Part 1: Stimulus transmission and the banking sector

Jan Bellens, EY’s Global Banking and Capital Markets Leader, joins John Orchard, OMFIF’s CEO, to discuss how commercial banks are coping with Covid-19. They focus on the crisis-related operational and commercial challenges, how the opposing needs of speed and prudence reconciled, how banks are preparing for impairments to their loan books, digital transformations and restoring reputational damage of 10 years ago.

Jan Bellens has been supporting executive teams of leading banks in their growth opportunities and multi-year business transformations for the last two decades. Jan contributes extensively to EY’s global thought leadership. His most recent publications are in the domains of resiliency, recovery, stimulus transmission and growth programs for banks related to the pandemic, transformation and innovation in the banking and payments landscape, and sustainability and responsible banking.

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John Orchard: Welcome to this discussion with EY on the economic response measures to the Covid-19 crisis. We are looking at transmission mechanisms, specifically via the commercial banking sector. How are banks dealing with the government supported lending they have been asked to do? Beneath the headline numbers is a mass of new credit work to process, for example. Where have we seen difficulties and how have they been remedied? What are the success stories so far and what will be the long-term impact on their business models? Joining us to discuss this is Jan Bellens, global banking and capital markets sector leader at EY, who has been working with bank executive teams for 20 years.
Jan, please let us know what your role means on a day to day basis?

**Jan Bellens:** Well, like many of you I’m spending my days on long conference and video calls, staying in touch with our clients, discussing their priorities and then connecting our teams across the different service lines that we offer with our clients, such as assurance, tax, transaction services, and consulting.

**JO:** How you feel the banking sector is handling the Covid-19 crisis and how does it compare to the financial crisis we had a decade ago?

**JB:** I think this is a very different crisis from a decade ago. This is really a global health crisis. The previous crisis was mostly a financial one and that also means that the response of the banks is different. The first priority has been very much around operational resilience, making sure that customers have access to banking services and that employees are safe and can actually do their job. The banking system has held up in that respect very well and overall, bank boards and executive committees can be happy with how banks have been making sure that people can make payments, access loans, and their bank accounts.

**JO:** Take me through some of the schemes that have been set up by government requests that have been transmitted through the commercial banking system and how they are being implemented.

**JB:** Banks have been supporting customers and the broader economy by measures they have taken on their own account, which include fee waivers and forbearance measures. In many jurisdictions, banks have been called to transmit government stimulus into the economy, mostly, but not exclusively, towards small businesses. This has gained most visibility.

**JO:** Take me through some of the schemes that have been implemented so far and what has worked very well.

**JB:** It is important to note that when governments design schemes to get money into the economy, directly to customers and businesses, the implications for these institutions must be well thought out. We have seen a massive effort by the banks to get that money quickly out in the market. One example is Switzerland, where a scheme was co-designed with the top banks and a package of over Chf20bn of SME stimulus was very quickly distributed into the market. A relatively simple process designed mostly on a digital basis – with the aim that an SME applicant would be funded in 30 minutes – did not quite work as expected. But most SMEs that requested the loan were able to get their funding in a few hours, or at least in a day. So, a lot of SMEs in the Swiss market have been funded very quickly.

**JO:** How did they get that right? What contributed to that scheme being designed and then executed well?

**JB:** One of the key success factors was that it was really thought through from an end-to-end perspective. When the government was thinking about this programme, it solicited advice from the banks in the market on how to do it right, and so the process was designed principally around online processes. The form itself is used as the credit contract and is signed, scanned and sent by email or snail mail. The banks’ checks for risk purposes were
also relatively limited. So overall, the processes were designed in tandem with the design of the aim of the scheme.

**JO:** Which schemes have not worked as well, and how could they be remedied?

**JB:** It is important to ensure that the money goes to those businesses and customers that are most in need, while ensuring a the same time that there are no fraud or money laundering issues, particularly when banks are the entities responsible for that transmission. In the US, for example, the first wave of bank lending schemes with payment protection for small businesses was $376bn, followed by a second wave of $310bn. With these volumes being put into the market, institutions need a lot of checks to ensure the funding goes to those most in need, and that all conditions are met. Given this complex exercise, there has been a bit of a scramble to make sure that the banks can leverage technology solutions accordingly.

**JO:** Where have the challenges been with the Paycheck Protection Programme? Are they due to the sheer scale of it?

**JB:** There is the scale, and the fact that banks are cautious to ensure they are checking off all the conditions. Banks do not want to be held accountable for handing out funds to customers that didn’t justify it and are also very keen to avoid fraud challenges. Banks have to really tread a fine line between speedy action and making sure they don’t trip up over government conditions for eligibility.

**JO:** People tend to make mistakes when they are rushing. You are saying the US banks are especially mindful of that and trying to avoid future legal – and other – liabilities by rushing through processes at this stage?

**JB:** It is a fine balancing act and correctly so. The banks are keen to support the economy and its SMEs while also looking out for fraud risk, KYC or anti-money laundering risk.

**JO:** Are there lessons there in terms of process from the Swiss example you mentioned earlier, such as form designs and processes which could make this work more quickly?

**JB:** A lot of the banks and government institutions have realised that there was still an awful lot of paper shuffling in some of these processes. They have now seen that, even in a matter of days or weeks, they can put in place technology-based and data-based solutions which improve process. A number of executives have reported that work that normally takes six to 12 months to digitise can be done in a week. This is quite a wake-up call for some of the banks when the urgency is there. Overall, we will see much accelerated digitisation of some processes and the administration.

**JO:** One bank chief executive told me his digital plan advanced more in the first four weeks of lockdown than in the preceding four years of his tenure at that bank. What are you seeing in terms of the digitisation of banking business plans? Presumably, some will start to speed up the rationalisation of their branch networks, so it might become more profitable to be a universal bank, for example. How has the digital side of bank business models been propelled by this crisis?
JB: Banks at this stage are looking at how the return to their physical offices will pan out, what their workforce will look like post-crisis and how it will operate. The digital acceleration and their digital plans will be driven by what we can observe in terms of consumer and employee behaviour, and how those evolve. There is a discussion going on about real estate. But nobody has really pulled the trigger yet. We recently did a consumer survey across five large markets, UK, France, Germany, US and Canada, where 24% of those consumers said that they would bank more online, even after the crisis. This is lower than the number of consumers who would shop or seek health services online. Banks will definitely continue to invest heavily in terms of their digital transformation, but they will not be closing those branches as of yet.

JO: Indeed, some bank chief executives think that branches are the best place to cross sell products. Onto the medium-term: are there broader lessons from the credit analysis and credit disbursement work that is taking place on these government-guaranteed schemes?

JB: This is a big topic among several boards. One of the board members mentioned that the risk teams are giddy with excitement about the different scenarios that they can develop in terms of how the book will evolve. This is also a real challenge due to the degree of uncertainty in terms of duration of the crisis as well as the economic uncertainty. This translates into how much risk is supported by government funding and government stimulus and how much of it is not. Boards and CEOs are genuinely concerned about the so-called ‘day of reckoning’. The massive global government stimulus of $10tn that has been put into the markets has been tremendous. But this has serious implications if the crisis continues for longer and banks have to walk a fine line in lending to small business in this time. If for example, after six months, this is still not resolved and the SMEs can no longer be sustained, that debt could turn into non-performing loans for the banks. How would that be dealt with? There is quite a lot of concern about taking on these loans at the moment, correctly so. Governments are clearly doing the right thing for customers and for the economy but at the same time it is difficult to assess that risk from SMEs and mid-sized corporations.

