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July 2020

Summary Report document.

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Executive Summary

COVID-19 poses a major challenge to European bank solvency, liquidity and viability which could be more severe and have more profound long term consequences than the 2008 Global Financial Crisis (GFC). Although supporting customers and society through the pandemic is the first priority for banks, for this to be sustained, they must themselves remain solvent and viable. Capital is central to this challenge.

Banks' capital positions will deteriorate sharply

- The economic downturn will be substantially more severe than recent (pre-pandemic) central bank stress test scenarios
- Some banks' CET1 capital ratios could drop to below 10%
- Although regulatory forbearance will provide some breathing space, capital ratios will need to be restored as soon as possible after the crisis, possibly to higher levels than before

For many banks, organic capital regeneration on its own will not be sufficient to restore ratios

- European G-SIB profitability, which averaged ~5% RoE in 2019, will be undermined further through increased impairments and 'even-lower-for-longer' interest rates
- Even with a cessation of dividend payments it could take 5 years or more for profits to restore capital ratios back to target levels
- Banks will need to explore all options – including profit retention, asset restructuring/ refinancing, liability restructuring and new capital issuance - to rebuild capital in a reasonable timeframe… some creativity will be needed as traditional avenues such as rights issues may be closed off or be excessively costly
- The post-GFC experience is that early, decisive action pays off in the longer run

All recapitalisation options, including profit retention, will require a credible pathway back to economic viability where capital returns cover capital costs

- Business line restructuring, business model repositioning and strategic capital re-allocation will be required to ensure long term business viability and enable a successful capital re-build
- European banks overall have not covered their capital costs since the last crisis; the weighted average Economic Spread (defined as RoE minus CoE) for European G-SIBs was ~ -5% in 2019
- Successful recapitalisation critically depends on banks persuading investors that they can close this gap over a reasonable timeframe and sustain positive Economic Spreads thereafter
- Although in many cases the foundations for returning to economic viability have been laid already – with new strategies and transformations put in place – those foundations will need checking for soundness and suitability for a post-pandemic world as, in most respects, the challenge in returning to viability will be tougher than before
- However, the pandemic could also act as a catalyst to fast-track business model improvements by locking in new customer behaviours and staff working practices
- There may also be scope for banks to find new ways to support and serve customers and society through the recovery and beyond, and to strengthen their franchises for the longer term
- More agile planning and governance arrangements will be needed for banks to navigate the pandemic and its aftermath in a resilient and optimal fashion

European bank recapitalisation and transformation actions need ideally to be accompanied and facilitated by structural industry reforms

- Now is the time to re-set the dialogue with investors, supervisors and policymakers about how the industry must reform for the longer term
  - Europe is operationally 'overbanked' versus other major developed markets, but prudential and competition concerns as well as national political considerations have hampered consolidation
  - Due to an underdeveloped corporate bond market, Europe is heavily reliant on bank credit to finance corporate investment, while a lack of depth in securitisation markets has contributed to a build-up of capital-consuming 'back book' assets on bank balance sheets
- These factors have made European banks particularly vulnerable to periods of low interest rates, increased credit impairment and asset devaluation, and they will make it harder for banks and the economies they serve to recover quickly and robustly from the pandemic

In summary, European banks, supervisors and policy makers need to act decisively to respond to the immediate disruption from COVID-19, and to put the industry in a strong position to recover and thrive in the post-pandemic world.

For banks, this means preparing, planning ahead, and being ready to deliver and execute credible strategies to restore capital and economic viability following the pandemic.

1. Introduction

The post-GFC prudential reforms of the global banking system were intended to ensure that the impacts of the next banking crisis could be absorbed without de-stabilising the wider financial and economic system, and without recourse to taxpayers.

With the COVID-19 pandemic, the efficacy of these reforms is being severely tested in a way that vindicates the old adage that 'the next crisis will be nothing like the last'! Last time, the crisis originated from within the financial system itself, and mushroomed out to engulf the wider global economy. This time we are seeing the reverse: a public health and economic crisis threatening to engulf the financial system, and then reverberate back through the economy. Furthermore, this time around, the challenge goes beyond maintaining stability and avoiding recourse to taxpayers; banks have a crucial role (alongside governments) in softening the blow to the economy as well as to themselves.

To date, banks have voiced a strong commitment to supporting their clients and wider stakeholders through the pandemic. However, for this to be sustained they must themselves survive and, even before economic conditions return to some sort of normality, they must replenish their capital and resume the arduous process of returning to long term economic viability, which we define as being able to cover all costs including capital costs. To be clear, banks can be solvent and nominally profitable while still failing to cover equity capital costs. And they can survive periods of negative economic profitability (where RoE<CoE) if the market can see a way back. But if there is no clear way back to covering capital costs, then there simply isn't a long-term viable business which can recapitalise itself. This is an industry-wide challenge in Europe which the ECB has been pressuring banks about for some time through the Business Model Analysis (BMA) regime.

We believe the recapitalisation imperative that follows the pandemic will add further market pressure to the existing supervisory pressure and bring this issue to a head very forcefully.

For banks, dealing with the pandemic can be thought of as a three phase process echoing Deloitte's wider characterisation of what businesses everywhere must do, to *respond, recover*, and ultimately *thrive* once more. Except that, in the case of European banks, the 'once more' harks back to a now rather distant memory, since they had not yet recovered properly from the last crisis before entering this one.

The purpose of this paper, building on our accompanying summary report, is to examine what *respond, recover* and *thrive* mean for banks, specifically through a *capital* lens. The response involves both a protection and a further commitment of capital; the recovery must involve the replenishment of capital by whatever means are available; and the return to viability – the *thrive* phase – will involve such transformation as is necessary for banks to generate sufficient returns to cover their capital costs. This is something they have not done for over a decade.

This raises challenges for banks, of course, but also for regulators and policymakers, all of whom have an interest and a crucial part to play in guiding the European banking industry through the pandemic and beyond.

2. How much?

The financial performance and resilience of banks in a crisis is very much geared to the economies in which they operate. So any examination of the potential impact of COVID-19 on banks' balance sheets must start with the economic impact and outlook.

So far, European economies have already seen historically unprecedented declines in economic output, and there remains considerable uncertainty about the speed, profile and extent of the recovery when it comes.

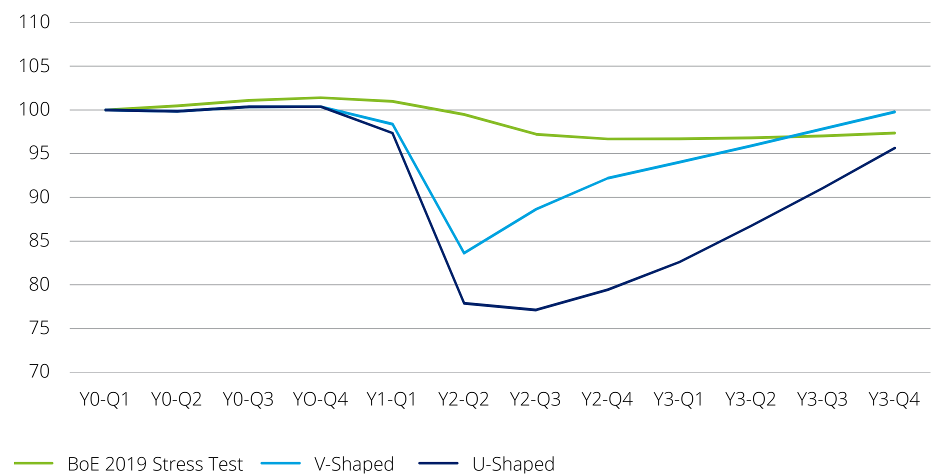
Just as the pandemic itself has played out differently across Europe, the economic impact and recovery experience (and available responses) will also be different in different European countries. However, all will suffer a very material deterioration in GDP. Taking the UK as an example, Figure 2.1 illustrates two possible GDP contraction and recovery scenarios, labelled as V-shaped and U-shaped, plotted against the GDP scenario from the 2019 Bank of England Stress Test[1]

Our V- and U- shaped projections already show a more pronounced contraction than the deepest point of the downturn assumed in the BoE 2019 stress scenario.

The wider European picture is similarly bleak. Figure 2.2 shows the ECB's Q1 2020 Euro area GDP projections in which, even in the most benign scenario, a deep recession with GDP contracting by up to 10% is now regarded as a given.

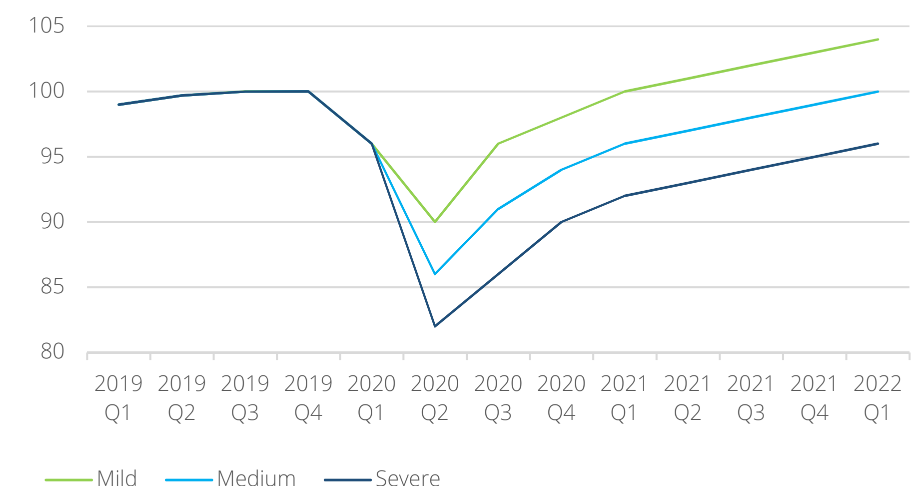
Looking ahead, the picture is highly uncertain. For example, the prospect of a strong and sustained recovery depends in part on what happens to unemployment, which in turn depends on how quickly economies can be safely reopened, and the effectiveness of government measures (such as the UK's furlough scheme) in protecting companies and jobs in the meantime.

