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PRACTICAL **LEADERSHIP**
AND **GUIDANCE** FROM
TORONTO CENTRE

SUPERVISORY RESPONSES TO THE IMPACT OF COVID-19 ON CREDIT QUALITY

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SUPERVISORY RESPONSES TO THE IMPACT OF COVID-19 ON CREDIT QUALITY

Introduction¹

The COVID-19 outbreak has had a sharp negative impact on economies worldwide.

This in turn has had a significant adverse impact on credit quality, not only because many borrowers cannot meet scheduled interest and principal payments, but also because in many cases the value of collateral has fallen.

There are some possible mitigants here – government loan guarantees and other forms of support for borrowers may reduce the default rate, while a sharp “V-shaped” post-outbreak economic recovery would enable many borrowers to return to something approaching normality.

Supervisory authorities and international accounting standard setters have responded in part by emphasizing – or creating – flexibility in the application of accounting and regulatory standards for the treatment of potentially impaired loans. 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 thereby to reduce the adverse impact on their measured regulatory capital ratios.

In effect, the authorities are 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. 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.

A prudent supervisor should assess and plan for less benign outcomes, in particular where the economic recovery is less immediate and/or less strong (a “U”-shaped or even an “L”-shaped recovery), which could threaten the viability of some banks and could lead to financial instability. In these circumstances, an excessive degree of supervisory forbearance would be overly protective of weak banks.

This Toronto Centre Note discusses some of the immediate and medium-term options for banking supervisors in response to the COVID-19 outbreak. It covers the application of accounting standards, the calculation of regulatory capital, and some practical advice for the actions that supervisors should be taking. One key message to supervisors is that they should ensure that banks are judicious in the use they make of the flexibility offered by accounting standards.

A suitably measured approach here would be for banks to take a borrower-by-borrower approach to loan classification; for banks to have in place proper oversight and governance of the decisions they take; for supervisors to keep a close eye on the extent to which banks’ assumptions are driving loan classification outcomes; and for both banks and supervisors to monitor credit conditions closely as new information emerges.

¹ This Note was prepared by Clive Briault.

Impact of COVID-19 on credit quality

The COVID-19 outbreak has had a sharp negative impact on economies worldwide. By April 2020, the 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.

Some corporates have already failed and been placed into administration or liquidation. More will fail. Lower incomes (even if only temporary) and increasing debts may already have tipped some heavily-indebted corporates and households into a position where they will never be able to repay their debts in full. Others may simply run out of cash. For the majority of borrowers, the probability of default has increased.

Meanwhile, the value of many types of collateral (for example, property, equity, and commodities) has fallen sharply. Assets pledged as collateral will also have become less liquid. So, loss given default rates will also have increased.

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.

In a small number of cases, the creditworthiness of borrowers may have increased – large technological firms, supermarkets, online retailers, online gambling firms, and some other sectors have benefited from changes in consumer behaviour during the COVID-19 outbreak. However, this will not offset the decline in the overall credit quality of a typical bank's loan portfolio during the current economic downturn.

Responses

Banks

In response to the COVID-19 outbreak, banks have granted some borrowers some forbearance in the form of:

- rolling forward interest and principal payments;
- interest repayment waivers;
- not triggering covenants in loan agreements relating to minimum levels of collateral and maximum loan to value ratios;
- applying lower interest rates on, or requiring less security against, some types of enforced borrowing (for example the drawing down of overdraft facilities); and
- offering new loans to enable borrowers with reasonable longer-term prospects to survive the current downturn.

This response by banks reflects a combination of:

- an assessment at the micro level that it is better to keep most borrowers afloat, at least temporarily, rather than take default actions against them. Moreover, as governments and macroprudential authorities have argued, the collective impact of banks taking default actions against borrowers would most likely accentuate the current downturn, trigger a downward spiral of “fire sales” and falling asset values, and weaken any economic recovery;
- expectations of a strong and rapid economic recovery;
- expectations about government support for borrowers and for the economy more generally; and
- actions by some governments and supervisory authorities to impose moratoria on repayments of interest and/or principal on some types of lending, or to mandate or

encourage banks to respond positively to requests by some types of borrower for a payment holiday.

