and, at least from a London perspective, more worrying – is a new fear about the damage that can be done by inappropriate or excessive regulation. In the five previous years for which we have survey data, regulation only made the Top Ten once (and, at that time, respondents were split between those who warned about too much regulation and those who worried about too little). This year, both domestic and international regulation make the Top Ten list – and there is no doubt that respondents’ concern is with the stifling impact of over-regulation.

As always, our Banking Banana Skins survey is a lively and provocative read. But it is much more than that. Even though a social scientist might wince at the methodological corners that get cut, it is a unique insight into what senior figures in the financial world believe the future holds in store. And (as previous surveys have demonstrated) it has powerful predictive value.

AH
Foreword

We are delighted to have the opportunity to sponsor this fascinating survey again.

As ever, the results reflect a blend of the topical and the hardy perennial. Thus, unsurprisingly, e-business has dropped away while concerns emanating from September 11 are prominent this time. Credit risk, though, retains a deserved place in the Top Ten: history tells us that banks have lost far more through poor lending than any other risk.

Most notable however, is the appearance of over-regulation as a concern running through many areas of the survey. The cost to the industry of regulatory change is large and growing, the implementation (in the UK) of N2 is only one milestone along the way. The industry faces Basel 2, mortgage regulation and increasing, often unrealistic, government expectations over money-laundering in the next few years. To this can be added the cost of changing systems to accommodate the planned switch to international accounting standards and the possible conversion costs of UK entry to the euro. This adds up to significant pressure on the cost base, and is a major issue for the industry.

On a more positive note, it is encouraging to see the general feeling that banks are now better prepared to manage their risks. Although one should never be complacent, it does seem that lessons have been learnt from the past.

John Hitchins
Lead partner, banking and capital markets
PricewaterhouseCoopers
About this survey...

The survey was conducted in December 2001. We sent out 1,000 questionnaires and received 175 replies. The questionnaire was in three parts. In the first, respondents were asked to describe, in their own words, their main concerns about the financial system over the next 2-3 years. In the second, they were asked to 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 indicate whether they were willing to be quoted by name.

The breakdown of respondent by type was:

- Bankers: 70
- Customers: 20
- Regulators: 16
- Observers: 63
- Unknown: 6

The breakdown by nationality of a respondent’s institution was:

- Belgium: 1
- France: 1
- Germany: 4
- Greece: 2
- Ireland: 1
- Italy: 3
- Japan: 5
- Malaysia: 1
- Multinational: 23
- Russia: 1
- Spain: 1
- Sweden: 2
- Switzerland: 10
- UK: 98
- US: 18
- Unknown: 5
Introduction and summary

This year’s Banana Skins are dominated by the operating environment: macro-economic uncertainty, and the pressures this puts on bank balance sheets. Credit risk tops the list because of the likelihood of severe loan losses resulting not just from recessionary forces, but from what are seen as poor lending decisions in the heady days of the 1990s: dot coms etc. The head of group risk at one of the UK clearers said: “My over-riding sense at the beginning of 2002 is of a greater level of uncertainty, both short term and longer term, than I can remember for many years.”

The strong showing by complex financial instruments (in 4th place) reflects sharpening concern about credit derivatives, which are increasingly seen as a potential rogue product, little understood and capable of transmitting risk to all sorts of unwitting parts of the financial system.

The high positions occupied by business continuation (5th) and insurance (7th) were earned largely by the effects of September 11, though insurance is also emerging as a problem area for all sorts of other reasons: capitalisation, poor regulation, and the strains on the life insurance side.

Also striking is the emergence of regulation as a top level concern. Domestic regulation (6th) comes steaming through on the back of fast-growing worries about its heavy-handedness and intrusiveness, particularly in the UK. International regulation (10th) scores high marks because of the growing perception that the Basel 2 process could turn into a fiasco. Not unconnected is the arrival for the first time of legal risk (15th) as a Banana Skin in its own right, and the strong showing by money laundering (up from 26th to 11th).

The list is also striking for what is not in the Top Ten. All the e-strategy concerns that dominated the last Banana Skins survey have slumped close to the bottom, as have worries about the challenges posed by new entrants to the banking business (though “quasi-financials” in the shape of Enron are emerging as a new class of worry). “Plumbing” issues such as back office and payment systems are also low
order concerns. Despite all the fuss about global warming and ethical issues, environmental risk holds on to its 29th place.

The second chart looks at Banana Skins in a different way: by whether they are seen to be rising or falling in riskiness compared to a year before.

The fastest risers all have to do with the topical banking environment: recession, loan loss, political shocks and the challenges posed by terrorism. But the chart also underscores rising concern about the quality of regulation, and the associated issues of financial crime: money-laundering, fraud. The rise of insurance and complex financial instruments highlights two potential problem areas for the future.

The fallers - pay incentives, rogue trader, e-commerce and merger mania – were all big issues in previous surveys, but are now seen as distinctly passé.

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 strongly positive. Of our respondents, 72 per cent thought institutions were moderately well prepared or better to handle the risks, up from only 51 per cent in the 2000 survey. Much of this increase was due to bankers themselves expressing greater confidence in their ability to identify and manage risk. But regulators and observers also gave a more upbeat response than in 2000. Only nine per cent of respondents thought bank preparedness was poor or worse, down from 13 per cent last time.
Who said what

A breakdown by type of respondent produces some revealing variations.

Bankers put the deteriorating economic situation and the risk of loan loss at the top of their list. They were also worried about the banking market’s excess capacity in a recession. They were confident about their ability to handle the downturn: risk management did not appear in their Top Ten. Bankers were also the group most pre-occupied with the quality of regulation, with heavy-handed domestic regulators an urgent concern.

While users were concerned about the macro-environment, they also focused on the products and services they receive from banks: derivatives, currencies, commodities. Their concern about political shocks and emerging markets reflected general anxiety about the political situation. They were less concerned about banks’ ability to manage risk, or the quality of banking regulation.

Regulators worried most about the mounting pressures on the banking system: recession, the stock market, loan losses. They also focused on “plumbing” issues such as the back office and the ability to survive terrorist attack. Their level of concern about the insurance sector was the highest of the four groups. Striking is the absence from their Top Ten of what are widely seen as specific regulatory concerns: money-laundering, mis-selling and risk management.
Observers focused on the increasing economic and political pressures on banks, and their ability to handle them through risk management. They also worried about the potential for derivatives to trigger systemic problems. On the regulatory front, their main concern was about the lack of effective international coordination, and the cumbersome Basel 2 process. Like the other groups, they did not feel that e-commerce was a pressing issue.

Some Banana Skins come and go, some are hardy perennials. The Top Ten since 1996 charts the changing concerns. Broadly, the mid- to late-1990s focused on the quality of management and strategy as new challenges loomed: technology, fresh forms of competition, new products. By 2000, concerns about market excesses were rising rapidly: an equity market crash, asset quality, culminating in the latest survey where direct survival issues top the list. The hardiest perennial is the theme of competition – new entrants, market over-capacity — closely followed by the ability to understand and manage technology. Striking is the disappearance of early concern over the quality of bank management.

The charts also show the ephemerals: the rogue trader so troublesome in 1996 and 1997 has completely disappeared, as have EMU and Y2K. One Banana Skin that seems to be making a comeback is emerging markets. This year’s strong showing by regulation is also new, as is insurance.

