OLIVER WYMAN

STEERING BANKS THROUGH THE CRISIS

The COVID-19 Pandemic Navigator

June 2020

PREFACE

Business leaders need new decision-making tools to navigate the next phase of the COVID-19 crisis, which is sure to be prolonged and remains highly uncertain. These tools need to account for what is happening in real time, help orient businesses around possible future outcomes, support top-down decisions, and enable teams to act across the business. This is why Oliver Wyman developed the Pandemic Navigator.

The banking industry has a crucial role to play in helping the global economy weather this crisis and return to growth. Yet banks face an enormous challenge in supplying the economy with credit: dealing with the uncertainty of future credit-worthiness and how this will be affected by the course the pandemic takes. Critical decisions need to be made now based on an understanding of the increased risk across the economy, with differentiation across individual businesses and consumers suggesting which impacts are temporary and which are permanent. This won't be like a normal recession; the impact will be highly asymmetric and influenced by public policy decisions.

Banks face four challenges in supplying credit. First, how to incorporate all the new and constantly changing information on the pandemic and manage against a complex set of scenarios. Second, understanding the impacts of COVID-19 over time across each corporate sector, given their financial condition and future consumer demand. Third, managing consumer credit portfolios when traditional indicators of payment behavior are distorted and payment capacity is highly uncertain. Finally, banks must upgrade their models to support loan loss provisioning and capital requirements with only intermittent regulatory guidance.

In this edition of our Pandemic Navigator Series we share some of the insights we have gleaned from our work with leading financial institutions so far, and then look broadly at the likely impacts on bank financial returns and capital.

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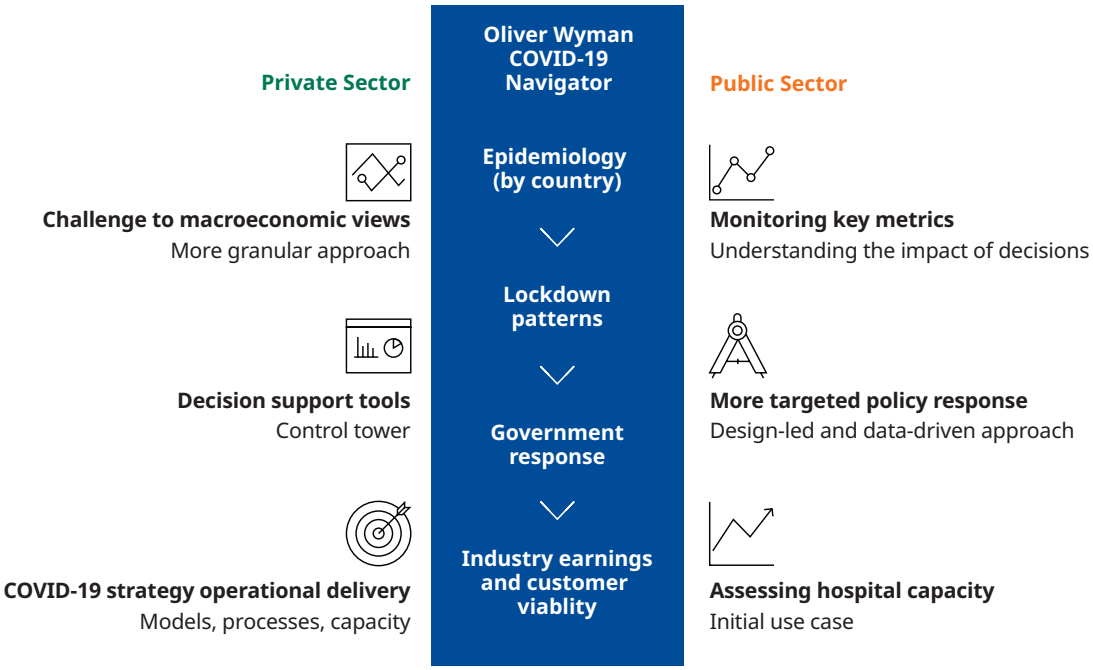
Exhibit 1. Oliver Wyman Pandemic Navigator



CHALLENGE 1
INCORPORATING NEW TYPES OF INFORMATION AND MORE SOPHISTICATED SCENARIOS

Planning scenarios in many financial institutions have been too simplistic. Many were based on the economy reopening at some point in 2020, followed by V-, U-, L-, or W-shaped economic recoveries. It is now clear the future is going to be much more complex, with on-off lockdowns possible and social distancing measures that will vary from region to region and over time.