JO: EY is already advising banks on the medium term with respect to how to think about and deal with NPLs. How banks are preparing for them?

JB: Banks have learned from the previous crisis, they are well capitalised and continue to stress test their books. They have a pretty solid view on where the different risks are in the balance sheet and are preparing to look at loan restructuring, credit workouts, schemes to operate certain assets with special purpose vehicles and how to get traditional investors into those assets to operate them in these challenging times. People with skills and expertise in capital restructuring of corporates will be critically important in the next year.

JO: How are regulators and supervisors helping? To what extent are they offering forbearance to banks being put under strain at the moment?

JB: The regulators have learned a lot through the last decade and from the previous crisis. Regulators have also been proactive to make sure that banks can play their role in supporting the economy at this crucial time. Some of these include postponing stress tests and supervisory actions, as well as providing some relief for risk limits. There has been close
contact and communication between regulators and bank boards, and some regulations have been eased to release some of the immediate pressure, where regulators feel it’s safe and secure to do so.

**JO:** How are banks managing to balance their social duty with their fiduciary duty to protect profitability?

**JB:** Bank boards are very actively thinking about this. They are well aware that they didn’t have the best record in society coming out of the previous crisis, and even going into this crisis. They know that playing a supportive role for the economy and their customers, socially responsible banking, is the way to improve their reputation. At the same time it’s a fine balancing act between providing a loan to those who need it but also taking care of the medium to longer term when it might not be fully clear whether that business is actually going to survive this crisis in the first place, or whether it was viable. That has also been demonstrated by the fact that quite a lot of banks in the US and Europe have made formal or informal commitments not to lay off staff in this calendar year, or to put certain restructuring programmes on hold.

**JO:** Some banks, particularly in Europe, have been waiting for a while for interest rates to eventually rise to help them with net interest margin. But that looks even further away. Is this crisis putting bank business models under strain again through the very ‘low for even longer’ interest rate environment?

**JB:** It certainly puts the return on equity targets under strain because of the credit provisions and then also because of the interest rate environment. There’s a lot of uncertainty in the overall economy, banks are well capitalised, so they do have good staying power. But it remains to be seen what happens over the next six to 12 months to see how overall bank profitability will evolve.

**JO:** What will be some of the long-term lessons – and even benefits – from the crisis for the banking sector?

**JB:** I would certainly hope for the reputation of banks to actually increase through this crisis where banks really play their role as a facilitator for the economy and for customers going about their business. It would be good for banks that have purpose in mind, that think about responsible banking across ESG targets to come out of this crisis stronger in terms of reputation, but also with growth prospects. This was confirmed by our consumer survey where we found that the majority of customers put very high premium on those institutions which seem to be doing the right thing during this crisis. Secondly with the digital acceleration, banks can become much more agile in a very short period of time and can leverage technologies, artificial intelligence, and other innovations to serve customers better. Hopefully this will prepare banks better for the next decade.

**JO:** Despite the very difficult challenges, socially, health-wise, and economically, it sounds like there is some benefit for the banking sector, potentially, in terms of how it is regarded, and indeed how it operates, compared with 10 years ago. Thank you very much for talking to us today, Jan.
Part 2: Stimulus transmission and its financial consequences

David Barker, EY’s EMEIA Financial Services Transactions Leader, joins John Orchard, OMFIF’s CEO, to discuss the shock-and-awe measures deployed by governments to rescue their economies and the short and medium-term implications for their finance ministries. They focus on the paths out of the emergency schemes, how governments are planning to restart their economies and what this will mean for their finances, how the crisis is fundamentally reordering priorities in both developed and emerging economies.

An investment banker by background, David Barker joined the consultancy firm in 2001, where he was global head of corporate finance for financial services for more than 10 years and was heavily involved in almost all the sovereign bailouts since the 2008 financial crisis. He has worked closely with many governments and supranational institutions over the last decade and so was asked to lead EY’s Covid-19 response across Europe, the Middle East and Africa. He has been addressing the intersection between governments and their treasuries with corporations and the public, often through the banking system.

Listen to the recording, or read the transcript below.

John Orchard: You have spoken to a lot of finance ministers over the past five or six weeks, David, what sort of advice are they looking for from EY?

David Barker: We have had a whole range of conversations to deal with the initial shock and what was intended as an awestruck response; large amounts of money to reassure the markets, corporations and employees. People are focusing on whether they have built the right sort of transmission mechanisms. Are they at scale? Are they working? What makes
them resilient and what is best practice? Having built these mechanisms, the conversation has now evolved significantly to the second layer effect; the economics, and in particular the affordability, which is going to become the next big challenge.

JO: We’re going to look at the crisis and its responses through the prism of those conversations and we will break it down into three stages – firstly the shock and awe measures, then their short-to-medium term effects and finally the aftermath and impact. What have been some of the key initial responses from finance ministers and how have they come about?

DB: We’ve spoken a lot about expansionary monetary policy and the impact of lowering rates, the creation of swap lines, the implications of regulatory forbearance, the removal of counter cyclical buffers, deferral of stress tests, as well as practical matters including non-performing loan recognitions and provisioning. We discussed the architecture of this set-up and the fiscal policy interaction – both direct and through commercial banks. We are advising on state aid considerations and setting up commercial paper asset purchasing programmes through central banks, grants and direct payments.

The biggest focus is the universal basic wage that so many countries have put in place for furloughed workers and what appropriate earning percentages might look like. A lot of those were predicated on expectations of a relatively gradual take up. A number of finance ministers have been really quite surprised by the demand and the impact it has had on their finances. We have had a lot of conversations about the appropriateness and the structuring of loan guarantees through the banking system – what is the right scale and how to get volumes of money moving quickly. In the UK, for example, which implemented a guaranteed loan scheme called the coronavirus business interruption loan scheme, there have been well documented concerns around the speed of deployment. The new smaller loans scheme has been much more effective. The volumes in the first couple of days are really quite substantial, with around £1bn issued already in the course of this one week. These are conversations about the breadth of the pipework and, longer term, how to build resiliency.

JO: So there has been a stronger take up of support schemes than originally anticipated? Where?

DB: We believe that a number of governments were looking at take up rates of 10% to 15% over time. We have seen multiples of that, three to four times, which is leading to what I call the ‘economic consequences problem’, including concerns over the long-term affordability of furlough schemes. How long can governments continue to plough a decent percentage of their debt-to-GDP ratio into structures that really are probably no more than delaying the inevitable consequence of what has to happen?

Once companies have got through the initial crisis, they will be forced to stand on their own two feet and deal with a world ahead of them which has massively changed. The furlough is merely a mechanism to taper into what for many countries will be a severe number of radical restructurings, with governments prioritising among industries and sectors. It has been an appropriate buffering but a lot more work looms ahead. It is almost as if the
tsunami water is drawing back a bit, but there is certainly the next stage of restructurings to come.

**JO:** What are the paths out of the furlough schemes? What are the immediate challenges for finance ministers in terms of affordability, and the effects on the financial system and the economy as a whole?

