

# Building sustainable models for banks and their investors

Bank Governance Leadership  
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# Bank Governance Leadership Network ViewPoints

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## Building sustainable models for banks and their investors

The seventh Bank Governance Leadership Network (BGLN) Summit took place on 30<sup>th</sup> September and 1<sup>st</sup> October in New York. This year's summit focused on how banks are adapting strategies, business models, and operations to a changing competitive landscape. Non-executive directors and senior executives from among the largest global banks were joined by regulators and other participants representing investor and other stakeholder perspectives for discussions on some of the challenges and opportunities for banks as they seek to improve returns and attract investment.

BGLN discussions have focused on the implications of regulatory reforms and market changes and the impact on business models since the network's beginnings. Participants discussed the long and rocky road along the journey to a "new normal," and the need to "keep debt and equity holders on board" along the way. In 2015, the market may no longer give bank leaders credit for being on the journey, wanting more clarity regarding the destination. The summit offered a unique opportunity to explore these issues as bank leaders shape the future of their institutions.

For the first time, BGLN participants were also joined by participants in the Insurance Governance Leadership Network (IGLN) for two joint discussions on issues of common interest. The combined group included more than 50 directors, executives, regulators, and industry experts representing many of the largest financial institutions globally, collectively representing nearly \$25 trillion in assets.

This *ViewPoints*<sup>1</sup> synthesizes themes emerging from the summit discussions, incorporating insights from other network discussions throughout 2015. It is organized around the following themes:

- **Regulation is driving changes to bank structures, operations, and business models.** (*Pages 3-10*) Regulation is a central force in reshaping the economics of banking. While much of the regulatory framework is now complete, the constraints on different businesses are beginning to lead to different strategic responses, even from once similar banks. A central focus now is on structural reform – making large banks simpler and more resolvable. In response, bank leaders are taking a closer look at their structures, operating models, and streamlining. And participants expect regulation to remain in flux, with tools like stress testing used to tweak capital requirements. Engagement between board leaders, regulators, and supervisors has become a regular practice and will remain important as the focus of regulation and supervision continues to adjust.
- **Building more agile banks that attract investment.** (*Pages 11-23*) At the core of the challenge for bank leaders is addressing what one participant called "agility risk," i.e. how do banks develop business models that are more efficient, flexible, and innovative, but also sound and stable from a risk perspective? While investors see reduced risk in banks, they expect continued regulatory pressure and returns to remain below the cost of capital in many large banks. Financial technology companies are increasingly putting pressure on banks to improve their customer interface and upgrade their technology. While banks are changing – improving efficiency, addressing cultural issues, and investing in technology – participants note they can only move so fast and invest so much. But bolder strategic decisions may still be needed as banks consider exiting businesses or major asset swaps. Ultimately, an increasingly diverse mix of financial institutions will serve customers as banks become more differentiated and new competitors increase in scale.

- **Board-shareholder engagement in an era of increasing activism.** *(Pages 24-28)* As banks come under pressure to improve returns, they can expect increasingly active investors to seek engagement with directors to discuss not just governance issues, but strategy as well. In addition to activist investors increasingly targeting larger financial services firms, large institutional investors are becoming more active as well. Some are issuing “requests for activists,” looking to partner with activists to drive change in their portfolio companies. As a result, boards should develop communication and engagement strategies and be prepared to articulate their plans to improve returns.
- **Market liquidity: the unintended systemic risk?** *(Pages 29-35)* Participants see new sources of emerging risk in the potential implications stemming from a lack of liquidity in certain capital markets, particularly those for bonds. A serious disruption in capital markets could cause significant challenges for banks and insurers. BGLN and IGLN Summit participants convened for a joint discussion about these potential sources of systemic risk and their implications, as banks and insurers overlap and interact in many markets but are subject to different regulations. Participants discussed the potential triggers for a liquidity crisis, how their firms can prepare, and what steps may be required by financial services companies, regulators, and central banks in the event of a crisis.

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These issues are explored in greater detail in the sections that follow. We encourage you to share *ViewPoints* with colleagues and others with an interest in the future of banking.

## Regulation is driving changes to bank structures, operations, and business models

For the last six years, regulation and supervision have been a central focus of BGLN discussions. This is no surprise given the scale of reforms and the implications for banks and markets. Discussions of business models and profitability take place within the context of regulation and supervision, which establish parameters within which bank leaders must make their decisions. A recent article in the *Economist* asserted, “The new masters of the financial universe are neither bank bosses nor hedge fund titans. They are the regulators whose job it is to make finance safer ... The decisions they and people like them make are shaping the industry.”<sup>2</sup>

The 2015 summit began, therefore, with a discussion on the current focus of regulators and supervisors, and the aspects of regulation that have the greatest implications for bank business models. These included business model changes stemming from regulations, a focus on structural changes driven by resolution planning, and the continuing uncertainty facing bank leaders as regulations remain in flux.

## Regulations have changed the economics of banking, with varying impacts on different businesses

Central to regulatory reform and having perhaps the greatest overall impact on bank profitability are capital and funding requirements. While international capital guidelines under Basel III have been agreed for some time, final capital, liquidity, and leverage requirements are only just being finalized for the largest banks. These requirements represent “the single most important decision that regulators have to make ... To a bank, nothing matters more than [the amount of capital they are required to hold]. It determines their ability to lend, their decision to grow or shrink each of their businesses and their ability to reward shareholders and employees.”<sup>3</sup> These requirements allow regulators “to influence how banks raise their money, as well as how they invest it.”<sup>4</sup>

An academic recently predicted that Basel III would turn banks “into over-regulated public utilities with limited profitability and ability to innovate.”<sup>5</sup> But a regulator expressed approval for the new framework: “*The regulatory framework is now built, and it is very complex. The binding constraints for given firms are not the same. For some, it is supplemental leverage ratios. For others, it is liquidity, total loss-absorbing capacity, or capital requirements. It varies, and no one equation fits all – and I think that is a good thing for the industry.*”

Capital, leverage, and liquidity rules and the accompanying stress testing continue to drive changes to the economics of bank businesses. Rules designed to limit trading and credit risk, like the Volcker Rule in the United States, are also driving banks out of previously profitable businesses. The impact and constraints vary for different businesses and different banks. As a result, summit participants reported starting to see some institutions historically in similar businesses and subject to the same regulations making different strategic choices in response.

## The focus is increasingly on structural reform

As capital, liquidity, and leverage requirements are finalized, the focus on making systemically important banks more resolvable has moved to the fore of regulatory reform efforts. A participant observed, *“We got through capital. We’ve come a tremendous distance on liquidity. The thing now is structure.”* The United States’ intermediate holding company rules and other calls for local capital, liquidity, and governance; the UK ring-fencing requirements; and the trading prohibitions initially introduced via the Liikanen Report in the European Union and the Volcker Rule in the United States are having a significant impact on how banks are structured and the businesses they select. But at the center of current structural reform efforts is a focus on simplification to improve risk transparency and, ultimately, to make banks more resolvable. A participant stated, *“The resolvability issue is huge.”*

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*“The  
resolvability  
issue is huge.”*

- Participant

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## Making banks more resolvable

Following last year’s summit, several directors acknowledged that discussing resolution planning had caused them to think differently about the process, the degree to which the regulatory community is focused on the issue, the role of the board in reviewing plans, and the extent of the plans’ implications. The Fed and the FDIC’s “sweeping rebuke”<sup>6</sup> of the initial plans submitted by 11 of the largest banks also got directors’ attention. One said before this year’s summit, *“Last year’s recovery and resolution plan results put the fear of God in many of us ... It led to some operating changes that impact some aspects of how we live.”*

The process of developing resolution plans is producing a range of impacts and implications for board consideration:

- **Simplifying bank structures.** The process has pushed more information about structures to the board, and has led to decisions that have reduced the costs of *“day-to-day governance”* of complex entity structures. According to one director, *“It is getting rid of a ton of legal entities that were set up for tax purposes. In a real mess, it would be hard to figure out what goes on in them ... It is helping us improve our technology systems. It is collapsing a lot of stuff that we don’t need. We will be a lot more streamlined.”*
- **Recognizing the importance, and imperfections, of the plans.** The objective of resolution planning is ultimately as much about making banks more resolvable in a crisis as it is about the plan itself. Directors have raised questions about their role in reviewing and approving resolution plans that can extend into tens or even hundreds of thousands of pages. One noted that even the executive summaries are hundreds of pages. Several participants suggested the impetus is on management to help boards understand what elements they need to focus on and understand. Similarly, while some bank directors and executives have called for greater guidance from regulators about what they expect in the plans, a participant suggested that boards focus on what steps are needed to make banks more resolvable first.

In a crisis, the plans will prove useful – at least *“directionally helpful”* – for bank leaders and resolution authorities in determining the key steps to effective resolution. But some participants still question their credibility. One said,

*“Resolvability has nothing to do with the document. If you are looking for the document on Friday night, you have a whole different set of problems.”*

- **Improving the dialogue between banks and regulators.** A participant observed, *“We have seen greater dialogue between the banks and regulators about this in the last year. In the past, we didn’t provide enough opportunity for dialogue. That is a big step. But I worry a little bit about regulators being too prescriptive. I worry about the industry waiting for regulators to tell banks what they should look like.”* Prior to the summit, a regulator noted the continuing role that recovery and resolution plans will have in supervisory interactions as feedback from regulators to banks improves: *“We want this to be an ongoing process: not just a once-a-year effort where a document is submitted and reviewed and they get a thumbs up or thumbs down, but a year-round dialogue like what we are seeing with capital planning.”*

### Changing the board discussion about structure, costs, and operations

Prior to the summit, a regulator observed, *“At the moment, boards are flying blind in terms of their ability to see what is really going on ... Restructuring, capital charges, and resolution planning are revealing that a number of banks still don’t know how they make their money. They just don’t have the information. Things like transfer pricing, the return on capital for specific businesses, etcetera, have been ignored for years but are now important as things are being hived off.”* By directly addressing these issues, resolution planning is contributing to improved transparency and knowledge of how capital is allocated and the returns it generates at a more granular level than had been the case in many institutions.

The resolution planning process has forced banks to consider their options and take a hard look at the costs and inefficiencies in complex legal structures. A director said, *“People have learned a tremendous amount through the resolution planning process. There is a huge cost just in the day-to-day governance of these entities that we couldn’t even remember why they’d been set up. When you take a resolution lens to them, it is very different. It is not just about cost cutting; it is asking, ‘Do these flows of capital even work?’”* These considerations have become *“central to all board discussions.”* Indeed, another participant admitted, *“Two years ago, you would have asked, ‘What are the capital and liquidity requirements at the top of the house?’”* But now, the participant said, *“You see a much richer discussion”* about capital and liquidity in subsidiaries and legal entities, and scrutiny of things like transfer pricing.

These structural considerations have become an important part of strategic decision making. One participant noted, *“We spent a lot of time at our strategic off-site looking at how you structure the firm.”* Despite noting some of the clear benefits of rationalization, a director highlighted the complexities of these decisions: *“Depending on where and how you operate, the considerations get quite complicated ... It is not a linear thought process.”* Another participant noted the challenges still ahead: *“Some of these entities make no sense and it costs nothing to get rid of them. That’s easy. The hard one is, ‘It makes no sense, but it’s going to cost us billions to get rid of it.’”* As a result, a participant asserted, *“You need a legal entity strategy, a financial strategy, including liquidity. Behind the plan, you need a set of capabilities – financial, operational – and you should be asking management to demonstrate and test their*

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*“I worry about the industry waiting for regulators to tell banks what they should look like.”*

- Participant

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effectiveness. How can the board get comfort that it all works, as opposed to comfort with what is in the plan?”

### Changing the governance of global banks

The focus of last year’s summit was the future of global banking in the face of what has been described as a “retreat into parochialism” and governments’ rush “to protect their own.”<sup>7</sup> There has been a push for locally managed subsidiaries with ring-fenced capital and liquidity and independent systems, risk management, and governance. A director summarized, *“In recognition that cooperation among regulators cannot be relied upon when things get tough, we continue to see balkanization of capital and liquidity, which fundamentally changes the economics of large, international banks.”* Partly as a result, there are fewer and fewer truly global banks, mostly headquartered in the United States, and some of the largest banks in emerging markets that had been looking to expand into developed markets are rethinking their international strategies. Even the Chinese banks, now among the largest globally, are looking to expand *“for geopolitical reasons, not economic ones,”* according to one participant.

