



WORST CASE SCENARIO MAY BE YOUR “BEST CASE” OUTCOME

September 2020



POINT OF VIEW | HOLLIS HART, SENIOR ADVISOR

US institutions and the US market are too optimistic about the overall US economy over the next 24 months. By underestimating the risks, leaders are missing a narrowing window of opportunity to protect their institutions.

The risk outlook is asymmetric, far more to the downside and little to the upside. We recommend leaders proactively move to protect operations, as these scenarios could lead to unprecedented financial and operational risks – unfortunately even in our Expected Case.

SCENARIO ANALYSIS

In developing this point of view, we examined the **three most probable ranges** of economic outcomes based on operating assumptions and developed recommendations for client actions associated with each.

1. **Expected Case:** 60%+ probability
2. **Upside Case:** 10% probability
3. **Downside Case:** 25% probability

More extreme downside outcomes represent the remaining 5% probability.

Additionally, we judge the possibility of a better than upside case as being less than 1%.

Based on our analysis, we foresee significant downside risk to credit and equity markets, increased personal and corporate defaults, and strained operations for many financial institutions – even in some of our more optimistic scenarios.

RECOMMENDED ACTIONS

We recommend leaders proactively consider the following activities regardless of expected outcomes to protect their organizations:

- **Lock in longer-term liquidity:** eliminate use of short-term funding. We envision there is a tangible risk to short-term liquidity availability at any price at certain points in time.
- **Investigate/Implement schooling alternatives** for staff.
- **Increase use of workforce productivity tools:** survey staff to determine major roadblocks.
- **Invest in cybersecurity** as cyber risks will increase dramatically.
- **Reduce expenses judiciously** as expense pressure will continue. Do not succumb to the temptation to release expensive, experienced middle managers, as these subject matter experts, tempered by business cycle experience, will be critical to success – maybe even survival.
- **Continue to review supply chain processes:** Assume that the likelihood of further deterioration in links with China is probable regardless of the outcome of the election.
- **Review currency mismatches** in global operations, with a focus on avoiding being short US dollars in case there is a continued global freeze. Running a “squared” position would be recommended.
- **Stress test operations** to identify operating and cash flow break-evens and what actions can be taken (before) those break-evens are reached. Positive cash flow is the “existential” issue. Mistakes in other areas can be damaging to the firm’s share price and reputation – but can be survived.

NAVIGATING THE EXPECTED CASE...

PRIMARY OPERATING ASSUMPTIONS

1 Treatments

A vaccine(s) and/or other treatment options will be identified, produced, and distributed by the end of the second quarter of 2021.

2 Policy Response

Regardless of which party wins in November, the Administration and Congress will pass legislation that enables the Treasury and Federal Reserve to:

- Provide material and massive financial aid and liquidity to the markets.
- Support state and municipal governments up to the level of COVID-created funding deficiencies (but not deal with pre-COVID deficits).
- Operate as the “market maker of last resort” across multiple asset classes, possibly including equity ETFs.

3 China

China will experience positive growth (in the 3% range); maintain a somewhat stable economy limited by reduced domestic demand; and return to purchasing global commodities in reasonable quantities – but will not be as significant of a global growth engine as over the past 15 years.

4 Consumer Behavior

Individuals align behaviors close to CDC recommendations with respect to social distancing and the use of masks.

5 Inflation & Interest Rate

Overall interest rates (both real and nominal) will remain historically low. Inflation will also remain low on a macro-basis (2% range or less), but there will be micro-bursts of inflation, particularly where distribution channels break down to include certain food commodities.

ECONOMIC OUTCOMES

- **Schools will move close to the 75% physical enrollment range**, allowing parents to increase work focus to a level that comes close to – but stops short of – the pre-COVID era.
- **Unemployment will remain stubbornly elevated:**
 - Before the third quarter of 2021, a significant level of “real” unemployment will remain (in the 10-12% range), which will include discouraged workers who have given up looking for jobs. With many workers receiving materially reduced overall compensation, financial defaults will occur.
 - After the introduction of a vaccine (or other treatments), unemployment will remain stubbornly in the 8-10% range. Workforce participation, both in terms of the number of jobs and the “quality” of jobs, will remain a challenge for at least the following 12 months through the end of 2022.
- **Major industries will continue under severe distress** with entertainment, transportation, retail, energy, education, and real estate particularly severely impacted (to include record bankruptcies filings).
- **Fixed income markets will remain relatively stable** among the higher-rated credits; **equity markets may trade down significantly**, but with continued sharp spikes in volatility.

Economic uncertainty could result in unprecedented financial and operational risks even within our Expected Case.





