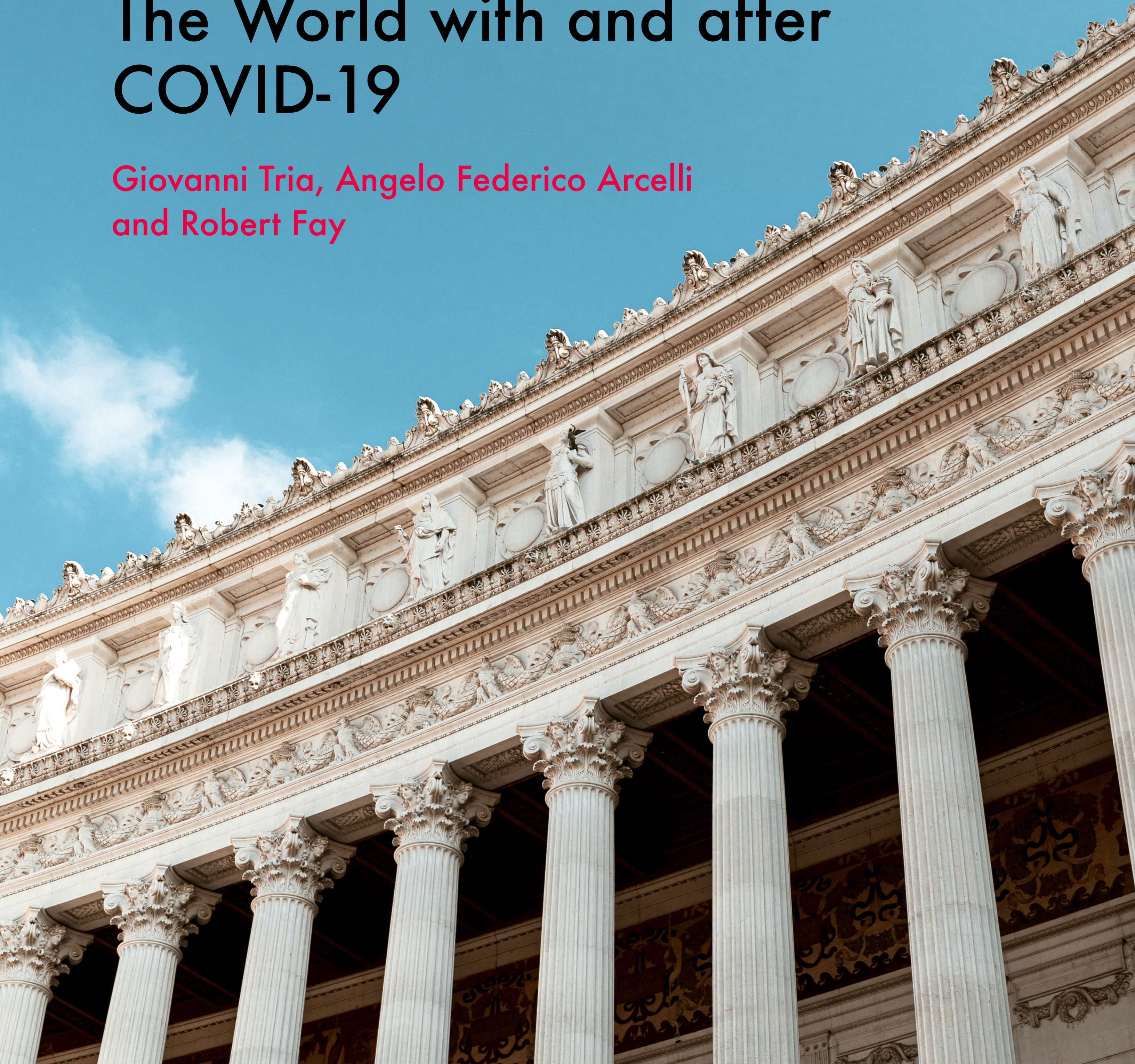
Centre for International
Governance Innovation

