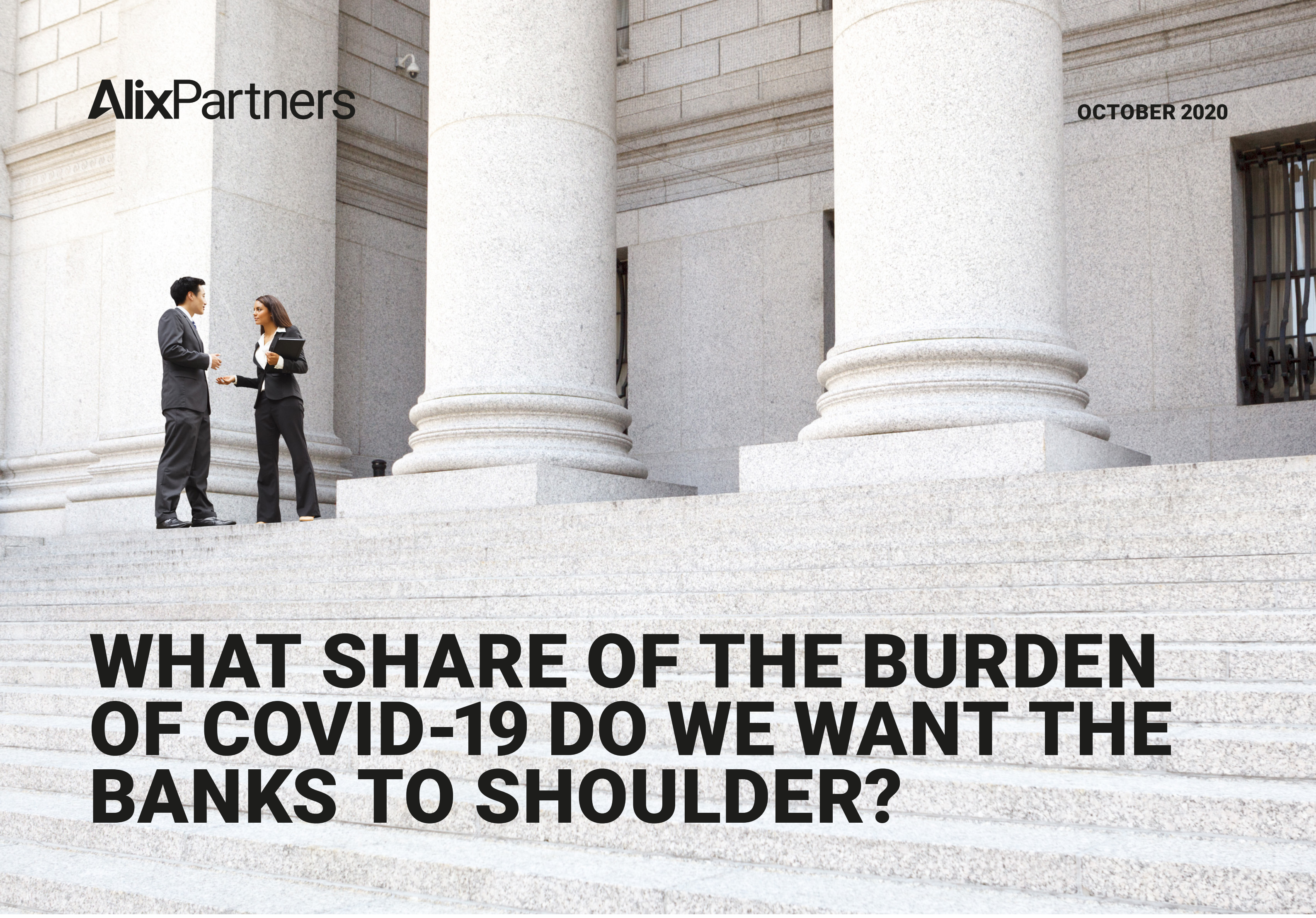
AlixPartners

OCTOBER 2020



WHAT SHARE OF THE BURDEN OF COVID-19 DO WE WANT THE BANKS TO SHOULDER?

