Financial Services Leadership Summit

July 2020

FSLS

SUMMARY of THEMES

Road to the Summit: Board chair discussion on risks and opportunities

On July 21, eleven chairs of the boards of banks and insurance companies from Africa, Canada, Europe, and the US met to discuss the risks of greatest concern in the current environment, as well as emerging opportunities.[1] The board leaders exchanged perspectives on the key issues facing their boards; the conversation will inform Bank and Insurance Governance Leadership Network discussions through the end of 2020, including the Financial Services Leadership Summit. Four major themes surfaced:

- **Firms are well capitalized, but concerns about financial resilience are growing**
- **Reputational risk is heightened as "days of reckoning" draw near**
- **A new paradigm for public sector involvement with business is emerging**
- **The race to digitize has only accelerated**

Firms are well capitalized, but concerns about financial resilience are growing

Months into the COVID-19 pandemic, the dominant and persistent worry for financial services leaders is financial strength. One chair noted, *"The biggest concern is the uncertainty about what the economic recovery is going to look like. The risk of a second wave of infections and possible further lockdowns is an unknown, as are the second and third order impacts all of this will have on economies."* This hampers strategic decision-making and challenges risk management. Another participant added, *"Most financial institutions are still looking ahead at a wide range of possible outcomes on how this might impact our customers and balance sheets."* Participants discussed how these concerns are influencing capital management and balance sheet resilience:

- **No immediate need to raise capital.** Financial institutions and regulators are assessing balance sheet health since a prolonged economic slowdown and a slow recovery look increasingly likely. Some industry observers and regulators have called for institutions to raise capital in preparation for significant economic stress. Most participants insisted that the need is not yet apparent. One said, *"I would say raising capital is still hypothetical unless you are facing an institutional crisis and must do it. The idea of preemptively doing it right now would be a difficult thing to consider."* Participants agreed that bank and insurer balance sheets remain strong, and that several factors would complicate raising capital now. A board chair explained, *"In Europe, given the interest rates and low valuations, it's very hard to imagine how we could ever raise capital unless we're forced to. I think the investment case in Europe is going to be very hard for the next year or two."* Participants noted that firms still have regulatory capital buffers and that regulators are providing forbearance if firms need to use them. But some questioned how markets might react if a financial institution were to tap into those buffers. A participant clarified, however, *"We're only going to use them if we absolutely have to, in which case we won't be able to worry about the market's reaction to it."*

"It is not a question of raising more capital, it is a question of preserving the buffers that we've got."

– Board chair

While banks are making significant loan-loss provisions, insurers also have financial strength concerns. One chair insisted, *"I think most of the insurance industry feel they're well-capitalized and aren't indicating that that they will need to buttress that with additional capital."* Countering this, another said that dynamics could change as the economic fallout affects asset valuations: *"The sector has the asset side of the balance sheet as well, we will see more risks coming with commercial real estate, commercial mortgages, etc. being impacted as time goes on."* Another chair pointed out that for insurers, *"The whole issue is credit migration for us. That's the focus. The portfolio doesn't actually have to go in default, just the change in ratings has an impact."* Another variable that could have a material impact will be how litigation around business interruption coverage is resolved. A participant explained, *"What happens with all these claims of business interruption coming in the COVID world? In the US, that will be decided by litigation over time. In the UK, it is turning into one big roll of the dice that will set the precedent for everyone. If that turns out badly, and the US also finds coverage in a lot of cases, the industry might need to find capital to cover that sizable exposure."*

- **The return of dividend payments remains an open question.** The uncertain economic outlook means that financial institutions and regulators are likely to be conservative regarding any return of capital to investors. One board chair said, *"I don't think the issue for the banks is insufficient capital; it is the ability to restart dividend payments. It is not a* *question of raising more capital, it is a question of preserving the buffers that we've got. The regulator here is happy for us to use those buffers, but not to use them and also pay dividends."* In some cases, regulators have placed restrictions on dividend payments, but elsewhere have only offered guidance, creating inconsistency in approaches. A participant said, *"In some areas insurers are being guided not to pay dividends, but some do, and some don't, and that has created chaos in the investment community. It's going to be a while before it's sorted out."*

"There may be financial institutions that are okay from a capital and liquidity position, but don't have healthy profits. Those will be targets for consolidation."

