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Buffering Covid-19 losses – the role of prudential policy

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Buffering Covid-19 losses – the role of prudential policy

Key takeaways

- *By allowing banks to run down some of their buffers, policymakers are sending a strong signal about their resolve to lessen the economic fallout from the pandemic. Such prudential measures complement the main policy levers: monetary and fiscal instruments.*
- *To avoid a reduction in credit to the real economy, authorities need to ensure that banks have the capacity and willingness to make use of the flexibility afforded by the buffer release. Payout restrictions on banks and risk-sharing between banks and the public sector will be key.*
- *For banks to continue playing a positive role in the supply of funding during the recovery, they should maintain usable buffers for a long period, as losses from a severe recession will take time to materialise.*

The coronavirus (Covid-19) pandemic is a rare type of shock to the world economy. Its sudden and massive impact on activity comes at a time when the legacy of the Great Financial Crisis (GFC) of 2007–09 is still weighing on public and private sector balance sheets. As its fallout will extend well beyond the removal of health-related restrictions, the subsequent economic recovery may be drawn-out. So far, the economic policy response has primarily involved the decisive use of monetary and fiscal tools. For their part, prudential authorities have sought to support the flow of credit to firms, households and governments, most notably by relaxing banks' constraints on the use of liquidity and capital buffers. This note discusses the conditions under which such a release of prudential buffers might help address the shock.

A release of buffers can complement and enhance the effect of fiscal and monetary policies, provided that banks are both able and willing to expand their balance sheets. For one, this means that markets' and management's assessment of what is a prudent buffer size should not prevent banks from lending. In addition, banks should see greater value in using balance sheet capacity for lending rather than for discretionary payouts: a trade-off affected by the extent of risk-sharing with the public sector.

Banks need to continue supporting economic performance in the medium term, ie the period after the lifting of stringent health-related restrictions. This is not a given. The recession will bring about large losses that will materialise only gradually. To avoid amplifying stress, banks will need buffers to absorb elevated losses for as long as the slump persists. After that, banks will still need buffers that they can draw upon in order to facilitate the rebound as robust counterparties and reliable intermediaries. It would be counterproductive if – because of depleted buffers – financial sector distress thwarts the recovery from a shock that was fundamentally non-financial.

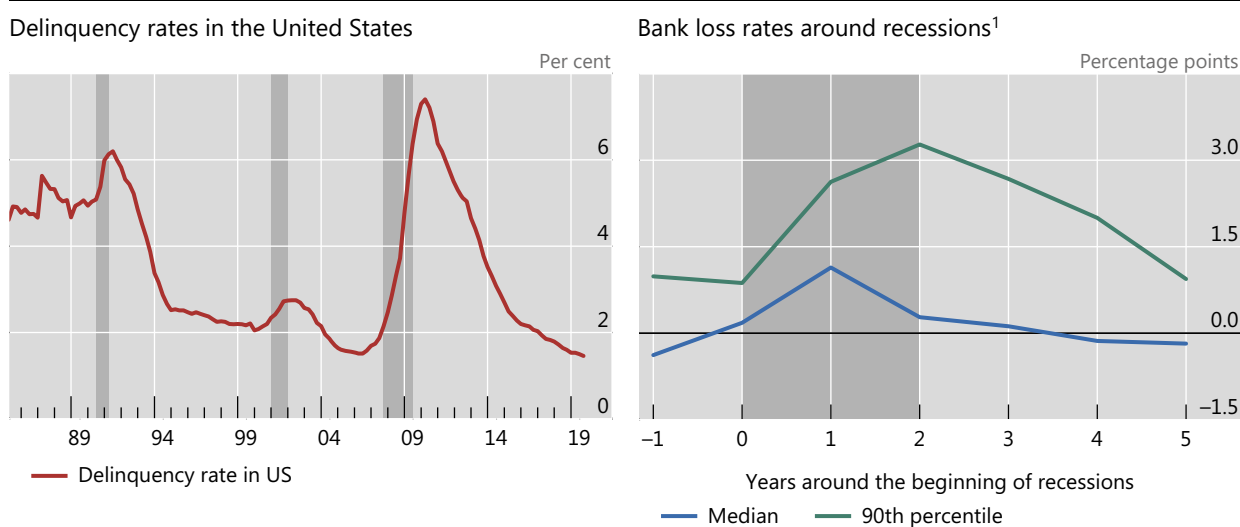
This bulletin has three parts. We first assess how banks have been and will be affected by the economic fallout of the health-related confinement measures and policy responses to this fallout. We then review the design and usability of prudential buffers. In the third part, we discuss how the relaxation of such buffers can support bank credit.

