



Can banks weather this storm?

**Credit liquidity and operational
resilience will be key banking
tools in the COVID-19 crisis**

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Overview

The COVID-19 pandemic crisis has dramatically gathered pace in recent weeks, with fresh developments almost by the hour. Many countries have declared national emergencies and are fighting to contain the virus' spread.

In such challenging times, banks have a fundamentally important role to play. This begins with central banks and then ripples out through economies via the banks themselves as they provide funding liquidity to support businesses and individuals.

Globally and locally, central bank actions have taken decisive and significant measures to mitigate the impact of these challenging times. The Federal Reserve (Fed) in the US has slashed interest rates by a full percentage point to effectively zero and launched a US\$700bn package of quantitative easing (QE). The European Central Bank (ECB) cut rates and extended its QE program in September, however didn't follow the FED and Bank of England with further cuts as of March 12th. They have announced measures to support bank lending and expanded its asset purchase program by 120 billion euros (US\$135.28 billion). There has also been a deal between six major central banks including the Fed and the ECB to lower their rates on currency swaps to help financial markets function normally.

These measures set the context in which banks can better support their customers. It won't be an easy ride ahead. Many businesses are likely to face severe difficulties in the coming weeks and months, and life will get tougher for the banks too. But the right steps are being taken by regulators and banks to bolster the system and help stabilize the situation

Implications on the banking sector

Although these measures are the right and necessary measures, but they could come to test some banks' capital strength. The ultra-low – or even negative – interest rate environment that has been created means margins are now extremely thin. Around two thirds of most banks' income is derived from interest. Banks in Europe are already constrained by the low interest rates that have prevailed there for some time. Banks in the Americas and elsewhere have higher levels of interest revenue, and as a result, higher valuations – but they too will become more challenged now.

Diversification and key challenges for mid-sized banks

In these circumstances, diversification of revenues that includes fee income is of utmost importance. The large international universal banks tend to be well-diversified across investment banking, wholesale and consumer lending as well as asset and wealth management. But many smaller or mid-sized regional banks are less diversified. The crisis could become more challenging for them if it deepens further or carries on for an extended period. Fintech and challenger banks may also potentially feel the pressure – as they will be unable to differentiate themselves by paying higher interest rates in the close to zero environment, while there could also be a 'flight to safety' as customers begin to place deposits with large established players instead.

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The way forward

Measures taken since the global financial crisis should allow the sector overall to “weather the storm.” Specifically, the tougher capital requirements that have been introduced and the stress testing regimes that regulators have implemented allow the banks to withstand a crisis much better than 10 years ago.

Banks should carefully consider whether regulators might postpone the introduction of any planned new rules to avoid further disruption and instead enable banks to focus fully on the crisis. Concerns have also been voiced by many about the effect of the relatively new IFRS 9 standard within IFRS (and ‘current expected losses’ under US GAAP) and CECL which force banks to take earlier provisions against bad loans.

The other key element for banks – as for all businesses - will be strong operational resilience and business continuity planning. Regulators have been pressing banks on these areas – now they will really come into play. Banks are already implementing a wide range of measures. They are stopping staff travel and changing working arrangements so that many more staff are working from home. Some are introducing shift arrangements where some staff work on site for two weeks while others work remotely, before switching over for the following week. For core activities such as fund transfer processing, banks are activating back-up sites run by a separate set of people (in case members of one team become ill). They are also separating key senior staff such as the CEO and COO to minimize the risk of both falling ill simultaneously. These are strong measures – needed for the extraordinary times we are entering.



“ During these challenging times, businesses including banking companies in Bahrain and worldwide are facing severe difficulties. But the steps are being taken by regulators and banks to bolster the system and help stabilize the situation.

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