OLIVER WYMAN

Conference Report — Financial Regulatory Outlook Virtual Conference, November 23, 2020

The World with and after COVID-19

Giovanni Tria, Angelo Federico Arcelli
and Robert Fay



Centre for International
Governance Innovation

OLIVER WYMAN

Conference Report — Financial Regulatory Outlook Virtual Conference,
November 23, 2020

The World with and after COVID-19

Giovanni Tria, Angelo Federico Arcelli
and Robert Fay

About CIGI

The Centre for International Governance Innovation (CIGI) is an independent, non-partisan think tank whose peer-reviewed research and trusted analysis influence policy makers to innovate. Our global network of multidisciplinary researchers and strategic partnerships provide policy solutions for the digital era with one goal: to improve people's lives everywhere. Headquartered in Waterloo, Canada, CIGI has received support from the Government of Canada, the Government of Ontario and founder Jim Balsillie.

À propos du CIGI

Le Centre pour l'innovation dans la gouvernance internationale (CIGI) est un groupe de réflexion indépendant et non partisan dont les recherches évaluées par des pairs et les analyses fiables incitent les décideurs à innover. Grâce à son réseau mondial de chercheurs pluridisciplinaires et de partenariats stratégiques, le CIGI offre des solutions politiques adaptées à l'ère numérique dans le seul but d'améliorer la vie des gens du monde entier. Le CIGI, dont le siège se trouve à Waterloo, au Canada, bénéficie du soutien du gouvernement du Canada, du gouvernement de l'Ontario et de son fondateur, Jim Balsillie.

Credits

Managing Director of Digital Economy Robert Fay
Program Manager Heather McNorgan
Senior Publications Editor Jennifer Goyder
Graphic Designer Brooklynn Schwartz

Centre for International Governance Innovation

67 Erb Street West
Waterloo, ON, Canada N2L 6C2
www.cigionline.org

Table of Contents

About the Authors

Giovanni Tria is a CIGI distinguished fellow and an economist with more than 40 years of academic and professional experience in the fields of macroeconomics, economic development policies, public economics and public investment assessment. He is an honorary professor of economics and president of the Centre for Euro-Asian Studies at the University of Rome Tor Vergata.

Giovanni has been minister of economy and finance within the Italian government, full professor of economics and dean of the Faculty of Economics at the University of Rome Tor Vergata, president of the Italian National School of Public Administration and member of the Board of Directors of the International Labour Office for the Italian government. He worked as an economic expert in many Italian institutions and government bodies and for international organizations. He is a member of the scientific committees of Italian think tanks and foundations and he is an editorialist for Italian newspapers.

Angelo Federico Arcelli is currently a CIGI senior fellow and a professor of economics of international institutions at Guglielmo Marconi University in Rome. Federico has served in several adviser roles, including at the European Investment Bank and at the Independent Evaluation Group (World Bank Group) and as a member of the executive board of the World Bank (in Washington, DC, 2008–2009) and of the consultative committee ("Osservatorio") on the European constitution in Italy's Ministry of European Union Affairs (2002–2004). In the private sector, he currently holds positions at Oliver Wyman and Marsh and McLennan Group. He holds an M.Sc. in economics and a Ph.D. in economic history, both from Bocconi University in Milan.

Robert (Bob) Fay is the managing director of digital economy at CIGI. The research under his direction assesses and provides policy recommendations for the complex global governance issues arising from digital technologies. He brings to this position extensive experience in macro- and micro-economic research and policy analysis. He is also a member of the 2020–2021 Information and Privacy Commissioner of Ontario (IPC) Ad Hoc Strategic Advisory Committee, providing feedback on the priorities the IPC will focus on over the next five years.

