



WHITE PAPER | BANKING & FINANCIAL SERVICES

Lessons From the Front Lines: Strategies Banks Can Adopt to Recover in the New Normal

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At the end of 2019, the world woke up to a global pandemic that continues to impact every economy at large. Rising death tolls and unemployment due to COVID-19 have severely impacted people's lives and businesses. Governments across the globe have shed hundreds of billions of dollars to not only provide subsistence to those severely affected but also stimulate economic growth.

No industry is exempt from the impact of COVID-19, and the banking industry is expected to undergo a massive makeover far faster than seemed possible. In the short to medium terms, banks must revisit their current liquidity positions, assess their stress levels, look for ways to reduce delinquencies and redefine business models to identify new streams of income to recover.

Many central and commercial banks have already taken steps to deal with the pandemic and the lost revenue due to payment breaks in an efficient way. Some of these measures include:

- Recover through the treasury function by managing liquidity
- Improve the credit function by managing credit risk
- Discover new income streams and manage operational cost
- Reduce delinquencies by adopting predelinquency measures and improving collateral cover
- Reinvent business models

These measures are significantly important from NTT DATA's perspective, and this paper details how banks can maneuver through each strategy and pave the way to recovery.

Current environment



Almost all central banks have asked individual banks of their respective countries to extend the payment breaks to their customers until March 2021.¹ Based on discussions with our bank clients, NTT DATA Services estimates that almost 60% to 70% of individual borrowers have opted for payment breaks. These numbers will negatively impact banks' gross non-performing asset (NPA) ratios, and we expect to see an almost 30% rise by March 2021. We also expect this number to go up to 42% under severe economic stress. The gross NPA ratio swelled for those sectors directly impacted by COVID-19, such as hospitality, aviation and construction.

Like many other industries, banking faces an environment of extreme uncertainty and unprecedented challenges. Banks across the globe seem to have entered the crisis with a variety of problems, such as difficulty with liquidity management and expected credit risk losses, as well as increasing pressure on customer service and operational capacity. As the pandemic continues, banks may see a rising number of non-performing loans and higher delinquencies, with the dual impact of lower collections and rising credit risk losses. Although customers will demand banking services, economic uncertainty and revised credit policies will threaten market expectations.

The extent to which banks will be affected by the crisis is expected to differ widely among institutions

and regions, and a lot will depend on an individual bank's exposure to the most affected sectors, such as hospitality and aviation. It's difficult for banks to have faith in their business decisions in terms of supporting investments in technology and automation or meeting the market expectations regarding customer growth given the current risk appetite. Because of their reliance on historical data, existing business models created with artificial intelligence and business intelligence may no longer be sound, and the challenges mentioned above are expected to affect banks' asset quality and profitability going forward. But banks are actively looking for ways to support their customers, and the capital relief regulators have provided in their respective regions are allowing banks to withstand potential credit risk losses.

Because the banking sectors of two major economies — the United States and Europe — have a greater role to play in bringing the world's economy back on track, we'll delve into these economies to better understand how banks in these regions have managed so far and what other best practices regulators have adopted to support the industry at large. The lessons learned from these economies will help you understand how effective an economic recovery supported by the banking industry will look and what other measures banks can take to regain economic health. And since growing economies have an equal and important role to play in any discussion about banking, we'll also share a few insights about what steps banks in India are taking.

United States

Banking regulators have pursued many different strategies in response to the rising fears over the global economic impact of the pandemic to reduce the massive effect COVID-19 has had on the industry. As cost pressures increase and revenue-generating activities come nearly to a halt, regulators are taking several steps to stimulate the economy and bring financial stability, including reducing interest rates and providing needed liquidity. The U.S. Federal Reserve (Fed) has asked large banks to preserve capital by suspending share repurchases, capping dividend payments and limiting dividends based on recent income.²



U.S. regulatory agencies also issued principles for offering small-dollar loans in a responsible manner to meet the short-term credit needs of financial institutions' customers. On March 15, 2020, the Fed announced it would reduce reserve requirements to zero for the first time ever.³ It encouraged banks to borrow from the Fed's discount window to meet their liquidity needs and to use intraday credit available through the Fed's payment systems as a source of liquidity. To meet additional funding and liquidity requirements the Fed also reduced the cost of swap lines and set up a new temporary facility that will work in parallel with swap lines.

