# Banking Banana Skins. Where do we go from here?

## Points of view by Chand Kohli

### Partner, PricewaterhouseCoopers

**Chand Kohli**
chand.kohli@ie.pwc.com
Tel: + 353 (1) 792 6519

This article describes the risk outlook for the global banking industry at a time following unprecedented stress in the financial markets. The findings are based on the CSFI (Centre for the Study of Financial Innovation) / PwC's 2010 Global Banking Banana Skins report which include responses from more than 400 bankers, regulators and close observers of the banking scene in 49 countries. Comments in this article are also based on the CBI/ PwC 2020 Vision report 'The future of financial services'.

The dash by governments around the world to rescue their banks from the financial crisis may have staved off a collapse of the system, but it has left the banking industry deeply politicised, a development which respondents to the survey find to be the greatest source of risk now facing the banking sector.

**The biggest Banana Skin is political interference**

As a risk, political interference (making its first appearance as a Banana Skin this year) has many angles: it distorts commercial judgement, it creates moral hazard, and it raises uncertainty about how and when financial support will be removed. Closely linked is the risk of too much regulation (No.3) from an over-reaction to the crisis.

**Banking Banana Skins 2010**

*(2009 ranking in brackets)*

1 Political interference (-)
2 Credit risk (2)
3 Too much regulation (8)
4 Macro-economic trends (5)
5 Liquidity (1)
6 Capital availability (-)
7 Derivatives (4)
8 Risk management quality (6)
9 Credit spreads (3)
10 Equities (7)
11 Currencies (13)
12 Corporate governance (16)
13 Commodities (12)
14 Interest rates (9)
15 Fraud (11)
16 Management incentives (17)
17 Emerging markets (18)
18 High dependence on technology (15)
19 Hedge funds (10)
20 Rogue trader (14)
21 Business continuation (23)
22 Retail sales practices (20)
23 Conflicts of interest (21)
24 Back office (19)
25 Environmental risk (25)
26 Payment systems (27)
27 Money laundering (24)
28 Merger mania (28)
29 Too little regulation (29)
30 Competition from new entrants (30)

What is striking about these Banana Skins is that they are common to all major banking regions, and are shared by bankers and non-bankers alike. Respondents, who include practising bankers as well as close observers of the financial scene and regulators, said that the 'politicisation' of banks as a result of bail-outs and takeovers posed a major threat to their financial health. This view was shared by all types of respondents in all the major banking regions, though for different reasons. Comments from the international participants included: Bankers seeing politics distorting their lending decisions; Non-bankers highlighting that political rescues had damaged banks by encouraging reckless attitudes, and regulators worried that governments may withdraw their support from banks before they had time to rebuild their financial strength, precipitating another collapse.

The global results present no surprises in an Irish context. The top risks identified in the report are also some of the key concerns for the Irish banking sector. When the taxpayer has effectively helped to capitalise the banking system, it is reasonable to expect that Government has a say in how the banks operate. The need to rebuild trust between banks and regulators and the populace at large is now more acute than ever. However, it is a question of balance to ensure that the banks will have long term capacity to return public funds and enable them to play their essential role in the wider economy effectively.

### State of the world economy

The dominant factor shaping risk perceptions is the state of the world economy. Respondents' comments about macro-economic trends (No.4) were broadly pessimistic, viewing the recent signs of recovery as fragile and vulnerable to further shocks. This accounts for the high position occupied by credit risk (No.2) where the outlook is seen to be for further losses as the true cost of the crisis is counted, and the lagging effect of the recession takes its toll on borrowers.

Although liquidity risk (No.5) has slipped from the top position it occupied in the last survey in mid-2008, it remains a high level concern. Tension in other financial markets, however, is seen to be easing, notably in derivatives (No.7), credit spreads (No.9) and equities (No.10). One market where risk is seen to be rising is currency (up from No.13 to No.11) with attention focusing particularly on the prospects for the US dollar. Concern has also eased about the outlook for interest rates (down from No.9 to No.14): although a sharp rise in rates may be imminent in an environment of dramatic monetary easing, it is also very predictable. Another notable decline is the risk associated with hedge funds (down from No.10 to No.19) with a falling off in their activity, but also an appreciation that they may be less threatening to financial stability than the banks themselves.

