

# Exit Strategies to Support Equitable Recovery and Address Effects from COVID-19 Scarring in the Financial Sector

Interim report

13 July 2022



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## Executive Summary

Recovery from the economic impacts of the COVID-19 crisis has been divergent across jurisdictions, partly due to different cyclical and structural factors including health measures and partly due to different duration of health policy related restrictions. Limited ability to provide additional policy support, in particular in the form of fiscal stimulus, has been a factor behind a relatively weaker recovery in many EMDEs than in AEs. This in turn makes risks of scarring in EMDEs typically much more significant than in AEs. Disruptions to global supply chains alongside global demand recovery, and in some countries greater demand stimulus, created upward pressure on inflation and global financial conditions began to tighten.

Russia's invasion of Ukraine has added substantially to these pre-existing challenges, by causing a setback to global growth, triggering higher inflation, and adding to economic uncertainty. Elevated commodity prices increase industry costs, and with high food and energy prices weigh on household incomes, particularly in EMDEs.

This exacerbates challenges for policy makers in supporting a strong, equitable and inclusive recovery. Vulnerabilities from the COVID-19 crisis may now materialise at a time when policy space is limited and firms and households have reduced financial buffers. Moreover, a more uneven global recovery increases the risk of negative spillovers. And vulnerabilities that COVID-19 support measures prevented from materialising may now come to the fore. Taken together, these setbacks may imply that the scarring effects from the pandemic have a greater potential to damage future growth.

A resilient global financial system is a necessary precondition for addressing these challenges. It supports the financing of the economy through a steady supply of credit to the economy and low risk premia; ensures effective transmission of monetary and fiscal policy thus allowing more room for manoeuvre; helps to cushion possible external spillovers and ensures that financial markets can continue to price assets, allow risk to be hedged and provide transparency to help resolve uncertainty.

Preventing scarring effects to sustainable growth over the long term requires effectiveness of domestic policies, containing cross-border spillovers and addressing debt overhang issues. Close cooperation and information exchange becomes more critical for authorities in ensuring appropriate tailored policy responses and exit strategies. Current challenges underline the importance of ensuring that jurisdictions' policy mixes evolve with the economic circumstances, providing the right tools and incentives as needed, while remaining financially sustainable. In a rapidly evolving economic and financial environment, this calls for the continuous assessment of impacts, interactions and trade-offs of policies affecting the financial sector, including the use of stress tests to gauge the impact of tightening financial conditions on credit quality. In addition, a better understanding of the build-up of hidden leverage in the financial markets should also inform decision making. Authorities should also consider further whether, and how, support measures could be made more targeted. Communication of policy can build on experiences made during the pandemic, including state-contingent considerations where needed.

The prospect of an uneven global economic recovery may increase the risk of negative spillovers and the importance of policies to contain them. Exit strategies need to reflect specific domestic economic conditions and avoid excessive financial market reactions, which may limit the scope

to engineer a fully synchronized exit across jurisdictions. For instance, clear and consistent messaging on central bank actions may help market participants to appreciate the motivation for and drivers of differences in policy normalisation across jurisdictions. Cross-border spillovers can also be mitigated by addressing excessive procyclicality in capital flows.

Targeted approaches and phasing-out of COVID-19 measures may help to mitigate adverse effects of high debt and prevent scarring. To this end, jurisdictions pay attention to the coordination of the narrowing down and phasing out of the support measures with the building up and provision of effective mechanisms to deal with the debt overhang resulting from these support measures, while taking into account the need for amending the support measures in light of recent events.

When commissioned in late 2021, this report to the G20 was intended to discuss policies in the aftermath of a past shock. Since then, the economic and financial market situation has evolved considerably. And the situation will evolve further in the months between this interim report and the final report in November. Bearing this in mind, the FSB invites feedback from stakeholders on the report, both in writing and in the form of a dedicated (virtual) outreach event.

This report primarily reflects experiences made until the first quarter 2022. The final report, to be delivered to the G20 in November 2022, will consider relevant new economic developments and input from stakeholders with a view to presenting conclusions regarding the financial stability issues related to scarring effects from COVID-19, and how the FSB will address these issues going forward.

## Introduction

The Indonesian G20 Presidency asked the FSB to report on exit strategies that support equitable recovery for financial stability. This work follows up to the April 2021 FSB Report on COVID-19 support measures<sup>1</sup> and the October 2021 FSB COVID-19 Lessons Learnt Report,<sup>2</sup> to achieve a global recovery that is even, sustainable and inclusive. This interim report will be submitted to the G20 Finance Ministers and Central Bank Governors in July and the final report to the G20 Summit in November 2022.

A speedy, sizeable and sweeping policy response has been key to limiting the economic fallout of the COVID-19 shock. Reflecting the immediate and severe impact of the shock on global economic activity, authorities implemented an unprecedented package of fiscal and monetary measures in response, helping to mitigate the adverse effects of the shock on the real economy and the financial system. These measures were complemented by the use of regulatory flexibility, intended to sustain the supply of financing to the real economy guided by the FSB's COVID-19 Principles which reinforced commitment to international standards. Fiscal, monetary and regulatory measures have supported each other.

The policy measures adopted in response to the COVID-19 shock were intended to bridge temporary economic disruption. As economies were recovering from the effects of COVID-19 during 2021, the question of whether, when and how to extend, amend or unwind support measures gained increasing attention. At the same time, concerns arose that the pandemic might cause long-term losses to output. Such scarring effects may result from damage to the factors that determine aggregate output – capital, labour and productivity.<sup>3</sup>

In a situation when many jurisdictions were in the process of exiting support measures, Russia's invasion of Ukraine has severely exacerbated recent challenges, or created new ones, for ensuring financial resilience and a sustained flow of financing to the real economy. These reflect weaker global economic growth and higher inflation, coupled with more divergent macroeconomic conditions across regions and heightened economic uncertainty. By the same token, further disruptions to global supply chains have reinforced questions about the combined long-term impact of the pandemic and the war on global growth.

This report considers exit strategies through the lens of financial stability and the capacity of the financial system to finance strong and equitable growth. While policy responses will be guided by broader considerations, there may be implications for financial stability. On the one hand, a premature withdrawal of support measures could produce procyclical effects, permanently reducing economic growth potential through unnecessary insolvencies and unemployment as well as affecting banks' balance sheets. Moreover, it could create negative cross-border spillovers. On the other hand, if support measures remain in place for too long, financial stability

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<sup>1</sup> FSB (2021a) *Covid-19 support measures: extending, amending, and ending*, April.

<sup>2</sup> FSB (2021b), *Lessons learnt from the COVID-19 pandemic from a financial stability perspective: Final report*, October.

<sup>3</sup> See IMF (2022) *G-20 Background note on minimizing scarring from the pandemic*, May. The paper refers to scarring as: "diminished long-term output relative to pre-pandemic projections". Aggregate total factor productivity - on which aggregate output depends - reflects human capital, technologies deployed for production, allocation of capital and labour across firms within the economy. The paper examines the scarring on labour markets, schooling that can adversely affect human capital of future workers, corporate sector vulnerabilities that may result in lower capital investments, and suboptimal policy setting that can hold back the allocation of resources and weigh on productivity.

risks may gradually build, by distorting resource allocation and asset prices, increasing moral hazard, postponing necessary structural adjustment in the economy and draining fiscal resources. This includes potential scarring through debt overhang, which depresses investment and growth.

This interim report discusses strategies to exit or amend extraordinary policies while supporting equitable recovery and addressing effects from COVID-19 scarring in the financial sector in light of recent developments. The first section sets the stage by discussing how the evolution of the pandemic and the Russian invasion of Ukraine have affected the challenges financial authorities face, and how these relate to the COVID-19 related measures taken so far. The following sections discuss specific policy challenges in more detail: ensuring the effectiveness of domestic policies (section 2); containing cross-border spillovers (section 3) and preventing scarring by addressing debt overhang issues (section 4). Section 5 considers the role of international standards. The final section presents preliminary conclusions and next steps.

