Banking Sector Regulatory and Supervisory Response to Deal with the Impact of Coronavirus

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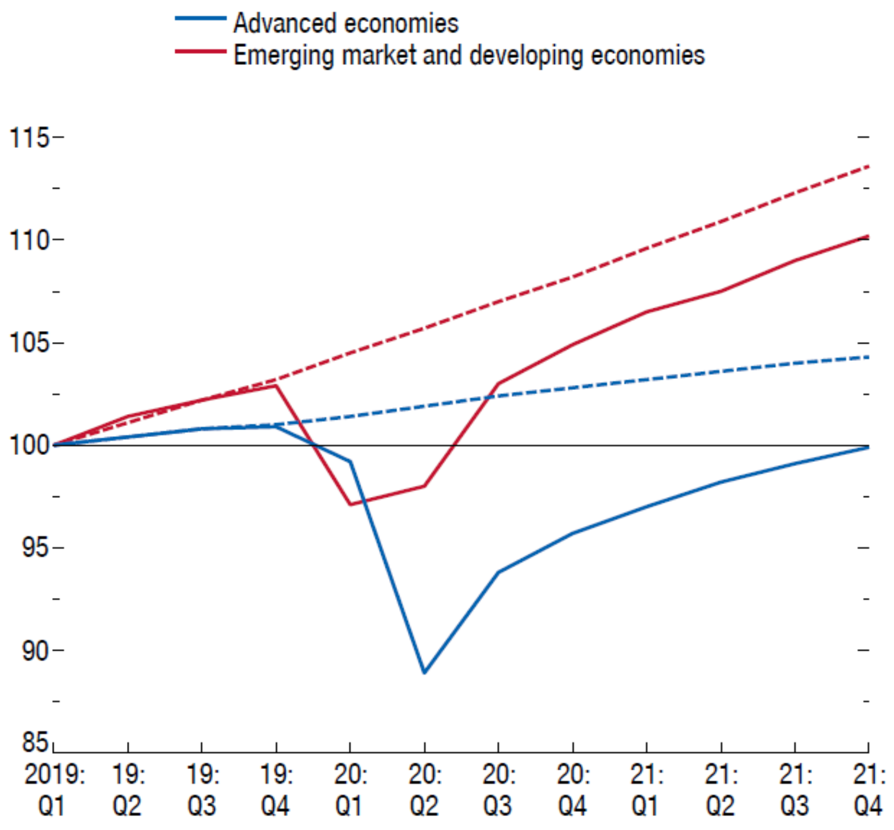
The COVID-19 pandemic is testing the resilience of the banking sector

Figure 1.6. Quarterly World GDP
(2019:Q1 = 100; dashed lines indicate estimates from January 2020 World Economic Outlook Update*)*



Source: WEO April 2020

What is the appropriate supervisory response?

MONETARY AND
CAPITAL MARKETS

Special Series on COVID-19

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Banking Sector Regulatory and Supervisory Response to Deal with Coronavirus Impact (with Q and A)[1]

This note provides MCM views on the appropriate regulatory and supervisory response to deal with the impact of the Coronavirus pandemic that can maintain the balance between preserving financial stability, maintaining banking system soundness and sustaining economic activity. Post-GFC banking regulation aims to protect the interest of depositors and preserve financial stability. Relaxing these minimum standards can jeopardize these objectives and precipitate further financial instability. Many supervisors have developed an approach to dealing with such large-scale disasters through guidance built around prudent renegotiation of loan terms without lowering loan classification and provisioning standards. Banks' existing buffers should be used first to absorb the impact of the crisis. In cases where the impact is much wider and/or longer lasting and banks' capital adequacy is compromised, supervisors should take targeted actions, including asking banks to submit a credible capital restoration plan and monitoring its execution. In such cases, governments may also choose to step in with fiscal support to aid borrowers to repay their loans and finance their operations or to help banks absorb the implications of the crisis. Throughout this process, transparent risk disclosures and supervisory expectations on dealing with the implications of the outbreak will be important for market discipline to work effectively.

I. INTRODUCTION

COVID-19 is taking a toll on economies and banking systems across the world, particularly in hard hit countries so far. The highest impact on banks is related to their loan portfolios where many borrowers across different sectors are facing sharp collapse in their income, and hence difficulty in repaying their obligations as

https://www.imf.org/en/Publications/SPROLLs/covid19-special-notes#mfp

Agenda

- **Objectives of the Regulatory and Supervisory Response**
- Measures related to banks’ loans and financial assets
- Impact of the crisis on banks’ regulatory ratios (capital, Liquidity, etc.)
- Overall Supervisory Response to the crisis
- Key Takeaways and Conclusion

Broad Objectives

- Support economy and credit provision
- Preserve financial stability and healthy and sound banking system
- Maintain international framework

Use embedded flexibility and uphold minimum standards

- Encourage use of capital and liquidity buffers
- Ease macroprudential measures
- Suspend capital distributions

