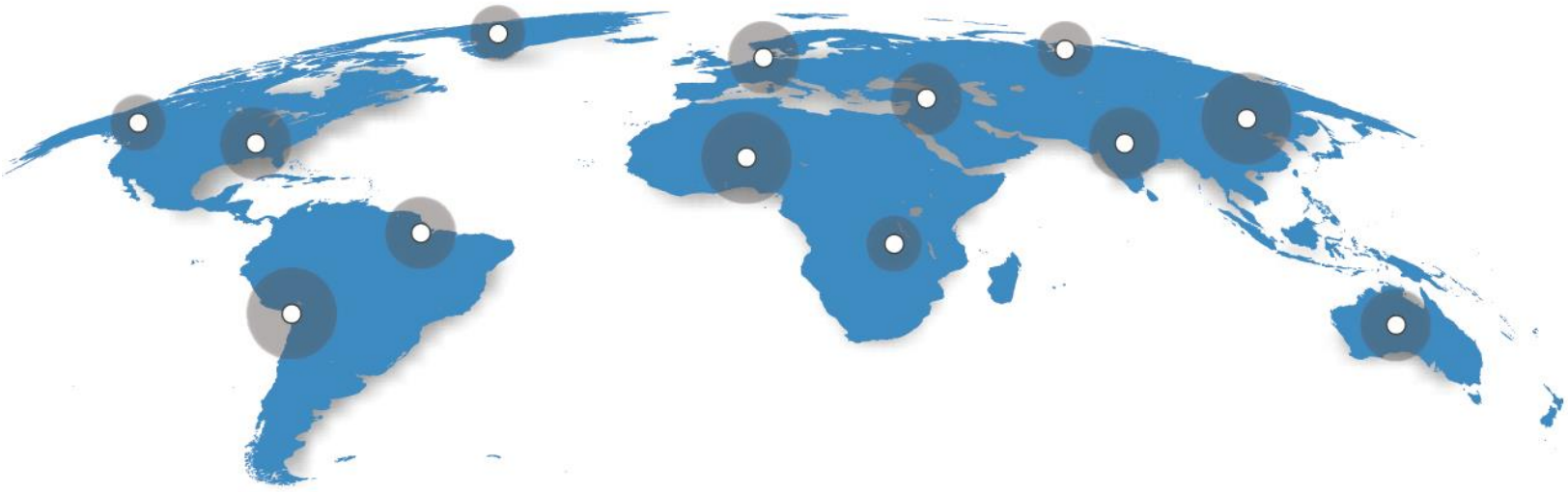
TORONTOCENTRE
Leadership in Financial Supervision

GUIDE TO SUPERVISION
IN THE COVID-19 WORLD



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Foreword

Toronto Centre is pleased to publish this **Guide to Supervision in the COVID-19 World.**

This Guide focuses not only on the current challenges – adjusting to supervisory staff working from home, addressing the heightened risks facing supervised firms, and the impacts of COVID-19 on financial inclusion – but also on how supervisors, in all sectors of financial services, will need to respond in the longer-term to the emerging new normal. The lessons learned from this pandemic could also be instructive to address future crises such as climate change.

Since March 2020, Toronto Centre has been on the front lines, virtually, of supporting supervisors by addressing their business continuity planning, capacity building, and other transition needs. We were glad to help, and we also gained invaluable insights that contributed to this Guide.

Toronto Centre would like to thank the many supervisory and regulatory agencies as well as international standard setters and other bodies that participated as our dialogue partners to inform this Guide by sharing their experiences of how supervision has changed as a result of COVID-19. We are honoured to be able to provide support to financial sector supervisors through these difficult circumstances by equipping with them with the tools and information presented in the following Guide. I would like to especially thank the co-editors, Clive Briault, Chair, Banking Advisory Board, Toronto Centre, and Phang Hong Lim, Senior Director of Supervisory Guidance, Toronto Centre, for making this quality publication possible.

Since our establishment in 1998, Toronto Centre has focused on one mission only: to provide high-quality capacity building programs for financial sector supervisors. Since inception, we have trained more than 13,000 supervisors from 190 jurisdictions. The objectives underpinning our mission promote sound and inclusive financial systems that will foster sustainable economic growth, gender equality, address climate risk, and reduce poverty.

We are grateful for the support of our funders, Global Affairs Canada, Swedish International Development and Cooperation Agency, the International Monetary Fund, as well as Jersey Overseas Aid, Comic Relief, and USAID, without whom we could not fulfil our mission.

I hope you will benefit from this publication.

Sincerely,

Babak Abbaszadeh, CEO, Toronto Centre

Executive summary[1]

This Toronto Centre Guide to supervision in the aftermath of COVID-19 is intended to help the leadership of financial supervisory authorities to determine the implications of COVID-19 for how they undertake their supervision of financial institutions and financial markets. It complements and builds upon Toronto Centre Notes[2] and webinars relating to the impact of the COVID-19 outbreak.

The Guide provides a framework within which supervisory authorities can review the actions they have already taken and consider what more they need to do. These actions cover both the immediate and the longer-term consequences of COVID-19, and they span the financial sectors.

Chapter 1 describes the various impacts of COVID-19, including on economic conditions, the risks facing the financial sector, the operating capacity of supervisory authorities, and financial inclusion. It also explores the emergence of the new normal – the longer-term external environment to which supervised firms and supervisory authorities will need to adjust and adapt.

Chapters 2–8 set out a series of practical steps that supervisory authorities can and should take in response to:

- the capacity constraints on supervisory authorities and the heightened risks in the financial sector (Chapter 2);
- COVID-19 related credit, insurance, pension fund, securities markets, and corporate governance risks in supervised firms (Chapters 3-6);
- the impact of COVID-19 on microfinance providers and financial inclusion (Chapter 7); and
- the emergence of the new normal (Chapter 8).

[1] This Guide was authored by Clive Briault, Denise Dias (CGAP), Carl Hiralal, Nai Seng Wong, and Paul Wright, and was co-edited by Clive Briault, Chair, Banking Advisory Board, Toronto Centre, and Phang Hong Lim, Senior Director of Supervisory Guidance, Toronto Centre.
[2] Toronto Centre (2020b-f).

Key messages

- Supervisory authorities and supervised firms need to adapt to the operational constraints and heightened risks resulting from COVID-19.
- Heightened credit risks and the potential for a longer-term deterioration of credit quality should be constantly re-assessed by supervisory authorities and supervised firms, given the broad-based and continuing impact of COVID-19 on most economic activities.
- Insurance and pension fund supervisors should assess the impact from this health crisis, amid a potentially long-term low interest rate environment, on the continuing viability of their supervised firms.
- Securities supervisors need to focus on maintaining orderly and functional markets, together with proper conduct oversight for all participants, particularly the retail segment, amidst increased market volatility and reduced market liquidity.
- Strong corporate governance in supervised firms is critical to provide assurance to supervisors on the ability of supervised firms to navigate the numerous challenges raised by COVID-19, which may be long-lasting and not easily reversed.
- The COVID-19 pandemic has heightened the urgency for supervisors to meet the challenges of underdeveloped digital financial services and infrastructure, not least given the disproportionate impact on the poor, particularly women, who are financially excluded.
- Supervisory authorities should adapt their supervision to the immediate constraints imposed by COVID-19, while planning for the longer-term impacts on supervised firms.
- Supervising the new normal requires supervisory authorities to plan for, and react to, the constantly changing environment, and to identify the varied impacts on individual supervised firms, while adapting their own supervisory practices with the help of technology.
- Supervisory authorities need to focus on capacity building so that their supervisors have the knowledge, skills, and experience to make good critical judgements.

1 CONTEXT: WHAT HAS CHANGED AS A RESULT OF COVID-19?

Supervisory authorities and supervised firms need to adapt to the operational constraints and heightened risks resulting from COVID-19.

Introduction

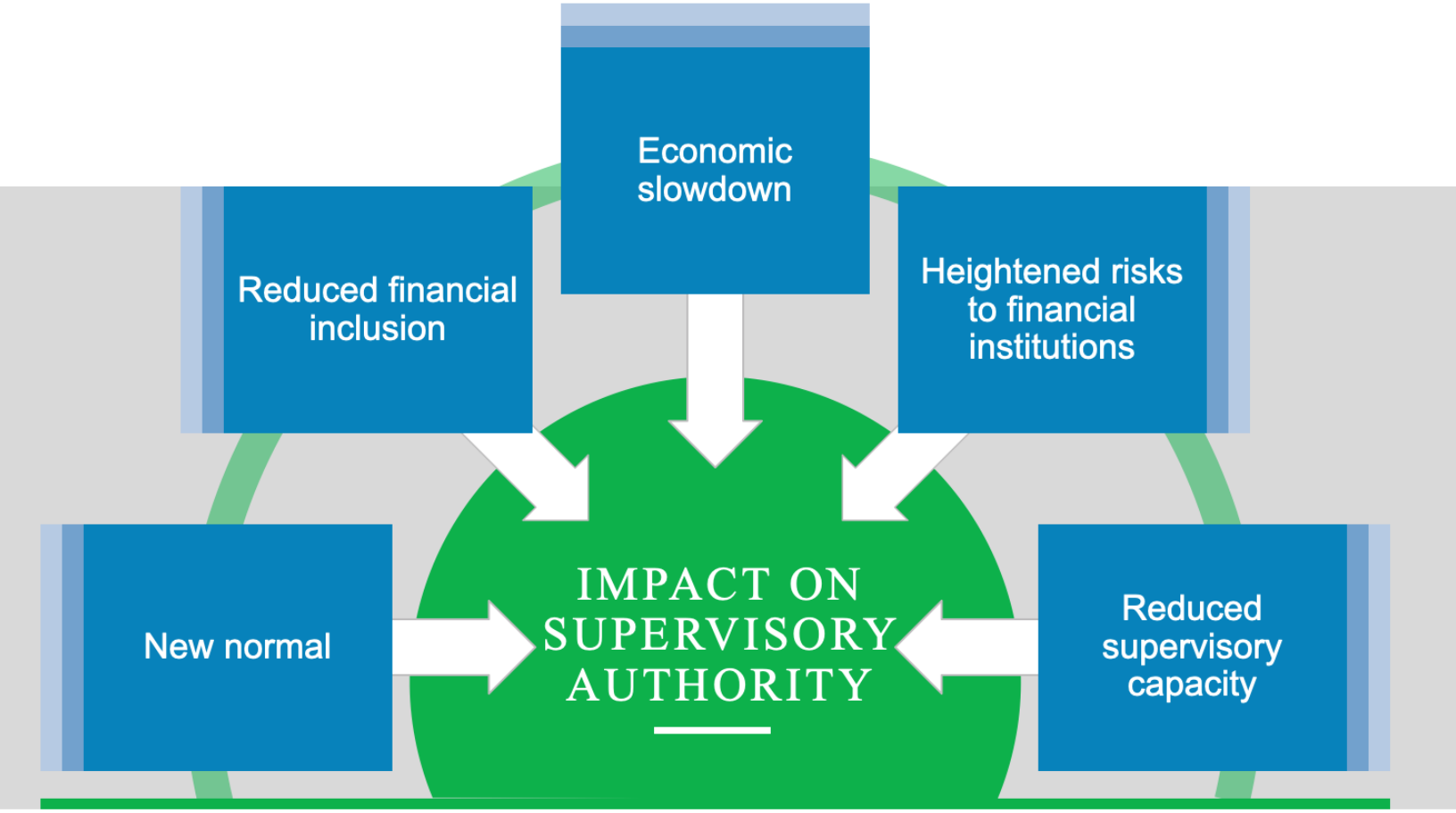
COVID-19 has had a marked impact on supervisory authorities across the world.

The tragic human cost and the impact of lockdowns and travel restrictions have reduced the operational capacity of both supervisory authorities and supervised firms.

The economic slowdown has increased the main risks facing all types of financial institution, including credit, insurance, market, and liquidity risks, and has reduced financial inclusion.

Longer-term, the emergence of a new normal will have a fundamental impact on financial institutions and on how they are supervised.

Impact of COVID-19 on supervisory authorities



Economic conditions and macro policy responses

The COVID-19 outbreak has had a sharp negative impact on economies worldwide. In April 2020, the International Monetary Fund (IMF, 2020a) was projecting a fall in global real GDP of 3 percent in 2020, down sharply from the 3.3 percent increase in global real GDP it had projected in January 2020. By June 2020, the IMF (2020c) had revised its projection down to a fall in global GDP of 4.9 percent in 2020, while the Organisation for Economic Co-operation and Development (2020) was projecting a fall of 6 percent. Initial hopes for a rapid V-shaped recovery and a return to normality later in 2020 have faded rapidly, to be replaced by a more prolonged and more uncertain economic impact.

Part of the reason for these sharp declines in real GDP is that the COVID-19 outbreak has had a negative impact on both demand (lower household and corporate incomes, and a sharp drop in economic confidence) and supply (the closure of factories, shops, offices, and tourist facilities, and disrupted supply chains). The economic downturn is also reflected in increased unemployment and poverty – COVID-19 has hit the poor, and poor women, hardest – corporate failures and downgrades, sharp falls in asset and commodity prices, and declines in world trade and international capital flows. In some countries, this worsened an already weak underlying position in terms of economic growth and fiscal deficits.

The economic downturn may leave behind deep scars: higher levels of unemployment, missing education of children, reduced investment (in particular foreign direct investment in emerging economies), trade disruption, and greater financial exclusion as a result of both increased poverty and an unwillingness or inability of some financial institutions to provide financial services and products (in particular lending to SMEs and some insurance products).

To some extent, the economic consequences of COVID-19 have been mitigated by the actions of the authorities – governments, central banks, macroprudential authorities, and supervisory authorities. But in some countries, this fire power may be exhausted before economies have fully recovered, leaving them exposed to economic weaknesses. Moreover, the virus has not yet departed, and there may be second (or multiple) waves – second spikes have already been seen in some countries.

Governments have responded to the economic impact of the COVID-19 outbreak by increasing – in some cases dramatically – the overall level of government spending, and by offering various types of loan guarantees, payment deferrals (either mandated through legislation, or voluntary), and tax and other relief to individuals and corporates. Some governments have injected capital into, or even nationalized, some failing corporates.[3]

Central banks have intervened in various ways to preserve liquidity in money and asset markets to allow the financial system to continue to function effectively, and to stimulate the economy. They have cut policy rates, reactivated quantitative easing asset purchases (and in some cases extended the range of assets they are prepared to purchase), provided additional liquidity to the financial system through refinancing and other facilities, and expanded the provision of US dollar liquidity through swap line arrangements.[4]

[3] Financial Stability Board (2020) and International Monetary Fund (2020b).
[4] Federal Reserve Bank of New York (2020).

Many **macroprudential authorities** have removed or reduced some of the capital buffers that banks are required to meet to lessen the extent to which capital requirements constrain the ability of banks to roll forward existing lending and to provide new lending to support the economy. This is consistent with the basic principle of macroprudential instruments being applied during the upswing of the financial cycle in response to threats to financial stability from excessive credit growth or asset price bubbles, but being removed or reduced during the downswing to prevent the supply of credit being constrained by prudential capital requirements.[5]

Similarly, some **supervisory authorities** have lowered their required capital and liquidity ratios, and applied forbearance to avoid breaches of minimum capital, solvency, or liquidity requirements from triggering the usual supervisory interventions, to prevent a reduction in the supply of financial services, the fire sale of assets, and potential contagion effects. In some countries this has been combined with restrictions on dividends and bonus payments by some financial institutions. Supervisory authorities have also been flexible in making allowances for the various operational constraints affecting supervised firms.

Heightened risks

Financial sector risks have increased as a result of the COVID-19 outbreak, although the full extent and duration of these shifts remains uncertain. Other, so far unsuspected, risks may arise before the crisis is over. These impacts may continue to worsen and may affect more sectors of the economy the longer the delay is to some form of normality. Financial institutions starting with weak financial and operational resilience will be particularly vulnerable.

Supervisory authorities and supervised firms need to adapt to the operational constraints and heightened risks resulting from COVID-19.

Credit – lower incomes (even if only temporary) mean that many borrowers cannot meet scheduled interest and principal payments. Some corporates have already failed and been placed into administration or liquidation. More will fail. Some heavily-indebted corporates and households may never be able to repay their debts in full. Meanwhile, the value and liquidity of many types of collateral (for example, property, equity, and commodities) have fallen sharply. Lenders with concentrations to specific sectors that have been hardest hit by COVID-19, such as households, hospitality, tourism, airlines, commercial property, and shipping, will be particularly vulnerable.

Other types of credit risk have also increased – some borrowers have drawn down committed facilities and the counterparty credit risks inherent in securities and derivatives transactions may have both increased in value and worsened in quality.

[5] Basel Committee (2010).

Payment holidays and borrowers running into payment difficulties more generally will also have an adverse impact on banks' and microfinance providers' cash inflows and therefore on their **liquidity positions**. The impact of this may be eased to some extent by central bank actions to inject liquidity into the system and to make more generous liquidity facilities available to individual banks, but some banks and microfinance providers may still face liquidity shortfalls.

Insurance – COVID-19 has had an adverse impact on both sides of insurers' balance sheets. On the asset side, reductions in asset values, the downgrading of securities, and increased market volatility have eroded asset value, forced some redistribution of assets, and increased uncertainty.

On the liabilities side, general (non-life) insurers are facing higher claims on some lines of business, including workers' health, travel, event cancellation, and business disruption (where insurers have agreed to meet some claims, or face legal challenges to whether business disruption insurance covers the impact of pandemics and government lockdowns). Life insurers are facing higher mortality claims, although this may be offset to some extent by the impact of lower life expectancy on annuity payments.

In addition, lower incomes and unemployment are resulting in policy cancellations and lower volumes of both new and renewal business. Together with some extended grace periods for paying premiums, this has strained the liquidity positions of some insurers. Increased demands for policy loans and surrenders of wealth management products could exacerbate this problem. The continuing low interest rate environment creates asset-liability matching challenges for insurers.

Pensions – the decline in asset values, market volatility, hardship withdrawals, and sponsors finding it difficult to pay or match contributions pose challenges for defined benefit and defined contribution pension schemes. Defined benefit plans may also be faced with asset-liability matching problems in the low interest rate environment.

Market – asset and commodity prices have fallen and become more volatile. Many financial assets have become less liquid, as have assets such as commercial property. Market liquidity is likely to remain under strain for some time, notwithstanding the support of central banks.

Operational – home working in financial institutions may have an adverse impact on a range of operational risks, including IT and data security (for example, insurers routinely handle highly confidential medical and other personal information), internal and external fraud, cyber-attacks, and internal network capacity, as well as on a range of control mechanisms, including anti-money laundering and know-your-customer protections, decision-making procedures, and internal inspections. COVID-19 may also have weakened the financial or operational resilience of third-party providers of services to financial institutions.