This interim report will serve as basis for stakeholder outreach and then inform the final report to the G20 Summit in November. It builds on the information sharing by members of the FSB and of its Regional Consultative Groups concerning their COVID-19-related policy measures, a survey among FSB members on exit strategies for equitable recovery and addressing effects of COVID-19 scarring in the financial sector, as well as the FSB Principles that underpin the official sector response to the pandemic.

## 1. Issues in promoting strong and equitable recovery from COVID-19

From a financial stability perspective, the issues in promoting strong and equitable recovery, and therefore for designing and implementing the exit from COVID-19 support measures, have evolved significantly over the past year or so.

During 2021, the global economic recovery, along with relatively accommodative global financing conditions and vaccination progress, have supported steps to exit from COVID-19 measures without large disruptions in financial markets. Yet the pace of economic recovery, and the room for winding down support measures, has been uneven between countries and regions. For instance, many emerging market and developing economies (EMDEs) have seen a weaker recovery than the major advanced economies (AEs). While this divergence to some extent reflects factors beyond COVID-19, such as different positions in the business cycle and longer-term structural factors, divergent vaccination rates and associated health policy measures have remained an important factor of economic performance. Lower vaccination rates and uncertainties about the future evolution of COVID-19 may imply protracted negative effects in some EMDEs. Moreover, a relatively weaker recovery in the context of increased fiscal support has further limited EMDEs' policy space.

Over the last few quarters, policy challenges related to tighter global financing conditions have come to the fore. The pandemic has left economies with higher sovereign debt burdens and – in many cases – already high corporate debt levels increased further as companies borrowed more to cover lost revenues or take advantage of historically low interest rates. As inflation started rising last year, following disruptions to global supply chains and sizeable demand



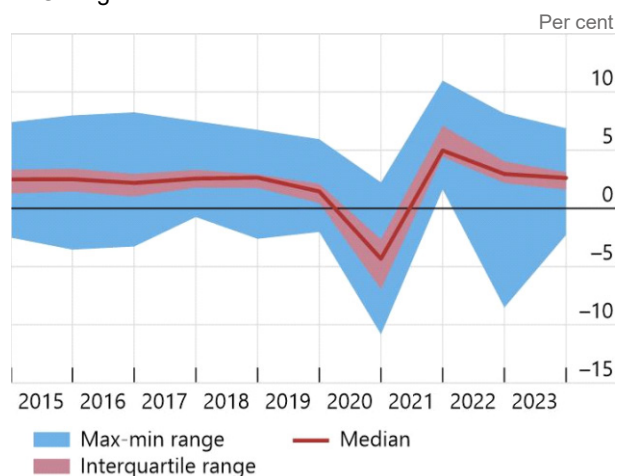
stimulus, global financial conditions began to tighten. The combination of high non-financial sector debt and tighter financial conditions may create challenges related to rising debt servicing costs and reduced fiscal space. This is particularly the case for EMDEs whose financing costs can be particularly sensitive to changes in investor risk appetite.

Russia’s invasion of Ukraine has added to these pre-existing challenges, by causing a setback to global growth, triggering higher inflation, and adding to economic uncertainty. After recovering from the impact of the COVID-19 pandemic during the end of 2021, the near-term growth outlook has since deteriorated over the past few months. The IMF projects global growth to slow from an estimated 6 per cent in 2021 to about 3.5 per cent in 2022 and 2023. EMDEs are often particularly hard hit as rising food and energy prices weigh on household income while fiscal space to counter such impacts is limited. Indeed, IMF forecasts indicate that divergence in economic growth rates is set to increase over the next few years, suggesting that an asynchronous exit is becoming more likely (Graph 1, left panel).

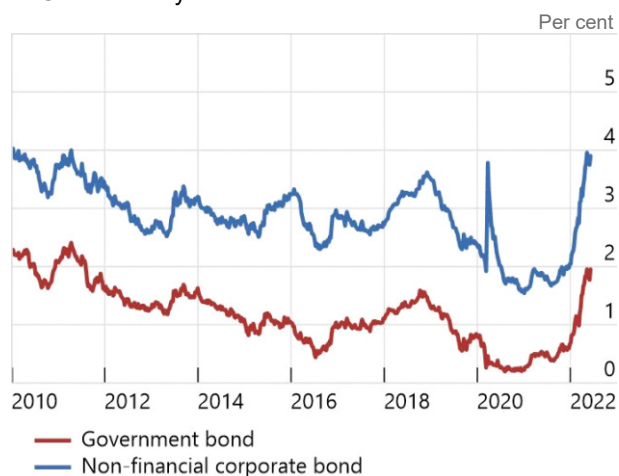
Inflationary pressures have heightened, largely driven by Russia and Ukraine’s roles as major exporters of key commodities and grains. Commodity price increases exacerbated by the war and broadening price pressures have led to 2022 inflation projections of more than 5.5 per cent in AEs and over 8.5 per cent in EMDEs. The result has been firming expectations of a removal of monetary accommodation and a tightening in financial conditions across the globe (Graph 1, right panel).

**Economic recoveries are diverging amid a tightening in financial conditions** **Graph 1**

1. GDP growth rates across FSB members



2. Global bond yields



Sources: ICE BofAML indices; IMF; FSB calculations.

The large change in the economic backdrop and high uncertainty has also affected the current and expected path of monetary and fiscal policies. Prior to the economic shock caused by the invasion, many jurisdictions were beginning to normalise fiscal and monetary policy settings. The use of programs to support the economy and the functioning of key financial markets had also declined in these jurisdictions, with facilities either being wound down or focussed on more targeted measures (see Annex). Some jurisdictions had also started to adjust their prudential measures. Such an exit had been proceeding smoothly, as the potential cliff effect at the end of the support packages had not materialised.

However, sharply higher inflation in a number of countries has led to actual and expected increases in monetary policy rates and a scaling-back of central bank asset purchase schemes. At the same time, the smooth exit from the economic support programs implemented to protect the economies from COVID-19 has been hampered by the intervening impacts of the war in Ukraine. A number of jurisdictions have adopted new fiscal support measures to cushion the impact of rising energy and food prices on household incomes, for instance through lower taxes on energy and fuel, energy price caps, or grants to low-income households.<sup>4</sup>

Deteriorating economic conditions and changing expectations of the future path of monetary policy have already induced a ratcheting-up of pressures in financial markets. Amidst high price volatility, commodity markets have experienced strains, reflecting large margin calls, undetected leverage, concentrated exposures and the opacity of at least some parts of commodity financing. By impairing the financing the supply of key energy, base metal and food commodities, such strains may have a disproportionately large macro impact.

More generally, previously elevated risk asset prices have started to fall, bond yields have risen, increasing the cost of financing the higher debt burdens resulting from the impact of the COVID-19 pandemic. Consequently, global bond issuance has also fallen sharply in 2022. The US dollar has also appreciated, especially against EMDE currencies, increasing the cost of foreign currency debt payments in EMDEs.

