Recent financial market events: Considerations and learnings that apply in the wider corporate world

Considerations for the Board and Executives

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What can we learn from recent events?

On 8 March, a bank and its primary regulator, the California Department of Financial Protection and Innovation (DFPI), publicly announced the bank's voluntary liquidation. Two days later, the DFPI announced it had closed the bank citing inadequate liquidity and insolvency, and appointed the Federal Deposit Insurance Corporation (FDIC) as receiver. There are a number of drivers of the current stress, but specific issues were a loss of consumer confidence, balance sheet mismatches and risk management challenges that collectively led to a depletion of the bank's liquidity, capital position and ongoing viability.

Further accelerated actions have been required in the banking industry since. Whilst Bank business models are quite unique to the sector, there are a number of points of read across that apply in the wider corporate space:

- Central banks have increased base interest rates at the fastest pace in recent history – from at, or around, zero to over 4% in the UK and US – faster than most expected - the tightening continues post these events.
- Loss of confidence can happen quickly – in a world dominated by social media and instant messaging, news (or rumour) travels fast and brand confidence can disappear in days or even hours.
- When there is a loss of confidence, the demand on liquidity is often much greater and more rapid than one plans for.
- Resilience plans may look effective on paper, but are they always able to be executed when the sudden need arises?

In the Middle East, banks' asset quality and balance sheets are constantly under scrutiny. As a consequence of this, banks have increasingly focused on further developing and enhancing their Early Warning Systems, to anticipate deterioration in credit and early signs of distress in corporates. Central Banks have also over the years tightened provisioning guidelines to ensure more transparency in reporting and recognizing non-performing loans early on banks' balance sheets and in ensuring that banks retain the appropriate amount of liquidity.

Funding for banks in the Middle East is generally stable and mostly from deposits, including a high proportion of government and government-related entity deposits, supported by sovereign debt issuance.

The economy, Middle East and global, and companies that drive it have generally responded well in the face of unprecedented events in recent years, but they have been bolstered in many cases by unprecedented support by states, ultra low interest rates and huge packages of liquidity from central banks, case in point being the AED 50 billion Targeted Economic Scheme (TESS) rolled out by the UAE Central Bank.

Companies have had to weather changes in business models and working patterns and significant increases in inflation driven by volatility and then recovery in demand, supply chain challenges, and conflict. The events of the last few weeks are understood to have been idiosyncratic and bank specific. They are nonetheless a reminder of the inherent risks all companies face, regardless of the jurisdiction, size and complexity.

The Covid pandemic and large scale restructuring cases in the Middle East such as NMC Healthcare, KBBO Group and Abraaj, illustrate the importance of effective governance and risk management to ensure prudent balance sheets and sufficient liquidity to weather an unexpected storm including a sufficient understanding of customer and supplier behaviour and contractual relationships.