The economic cost of COVID-19 has been, and continues to be, immense. But, in the UK, where will that cost land?

Ultimately, we believe that much of the cost will fall on the financial sector and within that, on the larger banks. How that burden lands requires some thought, if there was ever a time that we need a resilient and healthy banking system — to support our economic recovery — it is now.

In the short- and medium-terms, the coronavirus pandemic and the Government's response to it will inevitably harm the economy and bank profitability. The ability of the banking sector to attract the capital needed to support the essential services it provides over the longer-term is challenged by the costs that flow from COVID-19, layered as they are on top of wider sector disruption. Established regulatory objectives focusing on stability, prudential standards, competition and consumers remain important, but all of these regulatory goals and interventions must now be re-assessed through the lens of a radically changed macro-economic environment. Above all, we need to consider the importance of preserving a strong and competitive banking sector to the UK recovery. Without this re-assessment, there is a real danger of creating a spiral of low returns, restricted investment and lending, and macro-economic stagnation.

The banking sector entered the crisis with healthy levels of capital, which the Bank of England believes will keep the sector resilient, and able to support businesses through the crisis. The willingness of the sector to commit capital to the UK inevitably depends on the attractiveness and certainty of the returns that the sector can generate. One thing's for sure: returns will be suppressed for some time and the sector will be looking for reassurance that longer-term prospects justify decisions made today. HM Treasury needs to give regulators clear guidance on where it sees the balance between the established and broad regulatory agenda and the criticality of the sector's support for economic recovery.

We consider three questions, reflected in the three main sections of the paper:

1. What burden of cost might the banks be expecting to bear?
2. Can the banking system support rapid recovery under this cost burden?
3. How might the burden be shifted to lighten the load?

1 WHAT BURDEN OF COST MIGHT THE BANKS BE EXPECTING TO BEAR?

Banks have striven to support their retail and SME customers in navigating the pandemic, partly under regulatory direction. Their role in funding the economy through CBILS and Bounce Back loans has allowed businesses that might otherwise have failed to continue. Forbearance — the decision not to enforce rights against troubled borrowers — across many credit markets has enabled businesses and consumers to avoid insolvency, or at least has given them more time to adapt.

However, the economic impact of the pandemic will inevitably mean that many will not avoid financial distress, default and ultimately fail. The banking sector reported additional loan losses of £18 billion in the first half of 2020 and the Bank of England has estimated (in its May 2020 central case) that COVID-19 related loan losses may be as much as £80 billion. The August 2020 Financial Stability Report was more optimistic but pointed to material uncertainty and the spectre of the second wave has dashed hopes of an early recovery. Losses will be felt through the failure both of small and large companies and a sharp increase in retail credit defaults, due primarily to unemployment.

Ten factors that would cause losses to the banks:

1. **HIGHER UNEMPLOYMENT INCREASES PROBABILITY OF DEFAULT**

   The furlough scheme has protected the jobs of 9.5 million, but will end in a matter of weeks (31 October 2020); it remains to be seen how effective the new Job Support Scheme will be, but it is clearly far less generous. The MPC has predicted that unemployment will increase from 5.5% to around 7.5% of the country's workforce (2.3 million) by the end of the year.

2. **HIGHER TAXES REDUCE LOAN AFFORDABILITY**

   The cost to Government of the furlough scheme to 26 July 2020 has been £31.7 billion. This, together with the guarantee for the loan schemes and reduced tax receipts, will lead to a large deficit in 2020. To close this deficit will inevitably involve higher taxes for individuals and corporates, affecting their ability to repay loans.[1]

3. **REPAYMENT HOLIDAYS AND THE EXTENSION OF FORBEARANCE**

   The banks have been required to allow repayment holidays across all credit products. Although welcome in the short-term, repayment holidays increase customer debt burdens, which not only increase the probability of default but also the losses that the sector ultimately has to absorb.

