Executive summary

Certain instructive parallels do exist between the challenges that faced monetary and financial authorities as they began to grapple with the response to the Great Financial Crisis and building a global structure for pandemic prevention, preparedness and response.

- **However, not all lessons will be directly applicable when the urgency and global exigencies of the pandemic response are taken into account.**

"It wasn't raining when Noah built the ark."(Howard Ruff)

Some key takeaways from the GFC reforms

- Like the focus of this panel, the goal of post-GFC reforms was to build the foundation for prevention, preparedness, resilience and response (PPR) in the event of another crisis.
- Incremental, not a Big Bang: The post-GFC regulatory reforms that so profoundly shape the financial sector today were not the result of a "Big Bang" but a complex process with a four-year gestation. They are still being implemented.
- Immediate AND medium-term measures: The initial 2008 G20 Action plan included immediate (for execution within five months) and longer-term mandates.
- Revised governance did not create new bodies but enhanced and empowered existing ones. (CEPI vs WHO?)
- Once governance was in place and plans initiated, resources became available: Globally to IMF, regionally to ESM, SRF.
- One-size did not fit all: Due to local historical, legal, structural and political discrepancies among jurisdictions, a global regulatory template was not attainable or desirable. Instead, authorities designed global minimum standards with local implementation and certain margin for local interpretation.
- Reforms included compulsory crisis management plans that sharpened focus, decision-making and execution prowess across the industry. These included well-defined protocols for:
    - Escalation
    - Decision-making
    - Preparedness, including crisis management simulations

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    - "It wasn't raining when Noah built the ark." (Howard Ruff.)
- Reforms included system-wide stress tests of banks to ensure that they can withstand systemic shocks.
- The global reforms were complemented, in Europe, by regional implementation and architecture

Top conclusions for G20 HLIP (see below)

1) **Sustaining a commitment to preparedness over time: strong institutional structures and multi-year funding cycles.**
2) **Adapting responses and focus over time: flexibility to switch focus as needed.**
3) **Know when to be decisive and when to move incrementally**
4) **Recognise that the weakest link determines the strength of the system**
5) **Clear structures of accountability and political sensitivity are needed for global norm-setting**

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Introduction

The Great Financial Crisis caught governments and authorities unprepared, lacking the tools, governance, rules and resources needed to manage and control the contagious instability. As the financial crisis deepened, it became clear that the Bretton Woods institutions, the G-7 and other existing structures were not fit to purpose. In response, at the initiative of the newly enhanced G-20, the global community redesigned the institutional architecture, rules and roadmap of the global financial system to promote and protect financial stability.

The focus and efforts in 2008-2009 parallel in many ways, though not perfectly, the challenges facing authorities in 2021. The measures taken to enhance **prevention, preparedness, resilience and response**, can offer some lessons and a partial roadmap to the way forward.

The post-GFC reforms profoundly changed the way financial services companies work, take decisions, assess and assume risk and set priorities. They are part of the reason banks are able today to be part of the solution in managing the economic impact of the pandemic. Some of the post-GFC changes are instructive for post-pandemic reforms.

Incremental, not a big bang

- In 2008, leaders elevated the G-20 from a forum for finance ministers to a summit of heads of state and government.
- At the G-20's first meeting in Washington, leaders agreed on an analysis of the root causes of the crisis, common principles to reform financial markets to **prevent** a recurrence and an action plan for finance ministers.
- The "Action Plan to Implement Principles for Reform," included **immediate (within five months) and medium-term actions** to be taken in:
  - Strengthening transparency and accountability
  - Enhancing Sound Regulation through:
    - Regulatory regimes
    - Prudential oversight
    - Risk management
  - Promoting Integrity in Financial Markets
  - Reinforcing International Cooperation
  - Reforming International Financial Institutions

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- **These principles and goals set the stage for the post-GFC architecture that was developed over the next five years and is still being implemented today.**
    - **The incremental approach was necessary because of scope and complexity of the task. (This may not be applicable to the Public Health Commons but is worth noting.)**
    - **It enabled consultation and buy-in; phased-in implementation reduced risk of disruption.**

Governance: More empowered institutions, not new ones

- G-20 leaders called in 2008 for "a new Bretton Woods" or Bretton Woods II, but they drew almost entirely on existing bodies, some newly empowered to design and implement reforms. Key bodies included:
- The Financial Stability Forum, created in 1999, was recreated in 2009 as the **Financial Stability Board**, the centerpiece of the new governance, with the mission of promoting financial stability. It does this through standing committees on:
    - Assessment of Vulnerabilities,
    - Supervisory and regulatory cooperation,
    - Standards Implementation.
- The **Basel Committee on Banking Supervision** intensified its work on an updated, global framework of minimum capital standards meant to enhance financial stability and maintain a level playing field.

