MONETARY AND CAPITAL MARKETS

Special Series on COVID-19

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Unwinding COVID-19 Policy Interventions for Banking Systems

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This note offers some guidance and broad principles for managing the exit from regulatory and supervisory measures already taken, including borrower support, bank capital, and liquidity measures. It suggests ways to prioritize supervisory tasks during the exit process. The note also describes the trade-offs entailed by unwinding decisions and steps that authorities should take when the exit appears challenging and banks' asset quality is likely to deteriorate sharply, including situations that might evolve into systemwide banking sector stress. It advocates for quantitative analysis, including stress testing, to assess potential debtor and banking system vulnerabilities. Such analysis can also inform the preparation of contingency planning for bank resolution, including at the system level, as part of holistic unwinding strategies.

EXECUTIVE SUMMARY

Country authorities have implemented wide-ranging extraordinary monetary, fiscal, and financial regulatory measures to help contain the financial implications of physical distancing restrictions on households, corporates, and financial firms. Although appropriate at the outset of the crisis and there is a continued need for policies to flatten the insolvency curve in many countries, blanket measures are distortionary. Their use over prolonged periods can undermine credit discipline, misallocate scarce resources to zombie firms, and deter investment. As the pandemic's impact on societies, economies, and market players is becoming clearer, authorities are urged to consider replacing blanket measures with more targeted and timebound ones. This would help quickly re-establish open market dynamics, including to facilitate enterprise restructuring with fair burden sharing. In cases where nonperforming loans (NPLs) risk is rising to systemic levels, a holistic unwinding strategy is warranted and should be informed by a triage of enterprises (into viable, viable with restructuring, and unviable) to identify the policy trade-offs necessary given fiscal and financial stability constraints.

A wide range of unprecedented actions have been taken across multiple fronts, including fiscal, social, monetary, and financial policies, making for an exceptionally complex challenge in planning for exit. Unwinding

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strategies will need to be holistic, consider the potential for moral hazard problems, the complexities in the decision making process, the number of public oversight authorities involved, the extent of the trade-offs at hand, and the challenges in coordinating exit policies. Close coordination among multiple agencies (fiscal, economic, financial, regulatory, social) will be needed.

Notwithstanding these difficulties, regulatory and supervisory policies will play a critical role in preserving financial stability and credit discipline and ensuring that the flow of credit to the real economy is sustained during the unwinding period. The following principles and recommendations should apply during the unwinding period, with due consideration applied to country specific circumstances:

- **Moratoria and government guarantees:** Replace blanket freezes on debt repayments, foreclosures, and insolvency proceedings with targeted and timebound support to distressed but viable borrowers. To the extent that fiscal space allows, the introduction of targeted government support, including guarantee schemes should involve banks bearing risk, and progressively stricter eligibility criteria should apply over time.

- **Asset quality and provisioning:** Recognize the "true" state of the banking system. Asset classifications should accurately reflect balance sheet risk and provisioning rules should continue to apply (if weakened because of the pandemic, they should be restored); require banks with high NPLs to develop internal NPL management capabilities, plans, and tools and set ambitious operational targets to reduce NPL levels or write-off problem loans; and strengthen insolvency and debt enforcement framework capacity in preparation for the expected rise in cases.

- **Regulatory capital and liquidity buffers:** Reverse regulatory measures that are incompatible with accounting requirements and international capital and liquidity standards; fully enforce prudential, accounting, and regulatory frameworks as relief measures are lifted; allow for some flexibility in timing by requiring banks to implement medium-term plans to restore capital or liquidity shortfalls; and rebuild counter cyclical capital buffers once the impact of the shock is clear and economic recovery is firmly under way.

- **Profitability and capital distributions:** Restrict dividend distributions and share buybacks while bank profitability remains distorted due to emergency measures (for example, capitalizing interest income due but unpaid on a large volume of loans) and while the quantum of eventual losses remains highly uncertain.

- **Supervisory actions:** Intensify supervisory monitoring until extraordinary measures (for example, moratoria, government guarantees, etc.) are withdrawn; require banks to continually assess borrowers' creditworthiness until conditions have normalized; collect information from banks on interest income accrued but not received; closely monitor and follow up proactively with weaker banks; assess financial conditions under different scenarios including through stress testing; and ensure banks are prepared to tackle high NPL levels.

- **Bank resolution actions and contingency planning:** avoid initiating bank resolutions while pandemic restrictions apply given the high uncertainty; review the financial safety net and take prioritized action to strengthen elements that fall below international good practice; continue to apply corrective action frameworks, prepare bank resolution plans, maintain up-to-date contingency plans aimed at responding to potential systemic financial crises; and be ready to intervene if significant problems emerge after removal of exceptional policy support.

- **Communications:** decisions related to the preparation and implementation of unwinding policies should be communicated with "one voice" and provide clear timelines for which measures will apply and be unwound.

OVERARCHING CONSIDERATIONS

Country authorities have implemented wide-ranging monetary, fiscal, and financial regulatory measures to help contain the impact of the pandemic on households, corporates, and financial firms. Among them, the IMF identified more than 800 supervisory and regulatory measures (both micro and macroprudential) across more than 100 advanced and emerging market economies. Once the acute phase of the heath crisis is addressed, the policy focus will shift from dealing with liquidity pressures faced by borrowers and banks, to managing the reopening of the economy and supporting the recovery while addressing the lasting consequences of the pandemic on borrower and bank viability. The October 2020 *Global Financial Stability Report* lays out a roadmap for monetary and financial sector policies at different stages of the crisis (Box 1). This note provides a detailed discussion of considerations for country authorities in adjusting their policies in view of crisis developments, including trade-offs in considering exit from the extraordinary measures. It does not cover considerations related to monetary policy measures.

Countries have taken exceptional measures along many different dimensions. By now the relevant questions country authorities face is how best to (1) prepare for the lasting impact of the pandemic on financial institutions and (2) design exit strategies, for example, the timing, pace, and modalities of unwinding exceptional financial sector interventions. The priority in both areas is rebuilding buffers while avoiding cliff effects and undesirable consequences.

As the impact of the pandemic on societies and economies becomes clearer, authorities should move away from the hitherto systemwide application of extraordinary regulatory measures (for example, blanket support that does not take into account borrowers' capacity to pay) toward increasingly targeted actions, thereby using available resources more effectively and avoiding moral hazard. In doing so, it is important to distinguish borrower support measures (for example, moratoria and public guarantees) from measures related to the prudential and accounting frameworks.

Jurisdictions entered the crisis with very different initial conditions in terms of banking, sovereign, and corporate vulnerabilities. The health and economic impact of COVID-19 has also varied across countries and remains highly uncertain. Hence, it will be essential that the unwinding strategy and process be adapted to each country's context.

TRANSITIONING TO POST-PANDEMIC REGULATION AND SUPERVISION[2]

The uncertainty and the severity of the crisis justified extraordinary support measures, but the policy mix needs to be reevaluated. The priority now is to reexamine the trade-offs between short-term support and long-term sustainability and resilience and decide on the timing and pace of removing those measures. Policymakers will need to weigh these trade-offs as they consider unwinding the measures.

