Banking Banana Skins 2021
Covid special
The CSFI survey of the risks facing banks

Supported by
Chartered Banker
The Housing Finance Corporation
Cognizant
CSFI Centre for the Study of Financial Innovation

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Preface

This is the 14th Banana Skins Survey that the CSFI has published since the first one in 1998. (Actually, it is the 15th, but the first took the form of a series of short essays by senior City figures, rather than an attempt to measure risk quantitatively, as well as qualitatively.) It is, however, very different from those that have preceded it – not because we have changed the basic approach (we haven’t), but because the environment against which the Survey has been carried out is so very different.

You won’t find Covid19 listed as a separate item in the 23 key risks that we have identified. But it permeates almost every risk that is on that list – and it has changed the way that both practitioners and observers of the financial scene view the risks that we are likely to face going forward. Concerns about crime and security, taken together, are very much top of the list – largely because the combination of massive operational changes that have been forced on the industry and rapid technological changes that were taking place beforehand are making banking (and other financial services) much more vulnerable than ever before.

No2 on our list is no surprise – the macroeconomic environment, which (to put it bluntly) is pretty ghastly. It is closely associated with risk No5, credit risk – which seems likely to soar as extraordinary support measures are wound down. Personally, I would put that higher – particularly given the concerns about the reliability of business models, which comes in at No7. We shall see; I note that ‘insiders’ were significantly more confident of banks’ business models than were ‘outsiders’. That’s an interesting sidelight: risks identified by those who make a living out of providing financial services are rather different from risks as seen by those who are paid to watch the industry. At the other end of the scale, the dogs that did not bark are fairly predictable: no one seems particularly worried about a currency collapse, despite Brexit. And there is certainly no shortage of liquidity or capital (indeed, there may be too much). I am, however, a bit surprised at the low ranking both ‘insiders’ and ‘outsiders’ give to compliance risk; I hope they are right.

Overall, the authors point out that the Banana Skins Index - a rather basic measure of overall risk in the system (a simple arithmetic mean) – is at an all-time high, and that includes the aftermath of the Global Financial Crisis. That sounds right to me – but then, as an economist, I am a natural pessimist.

As always, I would like to thank my colleague, David Lascelles, who has overseen the BBS series since it took on its present form. This year, he was ably assisted by my co-director, Jane Fuller – like David, a graduate of the Financial Times’s school of journalistic hard knocks. Together, they have produced a report that is both eminently readable and genuinely important. Thanks, too, to Richard Smith for helping spread the word.

I would also like to thank the four institutions that provided financial support for this venture – the Chartered Banker Institute, Cognizant, the Housing Finance Corporation and Shawbrook Bank. We really appreciate the help they gave us, which made resuscitating the Banana Skins series, after a hiatus of six years, possible; we also appreciate the fact that they left the editorializing to us. The opinions expressed in this report are those of men and women who are deeply involved in the financial industry; the conclusions drawn from those opinions are those of the authors and the CSFI.

Andrew Hilton
Director
CSFI
Sponsors’ forewords

Chartered Banker Institute

Indices, rankings and lists are part and parcel of life – not least in the financial services sector. We use them as a shorthand – and we use them every day, sometimes many times a day. The reason we use them is that they are useful, but we have to know their limits. They can only be understood within a specific context, and we have to be aware that it is easy to be misled. Nevertheless, more often than not, they make us think.

That is certainly the case with this issue of Banking Banana Skins. It makes us think. We find ourselves in the middle of what is turning out to be the biggest economic shock (and health challenge) in more than a generation. It is no surprise that it has fundamentally changed the way the financial services sector perceives risk, and the Chartered Banker Institute – the oldest banking institute in the world – recognises that. It has, after all, experienced many challenges since it was founded in 1875, and it has helped ensure that qualified banking professionals have risen to them.

Moreover, there is a sense that what we are experiencing today is, in a real sense, a case of ‘new wine in old skins’. After all, the core tenets of banking remain unchanged – and the challenges themselves are, perhaps, not as different as one might think. Indeed, today’s emphasis on sustainability is really only an extension of the value we have always placed on stewardship, and the profession has always had to be vigilant against fraud and crime.

That is true today, and it will not change. Indeed, regardless of the Covid crisis, the world we are moving into will be one in which all professionally qualified bankers will have to be even more cognisant of their responsibility, their holistic responsibility, both to their clients and to the wider civil society. We will all have a crucial part to play in picking up the pieces after the pandemic, and we must live up to that responsibility. There will be no room for short-term thinking – and, in particular, for the ‘you’ll be gone, I’ll be gone’ mind-set that tainted the profession a decade or more ago.

Bill McCall FCBI FCSI
Chair

Cognizant

Reflecting on the findings and commentary in this latest CSFI study, I felt a sense of pride, as well as unease. Twenty-twenty and the pandemic, which has stolen so many lives around the world, forced the banking industry to react in ways that would have scarcely been thought possible 12 months ago. The deployment of new technologies, processes and ways of working is amazing, and a credit to the women and men who delivered during the worst of times.

However, the speed at which financial services practitioners have had to implement such radical changes creates opportunities for criminals to exploit perceived weaknesses or loopholes. Unsurprisingly, therefore, ‘fincrime’ and how to defend against it, is top of mind for our respondents. As a result, banks are having to implement new tactics and to develop defensive strategies that leverage big data and analytics to help tackle this rapid evolution of financial fraud.

Furthermore, respondents are clearly wary of growing competition from BigTech, and although it is itself a different type of risk, data is again coming up trumps as practitioners are looking to use data and AI capabilities to improve customer experiences and internal processes.

There are hard times ahead for us all, and we know the pace of change will continue - which is why I am delighted to collaborate with the CSFI on this report, and to share these valuable insights with you all.

I want to thank the practitioners and observers for their time and effort in bringing this report to life. If you would like to discuss anything raised, please do not hesitate to contact me.

Andrew Warren
Head of Banking & Financial Services
Andrew.Warren@cognizant.com
The Housing Finance Corporation

As we sit in our garrets contemplating the n-th Zoom meeting of the day, it is important to retain a world view of real and present risk. At the same time, as business leaders, we need our map and compass (or GPS these days) to help us steer towards a safe harbour/position of competitive advantage (delete as applicable). The CSFI’s Banana Skins Survey is one of those rare documents that allows us to consider both short term and longer term at once. It never makes for easy reading; that’s not its purpose. Its strength is its contributor list – ranging from central bankers and CEOs, to fintech, consultants, diplomats. Its format is plain English, not management speak.

Its key messages on cyber, macro-economics and the dark clouds around credit are hardly surprising. The survey was completed just before ‘Exiting the EU’, so trade-related risks lag. More subtly, flagging the growing importance of trends like culture and ESG is vital, as is the emphasis on the pace of change. Its longer-term trend analysis is also important to help calibrate the compass. Representing a non-bank finance firm, I commend it as required reading!

Piers Williamson  
Chief executive

Shawbrook Bank

This Banking Banana Skins report is a significant piece of research which provides a consolidated global view of the banking landscape and the ever-evolving risks and opportunities within it.