Conduct – financial institutions tightening their risk tolerance may exclude some customers from some business lines, increase prices unjustifiably, and be quicker to take action against customers facing financial difficulties. Employees working from home for financial institutions may act improperly in providing financial advice, opening new accounts, writing insurance policies, settling claims, and handling complaints. Consumers switching to digital financial products and services could become the victims of financial crime or misconduct as unscrupulous players identify opportunities for fraud, scams, or other wrongdoing.

In wholesale markets, changes to working arrangements have made it more difficult to monitor trading activities for market abuse and manipulation. This comes at a time when supervised firms' controls are under strain, along with supervisors' ability to monitor these controls.

Governance and controls – in addition to facing heightened risks, some financial institutions are having to reconfigure their businesses in the light of the crisis. Governance, risk management, and internal controls need to adapt to these heightened risks and new business models at a time when boards, senior management, and control functions are having to interact virtually and to rely on revised decision-making processes and management information.

Earnings and capital – lower revenue streams and higher losses will squeeze profitability and could reduce capital and solvency ratios.

Supervisory capacity

The increase in financial sector risks has coincided with pressures on supervisory capacity arising from lockdowns, travel restrictions and the need to maintain social distancing. The most immediate and significant change has been the sudden and large-scale move to working from home, which has not always gone smoothly. Pressure points have included:

- **Space** – the home physical environment for each member of staff, and health and safety issues such as longer-term ergonomic considerations.
- **Hardware** – the availability of laptops, home PCs, and cameras and microphones for calls and conferencing.
- **Connectivity** – software for access to head office IT systems, internet, phone lines, and electricity.
- **Data** – access to regulatory reports, files, and other data and information (paper and electronic).
- **Security** – of IT systems, confidential data and information, and email, telephone, and video contact with colleagues and with supervised firms, other authorities, and other stakeholders.
- **Decision-making** – processes and procedures for decision-making, documentation, and record-keeping.
- **Management** – maintaining effective group and one-to-one staff meetings, and monitoring and addressing the build-up of stress and mental health-related issues.
- **Culture and cohesion** – over time, and with the entry of new staff, it becomes more difficult to communicate and maintain the culture of the supervisory authority.

Supervisors have also found themselves unable to visit the premises of supervised firms to conduct on-site visits, or to travel to meetings with other authorities and stakeholders, domestically and internationally. Alternatives and work-arounds have been put into place, including through telephone and video conferencing; the increased use of technology for the transfer of data, information, and files; the physical delivery of files from a supervised firm to the supervisory authority; the reporting by supervisory firms of more granular data; and the use by supervisory authorities of alternative sources of information on supervised firms (for example from social media).

However, it is more difficult to read body language, facial expressions, and social interactions in virtual meetings with the boards, senior management, and other staff of supervised firms, and therefore it is more difficult to make some supervisory judgements. It is also more difficult to substitute for on-site file examinations and checks on the reliability and quality of data and other information reported to the supervisor – paper records can be scanned into electronic form, or even delivered physically to a supervisory authority, but home working may make it more difficult for the supervisor to review these records efficiently and effectively.

Financial inclusion

Many supervisory authorities in emerging economies have mandates and objectives to promote financial inclusion. The COVID-19 outbreak has had an immediate adverse impact on financial inclusion, by increasing the number of people in poverty and reducing the willingness or ability of some financial institutions (including microfinance and microinsurance entities) to provide financial products and services to some parts of the population. Any reliance on face-to-face contact in financial inclusion activities has been hard hit by the need to socially distance in response to the COVID-19 pandemic, by the closure of branches, and by reduced networks of agents. Supervisory (and other) authorities have suspended face-to-face financial literacy and education initiatives.

Meanwhile, however, the COVID-19 outbreak has accelerated digitalization. The use of technology has enabled a significant number of people to cope with the impact and spread of COVID-19 through digital financial transactions using mobile phones and the internet, the opening of digitally-enabled bank accounts, electronic retail payment systems, digital identification, and wide-scale home working. Government payouts have been made through digital channels, fees for digital retail payment systems have been reduced or waived, transaction limits for digital payments have been increased, and know-your-customer procedures have been relaxed or at least made more risk-based. This has maintained, or even enabled, financial inclusion for many people. However, it has not benefited those without access to digital services (or who are too illiterate to use digital channels) or those reliant on the use of cash, and it has opened up risks from cyberattacks, fraud, and scams.

Climate change

Although the COVID-19 outbreak has reduced, at least temporarily, carbon emissions and other damaging impacts on the environment, it has also halted or reduced progress on climate action. This is mirrored in part in delays to supervisory authorities developing and implementing a greater focus on how financial institutions are identifying, managing, and disclosing their climate change-related risks. There are opportunities for governments and others to borrow and invest in infrastructure to tackle threats such as climate change, but it remains uncertain how far this will be embedded in post COVID-19 economic restructuring.

Looking further ahead: the new normal

It is becoming increasingly clear that the world is not going simply to return to the old normal, nor indeed to reach any settled position in the near future. COVID-19 will have a prolonged and fundamental impact on financial institutions and on how they are supervised.

Financial institutions will face shifting patterns of risk and will need to accelerate their responses to developments in the use of technology. Many will need to revisit and adjust their strategies and business models.

Supervisory authorities will need to understand and adjust to these shifting risks and to the ways in which consumers interact with financial institutions. They will also need to accelerate their own use of technology.

While not presenting this as a forecast or prediction, or suggesting that all of these changes will be permanent, supervisors should consider the potential impacts on supervised firms, on financial stability more generally, and on supervisory authorities themselves, from scenarios that include:

Macroeconomic conditions – the sharp – and potentially prolonged – decline in global real GDP and in asset and commodity prices, shifts in the level and term structure of interest rates, shifts in credit spreads, shifts in the value of industry sectors, and a deterioration in the creditworthiness of some sovereign borrowers will all have an impact on the value of the assets held by financial institutions. The economic recovery may be slower and shallower than expected. The need to unwind government and central bank support at some point will create uncertainty in identifying the firms (financial and non-financial) which will – or will not – exit such support in good shape, which in turn may delay the speed of recovery.

Financial flows – capital flows (including foreign direct investment) and remittances have fallen sharply, and their volume and pattern are likely to have changed permanently. Financial markets will become more fragmented.

Physical flows – some restrictions on the cross-border movement of people and goods may remain. In addition, many companies are already beginning to rethink their supply chains and to take a different view of the balance between resilience and risk. Financial institutions may reflect

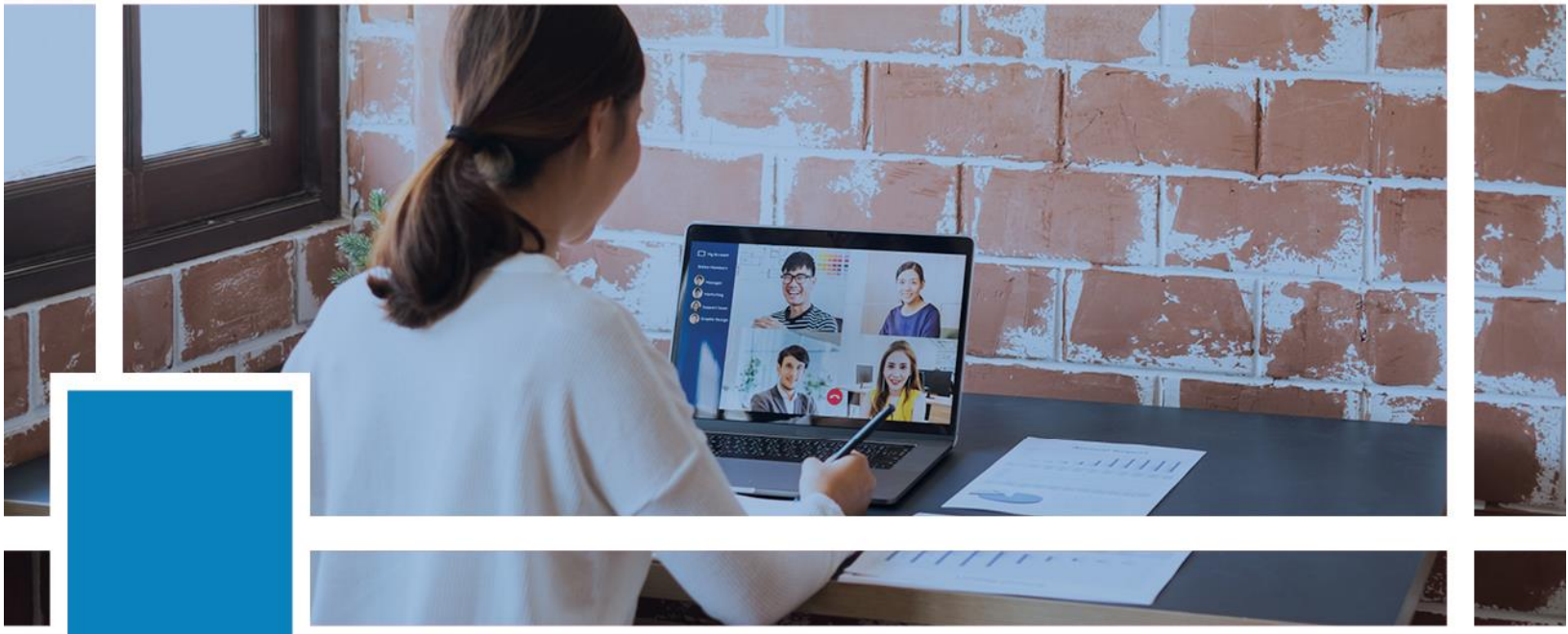
this in how they manage their reliance on outsourcing. The global economy will become more fragmented.

Technology – the current crisis has accelerated the shift towards technology-enabled, contactless, and customer-centric production and consumption of goods and services, working practices, and financial systems. The business model of financial institutions will become more digital-based as they accelerate the adoption of technology. There will be a further shift away from the use of cash to digital retail payment systems. Supervisory authorities will rely increasingly on data and data analytics.

Concentration – there is likely to be a further increase in the concentration and power of large corporates as a result of consolidation in some industries, reinforced by the economies of scale inherent in technology and the use of big data. This may include the financial sector, where supervisors will need to be alert to the systemic risks this could generate.

Moral hazard – government support for ailing companies, and prospectively for weak financial institutions, may create expectations that such support will be forthcoming in future crises, and thereby lead to an increase in risk-taking behaviours. There is a risk that the increased role of governments and central banks in the economy – through higher fiscal deficits, money-printing (central bank purchases of government bonds and other assets), bail-outs, and wide-ranging purchases in capital markets – and its attendant risks of vulnerability to capture by lobbyists and short-term political imperatives will distort markets, hold back economic growth, and generate greater uncertainty.

Wider concerns – there could be renewed outbreaks of COVID-19 or different viruses and diseases, causing further inequality, social divisions, and geopolitical tensions.



2 SUPERVISION PROCESSES, PROCEDURES, AND LEADERSHIP[6]

Supervisory authorities should adapt their supervision to the immediate constraints imposed by COVID-19, while planning for the longer-term impacts on supervised firms.

[6]This chapter is based on Toronto Centre (2020b), which also provides some illustrative examples of the actions that supervisors can take during crises.

What is different?

The COVID-19 crisis is creating unprecedented pressures on both supervisory authorities and supervised firms. Most supervisory authorities have activated their business continuity plans (where they had them in place ahead of the crisis) or taken broadly equivalent actions, the main immediate focus of which was on staff working from home (see Chapter 1). This proved to be reasonably successful once initial issues with IT provision, connectivity, internet access, and remote access to supervisory data and information had been resolved.

Meanwhile, as discussed in Chapter 1, many types of risk have increased in supervised firms and will remain elevated for some time.

Key issues

At the onset of the COVID-19 outbreak, the first key issue for supervisory authorities was to activate their business continuity plans (BCPs). A supervisory authority will not be able to meet its statutory objectives if it is not able to function in a crisis. Now that BCPs (or equivalent arrangements) have been activated, it is important for supervisory authorities to keep their operation under close review as the crisis unfolds and to ensure that lessons are learned for the future updating and development of their BCPs.[7]

Business continuity planning is fundamentally about identifying the most important and time-critical activities undertaken by the supervisory authority and ensuring that these can be carried out. The second key issue for supervisory authorities is therefore to reprioritize their activities in response to the shifting external risk environment and internal capacity pressures. Supervisors need to take the necessary prioritized measures to mitigate the short-, medium-, and long-term effects of a protracted period of stress.

A third key issue, to which we return in Chapter 8, is that amidst the contingency plans, social distancing rules, and travel restrictions, supervisors should review their modes of supervision and leverage technology where possible. In place of on-site inspections, supervisors can conduct off-site reviews of documents and video calls when clarifications are needed. These can be supplemented with more granular data collection and enhanced analyses to monitor key risk areas. Such a data-driven approach could facilitate more focused risk-based supervision, particularly of smaller financial institutions.[8]

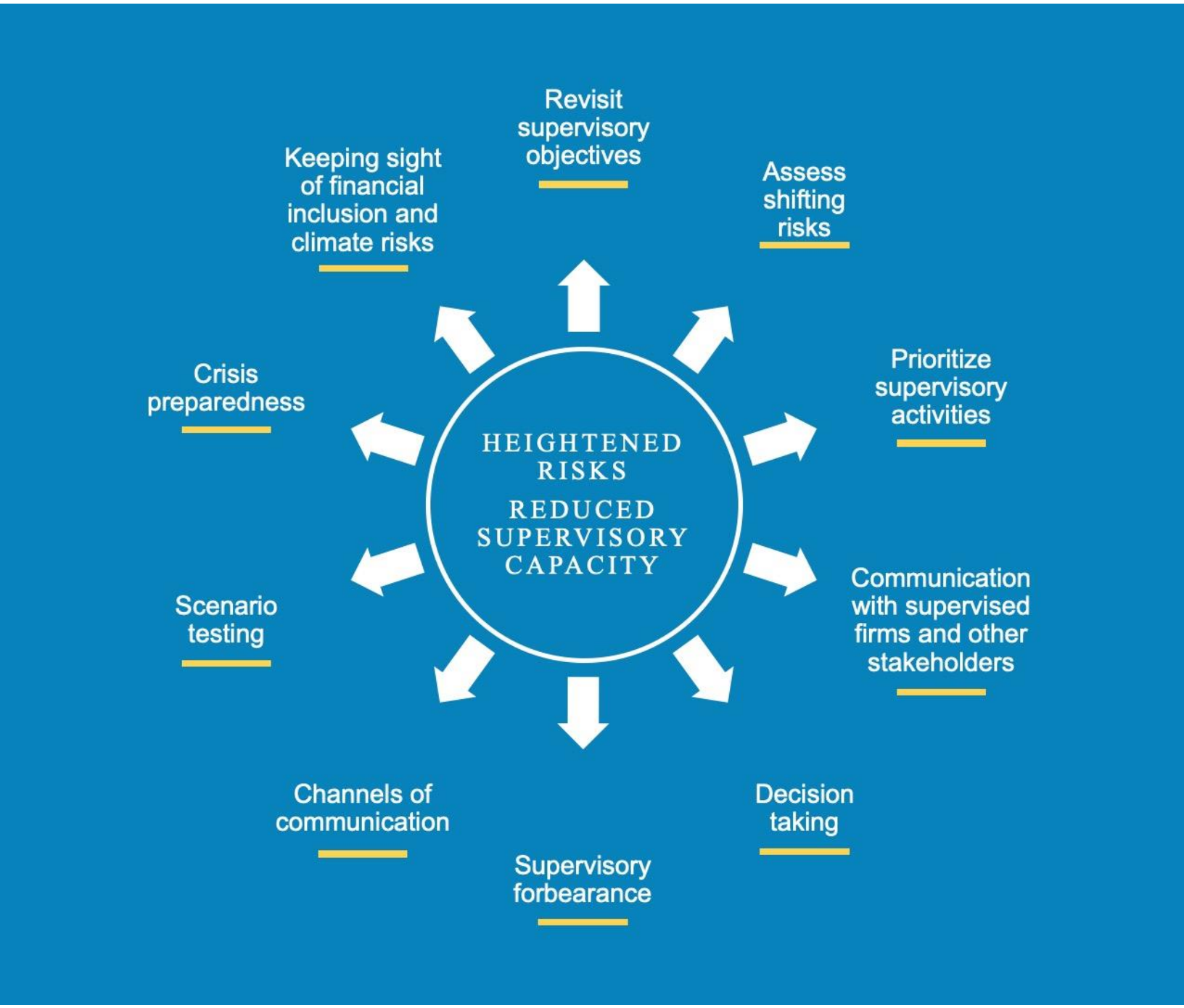
Supervisory authorities should adapt their supervision to the immediate constraints imposed by COVID-19, while planning for the longer-term impacts on supervised firms.

[7] Toronto Centre (2020c) discusses in more detail the construction and updating of business continuity plans for a supervisory authority.
[8] Toronto Centre (2020a) discusses in more detail risk-based approaches to the supervision of small firms.

Supervisory responses

The board and senior management of a supervisory authority need to demonstrate leadership and a clear sense of direction during a crisis. This should include the following ten elements.

Supervisory responses to COVID-19



1. Set strategic objectives

The strategic objectives of a supervisory authority will be determined by its statutory responsibilities, which are likely to include some combination of the safety and soundness of supervised firms, financial stability, consumer protection, market conduct and integrity, anti-money laundering, and financial inclusion. In addition, in a crisis a supervisory authority may also have an objective to work with other authorities to manage the crisis and to minimize the impact of the crisis on users of financial products and services.

2. Form a coherent view of how risks and risk tolerances have changed, and act accordingly

Supervisors should base their planning and actions on a clear view of how risks to their supervisory objectives have changed, and on how the risk tolerance of the supervisory authority may have shifted.

Some risks to supervisory objectives have increased in the current crisis. As discussed in Chapter 1, there are already significantly heightened levels of credit, insurance, market, liquidity, and operational risk. There is greater risk of systemic disturbance and certain types of financial crime. Supervisors cannot, and should not aim to, remove all risk; there will always be risks to the achievement of their objectives.[9] These risks need to be managed using the limited resources available to the supervisory authority, recognizing that while the crystallization of any risk is unwelcome, tolerances for them will differ.

Facing a combination of heightened risk and depleted resource, a supervisory authority should be more willing to tolerate low or moderate risks, at least temporarily. While the reassessment of risk tolerances sounds like a theoretical exercise and a distraction, it is something that all supervisors under pressure will find themselves doing in practice. This reassessment should also include the identification of new and emerging risks, and of new drivers of risk. Using a coherent framework allows a more thorough and rigorous process and provides staff with a clear rationale for what they are being asked to do. Tolerances for risk are also likely to vary over time.

