COVID-19

COVID-19 crisis considerations for Specialist Banks and Non-Bank Lenders

May 2020

pwc

COVID-19 considerations for Specialist Banks and Non-Bank Lenders

The impact of COVID-19 has far-reaching implications for individuals, businesses and the wider economy. As the UK and international responses have developed, specialist banks and non-bank lenders ("NBLs") are facing significant challenges ahead. In the past ten years, a plethora of new specialist banks and NBLs have entered the market; many are yet to weather a crisis or full economic downturn.

Whilst the 'real' economy is being supported by the Government's COVID-19 support schemes, banks and FCA regulated businesses find themselves excluded. Liquidity measures such as TFSME deployed by the BoE are seen to be useful in assisting banks, but have the knock-on effect of creating an unlevel playing field on funding for NBLs who are unable to access the scheme. Some relief has been provided through Government and HMRC backed initiatives like the job retention schemes, VAT deferrals and business rate reductions.

Liquidity and funding concerns

Limited visibility on new wholesale funding lines for NBLs resulting in a reduced **access to funding** when existing facilities are filled, and a concern that costs will increase

A customer rush to access fixed term savings resulting in an **impact on liquidity**, causing doubt over the future of a traditionally stable 'tap' upon which many specialist banks are heavily reliant

Volatility in the securitisation market resulting in a reduced **access to funding,** with some lenders unexpectedly having to retain assets or accept step-up costs with most secondary trades pricing to term

Asset performance concerns

New forbearance and customer assistance measures causing **loan performance** to deteriorate, impacting the wider loan book and raising questions around future expected credit losses

Immediate stress and forbearance on new loans; **impaired assets** could trigger margin calls and buy back obligations and hit capital through unforeseen provisioning

A base rate reduction by the BoE has triggered a direct hit to margins and **profitability of the loan book**

Operational concerns

Near closure of the housing market has led to an inability to perform physical valuations; tightening of underwriting criteria will make **future growth** of the loan book difficult

Immediate implementation of remote working; adapting systems and key processes along the value chain at rapid speed resulting in a reconfiguration of the **operational cost base**

Business continuity and operational resilience; shoring up **business continuity plans** including identification of critical staff, workforce capacity and IT

UK economic update snapshot

1

By our estimates the COVID-19 crisis could lead to a sharp fall in GDP in Q2 2020, perhaps around 12% to 16%, much larger than any quarter during the 2008-2009 financial crisis.

We have assumed an annual 2020 GDP fall of 5% to 10% under two different lockdown severities.

2

In the 4 weeks to 13 April, the number of new Universal Credit claimants was around 1.6 million.

The weekly number of new claims now appears to be on the decline, possibly due to the support measures announced by the government (notably the Job Retention Scheme).

3

Our recent PwC research survey shows that higher income groups (over £50k pa) are more than twice as likely to be able to work from home (c. 70%) as low income workers earning below £20k pa (c. 32%).

Suggesting that the negative economic impact of COVID-19 may be greater for lower income groups.

4

A recently published ONS survey shows around 60% of working-age households in Britain are worried about the impact on household finances.

With another recent ONS survey showing 45% of businesses surveyed reported lower than normal turnover levels.

5

The PwC/CBI Financial Services Q1 2020 survey shows that the value of non-performing loans was already on the rise pre COVID-19 (37% increase in Q1 2020).

Respondents expect this to rise by a further 28% in Q2 2020.

6

According to the banks and building societies surveyed in the FCA’s credit conditions survey Q1 2020, defaults on secured and unsecured household credit are expected to increase by 16% and 2% respectively in Q2 2020.

