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Banking Remade | Putting capital to work through COVID-19 and beyond

SUMMARY REPORT

July 2020

Full Report document.

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Contents

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

- Even with a cessation of dividend payments it could take 5 years or more for retained profits to restore capital ratios back to target levels
- Banks will therefore need to consider supplementing profit retention with other capital raising measures
- Some creativity will be needed in this as traditional avenues such as rights issues may be closed off or be excessively costly
- The post-GFC experience is that early decisive action on recapitalisation 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

- European banks overall have not covered their capital costs since the last crisis – cost of equity hurdle rates were missed by an average ~5 percentage points 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 (RoE-CoE) thereafter
- Although in many cases the foundations for returning to viability have been laid already, those foundations will need checking for soundness and suitability for a post-pandemic world
- As well as presenting new challenges, the pandemic could be a catalyst to fast-track business model improvements by locking in new customer behaviours and staff working practices and instituting more agile planning and governance arrangements

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', but prudential and competition concerns as well as national political considerations have hampered consolidation
  - 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 stress, 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 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, this 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 the financial system itself, and engulfed the wider economy. This time we have the reverse: a public health and economic crisis threatening to engulf the financial system and then reverberate back through the economy.

To date, banks have voiced a strong commitment to supporting their clients and wider stakeholders. However, for this to be sustained they must themselves survive and, when the crisis passes, they must replenish their capital and resume the arduous process of returning to 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 there isn't a long-term viable business which can recapitalise itself. This is an industry-wide challenge in Europe.

The purpose of this summary paper is to examine how banks can *respond*, *recover* and *thrive* again, 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, because there will be heavy losses; and the *thrive* phase will involve business transformation to deliver a viable future where capital returns cover capital costs. More in-depth discussion and analysis is provided in our full report of the same title.

2. How much?

European economies have seen unprecedented declines in economic output in the first half of 2020 and there remains considerable uncertainty over how much further there is to fall and when / how quickly a recovery could materialise.

Taking the UK as an example, Figure 2.1 illustrates two possible GDP contraction and recovery trajectories, labelled as V-shaped and U-shaped, plotted against the GDP scenario from the 2019 Bank of England Stress Test.

Although deeper than any recession since records began, the 'V-shaped' downturn still represents a relatively benign scenario in the circumstances. In a more prolonged 'U-shaped' downturn, a sharp rise in long term unemployment and a substantial and prolonged drop in property values should be expected. These would exacerbate consumer credit and mortgage-related impairments and thus be more damaging to banks' capital positions. The European picture is similarly bleak.

In its recent Interim Financial Stability Report,[1] the Bank of England estimated that UK bank capital ratios could fall to ~11%, based on an economic scenario published concurrently in its Monetary Policy Report (MPR).[2] This 'MPR scenario' (Figure 2.2), corresponds roughly with our V-shaped downturn. We have three observations on this:

1. Although 11% is well above the regulatory minimum, it is still an uncomfortable position for banks to have to recover from
2. 11% is an average, and some particularly exposed banks could experience materially worse outcomes
3. In a U-shaped recovery scenario, with a bigger and more sustained impact on long-term unemployment and asset values, the *average* CET1 outcome could be materially worse (say, sub-10%) with more exposed banks potentially hitting AT1 conversion triggers and breaching minimum capital levels.

Figure 2.1 UK GDP scenarios[3]