Need for more bank credit, despite large losses and reduced future profitability

By putting the brakes on the global economy, Covid-19 has already affected the banking sector. The severity of this economic sudden stop is still unknown, but the ensuing recession will in all likelihood be deeper than any in recent memory. Going beyond the immediate operational disruptions, the sharp downward revision to the economic outlook and investors' retrenchment have sent asset prices plummeting, inflicting mark-to-market losses on banks. In addition, corporate clients scrambling for cash have been drawing heavily on their credit lines, thus testing the resilience of banks' funding liquidity and reducing their capital ratios.

Credit losses linger on banks' balance sheets years after recessions

Graph 1



The shaded areas in the left-hand panel indicate recession periods (Q3 1990–Q1 1991; Q1 2001–Q4 2001; Q4 2007–Q2 2009). The shaded area in the right-hand panel indicates the average length of recessions (two years).

¹ Evolution of bank loss rates around recessions for a panel of 14 advanced economies since 1985. Time 0 is the year when the recession begins as indicated either by the NBER\CEPR or standard business cycle dating methods.

Sources: Pesola (2011); national data; authors' calculations.

Arguably, challenges for banks will just keep growing over the medium term. The initial pandemic-related economic losses will take time to crystallise. The removal of health-related restrictions will bring no immediate return to normal, even if it were to halt the slide in GDP. For one, historical experience shows that credit losses remain elevated for several years after recessions end (Graph 1). In addition, accounting and legal processes tend to delay recognition of losses, and recent policy measures in response to the current situation will result in an even slower loss recognition than usual. Provisions and writedowns will thus weigh on banks' profits for some time, potentially eroding banks' market valuations still further. Progress on post-GFC-balance sheet repair – still ongoing in some jurisdictions – could be at risk.

The main policy levers for tackling this economic shock are monetary and fiscal. Most urgently, central banks have focused on supporting core asset and funding markets in order to avoid adverse feedback from the financial sector to the real economy. Unprecedented fiscal measures – in the form of large-scale direct fiscal assistance or government guarantees on loans – have aimed at softening the impact of the Covid-19 fallout on firms and households, thus limiting the destruction of productive capacity and reducing the recovery time. As governments and central banks have greater flexibility to use their balance sheets in supplying liquidity and fiscal stimulus than private entities, monetary and fiscal policy instruments (new and old) have taken centre stage. These interventions also benefit banks by supporting valuations, improving liquidity and reducing borrowers' credit risk (Table 1).

Policy measures	Transmission channels		
	Valuations	Liquidity conditions	Balance sheet strength
Monetary policy	+ Reduces mark-to-market losses and market volatility	+ Boosts market liquidity + Improves availability and reduces the cost of funding liquidity	+ Reduces borrowers' debt servicing costs - Reduces banks' net interest margins
Fiscal policy	+ Supports economic activity - Increases medium-term sovereign risk	+ Reduces cash-flow pressures	+ Reduces likelihood and impact of borrower default in short-run - Strengthens the link between sovereign distress and bank resilience over medium term

Prudential policy faces a difficult balancing act. On the one hand, it needs to support bank lending during the crisis, thus facilitating the efficient transmission of monetary and fiscal measures to all corners of the real economy. On the other, it needs to preserve the ability of the financial system to contribute to a swift economic rebound once the health-related restrictions are lifted. As discussed next, the success of this balancing act depends on there being usable prudential buffers throughout the recession and into the recovery.

Prudential buffers: design and purpose

The regulatory framework comprises an array of prudential buffers (Table 2). They all have the same primary objective: to keep banks functioning despite shocks, thus strengthening the resilience of the system. Liquidity buffers help banks avoid a disorderly sale of illiquid assets. Capital buffers, together with minimum capital requirements, provide absorbing capacity for losses that exceed the level of banks' loan loss provisions. But unlike a breach of minimum capital requirements – which coincides roughly with the point of non-viability, or the trigger of a resolution process – the drawdown of buffers allows banks to continue operating as going concerns (Borio et al (2020)). That said, to preserve banks' shock-absorbing capacity, such a drawdown is subject to distribution restrictions.