Collectively, we’ve experienced a year like no other. The outbreak of the Covid-19 pandemic, not to mention the culmination of the Brexit process and its associated ripple effects, has significantly changed the risk landscape for UK banks.

Strategic risks of bygone years have now been supplemented with economic and political risks. Covid-19 has created a banking landscape which will undoubtedly leave a permanent imprint, and at the moment, anxiety remains heightened with concerns around financial crime, the prospect of increased non-performing loans as well as constant scrutiny of banks’ business models, both internally and externally.

But from adversity comes opportunity, and some comfort must be taken from our collective achievements during the last year. Unlike in 2008, sentiment towards the banking industry has remained positive as institutions stepped up to support both businesses and consumers in their time of need.

In the coming months, we will enter a new recovery phase and I truly believe that banks will play a crucial part in the successful and strong recovery of our economy. For ourselves at Shawbrook, the approaching months will see a coming-of-age for specialist banks, with the specialist banking industry truly differentiating itself from its challenger, neobank and fintech peers.

For over 20 years; the Banking Banana Skins report has documented the changing landscape of the banking industry; it is the complete report for anyone involved in banking as active practitioners or observers with a keen interest in our industry.

On behalf of Shawbrook, we are both delighted and proud to able to support the 2021 report as a partner and sponsor.

Dylan Minto  
Chief Financial Officer
About this survey

Banking Banana Skins 2021 describes the risks facing the banking industry as seen by financial service practitioners and close observers of the banking scene, such as analysts, consultants, regulators and academics. The survey was carried out in November and December 2020, and is based on 155 responses from 11 countries. About half were from practitioners and half from observers.

The questionnaire was in three parts. In Part 1, respondents were asked to describe, in their own words, their main concerns about the financial system over the next 2-3 years. Part 2 asked them to score a list of topical risks, or Banana Skins, and part 3 to rate the preparedness of financial institutions to handle the risks they identified. Replies were in confidence, but respondents could choose to be named.

This is the 14th Banking Banana Skins survey carried out by the CSFI since 1996.
Summary

This report describes the risk outlook for the banking industry at the beginning of 2021 – a time when the world was in the grip of Covid-19. The table below ranks the risks by perceived severity.

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<tr>
<th>Banking Banana Skins 2021</th>
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<td>(2015 ranking in brackets)</td>
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<td>1  Crime (2)</td>
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<td>2  Macro-economic environment (1)</td>
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<td>3  Technology risk (4)</td>
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<td>4  Security risk (-)</td>
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<td>5  Credit risk (7)</td>
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<td>6  Quality of risk management (6)</td>
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<td>7  Business model (10)</td>
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<td>11 Corporate governance (19)</td>
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<td>12 Culture (-)</td>
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<td>13 Political risk (5)</td>
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<td>14 International trade (-)</td>
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<td>15 Interest rates (14)</td>
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<td>16 Regulation (3)</td>
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<td>17 Management incentives (20)</td>
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<td>19 People risk (22)</td>
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<td>21 Compliance risk (-)</td>
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<td>22 Capital availability (13)</td>
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<td>23 Currency (17)</td>
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Not surprisingly, the report is dominated by the impact of the pandemic. Covid is seen by respondents to be opening up new risks for banks. But, possibly more important, it is accelerating the pace of change in the industry and could leave a permanent mark on its structure and the way it operates. The CSFI’s Banana Skins Index, a measure of the level of anxiety in the banking sector going back more than 20 years, is at an all-time high. (We examine the impact of Covid in greater detail on p.9)
While there is concern about the soundness of the banking system, this is, on the whole, muted thanks to the comfort provided by the higher capital requirements imposed after the 2008 crisis, and the authorities’ clear determination to provide the sector with whatever support it needs - particularly liquidity and regulatory forbearance, as well as government loan guarantees.

Greater risks are seen in the changes that the virus is forcing on the industry, notably in the areas of remote working and service delivery, and in questions about the ability of banks to adapt to them. These changes are likely to influence the future of the industry by favouring those with a technological edge and with the management capability to use innovation to improve customer service.

Risers and fallers

Dramatic changes in the banking industry are reflected in equally sharp shifts in risk perceptions. Here is a selection of risks whose ranking has shifted since pre-Covid days.

UP

Crime. New opportunities for cyber crime as the banks switch to a more remote banking model.

Credit. Bad loans will rise because of economic contraction.

Reputation. Banks are very much in the public eye as the pandemic evolves.

Business model. The banks’ ability to adjust to the impact of Covid is under question.

DOWN

Regulation. The risk of excessive regulation during Covid has receded as authorities avoid adding to compliance burdens.

Capital availability. The banks’ capital position is strong after a decade of rebuilding.

Political risk. This is not a time for political meddling in the banking system.

A major concern is that operational changes will lead to a weakening of control and therefore to security breaches. The top risk that emerges in the survey is that of crime, particularly penetration by cybercriminals taking advantage of new procedures that might not be as deeply bedded down as those before. Security (4), which is clearly linked, has appeared as a high level risk for the first time in this survey series.

There is also a cluster of risks linked to the banks’ ability to handle these changes - technology (3), the suitability of their business models (7) and culture (12). Opinion among respondents is divided as to whether the winners in this evolving world will be new technology-driven entrants or re-galvanised incumbents.
Another big set of threats comes from the deterioration in the world economy, caused by the shock of Covid and the inevitable rise in bad loans. **Macro-economic risk** comes No. 2 and **credit risk** No. 5. The risk in **interest rates** (15), already at levels low enough to squeeze margins, is not seen as serious, although opinion is divided as to whether rates will remain at depressed levels or surge in response to a return of inflation.

**Reputation risk** is a strong riser to No. 9. Unlike the 2008 crisis when banks were seen as the bad guys, Covid offers them the opportunity to become the good guys. But this will depend on how sensitively they handle their clients in the post-Covid recovery period. Closely linked to this is **sustainability** (10), where the banks’ commitment to tackling ESG concerns, particularly those related to climate change, is under scrutiny.

Other rising concerns include the quality of **governance** (11) in banks. The worry is that banks have become so big and complex that they defy control. Questions also persist about the quality of **risk management** (6), whether it is too mechanical, and too little respected. Banks could face difficult choices between growth and safety as they rebuild their business post-Covid.

Among **business practices** (8), poor treatment of customers is emerging as a risk. This is likely to grow as the number of customers under financial stress increases and the banking relationship becomes more automated and remote.

Striking is the low position occupied by “traditional” risks such as **liquidity** (20), **regulatory compliance** (21) and **capital availability** (22), confirming that bank soundness is not the most pressing issue right now. This is reassuring, but some respondents thought the authorities are only postponing the evil day.

In general, financial practitioners are more optimistic about the prospects for the banking business than respondents commenting from outside. For example, bankers rated their preparedness to deal with risk more highly than observers, and their anxiety level is lower. Perhaps that is not a surprise.