Conduct supervisors

Banking supervisory authorities with conduct of business responsibilities have encouraged these types of forbearance by banks as a means of treating their customers – in particular households and small- and medium-sized corporates – fairly during difficult times.

For example, the UK Financial Conduct Authority (2020) has introduced measures under which lenders are expected to:

- offer a temporary payment freeze on loans and credit cards for up to three months, for consumers negatively impacted by coronavirus;
- allow customers who are negatively impacted by coronavirus and who already have an arranged overdraft on their main personal current account, up to £500 charged at zero interest for three months;
- make sure that all overdraft customers are no worse off on price when compared to the prices they were charged before the recent overdraft pricing changes came into force; and
- ensure consumers using any of these temporary payment freeze measures will not have their credit score affected.

In the US, the relevant supervisory agencies² have encouraged banks to “consider prudent arrangements that can ease cash flow pressures on affected borrowers, improve their capacity to service debt, increase the potential for financially-stressed residential borrowers to keep their homes, facilitate the [lender’s] ability to collect on its loans, and mitigate the long-term impact of this emergency on consumers by avoiding delinquencies and other adverse consequences.”

There is a potential tension here between the different supervisory objectives of conduct and prudential supervisors, and therefore a difficult balance to be drawn between protecting consumers and maintaining the safety and soundness of banks.

Macroprudential authorities

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 designed to respond to financial cycles, namely that they should be applied during the upswing of the financial cycle but removed or reduced during the downswing to prevent the supply of credit being constrained by prudential capital requirements.³

Governments

Governments have responded by increasing – in some cases dramatically – the level of government spending, and by offering various types of tax and other relief to individuals and corporates.⁴ In some cases this will have a direct impact on credit quality, for example where governments have nationalized failing corporates or have provided specific loan guarantees or loan write-offs. In these cases, the government has in effect substituted itself for the original borrower. However, as with any credit risk transfer, credit risk is reduced only to the level of the government’s own creditworthiness, which in some countries may not have been

² Board of Governors of the Federal Reserve System et al (2020b).

³ Basel Committee on Banking Supervision (2010).

⁴ Financial Stability Board (2020) and International Monetary Fund (2020b).

high to begin with and may have deteriorated further as a result of the impact of the COVID-19 outbreak.

In other cases, the impact on credit quality is less direct, but nonetheless potentially significant, for example where governments have provided income support to individuals or corporates, written off or delayed tax payments, or provided other forms of subsidy. In effect, this more general government support mitigates some of the decline in credit quality that would otherwise occur.

Many governments have imposed moratoria on the repayment of loans, overdraft facilities, and mortgages.⁵

Central banks

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, and expanded the provision of US dollar liquidity through swap line arrangements.⁶

Accounting treatments

The responses outlined above still 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 economic consequences of the COVID-19 outbreak will mean that 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 deterioration in their lifetime probability of default.

This makes it particularly 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.

This coincides with the introduction of accounting standards such as International Financial Reporting Standard 9 Financial Instruments (IFRS 9) and its US equivalent under Generally Accepted Accounting Principles (GAAP), which were introduced following the 2008 financial crisis to make accounting for loan losses more forward-looking. These accounting standards determine not just how banks make public disclosures, but also how they calculate their regulatory capital ratios.⁷

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 authorities⁸ have emphasized, IFRS 9 is principles-based and these principles

⁵ Allen and Overy (2020).

⁶ See, for example, Federal Reserve Bank of New York (2020).

⁷ Basel Committee on Banking Supervision (2017).

⁸ See, for example, Basel Committee on Banking Supervision (2020b), Board of Governors of the Federal Reserve System (2020a), European Banking Authority (2020), European Securities and Markets Authority (2020), International Organization of Securities Commissions (2020), and Prudential Regulation Authority (2020).

could be used by banks to reflect their judgements on the positions of individual borrowers and on the economy more generally. It may be useful to draw out three steps in this approach.