Financial institutions need new critical inputs from outside the sector, especially from the world of healthcare. New details on the evolution of the pandemic, the implications of lockdowns and social distancing on cashflow, and shifts in customer behavior are coming in faster than can be processed through the existing planning infrastructure.

Banks need to identify a set of scenarios for the evolution of the pandemic based on epidemiological data and the likely containment strategies. These scenarios will provide a common foundation for a range of use cases, from operational planning of when and how to return to work to understanding the impact on customers and their financial services needs and risks. In addition to establishing these core scenarios, it is important for banks to reverse stress-test, understand which scenarios would truly make them change course, and know what the signals are for those.

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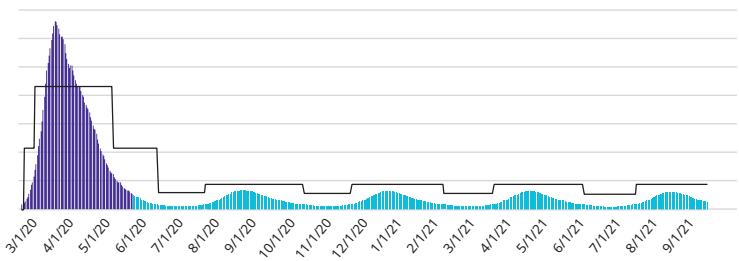
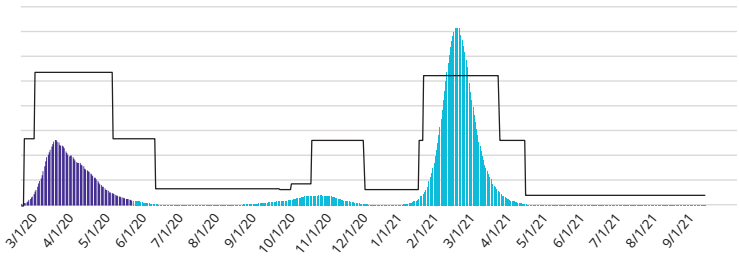
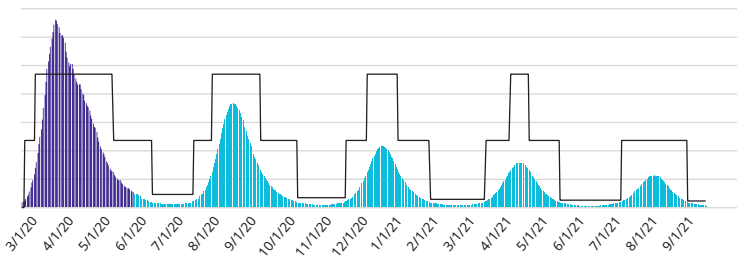
Exhibit 2. COVID-19 lockdown and recovery scenarios (European bank case study, June 2020)

Scenario name and evolution	Description
Tracing-led Suppression 	• A rapid build up of testing and tracing capabilities supports a successful transition out of lockdown • New outbreaks are easily identified and quickly contained preventing future major outbreaks • Confidence gradually builds as the economy beds down into the new normal
Winter Return 	• Assumes some benefits of seasonality in Summer months • Virus threatens another major outbreak in the Autumn/ Winter leading to the need for one or perhaps two further lockdowns • Possible that case load will be higher second time around but potentially offset by higher hospital capacity
Long-haul Containment 	• Every attempt to exit leads to fresh outbreaks and the need to tighten containment measures again • No benefits of seasonality assumed • Assumes the gradual build up of immunity over multiple years leading to less stringent lockdowns further into the future • The economy is constantly being dragged in and out of various states of containment

Active cases Active cases (projected) Lockdown intensity

We estimate, for example, that in some countries a winter return and second significant lockdown could cause the expected corporate default rate to double again. This is a likely enough scenario with a severe enough impact on bank capital to affect lending capacity now.

