

Extending the fuse – Loan book under scrutiny COVID-19 | Considerations for banks

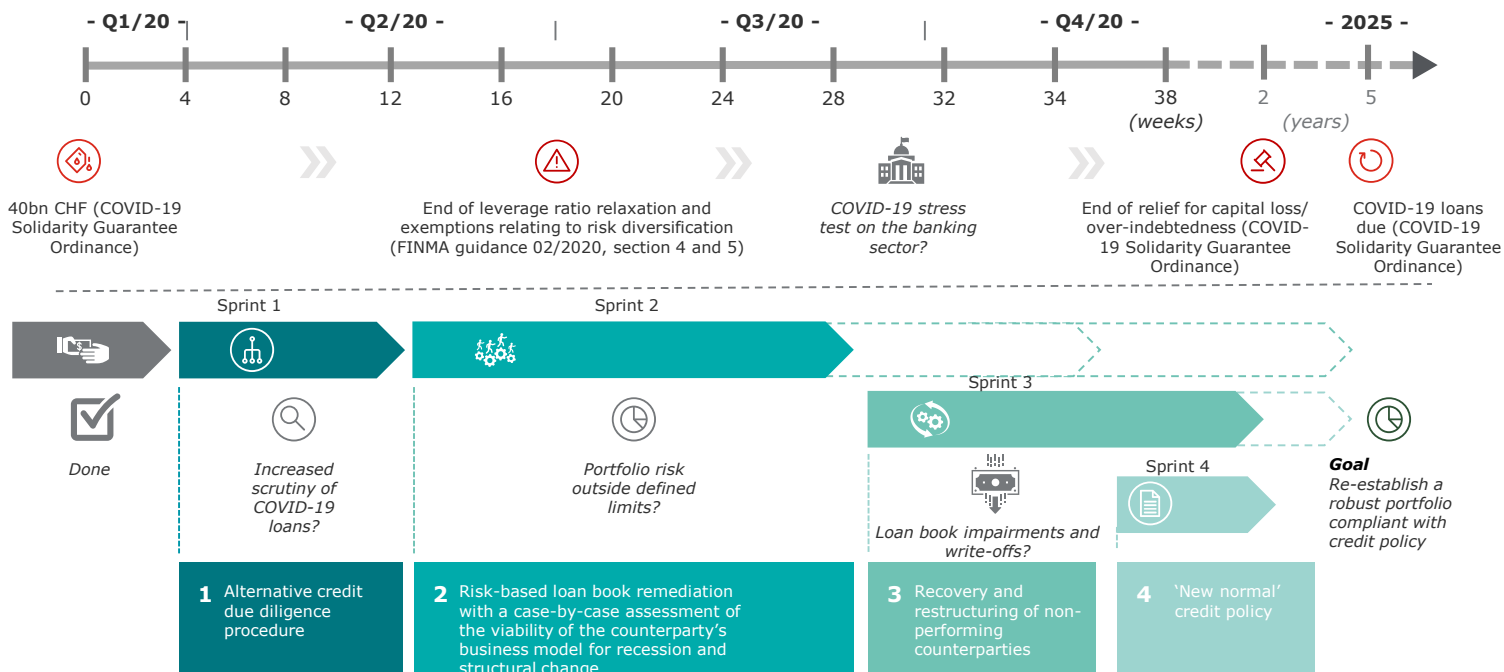
Banks were aware very early of the devastating impact of COVID-19 on the liquidity of their corporate customers. To provide liquidity to companies in the current crisis, the Federal Council has introduced a credit programme by emergency ordinance ('COVID-19 Solidarity Guarantee Ordinance'). Thanks to these measures the liquidity shortfalls and insolvency risks for companies are mitigated, at least in the short term. While the media focus has been on companies, the entire **loan book of lenders** is coming **under increased scrutiny**. Over the five-year term of the COVID loans, certain regulatory relaxations for banks in place now are expected to be withdrawn.

Existing **credit rating systems** for **early detection** of problem cases are **overburdened**: they are not set up to assess stress created by this unprecedented crisis (a demand side plus a supply side shock). Banks are seeking ways to assess credit requests and counterparties diligently in an efficient yet robust way, while the government's COVID-19 bridge loans 'extend the fuse' for only a limited time.

The impact of the crisis on credit approval, the viability of loan counterparties and value of collateral may prove **detrimental** in the medium term **for the quality of the loan portfolio** of commercial banks.

The loan book will be under even more scrutiny because the long-term effect of **COVID-19 as an accelerator of structural change** in the bank's counterparties will demand bold actions to bring the portfolio back within the limits of a revised credit policy. We suggest proceeding in 4 sprints through a number of critical milestones:

'Extending the fuse' program and its critical milestones



Ensuring compliance with COVID-19 'use of funds' restrictions

The credit program contains a number of restrictions on the use of the funds:

- ❑ Ensure high levels of due diligence for government restrictions, to prevent litigation and reputational damage.
- ❑ Implement monitoring of positions and controls to detect breaches of covenants in a timely manner.