This shift represents a fundamental change to the way global banks have been managed and governed. A participant observed, *“I am not sure global banks have come to grips with the reality of the new world.”* Another said, *“Financial institutions look more like a series of equity investments. As a director, are you prepared to be overseeing a choice of equity investments?”* This also represents an increasing shift from *“global risk management”* to *“local, regional risk management,”* which is *“very different from looking at things from a group level ... It’s being operationalized in a way that we’ve never done before.”* The result is that boards need not only a global perspective on the institutions but also a more granular perspective on local operations across the globe.

#### Structural changes to markets may also be coming

While attention has focused mostly on structural reform of banks, discussion at the summit highlighted the potential for structural changes to markets stemming from regulatory change as well. In addition to an in-depth discussion about the impact of regulatory changes and other factors on market liquidity (see the last section of *ViewPoints*, “Market liquidity: an unintended systemic risk?”), participants discussed additional changes that may be coming. One stated, *“A focus on intraday liquidity is coming.”* The result could be structural changes to markets, which participants suggested might not be working effectively, as several agreed that pricing for intraday liquidity had not reset as they would have expected. One offered the reforms to the tri-party repo market – which involved collaboration among major banks and the Federal Reserve to reduce systemic risk by eliminating intraday credit risk while enabling market participants to continue to efficiently fund their operations – as a possible example for how industry and regulators can collectively address intraday liquidity.

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*“How can the board get comfort that it all works, as opposed to comfort with what is in the plan?”*

- Participant

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*“Financial institutions look more like a series of equity investments. As a director, are you prepared to be overseeing a choice of equity investments?”*

- Participant

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## Regulation is likely to remain in flux

The direction of regulatory reform has been established for some time, and the details and implications widely debated. Yet the *Economist* recently wrote, “The disaster of 2008 persuaded officials not just to write harsher rules, but also to be more flexible ... The industry can game static, well-understood rules more easily than dynamic, fuzzy ones.”<sup>8</sup> And new rules are still being considered, finalized, or implemented, including leverage ratios, potential changes to risk weighting of assets, and a potential capital framework for interest rate risk in the banking book aimed at ensuring banks hold sufficient capital to protect against a sharp move in interest rates.<sup>9</sup> Some, former Federal Reserve Chairman Alan Greenspan among them, continue to argue for still higher capital requirements as a simpler way to address regulation.<sup>10</sup> Fed Governor Daniel Tarullo recently said the Fed would continue to adjust banking rules to account for more economic scenarios, spur changes in banks’ legal structures, and improve their efficiency.<sup>11</sup> In any case, regulators and legal authorities will continue to have significant discretion regarding how they deal with things like misconduct, which will continue to garner attention and, potentially, additional large fines.

Completing the international reform agenda and harmonizing approaches across jurisdictions is not easy. A summit participant noted, “*The Basel process is complex,*” and even when there is agreement on key regulations, implementation across countries often varies, despite international bodies’ best efforts. Another participant said the delay in completion of some aspects of regulatory reform is a result of regulators “*thinking carefully about how we get to the right outcome,*” as opposed to dithering or a lack of clarity regarding the ultimate objectives.

Some participants said this persistent uncertainty about regulation makes it difficult to plan. Outstanding questions about key regulatory changes in some jurisdictions mean that “*trying to plan for anything like a five or even three-year horizon is very difficult. With potentially fundamental changes to [risk-weighting of assets], the jaw of assumptions is quite wide ... And we are not yet able to take into account the pricing implications.*” Despite these challenges, a participant suggested that bankers are also sending mixed messages, with some urging regulators to “*get it over with, set levels, so we can get on with it,*” and others cautioning, “*Don’t go too fast, do it piecemeal, see what the impact is first.*” The same participant observed, “*Unfortunately, both are probably right.*”

## Stress tests will be a tool to adapt and refine requirements

Stress tests, another core tool of regulators, let them test the quality of banks’ credit and risk management and also make it possible for regulators to determine what share of profits can be distributed to shareholders. Stress tests can have a significant impact on markets. In 2014, the Federal Reserve blocked planned dividends and share buybacks at five large banks.<sup>12</sup> The European Central Bank’s first comprehensive review of European banks last year sought to assure markets that the banks’ health was well understood by their new regulator. Meanwhile, in the United Kingdom, the Prudential Regulation Authority is conducting its own tests this year of UK banks’ ability to withstand global economic shocks.

But some critics note that the inputs and assumptions in stress tests are often opaque to the banks and their investors, who remain “financially exposed to the decisions of

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*“Trying to plan for anything like a five or even three-year horizon is very difficult.”*

- Participant

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officials.”<sup>13</sup> Regulators will reserve the right to demand action from banks, even if the banks meet stated hurdle rates for capital, or may impose new capital requirements across the sector based on the tests’ results. A participant said of the Fed’s stress test, *“The analogy I like to use is banks all live in a corral made up of a regulatory wall, a liquidity wall, and a leverage wall. Around the corral is an invisible fence, which is CCAR [comprehensive capital analysis and review]. They don’t know where it is because they can’t see it. They are afraid to make moves because of the chance they will get shocked by CCAR ... These banks might be totally uninvestable because they need to maintain levels of capital that are unpredictable.”*

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*“These banks might be totally uninvestable because they need to maintain levels of capital that are unpredictable.”*

- Participant

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At the summit, participants discussed the ways stress tests will themselves need to change and adapt as business models – and the inherent risks – change. A participant observed, *“It is a challenge for sure when there is a fundamental change in business model – understanding how institutions will perform, the capital they would need under stress. That could definitely impact strategic choices.”*

### **The debate about regulatory reform is not over**

Banks remain a popular political target in the United States. A director observed, *“Bank behavior has been terrible, and Washington won’t forget that. There will probably be another crisis in the meantime, and that will only feed it. Elizabeth Warren, despite being a junior senator, is very vocal and very powerful. Eight or nine of the big banks have felonies against them. It wouldn’t take too much to push one of them in the wrong direction and cause them to fail ... We would then have a liquidity crisis of major proportions and the economy would go into a tailspin. The conclusion would be, ‘They can’t be regulated, so break them up.’”*

Elsewhere, banks face similar criticism, and there is similar talk of a need for additional regulatory reform. An executive noted, *“We still struggle to have a grown-up conversation between the industry and policymakers about regulatory reform ... but the costs of getting it wrong in either direction are too high. If we are regulating to the extent that banking models cannot support sustainable growth, we have a problem. The industry lost credibility when it used arguments about the reduction in credit in disingenuous ways, but there are genuine questions that need to be grappled with on both sides.”*

At the same time, summit participants revisited a recurring theme of BGLN discussions: the need for regulation to accommodate a changing financial services landscape. As an increasingly diverse mix of financial institutions emerges, including direct competitors to banks as well as collaborators, intermediaries, and vendors, participants question how regulation will adapt. Many see two primary issues for banks: (1) banks feel they are competing on an uneven playing field with competitors – from hedge funds and private equity firms to financial technology companies – who operate without the same regulatory constraints; and (2) perhaps more importantly, these institutions could be increasingly critical sources of potentially systemic risk.

For now, one participant said of some shadow banking institutions, *“If they are unlevered, and provide investability, it may actually lessen the potential instability of assets.”* But those institutions that remain outside the regulated sector are difficult to track, making it challenging for regulators to understand where money is moving and why, and to understand whether the system is becoming more or less stable as a result.

And regulators remain bound by mandates and resource constraints that limit their ability to expand oversight.

All of this suggests banks need to remain flexible. In a series of discussions in 2013 focused on evolving bank business models, BGLN participants agreed that “the fog” of regulatory uncertainty was abating and that it was time to make long-term strategic decisions. The following years have shown that regulation is still in flux and that the fog of uncertainty may persist. As a result, business models will have to continue to adapt.

### Board-supervisor engagement is now the norm

Some of the earliest BGLN discussions among bank directors and supervisors focused on the need to increase and improve engagement between the two. Once an uncommon practice in some countries, regular meetings between non-executive directors and supervisors has become increasingly commonplace. Virtually all directors at the summit reported regular meetings with supervisors in the jurisdictions where their institutions have significant operations. To be effective, participants emphasized the need to keep these interactions open and informal to ensure candid discussion. One stated, *“Do it alone, without management and without lawyers. Just talk ... If that creates anxiety for management, you have the wrong management.”*

The benefits of this engagement include improved benchmarking of governance and risk management practices and an improved understanding among boards about supervisors’ priorities. It has also allowed boards to share views regarding the need for supervisors to strike a balance between focusing on improved processes and things like technical models, and giving bank leaders room to exercise business judgment.

As bank boards come under pressure from investors to improve efficiency, things like risk, compliance, audit, and related costs are likely to come under closer examination, and discussing potential changes with supervisors will be increasingly important. Banks are spending as much as an additional \$4 billion a year in risk and compliance costs.<sup>14</sup> An investor in large banks said, “All I see are cases where compliance costs are going up, and that is a massive challenge for these banks. Every time I see the management teams, it is the first thing I raise with them.”<sup>15</sup> In the past, a director observed, *“Regulators would say no cost is too great given what happened.”* Discussing with supervisors where there are opportunities to improve efficiency will be important. A director said, *“It is hard for directors to know what investments are critically important. We want to do what is best to be safe, but efficiently.”* In response, a regulator said, *“If a firm is not efficient at doing what we expect them to do, and cost cutting will impact their ability to do that, then that is a problem.”*

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Prior to the summit, a regulator suggested bank leaders needed to be prepared to continue to adapt to regulatory drivers: *“There are more potentially binding regulatory constraints today. It requires a more complex analysis. I still think there are some pretty dramatic changes to come ... Bank leaders need to ask, ‘Do we have a model that gives us the ability to tweak and adapt over time?’ They should create a flexible strategy.”* Regulatory change remains a key component of strategic planning for bank leaders. A summit participant asserted, *“There is a real competitive advantage*

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*“Just talk ... If that creates anxiety for management, you have the wrong management.”*

- Participant

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*“We want to do what is best to be safe, but efficiently.”*

- Director

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*in the ability to manage regulatory change. At a strategic level, the ability to get comfortable with the evolutionary change and translate that into implications for the business model and capital allocation, and provide a strong narrative for how the operating model needs to change given the constraints, is essential.”*

## Building more agile banks that attract investment

*For a time, management was focused on the only criteria against which we were judged: controlling the overall risk profile of the bank. Now, we are under pressure regarding volume, growth, and profitability.* – Bank executive

Well-documented forces are putting pressure on banks' profitability, notably regulation, related market changes, and emerging competitors. In this environment, bank leaders are asking two fundamental questions: (1) What should our growth and return targets be? And (2) How can we achieve them? These basic questions are not easily answered. In the years before the financial crisis, returns on equity (ROEs) of 20% and higher were not uncommon, yet in hindsight most would argue that those profits were unsustainable and built on risk profiles that are unacceptable – and impossible to replicate – today. In fact, the current environment may represent a return to normal: evidence suggests that “for much of its modern history, banking has only just returned its cost of equity – and for long stretches, has fallen short of even that.”<sup>16</sup>

Most banks remain focused on boosting returns at least to exceed their cost of capital. But some BGLN participants say that banks have not done a good job of articulating their strategy and explaining to the market what expectations they have for returns. As a result, some investors do not understand the likely return on capital invested and associated risks; they are increasingly impatient and looking for faster improvement. Some analysts have called for major strategic changes, including the breakup of the largest banks or massive asset swaps among major banks.<sup>17</sup> Bank leaders are under pressure to respond, but they want to proceed with caution. They note that prior to the financial crisis, pressure from shareholders for “arguably unsustainable levels of return” created “pressure to increase leverage and take on additional risk.”<sup>18</sup>

Seven years from the height of the financial crisis, establishing strategies and business models that will achieve returns that attract capital without straying from their agreed risk appetite remains a challenge for banks. The 2015 BGLN Summit focused on this challenge and the possible ways forward. Boards are asking, *“How do large businesses morph themselves into something that is going to work in the new world?”*

This section of *ViewPoints* draws on insights directors, investors, analysts, and regulators shared, both prior to and during the summit, in conversations on the external forces putting pressure on bank returns, investor expectations, and the choices bank leaders are facing as business and operating models adapt. These insights are outlined in the following sections:

- **Investors see reduced risk, but expect limited improvement to returns**
- **Innovation in financial technology is changing the industry**
- **Large banks are changing, but cautiously**
- **An increasingly diverse mix of financial institutions will emerge**

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*“How do large businesses morph themselves into something that is going to work in the new world?”*

- Director

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## Investors see reduced risk, but expect limited improvement to returns

A director said, *“At the end of the day, what we really care about is driving value for shareholders. So how do we balance the demands and interests and articulate them properly to our owners?”* In a conversation prior to the summit, a chairman noted the obvious connection between the need to improve returns and the challenges many banks are confronting, asking, *“How do you refinance a bank at 5% ROE?”* Some responded that a reset in expectations was needed. At the summit, participants discussed how investor expectations were evolving.