Figure 2.1 UK GDP scenarios



Source: Bank of England 2019; Deloitte analysis

Figure 2.2 Euro area GDP scenarios[2]



Source: European Central Bank, Economic Bulletin, Issue 3/2020

1. Specifically, the Bank of England annual cyclical scenario (ACS) stress test. The Bank of England's 2019 *Stress Testing the UK Banking System: Key Elements of the 2019 annual cyclical scenario* provides more details. For comparison of stress impacts, we superimpose the onset of the COVID-19 V- and U-shaped scenarios (Q1 2020 start) with that of the BoE 2019 stress (Q1 2019 start). To show the lead in, we index the COVID-19 scenarios at 100 in Q1 2019, and we index the BoE 2019 stress test at 100 in Q1 2018. We show this comparison because it helps to indicate the severity of this downturn, in GDP terms, relative to what was previously considered to be a stress scenario.
2. See "Alternative scenarios for the impact of the COVID-19 pandemic on economic activity in the euro area", Economic Bulletin, Issue 3, European Central Bank

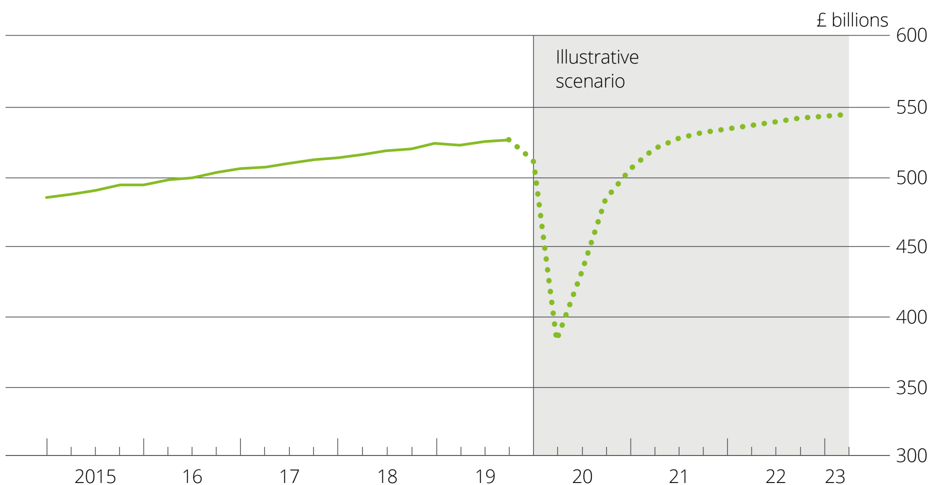
The 'V-shaped' downturn anticipates a reasonable degree of success in these efforts and thus represents a relatively benign scenario. In a more prolonged 'U-shaped' downturn, a sharp rise in long term unemployment and a substantial and prolonged drop in property values - to levels below those assumed in the BoE 2019 stress scenario - should be expected.

This is what makes the public handling of the pandemic as restrictions are eased such a delicate issue, since further outbreaks would almost certainly have to be met with further lockdowns, causing more lasting economic damage.

What might this imply for the capital adequacy of the UK and European banking systems? Staying with the UK example, a straight extrapolation from the {GDP-credit impairment-CET1} transmission assumptions contained in the BoE 2019 ACS stress test would be catastrophic for banks, given the likely severity of the GDP downturn relative to stressed GDP assumptions in the 2019 exercise. However there are good reasons to believe that the particular circumstances of this case (health crisis of hopefully limited duration, and fiscal policy responses which will hopefully buffer some aspects of the economy through the pandemic) will soften the capital impact to some degree, particularly in a V-shaped recovery scenario.

In its recent Interim Financial Stability Report[3], the Bank of England published the conclusions of a 'desktop stress test' analysis of the potential impact of COVID-19 on UK bank capital positions. This took as its basis the BoE's latest economic stress scenario, which was published concurrently in its Monetary Policy Report (MPR)[4]. Under the 'MPR scenario' – shown here in Figure 2.3, which corresponds roughly with our V-shaped downturn – the BoE estimated that average UK bank CET1 ratios would reduce to around 11%, still well above the regulatory minimum.

Figure 2.3 Illustrative UK GDP scenario



Source: Bank of England Monetary Policy Report, May 2020

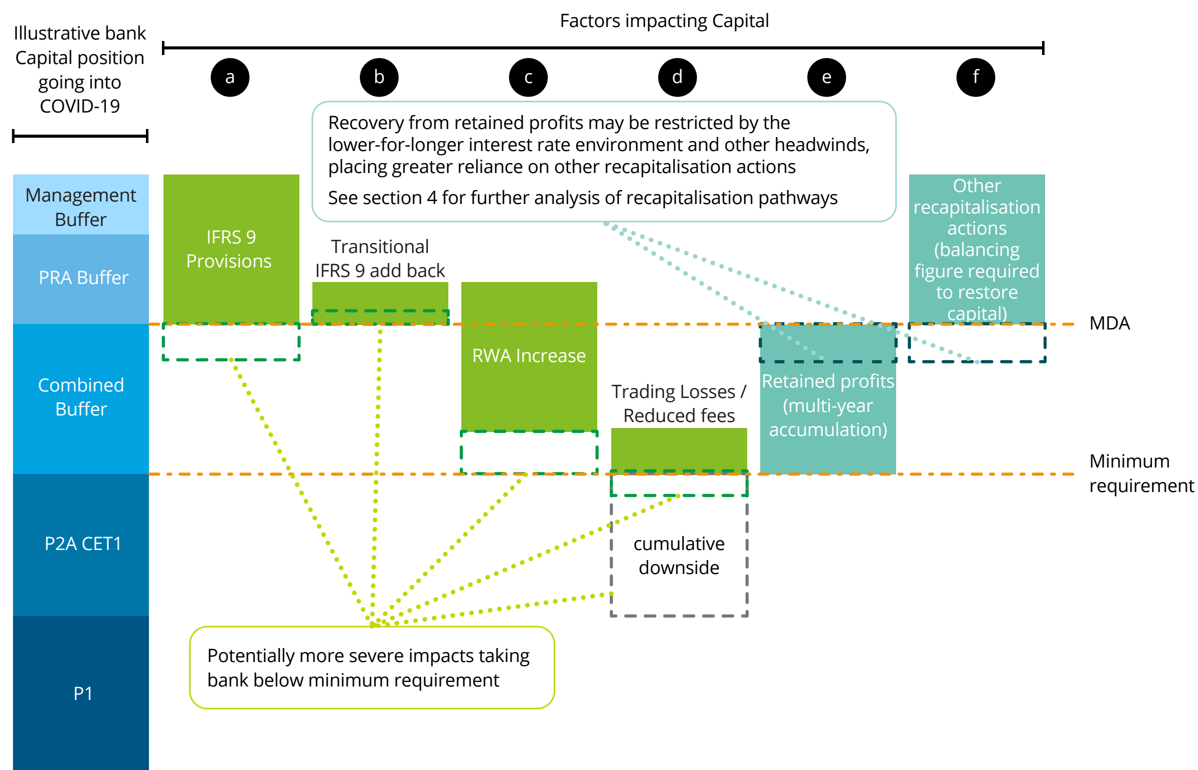
3. Bank of England Interim Financial Stability Report, May 2020
4. Bank of England Monetary Policy Report, May 2020

There are three observations to make here.

- First, 11% still represents an uncomfortable position for banks coming out of the pandemic,[5] and substantial capital replenishment will be required even in this case.
- Second, 11% is an average covering large and relatively diversified banks. Some banks with particularly exposed business models or sector exposure profiles could fare materially worse than the average.[6]
- Third, in a less benign scenario characterised by a more U-shaped recovery experience,[7] the average CET1 outcome could be materially worse (say, sub-10%) with weaker and more exposed banks potentially hitting AT1 conversion trigger points and breaching minimum capital levels.[8]

The transmission mechanisms for these effects, and the proportions and sequencing of how they would work their way through the capital stack of a hypothetical UK bank in a U-shaped scenario, are illustrated in Figure 2.4, with explanatory notes, below:

Figure 2.4 Illustrative impact on bank capital stack



Source: Deloitte analysis

5. For one thing, it is below the typical MDA threshold that would allow future dividends to be paid. With European G-SIBS generating 5% RoE on average pre-pandemic, it could take some banks a year or more to get back over this threshold. See Section 4 for further analysis and discussion on this point.
6. Only larger banks were in the scope of the BoE 2020 desktop stress test. Our analysis on a broader set of banks suggests that some, in particular those with less diversified business models and at-risk sector exposures, are more vulnerable.
7. There is credible independent support for this scenario, including a warning from the WHO chief scientist that the pandemic may not be brought fully under control for 3-4 years. In that eventuality, it is questionable whether a V-shaped H2 '20 recovery could be delivered and sustained, and/ or whether public employment protection measures could be kept in place, sufficient to prevent much higher long term unemployment from becoming entrenched.
8. We are not assigning a relative likelihood to the V- or U-shaped scenarios. We are just pointing out that a V-shaped recovery is not assured and, furthermore, that recapitalisation and business performance improvement plans need to be put in place either way: it is just a matter of degree.

Notes on Figure 2.4

Across recent BoE and EBA stress scenarios, increased impairment under IFRS9 has been the main driver of the deterioration in CET1 capital ratios (prior to the application of transitional arrangements for capital recognition). Key elements of the waterfall through the stressed capital stack are set out below:

a — The impact of **IFRS9 impairment provisions** in the recent BoE desktop exercise (490bps CET1) compares favourably with the corresponding impact in the 2019 BoE stress test (610 bps). This reflects the expected mitigating effect of the fiscal and monetary policy measures that have been taken to soften the long term economic impact. In our illustration, we have reflected the possibility of a substantially higher IFRS9 provision charge being required if a V-shaped recovery does not eventuate. We have also traced (as a dashed line) the additional downside in the case of our hypothetical bank having an unfavourable product, region, sector or asset class exposure profile. Likewise in categories b, c and d. We also show a cumulative downside (the sum of a, b, c and d downsides) superimposed on column d to illustrate a hypothetical 'worst case' outcome.

b — The recent European Commission proposal on **IFRS9 transitional** arrangements to follow Basel will potentially dampen the impact of increased Stage 1 and Stage 2 provisions. However, this only provides benefit for exposures prior to becoming 'credit impaired'. In a U-shaped scenario, if the current fiscal support measures cannot be sustained and companies go into straight default, the benefit of the transitional arrangement will quickly be eroded. Our illustration therefore shows a relatively conservative quantum of transitional benefit, as well as a dashed-line more pessimistic case.

c — Other adverse impacts to CET1 ratios are likely to arise from **increases in Risk Weighted Assets**. Credit RWAs are particularly likely to increase due to pro-cyclical elements in credit capital models, rating downgrades (under standardised approaches), and draw-downs on committed facilities. As a quid pro quo for regulatory forbearance, banks are also expected to continue lending to support the real economy. Although some of this is underwritten by the government, that which is not underwritten is also likely to result in further RWA increases.

d — We would not expect **trading losses and reduced fees** to drive significant capital losses by themselves, partly because there are pluses and minuses which could offset each other to some degree. For example, while increased market volatility will inflate market risk RWAs, the capital impact of this should be softened to a degree by increased trading profit. However, for multi-line banks with lending, trading and advisory businesses, trading losses and reduced fees could add significantly to credit losses and credit RWA increases (through a and c) and thus have a material bearing on the aggregate reduction in capital ratios. The more U-shaped the recovery (which is the basis of our illustration), the more likely it is that the minuses will outweigh the pluses as sustained economic weakness undermines deal activity and trading volumes.

e, f — **Retained profit accumulation** in the years following the pandemic will be a crucial source of new capital to restore buffers and return banks to their target ratios. However, with European banks averaging only ~5% RoE before the pandemic, and with big questions about how this might deteriorate further in the short term before gradually improving thereafter, we do not believe banks can necessarily rely wholly on this to restore capital ratios over a reasonable timeframe. Therefore, banks may need to consider **other recapitalisation actions** (such as rights issues, capital-accretive portfolio sales, 'back-book' refinancing structures and such like) to bring forward the restoration of capital buffers. We include these items to indicate the overall scale of recapitalisation that may be needed, not to express a view on their relative contributions or the timeframe over which it could happen. Further analysis on these questions is provided in Section 4.