Quarter-on-quarter defaults are expected to increase significantly more for small, medium and large non-financial corporations at 72%, 62% and 64% respectively,

PwC economics latest report:

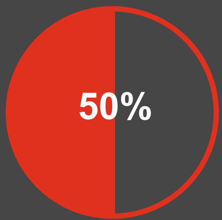
https://www.pwc.co.uk/services/economics-policy/insights/uk-economic-update-covid-19.html

PwC/CBI Financial Services Q1 2020 survey:

https://www.pwc.co.uk/industries/financial-services/insights/cbi-pwc-financial-services-survey.html

PwC bank and non-bank lender treasury survey

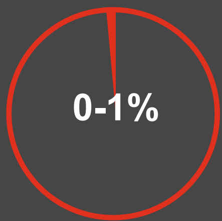
Our survey of 32 UK banks and non-bank lenders sought to identify the initial impact on liquidity and funding of COVID-19[1]

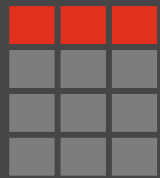


of NBLs surveyed expect a funding gap due to COVID-19.

3 - 6 month funding gap.

Interestingly, the majority of all respondents expect weighted average funding costs over the next 12 months to decrease by





The majority of NBLs and large banks responded that new lending activity has not ceased.

But specialist banks expect it to take **3 months** to recommence new lending activity.

All of the specialist banks surveyed have seen a **1 - 10%** increase in customer requests to withdraw deposits but only **40%** of the large banks have experienced this trend.

The following were cited as the biggest operational challenges highlighted by COVID-19:

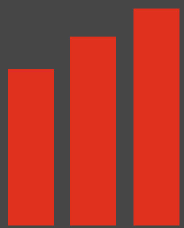
Team connectivity and remote working

Manual approval and sign-off processes

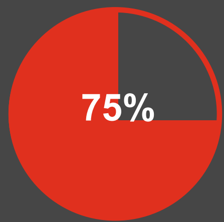
Business resilience and continuity planning

'What is your organisation's current priority / concern?'

Increase in Default Rates

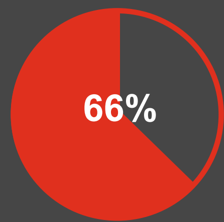


75% of NBLs surveyed expect 'moderate losses' associated with COVID-19



But **75%** of specialist banks expect 'high losses' and just over **75%** of large banks expecting 'low to moderate losses'

In terms of current operational headcount capacity, all specialist banks responded with 'normal' but **66%** of NBLs are working at **51 - 85%** normal working capacity



[1] *Selected results for all non-bank lenders surveyed and those banks with balance sheets under £5bn*

Liquidity and funding pressures

As with other financial crises, liquidity will be a priority for all specialist banks and NBLs.

There will be concerns from specialist banks who rely on fixed term deposits to fund their lending given the recent BoE base rate cut and an influx of customer requests to withdraw these deposits. However, we see the previously successful BoE TFS scheme which has now been extended via TFSME as going someway to alleviating this pressure.

The situation is more complex for NBLs who cannot currently access TFSME. The recent volatility in the securitisation markets and margin calls from wholesale funding providers is making these two traditional sources of funding less attractive. Over the near term we expect to see a number of alternative players stepping in to provide the financing required by the NBLs.

One way that specialist banks and NBLs could continue to maintain or even grow their front book in such a challenging time is by accessing the CBILS/CLBILS schemes, which may also become necessary to retain their current SME client base.

The combined effect of the BoE reducing the countercyclical capital buffer to 0%, the implementation of the final set of Basel III standards being delayed and much reduced lending activity across almost all products may cause a number of specialist banks to find themselves with excess capital. As a consequence, capital planning for the short, medium and longer term will be required as part of any COVID-19 response.

Key considerations:

- How do I manage customers with extenuating circumstances withdrawing medium and long term fixed deposits?
- What alternatives are available to fixed term deposits to plug the gap in my balance sheet?
- How can I best forecast behavioural changes which will affect my cash inflows and outflows over the medium term?
- Following the drop in base rates, how do I handle margin pressure coupled with increased funding costs?
- Will newly completed borrowers taking ‘day 1’ payment holidays trigger default events in existing wholesale funding agreements and possibly also trigger buy-backs?
- Are new wholesale funding and warehouse lines still available and at what price?
- How do I renegotiate debt covenants with current lenders; what is the new normal for market rates?
- Are retained deals for new securitisations the best short-term solution and is the best option to accept step-ups on existing securitisations whilst the market is pricing to term?
- How do forward flow agreements entered into in the recent past deal with a fall in estimated origination volumes?
- How can I access further capital to support the business in the next few months?

