Unwinding COVID-19 Policy Interventions for Banking Systems

The Joint Vienna Institute (JVI) Webinar
July 7th, 2021

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Monetary and Capital Markets
July 7th, 2021

Issues to consider in unwinding COVID measures

Outline

1. Initial policy responses and estimates of pandemic impact
2. General considerations on unwinding
3. Unwinding regulatory measures
4. Actions to promote financial stability

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Initial response measures vary across countries

Moratoria on

- Debt repayments
- Foreclosures and auctions (as well as eviction of tenants behind on rent)
- Insolvency proceedings (both new filings and existing cases)

Credit support

- Public guarantee schemes
- Term funding to banks to lend to firms
- Purchase of corporate commercial paper, bonds and asset-backed securities

Prudential and accounting rules

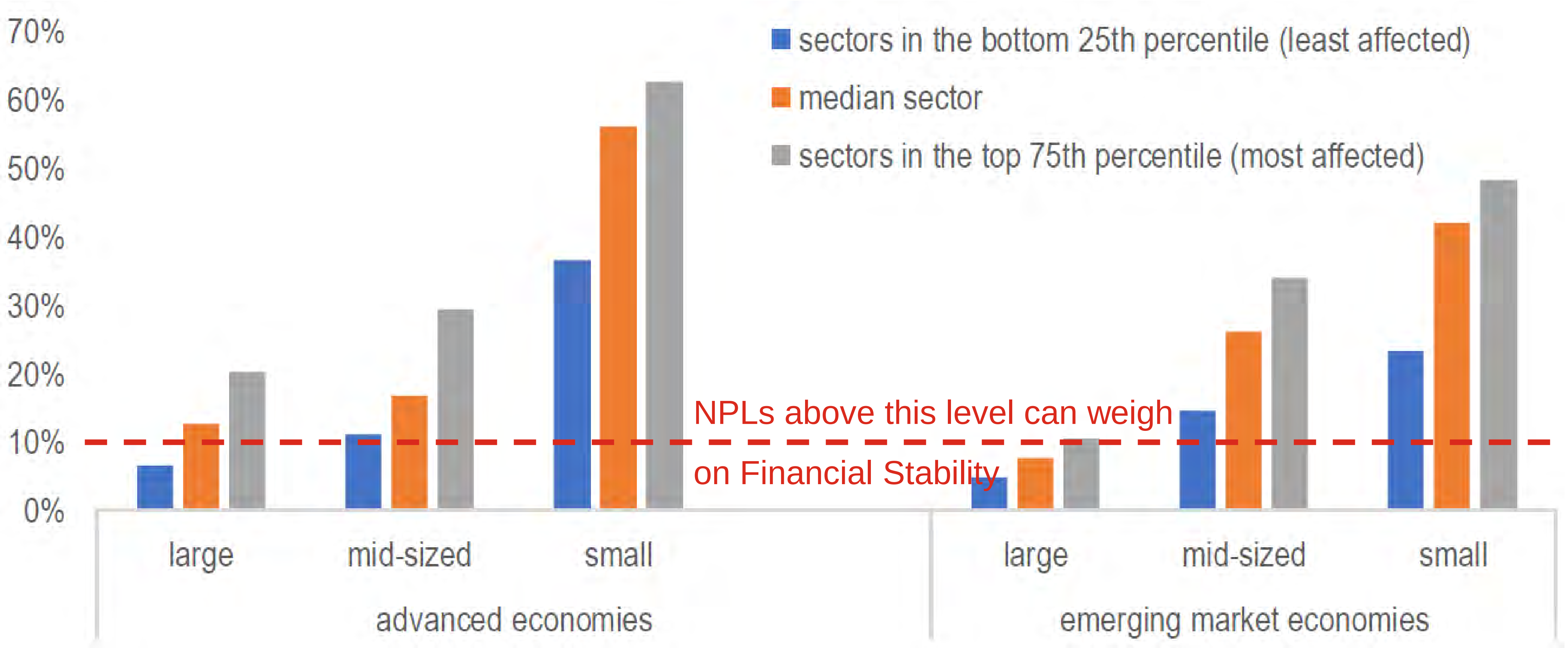
- Use of capital buffers
- Dividend restrictions
- Reduced liquidity requirements
- Suspension of changes to credit risk grades/classification and/or underwriting standards
- Allowing full recognition of loan interest income accrued but not collected

