EVALUESERVE

Sector Intelligence: Impact of Covid-19

Financial Services

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Financial Services: The What?

Global Activity and Critical Updates at a Glance

North America

- Despite recent regulatory easing by the Fed on big banks' capital requirements, US banks continue to remain under pressure as they plan capital buffers to mitigate business disruptions from the Covid-19 crisis.[1,2]
- US banks' transition to the new credit loss accounting standard, Current Expected Credit Losses (CECL), effective Jan 2020, is delayed under the new Coronavirus relief law-CARES act, as reserve provisions are expected to jump substantially.[3] US banks have put all share buyback programs on hold to provide lending stimulus. Further, a deterioration in credit quality of North American companies and the near-zero interest environment is likely to hurt margins. Large asset-sensitive banks may cut deposit rates further to match declines in asset yields.[4,5,6]
- The outlook for the US Life and Health Insurance sector is negative. Health insurance companies can expect elevated claims costs and lower premium volumes as unemployment moves upward, while the Life sector will suffer from low interest rates and investment income pressure from equity market declines.[7] Equity market losses and funds' outflows are pressure-testing the asset management industry. Active managers, already impacted by fee compression, face further headwinds in the industry.[8]

EMEA

- While the ECB* has taken emergency steps such as ensuring banks keep their credit lines open, allowing banks to temporarily default on the required capital levels, and setting-up a massive stimulus plan ($820 billion), many of Europe's major banks went into the crisis with their liquidity positions worsening.[9] Leading banks like Standard Chartered, HSBC, Danske Bank, and Raiffeisen Bank have already indicated toward missing profitability targets in 2020.

  The BOE** lowered borrowing costs further to 0.1% and increased its bond-buying program by ~$232 billion, to $752 billion.[10] Italy/Germany yield spread, a closely tracked measure of relative risks, has widened at 2.74%. The socio-economic shock to Italy due to the virus will likely weigh on banks' earnings and asset quality, leading to a rise in new non-performing loans.[11]
- Private equity (PE) firms are pushing their portfolio companies with already high debt loads to draw on credit facilities for mitigating any liquidity risk if the pandemic risk accelerates, a pattern on the rise among many PE managers.[12] Sell-off in equity markets and a drop in assets under management (AUMs) continue to affect the asset management industry's revenue.[13] Standard Life Aberdeen, UK's largest fund manager, was hit by massive outflows in March.

APAC

- China's central bank will cut down the cash reserves requirement for banks for the second time this year, releasing roughly $80 billion, as the government continues to promote lending to private borrowers and industries hit by the slowdown.[14,15]
- Although the insurance industry is facing a tough time, owing to the rise in payouts while investments suffer, China's non-Life insurers see a silver lining. Prolonged travel bans and quarantines have resulted in a decline in auto insurance claims, a bright spot for an industry that has been under severe impact.[16]
- M&A activity has slowed down as uncertainty in the financial market has made valuating companies more difficult. At least three Australian takeovers are facing lower prices and additional conditions in contracts.[17]
- For wealth managers, fund inflows from new customers in Asia declined in the first two months of the year. Yet according to the top managers active in the region, revenue from trading driven by the extreme market volatility has risen year over year.[18]

Analyst Note

Monetary policies and quantitative easing (QE) across the globe are aimed at promoting liquidity and stimulating credit, but the demand shock will require expansive and ongoing fiscal stimulus. Banks with credit exposure to vulnerable sectors like Energy, Hospitality and Leisure, Retail, Airlines, and Industrial products are likely to see loan-loss reserves increase as default rates tick up. A period of low interest rates may boost mortgage refinancing, benefitting banks in the short term, but illiquidity in the debt markets could halt future growth. Volatility in emerging currencies, sharp sell-off in global equities, asset outflows, and further deterioration in outlook are headwinds for the financial services sector globally.

