

Assessment on the Banking Risk Management under COVID-19

Chenxing Rong^{1,a,*}

¹*Business School, University of Exeter, Exeter EX4 4PY, UK*

a. cr641@exeter.ac.uk

**corresponding author*

Abstract: This essay explores how the banking industry in the UK has cooperated with the restoration of economic policies to stabilize the financial situation after the COVID-19 pandemic. It also analyzes how banks manage risks to prevent bankruptcy, specifically focusing on interest rate risk, credit risk, and market risk. The study uses the financial status and measures of the five major banks in the UK in 2020 and considers the impact of the pandemic, economic recession, and the Russian-Ukrainian war. The findings suggest that in order to deal with the coming risks, the banking industry needs to take several measures. In order to have a cushion to withstand possible losses, banks must first maintain appropriate core capital. Secondly, asset quality needs to be stable, which can be achieved through effective credit risk management. Thirdly, banks should focus on increasing interest rate income, as interest rates are likely to rise in the coming years. Finally, it is essential to actively manage risks, including market risks, to mitigate the potential impact of external events on the industry.

Keywords: interest rate risk, credit risk, banking management

1. Introduction

Under the epidemic, The comparatively "stable state" of the economic and financial climate has quickly given way to an ongoing "dynamic state." Commercial banks are more at risk than ever in 2020, and their performance is expected to start to decline. According to a news release issued by the World Bank, The international economy has had a severe contraction due to the Covid-19's swift and significant effects as well as the economic slowdown brought on by prevention and control measures. In 2020, the global economy will decline by 5.2 percent, the greatest recession since international War II [1]. Compared with the 2008 crisis, the banking sector at the time of the outbreak had stronger balance sheets, more abundant and high-quality capital, more liquid assets and less reliance on fragile funding. This crisis has shown the effectiveness of reforms implemented after the global financial crisis. However, this crisis has come on top of a combination of several trends of the past decade that have meant increasing competitive pressure on banks and reduced their profitability, and in the short term, the impact of the pandemic on The core indicators of volume, price and quality in the banking industry have certainly directly constituted an impact, mainly due to the decline in credit demand, some customers' bad debts and profit sharing, that all aspects of "quantity, quality and price" have been affected. A banking crisis could result from the current bad situation, which includes credit risk (loans and other assets become worthless and are no longer honored), liquidity risk (withdrawals

exceed available funds), and interest rate risk (rising interest rates decrease the value of bonds held by banks, forcing banks to pay out more deposits than they earn on loans) [2]. A systemic banking crisis happens when numerous banks in a nation encounter serious liquidity or solvency issues at once. Banks need to assess and respond to a variety of risks to avoid bankruptcy.

The UK's five largest banks have solid asset quality and strong risk resistance. The five largest banks in the UK had outstanding non-performing loans of £43bn, with an average non-performing loan ratio of 1.87 percent, down 0.01 percentage point from the same period in 2021. Lloyds was the only one of the big five to see a rise in bad debts, up 52.78 per cent from 1.31 percent in the third quarter of 2021 to 2 percent, driven by its mortgage business. The Bank of England has already raised interest rates several times in 2022 in response to soaring inflation, which has triggered higher-than-expected bad debts on adjustable-rate mortgages. The average core tier one capital ratio of the five largest UK banks fell to 14.04% at the end of the third quarter of 2022 from 16.36% at the end of the third quarter of 2021, mainly due to the expansion in risk-weighted assets. While the capital ratios of the five major banks have declined to varying degrees, they remain above regulatory requirements, reflecting prudent management by the five major banks. The Bank of England's Financial Stability Report 2022 shows that the UK banking sector is taking the initiative to strengthen risk management. Take HSBC: one is hedging against currency shocks through global operations. Revenue from the bank's "global foreign exchange" business rose 41% in the first three quarters of 2022 from a year earlier. Second, the timely disposal of risky assets. The bank disposed of operations in Russia, Greece and elsewhere in time to reduce its risk exposure in the first half. Third, reduce costs and increase efficiency. In the first three quarters of 2022, the bank implemented a \$1.7 billion "cost savings plan" and \$400 million in performance-related pay [3].

