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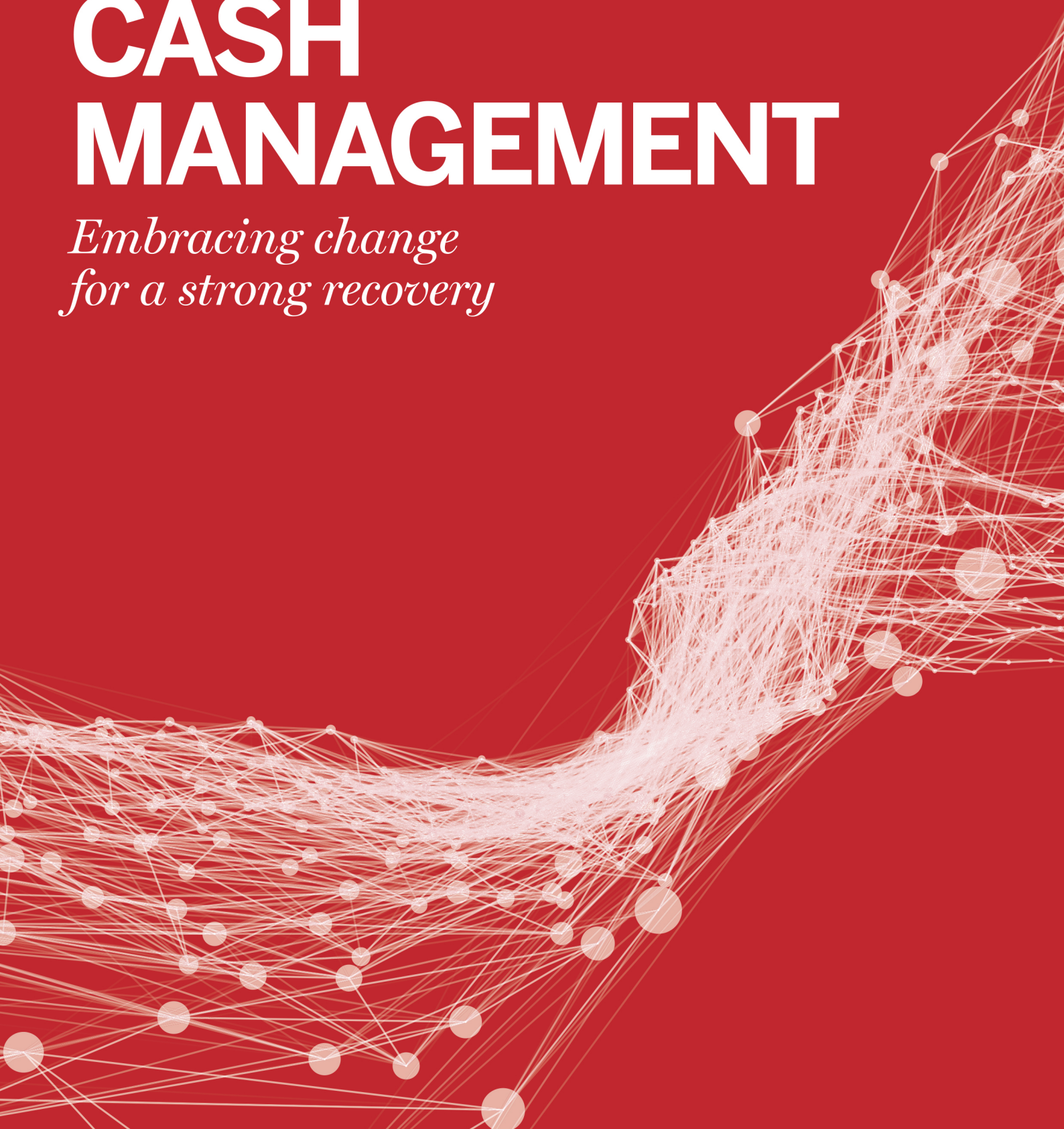
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JULY 2021

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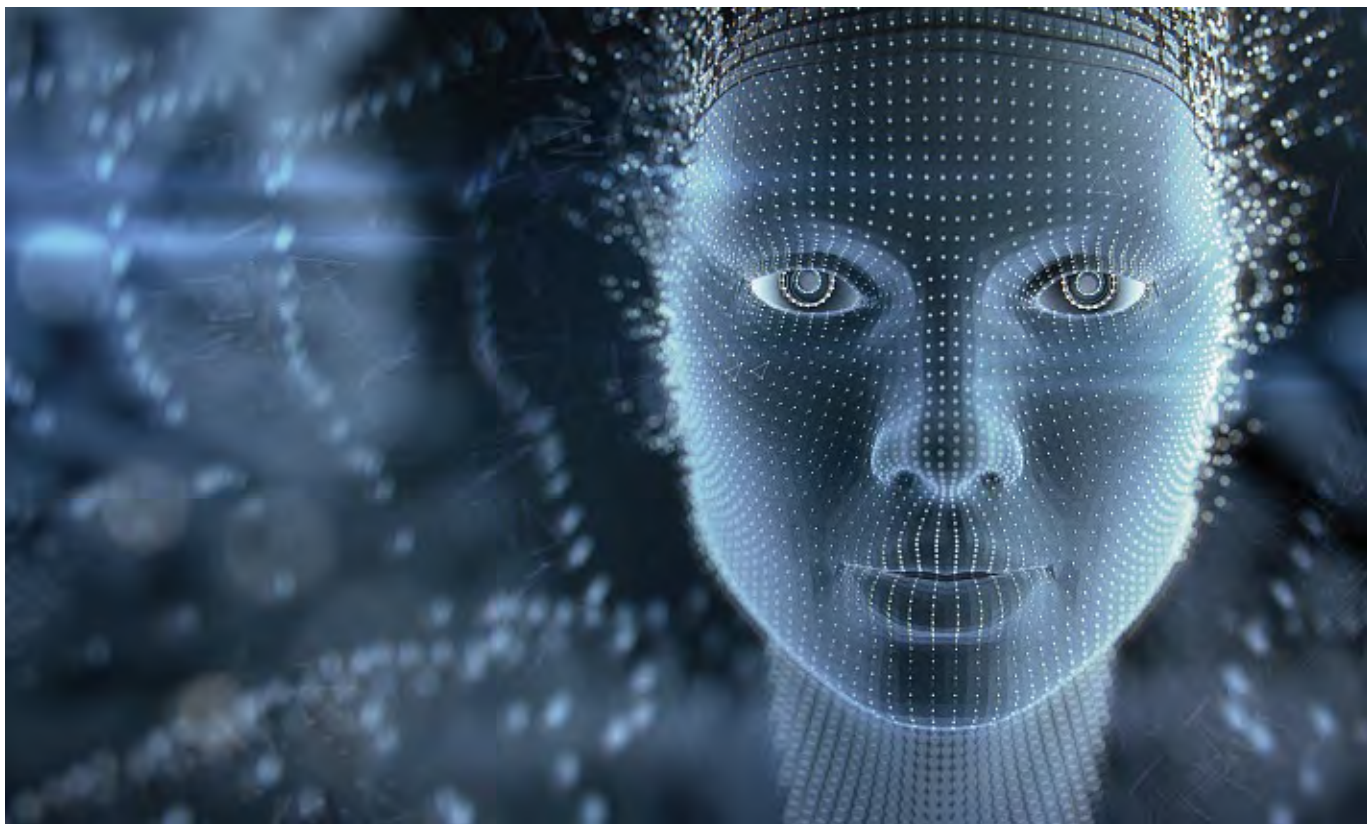
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THE CHANGING FACE OF CORRESPONDENT BANKING

