Deloitte.

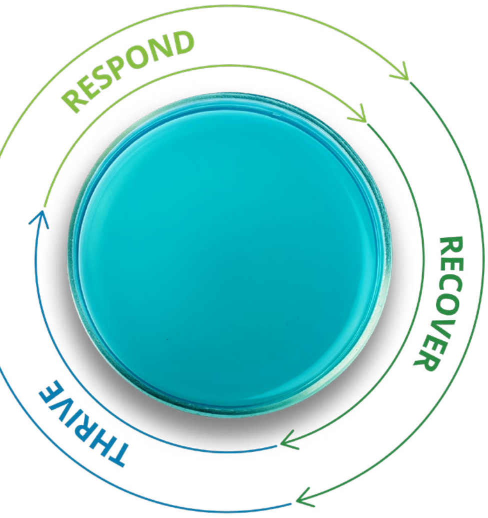
From now on

Finance function in the "new normal"
From challenges to opportunities in the Financial Services Industry after COVID-19

MAKING AN IMPACT THAT MATTERS
since 1845

The COVID-19 pandemic is having a profound **impact** on the **global economy**, but turning **current challenges** into new **opportunities** can be the proactive answer for **Banks** to **boost** the current depressed **economy** from immediate **response** and **recover phases** to a more forward looking **thrive stage**.

In this context, **Financial Institutions** entered the **crisis** in a much **better shape** than in **2008 financial crisis** and, even more importantly, they are not the source of the problem but they are playing a **social role** by **absorbing losses** and **keeping lending** to the economy in order to reach a **fast recovery**. Thus, **Bank & Insurance CFOs** are playing a **central role** to navigate the crisis since they need to carry on **business continuity** by increasing main Finance function **efficiency**.



Here are some key areas of intervention:

Finance Closing processes

have to rapidly report actual results by representing how the new measures in terms of liquidity injections and new lending are producing the first effects on the main financial statement items and how digital channels are supporting them.

Planning and Forecasting models

should embed scenarios planning techniques and capabilities. Integration with specific drivers (e.g. contagion curve trajectory, unemployment rate, etc.) and periodical updates are of paramount importance for Banks to evaluate exogenous variables impact on internal business.

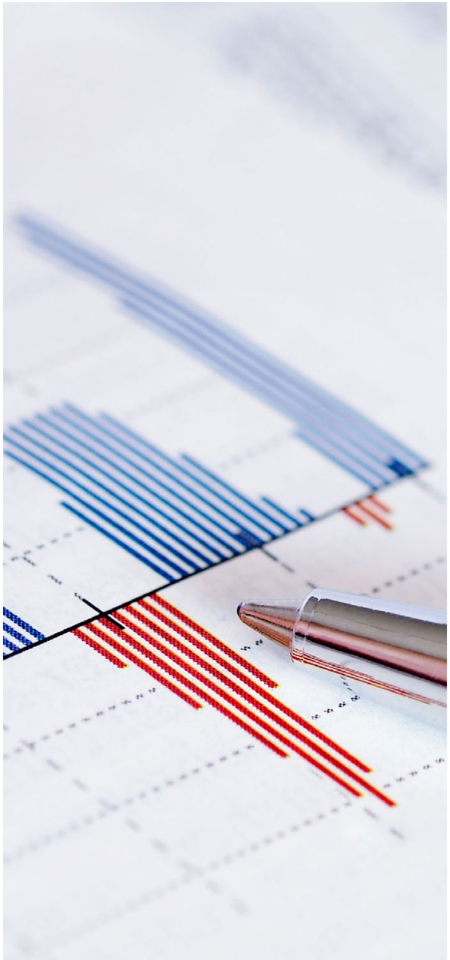
Costs Management decisions

are impacted to provide business continuity and regulatory compliance. However, CFOs should plan for the future as well as anticipate investments requirements in the Recover and Thrive phases.

Capital and Liquidity functions

need to focus on ensuring banks' solvability, while at the same time helping those business units to support the real economy.

In this context, **opportunities** can be **identified** and managed through **digital finance**, that acts as the **main CFO transformation program enabler** and allows **Financial Institutions** to **thrive** in the new normal.



Crisis Cycle: Banks will experience the crisis across three stages that may span from 6 to 24 months

Finance Closing

When delivering financial reports and statements, Financial Institutions should consider the **potential conditions** and the **risk exposures**, which may result from the pandemic. Bank & Insurance CFOs must also consider the additional challenges of executing reports with a **remote workforce**.

Having an **accurate financial picture** that takes into account the COVID-19 impacts is essential to make **informed decisions** about the Financial Institution's future. These information should be evaluated together with the **planning and forecasting reports** in order to be comprehensive and forward looking. The goal is to provide investors and other **key stakeholders** with the **right insights**.