4. **RISKY LENDING**

   HM Treasury has urged banks to continue lending during the crisis. The standard underwriting practices have been forced to set aside affordability concerns in extending loans. The higher debt burden will be too much for many firms.

5. **MORE DIVORCE**

   This is both a leading indicator and cause of mortgage default. The number of divorce enquiries during lockdown is up by 40%.

1. The IFS have developed a central case which suggests that if the UK economy were to achieve nominal growth of 3.8% (OBR long run growth projection post 2025) then an annual fiscal tightening of around £36 billion would be required

6. **HOUSE PRICES?**

   Changes in stamp duty have stimulated activity in the housing market and there appears to be some evidence that previous concerns that prices may drop by up to 10% in 2020 were unduly pessimistic. Any fall in house prices erodes borrower equity and, where this leads to negative equity, raises the likelihood of borrower default and the banks' exposure to loss. The stamp duty holiday ends in March 2021 and there remains a fear that any gains reverse.

7. **GENERAL DEFLATION?**

   Difficult to judge but if there were a period of deflation, then the impact on banks could be marked. Whilst the nominal value of loans is unchanged, deflation not only causes asset prices to fall but also income levels: loan affordability falls — increasing both the probability of default and losses in the event of default.

8. **CAPITAL ABSORPTION**

   Increased credit risk across loan portfolios will require the banks to allocate greater levels of capital against riskier assets. With capital being eroded as credit losses are taken, the prudential ratios will be squeezed from by both the numerator and the denominator. The FPC's 'desktop stress test' of UK financial stability[2], finds that the average CET1 ratio would fall from 14.8 to 11.0% — a decrease that represents 45% of the 'buffer' above the minimum capital requirements banks have been able to build up.

9. **CAPITAL REBUILD**

   In the future, we assume banks will be required to re-build their capital strength, repairing capital buffers, including re-instating the countercyclical buffer. Pressure to strengthen capital buffers too early will limit the sector's ability to carry on lending in an environment of large-scale job losses. The prospects for dividend payments against this recovery scenario are very limited; investor patience will continue to be tested. International banks, in particular, may come under investor pressure to move capital away from the UK to jurisdictions that can support a better rate of return.

10. **PROLONGED, VERY LOW INTEREST RATES**

    In March, the Bank of England cut the base rate from 0.75% to 0.25% and then to 0.1%, where it remains. With inflation well below the 2% target, the current yield curve is essentially flat — indicating that the markets expect very limited increases in rates over the next five years and that rates might remain some 40bps lower than expected before COVID. This sharply reduces banks 'net interest margin' (NIM) — the difference between what a bank pays depositors and charges borrowers. This is part of the critical role that banks play in the functioning of the economy giving depositors instant access to their deposits whilst extending long-term loans (the so called 'maturity transformation' role).

    In an already low-rate environment, these further cuts simply compress NIM, as floating rate lending products adjust automatically to a lower price point, with most savings and deposit interest rates already near zero. NIM fell by 16bps across UK RFB in H1 of 2020 and might be anticipated to be 25bps[3] lower in H2. This equates to a £4 billion hit on pre-tax profits.

The ultimate impact on banks' profits and their associated ability to attract capital to support future lending will depend on their ability to mitigate these losses by re-pricing and restricting lending to only the most obviously credit-worthy. This is not a welcome conclusion for an economy trying to address the twin threats of the pandemic and Brexit.

In competitive markets, increased costs in terms of expected losses and higher capital charges are usually passed on to customers in higher prices. This largely protects returns to shareholders to ensure the continued availability of funds for lending, but will also dampen demand to take on new loans to fund growth. Government will be keen to create a circuit breaker in the negative feedback loop of which this is part.

Any notion that this process can be averted by the banks absorbing losses, needs also to consider the links between the interests of customers and the interests of shareholders. Depressed shareholder returns reduce the ability of banks to provide the volume of lending required to fund the recovery and growth that customers seek.