3. Prioritize supervisory activities

Supervisory authorities need to prioritize their supervisory activities in response to heightened risks and reduced supervisory capacity. Significant changes in priorities should be determined by senior management and agreed on by the board of the supervisory authority.

Prioritization should already be a central feature of supervision. Supervised firms and issues should be classified according to the level of risk they pose to the achievement of the supervisor's statutory objectives.[10] The level and distribution of risk should then be the key drivers of the allocation of supervisory resources.

[9] See Toronto Centre (2018b).

[10] Toronto Centre (2018a) describes these central tenets of risk-based supervision.

Prioritization is key in a crisis. In extreme circumstances like the COVID-19 outbreak, risks will increase across the financial system. The gap between the perceived importance of high-impact or systemic firms and issues, and other firms and issues may widen. If the first priority is to prevent a high-impact or systemic event, it makes sense to maintain or increase the focus on systemic or high-impact financial institutions, even at the expense of reducing the scrutiny of lower-impact ones, at least in the short term.

The most critical supervisory activities that need to be carried out continuously are likely to include activities to maintain the prudential soundness of potentially systemic financial institutions in the financial system; and to maintain compliance with retail and wholesale conduct rules, anti-money laundering, and crisis preparedness (in case the heightened risks crystallize). These may require enhanced off-site supervision, based on additional regulatory reporting and intensified analysis of data and information – so data quality issues become critical.

Less critical activities should be capable of being delayed (for example, new authorizations, the implementation of some already announced policies and the formulation of some new policy initiatives, allowing extensions to supervised firms for the submission of ICAAPs, ORSAs, etc., and the analysis of returns for lower-impact firms); undertaken less frequently (for example, risk assessments for medium-low and medium-impact firms, some regulatory reporting, routine stress tests, and thematic reviews); or repurposed (for example, using stress testing and thematic reviews to assess the impact of the COVID-19 outbreak).

It may also be necessary to place greater reliance on supervised firms, where they have demonstrated good governance, risk management, and internal audit, and on accurate data and information reporting by supervised firms, for example in relying more heavily than usual on firms' own management or 'pre-packaged' information as well as the results of firms' own internal reviews and risk assessments. This could be combined with reminders to firms that a high level of reliance is being placed on them and that there will be serious consequences if this proves to be misplaced. This may be supplemented with an open-ended invitation to smaller firms or groups representing them to draw supervisors' attention to generic or industry-wide issues that may be giving rise to new, unexpected, or heightened risks.

For supervised firms with a cross-border presence, prioritization and deprioritization should also be discussed in (virtual) supervisory colleges, with scope for shifting the extent of reliance on home and host supervisors.

However, the reduced level of attention to less critical supervised firms and activities should be kept under close review as the crisis unfolds. Collectively, lower-impact/risk firms and issues remain a source of potential detriment to consumers and the wider financial system, and as such warrant some supervisory attention.[11] A backlog of smaller issues (and the attendant risks) may build up if the crisis is protracted and could prove overwhelming when the crisis is over.

[11] Supervisors who have a small firms strategy that recognizes these complexities (Toronto Centre 2020a) may find that it is necessary to adjust it and perhaps create a team specifically to maintain oversight of the risks arising from lower-impact firms and issues.

4. Ensure that there are channels of communication, however unconventional, with the highest-impact financial institutions and those involved in market-wide issues

Having identified the highest-priority supervised firms and supervisory activities, it is essential to maintain information channels that enable supervisors to understand the risks being faced and how these are evolving and being managed. While the usual forms of on-site work may not be possible, supervisors should look for alternatives and work-arounds, including more extensive contact by video, phone, e-mail, or other virtual channels; direct access (where possible) to supervised firms' own systems; firms scanning and sending files to the supervisor; and if possible some on-site visits for the most high-risk issues.

This may create heightened risks for supervisors that traditionally place heavy reliance on on-site activities such as physical file checking. As with all remote working, issues of data and information security may arise that need to be considered – but they may be unavoidable and, on a balance of risks, judged to be acceptable.

There should be an initial contact with each high-impact supervised firm to discuss its operational resilience, review its recovery plans, and to agree on communication and reporting arrangements during the crisis. It is likely that there will be a need for (at least) daily contact and close interaction thereafter, as well as various forms of enhanced monitoring – for example of liquidity, bank capital, insurers' solvency, and securities firms' position taking and valuations.

Supervisors should also monitor and review the implementation of contingency plans by major financial institutions. This would enable supervisors to assess whether key institutions would be able to maintain operational continuity under different pandemic scenarios and require enhancement to their business continuity plans where appropriate. Of particular interest would be any interdependencies across institutions and whether supervisors could help facilitate coordination amongst industry players.

5. Ensure that there is proper management, governance, and recording of important supervisory decisions

Most supervisory authorities derive their powers from legislation. These are delegated by the governing board of the supervisory authority, which retains overall responsibility for the authority's actions and for the achievement of its statutory objectives. The board should be fully apprised of the authority's response to any crisis, including any changes in delegated authority or the use of powers.

The board of the supervisory authority should be aware of, and ideally sign off on, changes in policies and priorities as well as significant management issues. It should constructively challenge the executive to explain key decisions that have been made and the analysis done to support them, while taking care not to add to the burden on the executive at what is certain to be a busy time. Some form of 'light touch' monitoring mechanism, potentially involving board committees, may need to be put in place in between scheduled board meetings.

It is also important that significant decisions and changes in procedures are properly documented. It is easy to lose sight of this in the heat of a crisis, but some measures will

have long-lasting effects and supervisory authorities may be held to account for their decisions and actions once the crisis is past. They will need to provide documentary evidence of their decisions and the rationale for them.

6. Put in place a rational approach to supervisory forbearance

A crisis affecting a significant part of the financial sector will inevitably create strains resulting in requests for supervisory forbearance. Financial institutions may ask to be allowed temporarily to breach capital, solvency, liquidity, provisioning, or reporting requirements.

The responses to some of these requests will be more straightforward than others. It is possible, for example, to weigh the benefit to a financial institution of postponing reporting on some required metric for, say, one month against the risk of a serious problem not being identified. In some cases, it will be expedient and appropriate to provide blanket exemptions in the case of 'lower-order' forbearance decisions with potentially low impact.

For other decisions however, the issues are much more complex. Deteriorations in credit quality may cause banks to breach minimum capital requirements (even after the removal of some macroprudential capital buffers). Insurers and position-taking securities firms may breach solvency requirements as a result of mark-to-market losses on tradable assets. Supervisors should try to avoid blanket forbearance measures here, because the potential costs are high. Instead, supervisors should consider the market-wide impact of forced liquidations of financial institutions on the economy and markets, and make case-by-case assessments of institutions' recovery options (raising additional capital or increasing retained earnings by withholding dividend and bonus payments).

One supervisory tool here would be stress testing, to assess the impact of alternative medium-term scenarios on supervised firms' capital and solvency. Stress test scenarios should reflect the new post COVID-19 financial landscape and interdependencies between financial institutions for a more realistic picture of the applicable risks. Forbearance would be more justified for those financial institutions where stress tests and credible recovery options showed clear paths by which these institutions could restore adequate capital or solvency.

7. Maintain effective channels of communication with other key stakeholders involved in managing the crisis

Where there exists a well-developed framework for financial stability oversight and policy, there should already be extensive coordination among supervisory authorities, central banks, macroprudential authorities, resolution authorities, and finance ministries. The need for such coordination is particularly acute during a crisis, especially one with market-wide implications such as the COVID-19 pandemic.

However, some countries do not have well-developed coordination frameworks and where this is the case, it is important for supervisory authorities to establish collaboration with a wide range of potential stakeholders, including the central bank (as the provider of liquidity, facilitator of market

operations, and often the macroprudential authority), the Ministry of Finance (as the provider of economic support and guarantees in response to COVID-19, and the potential provider of support for failing financial institutions), deposit and policyholder protection schemes, the resolution authority, other supervisory authorities (domestically and internationally), and the media and the general public.

8. Scenario test the possibility that the crisis will deepen or be more protracted than expected, with further impacts on risks and the availability of resources

The crisis may intensify in severity or duration. Market conditions – asset prices, liquidity, and potential credit delinquencies – may deteriorate further. Operational strains may mean that supervised firms are less able to function and/or the supervisory authority itself may come under further operational strain. Unscrupulous market participants who have previously been regarded as being low risk may see opportunities to take advantage of disruption to create detriment to consumers.

While it is clearly not possible to anticipate all possibilities, supervisors should conduct a high-level scenario-based exercise to consider how risks or operational constraints might intensify or emerge as the crisis evolves; how to respond if one or multiple major financial institutions ran into serious solvency or liquidity issues; and how to respond if a group of the supervised firms or supervisory activities to which less resources are currently being devoted emerged as a major source of risk during the crisis.

9. Enhance crisis preparedness

Supervisors should plan for adverse outcomes, in particular where the economic recovery is less immediate and/or less strong and could threaten the viability of some financial institutions or even generate financial instability.

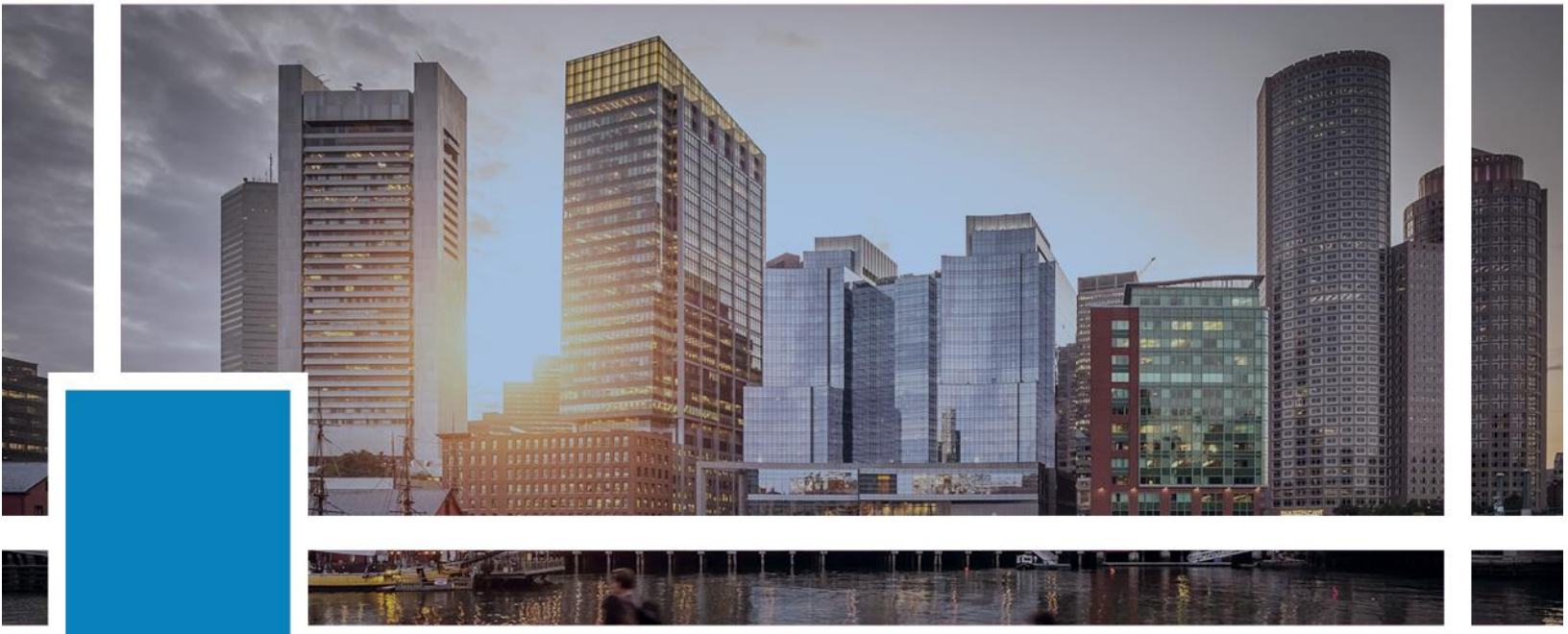
Supervisors need to plan in advance for the possibility that some supervised firms will become non-viable as a result of the COVID-19 outbreak. This will require supervisors to implement their exit policy for dealing with failed (or failing) financial institutions, be this through putting these institutions into liquidation, using the Financial Stability Board range of resolution tools,[12] or possibly requesting some form of government support. Supervisors should also ensure that they are ready for the possibility of a system-wide crisis and for the need to cooperate and share information with other authorities accordingly.

[12] See Toronto Centre (2020h).

10. Keep sight of wider issues such as climate change, financial inclusion, and gender equality

In dealing with a crisis, supervisors will rightly be focused on very immediate issues concerning the ability of supervised firms to continue to operate and the ability of consumers to reliably access financial services. There is a risk that other core issues – such as climate change-related risks, financial inclusion, or gender equality – may be ignored, or that the crisis itself, or decisions made in a crisis, may have adverse implications for these other issues. This is likely to become more of a problem as any crisis becomes more protracted.

Supervisory authorities should take the opportunity of their regular reviews of how their prioritization decisions and crisis management are functioning to maintain a strategic perspective on wider and longer-term issues. Important initiatives should not be abandoned because of a crisis, even if they are deliberately deprioritized for a period.



3 CREDIT RISK[13]

Heightened credit risks and the potential for a longer-term deterioration of credit quality should be constantly re-assessed by supervisory authorities and supervised firms, given the broad-based and continuing impact of COVID-19 on most economic activities.

[13] Toronto Centre (2020d) covers this topic in greater detail.

What is different?

As discussed in Chapter 1, the sharp downturn in economic conditions has had a significant adverse impact on credit quality. The impact of this is beginning to be revealed – many banks reported sharply higher non-performing exposures and loan loss provisions in the second quarter of 2020. The inability of some borrowers to meet interest and principal payments has also had an adverse impact on banks' liquidity. Policy responses by governments, central banks, and macroprudential authorities have provided only partial mitigation. Lenders that entered 2020 with weak financial position may be particularly exposed to the impacts of COVID-19 on credit quality and liquidity.

Governments, supervisors, banks, and microfinance providers have mandated, encouraged, or granted payment holidays to some borrowers, under which repayments of interest and principal are delayed (but not written off).[14] This is intended to allow loans to be rearranged or restructured in ways that may benefit both lenders and borrowers, to avoid putting borrowers with immediate repayment difficulties into default, and to avoid a sharp contraction in lending and a fire sale of assets held as collateral. It is not intended to lead to a permanent evergreening of loans.

Banks in some countries have also agreed not to trigger covenants in loan agreements relating to minimum levels of collateral and maximum loan-to-value ratios; to apply lower than usual interest rates on some types of enforced borrowing (for example the drawing down of overdraft facilities); to ensure that using any of these temporary payment freeze measures will not lower consumers' credit scores; and to offer new loans to enable borrowers with reasonable longer-term prospects to survive the current downturn.

Other types of financial institution also face credit risk, from lending, investments, guarantees, counterparties, and other types of exposure, not least insurers and securities firms. Parts of this chapter are therefore also relevant to them.

Key issues

The economic policy responses to the COVID-19 outbreak leave considerable uncertainty about the future, both at the macro level (the nature and shape of the economic recovery) and at the micro level (which individuals and corporates will be able to repay their debts in the future, and which will not). The creditworthiness of some borrowers will deteriorate over the longer term, while some other borrowers will need support in the short-term, but may not suffer a longer-term deterioration in their creditworthiness. Much will depend on the nature and pace of economic recovery.

This makes it difficult for banks to account for the impact of the COVID-19 outbreak in terms of loan classification, expected credit losses, provisioning, credit risk weightings, and the impact on their capital ratios. In many countries, the relevant accounting standard is International Financial Reporting Standard 9 Financial Instruments (IFRS 9),

[14] See, for example, Allen and Overy (2020).

or its US equivalent under Generally Accepted Accounting Principles (GAAP).

IFRS 9 sets out a framework for determining the amount of expected credit losses (ECL) that should be recognized and requires that lifetime ECLs should be recognized when there is a significant increase in credit risk (SICR) on a financial instrument. As the International Accounting Standards Board (2020) and international and national supervisory authorities[15] have emphasized, IFRS 9 is principles-based, and these principles could be used by banks to reflect their judgements on the positions of individual borrowers and on economic conditions more generally. There are three steps in this approach:

The accounting standards already contain some flexibility over how a bank should assess SICRs and determine ECLs based on the best available information about past events, current conditions, and forecasts of economic conditions over the total expected life of each credit exposure.

The authorities have issued guidance and revised rules to indicate how this flexibility could be applied in the current context.[16] Banks should apply judgement and adjust their approach to determining ECLs according to the current circumstances, rather than applying their existing ECL methodology in a mechanical manner.

The guidance and rule changes also refer to some specific accounting treatments in current circumstances. Payment holidays need not lead automatically to treating a loan as non-performing or in default.

Supervisory authorities have also provided guidance on the impact of the COVID-19 outbreak on the calculation of regulatory capital ratios.[17] This enables banks to reduce the extent to which non-payments of interest and principal feed through to higher provisioning and higher capital weightings, and to their measured regulatory capital ratios.

The full implementation of Basel III has been delayed by a year to January 2023.[18] Supervisory authorities have also relaxed and extended the transitional measures applying to the alignment of accounting and prudential measures of capital adequacy, allowing banks to avoid the full capital impact of expected credit losses in the initial years of moving to the new accounting standard.[19]

The prolonged nature of the COVID-19 outbreak intensifies the tensions between supporting lending through these relief measures and preserving the safety and soundness of lenders and financial stability more generally.

