Banana Skins 2000
The CSFI's annual survey of the risks facing banks

Sponsored by

CSFI
Centre for the Study of Financial Innovation
The Centre for the Study of Financial Innovation is a non-profit think-tank established in March 1993, to look at future developments in the international financial field - particularly from the point of view of practitioners. Its goals include identifying new areas of business, flagging areas of danger and provoking a debate about key financial issues. The Centre has no ideological brief, beyond a belief in open and efficient markets.

**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.
Banking banana skins: 2000

Foreword  Andrew Hilton, director, CSFI.

This is the sixth Banana Skins survey we have published; it is also, I think, the most interesting – not least because we now have a bit of a history with which to compare this year’s results. Add to that a tad more sophistication when it comes to the statistical analysis (thanks to PwC’s hands-on support), and there are real lessons to be learned.

I would point to two tables in particular:
- Table 7, which shows how bankers’ priorities have changed since 1996. Since some of the responses are prompted (and the prompts reflect an a priori judgment of what we think might be important), one must be cautious about comparisons. But it seems clear that respondents today are less concerned about risk management in general – but a lot more concerned about asset quality and the coming equity crash.
- Table 2, new this year, confirms this. Respondents were asked to rate risks by whether they were rising or falling. Correcting for the normal tendency to assume the worst, it is clear that asset quality and equity fears are top of the list – together with a rather amorphous group of issues related to management’s grasp of new technology.

All of this is discussed in his useful lively style by my colleague, David Lascelles. He is too modest to say so, but he still has great pulling power in the City. When he writes of a respondent that he is a “senior banker” or a “senior regulator”, be assured that these are household names; this really is a harvest of top peoples’ opinions.

In addition to the general perceptions of threat (which is probably the best reason to read David’s paper carefully), there are lots of little nuggets to be mined. Several made me stop and think:
- the vulnerability of the UK stock market to just two shares (BP Amoco and Vodafone Airtouch);
- the way that technology can concentrate risk, particularly at the back end;
- David Llewellyn’s rather neat observation that, in the financial services sector, “entry barriers are declining faster than exit barriers”;
- the threat of cross-border legal conflicts since global financial institutions have to operate under different (and perhaps incompatible) legal rules;
- equally, the obvious mismatch between global players and parochial regulators;
- the lack of a clear lender of last resort in the EU;
- the impact that a prolonged period of low interest rates is going to have on annuities, pensions etc.;
- the fact that employee compensation/gross revenue ratios in most investment banks are now routinely over 50%; and
- the prospect that black marketeers will have to change all their eurozone banknotes into euros before 2002.

Equally, the lack of concern about (in particular) payment systems and environmental risk is striking.

All of this is food for thought. I am grateful to David for having spent so much time working on the paper, to all the 192 respondents, and to PwC for providing both funding for the project and invaluable technical assistance.

This report was written by David Lascelles
It was made possible by sponsorship and technical assistance from PricewaterhouseCoopers
About this survey

The survey was conducted in April 2000. We sent out 1,000 questionnaires and received 192 replies, a response rate of just under 20 per cent. The questionnaire (reproduced in Appendix I) was in two 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. They could also add extra Banana Skins of their own. The one most frequently added was “asset quality”, and this has been added to the tables. Replies were confidential, but respondents could indicate whether they were willing to be identified.

The breakdown of respondent by type was:

- Bankers  89
- Customers  21
- Regulators  20
- Observers  60
- Unknown   2

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

- Belgium  1
- Finland  1
- France   4
- Germany  4
- Greece   2
- Ireland  2
- Italy    2
- Japan    9
- Malaysia 1
- Multinational  9
- Netherlands  3
- Sweden   1
- Switzerland  5
- UK1     21
- US      25
- Unknown  2
Executive summary

Banana Skins 2000 is the latest in the CSFI’s regular surveys that identify major threats facing banks over the next few years by asking the experts themselves. The survey is based on the responses of nearly 200 top bankers, regulators and close observers of the financial scene in Europe, North America and the Far East. Responses were received during April and May 2000.

The survey ranks 30 Banana Skins by their severity – and by whether they are becoming more of a threat, or less.

The main points are as follows.

• A collapse of equity markets is much the strongest concern. Banks increasingly have a direct exposure to the stock market, and any fall in prices there has a direct impact on their balance sheets. Their growing involvement with the volatile Internet and technology sector also makes them increasingly vulnerable to e-business shocks.

• The risk of economic overheating in the industrial economies, particularly the US, raises the potential for an equity market crash.

• The rapid evolution of e-business threw up several growing Banana Skins. Will banks be able to stay on top of a fast-changing marketplace, or will they be cut out by aggressive newcomers? Concerns in this area focused on the soundness of banks’ e-strategies and their grasp of technology issues. Failure on either front could be very expensive in terms of profitability and market share.

• Banks are responding to these challenges in potentially worrying ways. For example, they are seen to be cutting their lending standards to protect their market position – and this is stimulating concern about the quality of bank assets. Another response is the wave of mergers and acquisitions which is sweeping the industry and creating monster conglomerates which may be too big to manage.

• Banking regulation is seen to be increasingly effective at reducing Banana Skins at the domestic level, but poor international co-ordination is a concern. There are also indications that too much, rather than too little, regulation may be turning into a Banana Skin by piling on costs and distracting management.

• However the survey shows that many earlier Banana Skins are now shrinking: hedge funds, emerging markets and rogue traders which loomed large in previous surveys now come some way down the list.

• The survey also suggests that banks may now be better equipped to handle risk than before. The quality of risk management, which was the No 1 Banana Skin in the last survey, has slipped off the Top Ten. Just over half the respondents (51 per cent) thought that banks were at least moderately well prepared to handle the big Banana Skins. However the remaining 49% ranked preparedness as mixed or worse – indicating some disagreement in this area.
Banana Skins 2000

The Banana Skins in this report come not singly but in bunches - two to be exact. One is change: e-commerce, new competitors. The other is the immediate peril: toppy asset prices.

These challenges were summed up by the group risk director at a large UK clearer who said: “This is a period of extremely high strategic risk for the industry. There is no question that the Internet will result in big winners and losers, and the business models that are currently being developed will weed out the industry in a big way.

“Combined with this we are seeing plenty of signs of traditional banking problems which could emerge over the next couple of years if we get a market crash in the US and a downturn in the UK economy. Overall, not a very comfortable time.”

Table 1 shows how respondents ranked 30 Banana Skins by the severity of the threat they posed to banks. The message is clear. An equity crash may be top of the list. But the structural impact of new technology and rising competition poses a much more fundamental challenge to the banking industry.

On the other hand, many of the Banana Skins people worried about in the not-too-recent past, like hedge funds, emerging markets and the rogue trader, feature less prominently. System soundness questions such as regulation, payment systems, back office, risk management etc. are also secondary concerns.

Risers and fallers

What’s up, what’s down? The Banana Skins to worry about are not just the big ones, but the growing ones.

Table 2 tells another story. Here, respondents rank Banana Skins by whether they are rising, steady or falling compared to this time last year. The higher they are on the list, the faster they are thought to be rising. The lower they are, the faster they are falling.
The message here is that concern about the quality of bank assets (loans, investments etc.) is growing faster than well-worn fears of a crash on Wall Street. Other fast risers are competition from new entrants, money laundering, pay incentives and environmental risk.

The fallers are also notable: emerging markets, hedge funds and our old friend the rogue trader. Y2K was a complete non-risk so far as our respondents were concerned.

How well-prepared are banks to meet these risks?

Just over half our respondents (51 per cent) thought they were moderately well prepared or better. Only 13 per cent thought they were poorly prepared or worse. The rest said it depended on individual banks or countries. Richard Farrant, chairman of the UK’s Banking Code Standards Board said: “My concerns have diminished in the last year. Banks have become more experienced in handling high market volatility, and understand the nature of new technology-driven competition better. No doubt there will be winners and losers, but I am more confident they will emerge without major crises.”