The current environment poses at least three additional challenges to policy makers in terms of exiting from the extraordinary policy measures of COVID-19 while continuing to support a strong, equitable and inclusive recovery:

- The need for sustained policy stimulus amidst removal of monetary accommodation. Weaker growth may be weighing on income and employment, and rapidly rising fuel and food prices are in particular hitting vulnerable households and corporates both in EMDEs and AEs. At the same time, rising inflation together with tighter global financing conditions may further constrain domestic monetary and fiscal policy.
- A more uneven global recovery and diverging monetary and fiscal policy stances increase the risk of negative cross-border spillovers. These may emerge through trade and supply chain effects, not least with respect to key commodities; through financial interlinkages; and through potential liquidity strains in key funding markets.
- Vulnerabilities that COVID-19 support measures prevented from materialising may now come to the fore. In particular, with tighter financing conditions, corporate sector vulnerabilities, including due to debt overhang, may crystallise in some jurisdictions. At the same time, there may be less financial buffers and policy space available to fence such vulnerabilities. Access to capital market funding may also become constrained and market turbulence may also complicate private sector involvement more generally.

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<sup>4</sup> For instance, an overview of measures in European jurisdictions can be found at Bruegel (2022), *National policies to shield consumers from rising energy prices*, updated regularly. Some non-European jurisdictions have also taken action in this field, e.g. Indonesia has increased energy price subsidies.

Considerations about adjusting and potentially exiting support measures should take into account these challenges, to support global economic recovery in the near term, prevent COVID-related financial stability impacts and scarring effects to sustainable growth over the long term. To this end, authorities should consider the following issues: (i) how to ensure the effectiveness of domestic policies, to make good use of, and re-gain as appropriate, policy space; (ii) how to contain cross-border spillovers; and (iii) how to address debt overhang issues and other potential vulnerabilities in the non-financial sectors that may create scarring effects on growth in the longer run.

These three issues are examined in turn in the following sections from a financial stability perspective. A resilient global financial system is a necessary precondition for addressing the challenges discussed above. It supports the financing of the economy through a steady supply of credit to the economy and low risk premia; ensures effective transmission of monetary and fiscal policy thus allowing more room for manoeuvre; helps to cushion possible external spillovers and ensures that financial markets can continue to price assets, allow risk to be hedged and provide transparency to help resolve uncertainty.

## 2. Ensuring effectiveness of domestic policies

The policy measures adopted in response to the COVID-19 shock were intended to bridge temporary economic disruption. To this end, authorities typically deployed a mix of liquidity and financial measures (e.g. interest rate cuts, liquidity injections, extension of repo facilities, bond purchases, payment moratoria, loan guarantees). In addition, to support the flow of credit to the real economy and to free up bank capital, authorities utilised prudential policy measures (e.g. release of capital and liquidity buffers, restriction of dividend distributions, temporary relaxation of risk-weights and asset classification guidance). The mix and design features of these measures varied across jurisdictions depending on the healthcare situation (status of pandemic), varying policy space (e.g. existence of buffers, fiscal capacity), and capacity to implement measures. (See Annex for details.)

On the back of the gradual lifting of public health restrictions across jurisdictions in 2021 and the first half of 2022, economic activity could recover and the utility of continuing the “bridging” measures waned. Many jurisdictions kept an accommodative stance in their policies at first, shifting the focus of their policy responses to supporting a strong recovery and closing the output gap. With some economic sectors hit much harder than others, some jurisdictions kept targeted measures in place as needed, for instance on a regional or sectoral basis or for SMEs. More recently, some jurisdictions have put in place fiscal support measures to cushion the impact of rising energy and food prices on household incomes. The extent to which jurisdictions have been able to support a strong recovery depended in part on their fiscal space.

With regard to prudential measures, some jurisdictions are now increasing their countercyclical capital buffer rates in view of increasing vulnerabilities in the financial system, and many authorities have also gradually unwound the temporary flexibility on capital and liquidity ratios. In many EMDEs policy space, capacity to implement measures, and healthcare situation were relatively constrained. This may in some cases have led to earlier tightening or unwinding of support measures. Tightening or gradual unwinding in EMDEs was for instance done through (i)

narrowing of the scope of support measures and (ii) tightening the terms upon which the support is provided.<sup>5</sup>

Considering progress in exiting COVID-19 related measures on the one hand, and new policy challenges and constraints in the current environment (see discussion in the previous section) on the other hand, policymakers may consider the following in order to promote the effectiveness of domestic policies.

## 2.1. Identifying and using scope for targeting policy measures and timing them appropriately

Recent developments have underlined the importance of ensuring that jurisdictions' policy mixes evolve with the economic circumstances, providing the right tools and incentives as needed, while remaining financially sustainable. This may include efforts to target measures appropriately. Another is to take steps to manage potential intertemporal trade-offs. The FSB's April 2021 report on extending, amending and ending COVID-19 support policies emphasised the need to manage the trade-off between withdrawing measures too early, which could have adverse effects on growth, and withdrawing policy support too late and letting financial vulnerabilities build.

A basic precondition for such designing policies is to assess carefully whether adjustments to (or the expiration of) support measures is aligned with the economic outlook.<sup>6</sup> Authorities should therefore carefully monitor economic conditions and judge whether developments change assessments of the effects of policy measures in place in a significant way. Given the recent experience of another major exogenous shock, authorities may also carefully consider potential costs to medium-term resilience associated with a postponed exit from policy measures.

Financial markets may play a particularly important role for assessing the (expected) effects of policy adjustments in the current uncertain environment. In the environment, a wide suite of market-based indicators can help to gauge financial market participants' assessments of current and expected economic and conditions (and changes thereof), to inform decisions about changes in financial policy settings. Ensuring transparency and information that can be used by market participants to assess a firm's viability is critical. Capital markets can also play a critical role in facilitating lenders', investors' and other stakeholders' determinations of viability, through appropriate transparency and disclosures as well as efficiently functioning markets. A corollary is that authorities should ensure that financial markets remain open and orderly.

Assessing the evolution of borrowers' credit quality, and its dependence on public support measures, is of particular importance in this context. In some jurisdictions, certain borrowers

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<sup>5</sup> For example, India introduced a debt moratorium for all term loans that were classified as "standard" prior to the pandemic in March 2020, which was then replaced by asset classification guidance targeted to borrowers primarily affected by the pandemic in July/August 2020. The scope was then adjusted to target small businesses and individuals impacted by the economic consequences of the new wave of COVID-19 in April 2021. Argentina introduced a debt moratorium to all borrowers (except for credit card credit lines) that was in force for 12 months ending in March 2021. The moratorium was reintroduced in May 2021 in view of the new wave of COVID-19 but in a targeted manner, focusing on the sectors that were most affected as defined by a specific State programme. Meanwhile, Indonesia introduced a loan restructuring programme for borrowers affected by the pandemic that can be classified as performing loan. The programme has been extended until March 2023 with stronger risk management and prudential requirements to prevent moral hazard.

<sup>6</sup> FSB (2021a).

have now benefited from loan moratoria or payment holidays for over two years. This may obscure proper assessment of borrowers' overall creditworthiness by lenders, jeopardising their risk management. Similarly, although accommodative policies towards bank lending have supported the flow of funding to the real economy, they have also increased banks' balance sheets and credit risk stemming from the unguaranteed portion of loans, potentially impacting banks' resilience in the medium term. As part of their risk management, it is key for lenders to keep monitoring signs of reduction in credit quality. This can help to identify and address credit quality and debt overhang issues before they become potentially systemic. In the same vein, outstanding loans linked to expired moratoria should be monitored to determine whether they show a deterioration in their credit quality vis-à-vis those that did not enjoy moratorium.

Authorities should also consider further whether, and how, support measures could be made more targeted. A number of jurisdictions have taken steps in this direction, focusing on the most vulnerable corporates or sectors and applying stricter criteria for the provision of support. Where support measures were initially broad-brush measures that ensured rapid distribution of funding, more recently jurisdictions have amended the processes or the terms of the support.<sup>7</sup> In many jurisdictions also loan relief has become more targeted by making the relief subject to the borrower requesting it.<sup>8</sup> This approach, where the borrower requests these changes, helps to ensure that only those companies that need the relief would request and receive it.

