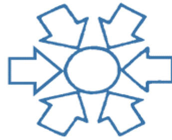
Caught in the Cross-Fire:
Foreign Banks, Geopolitical Risk, and What Comes Next



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- Globalization is the core construct of cross-border banking, but political consensus in many nations now opposes it. The return to isolationism thus redefines the strategic and regulatory framework for international finance, especially in the U.S. where geopolitical risk often comes with the speed of just one tweet.
- Growing geopolitical tensions have led to increasing use of "soft" power – i.e., economic sanctions, currency restrictions, financial-market barriers, and other weapons that realign global finance with sudden, often destructive force. Banks are thus forced into the line of fire.
- Post-crisis regulation and risk management have created formidable buffers to every risk but near-term and structural geopolitical dangers. However, geopolitical risk can be both managed and mitigated.
- Given the importance of dollar-clearing and the overall U.S. financial market, FBOs are critical analytical and geopolitical-risk management resources for parent banks.

Thank you, Briget, for inviting me to speak this afternoon to the IIB's board. This is a distinguished group of senior bankers from across the globe working at institutions that make an important difference to U.S. economic growth and global competitiveness. The tricky bit, as we'll discuss, is now to ensure that

this continues without sudden disruption, unanticipated compliance and reputational-risk challenges, or policy barriers to organic expansion, product development, technological innovation, and even M&A.

I have been advising global banks, central banks, and other international-financial institutions for more years than it will be polite for you all to recognize. I started my career in the 1980s during the last all-out trade war between the U.S. and a major nation with spillover impact on banking and global finance. Then, the global consensus was strong enough that the U.S. wreaked its vengeance on Japan not by restricting market access, but by persuading other nations to craft the first Basel capital standards. In essence, this was a globalized solution curtailing banks powered by home-country regulatory advantages, a solution that lasted until just about now.

Plowing on with all their peer reviews, consultative reports, and standards, global regulators often seem as blind-sided by the new political landscape as bankers. Just last Sunday, the Financial Stability Board assured G20 finance ministers and central bankers that the post-crisis regulatory framework is almost fully in place to the benefit of a remarkably-resilient global banking sector.[1] Although Basel III binds, the Financial Stability Board stipulates, and other global financial regulators carry on, the world of 2019 is structurally different than 1989. Financial regulators and financial institutions are still firmly committed to globalization. It's just heads of state and voters who aren't anymore.

For many of us, this is simply so far beyond our long-established way of thinking that we fail to anticipate or mitigate risks such as those following President Trump's decision to shut down the federal government on a seeming whim or to redefine the Middle East with a tweet. Similarly, who would have anticipated the idea that the U.K. could leave the European Union or that what Vladimir Putin last week described as the *Pax Americana* would be broken to the bits he celebrated on a podium with Philippine President Duarte. Clearly, the neoliberal order on which much of the global financial market rests is being shaken to its foundations.

This does not, however, mean that cross-border banking is so beset with risks that it's time to head to the bunker. Instead, it means it's time for a new cross-border risk-management and corporate-development focus on geopolitical risk. Let me first explain why this is of paramount importance in the U.S. as we head into the 2020 election and then turn to a paradigm for geopolitical risk management designed for foreign bank executives already dealing with complex policy challenges in concert with head offices often wrestling with home-country geopolitical risk of equal magnitude or worse.

The U.S. Outlook

Nationalist, populist, and progressive governments aren't unique to the U.S. However, as we are all based here, let me focus on challenges to global finance posed by the current U.S. political outlook. These are significant, and not just because President Trump came into office and to this day stands by his "America First" agenda. Conventional wisdom thought he couldn't win, conventional wisdom thought he didn't mean to be as populist as he is, and conventional wisdom still doesn't think he'll do much of what he's done. But much of what Mr. Trump does is due not only to his personal style, but also to a deep understanding that – like many other nations – the U.S. was changing profoundly up to 2008 and then was radically redefined by the great financial crisis of 2008. Understanding this and projecting its implications is key to effective geopolitical risk management.