Table 2

<table>
<thead>
<tr>
<th>1</th>
<th>Asset quality</th>
<th>Rising</th>
</tr>
</thead>
<tbody>
<tr>
<td>2</td>
<td>Equity market crash</td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>E-commerce risks</td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>Competition from new entrants</td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>High dependence on technology</td>
<td></td>
</tr>
<tr>
<td>6</td>
<td>Grasp of new technology</td>
<td></td>
</tr>
<tr>
<td>7</td>
<td>Economy overheating</td>
<td></td>
</tr>
<tr>
<td>8</td>
<td>Merger mania</td>
<td></td>
</tr>
<tr>
<td>9</td>
<td>Banking market over-capacity</td>
<td></td>
</tr>
<tr>
<td>10</td>
<td>Unsound new entrants</td>
<td></td>
</tr>
<tr>
<td>11</td>
<td>Fraud</td>
<td></td>
</tr>
<tr>
<td>12</td>
<td>Economic downturn</td>
<td></td>
</tr>
<tr>
<td>13</td>
<td>Interest rates</td>
<td></td>
</tr>
<tr>
<td>14</td>
<td>Commodities</td>
<td></td>
</tr>
<tr>
<td>15</td>
<td>Staff pay incentives</td>
<td></td>
</tr>
<tr>
<td>16</td>
<td>Money laundering</td>
<td></td>
</tr>
<tr>
<td>17</td>
<td>Environmental risk</td>
<td></td>
</tr>
<tr>
<td>18</td>
<td>Front office selling practices</td>
<td></td>
</tr>
<tr>
<td>19</td>
<td>Complex financial instruments</td>
<td></td>
</tr>
<tr>
<td>20</td>
<td>Back office operations</td>
<td></td>
</tr>
<tr>
<td>21</td>
<td>Currencies</td>
<td></td>
</tr>
<tr>
<td>22</td>
<td>Risk management</td>
<td></td>
</tr>
<tr>
<td>23</td>
<td>International regulation</td>
<td></td>
</tr>
<tr>
<td>24</td>
<td>Payment systems</td>
<td></td>
</tr>
<tr>
<td>25</td>
<td>Political shocks</td>
<td></td>
</tr>
<tr>
<td>26</td>
<td>Rogue trader</td>
<td></td>
</tr>
<tr>
<td>27</td>
<td>Emerging markets</td>
<td></td>
</tr>
<tr>
<td>28</td>
<td>Hedge funds</td>
<td></td>
</tr>
<tr>
<td>29</td>
<td>Domestic regulation</td>
<td></td>
</tr>
<tr>
<td>30</td>
<td>Y2K aftermath</td>
<td>Falling</td>
</tr>
</tbody>
</table>
Who said what

A breakdown of the results by type of respondent produces some twists.

**Bankers**

Bankers put a crash on Wall Street at the top of the list, but their concerns about asset quality were lesser. Technology and e-commerce issues were also prominent, as were the threats from new entrants to the business and over-capacity in the banking market. Risk management, regulation, hedge funds and emerging markets were way off the radar screen.

**Users**

Users of the banking system (corporate treasurers, financial service providers etc.) were concerned that banks were allowing their asset standards to slip. They also worried whether banks could master all the new technology.

Few concerns here about new entrants, presumably because users benefit.

**Regulators**

Regulators were concerned with the balance sheet: the quality of bank assets and the impact of a market crash. They were also the only group who put risk management in their Top Ten. Among strategic issues, they also queried the banks’ e-strategies and the fashion for mergers. They seemed less concerned about competition issues: market over-capacity and the arrival of new entrants.

No concerns about the quality of regulation, either.

---

**Table 3**

<table>
<thead>
<tr>
<th>Rank</th>
<th>Concern</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Equity market crash</td>
</tr>
<tr>
<td>2</td>
<td>E-commerce risks</td>
</tr>
<tr>
<td>3</td>
<td>Asset quality</td>
</tr>
<tr>
<td>4</td>
<td>Banking market over-capacity</td>
</tr>
<tr>
<td>5</td>
<td>Grasp of new technology</td>
</tr>
<tr>
<td>6</td>
<td>High dependence on technology</td>
</tr>
<tr>
<td>7</td>
<td>Complex financial instruments</td>
</tr>
<tr>
<td>8</td>
<td>Economy overheating</td>
</tr>
<tr>
<td>9</td>
<td>Merger mania</td>
</tr>
<tr>
<td>10</td>
<td>Competition from new entrants</td>
</tr>
</tbody>
</table>

**Table 4**

<table>
<thead>
<tr>
<th>Rank</th>
<th>Concern</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Asset quality</td>
</tr>
<tr>
<td>2</td>
<td>Equity market crash</td>
</tr>
<tr>
<td>3</td>
<td>Grasp of new technology</td>
</tr>
<tr>
<td>4</td>
<td>E-commerce risks</td>
</tr>
<tr>
<td>5</td>
<td>Banking market over-capacity</td>
</tr>
<tr>
<td>6</td>
<td>Merger mania</td>
</tr>
<tr>
<td>7</td>
<td>High dependence on technology</td>
</tr>
<tr>
<td>8</td>
<td>Economy overheating</td>
</tr>
<tr>
<td>9</td>
<td>Fraud</td>
</tr>
<tr>
<td>10</td>
<td>Complex financial instruments</td>
</tr>
</tbody>
</table>

**Table 5**

<table>
<thead>
<tr>
<th>Rank</th>
<th>Concern</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Asset quality</td>
</tr>
<tr>
<td>2</td>
<td>Equity market crash</td>
</tr>
<tr>
<td>3</td>
<td>E-commerce risks</td>
</tr>
<tr>
<td>4</td>
<td>Merger mania</td>
</tr>
<tr>
<td>5</td>
<td>Risk management</td>
</tr>
<tr>
<td>6</td>
<td>Economic downturn</td>
</tr>
<tr>
<td>7</td>
<td>High dependence on technology</td>
</tr>
<tr>
<td>8</td>
<td>Fraud</td>
</tr>
<tr>
<td>9</td>
<td>Grasp of new technology</td>
</tr>
<tr>
<td>10</td>
<td>Complex financial instruments</td>
</tr>
</tbody>
</table>
Observers

Observers (analysts, academics, consultants, journalists, lawyers, accountants) focused on the immediate threats: a market crash and declining asset quality. But the big issues were also high on their list: technology, restructuring and competition. They were the only group who included concerns about regulation in their Top Ten, but they attached little importance to risks in emerging markets and hedge funds.

Some Banana Skins are topical, others go on for ever. The Top Ten since 1996 (table 7) shows the Banana Skins that came and went: the rogue trader, emerging markets, EMU, Y2K… It also shows that poor management is no longer a specific concern, though it is wrapped up in a lot of the new Banana Skins: e-commerce strategy, technology management and merger mania.

A hardy perennial is the intensity of competition (over-capacity, new entrants, cross-border competition) and the risks that go with it: bad lending and falling asset quality.

The record also highlights the recent surge in technology management concerns. In the first two surveys, the main technology worry was that systems would pack up. Grasp of technology only emerged as an issue in 1998, to hit the No 4 spot in 2000, along with complete newcomers: e-commerce and technological dependence. The trend suggests that, despite topical concerns with a market crash, the big risk questions centre on the management of technology.

Table 7

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Poor management</td>
<td>Poor management</td>
<td>Poor risk management</td>
<td>Equity market crash</td>
</tr>
<tr>
<td>2 Bad lending</td>
<td>EMU turbulence</td>
<td>Y2K</td>
<td>Asset quality</td>
</tr>
<tr>
<td>3 Derivatives</td>
<td>Rogue trader</td>
<td>Poor strategy</td>
<td>Grasp of new technology</td>
</tr>
<tr>
<td>4 Rogue trader</td>
<td>Excessive competition</td>
<td>EMU turbulence</td>
<td>High dependence on technology</td>
</tr>
<tr>
<td>5 Excessive competition</td>
<td>Bad lending</td>
<td>Regulation</td>
<td>Banking market over-capacity</td>
</tr>
<tr>
<td>6 Emerging markets</td>
<td>Emerging markets</td>
<td>Emerging markets</td>
<td>Merger mania</td>
</tr>
<tr>
<td>7 Macroeconomic threats</td>
<td>Fraud</td>
<td>New entrants</td>
<td>Economy overheating</td>
</tr>
<tr>
<td>8 Back office failure</td>
<td>Derivatives</td>
<td>Cross-border competition</td>
<td>Competition from new entrants</td>
</tr>
<tr>
<td>9 Technology foul-up</td>
<td>New products</td>
<td>Product mis-pricing</td>
<td>Complex financial instruments</td>
</tr>
<tr>
<td>10 Fraud</td>
<td>Technology foul-up</td>
<td>Grasp of technology</td>
<td></td>
</tr>
</tbody>
</table>

Table 6

| 1 Equity market crash   |
| 2 Asset quality         |
| 3 E-commerce risks      |
| 4 Grasp of new technology|
| 5 High dependence on technology |
| 6 Merger mania          |
| 7 Banking market over-capacity |
| 8 Economy overheating   |
| 9 Competition from new entrants |
| 10 International regulation |
1 Equity market crash

No surprise that this was the Big Banana Skin. But our respondents struggled to say anything new. Wall Street is hugely overvalued, the technology bubble will burst, there will be a terrible mess… er that’s it.

