Baker McKenzie.

# FINDING BALANCE

## THE POST-COVID LANDSCAPE FOR FINANCIAL INSTITUTIONS

### Banking

Part 2

Resilience Recovery Renewal

# Overview

Welcome to the second in a series of briefings about how COVID-19 will affect financial institutions and its impact on current industry trends. In this issue, we focus on banking. 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. As always, there are doubtless other perspectives.

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 failures impacting balance sheets have been avoided so far. Systemically important banks will not need to raise more capital in the immediate term, but weaker, smaller banks, still feeling the effects of 2008, are likely to do so in due course. Many banks are seeing a fall in income caused, variously, by reduced retail consumer spending and fewer assets under management, although despite initial predictions investment banking activity has bucked the trend.[1] Among the worst affected sectors in commercial banking are travel, tourism, entertainment and fossil fuels, due to reduced consumption, geopolitical factors and sustainability policies.

What will the impact be? The trends that the sector faced pre-COVID-19, increasing global indebtedness, the growth in shadow banking, the disruptive but innovative impact of new technologies and the move to a more sustainable economy, have all been accelerated. Moreover, 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. This means 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.

# BANKING — RETAIL, COMMERCIAL AND INVESTMENT

# What has been the impact?

Over 300 banking sector prudential regulatory measures were taken in March and early April across the major economies in response to the COVID-19 pandemic.[2] Their purpose was to keep credit and liquidity flowing to business through regulatory flexibility, counter-cyclical loosening (e.g., over capital buffers), and by relieving operational pressures on the financial sector. Largely, these measures have been successful at this stage.

As regulated entities, banks' resilience has been stress tested over the past decade. According to the Bank of England, the impact of the economic shock on bank losses is likely to be limited for a number of reasons.[3] A faster recovery this time than after the 2008 crisis, government intervention to limit corporate impairment, the impact of job retention schemes reducing unemployment, and steps taken to limit the number of mortgage and consumer credit defaults.

Significant corporate failure affecting balance sheets, therefore, is unlikely in the short term, except for businesses already in difficulties before COVID-19 emerged. Where corporate borrowers were highly leveraged or suffered poor cash flow before the lockdown, it is unlikely they can now afford more borrowing to survive the crisis. Some businesses have been raising more equity — financial markets remain open — or restructuring their debts, but there will be failures leading to reorganisations and insolvencies. Not surprisingly, eurozone banks have reported falling demand for loans for long-term investment while receiving a large increase in requests for working capital to cover overheads.[4] An additional factor is that in recent years a global investment surge has driven a rising debt burden that, combined with ongoing economic disruption, has created the conditions for rising defaults. This factor is now likely to aggravate credit losses.[5]

By providing support to consumers and business — drawing on their substantial capital and liquidity buffers — in marked contrast to 2008, banks are mitigating the impact on the economy as a whole and, as a result, limiting their own credit losses and protecting their capital positions. Given the Basel III international capital adequacy reforms since the last crisis, market sentiment suggests that most banks, and especially systemically important ones, are unlikely to need to raise capital to strengthen their balance sheets. That is not to say weaker, smaller banks (for example, in southern Europe), which have yet to fully overcome the effects of 2008, will not do so in the future.

While the financial impact will vary from bank to bank, many will experience a fall in income caused variously by reduced retail consumer spending, fewer assets under management, together with a reduction in investment banking activity.[6] On the positive side, with increased volatility in financial markets some aspects of investment banking have already benefited and are likely to generate trading profits this year. In light of the reductions in central bank base rates, net interest margins will remain limited and while borrowing may increase, for example, through corporates drawing down on lines of credit, gains may be offset by bad loans. In fact, credit losses are likely to be significant. In retail banking, certain retail customers are particularly vulnerable — the self-employed, the hourly paid and those with unsecured loan products. In commercial banking, travel, tourism and entertainment sectors are the worst affected, as are the oil and gas sectors, because of lower consumption, geo-political factors and sustainability policies. Although elements of some economies are bouncing back after lockdown, it is still unclear what form the recovery will take or the timescales involved. Whether it is V, U or L-shaped will become clearer with the restart of schools in the northern hemisphere, and if this is followed by renewed lockdowns affecting economic activity.[7]