## Investors expect banks will be allowed to fail in a crisis

Investors see risk as generally lower in banks, but they believe that the public distaste for bailouts means that banks are more likely to be allowed to fail if they find themselves in an untenable position. A participant noted that historically, *“the bank default risk in advanced economies is less than half what it has been for non-financial corporates, which is curious, given the leverage, opacity of reporting, low barriers to entry, and vulnerability to technology. Why? Support from central banks and even blatant support in the extreme. That changed in the crisis. [Default risk] went to five times the level for corporates.”* Now, governments and central banks are less willing and able to bail out large banks, and debt investors see a real conviction to impose resolution authority. A participant said, *“There has been a changed reality in investor sentiment as a result.”*

On a more positive note, the overall reduced risk in large banks is slowly starting to impact the cost of capital. A participant said investors acknowledge that *“the major banks have made headway reducing leverage and risk, cutting costs, and streamlining their market-making businesses. As a result, both credit default spreads and the equity beta of the major trading banks has declined.”*

## The cost of capital may be coming down, but few banks are meeting or exceeding it

At the 2010 BGLN summit, directors predicted ROEs ranging anywhere from 5% to 20%, with one saying, *“The worst case of regulatory reforms gets you to 5% or 6%, but no one would buy us.”*<sup>19</sup> Several participants feel that this message has not reached the hearts and minds of investors; they say a disconnect still exists between what investors expect and what large banks are likely to be able to deliver in the near term. Others see this as the normal tension between companies and investors. Of course, there is also a broad range of results among banks, but several directors of banks that have seen improvement in recent years suggest the pressure for further improvement has not subsided.

According to one participant, in 2014, *“only two of the 14 largest banks exceeded their cost of capital.”* The reality all banks face is that *“funding costs are up, capital is up, risk-taking is gone, and the capital markets business models are broken.”* One fund manager noted, *“Shareholders are focusing on profitability rather than revenue growth for all of these banks ... [They] have taken a much greater part in pressurising management to reach their targets.”*<sup>20</sup> But a bank executive was skeptical about how much shareholders understand: *“Most investors don’t really get a good understanding of what the cost drivers are in banks ... We have done a bad job of explaining how*

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*“Funding costs are up, capital is up, risk-taking is gone, and the capital markets business models are broken.”*

- Participant

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that works, and investment banks in particular have done a bad job of horizontally managing costs.”

Another participant observed, “The investment community expects continuing pressure on the capital markets businesses of the bank from new and evolving regulation over the next three to five years.” Furthermore, in spite of the fact that research suggests the cost of equity is dropping, one participant warned, “the cost of capital is not changing fast enough” that most banks will be able to achieve returns above their cost of capital in the near term. As a result, “investors expect the negative carry to improve, but not to the level that it will offer a positive return to shareholders.”

#### Banks as regulated utilities?

While many banks continue to improve returns to exceed their cost of capital, some commentators have suggested return expectations need to adjust further to reduced risk. This theory holds that well-capitalized banks with less risky business models and lower volatility of earnings could be attractive to some investors and that the cost of capital could go down in response. Most BGLN participants have not seen evidence of this to date. One executive observed, “We have taken steps to make our risk profile more consistent, understood, and transparent to investors, but I cannot say that my perception is that this is recognized by investors ... We have not seen different valuations or premiums for that. I agree with the theory, but I have not seen it rewarded in practice.” This model of stable but lower returns has been compared to utilities. One chief investment officer said in 2011, “I think banks should not be seen as a growth industry ... They should really be seen as a highly regulated public utility.”<sup>21</sup> A director disagreed, saying, “The utility analogy is just a mirage in the desert ... Utilities have a basis for regulation based on a natural monopoly, and a cost and return on capital that is a basic, flat, unrisky business ... There are very few businesses in banking that are natural monopolies.”

“Investors expect the negative carry to improve, but not to the level that it will offer a positive return to shareholders.”

- Participant

### Innovation in financial technology is changing the industry

BGLN discussions have focused on the threat from new competitors, particularly from “fintech” (financial technology) companies. Retail and commercial banking, wealth management, and private banking are all susceptible to disruption and face the biggest pressure on margins from increasing competition. A director stated, “Competition and the business model is the biggest risk. It is heading in the direction of a more contestable market, with new competitors and informed consumers. The regulatory agenda is about eliminating barriers to entry. Our biggest threat is how that plays out and how we stay relevant.” The summit discussion delved deeper into how financial technology companies are responding to changing customer expectations and what banks can do in response.

#### Changing customer expectations are driving the growth of financial technology companies

Millennials – generally defined as people born after 1980 – not only lack a strong affinity for traditional financial services companies, they tend to prefer tech and

consumer brands for financial services. A summit participant referenced research showing that more than 50% of millennials do not differentiate among banks and that 70% would prefer to go to the dentist than listen to a bank's pitch. Further, 60% would prefer start-ups to banks, and 75% want financial services provided by trusted consumer brands.<sup>22</sup> They also value ease of use and convenience over privacy: *"No one wants their credit card statement out there, but if you grew up with Facebook, making personal information public, connecting, and collaborating, you may be more willing to trade information for a better rate, to make it easier to find and access products and services."*

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*"If you grew up with Facebook ... you may be more willing to trade information for a better rate ..."*

- Participant

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Some participants questioned how prevalent, and how enduring, these attitudes are. One asked, *"Will these attitudes prevail as this cohort ages, takes on new responsibilities, adopts a different worldview?"* But another observed, *"We use the term 'millennials,' but we are really talking about changing behaviors of anyone under 50. This is not about people being anti-establishment; it is people saying, 'I want this service, and I want it on my phone.' Most have grown up with that."*

Financial technology companies are focusing on ways to unbundle bank services – a participant said, *"No one wants to be a regulated bank holding company."* Instead, another said, *"They are looking to solve a specific consumer problem. It is easier to be agile when doing one thing."* In other words, fintech companies are endeavoring to cherry-pick profitable businesses, or profitable customer segments within businesses. They are emerging in payments, wealth management, consumer, and even commercial lending, foreign exchange, and bitcoin. And the people leading them are driven: according to one participant, *"They have a righteous zeal. They see a population that is not being well served by the traditional financial services industry."*

A participant said peer-to-peer lending has experienced a 150% compound annual growth rate over the last five years. Despite its name, peer-to-peer lending is increasingly represented by institutional investors – hedge funds, insurance companies, etc. – but with an innovative origination model. Perhaps the most important growth has been in connection to mobile applications. A participant noted that 4.5–5 times as many mobile phones have been sold as personal computers. This participant noted that mobile is *"personal, frictionless, easy to use, [and] supports payment networks,"* which makes it *"a large disruptive force."* Another participant noted that in underserved markets, more people have a mobile phone than have a bank account. Mobile also benefits from the network effect: the more people come onto the network, the better the experience and the lower the costs. As momentum builds, adoption could increase even faster. And, while some participants raised questions about security concerns, one said, *"Mobile is not inherently less secure. Technologies like fingerprint and iris scanning, location mapping, and voice signatures are being adopted."*

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*"They have a righteous zeal. They see a population that is not being well served by the traditional financial services industry."*

- Participant

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Despite this growth, the hype in the media, and comments from bank leaders like Jamie Dimon about fintech companies looking to eat the banks' lunches, these newcomers represent a very small portion of the market – less than 1% even in the areas of greatest penetration according to one participant. One director asserted, *"A new competitive threat is still just a competitive threat like the others every business faces."* And other participants point to the potential for *"something to blow up"* in this space, which could cause a backlash and potential regulatory response. Regardless,

it is clear that financial technology companies are disrupting the market for financial services.

### **There are opportunities for banks in financial technology**

Banking has already begun responding to innovations in financial technology. In a prior discussion on the topic, a subject matter expert observed, *“Banking has changed a lot: we have 24/7 banking, we can bank globally at any time online or via mobile apps. There has probably been more change than the industry gets credit for.”* At the summit, a director asserted that banks have to go further: *“It is not a question of can we do it. We have to do it. This is happening everywhere, and in every business. It is part of the evolution of determining how to keep the customer happy. It is part of the job of the board to be sure we are moving along that journey to sustainable profitability.”*

Indeed, there are opportunities that come with the threat. A participant observed, *“Most [fintech companies] need and want to partner with the bank infrastructure.”* This is not straightforward in all cases: a participant noted, *“It is difficult for banks to partner with [fintech companies] given regulatory ambiguity.”* For example, major bitcoin wallets and exchanges would like bank partners, but the anonymity of bitcoin means Know Your Customer compliance is impossible. One summit participant insisted that, perhaps counterintuitively, the result was that fintech companies *“want to be brought into the system, to be regulated.”*

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*“Most [fintech companies] need and want to partner with the bank infrastructure.”*

- Participant

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Cooperation and partnerships do bring risks. The *Economist* wrote recently, “Banks worry that co-operating is the first step towards losing the lucrative grip they have on their customers,” that their “efforts to sell multiple products to current-account holders are being undercut by the financial aggregators, which pitch financial products to customers using the data they have accumulated ... Bosses glimpse a future where customers use banks merely as a utility, depositing their money there but using unregulated startups to manage it. Smoother data-sharing would make that a reality. It is a prospect that should indeed frighten bankers as much as it delights their customers.”<sup>23</sup>

Acknowledging the risks, participants discussed ways that they can engage with the fintech community and adapt their own practices:

- **Be present in the fintech community.** A participant said it is important for banks to *“be in the ecosystem,”* to have a presence in financial technology centers like Silicon Valley, New York, and London to understand what is happening and where there are opportunities for cooperation, or emerging competitive threats. Banks need clarity regarding what they can achieve and their limits: where can they cooperate, and what is competitive?
- **Develop an in-house innovation group.** The entrepreneurial, creative culture needed to be truly innovative is difficult to achieve within the bureaucracy and hierarchy of banks. As a result, many have built innovation groups that operate at arm’s length from the bank’s core business functions or IT departments. Participants discussed the importance of preserving the culture of these organizations while also ensuring they don’t drift too far away from the businesses.

- **Make off-balance sheet investments in start-ups.** Banks can direct investments to areas that can support their objectives, if they are clear about what they are hoping to achieve and understand how start-ups and fintech companies can help them in that regard. A participant cautioned, *“If the objective is purely return on investment, then just invest in venture capital.”*
- **Improve data management.** Many fintech companies claim they have improved credit analysis through better data and better analytics. Participants acknowledged the material costs and roadblocks that stand in the way of their own improvements in these areas, but still see opportunities for better gathering, formatting, and centralizing of data into repositories that can be used for analytics. Technology continues to advance, now allowing for “report and predict” capabilities through cognitive computing or neural networks – what one participant described as *“Big Data 2.0.”*
- **Selectively adopt innovative practices.** Fintech companies are experimenting with new methods of connecting with customers, some of which large banks may be able to adopt. Some companies are using social media to determine the creditworthiness of borrowers and are using new methods to improve repayment rates – for example, by assigning mentors to borrowers or using creative ways to use technology to increase on-time payments.