Standards evolution

*Correspondent banking continues to develop at speed, propelled by huge infrastructure projects and the introduction of new and innovative initiatives. Deutsche Bank's **Marc Recker** reviews this evolution and explores the next generation of correspondent banking.*

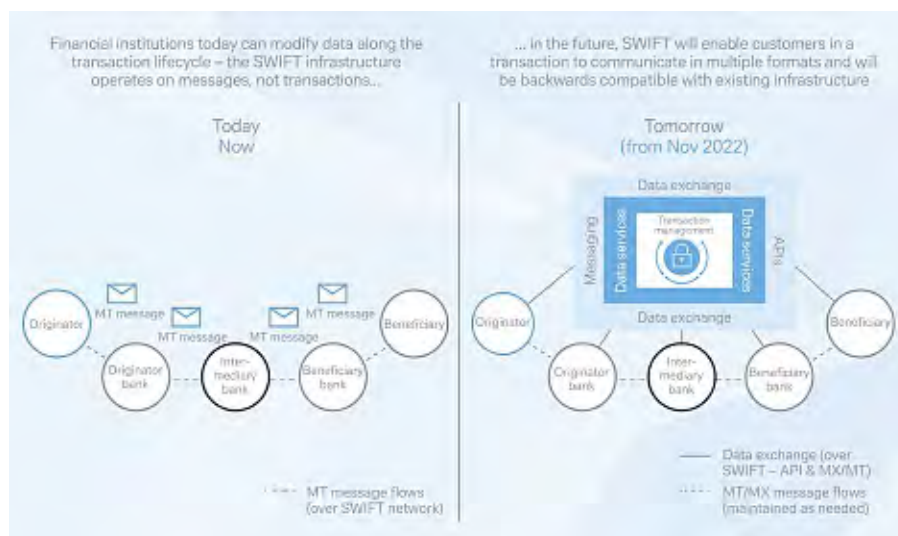
CORRESPONDENT BANKING remains under pressure, as shifting regulatory frameworks, changing customer demands and new competition put the model under the spotlight. There is a sense that the industry is reaching a defining moment that will decide whether it will thrive and continue to be the cornerstone of global trade. But what should banks, and the wider industry, do to ensure correspondent banking does not only succeed, but continues to adapt and evolve to the new real-time world?

Going forward, clarity and uniformity of standards will be increasingly central. Fortunately, efforts are well under way in this respect, and have been for some time. More than four years since its launch, Swift's global payments initiative (gpi) – the global payments

standard for correspondent banking – continues to play a major role, while other developments, such as the migration to the ISO 20022 global payment messaging standard and the introduction of Swift's Transaction Manager, are set to further expedite the evolution.

A NEW STANDARD FOR A NEW ERA

Standards lie at the heart of correspondent banking. They enable network participants to seamlessly exchange data with each other to execute payments securely and efficiently. In today's rapidly digitalising world, however, the industry's existing standards – developed at a time when storage and bandwidth were expensive, and before anti-money laundering and anti-terrorist financing checks became standard requirements >>



– have begun to show their age.

For example, Swift MT formats, the incumbent standard for cross-border payments messaging, have been in use for around four decades but lack the rich, structured information required in today's data-driven world; an update was due. In response, the payments industry – including domestic, high-value and cross-border payment systems – has begun the transition to the ISO 20022 messaging standard.

The ISO migration lays the foundation for the future, enabling banks and other participants in the end-to-end value chain to operate much more efficiently. It will deliver the information needed for reconciliation and liquidity management in a more structured and automated way, enabling fast, smooth and efficient payment processing. This will, in turn, unlock automated data analytics for improved risk mitigation, increase straight-through processing and enable the development of value-added services for corporate clients.

THE JOURNEY AHEAD

Many domestic payments systems, such as Europe's Single Euro Payments Area (SEPA)



THE ISO MIGRATION LAYS THE FOUNDATION FOR BANKS AND OTHER PARTICIPANTS IN THE END-TO-END VALUE CHAIN TO OPERATE MUCH MORE EFFICIENTLY ●●

and the SEPA Instant Credit Transfer, known as SCT Inst, have already migrated to ISO, while high-value payment infrastructures, such as the Eurosystem, the Bank of England and the Federal Reserve, plan to implement the standard in the coming years. In the correspondent banking space, Swift is set to migrate to ISO in November 2022, after which there will be a coexistence phase where ISO and MT legacy messages will exist in parallel until November 2025.

