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FINANCIAL

Finance in revolutionary times
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CRISIS MANAGEMENT

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DEAR READER,

Recent events in the U.S. banking sector, and broader concerns around instability and contagion within the global financial services industry, have meant that crisis management is once more front of mind for many institutions.

In addition, the world of business and finance is facing broader geopolitical and socioeconomic challenges, ranging from conflict, climate change, inflationary pressures, and precarious energy resources. Factor in heightened regulatory and competitive pressures, and it becomes clear that financial institutions must prioritize risk management, within their own organizations and with their counterparties.

The papers in this edition of the Journal address the theme of crisis management through various lenses, including regulatory compliance and traditional risk management, as well ESG, the low carbon economy, and sustainable finance. Our authors also explore topics such as the impact of social change on the world of finance, the rise of artificial intelligence and virtual reality technologies, and cybersecurity.

Contributions in this edition come from a range of world-class experts across industry and academia, and showcase some of the very best expertise, independent thinking, and strategic insights within the financial services sector.

As ever, I hope that you find the latest edition of the Capco Journal to be engaging and informative. Thank you to all our contributors, and thank you for reading.

Lance Levy, **Capco CEO**

FINANCE IN REVOLUTIONARY TIMES

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ABSTRACT

The structural changes of the fourth industrial revolution are considerable. In the financial services sector there is, inevitably, a lot of focus on the technological changes and their impact on financial markets. However, finance has a long history of adapting to technological innovation. Instead, it is consequences of social change that are likely to present the biggest challenge for finance over the next twenty years.

1. INTRODUCTION

The global economy is in the midst of a dramatic structural change, which the World Economic Forum has branded the "fourth industrial revolution". Automation, robotics, digitalization, and communication are driving the upheaval. Indeed, a case can be made that the current wave of change represents the most significant economic and social restructuring in the two-and-a-half centuries that have passed since the first industrial revolution. These changes have dramatic implications for international finance.

The inclination in any period of upheaval is to focus on the technological changes. Technology is the shiny new toy that naturally captivates our attention. But technology is just the starting point for the waves of change that ripple out to wash over every aspect of our lives. To use one obvious example: the combination of internet and laptop has facilitated the flexible working practices that have become especially common since the pandemic. That has immediate and obvious consequences for real estate demand (and thus asset valuations), along with the direction and profitability of the construction sector. For the first time since the original industrial revolution, urban living has become a lifestyle choice rather than an economic necessity for many. That change in real estate use leads to changing patterns of demand for transport infrastructure, food distribution, and service industries. It breaks down the distinction between investment and consumer spending (who is paying for the office desk today?). It arguably alters how members of a society interact with one another. It might even change dating patterns (the number of people finding partners in the workplace has fallen in recent years). This is about much, much more than the latest iteration of a smartphone or the fumbling steps towards artificial intelligence.

In the world of finance there is a similar tendency to focus on the technology as the disruptive influence. Financial market commentators are just as easily seduced by the luster of technology as anyone else – perhaps, considering the dotcom bubble, financial markets are even more at risk of being captivated by the novelty of technology. Certainly, financial technology does have the potential to change many aspects of finance, but finance is an industry that has constantly been disrupted by new technology. Double-entry bookkeeping, the telegraph, and the mainframe computers of the 1970s all revolutionized finance. Banks and other institutions are likely to adapt, just as they have done over the centuries. Just being animated (or scared) by the possibilities of blockchain or artificial intelligence is too narrow a perspective. Finance needs to consider the broader state of the world in which it operates. The challenges for finance from the wider social changes are certain to be more important than the nefarious world of crypto, or automated investment advice. These wider changes will disrupt employment, the global financial model, and raise questions about the allocation of financial capital.

2. EMPLOYMENT, PREJUDICE POLITICS, AND FINANCE

As with previous industrial revolutions, the economic and social changes that arise mean that the relative economic and social positions of individuals will alter. Some people will gain, often dramatically. At a time of innovation, the luck of having the right idea or optimal skills that are suddenly in demand can catapult an individual to higher levels of wealth and social status. At the same time, skills that previously conferred income and status can either be downgraded, or become obsolete. The legal clerk, increasingly automated into a low-status role, may well look with incomprehension and growing resentment at the rise of a social media influencer with a talent for livestreaming their computer gaming skills.