- Relax capital requirements that were above Basel standards

- Reduce minimum risk weights (SMEs / specific sectors)
- Reduce capital requirements below international minima
- Facilitate Capital distributions

Facilitate public and private policy measures – Minimize moral hazard

- Adjust regulation to reflect government support
- Facilitate restructuring of loans
- Provide guidance on the treatment of moratoria

- Relax large exposures and concentration limits

- Lack of exit strategy
- Disincentivize borrowers to resume payment

Provide guidance on asset classification and provisioning – Maintain transparency

- Guidance on loan classification, provisioning and disclosure
- Revise automatic reclassification for restructured loans

- Defer the impact of ECL provisioning on regulatory capital

- Freezing the classification status of creditors
- Extend the number of past due days for provision/ classification
- Relief of mark-to-market valuations.

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Measures related to banks' loans and financial assets (1)

- Supervisors should encourage prudent loan restructuring

- Need to uphold loan classification and provisioning standards while taking into account the heightened uncertainty about the crisis impact

- Prudential considerations and implications of some government announced measures: Loan payment moratorium, credit guarantees, etc.

- Views on Marked-to-Market relief measures

Measures related to banks' loans and financial assets (2)

- **Supervisors should encourage prudent loan restructuring**

  - Restructuring could take **many forms** (changes in payment terms and maturities, collateral requirements, interest rates and fees, etc.)

  - By providing a grace period, banks can help borrowers manage the temporary impact of Covid-19 crisis on their business and minimize their own losses

  - Existing rules provide **flexibility** to make a difference between short-term payment challenges and more serious LT solvency issues faced by borrowers

BCBS Guidelines on the Prudential Treatment of Problem Assets—Definition of Nonperforming Exposures and Forbearance

Measures related to banks' loans and financial assets (3)

- **Banks should follow certain requirements related to restructured loans**

Prudential (and regulatory reporting) dimension

- Loan classification and loan provisioning rules should **not be relaxed** (moral hazard and transparency issues).
- Banks should assess the capacity of repayment **under the revised terms of the contract**
  - Impact on the NPV? Loans subject to payment deferrals are not defaulted assets
  - Forbearance measure?
- Appropriate supervisory monitoring is needed

BCBS Guidance on Measures to Reflect the Impact of COVID-19

Measures related to banks' loans and financial assets (4)

- **Banks should follow certain requirements related to restructured loans (cont'd)**

<u>Accounting dimension</u>

- Whether restructured or not, loans could become **non-performing** (<u>Stage 3</u> under IFRS 9) and would require provisioning
- Some **performing** loans may also require higher allowances if:
  - Loans are moved between categories due to a significant increase in credit risk (loans moved to <u>Stage 2</u>)
  - ECL parameters are revised to reflect deteriorated economic conditions
- **Guidance** should be provided by supervisors

Measures related to banks' loans and financial assets (5)

- **Banks should follow certain requirements related to restructured loans (cont'd)**

<u>Accounting dimension (cont'd)</u>

- Current uncertainty poses **challenges** to the reliable estimation of losses
- When limited information is available, supervisors should provide banks **enough time** to assess whether borrowers are able to meet their obligations
- The forecasted cash flows of the loans should reflect banks' best estimate of the economic conditions that may exist **over the remaining life of the assets**
- Supervisors should explain to banks and auditors their views on the **range of economic scenarios** to consider in determining losses

Measures related to banks' loans and financial assets (6)

- **Banks should follow certain requirements related to restructured loans (cont'd)**

<u>Accounting dimension (cont'd)</u>

- Banks should take into account the implications of any **supporting mechanism** provided by governments and the **expected nature of the shock**
- Banks should not apply the standard mechanistically and should use the flexibility inherent in IFRS 9, for example to give due **weight to long-term economic trends**
- Relief measures such as repayment holidays or public guarantees should **not automatically** be a sufficient condition to move borrowers into Stage 2 ECL

Measures related to banks' loans and financial assets (7)

- **Prudential considerations and implications of some government or sector-wide measures**

<u>Exposures covered by sovereign guarantees</u>

- The relevant sovereign risk weight should be assigned to the exposure covered by the guarantee

- The existence of any credit risk mitigation should not exempt banks from performing the assessment of the borrower's unlikeliness to pay

While the guarantee may limit the losses for the bank should the borrower default, it does not affect the payment capabilities of the borrower

Measures related to banks' loans and financial assets (8)

- **Prudential considerations and implications of some government or sector-wide measures**

<u>General payment moratoria</u>

- Banks are in a better position than public authorities to identify loans that deserve to be restructured when borrowers are temporarily facing financial difficulties
- The response in several jurisdictions has taken the form of **general payment moratoria**
- Moratoria can be a useful tool in the face of a large exogenous shock but can give rise to **moral hazard**.
- This issue can be contained if the moratorium is **short lived, well targeted, and transparent**.