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Within Oliver Wyman we have also had to adjust quickly to build these tools. We have incorporated the highly sophisticated epidemiological analysis and forecasting of our healthcare team and combined this seamlessly with our underlying analysis of retail and corporate credit and bank loss forecasting. We are providing regular updates on the emerging impacts, right through to bank capital, of factors such as testing, immunity, and seasonality, including a regularly updated primer and Insight note around the public policy challenge.

A winter return and second significant lockdown could cause the expected corporate default rate to double again.

CHALLENGE 2
UNDERSTANDING IMPACTS ACROSS EACH CORPORATE SECTOR

Banks face an entirely new set of circumstances on corporate client solvency, liquidity, and profitability. The long-term viability of customers will vary by sector and region, but also within sector based on resilience, the impact of social distancing policies on business activity, their cost base structure, and their positioning through the recovery phase.

Traditional approaches to assessing financing needs and credit risks do not work in the current environment. Macro-based projections don't reflect the highly heterogenous impact on sectors, from food retailers and online gaming that are benefitting to airlines and hospitality that are fully shut down during lockdown. Historical financial statements, meanwhile, don't reflect the current impact on business and financials. And company-level, expert-judgment-based projections are also often inconsistent due to different views on how the crisis and impact will play out, and are manually intensive to update.

Sector-based cashflow analytics are now needed to quantify risks and liquidity needs. These analytics should enable rapid modelling of alternative lockdown and social distancing scenarios, with cashflow forecasts reflecting numerous factors. For one, the turnover impact due to the combination of demand drop-off and supply chain challenges. For another, the knock-on impact on profitability and cash burn rate (taking into account cost mitigation actions and impacts of government support). Cashflow forecasts also must reflect liquidity positions and associated financing needs due to negative cashflows as well as the longer-term affordability of debt required to finance negative cashflows, identifying which firms won't be able to repay the debt needed to survive the downturn within a reasonable period.

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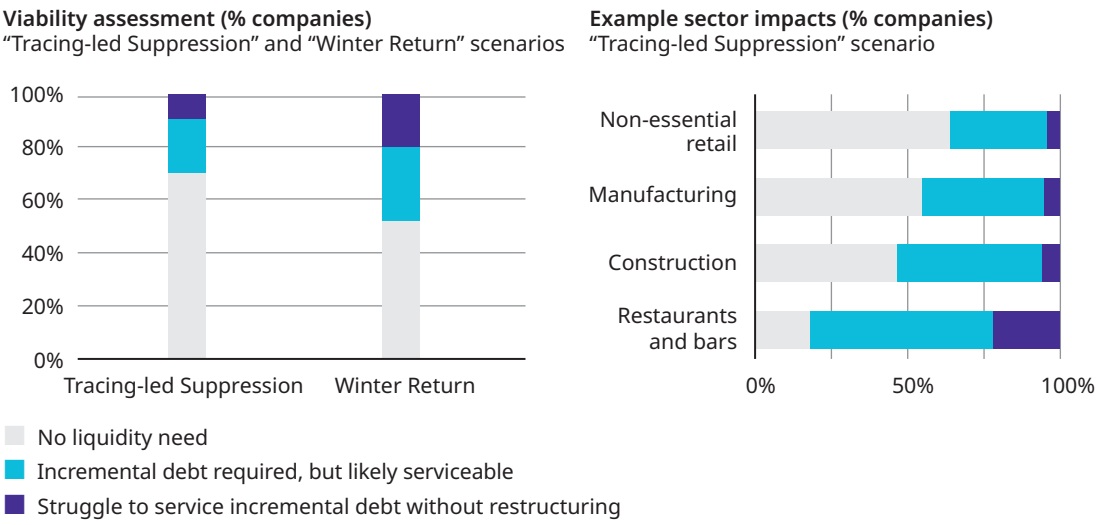
Liquidity needs vary greatly between countries depending on the mix of their economy and ingoing financial health. In the United Kingdom, even in our most optimistic scenario for the pandemic ("Tracing-led Suppression"), we estimate that more than one-third of corporates will need liquidity support during 2020. Across the UK economy, this implies incremental financing needs of more than £100 billion. The most severely impacted, around five percent of our sample, will struggle to service the interest, let alone repay the incremental debt. A second lockdown would increase these impacts significantly — likely more than doubling if there were a second lockdown.