First, the accounting standards already contain some flexibility over how a bank should assess SICRs and determine ECLs. IFRS 9 states that:

- the assessment of SICRs and the measurement of ECLs should be based on reasonable and supportable information that is available to a bank without undue cost or effort;
- the assessment of SICRs should be based on a number of quantitative and qualitative indicators, and should capture the changes in the lifetime risk of default over the entire expected life of the credit exposure;
- banks should develop estimates of 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; and
- banks should monitor changes to circumstances as new information becomes available and reflect this in their assessment of SICRs and measurement of ECLs.

Second, the authorities have issued guidance and revised rules to indicate how this flexibility could be applied in the current context. In particular:

- banks should consider the current exceptional circumstances when determining what information can be considered reasonable and supportable, taking into account the nature of the shock (whether it is expected to be temporary or not) and the scarcity of available and reliable information. It is recognized that any changes to ECLs in response to the COVID-19 outbreak will, at least initially, be subject to very high levels of uncertainty because only a limited amount of reasonable and supportable forward-looking information is currently available;
- 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. A number of assumptions underlying the way that ECLs have been implemented to date may no longer hold in the current environment. Normal relationships between credit risk and economic variables may not prove a reliable guide, given unprecedented levels of government-led support for borrowers. Events like a temporary loss of income will not necessarily have the same consequences as in the past. It is recognized that there has not been enough time and there is not enough information for these factors to have fed through to lenders' models; and
- when assessing forecast conditions, banks should take into account the effects of both COVID-19 and government support measures. Due weight should be given to established long-term economic trends when preparing long-term forecasts of economic conditions, given the challenges of preparing detailed forecasts far into the future and the likely temporary nature of the COVID-19 outbreak.

Third, the guidance and rule changes also refer to some specific accounting treatments in current circumstances, including:

- payment holidays (whether resulting from a bank offering forbearance, a customer asking for it, or a government imposing a moratorium on payments) granted across all loans of a particular type should not be an automatic trigger to conclude that an SICR⁹ has occurred on all these loans, and therefore that all these loans should move from Stage 1 (a 12-month ECL) to Stage 2 (a lifetime ECL measurement). However, banks should distinguish as far as possible between borrowers whose

⁹ Or a troubled debt restructuring (TDR) under US GAAP. See Board of Governors of the Federal Reserve System (2020a).

credit standing would not be significantly affected by the current situation in the long term and those that would be unlikely to restore their credit worthiness;

- the specific conditions of the COVID-19 outbreak may be used in individual cases to rebut the IFRS 9 presumption that payment defaults of more than 30 days provide evidence of a significant increase in credit risk; and
- a covenant breach or waiver of a covenant because of the COVID-19 pandemic should not automatically trigger the loans involved being moved into Stage 2 or Stage 3 for the purposes of calculating ECL.

There is therefore considerable flexibility in the application of IFRS 9, along with guidance on how this flexibility should be used. Such flexibility is clearly warranted in the current circumstances, but it is also clear that it should be used judiciously. Maximum efforts should be made by banks to assess the underlying creditworthiness of individual borrowers and the soundness of loans as conditions evolve, and to review the application of the standards accordingly. It is also essential that the use of this flexibility by banks is subject to high-quality governance and internal processes, not least given the unprecedented nature of the current situation and the significant uncertainties that exist.

Regulatory capital treatments

Supervisory authorities have also provided guidance on the impact of the COVID-19 outbreak on the calculation of regulatory capital ratios:¹⁰

- loans subject to government guarantees should use the relevant sovereign risk-weight rather than that associated with the borrower;
- payment holidays – whether granted voluntarily by banks or the result of government or supervisory policy – should not count toward the number of days a loan is past due in the context of applying default triggers.¹¹ Delays are only counted according to the modified schedule of payments;
- loans becoming more than 90 days past due as a result of payment holidays or other relief should not automatically be classified as non-performing, forborne, or unlikely to be repaid;
- breach of a covenant or the waiver of a covenant relating to the COVID-19 outbreak should not automatically trigger a default. The breach or the need for a waiver may indicate an unlikelihood to repay, but this should be assessed on a case-by-case basis;
- banks should apply sound risk management practices regarding the identification of defaults, assessing borrowers for other indicators of unlikelihood to pay, taking into consideration the underlying cause of any financial difficulty and whether it is likely to be temporary (as a result of the COVID-19 outbreak) or longer term;
- the assessment of a borrower's likelihood to repay should be undertaken on a case-by-case basis and should be based on the modified schedule of payments following any payment holiday. If the borrower remains likely to meet its obligations under the renegotiated contract, there is no need to classify the exposure as defaulted or to treat this as a distressed restructuring;
- where banks need to undertake a substantial number of individual borrower assessments, they should prioritize the analysis, focusing on exposures most likely to have a significant impact and analysing exposures at a portfolio level if necessary; and

