Bank Governance Leadership Network

June 2020

BGLN

SUMMARY of THEMES

# Accelerating digital transformation while grappling with credit and reputational risks

On June 2 and June 8, Bank Governance Leadership Network (BGLN) participants convened for two virtual meetings to discuss how banks have responded to the COVID-19 pandemic and implications for the future.[1] The key themes that emerged are synthesized in the following sections:

- **As digital transformation has accelerated, new risks have emerged**
- **Persistent uncertainty continues to challenge forecasting**
- **Banking models and reputations will be tested**

## As digital transformation has accelerated, new risks have emerged

The COVID-19 crisis has forced banks and their customers to use digital tools and processes to compensate for branch, office, and call center closures. Participants discussed some of the ways that banks have used technology to confront the challenges posed by the COVID-19 crisis, which of these changes may endure, and some of the emerging risks and challenges.

### Scaling technology adoption to move at pace

The pandemic and resultant lockdowns made remote interactions with clients and employees a sudden necessity, forcing banks to quickly expand and improve digital capabilities. A participant observed, *"Many firms first and foremost had a people focus, so they had to ask, How do you go to remote work overnight and implement business continuity to a degree that most organizations probably hadn't planned for? The second focus has been on digital user engagement, so how do you make sure the interactions with your customers—now perhaps solely digital—are resilient, and how do you scale them for the number of customers you need to?"* For some firms, responding to these questions required accelerated adoption of technologies like cloud computing and AI. A participant commented, *"We have definitely seen an uptick in the use of AI services and cloud providers to build chatbots to help*

> *"Suddenly the impossible became possible. Solutions that used to take 18 months to deliver are now happening in 18 days."*
>
> – Participant

*alleviate the pressure on call centers because volumes were so large."* In many cases, the rapid move to scale these technologies was made possible by an acceleration of internal decision-making processes. A director said, *"What I've heard is a lot of people saying, 'Suddenly the impossible became possible.' We've had internal teams saying certain solutions that used to take 18 months to deliver are now happening in 18 days."*

Many participants believe that the digital acceleration taking place today will have a permanent effect on the industry. A participant said, *"Every organization in financial services had a digital strategy of some kind, but this situation has become an accelerant. 'Someday' or 'one day' became 'today' for a lot of those organizations."* Some firms have had to bypass things like proofs of concept because there was no time. The result could be more agile organizations capable of delivering *"more projects and moving from project phase to production a lot faster,"* a participant predicted. Others see the current environment as a positive use case for investment in technology, including further migration to the cloud. A director said, *"Digital transformation clearly makes a big difference both for cost and efficiency. The use case for cloud already existed and has now been proven."* One executive asked, *"Where we have changed processes to act at pace, why would we go back to the old way of doing things?"*

Participants also noted, however, that barriers to accelerated adoption persist, such as concerns about concentration risk with large providers, the ongoing *"untangling of the legacy spaghetti,"* and organizational inertia, with some employees uncomfortable with new ways of working, or who see these technologies as a direct threat to their employment, and executives wary of the risk that accompanies massive transformation projects. Talent is perhaps the greatest barrier to digital acceleration at banks, according to one participant, who said, *"It's skillsets and experience; there just aren't enough people who know how to use the tools at banks."*

> *"People are breaking down barriers and moving at speed. As the pessimist, what I hear is people are working with inadequate sleep and analysis and taking on more risk."*
>
> – Executive

## Assessing the risks of a new environment

Though some participants celebrated the more agile approach their banks have taken to adapting processes, one executive cautioned, *"You just heard the optimist view, that people are breaking down barriers and moving at speed. As the pessimist, what I hear is people are working with inadequate sleep and analysis and taking on more risk."*

Bank leaders face the difficult task of balancing the traditional approach to risk management with the need to respond quickly to a crisis environment and a rapidly changing technology landscape. One participant stated, *"Time* *and time again, we've seen there are often compelling events that mean we have to look at risk differently and rethink things. I think many organizations are realizing in this moment that you can move forward, and you can do it more quickly than before by relying on the risk and compliance checks you have while evolving your governance framework as needed."*

## The cyber risk landscape is evolving

*"We have not yet seen the massive increase in sophisticated, advanced persistent threat cyber-attacks that we normally associate with events like these."*