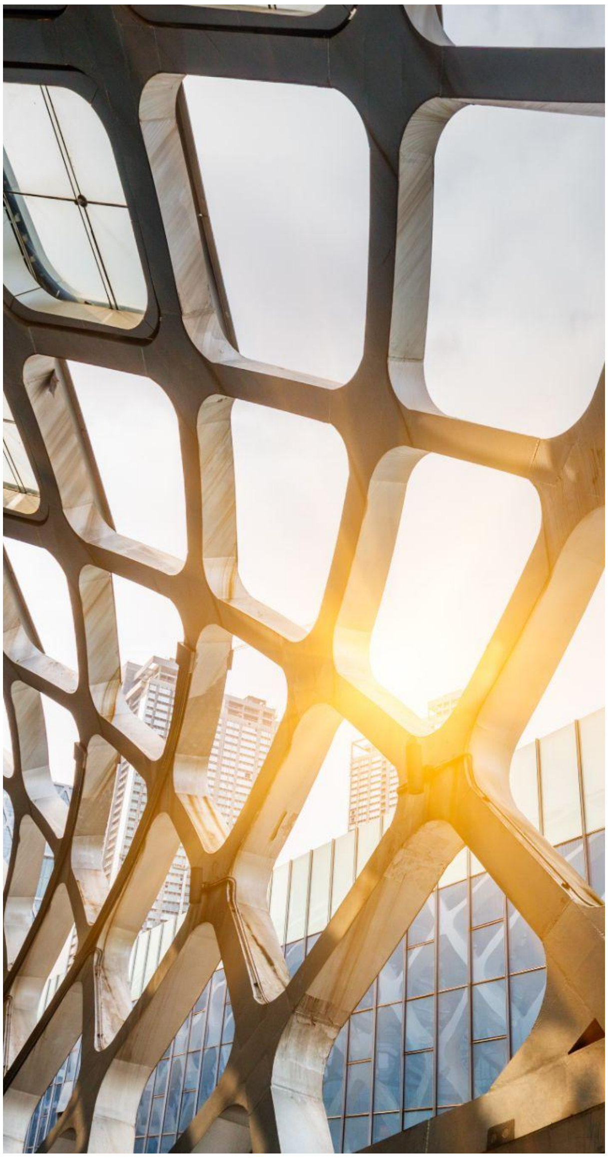
These recent cases have also highlighted the importance of using formal procedures such as the UAE and KSA bankruptcy laws to continue operations, restructure distressed businesses and ensure recovery for all stakeholders.

What can we learn from recent events?

So what should Boards and Executives be asking themselves to ensure effective governance and risk management?

- Has the approach to governance and risk management evolved to be sufficiently sophisticated and provide the necessary resilience required to navigate today's increasingly uncertain times?
- How resilient is the business model and growth strategy given the current changing geopolitical and macroeconomic dynamics specifically with respect to regional conflicts and fluctuations in oil prices?
- How is the potential impact (both in terms of quantum and speed) of public and market scrutiny managed, given perceptions and the risk of contagion spreading in a digital world?
- What risks are inherent in the company's third party ecosystem? Is the company aware of the legislative tools and changes in regulatory regimes that could affect and / or potentially benefit the company?
- Is the company prepared (and operationally able) to respond to the unplanned?

These questions become increasingly important specifically for family businesses in the Middle East, since they contribute a significant part of the GDP (60%) and employ more than 80% of the workforce in the region. In this document we provide some initial thoughts and questions on key areas and discussion points that company Boards should discuss and debate to manage their resilience in the current economic environment.



Questions companies should be considering to manage their resilience

Capital and liquidity	
Liquidity	In adverse trading conditions, required liquidity can often increase beyond what is forecast as suppliers demand tighter terms and customer payments can slow. • Do you have a robust and regularly updated short and medium term cash flow forecast, that is compared with actual trading and provides for a range of downside scenarios – approved by the Board and / or company management? • Have you considered your strategy should any debt covenants be triggered and facilities become unavailable? • Have you considered the liquidity impact of any margin calls on hedging / treasury positions?
Financing	Debt financing has become substantially more expensive and availability may come from alternative sources in the current climate. • Are you facing a refinancing event in the next 24 months – if so, do you have a strategy that is clearly executable? • Have you considered or enquired if your existing debt providers continue to have the appetite to provide financing? • Are you aware of alternative sources of debt financing and have these been appropriately explored? • Do you have forthcoming maturities or amortisation payments that will challenge your liquidity situation where it may be prudent to discuss an alternative route with lenders? • Do you need to consider a 'plan B', such as a balance sheet restructuring, consensually or by way of a formal process (Bankruptcy Process and Framework) to ensure the company remains in control and maintains optionality? • Is there any risk of breaching debt covenants and are you prepared for engagement with your lenders? • Are you monitoring your debt covenants based on both on, and off, balance sheet debt and do you need to disclose any off-balance sheet debt to existing lenders / investors? • Is funding from facilities being utilised properly? Are your short term facilities financing long term obligations?
Treasury	• Are your treasury policies and procedures fit for purpose? • Are deposits and banking facilities diverse enough to manage risk should a primary relationship not be available? • Where would your medium term liquidity come from in a situation where your primary relationship is not available? • As inflation, interest rates and commodity prices have varied, have you updated your hedging positions and strategy to reflect risk appetite?
Balance sheet	Suppliers, customers, and other stakeholders often rely on the quality of the balance sheet as one of the key financial data points when assessing financial resilience (and willingness to engage/continue engaging). • Does your dividend policy remain appropriate and provide sufficient room and runway to manoeuvre? • Do you need to raise equity to improve resilience? • If you have upcoming end of service benefit obligations, have you considered how your balance sheet decisions interact with your duties towards settling these?

