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Financial Services Practice

Leadership in the time of the coronavirus: COVID-19 response and implications for banks

As the effects of the COVID-19 pandemic continue to reverberate, banks have a role to play as systemic stabilizers.

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The profound humanitarian fallout of the COVID-19 crisis carries with it the potential equally disruptive economic fallout. The path ahead is hence a precarious one, driven by epidemiological uncertainty, the unique blend of resulting shocks to both supply and demand, and "preexisting conditions" in the global macroeconomy.

At this writing, Europe has become the prime epicenter of the crisis, with nearly 75 percent of new cases reported globally on March 18. In Italy, years of low growth and high government debt are colliding with the rapid spread of the disease in an elderly population. Spain and France, face similar prospects, as do many countries in Asia. Thailand, for example, is similarly reliant on exports and tourism receipts and already has one of the highest debt burdens in the region at around 75 percent GDP. The particular characteristics of the US economy may make it susceptible to the impacts of COVID-19, despite its general strength before the virus' arrival. A high number of households and businesses are vulnerable to the impact of disease-containment measures, because of their high-debt burden.

At the same time, yield chasing over the past several years may exacerbate the potential for market illiquidity. The Fed and the European Central Bank (ECB) have already cut rates to zero; historically low rates limit the tool kit of other central banks, and several global regions are probably already in recession as many economists and the latest data from China suggests. Addressing the situation will require further global action and public–private coordination. Banks around the globe will play a critical role in this as systemic stabilizers for their customers, their employees, and for their economies at large. Cash and deposit services, credit extension, payment facilitation, and market making are all essential services.

This memo lays out our initial recommendations for actions that banks should take now, beyond what common business continuity plans or crisis response checklists suggest. In their immediate response, we believe institutions should plan for an acute period of multiple months, spanning their entire footprint, and with a view of all stakeholders—not the more constrained circumstances that business continuity plans typically address. At the same time, banks may begin to stress test their capabilities and financials, laying the groundwork for identifying long-term strategic implications and ensuring a smooth bridge between the present and future.

Immediate response

Banks have already taken a series of actions in reaction to the spread of COVID-19. Common steps we've seen include establishing a central task force, curtailing travel, suspending large-scale gatherings, segregating teams, making arrangements for teleworking, and refreshing external-vendor-interaction policies.

Beyond these immediate and basic actions, banks should prioritize three measures tailored to the particular combination of biological and market stresses and how they affect the market. These points draw on the experience of China, Italy, and several other countries, acknowledging that differences exist in economic and political structures, healthcare systems, and social and cultural norms among these countries.

1. Normalize workforce measures for multimonth sustainability

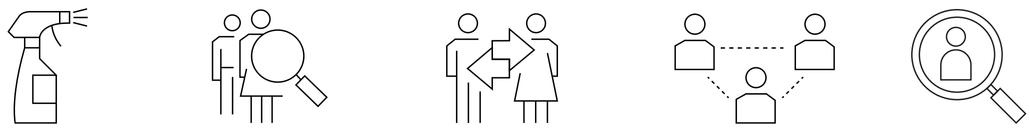
As a top priority, nearly all firms have already taken proactive measures to protect their people and to contain the spread of COVID-19 (Exhibit 1). These include restricting travel and taking other prevention-oriented policies, emphasizing workplace hygiene, offering alternative ways of working, and initiating proactive communication.

However, health measures to contain propagation may take months, not days or weeks, as we've seen in China. Therefore, banks will need to make sure the measures they have put in place are sustainable—and designed to get the best out of their people, while preserving their mental

Exhibit 1

For banks that choose to maintain branches, certain tangible actions can help manage operations while monitoring risks.

Checklist for banks that maintain branches



☐ **Clean**

Ensure cleanliness and deep clean all branches and customer-interaction locations to give employees and customers comfort

☐ **Identify**

Heighten monitoring of physical channels to quickly identify the ones affected (confirmed and potential) and develop a playbook for addressing contamination

☐ **Alter processes**

Identify and alter physical process requirements—to ensure continuity on main services even with branch closure or staff reduction[1]

☐ **Control**

Ensure appropriate controls in altered workplace setting and that trade-offs between contingency measures and risk appetite are well-considered

☐ **Monitor**

Monitor customer-service capacity against need and reduce operations if customer need is not evident

[1] For example, review ATM and branch limits on receipts and payments; identify alternatives to in-person sign-offs; leverage branches with remote advisory installed capabilities).

and financial well-being over such a period. Further, specific consideration will be required for contingent and contract workers, who might be most immediately impacted.