The quanta of impact outlined in this waterfall diagram are hypothetical and for illustrative purposes only.

Window 2.1 – Capital or liquidity or both?

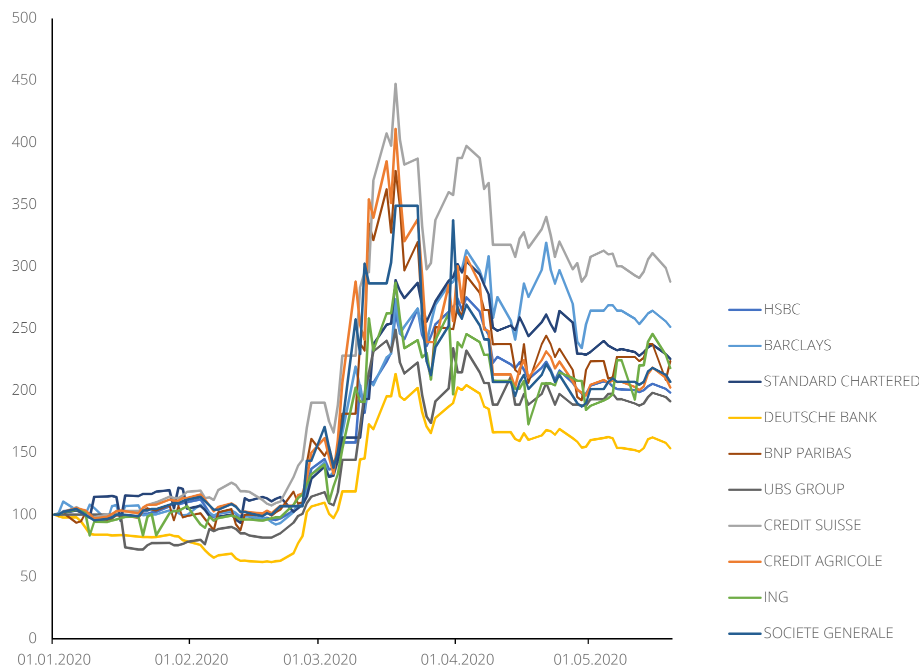
Although the focus of this paper is capital, the prudential reforms of the past decade have covered both capital and liquidity requirements. So which of these should be in the spotlight now?

The answer is both. Although capital is meant to do the heavy lifting in terms of loss absorption – with liquidity requirements being a further safeguard against cashflow interruptions that might have nothing to do with losses – a liquidity problem can also arise from a loss of *market* confidence in capital adequacy, whatever the position of regulators might be. This is typically what brings banks down in a crisis.

As such, a progression from a capital problem to a liquidity problem would indicate a much more serious development. This goes to the question of how credible the 'formal' treatment of banks' capital positions is seen to be, by the market. Bank Credit Default Swap (CDS) spreads are the things to watch in this regard (see Figure 2.5 below which shows a marked widening of actively traded CDS spreads since about mid-February), as well as interbank money market spreads (which have also widened).

Despite the undoubted benefits of the very substantial prudential capital buffers built up since the last crisis, and strong indications that regulators will give banks the 'technical' space they need, there is still clearly some market nervousness about the financial resilience of European banks at this time.

Figure 2.5 Select European G-SIB Credit Default Swap price movements, 1/1/20 = 100



Source: Thomson Reuters Datastream; Deloitte analysis

3. The regulatory position

Although it is possible that future stress tests will need to be recalibrated to account for the magnitude of this downturn – and that more capital will be deemed necessary to ensure that banks can withstand future crises – their first response has been to grant substantial latitude, albeit within the confines of existing laws, standards and relevant discretions.

3.1 Reducing pro-cyclicality in the regulatory capital regime

Regulators have been proactive in giving banks the green light to make use of the post GFC counter-cyclical tools within the prudential capital framework without triggering some of the supervisory interventions that would ordinarily accompany such a development.

In parallel, regulators have focussed on the pro-cyclical elements of the accounting and capital regimes, such as IFRS9, market risk capital requirements and Pillar 2 add-ons, in the latter case converting Pillar 2A/R requirements to nominal (rather than RWA-scaled) amounts. Further to this, there has been a delay in the implementation deadline for the finalised Basel III standards[9], providing banks with more time to deal with the operational aspects of implementing the required changes. However, more immediate regulation, such as CRD 5 / CRR 2[10] has not been delayed – in fact some elements which support bank capital ratios are potentially being brought forward.

There is another sting in the forbearance tail, besides the liquidity issue (see Window 2.1 above), in the form of a 'cliff effect' as some of the early allowances (e.g. IFRS 9 forbearance) bunch up and credit defaults roll through to capital models later and all at once.

3.2 Making use of buffers

Banks will therefore need to tread carefully when it comes to running down buffers, taking account of how rapidly the cliff effect could impact their ratios, and where this could leave them in terms of the position they need to recover from, particularly with regard to the following:

- ***Expectations of the size of the ensuing stress*** – Existing Pillar 2 buffers are calibrated to stress scenarios that are potentially more benign than even an optimistic outlook for when economic activity will return to normal (as we discussed in section 2). As such, the erosion of Pillar 2 buffers could be more rapid and go further than expected.
- ***Future viability*** – Making use of the Combined Buffer will place restrictions on banks' ability to pay dividends and other discretionary disbursements. This may be manageable today as dividend restrictions have been applied – *de facto* – across the board. But when MDA thresholds get reactivated (i.e. allowing dividends to be paid again, subject to MDA), banks that have gone further into their buffers will have a harder job getting back to a position of being able to pay dividends. They could come under sustained market pressure as a result.

The implications of this are significant: regulatory engagement and disclosure as buffers are used will be key to maintaining an orderly process; and banks should take early steps to conserve and/ or replenish capital even though they may appear to have ample buffer capacity. Further, banks should consider the operational and governance aspects of using buffers, with the likely increased regulatory reporting and analysis required during and post the pandemic as buffers are used and then rebuilt.

Finally, it is probable that regulatory forbearance in the use of buffers comes with the strong expectation that banks will develop credible plans for their timely reinstatement. In the Eurozone, it is likely that regulators will make use of Business Model Analysis work (which the ECB has been particularly focused on) to truly pressurise banks on their ability to rebuild buffers, and could encourage them to consolidate if their plans are found wanting. This could impact banks more quickly than they anticipate, possibly as part of the next round of SREP visits.

9. https://www.bis.org/press/p200327.htm
10. https://ec.europa.eu/commission/presscorner/detail/en/qanda_20_757

3.3 Future considerations

If bank losses exceed the capacity of existing buffers, any further relaxation - for example revisiting minimum capital requirements (starting with Pillar 2 minimum requirements, Pillar 2A/2R), or allowing a greater recognition of AT1 and Tier 2 capital in the capital stack and leverage ratio measures - would require more substantive adjustments including legislative changes. This could come through a review of Basel III, possibly at the EU level, where an initial Consultation Paper on CRD 6 / CRR 3 is due later this year. However, such legislative changes could take years to enact and take effect, and they would need to be designed to accommodate extreme circumstances (such as these) without constituting a permanent, undesirable, weakening of the capital regime.

While all of this is conceivable, in reality we see very little scope for meaningful accommodative changes to the substance of Basel III within a timeframe that would be helpful in the context of COVID-19. Banks should therefore assume that the ability to make use of existing buffers is about as far as regulatory forbearance can practically go.

Furthermore, although regulators have not given a definitive timeframe over which current regulatory forbearance measures will remain in place, we believe they will be eager for banks to recapitalise sooner rather than later, and they will begin to apply pressure in that direction (in readiness for the next crisis) once capital losses have stabilised. For the most part, therefore, banks will need to anticipate a timely unwinding of regulatory forbearance measures, and a possible eventual *increase* in capital requirements[11] beyond those already required under the Basel III changes currently due for implementation by January 2023.

11. This would likely come through a recalibration of stress tests in light of the pandemic, either on a bank-by-bank or across-the-board (Eurozone, UK, CH etc.) basis, rather than by way of changes to Basel III. The determination in this case would likely centre on the question of what – prospectively, in light of the pandemic – should now be regarded as a 'severe but plausible' stress scenario.

4. Bank responses

Assuming bank failures can be averted, some observers might take a sanguine view about the impact of COVID-19 on their capital positions - the attitude being that this is capital doing its job (absorbing losses).

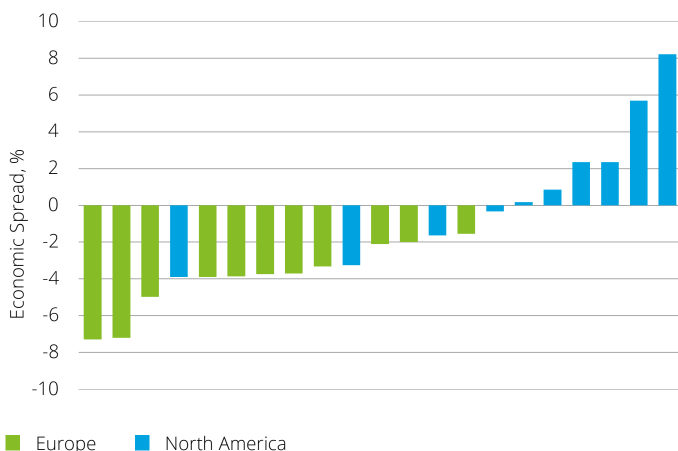
According to this view, neither banks nor the market should be unduly concerned about the erosion of capital buffers since this is what buffers are for. But bank capital also represents invested shareholder wealth (much of it in the form of pension savings, incidentally), and sooner or later banks will need to rebuild their capital positions essentially by attracting fresh investment. So, it is more than a simple re-stocking exercise: to attract new capital, or to be able to retain earnings without losing the confidence of investors, banks will need to be seen as investable businesses.

The problem is that the pandemic came at a time when European banks were already struggling to break even, economically,[12] and were priced in the market at values well short of their book values, as shown in Figures 4.1 and 4.2 below.[13]

That was the snapshot picture going in to the pandemic. The magnitude of the potential incremental impact of the pandemic on *future* economic performance can be seen in how bank share prices have responded since the start of the year, with approximately 40% falls versus a ~22.5% fall in the Euro Stoxx 50 index (see Figure 4.3 overleaf). Clearly, the market is expecting a substantial deterioration in an already weak economic performance[14] through some combination of realised capital losses and a further deterioration of long term Economic Spreads[15].