Other measures

- Lower interest rates
- Quantitative easing programs
- Outright fiscal support/tax moratoria

Solvency distress a substantial policy challenge

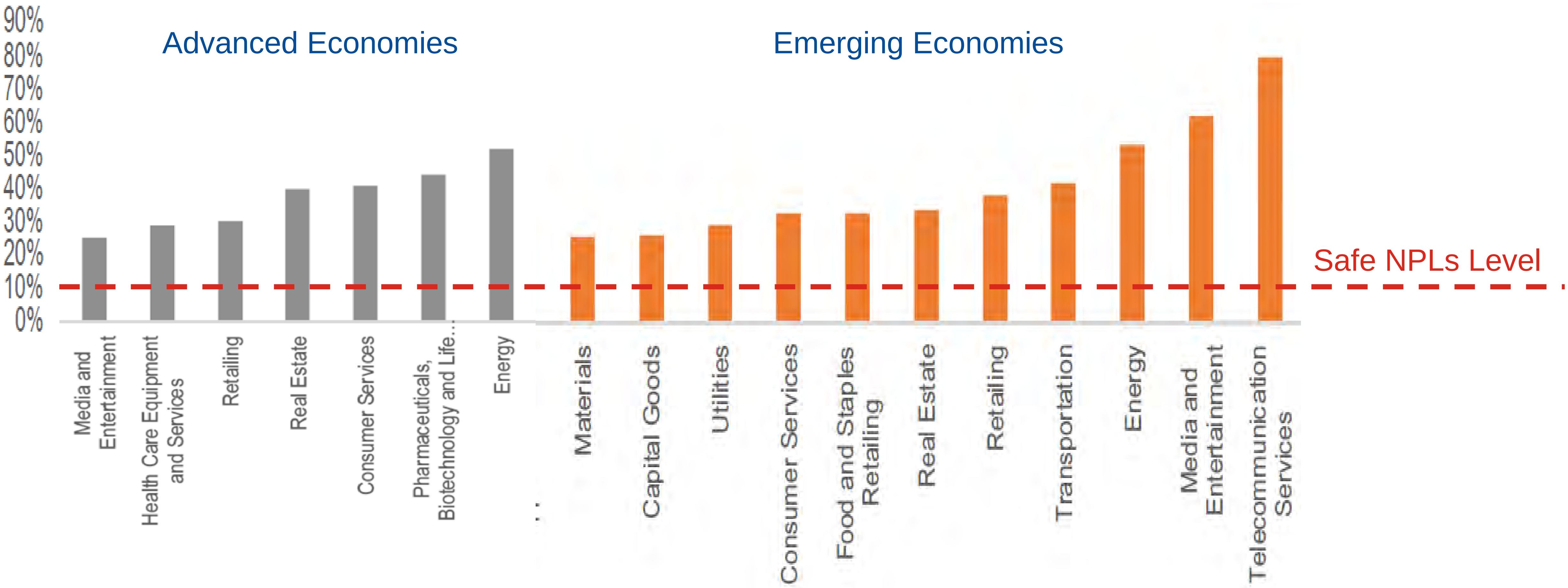
Share of debt at firms with solvency stress



Source: GFSR Chapter 1, April 2021 – analysis of 19,500 firms (half are SMEs) in 29 countries

Some industry sectors are in deep distress

Proportion of debt at mid-sized firms with elevated solvency stress



Source: GFSR April 2021

Poll #1

What blanket measures are currently in place?