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*“One of my biggest concerns is what I call agility risk ... we simply cannot move as quickly as our disruptive competitors.”*

- Director

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### Large banks are changing, but cautiously

Though the challenges banks face vary substantially, all large banks know they must improve their efficiency and their ability to adapt to market changes more quickly. A director said, *“One of my biggest concerns is what I call agility risk ... We have these big mainframes, huge numbers of people, cultures that have been there for a long while, and we simply cannot move as quickly as our disruptive competitors.”* Banks are focused on making strategic changes that will help grow the top line, while at the same time identifying ways to improve the bottom line by focusing on balance-sheet and profit-and-loss efficiency. Several participants suggested the market is growing impatient, expecting details on the timeline and execution of strategic decisions. But making major strategic decisions and business model changes in the current environment is not easy:

Every bank executive I meet is concerned about their future. They recognise that the traditional structures of banking are changing; that their margins, and therefore profits, are disappearing; that they need to move from physical to digital; that fintech is changing the market for good; that peer-to-peer, mobile and blockchain are key; that... well, you get the idea. Their problem is that they don't know what to do about it and consultants cannot tell them ... We are living in fast cycle change where many bankers – and consultants – are finding it hard to keep up.<sup>24</sup>

Banks are still managing near-term priorities, including regulatory changes and legacy compliance and legal issues, but participants note that banks are also changing strategies, structures, and business and operating models. They have been *“pruning,”* exiting non-core businesses and rationalizing legal entities. They are also doing what they can to reduce costs and increase automation and efficiency. Participants stressed, however, that they can only do so much so fast.

### Better understanding of relevant economics is improving decision making

A participant said, *“Banks are in a period where they need to learn how to manage. Traditionally, they are not well-managed, revenue-driven organizations on the capital markets side. They are only now beginning to be managed like traditional companies.”* A summit participant quipped, *“There aren’t a lot of industrial engineers or cost accountants in the business.”* A participant observed, *“One of the problems is that the investment banks didn’t know where they were making money.”*

That is changing. A combination of regulation (for example, stemming from resolution planning) and market changes have forced bank leaders and boards to develop an improved understanding of the economics and capital costs of individual clients and products and to think more closely about how to run these businesses more efficiently. A participant stated, *“You have to do it client by client and product by product.”*

### Leaders are focused on getting the balance right in technology investments

In a past BGLN discussion, a participant noted that banks are actually among the largest technology companies in the world. Unfortunately, their technological infrastructure is largely outdated, and some suggest banks’ investments have been mostly defensive investments, rather than long-term investments in the core platform. To keep up with the innovations emerging from fintech, improve efficiency, and improve the customer experience, banks must make massive technology improvements. Upgrading is essential, but the scale of what’s necessary is daunting. A director stated, *“The cost and process dynamics and operational efficiency required to be successful ... are of a different order of magnitude than what banks have thought about.”* Sorting out legacy systems will be complex and expensive. A participant said, *“You cannot underestimate the challenge of dealing with legacy systems and what is involved in getting things changed. It is risky; you need to work with regulators because you are dealing with such massive costs.”*

The summit discussion highlighted some of the challenges bank leaders face in managing technology investment:

- **Directors have limited technology expertise.** Despite efforts to bring technology experts onto boards, many directors still struggle to truly understand the complexities of the vast array of systems issues in these large organizations. One asked, *“As non-executive directors, how do we understand the information systems, legacy issues, cybercrime? Do you need an IT specialist on the board? How do you really understand these billions that go into IT?”*
- **Determining value in IT investment is challenging.** Directors and executives also struggle with understanding the return on technology investments. A participant said, *“It is hard to really understand what you are getting for your IT spend. We spend \$2 billion, and I have no idea what I am really getting.”* A director asked, *“Is anyone on the board willing to say, ‘I understand where the issues are, and I understand what the value for money is?’”*
- **Upgrades will take time.** Under pressure to control costs and improve profits, banks must balance massive technology investments that could have long-term efficiency benefits with the market pressure for short-term returns. There is also

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*“Traditionally, they are not well-managed, revenue-driven organizations ... They are only now beginning to be managed like traditional companies.”*

- Participant

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*“It is hard to really understand what you are getting for your IT spend.”*

- Participant

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risk involved in making massive changes quickly. Banks need to ensure systems are able to keep running while making changes. Participants broadly agreed with one who cautioned, *“You can’t go any faster. You can’t spend your way out of it.”* At the same time, business models are changing. A participant observed, *“A CFO said you can’t do any more automation because you don’t know where business models are going. You don’t want to be the most efficient buggy whip manufacturer.”*

Given the scale of spending involved, some suggested separating *“run the bank”* costs from *“fix the bank”* investments. A participant said, *“We still need to figure out how to pick and choose how to invest in innovation. The company is overwhelmed by the necessity to comply with the day-to-day of new regulations, reporting, and monitoring – a huge burden of compliance broadly defined. But we keep hearing, ‘One day, it will be different.’ Right now, there isn’t the bandwidth.”* Others see it differently. One asserted, *“The compliance work is just table stakes. The board needs to promote a culture of really encouraging innovation and new ideas ... You have to be able to find the capacity to do both.”*

### **Culture in banking is changing**

Culture has become a buzzword among bank leaders, regulators, and industry commentators. Much of the focus has been on risk culture, and in particular, on changing culture to mitigate conduct risk. In a BGLN discussion earlier this year, a director urged deeper change: *“If you are trying to achieve a reduction in conduct risk, that is a limited objective ... The board remains excited about conduct as a risk, and everyone is talking about values and culture, but I have seen nothing to suggest further, deep, holistic thinking about building an environment where the good parts of culture become a part of your brand that affects how customers experience dealing with the bank.”* Altering culture is difficult, takes time, and is complicated by the need to balance innovation, which often involves risk, against safety and stability. Changing the culture may also involve attracting different kinds of people.

Summit participants do see important cultural changes under way. Some indicators, such as pay as a percentage of revenue, are shifting in many banks. A director shared what he considered an illustrative experience: *“I had an investment banker ask me, ‘What does the board think of us?’ ... They are worried about being seen as bad guys. Something has changed when people with these egos are thinking like that.”* According to another participant, *“Fixed income is no longer the Wild West. The key will be cultural change inside these institutions.”*

The positive signs are welcome, but participants caution that culture change will be gradual and is not without trade-offs. One said, *“You need a generational change. The next generation is going to make much less than their predecessors. So how do we now “There is no proposition to attract people into banks. We would tend to bury a young, creative, smart individual “There is no proposition to attract people into banks. We would tend to bury a young, creative, smart individual “There is no proposition to attract people into banks. We would tend to bury a young, creative, smart individual motivate people who know the future will not be as good as the past?”*

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*“You can’t go any faster. You can’t spend your way out of it.”*

- Participant

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Banks will need to offer a compelling proposition to new hires and nurture a supportive culture, or they may struggle to attract the best and brightest. When asked what the value proposition would be for a “smart creative” – the term coined by Google’s founders – to join a large bank, one participant stated bluntly, *“There is no proposition to attract people into banks. We would tend to bury a young, creative, smart individual and say, ‘They don’t have enough experience,’ etc. The sheer numbers of people in large banks means those people can get lost.”* Others agreed, citing the *“hierarchical, bureaucratic”* nature of their organizations as a challenge relative to the smaller, more agile technology companies, hedge funds, and private equity firms against which banks will increasingly compete for talent. A participant observed, *“One of the challenges is that there’s a real ownership in innovative fintech companies from front to back on business strategy, implementation, and execution. But I don’t see that as a cultural trait in banking. Revenue generators see their job as to maximize revenue, and the rest of the organization supports them.”*

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*“There is no proposition to attract people into banks. We would tend to bury a young, creative, smart individual.”*

- Participant

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### **Repricing is still needed**

Participants generally agreed that new prices for products and services – ones in line with the new capital requirements and economics of banking – are necessary, but this repricing has not yet happened. One participant observed, *“Pre-crisis, a lot of risks were underpriced or unpriced. Does that repricing present an opportunity?”* Another said, *“The only way we can begin to address returns is going to require repricing of the services that we provide.”* Internal transfer pricing is also likely to be impacted. A director said, *“A lot of people think they are cross-subsidizing without actually paying for it with another part of the business.”*

Boards need to press management to properly allocate costs. A director said, *“Directors have to push management to charge the proper cost of capital to the businesses. The bottom quartile is probably diluting the returns, because unless you do it on a client-by-client basis, you want to grow these clients and preserve optionality.”*

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*“The only way we can begin to address returns is going to require repricing of the services that we provide.”*

- Participant

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### **Bolder strategic decisions may still be required**

Despite the changes under way, *“the really difficult decisions”* about major strategic moves may yet remain – for example, to separate major businesses completely. Though participants described the breakup of large banks, material asset swaps among large institutions, and consolidation via mergers as only remote possibilities, participants did raise questions about the longer-term strategic directions of their firms and the industry.

Are bank leaders responding appropriately to the challenges? Prior to the summit, a director observed, *“I don’t know any bank facing up to this need to reshape the business in a practical way. I know a few CEOs and chairmen who think about this, but I don’t know anyone who has really grasped it.”* A summit participant asked, *“How many people really do the work of saying, ‘What is the threat to my business model? Which businesses could I potentially lose?’ A lot of transformation has gone on, but it has largely been driven by regulation.”* Another added, *“[Change] will be forced. How can you run a business with returns below the cost of capital?”*

In the last six years, many banks have changed their senior leadership. Chief executives whose strength was driving growth and expansion were, in some cases, jettisoned for chief executives charged with cleaning up conduct, lowering the risk profile, and refocusing on core businesses. But now CEOs are facing pressure to move faster to improve performance. A participant observed, *“One of the reasons CEOs are being replaced is that when they revealed their strategies, they were viewed as not going far enough or fast enough, and there wasn’t enough detail around them.”*

While leadership of many of the largest US banks has been relatively stable, to date in 2015 five of the largest European banks have replaced their CEOs. A summit participant said, *“There are banks in Europe that fundamentally have to address their business models. CEOs are recognizing that what they had done for the last 10 years is no longer feasible.”*

#### Rethinking the benefits of scale

Regulatory and economic constraints are forcing banks to refocus on core businesses in core geographies as many retrench from countries outside their home markets and exit non-core businesses. This has prompted questions about the relative benefits of scale in banking. The debate over too-big-to-fail institutions prompted questions about the role of systemically important banks in the global and local economies. A summit participant argued that they continue to be necessary: *“Corporate needs served by the big banks will remain.”* But others asked if other models, such as correspondent banking or partnerships, might be able serve those same needs. Some large banks continue to argue that there are real economies of scale benefiting them. After an analyst suggested JPMorgan Chase would be worth more if split up, JPMorgan’s CFO, Marianne Lake, told investors, *“Our synergies are real,”* and attributed \$15 billion in revenue and \$3 billion in cost savings to its wide-ranging business model.<sup>25</sup>

A summit participant challenged conventional wisdom, saying, *“I am not sure there are any economies of scale in this business. There must be benefits to being right-sized at a smaller level.”* With technology and cost reduction efforts leading to more outsourcing and to utilities handling back-office tasks, the benefits of scale could increasingly be further called into question. A participant predicted, *“There could be a world where smaller firms could do well because the scale economies will belong to outsourced operations ... The movie will run backwards. A small or middle-market size will be optimal.”*

Still, the relative benefits probably depend on the business, with some requiring less capital and lower compliance costs. Many banks are exiting those businesses where they lack scale. A participant observed, *“We are seeing competitors disappearing. Some businesses don’t have scale, and they can’t afford the technology or compliance costs.”*

#### Making longer-term strategic bets

A commentator observed, *“The idea of breaking up big banks is in the wind again ... Why aren’t shareholders making more of a fuss?”*<sup>26</sup> As noted above, many participants indicated that banks are making material decisions about exiting businesses. But others pointed out that some banks are still playing a game of wait-and-see: *“Some banks are*

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*“[Change] will be forced. How can you run a business with returns below the cost of capital?”*

- Participant

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*“I am not sure there are any economies of scale in this business.”*

