May 2020

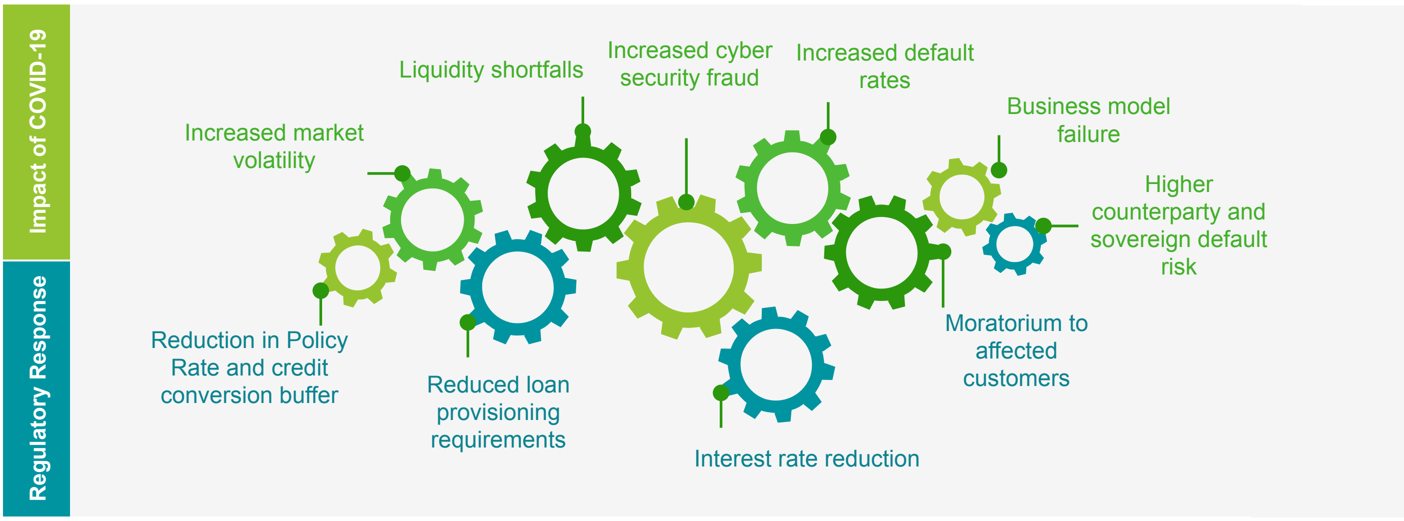
Financial risk implications of COVID-19 on banks

COVID-19's impact on individuals, communities and organizations is rapidly increasing. In addition to the effects on the supply and demand dynamics, COVID-19 has already disrupted the financial markets. Since the outbreak, bond yields, oil and equity prices have sharply fallen on the global market.

The disruption and implications of COVID-19 are also being experienced in our economy. Rapidly changing social norms, restrictions on transportation, slowdown in the level of economic activity, possible disruptions in the supply chain, high degrees of volatility in the markets and shock in the market sentiment constitute some of the preliminary challenges being experienced by banks. With ongoing shocks to supply and demand following the lockdown of some parts of the country, there is potential for further market disruption.

Risk managers and assurance practitioners therefore need to understand the implications of the outbreak on the banking business and means to effectively manage the risks stemming from it in order to ensure resilience.

Regulatory measures to address impact of COVID-19 on Banks



Regulatory Interventions

Regulators across different jurisdictions have introduced measures to mitigate the financial and economic impact of COVID-19.

Bank of Ghana has taken proactive steps to maintain stability in the market. Among others, the BoG reduced monetary policy rate from 16% to 14.5%, the lowest in more than 7 years. These measures, according to BoG, are to enable banks and SDI's provide more liquidity and financial support to critical sectors of the economy to mitigate the adverse impact of COVID-19 on the Ghanaian economy. The significant fiscal stimulus and an accommodative monetary policy may help provide some cushion against the economic fallout from the COVID-19 and help moderate the adverse impact on banks.

Though the response from government and regulators are timely, as the situation lingers, more policy actions and interventions may be required in order to mitigate the impact of COVID 19 on the nation's banks and customers.

Key highlights of Bank of Ghana's interventions:

8% 8% Primary Reserve Requirement, a 2% decrease from previous rate of 10% to provide banks more liquidity.

1.5% 1.5% reduction of Capital Conservation Buffer for banks from 3% to 1.5% to provide banks more liquidity.

5% 5% provision rate for loans in OLEM, a decrease from the previous rate of 10% to temporarily ease credit provisioning burden on banks.

30 days 30 days past due loan repayments for Microfinance Institutions shall be considered as "Current" as in the case for all other SDIs

Potential Impact on the Banking Sector

Operational Risk

The spread of COVID-19 has resulted in work disruptions like never before. The persisting challenge calls for institutions to be flexible and agile. The pandemic has led to some branches closing temporarily as some employees are required to work remotely. The additional operational cost of procuring logistics to equip staff work remotely is expected to impact revenue. Some banks could also experience delays in orders for laptops, servers and networking equipment which may further impact productivity. Since the scare of COVID-19, there has been a global spike in malware and fraud incidents. This is due to the huge influx of cyber security attack launched under the mask of COVID-19 with phishing attacks constituting over 80%. Zoom and other productivity tool supporting remote working staff have experienced security breaches during this pandemic. A timely intervention is required by banks to strengthen the cyber security landscape and protect sensitive data.