- Credit support in the form of large-scale moratoria on debt repayments, foreclosures, and insolvency help avoid deeper erosion in aggregate demand and sustain the flow of credit. However, exceptional support over a prolonged period can adversely impact economic recovery, if scarce public and private resources are allocated to unviable or low productivity activities. It may also adversely impact debt repayment incentives over a longer horizon.

[2] For broader macroeconomic principles of an exit strategy, see "IMF Note on Global Economic Prospects and Principles for Policy Exit," G-20 Meeting of Finance Ministers and Central Bank Governors, St. Andrews, 2009.

Box 1. Key Takeaways from the October 2020 GFSR

Chapter 1 of the October 2020 *Global Financial Security Report* recommends that accommodative policies should be maintained—and the authorities should be ready to tackle new financial risks as they arise—until the pandemic is under control and the economic recovery is firmly underway. In the recovery phase, liquidity should be gradually withdrawn, and banks should be encouraged to continue to recognize loss and over time rebuild capital if buffers have been entirely used and prudential ratios have fallen below regulatory minimum. Weak financial firms should be recapitalized, restructured, or resolved. Support for viable nonfinancial corporates should be better targeted to viable firms and restructuring mechanisms strengthened to reduce the future debt overhang while avoiding cliff effects. In the post pandemic phase, both micro and macroprudential measures must be used to prevent excessive risk taking, while strengthening the regulatory framework for addressing the vulnerabilities of nonbank financial firms. Considering that supervisory restrictions on distributions have positively impacted the banks' capital ratios and given the high degree of uncertainty, the supervisory approach toward dividends policy will require great attention before returning to normal operating mode.

Monetary and Financial Policy Road Map

Policy Areas	Great Lockdown	Gradual Reopening under Uncertainty	Pandemic under Control
Monetary Policy	Ease monetary policy, including use of unconventional monetary policy tools	Maintain monetary policy accommodation	Maintain monetary policy accommodation until the policy objectives (for example, inflation target) are achieved
Liquidity Support to Core Funding Markets	Provide support to maintain market functioning and liquidity	Maintain support, but adjust pricing as appropriate to incentivize and prepare the ground for exit from use of central	Gradually withdraw support, as warranted
Liquidity Support to Financial Institutions	Provide support to alleviate liquidity stress and support monetary policy accommodation	Maintain support, but adjust pricing as appropriate to incentivize the return to normal market	Maintain liquidity support only as required to support monetary policy accommodation
Measures to Maintain the Flow of Credit	Release macroprudential buffers, allow the use of capital and liquidity buffers, and apply regulatory flexibility as appropriate Suspend the distribution of banks' profits (dividend payouts and share buybacks) Provide financing support to households and businesses (see below)	Continue allowing the use of capital and liquidity buffers Suspend the distribution of banks' profits (dividend payouts and share buybacks)	Rebuild capital and liquidity buffers gradually over time while ensuring continued financial institutions' capacity to extend credit
Measures to Address Problem Assets	Provide guidance on asset classification and provisioning	Maintain prudential standards to incentivize the recognition and handling of problem assets	Require banks to develop credible plans to reduce problem assets over an appropriate period of time Handle weak banks that experience significant credit losses Foster the development of markets for distressed assets
Financing Support to Business	Provide credit guarantees (or other risk mitigation) and term funding to support new lending	Maintain financing support if containment measures are reintroduced, but tighten eligibility criteria to better target illiquid but solvent firms	Withdraw unwarranted supp
Debt Restructuring for Businesses and Households	Introduce repayment moratoria	Extend repayment moratoria only if necessary to prevent widespread insolvencies Facilitate debt restructuring that reduces debt overhang and/or adjust repayment schedule Provide solvency support to viable systemic firms, grants for smaller firms Ensure efficient out-of-court agreements, with fast-track procedures to support debt restructuring	Facilitate debt restructuring that reduces debt overhang

Source: Global Financial Stability Report, October 2020, Chapter 1, Table 1.1.

- Government guarantees support lending by reducing the risks taken by banks, but weaken banks' incentives to screen borrowers and limit market discipline by containing funding costs. They also increase fiscal risks and may endanger sovereign debt sustainability.

- Using the *flexibility* embedded in the regulatory framework provides near-term relief to banks but may facilitate imprudent lending if maintained for an extended period and create an expectation that regulators will continue introducing accommodative interpretations of the rules as the crisis unfolds.[3]

- Outright *relaxation* of microprudential and accounting rules (for example, asset classification freeze) can buy time for the authorities to implement effective support measures, but does not by itself solve the underlying problems and may compromise transparency by hiding bank losses and overstating capital adequacy, potentially undermining confidence in the financial system.

- *Restrictions* on dividend distributions preserve capital that can be used to absorb losses and support lending, but may impair investor confidence and increase the cost of capital if maintained for too long.

Some practical considerations for unwinding interventions include the following:

- Authorities should have a clear understanding of the implications of the emergency measures for the outcomes and incentives and behavior of market participants (borrowers, savers, lenders, and investors), as well as the trade-offs noted above. As considerable time has elapsed since the onset of the pandemic, its impact across sectors and on overall economic activity is becoming clearer. Authorities should use this information, including as collected by banks, to prepare evidence-based analysis to move toward more targeted and time-bound measures, while intensifying supervisory monitoring and ensuring transparency in regulatory reporting and public disclosure. For example, uneven impacts across sectors suggest that support might be targeted toward those most affected sectors, and a differentiated and possibly sequenced approach may be taken, while other sectors may no longer need support.

- Decisions on reversing COVID-19 measures should be adapted to each country's context and based on detailed assessments of (1) whether the measures worked as intended, (2) their impact on bank capital and liquidity and on overall financial stability, (3) the impact of reversal on the shape of the recovery, (4) whether fiscal and monetary space remains available, and (5) the interaction of other supportive fiscal and monetary measures with regulatory and supervisory responses. These factors will affect the scale, timing, and speed of unwinding. Given the scale and scope of measures taken encompassing many policy areas, coordination between national authorities (fiscal, monetary, financial, social) are critical in preparing and implementing a comprehensive exit strategy, informed by detailed analysis.[4]

- Cliff effects *should be avoided as much as possible.* Lifting measures prematurely could have adverse consequences. When regulatory measures are unwound, the timelines should be announced well in advance

[3] The Financial Stability Board and the standard setters have emphasized the importance of using the flexibility built into existing standards, including in the form of systemwide and firm-specific buffers to support the policy response. For the IMF and the World Bank staff high-level recommendations to guide national regulatory and supervisory responses, see "COVID-19: The Regulatory and Supervisory Implications for the Banking Sector," Joint IMF-World Bank Staff Position Note, May 2020. It was recommended inter alia to use the flexibility in the regulatory framework while upholding minimum prudential standards and preserving consistency with international standards.