- Participant

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*in unprofitable businesses in the hope that, sometime in the future, they may get the gold mine.”* While most participants agreed that they can no longer afford businesses that are not generating returns, there are important considerations many are still struggling to answer, for example:

- **Do we need to keep unprofitable businesses to attract and serve clients?** A participant asserted, *“Every board, especially if you have a capital markets business, has to understand where the loss leaders are and make judgments as to whether it makes sense to change.”* The calculus is not always straightforward, as another participant illustrated: *“Commercial paper is the worst business in the world. You’re not an underwriter, but you have the same liability. So why be in it? Because you need to be in that to do the bonds, and you need the bonds to get to do the [mergers and acquisitions]. So you’re in all these unprofitable businesses for other reasons.”* Problems arise when banks end up with too many loss leaders because they do not have a detailed understanding of which clients are profitable and in what products. A director said, *“Increasingly, we are looking at every product and every client to understand that.”* The outcome might be some difficult decisions and some difficult conversations with clients. One director said, *“Now you have a client that you’re doing a lot of business for. You have to know what that client costs you. You have to tell that client that if you want us doing this business for you, you have to pay for it.”*
- **If we exit businesses, can we get back in later?** As banks consider exiting once profitable businesses, they worry about permanently losing market position in businesses that may be attractive in the future. One participant asked, *“Can you get out and get back in at some point in the future? Are those exiting businesses counting on the possibility of getting back in?”* Another responded, *“History suggests you can ... In my lifetime, most of the banks here weren’t in capital markets, but got into it.”* *“Most banks bought those businesses, they didn’t build them,”* said another. A director pointed out that the decision need not be either/or: *“It is not binary. It is a question of scaling.”*
- **Are there opportunities for growth or consolidation in core businesses?** The banks that are retrenching from non-core businesses are focusing on building share where they believe they are strongest. Growth by mergers and acquisitions (M&A) and consolidation may not be among the options, however. One participant noted, *“We’ve had a lot of change in the models of individual institutions, but it’s mostly been done by firing people, not M&A. We have seen waves of layoffs. Some of them have gone outside the banking sector, but some have just gone to other banks.”* The political and regulatory climate may be a constraint as well. A participant said, *“Size still matters in the political arena. It is unlikely that regulators will support consolidation that could increase the size of institutions.”*

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*“Some banks are in unprofitable businesses in the hope that, sometime in the future, they may get the gold mine.”*

- Participant

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### An increasingly diverse mix of financial institutions will emerge

As non-traditional players in the financial services sphere continue to grow in scale and banks increasingly differentiate, the result will be a more diverse mix of financial institutions, focusing on different businesses. A participant predicted, *“We will see*

*many more models of a bank than we have been used to. The recognizable 'bank' will be an outdated idea."*

Smaller firms will be able to compete in some businesses. A participant commented, *"Historically, there were wide bid-offer spreads, large commissions, less liquid markets, [and] balance sheets were modest, and if we are evolving to that model, then the barriers to entry are low. Small firms would be able to achieve perfectly acceptable returns ... If you add to this the evolution of utilities handling back-office functions, then you are taking away scale advantages ... This is another world."* Some fear that smaller competitors, whether boutique investment banks or fintech companies, will *"skim the cream off the top and leave everything else,"* increasing competition in the highest-margin businesses.

Speaking about banks' adaptation, a participant observed, *"Ten or 15 years ago, we would all have adopted a big, integrated, international model. Now, we will be more different."* Another participant supplied examples: *"Credit Suisse and UBS are dramatically more different from each other than they were five years ago. Morgan Stanley and Goldman Sachs are now dramatically different, and these are banks we would have said were more or less the same."*

A participant said, *"The constraints are causing us to ask different questions. The client franchise, capital, [and] expertise are all leading to a more diverse universe of financial institutions."* The question, participants said, is whether customers and investors will recognize the differences. One said, *"The customer base of businesses is completely different. What will the difference be for customers? What is the value of the franchise?"* Another suggested, *"We will be more differentiated by the investor base. The client base mostly thinks we are the same."*

One participant stated, *"I think the increasing diversity is good for financial services."* Ultimately, that may be true, but it may not be good for every institution. Another participant predicted, *"We will see major winners and losers. Some major banks will be among the winners and losers."*

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At the summit, a director described the pressure bank leaders are under: *"We feel like the meat in the sandwich, caught between the regulators on one side, who are increasingly squeezing capital, and disruptors on the other side, who are seeking to offer some of our services without the same regulatory burden."* You could add to that a key third dimension: investors. These pressures from all sides are forcing banks to change their business models, their longer-term strategies, and how they handle operations and costs. But banks are diverse: they face different constraints and legacy issues, and their pressures come from different sources and have different characteristics. One participant posed some fundamental questions: *"What is a business model that is sustainable, and what is one that is going to be acceptable to society? What is socially acceptable banking?"*

In the immediate future, banks will continue to invest in technology, reduce complexity, increase efficiency, and refocus on core businesses. Banks may continue to have difficulty pinning down what expectations are appropriate for future returns, given the forces beyond banks' control, such as regulation. In announcing strategic

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*"The recognizable 'bank' will be an outdated idea."*

- Participant

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*"We will see major winners and losers. Some major banks will be among the winners and losers."*

- Participant

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plans in October, Tidjane Thiam, recently named Chief Executive of Credit Suisse, broke from precedent and said he would not set a target for return on equity. He said, “You can commit to what you control; if you commit to what you don’t control, you are just a fool,” noting that equity levels are determined by regulators.<sup>27</sup> What is clear is that the universe of firms providing banking and other financial services in the future will be very different from the one in which banks competed just 10 or even five years ago.

## Board-shareholder engagement in an era of increasing activism

“A dose of direct information may be the ounce of prevention that smart boards use to avoid a pound of cure in the form of derivative lawsuits, messy proxy fights, and activist battles.”<sup>28</sup>

As banks adapt their business models, they will continue to face pressure from an increasingly active investor base, which is fundamentally reshaping the corporate governance landscape. One way this has manifested is in calls for greater direct engagement with directors. Recent letters from large institutional investors demonstrate a clear expectation of regular investor-director communications.<sup>29</sup> The IGLN and BGLN represent institutions and sectors in transition, with much to communicate to the investment community regarding institutional health, strategy, and the implications of changing regulations. Although management has historically been the locus of shareholder communication, the fact that board directors are viewed as guardians of long-term strategy means that directors, including those in the financial sector, are under new pressure to engage with a wide range of investors. These investors are focused not only on governance issues, but increasingly on corporate strategy, risk oversight, and improving financial returns. Over lunch on 1<sup>st</sup> October, participants in the BGLN and IGLN Summits met jointly, along with subject matter experts and investors, to discuss emerging investor expectations.

### Pressure from investors is increasing

While activist investors tend to grab the headlines, institutional investors are also focusing more attention on large banking and insurance groups. Furthermore, increasingly, these two types of investors are finding common cause.

### Financial services companies are attracting more attention from activist groups

To date, activist investors have not waged public battles with financial services companies as they have with companies in other sectors. However, one participant warned, *“We cannot expect [that restraint] any longer. There is a massive wave of activists coming, and their influence is meaningful. As financial services companies, we haven’t seen them show up in the boardroom, but that is changing. The traditional view is we are protected by regulations, but the world is changing. More activity is coming our way.”* A recent letter from activist investor Carl Icahn to AIG calling for it to split into three companies demonstrates change may have already arrived.<sup>30</sup>

### Institutional investors are becoming more active

There has been a tectonic shift in the shareholder base of large companies over the last two decades. In the United States, index funds are now over 20% of the market and growing in size. As a consequence, major asset managers own an array of large companies, whether they would have chosen them independently or not. For instance, BlackRock’s \$2.9 trillion in passive investments (i.e., holdings in index funds and exchange-traded funds, or ETFs), means that the firm owns, frequently on a long-term basis, an average 4%–6% of an indexed company.<sup>31</sup> Since these passive hold companies are shareholders through the good and bad, they view engagement as a way

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*“The traditional view is we are protected by regulations, but the world is changing.”*

- Participant

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to enhance performance. In addition, one participant argued that many of these managers also compete against ETFs, and deeper engagement can demonstrate the value of their own pricing spreads for their clients. This is causing managers to seek more direct engagement with firms to press for improvements that will drive returns.

An emerging approach is partnering with activists. One participant described this new trend: *“These investors are turning to activists and even submitting an RFA: a ‘request for activists.’”* One director said, *“No company is immune. [Activist and institutional investors] are now acting in groups. I’ve been surprised by the long-term managers getting caught up with activists.”* A recent *Wall Street Journal* article highlighted activist investors’ increasing successes when supported by large institutional investors.<sup>32</sup> Institutional investors say that these new partnerships are valuable in improving corporate governance and performance, and that there is a growing trend toward “constructive activists rather than destructive activists.”<sup>33</sup> JPMorgan bankers recently cautioned, however, “In contrast to the situation of just a few years ago, companies must examine their long-only shareholders with a critical eye ... There are no ‘management friendly’ investors.”<sup>34</sup>

Many directors expressed fears that short-term activism would harm the long-term interests of their company. However, money is flowing to activists because of their perceived success in generating returns for their investors. One participant argued, *“There is a preponderance of academic data that suggests there is a sustainable performance improvement at a firm after an activist gets involved.”* A recent *Wall Street Journal* report that studied the impact of an activist’s arrival on large US companies concluded that shares of large companies confronted by activists are more likely to outperform those of their company peers, but the data demonstrates an overall mixed bag on activist impact.<sup>35</sup>

### **Governance issues remain important, but the focus is increasingly on financial performance and strategy**

The focus of engagement with directors has historically been on governance issues. One participant commented, however, *“At the end of the day, governance is interesting, but ultimately what attracts activism is the underlying share price and performance.”* This participant continued, *“For the activist class, the governance stuff is in large part window dressing for an economic agenda. Activists use governance as a lever to get the institutional investors of the world riled up.”*

Participants continue to see pressure from investors on governance issues, including compensation and board composition. One participant claimed, *“Some activists use compensation concerns as a screen to see if there are problems at the company.”* Others concurred, by citing recent debates regarding splitting the CEO and chairman role. The general consensus, however, was that the battle is heading in a new direction. One participant argued, *“The governance fight was won by institutional investors. The next battle is they want to tell people where to drive.”* Despite concerns about short-termism among activists, another participant noted increasing pressure for significant strategic changes: *“The safety net is no longer to buy back your stock. Activists are no longer asking for that. They want you to break up your company, to sell assets, or to sell yourself. It is becoming a strategic agenda, not a capital optimization agenda. That by definition is a long-term discussion.”*

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*“These investors are turning to activists and even submitting an RFA: a ‘request for activists.’”*

- Participant

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*“For the activist class, the governance stuff is in large part window dressing for an economic agenda.”*

- Participant

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**Proxy access: a rising tide**

This year, more than 100 US companies received shareholder proposals on proxy access or decided unilaterally to implement it.<sup>36</sup> Much attention is focused on proposals to allow shareowners with 3% of the company's stock, held continuously for three years, to nominate up to 25% of the board and to place those nominees on the company's proxy. Scott Stringer, New York City Comptroller and a leading advocate for proxy access, recently stated, "This fight is about giving us the opportunity to have a say in the companies we invest. Boards that are unaccountable should feel ... that they have competition at the ballot box."<sup>37</sup> One participant said, "The issue is whether to get out in front of this parade, and set proxy access up on your own, or wait for an active shareholder to propose it."

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*"In today's environment, with more active shareholders, poor engagement strategies are a risk."*

- Participant

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**Boards are exploring how best to respond to investor demands**

Participants acknowledged that views on engagement differ depending on country, board structure, and the level of activism among investors. As more investors actively press their agendas, boards will be called upon to engage directly on a broader range of issues.

