Unwinding COVID-19 Extraordinary Measures

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Session Outline

Overview

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Fictional Cases

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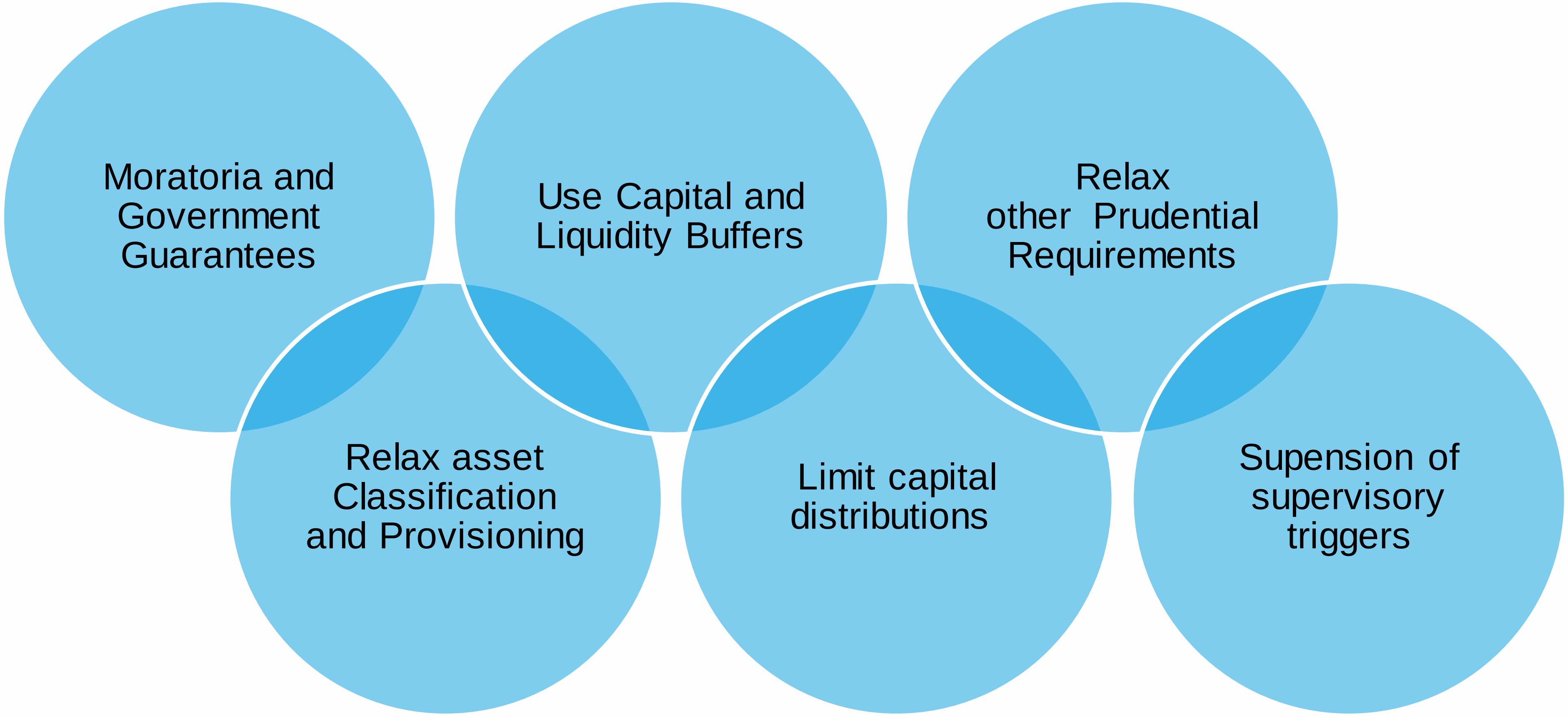
Q&A (through the chat)

Overview

- **Exceptional Covid-19 Measures**
  - Type of Measures
  - General Principles to Consider
  - Evaluation of the Measures

- **Unwinding of Covid-19 Measures**
  - General Considerations in unwinding
  - Key aspects for unwinding specific Covid-19 measures
  - Supervisory Actions

Authorities have introduced a wide range of Extraordinary Measures



Sound principles to address the COVID crisis while maintaining financial stability

Avoid hidden losses and structural relaxation of prudential rules

Be transparent, specific, time-bound

Avoid moral hazard and untargeted beneficiaries

Use embedded flexibility and uphold minimum standards

Coordinate with other relevant authorities

Monitor impact and reassess and unwind as needed

Let’s evaluate measures taken

Measures in accordance with sound principles

- Encourage loan restructurings.
- Clarify the treatment of moratoriums.
- Clarify treatment of government support (if necessary).
- Re-evaluate automatic reclassification of restructurings.
- Suspend dividends and other capital distributions.
- Encourage use of capital and liquidity buffers.
- Relax macroprudential measures.