The great financial crisis made the U.S. far more unequal far faster than ever before. Although America's legend is founded on equality and most Americans think they are middle-class, the U.S. is in fact the most unequal advanced economy in the world.[2] According to the U.S. Census Bureau,[3] U.S. income inequality is now the highest it's been since records began in 1967. The wealth of the top ten percent is 19 percent higher than it was before the crisis, even taking occasional stock-price declines into account. In sharp contrast, middle-income family wealth is still below where it was before the financial crisis and lower-income families lost 16 percent of their pre-crisis wealth (not much to start with, of course).[4] Further, the average wealth of the top ten percent is 13 times higher than that of the middle class; it was only 7 times higher in 1989 when inequality had already been rising for at least a decade.[5]

Given all this, it's unsurprising that the Democratic, progressive base is at least as protectionist as the Republican, populist one that empowers President Trump. Elizabeth Warren's "economic patriotism" platform speaks for many Democrats even though it differs from President Trump only in rhetoric, not substantive recommendations.

Both President Trump and Sen. Warren want to insulate the U.S. from China and, indeed, from other nations whose trade policies they think disadvantage U.S. workers. Each wants to use the value of the dollar as a weapon. Only Sen. Warren so far wants to break up diversified banks, but Donald Trump ran on an anti-Wall Street agenda and is likely to do so again, especially if the U.S. economy weakens. Both oppose Federal Reserve policy as insufficiently accommodative and both decried Libra and much in the new fintech framework. Neither is alone on these and other positions where populism and progressivism are indistinguishable.

2020 does, though, seem years off even though it's barely two months away. As we saw just last weekend, President Trump can upend U.S. policy with just a tweet. This realigns sanctions, reconfigures financing flows, presses the Fed to more accommodative policy that presses rates ever lower, adds volatility to repo- and other market-stability risks, and overall makes it hard to think about next November. The one coming up in two weeks is already sure to be fractious, volatile, and risky – and that's only if we're lucky.

Managing Through Mayhem

I do not need to tell any of you about all of the post-crisis rules that give the FSB so much comfort. Each of you has wrestled with credit, liquidity, market, compliance, strategic, operational, and reputational risk demands from U.S. and home-country regulators along with all the work needed to build out new risk-management frameworks. It is thus exhausting to consider the need now also to ensure effective geopolitical-risk management. Given that regulators have yet to demand it directly or via stress testing, it's also tempting to let this one go. Tempting indeed, but also dangerous given the global framework, impending elections, a looming economic downturn, and the profound shift in voter sentiment epitomized in the U.S. data on economic inequality. The U.S. should be at its most agreeable given historic employment, continuing growth, and low inflation. However, we are restive, disgruntled, polarized, and often even bitterly angry about those we think took away the prosperity to which we think we are entitled. Those now running for the White House hear these voices; those running U.S. banks must do the same to protect franchise value at so challenging a time.

In 2014, Federal Financial Analytics issued a brief guide to geopolitical risk.[6] Sparked by Russia's Ukraine invasion, many of the sanctions we anticipated came to pass in concert with still more compliance and reputational risk. However, the Obama Administration and many other national governments were then fundamentally committed to the global order; now, they're not.

As a result, the geopolitical risk-mitigation strategies we outlined then are even more urgent today. I actually started my career in geopolitical-risk management due to my background as an academic political scientist. Then as now, most geopolitical-risk management focused on fixed physical infrastructure due to the long-time horizon needed to recoup investment. Secure in market commitments to global finance, geopolitical-risk management at most banks confines itself to emerging markets and often focuses only on the extent to which corruption risks pose home-country legal liability. However, while geopolitical risk for fixed investments is a long-term hazard, these companies often have ample time to see it coming. Since money moves at the flip of a finger, banks don't.

As a result, effective geopolitical-risk management is essential even in the most advanced, law-abiding regimes. For example, sanctions and AML compliance in the U.S. involves not just knowing which entities now are off-limits, but which are likely to join them. Failing now properly to identify later geopolitical targets can expose a company to considerable administrative stress or far, far worse. As you know, OFAC has recently expanded the scope of sanction reporting and the deadlines by which it must be done.[7] I think it reasonable to expect that the penalties for sanctions violations linked to a country that has embarrassed or enraged President Trump will not only carry considerable legal and reputational risk, but now also franchise-threatening political danger.

However, geopolitical-risk management addresses more than avoiding harm; it also preserves opportunity. The U.S. for all its geopolitical risk is a nation with low macroeconomic risk and, at least for a while, positive interest rates. With the regulatory flexibility you won in the new "tailoring" rules, many of your banks now have considerable scope for U.S. organic growth, new-product offerings, and M&A. When the Fed finalizes the pending "control" rules,[8] this scope will increase and the opportunities for innovative offerings become still more appealing.