Prior to joining CIGI, Bob held several senior roles at the Bank of Canada (BoC), most recently as senior director overseeing work to assess developments and implications arising from the digitization of the Canadian economy. As deputy director of the International Department at the BoC, he assessed global economic developments and their implications for Canada and investigated a wide variety of issues, including those related to the international monetary system and global financial architecture.

Introduction

The coronavirus disease 2019 (COVID-19) pandemic has posed significant challenges for all economies, and for the financial sector, in 2020. At the same time, the crisis also brings material opportunities for beneficial change. Policy makers, regulators and governments have the chance to rethink the evolution of the financial systems and international relations to make them fit-for-purpose for what could now be called a "new normal," where green finance and sustainability will likely become key pillars of the post-pandemic world. A new age of increased digitization and the responsible use of data has the potential to not only change and challenge the financial sector, but also to reshape the mandate of central banks and supervisors. Doing this effectively means investing in revival and not just survival.

This year, discussions as part of the Financial Regulatory Outlook partnership between CIGI and Oliver Wyman aimed to examine the situation of the financial sector and provide perspectives as we likely (it is hoped) move into the recovery stage of the pandemic, given recent news of the imminent authorization and release of the first COVID-19 vaccines. But normality is likely going to take some time to arrive.

Banks and financial institutions will continue to face near-term uncertainty against a background of longer-term structural issues, although, in the near term, thanks to regulatory reforms made in the wake of the 2008 financial crisis, banks entered the crisis with larger and more resilient capital and liquidity buffers. Thus, they have been able to channel credit and provide support for government pandemic actions such as loan extensions for consumers and businesses.

The International Monetary Fund (IMF) notes that a forward-looking analysis of bank solvency in 29 countries (not including China) shows, in its October 2020 *Global Financial Stability Report* baseline scenario, that most banks will be able to absorb losses and maintain capital buffers above the minimum capital requirements (IMF 2020).

Clearly, should the recovery languish, banks may be forced to tighten lending standards, impairing credit growth. Indeed, the longer the pandemic lasts, the greater the strain that is likely to occur on bank balance sheets — via rising bankruptcies by firms and via high and persistent unemployment.

Moreover, banks are exposed to a variety of sectors, and this may affect different banks and regions and impair the credit channel to sectors that are hit the hardest, delaying the recovery.

Finally, the massive rise in public debt raises concerns over debt-sovereign linkages: the pandemic could cause banks to become excessively exposed to the domestic government sector.

Against this background, there are a few deeper challenges that were the focus of discussions at the 2020 edition of the conference, including climate change, digital technology, financial technology (fintech) and international cooperation.

Climate change affects bank balance sheets in ways beyond what we may think, and regulators are taking measures to cope with such risk. And this is clearly necessary; for example, the Bank of Canada, along with the banking supervisor the Office of the Superintendent of Financial Institutions, is planning climate-related stress tests, as are other central banks. European Central Bank (ECB) sources noted that analysis of the 12 largest banks and 14 largest insurers in the euro area shows that while a majority disclose the impact of their business travel, commuting and other energy usage, most of their exposure to climate-related risk likely stems from their financial activities (Lagarde 2020). Only five out of the group of 26 banks and insurers mentioned above partially disclose the impact of their financial assets, and none of them provides full disclosure (ibid.).

Fintech continues to march on and, like all digital services, has become even more important during the pandemic. Data is now an incredibly important asset. Banks hold enormous amounts of data, but so do the big tech companies. Banks are still struggling to decide whether they will complement fintech or are in competition with it, but their data, and the trust that their customers have in them, gives them some advantages. However, the looming possible entrants may be as disruptive in banking as they have been elsewhere. How could banks compete against cash-rich tech giants and their massive data sets, cash reserves and ability to tailor services and products? How do regulators need to adapt?

Finally, while ideally there would be greater international coordination on policies during a pandemic, sadly, this has been lacking overall. Cooperation is even more important with digital technologies, given that they span so many different policy areas. As the Group of Thirty (G30) report *Digital Currencies and Stablecoins: Risks, Opportunities, and Challenges Ahead* notes, because some new payment technologies cut across traditional lines of jurisdictional responsibility, coordination among regulators, domestically and internationally, will be necessary (G30 2020).