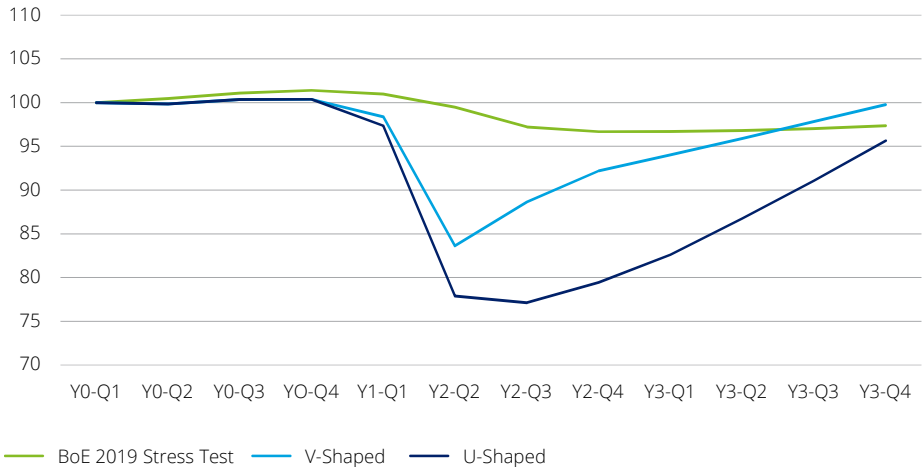
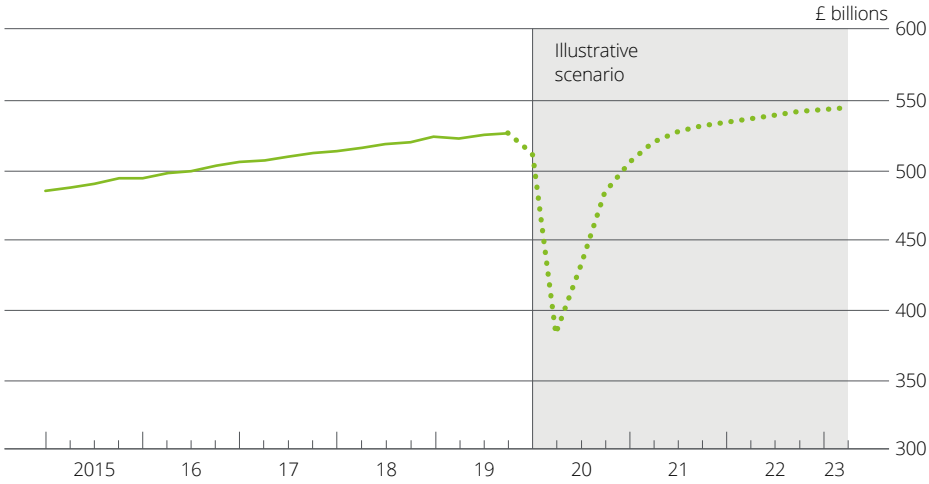


Figure 2.2 Bank of England 2020 illustrative UK GDP scenario



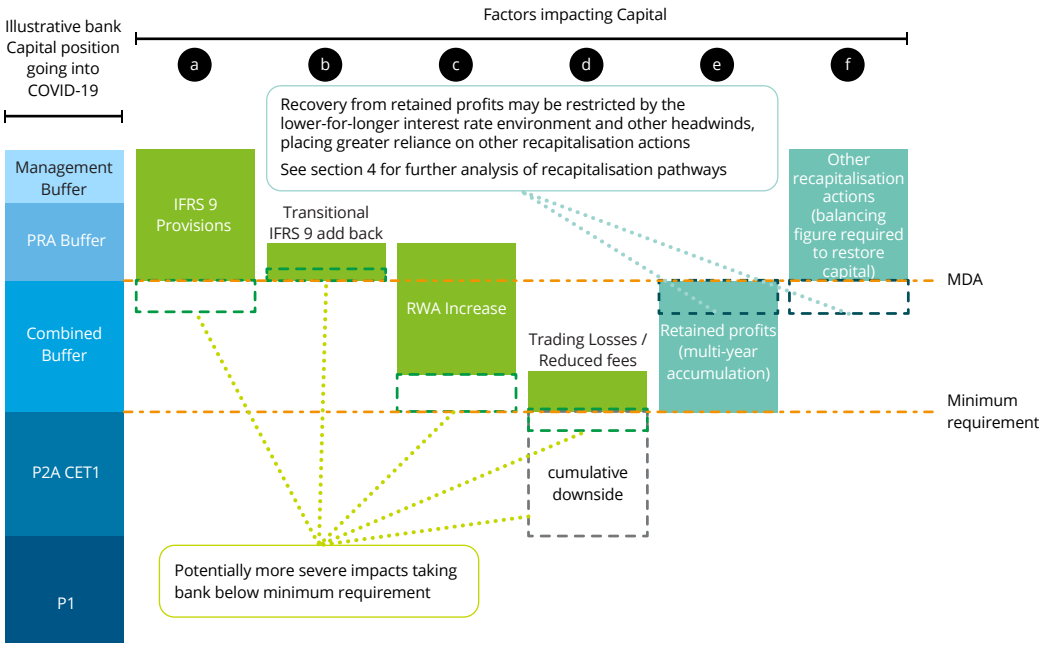
Source: Bank of England Monetary Policy Report, May 2020

