Financial Services

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SUMMARY OF THEMES

Board chairs assess the risks—and potential opportunities—of a deteriorating economic and geopolitical environment

A combination of events has produced one of the most challenging macroeconomic environments in decades. The board chair of a large financial institution observed, *"The biggest risk is the degree of uncertainty and volatility we face in the global economy. It feels like there are so many risks—from the war in Ukraine to cool relations with China, supply chain disruption, and interest rate and foreign exchange volatility. Nobody knows if we will we have soft landings or hard landings. So, the confluence of economic, monetary, and geopolitical risks is heightened."*

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>
> – Chair

On July 19, 2022, chairs of the boards of leading banks and insurers met to discuss the implications of these conditions and the major risks and opportunities facing their institutions in the months ahead. Participants agreed that the combination of a deteriorating macroeconomic landscape, rising geopolitical tensions, and political instability creates a uniquely challenging operating environment. *"In a nutshell, taking an optimistic view is not really compelling,"* said one chair. This summary captures key themes emerging from the discussion and is organized in the following sections:

- **The macroeconomic environment is fraught with risk**
- **Cyberattacks and the ongoing pandemic could bite again**
- **Competing priorities around climate transition create new challenges, but also opportunities**
- **The economic downturn and market correction could lead to further industry consolidation**
- **Conditions could generate opportunities for improved public-private engagement**

The macroeconomic environment is fraught with risk

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Inflationary pressures in the face of slowing or even negative economic growth make macroeconomic risks the primary source of concern for financial institution board leaders. One chair painted a grim picture: *"I see the risk of inflationary recession. Central banks are shifting policies, but it's likely we will see real negative rates for the foreseeable future, no matter how high the central banks go. Any central bank intervention will take much longer time to be effective in fighting inflation. So, we will face a unique environment where we see recession with persistent inflation."* The same participant described the challenges in responding, as policymakers face a "reckoning" for loose monetary policy that distorted behavior: *"In the past, the mechanism of monetary policy was much quicker, but the amount of money supply in the economy is so big now that it takes longer for central bank action to have an effect. Central banks are shifting policy, but we have not seen that, so what happens?"* The board chairs discussed the macroeconomic climate and the implications for their customers, their firms, and the financial system.

Businesses and consumers, unaccustomed to inflation, will be stressed, but systemic risk is limited

Participants noted that the combination of high inflation and a significant economic downturn represents unfamiliar territory for business leaders to navigate. One bank chair said, *"There are going to be companies that are seriously caught out by this. Most senior management at companies to which we lend have not experienced double digit inflation in their careers, and don't have a good idea how to manage it. I fear that some, especially in an environment with a tight labor market, will concede wage increases to keep staff, but will find that, in an environment with low consumer confidence, it is difficult to pass that through. So, they will see margin pressure. I fear we will see increases in bad debts."*

Participants regard large financial institutions as well-equipped to manage the resulting credit risk and see little risk of insolvency or danger to the soundness of the financial system. *"Financial institutions are well capitalized, with a lot of buffers,"* largely due to regulatory reforms put in place after the financial crisis, said one chair. *"My view is we can expect higher loan-loss provisions and some credit losses, but I think financial institutions are well-positioned to handle this. We are not where we were back in 2009."* Another was more cautious: *"There is a question mark about the stability of capital and earnings. I agree that large players are well capitalized, but in a low* *interest rate environment, some organizations took on risks, and as the interest rate profile changes, the risk profile changes. They could get caught on the beach as the tide goes out. It will expose inappropriate risk taking and weaker business models, both in banking and insurance."*

Financial institutions need to carefully manage reputational risk by "bearing some of the pain"

"Standards will go up ... we need to demonstrate support and willingness to share a bit of pain with consumers and SMEs."