These institutional reforms were put in place early in the process, *before* changes to capital requirements, liquidity and other reforms came into effect.

- By empowering and fine-tuning the focus of existing institutions, the G20 was able to leverage those bodies and overcome potential sensitivities or objections to centralizing power.

The global rulebook: Setting the standards

- The **BCBS** in 2010 issued proposed higher standards for capital and new requirements for liquidity (Basel II). Those proposals were subsequently revised and phased-in implementation began in 2013.
- Measures included stricter requirements for regulatory capital (reserves); countercyclical buffers; liquidity requirements; extra requirements for SIFIs.
- The BIS, IMF and other existing institutions were assigned specific roles in monitoring market conditions, providing early warnings, forecasting, providing policy advice, coordinating among member states and taking measures as required within their remits.

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- Banking supervisors required Recovery and Resolution plans for banks to demonstrate how they could recover from a crisis or be unwound without drawing on public funds.
- Enforcement is in the hands of national or EU authorities.
- Incentives and enforcement: As was the case with financial stability following the GFC, pandemic PPR could be incorporated into IMF Article IV assessments.
    - These assessments should be based on well-defined global criteria and should take into account qualitative as well as quantitative factors in order to provide authorities guidance in allocation of resources.
    - The assessments should include input from stress-tests conducted nationally under regional or global supervision to assess nations' preparedness and detect gaps in PPR structures.
- Credit rating agencies should be encouraged to incorporate pandemic PPR into their national and sovereign credit ratings.

Global resources

- Within this new architecture, IMF members agreed in 2009 an $850 billion injection of new resources, including a more flexible New Arrangement to Borrow.

Challenges: One-size-fits-all versus national realities

- The goal of global, enhanced standards often conflicted with the disparate nature of local regulatory and supervisory regimes.
    - The solution was to set minimum standards for local implementation, with certain margin for local interpretation.
- Supervision remains national (with regional oversight in Europe). Cooperation among supervisors has been significantly enhanced since the GFC.
    - This close cooperation helps ensure that standards do not slip or become a regulatory "race to the bottom."
    - Bilateral agreements are also important – for example, equivalence between the EU and the U.S. ensures regulations produce similar outcomes.
    - "Gold-plating" by EU member states as they implement reforms contributed to unwanted market fragmentation.

- Supervisors created the concept of "College of Supervisors" for international SIFIs. Under this concept, supervisors from Santander main markets – the EU,

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the UK, the U.S., for example – coordinate their supervision of the Group to ensure their visibility, expertise and understanding of the Group's position.

Regional response: Europe

- Within the framework, the European Union responded with directives to align European requirements and regulations with the new Basel III requirements.
- Europe faced aftershocks of the GFC in 2010-2013 with the sovereign debt/euro zone crisis. This spurred members to launch the plan for European Banking Union.
- The EU created a series of bodies to implement and complement the new global framework.
  - The European Supervisory Authoritiesto coordinate a single play book for EU banks
  - Single Supervisory Mechanism for larger European banks
  - Single Resolution Board
  - European Stability Mechanism (Euro zone only)
  - Single rulebook
- Resources were allocated: €80 billion to the European Stability Mechanism.
- The Single Resolution Fund, under the SRB, is funded ex ante by banks
- Pending work here includes the European Deposit Insurance Scheme.

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The view from a bank: A structured approach to crisis management preparedness

- ***"It wasn't raining when Noah built the ark." (Howard Ruff)***
- **A structured approach is needed to manage low probability, high-impact events that is consistent with BAU protocols but ensures proper coordination and rapid response.**
- Crisis management includes defined procedures for escalation, communications, and decision-making.
  - Top-level committees can be formed and convene in a matter of hours if necessary.
- **Simulation Exercises – WAR GAMES -** are a necessary and effective tool to train for these events.
- **In our experience, it is best to adopt a gradual approach with simulation exercises**, each exercise building upon the scale and lessons learnt from the former. Simulation exercises should also be proportional to an entity's degree of development of its Crisis Management structures, its size, complexity, risk profile, etc.