For the non-bank financial system the Fed created a series of emergency credit facilities, some of which are new while others have been revived from the 2008 financial crisis.⁴ The first revived option is the commercial paper funding facility to purchase commercial paper, which is an important source of short-term funding for financial firms, non-financial firms and asset-backed securities. The second is the

primary dealer credit facility, which provides short-term, fully collateralized loans to primary dealers. The third is the Term Asset Backed Securities Loan facility to make nonrecourse loans to private investors to purchase ABS backed by various nonmortgage consumer loans. Among the Fed's newly created emergency credit facilities are the Money Market Mutual Fund Liquidity Facility (MMLF), which is similar to one created in 2008 and makes loans to financial institutions to purchase assets that money market funds sell to meet redemptions. Others include facilities to support the corporate bonds market, the Secondary Market Credit Facility and the Payroll Protection Program Lending Facility (PPPLF). The Fed also announced the Main Street Lending Program (MSLP), which purchases loans from depository institutions to businesses with up to 10,000 employees or up to \$2.5 billion in revenues.⁵ Loans to businesses would defer principal and interest repayment for one year, and the businesses would have to make a "reasonable effort" to retain employees.

Europe

The European Commission has seen greater coordination among European Union (EU) members to develop and implement a combination of national fiscal policies and bond buying by the European Central Bank (ECB) in response to the economic impact of the pandemic. According to the Summer 2020 European Economic Forecast, Europe may experience deep economic recession during 2020.⁶ While the ECB president called on all EU leaders to take immediate action to prevent the slowdown, the European Commission indicated it would create a \$30 billion investment fund to address COVID-19 issues.⁷



The ECB has, in effect, decided to expand its long-term refinance operations (LTROs) and targeted longer term refinance operations (TLTROs) to provide low-cost loans to banks in the eurozone. The goal is to enhance the liquidity of banks in this region and to provide loans to small businesses at below-market rates.⁸ In addition, the ECB provisioned €120 billion for banks' asset purchase programs to provide liquidity.⁹ The ECB also announced it would create a \$1.5 trillion Pandemic Emergency Purchase Program (PEPP) to purchase public and private sector securities without any constraints to stimulate the European economy.¹⁰ Up to €3 trillion in liquidity will be made available by the ECB through refinancing operations.¹¹

While all this is happening within the eurozone, the United Kingdom has taken a number of steps to prevent any economic instability and to provide banks with adequate support. To deal with the disruptions anticipated from the pandemic within the British economy the Bank of England (BOE) cut its benchmark rates to a historic low of 0.1%.¹² It also revived its Term Funding Scheme, which provides banks with over £110 billion for loans at low interest rates to support small and midsize businesses.¹³ The BOE froze banks' dividend payments and reduced capital requirements from 1% to zero to boost credits.¹⁴ It also unveiled a £350 billion package that includes £330 billion in guaranteed loans for businesses, £20 billion in tax cuts, a three-month mortgage payment break for borrowers affected by the virus and a one-year "business rates" holiday for businesses in the retail, leisure and hospitality industries.¹⁵

The lessons learned from these economies will help you understand how effective an economic recovery supported by the banking industry will look and what other measures banks can take to regain economic health.

India

In response to the ongoing crisis, the Reserve Bank of India (RBI) announced several relief measures to enhance liquidity within the system. RBI reduced the repo rate by 75 basis points to 4.40%.¹⁶ It will conduct auctions of targeted long-term repo operations of up to three-year terms, amounting up to INR 2 lakh crore (approximately US\$26 billion) in different tranches for onward lending to small enterprises. It also lowered the cash reserve ratio by 100 basis points to 3% to further increase the liquidity of INR 1,37,000 crore for banks. Banks are permitted to borrow overnight by dipping the statutory liquidity ratio to 3% with immediate effect. Such liquidity measures will infuse liquidity of INR 4.74 lakh crore (approximately US\$63 billion) to the system, which is expected to reduce volatility in the banking system.¹⁷



Besides this measure, lending institutions are permitted to allow a moratorium of three months on installment repayments for term loans and the deferment of interest payments for the same period on all such working capital facilities. Banks have been advised not to include a moratorium period in computing the 90-day NPA norms for asset downgrades.¹⁸ The threshold amount of default has been increased from Rs 100,000 to Rs 10 million, with the intent to prevent triggering insolvency proceedings against micro, small and midsize enterprises (MSMEs).¹⁹ While such measures come from the regulators to ensure banks have enough liquidity, the banks themselves are on a fundraising splurge to protect their balance sheets from the after-effects of COVID-19. Several public and private banks have already divested their subsidiaries and implemented their fundraising plans (for example, issuing fresh equity or debentures and other securities) since the virus first emerged.