[4] For IMF guidance on how to adjust macroprudential policies based on the assessment of systemic risks, see "Staff Guidance Note on Macroprudential Policy—Detailed Guidance on Instruments," November 2014.

and, in cases where the expected adjustments are large (for example, rebuilding capital and liquidity buffers), a sufficiently long transition period should be factored in. Exit strategies should be cognizant of other non-regulatory support measures (for example, social spending, tax moratoria) and how long they will still be in effect, to avoid compounding cliff effects. Again, coordination between national authorities (which may also involve legislative assemblies) will be critical.

- To maintain confidence in the financial system and to address moral hazard issues, authorities should formulate a communication strategy to announce decisions related to the preparation and implementation of unwinding policies with "one voice" and provide clear timelines for which measures will apply and be unwound.[5]
- Several key factors should be considered for a successful unwinding process, as detailed below: strengthening supervisory monitoring of financial institutions, conducting enhanced diagnostics, assembling a range of information that is needed to evaluate trade-offs and make unwinding decisions, and analyzing the impact of policies under different recovery scenarios.

EXIT FROM BORROWER SUPPORT MEASURES

PAYMENT MORATORIA AND GOVERNMENT GUARANTEES[6]

Moratoria and guarantees have been widely adopted by countries. Declarations of public loan moratoria were used in 75 percent of emerging market and developing economies, while public guarantee schemes have been more common in advanced economies. These measures are typically decided by governments or lawmakers, not by supervisory authorities. Moratoria and guarantees are complementary tools, but can have very different effects on borrower incentives and bank financials. Loan repayment moratoria support borrowers facing short-term repayment difficulties, but can undermine credit discipline. Government guarantees can be used to ease bank capital pressures through reduced risk-weighted assets[7] while protecting them against credit risk and can incentivize further lending and/or loan restructuring.

General payment moratoria

Payment deferrals—individual loan restructurings or systemwide approaches—have been widely used. Most regulators have encouraged banks to work constructively and prudently with borrowers (for example, by offering payment holidays, lower interest rate, adjusted collateral requirements). In addition, the vast majority of jurisdictions have introduced some form of moratorium on debt repayments by borrowers. While supervisors have often provided general guidance, payment moratoria have typically been at the behest of legislators or part of sector-wide private initiatives.

[5] See also "Public Communication during a Financial Crisis," IMF Special Series on COVID-19, April 2020.

[6] Suspensions of foreclosures and insolvency proceedings were also used in a number of jurisdictions. See "Private Debt Resolution Measures in the Wake of the Pandemic," IMF Special Series on COVID-19, June 2020.

[7] The relevant sovereign risk weight should be assigned to the exposure covered by the guarantee to determine a bank's credit risk capital requirement.

Introducing payment deferrals creates policy challenges that will have to be carefully managed during the exit phase. Payment moratoria have pros and cons that are well known:

- It is sound policy to provide relief to borrowers facing short-term payment challenges by deferring payments rather than seizing collateral or pushing debtors into insolvency. General payment moratoria can also help by avoiding clogging the courts with a wave of cases and helping banks deal with a surge in restructuring requests that cannot realistically be assessed on a debtor-by-debtor basis.

- However, (1) debtors who were nonperforming and potentially unviable before the pandemic may unduly benefit from moratoria that lack eligibility conditions, thus diverting resources from productive use; (2) financially capable debtors may be disincentivized to repay their obligations, thus weakening credit culture; (3) loan balances grow over time as interest payments are deferred (payment on principal being suspended), increasing future risks for creditors and repayment burdens for debtors once the payment holiday expires; and (4) moratoria have an adverse impact on creditors' earnings, liquidity (cash-flows are deferred), and transparency about asset quality. Authorities need to be aware of these challenges, and borrowers should be incentivized to resume loan repayment at the end of the moratorium. In that respect, keeping extending blanket moratoria might not send the right signal and could impact on repayment discipline.

Particularly for wide-ranging moratoria, deciding the timing of exit so as to support recovery involves trade-offs. Terminating too early would adversely impact borrowers facing liquidity problems and lead to lasting damage to the economy and the financial sector. Keeping them in place too long may adversely impact economic recovery if credit flows to unviable firms. With the recovery so uneven, there may also be pressures to extend wide-ranging support.

Striking the appropriate balance between near-term economic benefits and potential longer-term adverse impacts on financial stability involves consideration of several factors. Since interest income on loans subject to moratoria may be overstated, can banks absorb the resulting loan losses?[8] Is it realistic to believe that borrowers could meet higher debt repayments in the future? Are payment deferrals effective in supporting borrowers (those currently distressed but viable in the medium term)? Are general payment moratoria weakening discipline and incentives for borrowers to repay their debts?

- *Trade-offs should be assessed and well understood.* Decisions on moratoria should be based on an assessment of the needs of borrowers; the effectiveness of historical and existing schemes; the scope for more targeted and time-bound programs; and the estimated current and future impact on banks' capital, earnings, and liquidity—comprehensive stress tests can help.

- *Moratoria should be time-bound and increasingly targeted over time.* Moratoria are a useful temporary safety net in an emergency but should be replaced with less distortionary measures if fiscal space allows. The latter include subsidies to help cover debtors' interest costs, guarantees on principal (for example, capitalized loan interest) and where appropriate, debt restructuring encompassing forgiveness. Support should become targeted to specific sectors and viable borrowers with continued liquidity constraints to incentivize loan repayment. Rigorous means-testing, monitoring and reporting, and explicit sunset clauses and excluding debtors that are unviable are important safeguards.

[8] Under International Financial Reporting Standards (IFRS), banks continue to accrue income on loans under moratoria. This assumes that borrowers will resume payments after the moratorium ends, which is unlikely to be the case for all of them.

- *Transition measures should be designed to strike a balance between immediate needs and the longer-term goal of fairly allocating the burden across debtors, creditors, and taxpayers.* During the transition, a holistic unwinding strategy is warranted in cases where there is a risk that NPLs could rise to systemic levels as initial moratoria are lifted. Such efforts to "flatten the curve" of insolvencies, sustain financial stability, and avoid permanent scarring will necessarily involve close coordination among key local stakeholders.[9] Authorities are recommended to undertake a high-level triage to identify the potential volume of distressed corporates using data collected since the start of the pandemic and projected forward using forecasts (for example, for interest coverage ratio, other corporate performance measures, or GDP) to identify the length of time for which support would need to continue for a given quantile of firms to remain viable in the longer term as well as the potential implications for banks.[10, 11] Analyzing these data by firm size and industry sector could facilitate the optimal design of targeted and timebound support while considering fiscal and financial stability constraints. The analysis would also help identify how structural reforms—such as strengthening insolvency and enforcement frameworks, developing a market for NPLs—should be designed and prioritized. The implementation of targeted measures will necessarily involve clear eligibility criteria and accountability requirements.[12]

- *Banks need to commence the loan-by-loan restructuring process and deal with unviable and insolvent debtors.* Banks should already be collecting sufficient evidence to triage borrowers and make a determination regarding future repayment capacity. Supervisors should encourage banks to proactively conduct objective viability assessments through individual screening to distinguish between borrowers facing liquidity shortages, distressed but potentially viable, and unviable and insolvent. Compared to the early stages of the pandemic wherein decisions were taken under acute time pressure, banks should now be able to devote more resources to conduct in-depth analyses of each borrower's situation. Supervisors should encourage banks to take prompt recovery action on unviable and insolvent debtors.

