MEMO

DATE: 17 March 2020

FROM: Oliver Wyman

SUBJECT: RESPONDING TO COVID-19: EXECUTIVE SUMMARY

The purpose of this document is to capture our latest and best view on the rapidly evolving situation with COVID-19 and the ongoing financial sector policy and bank responses to the crisis. This is a preliminary draft document that is being shared to capture the views of the industry and we welcome comments back on your experience. We expect the situation to continue to evolve at pace and will update our analysis as events unfold. For the most up-to-date analysis across a wide range of COVID developments please visit our website: http://oliverwyman.com/coronavirus.

Over the past few days we have held discussions with over 50 senior executives in financial institutions and government on the response to COVID-19 and the resulting decline in financial markets and oil prices. We observe that whilst they all have plans in place for business continuity, many have slightly different scenarios in mind to the one that is playing out with COVID-19 and are in the process of preparing for crisis management and longer-term effects. In the long-term, the economic, social, and regulatory impacts on the financial sector could be enormous over time if a severe scenario plays out.

More immediately, how organizations react during the crisis is the first concern. Poor behaviors during a crisis can significantly damage trust, with an average and sustained drop in share performance. Careful management of the immediate, as well as the longer-term, is critical.

As the number of cases of the Coronavirus (COVID-19) increases, the focus of companies must be on limiting the direct impact on employees and customers whilst supporting efforts to limit the spread of the virus. The healthcare sector, airlines, travel firms, and supermarkets are seeing the immediate impacts, and face a huge challenge over the coming weeks to respond effectively to the emerging crisis.

But it is the banking industry that may have the greatest single influence on the global economy, and how businesses and consumers are affected by the emerging crisis. Poorly organised, knee-jerk reactions could lead inadvertently to banks amplifying the impact of the outbreak. Well structured, considered and organised approaches will serve to dampen it.

The outbreak comes at a point when the economy is already fragile, with growth varying significantly between countries and significant uncertainty about the 2020 outlook. As evidenced by the recent emergency rate cuts from both the BOE and the Fed, policymakers are already acting to minimise damage and preserve economic stability in this turbulent time.

Against this backdrop banks are already starting to see early impacts of COVID-19 as cash flow pressures increase. As the outbreak becomes more severe banks will see covenant breaches, sharp increases in provisions, and falling investment demand. All this on top of the pre-existing commercial challenges for banks brought about by low interest rates and increased market disruption from newer competitors.

The question for the banking industry is whether it responds in a way which amplifies or dampens the acute economic damage. Even at this relatively early stage in the outbreak, our analysis suggests
that at a European level, the impact of falling interest rates, reduced economic activity, and increases in loan provisions will materially impact profitability.

All banks are working on their response to this challenge but, already facing material financial headwinds and low returns on equity, it is not a stretch to imagine a situation where triggers are hit and lead to a curtailment of credit to the economy, particularly SMES.

We have structured our assessment of the overall impact to the financial services industry and policy responses in three categories:

1. Actions by policy makers
2. Actions by financial institutions
3. Actions taken across policy makers and financial institutions

**ACTIONS TAKEN BY POLICY MAKERS**

Policy makers are acting quickly, in a significant way in an attempt to minimize the profound disruption to the economy and financial markets and provide additional flexibility to the system to cope with both the immediate shocks and long-term stress scenarios. We have identified three primary categories of responses from policy makers to date:

1. Directed responses using the financial system
2. Directed responses outside of the financial system
3. Directed responses aimed at improving the resilience of the financial system