However, anything bolder than organic growth requires advance understanding of potential geopolitical hazard. Indeed, current tensions complicate even seemingly innocuous transactions with nations as tied to the U.S. as Canada or Great Britain. Thought must be given, for example, to the extent to which the U.S. will try to use countervailing duties on foreign-currency transactions and then to how valuation changes affect anticipated return. The politics of the 2020 election also present risks for foreign banks of any nation when politicians are looking to score populist and progressive points. No one is a safer target than a foreign bank – you don't vote here, you're a bank, and your parent company is probably big.

So, what to do?

First, I recommend scenario analysis with a geopolitical focus so that you are not caught off guard by sharp reversals in U.S. domestic or foreign policy. You cannot of course prevent new sanctions or other barriers to cross-border banking, but you can see them coming and protect yourselves and your customers. Just because geopolitical risk isn't mandated in regulatory stress tests doesn't mean that scenario analysis doesn't work for geopolitical-risk identification and mitigation. It does – for example, if you forecast ahead of time which countries or counterparties are likely sources of geopolitical risk from

a U.S. perspective, then you can ensure you know how quickly to come into U.S. compliance. You are also then best able to anticipate geopolitical speed-bumps to new opportunities, pricing them in from the start.

Secondly, political advocacy is essential to the extent it's appropriate. As foreign banks, your place in U.S. political discourse is different, but IIB has been a very effective voice for the industry and for your head offices.

Finally, the global financial sector must take geopolitical risk as seriously as it takes the other, better-known risks redefining bottom-line strategies. Earlier this month, a United Nations Task Force spoke for many voices in a wide range of countries arguing that global finance had become so destructive to social welfare that governments should step in wherever private finance cannot validate the benefits of its own financial-intermediation services.[9] Many of your companies now are focused on sustainable, "green" finance, but this has not quelled proposals for central-bank digital currencies, Libra-style nonbank payment services, and many other proposals with far-reaching, adverse impact on the ability of global banks to continue to provide the cross-border financial services on which franchise value is premised.

Real change may seem a long way off, giving you time still to worry about quarter-over-quarter profits, but geopolitical risk has a nasty way of sneaking up on us. It will be hard – indeed, it will be impossible – to put global banking back together again if these structural, geopolitical forces tear it apart.

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[1] Financial Stability Board (FSB) Chair Randal K. Quarles, *Letter to G20 Finance Ministers and Central Bank Governors*, (October 13, 2019), available at https://www.fsb.org/wp-content/uploads/P131019.pdf.
[2] Carlotta Balestra and Richard Tonkin, "Inequalities in household wealth across OECD countries: Evidence from the OECD Wealth Distribution Database," *Organization for Economic Co-operation and Development (OECD) Working Paper No. 88*, 14-15 (June 20, 2018), available at http://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=SDD/DOC(2018)1&docLanguage=En.
[3] U.S. Census Bureau, "American Community Survey Provides New State and Local Income, Poverty and Health Insurance Statistics," *U.S. Census Bureau Press Release Number CB19-152*, (September 26, 2019), available at https://www.census.gov/newsroom/press-releases/2019/acs-1year.html.
[4] FRB Gov. Lael Brainard, "Is the Middle Class within Reach for Middle-Income Families?," (speech, Washington, D.C., May 10, 2019), available at https://www.federalreserve.gov/newsevents/speech/brainard20190510a.htm#fn16.
[5] *Ibid*.
[6] Federal Financial Analytics, *Message from Sevastopol: Geopolitical Risk Analytics and Mitigation Methodologies,* (March 11, 2014), available at http://www.fedfin.com/images/stories/client_reports/Geopolitical%20Risk%20Analytics_FedFin_3%2011.pdf.
[7] Office of Foreign Assets Control, Reporting, Procedures and Penalties Regulations, 31 CFR § 501, 84 Fed. Reg. 29055 (June 21, 2019), available at https://www.govinfo.gov/content/pkg/FR-2019-06-21/pdf/2019-13163.pdf.
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[9] Simon Zadek and Tillman Bruett. "Harnessing Digitalization in Financing the Sustainable Development Goals," *The United Nations Secretary-General's Task Force on Digital Financing of the Sustainable Development Goals*, (September, 2019), available at https://digitalfinancingtaskforce.org/wp-content/uploads/2019/09/Task-Force-CoChair-Interim-Report.pdf.