

Declog the spigot

Addressing liquidity risks posed by Covid-19

April 2020



Introduction

The economic disruption brought on by the Covid-19 pandemic offers many a parallel with the Global Financial Crisis of 2008, but it is also unprecedented in many ways.

The 2008 crisis had posed significant liquidity crisis and raised fundamental questions on the capability of banks to endure these. Indeed, this had prompted the Basel III regulations to be designed, with an aim to enhance regulation and tighten monitoring to address liquidity risks and thereby ensure financial stability.

Much of it applies to the current crisis, too, to the extent that economic distress typically manifests through disruptions in the basic demand-supply dynamics. However, the novelty this time around lies not so much in the nature of economic distress, but in the way it has originated and continues to spread.

The worst aspect of it is that the severity of the pandemic's impact and the timeframe of the lockdowns are unknown. The situation might worsen unless a vaccine becomes available soon. In that case, businesses might encounter severe liquidity crunch as supply of short-term funds might be severely crippled.

True, the measures implemented and liquidity buffers reserved as a consequence of the earlier economic crisis might serve as a cushion and mitigate the situation to an extent. Only this time, liquidity is required to not only cater to the economic downfall, but also to be diverted to ensure safety of people. In short, unlike earlier, funds have to be optimally utilised to save both life and livelihood.

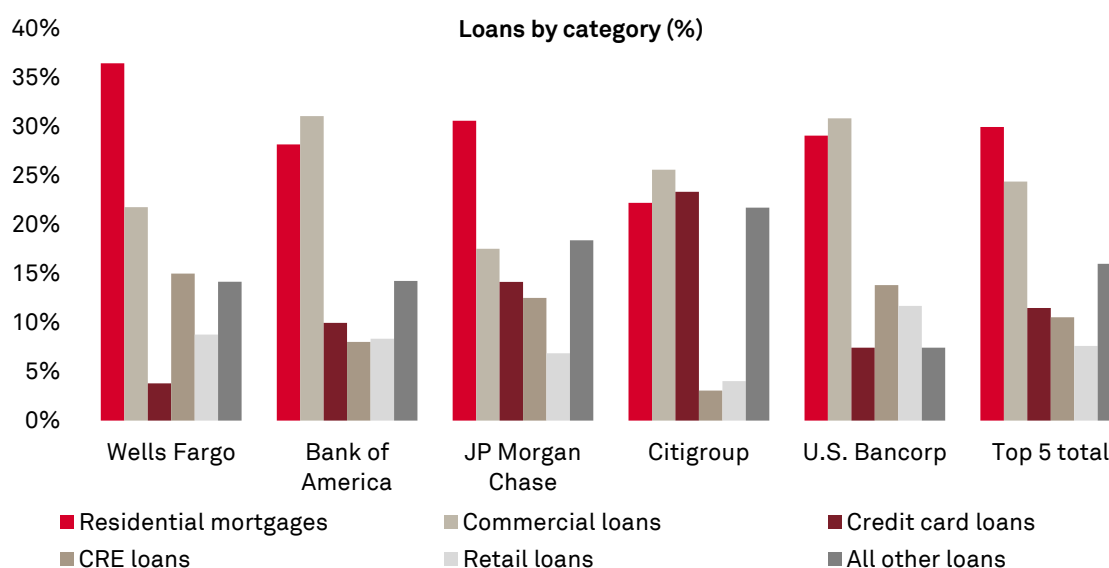
To tackle the liquidity risk and boost liquidity in banks, global regulatory bodies have temporarily exempted banks from fulfilling additional capital and liquidity requirements.

At this stage, it is crucial to decide the optimum liquidity buffers to be reserved in order to cater to the current liquidity needs and to ensure the institutions do not enter the vicious circle of liquidity risk.

This note throws light on how the current pandemic can impact liquidity in banks and how global regulatory bodies are dealing with it. It also suggests some precautionary steps in case the situation worsens.