Because banks are providers of essential services to customers and communities, and the markets more broadly, they will need to adopt a carefully segmented approach to workforce management, informed by service criticality and exposure risk (Exhibit 2). Particularly careful attention is required for those in the workforce who provide critical services that are either customer facing or that require infrastructure only available at work premises. These include, for example, branch employees, some call-center support, sales and trading personnel, employees in the Treasury function, as well as some facilities and custodial staff. Korea's Shinhan bank directed 150 of its call-center staff to work remotely, to handle activities that do not require access to customer information, such as queries on financial products. More detailed requests they forward to colleagues who continued working in the office.

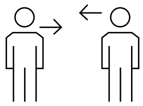
One case in point: trading activities are central for market functioning but cannot easily be executed remotely because of technology and compliance requirements. Most banks have already taken a number of actions including segregating team members and activating business continuity plan (BCP) sites for parts of the sales team. Furthermore, BCP sites may have insufficient capacity to support a split-team model, requiring banks to consider alternatives in the event of a prolonged crisis. Since the virus reaches across all major financial centers, the potential for simultaneous infection across sites rises as the disease spreads. Institutions should maintain and test backup plans in case this occurs and establish clear triggers for putting such plans in place, such as a case of infection at or in the vicinity of one site. Backup plans might include the potential to move immediately to a work-from-home model, for which regulatory clearance and robust technical testing should occur preemptively.

For those segments of employees for whom remote work is possible (a group that may well have to be larger than initially envisaged), banks should

Exhibit 2

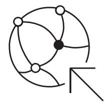
As COVID-19 cases grow, there is a range of actions emerging across banks to protect and communicate with clients.

Checklist for client engagement



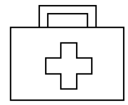
☐ **Engage clients**

Proactively reach out to clients encouraging proactive exchange on upcoming financial challenges and offer advice on how to weather negative impact. This will require training bankers to engage clients and coach them through the crises



☐ **Identify risk**

Review and sharpen risk identification, monitoring and measurement to identify clients with higher vulnerability to primary and secondary effects of the outbreak, and anticipate, as much as possible, detection of creditworthiness deterioration



☐ **Support vulnerable clients**

At a high level, clients that may need more support will be small businesses within affected sectors, individuals who are self-employed or working in affected industries, especially those with higher debt levels. On the other hand, larger companies may be less affected, along with those at the forefront of the humanitarian response

☐ **Mitigate risk**

Adjust potential credit-risk-mitigating actions for pre-delinquency, early delinquency, and nonperforming exposures, in light of specific implications of COVID-19 on clients, eg, temporary vs long-term nature of business disruption, value-chain considerations

review policies, practices, and controls and tailor them to the new working environment. “Work-at-home” organizations and routines, output-based performance management, and technological capabilities should be a particular focus. In parallel, banks should make sure both employee relations and internal technical support are sufficiently staffed and trained to accommodate potentially new and elevated levels of requests. Critically, institutions will need to ensure that appropriate controls are in place in all altered workplace settings and that trade-offs between contingency measures and risk appetite are well-considered. Key considerations include data security, fraud, cybersecurity, and privacy, especially safeguarding personally identifiable information. Bank managers should also pressure test and update business-continuity and disaster-recovery plans as needed for these new working conditions.

2. Provide essential banking services to retail consumers

People will continue to need essential banking services through these trying times. Banks should continue branch and ATM operations with the appropriate safeguards, while encouraging widespread use of remote services. This approach will account for needs and preferences across all consumer segments, including the older part of the population that is both more vulnerable to COVID-19 and less likely to adopt digital channels.

Institutions can continually monitor and assess consumer demand for in-person services to adjust capacity and minimize risks. For example, in some areas of China, banks observed limited demand for services other than ATM access and so were able to close most of their branch locations without disrupting customer service. Banks in several regions, including Hong Kong, Italy, and Germany, have also closed (some) branches or moved to restrict staffing and hours when the risk to the public and employees was deemed to outweigh the need to maintain the branch. In Korea, which has adopted aggressive virus testing, branches have tended to remain open unless active cases are detected.