Buffers were not designed for the proactive management of the macroeconomy, but can nevertheless support bank lending. Once losses have been absorbed, banks can use what remains in their buffers to switch to less liquid assets and/or expand their balance sheets. The rest of this section provides some detail on each of the buffers (BCBS (2011, 2013a,b, 2019)).

Capital buffers in Basel III are of three types, each entailing automatic distribution restrictions unless deactivated. First, the *capital conservation buffer* (CCoB) applies to all banks and cannot be deactivated. Second, the so-called *SIB buffers* apply only to those banks that are designated by the Basel Committee or national authorities as global or domestic systemically important banks (G-SIBs, D-SIBs), respectively. They enhance the resilience of SIBs, whose failure would destabilise the entire financial system. While a G-SIB buffer cannot be deactivated, that of a D-SIB may be in some jurisdictions. Third, the *countercyclical capital buffer* (CCyB) generates loss-absorbing resources in response to the accumulation of systemic risk during credit booms. National authorities determine the size of the CCyB and can deactivate it.

Liquidity buffer. The Basel III Liquidity Coverage Ratio (LCR) requires banks to hold a buffer of *high-quality liquid assets* (HQLA). In stress periods, the use of this buffer does not entail automatic distribution restrictions. If the LCR dips below 100%, supervisors are expected to impose on banks a timeline for rebuilding the buffer, according to the specific circumstances.

These buffers may be complemented by jurisdiction-specific *extensions* and/or additional *supervisory buffers*. The design of these buffers is at the discretion of individual jurisdictions.

Overview of prudential buffers

Table 2

Buffer	Level of design	Level of calibration	Distribution restrictions?	Possible to deactivate?
CCoB	Global	Global	Automatic	No
SIB	Global (G-SIB) / jurisdictional (D-SIB)	Global (G-SIB); jurisdictional (D-SIB)	Automatic	No (G-SIB); design-dependent (D-SIB)
CCyB	Global	Jurisdictional	Automatic	Yes
HQLA	Global	Global	Jurisdictional discretion	No
Supervisory	Jurisdictional	Jurisdictional	Design-dependent	Design-dependent

Prudential authorities can relax buffers in three ways. First, and most notably in the case of the CCyB, they can partly or completely deactivate existing buffers. Second, they can publicly or privately encourage the use of buffers, eg by temporarily not forcing banks to replenish drawn-down resources. Swift replenishment is costly for banks, especially in the midst of a crisis. Third, they can de-link the use of any buffer from payouts – for instance, by imposing blanket restrictions on the latter. When buffer use is no longer a reason for reduced shareholder returns, bank management has stronger incentives to deploy buffers for the extension of credit or for maintaining its loan book despite increasing risks.

In addition, prudential and fiscal authorities have taken complementary measures to increase the *effective* size of buffers.¹ For one, supervisors and regulators have allowed for a more lenient treatment of non-performing loans and have sought to reduce the erosion of bank capital that results from increased provisioning for expected credit losses. They have also provided guidance on how banks should reduce regulatory risk weights in order to take into account emergency support to the real economy, notably government guarantees. By slowing down the decline in banks' regulatory capital ratios, all these measures reduce the rate at which banks draw buffers down, spreading the recognition of losses and allowing a given amount of equity to support a larger lending volume.

Framework for assessing the use of buffers

The release of regulatory buffers gives banks more flexibility to use their balance sheets and can counter procyclical behaviour. But this will help to lessen the fallout of the Covid-19 shock only if banks have the capacity and willingness to respond to the prudential measures by supporting credit to the real economy. This should be the case both in the short term, while emergency health restrictions are in place and economic policy is focused on providing relief, and in the medium term, when the policy focus will shift to boosting the economic recovery.

Capacity. Banks can use buffers to expand their balance sheets only if regulatory requirements and/or supervisory expectations are the constraining factor for their balance sheet management. If, instead, stakeholders' risk perceptions and the attendant risk management expectations are the binding constraint,

¹ See BCBS (2020). Supervisory guidance is a common tool employed at different phases of the credit cycle.

relaxation of prudential requirements would not lead banks to deplete their “strategic reserves” (to borrow an analogy from the oil market), as they would fear that this would adversely affect their operations or funding. The latter is a likely outcome if, for instance, investors perceive the use of buffers as taking the bank too close to a trigger point, beyond which coupon payments on Additional Tier 1 capital instruments are suspended, or the instruments themselves are converted to common equity or written down.