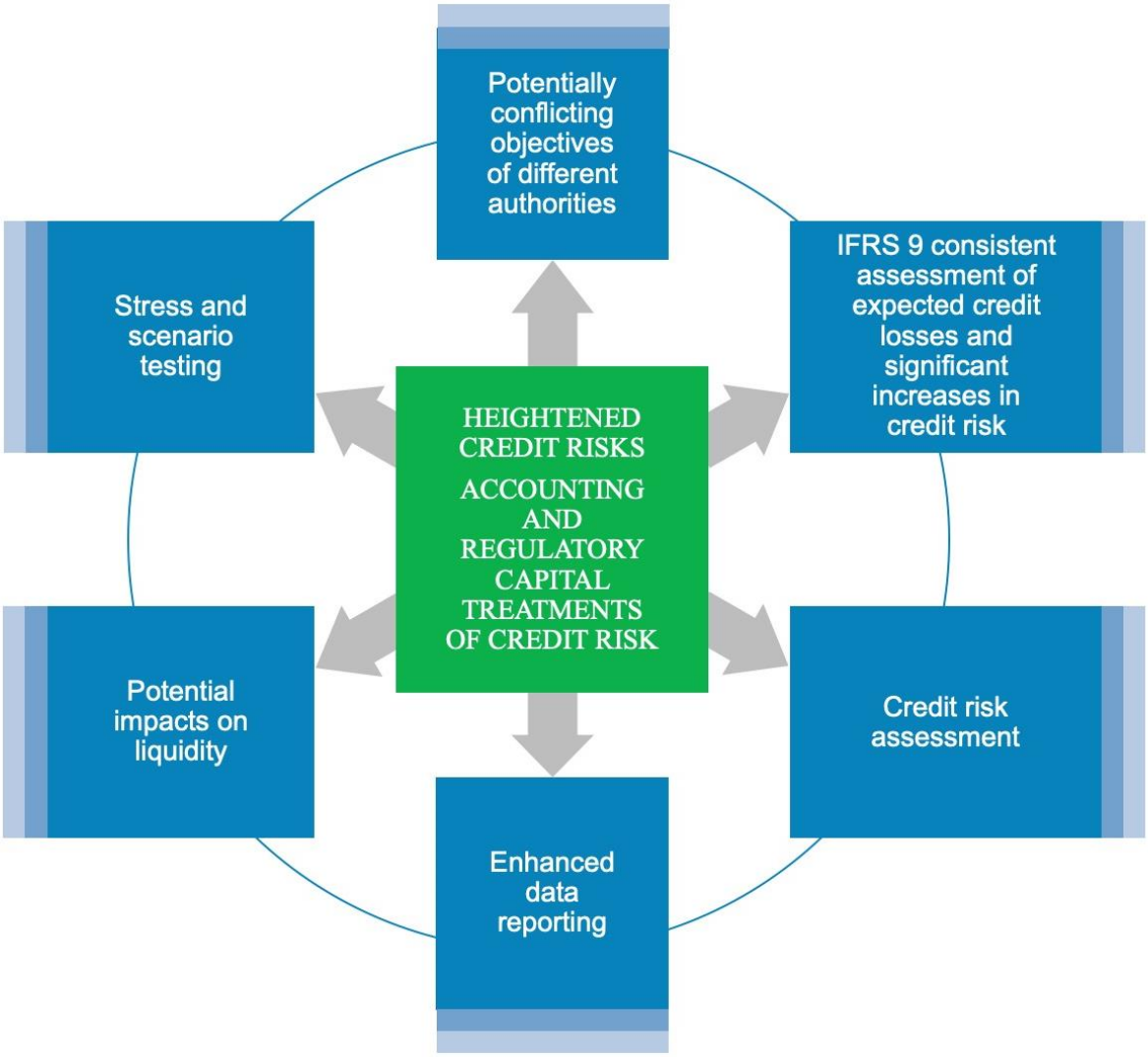
[15] See, for example, Basel Committee (2020b).
[16] Toronto Centre (2020f) discusses how such flexibility could apply in the case of Islamic banks.
[17] See, for example, Basel Committee (2020b).
[18] Basel Committee (2020a).
[19] Basel Committee (2017 and 2020b).

Supervisory responses

Many of the policy responses to COVID-19 involve the authorities accepting a higher level of risk (less prudent capital standards) in pursuit of the wider goal of keeping borrowers afloat during a difficult time and promoting economic recovery. But there are limits to how far this can go without leaving banks in an unsound position. It is in no one's interests to end up with under-capitalized (or even failed) banks with large amounts of lending to 'zombie' borrowers, and with inadequate provisions against non-performing loans.

Supervisory authorities need to recognize and address this dilemma in the face of the highly imperfect information about the nature and duration of the current economic downturn – credit conditions have certainly changed markedly for the worse, but the extent and duration of the deterioration are not known and will not be known for some time.

Supervisory responses: credit risk



Supervisors should focus in particular on the following six areas:

1. Recognize that there may be tensions, or even conflicts, across the objectives of different authorities

Macroprudential authorities have reduced or removed some capital buffers (see Chapter 1). Some conduct supervisors have encouraged banks to offer payment holidays, to charge low rates of interest on overdrafts, and to avoid, as much as possible, situations in which residential mortgage borrowers might be at risk of losing their homes.[20]

There is a potential tension here between the different objectives of macro- and microprudential authorities, and between conduct and prudential supervisors. Therefore, there are some difficult balances to be drawn between increasing the lending capacity of banks, protecting consumers, and maintaining the safety and soundness of banks. For example, micro-prudential supervisors might take a more cautious view of allowing banks to reduce their regulatory capital ratios at a time when risks to the safety and soundness of banks have increased, and non-performing loans and loan losses are increasing and could increase further.

There is therefore a need for close cooperation and coordination between macro- and microprudential authorities and conduct supervisors, and a means for resolving any conflicts.[21]

2. Promote a consistent and prudent approach to how banks assess and report expected credit losses and significant increases in credit risk

Supervisors should issue guidance[22] to banks on how they should assess SICRs, measure ECLs, take account of deteriorations in the value of collateral, make provisions, and calculate regulatory capital ratios in the COVID-19 outbreak economic environment. Guidance that payment holidays need not result in loans being classified as impaired is intended to allow banks the flexibility to take a case-by-case approach to assessing the likelihood of repayment. It is not intended to allow banks to avoid having to classify any such loans as being impaired on a blanket basis. The main objective here is to ensure a sound identification of credit impaired assets on bank balance sheets.

Supervisors may also need to issue guidance on how banks should report – to supervisors, investors, and other stakeholders – their approach to assessing credit quality and the impact of this on their balance sheets. Transparency, consistency and comparability in risk metrics is a pre-condition for banks, supervisors, investors, and the general public to monitor the effects

[20] See, for example, Financial Conduct Authority (2020a) and Board of Governors of the Federal Reserve System et al. (2020).

[21] This is discussed further in International Monetary Fund (2013).

[22] In some countries, this may have to be done through making revised rules or waiving existing rules.

of the current crisis on banks in a coherent way.

3. Ensure that banks have robust, coherent, and defensible processes for assessing credit risks

Supervisors should review whether banks have robust and defensible approaches to the management of their credit risk, and should intervene where necessary if these approaches are judged to be inadequate. This review should cover how banks are:

- taking a borrower-by-borrower approach to assessing creditworthiness and loan classification, distinguishing between borrowers on a consistent and justifiable basis;
- making responsible, measured, and accountable use of the flexibility allowed in accounting and capital standards;
- operating effective internal processes, and senior management and board oversight of the decisions they take;
- making adequate provisions and write-downs once non-performing exposures are identified;
- taking account of deteriorating sovereign risk on existing sovereign exposures and on loans (or borrowers) that have received government guarantees or other support during the COVID-19 outbreak; and
- making regular reassessments of credit conditions. Banks should not be allowed to manage their credit risk on the basis of over-optimistic expectations of a strong and rapid economic recovery, or of continuing government support.

This review should be based on an analysis of how each bank has approached the assessment of the creditworthiness of borrowers and loan classifications in response to the COVID-19 outbreak (for all borrowers, not just those granted payment holidays). The review should include the assumptions and modelling used by banks for these assessments; supervisors' own reviews of bank credit files and models (these could be sent by banks to their supervisors as a substitute for more traditional on-site examinations); and supervisors' own assessments of the creditworthiness of major borrowers, industry sectors, and consumer lending.

Banks and their supervisors may both place greater reliance on external auditors to review banks' approaches to the shifting nature of credit risk in current circumstances.

4. Review data on the impact of the COVID-19 outbreak on credit quality

Supervisors should review current reporting requirements – and amend them as necessary – to ensure that they are receiving on a regular basis the relevant data points, ratios, and other information to enable them to identify potential issues arising from the COVID-19 outbreak.[23] This should include:

[23] See European Banking Authority (2020) for a good example of how reporting requirements should be adjusted in light of COVID-19.

- data to assist in the early identification of potential problem loans or higher risk borrowers – both corporate and household – through monitoring of delinquency in repayments;
- standard metrics for non-performing loans (NPLs) – levels of NPLs, flows into and out of NPLs, provisioning, write-offs, and losses taken;[24]
- data on how the COVID-19 outbreak has affected loan classifications and loan loss provisioning, both overall and by sector (some lenders may have concentrations of credit risk to some of the worst affected sectors, for example households, hospitality, tourism, airlines, commercial property, and shipping);
- data on the type and amount of loans where the borrower has been granted a payment holiday, and data on how each lender has divided these loans into (a) loans where the bank has made use of the flexibility in accounting standards to treat the loans as continuing to perform, and (b) loans classified as non-performing;
- more granular data on credit exposures to enable supervisors to undertake their own assessments of credit risk for each financial institution; and
- financial institutions' own internal management information on credit risk, and their policies and procedures for managing payment delinquency and past due exposures.

Supervisors should then use these data to develop new supervisory indicators of the impact of COVID-19 on lenders' loan portfolios.

Supervisors could also undertake various types of horizontal review of how lenders are assessing the creditworthiness of their borrowers, and to look more closely at outlier lenders. For example, a supervisor could compare across lenders:

- the proportions of their loans affected by the COVID-19 outbreak (overall, by sector, by retail segments, and by individual large corporates);
- for loans where the borrower has been granted a payment holiday, the extent to which banks have used the flexibility in accounting standards to avoid classifying these loans as non-performing (again, overall and by sector); and
- in countries where major corporates borrow from multiple banks, supervisors could also review the extent to which individual banks have taken different approaches to assessing the post COVID-19 creditworthiness of these corporates.

It is also important that lenders keep their assessments under close review so that loan reclassifications can be made on an informed and timely basis as the situation develops and more information on underlying credit conditions becomes available.

[24] Annexes 1-3 of European Banking Authority (2018) provide a comprehensive listing of standard metrics for NPLs.

Heightened credit risks and the potential for a longer-term deterioration of credit quality should be constantly re-assessed by supervisory authorities and supervised firms, given the broad-based and continuing impact of COVID-19 on most economic activities.

This is also a good time for supervisors to be focusing on lenders' NPL management capabilities, in particular their ability to reduce NPLs through workout options and other tools. They should also be focusing on wider legal issues regarding the ways in which insolvency regimes and debt recovery processes could be improved.[25]

5. Review the impact of the COVID-19 outbreak on banks' liquidity positions

Supervisors should keep banks' liquidity positions under close review as the crisis unfolds, including by:

- monitoring the standard liquidity metrics, in particular the Liquidity Coverage Ratio and a cash flow maturity mismatch profile that is adjusted to take account of the impact of the COVID-19 outbreak;[26]
- requiring banks to provide additional data, for example daily reporting on some liquidity metrics, in particular shortfalls against expected cash inflows resulting from deferred payments of interest and principal; and
- requiring banks to explain how they are monitoring their liquidity positions, the roles of the risk management function, senior management, and the board, and the content and use of management information.

6. Stress testing

Banks should be stress testing their credit exposures and liquidity positions against a range of severe but plausible scenarios, including U-, W-, and L-shaped economic recoveries, by using stress tests that reflect the specific risks faced by each individual bank. Slower economic recoveries (overall, or in specific sectors of the economy) will result in higher levels of non-performing exposures, with consequences for banks' loan losses, credit risk weightings, and capital and liquidity ratios. Banks should report the results of these stress tests to their supervisors, together with the actions they would take if these more adverse scenarios began to emerge.

As in normal times, there are also benefits in supervisors undertaking their own stress tests to assess the possible impact of a standardized scenario on both the capital

[25] See for example the comprehensive guidelines published by the European Banking Authority (2018).

[26] Basel Committee (2019) discusses a wide range of liquidity metrics that banks should monitor, in addition to the Liquidity Coverage Ratio and the Net Stable Funding Ratio.

and liquidity positions of individual banks and on the resilience of the banking system as a whole. This supervisory stress test could be based on specifying alternative paths for economic recovery, or it could focus more directly on the impact of alternative levels of non-performing loans by specifying default and loss given default rates.

Stress tests should also consider possible feedback and second round effects. For example, a decline in banks' actual or perceived capital ratios could lead to a higher cost and reduced availability of funding (as happened in 2008). And the strains on government funding arising from the COVID-19 outbreak could have an adverse impact on the credit standing of some countries.[27]

Stress tests can provide valuable information on:

- the plausibility of each bank's scenarios and its credit and liquidity risk management capabilities more generally – some banks may not be using sufficiently severe scenarios, or may be making over-optimistic assumptions about the adverse impact of each scenario on their credit quality and liquidity. Some banks will need to raise new capital, not just to suspend dividend and bonus payments;
- which individual banks might be the worst affected by the COVID-19 outbreak, both immediately and over the longer term;
- the points at which individual banks would face a serious depletion of their capital resources or liquidity, requiring them to activate their recovery planning, and at which the banking system could become unstable;
- the extent to which supervisors can prudently allow banks to run down some capital and liquidity buffers, the options for continued supervisory forbearance, and the formulation of a medium-term exit strategy under which supervisors can reimpose the full range of capital and liquidity requirements; and
- the need to enhance crisis preparedness (see Chapter 2).

[27] This could also be reflected in a stress test by applying higher risk weights on sovereign and other public sector exposures.

4 INSURERS AND PENSION FUNDS

Insurance and pension fund supervisors should assess the impact from this health crisis, amid a potentially long-term low interest rate environment, on the continuing viability of their supervised firms.

What is different?

As discussed in Chapter 1, insurers and pension funds have faced a range of challenges arising from COVID-19. These vary across countries and even for different insurers and pension funds within countries, not least because of the breadth of mechanisms through which COVID-19 has had an impact on these types of financial institution.

One set of impacts arises from various types of insurance risk – shifting mortality rates across different age groups; health cover and workers' compensation claims (particularly from health workers); travel, business interruption, and event cancellation claims; and lower motor-related claims reflecting reduced road transport volumes.

Meanwhile, the economic environment is having an adverse impact on asset values and market volatility; is extending the prospective time frame for a continuing low interest rate environment; is leading to policy cancellations and a lower rate of new and renewed policies; and is making it more difficult for pension scheme sponsors to maintain their rates of contribution to the scheme.

It is not clear whether, overall, insurers' financial resilience will be more affected by the stress from financial market volatility or by insurance risk. But both types of impact will have an adverse effect on insurers' solvency ratios and liquidity.

There are also increased operational challenges and risks to address. Working from home was not unanticipated by many employers, but the scale and magnitude of the challenge exceeded what was expected. Many insurers responded by developing electronic platforms or facilities to process claims online. Insurers in general are also making increasing use of technology to underwrite new policies. This is a health crisis and it is important that insurers' critical systems continue to operate as their policyholders may increasingly need to utilize the health benefits of their policies.

Key issues

Insurers, pension funds, and their supervisors face two key issues from COVID-19. The first is to assess the current impacts on asset values, claims, premiums, and contributions, as discussed in Chapter 1.

The second is to consider and assess the potential impact of uncertain future developments, such as the interest rate environment, the depth and length of economic weaknesses, and the longer-term health impacts of COVID-19.

Interest rates were low – and in some cases declining – even before the COVID-19 crisis and this was exacerbated during the crisis as several countries lowered rates even more. Some monetary authorities and central banks have issued forward-looking guidance that interest rates will stay low for a while. A low interest rate environment creates asset-liability matching challenges for insurers and defined benefit pension plans. The low interest rate or even negative interest rate environment could affect those products with guarantees as these policies could come closer to being in the money. Actuaries should take this

increased risk into account in their modelling scenarios. There has also been a widening of corporate spreads as economic uncertainty increases. These trends tend to expose insurers to reinvestment risks and have an impact on reserving assumptions, particularly in life companies with longer-term products. This in turn could have a negative impact on solvency.

The impact of COVID-19 on the real economy could result in lower volumes of both new and renewal business. This is particularly problematic during a pandemic in emerging economies where insurance is sold face-to-face, more so than in developed economies. This trend will have implications for liquidity and market share.

Market volatility and the economic downturn have an impact on both defined benefit (DB) and defined contribution (DC) pension plans. Plans may experience declining solvency and funding ratios from asset depreciation values, liquidity challenges, and sponsors experiencing difficulties with making contribution payments.

Supervisory responses

Supervisory authorities need to recognize and assess the various immediate and longer-term pressures on insurers and pension funds as a result of COVID-19.

The nature and duration of the current economic downturn remains uncertain, as do the longer-term health and behavioral consequences of COVID-19.

Supervisory responses: insurers and pension funds

Supervisors should focus in particular on the following six areas:

1. Business continuity planning and operational resilience

Where in place, insurers and pension funds activated their business continuity plans (BCPs) as a starting point for adjusting to the COVID-19 world. BCPs cannot be expected to anticipate every situation and therefore leadership is critical to survival during the crisis. COVID-19 has caused serious disruption to financial institutions and therefore priority must be given to ensuring operational resilience as well as financial resilience. Financial institutions have been very much in the recovery, response, and communication phases of operational resilience, following a disruptive event.

Insurers and pension funds have coped reasonably well with the operational challenges arising from the COVID-19 outbreak. However, working from home has some limitations, especially over a prolonged period, and it is important for supervisors to monitor whether this is creating data protection and confidentiality issues, or is causing unreasonable delays in issuing new policies, dealing with claims, pensions administration and pension transfers, and the handling of complaints.

Supervisors also need to focus on whether insurers and pension funds have reviewed the functioning and adequacy of their BCPs, learned lessons from this and are revising their BCPs accordingly. The experiences of some countries of a second wave of COVID-19 infections makes this all the more pressing and important.

2. Protecting pension fund members

Pension fund supervisors need to engage in heightened levels of communication[28] with the trustees of pension funds to ensure that fund members are not disadvantaged during the COVID-19 outbreak. Particular attention is needed on issues such as investment risks, contribution holidays, and hardship withdrawal requests.

Supervisors and pension fund trustees need to step up their monitoring of the macroeconomic implications of the COVID-19 outbreak, to identify which plans are experiencing financial difficulties with contribution payments. Fund sponsors experiencing financial difficulties or liquidity problems could be constrained in making their regular contributions. Sponsors may be operating in industries that are severely impacted by the current crisis, for example, tourism, hospitality, and airlines. Major supplier companies could also be adversely affected. For employers that are not publicly listed, supervisors need to engage in creative ways to assess their financial situation.

Hardship withdrawal requests are particularly sensitive and difficult to address. This has implications for financial inclusion. Withdrawals from DC plans jeopardize the eventual pension payouts for members. This has significant and far reaching financial inclusion implications and need to

[28] See European Insurance and Occupational Pensions Authority (2020).

be dealt with in a balanced and proportional manner. Increases in requests require the trustees of a DC fund to engage in more efficient communication and education of members.

Many fund trustees and investment managers are under pressure to rebalance their fund portfolios, which could result in increasing duration mismatch and consequently increase the risk profile of the plan. Market volatility has resulted in declining funding ratios of many plans, so employers will be required to increase contributions for DB plans. The need to increase contributions can only be definitively determined by the appointed actuary at the valuation date. Actuaries have an obligation to recommend contribution increases based on projected funding requirements. However, many countries only require an actuarial valuation report to be prepared every three years. Supervisors should therefore consider encouraging these funds to commission an interim valuation to determine the funding status of the fund.

