



FINDING BALANCE

THE POST-COVID LANDSCAPE FOR FINANCIAL INSTITUTIONS

August 2020

First of ten parts



PART 1

INTRODUCTION

Welcome to the first of a series of 10 briefings where we discuss how COVID-19 will affect financial institutions and its impact on current industry trends. We reference the views of external commentators as well as sharing our own opinions. Please bear in mind that these represent our current views based on hypotheses that may change in a rapidly developing situation. Doubtless there are other perspectives.

Financial institutions must now navigate not only an economy in recession, but one where COVID-19 is disrupting business models and accelerating existing trends such as digitalisation and the importance of environmental, social and governance factors.

Arguably, in the face of lower revenues and with “disrupted” business models, organisations must now reset their costs to a level that allows them to be profitable in changed circumstances. Moreover, the pandemic affords them an opportunity to embark on radical change namely, “to completely (re)define how they want to operate in a post-pandemic world.”¹

¹ Oliver Wyman, How Financial Institutions Must Redefine Their Cost Structures, 27 April 2020.

Setting the scene

Although the COVID-19 health emergency with its lockdown and social distancing is driving the current downturn, the economy was already slowing prior to the outbreak.² For financial institutions whose failings were central to the 2008 financial crisis, because of the regulatory reforms of the last decade concerning transparency and prudential strength, they could be instrumental in the economic recovery alongside governmental fiscal and monetary stimuli.

Global GDP forecasts have been slashed and most regions are entering recession with the exception of China, where growth for 2020 is likely to reduce to a historical low of around 1% compared to recent growth rates of 8%. Global GDP is forecast to decline by 4% in 2020 - worse than in 2008. The contraction is likely to be deeper in the euro-zone at -8% compared to -4.5% in North America.³ Different sectors will fare better and worse. The winners include: grocery, video games, sportswear,

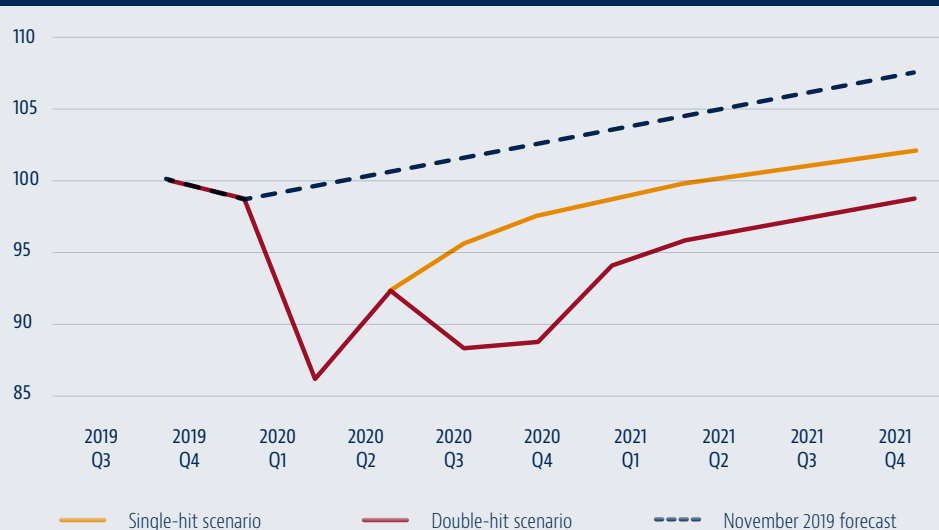
semiconductors, payments, internet, software, biotech & spec pharma, telecoms and IT hardware. The losers: airlines, luxury goods, fast fashion, beauty, travel & leisure, fitness, real estate, foodservice distributors and restaurants.⁴ Services will be amongst the worst affected. Those financial institutions most exposed to these sectors and regions will experience the greatest impact on their business.

When and what sort of recovery will we experience? Some commentators believe we are heading for a deep recession but do not think that the "hangover" will last long.⁵ For them COVID-19 is a Black Swan event coming out of nowhere, while the 2008 crisis developed out of decade long imbalances leaving a substantial debt burden in its wake.⁶ Less optimistically, most though consider a "V" shaped recovery is unlikely.⁷ Rather recovery will be more gradual taking the form of a "Nike swoosh." Others more pessimistically point to a "L" shape, where GDP does not recover to pre-crisis levels for many years - for example, containment policies are partially effective and lockdowns need to be repeatedly re-imposed. It is also important to recall that COVID-19 concerns demand and that simply relaxing the lockdown will not automatically lead to increased activity as public health fears may remain.

Research from previous pandemics show that the effects are most strongly felt in the tertiary sector - the service industries - which includes financial institutions. A good example is the impact of SARS in 2003 on GDP growth in China. The impact on financial institutions was the second highest, with only transportation being worse affected. Some industries rebounded quickly - notably industrials, hospitality/food and beverage, and transportation. Others, such as the financial sector, took longer to recover.⁸

A collapse in output followed by a slow recovery

World GDP, index 2019-Q4=100



² EY, Why private equity can endure the next economic downturn, March 2020.