Impact of the pandemic

Worsening credit quality: It is possible that credit quality will deteriorate quickly in sectors and areas more affected by the pandemic. Credit cards and personal loans, which are mainly unsecured debt, will be affected the most. Credit card companies can prepare for delinquencies to rise as daily wagers and lower-income population, who take credit for living and not just entertainment, will feel the stress to repay. As the chart below shows, credit card loans accounts for 12% of the top 5 banks in the world. Banks may soon start to encounter severe liquidity crunch as cash inflow in the form of repayments stops.



Capital market instability: The financial services sector's stability and profitability could come under pressure, which would reduce the accessibility of the capital market. The bid-ask spread might widen and demand for some asset classes might drop. Stock prices have already fallen and depending on how long the pandemic lasts, liquidity could dry up and lead to cash flow challenges for banks and their clients.

Capital reserve imbalance: Major central banks have announced a reduction in liquidity coverage ratios (LCR) below the standard 100% in order to meet liquidity demands. According to a recently published report by the European Banking Authority on liquidity measures, the weighted average of LCR for a monitored sample of 134 banks was 147% as of June 2019. Indeed, on average, LCR has always been above 100% since September 2016. But starting March 2020, the European Banking Authority has relaxed the 100% threshold for banks temporarily.

Similarly, the net stable funding ratio (NSFR) is relaxed by major central banks to show that they can endure outflow of funds without stopping lending. This means banks are exhausting their reserves and if the stress continues for a long time, banks might deplete their reserves soon.

Response of central banks so far

Along with pre-emptive measures, governments have directed liquidity towards banks

Monetary reforms/ Central banks	Payment moratoria	Interest rate cuts	Capital relief	Swap lines/Repo facilities	Asset purchases
Federal Reserve	PMCCF will allow companies access to credit and principal deferment for the first 6 months	The Fed has cut rates to a target range of 0-0.25%	Supplementary leverage ratio is reduced by 1%	Swap lines opened to other central banks. Liquidity facilities opened, including <ul style="list-style-type: none"> • FIMA repo facility • Primary and secondary market corporate credit facility • Term asset backed securities loan facility • Primary dealer credit facility • Money market mutual fund liquidity facility • Commercial paper funding facility 	Decided to purchase US Treasury securities, agency mortgage-backed securities, and agency commercial mortgage-backed securities in appropriate amounts
European Central Bank	Payment moratoria is introduced as a relief initiatives taken by credit institutions	Did not cut rates	ECB has allowed key banks to operate below Basel III Pillar 2 norms, liquidity coverage ratios and capital conservation buffer	Established swap lines from US Fed	Asset Purchase Programme (APP) worth €120 billion announced. Under Pandemic Emergency Purchase Programme (PEPP), additional €750 billion asset purchases announced
Bank of England	Mortgage and business loan payments can be deferred by UK families and companies	Bank rate reduced to 0.25%	UK buffer rate reduced to 0% from targeted path towards 2% for at least 12 months	Established swap line arrangements for US dollar liquidity. Enabled Contingent Term Repo Facility to compliment liquidity efforts	Expanded bond holding by £200 billion. £330 billion of guarantees and loans to businesses

Monetary reforms/ Central banks	Payment moratoria	Interest rate cuts	Capital relief	Swap lines/Repo facilities	Asset purchases
Reserve Bank of Australia	Home loan payment deferment by customers for 3 months	Policy rate reduced by 25 basis points twice to 0.25%	APRA has relaxed its capital requirement norms allowing banks to lend more within safe limits.	RBA has established swap line with US Fed to infuse dollar liquidity up to \$60 billion	RBA has formed term funding facility of A\$90 billion for SME lending and government has allocated \$A15 billion in residential backed and asset backed securities.
Hong Kong Monetary Authority	Payment deferrals on selected mortgages	Reduced rate by 64 basis points to 0.86%	Lower standards for liquidity ratios (LCR and LMR)	HKMA, being part of Foreign and International Monetary Authorities (FIMA repo facility), can enter into repurchase agreement with US Fed to exchange US Treasuries with US dollars to inject dollar liquidity	N/A