These themes are examined in greater detail in the sections that follow.
Insiders and outsiders

A breakdown of responses by type shows how differently risks are viewed from inside and outside the banking business. While the top risks are broadly the same, insiders are generally more optimistic than outsiders: their risk scores are lower (average 3.09 vs 3.15, out of 5) and they have a higher belief in their ability to manage risk and new competition. Is this a sign of complacency, or do they have a better handle on what is going on?

Risks that insiders consider to be more severe than outsiders include excessive regulation, the management of people, the pricing of risk, the outlook for interest rates and sustainability. Those that outsiders rank more highly include management incentives, the macro-economic environment, reputation and culture.

This suggests that insiders are more concerned with the practical issues of managing banks, and outsiders with matters of public concern, as one might expect - though it is notable that insiders are much more concerned about sustainability risks than outsiders.

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The impact of Covid-19

This “Covid Special” edition of Banking Banana Skins aims to extract the key messages about the impact of the pandemic on the banking industry from the large pile of responses we received from practising bankers and close observers of the banking scene. The overall message is not as depressing as one might expect: Covid need not be fatal, banks will get through it, but very probably in a changed form. The single fundamental risk is whether they are capable of surviving that transformation.

Covid will leave a deep and lasting mark on the banking industry, of that we can be sure. In the short term, the economic impact will seriously aggravate an already precarious global debt problem; in the longer term it will force the existing pace of change in the banking business and radically alter the way banks operate. This could lead to a restructuring of the industry in which the more tech-savvy banks will flourish. It will also compel regulators to take a hard look at the balance between forbearance and discipline as the banks struggle to recover once it is all over (some of our respondents feared it might never be). Politically too, the pandemic will alter the relationship between governments and banks by creating greater mutual dependence. The banks will be very much in the public eye because of their central role in sustaining economic activity and providing the means of survival. At the end of the day, the key question for banks is how they address this formidable agenda of responsibility and change.

Here, in summary, are the main Covid-related points that emerge from the responses to our survey, with the CSFI’s take on where it might all go:

• **Macro-economy:** The pandemic has induced recessionary trends which, because of their unusual nature, make the outlook very hard to predict. Exceptional levels of uncertainty are a key part of the mix. The tone of responses to this survey is generally pessimistic: the recession, it is felt, could be long and deep.

• **Interest rates:** This uncertainty includes the outlook for interest rates, which may remain low as an aid to recovery but which could surge in response to inflation, each scenario containing both good and bad news for banks. The survey responses showed no clear expectation either way, though there was possibly a majority for the “low and long” scenario.

• **Credit risk:** Debt levels, already high before Covid, are certain to rise as businesses and personal borrowers go under. Although government guarantees provide lenders with temporary protection, these will be withdrawn at some stage, presenting banks with difficult - even painful -credit risk decisions. The longer term outlook is for a huge enlargement of public and private debt, which will place credit risk at the forefront of bank stability concerns.

• **Crime and security:** Covid is forcing operational changes on the banks, such as work dispersal and technological adaptation, which are opening up new opportunities for security breaches and cyber crime. A serious incident could cause havoc - in the worst (though very unlikely) case, bringing the global payments system to a halt.

• **Risk management:** Current risk models are not up to predicting huge one-off events like Covid, and will need to be seriously re-examined. Repeat outbreaks of Covid and new variants will have to be factored in, along with fall-out that can only be guessed at at this stage.
• **Technology:** Covid is accelerating the pace of technological change in the banking industry by raising the need for remote operations and new service delivery systems. The ability of banks to meet this requirement is certain to be uneven; it could be decisive in banks’ survival chances and in the direction taken by industry restructuring.

• **Reputation:** The sensitivity with which banks handle their customers during (and after) the crisis will harm or enhance their reputation. Banks are lumped together in the public mind, so reputation management will have to be a collective effort.

• **Business models and culture:** The changes forced on the banks by Covid will require an evolution in business models and corporate culture. This may prove difficult to achieve, particularly for incumbent banks with set ways and legacy systems.

• **Competition:** Changes in the industry brought on by Covid, particularly in the area of technology and working practices, are likely to encourage new entrants and raise the level of competition. Operating efficiency and service quality (a growing concern) could determine the winners.

• **Regulation:** Regulatory forbearance is helping banks through the crisis, but it will have to come to an end some time. A post-Covid regime will be needed to rebuild strength and discipline in the banking system without jeopardising economic recovery. This will be a difficult and politically-charged task.
The Banana Skins

1. Crime (previous position 2) The risk to banks from fraud and cyber crime

The risk of criminal attack - already high before Covid - has been dramatically increased by the pandemic, making it the No. 1 risk now facing the banking sector.

The reason for this is that the big shift towards technology-driven systems which Covid has made necessary, including online banking, home working and operational dispersal, are seen to have opened up new opportunities for cyber crime. The proliferation of government support programmes is also an encouragement to fraud. All this is occurring at a time when management resources are tightly stretched and, as always, criminals tend to be a step ahead of the banks.

The head of compliance at a French financial services firm said: “With controls under severe pressure to deal with issues triggered by Covid, (e.g. IT infrastructure, remote working, encryption, e-signature), and looser lending standards intended to save small businesses, criminals have many more opportunities to find gaps.”

While many financial risks depend on local conditions, cyber crime knows no borders. Sue Milton, managing director of SSM Governance Associates, said: “Unlike other risks, this one is global and it happens daily. The crime remains the same but technology creates scalability by enabling access from anyone at anytime. It is too vast an area to be managed by one individual, business or sector.” Rick Murray, president of Liability Dynamics Consulting in the US, said: “Other risk categories threaten the profits and the asset values of banking. Crime increasingly threatens to make assets disappear entirely.”

The true extent of this risk remains hard to measure because it is under cover. Among the repercussions listed by respondents were data theft, operational disruption, fraud and ransom demands. According to one respondent, “ransomware is now part of everyday life”. The gallery of perpetrators includes rogue states or state-sponsored actors, as well as cyber-criminals and old-fashioned hackers and fraudsters.

Part of the concern is that banks are not taking sufficient action to tackle this threat. One respondent said that the risk was “massive with no clear plans to address it”. Another warned that cyber crime represented not just potential reputational damage “but threats of the payments system crashing”. But there may also be a tendency to inflate the risk. A number of respondents said that, while it should not be underestimated, it was, in the words of a regulator, “unlikely to be systemic”.

Crime can make assets disappear entirely
2. **Macro-economic environment (1) The risk that poor economic conditions will damage banks.**

This is a perennial high scorer since banks are both leveraged and cyclical. But the outlook for the world economy under Covid is exceptionally uncertain, and will affect key variables such as debt and profitability. At the moment, many of the potential shocks from this direction are being cushioned by government support and regulatory forbearance. But the time will come when these are no longer affordable or feasible.

The majority of respondents expected the recession to be deep and long, impacting banks through bad debts and loss of customers. David Llewellyn, professor of money and banking at Loughborough University, said Covid will affect banks in two respects: “The economic impact may be greater and longer-lasting than currently being assumed, and some heavily indebted companies will not survive even in a recovery.”