But what sort of a crash will it be? Messy. “The huge increase in securitisation relative to the banking system has created much greater volatility”, wrote a currency specialist. “In a serious correction this could lead to great instability and insolvencies”. The chairman of a large insurance company agreed. “The size of security inventories at the major international securities houses together with the volatility of markets could jeopardise the stability of any such house.” Another banker worried about Japanese and European asset-backed securities which carried a large liquidity risk for their holders, mainly supra-nationals. A regulator wondered whether mark-to-market rules would make things worse.

An economist said that there were now potentially far more illiquid stocks around because the exchanges had relaxed listing rules in the drive to attract new names. In the City, a merchant banker pointed out that the London market was at the mercy of only two stocks: BP Amoco and Vodafone Airtouch. With the large proportion of UK savings in tracker funds, any further decline in these stocks could lead to “a self-fulfilling bear market”.

Several respondents highlighted the impact of a crash on the insurance industry. A regulator saw “growing pressure on the solvency of life insurance companies as a result of higher historic liabilities against falling yields and asset prices (especially if equity and property prices fall in value)”. A clearing banker thought a break in the equity market “could destabilise the insurance industry and radically affect the savings market”.

Given that only two out of our 192 respondents saw the threat of an equity crash declining over the next 2-3 years, it has presumably been well flagged. But has it? A merchant banker wrote: “Risk has been forgotten about in this seemingly endless bull market.” A UK regulator wrote: “Banks have - we hope - adopted trading strategies...

When the bubble bursts

The key problem is the Wall Street bubble. This has, as always, been driven by a major growth in debt. When the bubble breaks, financial institutions will be very vulnerable for several reasons:

1. The bubble has depressed savings and stimulated investment. When the bubble breaks, savings will rise sharply and investment will fall. The resulting demand gap will not respond readily to lower interest rates, as it never does when asset prices fall. The next recession is therefore likely to be particularly severe.

2. Leverage has risen throughout the private sector. The combination of an unusually severe recession and excess debt will lead to many bankruptcies.

3. As the stock market has risen relative to GDP and derivative markets relative to the stock market, delta hedging will probably be impossible when the bubble breaks. As the law of large numbers has led to increasing concentration in the derivatives dealing, the risk of a major investment bank going bankrupt is high.

Andrew Smithers
Smithers & Co.

It could be messy...
which are sufficiently robust to cope with disruptive adjustments in these markets. But as time goes by there is a temptation to relax previously-agreed guidelines.”

Prof. David Cope of the UK’s Parliamentary Office of Science and Technology, put a different spin on the problem: “Science is going to deliver dramatic improvements in the quality of life in the near future. Entrepreneurs in these areas need to be able to seek funds in a calm and calculating setting, not one distorted by inflated over-expectations or deep post-crash cynicism.”

2 E-commerce risks

E-risks are the big newcomer to the Top Ten. They come in two shapes.

1. E-strategy disasters

A banking supervisor feared “disastrous entries into new technology by established firms that just can’t ‘hack it’ in the new world”. John Howell of CCL thought “the restructuring of the business will inevitably involve mistakes and cause hiccups”.

Does e-banking even work? “E-banking is proving costly to deliver, unprofitable, and open to fraud”, said the group head of finance at a large multinational bank. Richard O’Brien of GBN Europe thought that banks would find themselves unable to cope “in the ‘new economy’ of products and services being given away”. A financial regulator said that banks had traditionally made their money by overcharging and trying to “fool all of the people (and regulators) all of the time”. How would they make money in a new world of “informed, reasonably alert customers”?

Customer take-up is low. Several respondents feared that the “clunkiness” of the e-banking offering would only reinforce customers’ anti-bank prejudices, and that customer relationships would be undermined. A merchant banker said that traditional banks “risk being disconnected from their customer base on the retail side while being left with the wrong sort of corporates on their asset book. They could so easily be all washed up in three years’ time, with nowhere to go.” Robert Bennett, group finance director at Northern Rock, saw the shift to e-commerce “leaving existing banks in a no-win situation. If we keep branches open, our costs and viability are adversely affected. If we close them, customers complain that their service is reduced.”

The chairman of a UK clearing bank said that poor security and botched customer relationships raised the risk of a major loss of confidence and/or scandal. “The emotional over-reactive response to such an episode might well be extreme and long-lasting.” The director of a large fund management group thought all these trends “depersonalise banking and intensify moral hazard”. A Scottish banker also worried about the impact on the banks’ commercial customers: would they be able to compete in e-space, and were banks capable of assessing companies whose wealth lay in intellectual capital rather than buildings and machinery?

All in all, an Irish banker doubted “the ability of banks to cope with shareholder expectations regarding the Internet as a business channel”.

But there is a dilemma here because a good minority of respondents thought the biggest risk for banks was being left behind. A Japanese investment banker said that laggard banks “will look like dinosaurs”.

E-banking is clunky, unprofitable and open to fraud
Mario Cotto of San Paolo IMI said the dilemma was not just e-banking but the whole future of retail banking in Europe. “In Germany it is not profitable and there is a school of thought which says ‘leave this to other competitors’. In the UK small branches are being closed down and clients are being invited to deal with the post office. What is the future for retail outside big centres?…Is it possible to beat the Americans? If not, how much energy is being wasted?” His thoughts were echoed by a Continental bank chairman who worried about the slow pace of adaptation in Europe. “As such it is being left behind the US where more profound changes are taking place in financial services due to developments in internet banking, e-commerce etc.”

But is it all bad? A respondent from a large Continental banking group said his fears “are somewhat mitigated by my expectation that major/large traditional banks will get their e-strategies implemented in time”.

2. Safety of e-commerce

Many respondents, like Ian Mackintosh at Standard & Poor’s, saw “systemic threat arising from an e-banking incident”. A City lawyer said “a big increase in [Internet] use combined with only a small decrease in security risks leaves a net rise in risk”. Another respondent said that regulators would have to watch out because “some senior managements may be found wanting” on e-risk control.

Several respondents stressed that regulators should work more closely at the international level to pin down financial service providers - stockbrokers as well as banks - who used the Internet to become “homeless” and escape regulation. But some people thought the risks were too small to destabilise the system, and in any case were rapidly becoming better understood.

The security of e-commerce itself is still widely doubted, with obvious repercussions for banks through hacking, technology failure and fraud. A UK banker said: “The internet could become an unsafe transaction area, the public blaming it on the banks.” A risk analyst thought that banks’ eagerness to get into the market “is overriding the process of performing a basic risk analysis. Only one bank even has an e-bank function specialising in the risks inherent in e-business.”

But others saw security issues opening up new business avenues for banks - provided they moved fast enough. John Bullard of Identrus, the digital identity consortium, thought it was a matter of banks breaking out of the “country-by-country” mindset “to reinvent their role around digital identity”. But Nick Collin, a consultant specialising in Internet security, said banks might lose the whole
e-trust business - possibly even their status as “trust agents” - to the likes of Microsoft unless they came up with a workable scheme very soon.

3 Asset quality

Banks are letting the good times go to their heads, judging by the strong fears expressed about the precariously of their assets.

Concern rolled in from all quarters. From the US, bank analyst Ray Soifer reported “a marked deterioration in lending practices and credit standards”. In Japan, Andreas Prindl, former chairman of Nomura Bank International, said the stronger stock market and the mega-mergers “disguise the fact that much of the trillion bad debts in the banking system are still there, and the big construction companies are near to bankruptcy too”. In Europe, large Continental banks, particularly the Germans, have acquired uncomfortably large exposures to the high technology sector. And in the UK, Michael Green, director of group risk management at Lloyds TSB, saw “lax lending leading to over-indebtedness during what is currently a benign and forgiving lending climate”. Richard Heis of KPMG said that financial institutions still had incentives to be unhedged to get greater returns.

