COVID-19 LESSONS FOR BANK RISK MANAGERS

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This year has been an exceptional year. The economic cost of the coronavirus (COVID-19) pandemic has been enormous, with Q2 2020 showing the single worst GDP growth on record for most major countries, and unemployment growing to record levels. Government have responded with unparalleled and previously unthinkable levels of stimulus and other measures to protect lives, jobs, and the economy.

For the banking sector, this necessitated a thorough testing of business continuity plans, and disruption to operating models. It also caused an immediate crash in financial markets, and is gradually playing out in heightened non-performing loans (NPLs) and provisions. With enforced debt moratoria in place in many countries, the impact is lagged and the credit cycle is expected to peak in 2021, rather than this year.

There's an old adage of “never waste a good crisis”, so what can be learnt about risk capabilities and balance sheet from the experience of the last six months? Here's eight ideas.
ANALYTICS

1. Credit analysis — time for industry level analysis
The COVID-19 crisis has seen varying fortunes across industries, with e-commerce, gaming and internet tech seeing record growth and profits. At the same time companies in aviation, tourism and oil and gas face existential threats. All of our risk work during the pandemic has taken a granular industry view — assessing credit portfolios, optimising restructuring and collections, and for portfolio-level stress testing. Analytics built for at a segment level — to assess “general corporate” or “SME” portfolios — are transparently not fit for purpose.

Whilst the situation has undoubtedly been extreme, it is not a new phenomenon. All stresses have had major winners and losers (for example real estate in 2008–09, internet in 2001, and Asian sovereigns in 1998), and peacetime credit is also affected by forward-looking trends and risks that create more predictable winners and losers. That is well understood by equity analysts, by front offices looking for growth, and by risk departments in deciding sector strategy.

And yet, the majority of credit analytics remains at a segment rather than sector level — in part driven by a desire for simplicity in model management and a need for data to satisfy regulators (and those regulators’ desire for “use-test” consistency of model usage between capital and business applications). Now is the time to refine credit analysis to be structurally built around industries, and to bring together forward-looking views of industries across equity and credit analysis.

2. Credit analysis — time for cashflow modelling
Another critical feature of our COVID-19 credit analysis has been the centrality of forward-looking cashflow projections in assessing risk. Assessments made on historical financial statements in H1 2020 have been worthless (and widely disregarded), with a need to assess client’s ability to withstand future waves and lockdowns, and the impact of government stimulus.

For large corporates and specialised finance, cashflow forecasting as a tool is already standard, whilst a small number of banks have been successful in creating cashflow-based lending programmes further down the scale. Forward-looking cashflow-based risk modelling will be a central part of successful banks’ approaches to modelling all but the smallest or most highly collateralised SMEs.

3. Time for more analytics... and more expert judgement
The crisis is the first to hit the era of artificial intelligence and machine learning. This should accelerate the need for advanced analytics — static analytical models based on past data will fare badly in this scenario, and models that incorporate more factors and are more easily updated as events change will be a source of significant advantage. Banks that had more flexible systems and organisations set up to change analytics quickly in response to a fast-evolving crisis and government response have also fared better than those with more rigid structures.
BALANCE SHEET MANAGEMENT

4. Time for nimbleness... and imagination
COVID-19 has been a reminder of the critical difference between capabilities needed for “war-time” stress testing (done live in a crisis) and “peace-time”. The fast-evolving nature of the pandemic has forced scenarios to be updated virtually weekly, and a wide range of effects, counter-effects and forecasts to be considered. That requires nimbleness — a stress-testing and forecasting approach that requires large amounts of manual input and a lengthy process involving every business unit is not fit for purpose.

This should serve as a wake-up call for the imagination of stress testing units. “Global Pandemic” was on nearly every institution in the world's list of risks, and yet very few had really considered in any detail what this might look like or war-gamed how the institution could respond.

5. Time to look at capital
The full effect of COVID-19 on bank capital ratios is yet to play out. Moratoria, furlough schemes and social safety nets have formed a temporary dam on NPLs and impairments, but as these are lifted there could be a large volume of individual and corporate insolvencies — especially in industries that suffer both short-term effects from lockdown and long-term effects from the structural changes to behaviour, working, and the economy that the pandemic has accelerated.