Panel Discussion

During the virtual event, there was a lively panel discussion focused on how policy makers and financial services leaders can help the industry navigate the risks they face during and after the pandemic and, as a result, build more resilient economies and financial systems for the future.

The coordinated efforts of monetary and fiscal authorities, and of regulators and supervisors, are working to mitigate the worst outcomes of the pandemic. In the euro area, there was agreement to a historic support package that was not even seen in 2008. But the level of support cannot be continued indefinitely, and the response will likely require difficult choices and the targeting of resources. Given the impact COVID-19 is having on the economy, questions arise on whether we have an accurate handle on the stability and health of the banking system.

Banks are not the source of the crisis in the COVID-19 pandemic, and they have built up buffers, due, in part, to regulatory reform efforts over the past decade; however, as the waves of the crisis continue, action must be taken to ensure that a financial crisis does not emanate from the pandemic. On the one hand, this calls for the maintenance of buffers, and dividend suspension, and, on the other hand, there are calls to release buffers to assist the recovery. There is an inherent tension between these courses of action. The suspension in the distribution of dividends by banks may seem like a market activity disruption, but, in fact, it flags properly the extraordinary situation we are living in and the need to keep the highest standards of prudence in view of understanding the full scope of what is at stake.

To date, European economies have managed, in general, to withstand the first hit of the pandemic, and plans for recovery are ongoing. Of course, there are issues around the strength of the public and private balance sheets, with governments injecting large amounts of money into the corporate sector. As a result, at some point, banks may need to be recapitalized. But injecting money into the banking system needs to be done selectively to help winning banks win, while avoiding a glut of zombie banks at the same time. The ECB and the Single Supervisory Mechanism are actively monitoring the situation. Nevertheless, injecting public money may be problematic given new regulatory rules, and there is a need to remunerate private capital in order to be able to attract private resources to invest in the banking and financial sector.

Given the large effort expended in preparing regulators and the banking sector to shore up the financial system, it is now necessary to give certainties to the market in order to benefit from its potential in helping to solve this crisis. Impediments to private capital infusions include uncertainty over regulation: for example, whether bail-in will be enforced or suspended due to the systematic nature of the pandemic; the inability to securitize assets and so on.

A key issue is that the European "project" remains incomplete — there is still the need for common deposit insurance, capital markets union and securitization options to allow private capital to support banks. Strong bank governance is, therefore, critical and creates investable opportunities in the sector. More generally, European and international institutions would need to preserve the market, as we all need the market to stabilize the effects of the crisis, and restructuring will only be possible if the market functions and there is confidence.

At the same time, banks are expected to extend credit to viable businesses only and, indeed, this is an important element of the restructuring process. Recent work by the G30 has made a terrific leap on solvency and restructuring; nevertheless, today it is not just the banks' problem. There exists a general (global) solvency problem for corporations, which also need to restructure but where regulators have few tools. It is not clear which businesses are viable and which are not. Consumer behaviour is changing, and we will not know whether this is permanent for some time, which has important implications for determining where banks should reallocate credit, that is, how they should separate the wheat from the chaff. This is critical because while the pandemic has affected aggregate demand, it has also impacted aggregate supply — firms with strong organizational capital need assistance in order to maintain the supply side of the economy, but they could fail if they face a liquidity crunch. Such firms may have had solid business models and management but the pandemic was unforeseen and hard to insure against.

Given these circumstances, what can the banking sector do to support customer financial health? Equity injections into corporates and the restructuring of failing and changing parts of the economy are key, as is accelerating the reshaping of the economy during the pandemic and beyond. Support could include effective funding of small and medium-sized enterprises, facilitating appropriate loss absorption by existing stakeholders, and helping corporates to adjust to new business realities, rather than just trying to preserve the status quo.