Antony Elliott, group risk director at Abbey National, described the competitive environment as “not conducive to financial institutions exercising restraint”. He warned: “The worst excesses will only become apparent in a downturn.” John Ginarlis of CSC worried that not only banks but their customers were “completely forgetting all the lessons of 1988-89, and the over-leveraging and negative net equity which followed”.

Many respondents attacked what they saw as rash lending to trendy sectors. A fund manager with one of the large US investment banks highlighted internet and telecommunications ventures “where cash flows will be negative for the next five years. If liquidity were to dry up, investors might suffer significant losses.” Nick Carn of fund managers Alliance Capital agreed: “A buoyant capital market and very high levels of venture investment will lead to over-capacity and widespread bankruptcies, particularly as many of these ventures are cash flow negative.” A bank analyst said: “Selectively, the scale of investment by banks in private equity funds has become alarming.”
Shelagh Heffernan of City University Business School said the lack of information about the viability of dot.coms “could easily undermine financial systems”. And a German banker thought “it would be salutary to publish the cumulative negative net worth of household names in areas such as mobile phones”.

Other questionable lending included mortgages, where banks are advancing 100%+ of valuations at what could be the top of the cycle, and margin lending in the stockbroking community which only makes matters worse by fuelling over-exuberance.

Several respondents felt the bad lending problem was exacerbated by an over-reliance on automated and untested credit scoring systems. One described credit risk management as “comatose”.

There were a few dissenting voices. A UK clearing banker thought “conventional risks, namely credit and price risk, are now much better managed”.

### 4 Grasp of new technology

Do people really understand what’s going on in the brave new world? Views inside and outside the industry differ sharply.

The outsiders are very negative. They see bankers rushing into e-commerce without a grasp of either the technology or the issues, - and their level of understanding may actually be falling. Michael Mainelli of Z/Yen said “few European bankers understand technology, and delegate too much”. And it’s a top-level problem. “Old management may be aware of the risks of losing business, but doesn’t understand technology well enough to produce the right answers”, said Anthony Loehnis, an adviser to Tokyo Mitsubishi International.

As for the consequences… “Ignorance equates to business risk”, said one respondent. Another foresaw a shake-out. “Rapid technological change highlights over-capacity; some players will get it wrong and exit.”

But the chief executive of a large UK bank, while agreeing that technology grasp was an acute problem, felt it was easing as bankers gained in understanding.

### 5 High dependence on technology

The finance industry’s fast-growing dependence on technology is a new Banana Skin, and rising strongly. “Banks are now totally dependent on technology, yet few
senior managers or senior committees devote enough time to the risks related to that technology”, said a senior executive at a large US multinational banking group. This is not just a matter for the banks, but for customers who rely on them.

What are the risks of high dependence?

The unknown: “The danger to financial institutions comes from a mix of volume and complexity, which can only be managed by means of technology, on which we become increasingly dependent. Everything appears to be in order until an unexpected external event occurs which makes a nonsense of previously respected models and behaviour patterns”, said a London stockbroker.

Crime: denial of service attacks, technological fraud, security breaches. The potential for misuse was “huge”, said a banking respondent. Viruses are another worry. A US investment banker said “As was shown by Melissa, when a new virus is developed, the industry responds quickly, but the effects can be devastating”.

More weak spots in the system: John Gilligan of City Consultants said the launch of new services such as automated dealing “will often be achieved by bolting on new satellite systems for expediency, thus creating additional points of failure”.

Concentration: technology’s ability to destroy diversity. One respondent wrote of “the potential for technology to lead to a concentration of risk, for example when payment systems come together, or whole segments of the industry rely on similar hardware and software”. On the investment banking side, there was concern about “the consolidation of settlement and clearing, plus rising use of systems for trading platforms”.

Some respondents were more optimistic, stressing the gains in both understanding and systems security resulting from Y2K work.

6 Banking market over-capacity

Fears that there are just too many banks are rising strongly. David Kern, group chief economist at NatWest (which did its bit to ease the problem by merging with Royal Bank of Scotland), said: “Many of the specific banking sector risks reflect over-capacity, increased competition, reduced entry barriers and a heightened merger mania.”

Some respondents thought new entrants were getting into the market too easily. “Entry barriers are declining faster than exit barriers!” quipped David Llewellyn,

Technology destroys diversity

Building tomorrow’s banks

The continuing scope and scale and pace of technology development is going to be very hard for banks to keep up with managerially and financially. They will have to deconstruct their business, disintermediate themselves and dismember their personnel (including their management) to create the successful financial firms of the future. The component parts of today’s banking (personal, private, commercial, capital and investment) will need increasingly distinct and differentiated approaches. The banks of tomorrow will be as different from today’s as today’s are from those of the 1960-70s.

Chairman
UK merchant bank
professor of banking at Loughborough University. Rising competitive pressures were forcing financial institutions to cut their loan margins and take greater risks. One respondent saw “the usual cycle of increased profits leading to greater lending, leading to disaster”.

But others took comfort from the fact that the industry seems to have embarked on a phase of consolidation which will ease the problem, particularly in Europe where it is most acute (though merger mania was itself a big Banana Skin. See No 7.)

7 Merger mania

People are increasingly worried about mega-deals. The chairman of a leading UK investment bank said: “The pace of consolidation is increasing. Will this make the larger institutions more difficult to manage for its senior executives, more impenetrable for its regulators, and more politically vulnerable?” Concentration was also a bad thing. Michael Feeny of Sumitomo Bank saw “a monopoly of the markets by the chosen few”.

Loss of control. Many respondents saw management being deflected from running the business. Steve Davis of DIBC said the merger wave heightened operational risk. “The management problems at UBS - a merger ‘made in heaven’ - are a case study of such cock-ups.”

Can the resulting conglomerates even be managed? “Top management cannot know enough detail of the business or people. They become part of a machine to earn profits without regard to customer responsibility”, said City MP Howard Flight. And do they create value? A candid front-line comment came from Karl-Olof Hammarkvist of Merita Nordbanken: “Just now being involved in a major merger, I can see how easy it is to destroy value. The world simply gets too complicated.” One respondent thought the merger wave would be followed by a “cracking up wave”.

Then there is the supervision issue. Financial journalist Majorie Deane said “supervisors will have to accept internal risk management which may be unequal to the task”. A Continental banking supervisor put “the digestion of mergers” on his list of concerns.

Several respondents focused on Europe’s politically-inspired drive to create “national champions”. Benn Steil of the US Council on Foreign Relations said the new mega-institutions were “too big to fail” and a source of systemic risk. “They are effectively private ‘Credit Lyonnais’s’ waiting to happen.” A corporate financier at a (French-owned) investment bank, thought “the quest for national champions will distort pure
Mergers, mergers everywhere

reason”. Keith Gold at IBM felt the European M&A wave amounted to “betting the institution”.

But it wasn’t just a European problem. A South East Asian central banker said: “The rush to form mega-mergers gives rise to concerns about consolidation and integration from an institutional perspective: market issues such as competition, and systemic/regulatory matters such as ‘too big to fail’.”

From Japan, several respondents characterised the restructuring there as unplanned and lacking in commercial and regulatory logic. “‘Size is strength’ has replaced downsizing, without any thought being given to what creative strengths might be generated by growing larger”, was one comment.

A few respondents were more sanguine. A Japanese analyst said that, while the number of mergers would continue to rise, the risks would not. And at the end of the day, an executive at a German bank wondered “Who is at risk from this risk?”

8 Economy overheating

Is the macro-economy going to overheat, or turn down, or both? Overheating (placed 8th) was more feared than a downturn (11th).

Fears of overheating focused mainly on the US. “A sharp correction to the US economy would slash the South American/Asian recovery, triggering a new round of bank failures and high provisioning”, said a senior executive at a large multinational bank. Some respondents extended these fears to the UK. “The main risk is overheating followed by downturn. It rises with every year of strong growth,” according to Adrian Coles, director-general of the Building Societies Association.

Many respondents focused on the skews in the international economy. A leading academic economist said asset price misalignments (i.e. the euro too low, technology stocks too high) were interacting with macro-imbalances (US demand too high, Japanese too low). “These misalignments and imbalances will have to reverse some time, and when they do, it may be with more of a bang than would be comfortable or easy to handle.”

Japan’s precarious economy was also singled out. Peter Birch of N.M. Rothschild thought the lessons of Japanese deflation should be more widely learnt. “It is not difficult to envisage the US experiencing a major readjustment as households which are buoyed up today but with little savings turn into households with significant debt tomorrow once asset prices - property and stock market - decline.”