**Boards have been hesitant to engage directly with investors**

Some directors continue to express reservations regarding direct and independent board interaction with investors. One participant observed, "Board-shareholder engagement is the hottest topic in corporate governance and the one that has evolved the most in the last 20 years. It simply did not happen 20 years ago. When investors asked, doors were shut ... In today's environment, with more active shareholders, poor engagement strategies are a risk." Historically, senior management, particularly the CEO, CFO, and head of investor relations, handled most company-investor engagement. In discussions in advance of the summit, some participants expressed skepticism about increasing board-shareholder engagement. One director argued, "Management's role is to talk to shareholders in all cases. I would only agree to direct board engagement if it is absolutely necessary." Others highlighted potential regulatory concerns, especially fears of violating Regulation Fair Disclosure or related disclosure rules that would subject the company and/or director to liability.<sup>38</sup> Essentially, directors are fearful of accidentally providing investors with information that is not available to the public. Still, critics argue these fears are overblown. In a June speech, Vanguard's CEO commented, "Companies individually have to decide how best to manage the risk, but it shouldn't be by shutting out the shareholders completely."<sup>39</sup>

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*"If you have people on your board who don't know your strategy and how to communicate it, then they shouldn't be on your board."*

- Director

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As well, not all board members feel prepared to engage. "You need trained people talking to investors," said one director. Furthermore, selecting one or more board representatives to speak publically raises concerns about what messages will be shared with the markets, especially if there are issues on which the board is not yet fully aligned. Yet some felt strongly that all directors should be capable of engagement, with one director arguing, "If you have people on your board who don't know your strategy and how to communicate it, then they shouldn't be on your board."

## Boards are deploying an array of strategic and tactical responses

As requests for interaction increase, boards will need to develop strategies for meaningful and productive engagement and should take advantage of opportunities to get in front of potential investor concerns. Despite the reservations about engagement, most participants seemed to agree with one who said, *“The genie is out of the bottle. I don’t see us returning to less conversation with shareholders in the future.”* Accepting this reality, the discussion at the summit turned to strategic and tactical responses to investor pressure for communication:

- **Be proactive in articulating your strategy to improve returns.** Boards and management need to be able to crisply articulate the institution’s multiyear path to greater value. *“It is about getting ahead of the strategic agenda before someone else does,”* said one participant.
- **Use various methods to tell your story.** One participant observed, *“We are all required to do disclosures. This should be viewed as a communication opportunity and not just a compliance exercise.”* More holistically, directors were encouraged to use all available communication tools, including websites, to communicate with the broader investment community and offer a compelling narrative about the strategy and prospects of the firm.
- **Create board structures to handle shareholder engagement.** Participants asked how to strike the right balance in seeking out engagement. Some feared that without a reason to engage, direct interaction could do more harm than good. One possible solution offered was to create a dedicated committee to manage this delicate decision. *“An emerging practice is to create a committee on the board to deal directly with shareholders. It is a standing committee that is available to meet with shareholders for a standard review,”* one director explained.
- **Discuss with investors changes they would like to see.** Many directors argued that they gain the outside perspectives needed through meeting with analysts. Others claimed you need to go much further. *“Everyone should have a meaningful shareholder come talk to your board. What you hear from bankers is not necessarily the same as hearing directly from shareholders,”* said one participant. Some participants emphasized the influence of governance leaders at large institutional investors, with one describing the head of governance at a large institutional investor as being like *“the Ohio, Florida, and Pennsylvania of the electoral college.”* Understanding the key investor groups, and people within those investors who are most influential, is critically important.
- **Consider including an investor on the board.** Some participants argued for bringing a major investor onto the board. Even those who have dealt directly with activists found value in this approach. One participant observed, *“When these activists join your board, you can have a different conversation because they are wearing the same jersey.”* A director described the potential benefits: *“The activist board member is just as willing to take our data and change his mind [as to pressure us for change].”* However, some were concerned that inviting investors to the board could open the floodgates. One

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*“What you hear from bankers is not necessarily the same as hearing directly from shareholders.”*

- Director

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director commented, *“The problem is every day a new guy emerges. Once it starts, it doesn’t stop.”*

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While activist investors remain a cause of director apprehension, the broader trend toward increasing activism from large institutional investors doesn’t have to be a concern. Leading corporate expert Ram Charan recently observed,

As the biggest asset managers gain more power and exercise it more freely, they bear a heavy responsibility. They may influence employment, national competitiveness, and economic policy for better or for worse. They can ensure a balance between short-term and long-term corporate goals, and between value creation and societal needs. They can keep succession planning near the top of every company’s agenda. How they will discharge their responsibility remains to be seen.<sup>40</sup>

If appropriate steps are taken to actively shape and communicate a compelling strategic vision to the market and ensure investor expectations are understood and managed, greater engagement can be a constructive way to improve governance. It does, however, place a new responsibility on board directors already handling significant engagement with regulators and spending ever more time on core board responsibilities. The challenge for directors will be to balance these increased responsibilities and demands on their time.

## Market liquidity: an unintended systemic risk?

*Liquidity equals confidence; it is not hard to define. You can forget all the rest.*  
– Director

The financial crisis of 2008 revealed that neither regulators nor institutions had a clear picture of the risks building up in the financial system. The regulations crafted in response to the crisis have focused on ensuring that the largest financial institutions are better able to withstand shocks. Despite these initiatives, participants in the BGLN and IGLN see new sources of risk emerging, in part as a result of the very reforms aimed at making these institutions safer. A participant in the BGLN observed, *“Individually, the banks are safer. Collectively, the system might not be.”* Of particular concern are the potential implications of a lack of liquidity in bond markets. Prior to the summit, one executive said, *“The issue isn’t just corporate bonds and a liquidity shortage. It is deeper than that.”* Another executive said, *“I think this is more urgent than regulators think. We are sitting in a big asset price bubble. At some point, it will unwind. It is going to happen.”*

Both the BGLN and IGLN summit discussions focused on building sustainable business models for these large financial institutions. This includes minimizing obstacles to growth and navigating market risks. A serious disruption in capital markets could cause significant challenges for both banks and insurers. Over dinner on 30<sup>th</sup> September, BGLN and IGLN participants, representing more than \$25 trillion in assets, convened for a joint discussion on reduced market liquidity as a potential source of systemic risk and the implications. The summit discussion brought together insights from both bankers and insurers, who play very different but often-complementary roles in capital markets. A director noted, *“This is a fascinating area where banks and insurers overlap on many transactions but are subject to different regulations.”*

This *ViewPoints* section provides an overview of the dinner discussion, along with context from previous conversations on top and emerging risks in both networks, which identified liquidity and its cascading effects as one of the most urgent systemic issues.<sup>41</sup>

### Market liquidity is clearly reduced

In a recent speech, NY Federal Reserve Bank President Bill Dudley commented, *“Liquidity is dynamic, unobservable, and multi-dimensional in nature, and, as such, can only be measured indirectly.”*<sup>42</sup> Participants agreed with the challenge of quantifying liquidity, but offered clear evidence that it is significantly reduced from pre-crisis levels, especially in corporate bond markets. One participant argued, *“Worse liquidity doesn’t mean you can’t sell the bond. It does mean it is harder, takes longer, and is more situational. The liquidity is not as consistent and is not as predictable in today’s world, and this is considered the normal environment.”*

Participants expressed concerns that reduced liquidity in “normal” times suggests that evaporation of liquidity in a crisis could be faster, more frequent, and more severe than in the past, perhaps even worse than in 2008. As one director said, *“There will be a liquidity shortage in the next crisis, full stop.”* Essentially, the reduced liquidity in the business-as-usual market could increase the probability that it induces a crisis, with the ensuing feedback effects that much stronger.

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*“We are sitting in a big asset price bubble. At some point, it will unwind.”*

– Executive

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*“There will be a liquidity shortage in the next crisis, full stop.”*

– Director

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## An evolving liquidity crisis could trigger a systemic event in capital markets

Several investment firm leaders, including the Blackstone Group's Stephen Schwarzman and Larry Fink from BlackRock, have cautioned that a lack of liquidity could cause or exacerbate a financial crisis.<sup>43</sup> During June conversations on top and emerging risks, BGLN participants expressed concern that when the Federal Reserve ends its quantitative-easing program and raises interest rates, a sell-off of assets might be triggered, prompting a chain reaction with unexpected correlations and impacts.<sup>44</sup> While many participants still pointed to the impending rate reset from the Fed as a potential trigger, the Fed's postponement of such a rate increase raises questions as to what might trigger such an event. Whatever the trigger, whether rising interest rates, geopolitical events, or a major cyberattack, participants see potential for reduced liquidity to exacerbate a market panic.

### Rising rates or another trigger event may prompt a sell-off with few buyers

Participants expressed concerns about how investors will react to increased market volatility and the potential for a massive sell-off in a market with limited liquidity. A director wondered how retail customers would react as interest rates rise: *"On the bond side, for example in the ETF [exchange-traded fund] market, do retail customers understand yield maturity? When they see returns go negative for the first time, will they just sell? If so, where does the liquidity come from? Not the SIFIs [systemically important financial institutions]."*

An increasingly popular investment vehicle, ETFs were created for equities but are now used in bonds; however, since corporate bond markets are generally not as liquid or transparent as equity markets, there exists a potential liquidity mismatch between the ETFs, which are traded on exchanges, and their underlying components. In general, ETFs may prove more difficult to move in and out of in times of stress: steep share-price declines in August started in individual stocks and cascaded into ETFs, causing dozens to trade at sharp discounts to the sum of their holdings.<sup>45</sup> This may also induce circuit-breaker trading halts, which can allow sell orders to accumulate and invoke further market concerns. A participant highlighted the potential implications, saying, *"When discussing these liquidity challenges, we decided it is not about basis points, but how a liquidity event will manifest in ETFs and with retail investors. Banks are at risk."*

Participants warned that retail investors might not be the only ones that sell en masse. One director worried, *"Shadow bankers and investors in theory are professionals, and these changes in prices will be passed on and stay contained, but I don't think this will happen in practice."*

### New regulations limit the ability of financial institutions to act as market smoothers

Due to regulatory changes, banks and insurers are now limited in their ability to provide liquidity and reduce volatility, as they have historically. In the past, acting as market makers, banks served as shock absorbers by buying distressed assets. Now, however, many banks have effectively ceased market-making activities in key equity and debt markets, significantly reducing liquidity in the trading markets, especially for

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*"Do retail customers understand yield maturity? When they see returns go negative for the first time, will they just sell?"*

- Director

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corporate debt.<sup>46</sup> A chief risk officer summarized the problem: *“The industry has been firmly trained that size matters. Capital requirements, the leverage ratio, etc., have been driving every bank to shrink their balance sheets. Every firm is trying to keep inventory to the bare minimum. If you go back before the crisis, banks had large balance sheets with an ability to absorb corrections ... Volatility now is quite significant.”* Another participant commented, *“It is not just the Volcker rule. The psychology on trading floors is different than it was 10 years ago. As soon as you trade, the compliance people are after you. The traders say it is just not worth the hassle.”*

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*“Every firm is trying to keep inventory to the bare minimum ... Volatility now is quite significant.”*

- Chief Risk Officer

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On the insurance side, new restrictions are preventing insurers from taking their traditional long view during periods of volatility. Some commentators are predicting that new accounting and capital requirements for insurance companies and pension funds may cause them to move in an increasingly procyclical fashion.<sup>47</sup> As one director noted, *“In the old days, insurers loved volatility. The gnomes of Zurich would swoop in and buy huge chunks of capital markets at the bottom of the cycle. They were part of the self-correction of the market. Today, it is much more difficult because of capital rules that are more procyclical.”*

### **The sell-off may be magnified by herd mentality**

Much of the commentary on a potential liquidity crisis focuses on fears of massive market movements coming at the same time. Some are emphasizing the dangers posed by “price-insensitive” buyers and sellers, including central banks, financial firms under pressure from new regulations, and index-driven mutual-fund managers.<sup>48</sup> The growing role of these price-insensitive participants makes markets less self-correcting via price signals and increasingly homogenized in one direction. In addition, participants worry that the increasing number of high-frequency traders and others who use algorithmic programs to follow trends will magnify price volatility: *“The herd instinct will be magnified by the algorithms, which will amplify the speed and momentum,”* said one director. Another participant cited the specific challenge of fixed-income liquidity: *“just as the desired [trading and sell] volumes rise,”* the depth of the counterparties wanting to buy and trade declines and *“the pipes get narrower.”*

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*“The herd instinct will be magnified by the algorithms, which will amplify the speed and momentum.”*

- Director

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All of these factors could mean that an earlier-than-expected interest rate hike or other trigger event will result in an abrupt and dramatic rerating of bonds due to spooked investors, with everyone caught in the same trades needing to get out fast.<sup>49</sup> Because many investments are in illiquid funds, with fewer market makers, the sellers would be forced into fire sales, which could trigger a broader drop in asset prices.<sup>50</sup>

### **New market participants may behave in unpredictable ways**

An executive said, *“What scares me even worse than the broker-dealer situation is the huge number of people investing for duration who have no business doing that. It is the mutual funds buying bonds. You are applying liquid structures – the equity model – to an illiquid asset ... That is the bigger risk.”* This reflects participants’ wider concern about the impact of these new players in the market. A chief risk officer commented, *“The real liquidity issue is the impact of investors who shouldn’t be in the market.”*

In curtailing banks’ market-making ability, regulatory changes have created a void that shadow bank players, such as mutual funds and asset managers, are stepping in to fill.