DB funds may be experiencing liquidity challenges, at least in the short term, as the benefits and administrative expenses may exceed their contributions. These funds should be easy to identify based on the ratio of retirees to existing members. Investment returns may be depressed and insufficient to meet the required liquidity needs of the fund.

Supervisors need to ensure that hybrid funds (which contain features of both DB and DC) are not overlooked as these funds usually have contractual obligations for contributions or benefit payments.

Supervisors also need to be mindful that pension funds are long-term investors that make an important contribution to the economy. Like life insurers, their investment patterns tend to be counter-cyclical[29] and can therefore play a stabilizing role in the economy. However, investment managers and trustees may shift to a more risk-averse portfolio even when asset returns are low. Supervisors need to exercise a balanced approached when addressing funding shortfalls and lateness in contributions.

3. Solvency assessment

Low interest rates in major international financial markets have declined even further following the COVID-19 outbreak. This has a negative impact on insurers in terms of investment opportunities and asset-liability matching.[30] Compared to life companies, non-life insurers usually have a heavier weighting in high-quality, fixed income securities because of their shorter-term liabilities. The low interest rate environment would have a lagging impact on their investment yield. Market volatility, increasing risks on some business lines, policy lapses, and a reduced flow of new business have an additional adverse impact on profitability and cash flows, while the downgrading of corporate debt instruments could have a negative impact on the solvency position of many insurers as these securities move to a higher risk-weighted category.

This in turn could result in downgrades of insurers, and has implications for supervisors, particularly if these insurers are classified as systemically important. There could also be wider implications because, like pension funds, insurers are important institutional investors, so any de-risking on a major scale could have a significant impact on the real economy, including the supply of funding for investment projects. Supervisors therefore need to monitor closely the solvency and liquidity of

[29] Pensions Europe (2020).

[30] Milliman (2020).

insurers. Where there is sufficient certainty that insurers can rebuild their solvency and liquidity, supervisors may choose to exercise some temporary forbearance in allowing insurers to run for a period with lower levels of solvency and liquidity.

Insurance and pension fund supervisors should assess the impact from this health crisis, amid a potentially long-term low interest rate environment, on the continuing viability of their supervised firms.

4. Legal risk

Non-life insurance products (in particular for travel, medical cover, and business interruption) often exclude pandemic-related risks and/or government actions such as lockdowns in their polices; however, this is done on a policy-by-policy basis. The COVID-19 outbreak has led to legal challenges to these exclusions. In some cases, this has been from individual claimants, including from employees who have become ill from COVID-19 work-related conditions, while in others, supervisors have brought cases to the courts to establish legal certainty, for example on business interruption cover.[31] In other cases, policy-makers are trying, through legislative means, to make retroactive adjustments to existing contracts to permit coverage for business interruption.

If these measures are successful, non-life insurance companies in these countries could experience financial difficulties including liquidity challenges, since the premiums written did not take these potential claims into consideration and sufficient actuarial reserves would not have been established. Litigation also implies a potential increase in claim settlement times, resulting in long-tail liabilities. Disputes over coverage could also damage the reputation of insurers.

Supervisors should review the exposures of individual insurers to these risks and take the additional risks into consideration when assessing the capital and liquidity positions of these insurers.

5. Stress testing

Insurers should be rigorous in running a range of scenario and stress tests to assess the impact of severe but plausible scenarios on their solvency and liquidity positions. These should include a range of macroeconomic and interest rate scenarios; a range of mortality and illness rates; and a range of non-life claims including the potential consequences of insurers being forced to make unexpected payments against claims for travel and business interruption cover. The full effect of the COVID-19 pandemic has yet to emerge and because of this uncertainty, insurers need to be imaginative in the selection of base and adverse scenarios for stress testing purposes. The types of claims and incidences of claims could differ from those typically modelled by actuaries.

Insurers should report the results of these stress tests to their supervisors, together

[31] For example, in the United Kingdom the Financial Conduct Authority brought a legal test case to establish the obligations of insurers relating to business interruption policies. This found in favour of policyholders, with consequent financial implications for insurers. See Financial Conduct Authority (2020b).

with the actions they are already taking (reserve strengthening) and the actions they would take if these more adverse scenarios began to emerge.

As in normal times, there are also benefits in supervisors undertaking their own stress tests to assess the possible impact of a standardized scenario on both the solvency and liquidity positions of individual insurers and on the financial resilience of the insurance sector as a whole.

Stress tests can provide valuable information on:

- the plausibility of each insurer's scenarios and its risk management capabilities more generally – some insurers may not be using sufficiently severe scenarios, or may be making over-optimistic assumptions about the potential adverse impacts of each scenario;
- the points at which individual insurers would face a serious depletion of their capital resources or liquidity;
- which individual insurers might be the worst affected by the COVID-19 outbreak, both immediately and over the longer term; and
- the extent to which supervisors can prudently allow insurers to operate temporarily with weaker solvency or liquidity positions, the options for continued supervisory forbearance, and the formulation of a medium-term strategy under which supervisors can reimpose the full range of solvency and liquidity requirements.

Supervisors should also encourage insurers to focus more on longer-term scenario testing and strategic planning that encompasses decades rather than the normal three- to five-year cycle. These efforts should also incorporate strategies to identify and analyze climate-related risks, cyber risk, pandemic risk, and other potential threats to operational and financial stability. For many insurers, this will require a fundamental shift in thinking about the interdependencies among these risks, financial as well as environmental. There is ample and growing evidence that sources of systemic risk do not always stem from the financial and commercial sectors. The macroeconomic environment is increasingly becoming influenced by environmental factors such as climate risks, pandemics, and natural disasters.

6. Reinsurance

Following the COVID-19 outbreak, insurers may review their reinsurance arrangements, particularly non-proportional coverages: stop-loss and catastrophe. Stop-loss coverages may need to be revised. This has financial implications as this type of reinsurance coverage is usually written on a yearly renewable term basis. In addition, risk management officers may need to include financial and operational resilience analysis of their reinsurers in their risk management focus. The COVID-19 pandemic is global, and reinsurers will be facing claims globally. In aggregate, this could have a significant cost for the reinsurance industry, although the results to date show this is manageable, and could result in the downgrading of some reinsurers.

In addition to monitoring the financial position of reinsurers, supervisors should keep a close eye on shifts in the use of reinsurers by insurers, as the costs of reinsurance increase and as the financial

strength of some reinsurers may decline. Insurers that choose to rely less on reinsurance need to make the corresponding enhancements to their own provisioning, investment, risk governance, risk management, and internal controls to support this reduced reliance on reinsurance.

5 SECURITIES MARKETS

Securities supervisors need to focus on maintaining orderly and functioning markets, together with proper conduct oversight for all participants, particularly the retail segment, amidst increased market volatility and reduced market liquidity.

What is different?

COVID-19 has also had a significant impact on securities markets.

The most evident and immediate impact was a significant increase in market volatility.[32] The considerable uncertainty around how the virus would play out, how governments would respond, and the ensuing impact on economies, led to large price fluctuations in capital markets. Uncertainty, heightened risk aversion (with some investors looking to move out of capital market instruments into safer assets), increased funding costs, and some operational disruptions also contributed to a reduction in market liquidity,[33] which in turn added to the volatility. This was compounded by disclosure delays as COVID-19 lockdowns disrupted regular corporate reporting cycles.

In response, some market operators implemented mechanisms such as circuit breakers and trading suspensions to restore orderly trading conditions.[34] Some jurisdictions also introduced short sale restrictions, such as lowering thresholds for short sale disclosures or outright bans on the short selling of certain securities.[35]

Clearing houses and intermediaries raised margin requirements to protect against counterparty default.[36] Fund managers had to monitor liquidity risks actively and in some cases triggered redemption gates and deferrals to facilitate accurate valuations and provide more time for portfolio managers to liquidate assets in a thin market.

Overall, securities markets worked well during the immediate aftermath of the COVID-19 outbreak. Margin calls, circuit breakers, and other market mechanisms worked as intended, and enabled higher levels of transactions to be undertaken. Reforms introduced following the global financial crisis operated successfully, although some questions remain about the appropriate regulatory response to the impact of liquidity shocks on money market funds and to the inability of some collective investment schemes to meet redemption demands.

Once a combination of market mechanisms and central bank interventions had largely dealt with market liquidity issues, the focus of supervisors moved more to the solvency risk for some market intermediaries arising from falling asset prices and corporate defaults. Broker-dealers needed to keep a close watch on their exposures to ensure that they remain adequately capitalized. Some supervisors instituted more frequent, ad hoc tracking of key financial indicators to enhance monitoring of their supervised entities.

[32] The Chicago Board Options Exchange Volatility Index (VIX) spiked to more than 80 in March 2020, from less than 20 in February 2020.
[33] 96% of respondents to a survey by the International Swaps and Derivatives Association (ISDA) and Greenwich Associates (2020) reported a decline in liquidity as a result of COVID-19.
[34] The Standard & Poors 500 Index triggered Level 1 circuit breakers four times in March 2020.
[35] These included France, Italy, Spain, Belgium, Greece, Austria, and the European Securities and Markets Authority (ESMA).
[36] The Bank of England (2020) estimated that daily variation margin calls by UK-based central counterparties in March 2020 were five times the average daily variation margin calls for January and February 2020.

The uncertainty and operational disruptions brought on by the pandemic also created challenges for issuers and supervised entities to meet their reporting obligations. Supervisors have extended reporting deadlines and provided guidance on how to factor in the uncertainty in their disclosures. Issuers were also given time to make alternative arrangements (virtual meetings) for their shareholder meetings.

Securities supervisors need to focus on maintaining orderly and functioning markets, together with proper conduct oversight for all participants, particularly the retail segment, amidst increased market volatility and reduced market liquidity.

Key issues

Supervisors have responded in a challenging environment to maintain fair, orderly, and functioning markets. In the event, maintaining close lines of communications with the industry and markets was key to managing the dynamic situation – to identify matters that required urgent attention, and to provide timely and transparent guidance to supervised entities and investors.

While regulatory measures taken during the initial phase of the pandemic have helped to stabilize markets, it would be timely to review whether they are sustainable for the longer term. As we gradually settle down into a new normal of operating in a COVID-19 world, securities supervisors should continue to adopt a forward-looking, flexible, and transparent approach to market oversight and regulation (see Chapter 8).

Supervisory responses

Securities markets cover a wide range of activities and supervised entities. The mandates of securities supervisors differ, but the following areas for focus are intended to be reasonably universal in their applicability.

Supervisory responses: securities markets

1. Supervisors should work with market operators and clearing houses to maintain orderly and functioning markets

Financial market infrastructures serve as the first line of defence in monitoring and safeguarding proper market functioning. Market resilience measures like circuit breakers and trading suspensions should be calibrated based on local market norms. They should be clearly communicated to provide certainty on how they would operate (for example, when they will be triggered and how they will be lifted). Similarly, short sale restrictions should be adopted only when they are absolutely necessary to support market confidence and financial stability. Their potential negative impact on market liquidity and price discovery should be carefully considered. To minimize such effects, short sale restrictions should be implemented within a clearly defined framework and lifted when no longer required.

Amidst the market volatility, supervisors need to monitor closely how market operators and clearing houses manage their risks. This includes being operationally ready to handle sudden spikes in trading volumes. It also means ensuring that market infrastructures manage their exposures prudently through carefully calibrated margin requirements and position limits, and vigilant collateral management.

2. Supervisors need to strive to ensure that market intermediaries maintain robust operations that manage their risks effectively and provide customers with continued access to the markets

Supervisors should continue to monitor intermediaries' (including broker dealers and fund managers) business continuity plans, exposures, position limits, capital adequacy, and funding to make sure that they are ready to face operational disruptions, spikes in volatility, redemptions, and funding squeezes. Fund managers' liquidity management measures should continue to be applied in a transparent and consistent manner in the interests of all unitholders.

As with the credit and insurance risks discussed in Chapters 3 and 4, supervisors should consider the need for additional regulatory reporting and for stress and scenario testing to enable them to identify vulnerabilities and to monitor effectively the solvency and liquidity of market intermediaries.

Supervisors may also need to consider alternative trade surveillance controls. Social distancing rules and work-from-home arrangements have led to the adoption of new communications channels by traders that may not be set up to be recorded. Trading from home has been important in keeping markets open. Supervisors have provided temporary relief from some trade surveillance requirements pending technology upgrades.[37] In the interim, institutions should adopt alternative controls, such as written records, tighter position limits, and more rigorous post-trade surveillance. The latter could be challenging, especially in light of higher alert volumes amidst the market turmoil. Firms and supervisors need to explore using techniques such as machine learning and artificial intelligence to sift through alerts so that they can pay closer attention to higher-risk ones.

Supervisors should also consider a renewed focus on culture and conduct. Hard controls such as a compliance presence on the trading floor and bans on the use of personal devices have been rendered ineffective due to remote working. This creates challenges around the completeness and accuracy of time-stamping orders and trades. Easy access to unmonitored communications channels could increase opportunities for insider trading, market manipulation, and the front-running of customer orders. Financial institutions may therefore need to pay closer attention to soft controls like culture and values, to emphasize to staff the need to behave ethically and in the best interests of clients, even when no one is watching. It may also be worthwhile to explore broadening surveillance programs to include sentiment and behavioural analyses to detect cultural issues and to take early corrective actions.

[37] For example, ESMA announced on March 20, 2020 that it would temporarily relax the call recording rules under the second Markets in Financial Instruments Directive (MIFID II).

3. Supervisors should continue to provide guidance to issuers on how they should disclose the impact of COVID-19 on their businesses

As the COVID-19 pandemic evolves and government responses change, issuers need to update their disclosures to provide accurate and timely information to investors. These should include the impact of the deterioration in economic conditions, the effect of any government support, and issuers' risk management approaches to address COVID-19 risks. Issuers should also be reminded to disclose any material information (including going concern risks) on a timely basis and ensure strict compliance with insider trading regulations.

At an early stage of the pandemic, some supervisors extended reporting deadlines as issuers faced practical challenges arising from the non-availability of staff and/or service providers, travel restrictions, and uncertainty regarding the impact of COVID-19. As issuers have now gained familiarity with alternative reporting arrangements and with more supervisory guidance on what and how to disclose, the case for such relief may diminish, bearing in mind the competing objective of timely disclosure. Supervisors should review the time relief granted to issuers for their periodic financial disclosures and shareholder meetings, while retaining the discretion to reintroduce such relief should there be further major disruptions.

Supervisors should also review whether corporate regulations need to be modernized to allow electronic distribution of shareholder documents and virtual shareholder meetings. This will help avoid having to rely on temporary relief in future. Any such change will, however, need to balance the convenience to issuers and shareholders with the needs of those investors who may not have access to, or are unable to use, digital channels of communication.

4. Supervisors should continue to pay close attention to the ability of supervised firms to manage their technology risks and cyber security

During the initial phase of the pandemic, many financial institutions – including securities firms – increased their IT capacity rapidly to offer online access to customers and work-from-home arrangements for employees. The increased adoption of digital channels has been accompanied by more hacking activity.[38] Supervisors should ensure that firms undertake appropriate vulnerability assessments and penetration testing of such arrangements. Firms should step up their cyber surveillance and promote cyber awareness and vigilance among staff and customers to lower the risk of security breaches. Where IT capabilities are outsourced, proper third-party due diligence and reviews should be conducted to ensure that security standards are met.

[38] Trend Micro, a security solutions provider, estimated that virus attacks multiplied more than 220 times from February to March 2020 alone.

5. Supervisors need to monitor closely potential financial stability risks associated with the search for yield

In response to the economic downturn induced by COVID-19, central banks around the world have engaged in extraordinary monetary policy measures, which have led to a suppression of nominal and real bond yields.[39] The ensuing search for yield among supervised entities and investors could lead to unsustainable asset bubbles if not managed properly. Investors searching for yield may also be more vulnerable to fraudulent schemes that promise high returns. Supervisors would do well to monitor these potential risks and take pre-emptive actions if necessary. It may also be timely to review contingency plans for negative yields, so that the market would have transparent and efficient arrangements to deal with them should interest rates turn negative.

6. Supervisors should continue to exchange information on their COVID-19 responses and explore other opportunities for collaboration

Information sharing with other supervisors, both domestically and internationally, through online meetings or joint training sessions, could help improve future policy design and implementation as well as supervisory practices. Supervisors could also explore coordinating policy responses, especially where it relates to financial institutions operating across several jurisdictions.

[39] More than 60% of the USD 60 trillion global bond market tracked by ICE Data Services traded with yields of less than 1% as of 30 June 2020. Financial Times, "Desperate hunt for yield forces investors to take 'extreme risks.'" 27 July 2020.

6 CORPORATE GOVERNANCE[40]

Strong corporate governance in supervised firms is critical to provide assurance to supervisors on the ability of supervised firms to navigate the numerous challenges raised by COVID-19, which may be long-lasting and not easily reversed.

[40] This chapter is based on Toronto Centre (2020e), which also provides a series of illustrative examples of poor corporate governance in supervised firms and how supervisors should seek to improve corporate governance.

What is different?

Crises such as the COVID-19 outbreak heighten the importance of strong corporate governance. As supervised firms navigate difficult times, it is important that their boards deliver corporate leadership, provide strategic direction, ensure that risks taken by their firm are properly understood and managed, support and constructively challenge senior management, and ensure that their firms maintain financial and operational resilience and the fair treatment of customers.

The COVID-19 outbreak means that supervised firms are operating in abnormal circumstances – and this may persist for some time. As discussed in Chapter 1, financial institutions are facing heightened risks, from the wider economic environment and from operational strains such as staff working from home. Some firms are having to reconfigure their businesses in the light of the crisis. Governance, risk management, and internal controls need to adapt to these heightened risks and new business models.

Meanwhile, boards are themselves facing operational pressures. They may be unable to meet physically and have to conduct their business through phone or video links. Normal patterns of meetings, interactions with senior management, and decision-making processes may be disrupted, and it may not be possible for management to produce conventional management information for their boards.

Key issues

Corporate governance provides the structure through which the objectives of a firm are set, and determines the means by which these objectives are met and the performance of the firm is monitored. Toronto Centre (2016) sets out in detail the key elements of good corporate governance, and why this is important for supervisors of financial institutions.

The objectives of corporate governance overlap closely with the goals that supervisors of financial institutions seek to achieve, in particular the financial soundness of supervised firms, the protection of consumers and investors, market confidence, public trust and confidence in the financial system, and financial stability. Well-run and well-managed firms are less likely to fail and less likely to treat their customers badly or to be used for the purposes of money laundering. They will also be better placed to implement any changes in their structure or operations required by their supervisors. Supervisors should therefore have a deep interest in the corporate governance of the firms they supervise.