- *Supervisory monitoring should be strengthened until moratoria are withdrawn*:

    - Given the difficulty in analyzing the impact of the crisis on borrowers' financial situation due to heightened uncertainty, banks may be tempted to freeze loan classifications despite accounting and prudential rules requiring regular reassessment. In such circumstances, general moratoria could temporarily mask the full extent of credit quality deterioration and current prudential and accounting metrics might not appropriately reflect banks' real financial condition. The issue is compounded where national authorities eased loan classification and provisioning rules.

    - Banks should be instructed to continuously assess their borrowers' creditworthiness on the basis of granular data and the likelihood that the loans will be repaid as per the revised loan terms, with

[9] This will likely include the Ministries of Finance, Economy and Justice, the Central Bank, and the competent authorities for banking system regulation, supervision, and resolution.

[10] Although triage will suffer from substantial data challenges, it will be necessary in many cases to assess debtor health using multiple approaches and metrics given the considerable risks to financial stability and given fiscal and debt space constraints.

[11] For examples of how to assess corporate health, see "COVID-19 and Corporate-Sector Stress: Macrofinancial Implications and Policy Responses," IMF Special Series on COVID-19, 2021.

[12] Accountability could include publication of details of support received by companies as well as minimum monitoring requirements and meet a minimum financial reporting standard.

exposures reclassified as nonperforming where necessary. Supervisors should strictly enforce rules requiring banks to gradually record provisions when it appears that loans are deteriorating or impaired, instead of waiting for the end of the moratorium.[13] This would provide policymakers with more reliable indicators of asset quality and help avoid a large increase in NPLs and provisions at the end of the moratorium. Supervisors should collect information from banks on interest income accrued but not received, as capitalizing unpaid interest income while payment moratoria apply can substantially distort bank profitability.

- Supervisors should follow up proactively, particularly with weaker banks. Enhanced monitoring is crucial to detect early signs of distress and close engagement with bank management ensures that risk management procedures and processes are adequately strengthened. Supervisors should collect information about the scope of the payment moratoria and identify borrowers and exposures subject to these measures (for example, types of financial products, loan amount, number of borrowers, split between corporates and households, credit ratings of such borrowers, etc.).[14]

Supervisory authorities should be vigilant to the risks that may arise at the end of moratoria. Once general moratoria end, some borrowers may be unable to restart payments. Depending on how large such exposures are, this could lead to a spike in NPLs and required provisioning. Deferring loan loss provisions should be discouraged, especially because international standards already provide flexibility.[15] If banks breach regulatory minimum requirements as a result of substantial loan loss provisions, flexibility should be maintained and sufficient time provided to banks to restore their capital positions (see below).

Government guarantees[16]

Government guarantees can be a useful tool in the face of large exogenous shocks, but give rise to moral hazard. They may impact economic recovery if they direct scarce government resources to firms that might not ultimately be viable or do not need the support. They also increase contingent sovereign liabilities, yielding higher fiscal risk. In some countries, lack of fiscal space and concerns about debt sustainability constrain how much government support can be provided. Lastly, by shielding banks from bearing the risk of their lending, they could lead to borrower over-indebtedness.

Authorities should assess the benefits and risks of extending borrower-supporting public guarantee programs. To the extent that fiscal space is still available, authorities may consider replacing wide-ranging public guarantee schemes with well-calibrated, targeted, and time-bound programs focusing on distressed but

[13] When loans are impaired, the forecasted cash flows of the loan should reflect banks' best estimate of the economic conditions that may exist over the remaining life of the asset, in accordance with existing accounting requirements.

[14] See "Strengthening Regulatory Reporting and Offsite Analysis in Response to COVID-19," IMF Special Series on COVID-19, December 2020.

[15] As indicated by the Basel Committee on Banking Supervision (BCBS), in the case of public and private moratoria permitting suspension or delays in payments, the 90 days past due criterion is modified, as the delays are counted based on the modified schedule of payments. In other words, if a first post-moratorium payment is missed by a borrower (say on January 1, 2021, following the end of the moratorium on December 31, 2020), banks would wait three months (April 1, 2021) before considering the exposure defaulted and recording provisions.

[16] See "Legal Considerations on Public Guarantees Schemes," IMF Special Series on COVID-19, December 2020.

viable borrowers, which will require clear eligibility criteria.[17] Ensuring that banks maintain a residual exposure ("skin in the game"), usually by taking a first share of the losses, would avoid weakening banks' incentives to continue monitoring borrowers. The fees charged by the guarantor could also gradually increase over time to avoid crowding-out effects whereby banks would almost exclusively lend to sovereign guaranteed borrowers.

PREPARING SUPERVISORS FOR EXIT[18]

Banking supervisors and regulators have played a key role in contributing to policy responses while mitigating the procyclical impact of certain rules. Using the flexibility embedded in prudential and accounting frameworks, standard-setter bodies (SSBs), and most supervisors have provided guidance on how (1) extraordinary support measures should be treated (for example, capital treatment of loans subject to government guarantees), (2) restructured loans including payment moratoria need to be taken into account for asset classification and provisioning, and (3) expected credit losses (ECLs) should be measured.[19] Those measures are generally consistent with international standards and in line with IMF advice. Some regulators have also encouraged banks to use their capital and liquidity buffers to sustain the provision of credits (see sections below on capital and liquidity measures).

Guidance compatible with international standards that was introduced to support borrower relief measures can stay in place until these measures are wound down.

- *Guidance on payment deferrals* have helped banks manage a large number of COVID-19-related payment deferrals at a time when support had to be implemented swiftly and broadly rather than on case-by-case basis. The end of borrower relief measures and clearer economic prospects will reduce the uncertainty associated with the valuation of loans. This will be an opportunity for supervisors to enforce the usual prudential, accounting, and regulatory reporting framework and require banks to assess and classify loans on a case-by-case basis (including, but not only, upon restructuring).[20]
- Authorities may decide to preannounce a date beyond which accommodative treatments [21] will no longer apply to payment holidays, without waiting for the complete phase-out of those measures. This may be

[17] See "Public Sector Support to Firms," IMF Special Series on COVID-19, April 2020, and "Public Banks' Support to Households and Firms," IMF Special Series on COVID-19, April 2020.

[18] See "Supervisory Actions and Priorities in Response to the COVID-19 Pandemic Crisis," IMF Special Series on COVID-19, October 2020.

[19] Under IFRS, credit exposures are classified in three categories: Stage 1 at origination, which requires 12-month ECLs, based on 12-month probability of defaults (PDs) and loss given defaults (LGDs); Stage 2 when credit risk increases significantly, requiring lifetime ECLs (based on lifetime PDs and LGDs); and Stage 3 when loans are credit impaired, which also requires lifetime ECLs (the PD is 100 percent and banks have to estimate recoveries).