Targeted approaches and phasing-out may help to mitigate adverse effects of high debt and prevent scarring. To this end, jurisdictions pay attention to the coordination of the narrowing down and phasing out of the support measures with the building up and provision of effective mechanisms to deal with the debt overhang resulting from these support measures (see section 4), while taking into account the need for amending the support measures in light of recent events.

More generally, authorities should also consider further efforts to enhance the basis of information available to assess the effectiveness of policies. Some jurisdictions have invested in significant uplifts in data capability and IT infrastructure for economic analysis, also due to the weak reliability of traditional statistics during the pandemic, which fostered the usage of unconventional data, including big data.

## 2.2. Considering the interaction of and trade-offs between policy measures

The case for, and ability to, coordinate adjustments in support measures targeting the financial sector may depend on the type of policy involved. This may be most obvious when there is a directly link between different policy measures. For instance, the unwinding of credit subsidies

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<sup>7</sup> For instance, in Germany tax deferrals were still possible until March 2022 but only upon request. UK retail businesses benefit from progressively lower retail relief on business rates (100% relief until June 2021, 66% capped relief until March 2022 and 50% capped relief until March 2023).

<sup>8</sup> For instance, the Spanish public development bank had extended its deadline for applications to the SME loan guarantee scheme further, to the end of December 2021. Moreover, upon request by the borrower, the maturity of the loans and the guarantees could be extended for a maximum of 3 years, up to a maximum maturity of 8 years. Additionally, the grace period of the loans would be extended for an additional 12 months up to a maximum of 24 months. In Italy, in mid-2021 the access to law-enforced moratoria for SME loans was extended for a few months, while requiring an explicit request by the borrower, and limiting it to the principal amount of the loan, not the interests.

may have a direct (and measurable) impact on fiscal positions. Unwinding fiscal policies would also have an impact on borrowers' creditworthiness. In other cases, the interaction may be less direct. For instance, the unwinding of measures requiring lenders to provide credit relief to borrowers may ease balance sheet constraints on lenders and may as a consequence help to ease funding market conditions and facilitate an unwinding of liquidity measures (subject to other prevailing policy considerations).

The evolving economic conditions may affect the way different support measures interact and potential trade-offs authorities face in employing them.<sup>9</sup> In the current period of high economic uncertainty and rising inflation, asset prices may fall amidst still ample liquidity provision. The recent stresses in commodity markets have also focused attention on new channels of interactions. Increased financial participation may have increased the correlation between commodities and other assets, which may propagate volatility events.

Interconnections between policy measures can also be employed to reinforce the effectiveness of policy measures. In the prudential policy domain, some authorities provided flexibility on banks' leverage ratios<sup>10</sup> to increase the effectiveness of their jurisdictions' accommodative monetary policy. In Indonesia, some accommodative macroprudential policies are in place for banks with adequate capital and NPL ratios, in an effort to encourage them to lend more to specific hard-hit sectors that would otherwise have insufficient access to bank funding (MSMEs, low-income individuals and other priority sectors). For instance, banks that comply with a certain macroprudential inclusive financing ratio ("RPIM") may benefit from up to 100 bps of reserve requirement reductions.

Against this backdrop, the use of analytical tools to assess interactions and trade-offs of policies affecting the financial sector may support effectiveness of policies in the current environment. This may include the use of stress tests to gauge the impact of tightening financial conditions on credit quality. In addition, a better understanding of the use of "hidden" leverage<sup>11</sup> in the financial system – as highlighted by a number of recent episodes of stress in financial markets such as the Archegos event and the commodity markets turmoil – should also inform decision making.

### 2.3. Effective communication and outreach

Effective communication going forward can build on experiences gained during the pandemic. To ensure effectiveness of implementation of domestic policies, communication and transparency about authorities' policies, including state-contingent considerations where needed, has proven to be an important element of policy-making throughout the pandemic. Clear and timely information to a range of audiences (including other relevant government/public agencies) has been instrumental in anchoring the expectations of economic actors as much as possible.

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<sup>9</sup> A discussion of trade-offs can be found in FSB (2021a).

<sup>10</sup> Several member jurisdictions temporarily exempted central bank reserves from leverage ratio calculation, which may have eased banks' balance sheet constraints on their intermediation activity. See BCBS (2021) Early lessons from the Covid-19 pandemic on the Basel reforms, July.

<sup>11</sup> Leverage might be hidden because the entity with the leverage is outside the regulatory perimeter or because data reported are not sufficient to assess the vulnerabilities linked to leverage.



Many EMDEs in particular highlighted the importance of communication and transparency in mitigating potential cliff effects associated with ending the support measures and ensuring appropriateness in identifying the target borrower segments. They also used it to ensure consistency in policy measures and continued effectiveness of measures throughout their unwinding. For example, some jurisdictions publicly announced the objectives and deadlines for their support measures immediately when they were introduced so that the stakeholders would understand the policy goals and prepare for the withdrawal of the relevant measure. This also gave flexibility to the authorities as they could still extend the measures if needed. Brazil also communicated closely in real time with the accountability agency under the legislature about its policy actions to ensure accountability so as to speed up any legislative process and alleviate potential issues in the future.

India engaged stakeholders in determining the scope of support measures. It established a committee of external experts to recommend financial parameters<sup>12</sup> and their sector-specific benchmark ranges for such parameters (i.e. asset classification guidelines) to be factored in resolution plans. The expert committee recommended financial ratios for different sectors which could be considered by lenders while finalising a debt restructuring plan for a borrower. These parameters were published so as to help banks as well as borrowers in setting their expectations.

### 3. Containing cross-border spillovers

The prospect of an uneven global economic recovery may increase the risk of negative spillovers and the importance of policies to contain negative spillovers. However, the objective of such policies should not be to try and engineer a fully synchronized exit across jurisdictions. Indeed, it is crucial that exit strategies reflect specific domestic economic conditions and needs. This suggests that a more appropriate objective is to avoid excessive financial market reactions, which could materialise for example through sharp rises in risk premia or procyclical market reactions - during what is likely to be an asynchronous exit.

#### 3.1. Considering spillover effects in exit and other policy decisions

One way in which policymakers can work towards this goal is to consider potential spillovers and spillbacks in their decisions to adjust or exit policy measures to the extent that their mandates allow. The most material spillovers appear to arise in monetary policy and market liquidity support, which affect capital markets, capital flows and exchange rates. While authorities primarily set policy according to their domestic mandates and domestic economic conditions, spillovers and spillbacks may be relevant considerations, for instance where they impact domestic conditions.

Spillovers can also occur as a result of the exit from financial support measures. For example, the removal of public guarantees on business loans may have a negative effect on bank capital and reinforce home bias; and ending payment moratoria may abruptly increase non-performing

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<sup>12</sup> They are: (i) Total Outside Liabilities/Adjusted Tangible Net Worth; (ii) Total Debt/EBITDA; (iii) current ratio (Total Assets/Total Liabilities); (iv) Debt Service Coverage Ratio; and (v) Average Debt Service Coverage Ratio.

loans abroad. Here there is a need for international coordination and information sharing as jurisdictions consider how they design and implement exit strategies..

The FSB has played a crucial role in this information sharing, alongside its monitoring of the flexibility in standards that jurisdictions may have temporarily used as part of their policy mix to support the real economy. More granular data collection on the effects of measures and quantitative analysis has also been undertaken, for instance between 30 members of the European Systemic Risk Board (ESRB), and has been helpful for understanding and thus addressing cross-border spillovers.<sup>13</sup> The success of such exercises crucially depends on the availability of timely and standardised granular data and efficient sharing of that data, which may require confidentiality or other cooperation agreements between the associated central banks.