This impending deadline leaves banks with plenty of preparation work. The magnitude of the task ahead is substantial, and the effort required from banks remains significant. It will mean pushing forward internal projects – ensuring schedules are prepared, resources secured, budgets allocated and senior management informed ahead of the shift. Internal preparation should also be matched by external preparation. Education will be a key factor in this respect. ISO is not only a technological challenge: it will touch every aspect of the end-to-end payment chain and systems. Colleagues and clients alike should understand and be ready to consume the new standard from day one.

NEXT-GENERATION TRANSACTION MANAGEMENT

As part of a strategy to minimise friction, optimise speed and provide end-to-end transparency and predictability for cross-border payments, and facilitate a seamless migration to the ISO standard, Swift is introducing a new platform, known as the Transaction Manager, which will centrally maintain the full ISO 20022 transaction data.

Under the current model, financial institutions must pass all messaging data down the chain but, during the transaction



BY WORKING TOGETHER AS A COMMUNITY, THE INDUSTRY CAN ACHIEVE MORE FROM THE CORRESPONDENT BANKING NETWORK THAN WHEN IT OPERATES ALONE ●●

life cycle, this data can be modified. It means that the least rich, or 'weakest', message format in the chain determines what data is received by the end beneficiary. Swift's new platform will hold a central copy of the complete payment data, which will be accessible to every bank in the payment chain. This will allow rich data to be exchanged from end to end, thereby removing issues surrounding the weakest link in the chain, unlocking new services, streamlining processes and providing various compliance benefits.

In addition, the platform will mediate between banks using the MT (FIN-based), ISO 20022 or application programming interface (API) channels – allowing banks to adopt ISO 20022 at their own pace during the coexistence period.

This means that participants also need not wait until all parties in the payment chain are ISO-enabled but can reap the benefits of the new standard once they themselves have migrated.

MORE THAN JUST ABOUT INCREASING EFFICIENCY

While the migration to ISO 20022 and the introduction of Transaction Manager will undoubtedly lead to major efficiency gains in the cross-border payments space, for correspondent banking to truly thrive the industry will have to continue to innovate, take advantage of trends in the market and respond to changing customer demands.

A good example is capitalising on the growth of cross-border payments in the consumer-to-consumer, consumer-to-business and business-to-consumer segments, which are typically low-value. Here, banks have been fairly slow to respond to competition in the market, despite the advantage of having the network at their disposal. In these specific segments, clients are typically demanding full principal pay solutions with end-to-end pricing transparency upfront, and a processing experience that is equal to

the one they have with domestic payments.

If banks work collaboratively, they should be able to deliver this experience. The first steps have already been taken and much of the groundwork has already been laid with Swift gpi. Currently, about 20 banks, together with Swift, are developing an initiative to improve the experience for small and medium-sized enterprises and consumers that want to send low-value payments across borders. It will incorporate transactions with full principal amount, upfront fee predictability, no deductions and, for markets with instant or real-time capabilities, adoption of gpi Instant will enable instant settlement.

This initiative is a real chance for banks to regain and capture further market share. More information on it will be announced in the coming months, but it is an excellent example of how banks can work collaboratively to deliver on client requirements.

Such collaboration need not be limited to Swift. By working together as a community, the industry can achieve more from the correspondent banking network than when it operates alone. There is currently a lot of duplication in the sector, which gives banks an opportunity for attain significant cost savings and more resilient infrastructures. Take compliance processes for example: rather than each bank building, maintaining and improving its own infrastructure, they could connect to a central service provider via an API. Central utility services such as this – for processes that are less value-add and more must-have – could bring significant benefits in the future.

THE ROAD AHEAD

The correspondent banking industry continues to evolve in its journey towards an instant and frictionless future in which cross-border transactions can be performed between accounts anywhere in the world. There is, however, still some distance to travel and the large transaction banks, such as Deutsche Bank, are expected to lead in delivering initiatives without compromising the network.

The implementation and development of harmonised global cross-border payment standards, such as ISO 20022 and Swift gpi, as well as continued industry collaboration to improve the global correspondent banking network, will be major next steps if the vision is to become reality. But with the right initiatives, coupled with strong co-operation with Swift and the wider industry, banks can become a one-stop shop for fast, efficient payments of all kinds. **TE**



CLOUD PAVES WAY FOR DIGITAL TRANSFORMATION

Innovation

Cloud computing has become a platform for innovation, and banks are becoming comfortable with putting more of their operations on the cloud, leveraging its computing power and agility to provide new insights and value. Heather McKenzie reports.

WHEN DEUTSCHE BANK ANNOUNCED its development partnership with Google Cloud in December 2020, chief technology, data and innovation officer Bernd Leukert described it as “a new chapter” for the bank. The US tech giant was a “strategic partner” that would accelerate the Deutsche’s technology transformation, enable it to use data more intelligently and provide a flexible and safe environment to quickly deliver new products and services.

Gil Perez, chief innovation officer at Deutsche Bank, explains that in a heavily regulated industry such as banking, it was important to go with a single provider rather than adopt a multi-provider, or hybrid, approach to cloud computing. “There were many times people asked why we didn’t split up the work to minimise risk,” he says. “But the complexity of the controls and security layers that have to be put in place in order to certify just one cloud is huge.”

Digital transformation requires a move to the cloud, adds Mr Perez, and the bank aims to create a regulatory-approved global cloud infrastructure with an additional layer

of controls and capabilities to ensure compliance across more than 60 regulatory jurisdictions. “Once we have done this, we will have a valuable asset that we will open up to other companies in the ecosystem, increasing our collaboration with fintechs and other parties,” he says.

To expand customer reach, Deutsche Bank plans to list its Google Cloud products on Google Cloud Marketplace, to drive broader adoption of the bank’s new cloud-native services and solutions.