Risk gets lumpy

The concentration of risk in dealing with a handful of giants that represent a large proportion of the market is a phenomenon that current managers have not had to deal with. There will need to be an acceleration in the development of risk-reducing techniques (CLS, contracts for differences, margining, netting, collateralisation etc.) to prevent either the system grinding to a halt or forcing players to take on unacceptably high levels of exposure to a small group of institutions.

Managing director
US multinational bank

Turning down with a bang
9 Competition from new entrants

The arrival of aggressive new banking competitors, riding the Internet and travelling light, made this a fast-rising Banana Skin. Related fears about the soundness or otherwise of new entrants were less pronounced: they ranked 22nd.

The chief executive of a UK clearer said: “One of the biggest risks I see is the squeeze on margins in every line of business, which I fear is approaching. New entrants will drive down margins and the erosion will be continuous and across the board. It may take 3-5 years.”

A consultant at one of the large accountancy firms wrote: “The new players are spoiling the old market without creating a sustainable new one. At some stage the dot.coms must also make money. Roll on the internet bubble crash!”

We got similar comments from further afield. “Quasi-banks and non-banks are becoming important competitors” said an East European banker. And from Japan: “Both foreign and non-banking institutions’ inroads into retail banking business are creating a severe competitive environment in the commercial banking industry. This happens at a time when conventional banks are struggling to get rid of bad loans which they incurred in the past bubble economy.”

It’s also a concern for regulators. One of them saw “the entry of internet and other ‘new’ distribution channels causing havoc in the economics of traditional distribution channels”. Another thought “the risks to traditional banks with expensive branch networks from new entrants using new technology remains high”.

Unsoundness. The fear that newcomers might prove unsound came 22nd on the severity list - which was low. But it came higher on the rise and fall list (10th). New entrants were “get-rich-quick e-commerce fixers”, who would “soon find out how expensive the game is!”

“Many new entrants will fail, especially if we get a severe recession” said Philip Middleton of KPMG Financial Services Consulting. A respondent from a German bank said existing banks were in danger of being “completely removed from the food chain by the new e-banks which are new, unstructured and present higher risks to the regulators, the economy in general and to savers/investors”. A respondent from a large international banking group worried that too many Internet-based outsiders would get into banking “and then go belly up in a downturn or else fall on the wrong side of regulations due to inexperience. (Most internet companies are the antithesis of ‘regulated’ companies.)”

This raised a couple of regulatory issues. Were regulators scrutinising the newcomers closely enough? A British respondent thought the FSA “has done a good job in getting rid of them”. But Noriko Hama of the Mitsubishi Research Institute in Tokyo decried “the new policy of allowing all and sundry into the banking business. The erstwhile policy of allowing nothing has given way to a tendency to encourage everything: a dangerous swing.”
Then there was the eternal problem of competitive equality. The head of group risk management at a large multinational bank said that while the Basel capital adequacy proposals were generally welcome “there is a real danger that lack of a level playing field with non-bank financial institutions will significantly disadvantage the banking industry”.

10 Complex financial instruments

New-fangled instruments came out as a middle-to-high Banana Skin, rising moderately - about the same as last time. But as a respondent from the regulatory world said: “It’s been quiet of late…”

Many people think that bankers and regulators still don’t fully understand derivatives: the risks, their true cost, and the difficulty of unwinding them in a bear market.

Alfred Steinherr, chief economist at the European Investment Bank in Luxembourg, said international co-ordination among regulators in this area was weak. A handful of respondents noted there were now moves to bring more derivatives to the retail level, and wondered whether this was wise. A representative of the unit trust industry was concerned that the increasing use of OTC derivatives in tracker funds “introduces a new risk to the retail investor and banks.”

11 Economic downturn

See Economy overheating at No 8.

12 Emerging markets

Emerging markets came moderately high on the severity scale but are falling in importance. The comments were very mixed.

A lot of respondents warned that the crisis was far from over. “There is a danger of complacency setting in now we are through the Asian and Russian crises, and Latin America is relatively quiet”, wrote a US banker. “These are dangerous places from a financial point of view and need to be managed carefully. In my view, corruption is likely to be as great a problem as the economics in some of these countries, and financial institutions would be well-advised to tread carefully.”
A lot of respondents also highlighted the legal and political risks of operating in emerging markets, as well as the weakness of financial regulation. But at the end of the day, nearly twice as many respondents ranked the risk as receding rather than growing. One of them, for example, cited Russia as a falling risk “assuming Putin succeeds”.

13 Risk management

The quality of risk management is falling fast as a concern: it came top last time. Have banks got their act together, or are other Banana Skins just growing faster?

A lot of respondents felt that banks now managed risk better. A consultant at one of the large accountancy firms said: “I am more optimistic this year than I have been over the past few years. We have come through the introduction of the euro and Y2K with minimal difficulty. Perhaps the greatest challenge at present is the need for greater operational stability and operational capacity to support e-commerce and e-trading initiatives.” Another said: “Banks are realising and dealing with risks.”

But this optimism was not universal. A US observer of the banking industry thought that risk management techniques had been poor at capturing losses in low probability events, “so unanticipated losses could be substantial”. Many respondents also thought that benign markets and the recent absence of shocks were breeding complacency among bankers and regulators. Banks were “forgetting the tell-tale signs of risk when markets and economies are booming”, said Fields Wicker-Miurin of Vest@Capital. “Too many people think they understand risk management”, said the treasurer of a large clearing bank.

Can banks afford to be complacent at a time when the market is becoming more volatile? “Risks are moving from the specific to the general, and are therefore harder to deal with”, said Sir Brian Pearse, former chief executive of the Midland Bank. Simon Yun-Farmbrough, director of strategy at the Prudential, thought it was “probably time we had another failure of risk management systems in a large institution”.

In Japan, Rei Masunaga of the Japan Center for International Finance, said that banks were trying to maximise returns by shifting from traditional areas to riskier ones such as mergers and acquisitions and highly leveraged products. “This trend, if it goes too far, may have the effect of destabilising or even undermining the profit base of these institutions”, he said.
Some respondents highlighted operational risk which, as a Continental central banker noted, “is probably the main cause of individual institutions’ breakdown in the recent past”. Michael Lewis, deputy chief executive of APACS, saw banks adopting “inappropriate technology whose operational risks are neither understood nor controlled”, while a clearing banker feared risks in ‘softer’ areas like reputation.

Several respondents also decried the industry’s growing reliance on mathematical models. The chairman of a European bank stated: “There is no mathematical risk management substitute for an in-depth knowledge of credit risk exposures.” John Grout, former finance director at Cadbury Schweppes, said: “Too many banks are taking too similar risk profiles. A major shock to, say, collateral values will have a magnified effect, c.f. Japan but writ large in the US, perhaps.”

Roger Pratt, director of financial services audit at Ernst & Young, singled out a specific problem. “High quality people in critical risk control roles at all levels of management will leave the industry and much valuable knowledge will be lost. Particularly vulnerable are the trading businesses of securities firms and banks acquired by other financial players.”

Regulation was a middling to low Banana Skin. Worries about the challenges of globalisation ranked 14th, and weaknesses in domestic regulation 27th. But a lot of respondents said too much rather than too little regulation was the biggest problem.

Martin Owen of the UK’s Financial Services Authority summed up many of the issues. The huge changes afoot in technology and commerce mean that “financial
institutions will be flying by the seat of their pants, including making big commercial ‘bets’. The risks will be compounded by the growing difficulty for regulators and others in overseeing financial institutions operating on a multi-national, multi-product, multi-delivery channel basis.”

This view was echoed by a central banker from South East Asia: “With globalisation and the breakneck pace of changes it will be harder today and tomorrow for financial institutions and regulators to be well prepared.”

International coordination. Regulators are now working better across borders, but financiers are moving even faster. “Big players vs parochial regulators”, said an investment banker.

Poor coordination within the European Union was singled out by several respondents, not just between member countries but between regulators of the banking and capital markets. “The single European market is not coming together very harmoniously”, said a UK regulator. A bank credit analyst thought a sharp downturn would expose flaws in European banks. “The lack of an integrated supervision and ‘lender of last resort’ system in the EU is particularly worrying. In the sort of meltdown envisaged, who is going to support ING, HSBC, Credit Suisse?”