There is a further risk that the costs we identify will be borne disproportionately by the more established, relationship-driven banks — exactly those banks that need to actively support the economic recovery. Where costs are borne disproportionately by a subset of market participants, then those costs cannot be passed on to customers: affected banks will either need to absorb the higher costs or lose customers to rivals unaffected by the cost increases.

2. Under a predicted scenario outlined in the May 2020 Monetary Policy Report (the 'MPR Scenario'), which assumes social distancing and fiscal support measures begin to ease in June and are lifted, gradually, by the end of Q3. https://www.bankofengland.co.uk/-/media/boe/files/financial-stability-report/2020/may-2020.pdf
3. The impact of the rate cuts only impacted about 60% of H1. We assume 100% impact of the rate cut in H2

2 CAN THE BANKING SYSTEM SUPPORT RAPID RECOVERY UNDER THIS COST BURDEN?

The burden of COVID that we see falling on the banks seems both inevitable and disproportionate, as they are already being asked to meet the disruptive challenges of regulation, technology and new entrants:

REGULATORY CHANGE

FCA interventions aimed at improving outcomes for (some) customer groups have targeted traditional revenue streams, impacting incumbent banks with more significant back books and less credit-worthy customers on average. For example, the SEAR (Single Easy Access Rate) intervention will disproportionately impact the banks with large savings back books and erode the stability of their deposit base.[4] The intervention on overdrafts, which forced a re-balancing of arranged and unarranged rates, has allowed challengers like Starling and Monzo to cherry-pick low unarranged users and undercut the higher arranged rates that have inevitably ensued from this intervention.

TECHNOLOGY AND SHIFTING CONSUMER HABITS

These have changed the face of competition in UK banking over recent years. Historically, competition has relied mostly on rivalry between large retail banks focused on a relationship banking model, with large branch infrastructures. With the growth of online and mobile banking, challengers have emerged, and new entrants have largely focused on product competition, with lower cost, online business models.[5] In the overall transition to the digital economy, the sector has seen the branch infrastructure become increasingly uneconomic. The pandemic has clearly accelerated the pace of disruption.

NEW DISRUPTORS

There are growing challenges from new fintechs and large tech companies entering the lending market, such as Amazon and eBay. These firms have, for example, leveraged the innovations in Open Banking (the brunt of the cost of which was borne by the incumbent banks). Recent developments in the Wirecard case may change things but, to date, these firms have largely escaped the regulatory encumbrance of banking. In contrast to the relationship-driven approach that established banks operate, fintech look to cherry-pick profitable service areas that do not require full banking authorisation.

New entrants have been able to leverage data to target the most credit-worthy customers. As digitization increases, it seems likely that large tech players will use their access to and experience in leveraging disparate data to accelerate a change that will undermine the relationship banking model. The prospect of large parts of the banking relationship migrating to these tech brands over a 5-year+ time horizon is real. Tech players have shown they're prepared to push the limit of what they can do to gain market share without becoming subject to bank regulation.

And now on top of these...

COVID MEASURES

The Coronavirus Business Support Loans and associated forbearance and expectations of lending to questionable credits have generally relied on the large, incumbent banks. Although losses on the additional lending are mainly guaranteed by the Government, this doesn't address the concern that the increase in the overall debt burden becomes unaffordable. Ironically, the risk of defaulting on loans made prior to the schemes is made greater by the schemes themselves — and the lenders most affected will be the larger banks.

DEATH BY A THOUSAND CUTS

With increased entry, product regulation and the disproportionate impact of COVID-19 measures, incumbent banks face the risk of death by a thousand cuts, impairing their ability to lend at the rates and volumes needed. Regulation that affects them disproportionately will inevitably weaken their ability and appetite to invest in innovation, undermining a critical component of competition in the wider banking market. Less overall competition tends to be bad for consumers, even if other types of players have not been similarly weakened. From the perspective of lending through the crisis and avoiding a negative feedback loop, the point here is this: it's the competition between the incumbent banks that is most responsible for ensuring the appropriate volume of economic lending is available.