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- These exercises are also **useful to raise awareness across the organization** of tail risks, enhance preparedness to severe stress events, enhance the effectiveness of the crisis management framework, **and identify areas of improvement**.
- Crisis management simulations are conducted and then evaluated by third parties. These have included cyberattacks and acute deposit outflows due to a false rumor.
    - Crisis management procedures have been initiated in recent years for a number of issues.
        - **The COVID-19 procedure was initiated in the final week of January 2020; when cases began appearing around Santander's footprint, decision-making was facilitated by this structure. The Group went from 100% in-office to 50% work-from-home - 100,000 employees - in less than two weeks.**

<u>The view from a bank: Focus on procedures as well as outcomes</u>

- The post-GFC reforms profoundly changed the way banks work, take decisions, assess and assume risk and set priorities.
- Intensified supervision is now focused on **procedure as well as outcomes**.
    - Supervisors require not just reporting on levels of capital or loan quality, but how decision are taken, the procedures in place and the accountable executives. **This imposes a certain level of rigor and discipline in decision-making but can also make decision-making more cumbersome**.
- **Incentives**: To ensure accountability for risk-taking decisions, European directives placed ceilings on variable pay, require bonuses for senior executives be made through deferred payments over not less than five years and require *malus* and clawbacks from responsible decision-makers in the event of losses.
    - This ensures a degree of focus on medium- and long-term, rather than short-term, outcomes. It also affects banks' ability to recruit, particularly in tech innovation.
- In accordance with supervisory models, risk management was realigned into three "lines of defense":
    - First line: Business line risk assessment and decisions
    - Second line: Risk management division's policies and procedures for assessing and assuming risk, as well as setting enterprise-wide risk appetite.

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    - Third line: Internal audit's assessment of compliance with risk parameters
- Recovery, resolution and crisis planning and procedures: Banks are required to have regularly updated Recovery and Resolution Plans to show how they could recover from a crisis or be unwound without drawing on public resources.
    - In addition to enhanced enterprise-wide risk management, the Recovery and Resolution planning helps focus senior management attention of potential vulnerabilities and scenarios.

<u>**View from a bank: Some unintended consequences**</u>

- **Markets don't wait for phased-in requirements.**
    - Despite supervisors providing transition periods for banks to meet new capital requirements, markets have tended to impose a discount on banks until they have met the target. This makes them a less desirable investment versus other sectors and increases their cost of capital.
        - This could have a parallel in health care if countries unable to meet requirements according to set timelines are punished by investors and trade. Moving at the same speed would require stable, reliable funding.
- **Capital buffers have not been drawn down during the pandemic.**
    - Banking authorities have approved the draw-down of cyclical buffers to enable banks to lend even more during the pandemic. However, for same reason outlined above – markets' tendency to discount banks that are not meeting future capital requirements – banks have not drawn on these buffers. Authorities are analyzing possible remedies.
- Regulatory ring-fencing and "gold-plating" have fragmented, rather than more closely integrated, the single financial market in Europe.
    - National "goldplating" in pandemic PPR could create unwanted barriers to travel, trade and investment.
- **Lack of agility: Green, digital not adequately covered**
    - The current regulatory regime does not adequately address two of the greatest challenges facing banks, despite their potential impact on strength, stability and viability: the green transition and digital transformation.
    - Green: Markets need new incentives to support the transition to a low-carbon economy. Regulators should consider how to provide those incentives to banks, including by reducing capital requirements on loans that finance green activities.

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Digital: We need a level playing field, not to provide an advantage to banks but to remove the advantage that lightly regulated tech companies have enjoyed for the past ten years, even as they enter financial services.

- Lesson: Prevention and preparedness should not compete with or get lost in the climate challenge. Perhaps the way to think of this is that the climate reforms are like building a new house; the pandemic preparedness is one of the insurance policies we'll take out on the house.

- **Increased costs, less agile decision-making**
    - Compliance, reporting and the focus on procedure has sowed us in some ways, especially in digital innovation.
        - Because of these internal procedures, getting a new product to market can take us three times as long as it takes one of our digital rivals.

Top conclusions

1) Sustaining a commitment to preparedness over time: strong institutional structures and multi-year funding cycles.

It is a basic reality that the sense of urgency and commitment to a new level of readiness fades with time, as political focus moves on. You can see this both in the way in which the momentum behind banking union reform was difficult to maintain, but also in the parallel with the way in which commitments to new levels of global pandemic preparedness after SARS lost momentum after 3-4 years. One observation would be that this makes it important that reform work, and the new levels of risk awareness that it creates are insulated from a shift in political focus through- eg strong institutional structures around them, and multi-year funding cycles.