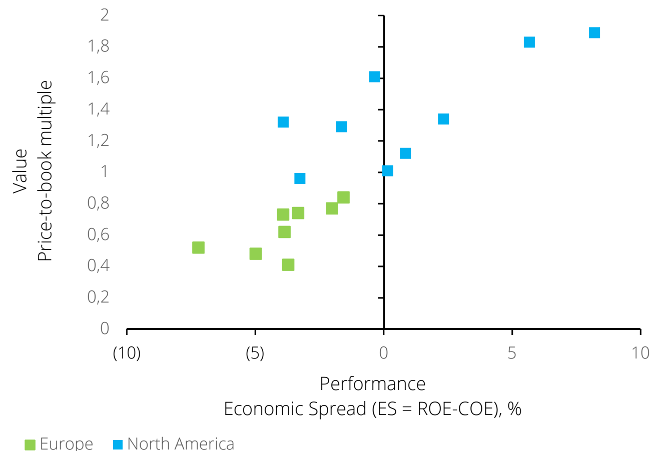
What this means is that the combination of a recapitalisation imperative (to restore buffers) and weak prospective economic performance makes the challenge all the harder, and all the more urgent. Putting it simply, banks with strong capital ratios but negative economic spreads (the pre-COVID-19 position for most European banks) have the relative luxury of a bit of time to transform their business models and return to economic profitability. Banks with positive economic spreads but damaged capital ratios (the likely post-COVID-19 position for some North American banks) can recapitalise with relative ease. But banks with damaged capital ratios and weak economic spreads (post-COVID-19 Europe) have an altogether tougher challenge[16].

Figure 4.1 European and American G-SIB Economic Spreads, 2019



Source: Deloitte Analysis

Figure 4.2 European and American G-SIB Economic Spreads v. P:B, 2019



Source: Deloitte Analysis

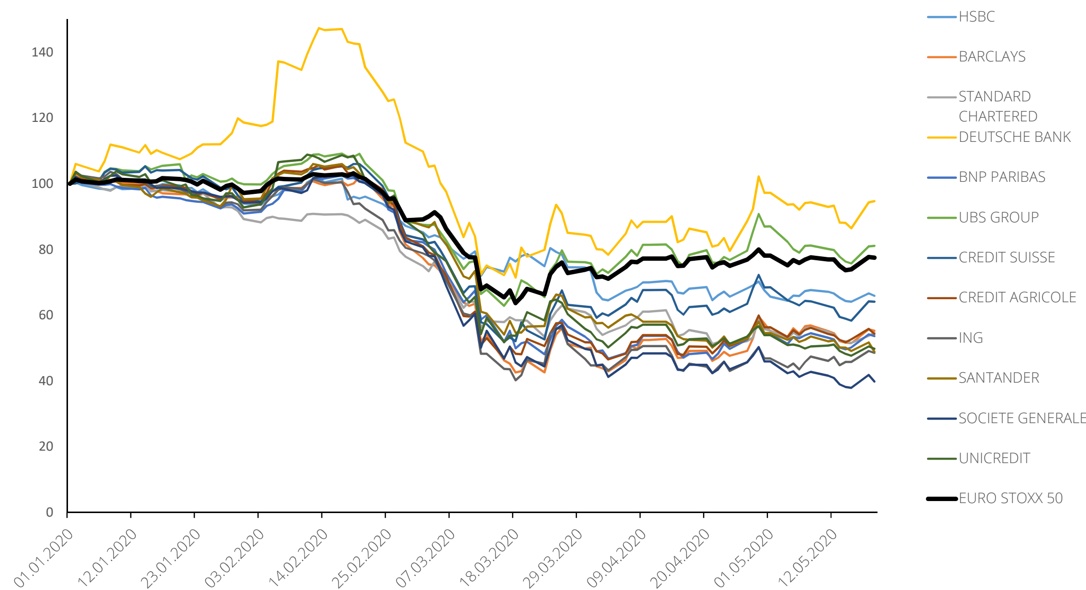
12. Economic breakeven being when RoE = CoE; where Economic Spread = 0%
13. Economic Spread performance for individual banks is calculated on the basis of their RoE as reported (Source: Thomson Reuters Worldscope Fundamentals) and CoE estimated on a CAPM basis using observed 4 year betas (vs MSCI) and composite risk-free and EMRP rates of 1.5% and 6.5% respectively. As a rule of thumb, an ES of 0% corresponds with P:B of 1. Thus, P:B < 1 reflects a market expectation of continued economic losses.
14. The 100 index value at the start of the year corresponds to a weighted average Price : Book ratio of 0.6
15. It is difficult to unpick these two factors – in a sense it doesn't matter because value is lost both ways – but, longer term, the ability to get back on the path to closing negative Economic Spreads is what matters most.
16. While it is true that some European banks have recapitalised in the past without, on the face of it, being 'economically viable' on our definition, this could be put down to investors deciding to underpin the value of their existing equity stakes while taking a long term view that, partly with the help of the additional capital, the banks in question have a genuinely viable future.

So, although capital may yet do its job in preventing insolvency, the two-fold challenge of recapitalising and restoring economic viability – of *recovering* and *thriving* – remains very substantial.

And it doesn't make very much difference whether the recapitalisation comes through fresh capital issuance or profit retention: banks will need a clear and credible path to economic viability in order to engender market and supervisory confidence in their capital recovery plans, whichever path they take.

If they resort to replenishing capital organically, i.e. through profit retention, without a credible path to economic viability they could see their share prices sag further to the point where they become takeover or breakup targets. If they resort to restoring ratios by de-levering on the asset side, i.e. through sale or closure of portfolios and businesses, without retaining critical scale efficiency and without a clear vision for the residual franchise, they risk ending up as smaller, less coherent, and less efficient versions of their current selves,[17] with similar consequences.

Figure 4.3 European GSIB share price movements versus EURO STOXX 50, 1/1/20 = 100



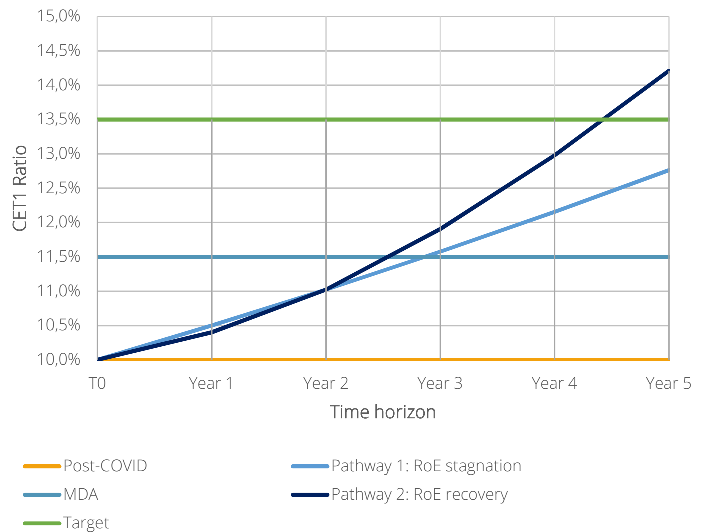
Source: Thomson Reuters Datastream; Deloitte analysis

17. In some ways this would feel like a re-run of the 2010s, with even less to show for it.

For many banks, even with decent prospects for performance recovery, it is unlikely that recapitalisation through profit retention alone will be a realistic option. Figure 4.4 illustrates two potential pathways for a representative bank coming out of the pandemic with a 10% CET1 ratio against a 13.5% target (in both cases all profits are retained and RWAs are held static):

- **Pathway 1 – *RoE stagnation***: European banks continue to struggle to improve RoEs, despite transformation efforts, due to increased headwinds from lower-for-longer interest rates; subdued economic growth; increased cost of risk; and ongoing barriers to operational consolidation.[18] RoE performance returns to the 2019 European GSIB average of 5% but then remains stagnant at that level.[19] In this case, it takes the bank 3 years to reach an MDA threshold of 11.5%, and it remains ~75bp short of its target CET1 ratio after 5 years.
- **Pathway 2 – *RoE recovery***: Banks respond quickly to the pandemic, acting decisively to bring forward transformational changes, including some that are precipitated by the crisis itself (such as a more rapid transition to digital channels; changes in working practices and real estate requirements; and M&A opportunities[20]). By doing this, they are able to more-than-offset the headwinds that cause RoEs to stagnate in Pathway 1. They are also helped in this by a favourable policy / regulatory environment, reflecting a renewed eagerness to facilitate a return to a fully functioning banking sector. Average RoE drops to 4% in year 1 (due to additional transformation investment costs), then recovers quickly in years 2 and 3 (to 6% and 8% respectively) before the pace of recovery reverts in years 4 and 5 to a rough pre-pandemic performance improvement trend-line (to 9% and 9.5% respectively). In this case, the MDA threshold is reached about 6 months sooner than in Pathway 1, however, the target CET1 ratio is still not reached until some way through the 5th year.

Figure 4.4 Illustrative organic recapitalisation pathways



Also, over this period, the tension between capital recovery, capital investment (including that which is required to fuel performance improvement, such as through higher technology spend) and profit distribution to investors (including pension funds relying on dividend yields) continues to require compromises to be made. Hence, despite this more positive recovery scenario, we question whether supervisors or investors would tolerate such a slow return to full recapitalisation and thus resilience to future stress events as well as dividend, investment and growth capacity. We suspect share prices would continue to underperform in this case.

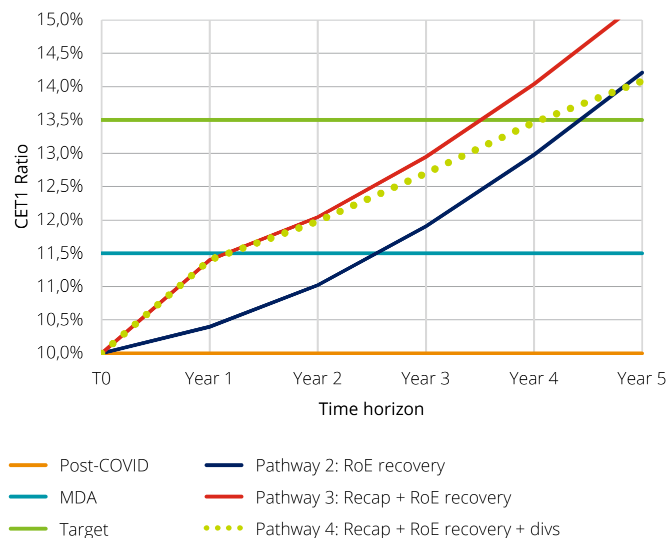
18. See Section 5 for further discussion on the prospects for European bank consolidation.
19. In this and other Pathways described below, for simplicity, RoEs and capital ratio improvements are assumed to be net of any non-dividend distributions and disbursements (such as variable compensation and AT1 coupons) that may be reintroduced once capital ratios are above the MDA threshold. In reality there would likely be a slight downward inflection in the capital rebuild at this point.
20. See Section 4.2 for further discussion of specific transformational changes prompted by COVID-19.