### The availability of capital is a big worry

Making its first appearance in the PwC Banana Skins series, the availability of capital (No.6) is seen as an area of high risk as banks try to rebuild their balance sheets. Although there have been a number of large recapitalisations in the crisis, investor appetite could weaken; there will also be selling pressure as governments seek to offload their stakes in the medium term.

Some of the risks facing banks are seen to be self-generated. Concerns about the quality of risk management (No.8) remains high following the disastrous losses suffered in the last two years. The risk of poor corporate governance has risen sharply (from No.16 to No. 12), and management incentives (No.16) remain a preoccupation, though opinion is divided between bankers who consider the risk to be outside interference and non-bankers who see bad incentives encouraging excessive risk-taking. Concern about conflicts of interest within financial institutions seems to be easing (down from No.21 to No.23). Many of the responses in the governance area were tinged with the worry that banks have not learnt lessons from the crisis and are too eager to get back to business as usual.

On the operational risk front, there was notable decline in concern

## Big movers

**Rising risks**

- Political interference: distorts commercial judgement, creates moral hazard.
- Too much regulation: over-reaction to the crisis.
- Capital availability: huge demands, weakening investor appetite.
- Corporate governance: will banks learn lessons from the crisis?
- Currencies: worries about US dollar volatility.

**Falling risks**

- Liquidity: not the problem it was a year ago.
- Credit spreads, derivatives, equities, interest rates: markets getting back to normal.
- Hedge funds: off the radar screen so far as risk is concerned.
- Back office: has stood up well in the crisis.
- Fraud and rogue trader: fewer incidents than might be expected in a crisis period.

about fraud (down from No. 11 to No. 15) and the rogue trader (down from No.14 to No.20) despite experience which says that both risks rise in a recession. However, the ranking of these risks is closely linked to the number of recent incidents, of which there have been few. Concerns about risks in the back office, payment systems and business continuity – all of which once featured high as Banana Skins – have eased considerably. There has also been a fall in the ranking of money laundering (down from No.24 to No.27) which is now viewed as reputational rather than financial risk. The perception of environmental risk (No.25) was unchanged despite the heat generated by the Copenhagen Summit.

Although competition from new entrants (No. 30) was seen to be the least of the risks facing the industry, it generated much comment from respondents about the dangers of weakened bank competition and greater complacency due to government bail-outs and higher regulatory entry barriers.

A break-down of responses shows an unusually high level of agreement among bankers and non-bankers about the main Banana Skins. Insofar as there are nuances, bankers are mainly concerned with the political and regulatory fall-out from the crisis, and non-bankers are worried that banks will fail to reform themselves, and merely head straight into a new crisis. Regulators focused on the quality of balance sheets and risk management. Geographically, concerns were also strikingly similar in the three regions surveyed: North America, Europe and the Asia-Pacific: all considered political interference, regulatory overkill and credit risk to be among the biggest dangers facing the industry.

## Only 9% of respondents think banks are well prepared to handle risk

We asked respondents how well prepared they thought the industry was to handle the risks they identified. Only 9 percent answered ‘well’ and 11 percent answered ‘poorly’. The remainder gave a ‘mixed’ reply. This is a more negative result than last time when 24 percent said ‘well’ and only 4 percent said ‘poorly’.