Willingness. Banks must also have the incentive to use freed-up balance sheet capacity for supporting credit to the real economy. This need not be the case. For one, banks with price-to-book ratios below one may be inclined to use this freedom for payouts, such as dividends, share buybacks or bonuses (Adrian et al (2018), Yang and Tsatsaronis (2012)). And, more generally, stable dividend streams are perceived as a sign of financial health. However, payouts would divert financial resources away from the containment of the pandemic’s economic impact.

Supervisory actions can help protect lending capacity from banks’ payout incentives. Authorities can engage in moral suasion or prohibit distributions. Arguably, blanket restrictions would address the collective action problem, as no bank wants to be the only one to hurt its shareholders. Supervisors also have some flexibility, eg with regard to the definition of “earnings” that determine the scope of maximum payouts.

Monetary policy can also increase the appeal of balance sheet expansion. Lower interest rates reduce banks’ cost of wholesale funding, and an expanded list of assets accepted as collateral by the central bank has a similar effect. In turn, lower funding costs lower the bar for the expected return on new loans.

Supervisory and monetary policy measures notwithstanding, given worries about severe downside risks, banks may expand their balance sheets only in the presence of public backstops. Risk-sharing with the public sector reduces the capital costs of private lenders (it enhances their balance sheet capacity) and improves the expected return from lending (increasing their willingness to lend). The government can achieve risk-sharing through various means (Landier and Ueda (2009)). For one, it can extend guarantees for existing and new credit to viable firms that have suffered from the pandemic shock. Loan purchases or subsidies by the government can also help. The best approach will differ across economies, as it depends on the fiscal authority’s constraints, the existence and specificity of legal and market infrastructure, banks’ capital resources, and the degree of uncertainty about the shock and the economic outlook. In either case, an integrated and comprehensive policy response will be key.

Medium-term resilience. Even if a buffer release ensures banks’ capacity and willingness to alleviate economic tensions in the short term, the use of buffers at the outset should not undermine banks’ resilience during the later stages of the crisis or the recovery period.

Demonstrating policy resolve today should not undermine confidence in tomorrow’s financial system. Bank counterparties, market participants and the public at large need to remain convinced that the banking systems’ buffers will help them weather economic stress along the entire path to full recovery. If past experience is any guide, buffers will be needed for quite some time (Graph 1). Only banks that remain resilient over the medium term will be able to continue playing a constructive role in supporting real activity, not least by smoothing Covid-19 losses over time.

Importantly, no matter how aggressive, the release of available buffers is unlikely to suffice on its own to compensate fully for the recession-induced erosion of capital. For example, the CCyB put in place by BCBS jurisdictions before Covid-19 was set no higher than 2.5% of risk-weighted assets, with most jurisdictions’ CCyB well below that level. Even tripling this amount by tapping into other buffers – while keeping some resources unused – would be only just enough to absorb the losses estimated in central bank stress tests. In recent versions of those exercises, recession-induced capital erosion was calculated to rise to 4–7.5% of risk-weighted assets (Bank of England (2019), Federal Reserve Board (2019), EBA (2018)). Given that the impending global recession is likely to match or exceed the most adverse scenarios embedded in these past exercises, capital erosion may be much larger, even if governments intervene to support banks (eg with guarantees).

Thus, a buffer release will be most effective if included within a general strategy for managing the *evolution* of the pandemic's economic impact with a *portfolio* of tools. Lessons from the past indicate that this strategy should have a medium-term horizon and combine transparency, effective market discipline and preservation of intermediation capacity (Caprio et al (1998), Egrungor and Cherny (2009)). It should help to avoid a financial crisis that will worsen the macroeconomic problem. Reading through this lens the messages from successful resolution of past banking crises (Borio et al (2010), Claessens et al (2014)), the restoration of credit flows to the real economy will be short-lived if banks become weighed down with bad assets and no buffers. Furthermore, government guarantee schemes should require banks to keep "skin in the game", thus both protecting the solvency of the public sector and leveraging lenders' ability to discriminate between good and bad credit. Preserving monetary and fiscal space is key, as banks' resilience is likely to depend for a long time on a combination of buffers and non-prudential policies.

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