SPA/20/02 May 2020

# SEACEN POLICY ANALYSIS

## CRISIS PREPAREDNESS IN THE AGE OF COVID-19: A PRIMER

Glenn Tasky

The South East Asian Central Banks (SEACEN) Research and Training Centre

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(The SEACEN Centre)
Level 5 Sasana Kijang, Bank Negara Malaysia,
2 Jalan Dato' Onn, 50480 Kuala Lumpur, Malaysia
Tel. No.: +603 9195 1888
Fax. No: +603 9195 1801
Email: enquiries@seacen.org

For enquiries, please contact:
Glenn Tasky
Director
Financial Stability and Supervision & Payment and Settlement Systems (FSS&PSS)
The SEACEN Centre
Email: glenn@seacen.org

The ***SEACEN Policy Analysis:*** **Crisis preparedness in the age of COVID-19: a primer** reflects the analysis and views of SEACEN staff and do not represent the views of its member central banks and monetary authorities.

*Notes:*

The SEACEN Centre recognizes "China" as People's Republic of China; "Hong Kong, SAR" as Hong Kong, China; and Korea as "Republic of Korea".

# FOREWORD

This paper is the third in a series of publications titled SEACEN Policy Analysis. The series is intended to provide in-depth analysis of topical policy issues in macroeconomics, monetary policy, financial stability, and payments systems, with a particular emphasis on contextualizing these issues to the SEACEN stakeholder space. The papers look at the contours of cutting-edge issues that arise with ever-changing macroeconomic environments and technological possibilities and focus more on policy options than on more technical analysis such as econometric modeling.

The current paper, “Crisis Preparedness in the Age of COVID-19: A Primer” authored by Glenn Tasky, SEACEN’s Director of Financial Stability and Supervision / Payment and Settlement Systems, sets forth the complex issues that regulatory authorities (central banks, stand-alone regulatory authorities, and deposit insurance agencies, collectively RAs) may consider tackling promptly in dealing with the possibly severe effects of the COVID-19 economic shutdowns and the likelihood of significant economic slowdown or recessions on the financial sector. Many RAs have taken steps to allow their banks to draw down capital and liquidity buffers, and some have softened provisioning requirements or the regulatory capital impact of higher provisions, but this paper goes further and outlines some additional actions that RAs may consider if they deem it appropriate under such systemic stress.

I wish to emphasize that the views expressed in this and all issues of the SEACEN Policy Analysis series are those of the author and do not represent the views of SEACEN’s member, associate member, and observer central banks and monetary authorities.

It is indeed a very difficult time as the world tackles this unprecedented health crisis and its toll on human lives along with its economic and financial consequences. At the SEACEN Centre, we are adopting a flexible strategy to adjust to the new realities by providing online learnings of the pandemic, while carrying out policy analysis of the responses on the macroeconomic, monetary, and financial front. We stand ready to provide assistance to members in building and strengthening their capacity as we adjust to the “new normal.”

**Mangal Goswami**
Executive Director
The SEACEN Centre

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# ABSTRACT

The paper outlines the complex issues that regulatory authorities (central banks, stand-alone regulatory authorities, and deposit insurance agencies, collectively RAs) are facing with the COVID-19 pandemic and economic shutdowns, with possible severe spillover effects onto the financial sector, and offers some possible responses to these issues. Matters such as communication, transparency, capital forbearance, industry consolidation, corporate insolvency, and provisioning are discussed in the context of COVID-19, with an emphasis on maintaining financial stability and keeping policymakers and the general public informed and on board with decisions and actions.

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# CRISIS PREPAREDNESS IN THE AGE OF COVID-19: A PRIMER[1]

## Executive summary and introduction

As the world confronts and manages this unprecedented health crisis from COVID-19 and attends to those already ill or infected, the primary concern of central banks, stand-alone financial sector regulatory authorities, and deposit insurers (collectively, regulatory authorities or RAs) must be the health and workplace safety of their senior management, staff, and those close to them. Beyond that, the RAs have a public policy objective of maintaining confidence in, and the smooth running of, the financial sector, the severe impairment or shutdown of which would spill over onto the real sector catastrophically in any economy, in any jurisdiction.