Understanding the flow of funds

In the interest of a robust balance sheet, banks should deploy their corporate advisors and special situation teams effectively:

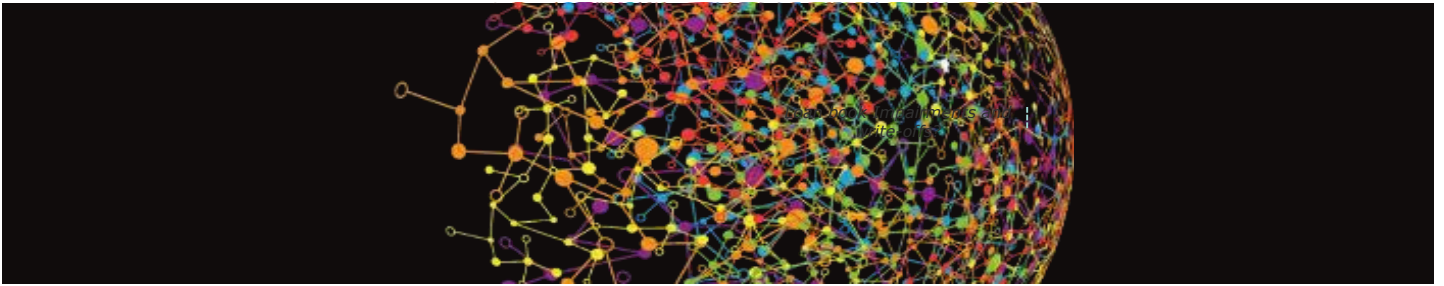
- ❑ Understand chain reactions of potential corporate defaults in the loan book by analysing the flow of funds.
- ❑ Understand why some businesses fail while others thrive in the same industry, using human intelligence paired with data analytics.

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Understanding the loan book in-depth to prepare for structural change

1 Alternative credit due diligence procedure

Credit due diligence

Most institutions have automated credit due diligence for COVID-19 (PLUS) loans but they face **difficulties** with their credit risk rating engines in **modelling stress induced by the COVID-19 crisis**.

SME groups might **apply for loans for multiple legal entities**, possibly including combinations of COVID-19 and COVID-19 PLUS. The **bank must** be able to **assess** in the lending process how this affects the **group liquidity situation as a whole**, especially if some units are (close) to over-indebtedness/insolvency situations and cash pools are dissolved:

- ❑ Recalibrate risk scoring engines and develop new models to deal with uncertainty.
- ❑ Provide advisors to corporate clients with simple yet solid tools to take appropriate and consistent decisions under stress.
- ❑ Free up more senior corporate debt managers for the more complex cases.

Credit approval

Banks may face difficult decisions in weighing the **financial viability of certain loan commitments** (to avoid over-indebtedness) against long-term **qualitative benefits such as customer loyalty**. The taxpayers who guarantee the loans expect banks to prevent abuse of the facilities but still to save jobs:

- ❑ Reinforce the internal control system to prevent compliance issues and potential legal liability for lack of credit due diligence.

Credit payment

Loans are granted as fixed advance or overdraft facilities:

- ❑ Adjust upper execution limits in the banking systems.
- ❑ Tighten controls on account movements to prevent abuse.

2 Loan book review and case-by-case assessment of the counterparties' business models to remain viable

Compliance and financial crime

KYC, AML and general **compliance risks** may increase significantly:

- ❑ Review and reinforce over-strained internal control systems.
- ❑ Prepare to return into ordinary regulatory parameters after the temporary easing of banking regulations such as Leverage Ratio.
- ❑ Recalibrate transaction monitoring and KYC procedures to cope with new threats posed by COVID-19-induced criminal patterns.
- ❑ Clean up missing identification and KYC elements according to CDB before the end of the relaxations granted by FINMA.
- ❑ Although breaches will potentially be reported as qualifications in the statutory audit report, this will only be after a long time delay.

Remediation of the entire loan book

Fundamental **changes to the business environment** raise concerns about whether the underlying assumptions for the assessment of the loan book's quality pre COVID-19 are still reliable:

- ❑ In the light of a 'new normal', the loan portfolio needs to be reviewed in a timely manner to identify corporates in the loan book with a business model that needs to be revised in order to remain viable after the industry has changed in structure.
- ❑ Quickly identify problem positions to be handed over to the special situations team.
- ❑ Anticipate regulatory stress tests based on COVID-19 scenarios.
- ❑ Ensure a high quality of credit documentation, including contractual formalities.

3 Recovery and restructuring of non-performing counterparties

Work out and restructuring

An **increase in corporate credit defaults** is **expected**, which will result in a **high workload** for the bank's **special situations teams** dealing with over-indebtedness:

- ❑ Prepare to **scale up resources** to work out waves of distressed loans over an extended timeframe.
- ❑ Early identification of **pre-COVID liquidity issues**: review conditions attached to a waiver, revise revenue forecasts and cash flows and work through scenario analysis to test headroom in downside cases (distinction of COVID impact).
- ❑ **COVID-19 credits of less than €500,000 do not count as debt** for the assessment of over-indebtedness in the sense of art. 725 (1) and (2) CO until March 2022.

Application of impairment rules

Forward-looking application of **impairment** rules, taking into consideration current circumstances to avoid a self-enforcing ripple effect:

- ❑ Identify impairment needs on credit positions that were already on the watch list before the crisis.
- ❑ Review critical positions to avoid discussions with the auditor.
- ❑ Understand the reasons behind standard impairment indicators such as deferred interest payments, as this could just be an unnecessary cautionary measure rather than an indication of potential default.

4 'New normal' credit policy

Capital, portfolio risk and KPIs alignment

The 'new normal' has an impact on the bank's **risk appetite**, its capital base and profitability. Credit policy will be revised to reflect the business strategy of the bank:

- ❑ Re-balance concentration risk by industry.
- ❑ Adjust to minimize or avoid concentration and lump risks in the portfolio.
- ❑ Adjust client targeting to enhance risk diversification in the portfolio.
- ❑ Review risk and position monitoring tools to cope better with liquidity KPIs of counterparties.

Capital and refinancing

The bank's own credit rating may need improvement after the crisis to strengthen competitiveness in a 'new normal'.

- ❑ Closely track the program for transition of the credit portfolio into the new target portfolio.
- ❑ Disclose measures and progress to rating agencies.
- ❑ Review ALM positioning.
- ❑ Closely monitor the real estate market.

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