Physical locations that adopt rigorous yet consumer friendly approaches to disease containment both safeguard health and inspire confidence in the system. Examples borne from experience include evident deep cleaning of all branches and ATMs, alternatives to in-person sign-offs, and further leveraging branches with remote advisory capabilities.

At the same time, banks should encourage and support customers to use digital and other virtual channels, wherever possible. To encourage customers to use remote channels and digital products, institutions can launch positive and safety-oriented messaging aimed at reducing reliance on branches for services that are digitally available—while also providing tutorials online and by phone and increasing remote support options. Banks can also enhance their current digital offerings, identifying key functionalities that can be improved quickly; for example, they can increase the limit for online activities, and they can simplify the procedure to reset passwords. Institutions in both Italy and China have found that many people readily used remote channels and digital offerings (see sidebar “Digital shift in China: Digital offerings can provide necessary services while supporting employee and community safety”).

Regrettably, increased fraud and information security risk are likely. Opportunists and threat actors may exploit confusion and vulnerabilities stemming from changes in ways of working and serving customers. Banks should include risk professionals on agile-product-development teams and run controls tests in parallel. However, they may also need adjust their risk appetite upward and should make this explicit. Recent regulatory communications seem to indicate that such an adjustment, if well-examined and well-communicated, would be positively received.

3. Fulfill social mission to support households and businesses with credit

A majority of households and businesses will be negatively affected by the unprecedented nature and extent of the current health and safety measures. For example, in the United States, 74 percent of workers say they are living from paycheck to paycheck, while 58 percent are paid by the hour. For them, financial impact of quarantine measures and lack of employment—due to reduced sector activity, such as travel—will be particularly difficult. The stress will be especially acute for those who are already in debt. These individuals will likely need further support from banks to support day-to-day liquidity needs through credit. Even in places where household savings rates are high, such as in some Asian countries, a greater connection to global markets means more households and businesses are likely to be affected.

Among businesses, the impact will vary significantly by sector and by company. It seems quite likely at this point that travel and tourism, entertainment, automotive, oil and gas, and healthcare industries will be most affected due to disruptions in supply

Digital shift in China: Digital offerings can provide necessary services while supporting employee and community safety.

On average, the Chinese population spent around seven hours per day on their phones before the virus struck, mainly on entertainment, social media, and gaming as well as ordering food and essential products for delivery. Banks that were integrated into this ecosystem or were able to roll out new solutions to interact with new behavior (for example, with the ability to make payments online or by having credit solutions online) were the most successful in driving customers to digital channels—and to ones that protect the customer as well as the employee. The increased use of digital alternatives during the crisis has changed company expectations for future digital offerings.

and demand. Within these sectors, smaller businesses, such as those that cannot shift to remote work and online delivery and those catering to the most vulnerable segments, are likely to be more affected.

From a credit perspective, banks should rapidly identify most affected sectors and customers to understand how they can be most supportive to their clients and community. Some are already considering relaxed payment schedules and availability of credit, and the media is already monitoring hardship requests. In doing so, banks might draw on lessons learned in Italy and elsewhere (see sidebar "Client response in Italy: Segmenting the client base can maximize the effectiveness of bank support."). This will include proactively engaging with clients to understand their situation, segmenting portfolios based on expected needs, developing an internal view of where support measures will be the most effective, and adjusting risk-mitigation actions for early delinquencies and for nonperforming exposures. While banks have taken some of these relief measures as part of natural-disaster response in the past, this situation will require a much broader geographical scope. Supporting clients in these critical times will deepen customer relationships and reaffirm the role of banks as key enablers of the economy.

Regulators around the globe understand the challenge and are already relaxing rules for banks. For example, the ECB announced on March 12 that banks can fully use their capital and liquidity buffers. Banks will be allowed to operate temporarily below the level of capital defined by the Pillar 2 Guidance, the capital conservation buffer, and the liquidity coverage ratio. The ECB also suggested that national authorities relax their required countercyclical capital buffers. In Asia, the Bank of Japan has loosened the monetary policy through conducting various operations including purchases of Japanese government bonds, US dollar funds-supplying operations, exchange-traded funds, and real estate investment trusts. In the United States, regulators have expressed support for firms that choose to use their capital and liquidity buffers to lend and undertake other supportive actions in a safe and sound manner, saying that these buffers were designed to support the economy in an adverse situation; this will also allow banks to continue to serve households and businesses.