**Category A: Directed responses using the Financial System**

<table>
<thead>
<tr>
<th>Policy response</th>
<th>Description</th>
<th>Extent being used already</th>
<th>Effect on the banking system</th>
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</table>
| Rate decreases  | Central banks deciding to lower interest rates | Across the world | • Limited effect in most economies
• Negative direct implications for banking systems (offset by indirect implications of keeping the economy functioning) |
| Small business & consumer forbearance programs | Lenders and insurers volunteering/forced to suspend or reduce credit or insurance payments, waive late fees, suspend reporting or foreclosures | • Across the world
• Mortgage repayment suspensions already announced in Italy and UK (RBS) | • Short term impact will depend on regulatory and auditor interpretation on how to interpret forbearance measures on NPL rates, RWA and provision levels. Without some level of neutralization of effects, impact on bank profitability and CET1 ratios could be severe
• In the medium term impact will depend on extent to which |
<p>| Large corporate forbearance program | Lenders volunteering/forced not to suspend credit repayments and/or classify overdue corporate loans | EU, US, Asia | |</p>
<table>
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<tbody>
<tr>
<td><strong>Funding for lending schemes</strong></td>
<td>Loans for banks to lend to corporates in specific portfolios such as SMEs</td>
<td>EU, Asia</td>
<td>• Lower funding costs&lt;br&gt;• Greater scope for lending&lt;br&gt;• Marginally improves profitability</td>
</tr>
<tr>
<td><strong>Liquidity</strong></td>
<td>Changes to collateral policy, short-term repos, longer-term lending instruments for banks, additional quantitative easing programs</td>
<td>EU</td>
<td>• Positive effect of relaxing regulatory requirements&lt;br&gt;• Large benefit for sovereign spreads and hence bank capital ratios</td>
</tr>
<tr>
<td><strong>Macropresidential tools</strong></td>
<td>Lowering buffers or countercyclical buffers of capital</td>
<td>EU</td>
<td>• Potential to use funds budgeted for buffers to finance lending</td>
</tr>
<tr>
<td><strong>Excess reserves</strong></td>
<td>Changing treatment of excess reserves dependent on specific rule changes</td>
<td>US, EU</td>
<td>• Depends on whether the rules are tightened/relaxed</td>
</tr>
<tr>
<td><strong>Lending by development banks</strong></td>
<td>Use of the EIB and other “promotional” banks to lend, particularly to SME’s</td>
<td>EU, Germany</td>
<td>• Possibility to co-finance some of the loans&lt;br&gt;• Improved prospects for some existing bank borrowers</td>
</tr>
<tr>
<td><strong>Additional regulatory requirements (Longer term)</strong></td>
<td>• Introducing requirements for banks to understand supply chain vulnerabilities of borrowers in credit underwriting&lt;br&gt;• Stress tests around pandemics and other shocks to supply chains</td>
<td>EU</td>
<td>• Need for additional resources and funds for compliance&lt;br&gt;• Better resilience resulting from better knowledge of borrowers</td>
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**Category B: Directed responses outside the Financial System**

<table>
<thead>
<tr>
<th>Policy response</th>
<th>Description</th>
<th>Likelihood of use in different jurisdictions</th>
<th>Effect on the banking system</th>
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</thead>
<tbody>
<tr>
<td><strong>Government forbearance schemes</strong></td>
<td>Suspending or postponing tax payments</td>
<td>Across the world</td>
<td>• Lower default rate on loans</td>
</tr>
<tr>
<td>Policy response</td>
<td>Description</td>
<td>Likelihood of use in different jurisdictions</td>
<td>Effect on the banking system</td>
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| Direct fiscal stimulus – borrow and spend           | • Direct investment packages for affected industries (e.g. shale, tourism, aviation, retail, food services and transport)  
• Payroll tax cuts | Across the world | • Lower default rates on corporate loans  
• Potentially decreased need for lending |
| Subsidy for costs of employees to be laid off       | Government providing a subsidy to temporarily cover the cost of employees who would otherwise be laid off in the most affected industries | • EU  
• Germany currently reviewing its program | • Lower default rates on corporate loans |
| Increasing sick leave allowance                     | • Extend sick leave for those that have some, allow for some sick leave for those that don’t have any  
• Sick leave for family care | US, given low social safety net | • No direct effect |
| Extension of unemployment benefits                  | Government extending the standard length of unemployment benefits for the duration of the crisis | US, EU | • Lower default rates on consumer loans |
| Infrastructure spending                              | Investment in large scale infrastructure projects to directly stimulate the economy | Depending on the severity of the crisis – across the world | • Potential to co-finance some of the projects |

**Category C: Directed responses aimed at improving resilience of the Financial System**

Market disruption caused by COVID will amplify issues resilience issues. In particular, there is a risk that ‘bad actors’ could attempt to use the significant market disruption to attempt cyber security and AML risks. Additional considerations with respect to payments and supply of cash will be important to ensure minimal impact of market disruption.
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</table>
| Additional/new regulation on cybersecurity requirements | Government requiring banks to have processes in place to prevent/minimise the negative effect of increased frequency of cyberattacks | US, EU, Asia                              | • Increase of compliance cost  
• More resilient tech systems |
| Tightening of AML requirements                       | Banks required to have adequate AML processes in place in the environment with increased volume of suspicious transactions | Across the world                           | • Increase of compliance cost  
• Improved AML capabilities applicable also in non-crisis times |
| Requirements on resilience of payment systems       | Government requiring banks/payment institutions to have adequate processes to ensure resiliency of payments systems | US, EU, Asia                              | • Increase of compliance cost  
• Lowering the fraud rate |
| Measures to ensure adequate supply of cash           | National mints and central banks to provide additional supply of notes/coins  
Banks volunteering/required to introduce cash withdrawal limits | Developing economies                      | • Avoids negative effects if restrictions result in bank runs  
• Lower consumer spending may otherwise result in higher rate of default on corporate loans |