4.1 Recapitalisation options

Banks therefore need to be proactive in planning how they will first rebuild their capital positions and then optimise them over the longer term within a context of strategic and business model repositioning, operational transformation, investment and growth.

Figure 4.5 illustrates two variations on recapitalisation Pathway 2 (Pathways 3 and 4), both involving an upfront 10% recapitalisation in year 1 (equity issuance, in some form[21]) as well as profit retention.

Figure 4.5 Illustrative recapitalisation pathways



- **Pathway 3 – *Recap + RoE recovery***: 10% recapitalisation in year 1 and full profit retention throughout. Although RoE is diluted in subsequent years relative to Pathway 2, due to the upfront capital injection, this should be offset by a lower CoE due to the reduction in leverage[22] (i.e. Economic Spread should be materially less diluted than headline RoE). More importantly in this context, capital recovery gets an early boost and then accelerates from there due to the after-tax yield on that capital[23]. In this case the MDA threshold is reached early in year 2 and the target ratio is reached midway through year 4 – a year earlier than in Pathway 2.
- **Pathway 4 – *Recap + RoE recovery + divs***: Once the MDA threshold is reached early in year 2, discretionary dividends are gradually resumed with pay-out ratios of 10%, 20%, 30% and 50% in years 2-5 respectively. Although in one sense Pathway 4 could be viewed as a case of raising capital in order to be able to pay it back through dividends, the more important point is that early recapitalisation could help to bring forward a release from MDA restrictions and thus enable *discretionary* strategic choices to be made (crudely speaking, between distribution, retention or investment of capital), *on positive economic grounds*, much earlier (by ~18 months) than would otherwise be possible[24]. That is, it would avoid being locked into a process of organic capital recovery – irrespective of investment opportunities - for an extended period, as Pathway 2 implies. Plausibly, the strategic optionality implied in this Pathway would also be more conducive to early share price recovery.

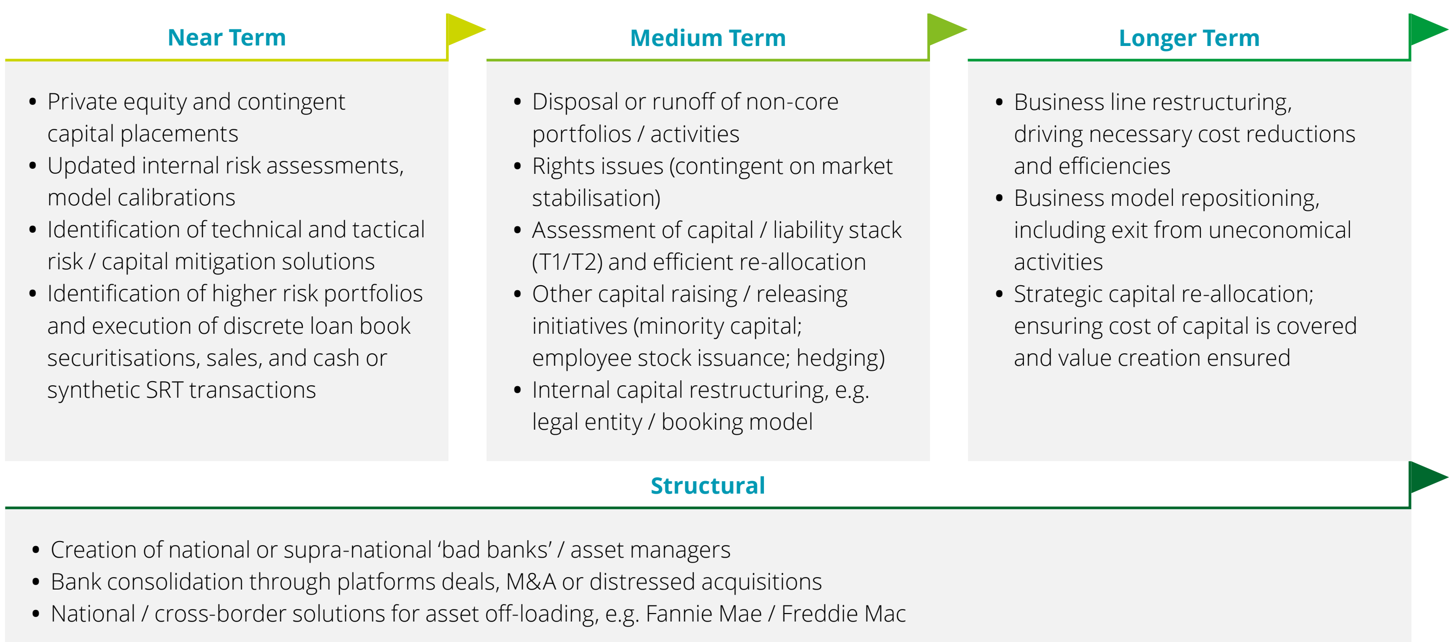
This is an important lesson from the 2008 GFC: early and decisive action to rebuild capital can provide a vital platform for subsequent performance improvement and share price recovery. Indeed the differential performance of American and European G-SIBs (see Figures 4.1 and 4.2), which has persisted for the last decade, is commonly attributed in large part to the swifter recapitalisation of the former[25].

21. Asset-side deleverage, through e.g. portfolio sales or other RwA reduction measures, should also be on the table for consideration, subject to their knock-on effects on liquidity, cost, and subsequent capital generation capacity. Such measures are most likely to be successfully delivered by those institutions which had conservative underwriting and pricing frameworks in place going into this crisis, and can thus offload assets in a capital accretive manner as and when the market stabilises.
22. The relationship between leverage and the CoE for banks is much debated. Our view, supported by our own and separate studies, is that bank CoEs are becoming more sensitive to leverage over time as too-big-to-fail reforms cause markets to re-price bank capital in response to the shifting burden of risk between taxpayers and investors. See Window 4.1 – *The cost of bank capital*, for further discussion on this point.
23. Our modelling assumes an after-tax yield (through marginal wholesale debt cost reduction) of 2%.
24. Clearly, other variations on this Pathway could be modelled - involving discretionary allocations of capital between capital recovery, dividends, or value-accretive investments as and when opportunities arise – with different profiles of capital and underlying value (and Economic Spread) recovery.
25. Of course, other economic and structural factors have played a large part as well.

Nonetheless, even with a favourable RoE recovery outlook, traditional sources of early recapitalisation, for example equity rights issues, could still be problematic given the current state of market turmoil. So a portfolio approach, including some 'creativity' in seeking capital accretive solutions on both sides of the balance sheet, together with operational transformations, will likely be required.

Figure 4.6 below depicts a portfolio and sequence of measures that banks could consider.

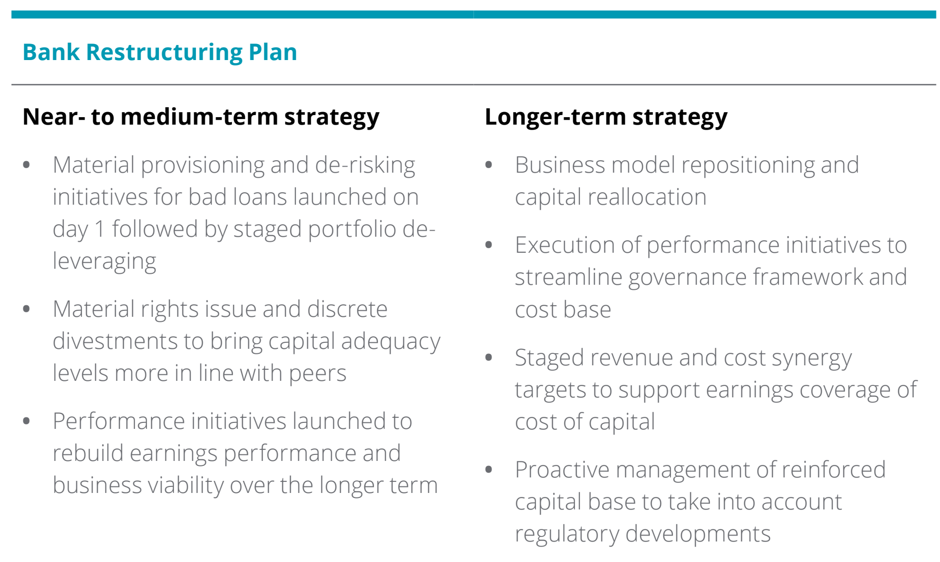
Figure 4.6 Solutions to restoring bank capital adequacy and future viability



There are precedents for such a 'holistic' recapitalisation and transformation response from the last crisis, including one European universal bank which recently re-stabilised its capital base, de-risked its loan portfolio and took radical steps providing for future business viability, all in an integrated transformation programme – see Figure 4.7.

Although undertaken in a more benign environment and dealing with issues specific to the bank in question, the success of this recapitalisation was the result of clear steps toward restabilising the capital base, de-risking the loan portfolio and providing for future business viability.

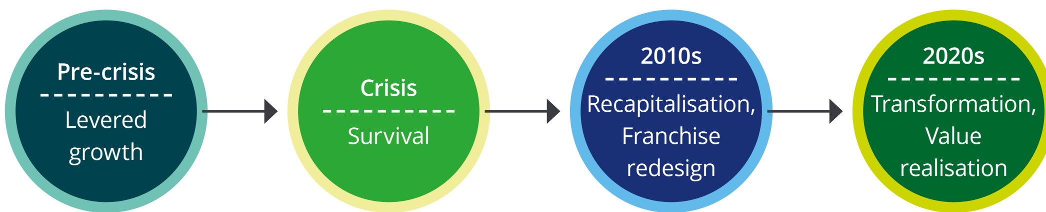
Figure 4.7 Integrated recapitalisation and performance transformation case study – European universal bank



4.2 Transformation options

Generalising from the above example, in our earlier paper on Capital & Performance Management,[26] we suggested that the strategic agenda for banks in the 2020s will be centred on Transformation and Value realisation, as depicted in Figure 4.8 below.

