Rapid Response

Keeping a lifeline of credit supply during COVID-19 (C-19).
What are the risks facing banks?

Navigating the human and business impact of COVID-19

COVID-19: What to do Now, What to do Next
COVID-19 has turned into a global crisis, evolving at unprecedented speed and scale. It is creating a universal imperative for governments and organizations to take immediate action to protect their people.

It is now the biggest global event—and challenge—of our lifetimes. As such, it is changing human attitudes and behaviors today and forcing organizations to respond.

However, the need to respond won’t end when the virus’s immediate threat eventually recedes.
Banks have played a key role in anchoring the economy at times of severe economic stress, but they are not immune to the fallout from C-19.

The immediate risk is credit defaults, amplified by the current ‘late cycle’ and ‘BBB bulge’.

It is tempting to use excess capital and liquidity to bolster lending, but that may invite longer-term asset quality implications. Additionally, firms should retain resources to mitigate second-order impacts such as market and liquidity risks, operational failures and financial crime.

This calls on leaders to strike a balance between responsiveness and resiliency. The fundamentals of integrated risk management apply now more than ever.
The immediate risk is credit defaults

Unprecedented in its impact, C-19 can affect different types of bank customers simultaneously: retail customers struggling to repay mortgages, small-medium size businesses failing to pay bills, and even global corporates finding it hard to issue bonds to cover debts.

This is happening at a time economists call the ‘late cycle’ – that is, the world is at the end of a period of prolonged growth, facing the challenges from years of cheap money and strong growth. Near-zero interest rates across developed markets have lowered borrowing costs and contributed to an increase in debt. This has created ample scope for market correction – even without C-19.

These existing vulnerabilities are receiving a real-life stress test from C-19. Firms in vulnerable sectors directly affected by lockdowns, and dependent on commodity prices and supply chains, are at the forefront of the shock.

Banks face the prospect of a significant drawdown of committed credit lines, working capital facilities, trade finance guarantees, as well as strains on customer loan covenants. Indeed, in the first three weeks of March 2020 alone, global firms have drawn at least US$124 billion from credit lines across the US and Europe.¹
‘BBB Bulge’ further seizes wholesale funding

Another dimension is that a bulk of the corporate debt build-up is on the brink of becoming ‘junk’ according to an Organisation for Economic Co-operation and Development (OECD) report. This is the so-called ‘BBB bulge’: BBB-rated issuances have ramped up in recent years, now accounting for nearly 30% of all outstanding corporate bonds globally.²

This means that US$3.8 trillion worth of corporate bonds could move to a sub-investment, or junk, grade with a moderate shock³—probably one far less severe than a shock like C-19.

This has triggered important sell-off by risk-sensitive investors, seizing up capital markets and wholesale funding further still.

We are seeing signs of this vicious cycle. Even as major central banks are injecting liquidity in the scale of trillions, financial markets are still showing a mood of ‘wait and see’.⁴
Market and liquidity risks
These include potential market losses in a volatile environment; rising liquidity risks as customer balances decline and wholesale lending activities dry up.

Country and sovereign risk
This is an unfortunate downside of government economic intervention, a risk heightened for those economies that also have a deep dependency on commodities and global supply chains.

Non-financial risks
These risks should rise as workforce, infrastructure and reporting processes come under severe strain. Indicators of financial crime and cyber crime are on the rise since the start of C-19.

Balance between responsiveness and resiliency

With bond and equity issuance opportunities drying up rapidly, the pressure from customers, corporations and governments should likely shift towards traditional bank lending.

Forbearance may unquestionably be the right response from a humanitarian and business perspective, but not managing this properly can cast a shadow that may outlast the eventual resumption to normal life after C-19.

In addition, C-19 may also amplify the interplay between various risk types (see right), making second-order impacts materialize more quickly than expected. Banks' operational capacity may come under challenge as they scale rapidly to channel government support, such as the Bank of England Coronavirus Business Interruption Loan Scheme (CBILS). Processes including eligibility interpretation, origination, onboarding, terms, recovery and collections will likely come under stress and call for more effective end-to-end control.

This calls on leaders to strike a balance between responsiveness and resiliency at a time of severe uncertainty. The fundamentals of integrated risk management apply more than ever.
Challenges for the Chief Risk Officer

Fast-changing data
It is difficult to source reliable data on where the impacts are and how they are evolving, due to complex impacts across credit and market risk: operational risk, people and workforce, infrastructure, supply chains, third parties and distressed customers.

Uncertain timeline
The challenges are accentuated by the different pace and scale of impacts by country, and the uncertainty of the duration of the stress conditions. A war footing may be required for a sustained period.

Conservative and irrelevant model assumptions
Financial stress forecasts can seem overly conservative in light of C-19 shocks: C-19 can cause underlying variables of risk models to deteriorate beyond the assumptions of the stress tests. In addition, Business As Usual (BAU) models may be less relevant in the current environment, as real-time, price-driven events (e.g. margin calls) and settlement risks pose a more immediate danger.

Increased sensitivity to aftershocks
With firms already facing pressures on their balance sheets, financial returns and workforce productivity, new and unexpected shocks can become more disruptive than under normal conditions and may further exacerbate the situation.
Now and next

Keeping a lifeline of credit supply is critical to support consumers, businesses and communities during this unsettling time. Managing credit risk is likely the most important and complex challenge.

Actions to take now

Source reliable and frequent data
Understand the latest scenarios and intelligence for COVID-19. Develop tailored analysis, ongoing monitoring and the execution capability to support a forward-looking and integrated response.

Establish a cross-functional war room
Bring together a dedicated team of domain specialists to analyse intelligence, manage info flow and coordinate actions across multiple functions (e.g. risk, collateral ops, trade settlements). Invoke pre-existing stress / crisis situation reporting plans (per BCBS 239).

Expand stress-testing scenarios
Define and run a wide range of scenarios for COVID-19 impacts over different time horizons. Rethink model development and validation rules to account for extreme and unexpected events in future internal and regulatory stress tests.

Actions to take next

Integrate pandemic risk into enterprise risk framework
Consider potential updates to risk taxonomy, anticipate regulatory requirements and new policies that may arise as a result of COVID-19.

Adapt decision-making models
Implement changes to credit risk models and loan origination rules for improved credit decision-making. Increase digital lending and automation (loan origination and monitoring) capabilities.

Leverage regulator and central bank measures
Harness measures initiated by regulators and central banks to mitigate the expected high inflow of defaulted exposures (e.g. relief in the treatment of non-performing loans (NPLs), lower procyclicality in IFRS 9 impairments, exposures with rescheduled principal / interest payments, reduction of capital requirements impact).
Rapid Response
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To help our clients navigate both the human and business impact of COVID-19, we’ve created a hub of all of our latest thinking on a variety of topics.

Each topic highlights specific actions which can be taken now, and what to consider next as industries move towards a new normal.

From leadership essentials to ensuring productivity for your employees and customer service groups to building supply chain resilience and much more, our hub will be constantly updated. Check back regularly for more insights.

VISIT OUR HUB HERE
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3. Ibid.
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