Financial Services Leadership Summit

October 2019

FSLS

SUMMARY of THEMES

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On 16–17 October 2019 in Washington, DC, directors and executives from around 30 of the world's largest banks, insurers, and asset managers met with fintech executives, regulators, and other experts for the Financial Services Leadership Summit. Discussions focused on issues that could represent systemic risks or challenge the resilience of firms and the financial system. Key themes emerging from the discussions are synthesized below.

Post-crisis reforms may soon be tested

Participants discussed a few key aspects of post-crisis reform efforts and the current environment as the global economy faces another potential downturn.

- **The sector is better positioned.** The aftermath of the financial crisis ushered in a sweeping reform agenda that has improved capital and liquidity and strengthened risk management across the industry, positioning financial institutions to better withstand economic shocks. One participant said, *"We are much safer now than we were years ago. Can we handle crises better than we could years ago? Clearly the answer is yes due to all the work done on prevention and regulatory apparatus improvements."* Despite these efforts and broad agreement among participants that the sector is in a better place, questions remain as to both the potential causes of a future crisis and the resilience of the system to them. *"There are aspects of the post-crisis reform that have still not been tested by a trust crisis. We still do not know the potential unintended consequences of these untested reforms,"* said a participant.

- **Regulatory response may be hampered.** The dialing back of the emergency powers of regulators and central banks, particularly in the US, generated concern among participants. A participant said, *"There have been discreet but significant changes to some of the regulatory powers … It is alarming to see central banks are a bit more circumscribed in their ability to respond to major crises going forward, and there are great concerns about whether they can do what they need to do in the next crisis, which is absolutely coming."* Public backlash against the bailouts of financial institutions in the wake of the financial crisis and high levels of current political turmoil spurred skepticism about the political viability of a similar response in the future. A participant said, *"You worry about the political costs of a response or whether the political capital is there to take action when needed."*

- **The low-rate environment may create systemic challenges.** Low or negative interest rates in several major economies have left monetary policymakers with little room to maneuver and created earnings pressure at financial institutions. Participants discussed the potential for increased risk taking as institutions search for new avenues of growth. One executive said, *"We're going to see historical structures and limitations being challenged. Product lines will stretch to go down market and further test your core competence. You need to pause and ask 'Do we really know what we're doing in this area? I know there's money here, but are we good at this?'"* Regulators shared concerns that such an environment could also foster conduct issues at financial institutions. One said, *"So much work has gone into building trust since the crisis … The ability to maintain that trust comes under greater pressure in poor economic conditions. You have people who are less risk averse and will be more desperate, and on the business side you see companies looking for new sources of profit."*

Non-financial risks continue their rise in importance

As the management of financial risks has matured, participants discussed new sources of risk to firms and the financial system. A regulator said, *"Going forward, there will definitely be a greater focus on non-financial risks. Cyberrisks are a part of that, and operational resilience broadly is becoming more and more important. These are harder than things like capital and liquidity, because they involve challenges that permeate the entire organization."* Participants identified a few key areas of focus:

- **Operational and technical resiliency.** As financial institutions become more and more digital, operational resilience has received greater attention. Customers now expect uninterrupted access to financial data and services, making any downtime increasingly unacceptable. Regulators have made this a priority in several geographies, asking firms to ensure they can continuously deliver services and withstand disruptions. These disruptions, especially to critical aspects of the financial infrastructure, can create systemic risks if core services cease functioning. An EY expert noted that the intention is, *"Not to look at a bank as a binary open or closed, but to focus on the delivery of certain services and think more granularly about how to deliver those critical services."* One director said, *"We have moved towards impact tolerance. I think there is a misunderstanding outside the industry, the idea that financial services can be riskless. It never will be—it has risks and always will. Regulators get that, but I'm not sure politicians or the general public do."*
- **Industry collaboration.** Challenges related to cybersecurity and data governance remain top of mind for financial institutions, and opportunities to improve information sharing and collaboration are emerging. Participants were joined by guests to discuss two key examples of collaborative efforts: Financial Systemic Analysis & Resilience Center (FSARC) and Sheltered Harbor. FSARC, established by a consortium of large financial services firms, develops scenarios and a risk registry to prioritize systemic risks along with other steps to promote the resiliency of the sector. Sheltered Harbor provides data backups and resiliency planning for financial institutions in an effort to protect customers, financial

institutions, and public confidence in the event of a catastrophic event, such as a cyberattack causing an institution's critical systems to fail. *"These are big issues for the industry. It's encouraging that this is the response to these risks and that the sector is taking actions and collaborating,"* said a director. Supervisors in a number of countries are looking to replicate the Sheltered Harbor model for their banks.