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1. Credit risk (3)

The threat of a “sea of red ink” engulfing the banking industry is the market’s worst fear, with the onset of a recession compounded by bad lending made in the balmier days of the 1990s.

Virtually all our respondents had anxieties about the quality of loan portfolios and even entire institutions. Some focused on individual sectors (telecoms, airlines, cruise ships, property, dot coms, small business, and personal credit all got mentions), some on the imprudence of banks, others still on the quality of risk management. Always, in the background, was the dark shadow of Enron.

Many wondered whether banks had really woken up to the dangers. An investment banker saw “a failure to grasp the deterioration in credit quality following the elongated downturn in some sectors e.g. farming, airlines, retailing in the US and Continental Europe, house prices”, while another respondent said it was “worrying that loan loss reserves/provisions have been declining as a percentage of total loans when corporate debt has been rising and cash flow is under pressure (in the US and elsewhere)”.

Rick Sopher, managing director of LCF Rothschild Asset Management, thought there was worse to come. “Have the excesses of the 1990s been fully uncovered yet (balance sheet manipulation, bad lending to ‘growth industries’, share options as a means of remuneration etc.)? Are LBOs and other leveraged forms of investing in corporate credit a stable way of lending to companies?”

A respondent from a German Landesbank said credit loss was going to be a long-drawn problem. “Asset values do not always collapse in months; they can crumble over years. That is a life-threatening problem, and not just for banks.”

Some thought the main problem lay in the US. David Llewellyn, professor of banking at Loughborough University said: “The US has a potential debt time bomb which, were it to explode, would be serious for the economy and also for the banks.” He described it as the sort of “low probability-high seriousness” risk which encouraged “disaster myopia”. David Kern of Kern Consulting feared there would be “a sharper cyclical downturn than envisaged in most people’s ‘central scenario’, coupled with a deflationary spiral on the real debt burden, and on credit quality in the main western economies, including the US”.

In the UK, much of the focus was on overstretched personal borrowing: mortgages, credit cards. John Caine, chairman of GCI Financial, said: “The retail lending sector is almost entirely at the mercy of a continued rise in the value of houses.” Ian Linnell of the Fitch IBCA rating agency, saw the risk of “payment shock” in the event that “the current framework of UK monetary policy breaks down and there is a substantial increase in
Rating the raters

Ratings agencies, supposedly the arbiters of financial strength, could also be a source of instability. Several respondents turned their guns on them.

“Rating agencies have become too powerful, especially in structured markets like asset-backed commercial paper. A change in rating agency models could have a major market impact through ‘hard wiring’ of investment decisions to ratings. (A version of Goodhart’s law applies: the excessive use of ratings means they can no longer be a neutral opinion of creditworthiness.) Rating agencies are more powerful than they want to be. Basel 2 thankfully will allow most capital requirements to be based on internal as well as external ratings. But the proposal for asset-backed securities is more ‘hard wiring’ and this is unfortunate.”

David Rule, Bank of England (writing in personal capacity)

“The increasing influence of rating agencies in markets generally and corporate debt particularly is not being matched by their business models (quality of people, and income from borrowers rather than investors), or by the regulatory oversight to which they’re subject (there is none). Something could go wrong here.”

Investment banker

interest rates. This could result in a significant increase in the debt service burden of individuals and corporates, given the high indebtedness of both sectors.”

Is it that bad? Despite the gloom, many respondents thought the banking industry was entering the recession in better shape than the last major downturn ten years ago. Michael Green, director of group risk management at Lloyds TSB, thought the negative credit consequences of the recession “will be containable”. A senior financial regulator wrote: “The larger credit risks have been handled well so far in the US and the EU, but great vulnerability remains, e.g. to 3G telecom failure.” Prof. Richard Dale of Southampton University agreed that the banking industry was entering the recession in a strong condition, “but the possibility of balance sheet deterioration affecting some systemically sensitive institutions is nevertheless a concern”.

Blue sky banking

“Coping with the impact of recession in many leading economies will test the skills of bankers and dealers whose experience is based only on the ‘blue skies’ of the 1990s. Bad debts and bond defaults will rise. The shock of a world in which profits do not soar inexorably upwards on the back of inflation and/or economic expansion will test the resilience of senior management incentivised to a high degree on the achievement of such growth.”

Director
UK clearing bank
2. Macro-economy (8)

The bleak economic outlook coloured virtually all the replies we received, with most of our respondents thinking that a delayed economic recovery was more likely than a recession that could still get worse, though there wasn’t much to choose between them.

The concerns were familiar: recession will damp down economic activity and push up unemployment and bankruptcies, which is bad for the banks. Ruben Lee of the Oxford Finance Group came in at the dark end: “The likelihood of a serious economic depression is greater than it has been for a very long time. Should this occur, a fall-out at one of the major financial institutions could have very adverse effects. Apocalyptic? Yes, but with a probability now seriously greater.”

The pessimists dwelt specially on the “illusion” that monetary policy could nudge the world economy forward when interest rates were already at rock bottom. An economic consultant felt the US’s economic problems offered no way out for the banks: the Fed’s monetary stimulus would either hit them through rising interest rates if it succeeded, or through rising bankruptcies if it didn’t.

Richard Farrant of the Banking Code Standards Board was more cheerful: “Overall I am much comforted by recession having arrived in a very orderly manner so far as financial markets in most developed countries are concerned.” A central banker came somewhere in between with his concern about “the unwinding of financial imbalances in core countries especially the US and possible implications for the periphery if the weakness in the global economy is prolonged. Compared with the previous year, ‘hard landing risk’ has materialised, but so far markets have weathered

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Japan emerged as much the most worst single country Banana Skin. One banker said: “The biggest risk to the international financial system is the condition of financial institutions in Japan. This applies to large and small banks and - as important - to life insurance companies. Accelerating deflation increases the problem.” A senior financial regulator said: “The prognosis for Japan seems hopeless. It must implode at some point and cause serious damage especially in Asia which is already highly vulnerable.” The treasurer of a multinational industrial corporation with large interests in Japan said: “We have so far relied on the government to bail problem areas out, but can this continue?”

Our Japanese respondents shared this view. “Japan remains an acute concern”, said Noriko Hama of the Mitsubishi Research Institute. Another warned of “an avalanche of risks including possible bank failures”.

A few respondents felt the risks could be contained, however. Richard Clarke of PricewaterhouseCoopers said the Japanese threat: “is so well known that I do not think a collapse would of itself threaten the global system - but secondary consequences such as a global recession might!”
Another respondent said: “Overall I suspect the industry will be fairly stable over the next 2-3 years with few failures from the global recession but some faltering.” The optimists also noted that the markets were already pricing in a strong recovery in mid-2002.

One respondent was honest enough to confess that he was completely at sea. “It is not clear to me how recession would affect the security of the finance industry, and it is the uncertainty itself that worries me.”

Some respondents pointed up the risk that banks might make the recession worse by turning off the loan tap at a crucial moment. Paul Dembinski of the Geneva-based Observatoire de la finance saw a “deepening of the short-termist view: generate income at any price, and push industrial enterprises to the wall”. An academic economist also perceived this risk, but in a more qualified way. “Against the background of a slowdown there is a danger that, egged on by regulatory concerns, commercial banks will switch too far into defensive mode. But there is also the reverse concern that, seeing this danger, central banks may flood the market with excess liquidity, sparking off further inflationary pressures in 2003. Either way, heightened macro uncertainty.”