– Board chair

- **Cross-border mergers and industry consolidation is possible.** Some observers predict that consolidation of the financial services sector – particularly among European banks – is "inevitable" as credit losses mount.[2] A participant predicted, *"In the eurozone I would be surprised if we didn't see more consolidation in the next three years."* Business model risk could also drive merger activity: a participant said, *"Given all we've talked about with respect to economic challenges, there may be financial institutions that are okay from a capital and liquidity position, but don't have healthy profits and cannot pay a dividend. Those will inevitably be targets for consolidation."* In the past, regulatory restrictions and governmental reluctance have made cross-border consolidation particularly challenging, but participants said that this is changing. One said, *"Regulators have been very clear that they want to facilitate consolidation within the eurozone. For the first time, the ECB is talking about facilitating cross-border consolidation, even among very large financial institutions. In the past there have been many obstacles to that."* The practical challenges of major M&A among large financial institutions remain a barrier, however, for example the political desire to maintain large financial institution headquarters within national borders–*"Do we need a 'Delaware' for Europe, where pan-European institutions can establish legal headquarters?"*- and integrating major IT systems: *"All financial institutions are in the middle of their own technology transformations: which among us would want to tackle a major integration in the middle of this?"*

Reputational risk is heightened as "days of reckoning" draw near

Financial institutions will face significant reputational risk in the coming months as government lending programs unwind, payment holidays come to an end, and customers and clients experience economic distress. A board chair observed, *"Many banks have been involved in government packages to*

> *"Compared to 2008, the number of small businesses affected is going to be much bigger and we will see that working through the system in just a few months' time."*
>
> – Board chair

extend huge amounts of credit to small businesses that may or may not have a viable future. The day of reckoning will come where it becomes clear that those companies cannot pay the debt that they've taken due to a lack of revenue." Many retail consumer customers will face similar stresses, which may challenge individuals' ability to pay mortgages or service personal debt. A chair described the risk this entails for banks in particular: *"At the end of the day, we are the people that call in the debts. I am concerned about the political and reputational backlash against the banks again. Compared to 2008, the number of small businesses affected is going to be much bigger and we will see that working through the system in just a few months' time."* Insurers have to deal with the end of premium deferments, distressed customers and assets, and conflict with customers over what is covered by business interruption policies; all these could pose major risks to brands and reputations.

Firms will need to find ways to demonstrate empathy as they work with distressed customers. One chair noted, *"What will cause the most reputational damage is not handling those distressed customers well, not being understanding. We are going to have to commit a ton of resources to ensure customers are being dealt with in a sympathetic way."*

A new paradigm for public sector involvement with business is emerging

> *"The most important impact that the coronavirus situation has had is redefining the relationship between governments, business, and society."*
>
> – Board chair

"The most important and significant impact that the coronavirus situation has had is redefining the relationship between governments, business, and society. All over the world this has been drastically altered. It has fundamentally changed things," stated one chair. Participants were largely complimentary of the swift actions taken by policymakers and regulators to limit the economic damage caused by necessary restrictions. *"Imagine what the world would look like without the extraordinary central bank and government intervention we have seen,"* said one participant, noting, *"The Federal Reserve has been pretty agile and done some extraordinary things that really haven't been done before. That was not a result of political pressure, it was just really smart people responding to incredible circumstances."* However, the unprecedented levels of government intervention in global economies may have long lasting effects on political influences over economic policy and even governance of individual businesses.

Some chairs wondered whether governments will be able to maintain the same flexibility in the coming months as the situation continues to evolve, or how some of the steps taken to date, such as government lending programs, will be resolved. One said, *"Many governments were agile in moving quickly and effectively to take action, but they're not being very agile about thinking through how they get themselves out of the issues they've created."* Government actions are likely to be subject to increasing scrutiny and political pressure, especially in the US, which is in the midst of a presidential election. A participant said, *"Even if some governments have acted incredibly well in making sure the crisis didn't get worse than it did, you know that everything is going to be subject to second guessing, to people asking why they wasted taxpayer money. There will be fights, and we will likely be collateral damage."*

"We have seen this movie before, we have seen what it means if taxpayers bail out an industry and the consequences of that action on that industry."