Proper communication may also help to contain spillovers. In particular, clear and consistent messaging on central bank actions may help market participants to appreciate the motivation for and drivers of differences in policy normalisation across jurisdictions. Indeed, feedback from FSB members suggests that consistent messaging helped manage spillover effects at the start of the tightening cycle and likely prevented large capital outflows from EMDEs.

### 3.2. Addressing excessive procyclicality in capital flows

Cross-border spillovers can also be mitigated by addressing excessive procyclicality in capital flows. Procyclical behaviour can amplify an external shock, as was evidenced during March 2020, including through the “dash for cash” dynamics. In March 2020 EM investment funds experienced very large redemptions as investors liquidated their positions. Some of these funds had to undertake large sales of assets to meet redemptions, adding to pressures in markets and to outflows of capital from emerging market economies. Many bond funds sold more assets than was strictly needed to meet redemptions. Although this was likely a precautionary step, in expectation of further withdrawals, the sales may have amplified the pressures in markets.

Recent FSB work has shown that non-bank financial intermediaries have played an increasing role in financing EMDE external debt (Graph 2, left panel). Part of this financing from NBFIs has been from investment funds with portfolios of EME assets. However, the greater reliance on NBFIs may have contributed to new challenges for EMEs. There is a growing body of literature which suggests that NBFIs’ investment in EMEs may be affected by changes in global financial conditions. This may have introduced additional procyclicality into investment flows that can amplify the volatility of capital flows to EMEs. This sensitivity to global factors may have been spurred-on by the increase in benchmark-driven investors. These investors use benchmark indices to guide their portfolio allocation, varying in the degree to which they track the underlying benchmarks. Assets benchmarked against key emerging market indices have tripled since 2010 (Graph 2, right panel).

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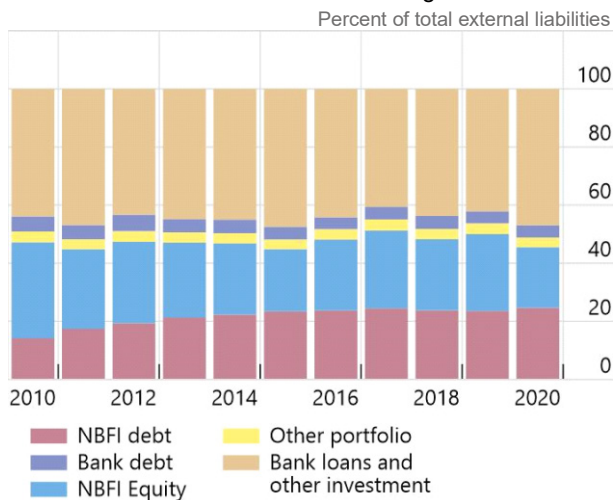
<sup>13</sup> ESRB (2021a), *ESRB report on the financial stability implications of COVID-19 support measures to protect the real economy*, February, and ESRB (2021b), *Monitoring the financial stability implications of COVID-19 support measures*, September.



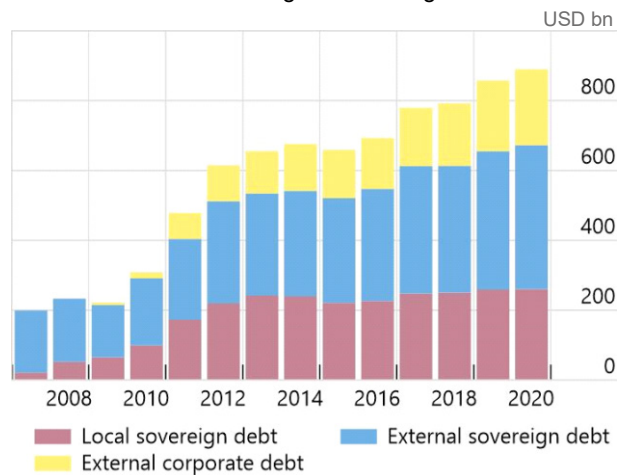
## NBFIs' financing of EMDEs' debt has grown significantly<sup>1</sup>

Graph 2

### 1. Breakdown of EME external financing



### 2. Assets benchmarked against JPMorgan EM indices



<sup>1</sup> These charts were first published in FSB (2022), [US Dollar Funding and Emerging Market Economy Vulnerabilities](#).

Sources: BIS; IMF; FSB calculations.

Central banks intervened in unprecedented scale and scope to stabilise and mitigate strains in global financial markets. Absent these interventions, market strains and capital flow volatility could have intensified and tested the resilience of the financial system, potentially leading to negative knock-on effects to the real economy. This suggests that policies are needed to improve the resilience of NBFIs, in particular open-ended funds, to future shocks and to resolve the underlying currency and liquidity mismatches.

Work to tackle NBFIs' vulnerabilities should remain a priority at the international level. Since EM funds located in AEs have an impact on markets and capital flows in EMDEs in times of stress, any policy measures adopted for investment funds will have implications for EMDEs as well. The FSB is assessing the effectiveness of existing policy recommendations to mitigate liquidity mismatches in OEFs globally and will report on its findings, including whether these recommendations need to be enhanced, at the November G20 Summit.

Excess procyclicality can also develop from other features of the financial system. One example is the mechanistic reliance on external credit ratings, which continues to be an issue in some parts of the global financial system. Credit ratings downgrades could have an impact on external investors' willingness and ability to finance debt, particularly when a country loses its investment grade rating. This could lead to an increase in financing costs for domestic corporates, including viable ones. Investors should continue to use due diligence with respect to their reliance on credit ratings, and there may be benefit in exploring how index providers could reduce their mechanistic use of credit ratings, for example by avoiding a rebalancing of indices during periods of stress. Yet another example where there could be procyclicality is in expected credit loss accounting, where we do not yet have the experience of a full credit cycle.

## 4. Preventing scarring and dealing with debt overhang

During the COVID-19 pandemic, debt levels of non-financial companies have reached unprecedented levels. While the debt situation varies considerably across countries - for

instance, in a number of countries cash holdings have risen along with debt levels, or debt overhangs has been moderated by a swift recovery of the economy – potential scarring effects are a concern in a number of jurisdictions.<sup>14</sup>

Developments over the past year may increase the risk of scarring from debt overhang, at least in some sectors. Rising interest rates and weaker growth may, over time, increase interest rate burdens and weigh on debt servicing capacity. At the same time, higher inflation would tend to reduce real debt burdens. Given recent shocks to global supply chains and commodity and energy prices, potential scarring effects from COVID-19 may be compounded in sectors and firms characterised by a combination of elevated pre-pandemic corporate vulnerabilities (e.g. leverage, profitability), adverse pandemic impact (after taking extraordinary COVID-19 support measures into account) and high energy intensity (i.e. energy inputs as a share of total output).

Addressing scarring risks requires resolving COVID-legacy debt overhang, while reducing the risk of newly-generated debt burdens due to additional, war-related support measures. The phasing-out of COVID-19 support measures may be supported by measures to directly address debt overhang, such as tailored conditions for the repayment of support loans ('pay as you grow'), creation of debt work-out mechanisms, ensuring support by well-functioning and efficient insolvency and liquidation regimes, and, with a view to lenders, tightening risk management and prudential requirements including the classification of distressed loans.<sup>15</sup>

#### 4.1. Managing debt overhang

Apart from possible carefully calibrated support policies to mitigate scarring effects, a key objective for policymakers should remain the efficient functioning of insolvency and liquidation regimes and debt restructuring possibilities for viable distressed firms. This will ultimately support efficient resource allocation and investment, and reduce medium-term vulnerabilities related to corporate debt overhang after the COVID-19 pandemic. Out-of-court workouts (OCWs) represent the alternative to full, formal insolvency proceedings and can be an effective procedural avenue to restructure debt to restore the financial soundness of a debtor company without interrupting its business. OCWs are generally less costly and more flexible, and they can play a useful role in dealing with a higher number of cases, particularly if the involvement of courts is minimal.

