A Strategic Approach to Addressing COVID-19 Impact

What Bankers Should Be Doing Now

MAY 20, 2020

PREPARED BY:

Walter J. Mix III
wmix@thinkbrg.com
213.261.7712

INTELLIGENCE THAT WORKS

Copyright ©2020 by Berkeley Research Group, LLC. Except as may be expressly provided elsewhere in this publication, permission is hereby granted to produce and distribute copies of individual works from this publication for nonprofit educational purposes, provided that the author, source, and copyright notice are included on each copy. This permission is in addition to rights of reproduction granted under Sections 107, 108, and other provisions of the US Copyright Act and its amendments.

Disclaimer: The opinions expressed in this publication are those of the individual authors and do not represent the opinions of BRG or its other employees and affiliates. The information provided in the publication is not intended to and does not render legal, accounting, tax, or other professional advice or services, and no client relationship is established with BRG by making any information available in this publication, or from you transmitting an email or other message to us. None of the information contained herein should be used as a substitute for consultation with competent advisors.

Facing a One-Hundred-Year Crisis

The impact of the COVID-19 health crisis is unprecedented in scale and reach. While 9/11 disrupted world travel and put cities on high alert due to public safety concerns, there was no widespread economic "lockdown." The 2008 economic recession put markets and businesses around the world in turmoil but did not induce the fear of public safety that accompanies a pandemic. The COVID-19 crisis combines both destructive elements. Every banker in the country is focused on the question of how to address the immediate and long-term impacts of this highly unpredictable generational crisis.

The first major element of unpredictability is determining when the pandemic could be over. We are seeing the negative effects of keeping the population sheltered at home for an extended period. The government reported that the GDP declined 4.8 percent in Q1 2020 and is currently 14.7%, an indication of the far greater impact that we are likely to see in Q2 and potentially beyond.[1] Inflation-adjusted **gross domestic product** (real GDP) is expected to decline by about 12 percent during the second quarter, equivalent to a decline at an annual rate of 40 percent for that quarter, according to the Congressional Budget Office.[2] Industries such as airlines, hospitality, and brick-and-mortar retail are reporting near complete declines in revenue. One study by the University of Chicago indicated that approximately 42% of jobs erased by the sheltering process will never return.[3]

It is not clear as of this writing whether the economy will recover in a *V* or *U* or *L* shape. With no quick fixes on the horizon, we are likely to be in an environment of rolling global market disruptions for several months, if not into 2021 and 2022. New treatments and a vaccine are being developed, but no clear timeframe has emerged. Decision makers from the federal down to local level are weighing the top priority of public safety against the long-term impacts on an increasingly interconnected economy.

There is a noticeable gap between the real economy and the stock market. How long will it take for the economy to recover? My practice focuses on several market coal-mine canaries: commercial and residential real estate, leveraged loans, auto loans, and the residential mortgage market. All are indicators of consumer and business health and tell the broader story of the economy in cities, counties, and states and up to the national level. In particular, significant concerns exist regarding real estate across the country, derived from the fact that many industries that lease commercial real estate have been affected by the precipitous downturn, including retail, restaurants, and entertainment. Many experts see permanent changes to business models.

Who will be standing once the crisis ends? Depending on how long the crisis continues for, we will increasingly see the largest, most sound companies survive. In stark terms, the companies that have plenty of capital to solve situations will last longer than those that do not. The existential concern is liquidity and credit quality. Many banks are allowing forbearance, but this will only last so long. Be ready for second-quarter numbers.

Every banker in the country is focused on the question of how to address the immediate and long-term impacts of this highly unpredictable generational crisis.

1 Heather Long and Andrew Van Dam, "U.S. unemployment rate soars to 14.7 percent, the worst since the Depression era," *Washington Post* (May 8, 2020), available at: https://www.washingtonpost.com/business/2020/05/08/april-2020-jobs-report/

2 Swagel, Phill, CBO's Current Projections of Output, Employment, and Interest Rates and a Preliminary Look at Federal Deficits for 2020 and 2021," Congressional Budget Office (April 24, 2020), available at: https://www.cbo.gov/publication/56335

3 Jose Maria Barrero, Nick Bloom, and Steven J. Davis, *COVID-19 Is Also a Reallocation Shock*, Working Paper No. 2020-59, University of Chicago Becker Friedman Institute for Economics (May 2020).

