

# Financial policies in the wake of COVID-19: supporting equitable recovery and addressing effects from scarring in the financial sector

Final report

14 November 2022



The Financial Stability Board (FSB) coordinates at the international level the work of national financial authorities and international standard-setting bodies in order to develop and promote the implementation of effective regulatory, supervisory and other financial sector policies. Its mandate is set out in the FSB Charter, which governs the policymaking and related activities of the FSB. These activities, including any decisions reached in their context, shall not be binding or give rise to any legal rights or obligations.

---

Contact the Financial Stability Board

Sign up for e-mail alerts: [www.fsb.org/emailalert](http://www.fsb.org/emailalert)

Follow the FSB on Twitter: [@FinStbBoard](https://twitter.com/FinStbBoard)

E-mail the FSB at: [fsb@fsb.org](mailto:fsb@fsb.org)

# Table of Contents

Executive Summary .....	1
Introduction .....	3
1. Current issues in promoting strong and equitable recovery .....	4
2. Ensuring effectiveness of domestic policies .....	6
3. Containing cross-border spillovers .....	8
4. Preventing scarring and dealing with debt overhang .....	10
4.1. Managing debt overhang .....	10
4.2. Distinguishing viable and non-viable companies .....	11
4.3. Relieving debt burden of viable companies .....	12
5. The role of international standards during the exit and beyond .....	12
5.1. Using the flexibility in international standards .....	13
5.2. International standards and the design and unwinding of measures .....	13
6. Conclusion .....	14
Annex: Overview of public feedback .....	16



## 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. In many emerging market and developing economies (EMDEs), limited ability to provide additional policy support, in particular in the form of fiscal stimulus, weighed on the recovery. At the same time, disruptions to global supply chains alongside global demand recovery, and in some countries greater demand stimulus, created upward pressure on inflation. Global financial conditions began to tighten against a growth backdrop where EMDEs were lagging behind advanced economies (AEs).

Russia's invasion of Ukraine has added substantially to these pre-existing challenges for achieving a strong, equitable and inclusive recovery, 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. In addition, a more uneven global recovery and a sharp tightening of global financial conditions increases the risk of negative spillovers and a sustained retrenchment of global investors into core markets. Many EMDEs have experienced capital outflows and currency depreciation. These setbacks imply that the scarring effects from the pandemic, Russia's invasion of Ukraine, and the repercussions of these shocks are likely to have a greater potential to damage future growth. Overall, risks of scarring in EMDEs appear to be much more significant than in AEs.

Tighter financing conditions and high market volatility have also exposed vulnerabilities in the financial system. Episodes of large shifts in bond prices and the resulting unexpectedly large margin calls exposed hidden leverage in the non-bank financial sector necessitated central bank liquidity support to a core government bond market. Commodity markets have experienced strains, reflecting large margin calls, undetected leverage and concentrated exposures. Interest rate rises have meant that banks may benefit from higher margins in the short term without adverse impacts on asset quality.

In the medium term, however, banks may be impacted by a deterioration in the economic situation, through credit risk materialising from their borrowers. Scarring effects, in particular in EMDEs, could exacerbate debt overhang issues. With a further deteriorating outlook for fiscal positions, the feedback loop from sovereigns to banks may worsen. Again, financial institutions in EMDEs may be most affected, due to a combination of high domestic debt burdens and a withdrawal of foreign investors.

Overall, developments over the past few months have reinforced the three additional challenges to policymakers noted in the FSB's interim report to the G20. These are: first, the need for sustained policy support amidst rising inflation and removal of monetary accommodation; secondly, the risk of negative cross-border spillovers from a deteriorating global recovery and diverging monetary and fiscal policy stances; and lastly, the fact that vulnerabilities that COVID-19 support measures prevented from materialising may now come to the fore.

Considerations about adjusting, amending and potentially exiting support measures should take into account these challenges, to support global economic recovery in the near term, and prevent 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. The report revisits these considerations in light of recent economic developments and stakeholder input received.

While policy decisions will reflect country-specific circumstances and needs, the FSB will continue to support a strong and equitable global recovery in three main ways: first, through intensive monitoring of vulnerabilities in, and assessments of the resilience of the global financial system; second, through regular exchange of information and experiences with prudential policy measures; and third, through the continuation of its work, in cooperation with IOSCO and other standard setters, to strengthen the resilience of non-bank financial intermediation (NBFI).

## 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. Following an interim report to the G20 Finance Ministers and Central Bank Governors in July,<sup>3</sup> this final report is submitted 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>4</sup>

In a situation when many jurisdictions were in the process of exiting support measures, Russia's invasion of Ukraine has severely exacerbated these existing challenges, and 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. Further disruptions to global supply chains have reinforced questions about the combined long-term impact of the pandemic and the war on global growth. As a result of new fiscal support measures in many jurisdictions aimed at mitigating the cost of soaring energy costs for households and companies, questions have returned on the interplay between fiscal and monetary policy, as well as on the trade-offs of future exit strategies for these new support measures.