**DB:** A number of economies had not restructured their banking systems, not only in western Europe. Coming into the crisis there were plenty of legacy non-performing exposures left on balance sheets, for example. Countries had capital raising measures in place through bank privatisations which have been interrupted, NPL disposal processes were disrupted. An early consideration for governance was around avoiding moral hazard by requiring the banks to underwrite 10%-20% of the risk in the guaranteed loan schemes. But with 10%-15% of GDP in terms of overall magnitude it is still a very sizable amount for a bank to be exposed to if it is not in good shape. So there is a question about how resilient they are going to be in some countries together with the longer-term conversations around so-called ‘bad banks’ [resolution vehicles for impaired assets], rejected so far in the euro area but on the minds of a number of countries.

**JO:** What are the similarities and differences with the crisis from 10 years ago? Banks may be under strain, but they are much better capitalised than in 2008. What risks are there to the financial system?

**DB:** It is certainly the sovereign banking ‘doom loop’, as it used to be called, and there is a danger that it may well remerge. There are lots of conversations on debt sustainability and affordability, where particularly in the euro area a number of countries have struggled to be convinced about the terms of supranational or European Commission or International Monetary Fund support measures. Many countries have focused very much on making their own preparations at a national level. That has been expressed by the number of people rushing to the Eurobond market to secure cash. I think that crowding out in debt markets is going to be an issue for the future.

Another thing we have noticed is that governments are keen to avoid the mistakes of the banking crisis, including negative perceptions of the sector’s behaviour itself. Most thoughtful governments have begun embedding social purpose and good governance and sustainability thinking into their response measures. This is focused around the intelligent, thoughtful and defendable use of taxpayer money. This will be particularly important as we go into the restructuring phase.

**JO:** How are finance ministries thinking about companies and banks that are not in particularly good health? Medium-term, how can they protect their economies from zombie businesses?

**DB:** Some transmission mechanisms are incredibly efficient and effective from inception. There are plenty of stories about how the Swiss managed within a matter of two or three weeks to initiate, set up and deploy a system that you would receive money the same day. The current small business system in the UK is actually deploying same day application funding, too. However, the funding was not evenly placed across the size of economies as there were a lot of ‘squeezed middles’.
We had conversations with several governments about setting up ‘field hospitals for corporations’ and how you might bring in a series of distressed and cashflow-negative companies, perhaps triage them with super-senior cash and evaluate their cash burn for a few weeks. Then we would find ways to classify them, from easy-to-resolve through to complex stakeholder restructurings with lawyers, bankers and accountants, and then on to those which unfortunately need to be administered.

The spread of stimulus was not necessarily even across the economy. Generally, the largest corporations were well catered for through commercial paper and the central banks. A lot of focus was put on furloughing the smaller companies. The middle section required rather more tinkering with than governments initially thought, and that brings back the role of commercial banks and them standing alongside government. An uneven distribution of stimulus was the first problem. From then on, by the time the scale of take up had been seen, there was a certain amount of gulping in finance ministries as they realised how expensive things would get. It would be no more than a buffer or a shock absorber to what some are calling a day of reckoning where corporations will have to stand on their own two feet in a changed world.

**JO:** There seems to be, as you say, a day of reckoning in the post. In the sovereign bond market some of that can be offset, perhaps, with monetary financing, which is controversial. How are finance ministries considering this issue of raising capital, whether it is sustainable and how to reduce it in the end?

**DB:** We have noticed that a number of conversations have shifted to philosophical thinking around sourcing asset pools for longer term financing. During the financial crisis we used to talk of bailing out and now the conversation is going to move more to bailing in to find those deep asset pools. These might include those much-vaunted private equity asset pools which I suspect might be much harder to deploy than governments perhaps understand, pools of insurance and reinsurance capital tied up in very strong balance sheets, sovereign fund money and supranational monies. This would also include things like transaction taxes, asset taxes and wealth taxes. So there are the beginnings of a discussion about how to rebalance policy, together with more immediate discussions in some smaller countries around the rush to finance. This brings with it the dangers of issuing government bonds to a banking system and reinforcing a negative loop of sovereign bank dependency.

But there are plenty of people rushing to the bond markets and there are extraordinary sums of money being talked about. In early May, the US administration said in the second quarter it has a need to finance $3tn. The markets will come to focus on gross financing needs and that is the appropriate place to think about sustainability. There are some concerns about longer term inflationary effects, but broadly, there is an expectation in this new world of close to zero rates for any sensible future planning horizon.

Therefore, you cannot look at simple debt-to-GDP measures as a way of figuring out sustainability as debt affordability is only part of the picture. If you look at gross financing needs globally you will find countries like the US and particularly Italy which have volumes which could even touch 20% this year, which is very high, dangerous territory, and as yet perhaps not reflected fully in government bond spreads. But there are complex and manifold reasons why that would not be the case yet.
JO: How are finance ministers and governments deciding what help to withdraw, when?

DB: Let us divide that into two parts. I described at the beginning how we were talking about a medical vortex and a focus on virus reproduction rates. And now, the economic vortex and a focus on affordability. Governments are trying to figure out appropriate real economy reopening protocols and restarting protocols. EY has been doing a lot of work for ministers of finance and economy, in a number of countries, centred on the likely duration of social distancing. Several governments are taking the view now that without a vaccine and mass testing, there is very little chance of removing social distancing. We are entering into conversations with sectors of industry on governments’ behalf. Some have asked us to convene industry sectors with trade unions and trade associations to discuss burden sharing among them, as well as reopening protocols.

This is complex in practical terms – take an oil and gas company for example and consider the different scenarios for an oil rig, petrol station forecourt or head office on the 33rd floor. You must explain to different sectors how they need to translate social distancing into particular working environments and then set protocols amenable to everybody to reopen. As to timing of which sectors to go, I think countries are having different experiences with medical outturns.

There seems to be some degree of consensus that social distancing is here to stay and that it has implications for things like tourism, hospitality, and airlines. Take countries such as the Philippines, Thailand, Greece, Portugal and Mexico, which have close to 20% of their GDP broadly dependent on these sectors. To the extent those countries are running furloughing schemes – the UK has indicated that social distancing is likely to remain in place until Christmas, for example – you’re going to have to see a lot of focus on how long these furlough schemes can be maintained and how affordable they are.

JO: How are you seeing governments and finance ministries consider the trade-offs and the complicated cost benefit analyses for preserving social distancing and therefore limiting the health impact versus the considerable impact on the economy?

DB: There is a large amount of work to be done both by governments and their advisers about scenario planning and economic impact assessment by sector. That can be very interpretive and subjective. Developing economies with very little capital to spend need to prioritise not just between sectors but also individual companies. There are countries that can’t afford furloughing at all, where furloughing and social distancing are described as a somewhat Western luxury to consider. There is a lot of work for governments – sometimes sponsored by multilateral banks and development agencies such as the United Nations Development Programme and working with firms like EY – to analyse economic impacts country by country, sector by sector.

JO: On the day after the day after: how are these finance ministers looking to get their economies back as close as possible and as quickly as possible to business as usual? More importantly, what problems do they see being left behind that will need medium-term attention?

DB: I mentioned earlier the idea of creating things such as lender of last resort facilities. A lot of work is about to come into immediate focus around the restructuring and the clean-
up. For example, what will the eligibility test be around governments becoming lender of last resort? Prior viability of the company will clearly be a major issue. As are the public interest, stewardship and governance. Will governments support companies that have foreign shareholders or that have private equity shareholders who don’t pay enough tax in their countries? These are immediate issues that governments are beginning to grapple with aided by firms like ours. In the longer term, there is an amount of reimagining about what does the future of commercial real estate look like, for example?