1. Bank of England Interim Financial Stability Report, May 2020
2. Bank of England Monetary Policy Report, May 2020
3. GDP = 100 in Q1 2019 for COVID-19 V- and U-shaped scenarios. GDP = 100 in Q1 2018 for BoE 2019 Stress. (Source: Bank of England 2019; Deloitte analysis). This shows the severity of this downturn, in GDP terms, relative to what was previously considered to be a stress scenario.

In the UK context, the key factors that will determine the recovery trajectory – V-shaped or U-shaped – include (i) the possibility of a second wave and consequent need to impose further lockdowns; and (ii) the effectiveness and sustainability of the government's fiscal measures to shield businesses and jobs for the duration of the economic interruption. While we do not assign a relative likelihood to a V-shaped or U-shaped outcome, we consider it prudent to anticipate at least the possibility of the latter, and in any case to make recapitalisation and business performance improvement plans accordingly.[4]

Figure 2.3 below illustrates how a U-shaped scenario could work its way through the 'capital stack' of a hypothetical UK bank:

Figure 2.3 Illustrative impact on bank capital stack[5]



Source: Deloitte analysis

Window 2.1 Capital or liquidity or both?

Although capital does the heavy lifting in terms of loss absorption, when capital becomes stressed, liquidity can develop as the more threatening issue. This is typically what brings banks down in a crisis.

This goes to the question of how credible the 'formal' treatment of banks' capital positions is seen to be, particularly in relation to regulatory forbearance (see Section 3). Bank Credit Default Swap (CDS) spreads are the things to watch in this regard, and these have widened considerably since the onset of the pandemic. Even with a substantial capital cushion, and strong indications that regulators will give banks the 'technical' space they need, there is clearly some market nervousness about the financial resilience of European banks at this time.

4. For reasons we develop in section 4 below, we believe these will need to be put in place either way; it is just a matter of degree.
5. The quanta of impact outlined in this waterfall diagram are hypothetical and for illustrative purposes only. For more information on the assumptions underlying this illustration see our full report.

3. The regulatory position

Regulators have been proactive in giving banks the green light to make use of the counter-cyclical tools that are built into the prudential capital framework. That is, they can dip into their capital buffers without triggering some of the supervisory interventions that would ordinarily accompany such a development.

That said, banks should be under no illusion as to what expectations lie behind these measures, in particular: that the goal is to enable banks to maintain credit supply to the real economy; and that banks will develop credible plans for rebuilding capital buffers as soon as they are in a position to do so.

In parallel, regulators have focussed on the pro-cyclical elements of the accounting and capital regimes, such as IFRS9 and market risk capital requirements. In the UK we have also seen the regulator 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,[6] 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[7], has not been delayed – in fact some elements which support bank capital ratios are proposed to be accelerated.

There is another sting in the regulatory forbearance tail, besides the liquidity issue (see Window 2.1), in the form of a potential 'cliff effect' as defaults roll through to capital models later and all at once. 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. This will involve very careful monitoring, which may require investment in enhanced modelling tools to keep track of the situation.

Meanwhile, regulatory engagement as buffers are used will be key to maintaining an orderly process, and banks making use of buffers can expect that capital restoration plans will be requested by regulators at the earliest possible point.

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. We therefore suggest that banks should work on the assumption 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[8] beyond those already required under the Basel III changes currently due for implementation by January 2023.