- **Governance challenges.** Boards of financial institutions are working diligently to improve oversight of issues like resilience and cyber, but the rapid pace of change has thus far made good practices difficult to establish. A director said, *"You gradually evolve to a comfort level on some of these issues, but the problem is the goal posts keep moving, so right when you start to get comfortable, things change."* One participant advised boards to ensure open communication across teams in these areas: *"Governance has to be set up in a way where people are not worried about silos and are acting in concert so that there is a clear communication channel internally."* There are also outstanding questions regarding the information directors should be monitoring in some of these emerging areas. As a director said, *"I think the metrics for nonfinancial risks are still not as developed or understood and we're still grappling with that."*

Traditional business models may face existential challenges

The rapid pace of change in financial services could pose challenges to incumbents and longstanding business models. For example, participants discussed the impact of new entrants, emerging technologies, data sources, and modeling methods, and the fragmentation of value chains in insurance. Technology firms are influencing customer expectations and habits, forcing banks and insurers alike to rethink their approaches. Things like digital currencies could challenge the intermediary roles of banks. One director said, *"Technology will empower some customers to change the nature of their relationship with the industry as a whole."* Another participant raised the possibility that insurers could face a more existential crisis: *"Given that insurance is based on risk pooling, at what point does really understanding the risk by individuals mean that the model breaks down so then people become uninsurable and the whole model is under threat?"*

Though large financial institutions may have changed their views of new entrants – often viewing them as potential partners rather than competitors – big tech firms continue to loom as disruptors for both insurance and banking. Participants noted that the ability of incumbents to take advantage of capabilities offered either by new entrants or major tech firms could tip the competitive balance in the industry. One insurance participant said, *"As a carrier, I would worry to see big tech in the industry, like if Google partners with a major carrier."*

Firms are grappling with climate change and sustainability

As climate change and broader sustainability issues move up risk agendas, more firms are exploring ways to respond to what could rapidly become an existential crisis. One participant said, *"We all say it's a long-term risk, but I'm not sure we'll have a long time to adapt."* Indeed, decisions made in the coming years in this area may have implications for not only firm reputations but also the financial system more broadly. The topic is also increasingly top of mind for some regulators, with some planning to include climate change effects in upcoming rounds of stress testing.

Participants discussed programs such as the UN-sponsored Principles for Sustainable Insurance (2012) and Principles for Responsible Banking (2019), both of which aim to position the insurance and banking industries to contribute to sustainability goals, including climate change. Some participants shared skepticism about the need to sign up to such initiatives. A director said, *"It's rhetoric over action."* An EY leader urged institutions to ensure they can meet their stated goals: *"We're seeing big commitments by firms that are actually tough to execute in reality."* For sustainability initiatives to be successful within an organization, key leaders will need to drive them according to one participant who said: *"You all have teams working on this at your firms, but it has to go from silos off in the corner to getting more engagement at higher levels. It cannot be a side project."*

Sustainability and other reputational risks are now board-level issues. Some firms are rethinking relationships that may bring reputational risk, such as with gun manufacturers or companies that pollute the environment. Though some noted their institutions have made efforts to exit such relationships, others warned that doing so brings complications and suggested direct engagement with clients to influence decision-making. *"We approach it through engagement. We need to understand if the company is diversifying, modeling their own scenarios, etc. Or are they just closing their eyes to all this and pretending it's not happening?"* Increasingly, some firms also see opportunities, for example, financing sustainable energy projects, offering green bonds, and linking sustainability objectives to interest rates for corporate loans.

China looms as an exogenous factor

Recent geopolitical turmoil and growing realization that the "Middle Kingdom" will not open up politically and economically have spurred a profound shift in US policy towards China, setting the stage for deep strategic competition between the world's largest economies. The need to push back against China's advancement remains a rare issue that garners bipartisan political support in the US. Though the trade war has recently shown signs of abating, one expert suggested it was a distraction relative to the broader strategic competition that will define relations between the two countries. At the same time, the pace of innovation in financial services in China, largely driven by the country's tech giants, may provide a lens into what the future of financial services may look like not just in China, but elsewhere as well, particularly in other emerging markets able to leap frog developed markets' legacy infrastructures. Participants discussed these issues and what they may mean for firms and the system.

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