Performance of underlying assets and loan book

The performance of almost all asset classes (secured, unsecured, SME and consumer) will be impacted by the likely rise in defaults and increased vulnerability of customers. The overall performance of the loan book at this fragile time will also be squeezed through margin compression on base rate linked products.

We expect the sector that will be hardest hit will be SME lending, especially those specialist banks and NBLs with less diversified books and significant exposure to retail, hospitality and leisure.

Consumer mortgages have a more immediate chance of affecting the income side of the equation with specialist banks and NBLs typically having a higher concentration of self-employed and ‘complex income’ borrowers in their lending book. New business generation will also be hampered by restrictions on valuations, and an increasingly cautious approach to underwriting and curbed risk appetite.

Experience dictates that unsecured consumer credit is typically the repayment that suffers first in times of distress. It will be interesting to see how recent FCA guidance on supporting borrowers struggling with credit card, overdraft and personal loan repayments along with support for furloughed and self-employed workers softens this impact.

Key considerations:

- Have you analysed your back book for elevated risks, e.g. concentration of self-employed and ‘complex income’ borrowers and certain distressed SME sectors?
- How should I incorporate the current crisis and future economic uncertainty in to my modelling for the purposes of IFRS 9 (expected credit losses and significant increase in credit risk)?
- For reporting purposes (half year results or reporting to financiers) how do I interpret IFRS 9 for the current circumstances?
- How will recovery arrangements on existing NPLs outsourced to debt purchasers be affected?
- Does adverse performance, forbearance or deterioration in LTVs trigger buy-back clauses in the funding arrangements I have?
- How will payment holidays on unsecured consumer credit affect my future recovery curve assumptions? What should I assume about future performance for SME borrowers requesting rent deferrals.

Operational considerations

The uncertainty surrounding borrower financial stability will shift the focus of specialist banks and NBLs from loan origination to customer support and special servicing as more attention is given to the performance of the back book. This will significantly redistribute the workload across the value chain and supporting teams, testing the lender's ability to retrain and redeploy employees effectively; coupled with less capacity driven by remote working and COVID-19 related illness.

As SME and consumer loan origination is typically more reliant on traditional forms of contact, social distancing measures will hinder accessibility and availability of the distribution channel and hamper pre-completion activities.

Key considerations:

How can I rationalise my product range to optimise the use of diminished resources as well as reduce costs? What products are causing a drag on NIM and ROE?

How do I assess credit underwriting and refine my scorecards in the prevailing climate, and balance the need to start originating again versus minimise the level of potential future losses on my front book?

What measures have I got in place for customers to access alternative distribution channels where face-to-face are no longer available? Which customer demographics, groups and products are most impacted?

How do I complete property valuations and surveys for mortgage originations given the Government's social distancing measures? What is the impact of the Government's request to postpone property completions until after COVID-19 on my origination volume forecasts?

Do I have the right KPIs in place to effectively manage a shift in operational activities to customer support and special servicing whilst supporting the performance of my back book?

Do I have the relevant capabilities to deal with higher volumes of customer queries and complaints, requests for payment holidays, arrears and restructuring arrangements?

How do I continue to comply with TCF regulation and identify and support vulnerable customers whilst still maintaining special servicing process standards?

As offshore locations face major disruptions due to COVID-19, how and what operations should I onshore in the short term to maintain BAU (e.g. KYC, AML and customer fulfilment)?

How quickly, and from what areas of the business can I retrain and redeploy staff to support operational pinch-points (e.g. collections and special servicing)?

Business continuity, support functions and IT

Specialist banks and NBLs will be heavily dependent on remote teams to support BAU, that are also likely to be reduced in size due to COVID-19. Workforce capacity will be a critical priority, an issue which is likely to be compounded by reduced services from third parties and offshored operations located in countries in lock-down. Specialist banks and NBLs will also need to be agile to react to changing Government guidance and measures in response to COVID-19.