In addition to these complex challenges, there is a consensus that future growth for banks may be largely determined by their ability to anticipate and navigate the shift to a low-carbon, clean-technology economy, in particular in the rebuilding efforts in a post-COVID-19 era — that is, it is possible that climate and sustainability will be embedded in these solutions. Managing the transition will require a greater focus on environmental, social and corporate governance investment to stimulate economic activity, and increasing pressure from both investors and customers, as well as the public at large.

The big policy issues likely to be tackled in the coming years include the challenge of the tech sector for bank business models (for example, whether fintech will complement or compete with banks), capital topics (for example, stress testing) and bank profitability, among others.

Toward a Renewed Bretton Woods

Adopting a coordinated approach and returning to a kind of informal — or even formal — agreement among states and international institutions is a possible way to cope with all of the emerging issues.

In the post-COVID-19 global scenario, the issues will be how to manage the explosion of sovereign and private debts accumulated throughout the world, how to regulate international capital flows resulting from liquidity created by the central banks' monetary stimulus and, finally, how to restore global supply chains. In order to achieve all of these aims, international economic cooperation needs to be maintained or, better yet, strengthened or reinvented.

This will not be an easy task in a complex environment where the strategic competition between China and the United States is a pre-COVID-19 legacy that has not disappeared and where there is the risk that it could evolve from a trade war to a financial and monetary confrontation.

The new Asian agreement on trade, the Regional Comprehensive Economic Partnership, can be seen as either a positive starting point for a new global agreement between Asia, the United States and Europe, or as a step in the direction of splitting global markets and economies in the direction of the so-called "decoupling" between the West and China-led Asian economies.

The first option is in the interest of the West and of the world as a whole, even if this option implies a more general agreement not only on trade but also on international financial and monetary systems that should take the new economic geography of the world into account.

The international monetary system established at Bretton Woods in 1944, in which the US dollar assumed the role of international reserve currency, no longer exists in its original formulation as a gold exchange standard. However, this system has resulted in a de facto international monetary system where, after more than 70 years and through various events and transformations of the global economy, the role of the dollar as an international reserve currency has not diminished.

The theoretical critique of a system where a national currency has the role of an international reserve currency has been reiterated many times in this long period, before and after the end of the dollar convertibility in 1971 and during the global financial crisis in 2008, when the so-called second Bretton Woods system, in which the Chinese currency was pegged to dollar, began to come to an end.

However, despite the United States (which had imposed the original solution at Bretton Woods) being challenged by the Asian emerging countries and by China, this system has persisted.

More recently, the debate on the international monetary system and the role of the dollar started again, before the pandemic, in connection with the escalating trade dispute between the United States and China, which represented a more general strategic and geopolitical clash.

In fact, three major factors have influenced the resumption of this debate.

The first factor is China's enhanced economic growth and its transformed position in international trade compared to 10 years ago. Connected to this evolution is the retreat from the hyper-globalization, and, in particular, the global economic process of decoupling as a strategy to respond to the technological and economic challenges posed by China.

The second factor, which is partially interconnected with the first one, is the phenomenon that has been labelled as the "weaponization" of the dollar — that is to say, the increasing use of the dominant position of the dollar in the international payment system and in the international financial infrastructures, with the aim to expand the influence of the American legal system in extraterritorial areas in order to pursue geopolitical goals.

The third factor, which possibly represents the major element of discontinuity with the past, is technology. Technology today offers new efficient solutions for the international payment system and, with the emergence of digital currencies and cryptocurrencies, reiterates on new bases the technical viability, although not yet political, of a global currency that recalls the old Keynesian idea of a supranational currency.

On July 17 and 18, 2019, at the meeting of Group of Seven (G7) finance ministers and central bank governors in Chantilly, France, Facebook's plan to launch the Libra, a stablecoin presented as a simple means of payment but pegged to a basket of stable currencies, was discussed with ill-concealed concern (G7 2019). It was immediately understood as representing the first real potential challenge aimed at what remains of the international monetary system established at Bretton Woods (what is more, it emerged from a pool of private companies).