While banks entered the latest economic downturn with stronger balance sheets than before the global financial crisis of 2008, some respondents pointed out that resilience to economic shocks might still remain a problem because of lack of profitability. Jackie Newbury, supervisory board director at Saxon Development Bank in Dresden, referred to “the endless low interest/negative rate environment leading to poor risk return evaluation”.

There were differing views about the prospects for banks under these conditions. Some respondents were encouraged by the fact that banks appear to be standing up to Covid so far, and even adapting to its demands. One respondent said: “High levels of NPLs and corporate failures are expected but can be managed [though there will be] staffing reductions and responsive cuts.” Others took a more Doomsday view, believing that the crisis could bring on a Darwinian cull, and even cause the demise of old-style banking. One said: “Recovery is looking exceptionally sluggish, with some key sectors also having to manage structural change.”

A respondent based in The Netherlands said: “My biggest concern is with banks in Southern Europe which already before the COVID-19 pandemic were not all equally healthy.” Others thought that banks in developing and emerging markets were more vulnerable to the economic fallout than those in developed markets.

3. **Technology risk (4) The risk that banks will fail to keep up with technological change**

This is the highest position that technology risk has reached in more than 20 years of Banana Skins surveys, reflecting concerns about the pace of change on this front and the ability of banks to keep up with it. A bank director based in Switzerland said that “technology is a significant risk to both reliability and future competitiveness”.

Another respondent said that the effect of Covid had been “to turn five-year tech plans into five-month tech plans”.

Some respondents saw technology as a game-changer for older banks laden with outdated systems: “Many asset managers and banks have layers of legacy systems which make the effective implementation of ML [machine learning] models impractical.” As a result, competition from more technology-oriented entrants was
seen as a potent threat. Steven Parker, CEO of consultants Crypterium, said: "Banks are just not keeping pace with digital disrupters and the implications of, for example, blockchain."

One respondent saw sheer size and complexity as part of the problem: "Big banks will always struggle and be more prone to mishap". Another said: "It is not so much that they will fail to keep up with ‘change’, but that they will not do the basic maintenance and upgrades required to keep everything working as is." For some, this could spell severe difficulties, even systemic disruption.

But others argued that even if big banks lagged behind in terms of technological change, they were in a stronger position with their diversified businesses and large investment resources. They could also benefit from action by central banks to improve the payments system. Philip Warland, a senior adviser at Kreab, said: “Better payment systems and cybercurrencies issued by CBs could make banks' business models look very different.” A senior supervisor, while acknowledging that banks might fall behind, said “it won’t affect their stability”.

### The differentiator

I Ironically, even though we are highly likely to see severe economic stress across nearly all countries around the world, this is much less of a risk to financial institutions as the outcomes are controllable. The great differentiator will be between those institutions that have maintained their seasoned staff, particularly risk experts with multi-business cycle experience, and also invested in technology and training; and those that have focused exclusively on cost cutting in order to report better operating leverage results.

Hollis W. Hart
President International Franchise Management (retired), Board advisor, Citigroup/ReferencePoint

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4. **Security risk (-)** The risk that new operating models, for example remote working, will open up new security risks

The rapid spread of digital and remote banking has greatly increased security risk for banks, pushing this Banana Skin to a high place in the ranking.

Clive Briault, director, Risk and Regulation Consulting and chair of the Banking Advisory Board at the Toronto Centre for Leadership in Financial Supervision, said that “as in other sectors, Covid has accelerated the use by banks and other financial institutions of technology, data analysis etc, which leaves them increasingly exposed to interruptions to IT and to access to data.” One respondent cited rising evidence of security breaches “already seen with a greater degree of interceptions, impersonations, challenges with wet signatures etc.”

A London-based risk manager put it this way: “As banks are forced to modernise their digital offerings, this will expand their surface area and expose them to even more security flaws in the various platforms consumers currently want to use.”

Working from home (WFH) poses particular risks. One respondent said it is difficult to retain control over processes distributed across homes. “WFH provides genuine
interruptions from children, pets, deliveries that can cause any of us to take our eye off the ball for a moment, resulting in clicking on to that dodgy link.” An investment bank advisor said that “remote working models are very porous, and controls will have more holes than in the traditional office-based system”.

However, respondents also pointed out that work is under way to tackle this risk. One said: “It is to the credit of banks that there has not been much bad news on this front since the start of the pandemic.”

5. Credit risk (7) *The risk that counterparties to transactions will fail to perform*

Concern about rising indebtedness, already high before Covid, has been greatly strengthened by the pandemic. Although this was not the top-ranking risk, it was the one which attracted the greatest amount of comment: unlike more new-fangled risks, it is familiar and relatively well understood.

Respondents said that a combination of loose monetary policy, the entry of non-banks into the credit market and ample liquidity could easily lead to a slackening of loan standards and a rise in complacency. Daniel Martineau, executive chairman of Summit Trust Group in Switzerland, said that “from students to credit card holders, to households, to SME companies, to multinational corporations and countries – they are all in an unsustainable position of indebtedness. The forbearance of debt is only putting people further behind [with] debt that they will not be able to pay back any time soon. Defaults at the lowest rungs of the ladder will lead to defaults higher up. The answer to this so far has been more debt.”

Another pre-Covid risk is the build-up of debt secured against property in residential and commercial markets. A UK supervisor said: “Property prices are at all-time highs in relation to income. Banks and insurers, particularly in the UK, are massively exposed to declining property values through mortgage lending on very low capital requirements. Most UK banks are close to their leverage ratio backstops. Large falls in property prices (eg to year 2000 levels in relation to income) would cause another banking crisis.”

Credit deterioration is likely to be concentrated in particular sectors such as real estate, retail, hospitality, tourism and travel. One respondent commented that “the ability to identify and bet on the right trends will become a key differentiator for banks.”

A more optimistic view was taken by a central bank analyst who said that the banks had entered this crisis in better condition than in 2008. “They do not have the kinds of commercial real estate, or securitised real estate, exposures they had entering the Global Financial Crisis. Their lending standards for retail have been more disciplined. And on the corporate side, major banks had already started to rein back on exposure to many of the sectors under structural pressures before this shock (eg reducing exposure to physical retail, construction, oil & gas etc).”

The credit picture, however, is varied. Much will depend on the direction taken by the global economy - about which respondents were generally pessimistic - and by interest rates, where the most likely scenarios are all double-edged. A big unknown is what happens when government loan support comes to an end. One respondent
said: “Borrowers will be under a great deal of pressure as aid from governments winds down after the peak of the pandemic.” A senior executive at a multinational bank foresaw “large corporates in high-impact Covid sectors losing access to the markets and running out of cash as their business models are threatened.” Others referred to “zombie businesses”, effectively dead but propped up by credit.

One respondent said that looking ahead is “predicting the unpredictable on a new scale. The banking system has no experience akin to the events of 2020, and thus finds it very difficult to model likely credit losses given the uncertainties of the bug, government responses (furloughs, tax support, lock downs, etc), and the outlook for employment, GDP, prices etc.”