RAs in most jurisdictions have responded with multipronged interventions into the financial markets, supplying liquidity on a massive scale, and have supported the financial sector mostly by temporarily relaxing capital and liquidity requirements and easing up on provisioning. But can they do more to prepare for and contain a possible financial sector meltdown? This Crisis Preparation for COVID-19 Policy Analysis suggests a possible approach for RAs, including these key principles:

- **Be transparent.** Be completely open about the condition and performance of the financial sector.
- **Communicate.** Frequently inform policymakers, the media, the financial services industry, and the general public about the state of the industry and the measures that have been taken to address problems.
- **Allow for regulatory forbearance on capital.** Consider keeping banks with weak or negative capital positions open, temporarily, if their condition is caused by the shutdown of the economy, thereby avoiding painful interventions. If such situations were to be more systemic, a broad-based recapitalizations of individual banks with public money may also be an option.
- **Meet the liquidity needs of banks.** RAs should do everything in their power to assure that banks suffering from liquidity stresses due to COVID-19 disturbances in the economy have access to borrowing.
- **Encourage consolidation.** RAs may consider intensifying their promotion of consolidating small banks into larger ones that could be more geographically diversified and "weather the storm" more easily.
- **Avoid accounting and reporting sleight-of-hand.** RAs may consider taking more lenient interpretations of existing rules, but outright manipulation to make banks appear better capitalized and profitable than they really are does not serve supervisory objectives, and there are advantages to accounting and reporting consistency, across time, across jurisdictions, and across institutions within the same jurisdictions.

In addressing a possible COVID-19 related financial crisis, as in any financial crisis, maintaining confidence and smooth functioning of the financial sector requires attention to the "force multipliers" of a crisis:

- ***Correlation.*** The situation where the same negative factor affects most financial institutions (for example, a sharp drop in housing prices or a sharp rise in unemployment)
- ***Connectedness.*** The situation where banks lend to and borrow from one another and/or banks purchase each other's debt and/or equity securities, causing possible linked failures
- ***Contagion.*** The situation where events negatively affecting a few banks (usually larger ones) lead to a loss of confidence in other banks, even if these banks are not negatively affected by the same events and there is little or no connectedness

In any given crisis, any one or all of these force multipliers may be in play.

1. This brief is intended to lay out issues and options for regulatory authorities. It is not intended to provide technical advice or advocate for the adoption of laws, regulations, and policies. The phrase "may" is to be construed in the subjunctive sense and not the permissive sense. The situations described are hypothetical and should not be construed as predictions. The author thanks Dr. Mangal Goswami (The SEACEN Centre) and Mr. Bryan Stirewalt (Dubai Financial Services Authority) for helpful comments.

In achieving this public policy objective of maintaining confidence and smooth functioning under extremely trying conditions, the RAs must be prepared to address a possible severe financial crisis quickly and effectively. This goal will require the RAs, together with the Finance Ministry and possibly other government leaders, to prepare and agree upon in advance measures that, if selected, could be put into place without much dissension. All of the involved organs of government should agree that stopping or at least attenuating a financial crisis, and its concomitant negative effects on the real sector, will necessitate all of the following activities:

- ***Allocating*** losses from failed financial institutions according to policies and procedures that, if not already enshrined in laws and regulations, are at least perceived as fair and do not further alarm depositors and other creditors
- ***Preventing*** new losses by reducing connectedness and contagion
- ***Bolstering*** surviving institutions by strengthening capital and liquidity positions, thereby making new lending and refinancing of existing lending possible

A 2020 financial crisis, should it materialize, will be different from the 2007-2017 Great Financial Crisis (GFC) and subsequent euro-area sovereign debt crisis, because the origin will be an exogenous, real sector shock and not a buildup of vulnerabilities in the financial sector itself. Even so, the trajectory of a severe real sector shock leading to a financial crisis that reverberates back again on the real sector may necessitate the use of some of the same tools that were used to react to the GFC, but perhaps to an even stronger degree, and may also necessitate the use of new tools with which RAs may be experimenting, and which may have to be adjusted as events unfold.

## The questions of transparency and communication

Two common themes of this brief that should be addressed right from the beginning are transparency and communication, which are different but intimately related. How much transparency should the RAs practice about the intrinsic condition of the financial sector? And how should these messages be communicated, giving policymakers and the general public the information they need to know, without alarming them?

***Argument in favor of transparency.*** The main argument in favor of transparency is that in the absence of full disclosure, and with possible suspicion by policymakers and the general public that "adjustments" have been made, they may assume that the condition of the banks is *even worse* than it really is intrinsically. An important lesson from the GFC is that surprises from hidden losses can weaken policy credibility. Frequent release of information on the condition and performance of individual banks and the banking sector as a whole, even if limited to just a few ratios and monetary amounts, can actually increase confidence in the banking sector. If outside observers see gradual declines in profitability and capital adequacy month by month, accompanied by analysis and commentary, rather than cliff-edge plunges at less frequent intervals, they will be more confident that RAs are on top of the matter, and there will be fewer leaks to the media and possibly alarming stories being written.[2]

***Argument against transparency.*** The main argument against transparency, and either not disclosing any information or allowing banks to appear better capitalized and more profitable than they really are, is that policymakers and the general public could become alarmed if they find out that the majority of banks are unprofitable and heading toward capital deficiency or even insolvency. This concern, which is not to be minimized, stems partly from a confusion about what "bank capital" and "bank insolvency" really are. The general public may confuse capital with cash, and they may interpret a bank's declining capital position as a hemorrhaging of cash. They may also confuse insolvency with illiquidity.