From an individual's perspective, this change in their position in the hierarchy can be hard to comprehend. Someone who is good at their job and diligent in applying themselves to work suddenly finds that their relative economic and social position has deteriorated rapidly. The causes of this relative social shift are complex, but people who are suffering rarely want to hear about complexity. As the world becomes more complex, people naturally crave simplicity. Simplicity is reassuring when the world is hard to comprehend. All too often, this is a situation that encourages scapegoat economics. The simplicity of blaming the personal loss on a minority group can be very appealing: "It is not my fault I lost my job, immigration took it away".

The world is already moving towards scapegoat economics, and the natural political response of prejudice politics ("Vote for me, we will build a wall and keep them out"). The so-called culture wars evident in several democracies are one example, where groups in society are demonized as being unnatural, unfair in their behavior, or in some other way worth "less than" the majority. To someone who has lost social and economic status as a result of the changing world, there is a perverse desire in seeing another group as being "beneath" you. In parts of the world, culture wars can produce deadly consequences.

Prejudice politics is a serious threat to democratic societies. It is also a disproportionate threat in the world of finance. The financial services sector depends, more than most parts of the economy, on what economists so clinically refer to as "human capital". From the relationships of wealth management to the ingenuity of financial engineering it is the quality of the people that matters. Finance requires having the right person, in the right job, at the right time. In a world of prejudice politics, irrational barriers may prevent the right person from being in the right job. These barriers may be formal, with regulation or laws that otherwise create obstacles to movement. Restrictions on immigration are a challenge for a global, skills-based industry like the financial services sector. Just as worrying, these barriers may be the insidious obstacles created by unconscious bias in a society where prejudice is more pervasive and irrelevant personal characteristics take precedence over merit.

> *"The challenges for finance from the wider social changes are certain to be more important than the nefarious world of crypto, or automated investment advice."*

Modern finance requires a high degree of labor flexibility, both geographical and between different roles in the workplace. It is possible that geographical mobility becomes less important in the future as flexible working grows, but the regulation of the financial services sector rather argues against this. Regulators tend to want financial professionals where they can see them, even if there is no actual justification for locating someone in a specific geography. The European Central Bank's insistence that financial personnel move to Frankfurt in the wake of the E.U.-U.K. divorce is a telling example.

Moreover, the financial services sector is a part of the economy that very clearly benefits from diversity amongst its decision-makers. Research in the U.S. shows that workers in financial services firms are paid around 30 percent more than those in less diverse firms. This performance premium reflects the benefits of challenging opinions and examining opportunities and risks from multiple perspectives. A monoculture of thinking is a risk in any economic environment. In a period of structural change, a monoculture of thinking with a tendency to extrapolate from past experience is likely to be a blueprint for failure. The potential for failing to identify new opportunities is obvious. More concerning is that a lack of diversity will obscure serious risks for the financial services sector.

2.1 What prejudice politics means for finance

The financial services sector is not a passive player in the process of structural change. As society reshapes itself, the labor force on which the financial services sector depends will be reshaped. This matters more to finance than to other sectors, because finance is more dependent on the talent of its people. Technology is not going to lessen that dependence on human talent and diverse opinions – if anything it is going to increase it.

3. GLOBALIZATION, DEGLOBALIZATION, AND FINANCE

Finance is still very much a global industry. While the global financial crisis triggered a retreat from globalization into regionalization (or, indeed, bankruptcy) for some, many banks and asset managers continued to operate in a global sphere. Today's economic revolution offers a threat to this global financial model with an increase in economic and general nationalism. Global firms, in any sector, become targets for such nationalism. The tendency is to see this through the lens of government regulation – sanctions, tariffs, and similar measures. That is certainly a threat to the global financial model. But the threat extends beyond just political gestures.