The FSB's recent peer review on out-of-court corporate debt workouts finds that FSB jurisdictions have adopted various approaches to complement in-court insolvency proceedings and facilitate restructurings through OCW frameworks, including most recently in response to COVID-19.<sup>16</sup> Most jurisdictions have various OCW frameworks in place which may be beneficial as different OCW frameworks can serve different purposes.<sup>17</sup>

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<sup>14</sup> Debt overhang could also pose risks to financial stability through several channels: underinvestment by viable corporates due to excessive indebtedness, misallocation of resources by financing unviable corporates and lower productivity due to loss of entrepreneurial capacity. It may also increase the risk of widespread defaults and insolvencies and therefore give rise to financial stability risks, possibly weighing on the solvency interconnection between corporates, lenders, sovereigns. See FSB (2022) *Approaches to Debt Overhang Issues of Non-financial Corporates: Discussion paper*, February.

<sup>15</sup> See section 2 of this report.

<sup>16</sup> See FSB (2022), *Thematic Review on Out-of-Court Corporate Debt Workouts*, May.

<sup>17</sup> Types of OCW include purely informal workouts on a contractual basis between debtors and creditors, without specific rules or procedures adopted for such workouts; enhanced procedures supported by laws or other procedural rules but without court involvement; and hybrid procedures with minimal court involvement (e.g. expedited reorganisations which are confirmed by a

Most OCW frameworks have been in place since before COVID-19. Some jurisdictions have introduced new frameworks or amended existing ones to cope with the consequences of the pandemic, in particular to support small and medium-sized enterprises (SMEs).<sup>18</sup> Some of these frameworks are temporary. While some jurisdictions recently reformed in-court insolvency procedures, establishment or reform of OCWs is often easier to achieve because amendments to in-court procedures in most jurisdictions require more complex legal and constitutional procedures.

As most corporates are typically SMEs, providing access to OCW procedures to SMEs and having the capacity to process a high number of debt restructurings is particularly relevant. About half of FSB jurisdictions have dedicated OCW frameworks for SMEs or facilitate OCWs for SMEs through simplifying the existing restructuring framework. The OCW peer review recommends jurisdictions to consider reviewing whether there exist significant barriers to the use of their OCW frameworks by SMEs, and take steps, as necessary, to reduce such barriers. To that end jurisdictions should consider collecting data and develop metrics necessary to assess the efficiency of the OCW frameworks in place, working with the private sector and academia where appropriate.

Where OCW procedures aim at processing high numbers of restructurings, these may maintain certain standardised elements such as sets of pre-defined outcomes. This facilitates negotiations and reduces costs, although simplified procedures may limit the flexibility of debtor-creditor negotiations and may warrant safeguards to protect debtor and creditor rights and avoid abuse.

## 4.2. Distinguishing viable and non-viable companies

Assessing the viability of the business helps better targeting support measures and of managing debt overhang. Broad-based measures such as loan moratoria policies may have affected the ability to assess viability and measure and address debt overhang. While broad-based programs were important and appropriate at the outset of the pandemic, more targeted measures could help in providing private sector lenders with proper incentives to distinguish between viable and unviable firms. Screening of debtors remains within the core competences of private sector lenders. Failing to distinguish between viable companies which need to restructure their balance sheet and unviable ones - that need to exit the market so that their resources can be used more productively - can have negative systemic externalities. These are the deadweight costs of unnecessary liquidation of viable companies on the one hand and the permanence of zombie firms in the economy on the other.<sup>19</sup>

The current heightened macroeconomic uncertainty renders assessments of the viability of non-financial firms challenging, and particularly so for SMEs, given that information in their regard is

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court and restructuring procedures which may have limited court intervention beyond confirmation). A purely informal OCW is generally considered most effective in restructuring financial debt with one main creditor or a limited number of creditors where no support for creditor coordination is required. Enhanced OCWs coordinate and increase the possibilities of reaching agreement among a larger number of creditors and between the debtor and creditors. Due to judicial intervention (albeit limited) of hybrid OCW procedures, these offer the possibility of majority decisions that bind dissenting creditor minorities.

<sup>18</sup> See Annex 2 of the FSB (2022), *Thematic Review on Out-of-Court Corporate Debt Workouts*, May.

<sup>19</sup> Viability is defined generally by reference to the net present value (e.g. DCF) of the company as a going concern exceeding the liquidation value of its assets. In this sense, a fully-fledged viability assessment inevitably involves a forecast of future cash flows of the borrower.

scarcer already due to the limitations of reporting requirements.<sup>20</sup> Common information sets for creditors could be made available to exploit economies of scale. For instance, creditors can leverage on cooperation with credit bureaus or seek a pooling of resources among creditors for this purpose. Governments may be able to generate and enhance the availability of data, such as tax or payment data.<sup>21</sup>

Effective action by lenders plays a critical role in this regard. They typically undertake a comprehensive credit risk assessment, considering the company's financial metrics, business model, and management performance. Creditor banks could be incentivised to actively assess viability and work on restructuring options with their clients by setting supervisory expectations or targets for viability assessments to be conducted by supervised banks for new under-/non-performing exposures, or requiring higher provisioning requirements in the absence of viability assessment and debt enforcement or restructuring measures applied.<sup>22</sup> Financial authorities may raise banks' attention to the need to increase their resources and expertise on debt restructuring, including creating pool of experts to undertake viability assessments with a view to debt restructuring over a large number of cases.

Where a high number of viability assessments, possibly of SMEs, have to be performed in a short time, governments or lenders may seek to develop structured approaches to facilitate a swifter path to the application of support measures or restructuring tools to corresponding needs. For example, permanently scarred sectors could be identified first, followed by the assessment of the prospective business models of individual firms in question. Proposals explored in a recent FSB discussion paper combine a systematic classification of distressed companies and standardised restructuring solutions.<sup>23</sup>

### 4.3. Relieving debt burden of viable companies

For viable companies, reduction in firm leverage as well as new supply of long-term capital for transition to longer-term sustainable business models may be achieved by the reduction of debt to a sustainable level in accordance with repayment capacity, and/or injection of fresh money in the form of equity or equity-like instruments.<sup>24</sup> Since a large part of corporate loans granted in the context of COVID-19 are backed by public guarantee schemes, lenders may have fewer incentives to provide equity, including through debt-to-equity swaps, especially in the case of riskier borrowers.

In phasing out COVID-19 support measures, governments may, depending on fiscal space, use an array of measures to foster non-financial corporates' balance sheets and work in tandem with the private sector to help support the transition towards a less leveraged economic system.

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<sup>20</sup> See Diez et al (2021), Insolvency Prospects Among Small-and-Medium-Sized Enterprises in Advanced Economies: Assessment and Policy Options, IMF Staff discussion notes N. 2021/002.

<sup>21</sup> Group of Thirty (2020) Reviving and Restructuring the Corporate Sector Post-Covid, December.

<sup>22</sup> See Diez et al (2021), Insolvency Prospects Among Small-and-Medium-Sized Enterprises in Advanced Economies: Assessment and Policy Options, IMF Staff discussion notes N. 2021/002.

<sup>23</sup> See FSB (2022), Approaches to Debt Overhang Issues of Non-financial Corporates, February.

<sup>24</sup> See FSB (2022), Approaches to Debt Overhang Issues of Non-financial Corporates, February.

