

INSIGHTS

Are the financial markets ready to weather the COVID-19 Storm?

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The current COVID-19 pandemic is causing significant concern in the financial markets, reviving memories of the 2008 financial crisis. The sudden and almost complete shutdown of many non-essential businesses due to the mandatory 'social distancing' requirements has resulted in a wave of business closures, factory shut-downs, lay-offs and government-backed furloughs in many countries across the world. The UN's trade and development agency estimates that the slowdown in the global economy caused by COVID-19 is likely to cost at least \$1 trillion.

The financial crisis of 2008 resulted in a renewed focus from regulators on ensuring that financial institutions held substantial buffers in terms of capital and liquidity (Basel III, CRD IV, etc) in order to establish safeguards in the event of another severe economic downturn. As no one expected that a global pandemic would break out with such universal consequences in the twenty-first century, the financial market is experiencing an unexpected shock as a result of COVID-19 coupled with the increased stress of a sudden and, arguably, equally unforeseen, drop in oil prices caused by a glut of supply resulting from the collapse of the OPEC plus production consensus.

This article will explore the effects of COVID-19 on the bank finance and project finance market as well as the wider ramifications of the pandemic on the financial markets.

How is COVID-19 affecting the debt market?

COVID-19 has rapidly impacted borrowers who, in many sectors, have consequently seen demand for their goods or services disappear in manner that is unprecedented in peacetime. As a result, the financial markets and credit committees of financial institutions all around the world are faced with making decisions in a climate that has an unknown trajectory, which adversely impacts any appetite for new or refinanced transactions.

In the project finance market, projects in the early development stage that don't have committed financing in place may struggle to raise debt in the timescales and manner the project sponsors originally anticipated. Projects that are under construction may experience delays in achieving project completion due to interruptions in supply chains as contractors and offtakers seek to invoke force majeure or change order notices. It is worth noting that the impact on project finance transactions will vary by sector, as many project financings are underpinned by long term offtake agreements which should not be impacted by the (hopefully) short term nature of the COVID-19 pandemic.

Material project agreements, including supply agreements, construction contracts, and operations & maintenance agreements will typically contain force majeure provisions. Force majeure provisions vary from contract to contract, but all will operate to excuse a contract party's failure to perform if such failure was the result of certain events of force majeure. These events may include natural disasters and other "acts of God," wars, general strikes and sometimes global pandemics. Non-performance or delayed performance under these material project agreements could potentially severely hamper a project ability to operate or complete the construction of its revenue-generating assets.

Moving away from project finance, given the current (near) economic and market shut down in certain sectors (such as, for example, aviation and hospitality), some borrowers face the real possibility of defaulting on their debt service obligations. If those loans are reclassified as non-performing loans (NPLs), there will also inevitably be a knock-on effect on impact on how much capital financial institutions have to carry on their balance sheets to compensate for the burden of these NPLs. It is for this reason that in the wake of the 2008 financial crisis the European Council was so keen to tackle this issue. In March 2018 the EC published a package of reforms aimed at reducing European banks' NPL stocks and preventing their future build-up. Other regulators, in particular in the Middle East, have followed suit. For example, the Central Bank of the UAE has put in place new requirements to enhance its reporting of non-performing loans (NPL) in an effort to align with international best practices.

Whereas the taxpayer was asked to bail-out many of the financial institutions during the financial crisis in 2008, financial institutions are now being asked, with government financial backing, to bail-out the tax payer. The amounts pledged by governments in the form of state-aid has been unprecedented in recent times. Regulators are asking banks to grant both private and business borrowers payment holidays, moratoriums and forbearance on their outstanding debt. Banks are being asked to use funds released by the relaxation of required capital and liquidity buffers (primarily a measure put in place to weather an economic downturn) to support households and businesses during the coronavirus crisis.

Notwithstanding all such efforts, what is becoming clear is that such measures will not be available for everyone and indeed, the market will witness a rise in the number of defaults and NPLs as a result of COVID-19. Banks have enjoyed record low NPL performance in recent years thanks to low rates and modest unemployment. That is over now.

With adversity comes opportunity

Whilst not expected at the beginning of 2020, the legal market will now inevitably transition to counter cyclical work as law firms will see an increase in restructuring, insolvency and litigation mandates. A number of borrowers with existing projects and outstanding debt facilities will inevitably be forced to seek the agreement of financial institutions on various forbearance measures. Financial institutions will be approaching such discussions with the knowledge that relevant governments and regulators are keeping a watchful eye on how these situations are resolved. Borrowers will be expecting financial institutions to respond positively to requests for forbearance in these unprecedented times. It is in everyone's interest that economic interests are preserved until such time as the world can emerge from the hibernation caused by the pandemic.

Conclusion

It is becoming increasingly clear that the role of banks, alongside a level of state intervention the world hasn't seen since the second world war, will be a crucial part of the reaction to, and eventual recovery from, the sharpest economic downturn in recent history. Although the Covid-19 pandemic is classified by the World Economic Forum as an 'exogenous' event (unexpected and unanticipated) compared to the financial crisis of 2008, which is an 'endogenous' event, some parallels can be drawn as to how the financial markets can react. Market participants are calling on financial authorities to help banks deal with the impact of COVID-19. Such forbearance could come in the shape of state guarantees or in the form of the relaxation of certain elements of bank capital requirements. Whilst we navigate our way through these uncertain times, what is clear is that the legal profession will play its part in implementing these measures as they filter their way through to individual transactions and contracts.