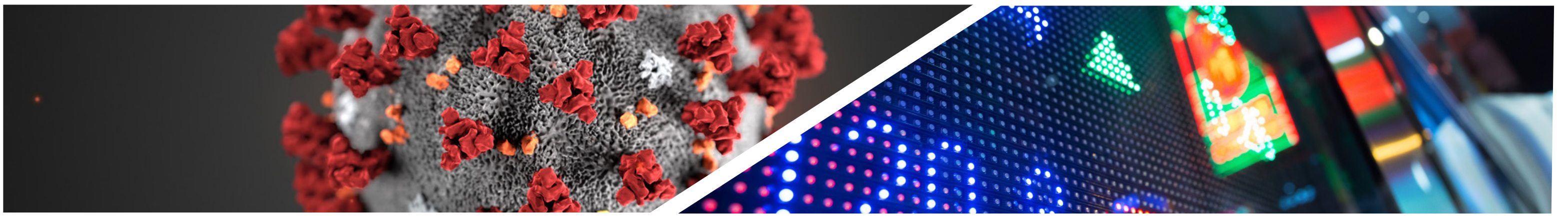

PANDEMICS & FINANCIAL STABILITY WEBCAST – DISCUSSION NOTE

CORONAVIRUS AND THE FINANCIAL SECTOR

IMPLICATIONS FOR SUPERVISORS

BACKGROUND

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

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

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

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

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

IMPLICATIONS FOR SUPERVISORS

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

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

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

Toronto Centre is launching a webcast series: Pandemics & Financial Stability to discuss the issues and opportunities for supervisors to deal with the impact of COVID-19 on the financial system.

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