long-term consequences of the COVID-19 crisis for risk professionals

by Oscar D. McCarthy, PRM

The COVID-19 crisis has already significantly impacted society, with widespread lockdowns in place to manage contagion risk and emergency measures in place to mitigate the associated economic damage. Risk professionals in the finance sector are dealing with the immediate consequences of these, relating for example to market volatility and credit provisioning, while working remotely. But what are the longer-term consequences of the crisis - and what do they mean for risk professionals? In this article we consider the longer-term impacts of government and central bank policies and their societal and technological consequences on the industry and profession.

the story so far

The immediate consequences of the pandemic are obvious, with lockdowns triggering a global recession and the economy kept alive on state aid: Zombie has become the corporate norm for many. Hence institutional balance sheets are becoming strange animals, with massive volatility in the trading book, a bloated state-backed loan-and-funding book, and operational anxiety as we (stress) test the limits of remote working.

A number of early observations can already be made from this crisis. The first is that the pandemic is far from over, and quality of government response is crucial: compare the mortality rates in neighboring countries, and extrapolate from this the confidence with which people will return to pre-crisis behaviors.

The second is that GDP contraction will be significant. Many official economic forecasts implicitly assume a V-shaped recovery. Given the non-symmetric nature of a pandemic (quick to escalate, slower to die down), this seems optimistic. There is significant room for pessimism in corporate financial health, with significant increases in insolvency. Given that state support schemes cannot last indefinitely, more failures will follow: this suggests that financial market corrections may be due. Financial Institutions should stress test numerous pandemic recovery scenarios, both for their own balance sheets and that of their clients and counterparties.

what’s next?

The principal unknown factor is duration: how long does the pandemic last, given that vaccines are a long way off? A certain amount of informed scepticism may be in order here.
Does this mean that we spend 2021 in a permanent amber state, with travel bans and track/trace tools used to minimize future outbreaks? And, crucially, where does this lead us? It’s the longer-term consequences that should give us pause for thought.

**economic consequences**

We are entering what will be the worst recession since the 1930s, with some economic historians looking as far back as the 1700s for comparable shocks. Ultimately, there are only so many businesses can be kept alive for so long: many more businesses will fail.

An extended pandemic will weaken the solvency of financial institutions, as insurance claims and bad debts spiral. In the short term, zombie companies can be kept alive through debt forbearance, and zombie banks proliferate as a consequence. Insurers will be less lucky, with less state appetite for deferral of claim payouts, combined with another prolonged period of near-zero or negative rates: not all will survive. Many financial institutions will need to re-capitalise; all will need to significantly change their operating model to lower expenses. We will likely see a lot of mergers and acquisitions.

An extended pandemic will also create tensions in the sovereign debt market. How do governments plan to finance the large and growing deficits? Political tensions mean that US deficit financing is less obviously available from China, and EU deficit financing requires structural reform. The squeeze will however hurt other, lower-rated borrowers: prepare for IMF interventions in those emerging markets hit hardest by the pandemic, such as Latin America. In southern Europe, the Euro crisis of the last decade threatens to re-awaken, especially if the EU institutions are politically and legally constrained. Monetary financing, until recently taboo, re-enters the policy toolkit, with hard-to-predict consequences. Future government decisions on how pandemic relief is financed will have a far-reaching impact on global economies.

**societal & technological**

Our relation with the state is changing, with the nation-state as the guarantor of public health and economic security. Public health management will become more intrusive. Privacy is dead, but arguably this is a compromise we have to make. More generally, a societal shift with government intervention more in vogue than ever, but with potentially dystopian hues if combined with a large increase in surveillance. As our ever-closer relationship with technology grows, through remote working, social connectivity, and societal surveillance, does society become less free? Watch closely to see how different governments use their newfound powers.
recovery

Longer-term, global economies will need to recover, which in many sectors will require Keynesian stimuli. A command/control economy increases state-directed investment and points to potential future credit problems. It also turns the finance sector into an agent of state regulation in many industry sectors, with institutions required to enforce state aid rules in targeted sectors. Corporate risk management will need to mature, with a better appreciation of uncertainty, and a renewed focus on resilience and sustainability. Institutions will increasingly need to promote these standards via their lending, investment and underwriting programmes. Client relationship managers thus become evangelists for better risk management.

A key question will be the extent to which these Keynesian stimuli will spur environmental policy shifts. Some will say the current crisis underscores the need for sustainability; others will say this is an expensive luxury, no longer affordable. Who will win the argument? The early signs from bodies such as NGFS and ECB are that many central banks lean to the former view, seeing sustainable infrastructure as having a double pay-back: recovery from the current crisis, coupled with mitigation for the next. It remains to be seen how widespread this view is and to what extent this becomes the golden asset class of the next decade.

conclusions

As the pandemic crisis continues, sovereign powers and responsibilities will continue to increase globally. Some will buckle: watch for troubled FI/Sovereign exposures. Some will struggle: watch for strained international relations and broader impact on global economy. Watch also for enlightened public policies: these will show the light at the end of the tunnel.

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