The way forward

Changes in CECL/IFRS 9: Apart from keeping adequate liquid buffers as per the Current Expected Credit Loss (CECL) or International Financial Reporting Standard 9 (IFRS 9) accounting principles, banks also maintain an allowance for credit losses estimated for the entire lifetime, for debt instruments, leases and loan instruments. Banks need to undergo substantial modifications to the procedure of lifetime expected losses computation to incorporate the risks arising due to the Covid-19 pandemic. The imperatives in this milieu:

- Forecasting the lifetime expected loss figures require a projection of macroeconomic factors such as gross domestic product and unemployment, which dictate the health of the economy. Given the economic distress due to the Covid-19 pandemic, these variables perform poorly and exhibit a declining trend. The likelihood of default, or the probability of default, in such circumstances, is inflated and needs to be reassessed as adverse economic conditions worsen default chances
- Apart from macroeconomic factors, microeconomic or borrower-specific variables used for computation of lifetime losses will be severely impacted. Liquidity risks emanating from the spread of the pandemic will definitely curb the purchasing power of the borrowers and degrade these variables. So, the exact impact of the pandemic on these variables at a geographical or industrial level needs to be assessed
- The definition of impairment becomes more stringent in these circumstances as a larger number of assets will be considered impaired contrary to normal market conditions. In case of IFRS 9, the basic segregation of assets into three buckets depending on the severity of credit quality deterioration, needs to be reassessed. Considering the dearth of liquidity in the economy, unlike in normal market conditions, more assets would be considered to be categorised as bucket 3, i.e. severely impaired
- At times, concessions such as troubled debt restructuring (TDR) are allowed to a debtor facing financial difficulties. Due to Covid-19, short-term modifications might be allowed to borrowers who were in the current status prior to the virus outbreak. Whether these modifications should qualify as TDR needs to be re-analysed
- Forecasting of losses using a number of adverse scenarios that simulate the various possibilities should be considered. Although potential impacts of the pandemic are currently unknown, considering a number of scenarios could serve as an early warning indicator of potential dangers
- A drastically conservative approach might not be suitable as a higher estimation of CECL would require banks to set aside higher reserves, which might lead to a liquidity crisis. So, the scenarios used for CECL computation should be probability weighted

Transparency: Liquidity indicators such as cash position indicator, core deposit ratio, and loan commitment ratio should be on high alert, transparent and actively monitored till the pandemic lasts.

Disclosure: Capital buffers have been relaxed in major central banks to support the economy and banks have been directed not to pay dividends or allow share buy-back to conserve capital. In light of all these monetary measures taken to ease liquidity, financial firms need to make disclosures about the effect of Covid-19 on their business within financial statements or other Securities and Exchange Commission filings, based on relevant disclosure standards.

Conclusion

Although the revamped regulatory frameworks introduced after the 2008 crisis are coming in handy now, there is still a lot of speculation on liquidity in banks. Even if we manage to slow down the spread of this virus anytime soon, the economy needs time to recover and go back to normal stage. Banks need to work on their contingency plans, as they do not typically take into account such global, widespread lockdown, travel restrictions, closed school and offices for long periods

Identifying potential risks with the present CECL/IFRS 9 models might not be enough. So, taking a forward-looking approach, we recommend that banks reassess and leverage their stress-testing models for the current environment and make sure they are still robust and stable. Since we have the data pertaining to the pandemic since December 2019, banks can calibrate their existing models and perform back-testing to ensure robustness. Revenue and cost models of banks need to be updated, too.

Since the economic impact and timeframe of this pandemic is yet unknown, considering a number of simulated adverse scenarios to forecast losses and keeping probability weighted capital for those scenarios might serve as an insulation against these risks right now. The aim should be to minimise these risks, which are difficult to avoid.

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