Market Risk

Currently, increased volatility and decline in value of many financial asset classes may impact the trading books of most banks due to the increased market risk. The uncertainty caused by the pandemic could lead to increased pressure on the local currency resulting in higher foreign exchange risk. Value at Risk (VaR) estimates could be used by banks to measure the maximum potential loss at a given level of confidence. Banks should also estimate how the reduction in interest rates will impact their rate sensitive assets and liabilities and the subsequent implication on profitability. Persistence of the outbreak could further weigh on investor risk appetite thereby impacting the stock and bond market.

Credit Risk

According to Moody's, global default rates are expected to increase as a result of the pandemic. Locally, the spread of COVID-19 will negatively impact many firms, mainly through potential disruptions in manufacturing supply chains, domestic consumption, tourism and exports, posting downside risks to their earnings prospects. This will in turn impact the capacity of such firms to meet contractual loan obligations with banks leading to an increase in NPLs.

Granting 6 months moratorium of principal repayments to firms in the airline and hospitality industries is expected to help provide support to affected entities. Despite the flexibility offered by BoG in loan provisioning, the lockdown in parts of the country and closure of some businesses may exacerbate the risk of defaults.

Parent companies of three banks in Ghana have been downgraded into junk category by Fitch (Fitchratings.com, 31 March 2020) signaling a potential increase in credit risk on the interbank market even though interest rates remain low. There may also be a potential increase in sovereign default risk evident from the downgrade of Ghana's outlook to negative by Moody's because of the pandemic.

Liquidity

To ensure adequate liquidity in the market, Bank of Ghana has intervened by reducing primary reserve requirement from 10% to 8%. Banks may further need to resort to contingency funding plans (CFPs) due to increased market volatility and potential limit/threshold breaches. Some banks may already be experiencing increased liquidity tightening. This may be as a result of the increased withdrawals and higher counterparty default correlation within affected sectors potentially leading to reduced net inflows in banks.

Capital Management

Despite the recent recapitalization, the pandemic is still expected to put a downward pressure on the capital of banks. Risk-weighted assets (RWA) may be impacted by higher charges from increased volatility levels and higher counterparty risks. This possible increase in loan provisioning from higher default rates from the pandemic could increase credit risk weighted assets therefore reducing capital adequacy ratio. Currently, it may be difficult to accurately predict how long the outbreak will last, as such timely measures are necessary to mitigate the impact of COVID-19 on capital.

The Way Forward

Short Term

Immediate recommendations for banks

- Assess and redesign business continuity plan to maintain operational resilience
- Examine the impact of COVID-19 on the credit and collateral quality of affected customers
- Build a robust stress test model which includes scenarios specific to COVID-19 to aid in contingency capital plan
- Evaluate and reinforce cybersecurity landscape in light of the pandemic

Medium term

Actions to maintain resilience in the course of the pandemic

- Continuously monitor credit portfolio using an automated credit risk assessment tool
- Assess effectiveness of hedging strategies due to changing market dynamics
- Develop a risk adjusted return on capital (RAROC) model to help in credit decision making and capital re-allocation during and after the crisis.

Long term

Post-Crisis Strategies

- Re-assess the effectiveness of business continuity plan in the event of any future crisis
- Incorporate insights from COVID-19 into risk management and BCM frameworks
- Align business processes to post-crisis regulatory reforms

Key Focus Areas

- Business Continuity Plan Assessment
- Worst-case COVID-19 Scenario Stress Testing
- Risk-Adjusted Capital Re-allocation
- Rapid Credit Portfolio Impact Assessment
- Strategic Hedging of Trading Book
- Robust Cybersecurity Systems Implementation

How can Deloitte help?

Rapid COVID-19 impact assessment
Re-examine governance structures, processes, systems, people, risk and controls in light of the pandemic and offer recommendations based on results from the impact assessment.

Capital management
As some sectors are of a higher risk due to the pandemic, we support banks develop a capital optimisation tool used to strategically allocate capital among sectors and business units to maximise return for each unit of risk undertaken.

COVID-19 stress testing
Assist banks by developing an automated stress test model to help determine impact of COVID-19 on capital, credit, operational, market and liquidity risk.

COVID-19 business continuity support
Support clients assess the effectiveness of their business continuity plan and crisis readiness.

Cybersecurity incident response support
Assist banks reinforce their cybersecurity framework against the increased attacks during the pandemic.

Remote Vulnerability APT
Support banks to conduct vulnerability assessment and penetration testing. We offer solution on how to close gaps and maintain business resilience.

Contacts

Charles Larbi-Odam
Country Managing Executive
Deloitte Ghana
clarbi-odam@deloitte.com.gh
+233 307 086 330

Kofi Awuah
Partner
Risk Advisory
kawuah@deloitte.com.gh
+233 501 648 111

Jeremiah Frimpong-Kwakye
Senior Consultant
Financial Risk Advisory
jfrimpongkwakye@deloitte.com.gh
+233 543 182 158