‘No painless way out of the bind’

I worry about the exponential increase in debt across the world. It results from morally hazardous ultra low and negative interest rates that encourage companies and households to borrow more and more. We are caught in a cycle of asymmetric monetary policy whereby successive financial crises have been addressed by monetary easing. Each new crisis is bigger than the last one while the potency of central bank interventions weakens. In due course when the pandemic is long gone inflation will accelerate. Yet at such high levels of debt central banks will be unable to raise rates without precipitating another even bigger financial crisis. There is no painless way out of the bind.

John Plender
Financial Times

Can risk models cope with Covid?

6. Quality of risk management (6) The risk that banks will incur losses because of inadequate risk management

The banks’ ability to manage risk is being put to a severe test by Covid, as the high position of this Banana Skin suggests. Although disasters have so far been avoided, difficult risk/profit trade-offs still lie ahead as the banks come under pressure to help customers within the bounds of prudence.

The wider question is whether risk management is up to anticipating the big unexpected event. This is virgin territory. A compliance officer said: “No aspect of the events that took place in 2020 is factored into the typical risk management model.” Much risk management expertise is built on experience, but as a former managing director of risk at an international bank warned: “Seasoned senior management [is] thin” on the ground. “Managers don’t have experience in navigating prior stress business cycles.”

Alastair Tyler, visiting professor at the London Institute of Banking and Finance, said that “banks are giving more attention to risk management, but need to be much better prepared for future crises, whatever form they may take. This is no easy task.”

However, a number of respondents said that risk management is now much improved, as the banks’ successful navigation of the early phase of Covid showed, and thanks to the tougher management and capital requirements introduced since the financial crisis of 2008. A director of a Swiss bank said: “General improvements in risk management mean this is not the risk it once was.”
7. Business model (10) The risk that banks will fail to produce post-Covid business models which meet changed commercial and social requirements

Covid is likely to bring about lasting change in the banking sector, testing the banks’ ability to adapt and survive. New developments could include negative interest rates, greater government involvement in the banking system, wider geographic dispersal of operations, and competition from opportunistic newcomers - all these on top of the technological revolution that was already under way before Covid.

Respondents agreed that business models will have to adapt, but offered conflicting views of how the banks would manage this. Some saw radical change occurring as tech-savvy firms picked off the best parts of the market, leaving the core banks to live off low profit traditional services. Large institutions had, as one of them put it, “neither the DNA nor the financial capital” to reshape themselves. Others were more positive, arguing that the core banks are better equipped to survive a period of heavy stress, and have shown impressive survival skills in the early stages of the pandemic.

Elizabeth Moody, director of executive education at the Open University, said there is “a massive job to do to remodel banks and other financial institutions, not least to develop and replace legacy IT systems and upskill/redeploy staff whose work has previously been relatively manual and repetitive, and to take advantage of AI and other technological innovations.”

8. Business practices (8) The risk that banks will be damaged by poor sales/customer servicing and other conduct practices

Business practices continue to be seen as an area where banks “have demonstrated an outstanding ability to score own goals”, as one respondent put it.

‘Only lip service to clients’ needs’

I think that the main problem for the banking industry is that large anonymous organisations find it increasingly difficult to relate to their clients.

Substantial investments have gone into regulatory and legal compliance, including box-ticking anti-money laundering and box-ticking risk management. Clients are viewed as a nuisance to be dealt with by pushing them online, even when the apps are not exactly client-friendly, or treating them as vessels into which financial products are poured.

There is only lip service paid to client needs. Relationships are increasingly impersonal and dictated by the bank’s needs, not the client’s, and often are non-existent. These are all ingredients for a medium-term implosion of the business model.

Rudi Bogni
Non-executive bank director
But the nature of the risk may be changing. Where concern in the past centred around acts of misbehaviour such as mis-selling and market manipulation, the focus now is on the treatment of customers, which many respondents felt would be a key determinant of success in a more depersonalised world. One respondent said: “The risk is […] that the service they provide will be less appealing than new approaches based on modern technology and data-driven service.”

Covid has also focused attention on the role of banks in the economy, which has remained elevated since the GFC and in the wake of mis-selling and market manipulation scandals. The CEO of a consultancy advising entrepreneurs commented that there is “much more focus on bank behaviour now. So if one misbehaves, it will have greater consequences,” she added.

Competitive pressure is seen as an issue because new entrants are often credited with being more user-friendly than the incumbents. One respondent characterised it this way: “Other digital services for money management seem to be making inroads to take the relationship away from traditional banks. More competitive risk, less poor service.”

### 9. Reputation (12) The risk of adverse perception or lack of public trust

In contrast to the last financial crisis, banks could emerge from Covid as the good guys who saved the world - rather than the bad guys who endangered it. But they are not there yet. A particular test of their “good citizenship” will be how sensitively they handle their clients during the recovery period. A central banker said: “Appropriate customer treatment as the government's emergency lending programmes come up for repayment will be ‘make or break’ for public perceptions of the banking sector's role during Covid.”

David Green, central banking consultant, said that “although the banks have got Covid-related funds out promptly, in general the climate for recovering them will be very poor and governments who have guaranteed loans will want to hide behind the banks.”

The risk to reputation is heightened by the fact that bankers are still seen as doing rather better than the rest of the population. Charles Henderson, a director at the UK Shareholders’ Association, said reputational risk is “high because employee costs still capture most of banks’ wealth generation with little to be shared by other key stakeholders, especially customers who make up a large proportion of the public.”

### Chance for redemption

The Covid crisis offers banks an opportunity to redeem themselves in the eyes of the public after their role in precipitating the global financial crisis of 2008. With Covid, banks are clearly not the source of the problem, but they can be part of the solution. But it's too early to say whether banks will grasp this opportunity, and whether, if they do, the public will give them credit for it.

**Andrew Cunningham**
Director, Darien Analytics
10. **Sustainability (24) The risks from environmental and social issues.**

Sustainability is the fastest rising Banana Skin in this year’s survey, up 14 places to a position in the top ten.

The risk remains hard to define, however. One respondent said it was the obligation of banks towards “a wider interest than just shareholders”, including employees and customers, and society at large. Some of these obligations are moral, such as being a good citizen; some more tangible, such as avoiding environmental damage.

The risks in getting these wrong include a poor reputation, boycott and financial loss if classes of assets are re-priced by sustainability concerns. Herman Mulder, chair of the Impact Economy Foundation in The Netherlands, described the risk as “huge, as costs, losses and liabilities will increase for non-sustainable practices”. Banks also face increased compliance risk as sustainability moves up the regulators’ agenda.

Respondents said that change here is happening faster than the banks realise. “Environmental, social and corporate governance (ESG) is no longer nice to have, or optional,” said a banking respondent. Climate change in particular, “is likely to come more quickly than expected, posing physical and transition risks to banks and insurers”, said a supervisor.