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

---

<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> FSB (2022a) *Exit Strategies to Support Equitable Recovery and Address Effects from COVID-19 Scarring in the Financial Sector: Interim report*, July

<sup>4</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.

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 risks may gradually build, 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. Finally, growing challenges for financial stability may directly affect policy choices.

This final report advances the work presented in the interim report in three ways. First, it updates the discussion of policy issues in light of economic and financial market developments since July. Second, it reflects feedback received through stakeholder outreach.<sup>5</sup> Third, it sets out, further steps that could be taken at the international level to aide jurisdictions in addressing the issues discussed in the report.

The report is organised as follows. The first section discusses how the evolution of the pandemic, the Russian invasion of Ukraine and subsequent economic developments have affected the challenges financial authorities face, and how these relate to the COVID-19 related measures taken. 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 concludes.

## 1. Current issues in promoting strong and equitable recovery

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 18 months. 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 EMDEs have seen a weaker recovery than the major AEs.

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, central banks started raising policy rates in a synchronised manner, and 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

---

<sup>5</sup> This report has benefitted from stakeholder input in response to the interim report published in July 2022. It moreover 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.



particularly the case for EMDEs, whose financing costs can be particularly sensitive to changes in investor risk appetite.

Russia's invasion of Ukraine 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. Inflationary pressures have been more persistent than expected and central banks around the world have raised their policy rates. Financial conditions have tightened at a rate not seen since the period immediately following the 2008 global financial crisis. Government and corporate bond yields have increased and market volatility remains elevated. The large change in the economic backdrop and high uncertainty has also affected the current and expected path of fiscal policies. Prior to the economic shock caused by the invasion, many jurisdictions were beginning to normalise fiscal 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. 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, 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 temporary 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>6</sup>

Financial stability challenges have increased over the past few months. Deteriorating economic conditions and changing expectations of the future path of monetary policy have already induced a ratcheting-up of pressures in financial markets. Risk asset prices have fallen, bond yields have risen, increasing the cost of financing the higher debt burdens resulting from the impact of the COVID-19 pandemic. The US dollar has appreciated, especially against EMDE currencies. This appreciation has further increased the cost of foreign currency debt for EMDE borrowers, intensifying concerns about debt sustainability for a range of borrowers, including sovereigns.

Tighter financing conditions and high market volatility have also exposed vulnerabilities in the financial system. Episodes of unexpectedly large margin calls and hidden leverage in the non-bank financial sectors necessitated central bank liquidity support to a core government bond market. Commodity markets have experienced strains, reflecting large margin calls, undetected leverage, concentrated exposures. Interest rate rises have meant that banks may benefit from increased margins in the short term and bank lending to the economy is not a constraint. In the medium term, however, banks may be impacted by a deterioration in the economic situation, through credit risk materialising from its borrowers. With a further deteriorating outlook for sovereign fiscal positions, the feedback loop from sovereigns to banks may worsen in particular in EMDEs.

Overall, developments over the past few months have reinforced the three additional challenges to policy makers in terms of exiting from the extraordinary policy measures of COVID-19 while

---

<sup>6</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.

continuing to support a strong, equitable and inclusive recovery, noted in the FSB’s interim report to the G20:

- The need for sustained policy support amidst rising inflation and removal of monetary accommodation;
- A deteriorating global recovery and diverging monetary and fiscal policy stances increase the risk of negative cross-border spillovers;
- Vulnerabilities that COVID-19 support measures prevented from materialising may now come to the fore.

Considerations about adjusting, amending and potentially exiting support measures should take into account these challenges, to support global economic recovery in the near term, prevent 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. The FSB’s interim report set out considerations on these issues from a financial stability perspective. The following sections revisit these considerations in light of recent economic developments and stakeholder input received.<sup>7</sup>

## 2. Ensuring effectiveness of domestic policies

The policy measures adopted in response to the COVID-19 shock were intended to bridge temporary economic disruption. 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 temporary 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. As a result, questions have returned on the interplay of fiscal and monetary policy, as well as on trade-offs associated with exit strategies for these new support measures.

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. A basic precondition for designing such policies is to assess carefully whether adjustments to (or the expiration of) support measures is aligned with the economic outlook.<sup>8</sup> Financial markets may play a particularly important role for assessing the (expected) effects of policy adjustments in the current uncertain environment.

---

<sup>7</sup> See Annex for an overview of stakeholder engagement.

<sup>8</sup> FSB (2021a).

Some jurisdictions have announced increased countercyclical capital buffer rates in view of increasing vulnerabilities in the financial system, and many authorities have also gradually unwound temporary prudential flexibility. For banks' balance sheets to be credible, it is fundamental that they identify risks in a timely fashion and that credit loss risks are recognised accordingly. Remaining regulatory relief measures should therefore be unwound promptly.