Cross-product controls also need to be beefed up. One regulator thought US investment banking groups and conglomerates should be more closely watched - a need which increases with the abolition of the Glass-Steagall Act separating commercial and investment banking.

David Shirreff of Euromoney thought regulators should focus more on smaller and unregulated institutions. “At the fringes, institutions scrambling for market share will sacrifice quality for quantity.”

The new Basel capital adequacy proposals attracted comment: they would provide more glue for the system, but would they impose “sensitive” capital charges for risk, and create the much-needed level playing field?

**Domestic regulation.** Domestic regulation is seen to be generally good in OECD countries, with the exception of Japan where there are still worries. But many respondents felt uneasy about emerging markets. The best that one of them could say was that this was “slowly being grasped in the Third World”.

---

**Who is the lender of last resort in Europe?**

---

**Can supervisors manage a crisis?**

My concern is that some institutions’ risk management systems may not be sufficiently robust to withstand the shocks that could lie ahead as recent market excesses are unwound. This prospect will, in turn, test the effectiveness of international supervisory cooperation - the weakest elements of which relate to the lender of last resort function and crisis management.

**Richard Dale**

Professor of banking
University of Southampton

* * *

Supervisors would sort out a crisis if one occurred - eventually.

**Anon.**
Overregulation. It was the danger of too much rather than too little regulation that exercised most people, particularly in the UK where the new mega-regulator, the Financial Services Authority, is being set up.

“The real risk is over-regulation!” thundered the chairman of a banking group. “Most banks, and certainly those in Europe and the USA are very sophisticated and quite capable of looking after themselves, sometimes with a little help from the regulator.”

Another UK bank chairman (this is clearly an issue that bothers top people) criticised regulators for trying to second-guess a bank’s board and management. “The obligation of regulators to satisfy themselves that supervisors are supervising is understood. But seeking that satisfaction by replicating in detail the supervisory process poses at least a moral hazard for the regulator, and the weakening of a board’s acknowledgement of its governance responsibilities.”

But is over-regulation a Banana Skin?

Yes. “Over-regulation at a micro level distracts management”, said a banker. A respondent from the UK mortgage industry said “increasing regulatory requirements are being imposed which constrain business innovation and inhibit competition”. Some people were also concerned about the effects on London as a financial centre. “Regulation in general is gradually making the City uncompetitive”, was a typical quote.

Financial Services Authority. Several respondents had a go at the FSA: one even described the Financial Services and Markets Bill as “a disaster in the making”. Most people criticised the Authority for being over-mighty, but one respondent wondered whether it would attract top talent and be “robust enough”. However one member of the FSA warned of even worse outcomes if the FSA was not a success: “The looming threat of a Euro-SEC means we need to make it work!”

15 Fraud

Fraud is a hardy perennial, still in the middle of the scale, but rising.

The big worry is that the Internet is a wonderland for miscreants, ranging from “fraud for fun” hackers to global bank robbers. Online banking merely opens up new routes into the bank vault, while the electronification of the share dealing process makes stockbroking vulnerable too. As one respondent pointed out, fraud prevention may be a growing business, but the stakes are growing too.

Richard Bell of the Royal Bank of Scotland wondered: “Will the fraudster be able to move faster and further than existing detection and control processes - specially the ability of governments to cooperate globally?”

But a number of people said that fraud, while damaging financially and reputationally, was not a systemic issue and should be kept in proportion.

16 Currencies

Foreign exchange turbulence was a middling risk, rising only moderately. Euro weakness is the biggest threat. Neil Record of Record Treasury Management, said
“country divergence within the Eurozone remains a major looming risk. My view is that any serious rift could pose a real risk of systemic bank insolvency.”

But some thought the problem lay with the dollar. Gilbert de Botton of Global Asset Management saw “a dollar which is a function of direct foreign investment to too great a degree, while the euro consolidates at these low levels”. Several respondents expected the dollar to slide if/when Wall Street breaks.

(A comfort for London: only one respondent saw any risks for the City in the UK’s failure to adopt the euro.)

17 Hedge funds

Still a middling risk, but most respondents saw it falling. “Banks are more conservative” said a US banker. Another said: “They got good lesson!” A third pointed out that banks could always hedge their exposure to hedge funds...

But John Plender of the Financial Times said that “though they are not the force they were in pre-LTCM days, the hedge funds are still an Achilles heel of the system”. And the chairman of a Continental European bank thought they still posed “a serious threat to the financial system through the exposure of banks and, secondly, through rapid increases in the cost of capital in the case of failure”.

18 Interest rates

A rise in interest rates is a low though rising threat, with all eyes on the US. A bank supervisor worried about “the extent to which interest rates may need to rise to calm inflationary pressure combined in the US with excessive private sector lending”.

But there is another dimension to this Banana Skin. Some respondents noted that permanently low interest rates made life very difficult for financial institutions, eg by squeezing savings products, pension funds and annuity rates.

19 Commodities

Low on the list, but rising slightly because of recent market volatility. But no surprises: oil was the worst trouble-maker, and gold got a few mentions. The financial sector’s exposure to commodities is modest, except for a few specialist houses.

20 Back office operations

Problems in the back office did not loom large, though there is some question whether bank systems can cope with the huge changes going on in the financial services industry.

Mergers, for example. David Potter of the Rose Partnership said consolidation “creates significant back office threats as systems, billing systems etc. don’t intermesh or are not rationalised effectively”. The growth of e-commerce will also test the robustness of back offices. Some concern was expressed about the ability of stock exchanges and stockbrokers to handle massive investment volumes. “The imagination of traders is developing faster than people and systems can keep up”, said a respondent
from a Dutch bank. But generally, the worry level was surprisingly low given the topicality of "operational risk".

21 Front office selling practices

Despite all the fuss over this particularly British problem, front office selling practices ranked quite low on the severity scale, rising slightly. Did the pensions scandal put a stop to mis-selling, or is it still lurking in the shadows?

The gloomy view was summed up by a clearing banker who thought there were “more mis-sellings to come out of the woodwork”. Several respondents thought the arrival of stakeholder pensions in 2001 plus growing demand for asset management services, the spread of complex products to the retail market, and an overheated mortgage market created just the right conditions for mis-selling. Paul Borrett of EFG Private Bank said: “There are a few time bombs here. Public understanding is still too low.” A banking consultant thought that unit trusts and ISAs (tax-exempt savings accounts) had many of the hallmarks of pensions mis-selling: misleading performance tables and inappropriate advice due to product complexity. These could become “a major risk from government/consumer legal action if there’s a downturn in the stock markets”, he said.

But other respondents thought “the major abuses are behind us” and “all the banks learnt a lot”. Martin Hall of the Finance and Leasing Association pointed out that this was a reputation rather than a financial risk.

22 Unsound new entrants

See Competition from new entrants at No 9.

23 Staff pay incentives

This was a low risk - but rising as competition for talent hots up, both within the industry and from dot.coms.

An investment bank chairman said: “People costs are rising alarmingly. This will lead to either lower margins (cost/income ratios) or reductions in staff numbers beyond what may be prudent from a supervisory point of view.” A European central banker saw “no improvement” in the situation.

Incentives that encourage excessive risk-taking were the main focus, specially at investment banks. A New York-based investment banker said that rising mobility was destroying culture and driving up cost ratios just as margins were coming down. Ratan Engineer of RSM Robson Rhodes said it was bad enough giving staff options by way of compensation. But to grant them rights over other companies’ stocks which you are incubating “is completely bizarre”.

A clearing bank director said the problem was not just with traders. “The packages now being offered to top management could equally lead to inappropriate policies if not carefully linked to shareholder interests. Incentivisation of the field sales forces
(as branch bankers are now effectively known) requires a strong compliance function/culture if mis-selling and reputational risk are to be avoided.”

The treasurer of a large multinational company was also concerned about the effect on shareholders. “Even the best investment banks have a ratio of employee compensation to gross revenue clearly north of 50%, and the weaker players must be much higher. I cannot see what value a business with this sort of structure can have to non-employees or how such a business can live under the same roof as a traditional banking business, whose value lies in its name, reputation, systems and asset base as much as its employees.”

One or two respondents thought the problem overdone. A US fund manager pointed out that bonuses go down as well as up, and a US analyst noted that they were currently going down with the market.

One respondent turned the issue on its head. Remuneration, he said, was one of the problems of working for a mutual. (He works for a mutual.)

24  Rogue trader

This trouble-maker has come down a long way since he ranked 4th in the 1996 Banana Skins. But can banks relax?