Several use cases for the partnership are being explored, including improvements to the bank’s Autobahn platform for corporate and institutional clients, with the aim of creating more personalised recommendations and experiences. New lending products to support pay-per-use models as an alternative to purchasing assets outright are also being examined.

DRIVING VALUE

Research by consultancy Accenture has identified an “uptick” in the cloud strategy among chief financial officers (CFOs), says

Ambrose Shannon, CFO practice lead at Accenture UK. “There’s also been a change in attitude towards cloud, with banks moving beyond a cost and efficiency agenda and now identifying the computing power and agility of the cloud to provide new insights and value. Cloud is no longer just about cost savings; it is changing how finance supports the business and how business better serves its constituents.”

The greater computing power that the cloud provides is enabling treasuries to run simulations of more sophisticated scenarios and stress tests. Financial organisations are moving cloud use cases into analytics, adds Mr Shannon.

Rob Enslin, president, cloud sales at Google Cloud, says there has been a change in attitude among financial institutions: “Financial services institutions (FSIs) initially were looking to migrate to the cloud to streamline processes, cut costs and to optimise infrastructure spend. However, increasingly FSIs want to go well beyond shifting existing applications to the cloud and digitally transform their businesses.”

The “democratisation” of data and analytics and the abundance of devices and systems have transformed information access and delivery. As a result, there is a continuously increasing amount of data that traditional infrastructures were not designed to support, he says. “C-suite leaders are now seeking ways to gain a competitive edge by applying application programming interfaces (APIs), machine learning and artificial intelligence against their data to innovate and create new services and lines of business. This is why the cloud has become a platform for innovation. By moving to the cloud, traditional banks can easily work with fintechs, or build their own innovative applications, and break down silos that used to exist when dealing with sensitive financial data.”

PANDEMIC ACCELERATION

Inevitably, the Covid pandemic has influenced financial institutions’ cloud strategies. Mr Shannon says the pandemic “shook the business community”, and the organisations that were more advanced in cloud technology performed better in the 12 months during the lockdowns. “These organisations were able to move much faster to home working and, more importantly, financial officers were able to provide real-time updates back to the group,” he says.

Trevor Belstead, chief information officer, wholesale banking and post-trade at financial services consultancy Delta Capita, says the pandemic accelerated cloud adoption plans in several different ways. “Buy-side firms are looking at more software-as-a-service (SaaS) and managed service-based solutions to accelerate their adoption of cloud to ensure they continue to operate in such a unique environment,” he says. These firms need to focus more on the competitive factors that will help them to increase quality and reduce costs. “However, the big question is: do these firms have the capability to accelerate cloud adoption while at the same time addressing expansive and intrusive regulations?” he adds.

Mike Tae, chief transformation officer at global financial solutions firm Broadridge, says cloud adoption within buy-side firms is part of a broader trend across financial services and was already increasing before the pandemic. “The pandemic accelerated this trend as firms had to move to a world of remote access. Firms using cloud-based services were better prepared to handle the demands of operational resiliency and business continuity. Those that were not [cloud-enabled] were forced to rapidly



C-SUITE LEADERS ARE NOW SEEKING WAYS TO GAIN A COMPETITIVE EDGE BY APPLYING APIs, MACHINE LEARNING AND AI

Rob Enslin ●●

migrate to the cloud,” he adds. Financial institutions had to create remote environments, such as call centres in the cloud or remote image-based desktop environments for their workforces.

Resiliency of services has been a key driver of cloud adoption for many firms impacted by the pandemic, says Mr Tae. By providing small and mid-sized firms the ability to build out an affordable, resilient infrastructure supporting the highest levels of business continuity (something that only the largest firms with scale could accomplish before), cloud infrastructure providers have levelled the playing field.

THE RISE OF APIs

Another effect of the pandemic has been an acceleration towards API-driven services, which has allowed financial institutions to assemble and integrate best-of-breed services. In risk management, for example, asset managers are using SaaS-based risk services that support newer risk models that can be integrated into existing systems using APIs. “The cloud is a key enabler of this trend, particularly as it relates to data and accessibility. Aggregating data from across disparate systems into a cloud data warehouse enables rapid deployment of new cloud-based API-driven services,” says Mr Tae.

As cloud computing has become cheaper and the technology and accessibility have improved, treasuries have had access to more timely and accurate data, says Leonardo Orlando, an executive in Accenture’s finance and risk practice. “This has improved activities like intraday liquidity management and anti-money laundering. Cloud is also enabling treasuries to do more automated hedging based on algorithms.”

Moreover, he adds, cloud computing is enabling greater transparency and information collaboration in treasury. For example, in settlement, all participants can use open-source technology in the same ecosystem to

exchange information and optimise overall settlement transactions.

The trend towards ‘hyper-converged’ infrastructure is bringing with it a transition towards a private cloud that can deploy workloads and applications, like a public cloud but on a smaller scale, says Mr Tae. Cloud-native applications can be deployed both on the public and private cloud with the ability to move workloads and applications easily across, depending on business and regulatory needs.

However, he believes the cloud of the future will not be about infrastructure but the ability to leverage a range of services on demand that would allow firms to assemble new services quickly. “The cloud of the future will be all digital, data-driven, and API-enabled.”

CLOUD STRATEGY

Another area in its early stages but “something to watch”, says Mr Tae, is ‘confidential computing’. This addresses data security, which has been one of the key barriers for firms migrating critical applications to the cloud. “Confidential computing allows processing to occur on encrypted data with the guarantee that this data is not visible to any application or code outside of that specific environment. This will provide companies with increased confidence that their data in the cloud is protected and confidential and will push them in the direction of migrating application workloads with critical and sensitive data to the public cloud.”

Deutsche Bank’s decision to opt for a single cloud provider has raised some eyebrows, as Mr Perez suggests. Mr Tae believes a multi-cloud approach allows access to best-of-breed services. “For instance, Google might have the best natural language processing service, while Oracle might have the best database service. One would also just access specific business functions on the cloud, such as a risk service on AWS or a market data service on Google from specific SaaS providers,” he says.