2. One example of how transparency calmed the markets, even in a midst of a crisis, was the 2009 Supervisory Capital Assessment Program, administered by the Federal Reserve in the United States in the form of rigorous stress tests on the 19 largest banking groups. The tests showed that 10 out of the 19 banks needed to raise a total of nearly $75 billion in capital, quite a large sum under recessionary conditions. Large as it was, however, the sum increased confidence in the banking sector to the point where the undercapitalized banks were able to raise nearly $150 billion – twice the amount required -- within a month of the results being publicly available. See Saunders, A. and M. Cornett, *Financial institutions management: a risk management approach,* ninth edition, 2018 for a good description of the program.

***Role of the media.*** The media can contribute positively to the process of informing the public, which is why RAs in crisis preparedness mode should devote time and effort to bringing in the media along the way in developing or modifying its crisis management program. Journalists, if properly briefed, can help make sense of technical terms such as defaulted loans, non-performing loans, rescheduling, restructuring, charge-offs, write-offs, and other concepts which have precise and different meanings in the context of banking regulation and supervision. Clear-eyed reporting can clear up erroneous notions, such as that loan-loss allowances are a "fund" that is "drawn down" by a bank in stressful times or that the RAs are allowing deadbeat borrowers to go scot-free. In some parts of the world, the public may have become unused to bank failures or even become alarmed if they hear that a bank is "failing or likely to fail." They may question why insolvent banks are allowed to remain open. All of these confusions, of course, can be amplified on social media and produce a situation of general panic. In these situations, the media, who have often been ahead of RAs in uncovering and reporting wrongdoing and mismanagement in the banking sector, can play a useful role in bolstering public confidence during the current crisis.

The same tools of effective communication will have to be used if and when RAs allow reductions in capital and liquidity buffers, such as the countercyclical capital buffer and the high-quality liquid assets (HQLA) required by the Liquidity Coverage Ratio (LCR), as some have already done[3]. Policymakers and the general public must be convinced that these buffers were created with the expectation that they will be used in a stressed environment, and RAs are not asleep at the wheel by allowing thee buffers to be drawn down. (Prohibiting capital distributions – dividends and share buybacks – and executive bonuses has been a common and very useful reaction in the current crisis; this policy tool helps preserve both the financial capital of the banks and the political capital of the RAs.)

## Dealing with the possible undercapitalization of many banks, or of the entire banking system in the aggregate

It's instructive to look at the worst-case situation and measures to handle it, then work back to the factors that may lead to such a situation. With economies essentially stopped or frozen, RAs may have to contemplate a banking system that in the aggregate is significantly undercapitalized, with some banks even becoming insolvent (assets less than liabilities). (As RAs seldom make decisions based on the market value of institutions, this brief will assume insolvency is on a book-value basis.)

***Forbearance on capital requirements.*** Banks, individually and in the aggregate, can continue to operate for months, or even years, in a situation of low or negative capital, though this condition is hardly desirable, and unsustainable over the long term.[4] If the global economic downturn continues, however, it is possible that RAs will face difficult decisions such as:

- Must we continue, through this period that we hope will be only temporary, to close and resolve undercapitalized banks?
- Do we adjust accounting and/or reporting rules to lift the reported (though not intrinsic) capital ratios temporarily, to avoid the immediate need for intervention and resolution?

3. These measures have been covered extensively in other publications and will not be discussed in detail here. However, it's worth noting that for the LCR, not only are RAs allowing banks to use the HQLA buffer, but in at least one jurisdiction, the RAs are excluding certain cash inflows and outflows related to the COVID-19 lending support programs from the calculation of total net cash outflows in the denominator of the LCR. See, for example, the Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System (collectively, the U.S. RAs) "Interim Final Rule," published in the Federal Register on 5 May 2020. The changes were made to neutralize the effect on the LCR of banks' use of the Money Market Mutual Fund Liquidity Facility and the Paycheck Protection Program Liquidity Facility. As an interim final rule, under the U.S. system, the rule is applicable immediately, although with a 30-day comment period. This technique is used by U.S. regulators only sparingly, under extraordinary situations when a regulation needs to be rushed into effect.