Exhibit 3. Corporate-sector cashflow analytics: liquidity levels by sector



Source: Oliver Wyman analysis, Oliver Wyman Pandemic Navigator

Banks need sector-based analytics for numerous purposes, from identifying the most at-risk sectors and clients, and underwriting of new financing, to providing evidence for government guarantee schemes, identifying non-performing assets, projecting how client-level risk ratings will evolve, and developing restructuring plans and asset disposals.

Longer-term, a sector lens will remain important as industry models change to restore profitability and improve resilience. Consolidation, diversification of supply chains, and changes to distribution models will create sector-specific opportunities for new and existing banking products. Leading banks already are working on this within their future target sector mix.

Corporate financing needs would likely more than double if there is a second lockdown

CHALLENGE 3
MANAGING CONSUMER CREDIT WHEN TRADITIONAL INDICATORS BREAK DOWN

The pandemic and public health responses are hitting individual households' finances unevenly across and within countries. Differences are driven in part by industry-specific impacts on their employers, and in part by availability of government assistance such as furlough schemes, payroll subsidies, and unemployment benefits.

Banks across the world have provided additional shock absorbers, such as emergency hardship programs, waiving minimum payments and removing fees for a period of several months. These programs help avoid escalating a temporary liquidity gap into a default and are being used widely.

Nonetheless, the sudden disruptions to consumer finances and behavior are increasing credit risk for banks. This is occurring as the traditional risk metrics banks use to steer their portfolios and customer-level decisions are thrown-off. For example, lenders normally monitor transitions into early stage delinquency, such as from current to 30 days past due and from 30 to 60 days past due, as strong early warning signals of future default risk. Widespread payment relief obscures this signal, because enrolled customers are not obliged to pay even if they can.

Likewise, while credit scores play a major role in both underwriting and forecasting, the odds of default for any given score level are increasing. While scores will remain important for rank-ordering risk, they will lose some of their power given that delinquency is a key driver in the scores. And in terms of payment capacity, meanwhile, widespread income instability makes relying on outdated income information dangerous for credit decisions.

To address some of these challenges, banks should look at alternative signals of payment capacity and behavior. Some are stepping up employment-verification procedures for the extension of new credit. Others are using deposit account data (including text), combined with machine-learning tools to develop new signals of income instability. And in absence of clear delinquency signals for customers in forbearance, banks can still derive insights from observing which payments customers continue to make and which payments they defer.

In addition to these fundamental credit risk management challenges, banks face further challenges in forecasting losses on their consumer credit portfolios. The unprecedented scale and speed of the economic shock is a major obstacle in of itself. Models calibrated to a historical unemployment range of four percent to 10 percent can produce implausible outcomes when unemployment is near 15 percent and could go to 20 percent. Even optimistic V-shaped recovery scenarios can produce implausible results in models calibrated to quarterly changes. At the same time, governments have been undertaking unprecedented rescue efforts. Stimulus payments, expanded unemployment insurance, and tax deferrals may mitigate or even overcompensate for lost income in many cases. It remains to be seen to what extent consumers will use this assistance to resume paying off loans, but loss forecasts will become sensitive to any estimates for this.

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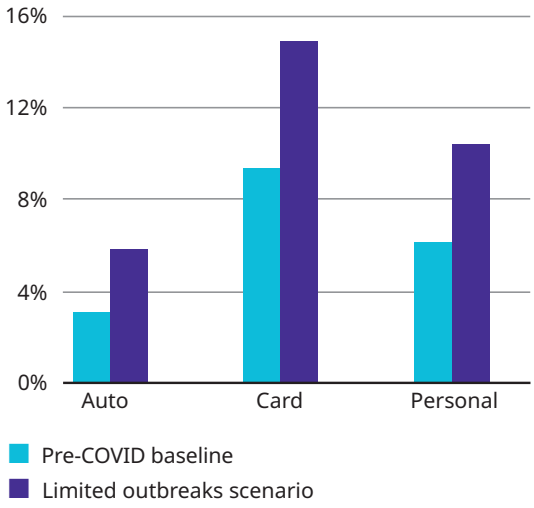
The United States, for its part, is experiencing some of the most acute impacts on consumer finances. Unemployment spiked from less than four percent in February to nearly 15 percent by April, representing tens of millions of jobs lost. While the United States has expanded unemployment benefits to mitigate the shocks to household finances, some households seem to be slipping through the cracks, particularly as the capacity of the unemployment benefit system is strained. More than eight percent of US mortgages were in forbearance as of mid-May.