We believe that the following **accounting** and **reporting issues** will be the most **impactful and challenging** for at least the next two quarters.

Finance functions will face **negative impacts** from the economic shock:

- **Credit impairment**: COVID-19 will affect the payment ability of customers with impacts on margins, interest rate reductions and provisioning.
- **Credit renegotiation**: Financial Institutions might be asked by customers to provide significant changes in existing obligations.
- **Market volatility**: Banks are having tough times in delivering accurate forecasts due to an increased market volatility.

Governments and **Regulatory authorities** are developing several initiatives to support companies in dealing with the crisis; examples include **tax reduction** / credit and **economic support** to foster liquidity; the main responses are coming from both EU and National governments through the amendment of ad-hoc decrees (e.g. "Cura Italia" , "Liquidità" and "Rilancio" decrees) and measures (e.g. "Payment Moratorium" amended by the Italian government).

Moreover, the impacts of **virtual environment** must be evaluated. In this period we are seeing a large increase of **remote working** (e.g. branches employees working from home) and **digital consumer's behaviours** (e.g. home banking). Therefore, the role of **digital channels** has taken on greater relevance and Financial Institutions need to consider this to better fit with the **"new normal"**.

KEY ACTIONS

Financial Institutions need to take the following actions to deliver an accurate financial picture:

- **Credit impairment**: Financial functions need to properly **evaluate impacts**, to **review** their deleveraging and de-risking **strategy** and to **determine** the **recoverable credits** by using estimated future cash-flows; this **evaluation** might change based on new **information available** without undue cost and effort (e.g. with parameter related to the COVID-19 effects, such as the geographical lockdown and the contagion rate).
- **Contract renegotiation**: Cash-flow **expectations** need to be reviewed by Financial functions so to take into considerations higher operating costs and/or revenue losses.
- **Market volatility**: Financial functions need to develop medium/long-term forecast, avoiding short-term income guidance. Market **volatility** is affecting financial **reporting**, especially when it comes to define **"fair value measurement"** of any company **market capitalization**.
- **Tax and Government support**: Finance functions must quickly evaluate the effectiveness of the **mitigation measures** amended by Regulators and Governments and of any additional remediation action.
- **Virtual environment**: Finance functions are increasingly relying on digital channels. Having a clear picture and reporting costs and benefits that arise from the use of **digital channels** will be key for streamlining business models and lead **management decisions**. Furthermore digital channels will be relevant for **financial closing** in a **shared remote working environment**.

Planning and Forecasting

Given the unpredictability of COVID-19 pandemic spread, many Banks are **unable** to **fit with plans and budgets** that were put in place as recently as one month ago. CFO's most urgent need is to to have a **real-time** understanding of the **impact** on **Banks' business model**. The current framework needs to be **re-designed** and re-calibrated, leveraging **agile** and **connected capabilities**, to ensure that they **fully reflect** any **risk** not previously evaluated. In order to update their plans, Banks need to act immediately by **planning various scenarios** and by combining **external impacts** (by assessing **ad-hoc drivers** such as the contagion curve trajectory, unemployment rate, lockdown measures, etc.).

The crisis impact on the banking sector depends on **multiple variables**, the most important being its duration; some Financial Institutions will start immediately the **"thrive" phase**, whereas others will continue to suffer.

To this aim, the Planning and Forecasting functions need to **refine** their **ambitions** and objectives by considering **different scenarios**, **specific business drivers**, **macroeconomic information** and **critical events**.

To face the new challenging situation, CFOs need to leverage **new advanced tools** that can:

- Predict the **potential network impacts** connecting **people**, **data** and **functions**.
- Accelerate **budgeting** and **forecasting processes** by providing **real-time business** and financial data, thus enabling **timely reporting**.
- Support the transition from **"predictive"** to **"prescriptive" perspective**.

Financial Institutions may consider a range of scenarios including the one where COVID-19 lasts for a widen period. Monitoring the past will not be enough , they need to make the jump from "predictive" to prescriptive" perspective.

KEY ACTIONS

The **Planning and Forecasting function can not refrain to**:

- **Consider multiple scenarios**, from the worst one to the best one (e.g. rate, credit portfolio, counterpart rating, etc.), taking into accounts talents, operations, suppliers, customers, and other key stakeholders, as well as the possibility that COVID-19 could persist for an extended period thereby creating further risks.
- **Include macroeconomic and additional company specific data** in their forecast. Governments (e.g. moratorium) and regulators' initiatives (e.g. ECB) should be assessed as well.
- **Consider potential COVID-19 related shocks** on clients (retail, corporate, private) so to anticipate any cash-flow drop, impossibility to pay bills and bankruptcy.