4. Drawbacks of leaving an undercapitalized or insolvent bank open are well-known: first, the incentive for bank directors and officers to take on much higher credit, market, and liquidity risk in order to "win the bet" and return to capital adequacy; second, the difficulties faced by an undercapitalized bank in staying profitable with far fewer interest-earning assets than interest-bearing liabilities, perhaps increasing the "size of the hole" to fill; third, the possible loss of confidence of bank depositors and other creditors as the undercapitalization drags on; and others.

- What kind of disclosures are required?
- Should we make capital injections into undercapitalized and insolvent banks with public money?

One possibility is for RAs to be completely transparent about the situation of widespread industry undercapitalization, communicating to policymakers and the general public that this is the condition facing the entire industry, is due to the pandemic, and is expected to be temporary and self-correcting after the level of economic activity picks up. RAs can stress, too, that the health of the banks in the aggregate is a concern that the RAs are monitoring closely.

It is instructive, however, that this was not the approach taken in the early 1980s in the United States, a boom time when the entire savings and loan (savings bank) industry was insolvent, and accounting rules and regulatory capital reporting were jiggled to make the industry appear solvent. The move was not transparent, but it was transparently political to anyone paying attention; few astute industry observers were fooled. CEOs of these intrinsically-insolvent institutions also responded to these acts of grace by taking on even more risk, so that several years later, when the accounting and reporting rules were changed again in the direction of greater (though not perfect) reality, the "hole to fill" was much bigger than it would have been if the regulators had been transparent from the very beginning, and intervened at an early stage to remove management, require private-sector recapitalization, and rein in some of the riskier activities.

An argument can also be made for keeping a large number of intrinsically undercapitalized or even insolvent banks open to serve community needs during the crisis and obviate additional complex decisions on which of them, and which parts of them, provide "critical services" to the real economy. To that extent, and with some adjustments (described below), an entire capital-impaired banking sector can be kept open and functioning, at least temporarily, almost as a public utility.

Standard-setting bodies are, understandably, rather silent on the matter of keeping undercapitalized or even insolvent banks open, preferring to focus instead on the adequacy of existing capital buffers to absorb the actual losses resulting from economic shutdowns and the increase in risk weights on assets resulting from a much wider range of possible outcomes[5]. Indeed, to date no jurisdiction has actually come out and proposed, at least not publicly, forbearance beyond the use of the buffers. As mentioned earlier, the imperative is for banks to continue to lend and to deploy their capital to support the economy with appropriate safeguards to manage such risk-taking. But as banks continue to lend, serving their existing customers who may be "hibernating," and participate in various programs developed by the monetary or fiscal authorities to stimulate lending, such as low-interest facilities, subsidies directly to enterprises, and government guarantees, capital ratios may indeed fall quite substantially, especially under very severe yet plausible assumptions about declines in the level of economic activity.

Of course, in many jurisdictions there are laws and regulations requiring RAs to intervene when a bank's capital falls below a certain level. Situations described by terms such as "failing or likely to fail," "point of non-viability," "critically-undercapitalized," etc., have mandated supervisory action such as beginning resolution procedures, revoking the banking license, placing the bank in conservatorship or receivership, or even liquidating the bank. As part of crisis preparedness, RAs may elect to approach lawmakers, or may change their own regulations autonomously if possible, for temporary authority to waive these mandated actions in order to keep troubled banks functioning, under intensive supervision but without any kind of disruptive intervention.

***Intensified supervision of undercapitalized banks.*** If RAs elect to keep undercapitalized or insolvent institutions open, then there is a need for far more intensive supervision than in a more benign situation. And while movement control orders remain in effect and social distancing remains the norm, it's not possible to send on-site examiners to the banks

5. See, for example, Lewrick, U., C. Schmieder, J. Sobrun, and E. Takats, 2020, "Releasing bank buffers to cushion the crisis – a quantitative assessment," BIS Bulletin No. 11, May: "Drawing down capital ratios by exhausting all buffers would expose banks to significant risks…Safeguards are needed to preserve capital ratios."

to evaluate management, spot excessive risk-taking, or uncover control deficiencies. Off-site supervision will have to fill the gaps, and may itself face obstacles, with late or less frequent reporting by the banks. Off-site analysts should maintain "real-time" knowledge of the banks, including monitoring media reports, reviews by rating agencies and security analysts, and understanding their interconnections with other banks. Frequent contact with directors and officers of undercapitalized banks is no less essential than before, even as it has become more difficult; meetings with bank management, even via videoconference, may be hampered by executive absences or even incapacitation.