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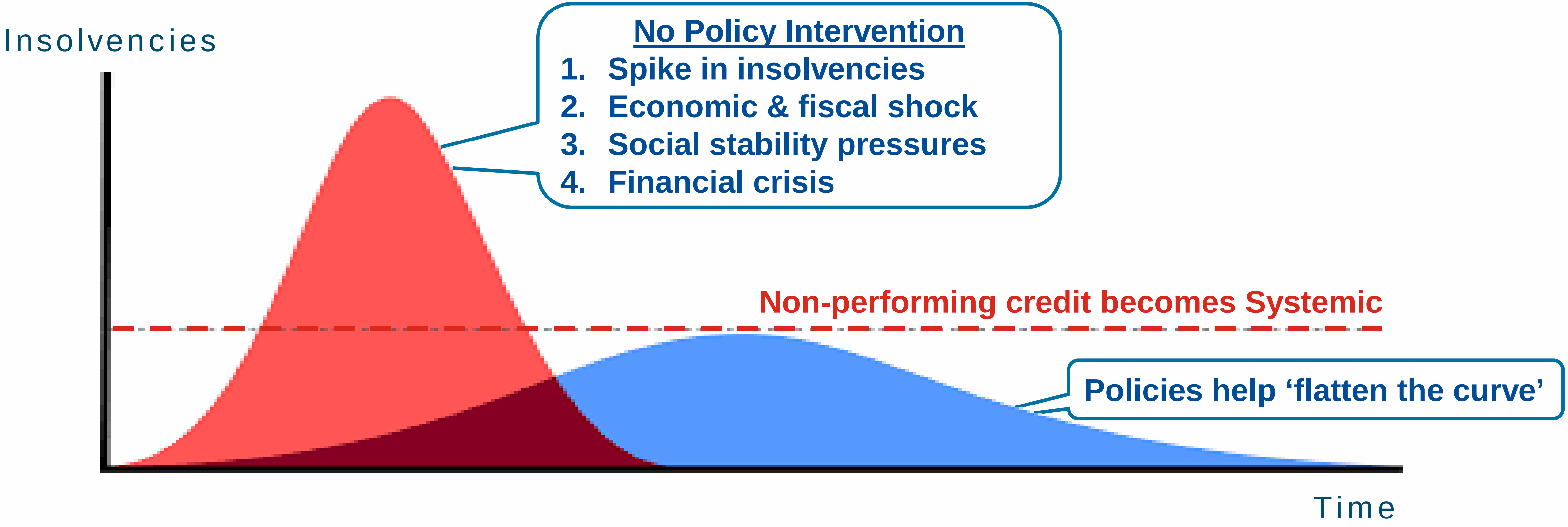
Identifying the 'safe path' to unwinding support



- At what level do NPLs have systemic impact on financial systems?
  - When they threaten viability of most banks (i.e. deplete capital, costs exceed income)
  - 15 percent of gross loans during Asian crisis
  - 5 percent considered high in EU, but 10+ percent may threaten viability

Continued support needed in many cases, but trade-offs are needed given fiscal and debt constraints

Replace blanket moratoria with targeted support

Timebound based on needs

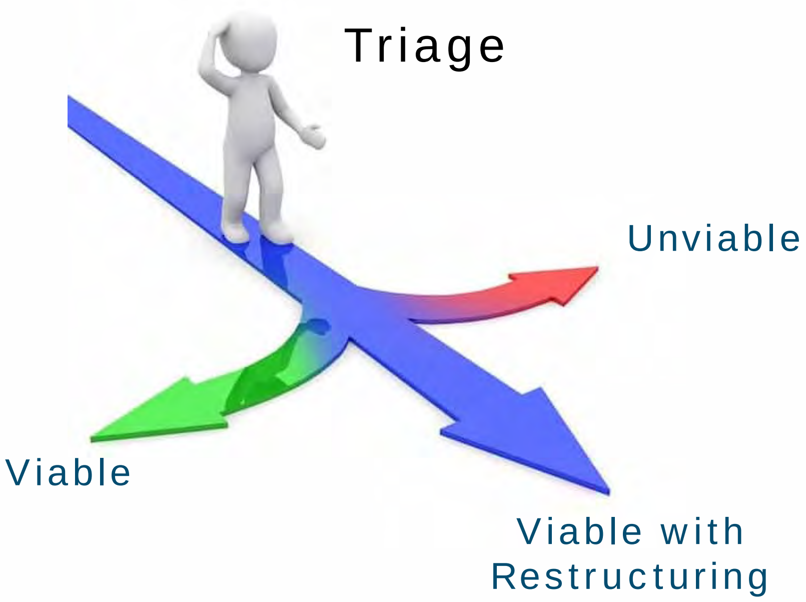
Should promote private investment & credit discipline