Still seen as high risk, despite the correction and recent recovery. A financial regulator said: “Equity prices could still fall sharply if deflation sets in. US/UK interest policy is highly supportive but we are all in uncharted territory now.”

Many respondents said the risk here is more to pensions and insurance than banks, with the possible exception of Japan where banks are exposed to equities through their life insurance subsidiaries. Other worries included the risk of higher market volatility, and the negative effect on corporate fund-raising. Emilios Avgouleas, managing associate of the financial markets group at Linklaters Alliance said: “A sudden fall will lead to severe under-investment as institutional investors switch to fixed income or cash.”

A regulator raised a different sort of risk: that of market fragmentation and reduced transparency due to growing competition between stock exchanges.

Up strongly from last time because of the can of worms opened up by Enron. Respondents feared the opaqueness and complexity of derivatives, and the fact that they had the power to connect up seemingly unrelated institutions. “Financial derivatives are largely unregulated, untransparent and misunderstood”, said a US respondent. Another respondent was worried about the difficulty of understanding derivative products “without the genuine co-operation of those devising, selling and personally profiting from them”. Nor is it just the size and complexity of the business that bothers people: there’s also the time horizon. One respondent pointed out that some swaps have a life of 60 years. With most derivative portfolios accounted for on a fair value basis, there is also the problem that growing amounts of unrealised profits are being included in bank results.
The threat from FRS 17

A new accounting standard for UK pension funds sounds a bit technical for a Banana Skin. But FRS 17 could hit company finances hard, including banks, by forcing them to mark the value of their pension funds to market, and account for surpluses/deficits in their balance sheets.

Neil Record of Record Currency Management predicted that it “will cause the insolvency of one or more major companies: e.g. BA, Marconi, BT. The problem, of course, is not FRS17 itself, but reality, which it quite accurately reflects. The impact on the banking sector will be substantial: the UK banking sector has large, vulnerable pension funds.”

A senior investment banker issued a different warning. FRS 17, he said, “will effectively force companies to move assets in existing pension schemes from equities to bonds. This will result in a massive drainage of funds from the UK equity market and thus dramatically increase the cost of capital to UK quoted companies - undermining our competitive position in the international marketplace. The law of unintended consequences has, I suspect, received very little attention in the City or the Treasury.”

The impact of fair value accounting was also listed by a Continental banking regulator as something to watch. US banking analyst Ray Soifer pointed up a related problem: “Initiatives by accounting standard-setters, specially in Europe, to require loans and other non-trading assets to be marked to market would reduce bank’s capital ratios to ‘fire sale’ levels when the capital is most needed, by encouraging banks to sell such assets at depressed valuations rather than accepting further downside risk, thus driving prices even lower.”

Credit derivatives drew a lot of comment. A regulator wrote: “One of the big tests this time round will be the ability of the credit derivatives market to handle ‘credit events’ - including the question what constitutes a credit event.” Others worried about the ability of these derivatives to transfer credit risk to inappropriate institutions like insurance companies or unregulated non-financial companies like Enron.

A senior investment banker feared that credit derivatives “may bring substantial dispute or litigation initiated by counterparties of (in economic terms) writers of credit insurance whose approach is quite different from that of the banks who are laying off risk in this new fast-growing market which has not yet been tested”. Chris Sutton of Logica saw derivatives as a way of “circumventing new regulations”. Other respondents highlighted the added risks from leverage.

But one respondent thought risk in this area was falling because “risk management is getting better”.

5. Business continuation (-)

This innocuous-looking phrase is all about dealing with terrorism, and not surprisingly it made a strong showing in the wake of September 11.
The risk to reputation

Several respondents commented that reputation was an increasing risk because of threats like money-laundering, fraud, mis-selling, or plain lack of integrity.

“These risks are not merely financial but reputational - and not to be underestimated!” said a City lawyer. David Shirreff of The Economist said: “Managing reputation risk depends on being able to respond immediately to any other risk event and handle the effects on a firm's reputation. One example: Goldman Sachs flying top brass to Singapore to smooth over takeover tactics that misfired. Are all firms geared up and ‘humble’ enough to do the same?”

Other sources of reputation risk that were mentioned included “social responsibility” and lack of transparency. One respondent thought the “lack of knowledge of ultimate beneficiaries of many transactions is widespread in the present political climate. This severely undermines the reputation of the entire financial system.”

Impact of the attacks. Generally, people thought the system stood up well, though many lessons could be learnt. A central banker said the attacks “showed weakness in addressing operational risk at a system-wide level, but markets proved remarkably resilient given the size of the shock”. Another banker said the events “have shown that whilst banks' business continuity plans probably address adequately damage to property and IT systems, concentration of key staff represents a significant vulnerability”. This theme was also taken up by Angela Knight of APCIMS: “City institutions mostly have their emergency recovery and back-up in inaccessible and vulnerable Canary Wharf. Against a September 11 type of event, the whole system will be lost, not just a part.” A further point was made: that while banks had planned for loss of systems and/or premises, few had considered the impact of a significant loss of people.

Future risks. Many respondents also feared that New York was not the end of the story. “A real concern must be that any ‘backlash’ against the ‘developed’ world will be directed towards the major financial institutions, including banks”, said a banking executive. Many also stressed the risks to the insurance industry.

How well prepared are banks against a new wave of attacks? A credit analyst felt that the aftermath of September 11 “has been underestimated and banks in general are not prepared for it”. A regulator said that the lessons “have not been acted on quickly”.

To balance the record, one respondent stated flatly that “I do not believe that terrorism poses a significant threat”. Another asserted that “the risk is the same, but awareness is higher”. A regulator said that the high risk was mitigated by low probability.
6. Domestic regulation (27)

This year’s shock riser, up from 27th place last time, reflecting fast-mounting concern about regulatory costs and pressures. While much feeling was expressed from the UK with the full-fledging of the FSA, these worries were strongly echoed from the Continent and North America as well.

Many respondents had a beef about what Robert Bennett, group finance director of Northern Rock, called “the massive increase in the amount and cost of regulation”. A senior banker thought the industry faced “death by suffocation”. Regulation was “confusing and out of proportion”, said a compliance officer at one of the big UK clearers, “over intrusive” according to a leading investment banker. Antony Thomlinson of law firm Eversheds said UK banks were “being burdened with a great increase in regulation, to no obvious benefit to the public, at a time when the economy is finely balanced”.

Keith Hawkes, head of network support at HSBC, saw banks facing growing risks simply from the pressure to keep abreast of the volume of regulation, and implement it without making mistakes or alienating customers.

Some respondents were less concerned. A few saw regulation as a steady or falling threat, like Philip Middleton of consultants Ernst & Young who welcomed the move “towards tougher domestic regulation and better, though still imperfect, international coordination”. Another UK respondent saw regulation as “a secondary concern looking ahead”. Some respondents even felt there was room for more regulation in some areas, particularly insurance. One thought the real problem lay in “unenforced regulation”.

While much of the concern centred on the cost of compliance and the sheer weight of regulation, some respondents focused on specific risks, viz.:

- Misdirection of resources: Regulation was “wasting management time and precious resources”, according to an executive from a Spanish bank.