Figure 4.8 Banks have shifted their strategic agendas through turbulent times



How does COVID-19 change this? In two ways, we suggest:

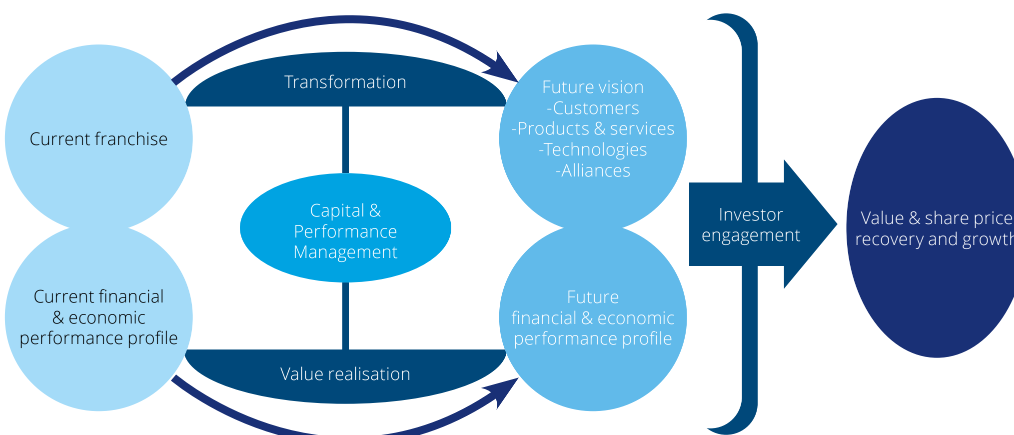
1. **2010s revisited.** Obviously so in the case of recapitalisation, but also to some extent in terms of franchise redesign as banks consider the full implications for their strategies of potential COVID-19-induced shifts in economies, markets, technologies, client behaviours and product/ service demand.

2. **Intensification of the transformation and value realisation** agendas, as banks respond to the need to work even harder to adapt to the realities, risks and opportunities of the new order and get back to economic viability.

In both cases, it will be crucial for transformation actions to be subject to rigorous disciplines to ensure that they support – *and are seen by the market to support* – capital and value recovery.

Capital and performance management discipline will play a crucial role in this. As well as maintaining solvency and liquidity in line with evolving regulatory and market disciplines, and being rigorous about ongoing transformation decisions particularly where new capital commitments are involved, banks will need to work especially hard to bring investors along with them in order for their capital commitments to be seen as 'investable' (i.e. likely, realistically, to support value and share price recovery and growth – see Figure 4.9). Otherwise, the interdependence between capital restoration and ongoing performance transformation is such that both will likely fail!

Figure 4.9 Realising value from transformation



Source: Deloitte analysis

26. Capital & Performance Management in the 2020s – Realising Value from Transformation

Window 4.1 – Fit-for-purpose transformation

Although the foundations for returning to economic viability may already have been laid – with new strategies and transformations put in place, as recently as 2019 in some cases – those foundations will need checking for soundness and suitability for a post-pandemic world. Picking up where they left off may not be the right answer, for three reasons:

1. The track record in realising value from transformation is not good, with restructuring activities in many cases having left banks with incoherent franchises and cost overhangs.
2. Transformations should be calibrated to the scale of the performance gap that needs closing, both overall and within business segments, and this is likely to have changed post-COVID-19. Banks may therefore have to recalibrate their responses, potentially involving more radical actions than were previously signed up to, such as business closures, M&A actions, or more ambitious commitments to new technologies and operating models.
3. Other changes could be triggered by specific features of the pandemic - brought about by shifts in client and stakeholder needs, behaviours and expectations - enabling banks to lock in operational efficiencies and deliver new client offerings.

In summary, banks will need to ensure that their transformations – including capital reallocations and investments in new cost-saving technologies, service capabilities, acquisitions and alliances - will result in sufficient revenue, cost, risk and growth improvements to close the performance gap, given the new realities, risks and opportunities of the post-COVID-19 world.

One of the key required disciplines will be to ensure that banks' constituent business segments are *individually viable* – each covering their respective capital costs taking account of their economic risk (beta) and leverage profiles – and / or that *group-wide synergies* that are relied upon to underpin the viability of the whole franchise are genuine, transparent, sustainable and reinforced as part of the transformation. Business models that in the past have relied on informal cross-subsidies between products and markets (retail deposit funding being a classic benefactor), or have been guided by crude capital allocation and transfer pricing models, need to be scrutinised and challenged going forward to ensure that they are robust with respect to post-COVID-19 realities.

This raises three issues that historically have confounded banks' efforts to transform their businesses: 1) how to account internally for capital; 2) how to account internally for cost; and 3) how to account internally for cross-business synergies.

On 2 and 3, briefly, it is crucial that targeted, segment-specific business model changes take full account of the marginal cost, revenue and growth impacts *on the whole franchise*.[27] This should drive marginal transformation decisions and execution strategies, and be reflected in steady-state performance metrics thereafter.[28]

On 1, the role of capital allocation and accountability in driving performance measurement and improvement has been heavily disrupted by the prudential reforms of the post-GFC decade. In particular, the industry orthodoxy of holding all business lines to a uniform bank-wide cost-of-capital hurdle rate, coupled with the emergence of regulatory capital as the primary determinant of internal capital allocations,[29] has led to material distortions in measured business unit performance. In turn, this has distorted bank decisions, including transformation decisions, where screening on the basis of 'headline' business unit returns on allocated capital, against a static, uniform hurdle rate (irrespective of what the 'true' underlying cost of capital might be), has been a major (in many cases erroneous) driver of bank actions.[30]

27. The downscaling of an underperforming business line (in terms of return on risk-weighted assets, say), in a way that leaves fixed operating costs 'stranded' for other business lines to bear, does not help very much and may in fact take the overall franchise backwards due to the loss of associated revenue.
28. Banks with highly centralised cost models, designed to drive internal operational efficiencies, have the complication of how to adjust those models, and reallocate costs, alongside any major restructuring of the business to improve performance.
29. Driven primarily by solvency concerns, and departing increasingly from economic risk considerations.
30. Various remedies for this are available, including using hybrid (economic and regulatory) capital allocation keys, and calibrating business segment hurdle rates to account for their individual risk and leverage profiles (the latter being a function of their regulatory - as opposed to economic - capital requirements). This is a complex area that needs very careful formulation and application.

Window 4.2 – Spotlight on Capital Markets

For broker-dealers, exposures to assets and liabilities subject to revaluation mean that they could suffer substantial write-downs as markets gyrate during the pandemic. This could be exacerbated by liquidity-driven valuation adjustments on complex or illiquid positions. Investment banks with large retail and corporate lending activities are likely also to be subject to the impact of surging problem loans and IFRS9 provisioning.

In terms of other P&L impacts, broker-dealers and investment banks could see their revenues increase in the near-term, with increased trading volumes and widening spreads. Advisory and execution fees associated with (forced, or crisis-driven) restructuring and M&A activity could also support revenue generation over the short-to-medium term. However, in the longer term, particularly in a U-shaped downturn scenario, the lack of underlying corporate investment would likely undermine Capital Markets origination activity (ECM, DCM), derivatives flow, and (discretionary) M&A work. Against that, advisory and deals revenues could be supported to some extent by longer term consolidation activity – including in the banking industry itself (see also Section 5) – as firms adjust to the 'new normal'.

Capital Markets firms may also be afforded less latitude in terms of using , and then rebuilding, capital buffers. Current indications are that regulators' primary concerns are to avoid disruptions to bank credit supply to the real economy. As a result, Capital Markets firms will need to consider carefully how they engage with regulators on these points.

Banks have also struggled to allocate capital in a way that optimises their financial capacity with respect to other prudential constraints (including leverage, stable funding, liquidity and risk appetite) and that maintains or enhances the strategic coherence of their business models.[31]

Over the past decade we have seen very dramatic changes in bank risk profiles and capital structures (both overall and in their constituent businesses), and a big system-wide shift in the risk burden (and therefore economic cost burden) from taxpayers to bank investors and between different categories of bank investor (CET1, AT1, T2 etc.).[32] In general, these have not been reflected adequately in banks' internal finance allocation and transfer pricing regimes; or the performance measures they drive; or the decisions they take as a result; or the investor / supervisory engagement strategies they follow.

With COVID-19, as banks face into further (planned and unplanned) changes in their capital ratios and risk profiles, and as they try to restore positive Economic Spread margins in a particularly unforgiving environment, having a good handle on their capital cost structures as they evolve (overall and across their diverse businesses), and factoring this into their decision making frameworks and stakeholder engagements, will be crucial.

31. This gives rise to a complex, multi-factor business and capital optimisation problem (i.e. on both sides of the balance sheet) - with shareholder value maximisation as its goal - subject to economic, market, competitive, operational, financial and prudential constraints.
32. See Window 4.3 *The cost of bank capital*

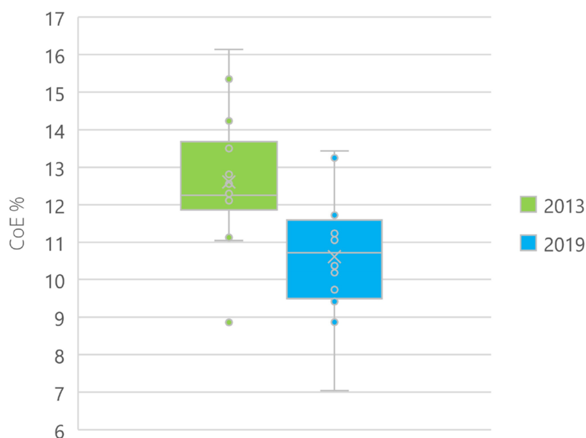
Window 4.3 – The cost of bank capital

We argue throughout this paper that the proper test of bank economic viability is the ability sustainably to cover capital costs. This in non-contentious: for one thing, it is embedded in the ECB's Business Model Analysis (BMA) framework for evaluating the long term sustainability of banks under its supervision.

A more contentious question is what that capital cost is or should be and, more particularly, why it has not come down more as banks have de-risked and de-levered their balance sheets since the GFC. As a rough approximation, using CAPM, bank CoEs were ~12.5% soon after the GFC and have since come down to a range of ~9.5%-11.5% for most European G-SIBs (see Figure 4.10 below). This is not as big a fall as theory would predict given the de-risking and deleverage that have taken place, and it means that the net monetary cost of servicing bank capital (€ capital x % cost of capital) has gone up considerably.

There are a number of possible explanations for this. One is that the deleverage effect on CoEs has been offset to a degree by the removal of implicit government guarantees which previously kept bank CoEs (as well as funding costs) to an artificially *low* level. It also made them largely insensitive to marginal differences and changes in financial leverage, thereby incentivising them to seek as much leverage as possible. As implicit government guarantees have effectively been withdrawn (creating upward pressure on CoEs), and been replaced with loss-absorbing private capital (creating downward pressure), and as banks have taken steps to de-risk their underlying businesses (downward pressure again), we have seen a modest commensurate (net) reduction in their CoEs.