Cost Management

The current COVID-19 outbreak has negatively impacted Banks' overall **profitability** and, in the short term, Financial Institutions need to leverage the **Cost Management function** in order to **optimize investments** and **costs**. Assessing the whole company **investment** plan to select and prioritize **key projects** is vital for thriving through the next normal. One of the key areas of focus for any Financial Institution is related to **technology investments** as they can further **streamline business processes** in the emerging new competitive scenario.

As a consequence to the COVID-19 crisis, Financial Institutions put in place **cost containment** policies and "strategies".

Examples include:

- **Freezing**, **postponing** or **canceling planned investments**.
- **Suspending discretionary expenses**.
- **Not paying dividends** (in EU, more than 75% of the total dividends planned to be paid, will be retained by Banks as capital on their balance sheets or used to absorb additional NPL increase)[1].

Banks play a crucial role and need to focus on new strategies in order to maximize their profitability and gain the role of "economy drive wheel".

KEY ACTIONS

Overall investment portfolio optimization

- **Non deferrable Investments include**:
  - projects ensuring **business continuity** and emergency management;
  - **investments** that facilitate the **recovery** and are aligned with the Financial Institution's strategy;
  - **investments** in **IT transformation** and **digitalization**, Technology will not only increase the overall company's **resilience** but also will favor the transition to the thrive phase. Particularly attention will be devoted to digital channels, predictive / prescriptive analytics, artificial intelligence, and cloud computing.
- **Other investments**: any deferrable investment should be carefully evaluated through a detailed business case within a dedicated decision-making framework to allow CFO to prioritize cost optimization initiatives.
- **Regulatory** and **mandatory investments** should be analyzed in detail to understand to what extent they are non-deferrable.

Continuous monitoring of investments: after selecting the investments worth pursuing, cost management functions should set-up a task force together with P&C department. The goal of such a team would be to monitor projects progresses and ensure that all major projects KPI (expected expenses / cash-flows) are met.

Significant reshape in pre-crisis expenses models: Banks should also consider to strategically review their pre-crisis discretionary expenses:

- **Short term**: cut some specific cost items, (such as business trips, printing, etc.) to balance other expenses increase (e.g. PC leasing, wi-fi network, etc.).
- **Mid-long term**: rethink indirect personnel cost and direct personnel expenses (considering the possibility to leverage smart-working opportunities, increased space among working stations, etc.).

[1] *ECB - "The current crisis is a wake-up call" – 13 May 2020*

Capital and Liquidity Management

In this difficult moment, Banks are particularly committed to face the steady **trade-off** between **regulatory requirements** and **strategical business needs**.

Like never before, Banks must exploit the **opportunity** beyond regulatory constraints and capitalize the efforts done on Regulation adoption (e.g. SREP process, macro-prudential capital buffers), to maintain a **sound capital** base to provide relevant **coverage** for the **rise** of the **cost of risk**.

European institutions and **governments** have recently decided to mobilize the banking system to provide firms with fresh working capital. In order to facilitate the recovery of the economic cycle, the ECB is **injecting new liquidity** to Banks to **ease capital** and **liquidity constraints** and enable them to **support corporates** and **SMEs**. CFOs are now devoting their attention to adequately **managing liquidity**, ensuring the Bank's solvability while maintaining the capability to fully support the **business units** in their **day-by-day activity** with their own customer base.

Indeed, main **Banks** are conducing additional **stress tests** with different underlying **COVID-19** scenarios in order to cope with the **current macroeconomic environment** and the **capital** and **liquidity soundness**.

Nonetheless, Financial Institutions are **not facing** an **immediate funding pressure** due to the **reduction** of issuance **volumes** of Banks debt instruments and their **increased pricing**. In this context, ECB funding provide **alternative source of funding** but, in the **long term**, Financial Institutions will need to replace

ECB funding with **market-based instruments**. Moreover, market funding needs will be affected by the need of Banks to comply with the **loss-absorbing capacity** of **MREL eligible instruments**.

Banks will have to face a double challenge on capital and liquidity management: ensuring an appropriate internal governance and an efficient support and proximity to customers.

KEY ACTIONS

Collateral Management & Hedging Strategy

- Define and execute new **strategies for collateral management** in terms of **eligibility criteria** defined for **financing guarantees** (e.g. ECB, SACE).
- Review the **securities portfolio** and **hedging strategies** to prevent significant losses arising from the market volatility and EBA payment Moratoria (former "Salva Italia" law decree).