However, many of the most important policy actions remain yet to be defined. Key questions that will need to be answered are:

- In the short-term regulatory interpretation of forbearance is critical – can Covid related forbearance, to any extent, be neutralised in stage 3 provisions; stage 2 provisions; NPL levels; RWA calculations? If this is not allowed impacts will be severe
- What guidance can regulators provide on how macro expectations should feed into provisions?
- How will regulators replace/alter stress tests to give them the necessary information to form policy? The banks will need to mobilise quickly to provide the necessary information
- How will the Impact of the absence of liquidity in credit markets be reflected in the valuations of traded assets?
- How will impact of Covid be considered in recovery and resolution planning rules (interpretation of likely to fail; ability to perform valuations; resolution options that are practically available; central bank ELA schemes)?
• What measures will be allowable within state aid rules (e.g. asset protection schemes etc)?

**ACTIONS TAKEN BY FINANCIAL INSTITUTIONS**

Financial institutions are moving quickly to understand and respond to the immediate impacts with an eye on long-term planning as the situation evolves. We are seeing six emerging areas of focus beyond the immediate business continuity imperative:

1. **Shift from business continuity to crisis management**
2. **Take scenario planning to “Level 5”**
3. **Be decisive in support for clients**
4. **Deliver on the demand for digital**
5. **Prepare for the long haul**
6. **Convene the industry**

**Shift from business continuity to crisis management**

All banks are revisiting, in detail, their business continuity plans. The aim is to reassure employees and ensure the business is ready to address supply chain constraints, demand shocks, and impacts to business partners. This is well underway, but will be insufficient if the situation continues to develop at the pace of recent weeks. Banks must plan and act on crisis management basis before, not after or if, it becomes a necessity.

Recent investments in business continuity planning and stress-testing provide a powerful starting point for the industry and should provide the basis for a considered response. But after the initial set of actions that these plans prescribe, management need to steer their response based on the actual situation they face. Existing reporting frameworks and management information tools are necessary but not sufficient.

It is critical that all banks take a “Control Tower” approach and build on business continuity plans. Tailored scenario modelling and contingency planning to continuously ‘run the numbers’ is needed to steer the ship, and 80/20 decisions will be the order of the day. New leading indicators which have more relevance to the outbreak need to be integrated into decision making, and real time judgement calls from client-facing, risk, and finance teams need to have a place at the table.

**Take scenario plan to “Level 5”**

Most firms right now are only in the early stages of their response: managing the immediate issues for their own staff, such as announcing travel bans, cancelling large-scale events, and implementing quarantine periods. This is critical but only scratches the surface of where banks need to go.

Rapidly, banks need to consider a range of scenarios of how COVID-19 could impact their clients, financials, and their own operations. Specifically, we believe three should be considered:

1. **Worst is over in two to three months:** Acute crisis largely resolved within a two- to three-month period, where business gets back to normal quickly after a material “bump” in the road
2. **Six months to regain control:** More extensive period of disruption over a six-month period leading to a no-growth scenario for the economy or a limited recession
3. **12+ months ongoing pandemic**: Virus spreads widely and public remains in heightened state of anxiety triggering a global recession

In each of these scenarios, if the policy response is insufficient, the risk of failure of the financial sector increases, potentially exacerbating the economic stress even as the pandemic is brought under control.

We make no comment in this note as to which of these is most likely, but we recommend banks consider all such scenarios and plan accordingly. This then needs to be taken to the “fifth level”:

**Level 2:**
Impact on those borrowers and associated sectors immediately and directly affected by COVID-19, with aviation the clearest example and where an updated view of the risk-rating of counterparties will be key.

**Level 3:**
Wider ripple effects for associated industries immediately affected, such as travel-related firms, restaurants/hospitality businesses, firms whose revenue is directly linked to international travel, and tourism, through to those sectors impacted by a sustained period of disruption to international supply chains.

**Level 4:**
Next-stage knock-on effects to key parts of the service industries that are of critical importance to the UK economy – notably banks, insurers, asset managers, lawyers, and accountants, all of which will be materially impacted if investor confidence is shaken and deal flows (and investment flows) dry up in both the public and private markets.

**Level 5:**
Resultant impact on the end consumer, from those already feeling the pain in some sectors (such as reduction in zero-hours contracts by companies pulling back on near-term spend), to more systematic cost reduction (and therefore job losses) across a broad band of sectors, as firms take proactive steps to protect operating margins during a period of demand or supply turmoil.

