CSFI

C E N T R E F O R T H E S T U D Y O F F I N A N C I A L I N N O V A T I O N

5 DERBY STREET
LONDON W1J 7AB

TEL: 020 7493 0173
FAX: 020 7493 0190

Banking Banana Skins: A round-table discussion with David Lascelles (CSFI), Sir Win Bischoff (Citigroup), Tom Huertas (FSA), and John Hitchens (PwC) held Thursday, July 17, 2008, at Innholders' Hall, 30 College Street, London EC4R 2RH from 12:30-2:15pm

It should have come as no surprise that this year's survey, carried out in the first quarter, would have been the "darkest" in the nine years of the survey, the first speaker said. More interesting was that all of the top 10 risks were of a short-term nature, perhaps implying banks were unable to see beyond the turmoil. Interesting two of these risks – liquidity at number one and credit spreads at three – were not mentioned a year ago. One respondent to the survey summarised the concern over liquidity, saying: "It's the fear of loss rather than the actual loss we need to manage." Macroeconomic concerns had risen from 15 to five with risk management climbing four places to six. Perhaps the greatest irony was that the complaint of too much regulation, 2007's table-topper, has fallen perhaps on the realisation that there had not been enough regulation.

The second speaker quoted a central bank governor as saying liquidity was trust. Certainly central banks, particularly the ECB and the Fed, have done a tremendous amount to restore trust. He said the absence of liquidity risk from previous Banana Skin surveys was extraordinary given its importance to banks. It was clear that banks had given liquidity away for small rewards.

Looking forward, he said the subprime crisis was nearly over but the full potential for its knock-on effects was yet to be seen. That in turn depended on the macroeconomic outlook. The speaker urged the authorities not to meddle with accounting standards – mark-to-market might be wrong but reform now would be a mistake. He worried about a rush to legislate generally. On the issue of risk he said that the problem was not with the systems but with wrong judgments that were taken.

The third speaker agreed the economy would have a huge influence and that capital markets had a habit of anticipating changes in direction. He suggested some other risks. One was crisis fatigue. Another was a danger that if explicit or implicit guarantees, such as that covering Freddie Mac and Fannie Mae, were not honoured, the market would react badly. Business continuity was important given the possibility of another 9/11 or geopolitical event. Regulatory reform could harm the outlook, while the need to relieve capital market constraints in areas such as right issues was important.

The fourth speaker highlighted a sub-theme within risk management, that banks had problems with quality of data that slowed their efforts to see the linkages and potential exposures. There was even some element of humility. Another overlooked area is the back office, which rose from 24th to 19th as a risk. They really struggled to cope in the second half of 2007 as policies that worked in a boom failed in the bust, the speaker said.

So how predictive is the survey? The fourth speaker highlighted three areas from the 2006 report. Firstly a credit risk was ranked second because of concerns that defaults could trigger a tightening of liquidity. Secondly there was plenty of concern over the opacity of risk. Lastly many people warned that risk management was becoming too mechanistic and losing the element of human judgement. Not bad, overall. One banker even foresaw the subprime crisis in 2006 and the same person is forecasting an upturn. So there is still hope!

One member asked about the impact of change in culture over the last 10 years from banking to trading. Another member quoted the late Sir Dennis Weatherstone of JP Morgan who said that that he rejected any new product he could not understand after it was explained three times. Many executives at banks did not understand the products their traders were selling. Judgement became a matter of box-ticking.

One member said imbalances, whether current account, trade or fiscal, were threatened to cause havoc. He warned that another Bear Stearns or `Northern Rock would unleash a left-wing backlash in both the US and Europe. The third speaker warned of growing hostility by taxpayers to be the lender of last resort to failed banks. One member agreed that the perception that banks were never allowed to fail would only encourage more risky unregulated activity.

Another member asked why shareholder destruction, which had inflicted great damage on pensions funds, was not on the list of risks. Another said there was a threat of overly strict regulation, which would reduce the earnings and activities of banks that could in turn convert a recession into depression.

So what should the 2009 survey ask that the 2008 one didn't? One member suggested a question about country leadership concerns in some European states and in the light of the US presidential election. The fourth speaker said potential compensation for past excessive overdraft charges could hurt retail banks in the UK. The third speaker said it would be interesting to know what bankers thought the "new normal" was. It certainly wouldn't be the conditions in 2006 and 2007. The second speaker suggested asking about the shift of economic power from West to east. Lastly the first speaker said the danger of overregulation was that it would encourage banks to innovate and move beyond the boundaries and creating conditions for the next crash to be even worse. On which upbeat note the roundtables closed for a summer break.