ALM and Liquidity

- Revise previous **Contingency Funding & Liquidity Plans (CFLP)** to ensure readiness to anticipate and manage COVID-19 effects on payments (e.g. EBA payment moratoria), customer behaviors, and financial market volatility.
- Upgrade the current ALM behavioral models (e.g. prepayment, NMDs, credit lines) to **take into consideration COVID-19 effects** on customer behaviors.
- Boost **data management** so to be ready for COVID-19 **liquidity reporting** and new ECB SSM liquidity exercise.

Profitability, Pricing & Capital Allocation

- Evolve the **internal mechanism of Fund Transfer Pricing (FTP)** to adequately price the new Corporate & SME financing by discounting the effects from **COVID-related guarantee schemes** (e.g. ECB, SACE).
- Align **capital allocation models** among business units so to consider COVID-19 effects on Expected and Unexpected Loss.

Our vision to reshape the FSI industry for the “new normal”

As governments take progressive measures to release the lockdown restrictions, Banks need to **act faster** then ever before. Particularly, Financial Institutions will be asked to **define** a **sustainable** and **adaptable** model supporting their differentiation in the marketplace during the whole recovery phase.

Many Financial Institutions had ongoing **digital transformation programs** in order to enable **new business models**. With COVID-19 severely impacting Banks, technology is proving to be **even more important** than ever to stay ahead of the competition.

The **Finance function** can support as a partner to **allow** the business to better support customers and exploit current opportunities, and to do so, **CFOs** need to define new **"agile-like" organizational models** to efficiently manage the finance processes anticipating the business, both in term of customer management (mortgages, loans, services, etc.) and operational activities (accounting, planning & control, regulatory, etc.). In order to reach these goals, Financial Institutions can leverage on **digital technology** (Artificial Intelligence, Machine Learning, Cognitive) to **get** the **benefits** and embed it in **finance models**, this also to get access to **new insights** and **leverage** on **talents**.

To effectively respond to the crisis, CFOs must look for finance efficiencies, evaluating new investments to **support digital transformation** and the creation of **new finance business models** that can impact positively on all performance components, and specifically:

- **Enhance** the **governance** and the **reporting framework** with the implementation of **further controls** for the **accounting** and disclosure issues arising from COVID-19.
- **Develop different scenarios** and combine them with **external impacts** by integrating them with **internal measures** within different timeframe and severity.
- **Align capital allocation models** among business units to new conditions arising from COVID-19 on both Expected and Unexpected Loss.
- **Prepare rolling cash flow forecasts** to actively manage liquidity and actuals cash flows ensuring liquidity for debt service, capital expenditures and operations.

The COVID-19 pandemic has presented **challenges** that no one in the **financial services industry** today could anticipate or plan for. In this context, **Financial Institutions** need to **exploit** these **challenges as opportunities** in order to **emerge stronger** and **thrive** in the **“new normal”**.

Relevant Deloitte Reads:

1. " Financial Reporting Alert 20-1 — Accounting, disclosure, and internal control considerations related to coronavirus disease 2019"
https://www.iasplus.com/en/publications/us/financial-reporting-alerts/2020/20-1
2. "COVID-19 and the investment management industry"
https://www2.deloitte.com/us/en/insights/economy/COVID-19/investment-management-impact-of-COVID-19.html
3. "The heart of resilient leadership: Responding to COVID-19"
https://www2.deloitte.com/us/en/insights/economy/COVID-19/heart-of-resilient-leadership-responding-to-COVID-19.html
4. "The economic impact of COVID-19 (novel coronavirus) "
https://www2.deloitte.com/us/en/insights/economy/COVID-19/economic-impact-COVID-19.html
5. "COVID-19 potential implications for the banking and capital markets sector"
https://www2.deloitte.com/us/en/insights/economy/COVID-19/banking-and-capital-markets-impact-COVID-19.html
6. "Potential implications of covid-19 for the insurance sector"
https://www2.deloitte.com/us/en/insights/economy/covid-19/impact-of-covid-19-on-insurers.html
7. "Beyond covid-19: New opportunities for fintech companies"
https://www2.deloitte.com/us/en/pages/financial-services/articles/beyond-covid-19-new-opportunities-for-fintech-companies.html

For more information on how CFOs and other C-Suite executives can respond to the current crisis, visit the dedicated **COVID-19** site on **www.deloitte.com**

Contacts

Luigi Mastrangelo
Partner
Finance & Performance
DCM Leader
Deloitte Consulting S.r.l.
+39 (348) 07 44 925
lmastrangelo@deloitte.it

Authors

Davide Grassi
Director
Finance & Performance FSI
Deloitte Consulting S.r.l.
+39 (346) 50 68 537
dgrassi@deloitte.it

Alessandro Rossi
Director
Finance & Performance FSI
Deloitte Consulting S.r.l.
+39 (347) 53 43 528
alerossi@deloitte.it