Overall, the challenges of COVID-19 mean that profitability in the short-term will plummet and all banks will need to act to mitigate loan losses; price in additional risk (and capital charge); offset the squeeze on the NIM; and restore capital levels to those expected by regulators.

4. The incumbent banks are more likely to have legacy books of easy access savings accounts which are currently paying low interest. Bringing these in line within a SEAR would adversely impact NIM. SEARs may also impact the stability of the banking sector's funding. Retail deposits have a behavioural maturity that banks rely on to support their lending activities. Without the deposit 'stickiness' of branch-based deposits and savings accounts, banks would be required to either (a) limit lending, or (b) hold greater stocks of liquid assets (for example Government Bonds), which is expensive for banks and will further raise the cost of lending
5. These trends have been facilitated by investments (borne by the incumbent banks) in Open Banking, Faster Payments, and in underpinning the FSCS scheme (which gives new entrants instant consumer credibility)

Key to achieving an acceptable level of profitability (sufficient to attract new investment to the UK banking) will be restoring NIM through a gradual re-pricing of the overall book, i.e. higher rates on new lending in some segments (e.g. commercial lending). However, the pace at which any repricing can happen will be constrained by an increased risk of default: higher levels of personal and corporate indebtedness will mean that many borrowers will be unable to absorb rate increases and banks will have to tread a careful line in refinancing existing borrowing and extending new loans.

The levels of return that the sector has been able to generate have failed to recover to levels which support the existing capital deployed. Price to book ratios remain well below 1, suggesting that the market does not see any near-term ability to generate healthy returns. Against this background, any rights issues will be highly dilutive.

The domino effect of high losses, depressed profits, poor shareholder returns, inability to raise capital, restricted lending and further losses stalling economic recovery is a real and present danger.

3 HOW MIGHT THE BURDEN BE SHIFTED TO LIGHTEN THE LOAD?

The burden of COVID is clearly immense. Much of it will fall to the banks and — perhaps disproportionately — to those banks that the economic recovery most depends on. Given the risk to the economy of an over-burdened sector, how might this burden be eased?

1. REGULATORY OBJECTIVES AND ALIGNMENT

We see four imperatives for the banking system, each pulling in a different direction: continued lending to the real economy vs maintaining the stability and viability of the banking system versus promoting competition vs protecting consumer outcomes. We posit that it is necessary and timely to step back and re-think the objectives, the policy hierarchy and the supporting regulatory structure of regulation, at a minimum for consumer and SME banking.

In any event, even within the existing regime, greater regulatory coordination and alignment are more crucial than ever, across all interfaces between Government and the banks.

2. OVERALL REGULATORY BURDEN

Additional regulatory initiatives need to be carefully considered, in the context of the overall burden and impact on the ability of the banks to attract capital and keep lending at levels that the economy needs. The notion that banks can absorb these additional costs without onward implications is mis-placed: eroded profits affect the ability to lend and meet the needs of customers and, at this time in particular, the wider economy.

The ‘Regulatory Grid’ could be an important element of this, but we think the regulatory authorities need to go further and consider the costs and benefits of each change, both in isolation and in aggregate. This aggregated cost must also be taken against a revised baseline that reflects a fully informed understanding of the outlook for the sector. This is clearly a challenging but, we think, vital undertaking.

One example may be to re-think the PRA’s decision to remove the discretion to use 180 days instead of 90 days in the ‘days past due’ component of the definition of default, for IFRS 9 purposes, for exposures secured by certain SME commercial mortgages. Given likely default rates due to the pandemic, these changes (due to be implemented by the end of 2020) will likely strain banks’ capital and their ability to continue to lend to SMEs.[6,7]

3. MORE SOPHISTICATED REGULATORY IMPACT ASSESSMENTS

The FCA has targeted a number of regulatory interventions on products where incremental profitability of sub-products (e.g. unarranged overdrafts) or customer segments (e.g. savings back books) has appeared 'high'. In so doing it has not (so far as we are aware) scrutinized the impact this might have on aggregate profitability. For example, the FCA’s review of business models did not include a holistic assessment of retail banking profitability. We believe these interventions should be revisited in light of the increased pressures that the banks and their customers are now under.