Measures related to banks' loans and financial assets (9)

- **Prudential considerations and implications of some government or sector-wide measures**

General payment moratoria (cont'd)

- If governments consider official moratoria useful in their specific circumstances, several elements should be considered to **mitigate risks to financial stability**:
  - Authorities should **avoid blanket moratoria**
  - The declaration of debt moratoria should not come from supervisors as it may **conflict with the supervisor's safety and soundness mandate**
  - Does **not remove the obligations** for banks to carefully assess the credit quality of exposures benefiting from restructuring measures
  - Banks and supervisors should continue to **closely monitor** credit portfolios

Measures related to banks' loans and financial assets (10)

- **Marked-to-Market relief measures:**
  - Important to maintain the confidence in the banking sector by ensuring that marked-to-market losses are not hidden:
    - "Marked-to-market relief" undermines transparency and market discipline
    - Changes to the capital framework aiming to filter potential negative impact also weakens the regulatory framework
    - When market illiquidity prevents the use of market prices, supervisors should carefully monitor banks' approach for asset valuation
  - Measurement and classification of financial assets are governed by accounting rules. Supervisors should ensure that banks observe the criteria for reclassification

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Impact of the crisis on banks' regulatory requirements

The regulatory response should be focused on <u>using the flexibility embedded in the regulation and supervisory processes</u> and should <u>avoid undue relaxation of prudential requirements.</u>

Capital

Liquidity

Regulatory Response to the crisis – Capital (1)

Available capital buffers should be used:

- Capital conservation buffer
- When already activated, Countercyclical Capital buffer could be released
- G-SIB and D-SIB buffers, where applicable
- Other types of buffers applied in some jurisdictions

Limit or Temporarily Suspend Capital distributions: (Div. Payouts, Share buybacks, etc.)

- preserves capital resources to support economy and absorb losses
- Reduces stigma associated with use of buffers and impact on dividend restrictions
- Precautionary step given the heightened uncertainty and in case of need of potential fiscal support

Regulatory Response to the crisis – Capital (2)

- **What if buffers are not available or not sufficient to absorb losses?**
  - Bank should submit a **credible medium-term capital restoration plan** that includes gradual restoration of capital taking into account market conditions and uncertainty
  - **Close supervisory monitoring and engagement** is needed while ensuring that the problem is only temporary.
  - The above targeted supervisory action should **focus on problems caused by the crisis** and not addressing pre-existing vulnerabilities.
  - For banks where the above actions are not feasible or sufficient, additional actions and coordination with other stakeholders may be needed.

Regulatory Response to the crisis – Capital (3)

- **What about jurisdictions that have not implemented Basel III yet?**
  - The targeted supervisory response described earlier is also applicable for these jurisdictions by having banks with compromised capital ratios submit a medium-term capital restoration plan.
  - For Jurisdictions that have **much higher capital requirements than international standards**:
    - Additional flexibility could be used, unless the excess requirements reflect specific institutional weaknesses or systemic vulnerabilities

Regulatory Response to the crisis – Liquidity (1)

- **The LCR is meant to be a buffer** and banks should be allowed to **use it** in case of funding or liquidity pressures.
- For banks with liquidity pressures or falling LCR:
  - **Close supervisory engagement** with bank to discuss the problem and immediate and longer-term measures and solutions
  - **Enhanced supervisory monitoring** should be introduced with focus on very short-term liquidity needs and options to address them
  - **Potential measures to restore liquidity levels** should be executed over an extended period of time avoiding additional stress on the bank or the financial system.
- Apply the same approach for banks that are subject to LCR thresholds in significant foreign currencies.

Regulatory Response to the crisis – Liquidity (2)

- **What about jurisdictions that do not implement LCR?**
  - **Supervisory flexibility** should also be exercised
    - Focusing on **engaging with the bank** to address liquidity pressures, both in local and foreign currency, in the immediate and short-term
    - Introduce **enhanced liquidity monitoring** with focus on very short-term liquidity needs
    - Discuss over the longer term **measures to restore liquidity levels** or other related prudential requirements in a way that avoids pressure on the market while maintaining confidence in the financial system
    - **Ensure transparency** in banks' reporting and recognition of any associated losses.

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Overall Supervisory Response to the crisis

- Issue guidelines on the flexibility embedded in regulation and on the prudential implications of official measures

- Review supervisory priorities and implementation timeline of new regulation

- Close monitoring and engagement with banks

- Ensure that supervisory responses are targeted to crisis issues and not to pre-existing vulnerabilities

- Promote transparency and clear communication

- Coordinate well to maintain financial stability (Globally / regionally and locally)

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Recommendations to guide national regulatory and supervisory responses

1. Use embedded flexibility and uphold minimum standards
2. Facilitate public and private support measures
3. Limit moral hazard – targeted and temporary
4. Provide guidance on asset classification and provisioning
5. Maintain transparency
6. Review supervisory priorities and suspend automatic triggers

Thank you

Q&As