Assessing the evolution of borrowers' credit quality, and its dependence on public support measures, is of particular importance in this context. Public support over the past years has helped avoid a wave of corporate insolvencies but it has also obscured borrower creditworthiness data. In some jurisdictions, certain borrowers have 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. Moreover, lenders may be unable to use the data of that period for their risk management going forward, which may lead to them relying on incentives (see Box).

#### **Box: Support measures and incentives**

Academic research has drawn attention to the behavioural effects of jurisdictions' policies, in particular in relation to public guarantees on loans and moratoria.<sup>9</sup> For instance, it suggests that, upon expiry of a loan guarantee to a borrower in difficulty, the bank may have an incentive to enforce the guarantee, rather than to keep the relationship with the borrower in place by restructuring the debt.

In view of this, one paper<sup>10</sup> proposes a transition phase that explicitly addresses these incentives, consisting of, among others, (i) monitoring, understanding and managing of risks that had been 'camouflaged' in the containment phase; (ii) tapering a loan guarantee in accordance with reduced exposure, rather than removing the guarantee at once; (iii) incentivising SME restructuring and pre-pack insolvency arrangements; (iv) stress-testing and assessing impact of debt relief restructuring on banks' balance sheets and viability.

Separately, on the back of the COVID-19 crisis, the sovereign-bank nexus has strengthened in particular in EMDEs.<sup>11</sup> An EMDE jurisdiction noted they had observed a shift, in particular in smaller banks, from direct lending to holding government bonds.

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. For instance, stress tests may help gauge the impact of tightening financial conditions on credit quality. In the current environment, several authorities have extended the use of stress tests to include ad hoc exercises, aiming at capturing for instance the impact of high food and energy prices. The information generated by such ad hoc stress tests may prove particularly useful for authorities and financial institutions in the current environment, to inform supervisory guidance, as well as to inform discussions between supervisors and the management of financial institutions. Moreover, assessments of financial system vulnerabilities may provide an important input into discussions of monetary and fiscal policies. Ensuring that financial markets remain open, orderly and transparent is also important. Transparency provides information that can be used by the

---

<sup>9</sup> Gobbi, Palazzo and Segura (2020), "[Unintended effects of loan guarantees during the Covid-19 crisis](#)", VoxEU column, 15 April 2020.

<sup>10</sup> Gulija, Russo and Singh (2022), "ECB Significant-Bank Risk Profile and COVID-19 Crisis Containment: What Approach in the Transitioning Phase?", IADI *Sponsored Papers Series*, no. 2, September.

<sup>11</sup> IMF (2022), "The sovereign-bank nexus in emerging markets: a risky embrace", *Global Financial Stability Report*, April, p. 41.

authorities and the public to assess these interactions and trade-offs and help resolve uncertainty in a volatile and evolving environment.

To this end, continued efforts to identify and address vulnerabilities in NBFIs are important. To support orderly and resilient commodity markets, IOSCO has undertaken a public consultation on its Principles for the Regulation and Supervision of Commodity Derivatives Markets.<sup>12</sup> Work is also underway to develop a better understanding of the use of “hidden” leverage<sup>13</sup> in the financial system. A number of recent episodes of stress in financial markets such as the Archegos event, the commodity markets turmoil, and recent market turmoil related to the use of liabilities-driven investments – should also inform decision making. In addition, as shown by recent market developments, further work to address sources of procyclicality related to margining is important.

- The FSB will continue to facilitate discussions among its member authorities in relation to supervisory and regulatory policy in times of stress, including the use of, and experiences with the use of stress tests in a rapidly evolving economic environment.
- The BCBS, CPMI and IOSCO looked at margin calls during the high market volatility and “dash for cash” in March and April 2020, and reviewed margin practices transparency, predictability and volatility across various jurisdictions and markets, as well as market participants’ preparedness to meet margin calls.<sup>14</sup> Based on that analysis, they confirm six areas for further policy work.<sup>15</sup> The BCBS, CPMI and IOSCO will work together and with the FSB to take forward this work.

### 3. Containing cross-border spillovers

The current challenging global economic environment may increase the risk of cross-border spillovers, highlighting the importance of policies to contain these risks. However, the objective of such policies should not be to try and engineer a fully synchronised 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.

As mentioned in the Interim report to the G20, the most material spillovers appear to arise in monetary policy and market liquidity support, which affect capital markets, capital flows and exchange rates. The FSB has played a crucial role to support international coordination and information sharing as jurisdictions considered design and implementation of their exit

---

<sup>12</sup> IOSCO (2021), *Principles for the Regulation and Supervision of Commodity Derivatives Markets*, (Consultation Report 05/21), November.