– Participant

The current crisis has created massive changes to the operating environment, exposing firms to new cyber vulnerabilities. One participant noted that criminal cyber activity, including fraud and phishing attacks, has predictably increased and highlighted concerns that the massively expanded remote-work environment has increased the risks of certain sorts of attacks, as well as insider threat risk. *"When people connect through VPN concentrators to the bank network, we are seeing an increased focus of attacks on those devices, and all firms should be improving standards around that,"* the participant said. On the positive side, many large banks have not seen a meaningful increase in cyberattacks from the most sophisticated actors, including nation-states. *"We have not yet seen the massive increase in sophisticated, advanced, persistent threat cyberattacks that we normally associate with events like these, perhaps because governments have been distracted by their own challenges with the pandemic,"* reported one executive, who added, *"Of course, any security person thinks in the back of their head that we're just not catching them yet, and that's certainly possible."*

Participants discussed topics bank boards should be addressing with management, particularly as the bank shifts from crisis mode, which inevitably involved accepting some short-term risk, to a more stable, but changed, operating environment.

- **Physical controls.** An executive suggested that boards ask, *"Where did we previously rely upon physical controls but now can't? Call centers are an obvious one, or physically secured non-traditional things, like cryptographic keys."*
- **New dependencies.** *"Where are there dependences and controls that are particularly important right now? Video and voice communications are big ones. For years, people have warned that phone calls are being surveilled at an increased rate—personal phone calls, smartphones … That's even more relevant now with everyone using Zoom and other platforms,"* noted one participant.

- **Information security.** Data security is always a priority, but a participant said, *"We should be looking at where data is outside of the control of where it normally would have been, for example the use of personal equipment. Almost every major bank I've talked to has allowed more employees to print from home. We are loosening some of those controls and accepting a tradeoff with respect to our data."*

*"We've had a number of cases of third parties falling victim to cyber issues."*

– Regulator

- **Third- and fourth-party resilience.** For the most part, digital channels have been able to handle the heavier load resulting from the shift to remote working, including channels that rely on third-party relationships. But a participant urged directors to ask, *"How are their controls? Do they have multifactor authentication? How have their controls been affected, and are they still up to the level you need? Also examine if third and fourth parties have the capacity you are going to need. In many cases you're relying on them like never before: are you checking on them?"* A regulator also highlighted this as a key risk: *"We've had a number of cases of third parties falling victim to cyber issues … COVID clearly provided a very good social engineering gateway, and a number of third parties have been quite spectacularly caught out."*

### Firms should track and assess the risks they have accepted

*"It's critical to look at the areas where you may have been rushing things and had to accept some risk. Now is the time to look back at those choices."*

– Executive

Participants stressed the importance of reviewing decisions made early on in the crisis, particularly in cases where the firm may have temporarily accepted greater risk. An executive said, *"It's critical to look at the areas where you may have been rushing things and had to accept some risk. Now is the time to look back at those choices and make sure they were well thought out."* A regulator agreed, adding, *"You need to have a ledger of all the decisions taken in the first few weeks when you may have thought you wouldn't be in this situation for so long. For risk committees, with the speed at which firms deployed solutions, you want to be looking back at those decisions to ensure they still make sense going forward and that you didn't miss anything."*

## Persistent uncertainty continues to challenge forecasting

Participants continue to question precisely how government lending programs will unwind and what kinds of risks their institutions will ultimately realize.

The unprecedented steps taken to control the pandemic, the delayed effects on some sectors, and the continuing uncertainty about global economic recovery compound the challenge for banks trying to model the impact on their customers and portfolios. One director said, *"It is still extremely uncertain what direction this will take. The longer it goes on, the more clarity we get going forward, but I am still convinced that even in countries with the most successful government support schemes, whether it really helps companies to survive in the long run remains uncertain at this stage."* And some participants cautioned that the second- and third-order economic and market effects are still not well understood and therefore may not be sufficiently accounted for in models. Participants shared the following:

*"It is challenging because the assumptions change daily in terms of industry sectors and economic variables."*