***Recapitalizing banks with public money.*** For those RAs who find keeping undercapitalized banks open unpalatable, broad-based recapitalizations of individual banks with public money may also be an option. As mentioned above, a financial crisis more often than not spreads to the real economy, causing a decline in the level of economic activity. Therefore, one goal of financial crisis preparation and management is to keep banks adequately capitalized and thereby able to continue lending to the real economy. From both an asset-liability management perspective and a liquidity perspective, recapitalizing banks may also help replace interest-bearing liabilities (some of which may have run off) with an interest-free (though not necessarily cost-free) source of funds, perhaps boosting bank profitability while keeping the size of the balance sheet constant and avoiding painful deleveraging.[6]

To minimize risk to the public purse, however, capital injections should be offered only to banks with trustworthy boards and senior management who have complied with laws, regulations, and best banking practices. Some boards of undercapitalized banks may even reject selling shares to the government. In this situation, RAs will need to decide if the capital injections are mandatory or optional. Policymakers and the general public will more likely accept a mandatory, across-the-board program than one in which only a few distressed banks receive funds, a situation that could give rise to corruption or at least the perception of favoritism toward certain banks.

## Encouraging consolidation of the banking sector

Many jurisdictions have too many banks or too many firms in other categories of depository institution, such as rural banks, savings banks, cooperative banks, and the like. RAs in some of these jurisdictions have attempted to encourage or force consolidation by increasing the minimum absolute amount of capital required or using moral suasion to persuade directors and officers of small banks that it is in their interest and the interest of the banking sector as a whole for them to sell out to another institution. In this effort, however, RAs sometimes run up against vested interests who want to keep small and/or underperforming banks open for private political or economic advantage.

The COVID-19 crisis, difficult as it is, can provide convenient political cover to push through consolidation. A great many depository institutions may become severely unprofitable and undercapitalized, making them ripe targets for takeover, including those formerly "untouchable." Some larger, publicly-traded banks have seen severe declines in their share prices, a situation that makes them ripe targets for takeover, as well.

## Meeting the liquidity needs of banks

Much has already been written in the national and international media about various measures adopted by central banks, such as easing requirements for discount window borrowing and long-term refinancing, to sustain the liquidity of commercial banks, which will not be covered in this Policy Analysis except to remind readers that an insolvent bank can remain open for a long period of time, while an illiquid bank must be closed (or resolved) immediately. Central banks may also elect to support entire markets for certain classes of securities, such as commercial paper or the activities of broker/dealers, to keep the liquidity of the system flowing, a practice known as "eligibility easing."

6. An encouraging example of bank recapitalization came from the United States, where at the height of the GFC the Treasury bought shares in 707 banks between March and December 2009, spending $205 billion. Eventually, as the markets recovered, the vast majority of those shares were repurchased by the banks, returning over $220 billion to the Treasury. The program, called the "Capital Purchase Program," was not a complete success: 32 banks that had received capital injections still failed.

In the broader markets, central banks should be alerted to reports of unusual activity by banks to sell these certain classes of securities. Fire-sales of assets to meet immediate liquidity demands can push a bank or banks from an illiquidity position to an insolvency position, and may cause the markets for these certain classes of securities to freeze up completely.

However, in crisis preparedness steps, RAs and banks must also remember that there are at least four, main sources of liquidity disturbance that tend to erupt at the onset of a financial crisis: panic withdrawals of deposits, inability to roll over non-deposit liabilities, drawdowns by customers of available credit under lines of credit, and a fourth, slower erosion of liquidity when borrowers stop making interest payments, reducing cash inflow. RAs may elect to encourage banks to "know their customers," that is, review their credit lines and their sources of deposits and try to anticipate the drawdown and withdrawal responses of the most stressed enterprises and households. Some of these enterprises and households may be calmed by communications from the banks that their needs will be met. Deposit insurers, in particular, have a special responsibility to calm the public and gently discourage depositors from withdrawing more than the necessary amounts of funds from their accounts.

The situation of inability to roll over non-deposit liabilities, such as interbank borrowings and short-term debt, is more challenging. (Long-term debt, such as instruments qualifying for Additional Tier 1 and Tier 2 capital, senior non-preferred notes, senior preferred notes, etc., is not always problematic, but RAs should keep a careful inventory of the remaining time to maturity of such debt.) Here, it is essential that active markets be maintained for the collateral that supports interbank borrowings, and if short-term unsecured debt is prevalent in the banking system, central banks may consider a special liquidity facility similar to what is sometimes set up for the commercial paper of nonfinancial firms.

