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Future risks from COVID-19

Bank funding and liquidity

August 2020

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Executive summary

The banking system has weathered the first phase of the COVID-19 economic shock, despite the initial severity with which it affected financial markets. However, the economic turbulence is by no means entirely behind us, and further stresses to bank liquidity and funding remain distinct possibilities.

The current situation is characterised by a multitude of contrary factors. Banks' sizeable liquid asset buffers gave them a strong starting position, but margin pressures are evident, and some specialist players may feel the squeeze on wholesale funding more acutely than the major lenders. Deteriorations in asset quality are also likely to generate further challenges for the sector. Subsequent episodes of stress are more likely to manifest at individual banks, rather than the type of system-wide episode seen in the early part of the year, with vulnerability to these pressures varying according to liquidity positions, business models and lending profiles.

There are a number of steps banks – and other financial services firms – can take to prepare for this. Active management of capital and liquidity structures, deeper stress testing (and better employment of its results), and enhanced collateral management are all vital. We anticipate in particular that liquidity management will be a crucial area of focus, with liquidity allocation set to become as important as capital allocation. Other things equal, banks with poorly managed liquidity are at greatest risk of having confidence drain away, either suddenly as a result of further economic or idiosyncratic shocks, or over what appears set to be a prolonged period of economic stress.

As solvency concerns increase, liquidity stress could also resurface if there are changes in perceptions of safe assets and counterparty risks. More generally, the global financial system remains vulnerable to another round of liquidity strain…

FSB, July 2020[1]

[1] Financial Stability Board, *COVID-19 Pandemic: Financial Stability Implications and Policy Measures Taken*, July 2020. Available online at https://www.fsb.org/wp-content/uploads/P150720-2.pdf

The initial shock from COVID-19

The initial shock caused by COVID-19 led to a sharp and deep economic contraction. The economic uncertainty in turn increased risk aversion and volatility in financial markets, leading to higher credit spreads and adding to pressure on collateral. There was also a widespread re-rating of risk in the market.

Early interventions eased stresses on the banking system. The cut in Bank Rate (the base rate set by the Bank of England) from 0.75% to 0.1% had a direct effect on short-term wholesale funding costs. The new Term Funding Scheme has made large quantities of cheap funding available (albeit so far not to non-bank specialist lenders). Coordinated central bank action eased access to dollar liquidity. The BoE was also clear that banks were able (and expected) to draw down on their (significant) liquid asset buffers. These measures are in addition to the BoE's standing liquidity insurance facilities.

Deposit funding volumes appear to have remained stable, or in some cases increased. Risk-averse clients have liquidated riskier assets and placed them on deposit, and many corporates have drawn on revolving credit facilities (RCF) and re-deposited the proceeds. Deposit funding appears plentiful, and remains cheap.

However, it has clearly not been plain sailing. Some of the potential funding cost benefit in wholesale markets was offset by an increase in liquidity premia and the deterioration in the perceived credit risk of banks. Furthermore, some corporates appear to be less willing to place funds with banks at longer tenors, preferring to retain access to their funds at short notice during this period of uncertainty. These funds are likely to be sensitive to credit ratings, many of which remain on negative outlook. With deposit rates already having been close to zero, many banks have been unable to pass on the full 65bps rate cut to depositors, creating additional margin pressures for which banks had little time to compensate in their structural hedging programmes.

Challenges are even more acute for those firms that remain more reliant on wholesale funding, and some Emerging Market banks, FinTechs, smaller specialists, and non-bank lenders may remain shut out of capital markets. The difficulties are particularly evident for some of the newer digital challengers, some of which remain loss-making, with the lockdown and economic squeeze impairing income streams on which their business models were heavily reliant.