“Always a possibility”, said a member of a large US fund management company. “Who knows?” asked a representative of the investment banking community. “The bonus culture encourages it”, said another. A US banker thought that the growing unit size of financial institutions made them less vulnerable to rogue dealing, but a Japanese analyst said: “A lot of things can be done by a single person.”

25  Payment systems

Risks from dodgy payment systems came low on the list and are only growing slightly. But will it stay that way in an increasingly technology-dependent world?

The deputy chairman of a large clearing bank said the headlong rush into Internet banking and technology “is a matter of concern with systemic failure of payment systems a growing possibility, although such failures ought to be short-lived and not life-threatening.” The growing global interdependence of payment systems was also highlighted.

Some respondents saw the threat coming from outside. One thought “electronic payment systems with dated encryption procedures are increasingly vulnerable to illegitimate, external attack/access”. W.W. Martin of the Royal Bank of Scotland/Natwest was concerned about the security of funds crossing electronic media such as the Internet and WAP. A respondent from one of the large card organisations worried about personal and financial data sitting on merchants’ and service providers’ servers. “The ease with which hackers obtain this data is astonishing - mostly a result of poor procedures and bad practices”, he said.

John Trundle, who heads the Bank of England’s payments division, said reducing foreign exchange settlement risk was a priority. “Although risk management practices
have improved in many banks, the unintended exposures remain enormous, and only a better processes like that of continuous linked settlement (CLS) will reduce them."

If payment risks got a low overall score, it was because respondents thought they were under control, thanks to central bank initiatives. The move to real time gross settlement (RTGS) was cited as a mitigating factor, and standards were rising with the spread of international best practice. Even if the risks were severe, there was “systemic resilience” according to one respondent.

26 Money laundering

A very mixed response. Most people put it low on the list, but those that ranked it high saw it as a BIG problem, mainly because of the new avenues opened up by Internet banking and the risk it posed to bank reputations. “Technology makes money laundering much much easier,” said the chief executive of a UK clearing bank. Also, they saw regulation being pretty ineffective. “Lots of crooks about and money laundering rules don’t stop it”, was a comment from the City of London. One respondent noted that black marketeers would have to convert all their European bank notes ahead of the euro changeover in 2002, which would give a nice fillip to business.

The more relaxed view was reflected in comments such as: “So much has already been done to address this” and “Too small to be significant in global terms”.

27 Domestic regulation


28 Political shocks

Shocks of a political kind came way down the list, with little change. But respondents interpreted this in two ways.

Upheavals

Most of them read this as an invitation to name trouble-making countries.

Clear winner was China, with the Taiwan problem, which got a couple of dozen mentions. Others were Zimbabwe, Russia, the US post-elections and Japan. One gloomy respondent wrote “Everywhere”.

Government meddling

Most of our UK respondents saw a different kind of political shock: the Blair government’s attempts to fan “anti-bank populism”, not surprising given that our questionnaire reached most people’s desks the same day as the Cruickshank Report advocating a shake-up of the banking industry.

Top bankers were particularly exercised. The chief executive of a large international banking group warned that “increasing orgies of government interference in UK will damage the global competitiveness of UK-based institutions and London’s leading position as a financial centre”.

A clearing bank chairman said regulation was becoming “more responsive to consumerist pressure from individual constituents (who vote) than to the concerns of corporate
practitioners (who don’t) who are primarily concerned with the integrity, efficiency and effectiveness of markets”.

The head of retail banking at a large clearing bank saw “back door socialisation of the banking system by government intervention in the name of consumer protection”. Another clearing banker feared that “if margins are reduced, then the financial stability of less profitable concerns will be threatened, opening up the possibility of failure”.

However others thought banks were protesting too much. One respondent said they had only themselves to blame. “They have done nothing in the past two decades to get across to the great British public that they are not a public utility and that they are entitled to charge for their services like any other service industry.”

The professor of banking at a leading business school warned: “If banks continue to charge internationally high prices for products which get low service quality ratings and frequent criticisms for opportunism, they will attract severe regulatory pressure.”

Environmental risk

We included a question about environmental risk to find out how it ranked in an era of climate change and Seattle-type activism. The answer is not a lot. Environmental risk came one from the bottom, though it is rising moderately.

Only seven respondents offered any comments. Two were about the ever-present risk of natural disasters, and one each about the risk of lending to the bio-technology industry, the UK’s new contaminated land regime, health risks from mobile ‘phones, and rising popular protests. The seventh, from Franz Knecht, a banker and consultant on environmental risk, warned that “corporate social responsibility” pressures were spreading from industry to the service sector. “As a consequence the financial sector will be confronted with the same demands, but might have more difficulty exculpating itself”, he said.

Y2K aftermath

“What a rip-off!” said a disgusted bank economist.
How well prepared are banks to deal with risk?

For the first time this year, we asked people how well prepared they thought their own and other institutions were to deal with the Banana Skins they had identified.

Just over half thought banks were moderately well prepared or better, which is not bad considering that nearly half of the respondents were outsiders with some detachment. The results were:

<table>
<thead>
<tr>
<th>How well prepared do you think your own and other financial institutions are to handle the risks you identify?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Moderately well prepared or better</td>
</tr>
<tr>
<td>Mixed</td>
</tr>
<tr>
<td>Poorly or worse</td>
</tr>
</tbody>
</table>

Much of the optimism was grounded in the belief that banks had learnt painful lessons, and were more alert and better equipped. Comments ranged from a building society’s “We are very well prepared: cannot afford not to be” to a more cautious “Well prepared but always challenged”. A senior regulator said: “In most countries, plenty of fat to handle problems.”

Many bankers stressed their improvements - “Getting better by the day: learning by doing”, said an investment banker - and the fact that there was always room to do better: “Well prepared, but the challenge is to keep up with the pace of change.”

Ian Linnell of credit raters Fitch IBCA, thought bank preparedness was “in general pretty good. However given the challenges of new technology and excess capacity, banks are having to do more in terms of cost reduction and diversification just to stand still.” Kathleen Tyson Quah of Granularity thought they were “very well prepared with sophistication improving noticeably over the past five years”.

Several respondents thought that risk management was becoming harder, not easier. “Major problems for banks are the speed of change caused by M&A and e-commerce, coupled with new entrants with less regulation. These are difficult to manage for all institutions,” said a clearing banker.

But no amount of preparation can guard against the unknown. A UK clearing banker said: “As ever, it is the risks we do not anticipate which we worry about.” Some non-bank respondents also acknowledged there were risks that individual banks could do little about, like global contagion and systemic risk.

But a lot of respondents equivocated. Some distinguished between OECD-based banks (good) and the rest (bad), (“In the West, specially UK and US, reasonably well prepared. In Asia, including Japan and emerging markets, much less so”) or between Us (good) and The Rest (bad).

Some thought that size mattered. A European central banker said: “Big players seem to be aware of all the risks in their business and able to cope with them efficiently.”
Second tier and minor institutions still have to develop adequate risk management systems and internal control procedures.”

Still others thought that, on paper, banks looked well-prepared but would always be zapped by the unexpected, for example new and little understood e-risks. The head of group risk management at a multinational bank said “I do not consider financial institutions generally have yet appreciated the risks arising from e-competition”. John Langton, executive director of the International Securities Market Association, said bank preparedness was “mixed at best. Merger mania is simply exacerbating the problems particularly amongst the EU-based financial community.”

The pessimists focused on complacency, the temptation to take ever greater risks, and the skeletons buried in bank balance sheets. A central banker said: “Not much better than last time - but they think otherwise.” A regulator agreed: “Poorly at this stage of the cycle.”

A banking consultant thought institutions were ignoring risks. “In particular they have high costs bases and presumption of an ongoing bull market. If there is a downturn, asset values and revenues will be tested.” A US observer thought they were “not well prepared. The big banks all have hedge fund-like units. They have taken big risks. They have made a lot of money so they are afraid to criticise internally.”

The breakdown by type of respondent throws up some wrinkles.