One reason for the high placing of this risk is that respondents thought banks are not taking it seriously enough. One of them said: “These matters are clearly on banks' agendas; but there is still a slight ‘What's this got to do with me?’ mindset that needs more discussion and education”. Some respondents even thought the banks might use Covid as an excuse to “back off”, though another added: “Transformational change emerges from most major crises, so this is actually an opportunity for institutions to set their bearings differently and do so quickly in relation to environmental and social issues.”

The ranking for this risk, however, contains an anomaly. Bankers placed it much higher (No. 6) than outsiders (No. 14) – suggesting (counter-intuitively) that they are considerably more concerned about it than those who criticise them.

11. **Corporate governance (19) The risk that weakness at board level will lead to poor oversight and control of banks**

The novel challenges thrown up by Covid call for a reassessment of the skills required of people who sit on bank boards and better management information systems. Many respondents felt that the shocks caused by the pandemic showed how difficult it had become for boards to stay on top of the risks, despite the effort put into strengthening governance in recent years.

One respondent said: “Boards today do not have the skill level and knowledge to be able to provide adequate oversight of global governance. This difficulty is compounded by the heightened demands, heightened expectations and heightened risks involved with being a bank board member.”
Dennis Cox, of Risk Reward Limited, said: “Governance groupings need to consider what are the key skills required now, which are likely to be different to those from pre-crisis environments.” Bank structures that are more widely dispersed could also complicate the task of monitoring bank performance. “The workforce continues to carry out business but is increasingly in silos due to a remote working environment and a reduced level of management and control function oversight”, said the executive director of a French investment bank.

**Disproportionate suffering**

I am worried about the build-up of debt in the real economy. At some point, this will put strain on our financial institutions. But those responsible for the financial system ought to be concerned about the cost of heavy indebtedness on many low-income people across the industrial world well before that happens. The stewards of the financial system cannot wash their hands of the disproportionate suffering of the less well-off, minorities, the marginalised in our societies when the way the financial system works contributes so much to this disproportionate impact.

Charles Taylor  
Visiting Scholar, George Washington Law School,  
Former US Deputy Comptroller of the Currency

However, other respondents felt that recent initiatives to strengthen individual accountability such as the UK’s Senior Managers and Certification Regime (SMCR) are paying off. Michael Cole-Fontayn, chair of the Association for Financial Markets in Europe, said that governance is “improving all the time, but there is no room for complacency, especially under SMCR”. Anthony Kirby, associate partner at EY, also took comfort from the impact of reforms: “Corporate governance and remuneration are developed in the major G20 countries and tied to prudential capital and board practices, so a lower risk.”
12. Culture (-) The risk that banks will fail to develop a culture which enables them to deal with the challenges of a post-Covid environment

If Covid marks a step in the evolution of banking services, culture will have to advance too.

In the new era, many of the components of traditional bank culture (such as buildings, paper, even human beings) may be replaced by remote communication and delivery, and by digitised processes. This will require an overhaul of attitudes and values. As the banks’ structures become more dispersed, they may also have to rely more on culture to preserve cohesion and ensure consistency in their dealings with customers.

The Covid factor
Most concerning of all to me is the effect that extended remote-working will have on the culture of an institution. Culture - the way our staff make decisions, exercise judgements, how they work with colleagues and with customers - is complex, almost organic by nature. Common patterns of behaviour, of the way things are done, are so often developed informally and in person. It’s less about ‘telling’ and more about showing, explaining, suggesting, observing, a look, a shrug, a laugh. Opportunities to do that in a virtual work world are profoundly different. Do we know how our staff are really feeling? Do they need help with a decision or reinforcement to exercise judgement? Will they develop, and then remain loyal to their organisation? What are the cognitive differences between interacting online and interacting face-to-face? We don’t know enough about this area yet.

Susan Rice
Chair, UK Banking Standards Board

One respondent observed that there had been “a lot of recent effort on culture, but it remains to be tested”. The coming “years of hard recovery”, as banks have to deal with the aftermath of Covid, could provide that test, said another.

13. Political risk (5) The risk of political interference in the management of banks

The banks’ role as vehicles for government programmes, notably as suppliers of credit during Covid, has exposed them to greater political risk, though whether this will damage them in the long run remains to be seen.

Many respondents commented on the unspoken bargain that has been struck between the banks and government: “We will protect you, but you help us through this crisis”. Pete Hahn, emeritus professor at the London Institute of Banking and Finance, said: “Governments are likely to see banks as beneficial tools to assist post-Covid recovery and may provide leverage to do so.” Another respondent said politicians were “getting more vocal during the pandemic and resulting economic crisis”.
Banks have cooperated in several ways: by restraining dividend payments, by supplying credit, even by overlooking credit ratings to speed up the process. Some respondents felt this endangers the banks because it weakens their independence.

John Tattersall, chairman of UK Asset Resolution, said: “Financial institutions are facing significant exposure to the economic fallout from the Covid 19 pandemic - and therefore to government policy in responding to that fallout. National economies have become far more dependent on government action, which can be difficult to predict and inconsistent.”

However, political risk as a Banana Skin has fallen sharply in the ranking (from No. 5 to No. 13), suggesting that while exposure has grown, the negative impact is seen to be small.

Some respondents saw greater dangers in geo-political risk, particularly the reversal of globalisation and the growing heft of countries like China - which, in the words of one of them, “do not augur well.”

14. International trade (-) *The risk of decline or turbulence in global trade*

Covid could damage international trade flows at a time when deglobalisation and protectionism are already having a negative impact. Specific concerns are that the pandemic will hold trade back and damage trading relationships. In Europe, Brexit presents a further source of uncertainty. One respondent said: “It seems highly likely that there will be a decline in global trade, which will reduce demand for international banking services.” A banker echoed this concern: “There will be decline and turbulence, and how it plays for banks is not obvious. But reduced flow business means fixed costs are harder to recover.”

Some respondents saw these changes benefiting centrally controlled economies such as China, which may be better placed to take advantage of them.

These uncertainties may impact banks through the business of their clients and borrowers rather than directly. However, the impact will probably be limited. Apart from specialist banks, trade finance represents a small and declining share of overall business, and banks have become accustomed to handling its ups and downs. One bright spot is the Biden Presidency which is expected to take a less antagonistic position on trade than Donald Trump. A manager of country risk at a large US bank predicted: “Trade will rebound.”
15. Interest rates (14) The risk to banks from movements in interest rates

Interest rates are a key risk for banks, but which way will they go? Our respondents saw varying scenarios:

- **A prolonged period of low interest rates**, where bank margins are squeezed, forcing banks to find new sources of revenue. A bank regulator was concerned that low interest rates would create “an appetite for ever more risky lending.” Simon Samuels, of Veritum Partners, said: “Zero or negative interest rates mean profit generation remains anaemic, which in turn hinders the ability of banks to rebuild capital.” On the other hand, low rates would help borrowers and reduce the risk of loan losses.

- **Negative interest rates**, which would create very difficult conditions and could even be fatal for weaker institutions. Dylan Minto, chief financial officer of Shawbrook Bank, said: “UK banks have little left in their financial armoury to enhance squeezed returns as we operate at the zero bound. Any move into negative rates will seal the fate of the sector's weak returns profile, rendering most UK large banks a utility.”