6. https://www.bis.org/press/p200327.htm
7. https://ec.europa.eu/commission/presscorner/detail/en/qanda_20_757
8. This would likely come through a recalibration of stress tests in light of the pandemic

4. Bank responses

Sooner or later banks will need to rebuild their capital positions, and this will not be a simple re-stocking exercise: to retain or attract new capital, banks will need to be seen as investable businesses, with credible paths to future economic viability.[9]

It does not help that the pandemic has come at a time when European banks were already struggling to break even, economically, as shown in Figure 4.1[10] below. That was the picture going in to the pandemic. The potential incremental impact of the pandemic on future economic performance can be seen in how European 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. Clearly, the market is expecting a substantial deterioration in an already weak economic performance.

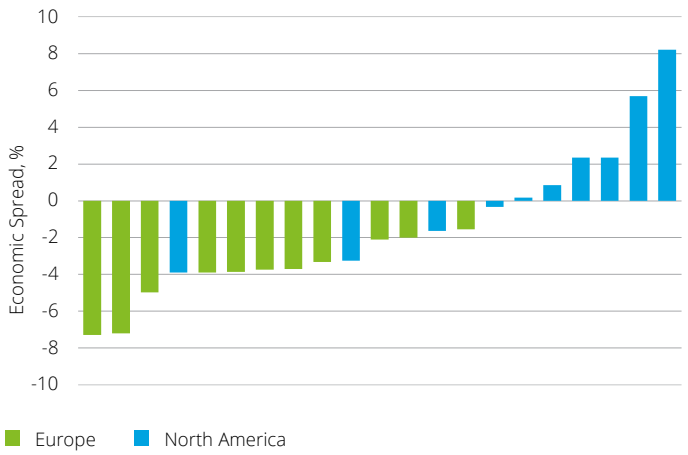
Required bank responses fall into two key and inter-related categories:

1. Capital restoration; and
2. Ongoing transformation to restore economic viability.

These categories are inter-related because, bluntly, banks will not be able to replenish their capital without a credible pathway to viability. This also applies to recapitalisation through profit retention because, following this path, without investor confidence in their long run viability, banks' share prices could sag further to the point where they become takeover or breakup targets.

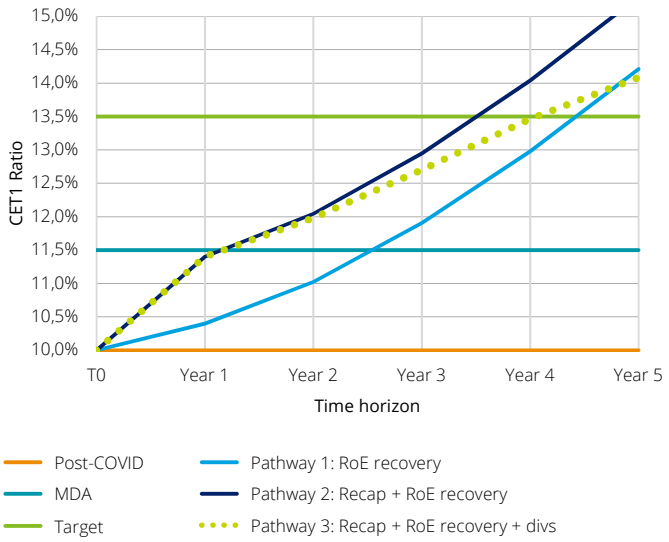
Either way, however, it is unlikely that recapitalisation through profit retention alone will be a realistic option, as it could take up to 5 years for target capital ratios to be restored even in an optimistic RoE recovery scenario. We question whether supervisors or investors would tolerate this. Banks therefore need to be proactive in planning how they will first rebuild their capital positions and then optimise them over the longer term.