¹⁰ See, for example, Basel Committee on Banking Supervision (2020b).

¹¹ Under the Basel Framework higher capital requirements are applied to loans that are classified as past due (usually on the basis of a 90 day past due criterion) or defaulted.

- in the period directly after a payment holiday, banks should pay particular attention to exposures that experience delays in payments on the revised schedule and identify potential unlikelihood to pay in a timely and consistent manner, taking account of all measures that would have an impact on the creditworthiness of customers.

In addition, supervisory authorities have relaxed the transitional measures applying to the alignment of accounting and prudential measures of capital adequacy. This relaxation allows banks not to take the full capital impact of expected credit losses in the initial years of moving to the new accounting standard. The Basel Committee (2020b) has recommended that supervisory authorities may:

- now apply the existing transitional arrangements, even if they were not initially implemented when banks first adopted the ECL model;
- permit banks to switch from the static approach to the dynamic approach to determine the transitional adjustment amount (even if they have previously switched the approach that they use);
- permit banks to use alternative methodologies that aim to approximate the cumulative difference between provisions under the ECL accounting model and provisions under the prior incurred loss accounting model; and
- for 2020 and 2021, allow banks to add-back up to 100% of the transitional adjustment amount to their core tier 1 capital (with this “add-back” amount then phased-out on a straight-line basis over the subsequent 3 years).

The full implementation of Basel III has been delayed by a year to January 2023.¹²

Supervisory actions

Banking supervisors are faced with an unprecedented set of circumstances. Credit conditions have certainly changed markedly for the worse, although the extent and duration of the deterioration are not known and will not be known for some time. Standard setting bodies meanwhile have relaxed some requirements and are emphasizing the scope for flexibility in the application of others. This section aims to provide assistance to supervisors struggling with the dilemma of how to make judicious use of the flexibility available to them while still maintaining a reasonable level of prudence in their supervision of banks.

Be clear about your objectives with respect to credit quality and COVID-19:

- maintain the safety and soundness of the banks you supervise;
- ensure that banks are able to continue to lend to households and businesses, and to support the real economy;
- robust and consistent market disclosures by banks; and
- fair treatment of customers.

Recognize that there may be tensions, or even conflicts, among these objectives.

Risks to the safety and soundness of banks have increased. They may increase further through measures designed to support the continuation of lending by banks to support the real economy. This may be justifiable, but this should be considered explicitly and kept under close review.

For example, during the COVID-19 economic downturn, macroprudential authorities have reduced or removed some capital buffers because (a) there is no significant threat to financial stability from excessive credit growth or asset price bubbles, and (b) high capital requirements might constrain banks from continuing to lend during the economic downturn and thereby increase the prospect of economic recovery.

¹² Basel Committee on Banking Supervision (2020a).

At the same time, conduct supervisors may be emphasizing the need to maintain the flow of lending to consumers, having only limited regard to a potentially marked deterioration in creditworthiness.

However, micro-prudential supervisors might take a more cautious view of allowing banks to reduce their capital ratios at a time when 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 micro-prudential regulators and conduct supervisors, and a means for resolving any conflicts.¹³

Understand current accounting and regulatory requirements and the links between them. This is not always straightforward, not least at a time when many countries are transitioning to IFRS 9 or similar forward-looking approaches to expected credit losses and are seeking to align accounting standards and the calculation of regulatory capital requirements.

Ensure the consistent and prudent assessment by banks of expected credit losses and significant increases in credit risk. Issue guidance¹⁴ to your 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.