Supervisors can have greater confidence in the internal control mechanisms of financial institutions with high standards of corporate governance, and in the information reported by such firms. Good corporate governance can be an important mitigant of the risks being taken by a firm, which is why an assessment of a supervised firm's corporate governance is a key element of risk-based supervision.[41] Equally, poor corporate governance is in many respects an additional risk in its own right.

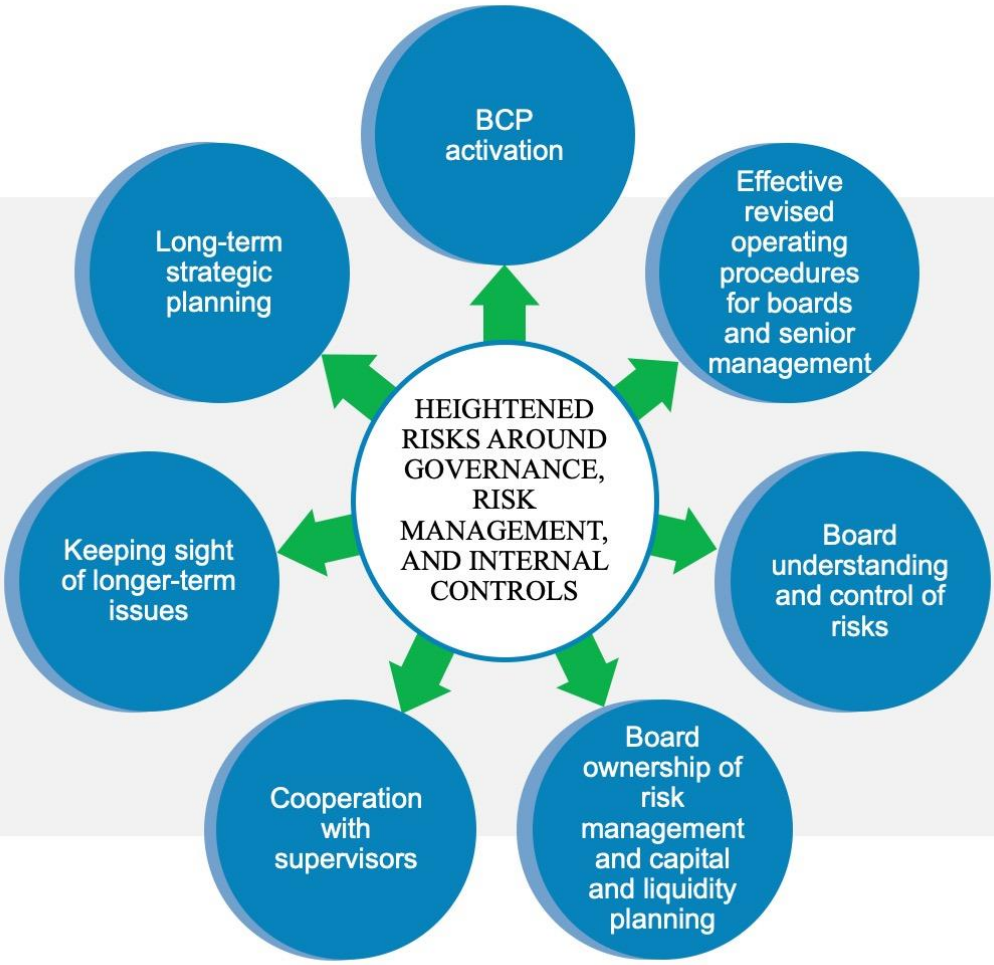
[41] See Toronto Centre (2018a) for a discussion of good corporate governance as a risk mitigant within a risk-based supervision approach.

Strong corporate governance is as important during the crisis as it has ever been, if not more so. Supervisors should not overlook the importance of good corporate governance and should not accept that it is too difficult for supervised firms to maintain strong corporate governance in the current crisis. Supervisors should monitor closely the corporate governance of supervised firms, including through direct contact with and assurances from firms' boards and senior management.

Supervisory responses

Supervisors should seek assurance that supervised firms have responded effectively to the current crisis and that the boards (and board committees) of supervised firms are operating effectively and are able to carry out their key roles.

Supervisory responses: corporate governance



Supervisors should check that the boards of supervised firms are demonstrating at least the following seven behaviours:

1. Supervised firms have activated their business continuity plans (BCPs)

The board should already have approved a generic BCP, and been fully engaged in the development of the firm's BCP, in particular the identification of critical activities and how staff and other resources will be deployed.[42] The board should then be informed immediately that the BCP has been implemented and should engage closely with senior management on its operation. At the onset of a crisis, senior management need to consider how the (generic) BCP may need to be adjusted in light of the specific circumstances of the crisis. The board should not be involved in every aspect of decision making during the crisis, but it must be comfortable that the BCP and the decisions and actions that flow from it provide an effective basis for the sound management of the firm.

Supervisors need to satisfy themselves that a supervised firm's BCP identifies critical activities, ensures an effective allocation of available resources, and enables the firm to continue to function soundly even if it is facing considerable stress.

Supervisors should also check that supervised firms are reviewing and updating their BCPs, using the lessons learned from the COVID-19 outbreak and its aftermath.

2. Boards have established effective operating procedures during the crisis to enable them to continue to undertake a changed but essential governance role

Effective corporate governance is even more important during a crisis than at other times. Boards need to provide leadership to the firm, oversee senior management, and ensure that risks are understood, monitored, and controlled.

During the crisis, boards need to collaborate with senior management on:

- **Communication channels** – while physical meetings may not be possible, full use should be made of video, telephone, and email links. There is no reason why high-quality communication cannot continue.
- **Board structures** – the board and its committees (such as audit and risk) must convene as often as necessary and in whatever form is available to enable them to continue to carry out their remits. There may be a case for making more use of board committees than usual in the interests of efficiency and getting things done.

[42] Toronto Centre (2020c) sets out the development and operation of BCPs for supervisory authorities. Most of the same principles apply to supervised firms.

- **Interactions with senior management** – the crisis throws into sharper relief the importance of striking the right balance between effective oversight and unwarranted interference by the board. The necessary oversight in a crisis may involve more (rather than less) frequent interaction with senior management, organized through video meetings.
- **Management information** – some adjustment may be necessary to the nature, form, and frequency that information is provided to the board in the light of operational and other pressures.

3. Boards understand and control the key risks supervised firms are facing

One of the central functions of the board is to understand the risks a firm is taking and to take the necessary steps to ensure that these are properly identified, monitored, and controlled. The board may do this directly or through a risk sub-committee, although as with any delegation, functions may be delegated, but responsibility is not.

In large firms, the Chief Risk Officer (CRO) is typically responsible for the analysis, aggregation, and monitoring of risks across the firm and reporting on this to senior management and the board. The CRO needs to be independent of revenue-generating activities and to have the standing and authority to be effective.[43]

Boards must have the information to enable them to carry out their responsibility of ensuring that risks are effectively monitored and managed. Good data are an essential foundation for risk monitoring and reporting. Streamlined risk reports at relatively frequent intervals may be necessary to ensure that key risks are identified and addressed, although this should not be at the expense of conventional and thorough reporting on the usual periodic basis.

Heightened or newly-emerging risks must be rapidly identified, controlled, and must remain within the supervised firm's risk tolerance. This may involve tighter limits, more stringent front-line controls and processes or, in some cases, the scaling back or cessation of some activities altogether. The board remains responsible and accountable for the way the firm operates during the crisis when there may have to be significant changes to methods of operation, risk management, and compliance procedures.

Boards must also recognize and address pre-existing governance and risk management weaknesses in the firm that are likely to have been exacerbated by the COVID-19 outbreak.

Supervisors need to have assurance that supervised firms have sound and robust processes for the identification, management, and control of current and emerging risks, including where risks – prudential, conduct, operational, and financial crime – have shifted and new risks have emerged during the crisis. It is not sufficient for corporate governance structures and processes just to be in place in supervised firms; they also need to be demonstrably effective.

[43] It is not realistic to expect some smaller firms to have a full risk management function and a dedicated CRO. In such cases, alternative structures may be appropriate, but without losing sight of the key principle that a senior individual should have an independent perspective on risk and access to senior management and the board.

Strong corporate governance in supervised firms is critical to provide assurance to supervisors on the ability of supervised firms to navigate the numerous challenges raised by COVID-19, which may be long-lasting and not easily reversed.

4. Boards promote and demonstrate ownership of enterprise-wide processes for assessing risk and the adequacy of capital, solvency, and liquidity

Day-to-day risk management remains of great importance in a crisis. However, boards should also work with senior management and supervisors to develop deeper, broader, and longer-term perspectives on crisis-related risks and the firm's ability to deal with stresses.

One good approach to this would be for supervised firms to revisit exercises such as stress testing, internal capital adequacy assessments (ICAAPs), and internal liquidity adequacy assessments (ILAAPs) for banks, and own risk and solvency assessments (ORSAs) for insurers, in the light of the COVID-19 outbreak. This should enable senior management and boards to consider whether they have a comprehensive view of risk; what additional risks the firm faces as a result of the COVID-19 crisis; how risks might evolve over time; the adequacy of risk management processes; how the firm's capital/solvency/liquidity might be affected by a range of severe but plausible stresses, including a crisis that is deeper or more protracted than expected; and what actions the firm should take to protect its viability.

5. Board members ensure that supervised firms cooperate openly and fully with supervisors, and make themselves available for contacts and discussions with supervisors

While open and constructive engagement with supervisors is always a priority, it assumes particular importance in a crisis. Supervisors should expect openness and cooperation from supervised firms, notwithstanding the operational and resourcing challenges they face.

Supervised firms should be proactive in informing supervisors of emerging risks and issues. They should not hold back from being open about conveying bad news about their business, and they should be resourceful and constructive in finding ways to provide necessary information and data.

Consideration should be given to making a board member responsible for supervisor relations to ensure that supervisors have the access they need at all levels.

In crises, supervisors may, out of necessity, need to place more reliance on supervised firms' own management and controls. This underlines the need for full and open access to senior managements and boards. The more a firm is able to show convincingly that it has a grip on the identification and management of risk, the more comfortable supervisors should be in placing reliance on the firm.

6. Boards keep sight of longer-term issues, even where these may not be the most pressing issues during the crisis

Boards and senior management of supervised firms should maintain at least some focus on issues other than those arising from the current crisis. They should not lose sight of issues that were important before the COVID-19 crisis, may still be important during the crisis, and will be important once the crisis is over. These include the risk management and disclosure implications of climate change-related financial risks;[44] assessing and responding strategically to fintech developments; facilitating financial inclusion; and major projects to improve IT infrastructure, data handling, risk governance, and internal controls.

Boards and senior management should be actively involved in any decisions to deprioritize or to delay taking forward these issues and should ensure that the agreed amount of attention is paid to them both during and following the crisis. They should be able to demonstrate to supervisors through board and other committee minutes, and through other evidence, that they are following through on decisions.

7. Boards consider longer-term strategies for their firms as the crisis unfolds

As discussed in Chapter 1, the COVID-19 outbreak and the various policy responses to it will affect the economic, market, and social environment in which financial institutions operate. Some of these impacts may prove to be only temporary, but others will be long-lasting and not easily or quickly reversed. Boards should therefore be engaging in scenario and other planning now. It is not too early to begin identifying how the world may have changed and how the supervised firm's strategy and business model may have to adjust if it is to remain viable. This process should be led and overseen by the board.

Supervisors should seek assurance from supervised firms that their boards have processes and procedures in place to determine how their strategies and business models may need to change.

Supervisory oversight and intervention

Supervisors should devote significant attention to corporate governance during the COVID-19 outbreak. They should scrutinize governance arrangements in supervised firms and use boards and senior management as an essential point of contact to discuss the changing nature and level of risks and corresponding risk management frameworks. As in normal times, it is important for supervisors to maintain close contact with the boards and senior management of supervised firms to establish that the board is effective in its role of overseeing the firm's strategy, risks, and controls. Supervisors need to know how a supervised firm is responding to the

[44] The impact of these risks on financial institutions is discussed in Toronto Centre (2017b, 2019c, and 2020g).

shifting nature of the risks faced by the firm, in order to form a supervisory view of the effectiveness of the firm's corporate governance.

The inability of supervisors to undertake the usual forms of on-site supervision should not be – and should not be allowed to be – an obstacle to maintaining close contact. There are ample opportunities for supervisors to continue to assess the effectiveness of corporate governance during the COVID-19 crisis, through reviews of documentation (such as minutes of board and committee meetings) and open-ended questioning of board members and senior management.

It is the job of a supervisor to ask questions of board members and senior managers, and they have an obligation to respond openly and constructively. For example, supervisors can use off-site monitoring and telephone or video discussions with members of the board and senior management to assess:

- whether the non-executive directors are sufficiently challenging of senior management;
- how well the board understands the risks that the firm is running, including how risks have shifted as a result of COVID19;
- how well the board uses information from the firm's external auditors, and from its internal control and internal audit functions; and
- how the board assures itself that the firm's internal controls, remuneration, and other policies and procedures operate effectively and are in line with the strategy and risk appetite set by the board.

For those supervisors whose contact with the boards and senior management of supervised firms is non-existent, or at best perfunctory and based on a limited standard checklist of questions, the COVID-19 outbreak is a great opportunity to start or build up such contact. A supervisor needs simply to pick up a phone or arrange a conference call to discuss the key issues facing a supervised firm in the current environment.

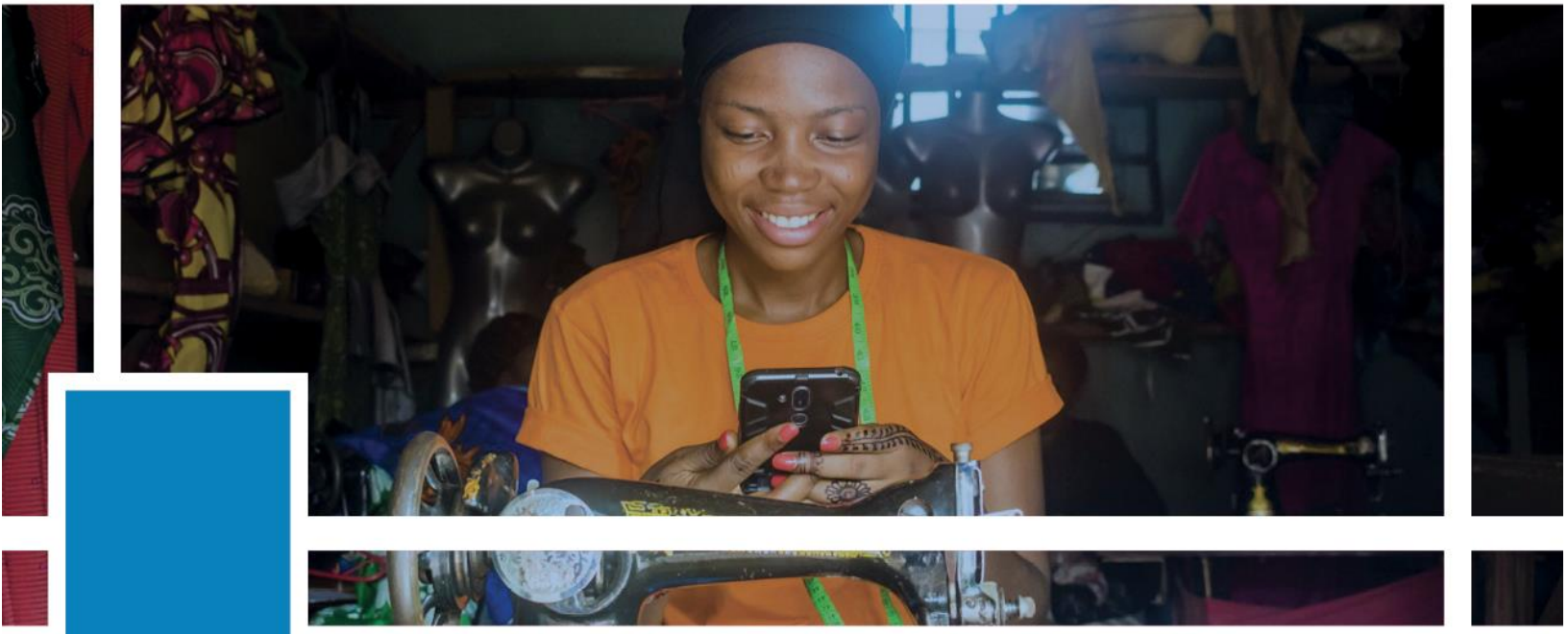
Supervisors may also make some use of attestations from supervised firms regarding the adequacy of their corporate governance. This can be effective provided attestations are subject to some level of checking and where firms know that they will potentially face sanctions if their attestations are discovered to have been unfounded.

Supervisors should intervene where supervised firms are not demonstrating good corporate governance. Most supervisors will initially seek firms' cooperation in improving corporate governance. Supervisors should inform firms of any material weaknesses in corporate governance and require them to take corrective measures in a timely manner. If firms are unwilling to make the required changes, then they may be required to hold additional (Pillar 2) capital, or to restrict their business until the shortcomings in corporate governance are rectified.

Where powers exist, fines may be imposed on supervised firms, or on individual members of the board or senior management, for failing to meet the required standards. A fit and proper persons

regime[45] may be invoked to replace members of the board or senior management who fall significantly short of fit and proper requirements. In extreme cases, supervisors may consider withdrawing a firm's licence to operate.

[45] Toronto Centre (2017a) outlines the operation of suitability regimes for senior individuals in supervised firms.



7 FINANCIAL INCLUSION AND MICROFINANCE

The COVID-19 pandemic has heightened the urgency for supervisors to meet the challenges of underdeveloped digital financial services and infrastructure, not least given the disproportionate impact on the poor, particularly women, who are financially excluded.

What is different?

Although microfinance providers (MFPs) reach over 140 million clients,[46] hundreds of millions of people are financially excluded or covered exclusively by informal services. 1.7 billion adults lack access to an account at a bank or non-bank institution.[47] The COVID-19 pandemic has exposed the challenges of being financially excluded and how underdeveloped digital financial services (DFS) and infrastructure can exacerbate such challenges. It has also put the future of many MFPs into question and revealed deep-rooted weaknesses in microfinance supervisory frameworks.

Financial exclusion heightens the post-lockdown risks for the poor, due to lack of access to finance to restart or adapt economic activities, and to risk-mitigating tools such as insurance to weather the hardships of a potential infection or devastating events such as floods, droughts, and locust invasions. These concerns are more acute among poor women, since they are more likely to be financially excluded and have been disproportionately hit by the pandemic.[48]

COVID-19 has exacerbated long-standing problems facing low-income borrowers and micro and small entrepreneurs (MSEs). In addition to the economic consequences, lockdowns have made it physically difficult (often impossible) to make payments such as microfinance loan instalments, which are typically made in person and in cash. Recognizing such challenges, many MFPs[49] have granted moratoria (suspension of instalment payments, fully or partially) and payment holidays (moratorium with suspension of interest accrual).