**Be decisive in support for clients**

Every financial institution must do something with the data and insights it has. It must act. However obvious that may sound, the underlying premise of this effort is to take action – not planning for planning’s sake. That means translating those scenarios into clear, supportive steps split by client type, sector, and institution to fortify them through a period of unpredictable and potentially severe disruption.

There are no perfect rules to achieve this and decisions need to be made with imperfect information. But institutions that are successful will be those that display the necessary levels of mental agility to take decisive actions and focus on meaningful areas of support, for example, offering extension of credit terms and credit holidays, ensuring clients are adequately insured or supporting corporate clients in better understanding the financial risk in their value chain. These actions and more will need to be undertaken without knowing the ultimate profit and loss and balance sheet consequences. Banks will have to do so in a way that allows them to react to events and drive everything through the lens of what can help the customer and be sustainable.

We recommend a rapid “triage” approach based on an assessment of the sustainability of clients in the most impacted sectors and regions, as outlined in Exhibit 1 below.
Guardrails must be set based on top-down assessments and judgements. Business and Risk must be involved in this, and this thinking needs to be integrated with downside/stress test planning. But implementation needs to be driven from the place where the information is greatest. Trust the front line and empower teams, within pre-set guidelines, to support the customer directly, and build feedback loops to drive best-practice solutions.

### Deliver on the demand for digital

If China is any indication, there will be a massive acceleration in customer demand for digital channels in the coming days. China’s financial services sector experienced 100-900 percent traffic spikes in key digital channels during the outbreak. Customers are unlikely to return to analog channels. Many banks now have a strong digital presence but may need to educate some segments around how best to access this. To achieve this, we recommend:

- Scenario plan around spikes in digital channel usage to ensure that the systems will remain online if they experience a 100-900 percent increase in traffic
- Rapidly develop and roll out an awareness/education campaign around digital capabilities and ramp up call-centre support for less tech-savvy clients as they transition to digital channels
- Fill any gaps in the scope of services that can be delivered through online channels e.g. large transfers, changing of names, probate

<table>
<thead>
<tr>
<th>COVID19 scenarios</th>
<th>Definition of scenarios of crisis evolution in terms of duration and dissemination</th>
</tr>
</thead>
<tbody>
<tr>
<td>Estimation of forward looking P&amp;L/BS and calculation of stressed ratios</td>
<td>Identification of sectors and geographic areas more affected in terms of revenues at risk (e.g. through sector’s input-output maps)</td>
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<tr>
<td></td>
<td>Identification of sectors at increased risk wrt the supply chain</td>
</tr>
<tr>
<td>Sector/Geographic area</td>
<td>Modelling of sector/geography scenarios impacts on single names solvency; e.g. estimation of potential impact on revenues and costs across identified geographies/sectors</td>
</tr>
<tr>
<td>Sustainability analysis</td>
<td>Ad-hoc analysis on few selected counterparties and individual plans definition/implementation; e.g. amount of new debt that allows the client to survive the crisis</td>
</tr>
<tr>
<td>Bucketing and prioritization of clients</td>
<td>Low risk clients able to manage the crisis across scenarios</td>
</tr>
<tr>
<td></td>
<td>Healthy clients before the crisis and able to sustain extra-debt once the crisis is over</td>
</tr>
<tr>
<td></td>
<td>Non-healthy clients before the crisis or not able to sustain extra-debt once the crisis is over</td>
</tr>
<tr>
<td>Possible actions</td>
<td>Clients should be targeted with dedicated campaigns</td>
</tr>
<tr>
<td></td>
<td>Provide financial support (e.g. debt restructuring or other forms of support)</td>
</tr>
<tr>
<td></td>
<td>Restructuring guidelines</td>
</tr>
</tbody>
</table>
• Plan for changes to physical branch infrastructure if required to support vulnerable customer through a protracted outbreak/period of quarantine

Prepare for the long haul

Banks can only continue to support the economy while they themselves remain financially robust. The need to support the economy must be balanced against prudent, institution-specific financial management. Business continuity plans will get companies through the next two to four weeks, and after a decade of stress testing and capital rebuilds, most institutions have sufficient financial resources to weather a downturn. However, after the initial scramble to respond, banks will need to look at the long-term impacts on their business. In the face of any prolonged downturn renewed management strategies will be needed.

In a scenario where the worst is over in two to three months, economic growth appears likely to flatline or reverse and central banks are likely to cut interest rates. Under this scenario our analysis points to revenues declines of 3-5% across European banking. If it takes six months to regain control, revenue losses could reach double digits and the threat of credit losses will rise considerably. We have not modelled through our third, most severe scenario due to the uncharted territory in which we would be at that stage.