Sources: (1) S&P Global MI, (2) WSJ, (3) S&P Global MI, (4) WSJ, (5) FT, Moody's, (6) S&P Global MI , (7) WSJ, (8) FT, (9) WSJ, S&P Global MI, (10) CNBC , (11) Euromoney, (12) Bloomberg, (13) FT, (14) WSJ, (15) SCMP, (16) Reuters, (17) Reuters, (18) Reuters, Evalueserve analysis , ECB* European Central Bank, BOE** – Bank Of England , Please note : Due to space constraints, we have limited our coverage to most critical updates and region.

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Financial Services: The So-What?

Near-Term Risk Outlook, Risk Mitigation, and Opportunities

Sector	Level of Risk and Opportunity: Near-term Risk	Level of Risk and Opportunity: Short-term Outlook	Potential Disruptions	Risk Assessment	Risk Mitigation
Banking	Moderate	Negative[1]	Liquidity squeeze, deposit runs, bank closures, and lower trading revenue	• Low deposit betas to preserve net interest margins (NIM) in a period of emergency rate cuts, increase in non-performing loans in sectors exposed to the crisis, funding and liquidity pressures, and market valuation losses, current expected credit loses' estimate CECL (US)	• Synchronized ongoing fiscal stimulus to boost the overall lending landscape- rise in C&I loans on banks' balance sheets, regulatory support in lowering capital buffers temporarily, expanding fee-based services and refinancing activities
Life and Health Insurance	High	Negative[2]	Rise in mortality, increase in claims, loss of new business, regulatory risk	• Lower returns on fixed income reserves, spike in mortality rates, impact of stock market declines/volatility on investment values and capital, implications of heightened insured claims, and regulatory risk if policy exclusions become legally binding	• Restructuring and spin-off, establishing transparency and re-thinking risk transfer controls, *Force Majeure* and *exclusion policy revisions* in new contracts, and pricing in the pandemic risk in new contracts
Asset & Wealth Management	High	Negative[3]	Delay in new fund launches, fund outflows, regulatory risk in global markets	• High redemption rate and capital outflows, exposure to risky global assets; material downgrades for collateralized loan obligation managers (CLOs)	• Increasing active management of funds amid volatility, reducing cyclical exposures in global risk assets, particularly in emerging markets (EMs) and Japan, investing in fundamentals and high quality balance sheets with sufficient cash flows, and resilient economies (US Treasury)
Private Equity	Moderate	Neutral[4]	Exiting portfolios, conducting due diligence and fundraising for leveraged buyouts	• Debt servicing by portfolio companies- increased liquidity and default due to constrained cash flows could worsen the outlook further	• Deploying excess dry powder as valuations decrease, targeting distressed assets in the most impacted industries, and raising new funds, improving risk strategy

To Watch Out For

- Market reaction to US fiscal response of $2 trillion stimulus; phase four infrastructure stimulus likely
- Sovereign Ratings and Debt rating downgrades, particularly Italian debt ; CLO downgrades
- ECB's targeted longer-term refinancing operations (TLTROs) and Pandemic Emergency Purchase Programme (PEPP), the Fed's revival of the Primary Dealer Credit Facility, and the Bank of England's unlimited commercial paper facility, Stimulus and support under the CARES act (US)

To Watch Out For

- Negative rates are coming to Australian banks, after the latest monetary ease by the RBA*
- Bank of Japan's pledge to buy more ETFs signals other central banks could follow suit in purchases of riskier assets[5]
- Spike of defaults in China's shadow lending is a risk to its banking system without additional government internvetion[6]

Sources : (1) Investment Executive , (2) Insurance Business , (3) FT , (4) Bloomberg, (5) Japan Times, (6) WSJ, Evalueserve analysis , RBA* – Reserve Bank of Australia

Financial Services: The Next-What?

Long-Term Sector Implications for Professional Services

Banking Sector

Banks need to plan for structural headwinds facing the sector while also preparing for an extensive business continuity plan for employees and at-risk customers (small businesses, students, and gig workers). Banks' response today will be critical to future customers and employee relationships. Professional services firms can advise banking clients on crisis-related delays in financial reporting, debt restructuring, emergency response & business continuity.

