How to make the most of a downturn

Financial services

The U.S. is in an economic downturn, with growth slowing and expectations of a recession rising. How can financial companies weather the downturn and position themselves for success during and after it? In this article, we discuss responses to the KPMG Q2 2022 survey of senior financial services executives, and share steps recommended by KPMG financial services specialists that you can take now.

What to prepare for

Almost seven out of 10 (69 percent) survey respondents were at least somewhat concerned about the U.S. economy, particularly those in the banking, capital markets, and insurance subsectors (72 percent). While 45 percent of respondents thought that the U.S. would enter into a recession in the coming 12 months, insurance executives were most concerned (52 percent). A similar pattern applied to the potential length and severity of a recession: 40 percent of insurance executives thought it would last more than a year, compared to 33 percent of all respondents, and 43 percent of insurance respondents expected it to be severe, much higher than the aggregate expectation of 31 percent.

Respondents' appetite for mergers and acquisitions (M&A) considerably varied. More than half (54 percent) of banking and capital markets executives—the highest subsector share, by far—said their companies were unlikely to make acquisitions. A similarly outsize proportion of insurance respondents (43 percent), by contrast, believed their companies would pursue high-impact deals. Nearly one-fourth (22 percent) of asset management respondents expected to make high-impact divestments, versus 10 percent in insurance and just 3 percent in banking and capital markets.

How companies are getting ahead of the downturn

All companies must be prepared for an economic downturn. Even casual observers of the business world would take this as a given, but among financial subsectors, the proportions of those with an existing plan significantly differed. Three-fourths (75 percent) of banking and capital markets respondents said their companies had either a comprehensive or high-level downturn plan; the corresponding numbers for insurance and asset management were 52 percent and 44 percent, respectively.

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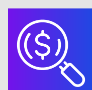
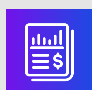
The biggest recession-related concerns and most likely actions for each subsector were:



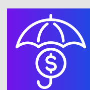
Asset management

Investors want products that outperform the market or deliver market performance at low cost. Intermediaries are focused on fewer providers and have reduced shelf space. Parties with products at both ends of the barbell will win, while those in the middle who do not have scale will struggle.



Banking and capital markets

Not surprisingly, a slowdown in loan demand also was the greatest worry (60 percent) for banking and capital markets respondents, whose most likely action would be to tighten credit requirements, as well.



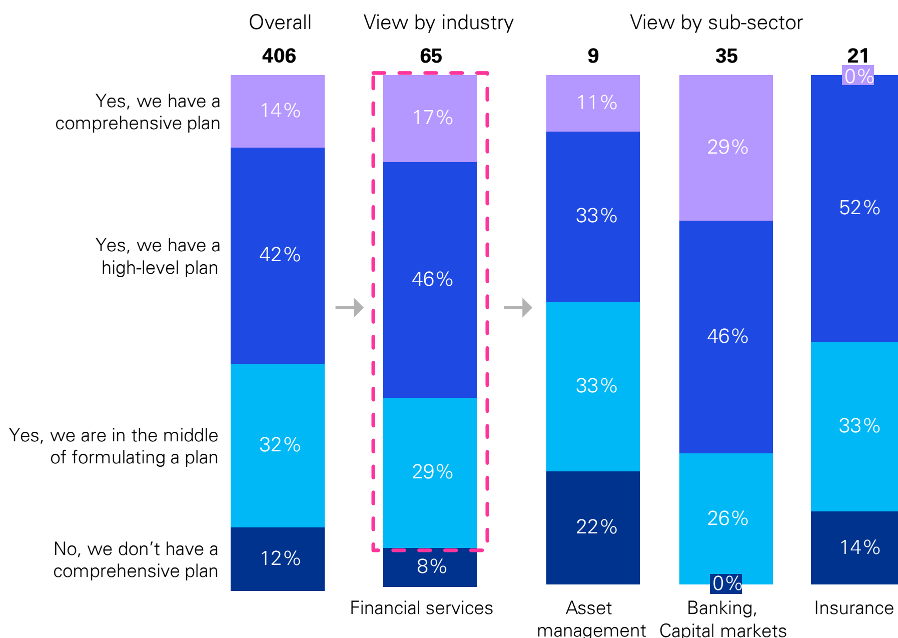
Insurance

Insurance carriers don't expect to be as severely impacted as they were during the last recession in 2008–2009. After a decade of growth, insurers are well capitalized, with a healthier balance sheet risk profile. Inflation in loss claims costs is a bigger concern due to higher auto repair, housing materials, and labor costs. The most likely action would be higher premiums on policies, which again could be impacted if the economy further weakens and individuals and businesses begin to feel the effects.

Downturn preparedness differs among financial subsectors

On a scale of 1 to 5, how concerned are you about the U.S. economy?