Risks and challenges

With the early market-wide stresses of the pandemic having passed, the wider real-economy impact of the pandemic is beginning to emerge. If the fallout lies toward the more severe end of the spectrum, we can anticipate further stress for liquidity and funding markets. H1 results are notable for the further increases in provisions for expected loan losses, but the true impact on asset quality will not be clear for some time, particularly given regulatory expectations that banks should provide forbearance for customers facing pandemic-related challenges. Government support schemes designed to cushion the economic impact of lockdown have also kept defaults to relatively low levels thus far, but as the BoE's latest assessment indicates, corporate insolvencies are likely to increase, and banks will indeed suffer further losses.[2]

[2] Bank of England, *Financial Stability Report*, August 2020. Available online at https://www.bankofengland.co.uk/-/media/boe/files/financial-stability-report/2020/august-2020.pdf

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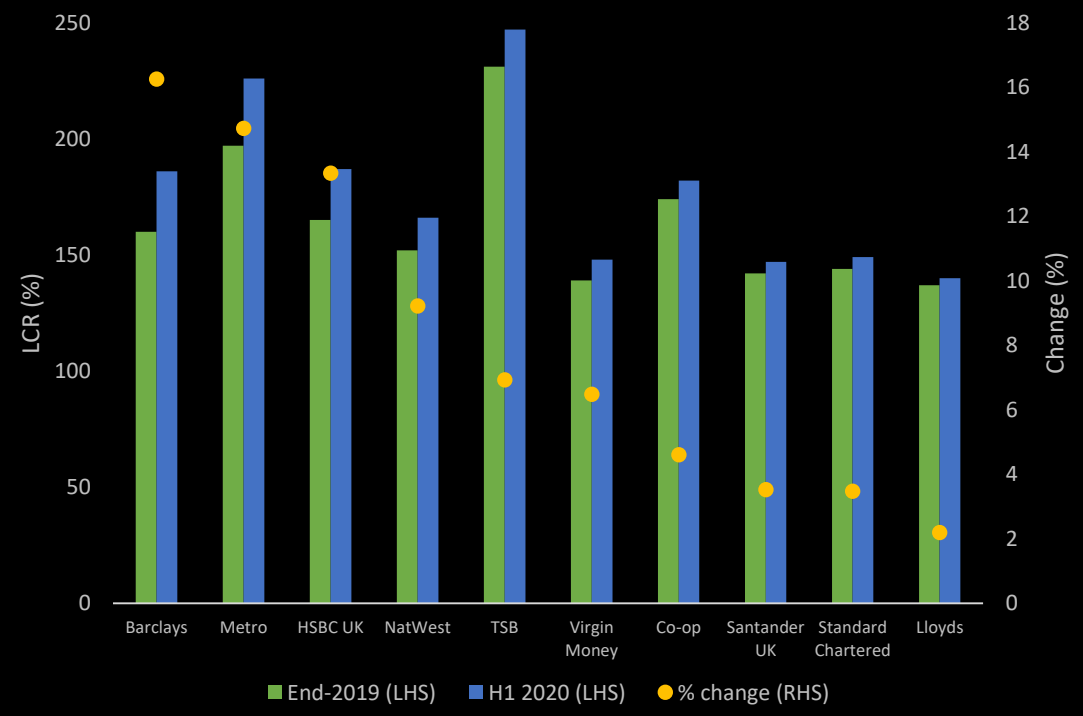
There are several areas in which challenges could emerge:

- **Regulatory ratios:** Liquidity coverage ratios (LCRs) look strong, remaining well in excess of 100%, and in most cases having actually increased relative to end-2019 as a result of the influx of deposits (Figure 1). These buffers are needed not only for the sake of prudence, but to manage against the volatile nature of the LCR: one UK bank reported a difference of almost £90bn between the highest and lowest valuation of its month-end liquidity portfolio over the first half of 2020 - approximately a third of the total size of its portfolio. The buffers built up through increased deposit volumes in H1 are by no means guaranteed to remain in place given that customers may need to withdraw cash to meet their own obligations, and volatility management will become ever-more important given the general uncertainty over the evolution of the pandemic. Aggregate figures may also mask specific areas of weakness in the composition of liquid assets (for example with respect to dollar funding), and there is also variation across the industry; banks at the lower end of industry averages are likely to come in for scrutiny when considered next to better-placed peers. The BoE has said that banks are expected to draw on their liquidity buffers as needed, even if this means LCRs fall below 100%,[3] but regulatory acceptance of this possibility does not mean that banks will find it a comfortable experience. Banks' net stable funding ratios (NSFR) may also come under pressure if corporates continue to prefer placing funds with banks at shorter tenors.