Tackling the Immediate Challenge

In navigating this ongoing crisis, bankers need to consider the most prudent course of action for their institutions. As a result, bankers will need to focus their attention on three main priorities: 1) shoring up financial stability, and in particular liquidity and credit; 2) effectively managing the bank's crucial role in government recovery programs; and 3) positioning the institution for long-term viability.

In terms of financial stability, bank executives should take concrete steps to help weather any substantial market downturn. These include:

Governance Review. Banks should consider corporate governance reviews by independent parties. Observing standards of care and demonstrating proper implementation will be a key factor going forward for many banks. One lesson from the past decade is that corporate governance failings related to issues such as risk management, compensation, shareholder activism, and board qualifications are common factors related to underperformance of banks. A proactive assessment can identify and address areas for improvement before they become critical weaknesses, rather than assess governance effectiveness after the fact. These independent reviews tend to be conducted by a holistic team that includes law firms, accounting firms, and banking experts who have worked through an economic downturn.

***CAMELS* Assessment.** Executives should perform an immediate self-assessment of the institution's CAMELS rating in light of new market realities. The system is utilized by regulators worldwide to evaluate a bank's overall condition, per the following factors: Capital adequacy, Asset quality, Management, Earnings, Liquidity, and Sensitivity. During the Great Recession, many banks declined within one examination cycle from highly rated to a very low rating.

Capital Adequacy. Capital adequacy is evaluated through capital trend analysis. High ratings are driven by factors such as compliance with interest and dividend rules, loan and investment concentrations and ability to control risk. In this environment, we are hearing a common theme that that most banks will have to raise additional capital in order to address credit costs going forward. There is concern regarding the adequacy of capital if the economy does not recover within a relatively short time period. Some advisors are recommending that banks raise capital now in anticipation of a prolonged downturn.

Asset Quality. Asset quality addresses the quality of institutional loans in relation to risk factors the company may be facing. The process also checks how the bank may be affected by the ratio of fair market value versus company book value of investments. In the current environment, this should be a deep dive; reviewers should perform a detailed portfolio analysis and move off weak loans and relationships wherever necessary. While most banks have sufficient capital, an outlying stress scenario may occur given the deep declines in many industries. This may impact commercial real estate (CRE) and commercial and industrial (C&I) more deeply than planned.

Management. Related to a governance review, management assessment determines whether an institution can react sufficiently to financial stress. It evaluates the general ability of management to ensure the safe operation of the institution while still in compliance with relevant bank policies and external regulations.

Earnings. The assessment rates quality of past, present, and potential future earnings by studying factors such as the company's growth, stability, net interest margin, net worth level, and quality of the company's existing assets.

Liquidity. Liquidity problems can lead to prompt regulatory action, including bank failures. To assess liquidity, reviewers map availability of assets that can be easily converted to cash, gauge dependence on volatile financial resources, and factors such as vulnerability to interest rate fluctuations. This component of the CAMELS rating is highly important, and a thorough review and immediate remediation is in order.

Sensitivity. Particularly relevant to the current situation, assessing bank sensitivity delves into the institution's resilience to certain market factors by analyzing management of credit concentrations. Highly concentrated lending to certain exposed sectors will result in heightened risk.

Each component is assigned with a 1 to 5 rating according to specific criteria: 1 signifies strong performance and no need for supervisory attention, and 5 represents critical deficiencies. For these risk mitigation efforts, it is crucial that the reviewers have independence from the functions they are evaluating. Failing to report potential deficiencies due to a conflict of interest will put the bank at great risk in an unforgiving market.

Managing the Government Response

Bank regulators are allowing forbearance, and many banks are providing same to their customers. Financial supervision is occurring off site in many cases. However, when regulators observe problems at banks, the level of supervision will increase markedly. Some banks are providing extended periods of forbearance, but others are not. The second-quarter numbers will become available in the summer, and this may be a day of reckoning for many customers and banks alike.

While the above discussion has focused on steps that banks can take to address general market risks, the COVID-19 crisis is also generating a wide range of government recovery programs that directly impact financial institutions. Banks are a key vehicle by which certain economic recovery measures are being implemented, and with that role comes responsibility and risk.

To date, Congress and the Trump administration have enacted strategies to mitigate the economic and social impact of COVID-19. The Paycheck Protection Program (PPP) and the Federal Reserve's Main Street Lending Program are the largest examples of this effort. Both measures are designed to keep enough fuel in the tank so that, when commerce resumes, there will be capacity available to restart the engine and outrun the negative effects of the crisis.