– Board chair

The pandemic is affecting some industries much more severely than others, for example travel, tourism, and hospitality, some of which will require government intervention to survive. Large financial institutions faced something similar following the last crisis, prompting one board chair to comment, *"We have seen this movie before, we have seen what it means if taxpayers bail out an industry and the consequences of that action on that industry. There may be an opportunity for us to help our corporate clients because they haven't seen that movie; we can help play a constructive role in that context."* But some chairs noted the different context this time; one said, *"I think there is a difference between airlines, auto, tourism, etc., versus the banks in 2008-09. Banks were seen as being the cause of that crisis. These industries I think are seen as victims of this crisis."*

The race to digitize has only accelerated

Financial institutions were forced to accelerate and expand digitization efforts during the pandemic, when virtually all customer interactions moved to digital channels. Many executives and directors note the benefits of this acceleration, but also the challenges and opportunities it poses for the long-term. They made the following observations:

- **Big financial institutions can be agile.** The need to act quickly has also demonstrated that financial institutions can adapt and move at pace. One participant said, *"The agility part of this is going to continue to be very important. Technology is what helps to enable that."*
- **Customer needs and behaviors have changed for the long term.** One chair emphasized that the rapid, large-scale adoption of digital should have a sustained effect: *"Yes, the efficiency and cost savings are great,*

but financial services companies need to be taking care of their clients this way regardless. People are seeing how necessary it is." Another said, *"We've seen an uptick in digital products and clients interacting digitally in different ways. I think the convenience factor for people during this crisis has driven a pretty rapid change in client behavior." Several predicted that these changes in behavior would have a lasting effect.*

"We can use technology as a sieve to ensure we get to the people who need help before they need it."

– Board chair

- **Investments in data management will help firms navigate this crisis.** Banks and insurance companies are investing in their ability to use and analyze data in ways that can not only help them manage risk more effectively but also help their customers do so. A participant noted, *"It's not just customers using the system, it's our ability to figure out when and where there could be issues. In the same way that branch managers used to know all their customers and their troubles, we can use technology as a sieve to ensure we get to the people who need help before they need it."* Another added, *"Technology is critical for really being able to understand where those pockets of distress are going to be sitting, using your data to figure out who is likely to recover sooner rather than later, identifying the longer term recoveries, and making better decisions for your customers and clients."*

"It's not just digitization, it's reinventing the business in a new technology structure. Those that can, may be positioned to acquire those that cannot."

– Board chair

- **Differentiation and strategic opportunities may depend on effective technology investment.** Participants highlighted that institutions that were further along with digital transformation before the pandemic are well positioned, while firms that were behind, particularly if they lack significant capital to invest now, may struggle. A board chair said, *"To some extent, it depends where you are starting from in terms of the number of legacy systems you have and how far along you are in your digital efforts as to how well positioned you are now."* Financial institutions that have successfully transformed their systems and processes may be better positioned to be acquirers of those who are unable to make a similar transformation. A board chair elaborated, *"It's not just digitization, it's managing a technology transformation, adoption of cloud solutions and reinventing the business in a new technology structure … Not all financial institutions can do that successfully, however. Those that can, may be positioned to acquire those that cannot, but it's probably several years in the future."*

Financial Services Leadership Summit

FSLS

SUMMARY of THEMES

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 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.

The perspectives presented in this document are the sole responsibility of Tapestry Networks and do not necessarily reflect the views of any individual institution, its directors or executives, regulators or supervisors, or EY. Please consult your counselors for specific advice. EY refers to the global organization and may refer to one or more of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. This material is prepared and copyrighted by Tapestry Networks with all rights reserved. It may be reproduced and redistributed, but only in its entirety, including all copyright and trademark legends. Tapestry Networks and the associated logos are trademarks of Tapestry Networks, Inc., and EY and the associated logos are trademarks of EYGM Ltd.

Meeting participants

- Paul Achleitner, Chair of the Supervisory Board, Deutsche Bank
- Bill Anderson, Chair of the Board, Sun Life Financial
- Norman Blackwell, Chair of the Board, Lloyds Banking Group
- Bill Connelly, Chair of the Supervisory Board, Aegon, and Non-Executive Director, Societe Generale
- Howard Davies, Chair of the Board, NatWest Group
- Tom de Swaan, Chair of the Supervisory Board, ABN AMRO
- Brian Levitt, Chair of the Board, TD Bank Financial Group
- Trevor Manuel, Chair of the Board, Old Mutual
- Chuck Noski, Chair of the Board, Wells Fargo
- Doug Steenland, Chair of the Board, AIG
- 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
- Jonathan Day, Vice Chair
- Brennan Kerrigan, Senior Associate

Endnotes

[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.

[2] https://www.euromoney.com/article/b1lsq764l5qhfc/large-bank-mampa-across-europe-is-now-inevitable