<table>
<thead>
<tr>
<th>Respondent Type</th>
<th>Moderately well prepared or better</th>
<th>Mixed</th>
<th>Poorly or worse</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bankers</td>
<td>60%</td>
<td>37%</td>
<td>3%</td>
</tr>
<tr>
<td>Bankers</td>
<td>Moderately well prepared or better</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bankers</td>
<td>Mixed</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bankers</td>
<td>Poorly or worse</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bankers</td>
<td>Bankers were the most optimistic (or complacent?)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Users</td>
<td>Moderately well prepared or better</td>
<td>45%</td>
<td></td>
</tr>
<tr>
<td>Users</td>
<td>Mixed</td>
<td>36%</td>
<td></td>
</tr>
<tr>
<td>Users</td>
<td>Poorly or worse</td>
<td>18%</td>
<td></td>
</tr>
<tr>
<td>Bankers</td>
<td>Fewer than half the users thought banks were well prepared</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Regulators</td>
<td>Moderately well prepared or better</td>
<td>36%</td>
<td></td>
</tr>
<tr>
<td>Regulators</td>
<td>Mixed</td>
<td>45%</td>
<td></td>
</tr>
<tr>
<td>Regulators</td>
<td>Poorly or worse</td>
<td>18%</td>
<td></td>
</tr>
<tr>
<td>Regulators</td>
<td>Only a third of regulators thought banks were OK. The greatest number gave a mixed response.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Observers</td>
<td>Moderately well prepared or better</td>
<td>42%</td>
<td></td>
</tr>
<tr>
<td>Observers</td>
<td>Mixed</td>
<td>32%</td>
<td></td>
</tr>
<tr>
<td>Observers</td>
<td>Poorly or worse</td>
<td>26%</td>
<td></td>
</tr>
<tr>
<td>Observers</td>
<td>Observers had the most extreme views, good and bad, though most of them thought the banks were OK. Only a third gave a mixed response.</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Banking Banana Skins 2000

Each year we ask senior bankers and close observers of the banking scene to describe their main worries about the banking industry as they look ahead. We’d be very grateful if you would take a few minutes to fill out this form, and return it to David Lascelles, CSFI, 5 Derby Street, London W1Y 7HD by April 7th 2000.

Question 1. Please describe your main concerns about the safety of financial institutions (both individual institutions and the system as a whole) as you look ahead over the next two to three years.
**Question 2.** Here are some of the areas of 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 you think are specially vulnerable. Please add more risks at the bottom if you wish.

<table>
<thead>
<tr>
<th>Area</th>
<th>Severity</th>
<th>Trend</th>
<th>Details</th>
</tr>
</thead>
<tbody>
<tr>
<td>Back office operations</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Banking market over-capacity</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Big market movements:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- commodities</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- currencies</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- equities</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- interest rates</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Complex financial instruments</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>E-commerce risks</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Emerging markets</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Environmental risk</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fraud</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Front office selling practices</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Grasp of new technology</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Hedge funds</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>High dependence on technology</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Macro-economic trends:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- downturn</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- overheating</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Merger mania</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Money laundering</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>New entrants, owing to:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- extra competition</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- unsoundness</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Payment systems</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Political shocks</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Regulation:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- poor international coordination</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- weak domestic regulation</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Risk management techniques</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Rogue trader</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Staff bonus arrangements</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Y2K aftermath</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

How well prepared do you think your own and other institutions are to handle the main risks you have identified?

....................................................................................................................................................................................

....................................................................................................................................................................................

Name: ...........................................................

Institution: .................................................

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


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


12. “Liquidity ratings for bonds”: A proposed methodology for measuring the liquidity of issues by scoring the most widely accepted components, and aggregating them into a liquidity rating. by Ian Mackintosh. January 1995 £25/$40

13. "Banks as providers of information security services": Banks have a privileged position as transmitters of secure data: they should make a business of it. by Nick Collin. February 1995 £25/$40


15. "EMU Stage III: The issues for banks": Banks may be underestimating the impact of Maastricht’s small print. by Malcolm Levitt. May 1995 £25/$40


21. "Banking banana skins III": The findings of a survey of senior UK figures into where the perceived risks in the financial system lie. March 1996 £25/$40

22. "Welfare: A radical rethink - The Personal Welfare Plan": A proposal (by a banker) for the private funding of health, education, unemployment etc. through a lifetime fund. by Andrew Dobson. May 1996 £25/$40


26. “Banking Banana Skins: 1997”: A further survey showing how bankers might slip up over the next two to three years. April 1997 £25/$40
27. "Foreign currency exotic options": A trading simulator for innovative dealers in foreign currency (with disc). Winner of the 1997 ISMA/CSFI Prize for financial innovation. by Stavros Pavlou September 1997 £25/$40

28. "Call in the red braces brigade... The case for electricity derivatives": Why the UK needs an electricity derivatives market, and how it can be achieved. by Ronan Palmer and Anthony White. November 1997 £25/$40

29. "The fall of Mulhouse Brand": The City of London’s oldest merchant bank collapses, triggering a global crisis. Can the regulators stave off the disaster? A financial thriller based on a simulation conducted by the CSFI, with Euromoney and PA Consulting Group, to test the international system of banking regulation. by David Shirreff. December 1997 £25/$40

30. "Credit where credit is due: Bringing microfinance into the mainstream": Can lending small amounts of money to poor peasants ever be a mainstream business for institutional investors? by Peter Montagnon. February 1998 £25/$40

31. "Emerald City Bank... Banking in 2010": The future of banking by eminent bankers, economists and technologists. March 1998 £25/$40


35. "Cybercrime: tracing the evidence": A working group paper on how to combat Internet-related crime. by Rosamund McDougall. September 1998 £6/$10

36. "The Internet in ten years time: a CSFI survey": A survey of opinions about where the Internet is going, what the main obstacles are and who the winners/losers are likely to be. November 1998 £25/$40

37. "Le Prix de l'Euro... Competition between London, Paris and Frankfurt": This report sizes up Europe’s leading financial centres at the launch of monetary union. February 1999 £25/$40

38. "Psychology and the City: Applications to trading, dealing and investment analysis": A social psychologist looks at irrationality in the financial services sector. by Denis Hilton. April 1999 £25/$40

39. "Quant & Mammon: Meeting the City's requirements for post-graduate research and skills in financial engineering": A study for the EPSRC on the supply of and demand for quantitative finance specialists in the UK, and on potential areas of City/academic collaboration. by David Lascelles. April 1999 £25/$40


42. "In and Out: Maximising the benefits/minimising the costs of (temporary or permanent) non-membership of EMU": A look at how the UK can make the best of its ambivalent euro-status. November 1999 £25/$40


44. "Internet Banking: A fragile flower" Pricking the consensus by asking whether retail banking really is the Internet's "killer app". By Andrew Hilton April 2000 £25/$40

REGULATION 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

OTHER REPORTS
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

PLEASE MAKE CHEQUES PAYABLE TO CSFI.
NP. STUDENTS, ACADEMICS AND CHARITABLE ORGANISATIONS RECEIVE A 50% DISCOUNT.
The Centre receives general support from the following institutions:

Abbey National
Andersen Consulting
Barclays Group
Chase Manhattan Bank
Citibank
International Securities Market Association
ISMA Centre, University of Reading
Linklaters & Alliance
Merrill Lynch
PricewaterhouseCoopers
EFG Private Bank Limited
UBS/Warburg Dillon Read

Alliance & Leicester
AMS
Aon Risk Services
AT Kearney
British Telecommunications plc
City and Financial
Corporation of London
Council of Mortgage Lenders
Deutsche Bank
DTI/OST
EMI Group
GISE AG
Halifax plc
HM Treasury
HSBC Holdings plc
IIT, Bombay
INVESTEC
KPMG Management Consulting
Lloyds TSB
Lloyd's of London
London Stock Exchange
Midas-Kapitil International
Morgan Stanley/Dean Witter
National Westminster Bank
PA Consulting
Reuters
Rockport Financial
The Rose Partnership
Royal Bank of Scotland
Standard & Poor's Ratings Group
Standard Chartered Bank
Thomas Cook Group

Arthur Andersen & Co.
Bank of England
Brigade Electronics
British Bankers' Association
British Invisibles
Cable & Wireless Communications
Canadian High Commission
City Consultants
Cityforum
EPSRC
Ernst & Young
Financial Times
Fitch IBCA
Futures & Options Association
JF Chown & Co.
Lombard Street Research
National Savings
Prudential plc
Record Treasury Management Limited
Scherders
SERM Rating Agency
Traideoint

In addition, the Centre receives special purpose support from, among others, BDO Stoy Hayward, the Building Societies Association, Hammond Suddards, IBM, IMI/Sigeo, Lovell White Durrant, DfID, The Banker, Saudi International Bank, and the World Bank Group.