The pandemic had just begun to have serious impacts as the first quarter of 2020 was ending. The largest US banks increased their reserves for consumer loan losses in aggregate by 33 percent, on top of the day-one impacts of adopting the current expected credit loss standard, or CECL, that they had recognized in the same quarter.[1] Yet even as first-quarter results were being disclosed in subsequent weeks, economic forecasts deteriorated as the pandemic continued to take hold.

Exhibit 4. Expected life-of-loan losses on existing consumer portfolios (US)



Source: Oliver Wyman analysis, Oliver Wyman Pandemic Navigator

Using scenarios informed by the Pandemic Navigator, we estimate that, in aggregate, loss reserves for outstanding non-mortgage consumer lending exposures (particularly auto loans, personal loans, and credit cards) could increase by a similar amount in the second quarter as in the first. Under a scenario of several further local outbreaks but no national second wave, loss expectations on existing portfolios would rise rise by 60-90% compared to the pre-COVID baseline. In this scenario, outbreaks would occasionally interrupt economic recovery in individual states, leading to a moderate recovery in which national unemployment begins falling in the third quarter but takes until mid-2021 to fall back under 10 percent, and ends 2021 around eight percent.

Under a scenario characterized by several further local outbreaks but no national second wave, loss expectations on existing portfolios would rise by 60-90% compared to the pre-COVID baseline.

1 Consumer credit allowance details based on disclosures of JPMC, CITI, BAC, and WFC. Excludes allowances for unfunded commitments for Bank of America and Citi because they have not been allocated to consumer or commercial allowances.

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CHALLENGE 4
UPGRADING CAPITAL AND PROVISIONING MODELS TO REFLECT COVID

Economic damage from COVID-19 will translate into increased loan loss provisions and, especially for firms using internal ratings-based models, increased risk-weighted assets (RWAs). Given uncertainties, we expect wide variation in timing of provisions between banks, but this will begin to impact returns and common equity tier one (CET1) ratios negatively.

Loan-loss provisions were intentionally made more cyclical in the United States to address shortcomings observed during the last crisis. Complex models have been developed to calculate provisions by forecasting a range of future scenarios, usually based on macro variables such as GDP and unemployment, as well as observed risk deterioration. However, many macro models are highly sensitive, and so short-term but extreme effects on GDP and unemployment can lead to overestimates of provision levels.

Meanwhile, RWAs, and the customer ratings used to calculate them, are designed to be largely through-the-cycle, rather than point-in-time. For example, corporate ratings are often based on historical financials, which will lag real-time developments by up to 18 months, absent judgmental downgrades, but will then be slower to reduce when the cycle turns. Retail and small and medium-sized business scorecards, however, typically include behavioral factors intended to pick up on deterioration in individual clients, and the current system-wide shocks will therefore cause structural increases in RWAs.

This combined effect will potentially squeeze the CET1 ratio. As we show in the sample forecast (Exhibit 5), for this bank we estimated a 100 to 150 percent increase in provisions coverage and a 15 to 20 percent increase in RWAs leading to a possible three percent deterioration in the CET1 ratio.