[20] As clarified by the Basel Committee on Banking Supervision, loans subject to payment deferrals are not reclassified as defaulted upon restructuring. However, once payment deferrals are implemented and over the remaining life of the transaction, banks should continue to assess borrowers' unlikeliness to pay (based on whether borrowers will be able to repay the rescheduled payments) and may reclassify exposures as defaulted or credit impaired depending on the outcome of this analysis that should be carried out regularly, including the during the payment deferrals phase. The question is whether this is actually done by all banks.

[21] Standard-setting bodies and many supervisors have indicated that payment holidays granted to borrowers in response to COVID-19 (1) should not be considered distressed restructuring and should not automatically trigger a prudential default; (2)

desirable when it appears that lenders are not taking the necessary steps to ensure that borrowers' creditworthiness is adequately reflected in loan classification and provisioning.

- *Guidance on ECL provisioning* that recommends to not apply standards mechanically (for example, giving due weight to long-term economic trends while reflecting the impact of supporting measures when estimating ECLs) remains relevant in the exit phase, subject to adequate supervisory scrutiny.

Early recognition of the scale of the pandemic's impact on banks is essential. As the crisis subsides and its impact becomes clearer, banks should submit a feasible medium-term capital restoration plan that provides for capital augmentation in a gradual way, taking into account any remaining market uncertainty and banks' ability to raise capital in such an environment. Necessary supervisory actions should not be delayed (for example, weak bank governance). Supervisors should also continue to adjust their priorities (Box 2).

Tackling high levels of NPLs requires enhanced monitoring and possibly separating out their management from normal banking business.[22]

- Prudential oversight can foster active NPL resolution by placing banks with high NPLs under enhanced monitoring; requiring them to develop internal NPL management capabilities, plans, and tools; and setting ambitious operational targets to reduce NPL levels or write-off the problem loans. The European Banking Authority's "Guidelines on Management of Non-Performing and Forborne Exposures," (October 2018) and "Guidelines on Loan Origination and Monitoring," (May 2020) provide good references of international good practice for how banks and should prepare to tackle high NPL levels and strengthen credit risk management.

- Although managing moderate volumes of NPLs is part of normal banking business, dealing with very large NPL portfolios is often not a core competency of banks or their managers and requires specialist skills. Separating the management of impaired loans from regular loan servicing through the creation of in-house or subsidiary units can help banks manage large amounts of distressed assets by separating these functions from core operations (raising funds and making loans) and allocating scarce specialist skills (such as real estate or industrial sector experts) to recovering value from NPLs. Banks have five basic options to deal with NPLs (restructure the loan terms, settle with borrower at a discount to the amount due, dispose of the risk to third parties, enforce their rights against loan collateral, or seek insolvency proceedings).[23] Banks should be encouraged to develop these tools and operational capacity so they are in the position to maximize value recovery.

- Activities that were postponed or put on hold in the early phase of the crisis should be progressively reintroduced in the regular supervisory cycle. To optimize strained capacity given the pressures of the pandemic and allow banks to focus on key operations, certain activities were deprioritized by supervisors. In countries where the operational pressure has abated to some extent, this approach may be reconsidered. Clearly communicating supervisory expectations will be important in this regard. Supervisors should clarify

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should not automatically result in exposures moving from a 12-month ECL to a lifetime ECL measurement; and (3) should not lead to the loan being categorized as forborne.

[22] See "COVID-19 and Corporate-Sector Stress: Macrofinancial Implications and Policy Responses," IMF Special Series on COVID-19, forthcoming; and "Private Debt Resolution Measures in the Wake of the Pandemic," IMF Special Series on COVID-19, June 2020.

[23] Common loan restructuring tools include extending the maturity, reduced-interest loans, debt-for-equity swaps, repayment reduction through "warehousing" a portion of the debt, and write-offs of portions of the debt (typically based on repayment performance for the remainder of the debt).

their expectations and explain in advance how these activities will be reintroduced with a clear timeline for the restoration of precrisis supervisory procedures. As many supervisors have already announced longer implementation timelines for new regulations (for example, implementation of outstanding Basel III standards was delayed by one year), further delays in implementation are not recommended.

Box 2. Enhanced Supervision during the Exit Phase

Supervisors should continue to adjust their priorities and focus on the most meaningful risks such as credit exposures to vulnerable borrowers, operational resilience, and liquidity risk:

- Credit risk is highly likely to deteriorate, and banks will have to take steps to recover claims. Therefore, risk management, collateral valuation, and asset recovery procedures and processes should be subject to enhanced supervisory scrutiny to ensure that banks are well prepared to face a surge in NPLs.[1] Supervisors have an important role to play in promoting sound practices:
    - To ensure adequate loan classification, supervisors should examine critical data to monitor asset quality, using a variety of tools (enhanced offsite monitoring, peer review, testing of a sample of transactions, benchmarking by comparing the regulatory classification of syndicated loans held by several banks, etc.).
    - Regulatory reporting and supervisory analysis should be strengthened to identify emerging risks, gauge potential future losses and introduce bank-specific action plans as required. Supervisory analysis may rely on a mix of information already represented in periodic regulatory reports as well as on ad hoc information deemed relevant to the current crisis (information on government guaranteed loans, exposure amounts that have been restructured and the types of restructuring). Sensitivity analysis based on what-if scenarios should also be conducted (for example, impact of corporates rating migration on internal ratings-based (IRB) banks, impact of loan payment deferrals on provisions by quantifying potential losses under different scenarios with varying degrees of severity (for example, all or partial movement of payment deferrals to stage 2 and/or stage 3), and impact on capital if accrued interest on nonperforming loans is reversed, etc.)
    - When banks estimate modelled credit risk parameters to calculate ECLs and risk-weighted assets, supervisors should double check that the performance of ECL models and IRB models remain adequate and that steps are taken by banks when performance has deteriorated. Further, supervisors should ensure that credit risk parameters are updated and recalibrated in a timely fashion. Lastly, supervisors should review banks' provisioning practices. Diversity in provisioning practices and differences in modelled provisions should warrant further investigation.
- Banks' operational resilience has been tested during the COVID-19 pandemic. It has also accelerated the path toward digitized core-banking processes to enable contactless customer engagement during periods of quarantine and social distancing. Supervisors should analyze the experience to date, review the lessons that have been learned and assess whether additional measures should be taken by banks and supervisors to mitigate operational risks, including cyber risk (for example, additional guidance on data integrity/security).
- Liquidity pressure may also intensify for some banks,[2] which will require further supervisory work to enhance monitoring (if not already done) and assess banks preparedness to face liquidity shortages.

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[1] Banks face higher NPLs and provisions on their loan portfolios due to the impact of the crisis for two reasons: whether restructured or not, some loans become nonperforming (so-called Stage 3 under IFRS 9) and require provisioning; performing loans also require higher loan allowances when ECL parameters are revised to reflect deteriorated economic conditions and/or loans are moved between categories (from Stage 1 to Stage 2).