Governments have adopted a range of methods to affect government-to-person (G2P) transfers during the pandemic. Where digital channels were developed prior to the virus outbreak and there was a high level of financial inclusion (as for example in India), G2P payments immediately reached the large majority of the intended beneficiaries.[50] However, due to financial exclusion and underdeveloped retail payments infrastructure, some governments had to resort to transporting cash during the pandemic to deliver G2P transfers, or to request beneficiaries to go to a bank branch (exposing them to the virus). In some countries, the government mailed single-use debit cards, which was an expensive solution. In others, banks unilaterally opened accounts to enable G2P transfers, which raises consumer protection issues.

Key issues

Many financial authorities have sought to improve retail payments infrastructure, enhance digital connectivity to financial institutions (including MFPs), strengthen linkages with the fintech ecosystem, and foster inclusive DFS that cater to the needs of the unserved and underserved. However, despite the potential benefits, rapid digitalization could lead to exclusion and augment the risks faced by vulnerable segments.[51] Cash is, and is likely to

[46] Bull and Ogden (2020).
[47] Global Findex 2017.
[48] Koning et al. (2020).
[49] Bank and non-bank institutions whose activity focuses on providing microfinance services. This includes commercial banks in certain countries, microfinance institutions (MFIs), credit cooperatives, and non-governmental organizations (NGOs). See CGAP (2020a) for an MFP typology.
[50] MicroSave Consulting (2020).
[51] Bank for International Settlements (2020).

continue to be, crucial for a large segment of the population in developing and developed economies.

Similarly, while some countries have pushed for accounts to be opened for the poor, account ownership does not automatically lead to service usage. For people living in areas where digital payments are not widely used, trying to use an account can be inconvenient, costly, or impossible. Moreover, the COVID-19 pandemic has given rise to a host of digital frauds and scams targeting vulnerable segments,[52] and the lack of digital ID systems in many countries adds to these risks.

COVID-19 has led policy-makers to seek solutions such as measures that have a palpable, immediate short-term impact on financial inclusion. In some areas, supervisory crisis responses such as the quick adoption of a risk-based approach to account opening rules to facilitate G2P payments could have long-lasting positive effects on financial inclusion,[53] but financial inclusion is essentially a long-term game. It entails giving consumers a choice to acquire and use a range of adequately designed and delivered services, from transaction accounts to pensions and insurance. It requires addressing the persistent gender gap[54] in financial services based on knowledge about the reasons for women's exclusion and how better service design could cater to their financial, professional, and familial responsibilities. The lack of gender-disaggregated data[55] to inform policy interventions hinders this process.

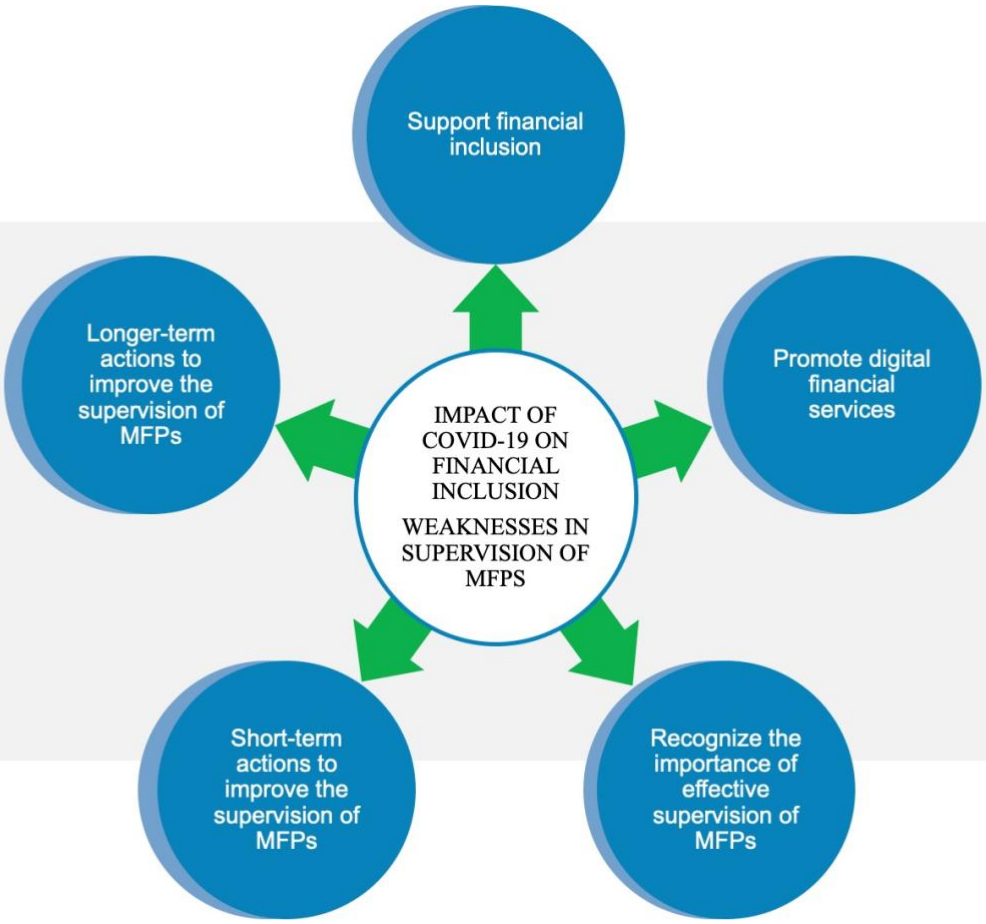
Debt relief measures in the microfinance sector have received less attention by the international community and national regulators than the moratoria applied in developed countries by commercial banks (see Chapter 3). The regulatory measures have been less detailed and often not customized to microfinance.[56] Low income borrowers and MSEs could be exposed to risks such as unaffordable post-moratorium installments, unsolicited loan restructuring, and future discrimination based on their participation in a moratorium.[57] Forbearance can strain MFP liquidity in the short-term and have an enduring negative impact on MFP solvency. Unclear rules could reduce the transparency of public disclosures, affecting investor confidence.

Supervisory responses

Supervisors need to address both financial inclusion and the interrelated weaknesses in the microfinance sector to ensure service continuity for, and protection of, microfinance clients. Supervisors should support financial inclusion by helping to address the gender divide while fostering MFPs' digital transformation and linkage to the DFS ecosystem. MSEs and poor households need to be adequately served and supported through this crisis and its aftermath by inclusive, digitalized, and resilient MFPs.

[52] Boeddu et al (2020).
[53] CGAP (2020b).
[54] Navis (2020).
[55] UNSGSA (2020).
[56] CGAP (2020c).
[57] Rhyne (2020).

Supervisory responses: financial inclusion and microfinance



Supervisors should:

1. Support financial inclusion

Supervisors should fully embrace financial inclusion as a statutory goal that complements and reinforces mandates such as financial stability, integrity, consumer protection, and competition. Effective risk-based supervision can enable innovation that supports financial inclusion while mitigating undue risks. By purposely adopting approaches that contribute to financial inclusion, supervisors can help to avoid deepening the digital and gender divides and stifling competition.

Supervisors are not solely responsible for implementing financial inclusion policies, but they set important conditions for enduring and meaningful inclusion by, among other activities, gathering and analyzing data. Hence, an immediate area of attention should be to improve the collection of financial inclusion indicators, the bulk of which are supply-side data, partly derived from regular supervisory reporting. In some jurisdictions, supervisors may also be able to collect data from unregulated MFPs.

Supervisors should assess whether there are opportunities to improve the timeliness, quality, and scope of data, such as to understand the current state and the reasons for gender-based financial exclusion and other types of discrimination. Gender-disaggregated supply-side data, complemented with other sources such as demand-side surveys and customer interviews, are essential for designing solutions to gender inequality. Financial inclusion indicators may also have supervisory value, for example in product suitability assessments as part of retail conduct supervision (where the supervisor has such a mandate) or even as part of credit risk analyses.

Where supervisors are involved in financial education initiatives, they should switch as far as possible to virtual channels of communication, including the use of the internet and social media, recognizing that face-to-face channels have become more difficult.

The COVID-19 pandemic has heightened the urgency for supervisors to meet the challenges of underdeveloped digital financial services and infrastructure, not least given the disproportionate impact on the poor, particularly women, who are financially excluded.

2. Promote digital financial services (DFS)

Financial inclusion goes beyond microfinance – DFS have been a global driver of inclusion for many years. Moreover, the digitalization of MFP operations and stronger linkages between MFPs and the DFS ecosystem could contribute to greater MFP efficiency and resilience. DFS development is inexorably linked to the development of infrastructure such as telecommunications, digital identification, credit information systems, collaborative customer due diligence mechanisms, and interoperable digital payment systems, including instant payments. Also, key regulatory enablers – including the regulation of agents and e-money issuers – must be in place.[58] Supervisors can influence policy decisions in these areas, given their potential impact on the risks and opportunities created for MFPs and consumers. Another area of great importance is data protection, which is the foundation for the safe development of data sharing schemes such as open banking/finance, and cloud-based businesses.

Supervisors should continuously update supervisory guidance to assess inclusion-friendly innovations such as DFS offerings (for example, digital credit and mobile insurance), digital customer on-boarding and authentication (simplified customer due diligence), and novel business models (for example, platform businesses and products based on data sharing).

Supervisors should also consider carefully the extent to which they want to encourage innovative fintech entrants to their financial systems, through an accommodating approach to licensing and authorization (perhaps including the use of sandboxes[59]

[58] Staschen and Meagher (2018)

[59] Toronto Centre (2017c).

and innovation hubs), while recognizing the risks that may arise from fintech.[60]

3. Recognize the importance of the effective supervision of MFPs

Microfinance supervisors face daunting challenges that reduce their ability to manage the COVID-19 crisis and support economic recovery, including:

- the fragmentation of the regulatory microfinance framework, leading to unequal treatment of similar services;
- unclear or incomplete microfinance regulations – microfinance regulation may be less developed than banking prudential regulation in areas such as risk management, business continuity, governance, internal controls, and exit policy;
- insufficient supervisory resources (budget and IT resources), insufficient staff with adequate skills, knowledge, and experience, and limited statutory powers, tools, and overall preparedness to deal with troubled MFPs;
- low-quality, outdated, and unreliable reported data from MFPs, including on loan portfolios;
- a low level of digitalization of MFPs, constraining supervisory reporting and portfolio monitoring, and limiting the options MFPs have to manage the crisis (for example, not being able to accept digital loan payments);
- the concentration of microfinance funding in a few investors;
- lack of depositor protection; and
- deficient risk management and governance standards among many MFPs, resulting in excessive risk taking, poor business conduct, vulnerability to operational disruptions, and political interference.

Supervisors need to act urgently to bring microfinance supervision up to the level of the supervision of other financial sectors, following an effective risk-based approach, particularly given the great numbers of small supervised MFPs.[61] While many MFPs will and should remain unregulated from a prudential perspective, regulated MFPs should be subject to technically-sound supervision, based on a solid regulatory foundation.

[60] Toronto Centre (2019e).

[61] Toronto Centre (2020a) discusses the risk-based supervision of small financial institutions.

4. Take immediate actions to improve the supervision of MFPs

Supervisors should closely and effectively monitor at least the largest MFPs, in particular deposit-taking MFPs. This should cover:

Liquidity, funding, and solvency – lending-only MFPs are particularly vulnerable to liquidity shortages, and there are accounts of financial cooperatives facing runs on deposits during the pandemic. When loan repayments are suspended, MFP liquidity can quickly dry up. Supervisors need to monitor MFP liquidity levels with greater frequency, assess funding sources and their capacity and willingness to shore up MFPs, and consider whether the short-term liquidity issues could become solvency problems.

Monitoring loan moratoria and other restructuring – as discussed in Chapter 3, supervisors can require more granular reporting to enable them to monitor the performance of loans that were granted moratoria or other types of forbearance. Particular attention should be given to loans that were delinquent prior to being granted forbearance, loans to related parties, large loans, and different borrower segments. Supervisors should be assured that MFPs have procedures to monitor their clients' situation by communicating with them throughout the crisis, and to capture and record granular information on borrowers' recovery prospects to allow effective portfolio management, including timely adjustments to loan classification and provisions in case of deterioration. Supervisors should be confident that MFPs make transparent and accurate financial statements and regulatory reports.

Ensuring fairness of moratoria and other restructuring – a balance is needed between the interests of consumers and MFPs. Supervisors should provide clarity with regard to the treatment of loan payment moratoria and restructuring by MFPs. Supervisors should require and monitor that MFPs act in the best interest of consumers and make their best effort to clearly and fully communicate the workings of moratoria and other restructuring. Supervisors should pay special attention to situations where MFPs apply forbearance unilaterally (borrowers have to opt-out instead of opt-in).

Credit reporting – supervisors should clarify how the relief granted in the context of this pandemic should be reported by MFPs and should enforce these rules. Borrowers' credit scores must be protected while the credibility of credit information systems remains a priority. Crisis-related forbearance should be reported to systems using special codes to flag the event, but this should not result in a downgrading or be considered a negative event in the borrower's payment history. Participation in the crisis-related relief should not be an obstacle for future access to finance.[62]

Public disclosure of exceptional prudential treatment – while granting exceptional prudential treatment for moratoria is important to avoid procyclical behavior by lenders, it risks masking the true financial standing of MFPs. Only a few countries, such as Mexico, have defined the rules for MFP public disclosure in this context.[63] This includes, for instance, the requirement for MFPs to disclose the results that would have been obtained had the MFP applied the standard prudential rules to the forborne loans.

Digital consumer risks – the COVID-19 pandemic has been the backdrop of a global surge in frauds, scams, cyber-attacks, and questionable business conduct.

[62] Chhabra et al (2020).

[63] Chapter 3 discusses the guidance issued to commercial banks.

Supervisors need to step up data-driven retail market conduct supervision. Moreover, crisis response measures such as the imposition or permission of free digital payments should be monitored to check that they do not reduce competition by favoring dominant players.

5. Take longer-term actions to improve the supervision of MFPs

While dealing with the immediacy of the crisis, microfinance supervisors should also devise a plan to address long-standing weaknesses that limit their current and post-pandemic effectiveness. A long-term plan to build back better would include, for instance:

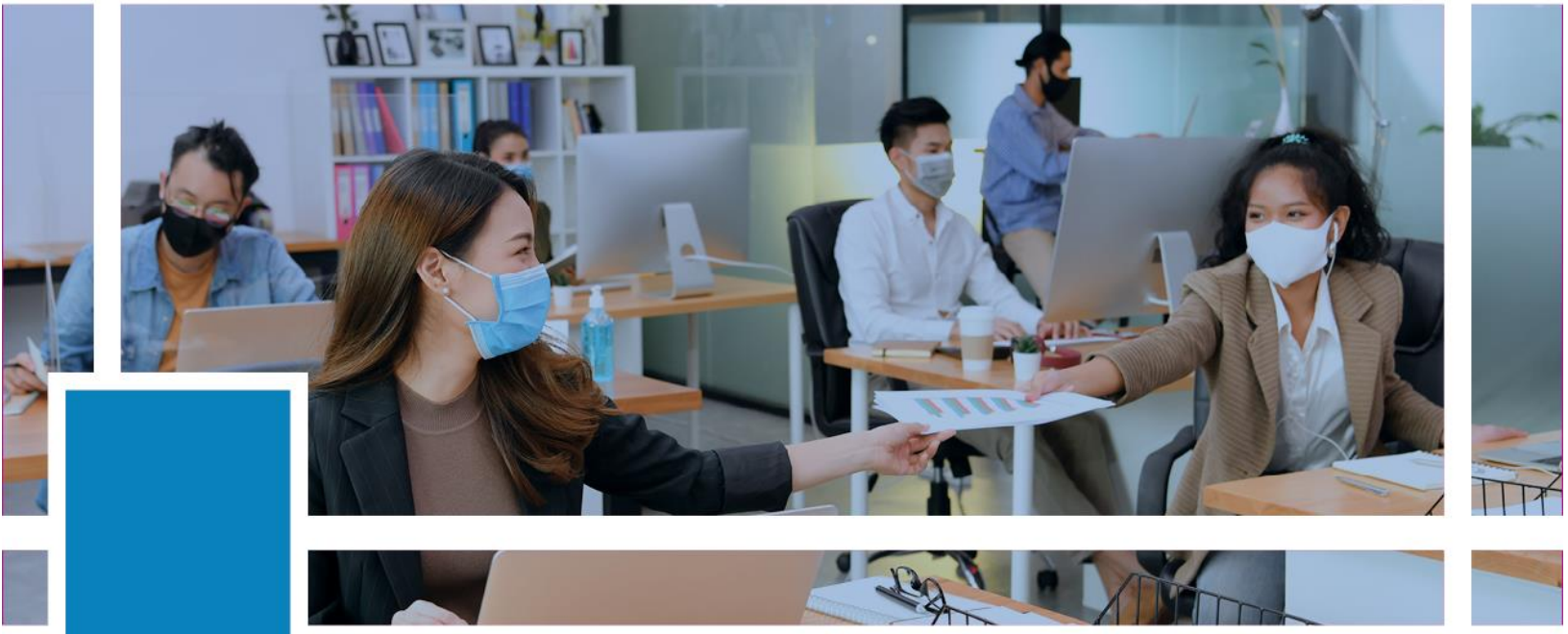
- Assessing the microfinance legal and regulatory framework and devising a plan to align it to best practices to treat the microfinance sector as an integral part of the regulated and supervised financial system, following common principles of good governance and risk management. This should cover a clear regulatory perimeter for MFPs, prudential and retail market conduct standards, an assessment of the limitations to shareholding structures and funding sources, a legal path for non-governmental organization (NGO) MFPs to transform into private companies,[64] prohibition of at-scale deposit-taking by unregulated MFPs and by NGO MFPs at any scale,[65] and deposit insurance protection for MFP depositors.

- Designing and implementing a risk-based, data-driven, and forward-looking supervisory approach that enables effective monitoring of large numbers of small MFPs alongside larger MFPs; effectively and continuously assesses microfinance credit risks; is customer-centric in its consumer protection and data privacy mandates;[66] strengthens inter-institutional information exchange and collaboration, such as with the deposit insurance agency, consumer protection and competition authorities, and self-regulatory organizations; has built-in early warning systems at least for credit, liquidity, and solvency risks to enable early supervisory action to deal with troubled MFPs; and has a clear framework for dealing with failed and failing MFPs.

- Conducting a gap analysis of the supervisory authority and designing solutions to the gaps, including a suptech[67] strategy.