- Loss of diversity: A senior UK banker said regulation “is now driving institutions into a one-size-fits-all, while also demanding an environment of no failures. The result will be increasing conformity and the consequent increased risks of systemic failures.” Another respondent saw regulation causing an “enforced homogeneity of risk management systems”.

Mind your backs!

“Consumer pressure on the regulator could lead to a fear of failure becoming such a dominant concern in the regulation of financial institutions that innovation will become progressively more difficult. An unexpected consequence of the establishment of the FSA is that it is being held responsible, and correspondingly pilloried by politicians and the press, whenever an institution fails. That could lead to the development of a ‘guard one’s back’ mentality among regulators that, in turn, would lead them to bear down even more severely on innovators.”

Lord Tugendhat
Chairman, Abbey National
The consumers are restless

Pressure from consumerist movements and interference by government were widely identified as a growing Banana Skin. A director of one of the large UK banks said that consumerism was “taking over from classic solvency as the guiding light of regulators, demanding ever more transparency of product design and realistic pricing”.

The chief executive of a large clearing bank said his major concern was “undeliverable customer expectations”. These appeared to have “reached the point of litigation or complaint if their performance (i.e. in pensions or savings) does not exceed the average! Relative underperformance is not acceptable.” Another bank chief executive saw “a significant extension of consumer rights and implied rights capturing new areas, e.g. investment management performance”.

However a response from the other side of the market painted a different picture. Stuart Cliffe of the National Association of Bank and Insurance Customers warned that “consumer market controls will become much more important as customers lose patience with overpriced or underserviced products, and watchdogs gain in authority”.

Peter Barenco, chief executive of the UK’s National Savings, pointed up the plight of consumers who had been pushed into taking excessive risks with their savings by “a simplistic equity cult/extrapolation allied to commission-hungry sales forces, and sensational personal finance journalists with limited technical knowledge and no responsibility for reporting back on what they told their readers/viewers/listeners”.

- **Replacement of judgment by rules**: Ian Mackintosh of Standard & Poor’s saw “too much interference from regulators in the granular details of risk assessment. Rules work less well than judgment.” Malcolm Matson of National Telecable worried about “an abdication of individual moral responsibility in favour of corporate conformity with specific regulatory requirements”.

- **Impact on smaller institutions**: “Over-regulation will put small financial institutions out of business”, warned the chairman of a small financial institution. “Small institutions face massive additional regulatory cost and pressure”, said a building society chief executive. “More and more regulation of administered rates reduces margin management ability.”

- **Poor implementation**: The head of retail banking at a UK clearer complained of “a lack of joined-up regulation”, while an investment banker said regulators focused too much on the downside and overlooked mitigating factors.

- **Loss of innovation**: A senior banker said the cost of regulation included not just the FSA but money-laundering, data protection, health and safety. “There is not only the cost of meeting the requirements of all this legislation, but also a growing risk of stifling the entrepreneurial spirit with regulatory concerns.”

- **Cost** (not just to the industry but to users of the financial markets): A respondent from a German Landesbank said that regulatory costs “should not make it impossible for smaller corporates to raise money or for smaller financial service companies to
offer their services”. From the retail side, a respondent said “Value for consumers becomes eroded by excessive and misplaced regulation that is both costly and confusing”.

### Germany

The survey revealed growing concerns about the soundness of the German banking system. Several respondents, including a strong dose of regulators, felt that pressures on the country’s thousands of tiny banks and larger incidents like the Berliner Handelsbank problem could generate trouble.

An international regulator wrote: “Problems are increasing in the German banking system - relatively much lower capital ratios than the rest of Europe, under provisioning for Mittelstand and former East Germany, removal of state guarantees impending, more fraud/bad debts because of entanglement with political figures etc.”

### 7. Insurance (-)

The insurance sector - both general and life - is emerging as a big worry area for a host of reasons: terrorist shocks, funding problems, risk transfer, regulation, Equitable Life etc.

A financial regulator said: “The general and life insurance industries, now globally very vulnerable, could drag governments in big time, and damage risk transfer strategies.” The chief executive of a large international banking group said the insurance industry was “assuming risk without adequate analytical resources or regulation”. Richard O’Brien of Outsights said concerns in this area were surging because insurance has “a regulatory structure needing modernisation and is linked to major issues such as the future of long term savings and perception of risk”.

A number of respondents worried about the knock-on effect on banks with insurance subsidiaries. A banking consultant said bancassurers could take a double capital hit from the recession: higher loan losses and the need to recapitalise their insurance business. The pressures on UK, Dutch and Japanese insurers were most frequently cited.

**Life insurance.** The worries here were wide-ranging. A Swiss banker wrote: “The life insurance business faces major challenges. The problems are mediocre management (even by commercial banking standards), changing tax treatment in Europe, therefore more performance-driven competition with other asset gatherers/wealth managers and, lastly, if the equity markets stay negative or flat and interest rates low, difficulty funding existing and future liabilities.” Several respondents also feared that Equitable Life would not be the end of the life insurance saga.

**General insurance.** The concern on the property and casualty side is over the capacity of the industry to handle mounting claims, and provide effective risk transfer from other financial sectors like banking. An investment banker wrote: “The insurance available to financial institutions provides for costlier cover of fewer risks and could deprive firms of urgently needed financial risk mitigation. Terrorist and other exclusions may call for public underwriting on pool re-insurance lines which some governments do not provide.”
Even though recent shocks have allowed insurers to jack up rates, there was also scepticism about the sustainability of the sector’s new economics. An investment banker wrote: “The bottom of the insurance cycle together with September 11 have attracted huge amounts of capital into the insurance market ensuring that the upswing in the cycle will turn into a short term spike before rates collapse from overcapacity and the market descends into long term unprofitability.”

8. Emerging markets (12)

Events in Argentina helped to push this one up the rankings. Many respondents felt, as one put it, that “another major default is en route”, with countries like Indonesia, Turkey and Brazil mentioned. Richard Spiegelberg of Chancery Communications foresaw the failure of a major financial institution in Asia as a result of weakening economic conditions. Others expressed concern about the fall-out in that region if Japan went down, and about emerging markets in general if the US did not pick up soon. One respondent warned of the risk of “governments unilaterally lowering the coupon on outstanding high yield debt”.

But some respondents scored this as low risk. A fund manager said the risks were confined to Africa and Latin America, and a banker thought the whole category was declining in risk “except Argentina which is discounted”. Others pointed out that there did not seem to be big bank exposures.

A reflective response came from a member of the development community who discounted the short term risks and said: “If the process of impoverishment is not reversed, our economies and prosperity are threatened too.”

9. Banking market over-capacity (6)

Though down from last time, this Banana Skin has held up because of the acres of balance sheet space being freed up by the economic downturn. “There’s lots of excess lending capacity chasing few deals”, according to a commercial banker, and a respondent from the investment banking side described the capacity problem there as “rising fast”.

The problems vary from one segment to the other, with “wealth management” under pressure because of the hordes of new entrants, and the position in Europe being specially difficult. Overcapacity was expected to be a factor behind further consolidation in the business, though a respondent from a French bank wondered “can EU combinations really cut costs?”.

No way out

Why does banking suffer from chronic overcapacity? According to Swiss banker Rudi Bogni, it is because superfluous banks don’t can’t get out.