It is estimated that in the past year, more than 70% of corporate credit was purchased by investors such as mutual funds in a search for yield.<sup>51</sup> One participant worried that shadow bank players would be more likely to act on herd instinct. The problem is that asset managers rely on potentially less reliable forms of funding in which they are obligated to return investor funds on demand, and the positions shadow bankers have taken may be opaque to other market participants and regulators.

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*“Things that are not correlated become correlated in times of stress.”*

- Director

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### **Correlations may not be well understood**

Participants said that the real danger of a liquidity crisis is not its immediate impact – which may involve challenges in executing trades and increased volatility – but in exposure to correlated risks. As one director commented, *“The real problem is that things that are not correlated become correlated in times of stress.”* Participants expressed concerns about three issues in particular:

- **Models may understate correlations.** Participants agreed that models may understate risk during times of market stress. One participant said, *“I worry about the liquidity of so-called liquid assets [in a liquidity crisis]. Models may also overstate the value of collateral, and counterparties may be less robust than expected. I am skeptical about the value of collateral on the trading books in investment banks.”* Several participants raised concerns about model risk more broadly. A director said, *“I am a mathematical modeler by training, and I don’t believe them.”* Another warned, *“Volatility will be higher, and the correlations will be higher than the models think.”* In economic terms, participants expressed fears of *“regime switching”* in which correlation matrices used in a business-as-usual environment become inaccurate during periods of financial distress.
- **Accounting could exacerbate contagion.** Participants fear that the vulnerabilities of pension funds, insurers, and others to liquidity issues could be *“magnified into their firms by mark-to-market accounting.”* A director predicted, *“[Vulnerability] will move quickly into our balance sheets, then into capital.”* Insurance directors were quick to note that Solvency II has potentially made the problem even more acute. One executive commented, *“The whole framework is creating risks that the regulators don’t understand themselves. If volatility all goes one way for a variety of companies, combined with the new framework, it is so complex that nobody knows how it will all play out.”* Another participant elaborated, *“Because of mark-to-market accounting, the risk is not just in trading, but in simply holding when the volatility hits.”* Procyclical capital rules and mark-to-market accounting may mean companies must sell into distressed falling markets, which could create a detrimental feedback loop. An insurance director stressed the negative impact of adopting mark-to-market accounting: *“Volatility in itself should not matter to insurance as we can hold something for 25 years, but these new regulatory requirements require marking everything to the market.”* Another participant added, *“In crisis, there is no liquidity, so there is no fair value because there is no market.”*
- **The contagion mechanisms could be faster.** Participants pointed to the possible implications of technological changes on market volatility and, ultimately, a systemic event. One regulator asked, *“Is it a better world because of the reforms, or worse because it is different and moving faster than ever?”* Directors expressed

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*“Because of mark-to-market accounting, the risk is not just in trading, but in simply holding when the volatility hits.”*

- Participant

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fears that electronification and digitization are fundamentally changing the structure of financial markets. Flash crashes in recent years highlight the impact of these changes, especially the influence of automated trading and the growth of high-frequency trading, which is blamed for exacerbating episodes of market volatility as it exaggerates price movements on low-volume trades, particularly in the event of a crash.<sup>52</sup> Directors also cited the possibility of other technological developments like social media contributing to a systemic event. One participant argued, *“Things like social media will accelerate the impact. The run on the bank will be online. There will be no lines at the branch.”* As a result, another participant stated, *“We will get down to liquidity levels in 2008 like that. Then it will get worse.”*

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*“The run on the bank will be online. There will be no lines at the branch.”*

- Participant

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### Financial institutions and regulators are identifying appropriate responses

Participants highlighted the challenge of preparing for a liquidity crisis. As one director argued, *“In a crisis, liquidity disappears. It is hard to prepare for zero liquidity.”* Despite these difficult realities, participants encouraged a combination of firm-level and industry-wide actions.

#### What can individual firms do?

*“Sure, I am worried about it, but it is not clear what there is to do. Manage it as best you can internally? Model it? Hope for the best?”* asked one director. Participants offered three responses financial institution leaders can take:

- **Run scenario analyses and adapt stress tests.** Participants emphasized the importance of stress tests in trying to understand the implications of a potential liquidity crisis as well as improving transparency about internal exposures. One director noted, *“There are stress tests we didn’t do before that we do now. As well, recovery and resolution planning has improved visibility of trade flows within the organization.”* Still, participants questioned how to scope and provide parameters for a stress test relating to liquidity. One participant suggested, *“We separate liquidity from other systemic risks. They are highly correlated, but we start separate.”* Others said they simply needed to stress test multiple scenarios: *“The more ways to stress test it, the better.”*
- **Reduce risk in assets and trading strategies.** Some participants argued for fundamentally more cautious approaches to trading and liquidity management. One participant suggested, *“You could do less tactical and short-term trading. Instead, do more fundamental and long-term trading. Simply don’t buy bonds you are worried about. You can’t take liquidity for granted.”* Another cautioned, *“You say you want to hold more liquid names, but those will be the ones sold first. Are you safer holding the next level down?”*
- **Ensure the board gives liquidity risk due attention.** Given the magnitude of the potential risk, a director said, *“This is definitely an issue for the board. The question is how does it affect your risk tolerance? It is the board’s job to define the tolerance and appetite.”* In addition, most directors emphasized the importance of the board pushing back on information from management. One director commented, *“You can’t just stress test and hope for the best. Directors have to be skeptical of stress tests. For example, are you testing for a shrinking pool of*

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*“Simply don’t buy bonds you are worried about. You can’t take liquidity for granted.”*

- Participant

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*counterparties?”* In general, most participants agreed the most important board response is to force discussion and to bring independent thinking. As one participant remarked, *“I sometimes worry about quantifying things because you can take false comfort. I’m more comfortable with ambiguity. If I don’t know what it is, I’ll ask a lot more questions.”*

Some directors suggested bringing in a third party to test managements’ approach and ensure they are considering the full set of potential issues. Ultimately, participants agreed with one who said just raising the issue at the board is important: *“The response is better if you have the discussion.”*

### **How can communication and coordination across the industry improve?**

A director remarked, *“We need a positive, more constructive dialogue with the regulators. We need to identify positive ways to introduce liquidity as opposed to unpicking regulations.”* One director suggested that communication is improving: *“We have constant constructive dialogue with our regulator. They have been a little hesitant on disclosing certain information, but they have helped to implement extremely useful exercises.”* Some participants were optimistic that the response from regulators will be faster in a future crisis, given the experience of the last one. Yet they also encouraged regulators to take further steps to prepare their own scenarios and response plans. As one participant remarked, *“They make us go through recovery and resolution planning. I hope the regulators are doing the same thing for a market systemic risk so that they have a playbook.”* Another said what is needed is *“a three-way dialogue among banks, regulators, and the government, and it should start very soon. We need proposals for solutions.”*

One suggested solution involved the use of circuit breakers in extreme market conditions. Some participants viewed this approach as an opportunity to stem the spread of problems from a liquidity event. However, one regulator, citing the experience with ETFs, warned of the potential unintended consequences: *“The fascinating thing about ETFs is there are all these circuit breakers, but they actually aggravate problems because you suddenly can’t trade.”* One commentator proposed the creation of a new pan-industry market-making utility to replace the market-making role banks previously played.<sup>53</sup>

### **Will a liquidity crisis force central banks’ hands?**

A participant predicted that, ultimately, *“central banks won’t be lenders of last resort, but lenders of first resort”* because they will have to provide market liquidity in a crisis. Part of the challenge is political pressure opposing government intervention, as well as legal constraints on what the Fed or other central banks are permitted to do. In the United States, the Dodd-Frank Act prohibits the Fed from lending to individual institutions whose solvency is in doubt; instead it *“relies heavily on new, complex, and potentially unwieldy regulatory and resolution mechanisms to prevent and tame future crises.”*<sup>54</sup> The Fed can still use broad-based programs to provide liquidity. As one participant summarized, *“The right focus is on the central banks. There will be a moment of truth, and ultimately it will become a political decision.”* One participant stated, *“I don’t see any other mechanism other than the Fed doubling their balance sheet. We will need an act of Congress.”*

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*“This is definitely an issue for the board. The question is how does it affect your risk tolerance?”*

- Director

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*“There will be a moment of truth, and ultimately it will become a political decision.”*

- Participant

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There has been significant debate in the press on whether liquidity fears are overblown. The *Financial Times* reported, “In absolute terms, trading volumes in corporate bonds and government debt are for the most part climbing,” and noted that bid-offer spreads (a popular means of judging liquidity) are at a healthy level.<sup>55</sup> As well, financial commentator Martin Wolf suggested reduced liquidity might actually be healthy: “Keeping markets liquid when panic comes risks making the next crisis worse. We have become addicted to market liquidity. But it is too fragile and perverse in its effects on incentives to be viewed as a universal feature of our capital markets.”<sup>56</sup>

BGLN and IGLN participants suggested the danger might be understated, as they are clearly concerned about the potential for reduced liquidity to increase the likelihood of a systemic crisis and exacerbate its severity. As insurers and bankers continue to monitor and prepare for a liquidity event, we hope network discussions will bring attention to the issue and allow for continued engagement among key stakeholders.

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## Appendix: Summit discussion participants

Over the last year, Tapestry and EY hosted five BGLN meetings, including the seventh BGLN Summit, and had over 65 bilateral conversations with directors, executives, regulators, supervisors, policymakers, and other thought leaders. Insights from these discussions helped to shape the summit agenda and inform the enclosed *ViewPoints* documents.