A REVIEW OF DOWNSIDE AND UPSIDE CASES

DOWNSIDE CASE CONSEQUENCES

Our downside case rests on the following key assumptions:

- **Politics become even more muddled with a disrupted November election.** The Administration and Congress cannot find timely bipartisan agreement on public policy execution, and therefore, support activity is limited and fragmented. Signaling to the population continues to be inconsistent with CDC recommendations.
- **Vaccine(s) introduction is delayed in development, distribution, or market acceptance** through late 2021 or 2022.
- **Schooling for children remains problematic** and less than 50% of school-age children can attend in person on a five days per week basis.

Any of the above alone will result in severe negative consequences for the US economy including but not limited to:

- **Federal failure to speak with one unified science / health voice** leads to counterproductive behavior in terms of mask wearing and social distancing.
- **Individual bankruptcies will skyrocket to unprecedented levels.** Given the ongoing stress of consumers and businesses, bankruptcies will spread beyond the industries identified in the Expected Case.
- **Financial distress will accelerate the failure of many colleges**, adding to unemployment.
- **State and municipal governments will be short of tax revenue and have limited borrowing capacity**, thus necessitating the need to cut services; this scenario will make it even more challenging to help those most in need.
- **The lower-rated credits in the fixed income market will see a major decline in prices; and the equity markets will suffer a major retrenchment.**

UPSIDE CASE OUTCOMES

Our upside case is driven by the following assumptions:

- **Increased bipartisan cooperation** between the Administration and Congress, resulting in major infrastructure investment activity.
- **Strong proactive support for the unemployed.**
- **Material support to educational institutions at all levels**, particularly for children.
- **State and municipal assistance allows local governments to maintain services and provide support** to the significant number of those in need (in terms of food, shelter, and other benefits).
- **Early confidence in the safety of work, shopping, and travel.**

We believe the likelihood of the upside case remains slim; proactive planning for the worst-case scenario may be your “best case.”

Leaders should consider acting now to mitigate financial and operational risks that we believe are highly probable events in the current environment.



ABOUT REFERENCE POINT

Reference Point is a boutique strategy, management, and technology consulting firm focused on delivering impactful solutions for the financial services industry. We combine proven experience and practical experience in a unique consulting model to give clients superior quality and superior value. Our engagements are led by former industry executives, supported by top-tier consultants. We partner with our clients to assess challenges and opportunities, create practical strategies, and implement new solutions to drive measurable value for them and their organizations.

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HOLLIS HART

Hollis Hart is a **Senior Advisor** at Reference Point and a member of the firm's Advisory Board. In his role, Hollis focuses on supporting strategic planning, global governance best practices, work with FinTechs/RegTechs, and risk service offerings.

Hollis held senior roles at Citibank, spanning global business management, governance, audit, and risk. Most recently, as the President of International Franchise Management (IFM) he had responsibility for the country heads managing Citi's 100 presence countries, oversaw the global governance framework, supported home/host regulators, and the 40+external country boards. Hollis also served as a member of Citibank's Risk Committee; the Global AML, Compliance: Legal Entity, Vendor and Sovereign Risk Committees; Cyber oversight; and Women4Citi. Other responsibilities included the Global Management Program (GEMA); and the Military Equipment Policy. Previous roles included: Asia M&A Head, Asia Real Estate Head, U.S. Banks Head, Tokyo Corporate Bank Head; Japan Merchant Bank Head; Transaction Services Global Risk Head, International FIG Risk Head, and Global Trade Risk Head; Latin America Broker-Dealer Risk Head. In addition, Hollis was also asked to support the newly created Alternative Assets Group as its first Global Risk Head.

ABOUT THE AUTHOR

Hollis has leveraged his deep understanding of the global financial services landscape, dynamic regulatory environment, and risk management best practices in various board and advisory positions throughout his career. Most notably, he has served as Chairman of the American Bankers Association's (ABA) Corporate Banking Committee; as a Board Member for RMA's Global Advisory Board, Korea Society, and BCIU; and as Trustee and an Executive Committee Member for the Committee for Economic Development. Hollis currently serves on the Boards of the Moa Bay Mining Company and the Cuban American Nickel Co. He is a Senior Fellow of the Conference Board. Hollis consults for private sector and public/regulatory groups on global risk concerns and best practices in aligning emerging FinTech and RegTech activity with legacy financial institutions.

Recent publications include the *American Banker* and **Smart Regulation** (available on Amazon).

Hollis has a BA:Yale College, MBA: The University of Chicago, and was a Rhodes Scholar finalist.

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