[2] Bank runs may be triggered by the announcement of substantial bank losses that are higher than expectations, wholesale funding can quickly disappear, some banks might have already used a large portion of their liquid assets, central bank interventions may be wound down, etc.

Supervisors should intensify or, at a minimum, reactivate stress testing programs. Many supervisors postponed supervisory stress tests at the outset of the pandemic given various challenges (limited data and resources, operational constraints, high uncertainty, difficulty with measuring the impact of policy actions). Some challenges remain, but stress testing is essential to (1) inform policy adjustments; (2) identify weak banks and risky portfolios requiring enhanced surveillance; and (3) provide a credible estimate of additional capital needs by individual firms and/or for the system as a whole. Supervisors may use top-down stress tests relying on already available information extracted from the regular supervisory reporting without having to request additional data from banks. Depending on the authorities' expertise and given the range of potential macroeconomic outcomes resulting from the COVID-19 crisis, scenario-based stress tests may be accompanied by supplementary information such as sensitivity analyses that can consider more extreme scenarios, and reverse stress tests identifying the scenario consistent with a particular level of bank capital.

EXIT FROM BANK PRUDENTIAL MEASURES

REGULATORY CAPITAL MEASURES

Many jurisdictions have utilized the flexibility built into the Basel III framework since the outbreak of the pandemic; some countries also relaxed prudential standards. Under Basel III, total regulatory capital consists of the sum of three elements—common equity Tier 1 (CET1), additional Tier 1 (AT1), and Tier 2 (T2). On top of the regulatory minimum requirements, banks are required to hold buffers, notably (1) the capital conservation buffer (CCB), to avoid facing restrictions on capital distributions; (2) the counter-cyclical capital buffer (CCyB), if it has been activated; and (3) a buffer applied to institutions designated as systematically important. In response to the COVID-19 crisis, most jurisdictions released the CCyB and encouraged banks to draw down their CCBs while using the flexibility offered under the Basel framework and introducing transitional arrangements to smooth the impact of ECL accounting on regulatory capital. On grounds of prudence, many jurisdictions restricted capital distributions to preserve CET1 capital levels. A number of jurisdictions also lowered prudential requirements below Basel framework levels.[24]

Key questions need to be answered before considering unwinding COVID-19 regulatory capital measures. Are the measures necessary to sustain the flow of credit to the economy? What is the path of future losses? What is the risk of having lower prudential standards if and when a wave of potential losses from the crisis hits banks? What is the potential adverse impact of these measures on confidence in the banking system?

Supervisors should have a good understanding of the baseline impact of the measures that have been taken so far. Exit strategies will have to consider the intertemporal trade-offs between the desire to support credit provision in the short-term and maintaining longer-term resilience given the associated risks. This requires a review of the effectiveness of capital measures as well as an in-depth assessment of the impact on banks' capital of extending the measures:

- Under a slow recovery scenario, as borrowers' short-term liquidity challenges turn into solvency problems, bank lending by itself may not succeed in boosting the recovery. Credit to unviable borrowers would instead add to exposures that are likely to result in financial losses, thus weakening financial stability and reinforcing

[24] Examples include lowering of risk weights for loans to small and medium-sized enterprises and affected sectors like tourism and health or carving out certain exposures from the leverage ratio without offsetting the impact of such adjustments on the ratio, as required by the applicable international standards.

the downturn. Moreover, while regulatory flexibility provides near-term relief to banks, it may also undermine confidence in banks if maintained for an extended period of time.

- Against this backdrop, supervisors should use stress tests and other diagnostic tools to get a sense of the potential time profile of losses and assess whether the existing supervisory stance should be maintained or adjusted. Depending on the results of such analysis, authorities may have to assess whether policy encouraging banks to use the CCB needs be adjusted, should banks risk face substantial losses under a prolonged recovery. The results of these analyses would also help supervisors challenge banks' capital projections in a forward-looking manner, in particular the credibility of the mid-term capital plans including dividends distributions.

Rebuilding macroprudential buffers such as the CCyB should only be prioritized once the impact of the COVID-19 shock on banks becomes clearer and the economic recovery is firmly underway. The activation of the CCyB is unlikely to be an immediate priority for the authorities when the recovery starts, unless excessive risk-taking and financial imbalances are observed. A return to a steady-state level should be gradual to (1) avoid procyclical effects and downward pressures on lending and (2) provide banks with sufficient time to build up the CCyB from retained earnings to the extent possible. In the meantime, clear communication from the authorities stressing that the buffers that were released remain available to be used would be useful.[25]

Banks that record substantial losses and breach regulatory minima despite exceptional supporting measures should be provided with enough flexibility to restore capital levels. In particular, they should be provided with adequate flexibility to restore CET1 and Tier 1 capital levels under a going concern scenario.[26] The approach recommended in the IMF April 2020 note issued shortly after the outbreak of the pandemic also remains valid going forward during the exit phase.[27] Capital restoration plans should take into consideration banks' access to capital markets and their ability to generate profits in the medium term. Implementation of these plans should be subject to intense supervisory scrutiny. In case the capital restoration plan is not being complied with, the supervisor should proactively discuss any potential or existing difficulties to meet the agreed targets. Where banks are unable to submit a credible capital restoration plan and where the confidence in the banking system would be severely impaired and resolution cannot be effectively implemented, authorities may need to provide public support to systemic entities.

As long as uncertainty remains high, policy restricting capital distributions should continue to apply on grounds of prudence during the exit phase. Once the pandemic's impact becomes clearer and losses can be

[25] See "Main Operational Aspects for Macroprudential Policy Relaxation," IMF Special Series on COVID-19, September 2020.

[26] Where banks record substantial losses, CET1 capital is depleted and regulatory capital may fall below regulatory minima (4.5 percent CET1, 6 percent Tier 1). AT1 instruments that are designed to bear a loss on a going-concern basis might also be affected through the automatic conversion in equity/write-down mechanism at a pre-specified trigger point (when CET1 falls below 5.125 percent). To restore capital levels, banks would have to issue new capital in the market (common equity and AT1 instruments where possible) or replenish capital organically. T2 instruments only provide loss absorption on a gone-concern basis and would not be affected in that scenario.