Measures whose implementation could conflict with sound principles

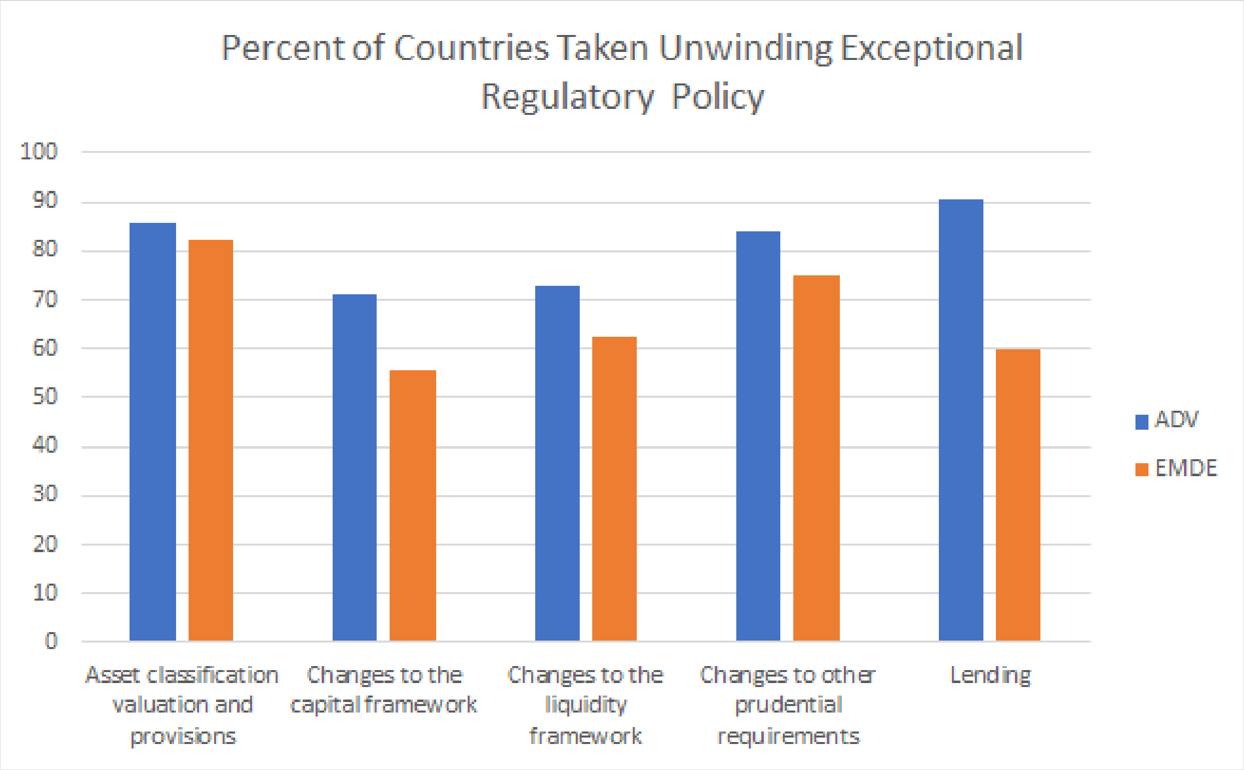
- **Defer the provisioning of expected losses.**
- **Relax limits on concentration and large exposures.**
- **Relax collateral valuation requirements.**
- **Relax capital requirements below Basel.**
- **Reduce capital conservation buffer.**
- **Relax liquidity requirements.**

Measures in conflict with sound principles

- Freeze credit risk ratings.
- Relax rating standards (such as extending days past due for provisioning and rating).
- Eliminate exposures from prudential requirements.
- Measures that discourages debtor payments.
- Not having an exit strategy.

Unwinding exceptional regulatory policy interventions

Many countries are making good progress unwinding exceptional measures



General Considerations in Unwinding

- Move extraordinary regulatory measures to increasingly targeted actions, using resources efficiently and avoiding moral hazard.
- Unwinding strategy should be adapted to each jurisdiction – based on state of banking sector and sovereign /corporate /household vulnerabilities
- Pace and Timing of unwinding measures should balance the benefits of short-term support and the risks to longer-term sustainability and resilience

Payment Moratoria and Government Guarantees

- Replace blanket freezes on debt repayments with **targeted and timebound support** to **distressed** but **viable** borrowers.
- If fiscal space allows, targeted government support, including guarantee schemes, should:
  - involve banks bearing risk,
  - and apply stricter eligibility criteria over time.