– Director

- **Banks are continually updating scenarios and risk models to assess future needs.** As the economic impacts of the pandemic become clearer, banks are assessing balance sheet health and capital management, and activity that is prompting many to update risk models and stress scenarios in an attempt to stay ahead of the curve. The level of uncertainty in the operating environment continues to pose challenges, however. One director asked, *"How do we get these models right? These are really complex, and we haven't been through this type of cycle before. We're focused on trying to do the best we can to ask whether we're getting the right results, whether credit risk looks as we expected it to."* Another said, *"It is challenging because the assumptions change daily in terms of industry sectors and economic variables."* A lack of regulatory harmonization may further complicate benchmarking among peers across countries, but participants displayed hope that this will improve soon. A director observed, *"We've started seeing a lot from regulators trying to get consistent stress scenarios across the board. Then firms can look across the large banks to see if they're an outlier or not. I think it's a real challenge, and there's a huge amount of board focus right now on trying to get it right."* Another participant added, *"We decided not to do a full [comprehensive capital analysis and review] rerun, but we will drill a level down from that and do a monthly review to look out at least 18 months at impacts on capital assumptions, liquidity, etc."*

- **Uncertainty challenges traditional credit risk analyses.** A director said, *"When you look at credit evaluation, there is a sort of business-as-usual process for trying to make determinations and judgments. It is very different this time around, and that is due to the extraordinary government support programs. The swiftness with which these programs were put in place left uncertainty about where we'll end up when the grace periods* *end. We have no way of forecasting actual impacts on every borrower."* Some participants stressed the importance of continued due diligence around credit and fraud risk, even where government programs do not require stringent oversight procedures. An executive explained, *"We don't have a real formal obligation to do that, but I want to be sure that we're doing whatever is reasonable, because I don't want to be in a bad position a few years from now when the loans aren't being returned and it becomes a legal debate. The rules can be clear, but then it can suddenly become a political process, and then people look at the banks' due diligence."*

*"The swiftness with which these programs were put in place left uncertainty about where we'll end up when the grace periods end."*

– Director

Several participants remained convinced that governments will ultimately take equity stakes in some businesses, particularly in heavily impacted industries that provide critical infrastructure, like airlines. Others expressed continued frustration with the lack of clarity in many areas and were skeptical that governments would want to hold significant stakes in many companies. One director said, *"If you look at what is going on around the world, governments are not ruling anything out, and I do think we'll find that, in many cases, governments will take stakes in some of these companies. However, governments have seen highly varying success rates with such approaches in the past, so we will see whether it works and is profitable this time."*

## Bank models and reputations will be tested

Participants discussed the risks for banks as government programs to support individuals and companies through the COVID-19 pandemic expire and the financial impact of the pandemic and economic shutdowns catch up with more customers.

### Overseeing reputational risk

The central role that financial institutions played in responding to the crisis may have been a boost to morale and to bank reputations. An executive said, *"The reputation of banks is not always the best, and this has definitely helped to give us pride in our own organization and the role that we've played responding to the crisis. Banks have proven to be a critical infrastructure to the population, and governments have signaled that, and I think that is good for the image of our industry."* Nevertheless, the executive added that the outcome for banks, *"will depend on how the world looks in a couple of years."*

As government lending programs unwind, how banks handle the collection process, as well as how they deal with distressed customers, presents significant reputation risk for lenders. A participant stated, *"How you act and* *behave in the next 12 months will determine how you are perceived for the next 12 years."* A director summarized the challenge: *"Figuring out a smooth process for getting the money out was a lot easier than getting it back will be."* One director predicted difficulties as government-provided funds and other easements like repayment holidays and moratoriums on mortgage payments and evictions come to an end. A director said, *"Society will be very unforgiving to businesses that don't appear to be in tune with expectations, and it will be an incredible challenge to handle the wave of foreclosures and bankruptcies in a way that's in tune with societal expectations. If you look back through history, you see businesses and industries that are defined by how they act in these environments. Bank bashing is an Olympic sport, a lot of medals have been given out, and that will continue."*

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>
> – Participant

Another described an additional dimension to the reputation risk banks face: *"There will be an awful lot of companies who will need to trade their way out of this problem, and that will take time. It will take time for people to do that and rebuild balance sheets, and if the banks are seen as cramping companies' recovery by putting back on covenants or demanding that they are the first recipients of any cash flow, that will cramp the economic recovery."* These concerns make this an area requiring critical board attention. One director said, *"It's really vital that boards are aware of the key decisions being made and the way these decisions will manifest and affect perceptions not just externally, but also internally among our employees."*