In the case of non-agency residential mortgage lenders, the Federal Housing Finance Agency announced support for the mortgage industry. On the state level, there have been announcements of mortgage and consumer loan forbearance programs in effect until stay-at-home orders are lifted. However, depending on how long the crisis lasts, additional support may be needed to ensure orderly continuation of housing finance for the country.

Each of these measures directly requires the participation of financial institutions in the form of either new lending or forbearance decisions. This has already begun to generate controversy: The PPP has been the subject of numerous allegations of larger institutions gaming the program to focus on existing customers. Banks will need to focus on completing forgiveness applications properly and ensuring proper implementation of "know your customer" programs. As of this writing, the US Department of Justice has announced that it will investigate some of the largest banks. Bankers will need to perform exhaustive reviews of their PPP programs, including for potential fraud.

Administering these programs carries substantial reputational risk when they are not adequately governed, and Congress has promised to ramp up oversight into how banks have managed these loans. While regulatory scrutiny may ramp up slowly during quarantine, it will come eventually, much like the wave of foreclosure violation enforcement actions that emerged in the post-2008 period. Now is the time to ramp up internal oversight of how the programs are organized and documented.

An important question is whether requests for forgiveness will be granted. The government will conduct audits of the larger PPP loans. There will also be extensive Congressional oversight. Fraud and basic errors will be assessed carefully, and banks should plan accordingly.

Long-Term Considerations

Once these emergency measures are exhausted, how will the government respond next? There may be additional rounds of governmental support. Congress is expected to pass legislation to shore up state and local governmental budgets. Typically, for better or for worse, legislators and regulators go back to the last playbook. These past events will help us determine where the floor or "trough" may be in our current situation. This may lead to regulatory action—including consent orders and even more severe action—depending on the economy.

One obvious factor is that the nation will have a presidential election in November of this year. How will the winner of the election impact the timing of the recovery from the crisis? One past event to which we can look for clues would be the savings and loan crisis of the late 1980s and early 1990s. The George H.W. Bush administration developed a plan to address non-performing assets in troubled institutions. The plan was implemented during the early 1990s, allowing troubled assets to clear and the economy to restart. Another example would be the continuation of the TARP program under the Obama administration after its initial passage under the George W. Bush administration. These examples suggest that even if there is a change in administration, there is likely to be a fair amount of policy continuity in terms of recovery programs.

How long will it take to recover from the current crisis? It took seven years to heal from the Great Recession of 2008. The economic problems, this time around, include some 180 countries and may be deeper and broader in the United States. Almost all industries globally are affected, not just those deeply related to the mortgage market, as with the Great Recession. We saw with both the S&L crisis and Great Recession that it took a while for the bank regulators to plan and execute "arranged marriages." Under such circumstances, the FDIC is will likely step up to the problem with closures and resolutions.

Following the Great Recession, numerous unhealthy banks were acquired by healthier institutions through resolutions by the bank regulators. This process could well be repeated as credit costs wash through the financial system. Telltale signs regarding the health of financial institutions are already publicly available through the FDIC website, publicly available stock price information, and other public sources.

The question on every banker's mind is: How can a bank be well positioned to survive the crisis and be an acquirer rather than be acquired? The difference between the two will be driven by whether bank boards and management teams design and implement decisive action. This will include intervention to improve financial stability, a renewed focus on strong governance, and a continuous, open dialogue with regulators.

About the Author

WALTER J. MIX III
wmix@thinkbrg.com | 213.261.7712

Walter J. Mix III heads the Financial Services practice at BRG. He is a former commissioner of the California Department of Financial Institutions (DFI; now called the Department of Business Oversight) and also previously served as a banking executive at Union Bank of California. Mr. Mix advises domestic and international bank clients on corporate governance, risk management, strategic planning, and financial advisory assignments.

About Berkeley Research Group

BRG is a global consulting firm that helps leading organizations advance in three key areas: disputes and investigations, corporate finance, and strategy and operations. Headquartered in California with offices around the world, we are an integrated group of experts, industry leaders, academics, data scientists, and professionals working beyond borders and disciplines. We harness our collective expertise to deliver the inspired insights and practical strategies our clients need to stay ahead of what's next. Visit thinkbrg.com for more information.

THINKBRG.COM