“The only practical exit route is via merger or takeover, which often leads to a dilution of the strengths of the acquiring bank. Few banks return capital to shareholders. Indeed it is normally only strong banks which do so. Weak banks with no real franchise or competitive edge tend to hang on to their capital and independence. There is no real mechanism to put laggards out of their misery without weakening other parts of the financial system.”
10. International regulation (14)

In contrast to concerns about domestic over-regulation, the worry on the international front is that regulators will fail to get an effective cross-border act together. A US respondent said: “The problem is that too much is asked of regulators without giving them the tools. In general the financial regulatory system is overstressed and may buckle.”

Much the biggest item was Basel 2 (see box). But a number of Europe-based respondents also worried that the EU would fail to implement single market reforms, including the Lamfalussy regulatory proposals, and that this would leave gaps or encourage regulatory arbitrage. A regulator said it was “Lamfalussy crunch time”, and warned: “There is a big risk of failure.”

A number of respondents also pointed up the absence of a “lender of last resort” in the EU. Tim Congdon of Lombard Street Research asked: “How will blame between different nations be allocated in the event of a serious pan-European banking crisis? The responsibilities of different governments are unclear, while the governments themselves are no longer able to borrow freely from the central bank to support their banking systems.”

Basel 2: making things worse

Many respondents feared that Basel 2 - the new international capital adequacy accord - could turn into a big Banana Skin because of the massive resources required to implement it, and the distortions it would introduce.

A credit analyst said the proposals were so complex that they risked failing, “thereby causing the whole Basel process to fall into disrepute and undermining the reasonably solid structure of international regulatory cooperation that has been built up”. A respondent from a Russian bank thought Basel 2 was “an operational risk in itself”.

The major worry is the accord’s pro-cyclical character: loading banks with more capital requirements the worse things get. One respondent said that Basel 2 “compounded risk management problems rather than addressing them”. A banking consultant said the accord would “lead to less, not more, transparency of risk and to differing regulatory interpretations (e.g. between Germany and the UK) which will open up capital management loopholes and hide underlying risks”.

Respondents also warned about unintended consequences, for example driving more credit risk on to Basel-free institutions outside the banking industry. One respondent warned that institutions would take up positions ahead of the new capital requirements which could produce “significant capital shifts”.

Many respondents also complained about the tortuousness and opacity of the Basel consultation process. An Irish banker was concerned about “the drive to finalise it without thorough pre-testing of its impact on institutions/sectors, or a firm understanding by Basel of its likely application by individual national regulators, including the EU”.

CSFI 5 DERBY STREET, LONDON W1J 7AB Tel: 020-7493 0173 Fax: 020-7493 0190 E-MAIL: info@csfi.org.uk WEBSITE: www.csfi.org.uk
Not everyone was gloomy. Robert McCracken of Ernst & Young thought the international regulatory system “seems to be working better, if not perfectly”. And a regulator said that “e-bust, the equities slide, September 11, recession, Enron and Equitable have proved salutary wake-up calls. This reflects well on the central banks (specially the Fed) and the supervisory framework (much stronger internationally than before, however imperfect) and on the risk management systems of the major players (infrastructure providers as well as banks).” One respondent even suggested that a lack of regulatory coordination might be “a good thing”.

One of the few positive comments came from a building society respondent who said “Basel will cause a slowdown in progress but should provide more robust institutions”.

### 11. Money-laundering (26)

Up sharply from last time, and no surprise given September 11, along with developments like the introduction of the euro which highlight the scattered nature of the risks: fraud, reputation, regulatory sanction. One regulator warned that there would be “political fall-out for banks not seen as 100 per cent cooperative”. But a number of respondents felt the risk was overblown. “Not a significant threat”, according to a fund manager, while a central banker pointed out that it was “not systemic”.

A large number of respondents also felt that the real risk lay in political and regulatory over-kill. Tony Worthington MP commented: “From apathy about money-laundering we have gone to hyperactivity following September 11. I am not convinced we are acting coherently.” UK banks were particularly aggrieved by the clobbering they have received. A member of a large London-based multinational bank commented: “Every bank’s reputation is at risk due to the heavy-handed approach of the FSA whose rules on money-laundering are known only to the FSA.”

Banking analyst Ray Soifer said: “In their zeal to enforce anti-money laundering laws and to increase tax collections, governments risk diluting traditional bank secrecy to such a degree as to drive more funds and transactions underground outside the banking system entirely, where the risks to international stability may prove even greater.”

### 12. Risk management (13)

Two concerns predominate: the quality of risk management systems, and a loss of recession experience in banks due to the long bull run.

An investment banker wrote: “Risk models are proving inadequate to deal with today’s markets. A prolonged economic downturn will have consequences for banks’ credit exposures which are poorly modelled and therefore pose systemic risk. In particular credit ‘contagion’, as we have seen in the telecoms and energy sectors, is on the rise.”

A clearing banker wrote: “The long period of bull market conditions and intense competition in financial services have adversely affected the risk culture in some
banks. Such banks have done one or more of the following:
- taken on long-term business at margins which are barely profitable even in periods
  of strong economic performance, and will prove loss-making in other circumstances;
- accepted poorer quality business to provide volume growth;
- accumulated excessive risk concentrations in their preferred markets.”

Several respondents shared the view that recession would encourage greater
risk-taking by banks driven by what one called “excessive optimism about risk
control”. Keith Brown, chairman of the international advisory board of
Italian bank Bipop Carire, also worried about “boards of directors unable to
understand risks being taken by the
executive”. Consultant Richard Bell
said: “Where this recession will be
different is that most banks believe
their risk mitigation techniques will
shelter them from the difficulties seen
in the past. My fear is that this will be
illusory to a significant extent. Risk
mitigation will re-allocate risks to
different counterparties, but not
eliminate them.”

But the chairman of a Continental
bank was more sanguine: “The concern
is that not all banks have appropriate risk management systems to handle the higher
level of risk. But with bank supervisors paying increasing attention to operational
risk, and subjecting risk management models to greater scrutiny, one may say that the
danger is exaggerated.” A number of commercial bankers also showed an awareness
of the risks. Susan Rice of Lloyds TSB Scotland said credit decisions were based too
much on the past. “They need to be tempered to some extent with an eye on the future
which is increasingly very different from what’s gone before.”

### Reliance on models

The increasingly mechanistic approach
to risk management bothers some
people.

A central banker wrote: “As business
becomes more complex and the
environment more dynamic, there may
be a tendency to rely too heavily on
models and systems.” Another
respondent said: “The growing lack of
diversity among financial institutions (e.g.
life insurers becoming more like banks)
and the increasing reliance on very similar
risk management systems encourage
everyone to over-react in the same way
at the same time.” A senior commercial
banker thought that “over-reliance on
value-at-risk is very dangerous”.

### 13. High dependence on technology (5)

A weakening concern, but one that nags nonetheless. “Microsoft have us over a
barrel”, complained one banker.

The head of operational risk at a major US banking group worried about “increased
technology dependence and the consequential need to mitigate information system
security issues such as fraud, crime, viruses etc.”. Michael Feeny of Sumitomo
Mitsui Banking Corporation had a similar concern that “increased electronic automation
dealing in world financial markets heightens the system’s vulnerability to attack by
electronic infiltration”. A senior US investment banker said: “My concerns are the
threat of terrorist attacks following September 11, closely linked to the high dependence
on technology which is present in the industry. Also, the lack of controls (risk
management etc.) in relation to the increased utilisation of technology such as straight-
The global village

Growing connectivity - technological and trading - in the financial markets means fewer firebreaks and a greater risk of contagion.