(N=406, all respondents)



Source(s): Economic Slowdown Survey results

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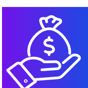
What to do now

Inflation, rising interest rates, and economic downturn affect financial subsectors differently. While one might expect this environment to be uniformly negative among subsectors, it isn't—and companies that are well prepared could benefit in the short term while positioning themselves for stronger growth in the future.

Here's what KPMG specialists think about what's going on in key financial subsectors and what companies can do about it:

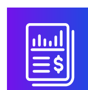
Asset management. Traditional asset managers face stresses on AUM due to market performance combined with an increasing cost of capital as interest rates rise. Managers of less liquid assets (private equity, private credit, venture capital, real estate) face tailwinds from institutional investors' increased allocations to public pension plans and sovereign wealth funds.

To fight back, AMs should slash costs, add scale through complementary acquisitions, or consider joining forces with a competitor. It's also worth noting that the forces that have driven industry consolidation for years—fee compression, rising costs, product-line expansion—are intact and expected to stay that way. In traditional asset management, niche performers and active managers who demonstrate sustained market outperformance and offer passive products that deliver market performance at low cost will win shelf space. For managers of less liquid assets, continued focus on performance and client, relationships will spur growth.



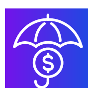
Banking. Rising rates generally help banks by enabling them to charge more for loans and attract more deposits via higher-yielding savings accounts. But these benefits are offset by slower economic activity and less demand both for consumer loans and corporate financings.

The key actions banks should take are to cut costs, reduce credit risk, and divest non-competitive businesses. Those with strong balance sheets have an opportunity to make strategic acquisitions—of fintechs, most notably—at beaten-down valuations.



Capital markets. In the near term, volatility in financial markets should help capital markets firms in the form of higher trading volumes. Underwriting of corporate debt, furthermore, tends to increase as companies seek to lock in current rates in anticipation of tightening by the Fed.

Extraction of costs should be a priority for capital markets firms in a downturn. Leaner firms should not only see wider profit margins, but also become stronger acquirers or more attractive acquisition targets.



Insurance. The good news is that rising interest rates allow insurers to reinvest/invest their investment portfolio/premium inflows at higher yields. The bad news is that higher inflationary conditions and increasingly harsh weather events could drive higher losses and claims costs.

M&A offers insurers an opportunity to optimize their portfolio of businesses and most effectively deploy their capital toward future growth and innovation. Whether deals are offensive (i.e., buying businesses that can boost growth) or defensive (i.e., selling units that are unprofitable or have low growth prospects), insurers can use M&A to deploy capital for their strategic advantage in a downturn.

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How KPMG can help

KPMG works with financial services clients to maximize growth, earnings, and value throughout the business cycle. In the current environment—with expectations of an economic downturn along with a high degree of uncertainty—the challenges we work on with banks, capital markets firms, asset and wealth managers, and insurers include the following:

Efficiency improvement: We collaborate with clients to identify efficiency improvement and cost reduction opportunities across their full cost structures, including process redesign and digitization; review of employee staffing levels and costs; review of procured cost base; redesign and virtualization of technology infrastructure; optimization of branch network and other physical location costs; and redesign of corporate functions and shared service models.

Portfolio review and strategy: Review of credit and asset portfolios to develop early warning indicators of potential distress; to revisit sectoral and concentration limits; to consider adjustment of unutilized credit lines; and to identify opportunities to overweight sectors that are likely to be less sensitive to (or in some cases even to benefit from) an economic slowdown.

Model review and recalibration: Many predictive models employed by financial institutions have been trained on parameterized data that predates potential regime shifts. Consumer credit models are trained on defaults that predate the blossoming of the gig economy, commercial credit models that do not reflect recent supply chain stresses, and deposit behavior models developed with data from an era when moving money might require a branch visit rather than a few clicks on a smartphone. These are all good candidates for review and adjustment, or reparameterization, heading into the next downturn.

New product and service opportunity development: Downturns and inflationary pressure aren't just challenging for financial institutions—they're also challenging for financial institutions' customers. We work with our financial institution clients to identify new opportunities for them to help their customers respond to these pressures. This might mean improved cash forecasting and liquidity management practices for commercial treasurers, or energy price hedging products for consumers.

(A different kind of) recovery planning: We also work with clients to look past the coming downturn. Our focus is to help clients ensure they are positioned to capitalize on the eventual economic recovery. We identify clients and sectors likely to be "fast out of the gate" in the recovery, and confirm that adequate business development and origination capacity is preserved to capitalize on these opportunities. Carrying excess origination capacity through a downturn can be painful, but institutions that have to re-hire and re-build capacity during the recovery are likely to miss out on two to four quarters of growth.

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