Having spoken with a number of bank heads around Europe, many have found it surprisingly easy to work from home, notwithstanding one or two instances where middle offices have been impacted by not having access to laptops at first. There is a desire in some cases to start reshoring certain core functionalities within industries; PPE and life sciences for instance. I do believe that the experience of Covid-19 actually has a few silver linings to it. Some are around institutions and sectors being able to be more productive and figuring out ways to operate which don’t need the number and the distribution of people that they have now. Perhaps they need fewer retail outlets and clearly more automation around their online and digital offerings. A lot of focus from governments is on reimagining city centres, where incidentally commercial real estate is one of the core collateral assets in the banking system. How are we going to think about future strategic planning there? What are alternative uses for these assets?

**JO:** A further challenge to consider, if businesses come out of this crisis more efficient or more productive, is less demand for employees. Are you having conversations with finance ministers that are starting to consider these structural issues in the medium term?

**DB:** The rate of acceleration of digitisation and automation has taken a real leap forward in the last two months and is planned to continue at pace. That will necessarily improve productivity but as you say probably with fewer people. Some of the projections of unemployment rates are pretty startling. The US has suffered around 50m unemployed in four weeks. The Banco de España in the last 48 hours or so has looked at a worst case unemployment rate of 19%. With unemployment comes both a loss in revenue and an increase in governmental expenditure and so they are trying to get their minds around the issue of where the unemployment sectoral impacts will lie. They are beginning to think about retraining schemes and pivoting sections of the workforce.

A classic example which UK people often talk about is picking agricultural crops. That same argument applies, I learned, in Uzbekistan and Kazakhstan, where people migrate across borders, some of them to Russia, to pick the agricultural crop. But those borders are now closed and prospectively are likely to remain closed.

We have seen a number of airlines around the world encourage their staff on furlough schemes to actively get involved in local social relief programmes or in their national health system. So governments are looking at the development training exercises needed to redeploy excess pools of labour. I think there is some very strategic longer-term reimagining going on and governments are looking to lock down even the vaguest sense of numbers around it.
JO: Notwithstanding the fact that budgets will be under strain, is there talk about investment into digital infrastructure?

DB: Exactly. I think of things like the Amazon technology to do cashier-less shopping: walk-in walk-out and experience the Uber effect of contactless shopping. You can see that as being an interesting way of even lowering the physical cost base of city centre retail premises. So I think digitisation en masse is on the way, however it is important to digitise in a resilient way. Resiliency – onshore, locally assured resiliency – is going to be another key component alongside all the other stakeholder value issues, making sure that, should lockdowns or future pandemics come back, you aren’t solely reliant on ‘just in time’ supply chains anymore.

JO: Let us go back to explore those countries that will take longer to recover and will struggle to do so on their own. Quite a few might need help from multilateral organisations, development banks, and other inter-governmental institutions. What are you seeing there?

DB: Quite a lot of effort, and real speed and progress to – shall we say – try to push ‘targeted money’ out of the door at speed. The World Bank has earmarked $150bn at a rate of $10bn or so a month for 15 months to be spent, for example, and the European Bank for Reconstruction and Development is doing similar things. These are very targeted to help the most disadvantaged in society, such as helping smaller micro community SMEs by getting micro lending to them. These schemes often having a prioritised focus around diversity and gender issues in those countries, so trying to pick up the most at-risk groups. The IMF has now publicly said it has over 100 bailout applications.

As with any global infrastructure, there is a need to build scale and resiliency into the processing and there’s a need to get requests for proposals to countries out at greater speed. So again, firms like mine have been helping to draft some of these and are working alongside multilateral development banks to try to accelerate what I think was very good start for many of them.

JO: Thank you very much, David. This has been a very interesting discourse on what is taking place in finance ministries, what they have to address today, tomorrow, and the years and decades to come. Thank you very much for talking to us today.
Part 3: Worldwide insurance heading for shake-up

Simon Woods, EY’s Global Insurance Industry Leader joins David Marsh, OMFIF’s Chairman, to discuss the pandemic’s effect on the global insurance industry, including the immediate and longer-term consequences for operations and technology, looking at the challenges and opportunities brought by digitalisation. They examine the financial health of the insurance sector as a result of the volatility in financial markets and the recession, and what can be said of the significant strain on capital, liquidity, and investment strategies. They address big questions on how the insurance industry can work with customers, governments and regulators in contributing to the wider economic recovery and investigate the outlook for innovation, and worldwide insurance consolidation.

Simon Woods is the leader for insurance strategy for the Europe, Middle East, India and Africa region and a veteran of the sector, having been at EY since 2014, and in the 15 years before that before that covering insurance in various investment banking positions.

Listen to the recording, or read the transcript below.

David Marsh: Simon, insurance companies are facing major challenges in many areas. What has been the crisis response, first of all, in the fields of people, operations and technology?

Simon Woods: The immediate response was on ensuring people were safe, ensuring that they were able to work from home and that business operations were up and running in a remote environment, with customers looked after. Within days of lockdown, there were massive amounts of calls coming in, particularly in areas like travel insurance. Some customers have had call centre issues and have had to recapture operations from India.
Generally, the insurance industry, whether in the US, Europe or Asia Pacific, has responded very strongly and has had no major issues from the people or operational perspective.

**DM:** Do we now see an effect in terms of medium-term challenges as companies face the next wave of the crisis?

**SW:** We see a range of more complex issues for insurers to focus on. There are six themes prevalent among chief operating officers and HR departments. First: safe return to the office. The lockdown continues in many parts of Europe and in the Americas. And we are seeing different attitudes on who should go back to work, who wants to go back to work, and how to do that and in a logical and safe way. Allied to that is the second question: the future operating model. People have been quite surprised about certain things that have happened positively regarding working from home. The question is: Do I need the same office footprint I have today? Can I have a more flexible, agile workforce? How do I draw positive lessons from the lockdown? That leads us to the third point, the theme of digital and technology adoption, and, fourth: organisational agility: How do I become a more agile, responsive organisation? Fifth: As the COO, how do I deliver return on investments? We are seeing a lot of focus on big projects. Some of them are being delayed, some of them being deferred, but the critical thing for the business is to deliver on the projects and on the returns. At the same time, and sixth, we are seeing a focus on strategic cost reduction, incomes are coming down across the sector and people have to know what is their cost base, and also their capability set, in the future.

**DM:** The insurance industry has sailed into quite a storm, in many ways. They are now taking action to meet the consequences. Some of the responses must have been things that different companies were thinking about doing anyway. And the extreme nature of the crisis speeds up innovation in some sense.

**SW:** A lot of our clients would agree that this has accelerated some trends we have seen for some time. At EY, in February, we ran our next wave ‘vision of the future’ in insurance, in commercial and specialty lines. When this came out, I felt it was a bit like science fiction. And then we revisited it, three or four weeks ago. And we realised that a lot of what we had forecast as the state of the industry in 2030 was actually happening now.

**DM:** Which kind of companies are doing well – and less well?

**SW:** It is very much about digital and tech adoption. Insurers that have pivoted to become a more digital organisation are much better placed. We are seeing usage-based insurance pick up, while some of the traditional sales channels fall down. Face-to-face distribution is a major issue for many insurers. The people with a multichannel approach, and the ability to sell services and distribute their products through digital media, are doing much better than those who rely more on traditional business models.