From a liquidity perspective, the simultaneous supply and demand shock has stressed companies across industries, pushing them to draw on credit lines to support working capital and stockpile cash. Additional drawdowns in commercial as well as retail lines of credit are also to be expected, in combination with a "flight to quality" toward deposits of certain customer segments, such as wealth-management clients. Strong internal liquidity-management practices will be required for banks to be maximally effective in supporting market liquidity and changing customer borrowing needs. The severity of the crisis is likely to lead to larger-than-expected drawings on credit lines. High market volatility will also elevate margin calls for derivatives. The liquidity coverage ratio as a measure of outflows over a one-month period may not be enough to capture all the risks to liquidity from a longer period contagion. Banks will need to upgrade their risk models and mobilize collateral for refinancing at central banks.

Banks should remain vigilant about liquidity measures to support their customers and confirm that telling indicators, such as corporate-deposit rates and interbank lending, are monitored with the right level of attention and escalation. Select leaders should ensure proactive communication and clear, deliberate signaling. It is even possible that US banks may be faced with the question of whether to pass on negative interest rates as banks have done in many European countries in recent years.

Stress testing financials to plan for the future

We anticipate that financial-institution performance will be hit across all dimensions—fees, interest revenue, losses, and expenses. However, variances will be substantial by sector and customer segment, with details depending significantly on the scenario that ultimately unfolds. While the exact financial impact of the COVID-19 crisis remains highly uncertain and will be bank dependent, we anticipate the following:

Client response in Italy: Segmenting the client base can maximize the effectiveness of bank support.

In addition to the government-mandated payment holiday on mortgages, some Italian banks are developing frameworks to assess which proactive actions may have the more effective outcome on clients, including considerations such as the following:

— *level of COVID-19 impact,* for example, geographical areas most affected by the virus

— *type of loan,* for example, primary-home mortgages, secondary-home mortgages, unsecured personal loan