In cash savings, the introduction of the Single Easy Access Rate (SEAR) is designed to lead to higher interest rates for longer standing customers. It is unclear how these better rates of interest are to be achieved without being largely at the expense of the sector’s NIM. It is also not clear whether sufficient thought has been given to the impact on the funding model adopted. Reforms that discourage sticky savings and deposits will require the

6. Although banks may have been able to defer some of the IFRS 9 impact of COVID-19 whilst the position remains uncertain, as clarity emerges it seems likely that a significant portion of lending should migrate from Stage 2 to Stage 3. We have already seen some recognition in the larger UK banks’ Q1 results, in which expected credit losses recognised are higher than the whole of 2019 and can expect to see more recognition at the end of Q2
7. Another example may be how lenders assess each current mortgage’s classification under IFRS 9. Lenders will have difficulty deciding how to assess applications from customers whose income has been unstable due to the lockdown or an extended furlough

bank treasurers to hold more assets in liquid assets. This is not only more expensive for the sector, but also means that less funding is available for lending. A more sophisticated assessment of the impact of this reform against the evolving background of COVID-19 is required.

More broadly, the precise impact of measures designed to increase competition or protect vulnerable customers needs to be considered more thoroughly. The FCA's competition duty must look to recognize the wider impacts of interventions on the sources of competitive pressure in the market. Measures that have a disproportionate effect may undermine important elements of competition and, as described above, severely constrain the ability of mainstream lenders to provide adequate levels of lending. It is precisely at times of economic stress like these that the value of competition in relationship banking — as opposed to entrants focusing on individual product lines — can be seen for the wider economy. Banks that take a longer view on the prospects and track record of consumers and businesses are better placed to help them ride out periods of unemployment or financial distress.

Arguably the current regulatory framework hands new entrants' certain advantages which may be understandable within limits. But now — more than ever — regulators need to (re)think what those limits should be if they want to preserve competition from incumbent banks and the investment that will be needed to do so. There is a sense that HM Treasury is looking to the bigger banks to support initiatives that will maintain the real economy and allow it to recover quickly. Ministers have spoken about the sector returning the favour of taxpayer support through the financial crisis; it may well be right that better outcomes can be achieved through a co-ordinated response. This is not the same as saying that incumbent banks should carry a disproportionate share of the burden. The Treasury and the regulators will need to mindful of the need to encourage competition in the sector through the crisis and beyond.

4 ALLEVIATE THE NEGATIVE IMPACT OF THE COVID MEASURES

There is concern about prolonged negative fallout from the banks' involvement with the COVID lending measures. The CEO of UK Finance expressed the concern that '[banks] end up being the bad guys again when it turns out [the loans] can't be repaid' and highlighted concerns that some small businesses have wrongly perceived the state-backed loans to be a grant. This has led to lenders emphasising the borrowers' liability for the loans.

One potential approach, raised by a number of key figures in the banking sector, is to create a Special Purpose Vehicle ('SPV') to act as an asset manager for the approximately £43 billion of CBILS, CLBILS and BBLS loans, removing the potentially toxic debt from the banks' balance sheet. City UK has taken this suggestion forward and proposes that the loans from these schemes be converted into subordinated debt, tax liabilities or preference shares. A new entity would be created to hold these instruments, removing unsustainable debt from the balance sheets of SMEs and creating capacity to take funding for growth. HM Treasury has, for now, pushed back on such proposals but we would encourage ongoing debate.

5 ENSURE REGULATION APPROPRIATELY ADDRESSES TECHNOLOGY TRENDS

The FCA's mission includes 'Encouraging Innovation'. This has often been interpreted as encouraging entrants with new offerings and business models, but it should also embrace new offerings from the incumbent banks. If a solution is not found to the unsustainable debt that corporates have taken on, and incumbent banks are required to deal with a tsunami of loan defaults, then their capacity to fund innovation will be compromised. As we saw in the wake of the financial crisis, under-investment in new initiatives slowed the pace of innovation. The sector has been slow to drive improved outcomes for consumers that technology and data might have facilitated. At the moment, many fintechs have largely escaped the regulatory encumbrance of banking.