- **Advisory on reporting and restructuring:** While most of the big global banks are well capitalized to weather a temporary economic downturn post the Global Financial Crisis, smaller and regional banks with exposure to vulnerable sectors may require potential restructuring advise. Banks must become prudent with these sudden strains on credit by adding pandemic clauses and strict loan agreements in the future, as the current spike in credit drawdowns by companies to preserve cash could have an adverse impact on banks' balance sheets.[1]
- **Long-term contingency planning:** To plan for an extended business continuity in light of the current pandemic, banks should strategically fast-forward their transformation to more digital and tech-enabled offerings, optimize their physical footprint, and cover future risk with a business-interruption insurance.[2]
- **Deals and goodwill impairment:** With a growing list of banks trading below book value globally, many banks may need to book a goodwill impairment charge if goodwill exceeds 50% of the banks' total equity. M&A activity in the sector is likely to pick up after a temporary halt, as banks with strong balance sheets will find attractive targets to expand revenue and grow customers.[3]
- **Debt deluge & regulatory intervention:** Low investment grade corporate leverage is at an all-time high. Banks with underperforming loans may restrain lending and misdirect it to 'zombie firms'. Further, banks may feel pressured by regulators to lend to affected firms. (refer- TLTROs, PEPPs)

P&C and Life Insurance

As the Covid-19 outbreak spreads further, global insurers, which initially brushed-off coronavirus-related claims, are faced with a double threat: a sharp rise in payouts at a time of outsized investment losses. Professional services firms can advise global insurers to restructure operations, prioritize investments, offer pandemic-focused solutions, and navigate through a new regulatory landscape post the Covid-19 crisis.

- **Pandemic protection/business-interruption insurance:** Given massive catastrophic losses from an ongoing crisis, pandemic policies represent a big market for commercial insurers and reinsurers. Only a few insurers cover pandemics, because the risk is not well understood and is difficult to price. As a success story, Marsh, a leading insurance broker, experienced a surge in inquiries for PathogenRX, a product it launched in 2018 (underwritten by Munich Re) to provide financial protection to companies hit by an infectious disease outbreak in the US and Asia.[4]
- **Investment in emerging technologies:** Insurers have been deploying capital on share buybacks over the past few years. Unsurprisingly, the strategy failed in the current environment, amid a massive sell-off in the insurance sector. Insurers' focus should shift toward risk mitigation, investment in emerging technology, and moving toward agile business structures.
- **Regulatory risk:** Life Insurers are headed for losses and would face regulatory risk if policy exclusions and extended liability become legally binding. Several Chinese insurance companies (Ping An, China Life) have extended their responsibilities for some categories of insurance contracts to include the new coronavirus pneumonia, mandated by the Chinese government.[5]
- **Restructuring operations:** Global insurers manage more than $20 trillion in assets worldwide.[6] Massive volatility in equity and fixed income markets is putting pressure on their income from investments. Outsourcing asset their management wings and increasing their exposure to alternative investments could help insurers navigate through these volatile markets.

Analyst Note

- US banks are well capitalized going into another crisis after the lessons of the 2008 financial crisis. However, a health crisis of this magnitude could severely impact the weakest banks, predominantly in Europe, and eventually spilling to other markets, especially EMs. In particular, the resilience of China's banking system could be severely tested by the State Council's proposed credit expansion at rates below 5%. The "China Financial Stability Report" (2019) and annual stress tests outlined that a negative scenario of economic growth faltering to as low as 4.15% could trigger a five-fold increase in bad loans among the nation's 30 biggest lenders.[7]
- Catastrophe losses in the past two years were favourable for the global P&C insurance industry, providing the largest insurers with strong reserves. On the other hand, life insurers are at continued risk as growth in annuity and life products remains an ongoing challenge, accentuated further by the new Covid-19 crisis.

Sources : (1) S&P Global MI, (2) American Banker, (3) S&P Global MI, (4) CNN, (5) NBD Daily Economic News, (6) Reuters, (7) Bloomberg, (8) S&P Global MI, Evalueserve analysis

Financial Services: The Next-What?