2. Liquidity Risk

Liquidity risk generally refers to the risk that a financial product will not be easily traded or sold due to a lack of market mechanisms or low demand; That is, the risk incurred when there is a liquidity gap in the fund. Since the 2008 financial crisis, the UK has launched successive rounds of quantitative easing to stimulate the economy. The QE policy brought a low interest rate environment, which boosted consumption and investment; Over all, the sharp increase in the supply of local currency has contributed to the growth of local currency. Depreciation stimulated exports and brought the current growth. The loose monetary policy should help the banking sector maintain better liquidity and avoid bank failures. However, the implementation of loose monetary policy until negative interest rates, and for an extended period of time, will undoubtedly cause damage to the banking sector, and indeed the financial sector as a whole. A sharp decline in the bank's profitability would undermine its financial sustainability, capital replenishment and disposal capacity for non-performing assets.

3.75 billion pounds worth of three-year government bonds with a yield of -0.003% were issued by the UK in May 2020. This issuance received 8.1 billion pounds of subscriptions, with a subscription ratio of about 2.15 times. This is also the first time that the UK has issued medium- and long-term government bonds with negative interest rates, raising market expectations for the Bank of England to cut interest rates to negative. After the UK issued negative interest rate government bonds, the Bank of England also changed its attitude towards negative interest rates. Both the governor of the central bank and member of the Monetary Policy Committee Teneyro stated that they would not rule out negative interest rate policies. The Bank of England will cut interest rates to negative interest rates in the interest rate meeting in November 2020. Before the issuance of negative interest rate bonds, the market still expects that the Bank of England will not implement negative interest rates until at least 2021. Compared with before the issuance of negative interest rate government bonds, the market expects the Bank of England to cut interest rates nearly a year earlier. According to the Ping An Securities Co., Ltd. at present, the CET1 level of major British banks is considerably higher

than the regulatory requirements: the lower limit of the CET1 ratio (including the protective buffer capital requirement) stipulated in Basel III is 7%; the CET1 "reference ratio" set by the Bank of England in the latest stress test (The warning line set after combining regulatory requirements and international accounting standards) is 7.6% [1].

According to Economic and Fiscal Outlook Office for Budget Responsibility CP 804 [4]. Despite the slowdown, it will be difficult for inflation to return to the Bank's target of 2%, and interest rates are projected to keep rising. There will be a significant tightening of fiscal policy and a reduction in energy subsidies for both individuals and enterprises. The dispute between Russia and Ukraine has not yet been resolved. Both sides are currently less inclined to discuss peace. The UK economy is expected to experience a recession, which will likely be deeper and last longer than in any other G7 nation. UK individuals and companies would experience the recession more severely, the benefit of higher interest rates on banking revenues will be partially offset by a worsening investment environment, and there will also be a greater danger of a decline in the quality of UK banks' assets. HSBC and Standard Chartered, which focus on emerging markets, will outperform Lloyds and NatWest, which focus on domestic retail services.

Tightening liquidity and rising funding costs have raised the bar on the resilience of banks' operations. The conflict between Russia and Ukraine and the huge monetary tightening have had a dramatic impact on liquidity in financial markets. On September 23, 2022, the British Truss government launched a "mini-budget" to promote economic growth, including a series of tax cuts, which required the British government to borrow on a large scale. Huge panics and a sharp rise in funding costs have triggered a crisis in pension liquidity. To raise money for margin calls, fund companies have had to sell Treasury securities, creating a vicious circle of falling asset prices and tightening liquidity [5]. The Bank of England quickly intervened to stabilize the market. In addition to purchasing long-term bonds, Woods, president of the British Prudential Authority (PRA), held an emergency meeting with the presidents of Barclays Bank, Lloyds Bank and other banks, asking them to provide information related to fund companies during the day. Exposure report to review their ability to meet margin calls. According to the Financial Times, Lloyds Bank's exposure to the UK bond repo market reached 52 billion pounds (accounting for 13% of the size of the repo market), while NatWest, HSBC and Barclays' exposures were 25.8 billion, 8 billion and 3.2 billion pounds, respectively [6]. Banks typically need to send margin calls to customers in the morning, requiring them to post collateral by 1 p.m. Because of increased market volatility, even in the opposite direction, fund companies need to sell assets cheaply in exchange for collateral. These collaterals need to be returned to the customer the next day. Britain opens up to 40 billion pounds (\$45.1 billion) in financing applications for energy traders to avoid worsening liquidity crisis. The widening of spreads prior to the Bank of England's intervention was mostly due to counterparty risk, which also raised liquidity risk. However, after the central bank began quantitative easing (QE), this relationship changed [7]. We offer proof that QE operations have been successful in lowering liquidity premiums and eventually credit risk indirectly by using the total value of asset purchases as a proxy for central bank liquidity provision.