Deposit insurers, supported by government policymakers, may also elect to raise the covered amount, as was practiced by several deposit insurers at the onset of the GFC. RAs may also choose to pause any discussions that may have been started over "bailing in" uncovered depositors. It may also be necessary for deposit insurers to commit (with fiscal backing, if required) to immediate depositor payout from accounts at a closed bank if immediate payout is not yet a long-standing practice in that jurisdiction. All of these measures may help to avoid a rush to cash out of accounts or stop a rush that is already in progress.

## Making the resolution of banks speedier

Although in some jurisdictions RAs may elect to keep insolvent or undercapitalized banks open during the crisis, there may be banks that are illiquid, suffer from internal or external fraud, or are in severe breach of laws and/or regulations. These banks should be resolved, not be given a COVID-19 grace period. However, the crisis may give RAs momentum to argue for a speedier resolution process.

In many jurisdictions, failed banks are handled by collective insolvency proceedings which entail the partial or total divestment of a debtor (the failed bank) and the appointment of a liquidator or an administrator normally applicable to banks under national law and either specific to those institutions or generally applicable to any natural or legal person. Some jurisdictions have special provisions for banks, whether they are systemic or not. Sometimes they are self-contained and bank-specific (like in the United States). That approach is preferable, in that it keeps failed banks as much as possible out of the court system, where resolution may drag on for months or even years. Other jurisdictions use the ordinary bankruptcy or company law but with special provisions for banks, which leads to confusion in many instances.

There may not be time or political appetite for emergency changes to bank resolution regimes, but the current crisis, when courts are hearing cases only virtually and ordinary bankruptcy proceedings are exploding in number, could provide needed momentum to push through a reformed resolution regime, even if only temporary, that removes the courts from the procedure and confers all powers on the resolution authority. Such an empowered authority could swiftly decide on the most appropriate means for satisfying the claims of depositors and other creditors while preserving critical, crisis-related functions of the bank, if any.

## Modifying corporate insolvency regimes: balancing interests of banks and their borrowers

Efficient, equitable, and transparent corporate and individual insolvency regimes are considered part of the "enabling environment" for sound banking, and are not generally in the remit of RAs, who focus on the legal and regulatory framework for sound banking *per se.* In the current crisis, however, RAs do need to pay attention to the actions of their regulated banks toward their borrowers, who may be suffering from severe financial distress. Sharp increases in corporate and individual insolvency may occur in many jurisdictions, whether or not there are measures to stave off insolvency in the form of special favorable lending programs or even grants.[7]

Waves of corporate bankruptcies because of COVID-19-related developments such as a sharp drop in consumer spending, inability to access materials from suppliers, government-mandated business shutdowns, or incapacitation of management and/or staff, it should be emphasized, will have a devastating effect on the economy currently, as well as on the recovery of economic activity once the pandemic has been contained. Relationships with employees, suppliers, and creditors will be cut and not easily restored. Assets, such as buildings, vehicles, and equipment, may be dumped on slow markets. If a mechanism could be developed to "hibernate" firms that would be viable were it not for the pandemic, society as a whole would benefit.

Accordingly, it is in the interests of RAs and their regulated banks to seek enhanced loan workout solutions with borrowers, rather than having the banks default to standard insolvency practices. Banks should, in turn, go along with modified insolvency regimes, because for certain borrowers they may find themselves in conflict with other creditors who want to act even more aggressively to push an otherwise viable firm into value-destroying bankruptcy.

What are some of these modifications to insolvency regimes?[8] Some important ones include the following, where applicable:

- Suspending the duty of directors to file for bankruptcy in jurisdictions where directors are required to initiate insolvency proceedings once a company becomes insolvent.
- Suspending the duty of directors to recapitalize, liquidate, or place into bankruptcy firms that are not insolvent, but whose capital falls below a certain level.
- Suspending the rights of creditors to file involuntary bankruptcy petitions.
- Increasing the threshold of amounts owed for creditors to file involuntary bankruptcy petitions.
- Preventing secured creditors from overriding the automatic stay on creditors' enforcement of their rights. This automatic stay is a feature of bankruptcy laws in order to avoid creditors racing to collect amounts due, which may end up destroying value in the firm.
- Giving priority, in the priority of claims, to "debtor-in-possession" financing extended to a firm experiencing temporary financial distress, to incentivize lenders to provide these emergency funds.
- Suspending the requirement to proceed to liquidation if the business activity has stopped.
- Encouraging out-of-court loan workouts.

