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# Addressing the Pandemic of Loan Defaults in a Post COVID World

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As COVID-19 lockdowns disrupted supply chains, stalled production, and upended established commerce channels, businesses across the world faced losses and eventual shutdowns. Small and medium businesses were particularly impacted and over 400 million full time jobs were lost in the second quarter of last year.**1** Banks form the nerve center of business and economy, and they will inevitably bear the brunt of this crisis. Industry estimates suggest up to 80% of businesses could default on their bounce-back loans.**2** The impact of such large-scale loan default will undoubtedly be significant, and the sector will likely need to make some strategic realignments to recover and grow in the months to come.

## The Scale of Loan Defaults Caused by COVID-19

Non-Performing Assets (NPA) of almost all US banks show a 22 percent increase at end of Q2 2020 when compared to the data at the end of 2019.**3** Reports indicate that NPAs of Indian banks is likely to double by the end of the current fiscal year. And the global economy is expected to contract significantly over the next few months, forcing the US alone to bear loan related losses to the tune of over $700 billion.**4** The annual provisioning exercise done by most banks and financial institutions has been rendered redundant given the scale of disruption. But banks have learnt from earlier financial crises like the Great Depression and global recession of 2008 to create reserves to protect against bad loans. For example, top US banks JPMorgan, Citigroup, and Wells Fargo collectively set aside $28 billion in the second quarter of 2020 for bad loans.**5** The Bank of America has provisioned over $4 bn to cover loan defaults due to the pandemic.

Of course, Governments of almost countries around the world have already announced various fiscal aids and moratoriums to help debtors' tide over this crisis. But they will need to continue supporting the sector with supportive policies as they try to recover.

Fintechs are not immune either. The last decade has seen a substantial rise in fintech led personal loans that include home loan, vehicle loan, credit card, consumer durable loan and education loans and even loans for smaller items for lower amounts. Most of these small ticket loans are taken by mass market workers with no job security. Such loan seekers are likely to be caught in the loan stacking

phenomena where they take one loan to pay off another, creating a never-ending cycle of debt. Unfortunately, fintechs offer most of these loans to beef up their lending portfolios and their customer numbers. They also do not ask for significant assets as assurance against the loans, which attracts these customers. Such low value assets are not enough to offset the loan amounts in case of default. And a large number of bad loans can put tremendous strain on a fintech's capital structure and might even wipe out its entire net worth.

**Strategies for Recovery and The Technology That Will Power Them**

Borrowers must eventually either repay their loans or default. And in the latter eventuality, just provisioning capital is not enough, banks must also help the customer by offering additional loans or interest waiver options. The Bank of America has processed over 334,000 Paycheck Protection Program loans to the tune of $25 billion to small business owners.**7** It has also processed over 1.8 million loan deferrals. In the UK, the British Business Bank and trade association UK Finance have started discussions with commercial lenders to set new standards for debit collection. As of July 2020, UK lenders have approved more than 1 million loans worth £45 billion including loans offered under the Coronavirus Business Interruption Loan Scheme, as well as the Bounce-Back Loan Scheme.**8** Banks must work together to formulate an industry wide code of conduct on loan defaults and collections which must be borrower friendly and constructive. After all, most defaulters are victims of circumstances and how banks treat them in their moment of crisis will determine their relationship and loyalty with the bank in the future.

Right now, banks must focus on identifying loans that have the potential of turning bad. This is not as difficult as it sounds, because even though some pre COVID-19 rules could be obsolete there are still many other factors determining loan repayment such as moratoriums, duration of recession, pace of economic recovery etc. Banks must adopt a portfolio approach that considers key factors like the type of loans, the industries in which they have exposure, their capital and liquidity situation etc. Many banks are starting to pull back from certain segments and product categories. For example JP Morgan Chase stopped accepting new home equity line-of-credit applications and Wells Fargo recently stopped auto loans via independent dealerships in the US as the auto sector has taken a huge hit this year and Wells Fargo considers it risky. Banks could also consider creating a non-performing exposure unit with experts from different departments in the bank to monitor and react to the changing economic situation.

The best choice before banks and NBFCs is to still grow their loan business. Identifying creditworthy customers should be a top priority. While the credit score of individuals is a good place to start, banks must go beyond segment-based analysis and risk profiling. Given the disruption the world is going through right now, the data traditionally used in credit risk assessment is obsolete and using data dating back more than 6- 12 months will not be sufficient to determine current creditworthiness.

Now more than ever, banks need to invest in cutting edge data analytics solutions that can correlate real time data analysis with historical data to give intelligent accurate insights. Artificial Intelligence and Machine Learning are now no longer good to have technology investments. They are crucial for carrying out the real time, large scale data analysis that banks need right now to recover from this situation.

Of course, the banking sector had embarked on its digital transformation journey sometime back. But right now, the pace of this transformation must be accelerated and new technologies like AI and ML implemented immediately. Digitizing legacy banking cores to handle deployment of modern technology is not just expensive and time consuming but also risky considering the sensitive nature of the data they hold. A third-party middleware that can sit on top of the core to host technology solutions and orchestrate data from the core is a good way to ensure an agile IT system for banks.

The good news is that the pandemic has led many financial institutions to step up their digital strategies and adopt new technology-based credit risk models. After all, the future of their business depends on it. Through every crisis in history, the banking sector has used their experience to come up with strategies to safeguard their business from future shocks. The COVID19 disruption is no exception. It will serve to accelerate digitization as banks work towards improving resilience. This is an opportunity to improve process and serve the customers better and the banking sector will no doubt leverage it to its fullest.

**Sources:**


**1**ILO
**2**The Guardian
**3**BankRegData
**4**McKinsey
**5**Business Insider
**6 & 7**Fox Business
**8**S & P Global



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