[27] See "Banking Sector Regulatory and Supervisory Response to Deal with Coronavirus Impact," IMF Special Series on COVID-19, April 2020. To the extent that the legal framework provides the necessary flexibility, supervisors may wish to temporarily reconsider the automatic activation of corrective measures when capital adequacy ratios fall below certain thresholds in favor of discretionary, risk-based approaches aimed at maintaining long-term financial stability. However, as the crisis subsides and its impact becomes clearer, banks should submit a feasible medium-term capital restoration plan that provides for capital augmentation in a gradual way.

quantified with a degree of comfort, systemwide policies limiting capital distributions may be relaxed progressively. Before any relaxation, supervisory stress tests should be used to ensure that banks remain well capitalized and able to support the economy. Maintaining some restrictions on capital distributions should also be considered when loss recognition is postponed and banks' results are likely to be distorted as a consequence. As within each jurisdiction some banks may recover from the crisis faster than others, moving to a case-by-case approach could be considered but the choice involves trade-offs—a systemwide approach helps reduce stigma, a case-by-case one avoids penalizing banks with stronger capital positions and solid profit generation capabilities. For a case-by-case approach to be effective, (1) supervisors should have the ability to clearly identify vulnerable banks and review their forward-looking capital plans, and (2) stigma risk should be mitigated through, for example, adequate communication, sufficient banks disclosure, and banks avoiding excessive reliance on volatile sources of funding, among others. Regardless of the approach chosen, it will be important to ensure that supervisors have sufficient tools to challenge banks' capital projections and assess the credibility of their mid-term capital plans, including planned dividends distributions. This is critical to ensure that banks (1) can meet minimum requirements under a broad range of scenarios accounting for uncertainty and (2) are able to rebuild capital buffers over time.

Regulatory measures that are not compatible with international standards should be reversed. The vast majority of policies introduced by some countries to lower capital requirements below international standards have been temporary and time bound.[28] According to initial announcements, most of these relaxation policies are meant to last between six months and two years. The key question is whether they should be extended. Considering that these measures are inconsistent with international prudential standards and entail risks, jurisdictions should prioritize a restoration of the prudential framework. A short phasing-in period could be considered to avoid cliff effects while giving regulators enough time to assess to full effect of the pandemic on the banking system. However, at a minimum, it will be essential to strengthen supervisory monitoring. Maintaining some restrictions on capital distributions could also be considered given that banks are operating below Basel standards.

Jurisdictions that have not implemented Basel III need to consider the nature of the prudential requirements that were eased. In jurisdictions that do not have capital buffers designed under Basel III to absorb the impact of a crisis, buffers might have been embedded into higher risk-weights or higher minimum capital adequacy ratios:

- Where buffers are *macro-financial* in nature (that is, they reflect systemic vulnerabilities) and have been used (for example, selective lowering of risk-weights that remain equal to or higher than that prescribed in the Basel framework), jurisdictions should wait to restore the precrisis prudential requirements until the shock has been fully absorbed by banks. Over the medium term, these jurisdictions could consider the benefit of explicitly designing their capital requirements to incorporate capital buffers that could more readily be used in times of stress.

- Where buffers reflect *institutional weaknesses* (for example, weak risk management, difficult collateral enforcement, etc.) and have been used to support lending in the face of the pandemic, authorities should start progressively restoring precrisis requirements with a view to avoiding a procyclical recalibration of standards that could disincentivize lending during the recovery phase. The length of the phasing-in period may take into consideration (1) the impact of increased capital requirements on lending, (2) banks' ability to comply with

[28] These jurisdictions have implemented the Basel standards but not always the Basel III framework.

higher capital requirements,[29] and (3) whether confidence in the banking system would be affected during the exit phase if reduced standards were to be maintained for an extended period of time.

Special attention should be given to situations where changes to prudential rules have been combined with a relaxation of accounting requirements. Extraordinary measures are intended to support credit provision in the short-term while maintaining longer-term resilience, hoping that confidence in the banking system will not be affected. While many supervisors have provided useful guidance in the context of COVID-19 on how restructured loans including those subject to moratoria should be classified and provisioned—loans subject to moratoria should not automatically be reclassified to default upon restructuring, but banks should continue to assess and borrowers' ability to pay based on the rescheduled payment profile and provision accordingly—measures relaxing accounting standards have also been introduced against IMF advice. Certain authorities, for example, have frozen the asset classification status and provisioning requirements for loans that were performing before the outbreak of the pandemic or changed the definition of NPLs, which raises concerns as financial statements and prudential ratios no longer adequately reflect the true values of banks' assets. Given that a relaxation of accounting rules is highly likely to adversely impact trust in the banking system at some point (the tipping point cannot be anticipated), authorities have limited leeway and should be mindful that delaying decisions on reversing measures that have eased simultaneously prudential and accounting standards would entail risk.

Measures that relax loan classification and loan provisioning rules should not be extended given the adverse impact on transparency. Instead, jurisdictions should prioritize restoration of the accounting and prudential frameworks (including, where available, prudential loan loss provisioning), requiring banks to reclassify exposures as NPLs and record accounting provisions if necessary, using prudential provisions as a backstop where such framework has been introduced. As mentioned above, phasing-in arrangements could be considered as restoring precrisis rules aligned with international standards following a period during which loan classification was frozen is highly likely to lead to a sudden and abrupt increase in NPLs and provisioning. Supervisors should therefore quantify the potential impact on banks' solvency and stand ready to take action. In the meantime, supervisors should intensify monitoring and ensure that banks regularly assess the creditworthiness of borrowers.

PRUDENTIAL LIQUIDITY MEASURES[30]

Most countries have emphasized that liquidity buffers can be used under stress. For example, various authorities have reminded banks that the liquidity coverage ratio (LCR) is a buffer and that ratios can dip temporarily below the normal threshold where necessary during a period of financial stress.[31] These measures are in line with recommended practices. However, weakening requirements *before* financial stress occurs, for example by reducing the LCR to 80 percent from 100 percent or changing the regulatory composition of high-quality liquid assets (HQLA), is not recommended, as banks would be less resilient in case of a liquidity crisis

[29] When precrisis requirements are restored, capital adequacy ratios will decrease immediately (everything else being equal) or will remain unchanged but will be compared to higher regulatory minimum. The question is, will banks be above regulatory minimum? Simulations should be made by the authorities.

[30] Excludes measures also taken for monetary policy purposes, for example, reduced reserve requirements, asset purchases, expanded repurchase facilities, and access to standing facilities.

[31] It is important that banks make use of the buffer under stress in order to ensure liquidity in the system and avoid contagion effects that might trigger liquidity problems in other banks.

and would no longer be required to provide LCR restoration plans when they go below the 100 percent threshold. Several authorities have also adjusted loan-to-deposit requirements to encourage banks to lend (for example, higher maximum loan-to-deposit ratios). Large increases in loan-to-deposit ratios, however, may signal liquidity issues and/or excessive lending insufficiently backed by stable resources. In such event, effective and close supervision should be ensured (review of the composition of banks liquid assets, analysis of maturity mismatches, monitoring of the stability of deposits).

Measures incompatible with international standards should be unwound first, to bring them back within the flexibility of existing frameworks and standards. For example, restoring the LCR to 100 percent and the composition of HQLA. The timeframe for restoring requirements would depend on (1) how far the indicator is from required or desirable levels, (2) whether this is isolated or systemwide, and (3) expected forthcoming liquidity sources and needs.