Participants also discussed the potential for litigation risk in this environment. One director said, *"Demonstrating that the bank did enough before going to the government to ask for the guarantee, that's something where I can see a lot of litigation unless it gets clarified."* Another said that litigation risk was an inevitable consequence of the government response programs: *"I said from the beginning, of course we have to participate because it's the right thing to do for our customers, and if we don't participate we'll be sued, but we need to be realistic that by participating in it, we will also be sued."*

## Adjusting operations to deal with distressed customers

Working through collections and debt solutions in this environment will stretch bank resources. A director said, *"This requires forecasts of income and expenditure, understanding of a customer's ability to afford to meet obligations, and one-on-one engagement and interaction with customers on how to restructure payment obligations. The capacity as a bank to do that will be challenged significantly, and the ability and capacity to engage with*

> *"The ability and capacity to engage with consumer credit challenges will put a massive strain on the system."*
>
> – Director

*consumer credit challenges will put a massive strain on the system."* Some firms are getting creative to ensure they have the necessary skills and experience: *"We are adapting our operations, focusing on ensuring we have teams with credit and recovery skills, and even looking at bringing back people who retired, but who have been through prior recessions to help on this."* With many economies confronting a potential extended recessionary period, some noted that banks may need to explore ways to enhance customer wellness assessments. A director said, *"There is a difference between business as usual versus having to assess whether customers are in distress, and quite frankly all of the assessments and sensitivities will need to be stepped up."*

Some banks are turning to intelligent automation to support these processes. A director described the limitations, however: *"It's not like you can just solve this by moving everything to the cloud or just using bots. A lot of this needs to be a real conversation and a real understanding. Your customers and clients will need to feel like they are really being heard and interacted with."* One participant said the use of technology for issues like this might be an area worthy of increased attention and perhaps clarification from regulators. A director stated, *"It's critical to get arms locked with regulators so we understand how we're supposed to use chatbots and things like that in these circumstances, because my guess is that would not be an acceptable use of technology in many cases."*

> *"It's not like you can just solve this by moving everything to cloud or just using bots. A lot of this needs to be a real conversation and a real understanding."*
>
> – Director

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As bank leaders consider the best path forward for their institutions, a key challenge will be in determining which operational, cultural, and even societal changes brought by the crisis are temporary, and which may have more staying power. These assumptions for the future will have important implications for operating and strategic decisions going forward. One director said, *"Culturally, I think in some ways customers and employees have changed permanently, so some of this is here to stay no matter what happens with the virus. It's just going to be part of the fabric of companies now, and that applies to banking as well."*

# Bank Governance Leadership Network

SUMMARY of THEMES

## About the Bank Governance Leadership Network (BGLN)

The BGLN addresses key issues facing complex global banks. Its primary focus is the non-executive director, but it also engages members of senior management, regulators, and other key stakeholders committed to outstanding governance and supervision in support of building strong, enduring, and trustworthy banking institutions. The BGLN is organized and led by Tapestry Networks, with the support of EY. *Summary of Themes* is produced by Tapestry Networks and aims to capture the essence of the BGLN discussion and associated research. Those who receive the *Summary of Themes* are encouraged to share it with others in their own networks. The more board members, members of senior management, advisers, and stakeholders who become engaged in this leading edge dialogue, the more value will be created for all.

## About Tapestry Networks

Tapestry Networks is a privately held professional services firm. Its mission is to advance society's ability to govern and lead across the borders of sector, geography, and constituency. To do this, Tapestry forms multistakeholder collaborations that embrace the public and private sector, as well as civil society. The participants in these initiatives are leaders drawn from key stakeholder organizations who realize the status quo is neither desirable nor sustainable and are seeking a goal that transcends their own interests and benefits everyone. Tapestry has used this approach to address critical and complex challenges in corporate governance, financial services, and healthcare.

## About EY

EY is a global leader in assurance, tax, transaction, and advisory services to the banking industry. The insights and quality services it delivers help build trust and confidence in the capital markets and in economies the world over. EY develops outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, EY plays a critical role in building a better working world for its people, for its clients, and for its communities. EY supports the BGLN as part of its continuing commitment to board effectiveness and good governance in the financial services sector.