One outcome of COVID is the acceleration of digital adoption, even among previously resistant customers. Neobanks and challengers will be able to embrace the changes in customer behaviours and respond to cost pressures in a more agile way. There is therefore a prospect that, if these pressures on the business model of incumbents play out — and even more so if they are compounded by future interventions — we might see a major re-balancing, with market conditions tipping in favour of big tech. Given the very current challenges regulators are seeking to address in other markets that have become dominated by big tech, regulators and HM Treasury must have an informed view on the desirability or otherwise of such a shift and on how their regulatory policy choices may push the market in one direction or another.

One issue related to this — in light of falling footfall and more digital adoption — is the need for incumbent banks to accelerate branch closures. Access to cash and branch-based banking services remains important to a shrinking minority of individual and SME customers. Of course banks should support their customers in making the transition and offer access to banking through innovation. The FCA and policy makers generally should encourage innovation, whilst accepting that banks may need to close large numbers of uneconomic branches.

CONCLUSIONS

The Government and the banking sector have worked well together to help firms mothball operations, retain jobs and fund fixed costs. Even if schemes are established to convert or subordinate COVID-related debt, the burden of pre-existing debt will also have increased through the roll-up of interest. Loan losses have already begun to rise and, before an economic recovery restores company profits, many more firms will fail. These loan losses will fall, in large part, on those banks with large, established loan books.

Economic recovery may be fragile for some time; interest rates will remain low and the prospects for sector profitability suppressed. Banks are planning carefully to navigate loan losses and the impact on their capital position. The expected losses will suppress dividend expectations, while investors will also be aware that, even when loss rates begin to tail off, the sector will be asked to restore capital buffers. Bank executives will need to plot a careful course that demonstrates that their use of scarce capital is in the long-term interests of shareholders.

The regulatory agenda needs to adapt to these new circumstances. HM Treasury should work with regulators and the sector to ensure that regulatory objectives are aligned and that the impact of proposed changes are fully understood. Measures taken to respond to COVID seem set to have a disproportionate impact on more established banks, whilst the pandemic has undoubtedly accelerated social and technological change, which has spawned and will spawn greater competition in the sector. Government will need to be mindful of how the virus, and its own response, will affect different banks. Where interventions have disrupted competitive dynamics, schemes should be implemented to correct this disruption.

With mounting rates of corporate failure, unemployment rates surging, and an unprecedented peace time fiscal deficit — when it really matters — we all need the UK banking sector to be robust, resilient and healthy. Adapting the regulatory environment to a COVID and post-COVID economy will play a vital part in achieving that.

AlixPartners

CONTACT THE AUTHORS:

Liam Colley
Managing Director
+44 20 7098 7570
lcolley@alixpartners.com

Tim Roberts
Managing Director
+44 20 7332 5220
troberts@alixpartners.com

James Worsnip
Managing Director
+44 20 7098 7447
jworsnip@alixpartners.com

ABOUT US

For nearly forty years, AlixPartners has helped businesses around the world respond quickly and decisively to their most critical challenges – circumstances as diverse as urgent performance improvement, accelerated transformation, complex restructuring and risk mitigation.

These are the moments when everything is on the line – a sudden shift in the market, an unexpected performance decline, a time-sensitive deal, a fork-in-the-road decision. But it's not what we do that makes a difference, it's how we do it.

Tackling situations when time is of the essence is part of our DNA – so we adopt an action-oriented approach at all times. We work in small, highly qualified teams with specific industry and functional expertise, and we operate at pace, moving quickly from analysis to implementation. We stand shoulder to shoulder with our clients until the job is done, and only measure our success in terms of the results we deliver.

Our approach enables us to help our clients confront and overcome truly future-defining challenges. We partner with you to make the right decisions and take the right actions. And we are right by your side. When it really matters.