Prejudice politics lends itself to economic nationalism. "It's all the fault of the foreigner" is an argument that has been a politician's excuse for economic problems for centuries. The 1436 bestseller "Libelle of Englyshe Polycye" firmly laid blame for all England's economic woes on the Italians. Economic nationalism can be wielded against all sorts of companies, of course, but the global nature of financial markets renders firms in this sector particularly vulnerable to barriers being imposed. Because the financial services sector is heavily regulated, regulatory barriers to operating globally are a particularly difficult problem. Regulations in different countries do not have to sympathize with each other, and while governments no doubt aim to achieve financial stability in their regulatory regimes it would be naïve to suppose that national interest is not also going to shape the rules that are in place.

These factors mean that an increase in economic nationalism is likely to have financial firms in scope, particularly in the application of non-tariff barriers to trade.

A further challenge from economic nationalism for the financial services sector is the specific field of financial research. Economic nationalism aligns to pure nationalism – and raises potential tensions for a global financial institution. Financial firms have a duty to provide their clients with

objective research. Inevitably that research will be critical of an economy from time to time. Such criticism may fall foul of economic or general nationalism. Certain governments do not like their policies being criticized. Instinctively, this resistance to criticism is attributed to authoritarian regimes, but it can also apply in democracies (where a government's political opponents may seize on research from the financial services sector to further their own agenda). The risk is that by providing independent research for the benefit of their clients, a firm may be subject to barriers to doing business in a country. This can range from exclusion from government deals, to the more serious persecution of a financial firm's employees within the country.

The choice for a financial firm cannot (or should not) be between independent research and research that follows a "party line". But the choice may have to be between independent research that may threaten the conduct of business in a specific country, and not publishing any research on that country. If financial services firms fall silent on parts of the global economy (at least from the perspective of their clients), it diminishes the benefits of being a global financial institution.

While it is easy to characterize nationalism in terms of the nation state, it is worth remembering that economic nationalism may also be practiced by customers of a financial institution. If the world fragments further into nationally motivated spheres of influence, it can become more difficult for financial firms to operate globally. The idea of global values or a global culture within a firm is important, especially in an industry that is so dependent on human capital. But this immediately throws up a challenge – the values of a firm may win the support of its employees and be consistent with the best arguments of economic efficiency, but still be viewed as a challenge to the nationalism of certain groups. For example, support for LGBTQ+ rights is likely to be in the interest of a financial services firm that wants its employees (including the 10 percent or so who will be LGBTQ+) to be as productive as possible and able to work wherever they can contribute most to the firm. At the same time, this stance will be attacked, or even illegal, in certain countries around the world. Indeed, this can extend to sub-nationalism, as the attacks on the values represented by sustainable investment by individual states in the U.S. have demonstrated.

It might be tempting to suggest that financial services firms should simply adopt a neutral stance in the face of such threats. This is not practical, however. Shareholders, employees, and clients increasingly require firms (particularly global firms) to have clearly elaborated principles. Neutrality is increasingly treated as opposition to one's own view, especially when run through the binary filter that social media so often represents.

3.1 What challenging globalization means for finance

Finance remains a global industry, at a time when global firms are being increasingly challenged. The acceptance of a higher regulatory requirement in finance renders the sector peculiarly vulnerable to deglobalization forces, as regulation is often used as a cover for economic nationalism. Like other global entities, financial services firms face the challenge of consistently applying basic human values to a complex global environment.

4. CAPITAL CONTROLS AND FINANCE

While deglobalization threatens financial services firms as global entities, challenging global capital flows threatens the instruments by which financial services firms make money. Perversely, this attack can work on both capital outflows and capital inflows.

Attacking capital outflows is nothing new. Hoarding capital in the domestic economy was a well-established trend of the mercantile era before the 20th century, and indeed has lingered on in several parts of the world into the 21st century. Economic nationalism naturally lends itself to this policy of hoarding. The idea is simple – money should be invested domestically, because that is what should be prioritized. "America First", a policy slogan with a history dating back over a century, is a recurring instance of the idea of hoarding capital. As an idea, it is far from unique to the U.S.