Asset Quality and Provisioning

Accurately reflect risks and losses in banks' balance sheets

Continue to apply or restore relaxed provisioning rules

Require High-NPL banks to develop NPL management capability, tools, and ambitious plans to reduce NPLs

Strengthen insolvency and debt enforcement framework capacity in preparation for the expected rise in NPLs

Capital and Liquidity Buffers / Capital Distribution

Reverse regulatory measures that are incompatible with international accounting and regulatory standards

Fully enforce prudential, accounting, and regulatory frameworks as relief measures are lifted

Retain flexibility by requiring banks to implement medium-term plans to restore capital or liquidity shortfalls

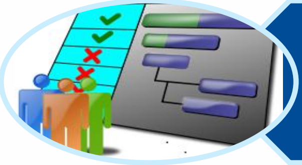
Rebuild capital buffers once the impact of the shock is clear and economic recovery is firmly under way

Restrict dividend distributions / share buybacks if bank profitability remains distorted due to emergency measures

Supervisory Actions

- Intensify supervisory monitoring until measures are withdrawn
- Require banks to continually assess borrowers' creditworthiness until conditions have normalized
- Closely Monitor and follow-up weaker banks
- Ensure banks are prepared to address potential high NPLs
- Assess financial conditions under different scenarios (Stress testing)

Bank Resolution and Contingency Planning


Review the financial safety net and take prioritized action to address gaps


Continue to apply corrective action frameworks


Prepare bank resolution plans


Maintain up-to-date contingency plans aimed at responding to potential systemic financial crises


Be ready to intervene if significant problems emerge after removal of exceptional policy support

Four Fictional Cases
for chat discussion

Bringing the asset classification rules back to normal
Alexis Boher

Restoring dividend payments
Alexis Boher

Unwinding prudential liquidity measures
Aldona Jociene

Overall design emergency measures and exit strategy
Dirk Jan Grolleman

Bringing the asset classification rules back to normal

Recommended best practices for unwinding special measures on asset classification and provisioning of expected credit losses

- Supporting bank financing of the economy has been crucial. But updating the effective credit risk exposure and assessing the crisis' impact on banks' accounts (balance sheet and profit & loss) has become essential for financial stability.
  - Restoring sound regulations on credit risk
    - Credit classification: NPL criteria, restructured loans
    - Expected losses: identification, assessment, provisioning
    - Credit risk management: origination, guarantee, oversight, recovery
  - Implementing thorough and targeted risk-based supervision
    - Off-site supervision: micro- and macroprudential, risk focused
    - On-site inspections: targeted control of asset classification and provisioning
  - Engaging early intervention to address identified issues on fragile banks
    - Waiting may not be a reasonable option – Deciding preventive measures may be suitable

Bringing the asset classification rules back to normal (Continued)

Interactive discussion on a concrete case

- The Authority has granted banks the possibility to restructure loans without limitation for the last two years, and it has suspended on-site inspections while teleworking.
  - What should be done to unwind and go back to normal supervision?
    - 1 => To be compliant again, <u>regular prudential rules on credit classification should be restored and become mandatory immediately</u>.
    - 2 => To make it all clear, <u>a comprehensive asset quality review (AQR) of all banks should be implemented by the Authority in the field within six months</u>.
    - 3 => To ensure accurate financial disclosure, <u>expected credit losses should be fully covered by loan-loss provisions by year-end</u>.
    - 4 => To move forward, <u>banks showing low NPL provisioning ratios should be severely sanctioned</u>.
    - 5 => To ensure reasonably appropriate supervision, <u>none of the above</u>.

Please choose the best(s) option(s) and explain why; ask questions through the chat.

Restoring dividend payments

Recommended best practices for restoring banks' capital distribution

- Ensuring banks' capacity to preserve their capital during the crisis, even by restricting legal rights of distributing dividends, has been a popular special supervisory measure. But such exceptional restriction can only be temporary.
  - Restoring dividend payments
    - Unwinding such a measure may be decided globally rather easily, but it may need to be tailored to specific individual situations.
    - Unwinding should be based on a prior objective and forward-looking assessment by Authorities of banks' capacity to distribute dividends, if:
      - consistent with current and provisional prudential ratios,
      - profitability permits, and
      - expected credit losses generated by the pandemic have been properly assessed and adequately covered by provisions.
    - Financial stability should be considered before unwinding, not only restoring investors' rights at any cost.

Restoring dividend payments (Continued)

Interactive discussion on a concrete case

- The Authority has suspended dividend distribution by all banks for the last two years, and shareholders are complaining this measure has become unjustified.
  - What should be done to unwind and go back to normal supervision?
    - 1 => <u>Allowing systemic banks only to restore dividend payments</u>, to preserve the international attractiveness of the banking sector.
    - 2 => <u>Extending the suspension period for one more year</u>, to demonstrate the Authority's independence against financial lobbyists.
    - 3 => <u>Agreeing on restoring dividend payments selectively on a case-by-case basis</u>, based on a risk-based prudential assessment and prior approval by the Authority.
    - 4 => <u>Unwinding the dividend suspension measure for all banks</u>, if the Authority has assessed that financial stability may not be undermined anymore by regular capital distribution.
    - 5 => <u>Working on enhancing the legal powers of the Authority to impose a restriction of dividend distribution by a fragile bank in the future</u>, should such a measure be usefully part of an effective early intervention framework.