Noriko Hama of Mitsubishi Research Institute said: “Intense global linkage begets a high risk of globally synchronised financial panic.” Banking analyst Nick Antill highlighted trading connectivity: “Regulators have concentrated on the individual riskiness of the asset portfolios of banks as separate entities, rather than on the risks to the banking system as a whole resulting from asset swaps, asset securitisation, the use of derivatives to hedge positions etc.” A UK clearing banker said increasing reliance on sophisticated and inter-connected systems/technology solutions created the risk that “prolonged failure might pass the point of recovery”.

A number of respondents also cited this risk in the context of outsourcing.

However a respondent from a German bank made a point of ranking this as a low risk: “How else can you operate nowadays?”

14. Political shocks (28)

This risk has come shooting up the league table compared to the tranquil days of 2000. And no prizes for the reason. “The world is a more uncertain place”, said a fund manager. “What next in the Middle East and Asia?” wondered a banking supervisor.

But there are other types of political shock as well. As one respondent put it: “Political backlash against open markets” - and the assault of the anti-globalisation brigade. Several respondents also identified political risk of a different kind: growing government interference in banking. This seems to be a particularly European phenomenon, with several people decrying meddling from Brussels (eg over cross-border payment costs) and, in the UK, the succession of government reports and inquiries into the banking system. Massimo Roccia of the European Banking Report, the research arm of the Italian Banking Association, stressed the heavy fiscal and regulatory burdens carried by Italian banks, and the competitive disadvantages they suffer as a result.

15. Legal risk (-)

A newcomer to the charts for many reasons: the growing complexity of contracts, the stresses of recession, dramatic cases like Merrill-Unilever, and its unpredictable nature. One, also, not to be underestimated because of its technicality.

A senior investment banker wrote: “The expansion of financial institutions’ activities (both their nature, e.g. energy trading) and their geographic breadth will lead to a significant rise in regulatory risk (for certain institutions) and potentially damaging legal liabilities.”
A lawyer wrote: “The solidity of the documentation of many deals executed during the bull market will be put to the test. Watch out for structured finance transactions (securitisation in particular) and emerging markets. Some might discover that there is more to law than ‘pushing paper out’!” Others saw credit derivatives and environmental matters triggering litigation. A regulator pointed to “complex cross-border structures”.

George Cardona of Cardona Lloyd & Co stressed that litigation risk is different because it produces “unpredictable decisions with large financial consequences as occurred in Equitable Life. Financial institutions have become better and better at quantifying and so managing quantifiable risks. But this risk is not quantifiable in the same way as others.” One of our respondents warned of “maverick judgments in obscure courts as desperate times lead to desperate measures”, while another saw legal risk being fed by the rise of the “blame culture”.

### 16. Hedge funds (17)

A middling risk, this, and little changed. Hedge fund failure is one of those fizzing bombs that a lot of people expect to explode in a downturn, but without being sure where, when or how badly. Chris Sutton of Logica said they still had “huge destabilisation potential”, and a fund manager described the risk as “unquantifiable”. An academic respondent said the problem was not just the size and prominence of the hedge fund sector, but “its lack of regulation and transparency”.

#### The margin squeeze

The pressure on bank earnings is not only tightening, but coming from more angles: recession and structural change in the business, notably e-commerce.

On the economic front, Alfred Steinherr, chief economist at the European Investment Bank, warned that “bank results are at risk due to lower lending activity, higher default risk, and lower investment banking income”. There was “a big restructuring in banking to come”, he said. Several other respondents warned of the bigger risks taken by banks “desperate for earnings growth and to meet investor expectations”, in the words of Steve Davis of DIBC. An investment banker worried about “failure to cut fixed costs particularly staff costs, quickly enough in the face of falling gross income, both investment banking income and interest rate based income”. A respondent from the UK’s mortgage industry said some lenders were vulnerable to default because they had made home loans on very tight or even negative margins to keep business flowing.

On the e-front, a building society executive warned that technology was reversing the balance of power between bank and client: “New technology combined with the internet is making it more and more possible for virtually anyone to see the full range of financial service products and services.” The resulting margin pressure, he warned, could lead to a big shake-out in the business.

One respondent saw banks caught in “a dichotomy of cost reduction and the requirement for ever more resilient infrastructure, secure environments etc., versus the need to remain competitive and invest in multi-channel platforms, more sophisticated CRM etc.”.
The head of group risk at an investment bank worried that the sector is showing “very fast growth. Many of the hedge funds are new and small. Do financial institutions and/or investors really understand these products and their associated risks?” But Prof. Michael Dempster of Cambridge’s Financial Research Centre said: “Their importance has diminished with the equity recovery.”

17. Front office selling practices (21)

This was viewed as a relatively low risk despite the publicity attending scandals like Equitable Life, and the interest that the regulators are taking in mis-selling.

Various areas were highlighted: mis-selling through e-distribution channels, over-selling of equity-based mutual funds, and in the UK, mis-selling of “demonstrably poor value and inappropriate products such as accidental death cover and payment protection plans”. A regulator thought that underperforming equity markets would make other asset classes more attractive to the retail sector, with an increased risk of mis-selling.

One respondent argued this risk with some passion: “I think we are going to see more and more aggressive selling of financial services using the retailing techniques of the supermarkets. Sainsbury’s Bank is doing very well by using blatant ‘two for the price of one’ offers. Abbey is turning its branches into coffee bars etc. What is this going to do for the industry, for bad debts, provisions? The latest mega-report from the National Consumer Advice Bureaux on financial literacy makes salutary reading, not least concerning the dodgy practices of the industry.”

Staff and skills

The banking industry’s loss of experience through redundancy and declining skill levels is an emerging Banana Skin, our survey showed.

One respondent worried about the “shortage of experienced staff who have ‘been there, done that’ as we hit a recession. Ageism and eight years of economic growth have made management capacity a real anxiety! This applies not just to credit decisions but to operational risk management.”

Another said that banks were steadily retiring people over 50. “Mistakes have been made through inexperience, and many of those mistakes have yet to work through the system. Further mistakes are being made in a bad economy which may compound the errors.”

On the skills side, a banking educationist saw “very little commitment to career development despite the spin about lifelong learning and being the ‘employer of choice’. What spend there is in this area is focused on vocational on-the-job training, aimed at impacting the bottom line now.” He also warned of the “deskilling of the industry” through call centres and centralised processing with high staff turnover and low skill development. The skill shortage would destabilise the industry because it would weaken compliance and encourage poaching.
18. Fraud (15)

Little change from last time, though the definition of fraud is widening to include all sorts of new-fangled e-crimes. The chief executive of one of the large UK banks listed the general rise in financial crime among his strongest concerns. Another respondent cited “fraud resulting from IT security failure”. A third thought the euro “provides the perfect conditions for it”, and a fourth pointed out that it always rises in recession.

A respondent from one of the large credit card companies supplied this disconcerting comment: “Hacking still not under control. A lot of work is being carried out, but there is defeatism in the air. The bad guys always seem to find a way round the most sophisticated defences.”