**DM:** Companies are being hit by a combination of three things. One is a big increase in pay-outs for all kinds of things from travel insurance to events. Second, premium income may have taken a hit because of the fall in consumer incomes. Third, on the investment markets, many companies will have been badly hit by the downfall in equities. There may have been a partial recovery, but they still have to cope with negative interest rates in many core areas. What can companies do about this array of financial challenges?
SW: There are three waves. One is immediate: the fall in equity values, the widening of bond spreads and the further fall in interest rates. That creates a solvency problem for companies. It is not necessarily a cash problem, but it is a mark-to-market effect. Many insurers have weathered that pretty well. There has been some regulatory forbearance, too, to avoid procyclical behaviour. We have also seen insurers raise equity and debt as markets recovered in the immediate aftermath of the mid-March turbulence.

DM: And beyond the immediate solvency issue...

SW: Among the two longer-term issues, one is loss of income, either due to falling premium volumes or lower returns on investments. Regarding return on investment, that is a question about reinvestment risk, as opposed to an immediate fall of income. Many insurers have matched assets with liabilities and have locked in income – as long as there are no defaults. Beyond that, much depends on how severe the recession is. How long does it take to get back to normal? What does that mean for the health of insurance companies: the affordability of premiums, but also their investment books? What is the likely default and downgrade experience?

DM: Can you see some trends in different jurisdictions – in America, in Europe and in Asia?

SW: Let’s look first at segments. In the P & C business – property and casualty, non-life business – people are a lot more bullish and optimistic about future growth prospects, particularly in places like the London market. It is the same in some areas of reinsurance where we are seeing rate-hardening: the price of risk is rising due to a shortage of capital. In the life insurance business, we are seeing a bigger drop off in new business. And with low interest rates and the fall the markets, it is much harder to see that market recovering with new business.

DM: The people in life are a bit more dour?

SW: The velocity of the life business is much lower than that of the non-life business. Liabilities are much longer, typically 20 to 30 years. It takes longer for those books to turn over. The ability to reprice and re-invent yourself on the P&C side is a lot easier given the shorter-term nature of the business.

DM: And the geographic variations?

SW: We see different responses depending on the state of lockdown. Across Asia, particularly in China, there has been almost a return to normality, with some really interesting things in the Chinese insurance market regarding innovation, new ways of servicing customers. That is slowly drifting westwards. The Anglo-Saxon world tends to be more immediate, in terms of their responses, whereas the European model is more cautious. That reflects the ability to adapt your business model. In continental Europe there is a greater need to consult with staff, and this applies more prevalently than elsewhere to other sorts of regulation.

DM: Negative interest rates on government bond markets are probably here to stay. Has that had a particular impact on the European business? A lot of people are worried about
whether some smaller insurance companies, or even bigger ones, may have solvency problems?

**SW:** I am sitting in Switzerland where we have the lowest negative interest rates in the world. The question is really one of asset-liability management, rather than negative interest rates per se. When I was in investment banking, before I joined EY, I was in risk management. Whenever I tried to sell interest rate derivatives, people were telling us that rates couldn’t go any lower. And yet, for the last 15 years, they have kept on falling.

**DM:** And now?

**SW:** Negative interest rates are not a surprise in Europe, whereas they would be for the US where rates have been a lot higher. Many insurers are now ready. And the regulators in Europe have been quite focused on ALM. That is a key point of Solvency-2, with asset and liability matching. So in the short term, we are not expecting negative rates to cause solvency problems. The bigger issue is the ability to sell your product. A lot of traditional life insurance coverage in Europe relies on guarantees. It is very hard to provide cost-effective and meaningful guarantees in the current interest rate environment. Even a zero guarantee, which most people would not put a lot of value on, is very expensive at the moment.

**DM:** What are the big issues for insurance companies in the recovery phase? You are very keen on the ‘social purpose’ of insurance.

**SW:** The first thing to remember about insurance is it works quite differently from banking. Very simplistically, banks lend money to individuals, and that is paid back and there are some defaults. By and large the money flows, and then there is a loss later. Insurance operates the other way around. Everybody pays a premium. And some people have a loss event in the future. Insurance suffers relative to banking in terms of ability to inject a lot of money into the economy quickly. And it is very hard for the insurance industry to provide cover retrospectively. That is one of the big debates now, regarding business interruption cover. There is a view that – even though the contractual terms excluded pandemic risk – insurance companies should have paid claims. That is a huge issue – and is tied up with a perceived erosion of trust in the industry.

**DM:** So what are the options for the future role of insurance industry?

**SW:** Clients are very optimistic. Working with the industry, regulators and governments, we see three different potential models. The first one is using the insurance loss-adjusting mechanisms to get money fast to people – to pay claims effectively through the network of agents, in a way that is complementary to the banking channels. The second is to provide risk cover for essential get-back-to work or get-the-economy-going types of businesses, for example, underwriting vaccine supply chains, providing trade credit or whatever. Third, more grandly, there is talk of pandemic risk insurance or PRIA which is a very similar concept to post-9/11 terrorist cover, which was called TRIA in the US. This provides some kind of government- or country- backed fund, so, in any future pandemic, there would be funds available.
DM: What role is played by the regulators here? Who do you talk to regarding new innovative products?

SW: There is usually a company-level view – often a CEO agenda item. And this is a question for regulators and governments too. A key part of macroprudential stability is the ability, whether in insurance or banking, to provide funding and risk capacity for the economy to get going. There is a huge amount of engagement among senior regulators regarding the prudential side, as well as the conduct or customer side. We see a lot of focus within European finance ministries on the cost of furlough schemes, the potential hit to tax revenues, and a great desire to get economies going again. The door is firmly open to good ideas, particularly ones that don’t require immediate cash contributions. So we see a coalition of the insurance industry, regulators, and governments to make these things happen.

DM: Is this specifically linked to the fear or the threat of pandemics? After all, pandemics have been with us since biblical times. Or is this more about the threat to society of enforced lockdowns for whatever reason, which could be due to terrorism or natural catastrophes. And then there is also the effect of other interactions with the globalised supply system. The insurance industry could work together with governments and regulators to make the world a safer place. Can you give me an inkling of the kind of threats you are looking at?

SW: People are not so worried about the pandemic per se, it is much more the societal impact of the lockdown and the consequent financial impact. We have spiralled down through a combination of health worries leading to lockdown, leading to economic slowdown. The desire is to reverse that spiral, also by providing confidence on health.

DM: Can you give an example?

SW: Reinsurance can provide support to the supply chain for vaccine production. Providing security on vaccines getting from country A to country B, for instance in maintaining temperature controls, is a highly delicate job – providing cover for that is important. With risk financing comes the ability to borrow money, and you can then restart the economy. Risk coverage for small business owners so they can reopen is another example. We have seen that in Switzerland and Germany, where insurers are paying out on business interruption claims to the restaurant industry or the Munich beer gardens, to get those businesses going again. That creates confidence and momentum in the economy. It is a combination of removing the medical concerns and providing confidence that businesses and people can get going again. That then can help create a safer world.

DM: Synthesising what we have been talking about, it seems that there are three main strands to the successful insurance company of the future. First, get the nitty gritty right, all the things that could go awry – people, operations and technology. Second, without the necessary finance and some powerful systems behind it, even companies with the best ideas will not prosper. And third, there is innovation and an eye for the bigger picture. Are there companies that combine the best of all these worlds?

SW: The bigger stronger companies are generally better placed, better resourced to invest in the nitty gritty, including in digital transformation, and they have the financial
wherewithal to weather the storm. The bigger groups are in a stronger place than the midsized companies. But there is a cost of size, in terms of lack of agility. The market is moving rapidly – not just the financial markets, but also in terms of customer affordability, customer preferences and so on. The winners will come from a combination of the bigger groups with agility to amend their strategy to take advantage of opportunity, and the more agile, digital start-ups with enough financial wherewithal to survive.