2) Adapting responses and focus over time: flexibility to switch focus as needed.

Within a sustained commitment to risk awareness there nevertheless needs to be a degree of flexibility around areas of focus and a capacity to see new risks emerging. The prescription coming out 2009 was very strongly focused on bank prudential strength and liquidity, because that was the 'disease' in that case. But we need to recognise that the 'disease' will often be different – the next issue may be asset class related like Exchange-Traded Funds (ETFs), a solvency crisis, or it might be a chronic

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problem like leverage or bad debt suppressing lending. A future pandemic is unlikely to have exactly the same kind of transmission or impact profile.

3) Know when to be decisive and when to move incrementally

To be sure, the process of financial services reform after 2009 was based around trying to be a clear consensus and then advance in defined steps to a new shared baseline. As you say, this meant a high level of buy-in. Arguably there were other areas where a degree of decisiveness was needed, at least at the national level. In this case, action to deal with NPLs stands out. In the case of covid-19 I would say that global action of vaccine deployment needs immediate action; new protocols for future crises need strong buy-in and perhaps a treaty-like structure to set a new global baseline.

4) Recognise that the weakest link determines the strength of the system

One of the key points about banking union is that it was an attempt to address the way in which weak links (either sovereigns or banks) in the system could be targeted by investors (or speculators) and could impact the integrity of the whole Eurozone and its banking system. A degree of collective action was needed to remove the vulnerability of the system to any individual part. I would argue that there is a parallel here with the need for a genuinely global solution on vaccine deployment and global 'herd immunity' – without ensuring the reach of containment into every part of a globalised society, we are leaving the system as a whole exposed in important ways. This requires a degree of solidarity and a big measure of redistribution….

5) Clear structures of accountability and political sensitivity are needed for global norm-setting

Once the Basel process entered the more granular phase of its standard-setting, it inevitably started to move into difficult territory in which it was often argued that it was failing to reflect national specificities and was imposing norms in a problematic way. The US and the EU both in different ways found it difficult to appear to be ceding authority to this process, even though they were participants in it. If this is true for banks and banking, it will be even more true for global mechanisms of pandemic management, where national politicians guard prerogatives very carefully because they are subject to very clear political demands for accountability. So while we clearly need to improve technocratic global governance of pandemic readiness and cooperation, we need to be always alert to the ways in which such governance cannot

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become detached from the politicians who are actually accountable for outcomes on the ground. As the experience of the WHO shows, this is very hard to do.

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ANNEX I

Options for private finance in the global public health commons

If there are financing gaps that the private sector should be covering but is not, it is because the right risk structure and incentives are not in place. Our solutions should focus on creating the conditions for the private sector to step in where it is not doing so today.

Some of the concrete areas where financial institutions could contribute could be:

Blended finance mechanisms

Boosting blended finance mechanisms, taking advantage of philanthropic and development bank financing, for the provision of guarantees and other risk mitigation instruments, which allow the mobilization of private capital towards the financing of R&D on medical products, improvements in the treatment and diagnosis capacities of healthcare facilities and personnel, etc.

Trade and supply chain finance, stockpiling

Provision of trade and supply chain finance to cover the financing needs of value chains, distribution and suppliers of pharmaceutical companies and the health sector, strengthening the local capacity of the countries in the provision of products and services in their systems of health.

Financing or private-public partnerships

Support to public and private clients in the structuring and financing of PPPs for the renovation or construction of health infrastructure, helping cover the existing financing gap, especially in emerging and developing countries. The mobilization of private capital in the health sector is essential to guarantee the expansion of health coverage, its regular maintenance, the transfer of knowledge and the stimulation of the use of new technologies.

Social bonds for the health sector

Provision of advisory and structuring capacities for the issuance of social bonds of corporate clients in the health and pharmaceutical sector aimed at supporting capital investments in medical infrastructures and in the capacity to manufacture and develop new treatments and vaccines needed and acquired by governments and

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agencies of public health, guaranteeing their access to the most vulnerable population segments.

Incentivised support for SMEs
Incentivised financing via loans or leasing to SMEs in the health sector to improve their operations, which could be leveraged in financial support from development financial institutions through lines of financing, credit guarantees, etc.

Incorporate health services in financial inclusion activities
Improve the ability to access health services for vulnerable populations at the base of the pyramid by introducing health insurance in parallel with microcredit and micro savings products in the Prospera and Tuiio programs.

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