Dr Andreas Bohn, partner in consultancy McKinsey’s Frankfurt office, believes there will be more efforts to move larger parts of banks to a cloud – not only data, risk and analytics, but also client front ends. He believes there will be more attempts for partnerships related to data analytics. “It is foreseeable that cloud providers will develop from IT and system providers to infrastructure providers, such as telephone companies. There is also a good chance that they will be regulated more in the future,” he says. ^{1B}



CENTRAL BANK DIGITAL CURRENCIES: HASTE WITHOUT SPEED

Cryptocurrencies

*While China is driving ahead with its digital yuan initiative, other major CBDC projects have been making steadier progress. Deutsche Bank's **Graham Buck** reports.*

HAVING WON THE OPENING BATTLES, will private cryptocurrencies ultimately lose the war? Put another way, after surviving price volatility and efforts to limit their development, will cryptocurrencies ultimately be eclipsed by central bank digital currencies (CBDCs)?

The attitude of the world's central banks towards CBDCs has undergone a marked sea change. As the Bank for International Settlements (BIS) noted in an August 2020 working paper, US economist James Tobin outlined the concept in 1987 but early responses ranged from sceptical to hostile. Yet the BIS's 2021 survey of more than 60 central banks found that 86% of them were developing a CBDC.

The work extends beyond research: 14% of them are already running pilot projects and 60% are experimenting with a proof-of-concept. Innate caution has given way to acceptance that a steady decline in the use of cash requires a response – preferably one involving a degree of government oversight.

The pandemic has accelerated the process, drawing consumers away from banknotes and cash and making them



THE PERCEIVED BENEFITS OF CBDCs INCLUDE REDUCED POTENTIAL FOR FRAUD AND OTHER FINANCIAL CRIME SUCH AS TAX EVASION AND FUNDING TERRORISM ●●

accustomed to contactless payments. Marion Laboure, a macro strategist and research analyst at Deutsche Bank, describes cash as “the dinosaur that has not died” and suggests that, while in no danger of any imminent demise, the pandemic has accelerated its decline by four or five years. “The world has shifted from asking whether digital currencies will succeed, to how and when they will become mainstream,” she wrote in a recent white paper. “Using cryptocurrencies for payments will accelerate.”

For governments, the perceived benefits of CBDCs include reduced potential for fraud and other financial crime such as tax evasion and funding terrorism; facilitating instant and cross-border payments; reduced transaction costs; greater financial inclusion within society; and the ability to target financial aid directly to individuals.

Introducing CBDCs in combination with distributed ledger technology (DLT) also offers governments and central banks various governance advantages, enabling them to exercise control over money transfers to companies and individuals, and devise more targeted, efficient monetary and fiscal policies.

VARYING SPEEDS

Although the era of the digital dollar, euro and pound is steadily approaching, actual CBDC launches to date have been on a small scale. The Bahamas was a pioneer, launching the so-called ‘sand dollar’ – a digital version of the Bahamian dollar – in October 2020. Sweden’s e-krona pilot is also making progress, with the Riksbank announcing in April that the coming months will see com-

mercial banks included in the next stage of its project on how a CBDC would affect commercial and retail payments.

More significantly, the People's Bank of China (PBOC) has been piloting a digital yuan since its April 2020 trial in four Chinese cities, and it aims to ramp up domestic use ahead of February 2022's Winter Olympics. "The introduction of a digital currency in China could lead to an acceleration of other projects as other central bankers become more worried about the race for digital currency supremacy," suggests Markus Mueller, managing director, global head of chief investment office at Deutsche Bank International Private Bank (IPB).

Many have commented that the Chinese government's keenness to push ahead with the initiative is driven by more than the benefits outlined above. Adopting a CBDC for use both at home and internationally would see China challenge the dollar's dominance. The size of its population and economy strongly positions China for superseding the US at some future point as the main provider of the global reserve currency, a major motivator for leading the CBDC race.

"At the same time, [other] central banks have not stood idly by," says Mr Mueller. "The monopoly of money creation and management has traditionally lain in the hands of central banks – or monetary authorities – in most countries. Naturally, they are interested in keeping a control on what constitutes money to effectively manage the economy. "In that sense, accelerated central bank research and experimenting activity around CBDC can be interpreted as a reaction to the development and evolution of private cryptocurrencies and the various private payment providers. Central banks want to establish an alternative state-of-the-art payment solution."

Ms Laboure agrees that central bankers and policy-makers in Europe and North America are likely to accelerate their research on CBDCs and launch pilots; she also expects them to displace non-bank digital currencies over time and become the norm. But progress is lagging compared to the PBOC's rapid rate of development.

In October, the European Central Bank (ECB) announced it was stepping up its review of a digital euro and reported that feedback from a public consultation had been generally favourable, despite concerns over privacy issues. Confirmation is expected shortly on whether it will begin working towards a launch.

Recent guidance from ECB president Christine Lagarde indicates that, provided



MONEY CREATION AND MANAGEMENT HAS TRADITIONALLY LAIN IN THE HANDS OF CENTRAL BANKS – OR MONETARY AUTHORITIES

Markus Mueller ●●

the bank's policy-makers approve the project, the digital version could become reality by mid-decade. "We need to make sure that we do it right. We owe it to the Europeans," said Ms Lagarde. "The whole process – let's be realistic about it – will, in my view, take another four years, maybe a little more."

Across the Atlantic, the Federal Reserve announced on May 20 that it will issue a research paper on a digital currency in the summer, with chairman Jerome Powell commenting that the Fed had been "carefully monitoring and adapting" to innovation in payments technology.

Previously his tone has been cautious. While the Fed has begun a major research and development project on a CBDC and is working with the Massachusetts Institute of Technology (MIT) to establish a technology platform for supporting a digital dollar, Mr Powell has regularly emphasised that the Fed feels under no pressure to be first. In a recent CBS interview, he maintained that the jury is still out on whether such a launch would actually provide a public benefit, and that any decision needs to involve both the public and Congress.