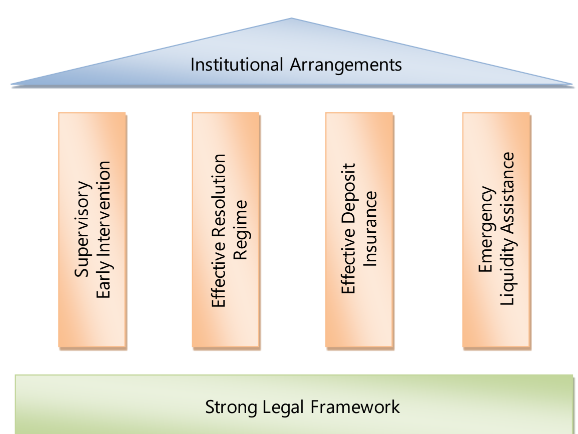
Continuous monitoring of liquidity conditions to gauge levels of stress is recommended. The exact indicators would depend on country-specific circumstances and potential sources of liquidity stress, for example, the size and structure of the interbank market, depositor confidence in banks, developments in the foreign exchange market, and/or forthcoming maturing/rollover of large public or private debt obligations. For prudential liquidity measures, a period of stable indicators (1–3 months) at prevailing pre-pandemic levels would need to be observed before restoring the requirements. However, in COVID-19 conditions wherein business needs for liquidity will be affected by renewed lockdowns, it may be prudent to hold off on tightening until the possibility of abrupt disruptions due to the resurgence of the virus becomes unlikely.

CONTINGENCY PLANNING IN THE CONTEXT OF COVID-19

Systemic bank solvency challenges may emerge in some countries as a result of the pandemic. As the pandemic's impact across social segments and industry sectors has been far from even, it should be expected that some loans will not recover and thus result in higher NPL levels in the most impacted cohorts even under a robust economic recovery. Banks most exposed to the most vulnerable borrowers may, therefore, face a threat to their own viability even under optimistic scenarios of recovery from the pandemic. If financial sector problems become widespread or systemic, creditors and investors may no longer be able to distinguish viable from nonviable banks, and confidence in the overall financial system may be undermined, triggering liquidity distress.

With financial stress expected to rise, countries should strengthen the financial safety net and prepare contingency plans now. Past crises teach us that financial systems can be made substantially more resilient with well-developed financial safety net infrastructure (see text figure) and good planning (for example, preparation of contingency plans). Authorities should undertake a detailed review of the financial safety net in place and take prioritized action to strengthen elements that fall below international good practice. Authorities are also recommended to take any steps needed to ensure that the core entities of the financial safety net—central bank, financial supervisory and regulatory agencies, resolution authority, deposit insurer, and Ministry of Finance—have clear mandates and sufficient operational

The Financial Safety Net



independence to be able to prepare, coordinate, and execute their tasks, including under time pressure. Strengthening financial safety nets and preparing contingency plans can take considerable time; authorities should undertake this work as a priority.

While initiating bank resolution may be neither desirable not practicable in the midst of a health crisis, authorities should continue to apply corrective action frameworks, update resolution plans, and prepare for contingencies in anticipation of a return to normalcy. Action to intervene failing banks can entail significant risks and operational challenges even during normal times, including valuing the bank's assets and identifying optimal resolution options, acceptable capital, funding, and governance structures. These challenges increase substantially during uncertain periods and bank resolution typically involves deploying several onsite teams with specialist expertise over a period of months. While in most circumstances early quantification of losses followed by prompt intervention are the recommended steps, initiating bank resolution during pandemic restrictions may not be practicable. In addition, given the unprecedented nature of the shock and large uncertainty about the recovery, forcing too rapid a recognition of uncertain losses may constrain banks' ability to play an important role in absorbing the shock and authorities may need to wait until the longer-term impact on bank loans can be more reliably estimated. Authorities should continue to apply corrective actions as appropriate given circumstances and prepare bank resolution plans, maintain up-to-date contingency plans aimed at responding to potential systemic financial crises, and be ready to intervene if significant problems emerge after removal of exceptional policy support.

Determining whether a systemic solution is needed involves assessing the viability of individual institutions and plans to address the findings. Any such assessment can only be credibly carried out once there is more clarity on the lasting economic and financial impact of the pandemic, and once on-site access is possible. Bank resolution and restructuring options can only be identified once the size and distribution of losses has been quantified and the viability of individual institutions has been assessed. Capital needs can vary significantly across banks given differing business models and risk appetites combined with incentives to hide problems and delay loss recognition and provisioning that would adversely affect profitability and capital. These problems tend to be exacerbated by weaknesses in governance, risk management, and external audit and can be prudently and consistently assessed only through targeted on-site diagnostics. Targeted diagnostics—asset quality reviews and forward-looking assessments of viability (sometimes combined with solvency stress tests)[32] should be undertaken by independent experts under the instruction and oversight of the bank supervisor. Key steps of a successful diagnostic approach include undertaking a high-level risk assessment and specifying a detailed valuation methodology that applies a consistent and prudent set of valuation criteria to the assets of the majority of the banking system. Authorities should ensure that each institution is viable on a forward-looking basis—that is, able to meet capital, liquidity, and other regulatory requirements; attract market funding and satisfy redemptions; and generate adequate returns. The forward-looking assessment should consider the potential for adverse fluctuations in dominant risks, including loan classifications, real estate collateral values, bond credit ratings, and currency values.

A plan for managing the results of the diagnostic exercise is needed well in advance of the results, to allow for any legislative reforms and preparations required. The plan needs to cover a triage of viable and non-viable banks with the actions to strengthen the former through restructuring and recapitalization, and to intervene and resolve the latter. State intervention in the banking system, including through capital injections,

[32] For more details, see "The Role of Bank Diagnostics in IMF-Supported Programs," IMF Technical Notes and Manuals, December 2019.

may be necessary in some cases to underpin financial stability. The solutions being considered need to be carefully designed, incorporate the highest standards of transparency and accountability, ideally be temporary in nature, and be fully consistent with the government's fiscal and debt strategy.[33] They will need to be multifaceted and adapted to country-specific circumstances to address solvency in both the corporate and financial sectors and differentiate between different types of impaired assets. Supervisors and regulators are encouraged to preemptively build their NPL oversight capacity to international good practice.[34] There is no one-size-fits-all solution to bank restructuring or NPL resolution, and country authorities should undertake detailed diagnostics of the obstacles to NPL resolution before recommending systemic solutions such as public asset management companies.[35] Public asset management companies are not suitable for restructuring heterogeneous credits to small corporates and small and medium enterprises; originating banks with company specific knowledge are best placed to identify how to minimize losses and preserve viable firms.

[33] For more details, see "Managing Systemic Banking Crises—New Lessons and Lessons Relearned," IMF Departmental Paper, February 2020.

[34] The European Central Bank's and European Banking Authority's approach provides a good reference example.

[35] Experience with publicly owned and managed asset management companies has been mixed. Their costs and benefits should be assessed carefully and other options considered if sound institutional design cannot be guaranteed, the political will to recognize loss is lacking, transfer prices are difficult to establish from market observations, there is no clarity about the level of banks' exposures to troubled assets, or when there are profound weaknesses with creditor rights. See "Issues in the Establishment of Asset Management Companies," IMF Policy Discussion Paper, 2004.