**DM:** And there will be consolidation, won’t there?

**SW:** Some capacity will come out to the market. We are already working on M&A deals regarding firms with rating agency and capital challenges. Some really exciting fintech companies are struggling with funding and looking for safer homes. So, yes, there will be consolidation.

Additionally, we must consider the rise of alternative capital, as hedge fund capital comes into the insurance and reinsurance industry. The question is how long that money will stay around given the opportunity to invest in other parts of the market now at higher returns, and also in view of some of the losses that have come through.

**DM:** Who will be the industry trailblazers in the next five to 10 years?

**SW:** The more open-minded big players will be the winners. Firms more biased towards non-life and risk products will be able to accelerate out of the problems more quickly. It is easier to turn a non-life business around, to write better rates and to innovate than for the life companies. In this latter group, there will still be a drag of legacy books particularly in a low interest rate environment, where the guarantees that have been written in the past will continue to be very capital intensive, and drag on capital returns and resources. The good start-up companies will do well, too – as well as the more agile bigger companies.

**DM:** Perhaps a large company with lots of start-up mentalities within it, that might be the one to go for. That is a good note on which to end. Simon, thank you very much for talking to me about the insurance industry’s challenging times.
Mike Lee, EY’s Global Wealth and Asset Management Leader, joins Marcin Stepan, OMFIF’s Head of Programming, to discuss the pandemic’s effect on asset management. They focus on the financial fallout from the crisis as companies face shrinking revenues and operating margins. They examine the challenges and opportunities in strategically approaching cost reduction and control, while ensuring scalability and elasticity to meet future growth needs.

Mike Lee is responsible for the execution of EY strategy for the sector. With more than 30 years of industry experience, he has served as the lead client service partner for many large and well-known alternative and traditional wealth and asset management organisations. He has worked alongside many talented teams and helped devise and execute strategies and optimise clients’ capabilities as they navigate a time of exponential change.

Listen to the recording, or read the transcript below.

Marcin Stepan: Mike, how has Covid-19 impacted the asset management industry?

Mike Lee: We look at things through three lenses: what is happening ‘now’, what could happen ‘next’, and what needs to happen ‘beyond’ that. In terms of ‘now’, our focus has been on valuation and liquidity, as well as how government stimulus packages or regulatory relief provide opportunities for wealth and asset managers, underlying investees and customers.
At the start of the pandemic, our main focus was on how to value less liquid asset classes and how to deal with the need for revalidating and recalibrating models to handle valuation challenges. From a liquidity standpoint, underlying investors are looking to potentially redeem commingled or direct products, and asset managers need to be able to manage those requests without significantly impacting the overall portfolio.

In terms of ‘next’, we’ve been thinking about how to manage a ‘return to office’ and what that means to organisations as they manage their own people getting back to office and how they interact with their clients.

As organisations continue to face challenges, both within the industry and for those companies and organisations in which the industry has invested, there are a lot of discussions on restructuring and workouts and the like. The pandemic has accelerated certain processes that were happening before the outbreak, such as digital transformation. We are also expecting an increased focus on strategic transformation, particularly cost. Many organisations are trying to navigate what comes next.

Finally, in terms of products, we are paying particular attention to sustainability and environmental, social and governance factors. As a result of the pandemic, greater attention is being paid not only to the ‘E’ but also the ‘S’.

**MS:** How is this crisis different to the 2008 financial crisis? And what lessons from that period has the industry been able to apply?

**ML:** This crisis differs from the financial crisis in that it is a health crisis, with much broader and deeper human, societal and financial impacts. All industries have been impacted. Many economies have shut down, and fortunately some are beginning to re-emerge. The 2008 crisis was primarily financial and had a greater impact on specific industries, whether financial services or automotive, among others. The lessons learned from that period relate to three areas. One is on liquidity management preparation. One of the big things we saw from the financial crisis was the need for funds to either implement gates or suspensions. More than 100 funds needed to either throw up gates or suspend redemptions. Many had to close because of a liquidity mismatch between the portfolio and redemption requirements. We have seen the lessons learned from that be applied quite well in how organisations have prepared to manage liquidity through this crisis.

Coming out of the financial crisis, some managers wished they had put more of their proverbial ‘dry powder’ to work, because those that actually did have seen better returns overall on a relative basis compared to those that did not. With regards to communicating with stakeholders, in companies that best handled the crisis, leadership was proactive, transparent, empathetic and communicated frequently. I am seeing more of that through this crisis.

Many organisations that faced dropping top line revenue and compressed margins took a tactical approach to cost management. The pandemic is an opportunity to take a much more strategic view of transformation. With a focus on cost, it is about looking at the structural and strategic side of things rather than just the tactical. For example, structural areas like location strategies, legal entity structure, organisation and people, and especially how to re-evaluate client segments.
**MS:** How do companies remain competitive in this new environment?

**ML:** What is important is taking a longer-term view and staying committed to that despite some of these short-term challenges. Specifically, there will be a focus on the importance of scale and digital, and improving overall operating leverage and the ability to optimise that cost base. There will be opportunities to utilise mergers and acquisitions and restructuring of the business to remain competitive. There is a need to constantly evaluate business model and strategy, and rethink some of the traditional metrics by which you gauge success for your organisation.

**MS:** How would you suggest that companies approach or manage cost cutting and scaling growth at the same time?

**ML:** It depends on the core objectives of their transformation programme. It is about cost reduction but at the same time, building the business around scalability and efficiency. Companies should leverage this for growth. It is an opportunity to look at the flexibility of the cost base. And equally, if not most important, is having effective cost control coming out of this. Rather than measures to cut, these should be measures to reinvest in the business – creating investment capital to reinvest in growth.

**MS:** How could this fit in strategically and structurally?

**ML:** The organisation needs to ensure the objectives of the cost transformation efforts align with its overall strategic objectives and initiatives. For example, organisations often focus on process redesign or how to intelligently automate certain areas or functions to take out cost.

But the greater initial focus should be on structural changes like potentially exiting smaller locations where activities could be consolidated into regional hubs or even more strategically around engaging differently. And in many cases, activities could be digitised across client segments to provide targeted insights about what processes to ultimately redesign or automate. But throughout the entire implementation initiative, organisations really need to keep a targeted focus on how they track the benefits of the programme and embed a finance role within the exercise so they can measure the benefits at every stage.

**MS:** What parts of the business are typically at risk?

**ML:** It is not a one-size-fits-all answer, it depends on the organisation. Are you a globally integrated organisation, or are you a multi-boutique? Are you trying to transition from one to the other? But it really comes down to looking across the value chain. It can be the distribution function, manufacturing, operations, as well as some of the ancillary functions that cut across the three lines of business, whether it is business risk, compliance, or internal audit. When you look at historical cost transformation efforts, around 75%-80% of the costs that are identified as being able to get redeployed are focused on people, products, process and technology.

With Covid-19, many organisations and governmental bodies have ensured that their people were a primary focus. Today’s environment requires a different approach to which levers to pull and an overall adjustment relative to what may be at risk.
MS: To what extent are technology and data automation the panacea for cost reduction?