## The Banana Skins Index is at an all-time high

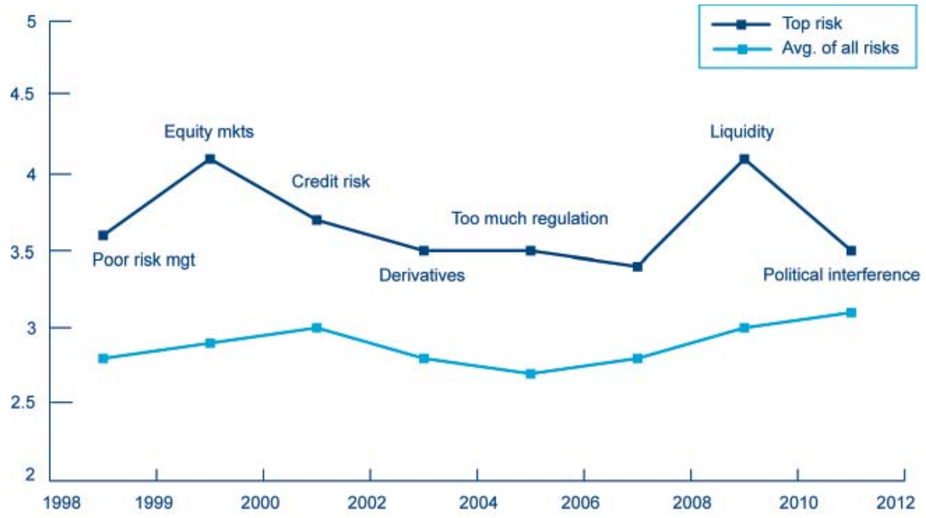
The Banana Skins Index tracks responses over time and can be read as an indicator of anxiety levels on a scale of 1-5. The top line shows the average score given to the top risk over the last 12 years, and the bottom line the average of all the risks. Although the top risk has fallen off, the All-risk index is at an all-time high, an indication of the exceptional level of anxiety currently gripping the market.

The course of the index over the last decade shows the finance sector emerging in a bullish mood from the late 1990s but running into the frenzy of the dot com crash in the early 2000s. Although the top risk peaked in 2000, the overall anxiety level continued to rise for two years in the messy aftermath. The risk level then subsided as stability returned to the markets. However, the first indications of anxiety about the soundness of the bull run appeared in 2006 survey with a sharp rise in the All-risk index, which has continued with the poll.

## Who said what?

Bankers: Bankers put political interference at the top of their risk list because of the pressure it creates to override commercial judgement, e.g. by forcing them to lend in a recession. Concern about a regulatory over-reaction to the financial crisis is closely linked. Bankers’ worries also include a worsening credit outlook as bad debts continue to pile up, and the availability of new capital. Their concern with liquidity risk and the derivatives market, particularly credit default swaps, remains high.

### The Banana Skins index



Regulators: The prospect of another wave of bad debts heads the concerns of regulators as recession takes its toll on borrowers – and uncertainties still cloud the financial markets. Liquidity, currency, credit spreads and commodity risk are all high on their list. Regulators also worry about political interference, in their case because of the uncertainty about how and when governments will withdraw their support. The weaknesses in bank governance exposed by the crisis is another concern.

Observers – non-bankers, analysts, consultants, academics: Non-banker respondents share the bankers' concerns about political interference, though for different reasons: they are worried about the moral hazard created by bank rescues and wonder whether bankers have learnt lessons from the crisis. They also suspect that banks have not got to the bottom of their bad loans, and are skimping on their risk management. Non-bankers are the most pessimistic of the major respondent groups about the economic prospects, fearing a 'double-dip' recession.

**2020 Vision for financial services**

PwC's recent 2020 vision for the financial services sector outlined what the future holds for the industry as follows:

Global banking will continue to be dominated by a few large institutions – mainly universal banks. There will be more consolidation of banks internationally, with Chinese banks starting to appear in the top 10.

Investment banking – with casualties among the biggest global investment banks during the financial crisis, new competition will emerge from hedge funds and boutique advisors.

Building Societies could play an enhanced role in retail banking through continuing mergers, so long as obstacles created by the way they are regulated can be removed.

Insurance will see further consolidation, though post-crisis capital requirements could weigh the sector down. There is scepticism in the sector about whether government moves to increase savings will achieve their objectives.

Financial products will become more transparent, with innovation having to fight to prove its worth.

Sustainability – there will be pressure on banks and other sectors to move away from a focus on short-term performance and in particular we will see greater attempts to link reward with long term performance.

Government intervention and tougher regulation will continue, with continuing international coordination of measures to avoid a repetition of the financial crisis.

Risk management – regulators will refine capital adequacy rules by setting risk-adjusted requirements for particular activities. This will make some activities less attractive.

*Chand Kohli leads the Banking and Capital Markets practice at PricewaterhouseCoopers*

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