Figure 4.10 European G-SIB Cost of Equity estimates (CAPM basis, Box & Whisker) 2013 and 2019



Source: Deloitte analysis

A further explanation for stubbornly-high bank CoEs is the emergence of new, heightened, or previously obscured risks for investors to worry about, such as conduct risks. Although some of these (conduct, for example) are specific to banking, and therefore (being diversifiable) should not affect CoEs, others (such as climate- and, of course, pandemic-related risks) are clearly systemic. Another factor that has become more significant recently is the combined impact of ultra-low interest rates (squeezing net interest margins) and high fixed operating costs. This *operating leverage* (through both income and cost lines) has amplified the systemic earnings volatility of banks at this time (and therefore their equity betas), particularly those with high proportions of interest versus non-interest income and fixed versus variable costs. Many European banks fit this description.

The removal (or substantial diminution at least) of implicit government guarantees has also meant that bank CoEs are now significantly more sensitive to marginal differences and changes in underlying risk and leverage than was previously the case. So although prudential reforms have added cost, they have also reduced the marginal economic cost of holding capital, with RoE dilution now more likely than before to be compensated by CoE dilution.

On this analysis, capital is no longer the 'commodity' that many banks still treat it as being (i.e. a raw material, with undifferentiated cost, to be procured and used as sparingly as possible). Of course some frictional capital costs do remain, and capital supply constraints are still a reality for many banks, particularly in a post-COVID-19 setting as we have emphasised. So capital efficiency still matters a lot. But as we have also emphasised, this should not constrain or distort strategic portfolio choices to the point where franchise integrity, operational efficiency or strategic optionality are compromised, since these are ultimately critical to banks' investability and thus to their ability to raise or retain the capital they need.

On balance, therefore, as capital is eroded and rebuilt through and beyond the pandemic, where possible we believe banks should consider erring on the side of greater and faster recapitalisation.

Post-COVID-19 transformation responses won't just be about recovering from the economic setback (although that will clearly be a big part of it) – the pandemic could also act as a catalyst for some other important and in some cases overdue changes as well. For example, banks might 'lock in' or extend some of the operational changes that have been triggered by the lockdown, on the basis that customer and other stakeholder behaviours and preferences may themselves have changed permanently from the experience. These include remote working for staff, wider take-up of telephone and internet banking, greater use of 'virtual' relationship management practices in place of physical client meetings, and greater use of video-conference facilities for supervisory and investor interactions, presentations and other events.

Such developments could also accelerate the take-up of already-established operational and 'ecosystem' innovations, including the deployment of Cloud technology, the establishment of industry utilities, and the formation of product, service and operational alliances including with FinTech firms. This could also substitute for, or else pave the way towards, more widespread operational consolidation in Europe's banking industry (see also Section 5).

Taking these recapitalisation and transformation actions together, banks need to formulate and execute integrated short and medium term responses across all key performance domains, paying particular attention to the areas that have been or will be most disrupted by the pandemic. To help frame such responses, we have developed a structured framework to enable banks to focus on and work through their key change priorities across Capital, Franchise, Customer and Operations domains (see Figure 4.11 below).

Figure 4.11 A structured response and recovery framework

Source: Deloitte analysis

Window 4.3 – Spotlight on the Mid-tier and Challenger sector

This heterogeneous grouping can be divided into three sub-segments, each likely to face capital pressures as a consequence of COVID-19:

1. *Traditional / full-service challengers*
    - Already struggling to cover capital costs due to a weak economic environment, intense competition from majors, and a lack of either scale or operating model (technology) differentiation to compete effectively with major incumbents on cost
    - Could suffer significant credit impairment costs, particularly if disproportionately exposed to weaker credits and unsecured assets
    - Scope to restore capital through organic generation or new capital raising therefore somewhat restricted, leaving banks to contemplate more radical changes or seek buyers

2. *Specialist lenders*
    - Entered the crisis with respectable (albeit declining) underlying profitability
    - However, balance sheet resilience somewhat untested as a consequence of:
        - Loan books typically built up in benign conditions (post GFC), therefore credit underwriting quality untested
        - Stickiness of deposit funding also untested in stress conditions, therefore potential overreliance on wholesale funding markets

3. *"Neo banks" (pure play digital challengers)*
    - Typically entered the crisis with venture funded high growth - and somewhat speculative – strategies and business models
    - Customer profile typically younger people, with whom the banking relationship (which also may not be the primary relationship) is largely lifestyle driven, and is hence exposed to lifestyle changes including through unemployment
    - Although the business model is less exposed to credit losses – being more fee based – some less established players may see their profitability and cashflows deteriorate due to general economic weakness affecting service demand

In all three cases, we could see a 'survival of only the fittest' scenario, with stronger more agile firms able to defend their niche positions or restructure their business models sufficiently to remain resilient, and weaker parties either being acquired for their intellectual property or else failing outright.

5. Policy responses

Besides maintaining bank stability during the crisis and addressing its likely legacy of impaired loans,[33] there are a number of respects in which more fundamental and structural policy responses are needed to improve the efficiency, resilience and viability of the European banking industry.

Two key features stand out:

1. ***Operational overcapacity*** – As a consequence of a general capacity overhang arising from the GFC, and various national political, prudential and EU competition-driven obstacles to consolidation, Europe is operationally 'over-banked'.[34] To address this, national and EU level policy measures (involving reduced fiscal, prudential and legal barriers to consolidation) are needed to facilitate the removal of excess capacity, by means of either:
   - *Bank consolidation* through M&A; and/ or
   - *Operational consolidation* through alliances and industry utilities[35]

   Banks' role in this is important, as this is where the pressure for consolidation must come from: banks need to be creative in identifying consolidation opportunities and working with authorities to address any prudential or competition concerns arising. FinTech firms and other service providers have a role to play too in developing operational consolidation services and platforms.

2. ***Over-reliance on bank credit*** – Europe is renowned for the dominance of bank credit – as opposed to corporate-issued bonds – in funding major companies. As well as exerting a drag on new credit origination (due to the capital tied up in banks' back books), this has made European banks particularly vulnerable to periods of economic stagnation, low interest rates (compressing profit margins) and loan delinquency. Policy measures are thus needed to deepen the European corporate bond market, increase access to lending markets for alternative funding providers (e.g. funds) and remove some of the legal and prudential frictions that currently inhibit asset securitisation and alternative equity investment in bank asset pools.

   Banks' role in this – besides doing what they can to support the policy agenda (for example through participation in any relaunch of the Capital Markets Union initiative, or nurturing domestic corporate bond markets) – is to continue driving the distribution of bank-originated credit into the wholesale securities and capital markets.

These issues are not new and the need to resolve them is well understood (though they differ somewhat in character between Eurozone, other EU, and non-EU countries). However, a variety of obstacles - including national brand identities, political sensitivities and prudential and competition concerns - have so far made policy progress difficult. For example:

- **Brand identity** – Many European banks identify as 'national champions' and the deep customer relationships that go with that are often anchored in credit commitments, particularly in the corporate market. This potentially acts as a barrier to cross-border consolidation and the development of a deeper corporate bond market.
- **Prudential** – Consolidation, of the M&A variety at least, runs counter to the too-big-to-fail (TBTF) agenda. Although the ECB for example has increasingly emphasised the need for consolidation, policy makers and regulators still need to weigh this against the prudential implications. This tension has often meant that cross-segment and cross-border consolidations (and extant groups) have had to mitigate TBTF risks through various structural and capital measures (such as ring-fencing, subsidiarisation, IHCs and G-SIB buffers) that have negated some of the scale efficiencies that such consolidations might otherwise offer.
- **Competition** – Consolidation within national markets clearly gives rise to concerns about competition, particularly where that consolidation is comingled (as it was post-GFC in some cases) with some element of state aid.

33. There are press reports of an ECB sponsored 'bad bank' being set up to deal with COVID-19 related toxic debt – see Irish Times, *ECB prepares Nama-style 'bad bank' plan for Covid toxic debt*, 10th June 2020
34. As an illustration of this, the US has approximately 3 large banks per € trillion of GDP while Europe has approximately 8 per € trillion – over 2.5 times the coverage level.
35. This could be more palatable than M&A-driven consolidation for reasons noted above, and also more in tune with how the industry is evolving anyway as a tech-networked ecosystem.

There are theoretical remedies to all of these issues, particularly as European financial markets become more fungible (within the EU at least). In principle, technology innovation and wider 'ecosystem' developments should also enable the consolidation and streamlining of costs (which is the main goal) without necessarily having to go down the M&A route with its attendant prudential and competition complications.

Of course there are challenges in the detail (such as differences in national tax and legal frameworks), and a degree of inertia and possibly some political resistance involved also. But the combination of an urgent need for bank recapitalisation, and its dependency on such policy measures and industry initiatives being taken, could - in the wake of the pandemic - create sufficient political and industry resolve for the obstacles that have so far stood in the way to be overcome.

Window 5.1 – Customer forbearance, COVID-19 style

Banks are now seen to have particular obligations to support their clients, the economy and wider society through the pandemic. Although to a degree they are being backed by governments, and are being given the necessary regulatory latitude, to some extent they are also expected to put their balance sheets on the line in the public interest.

Banks have been quick to offer support to their clients, including through various government-sponsored credit schemes, but they have a fiduciary responsibility to shareholders as well and must somehow square this with the societal obligations they now live under. This raises important questions for the longer term.
For example:

- Does this mark an important shift in the public relationship with banks? The post-GFC reforms were about making banks stand alone, at least financially, in the sense of no longer having recourse to taxpayers in the event of their failure. Is there a public quid pro quo for what they are now expected to do, given that a 'suspension' or at least relaxation of underwriting standards and collections and recoveries policies could contribute to their capital losses? Or is there a pro-cyclical case for saying customer forbearance, even on this scale, protects capital in the long run?
- How might this change the evolution of the industry in terms of its relationship with society? Will it, for example, give new impetus to the ESG/ Purpose/ Reputational agendas? Or could it lead to a splintering between utility banking (fulfilling a critical service function, under heavy direction and regulation, but with some element of public protection) and full-service commercial banking (fulfilling an economic value-add function, freer to go where it pleases and to succeed or fail in the normal commercial way)?

6. Key next steps for banks

By this stage, most banks will have put in place intensive capital monitoring procedures.

In addition to this, in summary, we expect that banks' near term priorities will involve:

- Planning their strategies for depleting capital buffers over coming months, taking into account that there may be a cliff-edge effect/ acceleration of losses and further downside scenarios to prepare for.
- Taking immediate steps to mitigate RWA increases, such as undertaking necessary 'repair' actions to models in order to remove any excess supervisory add-ons; identifying and removing inefficiencies in intra-group capital usage (e.g. trapped capital in legal entities and unnecessarily capital-intensive intra-group bookings); and accelerating non-core disposals and RWA hedging transactions where possible.
- Enhancing their business and technology architectures, for example, data clean ups and strengthening operating models, to help deal with the disruptions ahead as smoothly and efficiently as possible.
- Developing longer-term plans for rebuilding capital, recognising that organic profit generation may not be sufficient or optimal, and therefore that early proactive recapitalisation options should be explored. Consideration should be given to new capital raising initiatives such as rights issues or other asset- or liability-side restructurings to accelerate the restoration of capital ratios to target levels.
- Revisiting strategies and operational transformation programmes (or launching new programmes) to recover the setbacks from the pandemic and to resume the return to long term economic viability. Banks will need to re-evaluate the key macroeconomic assumptions underpinning their existing plans, and also to factor in how the pandemic may affect markets, competition, customer needs and preferences, etc. in a more fundamental way.
- Preparing for conversations with their supervisors and the market about capital rebuilding, and developing robust and credible business and capital plans to support this. As part of this, preparing for new levels of frequent and intense supervisory scrutiny which we expect will last for the foreseeable future, with a particular focus on governance over the actions taken.