# What action should banks be taking?

As a first step, management will have identified those industries and market sectors worst effected by COVID-19 through analysing and monitoring the economic environment. McKinsey & Co advocate reverse stress testing to identify the worst-case scenarios — a common regulatory requirement. Scenarios should be developed around not only the macro-economic, but also the human reaction to the disease (i.e., the willingness to socially interact) including the governmental response and intervention. Crucially, existing assumptions on which existing models are based should be revisited, as they may no longer be relevant. In the light of lower revenues and with "disrupted" business models, banks must now look to reset their costs to a level that allows them to be profitable in changed circumstances. In this way, the pandemic provides an opportunity to embark on radical change "to completely (re)define how they want to operate in a post-pandemic world."[8]

While avoiding excessive pro-cyclical effects is obviously prudent, so is a willingness to recognise non-performing loans and book losses. To date, US banks, encouraged by their regulators, are being most realistic, in contrast to EU banks that are taking a softer approach. Nonetheless, the largest UK, Swiss and eurozone lenders were expected to make at least EUR 23 billion in provisions.[9] This is important because as the 2008 financial crisis demonstrated, banks saddled with debt are less able to lend and their share valuations suffer.[10] Weaker banks in some regions, including Europe, should consider merger or consolidation. This is not a new topic and in the eurozone has been seen as a likely consequence of European Banking Union but, to date, in part, political and cultural differences have impeded such steps.[11] COVID-19 has accelerated the process and the European Central Bank is consulting on issues seen as obstacles to mergers.[12] We have already seen proposals this autumn for the further rationalisation of the banking sector in the Spanish market.

Technology is transforming banking by opening up the sector to competition, introducing new services and disrupting incumbent business models. COVID-19 is accelerating existing trends toward digitalisation, for example, though remote working and the delivery of financial products. The path toward retail branch closures continues. The ability to cut costs through technology will be especially important as the number of non-performing loans grows 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.[13] This requires new investment and, therefore, represents a cost to P&L. Operational resilience has risen up the priorities of banks and regulators in recent years, and the focus appears to have paid off. In light of the risk of future pandemics, increasing vulnerability to cyber-attack and climate change, it will remain a priority for investment and focus for banks in the future.[14]

Banks are being required by central banks to consider climate change when assessing the adequacy and resilience of their prudential strength. Together with the asset management sector, they face commercial and competitive pressure to prefer sustainable lending and investments. The voluntary recommendations of the Task Force on Climate-related Financial Disclosures (TCFD) are being supplemented by mandatory disclosure requirements, for example, under the European Commission's Action Plan on Sustainable Finance.[15]

A special mention about Chinese banks that are now significant in size. In 2019, these banks earned three times the amount of investment banking fees than their Asian competitors excluding Japan. Their share of total lending has increased from 1% in 2000 to 14% today. If China exits the economic turndown in a relatively better shape than other countries, its top tier banks may finally be a force to reckon with internationally, especially in emerging markets.[16] Other factors supporting this development are China's Belt & Road Initiative and European banks reducing their balance sheets and selling foreign subsidiaries.[17]

# What happens when the tide goes out?

In the aftermath of a crisis, it is usual to expect enforcement and compliance activity to increase. An analogy can be made to the tide going out to reveal wrongdoing that was previously hidden by business as usual activity. Additionally, stressed market conditions and laxer controls may result in a variety of forms of misconduct. The European Banking Authority refers to experience from past crises, suggesting that in many cases illicit finance will continue to flow. It says there is already evidence of increased levels of cyber-crime, COVID-19-related frauds and scams. It reminds banks and other organisations to take risk-sensitive measures to establish the origin of unexpected financial flows from customers in sectors known to have been impacted by the economic downturn and COVID-19 mitigation measures (e.g., laxer KYC for emergency loans). Banks should update their ML/TF risk assessments accordingly.[18]

In consequence, while activity on regulatory enforcement and compliance investigations 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 will change quickly when business activity returns. Banks, in common with the financial sector, therefore, should generally maintain focus on their control environment. Regulators have been clear that while some regulatory obligations, such as reporting, may be deprioritised, this does not apply to AML and conduct issues. Future enforcement and compliance activity should be seen in light of the increasing regulatory scrutiny of the sector, including the holding of individual senior managers to account. When comparing the position to 2008, that crisis originated in part because of the misconduct and excesses of the sector that is not relevant today, so the level of regulatory and compliance action may not reach the same level in the years after 2009.