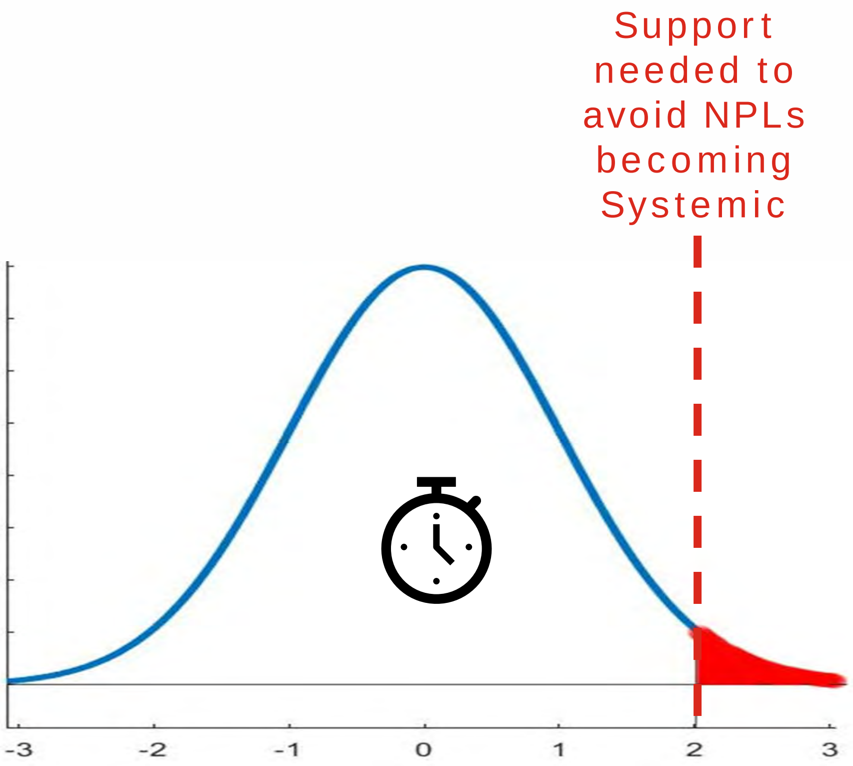
Lead to enterprise restructuring with fair burden sharing

Financial systems should not become de-facto safety nets through use of long-term and blanket moratoria

When holistic unwinding strategies are needed: Quantifying and calibrating the policy support

- Recent observations
- Economic forecasts
- Business forecasts





Poll #2

Risk of NPLs rising to systemic levels (15% or higher)

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Reminder: Overall Objectives of the Regulatory and Supervisory Measures


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COVID-19: The Regulatory and Supervisory Implications for the Banking Sector

A Joint IMF-World Bank Staff Position Note[1]

May 21, 2020


MONETARY AND CAPITAL MARKETS

Special Series on Financial Policies to Respond to COVID-19

Regulatory and Supervisory Response to Deal with Coronavirus Impact (updated with Q and A)

Prepared by: Financial Supervision and Regulation Division, MCM Department—with helpful comments from colleagues in MCM's Financial Crisis Preparedness and Management, and Monetary and Macroprudential Policies Divisions

March 31, 2020

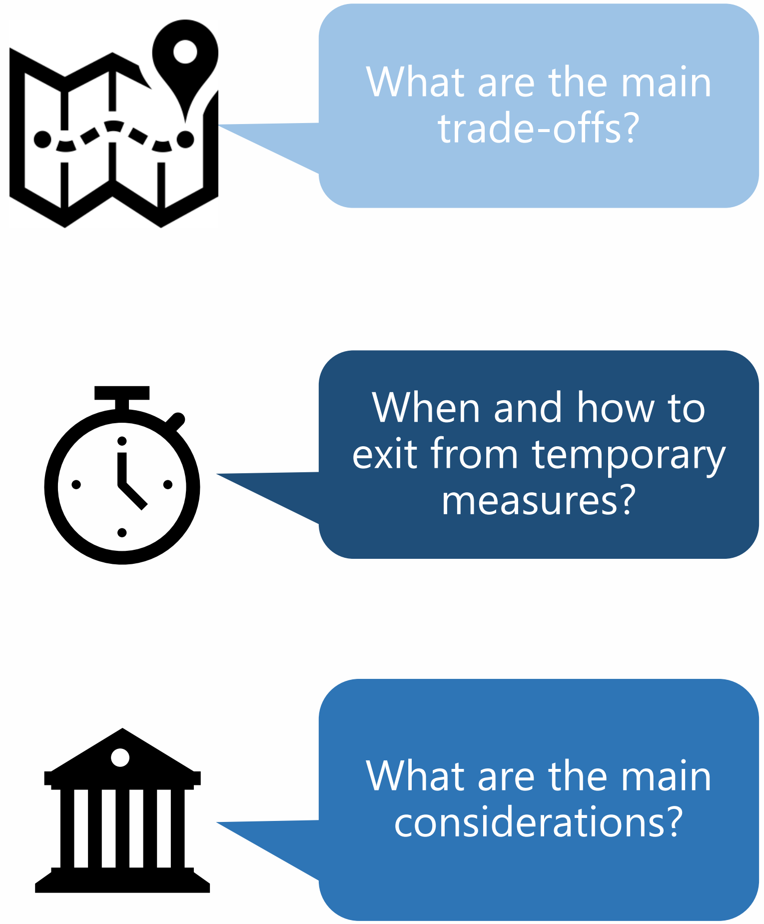
Regulatory and Supervisory measures to COVID-19