Meanwhile, the Digital Dollar Project – a non-profit joint initiative between the Digital Dollar Foundation and consultancy Accenture – will run five pilot programmes over the next 12 months whereby financial firms, retailers and non-governmental organisations will test the potential uses of a US CBDC. The aim is to complement the MIT project and generate data to help policy-makers in developing a digital dollar.

COMPETING WITH CRYPTO

The Bank of England (BoE), which over several years has assessed the case for a digital pound, announced on April 19 that it was setting up a taskforce with HM Treasury to explore the potential for a sterling-denominated CBDC. Its remit will be to consider the "benefits, risks and practicalities", and whether the use case for such a development

is sufficiently strong.

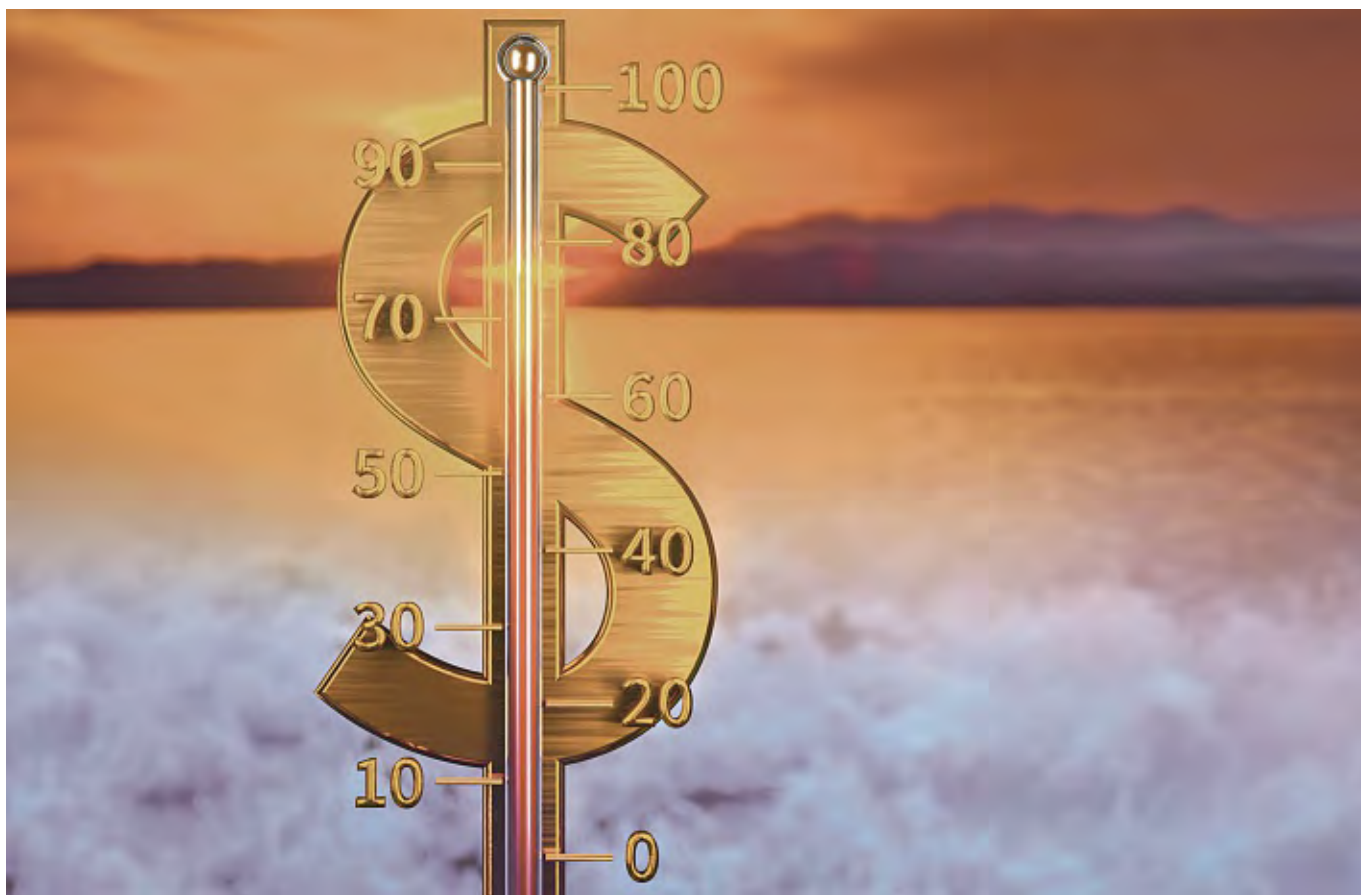
A Reuters report noted: "A BoE-backed digital version of sterling would potentially allow businesses and consumers to hold accounts directly with the [central] bank and to sidestep others when making payments, upending the lenders' role in the financial system."

But with China leading the race towards a launch, and others still at various stages of development, whether CBDCs will ultimately diminish the appeal of bitcoin and its peers is unclear. Alexander Bechtel, head of DLT and digital asset strategy at Deutsche Bank Corporate Bank, describes bitcoin and CBDCs as "two totally different animals", each with its distinct ideology and expectation of how the monetary system should work. Bitcoin, as a fully decentralised, permissionless, open and borderless system for storing and transferring value, lacks any central authority or monetary policy, as the maximum supply of bitcoins is fixed.

"That might sound attractive, but comes with several trade-offs: for example, it is difficult to square with existing regulation, there's no institution you can go to or number to phone if you have problems, and it does not scale properly," says Mr Bechtel. By contrast, a CBDC is digital legal tender issued by a central monetary authority. "It is fully controlled by the state and the central bank acts as the trusted third party conducting monetary policy by steering interest rates and changing the money supply."