Figure 1: UK bank LCRs



***Source**: Company reports, Deloitte analysis.*
***Notes**: (i) HSBC UK refers to UK ring-fenced bank; (ii) All figures compare 31 Dec 2019 with 30 June 2020 except Virgin Money for which data is from 31 March 2020 to 30 June 2020.*

[3] Bank of England, *Q&A on the use of Liquidity and Capital Buffers*, 20 April 2020. Available online at https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/publication/2020/qanda-on-the-use-of-liquidity-and-capital-buffers.pdf

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- **Collateral quality:** Banks' management of their collateral has developed considerably since the last financial crisis, and the BoE has indicated that banks have substantial volumes of collateral positioned to enable access to its liquidity facilities. However, if collateral quality deteriorates, the pool of assets that banks can pledge to counterparties (including the BoE) will shrink, while the haircuts on those assets will increase, creating pro-cyclical pressures. It remains to be seen whether the BoE will follow the ECB in anchoring the ratings of collateral to a particular date to avoid this dynamic. Looking ahead to the longer-term, banks should also remain aware of the phase-out of LIBOR-linked collateral over the course of 2021.
- **RCFs:** Continued high corporate use of RCFs may reduce banks' capacity to deploy their balance sheet strength elsewhere. If corporates' access to reasonably priced funding becomes further constrained, banks may face difficult decisions around where to direct what liquidity they do have available. We expect constrained liquidity to be channelled towards higher-margin business, putting a premium on liquidity allocation akin to the existing focus on capital allocation.
- **Credit ratings:** So far there has been no widespread downgrading of bank ratings, but the majority of banks have been on negative outlook since April. The major high street banks' wholesale funding ratios are lower now than during the last financial crisis, but wholesale funding positions are for some banks by no means negligible, and this funding remains sensitive to ratings, with distinct step-changes at certain ratings boundaries. Furthermore, given the current corporate preference for depositing funds at short tenors, ratings downgrades could trigger abrupt movements in corporate deposits and thereby in liquidity positions.
- **Bail-in-able debt:** Many banks are in the process of issuing bail-in-able debt buffers ('MREL' or 'TLAC') to be used in the event of their failure, and the costs of doing so had already been looking particularly high for challenger banks and other smaller players. The cost of continued MREL issuance could offset reductions in funding costs arising elsewhere, particularly if asset quality deteriorates further or we see ratings downgrades. The BoE indicated in May that it is keeping its MREL framework under review and that it will "exercise its discretion" with respect to timelines,[4] but what this entails in practice will not be clear until later in the year.

"Given the current corporate preference for depositing funds at short tenors, ratings downgrades could trigger abrupt movements in corporate deposits…"

[4] Bank of England, *Statement by the Bank of England the Prudential Regulation Authority on resolution measures and Covid-19*, 7 May 2020. Available online at https://www.bankofengland.co.uk/-/media/boe/files/news/2020/may/statement-by-the-bank-of-england-and-pra-on-resolution-measures-and-covid-19.pdf

Planning ahead

In our view, banks could consider a number of steps to mitigate some of these downside risks.

Precise and granular management of liquidity

Given the possible evolution of the economic situation, it is vital that banks focus rigorously on liquidity and funding. This means detailed analysis of the adequacy of current financial resources, as well as more sophisticated tracking and forecasting of key metrics such as the LCR and NSFR. Management of LCR volatility will be critical, as LCRs could conceivably dip as quickly as they rose in the first half of the year if customers need to access cash *en masse* as a result of a deteriorating economic situation.