Please choose the best(s) option(s) and explain why; ask questions through the chat.

Prudential Liquidity Measures

Use embedded flexibility and uphold min standards

YES	!	no
Encourage use of liquidity and capital buffers	Temporary reduce LCR requirement from 100 to 70 percent	Change prudential liquidity rules

Why authorities implemented this measure?

- To support economy through provision of credit
- To mitigate the potential liquidity strain on the banking sector
- Banks are reluctant to draw down LCR buffers

What are main risks?

- Banks would be less resilient in case of a liquidity crisis
- Banks would no longer be required to provide LCR restoration plans when they go below the 100 percent threshold

Recommended Best Practices for Unwinding Prudential Liquidity Measures

When and how to exit from temporary measures?

Measures incompatible with international standards should be unwound first, to bring them back within the flexibility of existing standards.

The timeframe for restoring liquidity requirements would depend on:

- How far LCR ratio is from 100 percent;
- Whether this is isolated or systemwide;
- Expected forthcoming liquidity sources and needs.

Continuous monitoring of liquidity conditions to gauge levels of stress is recommended.

- Period of stable indicators at prevailing pre-pandemic levels would need to be observed before restoring these requirements.
- Use stress tests to inform decision-making.

What are other considerations?

- Implication of the reversal of liquidity measure on the shape of the recovery?
- Impact of the liquidity measure on overall financial stability?
- Risks of having lower liquidity prudential standards?
- Impact on confidence in the banking system?
- Liquidity relief measure worked as intended?

Practical Case: Unwinding Prudential Liquidity Measure

Interactive discussion on a concrete case

- The Authority temporary reduced LCR requirement from 100 to 70 percent.
  - What should be done to unwind and bring back LCR requirement to 100 percent?
    - 1 => To be compliant again, <u>banks should be directed to comply with restored requirement (100 %) immediately</u>.
    - 2 => To make it all clear, <u>the Authority should use stress test and monitor relevant indicators (e.g., interbank market, depositor confidence in banks, development in the FX market, and/or forthcoming maturing/rollover of large public and private obligations) and restore LCR requirement only after a period of stable indicators (1-3 months) at prevailing pre-pandemic levels would be observed</u>.
    - 3 => To avoid adverse consequences, <u>the timeline of restored LCR requirement should be announced well in advanced and sufficient transition period should be factored in</u>.
    - 4 => To move forward, <u>banks should not be allowed to use embedded flexibility in LCR regulation during renewed lockdowns (period of financial stress).</u>

Please choose the best(s) option(s); ask questions through the chat.

Country experience: How to deal with the crisis?

Starting position:

- Developing/emerging economy
- Households and certain sectors of the economy vulnerable to the shock
- Expectation that the pandemic will be a temporary phenomenon
- Banking sector relatively well capitalized in particular the larger banks

Policy design:

- Support to the economy key to avoid unnecessary destruction of jobs and businesses and to be well positioned once recovery starts
- Banks well positioned to continue lending, but may need comport/stimulation

Country experience: Emergency measures

Monetary policy emergency measures:

- Lowering of policy rate
- Emergency liquidity facilities (3 – 4 years, below market interest rates)

Regulatory emergency measures:

- Moratorium up to 1 year (mix of broad based and specific)
- Freezing of asset classification and provisioning up to 1 year
- Zero risk weight for loans funded through emergency facilities
- No dividend distribution
- Close monitoring of ratios with and without forbearance

Country experience: Exit emergency measures

Exit strategy:

- Exit regulatory forbearance measures 1 year after adoption
- Asset classification and provisioning rules applied again after exit
- Banks facing provisioning shortfalls allowed to rebuild provisions gradually over a period of 2.5 years
- Banks using phase in of provisioning requirements not allowed to distribute dividends and subject to close monitoring

Country experience: Polling question

How would you classify the overall design (emergency measures and exit) of the policies?

- **Potentially destabilizing**: Emergency measures and exit strategy relying too much on forbearance
- **Too much relying on forbearance, but not destabilizing**: Emergency measures relying too much on forbearance but achieving their purpose (continued lending). Phase-out period maybe long, but overall approach to the exit strategy balanced.
- **Acceptable:** Measures using forbearance, but not destabilizing. Exit measures well-tailored.
- **Well designed:** Forbearance is an important tool to support the economy and achieve public policy objectives.

Thank you!

Q&A