19. Currencies (16)

A moderate risk - much the same as last time, with concern strongest among non-bankers. Respondents see risk in macro-economic uncertainty and a sudden unwinding of “imbalances”. Diane Coyle of Enlightenment Economics warned: “The longer the big corrections are overdue, the worse it will be when they happen.”

The most frequently mentioned specific risk was the euro. Neil Record of Record Currency Management said: “I still think there is a nil-anticipated risk of exit by one of the euroland member states. The consequences are likely to be catastrophic for the banking system.” Another respondent had a similar concern: “EMU may cause instability from economies straining against each other, and from the continued uncertainty over the UK position”. And Robert Laslett of Charles River Associates saw the EMU Stability Pact “under threat”. Another respondent saw a longer term risk: “The deregulatory shock in Europe from the single currency and single market will probably expose the weak spots in the system, and throw up systemic threats.”

Other currency worries included sterling (which one respondent described as “supported by nothing more than hot air”), an excessively strong dollar, and the perilous position of the yen. One respondent thought emerging market currencies could cause problems.

20. Grasp of new technology (4)

Down a long way from last time because of the parallel decline in concern about e-commerce. The main message was that the top decision-makers in banks do not understand technology well enough to make the right choices. A respondent from a
Continental bank also made the following point: “Many organisations (not just in the financial sector) do not realise how dependent they are on tailor-made or workaround solutions developed by a few experts. When these people leave, their successors will take a long time to understand the workings of the programs (even if they have been fully documented) and may find it more economical to re-write the whole routine.”

21. Interest rates (18)

A relatively low risk, though two concerns emerged.

The most frequent was whether the world was ready for the inevitable rebound in interest rates. A financial regulator feared some institutions would get “caught on the turn”. John Ginarlis of CSC worried that “corporations and consumers have become convinced we are now in a low interest rate environment permanently. The US and Europe might face an unwelcome rise in interest rates, and there is some sign of interest futures starting to reflect these fears.”

But for some it was the opposite fear: that deflation would keep interest rates low and put a terrible squeeze on financial institutions. (See box)

The risk of deflation

Low or even falling inflation could have a devastating effect on the finance industry.

Chris Ellerton, banking analyst at UBS Warburg, said much the most important development for the banking system was the threat of deflation following the recent lending boom, particularly in property. A bank economist asked: “How will financial institutions deal with an environment of recession or slow growth with very low inflation or deflation? While short term interest rates are likely to be low, asset prices could fall further.” David Potter of the Noble Group saw banks “failing to appreciate and adapt to a non-inflationary (and probably deflationary) environment. This will be especially marked in the pensions and savings sectors.” David Bell, a director of Pearson, said: “Managing a bank in a zero (or even negative) inflation economy presents new challenges. The record of Japan is not exactly encouraging in this respect.”

Economist Graham Bishop said that “Low interest rates, specially at the longer end, will expose the high level of costs in the long-term savings institutions. This would lead to (a) heavy losses as they subsidise returns to the saver, (b) disintermediation and (c) unexpected consolidation. In turn, that impacts consumer confidence in these institutions just as they ought to be building up pensions funds.” Mario Cotto of San Paolo IMI commented: “After the pensions bomb, maybe an annuity bomb!” A clearing banker pointed out that low rates had the perverse effect of encouraging high risk ventures that promised higher yields.

Philip Warland of PricewaterhouseCoopers took a cautious long term view: “Too many people assume equity markets will perform in nominal and real terms as they have done over the past two to three decades. They will still be the best bet for the long term, but I would be happy with 2-3% real, i.e. a smaller gap over deposits than we have been used to.”
22. Commodities (19)

These remain a low source of concern. Several respondents mentioned oil as a worry, but in general, a fund manager said, “prices are likely to stay low”. Nonetheless, this was a Top Ten Banana Skin for users of the banking system.

23. Back office (20)

Little changed, probably because there have been no scandals or crises, but this is nonetheless viewed as a potential danger zone. One clearing banker described it as “an area of constant risk”. Martin Hall of the Finance and Leasing Association pointed up its vulnerability to terrorist attack. Another risk is the unfamiliar or unnoticed exposures it can create through outsourcing (now a growing regulatory concern). A further problem is the constant pressure it faces to cut costs, which can itself be a source of risk.

24. Rogue trader (24)

This risk has not altered at all, probably because of the absence of major incidents - other than “mis-keying”, which seems to be the new buzzword. But some respondents were looking further afield than the trading room. An investment banker wrote: “Standards in the investment banking business have been tightened up since the Barings collapse. The same would be hard to argue for the accounting industry where standards need to be carefully monitored. A post-mortem of Enron will probably clarify the gravity of the danger, but it is clear that lax auditing can allow substantial irregularities to perpetuate at a firm.” Another respondent thought the problem was “rogue directors” who were way out of their depth.

25. E-commerce (2)

Here’s a turnaround: in second place last time, way down this. The whole e-strategy worry list seems to have collapsed. As one respondent said: “No-one is focusing on ‘e’ any more.” Others said “not material” and “well down the agenda”.

If there was a concern, it was about exposure. One respondent pointed out that banks are carrying losses on their internet banking investments, and another said: “Banks which rely on internet banking are in difficulty.”

But several respondents saw a longer term risk in the banks’ half-hearted approach to e-commerce. The head of e-banking at a major Continental bank said that even if the hype was over, banks shouldn’t dawdle. Nick Collin, an e-strategy consultant, thought banks risked being overtaken by their failure to get to grips with e-commerce. “For example, the only person-to-person e-payment solution of any market share is PayPal - a non-bank. Even with B2B payments, the banks are still dithering over whether Identrus or Swift will run the scheme.”
Another e-commerce specialist said: “I am surprised that, with some notable exceptions, banks have not really started to build their businesses around it with anything like the resource/energy that will be needed…The impact on banking has barely begun.”

26. Merger mania (7)

A receding risk, though one with a long tail. Most of the respondents who listed this Banana Skin were concerned about the legacy of the 1990s’ merger mania. A banking consultant said “the frenzy has resulted in large complex institutions with a plethora of systems. The ability to manage such organisations in a coherent fashion must be questioned.” Karl-Olof Hammarkvist of Nordea, itself the product of many a merger, listed the risks:

- “increased operations risk e.g. incompatible systems, things falling between two stools, political in-fighting;
- unforeseen exposure increases in the merged credit portfolio;
- strategic risk from EU pressure for cross-border mergers.”

Another respondent took the theme a step further: “There is no satisfactory mechanism for the work-out of complex structured banks that get into trouble.” And a central banker commented: “Domestic consolidation of the financial industry and globalisation will lead to institutions that may be ‘too big to fail’ with consequences for public policy.”

But a lot of our respondents also felt that merger mania was far from over, if only because the recession would force the pace of consolidation in an over-supplied market. Several worried that future mergers would, on past history, destroy rather than create value, and lead to a loss of diversity in the system. Others said that consolidation had allowed small numbers of banks to dominate segments of the market, or to gain excessively high exposures to particular sectors.

An investment banker with a large French group worried about the creation of “a pan-EU high-tech banking leviathan”. He said: “Extrapolating forward the advent of the euro, one can envisage the creation of a pan-EU retail and wholesale banking group in the belief that the EU is a homogenous territory. To attract customers, particularly young ones, it would offer the most high-tech service. But being both unproven across borders and vulnerable to cyber fraud, it would rapidly lose touch with its customer base as its service collapsed.”