The main objective here is to ensure a sound identification of credit impaired assets on bank balance sheets. The consistency and comparability in risk metrics is a pre-condition for banks, supervisors, investors and the general public to monitor the effects of the current crisis in a coherent way.

Ensure that banks have robust, coherent, and defensible processes to allow them to distinguish between borrowers whose credit standing may not be significantly affected by the current situation in the long term, and those that are unlikely to restore their credit worthiness. 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.

Supervisors should ensure that banks are distinguishing between borrowers on a consistent and justifiable basis, notwithstanding that banks' operational capacity to make in-depth assessments of individual borrowers may be limited under current circumstances. This is a key control function for banks.

The main objective here is to avoid either exaggerating the impact of the COVID-19 outbreak (by treating all loan payment holidays as an act of default) or underestimating the impact (by treating all such loans as being unimpaired). One key rationale for the introduction of IFRS 9 was to ensure that banks recognized poor-quality loans and built up provisions at an early stage, rather than taking an over-optimistic approach under which non-performing loans were not recognized until their value had fallen sharply.

It is also important that banks 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.

Monitor and assess banks' own processes to assess significant increases in credit risk and to determine expected credit losses. Supervisors should review how banks are

¹³ This is discussed further in International Monetary Fund (2013).

¹⁴ In some countries this may have to be done through making revised rules or waiving existing rules.

undertaking their analysis of credit quality and should intervene if this is judged to be inadequate.

This supervisory review should include the ways in which banks are calculating their best estimates of the creditworthiness of individual borrowers, exercising judgement and applying flexibility in loan classification, and applying strict controls in credit management (both in front line business areas and in the risk management function). The review should also establish the extent to which these processes are subject to challenge and oversight by senior management and boards.

This review could be based on a combination of information provided to supervisors by banks, 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 and of industry sectors.

Another key input to supervisory review would be details provided by banks of the calculation of various elements of loan non-performance (probabilities of default, default rates, provisions, loan losses, etc) under different assumptions. This could include, for example, a comparison between (a) the counter-factual of what would have been the outcome under current circumstances without using any of the flexibility under accounting standards, and (b) the actual outcome calculated by banks using the flexibility in accounting treatments. This would provide one indication (through a horizontal supervisory review of the results) of the extent to which banks have differentiated between borrowers (in terms of those whose longer-term creditworthiness is judged by a bank to have been impaired, and those whose longer-term creditworthiness is judged to have remained unchanged).

Also, in countries where major corporates borrow from multiple banks, supervisors could review the extent to which individual banks have taken different approaches to assessing the creditworthiness of these corporates under current conditions and could then look more closely at banks taking outlier approaches.

Expect banks – in particular larger banks – to undertake their own analyses of possible scenarios. Banks should be stress testing their credit exposures against various severe but plausible scenarios, including “U-” and “L-shaped” economic recoveries, not simply assuming that there will be a rapid “V-shaped” recovery. Slower and smaller economic recoveries will result in higher levels of non-performing exposures, with consequences for banks' loan losses, credit risk weightings, and capital ratios.

Banks should also be taking into account their own ability to take mitigating actions and the potential value of government interventions.

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. This is similar to banks submitting an ICAAP and a recovery plan. In turn, supervisors should be interested not only in the results of the stress tests but also what they demonstrate about the plausibility of each bank's scenarios and about each bank's risk management capabilities more generally.

Undertake your own stress tests. As in normal times, there are benefits in supervisors undertaking their own stress tests to assess the possible impact of a standardized scenario on both individual banks and on the resilience of the banking system as a whole. This should be in addition to, not a substitute for, individual banks conducting their own stress tests (which should focus more closely on the specific risks facing each bank and should encompass a wider range of scenarios).

This supervisory stress test could be based on specifying alternative paths for economic recovery in some detail, or it could focus on the impact of alternative levels of non-performing loans (so it could ask the question “what would be the impact on banks’ capital ratios if default rates increase to X percent, with loss given default of Y percent?”). It is also necessary for supervisors to apply a consistent standard to assessing the results of such stress tests.