One month later, one of the participants of the July G7 meeting, Mark Carney, who at that time was the governor of the Bank of England, spoke in front of an audience made up of bankers and economists at the US Federal Reserve's annual symposium in Jackson Hole, Wyoming. He asserted that the world dependence on the US dollar was no longer sustainable and invited the IMF to take the lead on designing a new international monetary and financial system based on multiple currencies (Carney 2019).

The core of Carney's analysis was, first, that a flexible exchange-rate regime is not the solution that will enable countries to absorb global shocks and, through a flexible monetary policy, maintain stable production levels and domestic prices; and, second, that global growth is strongly affected by the impact of American economic and monetary policies on the dollar, leaving countries exposed to the volatility of the US currency and to global risks.

Carney's conclusion, as well as that of other economists, is once more that the dominant role of the dollar in the monetary system is a source of instability and that, as a result, a multipolar system transition is needed. This multipolar system could be based on either several international currencies or a single global currency, which could take the form of a global electronic currency. The alternative could be a future conflict between the dollar and the renminbi, with the use of the latter now increasing in global trade.

These analyses are not much different from those made by the People's Bank of China (PBOC) governor Zhou Xiaochuan 10 years earlier, in 2009. Zhou, in turn, was reintroducing the debate from almost 50 years earlier, during the 1960s, by the

Belgian-American economist Robert Triffin and the French economist Jacques Rueff on the instability of the system established at Bretton Woods.

However, the transition to a new international reserve currency is a complex issue that follows not only an economic decline of the issuer country, but also the diffusion of the new currency as a medium of exchange, which, therefore, must be efficient and convenient in the international payments.

It follows that technology can play a key role today in overtaking the network externalities that hinder the transition to a new international monetary system similar to that proposed by John Maynard Keynes. Technology can do this by creating — using Carney's definition — a "hegemonic synthetic currency" through a network of central banks' digital currencies. China has already announced that the PBOC is planning to issue an official digital currency, and the EBC is studying a digital euro.

Those who argue against a new global currency in the future recall data showing evidence about the persistent dominant role of the dollar as a safe asset that stems from the fundamental integrity of the American political and economic system. The dollar is principally supported by the well-functioning US institutions, which ensure a developed and liquid financial market, and a strong legal system, which protects investors. These characteristics are not yet present, for instance, in China.

It is not actually known if the central position of the dollar will depend once more on a substantially spontaneous dynamic or if the attempt to avoid a long global recession will favour the idea of a new Bretton Woods, which, alongside a new agreement on shared rules for international trade and World Trade Organization reform, could lay the foundation for a monetary system founded on rules that are coherent to those that should oversee international trade.

Global value chains have been the core element in the growth of international trade — and of the global economy — in the past decades. In the post-COVID-19 world, the idea of proceeding toward a decoupling process — namely, reducing the connections between Western and Chinese-influenced economies — is likely to be reinforced, for technological and geopolitical competition reasons, by the tendency to review global value chains.

This perspective could be economically devastating and dangerous, leading to the possible deterioration of relations between countries. A protracted "trade war" will likely affect the monetary and financial system and risk starting a "currency war." In response, only a coordinated effort for the reconstruction, in a new deal, of the monetary system worldwide, could be the way to avoid a very costly "financial war."

The global financial and trade architecture, since the Bretton Woods Conference more than 75 years ago, has ensured the stability of the financial order and somehow (with notable changes and adaptation) survived until today. However, the current situation seems to have pushed it to the limit.

Almost 75 years ago, a framework to govern currencies, trade and development for many years to come emerged from Bretton Woods, and the IMF was established as a guardian of financial stability and trade. Even today, the US dollar is still the main international reserve currency. It is now time to rethink a scheme for the years ahead. A new Bretton Woods initiative, jointly promoted by all main economies, including the new emerging ones, is required. The first step should perhaps be a renewed EU-US transatlantic pact.