ML: What matters is a company's starting point, whether it is the data, the desire to have a single source of truth, having a singular product master, security master, or client master, which life type systems were developed internally and what was vendor acquired. There is no 'one size fits all'. Companies need to really evaluate what is best for the organisation. Is it a system re-platforming? Some issues will be addressed through intelligent automation and syncing of systems in lieu of a broad scale implementation which, in and of itself, brings complexities and costs challenges. It depends on an organisation's circumstances. Lessons can be learned from others but at the end of the day, it is taking that internal look and asking yourself “What is the most significant problem that we are trying to solve?”

MS: Where have companies succeeded in applying technology and digitalisation?

ML: Some organisations have struggled because there was a lack of collaboration between the IT function and the business. Others face challenges because they start from the middle, rather than leading with a vision. This is where we have seen some organisations struggle.

A big proponent of success is collaboration between the business and IT teams, having the right agents of change and having the capacity to commit to the programme. It is really about quality and having that targeted focus. And then ultimately, it is about having KPIs to measure progress and related accountability.

MS: When it comes down to some quality levers within strategic cost transformation, people often turn to centralisation and outsourcing. How should companies approach this to get the best value?

ML: So many discuss 'core' versus 'non-core', the idea that if something is not core to the business, it can be outsourced. I tend to look at things through three different lenses. It is more about what is mission critical instead of what is core versus non-core. ‘Mission critical’ means that it is the most important and what the organisation itself should do because it is a value differentiator for them.

‘Non-core’ is on the other end of the spectrum: systematic, routine, lower risk, where you look for opportunities to outsource or offshore, in a low-cost service delivery area. But then there is middle bucket of core, where maybe there is an opportunity to implement more of a centralised shared service model. Not necessarily a low-cost location, but maybe lower cost or even a 'near shore' location where you can still retain the responsibility internally or you can look to a third-party vendor. And I think there you also have a different level of oversight that is required relative to what you may otherwise do with the 'non-core' areas.

MS: Covid-19 has impacted the way we work, with people working virtually and not having to travel as much. How do companies factor this in? And how would you expect that we will be working moving forward?

ML: Going forward, we need to be able to focus on enabling a much more flexible, multi-channel operating model. As part of our return to office efforts we will look at how to optimise real estate in our locations.
It is estimated that around 40% of people in the industry will keep working from home. The multi-channel approach is going to be critical because one of my biggest concerns coming out of the pandemic is the impact to culture. Many organisations ‘are who they are’ because of their culture, so it might be worth elevating ‘chief culture officers’ to look at how to retain that culture. Everything from the stewardship model or the apprenticeship model, interpersonal interactions with mentors or leaders that help guide and inform workers. The way companies give feedback, their talent management approach, will be incredibly important going forward.

**MS:** As companies look to having people return to work or as they adapt to new working conditions, how can they ensure staff productivity and staff satisfaction?

**ML:** They need effective agents of change. Companies need the ability to retain their culture, but also recognise that not everyone is going to react in the same way. Take the ‘20-60-20’ rule, but it is directional: 20% of an organisation will embrace change willingly. Managers need to leverage these people to support the agents of change leading the program. On the other end of the spectrum, 20% are going to resist change. This is natural. And 60% are in the middle, with some reluctance towards, yet openness to, change.

To convince the majority of the organisation to make the changes that are needed, it is important to hone in on that middle 60% and address their feedback and needs, to ensure that the organisation is moving in the desired direction, led by those effective agents of change. You want to be as inclusive as possible. But you need to recognise that some resistance is normal and manage that accordingly.

**MS:** What are your final lessons or final words you want to share when it comes down to cost transformation? And how do we make sure that we have these agents of change leading in the right way?

**ML:** We spoke about transformation with a focus on cost in many respects, but it is more about transformation of the business strategically. It is incredibly important to evaluate the organisation’s broader leadership that is going to be driving this change and making sure that you have the right agents that can bring the organisation with them to make the necessary changes. With any transformation, the entire organisation will be impacted, and you want to bring along the organisation in a way that its people understand because that is going to be your culture going forward.

We have seen that success is based on the ability to commit and follow through, as well as establishing the right KPIs to measure progress and ensure accountability. But most important is building these programs into the DNA to ensure that you can sustain the benefits going forward.
Part 5: Designing a sustainable recovery

Tom Groom, EY’s Banking and Capital Markets Partner, joins Danae Kyriakopoulou, OMFIF’s Chief Economist, to discuss sustainability and the economic recovery from Covid-19. They examine how Covid-19 has affected sustainability measures and whether it presents opportunities for transitioning to a greener economy during the recovery, including tying ESG goals to government support. They also focus on data related problems and how risk-weighted assets can be used to move to a greener lending.

Tom Groom is the Managing Partner for Financial Services, Strategy and Transactions practice in the UK. Tom advises banking and capital markets on a range of topics, including sustainability, strategic cost transformation and M&A. Tom has been at the forefront of Covid-19 response with banking clients – leading conversations about stimulus, its delivery via the banking system and how it can be done in an effective and sustainable way.

Listen to the recording, or read the transcript below.

Danae Kyriakopoulou: Tom, how do you think the COVID-19 situation is impacting the sustainability agenda? Businesses, corporates and the banking sector are suffering at the moment and regulators are thinking twice on how they should protect the financial sector from sustainability related risks. For example, we have seen the Bank of England postponing its climate stress tests but at the same time, we are hearing all these slogans about “build back better” and “green and smart recoveries”.

Tom Groom: Covid-19 doesn’t change the sustainability challenges that we face. It has reframed the question and some priorities. We have seen some incredible acts over the last
few months, competitors collaborating or state-owned enterprises working together in better ways, like the way in which ventilators have been produced en masse and across several different countries.

There is a higher acceptance of change, a higher ability for people to imagine a different future and different organisations have been reflecting on the purpose and societal value in their decision making. That gives me a lot of hope around the medium and the long term. In the short term, other necessities have come to the fore, maintaining employment, keeping economies moving, keeping business moving and reducing the impact on households. There are massive volumes of credit extension, which have impacted the policy and regulatory agenda but moved it away from some of the sustainability topics.

I have a lot of hope for the longer term. Covid-19 provides some great examples. It will help in due course. Corporates have had to think a lot more about supply chains. That is critical for understanding the transition of individual corporates. There should be some good things that come out of it but in the short term it has impacted the initial priority list.

**DK:** That is an optimistic way to look at it and it will be great if this is used as an opportunity to “build back better”. What do you think are the challenges to make that happen and how does the timing of these actions come into play in these decisions? What are the considerations that regulators may have in terms of providing support but not letting sustainability slip down the list of priorities?

**TG:** Before I touch on the financial sector and regulation, let’s look at the attachment of green priorities to stimulus measures and the pushback. This reflects a frictional period around time horizons. The targets for Paris-alignment and what big corporates have said around net zero by 2050, are outside planning horizons. The pressure to incorporate some green measures or yardsticks into the stimulus packages or specific situations means touching on quite a difficult point. For a lot of corporates, it is really difficult to translate 10-20-30 year objectives into short term planning.

In relation to the banking sector, there are really difficult paths for regulators and supervisors to walk. You mentioned the Bank of England removing its stress testing with a sustainability-based scenario in 2021. There needs to be a policy objective. It is an important instrument for prudential supervision. It has been deferred to enable revival and growth, such that banks don’t have to have concerns around some of their capital ratios and their ability to extend credit. Reintroducing stress testing needs to come at the right moment. That is in the context of withdrawal of all sorts of other stimulus packages like government backed loans or sales tax deferred rules or job schemes for those on furloughs. That will be a difficult one to land.