Ensure that stress tests consider possible feedback and second round effects. As with all stress testing, by banks or by supervisors, it is important to recognize that there could be feedback and second round effects as a result of the initial shock. For example, a decline in banks’ capital ratios could lead to a higher cost and reduced availability of funding (as happened in 2008). Higher levels of non-performing loans will constrain banks’ ability to lend and could therefore lead to a further decline in economic activity, as could an attempt by banks to de-risk by constraining new lending. And the strains on government funding as a result of the COVID-19 outbreak could have an adverse impact on the credit standing of some countries, which ought to be reflected in sovereign risk weights.

Use the results of stress tests to inform supervisory decision making. Stress tests will provide valuable information on what the “tipping points” might be for individual banks and for the banking system as a whole, in terms of the points at which banks would face a serious depletion of their capital resources or liquidity.

This should inform supervisory views on the circumstances in which assessing credit quality on the basis of expecting a rapid economic recovery is no longer viable; on which individual banks might be the worst affected by a prolonged economic downturn; and on the options for continued supervisory forbearance (such as allowing banks to continue to operate with low capital ratios until either they can raise more capital or the economy recovers).

Enhance your crisis preparedness. Some banks may end up being non-viable as a result of the COVID-19 outbreak. Supervisors need to plan in advance for this possibility. This will involve planning to put banks into liquidation, to use the Financial Stability Board range of resolution tools, or possibly for some form of government support (full public ownership or some form of burden-sharing with creditors or other banks).

Supervisors should also be ensuring that they are ready in terms of preparedness for the possibility of a system-wide crisis and sharing information with other authorities accordingly.

This would also be a good time for supervisors to be focusing on banks’ internal NPL management capabilities, in particular their ability to reduce NPLs through workout options and other tools, and on wider legal issues regarding the ways in which insolvency regimes and debt recovery processes could be improved.¹⁵

Consider the potential medium- and longer-term impacts of not only the COVID-19 outbreak but also of the wide-ranging policy responses. This is difficult to predict, but all of the actions taken by governments, central banks, and supervisory authorities themselves will have impacts in many areas, which in turn will affect the environment in which banks and other financial institutions operate.

Longer-term impacts of the COVID-19 outbreak and the policy responses to it could include the level and term structure of interest rates and credit spreads; sovereign creditworthiness and the limited capacity for further government support of borrowers or of financial institutions; a restructuring of global supply chains; shifts in the volume and pattern of

¹⁵ See for example the comprehensive guidelines published by the European Banking Authority (2018).

international capital flows; an acceleration in technology-enabled production, working practices, and financial systems; a further increase in the concentration and power of large corporates and; less tangible areas such as perceptions of continuing government support for ailing borrowers and weak banks.

Conclusion

This Note advises supervisors to pay particular attention to the following as the current COVID-19 crisis unfolds:

1. The pervasive nature of the crisis. The impacts are far-reaching, and all the authorities with responsibilities in the financial sector – ministries of finance, central banks, macroprudential regulators, and both prudential and conduct supervisors – are involved in responding to it. These authorities will have different remits, objectives, and powers.
2. This legitimate divergence of remits and objectives highlights the need for coordination – and in some cases the resolution of conflicting objectives and actions – within countries (and in some cases internationally).
3. The importance of making judicious use of the flexibility available under accounting standards, and to adjust capital standards, given the unprecedented nature of the crisis.
4. In making use of this flexibility, supervisors need to achieve a difficult balance. There is a strong desire to allow banks to continue to function and play their part in overcoming the looming economic challenges. It is in no-one's interest however for banks to manage their credit risk on the basis of over-optimistic estimates of the impact of government support or unfounded expectations of a strong and rapid economic recovery.
5. This Note suggests various ways – counter-factual calculations and stress testing – through which supervisors can build a quantitative picture of emerging credit risk and its potential implications for individual banks and for the banking system more widely.
6. Banks need to collaborate with supervisors in this difficult task. They need to demonstrate that they have robust and defensible approaches to the management of their credit risk and to making responsible, measured, and accountable use of the flexibility allowed in accounting and capital standards.
7. It is also essential to maintain close oversight in these fast-moving and uncertain times – reasonable judgements taken yesterday may no longer be valid tomorrow.

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