– Chair

The board chairs anticipate that the macroeconomic environment will create economic distress for customers, particularly consumers and small-to-medium enterprises (SMEs). They agreed that how financial institutions respond to these economic hardships will affect their reputations for years to come. One chair said, *"Banks and insurance companies will be under scrutiny,"* while another noted, *"We will all be held to higher standards of behavior. There will be an unwillingness to accept anything not perceived as fair."*

Mitigating reputational risk will be critical. One chair said, *"Our goal, as far as we can, especially for consumers and SMEs, is do no harm. We need to make sure we have strong support mechanisms in place, that we are empathetic to the challenges people are facing, while protecting the balance sheet and shareholders. Standards will go up, rightly in my view, and we need to demonstrate support and willingness to share a bit of pain with consumers and SMEs."* As a result, financial institutions need to be preparing now for what is coming: *"We need to be thinking now about how to get ahead of that. We are facing a world of negative real incomes over the next year, and we need to be supportive of that."*

Developing an appropriate response will require deft leadership. A chair stated, *"Empathetic leadership will be important. Stakeholders, especially employees, appreciated that during the pandemic and don't want that to disappear. Demonstrating empathetic support in leadership is something we can control amidst volatility and uncertainty. We need to communicate, pay attention to employees, address compensation at lower levels. For customers, it's about being able to spot areas of distress early through technology and being proactive. We have to be as proactive as possible, even when we don't have all the solutions."*

Economic adversity could give rise to social and political unrest

While the direct effects of stagflation are concerning, participants also highlighted the potential for second order effects, particularly the risk of social and political upheaval. Economic stress is highlighting political dysfunction in many countries and on a global scale, and risks exacerbating polarization and

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extremism, making it even more difficult for policymakers to mount an effective response. This will be compounded by *"the lack of trust in institutions,"* said one chair. *"With inflation in particular, consumers are looking at government, banks, and big businesses and wondering if they have been let down by us all. All of this adds up to the question: what are leaders doing for our people?"*

One chair suggested that these political and social issues *"add more fuel to risks than they otherwise would have had, and the lack of coordination across the globe and within ministries and markets amplifies every risk on the page."*

Participants outlined the following concerns:

- **Social and political instability will escalate.** *"The biggest risk from my point of view is social unrest,"* said one chair. *"It is likely that no matter what politicians are doing, we'll see reactions from people showing their dissatisfaction. The gilets jaunes in France may come back … Populism will come back in a more violent way, I'm afraid, in the future."* Another participant noted, *"Canada is seen as a paragon of stability and virtue, but even there we are seeing the rise of populism and pressures. We will see political instability across the world."* Another participant predicted, *"The economic situation is likely to lead to greater populism and extremism."* That populism could take multiple forms, but one chair also predicted *"the rise of labor as a significant theme."* Some institutions are identifying methods to capture the risks these social and political shifts could present: *"All major insurers are running stress testing, not just on economic inflation, but on 'social inflation,'"* according to one participant.
- **Financial institutions could be targeted by policymakers.** Perceived lack of empathy or fairness could lead not just to reputational damage, but also adverse policy developments for financial institutions. One director said, *"In this political environment, the risk of ill-informed and populist measures that will tie our hands and ultimately hurt consumers is high."* Financial institutions could become the target of such policies: *"We saw what happened in Spain—a new tax on banks. Others will follow that example,"* predicted one chair. Another agreed: *"Canada already has a special tax on banks—the recovery dividend—because people perceived banks did better than others during the pandemic."*
- **Political motivations are causing divergences in monetary and fiscal policy.** Tensions between policymakers and central banks could challenge efforts to address inflation. One chair noted, *"Central bank bashing is a global sport."* Another observed that, in the UK, *"Politicians*

are giving little support to the Bank of England. The Bank is getting swiped by politicians, which is new. For 25 years central bank independence has been expected, but that's not the case now." A key risk, one participant said, is the *"disconnect between fiscal and monetary policy in many countries,"* with central banks raising rates to tighten the money supply, while politicians support fiscal stimulus to ease their constituents' pain. A chair warned of *"reckless promises on tax and fiscal policy,"* from politicians looking to win elections, adding, *"We know governments tend to turn the taps on before an election. This accentuates severe inflationary risk in this economy and the concern is we end up in an inflationary spiral."*

Cyberattacks and the ongoing pandemic could bite again

"This coming winter, with a shortage of energy, I'm afraid we'll see attacks on energy providers' IT capabilities."