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



Source: Deloitte Analysis

Figure 4.2 Illustrative recapitalisation pathways



Source: Deloitte Analysis

9. While it is true that some European banks have recapitalised in the past without, on the face of it, being '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.
10. Economic breakeven being when RoE = CoE; where Economic Spread = 0%. In Figure 4.1 Economic Spread is measured on the basis of 2019 RoEs as reported (Source: Thomson Reuters Worldscope Fundamentals) and CoEs estimated on a CAPM basis using observed 4 year betas (vs MSCI) and composite risk-free and equity market risk premium (EMRP) rates of 1.5% and 6.5% respectively. See our full report for a discussion on the cost of bank capital; how it has changed and become more sensitive to leverage since the GFC; and what this means for capital allocation, transfer pricing, performance measurement and the various management decisions that stem from that.

Figure 4.2 illustrates three pathways to recapitalisation: Pathway 1 relies on profit retention alone[11]; Pathway 2 supplements this with a 10% recapitalisation in year 1; and Pathway 3 brings forward a gradual resumption of dividend payments from year 2 onwards.

Although Pathway 3 could be viewed as a case of raising capital in order to be able to pay it back, the important point is that early recapitalisation could help to bring forward a release from MDA restrictions and thus enable strategic choices to be made between distribution, retention or investment of capital, on positive economic grounds. That is, rather than being locked in a process of capital recovery – irrespective of investment opportunities – for a full 5 years or more. This is an important lesson from the GFC: early and decisive action to rebuild capital provides a vital platform for subsequent performance improvement.

Nonetheless, traditional recapitalisations such as rights issues could still be problematic given market conditions. 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 4.3 depicts a portfolio and sequence of measures that banks could consider.

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.

Figure 4.3 Solutions to restoring bank capital ratios and securing future viability

Near Term

- Private equity and contingent capital placements
- Updated internal risk assessments, model calibrations
- Identification of technical and tactical risk / capital mitigation solutions
- Identification of higher risk portfolios and execution of discrete loan book securitisations, sales, and cash or synthetic SRT transactions

Medium Term

- Disposal or runoff of non-core portfolios / activities
- Rights issues (contingent on market stabilisation)
- Assessment of capital / liability stack (T1/T2) and efficient re-allocation
- Other capital raising / releasing initiatives (minority capital; employee stock issuance; hedging)
- Internal capital restructuring, e.g. legal entity / booking model

Longer Term

- Business line restructuring, driving necessary cost reductions and efficiencies
- Business model repositioning, including exit from uneconomical activities
- Strategic capital re-allocation; ensuring cost of capital is covered and value creation ensured

Structural

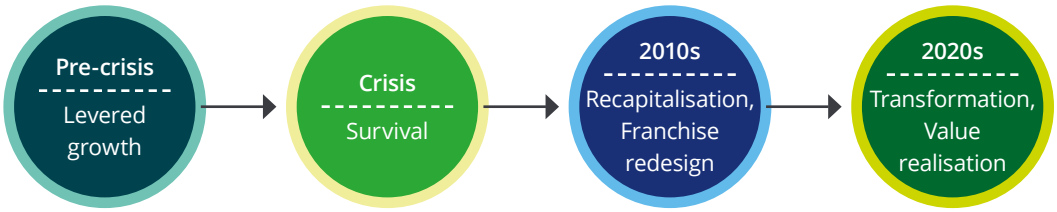
- Creation of national or supra-national 'bad banks' / asset managers
- Bank consolidation through platforms deals, M&A or distressed acquisitions
- National / cross-border solutions for asset off-loading, e.g. Fannie Mae / Freddie Mac

Source: Deloitte Analysis

11. This assumes an S-shaped recovery in RoE performance from 4% in year 1 up to 9.5% in year 5

Generalising from this example, in our earlier paper on Capital & Performance Management,[12] we suggested that the strategic agenda for banks in the 2020s will be centred on Transformation and Value realisation, as depicted in Figure 4.4.

Figure 4.4 Banks have shifted their strategic agendas through turbulent times



COVID-19 changes this in two ways:

1. **2010s revisited.** Obviously so in the case of recapitalisation, but also in terms of franchise redesign as banks consider the full implications of 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[13] and appropriate disclosure to ensure that they support – and are seen by the market to support – capital and value recovery.

Window 4.1 Fit-for-purpose transformation

Although the foundations for returning to 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.