Options that have been so far explored by different jurisdictions or proposed by literature<sup>25</sup> include debt-to-equity-swaps to provide firms with the required liquidity without increasing their leverage (conversion of loans into grants), state contingent loan repayment (e.g. linked to business returns and in the form of future taxes), publicly sponsored equity and quasi-equity injections such as preferred stocks and convertible loans (possibly against haircuts on tax debt, social security claims or other debt towards public hands), and tax incentives aimed at reducing the fiscal preference for debt.<sup>26</sup> A variant of the above-mentioned policy is to subsidize voluntary restructuring by means of tax credits to haircut-consenting creditors. Private equity funds and credit funds can play a significant role in terms of provision of new money and facilitating workout processes. However, the more challenging conditions in capital markets may make some of these solutions more difficult to achieve. Capital markets provide a range of financial options for new money and to ensure adequate provision of new funding without increasing debt levels, it becomes more important to address any incentives that create a bias towards debt rather than equity.

Since government-only equity injections, including debt-to-equity swaps and debt-to-debt swaps of crisis loans, might be accompanied with deadweight losses, policymakers can instead incentivise the provision of risk money from private investors by using public funds as a catalyst or by developing equity co-funds.<sup>27</sup> Some FSB member jurisdictions have a framework for co-funding in which government funds provide equity at market conditions, jointly with private investors, or government-affiliated financial institutions provide subordinated loans to attract loans from private financial institutions. By utilizing a co-funding scheme, viability assessment can lever on private sector expertise as governments usually do not have the expertise or capacity to perform viability assessments.

Available evidence suggests that recapitalisation schemes introduced in different countries had a lower take up than expected. This could be due to the reluctance of in particular SME shareholders to open and dilute the company capital, or the relative convenience of subsidised or guaranteed loans in comparison to capital issuance. It is important that any such recapitalisation measures include design features to foster their demand.

## 5. The role of international standards during the exit and beyond

The global financial system withstood the stress to the pandemic thanks to greater resilience, supported by G20 reforms and the swift and bold policy responses. Effective implementation of those reforms meant that core parts of the system entered the pandemic in a more resilient state than during the 2008 financial crisis.<sup>28</sup>

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<sup>25</sup> See Demmou et al. (2021) *Insolvency and debt overhang following the COVID-19 outbreak: Assessment of risks and policy responses*, OECD Economics Department Working Paper No. 1651, January.

<sup>26</sup> The application of government support in the context of debt restructuring will have to be applied in line with state aid and competition rules. In general, public sector involvement would also normally be considered a last resort to be used in exceptional circumstances, with the focus being on private-sector led solutions.

<sup>27</sup> Demmou et al. (2021).

<sup>28</sup> See FSB (2021c), *Promoting Global Financial Stability: 2021 FSB Annual Report*, October.



The FSB Principles underpin the importance of global financial resilience as a condition for equitable recovery, while recognising the need to use the flexibility embedded in international standards. Among other things, these Principles include that authorities will use the flexibility built into existing financial standards but also act consistently with international standards, and not roll back reforms or compromise the underlying objectives of existing international standards. The financial stability benefits of the full, timely and consistent implementation of G20 reforms remain as relevant as when they were initially agreed. Monitoring and coordination, guided by the FSB COVID-19 Principles, has discouraged unilateral actions that could distort the level playing field and lead to harmful market fragmentation. Maintaining close monitoring and cooperation are critical given the impacts of the pandemic and the need to support the resilience of the global financial system and address long-term structural developments in the financial system. For example, by working towards a consistent regulatory framework for addressing NBFV vulnerabilities, this will also help to address some of the cross-border externalities outlined in section 3.

**Box 1: FSB Principles that underpin the official sector response to COVID-19<sup>29</sup>**

1. Authorities will, individually and collectively through the FSB and standard-setting bodies (SSBs), monitor and share information on a timely basis to assess and address financial stability risks from COVID-19, so as to maximise the benefit of a global policy response.
2. Authorities recognise, and will make use of, the flexibility built into existing financial standards – including through the use of firm-specific and macroprudential buffers – to sustain the supply of financing to the real economy, to support market functioning and to accommodate robust business continuity planning.
3. The FSB, SSBs and authorities will continue to seek opportunities to temporarily reduce operational burdens on firms and authorities, so as to assist them in focusing on COVID-19 response. This includes, for instance, delaying implementation deadlines, reprioritising timetables for initiatives in other policy areas, or providing flexibility in technical compliance rules.
4. Authorities' actions will be consistent with maintaining common international standards, given that these provide the resilience needed to sustain lending to the real economy, and preserve an international level playing field. Such actions will not roll back regulatory reforms or compromise the underlying objectives of existing international standards.
5. Authorities will coordinate through the FSB and SSBs the future timely unwinding of the temporary measures taken, to assist in returning financial conditions and firms' operations to normal in a smooth and consistent manner and to maintain financial stability in the longer term.

## 5.1. Using the flexibility in international standards

The international standards adopted through the G20 reforms overall provided sufficient flexibility to support an effective policy response during COVID-19. Reflecting jurisdiction-specific circumstances and needs, authorities broadly used the flexibility within international standards to support financing to the real economy. Such was the case for FSB standards on resolution regimes and on compensation practices; the BCBS Basel III framework; the CPMI-IOSCO *Principles for Financial Market Infrastructures*; the IOSCO recommendations for investment funds and money market funds (MMFs); G20 commitments on over-the-counter

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<sup>29</sup> See FSB (2020), *COVID-19 pandemic: Financial stability implications and policy measures taken*, April.

(OTC) derivatives market reforms; and IAIS standards. For example, most regulatory and supervisory measures for the banking sector were capital or liquidity-related and the large majority of these made use of the flexibility embedded in the Basel III framework. Most of these were temporary and had ended or were set to end before 2022. Some of the measures were tailored to enable banks to continue lending to specific sectors and types of firms, provide consumer forbearance and support targeted government programs. Resolution authorities have continued recovery and resolution planning consistent with the FSB *Key Attributes of Effective Resolution Regimes for Financial Institutions*. The regulatory and supervisory measures taken by authorities on MMFs and investment funds indicate that the high-level IOSCO standards provided flexibility to adjust the use of those standards to the specificities of the turmoil.

In a few cases, individual temporary measures have gone beyond the flexibility available in standards in order to respond to extreme financial conditions and provide additional operational flexibility to financial institutions. For example, some measures that went beyond the flexibility in Basel III include reducing certain credit risk capital, leverage ratio or liquidity requirements; and postponing the entry into force of the large exposures framework. Most of these measures are temporary in nature and several have already expired.

The FSB and SSBs are working to draw lessons about the motivation, timing and effects of measures that go beyond the flexibility embedded in international standards, as such lessons may have implications for the effective functioning of international standards.

## 5.2. Role of international standards in the design and unwinding of measures

International standards affected the design and implementation domestic policy measures in response to COVID-19. Several jurisdictions noted that such standards helped in the design of their measures, with some jurisdictions using the international standards as an anchor of sorts to ensure that measures did not deviate too far.

Where jurisdictions have used the flexibility in international standards and start to unwind in a return to the pre-COVID application of international standards, several are not encountering any challenges. A few jurisdictions that have unwound their measures (or are in the process of doing so) note the importance of phasing out these exceptional measures gradually and communicating the timing of such unwinding to financial markets.

The FSB lessons learnt report noted several areas that warrant attention going forward, such as the functioning of capital and liquidity buffers,<sup>30</sup> the need to strengthen resilience in the NBFIs sector, and issues relating to possible excessive procyclicality in the financial system (such as procyclicality in margin practices, mechanistic use of credit rating agency ratings and potential procyclicality from expected loss accounting standards' interaction with capital requirements).

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<sup>30</sup> Banks generally did not need to use their capital and liquidity buffers to meet loan demand. However, there are indications that banks might be reluctant to dip into their buffers if needed to meet credit demand. Authorities released countercyclical capital buffers quickly, but such buffers were not always available or of sufficient scale to provide substantial additional macroprudential space. And while banks did not face large liquidity pressures overall, some took defensive actions to maintain their liquidity levels well above regulatory minima. For more information, see BCBS (2021) *Early lessons from the Covid-19 pandemic on the Basel reforms*, July.