– Chair

Though macroeconomic risks are top of mind, participants warned of other risks that could crystalize in the coming months:

- **The lull in cyberattacks will only be temporary.** Participants agreed that the *"positive surprise"* of an absence of a significant increase in cyberattacks in the wake of the Russian invasion of Ukraine is unlikely to last. As cyberattacks accelerate, financial services and energy will be the two key sectors targeted, predicted one participant. Another agreed that energy would be particularly vulnerable: *"This coming winter, with a shortage of energy, I'm afraid we'll see attacks on energy providers' IT capabilities."*

- **Endemic Covid combined with resurgent flu could exacerbate labor shortages.** One participant warned that the ongoing effects of the Covid-19 pandemic could be compounded by a particularly harsh flu season this year. *"I think we should prepare ourselves for a tough flu season, with the lack of immunity since we haven't really experienced flu over the last couple of years. With the flu and Covid, we'll see significant impacts in an already tight labor market. We need to redouble efforts for public health interventions and within companies to mitigate that."*

Competing priorities around climate transition create new challenges, but also opportunities

Chairs describe a *"fraying of the consensus"* around climate transition as concerns around energy affordability and security mount. Several major institutional investors and regulators have moderated their approach, allowing for a more nuanced discussion around climate transition planning. While some politicians have followed suit, others are actively opposing climate transition efforts. One participant noted, for example, *"In Texas, to participate in municipal bond auctions and underwriting, you have to submit a statement in support of fossil fuels."* In the UK, conservative politicians jockeying to succeed Boris Johnson *"have steered as far away from climate change in discussions as possible, reflecting the growing resistance among the rank and file in the Conservative Party to deliver on the nation's net zero commitments."* One participant described the political dynamics at play, *"It's understandable if you are a consumer struggling with high energy prices, that anything that makes that harder is going to be a tough sell. And politicians simply amplify the views of their constituents."*

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But activists and NGOs are still pushing for aggressive actions to reduce dependence on fossil fuels, leaving financial institutions feeling pulled in opposite directions. One chair said, *"At the moment, we sit in the middle, and the two extremes are moving away. We think we have a responsible approach to managing the transition—we push on our stress tests and only lend to those with credible net zero transition plans. But this pragmatic approach is being left stranded by the two extremes.*"

At the same time, the economic situation and resulting market volatility is testing investors' commitments to sustainable investing. After a period of outsized returns, ESG funds are likely to underperform in the coming months. *"It's easy to sell these kinds of products if they are generating alpha,"* one board chair noted. *"But it's now clear if you have no exposure to fossil fuel or defense, you are underperforming, so you will see investors' desire and commitment be tested this year. It will be a double whammy—you will see underperformance and negative returns."*

Some participants painted a more optimistic view, suggesting that the current energy crisis is injecting a healthy dose of realism into discussions of climate transition. Politicians, regulators, investors, and other stakeholders, participants said, are more willing to consider the need for energy security and affordability as the economy transitions away from fossil fuels. *"An opportunity in this moment, perhaps a silver lining to the current disruption, will be a more fulsome and well-thought-out conversation on how some of these opportunities can be brought to fruition, through private financing or public-private partnership. Perhaps the reality of energy insecurity ultimately will spur a more cohesive conversation between policymakers and institutions who need to operationalize this."*

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> – Chair

A more nuanced approach to climate transition creates opportunities for financial institutions. One chair said, "*Banks have to play a constructive role, but we have to move away from black and white to consider energy security and affordability vs. accelerating decarbonization. We will have to help clients finance a transition that makes sense."* Another pointed out, *"On climate, pools of private capital can do an enormous amount of good. The opportunities to effectively reallocate capital and investment are huge."* Capitalizing on some opportunities will require government partnership to encourage investments: *"Sometimes the risks are too much to take on. We need government support, such as subsidies and investments in new technologies like carbon capture and sequestration to make them viable and scalable."*

The economic downturn and market correction could lead to further industry consolidation

The current economic landscape could create opportunities for banks and insurers to capitalize on the struggles of fintechs or weaker incumbent firms.