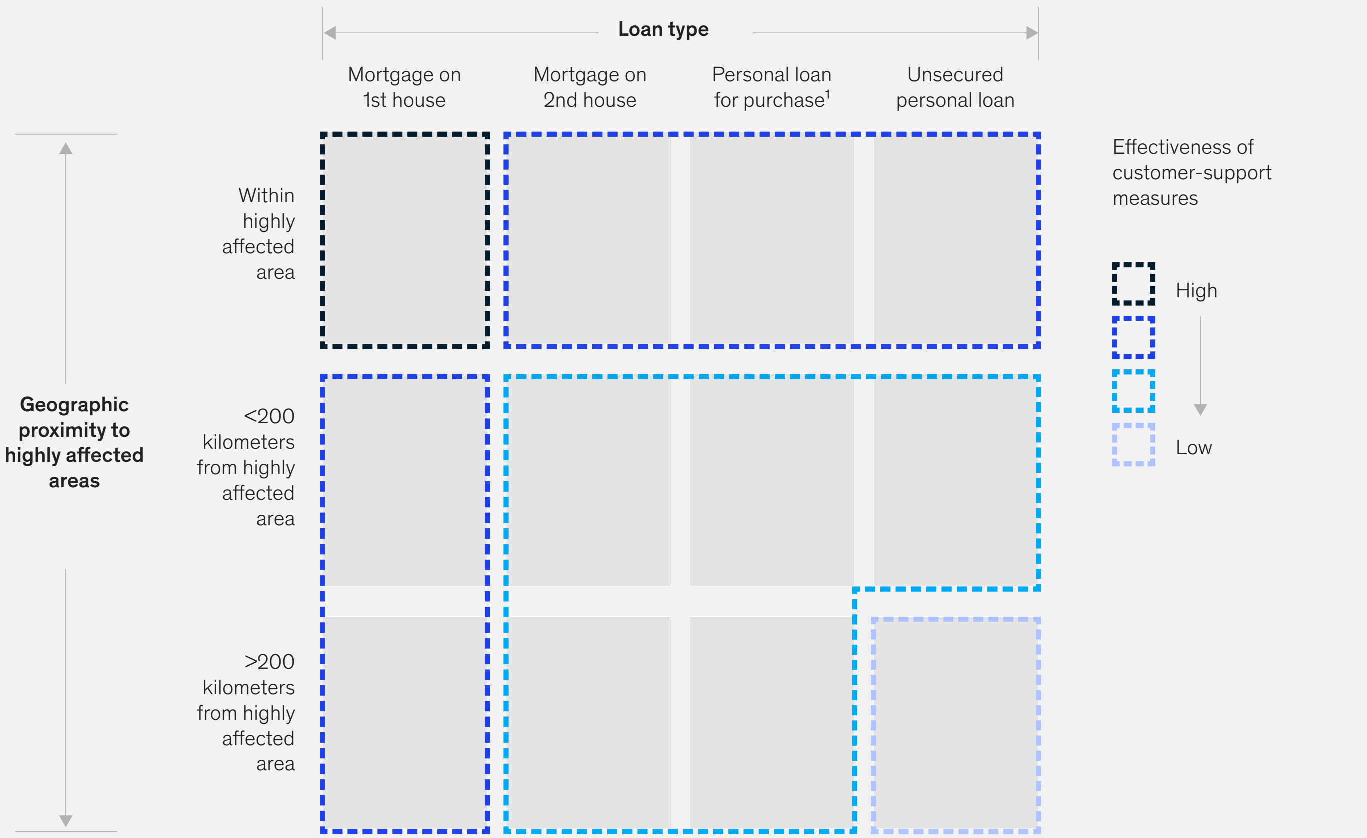
— *client delinquency stage*

This segmentation allows the effective prioritization of cases based on their criticality. For example, clients that are most affected by COVID-19 and have a primary-house mortgage will be supported with the highest priority in case of need (exhibit).

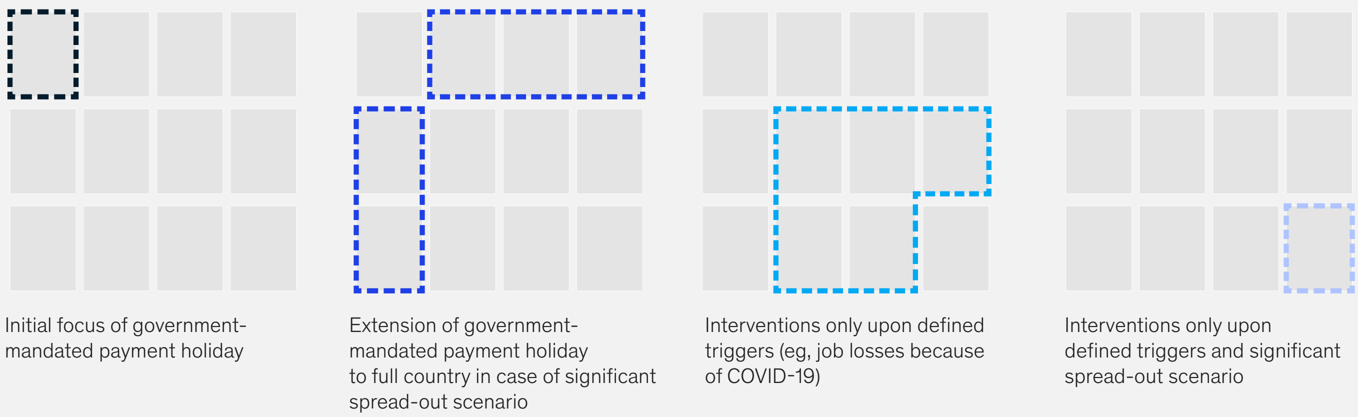
Exhibit

Some Italian banks are prioritizing support for customers, based on proximity to the outbreak and type of loan.

Effectiveness of loan-relief measures, including impact on P&L and capital



4 groups of loan-relief measures



[1] Such as for a car or home renovation.

— *Fee income likely will fall,* driven by lower consumer spending in retail businesses, decreased assets under management in asset-management divisions, as well as slowdown in investment-banking activity. Some sales and trading businesses may be an exception: fixed-income flow volumes may increase, and high volatility will translate to elevated bid–ask spreads and potential mark-to-market gains.

— *Net interest margins will remain compressed,* as rates remain low or fall slightly further. Any increase in borrowing volumes, for example, from drawdowns on lines of credit, may be offset by losses in credit portfolios.