- **An upturn in rates**, triggered by inflation. Although this would restore interest margins, it would put stress on borrowers. City economist Andrew Smithers said: “Private sector debt has grown to dangerous levels. When inflation picks up, bankruptcies will rise sharply.”
There was no clear consensus among our respondents about which of these scenarios is the most likely, though the “no change” contingent was probably the largest. What these comments show, however, is that the scenarios are all double-edged: they contain both good and bad news for banks.

Practitioners were considerably more worried about interest rate risk than observers, ranking it No. 8 vs No. 16. But while bankers saw this as a key risk, outsiders thought that managing it “is what they are paid to do”.

16. Regulation (3) The risk of excessive or inappropriate regulation

Regulation has fallen very sharply as a concern, down 13 places in the ranking. In the past, it scored high because it was widely seen to be excessive, and - on balance - a drag on a healthy banking system.

Some of the earlier concerns about overkill remain, for example in anti-money laundering regulation (AML) which respondents said was making life unnecessarily difficult at the customer-facing end and could even hamper the banks’ ability to finance recovery.

However, the drift of opinion is now in the opposite direction, mainly because higher capital requirements and the forbearance shown by regulators during Covid are safeguarding the banking system. “If anything, regulations have helped put banks in a better place to sustain the shock of this crisis”, said Olivier Beroud, director of BCL consultancy.

This Banana Skin uncovered a sharp difference of opinion between financial practitioners and observers. Those in the financial services business ranked regulation No. 11; those outside No. 17. Many banking respondents felt that regulation is still fundamentally excessive. David Potter, a former banker now chairman of Gresham House Strategic, said that “over-regulation will strangle banks and financial institutions and make it increasingly difficult for them to provide banking services”.

But observers took a more positive view. Thomas Huertas, senior fellow at the Center for Financial Studies in Germany, said that given the scale of the guarantees provided to the banks by the authorities, “it is difficult to conclude that regulation is excessive”.

The strength of feeling among outsiders ran high. Some respondents said that, if anything, there needs to be more regulation, for example of capital adequacy and areas of emerging risk such as climate change and the non-bank sector. Duncan Alford, associate dean and professor of law at the University of South Carolina, said: “I am concerned about a weakening of financial regulation in the wake of the pandemic.” Another respondent proclaimed: “From a banker’s perspective, there is a high risk of inappropriate regulation. From my perspective, there is a hope for it.”
New competition

A theme running through the responses is that Covid will enlarge opportunities for new entrants to the market by making banking more technology-driven.

A respondent from the US said: “Regulated international and large regional banks continue to be disintermediated by non-bank institutions and fintech companies, whether (it is) peer-to-peer lending, remittances and FX payments, or AI wealth management. Banks rely on VERY cumbersome legacy (in many cases still mainframe) technologies. With these, they can’t compete. The business remaining with banks will be capital intensive.”

But others said that the market is becoming overcrowded and could see casualties. Paul Lynam, chief executive officer of Secure Trust Bank, said: “As ever, as economic cycles progress, new lenders, banks and non-banks, enter the market. They typically chase market share via aggressive risk-taking and/or low prices. There is a danger that Covid will expose those who have been too aggressive in sectors such as commercial property lending (retail, hotels, offices) and in asset finance.”

Stewart Fleming, associate fellow at the Royal Institute of International Affairs, said: “We are witnessing the beginning of efforts by ‘Big Tech’ companies, most obviously Facebook, to move into the financial sector, but wanting to operate outside what are primarily national, or in the case of the EU/euro area, regional regulatory frameworks. History suggests that this will not end well.”

17. Management incentives (20) The risk to banking soundness and reputation from poorly designed incentive structures

The risks from poorly structured management incentive schemes are seen to be less acute now that they have come under closer regulatory scrutiny. However, this is another Banana Skin where the perception of risk varies greatly between financial practitioners and observers.

Those inside the business ranked it No. 20, while those outside put it at No. 12. One (former) banker said incentives are “a red herring” loved by politicians and the media. “Decent oversight by the board and the regulators should be able to easily rein this issue in.”

But others felt that incentives continue to damage the culture and reputation of the financial services business. A City commentator described them as “completely at odds with the old fiduciary ethos of banking”. There were also concerns that incentives would encourage bankers to take unnecessary risks as they sought to rebuild their businesses after Covid.

Also, it is not only a matter of reputation. One respondent commented that “banking has a unique vulnerability to unsuitable incentives because capital can be wrongly deployed faster and more easily than bricks and mortar”.

Just a red herring?
18. Pricing of risk (9) *The risk of mispricing due to competitive and other pressures*

The pressure to misprice financial assets to win business will always be present, but current conditions could make it worse.

The chief risk officer at a UK financial institution said: “Post-Covid, the desire to help the economy could lead to far too low pricing and poor credit controls of loans.” Another respondent agreed: “Low interest rates and pressure to lend to businesses and individuals to ease the impact of Covid have heightened the risk that too much will be lent to the non-creditworthy.”

Competition could also drive loan rates down to unrealistic levels. A credit analyst observed that in the traded markets “several high-yield credits are now probably overpriced, given the average loss-rates observed historically over the credit cycle.”

A novel suggestion was that the risk of mispricing will increase as more dealmakers begin to work remotely and lose the trading room atmosphere. But another countered that this might improve pricing because it would eliminate “group think”.

19. People risk (22) *The risk that banks will be unable to operate with changed working practices, and will have difficulty attracting and retaining talent*

In a post-Covid world, will banks be able to attract - and retain - good human talent? This emerged as a low-level risk. Matthew Gamser, chief executive officer of the SME Finance Forum at the International Finance Corporation, said that “more and more banks are recognizing this challenge and at least trying to deal with it”.

If there are difficulties, they are likely to come from more fashionable technology-driven employers. “The challenge from fintech (regtech, insuretech, etc) is real” said one respondent, though it might hit second tier more than top tier banks.

A changed world will also call for fresh training. Philip Brown, inclusive finance investment specialist, said that banks will have to ensure that “the staffing talent pool is appropriately skilled, aligned with strategy and sufficiently diverse to provide ingenuity and innovation”.

Some respondents thought staff loyalty might be a problem. Consultant Keith Gold said: “Given the working-from-home development, I am very concerned about new hires into financial institutions over the next few years. Who will they learn from, who will be their mentors and role models? How will they be immersed into teams and organisational culture? This poses a serious risk.”
20. Liquidity (18) *The risk that banks will encounter liquidity problems.*

The risk of a liquidity crisis in the banking system is seen to be low because central banks will ensure it does not happen. Former Bank of England deputy governor Sir Andrew Large said that “the authorities are pretty well prepared to accommodate liquidity shortage”.

However, some respondents feared that central banks had only postponed this risk, and that a liquidity crisis is not out of the way. A Japanese respondent anticipated “a backlash” in the financial markets. Others feared there would be a lending binge; Bing Shen, US-based director of Far Eastern International Bank, said that too much liquidity would lead to “a loosening of credit standards”.