Conclusions

Clearly, the recent US election and the shift to a democratic administration may significantly support multilateralism, and a new approach by the United States to international dialogue will have a sizable signalling effect on others' behaviour.

The main global players need to find common ground and a common path. The US position on a number of issues is unlikely to change completely, although already there is the promise of a new path, which may bring future benefits.

This particular discussion on the need to renew international agreements led to three important findings (which are also challenges), namely:

→ how to manage the explosion of sovereign and private debts accumulated throughout the world;

- how to regulate international capital flows resulting from liquidity created by the central banks' monetary stimulus; and
- how to restore global supply chains.

All of them require a renewed emphasis on international economic cooperation and, indeed, a new Bretton Woods that considers the shifts in global economic activity and the rise of the digital economy.

But other relevant topics were also addressed. Clearly, there are issues around the strength of banks' balance sheets, with governments injecting large amounts of money into the corporate sector. As a result, at some point, banks may need to be recapitalized; however, injecting money into the banking system needs to be done selectively to help winning banks win. Equity injections into corporates and the restructuring of failing and changing parts of the economy are key, as is accelerating the reshaping of the economy during the pandemic and beyond.

Future growth for banks will be largely determined by their ability to anticipate and navigate the shifts in responding to the pandemic: green finance and sustainability will be key pillars of this growth.

Works Cited

Carney, Mark. 2019. "The growing challenges for monetary policy in the current international monetary and financial system." Speech at the Jackson Hole Symposium, August 23. www.bankofengland.co.uk/-/media/boe/files/speech/2019/the-growing-challenges-for-monetary-policy-speech-by-mark-carney.pdf?la=en&hash=01A18270247C4569 01D4043F59D4B79F09B6BFBC.

G7. 2019. "Chair's Summary: G7 Finance Ministers and Central Bank Governors' Meeting." www.g7.utoronto.ca/finance/190718-summary.html.

G30. 2020. *Digital Currencies and Stablecoins: Risks, Opportunities, and Challenges Ahead.* Washington, DC: G30. https://group30.org/images/uploads/publications/G30_Digital_Currencies.pdf.

IMF. 2020. *Global Financial Stability Report: Bridge to Recovery.* Washington, DC: IMF. October. www.imf.org/en/Publications/GFSR/Issues/2020/10/13/global-financial-stability-report-october-2020.

Lagarde, Christine. 2020. "Climate change and the financial sector." Speech by Christine Lagarde at the launch of the COP 26 Private Finance Agenda, London, February 27. www.ecb.europa.eu/press/key/date/2020/html/ecb.sp200227_1~5eac0ce39a.en.html.

Agenda

November 23, 2020

15:00–15:10	**Welcome: Oliver Wyman and CIGI**
	→ **Robert Fay**, Managing Director of Digital Economy, CIGI
	→ **Dominik Weh**, Partner, Oliver Wyman
15:10–16:10	**Panel discussion followed by Q&A**
	→ **Ted Moynihan**, Global Head of Financial Services, Oliver Wyman (moderator)
	→ **Elizabeth McCaul**, Member of the Supervisory Board, ECB
	→ **Raghuram Rajan**, Former Governor of the Reserve Bank of India, University of Chicago
	→ **Lorenzo Bini Smaghi**, Chairman, Société Générale
16:10–16:30	**Keynote address followed by Q&A**
	→ **Giovanni Tria**, Former Italian Minister for Economy and Finance, and Distinguished Fellow, CIGI
16:30–16:40	**Closing remarks**
16:45	**Close**

Centre for International Governance Innovation

67 Erb Street West
Waterloo, ON, Canada N2L 6C2
www.cigionline.org

RECYCLED
Paper made from recycled material
FSC® C023070
www.fsc.org