New societal and regulatory expectations will reshape capital markets

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In the final blog in this series, we look at three forces related to regulation and society that we expect to shape capital markets.

Under even the most benign of the scenarios, we expect the pandemic to have lasting repercussions, although the nature of the repercussions is dependent on the scenario. In particular, the scenarios variously encompass the possibility of a drive towards more socially-engaged ‘stakeholder capitalism’ or the prospect of governments adopting more isolationist policies. And in all scenarios, governments and regulators are likely to respond to lessons-learned for capital markets from the pandemic, including by introducing new regulations. In summary, society and government will be important forces in determining the future of capital markets.

As a reminder, our scenario planning framework considers four scenarios that could play out over the coming months (and years):

- ***The Passing Storm*** – relatively successful management means that pre-pandemic norms return in many areas, although not without lasting repercussions. These disproportionately affect lower and middle income individuals and communities.
- ***Good Company*** – the role of large corporations and of the wholesale financial services industry in supporting the public response accelerates developments towards more socially engaged ‘stakeholder capitalism’. The financial services industry adopts a heightened responsibility post crisis, both economically and socially.
- ***Lone Wolves*** – a prolonged pandemic period, with unpredictable bouts of volatility and an extended global recession spurs governments to adopt isolationist policies. This leads to insufficient global coordination.
- ***Sunrise in the East*** – a more effective response and better recovery trajectory accelerates a long term increase in the relative importance and influence of East Asian nations including China. Western recovery is based on lessons learned from the earlier recovery observed in the East.

Across all potential scenarios, there are underlying industry forces which we believe will drive impacts across capital markets institutions. For each force, we have highlighted likely implications and resulting key challenges that capital markets institutions will face under the relevant scenarios:

1. Deepening Capital Markets will play a more prominent role in funding and sustaining the real economy	
Leading Observations: The pandemic has occurred at a critical time for European banks, with profitability already	***Key implications under the most significantly impacted scenarios****: Sunrise in the East and Lone Wolves:* • Unlocking capital from insurers, pension funds and private equity could

under pressure and Brexit raising the prospect of the fragmentation of European markets.

In order to support the economy governments have guaranteed loan programmes to SMEs, but in the absence of a sustained economic recovery, many of these loans may ultimately default. Governments are considering longer-term solutions to avoid significant bankruptcies and the attendant unemployment.

Historically, the concentration of liquidity and financial expertise within the EU in London impaired the ability of smaller corporates to access that expertise and capital markets, contribution to the less developed capital markets as compared to the UK and US.

More than 80% of European corporate funding comes from banks and SMEs face unnecessarily high costs and complex obstacles in listing shares.

present opportunities to support SME recapitalisation and merit further consideration. However, unlocking private capital for this purpose and on this scale has not been done before and will require innovative structures.

Key implications under the less significantly impacted scenarios: *The Passing Storm and Good Company:*

- The scale of the recapitalisation challenge for the corporate sector likely necessitates a mix of measures, both equity and longer-term debt, and participation from a broad range of investors.
- Brexit has accelerated the need for the EU to achieve the deepening of European capital markets that the Capital Markets Union initiative aims to achieve.

We see the following key questions facing capital markets institutions:

- What new opportunities and possibilities does the coming economic reconstruction bring?
- What capabilities and resources will be needed to execute successfully on these? Is it necessary to partner or collaborate externally to access these?

2. New forms of financial supervision and new responsibilities for banks will emerge

Leading Observations:

Globally, there has been an increased push from regulators, supervisors and policymakers for firms to consider climate change in their approach to risk management and scenario analysis, and in the disclosures they make to financial markets. While most climate risk related actions are currently voluntary initiatives, many are likely to become mandatory.