Managing the monsters

“One thing that has struck me with much force is the number of leaders of institutions who either do not understand the business they are in or the risks they are running. This is particularly true of the conglomerate banks, especially when they are focusing on building particular parts of the business. Their assessment of the upside is always more rigorous than the downside. Not a systemic issue, but I guess there are fewer and fewer people who can manage these monsters.”

Banking consultant
27. Payment systems (25)

The risk ranking remains low, perhaps surprisingly so given the worries that were expressed about the concentration of US payment and settlement systems post-September 11.

A regulator wrote: “We continue to experience periodic IT problems with key infrastructure providers. There is a risk that these could occur in a volatile, fast-moving market and cause wider problems.” A lawyer also pointed up the continuing legal risks: “International clearing and settlement systems operate in a world where there is little coordination between operations and the regulatory and legal background. This produces problems for the system as a whole and, consequently for the individual participants.” Kathleen Tyson-Quah of Granularity also worried about the liquidity impact as continuous linked settlement systems came on stream.

However John Trundle, head of the division for financial stability at the Bank of England, said that progress was being made at both domestic and international levels. “In the UK, we need to get money market instruments settled in a ‘delivery versus payment’ process. Internationally, the big infrastructure risk remains foreign exchange settlement. Continuous linked settlement, which plans to go live in the middle of 2002, offers the best prospect of substantially reducing that risk.”

This seems to be a shrinking Banana Skin because, as a trade association official put it, “market conditions take care of it”, and bonuses are cut in a recession.

But some respondents saw bonus cuts themselves as a new danger. “Falling bonuses can be as dangerous as rising ones!” said a regulator. “Managing [staff bonus] expectations after a decade of unrepeatable boom will be a real challenge”, said an investment banker. Another respondent warned that staff motivation problems “could rise with recessionary disappointment”.

Bring back Glass-Steagall

Should investment banks be getting into the loan business? Some respondents thought this was asking for trouble.

A German investment bank representative wrote: “In the US we have seen how ‘bulge bracket’ securities houses are being forced to make loans to their largest corporate clients in order to be eligible to earn more fees from them. This looks to be a trend that will continue and spread to Europe. We have begun to see the consequences of Enron’s failure on the banks, but an unexpected failure of a number of huge blue chip companies in the US or Europe could now make large holes in the balance sheets of investment banks as well as commercial banks.”

A Swiss banker wrote: “As investment banks start lending money and get closer to really big balance sheets, hold on to your wallets!”
29. Environmental risk (29)

Fears of global warming and ecological catastrophe have not much altered the perception of the environment as a low financial risk, though it is rated as a riser. “There’s greater world awareness”, said one respondent.

Respondents saw this variously as an insurance risk, a legal risk or as a reputation risk. Peter Hughes of The Smart Company widened the question to include corporate social responsibility, and wondered whether banks had built this into their risk management effectively enough, now that investors were becoming more discriminating.

Answer probably no. A UK clearing banker commented: “The attempt to pressure business into adherence to codes focused on social, environmental and ethical issues is seen as a negative development.”

30. Competition from new entrants (9)

This has receded dramatically from its high place in the last survey, probably because of a shift of emphasis. The problem this time round is not so much new entrants to banking, as non-entrants - i.e. competitors wholly outside the banking system (though given the Enron factor, it is surprising that this Banana Skin ranked so low).

The chairman of a European bank wrote: “The proliferation of financial service providers, mainly non-banks and new specialised entrants largely lacking a seasoned banking mentality and a commitment to soundness, does present a challenge. Supervisory authorities cannot afford to stay a step behind financial innovation any longer.”

This view was shared by a UK banker who worried about “the impact of new participants in financial markets many of whose activities are not transparent and not adequately regulated or controlled, e.g. hedge funds, debt traders, insurance companies”. With Enron in mind, John Plender of the FT wrote: “More financial business capable of posing a systemic threat is taking place outside the heavily supervised parts of the system. Innovation is leaving regulation further and further behind.” Fields Wicker-Miurin of Vesta Capital asked: “How, where do you capture information that would affect markets and increase systemic risk?” Michael Mainelli of Z/Yen said the rise of quasi-financials heightened the problem of counterparty risk.

Some respondents worried about the impact of new entrants on the UK banking market. One banker listed his main concern as “income and funding threats from continuing pressure on savings rates for traditional retail banks in competition with newer providers with lower cost structures”. A regulator also raised the rising threat of new entrant competition in two other areas: exchanges and clearing houses.
Preparedness

Financial institutions appear to be much better equipped to handle this downturn - that seems to be the opinion of bankers and of those who observe and regulate them. Of our respondents, 72 per cent thought institutions were moderately well prepared or better to handle the risks they identified, up from only 51 per cent in the 2000 survey. Much of this increase was, admittedly, due to bankers themselves expressing greater confidence. But regulators and observers also gave a more upbeat response than in 2000.

The two reasons most frequently cited for greater confidence were the healthy capitalisation of the banking sector, and the large amount of work that had gone into risk management. Kathleen Tyson-Quah said: “The controls and sophistication of international financial markets are much improved over the past decade. Most banks are rigorous in monitoring their risks and wary of excess in the current environment. While there is weakness and room for improvement in some quarters, many bankers can take pride in the professionalism and good practice they have developed since the last big downturn.”

A UK banker said “We are better prepared than at any time over the last decade”, while a US banker said banks “have a good balance of statistical methods, and senior management is continuously engaged”. But while many respondents said they felt confident about their own institutions, they expressed wariness of others, though the

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A senior executive of one large international banking group said: “Others? I feel more confident about them, though I have done for a long time. People, managements are more prudent than they have been, are more conscious of returns and risks.”

The pessimists focused on the temptation to take short cuts, or turn a blind eye to risk in order to generate earnings. “Some senior managements don’t fully understand the market malaise”, said a respondent from the investment banking side. “The thinking is happening, but in a cost-cutting environment it is not easy to get decisions agreed”, said a banking consultant.

Something that is clearly new post-September 11 is the awareness of extreme risk. “I worry about extreme scenarios, terrorism”, a banker confessed. “The biggest question is whether the complexity and chaotic nature of events now can be handled collectively by institutions when/if something unwelcome happens”, said another. “Plans will mitigate but not remove risks”, said a third.

A number of respondents said that their concern was not so much about the banking sector as insurance because of the uncertainty and pressures on capital. Some also said that they felt more confident about the ability of regulators to handle a sharp downturn.

The final word

“I have spent 30 years looking at real crises and at crises that people imagined were going to happen. The real crises were always much less significant than people thought at the time. The imagined crises were always much worse than anything that actually happened.

“The market economy is very robust. Why people assume it will fail is difficult to understand. It will not fail. Over-regulation and government interference can make financial markets less efficient - and will do so in the UK and Europe over the next three years. That will pass when people see the costs it brings.”

Kenneth King
Managing director
Rexiter Capital Management
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 Balls. September 1993. £40/$65

2. "Derivatives for the retail client": A proposal to permit retail investors access to the risk management aspects of financial derivatives, currently available only at the wholesale level. By Andrew Dobson. Nov 1993 (Only photostat available) £10/$15

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

6. "UK financial supervision": A radical proposal for reform of UK financial regulation, (prepared pseudonymously by a senior commercial banker), May 1994 £25/$40

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


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