Webcast – Discussion Note

Coronavirus and the financial sector – implications for supervisors

This briefing note sets out some issues for discussion on the response of financial sector supervisors to the coronavirus pandemic.

1. Background

Much of the impact of the coronavirus has thus far been directly on the real economy rather than through the financial system. This impact has varied considerably by country and region, but it has been characterised by a reduction in demand for many goods and services; a supply side shock through the closure of productive capacity and sales outlets, and supply chain problems; capital flight and travel restrictions; increased uncertainty and anxiety about the economic outlook; falling commodity prices; and official sector policy responses (current or prospective) to finance additional health spending and other response measures.

These impacts may be temporary, but they will not necessarily be reversed or unwound rapidly and there is likely to be a long-term negative impact on the real economy.

Coronavirus and its impact on the real economy also affect the financial sector. This has included sharp falls and greater volatility in equity and other asset prices; lower government bond yields, but increasing spreads for corporate borrowers; a tightening in market liquidity; a deterioration in many borrowers' creditworthiness; and increased risk of investor withdrawals from open-ended funds, and of "fire sales" of assets. In the longer term, these developments could negatively affect the solvency and liquidity of some financial institutions. In turn, this could lead to increased risks of adverse confidence/contagion effects on financial institutions believed to be in a weaker position, or from general uncertainty.

A negative impact on the financial sector can feed back onto the wider economy and potentially lead to downward spirals. Borrowers and other users of financial services face a higher cost of capital; a higher cost and reduced availability of financial services more generally; and an unwillingness or inability of financial institutions to finance the impact of (temporary?) shocks and to support borrowers and other us ers of financial services back to a degree of normality.

Policy responses have been varied, and not well coordinated internationally. They have included an easing of monetary policy; higher government spending (on health services and to provide an economic stimulus); and financial stability policies (for example the reduction/removal of macro-prudential capital buffers and other counter-cyclical measures in an attempt to maintain the flow of credit to the economy).

2. Implications for supervisors

In part, supervisors need to "keep calm and carry on". Supervisors should monitor economic and market developments; monitor the solvency and liquidity of individual financial institutions, taking into account the impact of coronavirus on the creditworthiness of borrowers and the value and volatility of traded assets; intervene to ensure that financial institutions are taking a prudent approach to valuations, provisioning and write-downs; and monitor retail and wholesale market conduct for any signs of the mis-treatment of customers or market abuse.

Q1 What issues have arisen – or may arise – for banking, insurance, pensions and securities supervisors in these "core" roles?

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But supervisors also need to address some more difficult issues. There may be some tough judgement calls to be made here as financial institutions face (temporary?) solvency and liquidity issues; as borrowers seek to mitigate (temporary?) cash-flow problems; as macro- and micro-prudential considerations may point in different directions; and as both supervisory authorities and financial institutions are forced to implement business continuity measures.

Q2 How much forbearance should supervisors allow for financial institutions facing (temporary) solvency and liquidity difficulties? Although some banks may be in a much stronger position today than they were going into the global financial crisis in 2007/08 is this true of all banks and all financial institutions? Insurers may face declining solvency as a result of sharp declines in asset prices – what should be the supervisory response to this? The coronavirus crisis will be the breaking point for some financial institutions – should they then be allowed to fail?

Q3 Is there a role for supervisors in encouraging financial institutions (primarily banks) to allow borrowers with temporary cash-flow problems to delay interest and capital repayments? And where such treatment is granted by lenders, how should this be reflected in the classification of these loans?

Q4 The current situation may be a classic instance of where macro-prudential capital buffers should be removed to free up capacity to preserve the flow of credit. But how do micro-level supervisors view this – do they agree with lower capital requirements at a time of declining asset quality and higher levels of non-performing loans? Would micro-level supervisors prefer to retain capital requirements as protection against current and prospective vulnerabilities? What if the economic situation worsens further?

Q5 The coronavirus outbreak demonstrates the importance of business continuity planning (by supervisory authorities and regulated financial institutions), crisis preparedness and crisis simulations. Most immediately:

- ***(i)*** ***What should be the supervisory response to increased working from home (or back up sites) by regulated financial institutions? Remote working creates its own operational risks, for example in maintaining confidentiality, in accessing data and information, the inability of key decision-making committees to meet physically, and greater opportunities for market abuse (for example through the use of unrecorded telephone lines).***
- ***(ii)*** ***Similarly, for supervisory authorities, what is their capability for effectively carrying out their responsibilities in the light of working from home (access, confidentiality, decision-making, communication with regulated firms and with other authorities (national and cross-border)? And could they cope with an absence of key staff through illness, at a time of heightened risks and fast-moving economic and market developments?***

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