³ Economist Intelligence Unit, Covid-19 to send almost all G20 countries into a recession, 22 May 2020.

⁴ See Jefferies Global Equity Research, Covid's Impact: How Will We Live, Work & Play?

⁵ Bank of England, Opening Statement, Joint Financial Stability and Monetary Report, 7 May 2020.

⁶ See Goldman Sachs, Top of Mind, 24 March 2020.

⁷ Financial Times, The week business waved goodbye to the V-shape recovery, Tom Braithwaite, 1 May 2020.

⁸ Bain Brief: Beyond the Coronavirus Crisis: Prepare Now.

EFFECT ON FINANCIAL INSTITUTIONS SEGMENTS

At the beginning of the COVID-19 crisis financial institutions faced two main challenges. First, prudential: a sudden drop in the value of financial assets, or loss of liquidity, whether domestically or elsewhere in the world. Much of the initial falls on financial markets have since been reversed, but asset valuations in the worst affected parts of the economy are significantly down. The second, operational: the failure of systems and controls that underpin the financial system in the face of operational risk reflecting inadequate resilience. By and large, with the reforms enacted since 2008 most financial institutions have performed well - in fact in certain respects surpassing regulators' expectations!

A longer and more protracted recession has implications for financial institutions as it does for other sectors of economy. At a high-level while organisations remain well capitalised, the position could deteriorate. Banks will face increasing levels of non-performing loans with corporates drawing down pre-existing credit lines; private equity will face calls to support their portfolio companies; with funds and insurers experiencing lower levels of returns on their market investments, with potentially, higher levels of redemption requests raising liquidity issues and possible "fire sales."

PART 2

Banking - Retail, Commercial And Investment

Thanks to the higher prudential standards put in place by Basel III and state-backed loans and grants for corporates (administered by banks), significant corporate failure impacting balance sheets has been avoided for now. Systemically important banks will not need to raise more capital, but weaker, smaller banks, still feeling the effects of 2008, are likely to do so in due course. Many banks will see a fall in income caused, variously, by reduced retail consumer spending, fewer assets under management, together with a reduction in investment banking activity.⁹ In commercial banking, lending to travel, tourism, and entertainment will be worst affected - as will oil and gas sectors - much due to reduced consumption, geo-political factors and sustainability policies.

In the aftermath of a crisis, enforcement and compliance activity usually increases. There is the analogy of the tide going out to reveal wrongdoing that was hidden by business as usual activity. What this means is that while such activity is currently low - in part because supervisors are focusing on other priorities (e.g. ensuring customers are protected, that markets continue to function well, financial stability and the availability of liquidity) - this is likely to change quickly when business begins to recover.



⁹ McKinsey & Company, Leader in the time of coronavirus: COVID-19 response and implications for banks, March 2020.

PART 3

Insurers

Solvency coverage ratios for general and life insurers are generally healthy.¹⁰ Insurers are likely to encounter relatively moderate business disruption and travel insurance claims given policy exclusions, although where there is ambiguity - especially over business disruption losses - there is scope for higher payouts and litigation in the future - particularly in the US.¹¹ There are signs, internationally, that regulators are being proactive with regard to coverage issues.

The UK Financial Conduct Authority, for example, intends to seek declarations in the courts over the meanings of insurance terms and conditions, with a view to quickly resolving ambiguities. Additionally, there is a significant risk of loss of value on invested investment insurance premiums - with life, as opposed to general insurers most affected, due to market volatility especially in case of new outbreaks and lockdowns, that could promote industry consolidation in the medium term.



¹⁰ Willis Towers Watson, Covid-19 Willis Re Report 1st Edition, 23 April 2020.

¹¹ Financial Times, Old school trading under threat as insurers rethink life at Lloyd's, 13 May 2020.

PART 4

Financial Sponsors: Asset Management / Private Equity / Sovereign Wealth Funds

Sovereign wealth funds face similar issues as do private equity and the asset management / pension funds sectors, but because of their deeper pockets, they are better placed to take advantage of the crisis to acquire stakes at discount.

A key issue for the sector is liquidity in the light of potential redemptions. Investors may seek to redeem their holdings and, therefore, careful management of liquidity risks that come with large outflows will be needed to avoid the forced sale of assets. For the moment, markets have stabilised and rallied, although further volatility could be seen as markets react to the continuing progress of the COVID-19 pandemic and its effect on the economy - especially over predictions about the type of recovery.¹²



¹² Bank of England, Speech, Seven Moments in Spring, 4 June 2020.

PART 5

Financial Market Infrastructure

Banks and other financial institutions rely upon financial market infrastructure to ensure the provision of financial services, for example, central counterparties and payment systems. The COVID-19 crisis has seen very significant demands placed on market infrastructure, whether it be trading venues, clearing or payment systems.

On the whole FMI has shown resilience and performed well under stressed conditions.¹³ Regulators have been reviewing contingency plans and assessments of operational risk.¹⁴ It is likely that payment systems such as card schemes will have lower expectations for revenue growth. In particular, credit card transactions have declined, as most travel activity has stopped.