The FSB and SSBs are making progress in each of these areas by updating the analysis from the July 2021 BCBS report on early lessons from the pandemic, to be included in a more comprehensive evaluation report to be published in late 2022; advancing the comprehensive work programme to enhance NBF1 resilience while preserving its benefits;<sup>31</sup> and taking forward work on procyclicality in margining practices.

## 6. Conclusion and next steps

Recovery from the economic impacts of the COVID-19 pandemic has been divergent across jurisdictions, partly due to different cyclical and structural factors and partly due to health policy related restrictions that have remained in place in some regions longer than in others. Limited ability to provide additional policy support, in particular in the form of fiscal stimulus, has been a factor behind a relatively weaker recovery in many EMDEs than in AEs.

Russia's invasion of Ukraine has added significantly to these pre-existing challenges, by causing a setback to global growth, triggering higher inflation, and adding to economic uncertainty. Elevated commodity prices increase industry costs, and with high food and energy prices weigh on household incomes, particularly in EMDEs.

This exacerbates several challenges for policy makers in supporting a strong, equitable and inclusive recovery. For instance, sustained policy support may be needed in a number of jurisdictions while vulnerabilities from the COVID-19 crisis may materialise at a time when policy space is limited and firms and households have fewer financial buffers. Moreover, a more uneven global recovery increases the risk of negative international spillovers.

Taken together, these setbacks may imply that the scarring effects from the pandemic have a greater potential going forward to damage growth. The combination of tighter financing conditions, less favourable macroeconomic conditions – including high and volatile commodity prices - may challenge the provision of finance to the most productive and sustainable uses. The risks of scarring may be particularly significant in EMDEs that may experience large swings in external financing conditions while having limited policy space to support the smooth provision of financing to the real economy.

A resilient global financial system is a necessary precondition for coping with these new challenges. At the same time, preventing COVID-related financial stability impacts and effectively preventing scarring effects to sustainable growth over the long term requires effectiveness of domestic policies, containing cross-border spillovers, addressing debt overhang issues. Close cooperation and information exchange becomes more critical for authorities in ensuring appropriate tailored policy responses and exit strategies.

When commissioned in late 2021, this report to the G20 was intended to discuss policies in the aftermath of a past shock. Since then, the economic and financial market situation has evolved

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<sup>31</sup> This work programme is being carried out within the FSB as well as by SSBs and international organisations; see FSB (2021d) *Enhancing the Resilience of Non-Bank Financial Intermediation*, November. In 2022, remaining work on specific issues identified in the FSB's holistic review of the March 2020 market turmoil will be completed, including on open-ended funds; margining practices; and the liquidity, structure and resilience of core bond markets. In addition, the FSB is developing a systemic approach to NBF1 and policy proposals that are effective from a systemwide perspective. In October, the FSB will deliver a comprehensive progress report on the various initiatives under the NBF1 work programme to the G20 Summit.



considerably. And the situation will evolve further in the months between this interim report and the final report in November. Bearing this in mind, the FSB invites feedback from stakeholders on the report, both in writing and in the form of a dedicated (virtual) outreach event.

The final report, to be delivered to the G20 in November 2022, will consider relevant economic developments and input from stakeholders with a view to presenting conclusions regarding the financial stability issues related to scarring effects from COVID-19, and how the FSB will address these issues going forward.

## Annex: Evolution of support measures and exit strategies

Many FSB member jurisdictions are gradually unwinding policy measures taken since March 2020, but the timing of their approaches to the unwinding of some types of measures differs.<sup>32</sup> Jurisdictions continue to report that they monitor health (and health-related behavioural), economic and financial developments to determine whether and when to fine-tune, extend or end a specific support measure. Some jurisdictions have repurposed existing COVID-19 support measures in view of the recent economic developments affected by the war in Ukraine.

With effects of the pandemic lasting longer than initially expected, authorities have continued to facilitate liquidity and supply of finance to the real economy while trying to avoid over-indebtedness.<sup>33</sup> That said, progress in combating the pandemic has allowed some jurisdictions to start transitioning to a post-pandemic economy as the health situation evolves and economic activity picked up.<sup>34</sup> Many AEs have taken steps to partially or fully unwind a number of measures that supported the real economy. On the other hand, fiscal constraints may also have affected expiration of certain measures in emerging market and developing economy (EMDE) jurisdictions.<sup>35</sup>

Some of the funding facilities for banks and markets remain in place, while others are being unwound. US dollar (USD) temporary swap lines between the Federal Reserve and nine other central banks, as well as some corporate and government securities repurchase facilities and repo operations have ended. Measures that aimed to incentivise lenders to support SMEs such as lending support programmes were extended in some jurisdictions, in some cases with a more limited scope. For instance, Korea had established a support program for SMEs affected by COVID-19, and other small businesses, which now will be targeted to small business owners engaged in the service industry. Finally, some jurisdictions extended measures that allowed banks to use corporate credit claims as monetary policy collateral.

Some jurisdictions have unwound measures to support market functioning, while others have stepped up efforts in this area given recent volatility. Some jurisdictions note that they have stood down their COVID-19 related monitoring of markets. In view of market volatility in the past months, some jurisdictions have reimposed short selling suspensions and/or tightened circuit breakers (Indonesia), while another (Australia) indicates they continue monitoring of market integrity, standing ready to action possible rumours and ensuring that companies comply with their disclosure requirements. Some jurisdictions have made measures permanent, such as the possibility to hold remote shareholder or board meetings, or to work from home.

A shift from *general* support measures to *targeted* measures for the hardest-hit sectors, regions and borrowers has been observed in jurisdictions as their health situation improves. Public sector lending, grants or other relief measures to corporates and households have been unwound in many jurisdictions and, where still in place, have become more targeted, for instance to prevent

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<sup>32</sup> This annex provides an overview of extensions, adjustments and unwinding of COVID-19 support members since September 2021. The reporting period covers September 2021 to April 2022. It was prepared on the basis of the information reported by FSB members to the FSB's repository of COVID-19 support measures.

<sup>33</sup> Corresponding to pandemic phase 3 as described in FSB (2021a), p. 4, table 1.

<sup>34</sup> Corresponding to pandemic phase 4 as described in FSB (2021a), p. 4, table 1.

<sup>35</sup> IMF (2021), IMF Blog "[Drawing Further Apart: Widening Gaps in the Global Recovery](#)", 27 July.

mass insolvencies and ensuing job losses, and to support corporates in adapting to changing consumer demands. That said, some jurisdictions have repurposed COVID-19 support measures, for instance by making partially government guaranteed loans available for firms particularly affected by the war in Ukraine. Updated guidance on asset classifications in some jurisdictions also focuses on mitigating consequences for micro- and SMEs. In the same vein, in some jurisdictions moratoria or other loan restructuring measures targeting loans to SMEs have been extended further.

Some EMDE jurisdictions have until recently continued to encourage the use of capital and liquidity buffers to support lending. Many jurisdictions are revising their policies in order to gradually return to normal requirements, including returning to implementing elements of international standards. Some jurisdictions are raising countercyclical capital buffer rates in view of increases in key vulnerabilities. Temporary adjustments on risk weights of assets has been withdrawn in some cases as well. That said, a number of jurisdictions are for the moment continuing their measures exempting certain exposures from banks' leverage ratios.

Most jurisdictions have amended or ended their guidance or rules on restricting dividends and other distributions. Instead, some of these authorities either call on banks' boards to exercise prudence on these matters or provide indications of quantitative limits.