Strategies banks can use to recover safely



The measures taken in the U.S., Europe and India show how regulators in each economy have effectively advised banks on how to preserve capital or provided them with much needed liquidity at reduced borrowing interest rates and through smaller loans and emergency credit facilities. Banks are passing on these benefits to their customers, supporting them during these difficult times by extending low-cost loans, loan payment moratoriums, and interest and fee waivers — all of which undoubtedly will impact their balance sheets and business models. Such initiatives will reduce economic damage and reinstate customers' confidence in the banking system. Banks will continue to play the role of catalyst in reviving the economy during this unprecedented time. It's also very likely that in paving the path to recovery, banks may have to reimagine their business models and accelerate long-term initiatives at the cost of short-term recovery measures.

In addition to these measures, NTT DATA Services recommends that banks consider five important initiatives:

1. Recover through the treasury function by managing liquidity

Despite the remedial measures taken by government and central banks to infuse liquidity into the financial system, banks may still face liquidity challenges due to increased demand for withdrawals, difficulties raising funds amid the pandemic and deferment of any loan repayments due to moratorium clauses to which banks must adhere. Banks already run the risk of a liquidity crunch in anticipation of the rise in non-performing loans after the U.S. government stops COVID-19 payments and the moratorium period ends. Banks should advise customers that interest accrued during the moratorium is an additional burden on them and that paying it off early and slowly might help more than deferring it for an extended period.

Due to the cashflow mismatch, banks will have to face a severe liquidity crisis in meeting interest and maturity obligations over time. Deepening the liquidity crunch, any support now extended by central banks is expected to end soon, and banks will have to look for alternate sources of long-term funding options for sustainment. While banks may already follow the best practices to manage liquidity risk, existing models may not be adequate to do so effectively. Therefore, banks should take stock of their current situation and identify all possible sources of liquidity. Although banks must forecast the projected liquidity requirements, they should also perform a certain level of stress testing against the odds of a second major COVID-19 outbreak occurring. Risk monitoring techniques, such as monitoring liquidity coverage ratios and short-term dynamic liquidity statements, will help banks consider possible liquidity risks and liquidity mismatches, as will advance planning, if an adverse situation arises.

2. Improve the credit function by managing credit risk

Banks will continue to play a central role in providing customers with easy access to funds. At the same time, they must be proactive about preventing rising credit defaults and falling collateral value due to the sale of non-performing assets. As the situation worsens, it's likely that both net interest income and return on equity could decline for banks of all sizes in the short to medium term due to thin margins and rising risk-related costs. To minimize risks, banks must gauge the magnitude of the credit losses they anticipate from different portfolios, as the impact of the pandemic could vary for each sector.

Banks will have to rerun their risk analytics programs using early warning indicators. They'll have to identify the probable risks for each sector to which they're exposed, and then revamp their credit policies and readjust their exposures based on their assessments of the sectors most likely to recover fast. Banks may have to adjust their risk-related models, as well as redefine their risk assessment frameworks, credit restructuring models, delinquency models and risk information management systems.

3. Discover new income streams and manage operational cost

Given that deposits at banks may decrease further and interest rates may remain low, the income stream for banks will be limited. In such situations, banks will have to discover new ways of earning by shifting from fund-based to fee-based incomes. Banks may look to provide value-added services, such as credit underwriting, to those customers with strong balance sheets. Service footprints will have to be expanded to generate new fee-based income in adjacent areas like online trading platforms and online credit platforms, bringing more digital touchpoints to these services than ever before. Banks may consider offering banking-as-a-service options and provide service functions in return for fee income. To encourage deposit inflows, banks will have to innovate on the product side by, for example, offering new investment products that encourage younger generations to invest more toward their future financial security.

One characteristic of a bank operating in the new normal is a radically lower cost structure. As banks in the near term continue to face pressures on income growth, controlling costs and finding efficiencies will be crucial. In addition to relying on technologies such as artificial intelligence and machine learning to reduce operational costs, service outsourcing could allow banks to manage their balance sheets with less operational hassle. In an effort to reduce costs, banks must balance the pressures to reduce capacity with the need to maintain operational resiliency to avoid penalties regulators may impose for non-compliance.

