COVID-19 Recession: Hope for a sprint, plan for a marathon

By Joseph L. Breeden, PhD

Economically, this is the most uncertain period in our lifetimes. The range of possible impacts of COVID-19 on our financial well-being is greater than any previous event on record. A nation-wide natural disaster has never occurred before. A natural disaster that starts as suddenly as a hurricane, yet keeps growing in force over weeks or months is unprecedented. No one can know with even the ordinary level of uncertainty what the rest of 2020 will hold. Even if never before in your professional career, this is the time that you must stress test everything you do.

Everyone hopes that the shelter-in-place policies being enacted now, though devastating to the economy, will be the lifeline needed by hospitals and medical workers to deal with the wave of serious COVID-19 cases. We all hope that if we come together as a society and adhere to these rules, the spread of the disease can be brought down to a low enough level that nearly normal life can resume. We hope that for our customers, this is a short, narrow financial shock and we can sprint together with them across a finish line that might be only a couple months away. We hope.

Businesses that run on hope too often fail. Disaster plans cannot be based upon hope. We need to consider the range of possible outcomes and make sure that we are prepared to deal with what realistically could happen. Early data on COVID-19 suggests that we need to plan for a much longer-lasting event. We need to prepare our business and our customers for the all too real possibility that this is just the first mile of a marathon ahead of us. If we plan for that possibility, we maximize the chance that we cross the finish line together, whenever it arrives.

The Range of Possibilities

In February 2020, when we knew that COVID-19 was coming to the US, the closest precedent was the Hong Kong SARS Recession in 2003. I worked with a major bank in HK at that time and it offers some useful lessons, but also important differences. Early expectations for the COVID-19 impact on the US were for a V-shaped recession because of what happened in Hong Kong. The fear of catching SARS caused businesses to close, house prices to fall, and unemployment to rise. For one quarter, GDP plunged, but as soon as the disease dissipated, the economy rebounded strongly. Hopes for a short wave of COVID-19 infection in the US and corresponding V-shaped recession could be called the COVID-19 Mild Recession scenario. The $2 trillion rescue package just passed by Congress confirms that the Mild scenario is unlikely at this point.

A more likely outcome is that shelter-in-place requirements and dramatically reduced business activities cause a significant reduction in GDP through the Spring and Summer before stabilizing. Unemployment, already spiking in March faster than ever seen before, would reach recessionary levels approaching 10% after adjusting for government programs to encourage businesses to retain workers. Although the onset of the recession would be faster than ever

seen before, the duration would be short with a very strong rebound by the end of the year. The net impact of all this volatility would look like half of the 2009 recession, although with the stresses coming in difference industries and loan types from the last recession.

The worst-case scenario is not as unlikely as we would like. With a true end to COVID-19 at least 12 to 18 months away, recurring waves of infection could sweep the US. Hong Kong is already into its second COVID-19 wave, proving the concept. Also, looking to Australia we see that cases rose from 70 to 2,400 in two weeks, during their hot summer. We cannot count on summer beating the virus. The economic impact would be a prolonged recession, possibly reducing US GDP by 5% to 6% for 2020 and the GDP growth stabilizing in early 2021 at a lower level. Even with government supports, unemployment could top 15% and remain there for many months.

The greatest risk in the prolonged recession scenario is that it triggers a wave of defaults in C&I, CRE, and Small Business lending. With the dramatic, leveraged loan growth in this section, this is the real risk of a replay of the Great Recession. So far, the Federal Reserve appears ready to buy as much corporate debt as necessary to prevent that from happening.

Portfolio Implications

Just as we have never seen a recession as suddenly severe as with COVID-19, we have never witnessed such an immediate government response and of such magnitude. As we move toward more severe economic scenarios, we expect additional waves of government support. In the Hong Kong SARS Recession, we learned that the best way to model recession from an epidemic was to look at consumer response to economic conditions rather than trying to model the number people who were sick. The US government response is so intense this time, that loss forecast models looking at macroeconomic factors will over predict the consequences to consumers, so neither number of confirmed cases nor level of unemployment will truly express the net impact on consumers.

With no historic data on a comparable pandemic, our only path is to run our models against macroeconomic data and incorporate qualitative adjustments (Q-factors) to dial the results back some amount to compensate for government assistance. The Coronavirus Aid, Relief & Economic Security (CARES) Act is a $2 trillion attempt to prevent exactly what our models would predict, but no government program will be able to erase all effects, so reality will be somewhat less than the unadjusted model forecasts but not negligible.

Examiners and auditors often dislike negative Q-factors, management judgment reducing loss estimates from models, but this is a clearly valid exceptional case. Perhaps the best approach is to assume that the COVID-19 Severe Recession will occur, but assume that portfolio losses will look more like the COVID-19 Adverse (median) case.

Lender Actions

“Good” outcomes for lenders will not be achieved without aggressive action and some amount of pain. This is where lenders must plan for a marathon. If otherwise good borrowers will be

distressed for 6 to 12 months, but we are convinced that a strong rebound will happen eventually, how do we get them there? Hardship programs, loan rewrites, and other support programs must consider that the stressful period could be lengthy.

From a collections perspective, expect the payment hierarchy to shift. With large numbers of people out of work or working from home, the vehicle may be the least useful asset. Payment and foreclosure moratoria on mortgages mean that consumers might stop paying those early as well. In a home-based economy, credit cards and lines of credit may be the greatest asset to both consumers and small businesses.

Consider also how to lend through the crisis. Governments are encouraging lending and are offering substantial support to do so, but this still must be thoughtful. The crisis is a very industry-specific event. While many people are suddenly without work, others in critical infrastructure industries are working harder than ever to support society. Both groups may may continue to be good credit risks, but what kind of loans does each group need? Those 0% teaser rate credit cards, targeted to the good consumers, look like an ideal way to help borrowers across this chasm and obtain longer-term goodwill.

This is a different kind of crisis, and it creates an opportunity to go beyond marketing clichés and really forge partnerships between lenders and borrowers. Our society needs both to bounce back stronger, the way we hope.

The COVID-19 Mild, Adverse, and Severe Recession scenarios described above are available to Profitstars CECL customers from ScenarioAI.com at 50% off the regular price. Contact us for how to use these in your loss forecasting.