There will be increasing pressure on IT to support core business activities, which will include larger customer volumes through digital and online distribution channels and self-serve, remote working, maintenance of remote data back-up servers, and mitigating increased IT security risks e.g. cyber attacks.

Key considerations:

How mature and robust is my business continuity planning? Does it cover ‘Black Swan’ events, such as COVID-19, and are there any immediate gaps to remediate?

Who are the critical staff for business continuity, including staff that are required to maintain customer service and meet regulatory filing deadlines?

Have I considered the capacity of my workforce given illness and the Government self-isolation guidance? What measures have I introduced to maintain motivation, productivity and well-being for an extended period of time?

Do I have clarity on which activities can actually be done remotely (while being compliant with conduct and regulatory requirements)? What IT security and GDPR protocols are required to support working from home?

How should I rationalise my existing transformation programme, considering my current availability of resources including cash and people? What transformation initiatives are required to minimise the impact of COVID-19?

What is the likely impact of COVID-19 on third parties and their ability to service my organisation? And, are there force majeure or pandemic clauses in those agreements?

Do I have a comprehensive understanding of third party suppliers’ continuity arrangements (and their subsequent arrangement for mitigating supplier risk for their own critical vendors), including financial market infrastructure such as Visa and Swift?

Do I have appropriate plans on how and who will respond to the PRA/FCA, media and other key stakeholders?

Do I have the necessary IT capabilities (e.g. bandwidth, network capacity, hardware, access to physical sites) to support remote access to data and systems and handle surges in customer demand on digital customer interfaces for both distribution and self-serve?

Have I undertaken an assessment of potentially elevated cyber security risk given the track record of attacks during stress in financial markets?

How the PwC FS Deals team can help and support you

Managing your cash flow

13 Week Plan – Our team is continuing to engage with companies dealing with financial stress:

- Advice and assistance in the preparation of a 13 week cash flow forecast
- Advice on short term cash and cost levers, including managing the working capital cycle
- Monitor and update the company's cash flow forecasts against trading results and covenants on a weekly basis

Realising and raising capital

Emergency funding lines (including senior finance, subordinated debt and equity) – Our team can provide advice and assistance in relation to your strategy for engaging with funding partners and subsequent negotiations:

- Identify potential funding and equity partners to meet your specific requirements
- Comment on your revised financial forecasts from a financing perspective
- Advise on and assistance with the production of materials to be used for these discussions

Portfolio disposals – Over the last 5 years our team have advised on over 25 performing and non-performing loan portfolio sales in the UK with an outstanding loan balance of over £20bn:

- An efficient way to realise a substantial amount of capital relatively quickly especially if those portfolios are starting to show signs of distress
- Find a buyer who can work quickly to an agreed pricing mechanism to cut through the current uncertainty

We can provide buy-side support if you are interested in purchasing portfolios, or exploring an acquisition.

Operations and IT

Interim operating model – Identify workforce redeployment and process optimisation to reflect the shift in operational focus from sales and originations to servicing and collections management

Business transformation and 'cost out' – Where lenders are experiencing a deterioration in performance, we can review their business transformation programmes, and identify and quantify 'cost out' opportunities

Cyber security – Support lenders with information security and assess areas of elevated cyber security risk

Carve-out – Support the execution of forced sub-business divestments to release capital to support your core lending business

Valuations support

Portfolio valuation – Support you with portfolio valuations, on a one off or recurring basis, providing independent insight into valuation at times of high market volatility using our proprietary Loan Portfolio Valuation tool.

Business valuation – Support with valuation of your business, or part of your business to support with divestment processes or pricing for external investment.

https://www.pwc.co.uk/services/transaction-services/valuations/valuation-in-times-of-market-uncertainty.html

Credit risk and IFRS 9 – The current climate may raise questions around existing and emerging credit risk within your loan portfolio. We can help you to understand these risks and perform analysis to see what may happen under different macroeconomic scenarios. We can also advise you on how to update your IFRS 9 loan provisioning models.

Financial instruments valuation – Support with valuation of complex financial instruments, both on a standard fair value basis and in close-out in the current market.

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