Long-Term Sector Implications for Professional Services

Asset and Wealth Management

With revenues tied closely to the capital markets, publicly traded asset managers have seen their share prices fall 20% to 30% since the market highs in February, driven primarily by weakening GDP growth, high volatility, and significant capital-market losses globally. As predictions of a downturn increase, M&A and IPO markets may also contract.

Professional services firms can guide asset managers on the following four critical areas:

- **Product and strategy:** Traditional managers and passive portfolios may lose support in a down market. Alternative managers may be positioned to invest in special opportunities as well as distressed companies at more favorable valuations. Consolidation in the industry will likely remain high amid the continued need for existing players to achieve scale and specialization.
- **Business continuity and communication plan:** In anticipation of a prolonged crisis, global asset managers will need professional guidance on setting up an extensive and resilient business continuity plan that covers operations, technology breaking points, third-party risk, net asset value calculation and determination, people concerns, and financial reporting.[1]
- **Cybersecurity and third-party risk:** While cybersecurity continues to remain a top priority, asset management firms may face additional threats and vulnerabilities due to higher levels of remote access to core systems, leading to significant regulatory exposure. Some regulators have mandated financial institutions to ensure additional risk mitigation measures while carrying out their business-continuity plans in the wake of the Covid-19 crisis.[2]
- **Accelerating digital strategy:** The asset and wealth management (AWM) industry is experiencing a digital push. Social distancing and travel restrictions also create an opportunity to emphasize digital channels to reliably continue regular engagement between investors and advisers.[3]

Private Equity

Private equity performance is closely linked to the economy. However, it is also one of the most resilient sectors with over $2 trillion in dry powder. The immediate consequence of COVID-19 is the impact of travel restrictions that may primarily impact deal sourcing, due- diligence, and fundraising.

Professional services can provide guidance on the following four critical areas:

- **Deal sourcing:** Contrary to a period of record-high valuations until recently, the Covid-19 crisis is likely to present ample buying opportunities for PE firms due to the sudden availability of distressed and deeply discounted assets. PE firms may have to put more equity into acquisitions, perhaps accepting lower, less leveraged returns. Managers must be prudent in deploying capital and searching for assets in resilient sectors that are less likely to be affected by coronavirus; e.g., technology, business services, and software. PE firms will be willing to pay a premium for stability over growth.[4,5] However, they may find it challenging to carry out exit strategies for their existing portfolios.
- **Fundraising:** Potential government shut-downs are likely to slow deals that are on the table and awaiting approval. Fundraising from existing investors (with whom physical meetings may be less critical than first-time investors) may still be possible. If restrictions prolong in the long term, approval may be required for both longer fundraising periods and investment periods to deploy committed capital.
- **New products and strategy:** The current environment may also enable some fund sponsors with distressed opportunity strategies to activate funds that they raised specifically to invest upon a credit dislocation. PE firms that maintain strong balance sheets and utilize prudent levels of leverage will fare better than their aggressive counterparts. Firms may re-assess and draw on available credit lines of portfolio companies when appropriate.
- **Portfolio diversification:** Pension funds and institutional investors allocate capital toward private equity, in order to achieve their targeted returns, during periods when traditional asset classes tend to underperform. As a result, demand for solutions with focus on due diligence and access to specialized alternative managers should rise.

Analyst Note

Assset and wealth managers, already in an inflection point to transform business models, are facing another dilemma from the outbreak, as insitutional investors shift to alternative and high-yielding assets.

Analyst Note

While private equity firms seem to have an upper hand in the near-term with an array of attractive opportunities, the highly leveraged portolio companies on their books are extremely vulnerable to an economic shock, as was evident during the global financial crisis. Given the level of debt present on most portfolio companies' balance sheets, some firms may face increased liquidity risks.[6]

Sources :(1) On wall street , (2) Financial Advisor IQ, (3) Yahoo Finance, (4) Bloomberg, (5) FT, (6) Bloomberg , Evalueserve analysis