Banks should conduct short-term stress tests to consider the impact of a rapid worsening of the public health situation, while longer-term stress tests (e.g. assuming six months of persistent, moderate stress) should also be undertaken to ensure that buffers are appropriate. Analysis should include detail on intra-group dependencies, currency-specific issues, the potential for tenor mismatches between loan and deposit books, the impact of unexpected volatility in financial markets, concentration risks, sector-specific stresses, and any potential cliff effects of government funding schemes. Banks should also assess which business lines and products create LCR volatility, and consider mitigating options, including reducing such activities where necessary. Existing funding plans, particularly regarding MREL issuance, should also be revisited in light of the current circumstances.

The case for capital issuance

Perceptions of capital adequacy are inextricably linked with bank liquidity. Concentrated credit losses with a material capital impact are likely to translate into liquidity pressures, and the prospect of large write-downs is now greater than at any time since the last financial crisis. The sizeable increases in provisions seen in the first half of 2020 are the first part of this process, but the true picture will only become clearer over time as the economic situation evolves.

Nevertheless, capital positions generally remain strong across the banking sector, with many banks reporting increases in capital ratios over H1 as a result of the cancellation of dividends and IFRS 9 transitional relief. The BoE's view is that banks' capital buffers remain "more than sufficient" to absorb the aggregate credit losses projected under its central scenario ("somewhat less than £80bn"[5]), and May's "desktop stress test" projected a dip in average capital ratios to around 11% - well above minimum regulatory hurdles. However, as always, a healthy aggregate figure does not necessarily imply that all banks will remain in this territory. Furthermore, even banks that do not dip below this figure will inevitably need to rebuild capital back to more comfortable levels in time, and the sector must grapple with how best to do this considering that it remains under pressure to continue to lend, and that the outlook for profitability (and therefore capital strengthening through retained earnings) remains poor.

One possibility is early, pre-emptive, capital issuance as a way to avoid a prolonged period of painstaking capital recovery. Such a move would, among other things, help alleviate liquidity and funding pressures, particularly around wholesale funding costs given that these are directly affected by capital adequacy. We explore the case for recapitalisation and other recovery actions more fully in our recent paper *A stress event like no other*.

[5] Bank of England, *Financial Stability Report*, August 2020. Available online at https://www.bankofengland.co.uk/-/media/boe/files/financial-stability-report/2020/may-2020.pdf

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The end of the beginning

Experience from previous financial crises suggests that even if banks have been able to navigate some of the near-term challenges of the market-wide stress, the continuing pressures generated by a large economic contraction will bite further down the line; the last financial crisis, for instance, took place over an extended period of at least 18 months. Furthermore, as information becomes more available about the particular ways in which individual banks are affected by the economic situation, pressure will more likely become concentrated on individual banks, as opposed to the type of market-wide stress witnessed in recent months. While banks undoubtedly entered the pandemic from a position of balance sheet strength as a result of a decade of regulatory reform, we have only reached the "end of the beginning" of what is likely to be a prolonged period of economic pressure on the industry. As such, banks should work to ensure that their financial resources and their capacity to manage them are sufficient for all eventualities.

Authors

Simon Brennan
Director, Centre for Regulatory Strategy, *EMEA*
simbrennan@deloitte.co.uk

John Andrews
Centre for Regulatory Strategy, *EMEA*
johandrews@deloitte.co.uk

Contacts

David Strachan
Partner, Centre for Regulatory Strategy, *EMEA*
dastrachan@deloitte.co.uk

Tom Spellman
Partner, Risk Advisory
thspellman@deloitte.co.uk

David Hewitt
Director, Risk Advisory
dahewitt@deloitte.co.uk

Mike Williams
Partner, Audit
mikewilliams@deloitte.co.uk

Andrew Freeman
Director, Audit
anfreeman@deloitte.co.uk

Phillip Olivier
Director, Consulting
phillipolivier@deloitte.co.uk

Miles Kennedy
Consulting
mkkennedy@deloitte.co.uk

Deloitte.

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