¹³ Bank of England, Opening Statement, Joint Financial Stability and Monetary Report, 7 May 2020.

¹⁴ Bank of England, Statement to the Treasury Select Committee, 3 March 2020.

IMPACT ON KEY INDUSTRY TRENDS

To understand the emerging landscape for financial institutions, it is crucial to look at the impact of COVID-19 on existing global industry trends. To what extent are they reinforced or are now less relevant?

PART 6

Rising Global Indebtedness

The trend continues - but will there be a reckoning? In recent years a global investment surge has driven a rising debt burden, which combined with ongoing economic disruption, has created the conditions for rising debt defaults. The lockdowns imposed by many governments to tackle the public health emergency, the consequent disruption to supply chains and the reduction in demand for those corporates whose business models are most impacted by social distancing, will almost certainly trigger defaults and bring their viability into question. In the initial stages, a combination of employee retention schemes, loans, tax holidays and stays on litigation and new insolvency procedures, have placed business on life support. A further unknown concerns the path of interest rates in the future that are at historic lows.

This means that there will be significant credit losses for commercial banks that must agree to either restructure debt or write off much of their exposure. Private equity could be even more exposed through their portfolio companies than banks, which are more constrained in their lending by regulation. For corporates with weak balance sheets, additional borrowing is unlikely to be sustainable despite further reductions in the central bank base rates. To survive, new equity is likely to be required.¹⁵



¹⁵ TheCityUK, Recapitalising the post-Covid-19 economy, 11 May 2020.

PART 7

Shadow Banking

Shadow banking will become even more important. The term refers to where a variety of institutions, other than banks, provide finance to companies without intermediaries and which encompasses what is known as alternative lending by private equity. According to the Financial Stability Board's annual 2019 report, non-bank financial intermediation now represents 13.6% of total global financial assets. Of note, investment funds and money market funds are also large providers of short-term credit to banks. The shadow banking sector has benefitted from over 10 years of ultra-low interest rates leading institutional investors to search for higher yield. COVID-19 will prompt corporates to seek funding for their recovery and renewal. The speed and flexibility enjoyed by shadow banks over traditional lenders is likely to boost their market share further.

But the sector is exposed to risks. Its rapid growth, demonstrated by increasingly competitive lending, can tempt lenders to engage in excessive risk-taking or writing business outside their core markets. Naturally, as the economy goes into recession, credit quality will deteriorate and defaults will increase. Funding and liquidity pressures may see a reduction in the availability of wholesale financing and/or a mismatch between asset maturities and liabilities (e.g. forced sales by open-ended funds).¹⁶



¹⁶ Bank of England, Speech, Seven Moments in Spring, 4 June 2020.

PART 8

Increasing Regulatory Scrutiny

The trend continues and looks to be gaining added impetus. Over recent decades, especially since the 2008 recession, we have seen an increasing incidence and effectiveness in the regulation and supervision of financial institutions. The trend towards requiring organisations to act in their clients' best interests over and above strict contractual obligations - paying close attention to their regulators' expectations - has received added impetus in light of the flexibility and forbearance towards customers, which was required of the sector in the opening stages of the lockdown.



PART 9

Impact of New Technology

Technology is transforming banking and financial services by opening up the sector to competition, introducing new services and disrupting incumbent business models. While accepting it is impossible to predict what may happen, TheCityUK notes that “we are already seeing the way people think about and use digital technology undergoing a radical transformation.”¹⁷

The immediate impact of COVID-19 is to boost existing trends, for example, digitalisation and the remote delivery of financial services. According to the European Central Bank, COVID-19 is accelerating digital transformation in banking. The ability to cut costs through technology will be especially important as the number of non-performing loans grow and, in Europe, low rates of return for banks are squeezed even further. It is here that small virtual-only banks benefit from cost efficiencies, providing significantly higher rates of return than traditional banks.¹⁸

Less happily, with so many in the financial sector working remotely, there is an enhanced risk of cybercrime - especially for banks transferring processes to contingency environments running on outdated security systems.¹⁹ For many financial institutions, cyber-attack is the highest operational risk they face as they hold so much sensitive (financial) data of great interest to hackers.



¹⁷ TheCityUK, Enhancing the UK's Approach to Innovation in Financial Services, 7 May 2020.

¹⁸ European Central Bank, Pentti Hakkarainen, The Supervision Blog, 8 May 2020.

¹⁹ European Central Bank, Pentti Hakkarainen, The Supervision Blog, 8 May 2020.

PART 10

Sustainable Financial Institutions

Over the medium term, all aspects of environmental, social, and governance (ESG) will become more important. The crisis brought home the importance of ESG concerns - not only environmental - also but social and governance issues. This has risen up the public agenda as well. Successful financial institutions will likely have embedded sustainability within their prudential frameworks and have taken advantage of their favourable regulatory treatment to improve their competitiveness. More generally, corporates that have stronger, more resilient business models, especially taking into account their ESG footprint, may represent better value partners to financial institutions in the longer term and, therefore, more deserving of equity or loans to survive the economic downturn.





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