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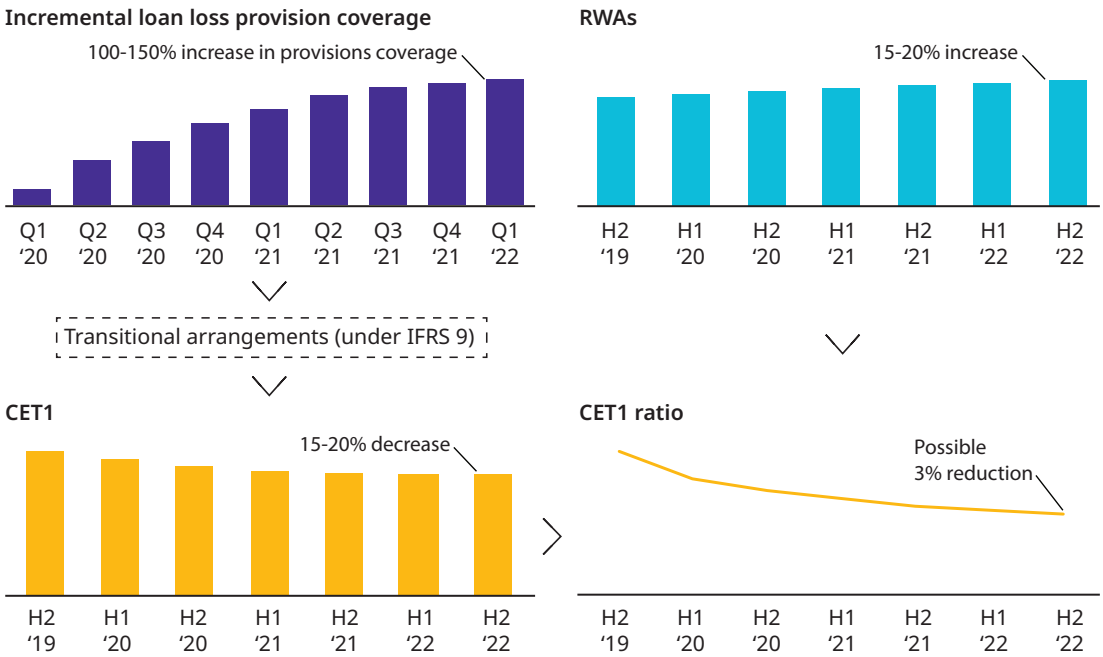
Exhibit 5. Potential impact of COVID-19 on capital — tracing-led suppression scenario (anonymized European client example)



Source: Oliver Wyman client example, Oliver Wyman Pandemic Navigator

Regulators have been explicit that system-wide forbearance measures should not automatically affect provisions for non-performing credit exposures, and that medium-term viability analysis should be the deciding factor. Some banks are adjusting scenarios to remove very short-term effects such as temporary unemployment during lockdown and including the impact of government initiatives such as furloughing and government support schemes. Others are using name-level cashflow forecasting to provide a more accurate and objective measure of customer viability than macro models, to drive classification of non-performing exposures and near-term provisions. Cashflow forecasts can also be used to project future ratings migration and RWA levels.

European banks can partially mitigate the impact on capital under IFRS 9 using the transitional arrangements until December 2022, reducing the risk cost on capital of performing exposures. The key capital impact in the next few years would then be felt through increases in "Stage Three" provisions, where the loss event has occurred. Meanwhile, US banks have been granted capital relief for two years from an agency estimation of the impact of CECL, which may be smaller or larger than the actual impact.

Given the continued uncertainty, banks' ability to forecast such financials rapidly under changing lockdown scenarios will be critical for prudent planning and quick responses.

For an example bank we estimated a possible three percent deterioration in the CET 1 ratio.

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CONCLUSION: THE IMPORTANCE OF CONSISTENCY

Banks are developing a wide range of new tools and capabilities quickly to deal with the new environment. New epidemiological and macro scenarios are unfolding, and banks are tapping new data sources to understand the impacts.

Maintaining consistency now becomes critical to enable senior management to steer across the institution. The same planning assumptions should be used across retail, small business, and large corporate segments. The same signals being used to make forbearance and lending decisions on the front line should be rolling up into credit management, loss forecasting, and capital management. And the same decision inputs driving capital allocation and scenario assessment should be used to drive financial planning and strategic decisions. Banks need a central function — a "control tower" — that takes responsibility for assumptions on the nature and shape of the lockdown and recovery and delivers a new set of management information to support the senior team, external communication, and supervisory dialogues.

In effect this means the entire credit and balance sheet management architecture of banks, built over decades, is being upgraded in a matter of months. The banking system is rising to this challenge. But the stakes are high. The effective supply of credit, and therefore the robustness of the economic recovery from the crisis, will depend on how well banks manage to adjust to these intensely challenging conditions.

The entire credit and balance sheet management architecture of banks, built over decades, is being upgraded in a matter of months.

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