7. The Yale School of Management blog https://som.yale.edu/faculty-research-centers/centers-initiatives/program-on-financial-stability/covid-19-crisis identifies the following types of assistance to firms, particularly SMEs, that have been provided by various jurisdictions: Grants - government payments to or on behalf of SMEs; Forgivable Loans - loans extended to SMEs that they do not have to repay under certain circumstances; Direct Lending - government loans to SMEs; Credit Guarantees - government guarantees to induce private firms to lend to SMEs; Funding for Lending - funding for private lenders to induce them to lend to SMEs; Payment Forbearance - delays on amounts SMEs owe to creditors; Tax Policy Changes - waivers of/revisions to the tax code to reduce or delay taxes owed.

8. This section borrows heavily from Meneznes, A. and S. Muro, 2020, *COVID-19 outbreak: implications on corporate and individual insolvency,* World Bank, April; and Gurrea-Martinez, A., 2020, *Insolvency law in times of COVID-19,* Ibero-American Institute for Law and Finance, April.

It should be clear that in the wider commercial environment if enterprises that are viable but for COVID-19 interruptions are not automatically thrown into bankruptcy proceedings, the banks that have lent to them can pursue loan workout strategies with the existing management structure and asset mix, possibly speeding their recovery when economic activity begins to resume.

## The impact of borrower distress, loan rescheduling and restructuring, repayment moratoria, and accounting and reporting practices on bank profitability and capital adequacy

Many jurisdictions around the world have encouraged or required their banks to *reschedule* loans for all or certain classes of borrowers who will find it difficult or impossible to make scheduled principal and interest payments, as a result of a generalized economic shutdown due to COVID-19. (Rescheduling is to be carefully distinguished from *restructuring*. The former refers to stretching out the timeline of required payments of principal and/or interest on a loan; the latter refers to actually reducing those payments, through waiving part of the principal and/or reducing the interest rate. Sometimes a loan modification combines both rescheduling and restructuring.)

In both rescheduling and restructuring, the intent of the bank should be that the borrower will be able to meet the revised schedule of principal and interest payments. For loan classification and regulatory provisioning purposes, under a pre-IFRS 9 or transition period regime, the loans could be upgraded to "performing" or "standard" status, once the borrower emerges from any "grace period" embedded in the new contract and actually begins to make payments according to the revised schedule.

***Implementation of IFRS 9 in the face of many reschedulings and restructurings.*** Things get complicated when the transition to IFRS 9 and COVID-19 reschedulings and restructurings are occurring simultaneously. Most jurisdictions that have implemented loan repayment moratoria in response to COVID-19 have done so on a blanket basis (or at least targeting certain industries that are likely to be most affected), not individual borrowers. Moratoria have also been combined with governmental guarantees, particularly for loans to small- and medium-sized enterprises (SMEs). In general, RAs have taken a lenient attitude toward accounting and reporting for these loans, not requiring them to be considered "non-performing" and not requiring, from an IFRS 9 perspective, them to be treated as having experienced "a significant increase in credit risk," which would otherwise have necessitated a move to "Stage 2" and an increase in required loan-loss allowances.

The philosophy behind this relatively lenient attitude, especially with regard to the blanket moratoria, is that IFRS 9 could envision a "long-long" term approach to firm viability, so that the current dire situation is viewed (from a discounted net cash flow basis) as just a "blip" in a long chain of expected payments. Especially when combined with government guarantees, loans whose required repayment is stretched out over a 10-year (or longer) period in a near-zero interest-rate environment would hardly even require more loan-loss allowances.

Restructurings, on the other hand, pose a different set of challenges. When principal and/or interest payments are actually reduced, and not just stretched out over longer time periods, discounted cash flows can decrease substantially even with ultra-low interest rates. In that situation, RAs may elect to apply existing accounting and reporting rules with less or no leniency.

***The important distinction between forbearance and a more lenient application of the rules.*** As time goes on, with COVID-19 looking like a long-lasting, devastating hit to the level of economic activity, some RAs may begin to advocate delaying the implementation of IFRS 9 (or other expected credit loss regimes). In the United States, for example, the Chair of the Federal Deposit Insurance Corporation (FDIC, which is a banking supervision agency, resolution agency, and deposit insurance fund all at the same time) wrote to the Financial Accounting Standards Board (FASB, the standard-setter for the accounting regime used in the United States) asking for a delay in implementing the Current Expected Credit Loss (CECL) regime, a stricter and simpler variant of IFRS 9, for banks currently subject

to the transition. Her reasoning was so that banks could then "better focus on supporting lending to creditworthy households and businesses."[9] The U.S. Congress, for its part, mandated in the Coronavirus Aid, Relief, and Economic Security (CARES) Act, signed into law on 27 March 2020, that banks be given the option to delay CECL implementation until the earlier of 31 December 2020 or when the national emergency declaration is lifted.