- **Support economy and provision of credit, liquidity and other financial services**
- **Preserve financial stability and a healthy and sound financial system**
- **Maintain international framework**

Wide range of measures implemented, sometimes against Fund advice

	YES		no
Facilitate policy measure – limit moral hazard	Encourage and facilitate prudent restructuring of loans Provide guidance on the treatment of moratoria Reflects government support	Relax large exposures and concentration limits	Lack of exit strategy Disincentivize borrowers to resume payment
Maintain transparency	Guidance on loan classification, provisioning and disclosure	Defer the impact of ECL provisioning on regulatory capital	Freeze the classification status of creditors and/or the level of provisioning
Use embedded flexibility and uphold min standards	Encourage use of capital and liquidity buffers Ease macroprudential measures Restrict capital distributions	Relax capital requirements that were above Basel standards	Reduce minimum risk weights Reduce capital requirements below international minima Facilitate Capital distributions
Review supervisory priorities and automatic triggers	Suspend automatic triggers for supervisory actions Additional flexibility for capital / liquidity restoration plans Postpone new regulation	Postpone regulation that was supposed to have been already implemented	Delay due supervisory actions

General considerations on regulatory measures



– Trade-offs to be addressed:

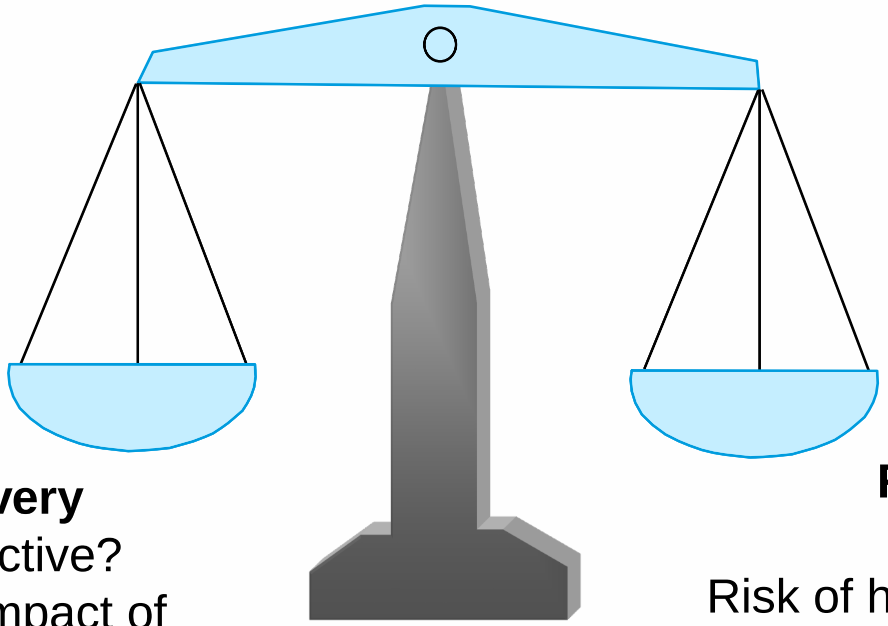
- Credit support (e.g., moratoria): help avoid deeper economic effects vs. resources are allocated to unviable activities
- Using the *flexibility* embedded in the regulatory framework provides near-term relief but may create an expectation that more accommodative interpretations will be introduced
- Restrictions on dividend distributions: preserve capital vs. impair investor confidence
- *Relaxation* of rules helps buy time but compromises transparency

– Several key questions:

- Covid-19 policy measures worked as intended?
- Impact of the measures already taken on overall financial stability?
- Impact/implication of the reversal of Covid-19 policies on the shape of the recovery?
- Fiscal and monetary space remains available?