	• In situations where there is either an existing, or risk of a net liability position, or where there is a risk that the business may not be able to pay debts as they fall due, are you taking appropriate advice around directors' duties? • Are you monitoring your contingent liabilities and are they in line with the demands of the business?

Supply chain and counterparties	
Credit insurance	Loss of credit insurance could lead to a request for a material change in credit terms from your suppliers. • Are you aware of the availability of credit insurance over your business to your suppliers? • How would you manage a change in availability based on trading performance, insurers appetite in your sector, or adverse rumour? • Do your banking facilities require credit insurance cover on your customers? How would the loss of credit rating for a key customer impact your liquidity if facilities became restricted?
Supply chain resilience	A sudden loss of a key supplier could lead to costly delays in provision of your own goods and services, overruns, claims, or loss of key contracts and customer relationships. • Do you understand your critical suppliers, including their financial and operational resilience? • What is your plan should a risk of failure in the supply chain arise – alternative supplier/provide short term support/rescue supplier? – Are you prepared for the structuring of any support?
Counterparties	Being able to find and search all the details of your counterparties and contracts help with risk management, efficiency, and is critical in a crisis. • Are all your customer, supplier and other contracts held centrally on an easily accessible and searchable platform?

Ability to act in a crisis	
Crisis or contingency plan	• Do you have a crisis or contingency plan in place? Is it fit for purpose, with a reporting and communications strategy, and key individuals (and substitutes if required)? Does it contain contacts for specialists and advisors as the situation requires? Does it contain a list of key questions and points that need answering at T0?
Operational capability to deliver in a crisis	In a crisis, operational volumes in certain parts of the business may be pushed beyond capacity, additional calls may be received from customers or suppliers, additional information may need to be processed, finance, operational, or legal teams may need additional support. Existing teams may not be available. • Have you considered where additional resource, support, or surge capacity would come from to deliver critical functions? • How can I use digital tools most effectively in such a situation?
Communication strategy and plans	• Has the company recently evaluated its investor, supplier, customer and other stakeholder communication plans in the event of adverse events, rumour or poor performance? Do the scenarios considered adequately cover current risks, including the impact of social media?
Succession plans	• Is there a succession plan in place for family-owned businesses? Has this plan been discussed with key stakeholders (management, lenders etc.) and is there a plan in place to transition to new shareholders, if required?

No regrets moves	
Cost base	Peak inflation *may* be behind us, the labour market is softening in places and supply chains are becoming more consistent. • Are you finding that you have over-invested in your human capital – do you need to make plans to adjust this? • Have you considered where the balance of supply and demand may now have tipped in your favour and contracts could be renegotiated? • Have you got a view of excess cost that may be able to be removed from the business?
Working capital	In the higher interest rate and capital cost environment cash released from working capital can be a 'free' contribution to your liquidity profile. • Have you reviewed your working capital efficiency – is it optimised? • Are there any quick wins that can be achieved to alleviate any immediate liquidity pressures?
Non-core	Poor performing or non-strategic divisions can be a drag on the value of your business, consume working capital and require excessive management time. • Have you considered tactical, rapid, divestments of non performing or non core divisions and the release of value, working capital and time this could create?

Middle East Restructuring leads

This document contains themes and questions that are relevant to a broad cohort of businesses or are situation focused. For an industry or sector specific lens please engage with our restructuring experts in the Middle East region

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