Actions such as these clearly illustrate the difference between forbearance, which is an action or statement by RAs that, at least temporarily, the rules do not apply to one, some, or all banks, and regulatory leniency, which is a less conservative interpretation of rules that remain fixed. Over the past thirty years, forbearance has developed a negative connotation, while leniency is viewed more positively when the actions (or inactions) of RAs are evaluated and held accountable after a crisis has passed. In the current context, taking a "long-long" view of the economic horizon in an IFRS 9 application is regulatory leniency, while delaying the implementation of the standard is forbearance.

There is no doubt that IFRS 9 and CECL are more complex than earlier rules for determining loan-loss allowances, and there may be some merit in the argument that banks, many of whom may soon be operating with diminished staff numbers, should focus on the provision of basic services and not on implementation of complex accounting rules. However, RAs should exercise extreme caution in advocating for a delayed transition on the grounds that it would make (reported) capital and (reported) profitability look worse (to be fair, the FDIC Chair was not making that argument), or that a delayed transition would result in more loans being originated than under the current transition.

Moreover, the effect of relaxed standards on the accounting for and reporting of problem loans is not evenly distributed across the banks. The relative ranking of banks in terms of overall financial strength may well change when broad-based adjustments are made in accounting and reporting standards, even if the intrinsic ranking stays the same. The effect of these changes in relative rankings may be to *distort supervisory decision-making,* which would be most unfortunate in a time of crisis.

There is a long-standing dispute in banking and bank supervision and regulation over the idea that a strict regime of loan-loss provisioning leads to less lending, and a more relaxed regime leads to more lending. The idea has a certain plausibility, but cracks in the wall of certainty appear as soon as one considers that no loan-loss provisioning regime can alter the occurrence or the magnitude of credit losses, only the timing of these losses' recognition. Loss recognition can be upfronted, or it can be pushed forward in time; but the magnitude of the loss results only from the ability and willingness of the borrower to repay the loan on time and in full. No loan officer, unless corrupt, deliberately makes a loan that will have to be assigned a high loan-loss allowance right away. Most loan officers will say that the provisioning regime in force has no impact on their decision to approve a loan or not, only the contours of the bank's overall credit policy and his/her assessment of borrower ability and willingness.

Another argument against delaying the transition to IFRS 9 or CECL is that "temporary" measures to address reported (though not intrinsic) bank capital and profitability have a way of becoming permanent, long after the crisis conditions have abated. The combined efforts of international standard-setting bodies and RAs throughout the world to introduce tougher requirements to bolster the resiliency of banks and lessen the probability of another financial crisis have already required enormous adjustment, much of it successful, on the part of the banks. It would be disappointing if the banks used the current crisis to dilute the post GFC reforms by advocating and pushing through for a permanent relaxation of capital, liquidity, accounting, reporting, or disclosure requirements.

## Conclusion: Prepare, be transparent, and seek legislative authorization for extraordinary measures

RAs around the world are in an extremely difficult position. They are going to be required to make rapid-fire decisions, spurred on by capital and liquidity stress conditions at banks and other financial

9. Letter from Jelena McWilliams, FDIC Chair, to Shayne Kuhaneck, Acting Technical Director, FASB, "Request for Delay in Transitions to and Exclusions from Certain Accounting Rules," 19 March 2020.

institutions, in an environment in which senior officers and staff – at both the RAs and their regulated institutions – may be absent or incapacitated. That frightful situation brings into even sharper view the necessity for RAs to prepare for crises, and get their crisis management tools ready and sharpened, for rapid deployment.

In the long run, the legitimacy of RAs will depend on how, and how well, they used their delegated authorities from legislative frameworks. Extraordinary measures, such as allowing banks to remain open with negative capital, should have legislative authorization, so that post-crisis inquiry commissions, who will ask painful questions (What did the RAs know? When did they know it? Did they take appropriate and timely action, given their authority?) do not result in constraints on these RAs' future abilities to respond to crises nimbly and effectively while maintaining their credibility.

And finally, transparency does matter. Policymakers and the general public have the right to know the true condition of individual banks and the banking sector as a whole. They also have the right to know when and how forbearance and regulatory leniency have been applied, and the reasoning behind them. Paradoxical as it may sound, one of the benefits of the waves of financial crises that have washed over the world in the last 50 years is that the public may be less sensitive to negative news coming out of the financial sector, and more accepting of the reassurances given by RAs and governments. But they will not be fooled by accounting and reporting manipulation that has fooled them too often in the past.

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