Attacks on capital outflow have extra resonance when they are tied to the movement of production, and thus employment. This circles back to the scapegoat economics arguments.

At the same time, economic nationalism can impose restrictions on capital inflows. Here, the focus is ownership of "our" assets (generally using a very imprecise idea of what "ownership" actually constitutes). The U.S. was very critical

of Japanese purchases of U.S. assets in the 1980s. Today there are wider global concerns about Chinese purchases of overseas assets. A range of reasons are offered – state support for the purchasing investor and national security are often cited. Infamously, the French government considered yoghurt to be a strategic national asset, to prevent foreign capital acquiring dairy firms.

Attacks on both capital outflows and capital inflows are most common in the government sphere. There can even be outright prohibitions on capital flows (most common under the national security excuse). There may also be capital controls, tax penalties, or, of course, disproportionate tax incentives to keep the money at home.

There is also a non-government role around capital flows. Media and public opinion can do damage to a company's brand reputation if the company's investment strategy is cast in a sufficiently negative light. Retail investors tend to have a "home country" bias in their personal investment strategies, and that can enhance the parochialism of popular opinion when it comes to capital flows.

Obviously, attacking the flow on which the financial services sector depends is something that adds a risk to financial firms. Contingency plans need to be in place to deal with the threat. Firms need to be agile enough to deal with sudden restrictions, and to be able to adapt their business to the risk of irrational limits on capital transactions. Investment firms, in particular, need to be prepared to explain and defend their international investment decisions to both a domestic and an international audience.

4.1 What capital restrictions mean for finance

Restrictions on global capital flows is a policy that comes in and out of fashion in financial markets. It certainly seems likely that the risk of restrictions will increase as economic nationalism takes hold. In these circumstances, financial services firms face increased uncertainty about where and how they can undertake business, and will have to adapt their strategies accordingly.

5. CONCLUSION: FINANCE IN REVOLUTIONARY TIMES

While the glamour of fintech is seductive, it is unlikely to be financial services sector technology that is the most disruptive aspect of the fourth industrial revolution. The financial services sector needs to consider the real-world changes and how the social and political response to those changes will shift the risks that surround finance.

Obstacles to employment are increasing between countries, and indeed within countries as groups in society are demonized. Global firms of any nature are subject to attack, and the financial services sector may face increased struggles in the face of economic nationalism. The capital flow that is the raison d'être of the financial services sector is also subject to specific attack, whichever way it is flowing.

How can financial firms respond to this? There are two obvious approaches. The first is to make the economic case for sensible policy responses. Financial services firms are particularly damaged by prejudice politics, and it is appropriate for them to take a stance. Explaining the negative economic consequences of economic nationalism and increased uncertainty can help sway the arguments in favor of a more rational course of action. As the consequences of social policy bleed into economics, it may well become necessary for financial services firms to specifically opine on social issues.

It could be argued that in acting in this fashion, the financial services sector is tackling the symptoms of the problem, not the cause. This is true, but the symptoms are sufficiently corrosive as to warrant urgent treatment. More controversially, the financial services sector might consider attempts to tackle the root causes of the problem. This is not to stand like modern day Luddites in defiance of technological progress. Rather, the financial services sector can look at ways to mobilize capital to have a wider impact in society. There are economic arguments for investing beyond the mechanical output-based approach that is represented by gross domestic product and similar measures. Mobilizing and directing capital in a way that helps maximize the benefits and minimizes the costs of the fourth industrial revolution so as to generate the most beneficial impact for society may be the most important consequence for the financial services sector of these revolutionary times.

ABOUT CAPCO

Capco, a Wipro company, is a global technology and management consultancy focused in the financial services industry. Capco operates at the intersection of business and technology by combining innovative thinking with unrivalled industry knowledge to fast-track digital initiatives for banking and payments, capital markets, wealth and asset management, insurance, and the energy sector. Capco's cutting-edge ingenuity is brought to life through its award-winning Be Yourself At Work culture and diverse talent.

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