12. Capital & Performance Management in the 2020s – Realising Value from Transformation
13. For example, ensuring that business segments become individually viable – 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, or 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 economic realities. See our full report for a discussion on capital optimisation, allocation and transfer pricing challenges and remedies related to this need.

5. Policy responses

Besides maintaining bank stability during the pandemic and addressing its likely legacy of impaired loans,[14] more fundamental and structural policy responses are also needed to improve the efficiency, resilience and viability of the European banking industry.

Two key features stand out:

1. ***Operational overcapacity*** – Europe is operationally 'over-banked'[15] and this acts as a constant drag on industry efficiency. To address this, national and EU level policy measures 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[16]

   Banks' role in this is to be creative in identifying consolidation opportunities and to work with authorities to address any prudential or competition concerns arising.

2. ***Over-reliance on bank credit*** – Europe is renowned for the dominance of bank credit (as opposed to capital markets) in funding major companies. This exerts a drag on new credit origination - due to the capital tied up in banks' back books - and it makes European banks particularly vulnerable to periods of stress. Policy measures are thus needed to deepen the corporate bond market and free up more asset securitisation and/ or alternative equity investment in bank asset pools.

   Banks' role in this is to support this policy agenda (for example by contributing to a revamped Capital Markets Union project) and 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. However, a variety of obstacles - including political, prudential and competition concerns - have so far made progress difficult. Looking ahead though, 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 previously stood in the way to be overcome.

14. 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
15. 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.
16. This could be more palatable than M&A-driven consolidation and also more in tune with how the industry is evolving anyway as a tech-networked ecosystem.

6. Key next steps for banks

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

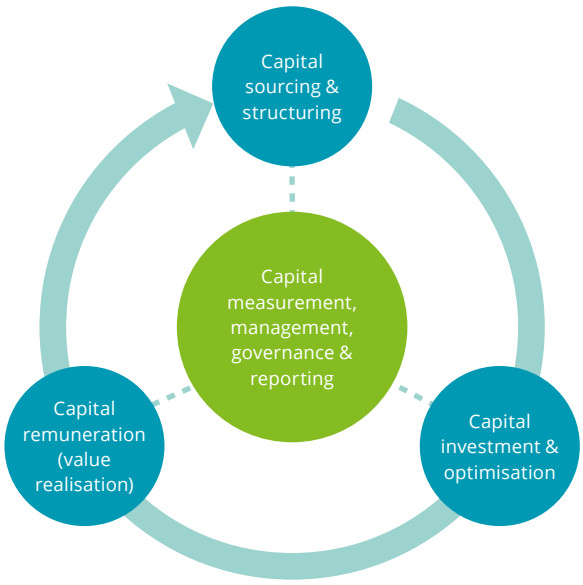
In addition to this, in summary, we expect banks' near term priorities will involve:

- 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 upgrading models to remove excess supervisory add-ons; resolving inefficiencies in intra-group capital usage (e.g. trapped capital); and accelerating non-core disposals and RWA hedging transactions where 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.
- Revisiting strategies and operational transformation programmes to recover the setbacks from the pandemic and to resume the return to long term viability. Banks will need to thoroughly 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.

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 6.1), 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.

Figure 6.1 Capital Lifecycle



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, as illustrated in Figure 6.2.[17]

To support this, we believe banks will need to invest in their financial analysis, business modelling and decision making capabilities and processes because the status quo will prove to be too cumbersome to deal with the pace of change and level of scrutiny demanded. Although we don't see an immediate substitute for existing planning and governance frameworks – with their inbuilt rigours and crucial checks and balances – we believe that an intermediate layer of analytical, decision support and reporting capability will be called for. This will act as a bridge between existing formal processes and the executive judgements which will now have to be made 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 COVID-19 / capital responses already in mid-flight.

Figure 6.2 COVID-19 / Capital task force matrix

17. Our full report provides an illustrative terms-of-reference for a COVID-19 / capital task force.

Please see our accompanying full report at https://www2.deloitte.com/uk/en/pages/financial-services/articles/a-stress-event-like-no-other.html?nc=1 or through this link for more information on the topics raised in this paper.

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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