Nonetheless, non-bank digital currencies have significant attractions, which were examined in a Deutsche Bank IPB report, published shortly after the BoE's announcement. In 'A tale of two siblings: cryptocurrencies and CBDC', Deutsche Bank IPB global chief investment officer Christian Nolting suggests that while CBDCs and private sector cryptocurrencies are "far from being two sides of the same coin", both may now be approaching critical mass. The latter are here to stay, the report concludes, but in the longer term their appeal could wane once central banks in developed economies start rolling out CBDCs.

Mr Nolting adds that the potential policy and societal impact of a CBDC will be better assessed once one reaches full operation in a major economy, which could still be several years away. However, governments and more digitally aware populations could ultimately favour CBDCs over bitcoin and its peers. In that event, he says, "the more successful cryptocurrencies are likely to become increasingly differentiated in terms of business models and utility". **FB**



UNDERSTANDING CLIMATE-RELATED FINANCIAL RISKS

Geopolitical risk

Climate change is the most significant geopolitical risk to emerge in the past year, motivating banks around the globe to track and manage their exposure to what is now being referred to as 'green swan' risks. Heather McKenzie reports.

THE PHYSICAL RISKS OF A CHANGING CLIMATE and the transition risks of adjusting to a low-carbon and more environmentally sustainable economy will become “increasingly material” for banks in the coming years, Frank Elderson, vice-chair of the supervisory board and member of the executive board of the European Central Bank (ECB), told a conference in Frankfurt in April.

For this reason, the ECB is undertaking a stress test to assess the impact of climate-related risks on the European banking sector over a 30-year horizon. This entails the ECB mapping projections of climate patterns and expected climate developments to the location of firms’ physical assets, and estimating the impact that severe climate events would have on those assets and, consequently, on banks’ portfolios. Together with other central banks, the ECB is developing joint climate stress-test scenarios.

The ECB has also asked banks to assess themselves against the supervisory expectations outlined in its ‘Guide on climate-related

and environmental risks’, issued in November 2020. Banks are expected to draw up action plans for aligning their practices to the expectations. More than 112 institutions, representing 99% of total assets under the ECB’s direct supervision, have submitted self-assessments and are finalising their action plans.

The ECB is assessing their responses, and Mr Elderson said: “Where we see that banks are not managing their exposures to climate-related risks in an adequate manner, we can and will draw on the full supervisory toolkit at our disposal to correct that situation, just as we do for any other material risk.” He added that ECB Banking Supervision has identified climate change as a key risk driver for the European banking sector.

Banks are still in the early stages of incorporating climate change into their risk frameworks, and risk identification and risk limits around climate-related goals do not yet feature in their risk management processes. This needs to change, Mr Elderson said at the conference, and euro-area banks

must “drastically improve their capacity to manage climate-related and environmental risks and start acknowledging how these risks can drive others, including credit, market, operational and liquidity risks”.

The stress test will help the ECB to catalogue the “resilience of banks’ balance sheets to risks coming from climate change”, he said. “Importantly, this exercise will push banks to strengthen the climate dimension of their risk management toolbox. Finally, the exercise will also dramatically increase the availability of data and shed light on our supervisory reporting needs around these types of risks. Given our current lack of data, this will greatly help us in charting the course forward.”

GLOBAL MOVES

Supervisory authorities in Australia, Brazil, Canada, France, Hong Kong and Singapore have also conducted, or are scheduled to conduct, climate-related stress tests. In June, the UK’s Bank of England (BoE) launched a climate-related stress test as part of its biennial exploratory scenario testing. Seven of the largest banks and building societies, five large life insurers and six large general insurers were invited to take part, together with 10 selected Lloyd’s of London managing agents.

UK banks are “well advanced” in preparing for climate stress tests and meeting supervisory expectations for financial risk management related to climate change, according to research by German rating agency Scope Ratings. “The focus on climate, and environmental social and governance (ESG) more broadly, is increasing but it is not always clear what is material and relevant from a credit investor’s perspective,” says Pauline Lambert, executive director in Scope’s financial institutions team. “Ideally, we would be able to assess the nature and magnitude of the climate-related risks to which banks are exposed. However, disclosures are still evolving, and making direct comparisons between banks remains challenging.”

One of the desired outcomes of the UK stress test is to evaluate the size of participants’ financial exposures. Like the ECB, the BoE has stated that the exercise will not be used to set capital requirements, but Ms Lambert says depending on the materiality of the risks, “we believe this is likely to impact capital requirements in the future”.

Large UK banks have been making disclosures in line with the Financial Stability Board’s Taskforce on Climate-related Financial Disclosures framework, which was designed to improve and increase reporting



IT IS IMPORTANT TO EMBED GOALS TO BE ACHIEVED OVER A LONGER PERIOD OF TIME INTO THE OVERALL ESG STRATEGIC PROGRAMME

Andreas Bohn ●●

of climate-related financial information. Scope Ratings says there is “relatively good” detail from UK banks about the management of climate-related risks and the work that is being done to evaluate exposures under different climate scenarios. Drawing conclusions about the impact on loan books, however, is still not feasible, it adds.

SUCCESS METRICS

At the treasury level, success of an ESG programme would be first defined as being able to issue suitable financing instruments, says Dr Andreas Bohn, partner at McKinsey’s Frankfurt office. Second, a programme should obtain meaningful external recognition and rating for achievements that can be realised in a short timeframe.

“It is important to embed goals to be achieved over a longer period of time into the overall ESG strategic programme of the company,” says Mr Bohn. “This means that goals and strategy are transparent; furthermore, [that] expectations from regulators, investors and relevant rating agencies are understood and embedded in the overall strategic ESG programme.”

When it comes to treasury activities, he says, a first step should be issuing ESG-compliant financial instruments, such as inaugural bonds and notes that can be associated with and linked to ESG-compliant assets. This should be supported by respective opinion providers and rating agencies, he adds. “In the medium and long term, it is important to align the issuance programme and investment policy of the treasury department with a coherent overall ESG strategy of the company. The overall ESG issuance strategy should be embedded in a holistic framework of governance, risk and performance metrics and reporting.”