— *Credit losses will be elevated across most sectors,* across small businesses and in certain retail segments (for example, self-employed workers, hourly-wage earners, uncollateralized products). Within commercial banking, travel, tourism, and entertainment segments will be the hardest hit. Oil and gas lending may also be challenged, with ultimate outcomes depending heavily on geopolitical factors affecting oil production and price. Across all industries, smaller and less efficient businesses will be hit disproportionally.

— *Remote work may increase costs* for setup, and may cascade to lost wages normally paid to hourly workersy and contingent staff. Operational losses due to fraud are also likely to increase.

To understand the impact on their own portfolio under rapidly evolving scenarios, banks need to apply testing tools, complemented by close continued monitoring. To do so, they can leverage their existing stress testing frameworks, such as the capital adequacy infrastructure developed as part of Comprehensive Capital Analysis and Review (CCAR) in the United States. To maintain safety and soundness and limit impact on financials, banks should maintain an up-to-date and scenario-based view of expected financial impact across businesses. In doing so, however, we believe five key imperatives should be borne in mind:

1. *Prioritize and iterate.* Unlike regulatory stress testing, this is not a hypothetical exercise. Stress-test results have direct implications for decisions banks are making in real time. Banks will need to identify which industries and segments are in most imminent danger and quickly analyze and monitor data for early warning signals. That base will allow them to build a fuller view of the economic landscape iteratively, as the pandemic evolves.

2. *Reverse stress test to identify worst-impact scenarios.* Regulatory stress testing, as well as most banks' supplemental stress testing, lay out specific hypothetical scenarios to assess their potential impact. In today's world, banks should look immediately to understand the outer limits of possible actions to support borrowers and markets during the trough.

3. *Build scenarios based around potential virus spread and human reaction.* Building mere macroeconomic scenarios will not be helpful as these would be divorced from the underlying drivers of the crisis. Instead, scenarios should be built around the spread of the virus. This will require developing a range of expectations for the progression of the disease, government response, and supply and demand shifts, and only then looking at macroeconomic changes. Analyzing the interaction between supply and demand and associated impact on macroeconomic factors will be particularly complex, as there is no direct historical precedent. Historically linked variables, such as income and employment, may decouple. Typically decoupled variables may become more correlated, such as when multiple business-continuity-plan scenarios occur simultaneously across the globe. Also consider "knock-on" operational risk-like scenarios, for example, the impacts of food shortages.

4. *Examine performance assumptions built into existing models.* Because the situation is unprecedented, assumptions built into models may not hold. For example, assumptions common in some treasury models have already

been broken in this past week's US Treasury price movements. As another example, collections-efficiency assumptions are unlikely to hold because of situation-dependent decisions on when and whether to collect at all.

5. *Incorporate implications of near-term actions, including on expenses.* Most institutions have appropriately acted quickly to try and contain virus spread and protect their employees' and customers' health. If these measures remain in place for several months—consistent with China's experience—their implications may be nontrivial and will need to be better understood.

As deposit gatherers, credit grantors, and payment facilitators, banks play a vital role in the functioning of the economy. They are not simply commercial enterprises but provide important services to individuals and communities. Their health, and that of their workforce, the continuity of their operations, and their safety and soundness are therefore critical. The last financial crisis led to much emphasis on the systemic risks posed by banks; the current one, which has entirely originated from outside the banking system, provides the opportunity for banks to prove their role as systemic stabilizers, delivering services at least in part for social good. Needless to say, this will require very careful thinking and trade-offs among various short- and medium-term options.

In doing so, bank leaders should bear in mind that this crisis is likely to reinforce, in direct proportion to its extent and duration and maybe even more, a number of existing trends. Workplace dynamics and talent management, already evolving in a digitizing world, may be durably changed after an extended period of remote working. As they settle into their new routines over the next weeks or months, banks should consider this as a testing ground for what does and does not work and draw implications for their HR, organizational, governance and culture transformations. Likewise, customer routines and expectations may also shift further in meaningful proportions, both in terms of digital adaptation and the expectation for proactive communication and care. Operational resiliency is also bound to remain critical with mounting risks of pandemics, societal and geopolitical tensions, and climate change. Banks should carefully draw on the lessons that the current situation offers and use them to inform their digital transformation, while building a much higher degree of both operational and financial resiliency.

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