- **Fintechs' difficulties may generate opportunities for incumbents.** As fintechs struggle to reach scale and face plummeting valuations, incumbents may find opportunities either through acquiring them or entering markets fintechs have pioneered. One bank chair said, *"Some kind of shakeout is going on the fintech world. Quite clearly, valuations have changed radically. Those that were outside any sensible valuation might be worth looking at now. That will create some opportunities. In some cases, they've created new markets, such as decentralized finance and buy now, pay later, but are not serving them well. So, there are ways for banks to pick up those opportunities where fintechs may have identified gaps in the market, and having identified them, can't serve them in a responsible way or expand."* Another participant agreed: *"Many fintechs are finding it very expensive and difficult to acquire clients. Complementing new technology with established networks of clients is a winning proposition."*
- **Economic and market pressures could accelerate industry consolidation.** As weaker firms increasingly find themselves under economic stress, this may create strategic opportunities for stronger incumbents. One chair predicted, *"Consolidation, long awaited, is coming in this environment. It is not easy to do in tough times, but that*

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– Chair

is also when people are forced to take tough decisions–to justify to stakeholders and even governments. There are many players who struggle with fundamental structure of business model issues. No matter how the economy performs, for many banks and some insurance companies, it will be hard to exist in the future, so that creates opportunities for M&A. For part of the insurance industry and more so for banking, there are players who can't pay for the cost of capital in a structured way." According to another board chair, *"We need some European bank boards to become scared. They might need to see those risks coming through and hitting these institutions, so they start to debate the best route to deliver value. Conditions have not been in place for that for a long time, but they may now be faced with some difficult choices."* And yet, political and regulatory hurdles to consolidation persist, especially in Europe, which lacks an effective capital markets union. One participant noted, *"There is still a mentality that you need to have national champions, but this is a costly exercise. Domestic consolidation can still happen. We may need a round of further domestic consolidation and then Europe–wide consolidation."*

Conditions could generate opportunities for improved public-private engagement

"Government budgets will be under such pressure, they will be looking for private capital to play a role ... Conditions are in place for a dialogue."

– Chair

A participant noted, *"The issue of resilience will go up big time on the political agenda–health, defense, energy security. That focus will lead to the opposite of globalization."* And yet, given the barriers to government action on these big, thorny issues, participants see an opportunity to open discussion on how the private sector, and financial services specifically, can support things like climate transition more effectively. A participant said, *"Government budgets will be under such pressure, they will be looking for private capital to play a role. These are clear and present issues. Conditions are in place for a dialogue, rather than chucking a policy over the fence."*

Unfortunately, another participant sees *"politics as overriding"* these opportunities for dialogue in some places, but also noted, *"There has been a lot of dialogue and coordination on cybersecurity. Energy security will be a priority for the next six-to-twelve months and could follow a similar approach."* According to another, *"Dialogue is accelerating because of energy cost and security issues. The real human cost of getting it wrong in any direction is so great."*

Appendix

The following individuals participated in these discussions:

Participants

- Bill Connelly, Chair of the Supervisory Board and Nomination and Governance Committee, Aegon
- Howard Davies, Chair of the Board, NatWest
- Sergio Ermotti, Chair of the Board, Swiss Re
- David Roberts, Chair of the Board, Beazley
- Kate Stevenson, Chair of the Board, CIBC
- Katie Taylor, Chair of the Board, RBC

EY

- Jan Bellens, Global Banking and Capital Markets Leader
- Isabelle Santenac, Global Insurance Leader

Tapestry Networks

- Dennis Andrade, Partner
- Eric Baldwin, Principal
- Tucker Nielsen, Principal
- Andre Senecal, Associate

About the Bank Governance Leadership Network (BGLN) and Insurance Governance Leadership Network (IGLN)

The BGLN and IGLN address key issues facing complex global banks and insurers, respectively. They primarily focus on the non-executive director, but also engage members of senior management, regulators, and other key stakeholders committed to outstanding governance and supervision in support of building strong, enduring, and trustworthy financial institutions. The BGLN and IGLN are 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 network 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 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.