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EY Building a better working world

## Appendix: Meeting participants

- Homaira Akbari, Non-Executive Director, Santander
- Jeremy Anderson, Vice Chairman and Senior Independent Director, Audit Committee Chair, UBS Group AG
- Nora Aufreiter, Corporate Governance Committee Chair, Scotiabank
- Colin Bell, Group Chief Compliance Officer, HSBC
- Win Bischoff, Chair of the Board, JP Morgan Securities
- Jonathan Bloomer, Chair of the Board, Morgan Stanley International
- Agnes Bundy Scanlan, Non-Executive Director, Truist Financial
- Martha Cummings, Former Head, Compliance Strategy & Operations, Wells Fargo
- Bethany Dugan, Deputy Comptroller for Large Bank Supervision, OCC
- Terri Duhon, Risk Committee Chair, Morgan Stanley International
- Tim Flynn, Audit Committee Chair, JPMorgan Chase
- Tom Glocer, Lead Director, Morgan Stanley
- Tobias Guldimann, Audit Committee Chair, Commerzbank
- Robert Herz, Audit Committee Chair, Morgan Stanley
- Petri Hofsté, Audit Committee Chair, Rabobank
- Phil Kenworthy, Non-Executive Director, ClearBank
- Tom Killalea, Non-Executive Director, Capital One Financial Corp
- Christine Larsen, Non-Executive Director, CIBC
- Axel Lehmann, President, Personal & Corporate Banking of UBS Group AG, and President UBS Switzerland
- Stuart Lewis, Chief Risk Officer, Deutsche Bank
- Callum McCarthy, Nomination and Compensation Committee Chair, China Construction Bank Corp
- Richard Meddings, Audit Committee Chair, Credit Suisse, and Chair of the Board, TSB Banking Group

- Tom Mildenhall, Global Head, Technology Business Development, Bank of America
- Scott Moeller, Risk Committee Chair, JP Morgan Securities
- Scott Mullins, Head of Worldwide Financial Services Business & Market Development, Amazon Web Services
- Lyndon Nelson, Deputy CEO, Executive Director, Supervisory Risk Specialist and Regulatory Operations, Prudential Regulation Authority, Bank of England
- Andy Ozment, Chief Information Security Officer, Goldman Sachs
- Kevin Parry, Audit Committee Chair, Nationwide Building Society
- Marty Pfinsgraff, Risk Committee Chair, PNC Financial
- Bruce Richards, Chair of the Board, Credit Suisse USA
- Philip Rivett, Non-Executive Director, Nationwide Building Society, and Non-Executive Director, Standard Chartered
- David Roberts, Chair of the Board, Nationwide Building Society
- Sarah Russell, Audit Committee Chair, Nordea
- Alexandra Schaapveld, Audit Committee Chair, Société Générale
- Alan Smith, Global Head of Risk Strategy, HSBC
- Kate Stevenson, Corporate Governance Chair, CIBC
- Katie Taylor, Chair of the Board, RBC
- Jan Tighe, Non-Executive Director, Goldman Sachs
- Tim Tookey, Risk Committee Chair, Nationwide Building Society
- Michelle Trogni, Technology, Data and Innovation Committee Chair, Deutsche Bank

## EY

- Omar Ali, Managing Partner, UK Financial Services
- Andy Baldwin, Global Managing Partner, Client Service
- Jan Bellens, Global Banking and Capital Markets Leader
- Anthony Caterino, Vice Chair, Regional Managing Partner, Financial Services Organization

- Peter Davis, Americas Financial Services Advisory Leader
- James Karwel, Americas Banking and Capital Markets Leader
- Nigel Moden, EMEIA Financial Services Banking and Capital Markets Leader
- Marcel van Loo, EMEIA Financial Services, Regional Managing Partner

## Tapestry Networks

- Dennis Andrade, Partner
- Brennan Kerrigan, Senior Associate
- Tucker Nielsen, Principal

## Endnotes

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[1] A complete list of participants is included in the appendix. *Summary of Themes* reflects the network's use of a modified version of the Chatham House Rule whereby comments are not attributed to individuals, corporations, or institutions. Network participants' comments appear in italics.