In this environment, banks need to watch their own capital ratios. Learning from the 2008–09 crisis, the primary objective of CFOs should be to maintain healthy capital ratios without the need for painful deleveraging or slashing investment budgets. The period of pre-COVID largesse leaves plenty to do here — optimisation of pricing, funding strategies, risk-weighted asset (RWA) management and sensible cost management are all significant levers, and some strategic portfolio rationalisation is also in order.

On the flipside, if the global banking sector emerges mostly unscathed from the largest macro-economic shock on record, that would represent a startling success for the measures introduced in the wake of the financial crisis and recapitalisation of the banking sector. There is not the same obvious need for sweeping structural and regulatory reform that there was in 2008–09, which should give banks breathing room to focus on business priorities. And for the most heavily capitalised banks and markets, it may even be time to revise down capital buffer estimates.
6. Time to prepare for low rates
Europe and Japan have been living with low rates now for years or decades. And the experience is universal — low rates means low NIM means weak performance. Whist COVID-19 has at least dented the monetarist policy orthodoxy of the preceding decade thanks to the surprisingly active fiscal policy response, low rates now look set to persist across most major countries — the combination of the need to revitalise economies, structural factors (such as the gig economy) suppressing inflation, ageing populations, the need to service enormously inflated sovereign debt and an eye to avoiding harmful currency appreciation all argue for continued low interest rates.

Banks need both a tactical and a strategic response to this. Tactically that means greater discipline around pricing and margins — on both assets and liabilities — and a move away from rules-of-thumb approaches to balance sheet built around loan-to-deposit ratios and generalities, and towards scientifically-driven approaches based on an understanding of customer behaviour and pockets of value. Strategically, this means a reconsideration of portfolios, risk appetite, and a more aggressive move off-balance sheet to convert NII into fee-based income.
OPERATING MODEL

7. Time to gear up for working from home
Attitudes towards working from home have shifted dramatically through the crisis. Whilst some of the advantages of office-based work are made painfully clear (such as the ability to mix informally with colleagues and clients), the more lasting effect is likely to be the realisation that underused technology works.

Banks have found this especially difficult. Against a standard of being fit for mass working from home, data protection and cyber security approaches in many are straightforwardly not fit for purpose. It will not be enough to simply force employees back to the office — this will further disadvantage banks in the war for talent and is likely to be unsustainable. Instead, data and IT need to gear up to manage enterprise risks with a more distributed workforce.

But a move to working from home also brings new risks — managing conduct risk, compliance risk, fraud risk and enterprise security risks are all likely to be more difficult in a working from home environment where it is more difficult to observe colleagues. This as a challenge, but not a choice — winning banks will start to adapt now.

8. Time to look again at the operating model
The forced change in operating models present an opportunity to reassess. Already the crisis has revealed the strengths and weaknesses of banks' operating models — banks that relied heavily on rigid policies and processes struggled to adapt to radically changed circumstances; whereas those with strong risk cultures across both the first and second line of defence and a more digitally-native set of capabilities were able to respond more nimbly. There is a priority and opportunity to build a more resilient organisation.

CROs and CFOs should take the opportunity to look critically at efficiency gains based on a thorough retrospective of the lockdown period. What worked well under lockdown and what didn’t? What really needs to be done and what doesn’t? Where can things be done radically more efficiently? Are there parts of the business that are doing all the work and others that are freeloading? Are there critical capabilities that need to be built? And as a critical enabler — what does the pandemic period (and potential post-COVID-19 future) tell us about the right talent model for the future?
CONCLUSION

The COVID-19 period has been one of enormous disruption from which much can be learnt — both from the successes and the challenges. Perhaps of even greater significance in the longer-term is the potential that this period has to bring lasting behavioural changes to the way the world works; one that brings immense challenges and opportunities for the banking sector.

Significant change requires impetus, and momentum can disappear quickly — there are material cost savings and benefits available, but these will become exponentially more difficult to achieve the longer they are postponed. Instead, now is a good time for both a retrospective and a prospective review — a retrospective review to make sure that lessons are fully learnt from the experience of 2020 to date; and a prospective view on what may be required going forward. Together, these point to a radical adjustment and reprioritisation of development work in risk and in banking as a whole.
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