The following individuals attended the 2015 BGLN and IGLN Summits:

### BGLN Summit Participants

- Greg Bauer, Managing Director, Head of Global Banking, Moody's
- Doug Braunstein, Founder and Managing Partner, Hudson Executive Capital
- Tim Clark, Senior Associate Director, Division of Banking Supervision and Regulation, Federal Reserve System
- Alessandro Decio, Chief Risk Officer, UniCredit
- Nick Donofrio, Technology Committee Chair, BNY Mellon
- Dina Dublon, Risk Committee Chair, Deutsche Bank
- Brad Hintz, Adjunct Professor of Finance, NYU and former SVP Equity Research Analyst, Sanford C. Bernstein
- Bob Herz, Audit Committee Chair, Morgan Stanley
- Labe Jackson, Audit Committee Chair, JPMorgan Chase
- Stuart Lewis, Chief Risk Officer, Deutsche Bank
- John Manley, Chair, CIBC
- Callum McCarthy, Strategy Committee Vice Chair, ICBC
- Don Nicolaisen, Risk Committee Chair, Morgan Stanley
- Michael Paulus, Partner, Andreessen Horowitz
- Nathalie Rachou, Risk Committee Chair, Société Générale
- Bruce Richards, Senior Vice President, Complex Financial Institutions, Federal Reserve Bank of New York
- Alexandra Schaapveld, Audit and Internal Control Committee Chair, Société Générale
- Kate Stevenson, Non-Executive Director, CIBC
- Katie Taylor, Chair, RBC
- John Tiner, Audit Committee Chair, Credit Suisse
- Tim Tookey, Risk Committee Chair, Nationwide Building Society

### EY

- Ian Baggs, Global Banking & Capital Markets, Deputy Leader, Financial Services
- Ted Price, Advisor, Risk Governance
- Marc Saidenberg, Principal, Financial Services
- Isabelle Santenac, EMEA FSO Assurance Managing Partner
- Bill Schlich, Global Banking and Capital Markets Leader, Financial Services
- Ann Yerger, Executive Director, Center for Board Matters

### Tapestry Networks

- Dennis Andrade, Principal
- Jonathan Day, Vice Chairman
- Jason Watkins, Principal

## IGLN Participants

- Joan Amble, Non-Executive Director, Zurich
- Peter Babej, Managing Director, Global Co-Head Financial Institutions, Citigroup Global Markets
- Woody Bradford, Chief Executive Officer, Conning
- Herman Bulls, Risk Committee Chair, USAA
- Doug Caldwell, Chief Risk Officer and Management Board Member, NN Group
- Jan Carendi, Senior Adviser to CEO, Sampo Japan Nipponkoa
- Gautam Chawla, Managing Director, Financial Institutions, Citigroup Global Markets
- John Fitzpatrick, Non-Executive Director, AIG
- John Green, Deputy Chairman, QBE
- Peter Hancock, Chief Executive Officer, AIG
- Simon Harris, Managing Director, Global Head of Insurance, Moody's
- George Hasiotis, Managing Director, Cambridge Associates
- John Huff, Director, MO Department of Insurance, Financial Institutions, and Professional Registration; NAIC President Elect
- Cathy Kinney, Non-Executive Director, MetLife
- Joan Lamm-Tennant, Chief Executive Officer, Blue Marble Microinsurance
- Michael Lillard, CIO Fixed Income, Prudential Financial
- Sara Grootwassink Lewis, Non-Executive Director, Sun Life
- Mike McGavick, Chief Executive Officer, XL Group plc
- Rob Routs, Chairman, Aegon
- Nick Silitch, Chief Risk Officer, Prudential Financial
- Paul Smith, Chief Financial Officer, State Farm
- Doug Steenland, Chairman, AIG
- Theresa Stone, Regulatory and Public Policy Chair, AIG
- Stan Talbi, Executive Vice President, Global Risk Management, and Chief Risk Officer, MetLife

## EY

- Martin Bradley, Global Insurance Finance, Risk, & Actuarial Leader
- Shaun Crawford, Global Insurance Sector Leader
- Dave Hollander, Global Insurance Advisory Leader
- Mike Lee, Global Asset Management Leader
- Chris O'Hehir, Partner, Advisory

## Tapestry Networks

- Leah Daly, Principal
- Colin Erhardt, Associate
- Peter Fisher, Partner

## Endnotes

- <sup>1</sup> *ViewPoints* reflects the network's use of a modified version of the Chatham House Rule whereby comments are not attributed to individuals, corporations, or institutions. Network participants' comments appear in italics.
- <sup>2</sup> ["One Regulator to Rule Them All."](#) *Economist*, August 8, 2015.
- <sup>3</sup> Simon Samuels, ["Make up Your Mind on Banking Regulation."](#) *Financial Times*, August 26, 2015.
- <sup>4</sup> ["The Tarullo Show."](#) *Economist*, August 6, 2015.
- <sup>5</sup> Anthony Saunders, ["Is Basel Turning Banks into Public Utilities?"](#) *Journal of Financial Perspectives* 3, no. 1 (2015), 1.
- <sup>6</sup> Ryan Tracy, Victoria McGrane, and Christina Rexrode, ["U.S. Tells Big Banks to Rewrite 'Living Will' Bankruptcy Plans."](#) *Wall Street Journal*, August 5, 2014.
- <sup>7</sup> John Plender, ["The Greatest Threat Is the Destruction of Global Ties That Bind."](#) *Financial Times*, August 18, 2014.
- <sup>8</sup> ["One Regulator to Rule Them All."](#) *Economist*.
- <sup>9</sup> Philip Alexander, ["No Such Thing as Simple Banking in Basel."](#) *Banker*, July 27, 2015.
- <sup>10</sup> Alan Greenspan, ["More Capital Is a Less Painful Way to Fix the Banks."](#) *Financial Times*, August 17, 2015.
- <sup>11</sup> ["The Tarullo Show."](#) *Economist*.
- <sup>12</sup> ["The Tarullo Show."](#) *Economist*.
- <sup>13</sup> ["One Regulator to Rule Them All."](#) *Economist*.
- <sup>14</sup> Laura Noonan, ["Banks Face Pushback over Surging Compliance and Regulatory Costs."](#) *Financial Times*, May 28, 2015.
- <sup>15</sup> *Ibid.*
- <sup>16</sup> Tab Bowers et al., [The Next Normal: Banking after the Crisis](#) (New York: McKinsey & Company, 2010), 1.
- <sup>17</sup> See, for example, Patrick Jenkins, ["Time is Ripe for Radical Action by Deutsche Bank and Barclays."](#) *Financial Times*, January 26, 2015.
- <sup>18</sup> Julia Black and David Kershaw, [The Commission on Banking Standards Report and Bank Incentives: A Missed Opportunity](#), Law and Financial Markets Project Briefing 2/13 (London: London School of Economics and Political Science, 2013), 1.
- <sup>19</sup> Bank Governance Leadership Network, [Banking Industry Challenges through the Eyes of the Non-executive Director](#), *ViewPoints* (Waltham: Tapestry Networks, 2010), 14.
- <sup>20</sup> Laura Noonan, ["European Bank Bosses Pay Price for Slow Recovery."](#) *Financial Times*, July 9, 2015.
- <sup>21</sup> ["Big Banks Becoming 'Public Utilities': Strategist."](#) *CNBC.com*, June 28, 2011.
- <sup>22</sup> See Scratch, [The Millennial Disruption Index](#) (New York: Viacom Media Networks, 2014).
- <sup>23</sup> See Scratch, [The Millennial Disruption Index](#) (New York: Viacom Media Networks, 2014).
- <sup>24</sup> Chris Skinner, ["Does Anyone Really Think Banks Aren't Aware of the Fintech Challenge?"](#) *Banker*, September 1, 2015.
- <sup>25</sup> Kayla Tausche, ["JPMorgan CFO: Bigger Is Better ... for Now."](#) *CNBC.com*, February 24, 2015.
- <sup>26</sup> Jenkins, ["Time Is Ripe for Radical Action by Deutsche Bank and Barclays."](#)
- <sup>27</sup> Patrick Jenkins, ["Tidjane Thiam: Credit Suisse Boss Introduces a Quiet Revolution."](#) *Financial Times*, October 26, 2015.
- <sup>28</sup> Stephen Davis and Jon Lukomnik, ["Director-Investor Communication Is Coming. Here's How to Do It."](#) *Compliance Week*, July 7, 2015.
- <sup>29</sup> Martin Lipton, ["Responding to Institutional Investor Requests for Access to Independent Directors."](#) *Harvard Law School Forum on Corporate Governance and Financial Regulation* (blog), July 15, 2015.
- <sup>30</sup> Leslie Scism, Joann Lublin, and David Benoit, ["AIG Faces Push to Break Up"](#) *Wall Street Journal*, October 28, 2015.
- <sup>31</sup> Carol Loomis, ["BlackRock: The \\$4.3 Trillion Force."](#) *Fortune*, July 7, 2014.
- <sup>32</sup> David Benoit and Kirsten Grind, ["Activist Investors' Secret Ally: Big Mutual Funds."](#) *Wall Street Journal*, August 9, 2015.
- <sup>33</sup> F. William McNabb III, ["Getting to Know You: The Case for Significant Shareholder Engagement."](#) *Harvard Law School Forum on Corporate Governance and Financial Regulation* (blog), June 24, 2015.
- <sup>34</sup> Benoit and Grind, ["Activist Investors' Secret Ally: Big Mutual Funds."](#)
- <sup>35</sup> David Benoit and Vival Monga, ["Are Activist Investors Helping or Undermining American Companies?"](#) *Wall Street Journal*, October 5, 2015.
- <sup>36</sup> Tim Human, ["Proxy Access: What Happens Next?"](#) *IR Magazine*, June 9, 2015.
- <sup>37</sup> Sally Goldenberg, ["Stringer 'boardroom' movement finds some takers."](#) *Capitalnewyork.com*, April 30, 2015.
- <sup>38</sup> Regulation FD (Fair Disclosure), or Reg FD, was adopted by the SEC to address the problem of selective disclosure by issuers of material nonpublic information. Reg FD generally requires that when an issuer discloses material nonpublic information to institutional investors, the issuer must simultaneously make public disclosure of the information. Violations of Reg FD can subject an issuer, as well as the individual personnel at the issuer responsible for the violation, to an SEC enforcement action, which may result in civil penalties and/or injunctions.
- <sup>39</sup> F. William McNabb, ["Getting to Know You: The Case for Significant Shareholder Engagement."](#)
- <sup>40</sup> Ram Charan and Geoff Colvin, ["Why Vanguard and BlackRock Could Beat Peltz and Icahn."](#) *Fortune*, June 11, 2015.
- <sup>41</sup> See Bank Governance Leadership Network, [Top and Emerging Risks: Improving Identification and Oversight of Key Risks Facing Large Banks](#), *ViewPoints* (Waltham, MA: Tapestry Networks, 2015), and Insurance Governance Leadership Network, [Navigating Amongst Icebergs: Leading Insurers Address Emerging Risk](#), *ViewPoints* (Waltham, MA: Tapestry Networks, 2015).
- <sup>42</sup> William C. Dudley, ["Regulation and Liquidity Provision"](#) (speech, SIFMA Liquidity Forum, New York, September 30, 2015).
- <sup>43</sup> Stephen A. Schwarzman, ["How the Next Financial Crisis Will Happen."](#) *Wall Street Journal*, June 9, 2015, and ["Fed's Tarullo, BlackRock's Fink Cite Bond Market Liquidity Concerns."](#) *Today*, June 5, 2015.
- <sup>44</sup> Bank Governance Leadership Network, [Top and Emerging Risks: Improving Identification and Oversight of Key Risks Facing Large Banks](#).
- <sup>45</sup> Corrie Driebusch, Saumya Vaishampayan, and Leslie Josephs, ["Wild Trading Exposes Flaws in ETFs."](#) *Wall Street Journal*, September 13, 2015.
- <sup>46</sup> Stephen A. Schwarzman, ["How the Next Financial Crisis Will Happen."](#)
- <sup>47</sup> Tyler Durden, ["No Steve Schwarzman, That's Not How 'The Next Financial Crisis Will Happen.'"](#) *Zero Hedge* (blog), June 10, 2015.

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- <sup>48</sup> Ben Inker, "[Price-Insensitive Sellers](#)," *GMO Quarterly Letter*, 2Q 2015, 1-7.
- <sup>49</sup> Nouriel Roubini, "[The Liquidity Timebomb – Monetary Policies Have Created a Dangerous Paradox](#)," *Guardian*, June 1, 2015.
- <sup>50</sup> *Ibid.*
- <sup>51</sup> Gillian Tett, "[Healthy Liquidity Diet Needed to Survive Future Financial Shocks](#)," *Financial Times*, April 30, 2015.
- <sup>52</sup> See US Department of Treasury et al., *Joint Staff Report: The U.S. Treasury Market on October 15, 2014* (Washington, DC: US Department of Treasury, 2015).
- <sup>53</sup> Patrick Jenkins, "[Bank Dealmaking Is Being Replaced by Mundane Collaborations](#)," *Financial Times*, October 5, 2015.
- <sup>54</sup> Kermit Schoenholtz and Paul Wachtel, "[Dodd-Frank and the Fed](#)," *NYU Stern* (blog), July 18, 2015.
- <sup>55</sup> Robin Wigglesworth, "[Liquidity Pitfalls Threaten Parched Markets](#)," *Financial Times*, June 18, 2015.
- <sup>56</sup> Martin Wolf, "[Beware of the Liquidity Delusion](#)," *Financial Times*, October 6, 2015.