- Establishing a long-term view for a resilient, innovative, and customer-centric microfinance industry.

[64] Lauer (2016).
[65] "Non-governmental organisations or other ownerless entities (for example associations and foundations) should not be allowed to operate as deposit-taking institutions given that they lack shareholders with the incentive and capacity to infuse new capital in the event that the institution's solvency is threatened." Basel Committee (2016, page 10).
[66] Izaguirre (2020).
[67] Toronto Centre (2018c).



8 SUPERVISING THE NEW NORMAL

Supervising the new normal requires supervisory authorities to plan for, and react to, the constantly changing environment, and to identify the varied impacts on individual supervised firms, while adapting their own supervisory practices with the help of technology.

What is different?

Chapter 1 set out a wide range of elements that may characterize the new normal. There remains considerable uncertainty about which of these will dominate developments, but it would be unwise for supervisors to ignore the potential for weak economic conditions and continued market volatility, concentrations of weakness in specific industrial sectors, an acceleration of the adoption of technology, and changes in companies' strategies and business models. These will all have an impact on specific financial institutions and on the financial sector more generally. Meanwhile, supervisors should plan against the possibility of further waves of COVID-19 or the emergence of new viruses.

Key issues

As emphasized in earlier chapters, supervisory authorities and supervised firms need to keep an eye on emerging developments as the crisis unfolds and on possible future states of the world. A lack of foresight leaves all organizations vulnerable to a failure to recognize the need for change, and ultimately to non-viability or irrelevance. Four key issues stand out for particular attention by supervisory authorities.

Economic conditions may weaken further and risks to financial institutions may increase further. Supervisors should not simply assume that we are at, or are past, the worst of the impact of the COVID-19 outbreak and that all that is required is to wait for conditions to improve.

Transition to the new normal will leave some financial institutions vulnerable to failure. Some corporates will not survive in the new normal world, which will have a negative impact on some financial institutions and on the value and volatility of some securities and other assets.

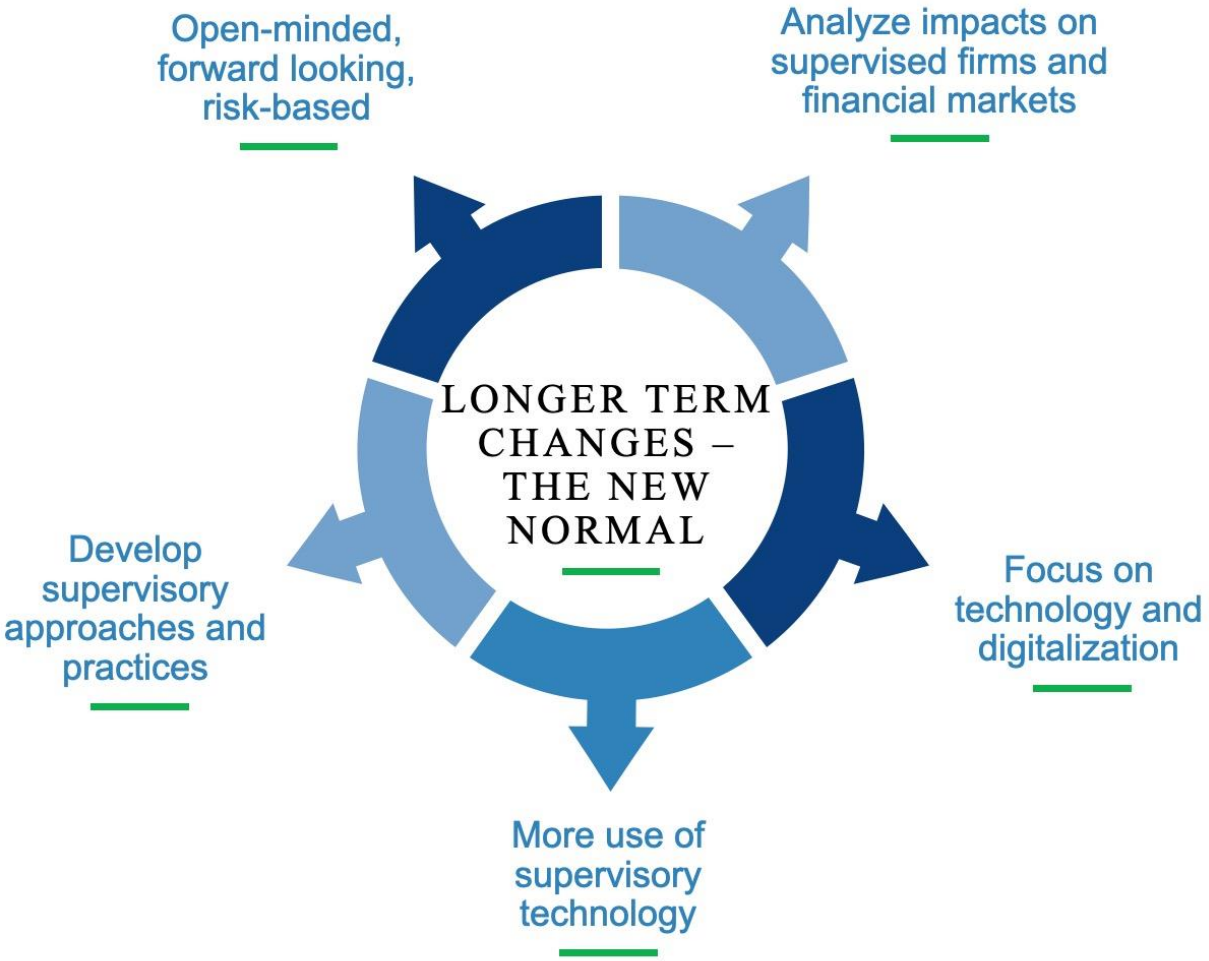
The greater use of technology and digitalization in all things, including in the financial sector, will create both benefits and risks. Risks to information security, cyber risks, and the wide array of risks (to financial institutions, to consumers, and to financial stability) arising from fintech applications will all increase.

Supervisory approaches and practices need to change. Supervisors need to make more use of the technology and data available to them, be more forward-looking and risk-based, and adapt to the changing environment and working practices.

Supervising the new normal requires supervisory authorities to plan for, and react to, the constantly changing environment, and to identify the varied impacts on individual supervised firms, while adapting their own supervisory practices with the help of technology.

Supervisory responses

Supervisory responses: the new normal



1. Be open-minded and forward-looking in identifying new normal scenarios

As discussed in Chapter 2, it is important that supervisory authorities conduct high-level scenario-based exercises to consider how risks or operational constraints might intensify or emerge as the crisis evolves; how to respond if one or more major financial institutions ran into serious solvency or liquidity issues; and how to respond if a group of the supervised firms or supervisory activities to which less

resources are currently being devoted emerged as a major source of risk.

In addition to this analysis of a deepening crisis, supervisors need to consider how the world might change as a result of the COVID-19 outbreak – what the new normal might look like. Supervisors need to be open-minded and forward-looking in considering alternative possibilities, including the characteristics outlined in Chapter 1.

This will probably not be high on the list of supervisory priorities in the immediate aftermath of the COVID-19 outbreak. However, six months into the COVID-19 impact, supervisory authorities should at least be putting in place a process to capture initial thoughts on how the new normal might differ from the pre-COVID world, so that at some point in the not too distant future they can consider what the new normal might look like and what implications this could have for the supervisory authority. This would be a productive item for initial discussion by the board and senior management of the supervisory authority late in 2020 or early in 2021.

2. Analyze the potential impact of new normal scenarios on supervised firms and markets

Scenarios for the new normal need not be a central forecast or the most likely outcome. They do not have to turn out to be accurate predictions of the future. Instead, there is value in analyzing the implications for the supervisory authority of a range of scenarios, then deciding which scenarios and potential implications pose the greatest risks to the supervisory authority's objectives and are therefore most in need of further consideration. The analysis should also identify and address any gaps in the supervisory authority's supervision toolkit or approach in facing potential scenarios.

It may be useful to consider two dimensions to the implications of the new normal for supervised firms and for the financial sector more generally.[68] One is the eventual steady state (albeit while recognizing that the world will continue to change), reflecting whatever structural shifts may have taken place in economic conditions, market developments, and the use of technology.

There may be time for most financial institutions to adjust to the shifting levels and patterns of risks and opportunities, and to move to viable and sustainable strategies and business models. Hence the importance – as discussed in Chapter 6 – of the boards and senior management of supervised firms undertaking their own scenario exercises and adjusting their strategies and business models accordingly.

The second dimension is the transition to the new normal. This could be disruptive and could lead to failures (both prudential and conduct) of financial institutions. Supervised firms may fail to adjust quickly enough, or their customers and counterparties may lose confidence in some firms or some types of firm, irrespective of whether this loss of confidence is justified by the fundamentals.

Supervisors need to be forward-looking in assessing the potential impacts of new normal scenarios on supervised firms and on financial markets more generally. They need to consider how risks and opportunities are shifting and may shift further; how these risks might affect

[68] These two dimensions are similar to the physical and transition risks facing financial institutions as a result of climate change. See Toronto Centre (2017b).

supervised firms and financial markets; and how firms are adjusting to these risks or opportunities (or failing to do so).

All crises have unanticipated consequences, some of which will extend beyond the immediate remit of supervisors. Some supervised firms may become excessively risk averse, with consequences for the wider financial system and for financial inclusion to the extent that some parts of the population are unable to access their products and services.

As we settle into a new normal, supervisors should also consider whether to revive regulatory initiatives that were suspended or deprioritized during the height of the pandemic.

3. Focus on technology and digitalization

Each supervisory authority will need to decide which risks to its supervisory objectives to focus on when considering new normal scenarios and their implications for supervised firms and financial markets. We do not consider all scenarios and all risks here, which will differ across countries and sectors of the financial industry. Instead, we focus on one key area that is likely to have a major impact on all supervisory authorities, namely technology and digitalization.

The COVID-19 outbreak has accelerated the general trend towards increased use of technology and digitalization. Examples of this include technology-enabled working from home, online shopping, and the greater automation of production processes.

Within the financial sector, this acceleration has been most evident in the increased use of digital access (through mobile phones or computers) to financial products and services, the use by governments of digital channels for making payments to households, the declining use of cash and an increase in the use of digital retail payment systems, and the increasing use of digital methods of identification (and the electronic submission of documents) as a substitute for physical know-your-customer and other anti-money laundering checks.

This acceleration is likely to continue. At the level of the economy as a whole, the main impacts on supervised firms will be through the successes and failures of their corporate customers in navigating this changing environment, and the implications of this for credit worthiness, securities prices, and insurance premiums.

Within the financial sector, the opportunities, benefits, and risks from fintech are already well mapped. Toronto Centre (2019e) set out the risks to financial institutions (in particular cyber security and other operational resilience risks, outsourcing, and the ability of financial institutions to manage change and to adjust to the competitive threat from new entrants); to consumers (from mis-selling, misadvising, data privacy and security, financial exclusion and discrimination, fraud and scams, and reduced competition); and to financial stability (disruption of existing market structure and infrastructure, concentration risk, the emergence of alternative channels of financial intermediation, herd-like behaviours, the growth of crypto assets, and the potential system-wide impact of cyber-attacks and other risks to operational resilience).

In response, supervisors need to:

- develop their capacity to understand and to respond effectively to these risks, especially as the pace of adoption of fintech applications accelerates. Supervisory authorities will need to recruit and develop different skills and expertise;

- assess the ability of incumbent financial institutions and new fintech-based entrants to find and implement viable strategies and business models;

- assess the governance and risk management of supervised firms from the fintech angle – how these firms identify, monitor, and manage the risks to them arising from fintech, including strategic, operational, compliance, cyber security and outsourcing risks; and how well boards and senior management understand fintech applications and the risks arising from them;

- focus on the operational resilience of supervised firms – not only in preventing operational failures from occurring, but also in responding and recovering effectively and quickly if and when such failures do occur. Supervisors also need to recognize here that increasingly digitized financial institutions, products, and services depend increasingly on IT services, telecoms, connectivity, and reliable electricity supplies;

- pay particular attention to cyber security risks and focus on the key elements of preparedness, risk identification, protection, detection, and incident response;[69]

- assess and respond to the risks arising from outsourcing, especially to unregulated service providers and to service providers located in foreign jurisdictions. This may be most pronounced for financial institutions and supervisors in emerging economies, where issues of reach to service providers may be most intractable;

- consider whether to be more or less accommodating in the licensing of new fintech-based entrants, including the use of sandboxes and innovation hubs to encourage and facilitate new fintech-based entrants; and

- monitor the regulatory perimeter for activities that need to be regulated and supervised.

4. Make more use of supervisory technology

Alongside the increasing digitalization of financial services, there is considerable scope for supervisory authorities to improve and extend their own use of technology (suptech)[70] and to become more data-led and intelligence-driven in at least their routine supervisory activities, including regulatory reporting and data analysis, risk assessments, enhanced off-site inspections, online transactional supervision of smaller firms, and handling applications for new authorizations.

Enhancing the off-site analytical capabilities of a supervisory authority becomes even more important in circumstances where on-site supervisory activities are restricted and where there is more reliance on receiving and analyzing good quality data and information to assist in the early identification of supervisory concerns.

[69] See Toronto Centre (2018d).
[70] See Toronto Centre (2018c) and Financial Stability Institute (2019).

Supervisory authorities are increasingly using fintech to improve supervisory efficiency and effectiveness, but there is scope to take this further.

Suptech can take many forms. At its most basic, it begins with supervisors inputting data from supervised firms into spreadsheets to generate some basic data analysis and reports on regulated firms. The next stage is electronic reporting by supervised firms, enabling the automation of at least some elements of the reporting and analysis process. Most supervisory authorities have reached at least this stage.

Suptech can then move forward in four main ways. First, data capture by pulling data from supervised firms. Standardized regulatory reporting (specific data reported at specific regular intervals) can be supplemented (or to some extent replaced) by systems that allow supervisors to interrogate supervised firms' own IT and data-handling systems. Digital platforms can enable information exchange between a supervisory authority and supervised firms. And – as has already happened – video conferencing can substitute if necessary for face-to-face meetings.

Second, supplementing regulatory reporting with additional information such as documents (credit files, meeting minutes, annual reports, product literature, etc.) and social media references to supervised firms (including the identification of complaints about supervised firms posted on social media).

Third, using big data architecture to store data and to make it more easily usable for analysis, for example more timely and flexible micro-level stress testing, including the use of cloud computing and data pools.

Fourth, extending the types of analysis undertaken from the calculation of ratios and the identification of outliers to the use of artificial intelligence, machine learning, and advanced data analytics, including to detect suspicious trading patterns.

Also in the technology space, an increasing number of supervisory authorities are using sandboxes and innovation hubs to encourage and test fintech applications, to identify and address risks in a constrained environment, and to act as a first point of contact for companies that are unsure about the applicable regulations.[71]

5. Develop supervisory approaches and practices

In addition to the technology-related responses discussed in sections 3 and 4 above, supervisory authorities should adjust their own approaches and practices to the new normal. It is difficult to put forward a definitive list of recommendations here, since this will vary across countries, but the following should certainly be strong candidates for consideration. All of them require varying degrees and types of capacity building in supervisory authorities, so that supervisors have the knowledge, skills, and experience to make good critical judgements.

[71] Toronto Centre (2017c).

Forward-looking and risk-based supervision – the need to consider the risks emerging from the new normal is itself a good illustration of the importance of forward-looking and risk-based supervision. Supervisors should be identifying emerging risks and how supervised firms are responding to these risks so that how they are managed and controlled, and the financial resources that firms should be holding against these risks, can all be considered as part of the risk assessment of supervised firms. This should then feed into the program of supervisory intervention for a supervised firm where the net risks are material.[72]

Supervisors should also consider how COVID-19 has fundamentally transformed the market landscape or the business models of supervised firms, and if so, whether supervisory frameworks need to be updated to keep pace with these developments.

Business continuity – supervisory authorities should review and update their business continuity plans, including to plan for the possibility of further waves of COVID-19 or the emergence of new pandemics, and the potential impact of operational or supplier failures on supervisory authorities that have become increasingly reliant on technology.

Financial resilience – where capital and liquidity buffers have been removed or lowered as part of the response to the impact of COVID-19 on economic conditions and to the importance of removing constraints on bank lending, supervisors will need to consider when and how these buffers should be reinstated, including the time that banks should be allowed to adjust back to the higher requirements.

International and national standard setters may review whether the detail of capital and liquidity requirements needs to be amended to reflect the shifting nature of risk under the new normal. For example, if fiscal positions are significantly weaker as a result of government interventions during the COVID-19 crisis, this may reawaken the debate on the appropriate level of risk weightings for sovereign exposures.[73]

Operational resilience – there should be a greater supervisory focus on the operational resilience of supervised firms, not just their financial resilience.[74] This should cover not only the measures that supervised firms put in place to reduce the probability of disruptive operational events occurring, but also the ability of these firms to respond and recover rapidly and effectively if and when such events do occur.

Enhanced cooperation and coordination with other authorities – many aspects of the new normal reinforce the need for supervisory authorities to cooperate and coordinate with other authorities, locally and cross-border, including the macroprudential authority on capital buffers, the Ministry of Finance and the central bank on financial stability, and the Ministry of Finance and the resolution authority on credible ways of reducing the expectation of future government bail-outs.

Financial inclusion – the COVID-19 outbreak has already had impacts (both positive and negative) on financial inclusion, and further impacts will arise from the new normal. Supervisors – especially those with financial inclusion and gender equality objectives – will need to consider how best

[72] See Toronto Centre (2018a, 2019a and 2019d) for a description of risk-based supervision.

[73] The Basel Committee (2017) issued a discussion paper on the treatment of sovereign risk exposures, but no new standards have resulted from this.

[74] See Basel Committee (2020c).

to build on the positive impacts for financial inclusion while mitigating the negative impacts.

Climate change – Many emerging economies will face serious uphill battles in rebuilding their economies, reducing both the chronic and new COVID-19-induced poverty, and ensuring that the vulnerable and marginalized, especially poor women, are not left behind in their recovery plans. A wide range of investments directed towards reducing and adapting to climate change can boost short-term job creation and incomes and generate long-term sustainability and growth benefits. However, supervisors should not rely on a green recovery from the economic impacts of COVID-19. There remains a considerable risk of continuing adverse climate changes, giving rise to climate change-related financial risks for financial institutions. Supervisors should therefore reinforce their focus on how financial institutions are managing and disclosing their climate-related risks,[75] and on how regulatory and supervisory measures might support environment, social, and governance (ESG) investing, green bonds, and blended finance.[76]

Supervisory authorities need to focus on capacity building, so that their supervisors have the knowledge, skills, and experience to make good critical judgements.

[75] This is covered in detail in Toronto Centre (2017b, 2019c, and 2020g).

[76] See Toronto Centre (2019b).

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