In the banking sector, we have seen a shift in recent times, particularly over the last 12 to 18 months, from viewing sustainability issues as a reputational risk to increasingly as a financial risk too. The stress tests helped to reinforce that view. Also stress tests help from a data standpoint, as a lot of the blockers we might talk about today are around the ability to
have the right data to understand your book and your customers’ exposures. Thinking through scenarios encourage data sets to improve.

The other topic around regulation, supervision and how they enhance greener recovery is the debate about the use of RWA, use of different risk weightings for green versus brown lending. I think that is a tough topic and there is a fine line on this one. Essentially, RWA is there to measure loss absorption, the requirement of capital to absorb losses and therefore to differentiate between what you might crudely call green and brown lending with risk weightings. You are essentially saying that one might lead to a higher loss than the other. I believe that is the case. However, the data sets are not there yet to show that to necessarily be true. This is where you might get some strange behaviours if regulators push for different RWA levels. I do think there is some good logic as to what governments can do maybe through things like asset protection schemes and guaranteeing elements of green lending. This gives banks a reason to have differentiated risk weightings on lending pools. I guess, there are initial conclusions that can be drawn around measures regulators can take to really help move to a greener lending base but they are not without challenge.

**DK:** Speaking about banks, how do you see their evolution on this?

**TG:** We saw quite a lot of change in 2019. For me that was the year where we saw a shift from thinking about sustainability risks as reputational ones to genuine financial risks, as we have talked about. It was also the year in which the level of shareholder and public interest really heightened and really hit the boardrooms. We have seen an increasing number of leadership strategy sessions, recognition of issues and public commitment from big banks.

At the moment there are lots of scenarios being run by banks that are quite long term. They think about outcomes in 2030, 2040 or 2050. It will be great to see some of that scenario modelling play through to a more granular level around the portfolio and traditional banking activities, risk appetite, risk limits and decision making with RM. So there is a level of maturing to go on that. Data, granularity and education are really big points to allow some of that to happen. That is probably a prerequisite to seeing operation change.

How the operational change happens is a difficult question. There are different schools of thought. Do you run a centralised or federated approach? It depends on culture. The banks with a central team can do well if they can command the voice in discussions with teams across the bank. If not, it can be a risk to have the perception of one team at the centre dealing with it and therefore it’s not a problem for everybody else.

**DK:** To what extent can we push some of these ESG considerations to the future when we are seeing some of outcomes happening in real time? How do you see that tragedy of the horizons, as Mark Carney called it, in the area of climate change?

**TG:** There are some real risks that are emanating and impacting today. There needs to be a careful consideration of those throughout the banking system. In relation to regulation and supervision, the challenge is to be able to codify these risk elements. In some ways it is
helpful to see some of these coming through because they are helping people to understand the physical consequences. Perhaps the unfortunate forest fires in Australia earlier in the year were a good example of physical risk that made banks think carefully about it. It is leading to quite reactive work around books, segmentation, exposure, be that geographical, products or projects related. We are going on a journey trying to understand these better and codify, so these can be managed through the risk framework.

**DK:** What is your view on the debate around green supporting and brown penalising factors? What we keep hearing from the regulators is that we don’t have enough data to show that ‘green is risk free’. At the same time we don’t have time to wait given the urgency of the climate threat. Is there a risk of making the perfect the enemy of the good? Another argument often voiced here is that directing credit to particular sectors should be up to the government, and it should be done through measures such as carbon taxes. What do you think about this? And finally, excluding or penalising brown industries may also hurt their prospects to transition towards a more sustainable path, which you also need alongside the investments in new green industries.

**TG:** It is important that regulatory oversight points towards the outcomes that we are looking for. When I think about how risk appetite is set in some of the banks and how lending decisions are made, RWA density has a role to play. What matters is the behaviours of risk managers and relationship managers around originating new products and relationships. And nobody has got right a return-on-RWA type metric. Those situations are more incentivised by relationship, sales credits and revenue measures. It is important to get regulatory tone and infrastructure there and a debate going around data sets and RWA.

The place to look is the lending that relationship managers are tasked with. The banking system does not need to wait for the regulator. RWA changes and sustainability driven stress tests lead to different outcomes. It is important to start on the front line. It gets you back to the same blocker around data. It is easy to make the problem too simple by talking about green lending and brown lending. It is easy to put coal production and steel manufacturing in brown and renewables in green. One of the big objectives is to facilitate transition. That is a difficult topic for brown borrowers. Use of proceeds becomes important. Green bonds have helped but there needs to be a more variable solution to financing brown businesses than just through green bonds, where we can deal with use of proceeds.

The other challenge is around transition. If you can pin use of proceeds to a brown borrower, to generate more of a green outcome, that brown borrower gets browner before it gets greener, because it takes energy to transition. Understanding all that nuance is an incredible challenge. It is important to embark on that journey, gather those data sets but, in the meantime, promote a different form of behaviour with the front office, with client onboarding and with new product approval.

**DK:** Do you want to also talk about the capital markets side and what innovation we are seeing there? What lessons can we draw from the green bond market?
TG: It is important to have investor demand. That is why green bonds have had success. Funds with an ESG mandate have invested in fixed income securities. It has created liquidity. Then products have been invented. It has been investor led, which is a fantastic way to clear a market.

There is some reluctance across different fund categories to raise funds on an ESG mandate because it holds you to a different standard. It leads to different levels of work required around due diligence. If it is taking more equity risk, you need to be able to take into account each element of ESG. And that is just not a path that some sponsors have trodden.

You need to be confident at the point of investment, then through the lifecycle. You need a monitoring and control approach.

Green bond activity, which is small in the context of the fixed income market, at about $250bn issued in 2019, is a success that goes back to standards that were put in place, by the marking scheme that capital market participants could point towards. The European Commission’s green bond standards and ECMA’s green bond principles helped galvanise the sell and buy sides. It had an impact in Europe. Of that volume in 2019, 45% was in Europe, which is in contrast to other fixed income areas where you see a greater proportion of issuance from the US. There is something that is being done right there.

We need to learn those lessons for innovation around other products. The fixed income product is a simple product to understand and administer. I think getting into other asset classes is tougher. They need standards that people can get behind.

DK: Going back to Covid-19, is anyone going to jump back on public transport? How will that affect the emissions we are seeing? Do you think we will see a rise in single use plastics?

TG: There are some incredible possibilities at the moment. What we have done over the last four months, is operate a big experiment. The footprint that we have every day, as it relates to travel, has changed.

The big question is when we move into greeting more of a hybrid economy. We worked from home. We have proven we can do that. We proved we can work in an office. What we have not proved is if we can do the two at the same time. Can we operate a hybrid model? There is a lot of incentive to take the good from what has happened and have a more flexible workforce, have a smaller footprint, not travel as much.

We need to better understand what a hybrid model means. I have worked out how to work with my team in the office and how to do it from home, but I am struggling to think about how I do that with a 50/50 mix. Making sure that people have equivalent opportunities and development time when you are operating from two different platforms. Whilst that doesn’t relate to climate, it is at the top of the funnel that then does have an impact. It impacts the way in which we operate and interact.
There is a different risk appetite people have developed around using public transport, around plastic production. There is plastic production going on that wasn’t happening before, to make screens and those kinds of things. How long does that last?

There are some risks there as well. Ideally, we would learn these lessons and get it right. I feel that we will be learning the lessons and trying to optimise hybrid working for quite some time. I do think it will be a benefit for us all.
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