Brexit will give the UK the ability to diverge from future EU financial services regulation and to revisit its implementation of existing directives and regulations, although there is unlikely to be a very significant shift in the near-term. While it is unclear what sort of

Key implications under the most significantly impacted scenarios: *The passing storm and Good company:*

- In the EU a host of new ESG-related legislative initiatives will affect firms. Disclosure provisions are being incorporated into both CRR2/CRD 5 and the IFR/IFD, and MIFID II is being amended to ensure firms take into account sustainability when making suitability assessments and in their risk governance and organisational structures.
- The Climate Financial Risk Forum (CFRF), an industry group convened by the PRA and FCA, launched a ‘Guide to climate-related financial

market access arrangements will govern the UK and EU's ongoing relationship, any significant departure from the EU's regulatory rulebook may exacerbate any fragmentation of EU capital markets, leading to higher trading costs and less liquidity.

risk management,' (the Guide) to complement existing frameworks. The Guide, as well as other regulatory developments in this area, accelerates the need for enterprise or firm-wide understanding of climate risk and the need for culture change.

***Key implications under the less significantly impacted scenarios**: Lone Wolves and Sunrise in the East:*

- The more the UK changes its regulatory system, the greater the ongoing cost for firms which operate across both the UK and EU and have to comply with two different regimes. In areas such as trading and investment banking, which are international and globally integrated, this will be particularly marked. Requirements to establish separate subsidiaries for EU market access purposes, with ring-fenced capital and liquidity, will further add to costs/increase inefficiencies.

We see the following key questions facing capital markets institutions:

- How can new metrics and factors be introduced into risk and capital management structures? What enhancements to data and process infrastructure are required to do this effectively and efficiently?
- How to calibrate response to new regulatory priorities, given the differing emphasis given to these in different key regions?

3. There will be an increased expectation for government and banks to work together and for banks to play a societal role beyond shareholder return

Leading Observations:

- Banks and governments have worked closely together to provide financial support to firms impacted by the COVID-19 pandemic, and to get the funds out to businesses quickly in order to minimise the impact of the crisis on the economy.
- In parallel, banks have called for support from regulators and supervisors to create capacity to deal

***Key implications under the most significantly impacted scenarios**: ALL scenarios*

- The relationship between banks and governments will be tested when SMEs that received COVID-19 funding default on their loans. There may be a role for the broader capital markets industry to provide investment where loans are not viable with debt to with the pandemic, for example by temporarily easing requirements or delaying timelines.

- There is an increasing recognition that the financial services industry can be a catalyst for change across other industries on topics such as climate and other environmental impacts, governance and wider societal impact through the money that the lend and invest and the transactions that they facilitate.
- Unlike some previous economic crises this one clearly emanates from an exogenous shock to the financial services industry. There is, however, an expectation therefore that banks and the wider financial markets need to support society and government in responding to the crisis.

equity conversion being one of the mechanisms proposed.

- Banks will be keen to preserve the positive social capital garnered during the crisis and will show a greater eagerness to get behind initiatives led by the government to support the wider economy with one eye on their ESG commitments.
- Regulators are alert to the risk that unintended consequences of regulations reformed since the last financial crisis may come to light during this period of stress, and have shown some appetite to address those unintended consequences.
- The increasing focus on ESG is likely to perpetuate a culture change, with banks having to consider how to embed ESG in a robust manner, as well as how to train staff and implement strategies across all teams and functions.
- There has been an increase in the issuance of social investment bonds, with banks and other firms such as Oil and Gas companies increasingly conscious of their carbon footprint and brand perception.
- Banks are coming under increasing scrutiny as to their investment from a sustainability perspective. For instance, banks will need to take human right risks and diversity requirements into lending considerations.

We see the following key questions facing capital markets institutions:

- Do new financial instruments and markets require new lines of business and new models?
- How to ensure that capital markets institutions remain able to attract and retain the leading talent, while continuing to serve existing and new clients?

Conclusion

While different scenarios will pose different challenges for institutions, particularly if those with a global footprint are faced with a divergent world (Lone Wolves), there are clearly some common themes. The world has changed in ways that give institutions both opportunities and imperatives - new financial markets, new metrics and models for assessing performance and long-term risks, and a changed social and political context.

Understanding this changed environment is the first step to navigating and executing successfully.

If you would like to discuss any of the implications articulated above, please reach out to one of the authors who can connect you with the appropriate expert.