3. Credit Risk

British banks are already reassessing their risk appetite, for example by targeting higher-credit customers and tightening lending to some retail, travel and manufacturing companies to reduce exposure to vulnerable sectors.

Major UK banks' non-performing loan ratios have stabilised temporarily and are still far lower than they were before COVID-19 [8]. It shows that in the first quarter of 2022, the proportion of non-performing loans in mortgage, consumer and corporate loans of UK banks remained unchanged as a whole. According to IMF data, by the first quarter of 2022, the non-performing loan scale of major

British banks reached 62.3 billion pounds, accounting for 0.98% of the total loan ratio (non-performing loan ratio), only one basis point higher than the end of 2021, and still ten basis points lower than the level at the end of 2019. It remains at a safe level. The creation of credit impairments involves the market pricing in future economic risk, which may not increase significantly even if a future recession materializes. Major UK banks registered credit impairments for the first time since the fourth quarter of 2020, but on a smaller scale.

Major banks have dramatically boosted provisions for bad loans in response to the pandemic, further eroding profitability as they fear more unemployment and company bankruptcies. HSBC set aside \$3.8 billion in the second quarter alone, which is seven times more than it did during the same time last year. Five banks—HSBC, Barclays, Lloyds, Standard Chartered, and National Westminster Banking Group—surpassed analysts' predictions by setting aside approximately \$22 billion in provisions in the first half [9]. The major banks acknowledged that, although the growth in provisions for bad loans would decline in the second half, the outlook remained bleak and that the epidemic had affected the economy more severely in the second quarter than in the first.

Ping An Securities Analysts contend that UK banks' provisions for non-performing loans are higher than those of other European banks, primarily as a result of the pandemic's severe impact on the country and the ongoing impasse in talks with the EU over a future free trade agreement [10]. The UK economy is expected to contract by 11.5% this year, and the eurozone by 9.1%, according to the OECD. In the absence of a second pandemic and a free trade agreement with the EU, according to the Bank of England, the economy will contract by 9.5% this year and not recover to pre-pandemic levels until the end of 2021.

4. Market Risk

Sharp swings in financial markets in the United States and Europe inevitably added to the pressure on the financial system. In the month since late September, 2020 the British government's "tax cut crisis" and the turmoil in the national bond market and the pension collateral crisis it triggered have further demonstrated the fragility of the British financial market. A hedging link between banks' net interest income and asset quality results from the typical negative correlation between interest rate levels and economic growth (prospects). The current growth of banks' net interest income can largely offset the adverse effects of economic growth slowdown. Another example is that the British banking industry has strong competitiveness worldwide, enabling it to form a huge global business system that can hedge regional risks through global asset allocation.

5. Conclusion

The financial system has been strained recently by changes in the financial markets in Europe and the United States, and the Bank of England's financial stability report for mid-2022 warns that inflationary pressures, sluggish economic growth, and tighter financial conditions will have a negative short-term effect on the financial position of UK households and businesses. The fragility of global debt is also likely to amplify pressures on UK financial stability, including exposure to Eurozone debt risk since June. The "tax cut crisis" and turmoil in the national bond market triggered a pension collateral crisis, putting pressure on pensions and creating a vicious circle. However, the UK banking system has ample liquidity, allowing it plenty of scope to accept pension deferments, or temporary payments on low-quality assets, rather than proceed.

Active risk management initiatives cover at least three areas. One is to hedge against exchange rate shocks through global operations. For example, HSBC's geographic diversification provides a significant hedge against currency movements. The second is to dispose of risky assets in a timely manner. HSBC promptly disposed of its operations in Russia, Greece, and other regions against the

backdrop of the outbreak of conflict between Russia and Ukraine and European debt risks. The third is to reduce costs and increase efficiency. In the context of expected weaker revenue, HSBC launched "Cost-Saving Initiatives" in time to reduce expenses, and its company-wide performance-linked compensation regime has also made spending and revenue more closely matched.

HSBC's operating expenses (adjusted) for the first three quarters of 2022 are \$24.4 billion, down \$700 million, or 3%, year-on-year, including \$1.7 billion in "cost savings program One step puts pressure on pensions, creating a vicious circle. This also explains why the Bank of England launched the Temporary Expanded Collateralized Repurchase Facility (TECRF) to guide banks to accept more types of assets as collateral for pension investment, which can have an immediate effect. This shows that on the premise that the fundamentals of the British banking industry are sound, it is not difficult to resolve the partial "liquidity crisis" in the MBF system.

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