For the purposes of the latter, we believe banks will need to invest in their financial analysis and business modelling capabilities, because the status quo will prove to be too cumbersome to deal with the pace of change, not just in relation to the pandemic.

At this point we don't see an immediate substitute for existing planning and stress testing frameworks, with their inbuilt rigours and crucial checks and balances. However, with the increasing necessity of taking decisions and giving disclosures in circumstances not envisaged at the (annual) planning stage, and with rapid turnaround, we believe that an intermediate layer of analytical, decision support and reporting capability will be called for. This would act as a bridge between existing formal processes and the executive decision-making judgements which of necessity will now operate with greater fluidity and urgency than ever before.

This need is imminent, as most banks with December year ends will be starting their FY21 planning in Q3 '20 – with economic uncertainty still very high and with their COVID-19 / capital responses already in mid-flight. Figure 6.1 overleaf illustrates what such a capability and process could look like.

Figure 6.1 Dynamic analytical and decision support framework

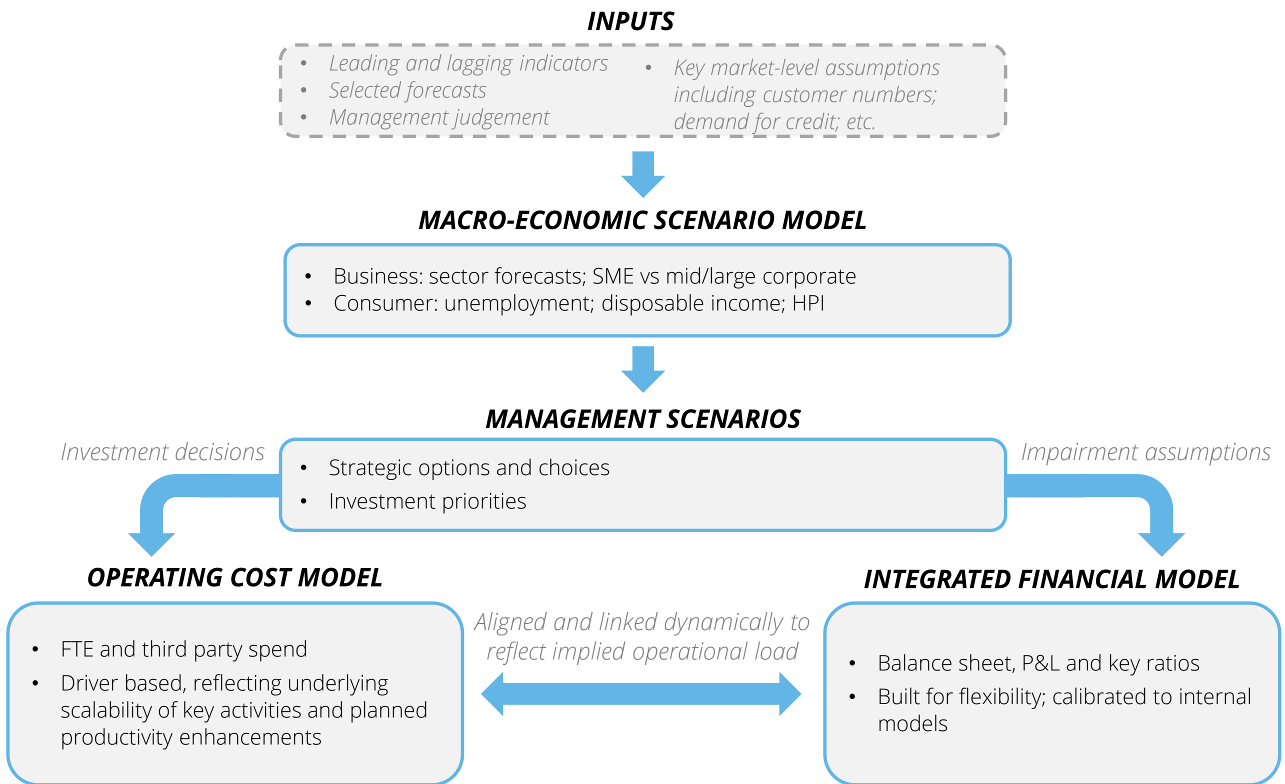
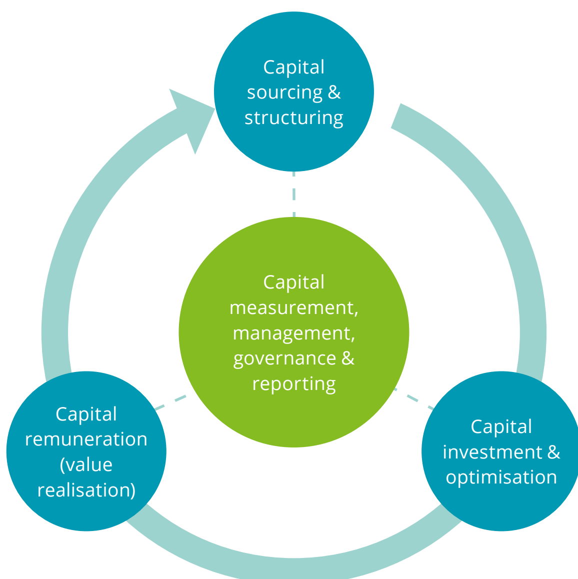


Figure 6.2 Capital Lifecycle

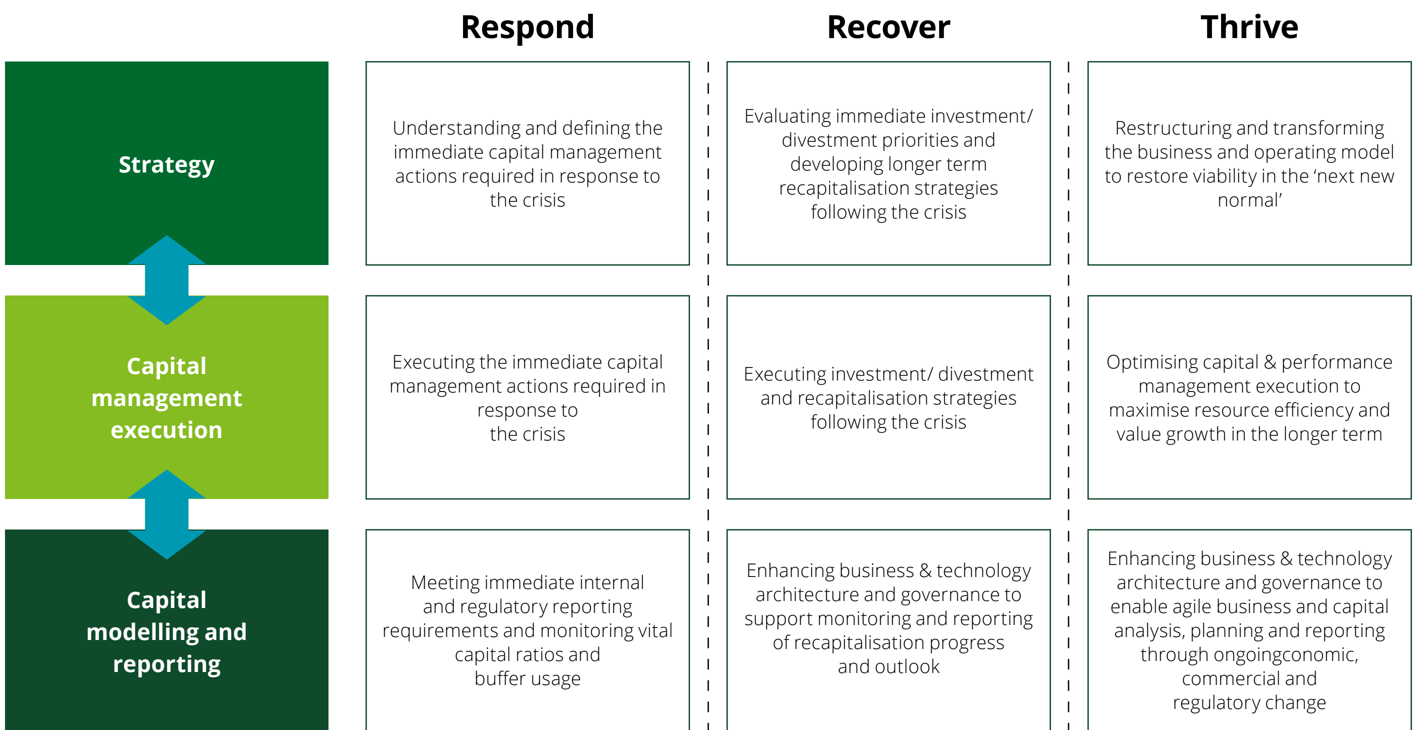


In summary, in response to the capital impact of the COVID-19 pandemic, and in anticipation of the far-reaching effects it will likely have on how societies, economies and markets function, banks will need to reposition their balance sheets and their businesses, possibly quite radically. Capital lies at the heart of this challenge, and banks therefore need to mobilise responses around the whole *capital lifecycle* (see Figure 6.2), encompassing:

- ***capital sourcing & structuring*** in the external capital market, including with respect to profit retention or distribution;
- internal ***capital investment and optimisation*** across competing claims to maximise resource efficiency;
- ***capital remuneration and value realisation*** through ongoing performance management and stakeholder engagement; all supported by
- sophisticated ***capital measurement, management, governance and reporting*** activity.

For the purposes of COVID-19, this needs to happen over a compressed timetable and in circumstances of ongoing uncertainty and rapid change. For this reason, we see a need for a dedicated **COVID-19 / capital task force**, charged with coordinating parallel and iterative responses across *strategy, execution, monitoring* and *reporting* domains, through 'respond', 'recover' and 'thrive' phases. An illustrative 'terms-of-reference' for such a task force is given in Figure 6.3 below:

Figure 6.3 Illustrative COVID-19 / capital task force terms-of-reference



Our industry and capital management expertise spans the whole capital lifecycle – and the full scope of required bank and related policy actions in response to COVID-19 – as illustrated above and outlined in preceding sections. To discuss any aspect of the foregoing, including how we can help, please contact our banking industry and capital & performance management experts as follows:

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Notes

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