Deciding on exceptional regulatory measures

What are the key questions?



Impact on recovery
Are measures effective?
What would be the impact of reversal?

Risk to financial stability
Path of future losses?
Risk of having lower prudential standards?
Impact on confidence in the banking system?

Fund recommendations in 2020

Use embedded flexibility and uphold min standards	YES	!	no
	Encourage use of capital and liquidity buffers Ease macroprudential measures Restrict capital distributions	Relax capital requirements that were above Basel standards	Reduce minimum risk weights Reduce capital requirements below international minima Facilitate Capital distributions

How to unwind capital measures?

- Reverse measures not compatible with international standards
- Keep restrictions on capital distributions, with adjustments
- Use stress tests to inform decision making
- Maintain flexibility to restore capital levels in case of breach
- Rebuild buffers once the recovery is firmly under way

What about countries that have not implemented Basel III?

-> consider the nature of the prudential rule that has been eased

Buffers are macrofinancial in nature

- Reintroduce pre-crisis prudential requirements when the shock has been absorbed by banks
- Consider the benefit of explicitly incorporating capital buffers in the regulatory framework

Buffers reflect institutional weaknesses

- Start progressively restoring pre-crisis requirements (with a phasing-in period)

On grounds of prudence, supervisors should continue to limit capital distributions


Special Series on COVID-19

The Special Series notes are produced by IMF experts to help members address the economic effects of COVID-19. The views expressed in these notes are those of the author(s) and do not necessarily represent the views of the IMF, its Executive Board, or IMF management.

July 7, 2020

Restriction of Banks' Capital Distribution during the COVID-19 Pandemic (Dividends, Share Buybacks, and Bonuses)

Rachid Awad, Caio Ferreira, Aldona Jociene, and Luc Riedweg[1]

High uncertainty

Need to increase resilience and capacity to support the economy

➢ **Temporarily** halt banks dividends and share buybacks

- ➢ **across the banking sector**

Unwinding COVID-19 interventions

Banks remain well capitalized

But uncertainty still elevated

Appropriate to **continue restricting** distributions

➢ Step-by-step adjustments could be considered

- Use stress tests to assess potential policy adjustments
- Be careful when loan loss recognition is postponed
- Ability to challenge banks' capital plans

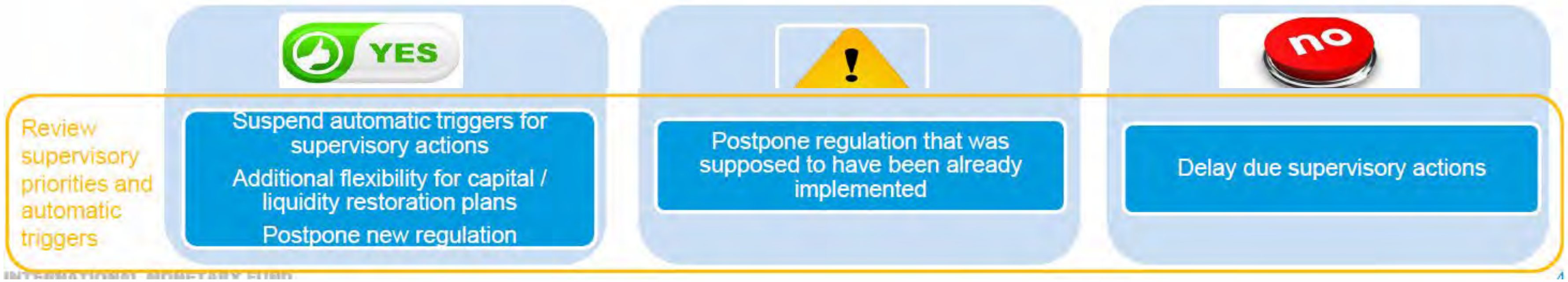
Fund recommendations in 2020

	YES	!	no
Facilitate policy measure – limit moral hazard	Encourage and facilitate prudent restructuring of loans Provide guidance on the treatment of moratoria Reflects government support	Relax large exposures and concentration limits	Lack of exit strategy Disincentivize borrowers to resume payment
Maintain transparency	Guidance on loan classification, provisioning and disclosure	Defer the impact of ECL provisioning on regulatory capital	Freeze the classification status of creditors and/or the level of provisioning

What about loan classification and provisioning?