Banks can cut costs by managing third-party spend and supplier management. With better predictions about the minimum required for sustainment, banks can reduce redundancies and make better use of resources. To reduce operational costs over the long term, banks could expand shared services and utilities, such as ATM pooling and back-office and infrastructure services. This is more like consolidating resources in a centralized location to achieve economies of scale. Banks will look to set up cross-functional teams at such central locations and deploy collaborative tools to enhance productivity.

4. Reduce delinquencies by adopting predelinquency measures and improving collateral cover

Banks will have to ensure the recovery of loan payments under moratoriums and make sure delinquencies don't rise. This can be achieved through well-constructed predelinquency management or a program that can be executed at various levels:

- **Account.** This level offers some flexibility in repayment terms to ease repayment stress, including:
 - » Accelerated payments immediately at the end of the deferred period
 - » Longer loan term to make up for missed payments so the borrower can avoid taking on additional monthly payments
 - » Increased monthly payments, which could be spread over the remaining term of the loan contract
- **Customer.** Apart from the re-amortization measures, which can ease stress for borrowers, banks can benefit from analytics using alternate data sources such as professional work websites (LinkedIn), social profiles on Facebook, credit card defaults and tools like psychometric tests that could help assess the intent and willingness of customers to repay, and thus enable banks to assess the probability of debt converting to a non-performing asset. Such psychometric tests can be performed on both new and existing customers. It will require banks to incorporate a psychology-based credit solution to augment their current credit models and loan monitoring.
- **Delinquency handling strategy.** Risk teams could segment customers by the sectors, jobs and businesses that are expected to be impacted differently by the pandemic. These specific segments need to be considered on various risk parameters with renewed thinking about collection strategies, contact strategies and customer experience.

Banks can also reduce their credit loss through multiple alternate means of handling debt recovery, including debt-to-equity conversions and pledging of shares. These options can provide banks with more opportunities to recover funds in case of liquidation or borrowers' inability to repay.

5. Reinvent business models

Continuous low interest rates, as well as enhanced regulatory pressure and increased competition from fintech challenged traditional banks before COVID-19 appeared. While banks so far have demonstrated their resilience, the pandemic has shown flaws in their existing operating models. It's evident that banking models, such as risk ratings, early-warning indicators and liquidity risk models, have all failed to predict unexpected large cash outflows, shrinking balance sheets and widening liquidity mismatches due to the pandemic.

An added challenge is that banks didn't have contingency plans in place to manage such a global crisis. They'll have to relook at some of their business models and any problems that became the reason for their failure. One issue we can easily imagine is the algorithms used to analyze historical data not including pandemic scenarios, leaving banks without forecasts to deal with the crisis. Further, the stack on which such models are built may not have been flexible enough to integrate the dynamic data required to recalibrate, simulate the situation and predict the probable failures that could help the banks to navigate through the crisis.

Banks should focus on adjusting their business models to include massive redevelopment plans and embed scenarios to deal with deficient business decisions. They can look at repricing gaps in their open interest positions and at the short- and long-term impacts on their net interest income and return on equity. With respect to international exposures, banks should assess current foreign exchange positions and identify which economies from their portfolio would recover fast. They should hedge their position to those economies with risk-adjusted foreign exchange exposure. Banks should also assess the financial viability of loans linked to some base and index rates, as interest rates are likely to remain unfavorable for them.



Conclusion

The impact of COVID-19 will not be over anytime soon, and an unanticipated second wave will also hit global economies — the perils of which are unknown. Given this uncertainty, regulators and banks appear committed to weathering the storm. Central banks are still pouring a lot of money into the financial system to help maintain liquidity, and individual banks continue to help their customers in whatever way is financially feasible. It's imperative that banks continue to assess their liquidity situation and readjust their risk policies and models to address the challenges of an uncertain market. Banks must also redefine their business models and identify new income streams and opportunities rather than continuing to rely on conventional banking revenue models.

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In his IT career spanning over two decades, Niraj has advised leading financial services and insurance companies across the globe in the areas of digital strategy, payments modernization, risk and compliance, process re-invention, automation and industrialization. He also has a strong focus on building new financial ecosystems, through fintech partnerships and collaboration. Niraj is a regular speaker at various industry forums and advises leading industry analysts on strategic imperatives for banks as they grapple with pressures of cost, compliance and customer retention.



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