Given the level of impact in the more extreme scenarios we believe it is prudent that banks start to build on existing recession readiness plans with the actions including:

• Building off the financial scenarios to determine the level of action that may be required on the cost base of the organisation in each of the outcomes

• Based on this, develop an actionable view of the short and medium-term cost levers that can be pulled to hold up economics in the event of a prolonged downturn, without damaging the customer proposition or underlying competitiveness of the organisation

• Working backward from implementation timeframes, determine an action plan that balances the need to continue to support the economy with prudent financial management

• Revisit and update inorganic options including partnerships, joint ventures and mergers and acquisitions

Convene the industry

A pro-cyclical response from banks to these pressures will deepen any downturn and flatten the recovery. Banks can and are taking action, but we believe the effort has to go further and the industry needs to look at ways it works in partnership with government and regulators, to help all industry participants support the wider economy. Banks should develop a set of policy or regulatory requests that will support the ability of the banking industry to minimise the impact of this crisis on its customers, for example:

• Monetary and Fiscal interventions to support the economy (recognizing power of monetary policy may be muted due to already low interest rates)

• Social policy changes (e.g. to statutory sick pay) to support the cash flow of those taking time off work due to their own illness or to care for sick relatives
• Tax policy changes to give relief to business with cash flow challenges e.g. Tax payment deadline extensions or relief on business rates
• Support of additional lending to business either via the banking sector, through mechanisms similar to the Enterprise Finance Guarantee scheme or directly to business and leveraging the role of institutions such as the British Business Bank
• Regulatory measures such as authorisation for firms to use their countercyclical buffer as part of the response or, with regard to liquidity, changes to collateral policy, short-term repos, longer-term lending instruments for banks, additional quantitative easing programs
• Accelerate payments from government procurement procedures, specifically targeted at SMEs
• Customer forbearance programs: Lenders and insurers volunteering or being forced to suspending or reducing credit or insurance payments, waiving late fees, suspending reporting or foreclosures

The evolving COVID-19 situation is complex and a considered, well managed and coordinated response by the banking sector will have a major bearing on how well consumers and businesses weather the storm and, in turn, the economy as a whole performs. There is already extensive work underway across all institutions on this issue, and we hope the six steps outlined in this article are helpful in making a difference in the weeks ahead.

ACTIONS TAKEN ACROSS POLICY MAKERS AND FINANCIAL INSTITUTIONS
The immediate challenges relate to BCM and operational sustainability and include:

• **People first: staff support and planning**
  - Scaling up the Work from Home Financial Institution, questions over when to trigger WFH arrangements, sustainability of having these for a long period, legal risks or concerns around equitable treatment of staff, concentrations of employees WFH versus in contingency locations, implications of dividing teams. Prioritising work and planning for absences.
  - Looking after mental health, including stress impacts of abnormal work, feelings of isolation, news broadcast triggers and fight or flight reactions, high cortisol levels rather than measured responses and focus on business as usual tasks
  - Maintaining productivity given changing situation and adjustments to work environment. Managing fragmentation of teams. Managing redirection of resources. Adjusting to different technology and new ways of communicating with colleagues. New interruptions and distractions
  - Open questions around incentives and boundaries with personal life, should employees should face sanctions if breaking quarantine? What to do about employees personal travel?

• **Defining an approach to manage risks of the Work from Home Financial Institution**
  - Some controls will not function as usual – for example inability to run full trade surveillance protocols in a WFH environment, flat-mates that belong on opposite sides of a Chinese wall or from competing firms, lack of clarity over how to access risk or compliance support
  - Less efficient technology leading to e.g. latency risks for Best Execution, or temptation to use home email systems rather than a slow VPN
  - Higher cyber and operational risk
Fragmentation of teams and abnormal work arrangements lead to dampened ability to respond rapidly and as a team when things go wrong (as well as implications for productivity)

- Planning for medium term client impacts and operational disruption
  - The impact of the virus on affordability, collections, recoveries, and customer treatment through this
  - New vulnerable customers; impact on earnings for self-employed and contractors. Mortgage payment holidays.
  - Stretched resources and sustainability of keeping markets going. Retail bank service disruption, e.g. if branches are staffed with low numbers. Operational resilience concerns.
  - Large and time critical remediation programs being put on hold
  - Capital adequacy and solvency

- Envisioning the path back to “new normal”
  Whilst it is important to react swiftly and effectively to these immediate impacts it is also time to start thinking and planning for the longer term economic, social and regulatory impacts which could have significant and lasting impact on the long-run ROE for the industry.