- Maintain guidance compatible with international standards
- Reverse measures relaxing accounting standards
- Intensify supervisory monitoring
- Timely identification of NPLs

Supervisory priorities



- **Early intervention** remains critical to address problems not caused by the COVID-19 pandemic

- Supervisors should continue to **adjust their priorities** and focus on the most meaningful risks (most likely credit risk, operational resilience, liquidity risk)

- Nonessential activities that have been postponed in the early phase of the crisis should be **progressively reintroduced** in the regular supervisory cycle

- **Supervisors should reactivate stress testing programs**
  - Challenges still high but more manageable
  - Sensitivity analysis, reverse stress tests may complement ST

Poll #3

What supervisory measures are currently in place?

Issues to consider in unwinding COVID measures

Recommended actions to promote financial stability – bank resolution considerations

<u>Operational Challenges & Increased Risk</u>

- Uncertainty with asset valuations
- Identifying credible resolution options
- Capital/funding/governance structures
- Managing sales processes
- Ability to deploy several specialist teams

Continue

Recommended actions to promote financial stability – National Financial Stability Committees

Monitor bank health

Upgrade financial safety net

Prepare contingency plans

Ensure effective operating arrangements

Holistic NPL management strategy

Translating a holistic unwinding strategy into a prioritized interagency action plan

Example actions include

Insolvency and enforcement

Bank Oversight Action Plan

Thank You

For MCM published notes, please see:
https://www.imf.org/en/Publications/SPROLLs/covid19-special-notes#mfp

IMF COVID-19 Publications relevant to this work

"Unwinding COVID-19 Policy Interventions for Banking Systems", Special Series on Financial Policies to Respond to COVID-19, MCM, March 2021.

"A Firm-Level Assessment to Better Target Future Policy Support", Chapter 1, April 2021 GFSR.

"COVID-19 and Corporate-Sector Stress: Macrofinancial Implications and Policy Responses", Special Series on COVID-19, MCM, forthcoming.

"Global Corporate Stress Tests – COVID-19 Impact and Medium-term Implications", IMF Working Paper, forthcoming.

"Flattening the Insolvency Curve: Promoting Corporate Restructuring in Asia and the Pacific in the Post-C19 Recovery", IMF Working Paper, January 2021.

Loan classification

Two criteria used to classify borrowers as defaulted: (i) number of days past due and (ii) unlikeliness to pay

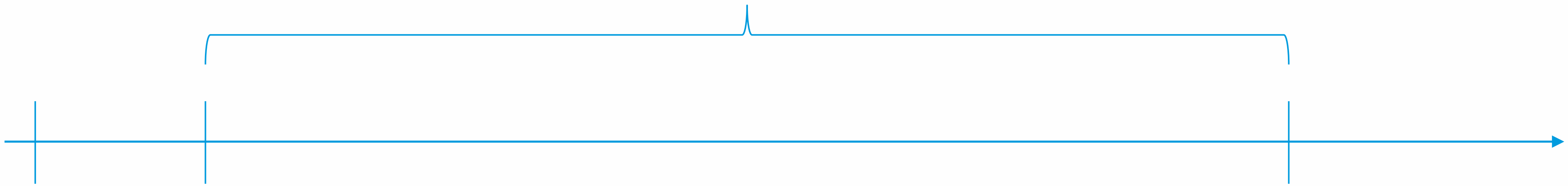
Calculation of days past due

- **BCBS**
  - Payment moratorium periods relating to the Covid-19 outbreak can be excluded by banks from the counting of days past due
- **Bank of England**
  - The BoE does not consider the use of a Covid-19 related payment holiday by a borrower to trigger the counting of days past due or generate arrears
- **European banking Authority**
  - In the case of moratoria permitting suspension or delays in payments, the 90 days past due criterion is modified, as the delays are counted based on the modified schedule of payments

Loan classification

<u>Calculation of days past due</u>

90
days



No payments are made

March 15
End of the
moratorium

April 1
Debtor missed the first
payment scheduled
after the moratorium

July 1
Borrower classified
as defaulted

<u>But</u>: The assessment of unlikeliness to pay during and after the moratorium should be based on whether the borrower is unlikely be able to repay the rescheduled payments