Banks and the pandemic: four critical steps to take even without regulatory prodding

A key justification for rescuing large banks before they fail – widely invoked during the last financial crisis – has been their irreplaceable role in supporting economies and preserving financial stability. If that is the case (which it is in Europe's notably bank-intermediated markets), banks should step up to the plate during the pandemic and fulfil their role in full gear and without any hesitation. And not only because regulators and politicians urge them to.

In the midst of the pandemic crisis and unlike the last time around, banks need to show the public at large that they should be viewed as part of the solution, not the problem.

It is unrealistic and arguably wrong to compare the current crisis with the global financial crisis of 2008-09. Covid-19 is first and foremost a distressing human-life crisis, rather than just a financial crisis. And this time, the banks are not among the parties triggering it. Equally wrong is to draw too many lessons from the post-9/11 crisis – which also stemmed from a non-financial source but whose economic impact was quickly defeated by the power of the Fed and other central banks. Central bank powers are far less mighty now, since so many tools in the kit have already been used and rates stuck at rock-bottom levels allow much more limited monetary-policy flexibility.

It is not surprising that the alphabet of doom is again being dusted off, from the optimistic V, going through W and U and all the way to the feared L. Several large European banks, possibly just entering the second stage of the Kübler-Ross curve's five stages of grief, seem to be relying on the V-shaped scenario. The assumption behind it is that the growth of the pandemic in Europe is likely to subside in a few weeks, following the encouraging pattern in China (at least as reported by the Chinese authorities). And, supposedly, after that the economy will gallop back up with a vengeance.

With the understandable 'too early to know' proviso, banks anticipated a hit to earnings of roughly 5%-10% for the year at a large banking conference last week[1]. After taking into account the positive impact of government guarantees and subsidies to help virus-impacted business borrowers, expected supervisory capital forbearance, and a postponement of tougher loan-loss provisioning rules (IFRS 9).

Despite these steps to help, the reality will probably end up being uglier than just a dip in income. The full impact of NPL recognition and provision taking may be softened up for a while, but the top revenue line will likely show a dramatic shrinkage for the next quarters – investment and wholesale banking, asset management and bancassurance, business lending, etc.

Faced with this reality, the banking industry should be aiming at far more than just meeting market expectations during these extraordinary times. Specifically, banks should publicly announce and start implementing their own set of highly visible actions. And they should do that without regulatory prodding. Some in the market may be disapproving, even angry. But many other market participants, and especially people beyond the market, could look at these steps positively.

[1] Morgan Stanley's European Financials Conference, 18-19 March 2020.

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Four actions banks should announce and implement

1. Banks across Europe should announce that no variable management remuneration (bonuses) will be paid in 2020 (or beyond if the pandemic extends into 2021). On their own, senior bankers could at the same time publicly state that they will not accept any bonuses, should these be offered to them. While many bankers will be working hard during this difficult period, so will health workers and employees in other services critical for society who do not get and do not expect banker-level bonuses.

   The most rewarding outcome for a bank in the age of the pandemic should not be closing a juicy commission-rich deal but saving a business from virus-triggered bankruptcy and its employees from being laid off. In any event the absence of a bonus could disincentivise bankers from contemplating high-risk high-return transactions, which is just as well.

2. The same should go for dividends. It is true that the expectation of a steady dividend is one element motivating investment in bank equities. But this flow was already interrupted during the crisis and in the post-crisis years and shareholders did not desert the sector. For banks, paying dividends to their shareholders is a choice, not a legal or moral requirement. And under the present dire circumstances, most shareholders are likely to understand this necessity. Specifically, dividends should not be paid because of the need of the bank to support the pandemic crisis all-hands-on-deck, not because the bank ran out of money due to mismanagement or foolish risk taking. Which would pretty much preclude dividend payments by all banks, bar none.

   Again, banks would do well to announce skipping dividend payments without being guided to do so by their supervisors. Any institutional shareholders disagreeing with this could express publicly their discontent. Which is unlikely to happen in these times of extreme public stress.

   It goes without saying, stock buybacks should be totally off the map also in banks' financial planning – again, without the regulators having to prohibit banks from doing it.

3. A key challenge for European banks in the digital age is reducing excess capacity – especially in physical branches and back offices. On balance, most large banks remain seriously over-staffed. To able to compete effectively, they need to become more efficient and shed legacy costs. But, in the spirit of St. Augustine's "give me chastity, but not yet" prayer and with the pandemic around them, banks should postpone cost-cutting when it entails staff reductions. This would not perhaps be in line with cold bottom line-driven calculations, but it would help banks' public image, not to mention employee morale and financial welfare.

   As government and central bank loans, subsidies and guarantees are intended to help pandemic-threatened businesses, some public statements (e.g. by the Bank of England's new governor) condition them to the preservation of jobs and salaries under threat. It is only logical that, in turn, the banks themselves should commit to the preservation of jobs and salaries under threat for their own staff. This would not be a goodwill act but the right thing to do under the current circumstances. There will be time to look again at optimising efficiency and boosting cost-income ratios later on, after the pandemic is gone.

4. Banks should also adjust their approach to risk-taking during the pandemic. Specifically, any activities liable to push a bank into new areas of risk – such as M&A and similar transactions which may make sense during more normal times – should be best avoided for a while. Management time and effort, stretched to the extreme in these difficult times, are better spent steering the bank's activities to support and guide businesses and individuals impacted by the coronavirus.

   Such an approach would be in line with the newly expressed regulatory forbearance on capital levels. It would be very clumsy for a bank to take advantage of any supervisory leniency in the current period to push for unnecessary risk-taking.

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