# THE FUTURE CHALLENGES FOR BANKS

How will banks have changed in the future as a result of COVID-19? Clearly retail, commercial and investment banking are very different. Interest rates have been cut still further to near zero or negative levels with a view to boosting the economy. While economic recovery and growth is in the interests of banks, which tend to grow in line with the economy, they will need to offer customers more revenue raising products and services — using technological innovation, otherwise retail and commercial sectors run the risk of a low return utility status. At the same time, they must meet regulators' requirements over their resilience to climate change while they respond to investors' ESG concerns.

Arguably, banks' ability to capitalise on stronger balance sheets and high levels of regulatory scrutiny, could leave the sector better placed to lend to corporates than alternative lenders, because fewer controls over their lending could see higher levels of default. We consider, however, that shadow banks are likely to expand their market share due to better access to capital and with less regulation enjoying greater speed and flexibility. As a silver lining, we will see investment banks benefitting from shadow banking, through significant fees earned by advising on corporate issuances or underwriting them — compared to the meagre interest on loans that sit on balance sheets.[19]

Regionally, we will see US banks benefitting from earlier recognition of bad loans on their balance sheets and larger Chinese institutions beginning to spread their wings. All this could be at the expense of weaker some European banks that will retrench further with smaller balance sheets and lower profitability and — if the politics are right — seeking overdue consolidation.

# Endnotes

1 McKinsey & Company, Leader in the time of coronavirus: COVID-19 response and implications for banks, March 2020.
2 Institute of International Finance, An Aerial View of the Bank Prudential Regulatory Response to COVID-19, 28 April 2020.
3 Bank of England, Monetary Policy and Interim Financial Stability Report, May 2020.
4 Financial Times, European investment plunge raises fears for future growth, 13 May 2020.
5 Financial Times, The Leveraging of America: How Companies Became Addicted to Debt, 10 July 2020.
6 McKinsey & Company, Leader in the time of coronavirus: COVID-19 response and implications for banks, March 2020.
7 Jefferies Int'l Ltd Equity Research, European Economy: What Can Real-Time Data Tell Us?, 27 August 2020 [no link].
8 Oliver Wyman, How Financial Institutions Must Redefine Their Cost Structures, 27 April 2020.
9 Financial Times, Banks across Europe braced for further heavy loan-loss charges, 26 July 2020.
10 Financial Times, Banks Need to Prepare Now for Covid-19 Losses, 8 July 2020.
11 D Schoenmaker, The Journal of Financial Perspectives, The new Banking Union landscape in Europe: consolidation ahead?, July 2015.
12 European Central Bank, Guide on the supervisory approach to consolidation in the banking sector, 1 July 2020.
13 European Central Bank, Pentti Hakkarainen, The Supervision Blog, 8 May 2020.
14 McKinsey & Company, Leader in the time of coronavirus: COVID-19 response and implications for banks, March 2020.
15 Bank of England, Dear CEO Letter, Managing Climate-related Financial Risk, 1 July 2020.
16 AllianceBerstein.com, Are Distressed Small Banks Putting China's Banking System at Risk?, 21 August 2019.
17 The Economist, As China Goes Global, Its Banks are Coming Out, Too, 7 May 2020 [no link].
18 European Banking Authority, Statement on actions to mitigate financial crime risks in the Covid-19 pandemic, 31 March 2020.
19 The Economist, As China Goes Global, Its Banks are Coming Out, Too, 7 May 2020 [no link].

**Baker McKenzie helps clients overcome the challenges of competing in the global economy.**

We solve complex legal problems across borders and practice areas. Our unique culture, developed over 70 years, enables our 13,000 people to understand local markets and navigate multiple jurisdictions, working together as trusted colleagues and friends toinstill confidence in our clients.

Baker McKenzie.

**bakermckenzie.com**