Ambrose Shannon, lead of Accenture’s chief financial officer (CFO) practice in the UK, says technology and sustainability need to be factored into financial institutions’ day-to-day operations. “Our research has

shown that the remit for ESG in banks and corporates falls to the CFO, and by extension, the treasurer.”

In Accenture’s CFO study of 1300 senior finance leaders from around the globe, carried out between April and June 2020, 68% of respondents said their department “takes ultimate responsibility” for ESG performance within their enterprise.

The study says: “CFOs play a critical role in addressing some of the most pressing societal and environmental challenges of our time. They can do that through more consistent ESG disclosures; for example, CFOs are embracing their role as growth catalyst by disclosing and ‘optimising’ stakeholder outcomes in these areas. Leading by example, CFOs can ensure that ESG performance metrics are embedded in financial planning and analysis, leveraging digital tech to activate ESG priorities at speed.”

Vinod Jain, senior analyst in Aite Group’s institutional securities and investments team, agrees that treasury as a group has an important role in ESG governance and the contribution to the overall corporate goal. “Treasury also connects with the outside world and there’s added pressure to demonstrate how a financial institution has complied with ESG strategies. Everything is being looked at through the ESG angle,” he says.

Mr Shannon refers to the ‘three Rs’ of ESG: risk, regulation and return. “On risk, treasurers should ask ‘what is the risk to my business, portfolio and lending book?’ The risks for banks are more pertinent when they are writing a mortgage that will be on their books for the next 30 years. There are also risks that arise from carbon pricing, asset stock valuations and lending.”

A problem in dealing with regulation, he says, is that there are five to six global ESG standards setters and several industry standards setters. “Banks can self-select standards that they will make disclosures on but in general, these aren’t prioritised in annual reports, for example.” The International Accounting Standards Board is looking to engage and formalise metrics, a move Mr Shannon says could result in a “shift in behaviour”.

Finally, if banks make the right decisions, there is a huge potential uplift in terms of return. “Banks can create new, tailored products in the ESG space that will drive returns,” he says.

FINANCING TRANSITION

A bank treasury has three potential roles in ESG: to incentivise, optimise and >>



ACROSS THE SUPPLY CHAIN,
THERE'S A DESIRE TO BE
CONSISTENT ON ESG, BOTH
INTERNALLY AND EXTERNALLY

Paul Sinthunont ●●

achieve internal ESG, according to Leonardo Orlando, an executive in Accenture's finance and risk practice. "Bank treasuries can create the funding structures for the changes required at corporates to achieve net-zero carbon. Funding and capital allocation to ESG-compliant corporates will become a competitive advantage for financial institutions."

Loans and funding strategies can also help to optimise corporates' ESG strategies, adds Mr Orlando. By creating green bonds and green asset-backed securities, bank treasuries can help even small companies to access the capital markets for funding for ESG projects. "Internally, the digitisation of treasury transactions can play a big role in a bank's own efforts in achieving ESG. Treasury is also the first line of defence against social factors such as money laundering and bribery. There are many different lenses through which there is applicability of ESG in bank treasuries."

There are challenges in integrating ESG into treasury operations, however. Mr Bohn says ESG considerations are becoming increasingly important for institutional and private investors and "may even represent an investment constraint". ESG ratings are playing a large role. "Hence it is important to have a plan of increasing ESG-compliant bond issuances. Furthermore, the efforts to increase a climate-neutral asset composition have been stepped up by both regulators and banks themselves. One of the latest examples is the Net Zero Banking Alliance (NZBA) of 43 founding banks. Treasurers can support this by structuring their invested securities accordingly."

The industry-led and UN-convened NZBA now numbers 45 banks from 23 countries with over \$28tn in assets. The members are committed to aligning their lending and investment portfolios with net-zero carbon emissions by 2050.

Launched on April 21, the alliance aims to reinforce, accelerate and support the implementation of decarbonisation strategies, providing an internationally coherent framework and guidelines in which to operate, supported by peer-learning from pioneering banks. It recognises the vital role of banks in supporting the global transition of the real economy to net-zero emissions.

Among the commitments the NZBA banks have made is to transition the operational and attributable greenhouse gas emissions from their lending and investment portfolios to align with pathways to net zero by 2050 or sooner. Within 18 months of joining, banks will set targets for

2030 (or sooner) and a 2050 target, with intermediate targets set every five years from 2030 onwards.

PRIORITIES AND TARGETS

Banks' initial 2030 targets will focus on priority sectors where they can have the most significant impact – that is, the most greenhouse gas-intensive sectors in their portfolios – with further sector targets to be set within 36 months. NZBA members will annually publish absolute emissions and emissions intensity in line with best practice and, within a year of setting targets, disclose progress against a board-level reviewed transition strategy for proposed actions and climate-related sectoral policies.

Mr Bohn says that since ESG and climate risk targets often can only be achieved over a longer period, it is important to define ambitions clearly and have a viable strategy that is transparent to external stakeholders and employees. "The composition of assets and funding sources needs to be aligned over time and external stakeholders need to grant sufficient time. At the same time, the company can focus on what can be implemented in the short term, such as issuance and rating of the first relevant ESG-compliant bonds."

Paul Sinthunont, a senior analyst at Aite Group, says there is increasing pressure on financial institutions to change the way they run their businesses. "Across the supply chain, there's a desire to be consistent on ESG, both internally and externally. Firms managing money can help to steer the direction of the companies with capital. There is an expectation that a partner will have the same approach as you. ESG compliance will become an accepted standard, and any financial institution or company not embracing it will not win much business."

Accenture's Mr Shannon says the great energy and enthusiasm for the ESG agenda in wider society means banks and businesses are being challenged on their commitment to net-zero carbon emissions. "Financial institutions face questions about what they are financing and how they are plotting their own transitions to net zero carbon. It is early days in some respects for ESG, but everyone is on the road. It is complex – banks cannot stop funding certain supply chains and switch into others, because everything is interconnected. However, with consistent standards and dedicated defined policies, financial institutions will be able to invest in areas that are aligned with where society is moving." ^{1B}