There could also be a political backlash if banks come to be seen as “too big to fail” and get bailed out, as happened in the 2008 crisis. Kathleen Tyson, chief executive of Granularity, said: “The financial system is heavily biased in favour of those with access to central bank liquidity and emergency liquidity facilities, further embedding the discrimination that has fuelled concentration in the banking sector and global wealth inequality since the crisis of 2008-10.”

21. Compliance risk (-) *The risk of sanctions from failure to comply with laws and regulations.*

Compliance risk is seen to be low because, as one respondent said, “Recent sanctions should mean [it] is fresh in banks’ collective memory.”

Nevertheless, there are still causes for concern. One was an attitude in some banks that penalties are “a cost of doing business”, despite regulators’ measures to increase personal accountability for breaches. Another was that this risk will continue to grow with the volume and complexity of regulation. One said: “The banks are working so hard to keep the regulators at bay that they are pissing off their customers”.

22. Capital availability (13) *The risk that banks will not be able to raise affordable capital*

A shortage of capital to restore the banking system after Covid is not seen as a high risk. Banks have been better capitalised since the rebuilding after 2008, and demand for capital is not strong.

A financial strategist said: “As we reach the end of 2020, I am far less concerned about the safety of financial institutions than I was six months ago. The extra capital that banks and insurers in particular were forced to hold to support their operations after the 2008 crisis has provided the financial system with considerably more resilience. This is true of the UK, but probably generally true worldwide.”
However, there are concerns. One is the ban on dividend payments, though this will presumably be lifted at some point. Another is the need to generate sufficient returns on the larger amounts of capital that banks are now required to hold. A respondent said that “the amount of capital deployed in banking greatly exceeds available revenue sources.” A third is that “despite assumptions to the contrary, many FIs will need equity injections given Covid losses and other disruptions” which could be difficult under present conditions.

**Consolidation on the way**

I think the banking system as a whole has sufficient capital to weather the next three years, particularly in the US and UK. Pressure building in Europe for the consolidation of institutions struggling to earn a return sufficient to cover their cost of capital raises the possibility of ill-conceived or poorly executed mergers, threatening individual institutions. In the UK and elsewhere, some of the newer banks are unlikely to survive the next couple of years as they have not yet reached a sustainable scale and are already struggling to raise new funding or capital. These are not systemic, though, and so resolution through consolidation should be eminently achievable.

**John Hitchins**
Chair, Audit Committee
Aldermore Group

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**23. Currency (17)** *The risk to banks from volatility in the foreign exchange markets*

Concern about currency risk is low. If volatility hits the foreign exchange markets, banks should be hedged against it and may even be able to turn it to advantage. Possible causes of currency volatility mentioned by respondents included Brexit and the US Presidential transition.

A new form of risk could, however, be emerging with the growth of cryptocurrencies. Several respondents felt that these markets are insufficiently understood and regulated, but have the potential to cause disruption. Dave Birch of 15Mb Ltd, said: “If F/X includes cryptocurrency, then fun times ahead, but don't banks make money out of volatility?”
Preparedness

We asked respondents how well prepared they think banks were to deal with the risks identified by the survey, on a scale where 1=poorly prepared and 5=well prepared. The average (mean) result was 2.90, some way below the 3.13 scored in 2015.

Bankers rated their preparedness higher than non-bankers: 3.12 vs 2.75

On the plus side, respondents said that banks are generally well-placed to handle risk with adequate capital and a commitment by central banks and governments to provide support. They have also got through the early stages of Covid in reasonably good shape. On the minus side, there were comments that effective risk management required imagination and flexibility as well as good systems, and that these are frequently lacking.

One respondent said: “Over the past decade, banks have made significant improvements to risk management. More widely, regulators have made significant strides to improve systemic stability. Black swan events like Covid have been shown to have minimal impact on bank stability. Risks are possibly greatest when facing long-term restructuring of the markets driven by technological and wider economic factors. Time to prepare and mitigate will reduce the impact.”

The changing face of risk

Some Banana Skins come and go, some are hardy perennials

The Top Ten since 1998 show how concerns have changed over more than two decades. The 1990s were dominated by strategic issues: new types of competition and technology, dramatic developments such as EMU, the Internet and Y2K. Many of these faded, to be replaced by economic and political risks - and particularly by concern over the growth of regulation. The period after 2000 also saw the rise of new-fangled risks such as derivatives and hedge funds, the latter making their first appearance in 2005.

The 2008 survey, conducted at the height of the global financial crisis, brought the focus sharply onto credit and market risks, and propelled two new entrants to the top of the charts: liquidity and credit spreads. The next two surveys, conducted at a time of great financial turmoil, showed a twin preoccupation with financial dangers (credit, derivatives, liquidity, capital) and the growing backlash against banks as seen in the sharp growth in regulatory and political risk.

The 2014 survey, the first in the post-crisis era, showed a hardening of the view that these external risks were damaging, but also a lower concern with crisis-critical issues such as credit risk, capital adequacy and liquidity (which disappeared from the Top Ten for the first time since the crisis began). But ominous new risks appeared, in particular technology and criminality as banks discovered their vulnerability to cyber crime and ageing IT systems.

The latest survey confirms these fears. Technology and criminality risk are now in the top five, ranking alongside the state of the economy and credit risk as the top threats to the industry. Also significant is the appearance of concern with sustainability and reputation as bank behaviour comes under closer public scrutiny.
## Banking Banana Skins: The Top Ten since 1998

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<th>Year</th>
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<tr>
<td>1998</td>
<td>Poor risk management</td>
<td>Y2K</td>
<td>Poor strategy</td>
<td>EMU turbulence</td>
<td>Regulation</td>
<td>Emerging markets</td>
<td>New entrants</td>
<td>Cross-border competition</td>
<td>Product mis-pricing</td>
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<td>2000</td>
<td>Equity market crash</td>
<td>E-commerce</td>
<td>Asset quality</td>
<td>Grasp of new technology</td>
<td>High dependence on tech.</td>
<td>Banking market o’-capacity</td>
<td>Merger mania</td>
<td>Economy overheating</td>
<td>Comp. from new entrants</td>
<td>Complex fin. instruments</td>
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<tr>
<td>2003</td>
<td>Complex financial instruments</td>
<td>Credit risk</td>
<td>Macro economy</td>
<td>Insurance</td>
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<td>2005</td>
<td>Too much regulation</td>
<td>Credit risk</td>
<td>Corporate governance</td>
<td>Derivatives</td>
<td>Hedge funds</td>
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<td>Currencies</td>
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<td>2008</td>
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<td>Credit risk</td>
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<td>Risk management quality</td>
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<td>Credit risk</td>
<td>Macro-economic trends</td>
<td>Regulatior</td>
<td>Capital availability</td>
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<td>2014</td>
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<td>2015</td>
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<td>Technology risk</td>
<td>Political interference</td>
<td>Quality of risk management</td>
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<td>Reputaion</td>
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<td>2021</td>
<td>Crime</td>
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