<sup>13</sup> Leverage might be hidden for a number of reasons, e.g. because the entities with the leverage are outside the regulatory perimeter or because data is not reported in a way that is sufficient to assess the vulnerabilities linked to leverage.

<sup>14</sup> See BCBS, CPMI, IOSCO (2022) *Review of margining practices* (September).

<sup>15</sup> These are: increasing transparency in centrally cleared markets; enhancing the liquidity preparedness of market participants as well as liquidity disclosures; identifying gaps in regulatory reporting; streamlining variation margin processes in centrally and non-centrally cleared markets; evaluating the responsiveness of centrally cleared initial margin (IM) models to market stresses with a focus on impacts and implications for CCP resources and the wider financial system, and; evaluating the responsiveness of non-centrally cleared IM models to market stresses.

strategies. 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.

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 money market funds (MMFs) and open-ended investment funds, particularly those invested in less liquid assets like corporate or emerging market bonds, experienced very large redemptions as investors liquidated their positions. Some of these funds had to undertake large sales of assets to meet redemptions, leading to illiquidity and spill-overs in underlying 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. If central banks had not intervened to stabilise and mitigate strains in global financial markets, 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. Work to tackle NBFIs’ vulnerabilities should therefore remain a priority at the international level. Since emerging market 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. Procyclicality can also be created through insufficient transparency, predictability and preparedness to meet margin calls (see section 2 above).

The FSB has assessed the effectiveness of existing policy recommendations to mitigate liquidity mismatches in OEFs globally.<sup>16</sup> It found that certain enhancements to the existing international recommendations and related guidance would significantly strengthen the current framework and OEF liquidity management practices, benefitting financial stability as well as investor protection. The FSB and IOSCO will carry out follow-up work based on the assessment’s findings. This would involve revisions to the FSB and IOSCO Recommendations to address structural liquidity mismatch and promote greater inclusion and use of LMTs as well as to clarify the appropriate roles of fund managers and authorities in implementing these Recommendations; development of detailed guidance on the design and use of LMTs; work to enhance the availability of OEF-related data for financial stability monitoring; and steps to promote the use of stress testing. Engagement with stakeholders, including through public consultation of the proposed revisions to the Recommendations and of the new guidance, would form a key part of this process.

Excess procyclicality can also develop from other features of the financial system. One such example is the mechanistic reliance on external credit ratings, which continues to be an issue in some parts of the global financial system. Credit rating 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

---

<sup>16</sup> See FSB (2022b), *Enhancing the Resilience of Non-Bank Financial Intermediation*, November.

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.<sup>17</sup> Yet another example where there could be procyclicality is in expected credit loss provisioning where we do not yet have the experience of a full credit cycle, although recent analysis finds little sign of procyclical effects on lending during the pandemic.<sup>18</sup>

- The FSB will, at its December 2022 EMDEs Forum, discuss in depth policy issues concerning cross-border spillovers and potential measures to address them.
- The FSB and IOSCO will carry out follow-up policy work on liquidity mismatches in OEFs, based on the findings on the effectiveness of existing policy recommendations.

## 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>19</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 tends 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).

### 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.

---

<sup>17</sup> FSB (2022c), *US Dollar Funding and Emerging Market Economy Vulnerabilities* (April).

<sup>18</sup> BCBS (2022), *Buffer usability and cyclical in the Basel framework* (October).

<sup>19</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 (2022d) *Approaches to Debt Overhang Issues of Non-financial Corporates: Discussion paper*, February.

The FSB's 2022 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>20</sup> Most jurisdictions have various OCW frameworks in place which may be beneficial as different OCW frameworks can serve different purposes.<sup>21</sup> Going forward, the report recommends that jurisdictions should consider assessing the efficiency of their OCW frameworks, collecting data and developing metrics for these assessments, reviewing whether there are significant barriers to their use by SMEs, and taking steps to reduce such barriers where necessary.

## 4.2. Distinguishing viable and non-viable companies

Assessing the viability of the business helps better targeting of support measures and of managing debt overhang. 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 scarcer already due to the limitations of reporting requirements.<sup>22</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>23</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>24</sup>

---

<sup>20</sup> See FSB (2022e), *Thematic Review on Out-of-Court Corporate Debt Workouts*, May.

<sup>21</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 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>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> *Ibid.*

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

### 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>25</sup> 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.

- The FSB will continue to monitor the evolution of debt and non-performing assets for financial system resilience, and to facilitate discussions among its member authorities on supervisory and regulatory policies for dealing with debt overhang as needed.
- The FSB, working with the IMF, World Bank and other international bodies, will promote the sharing of out-of-court corporate debt workout practices and experiences.

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

The financial stability benefits of the full, timely and consistent implementation of G20 reforms remain as relevant as when they were initially agreed. 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>26</sup>

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. Under these Principles, 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.<sup>27</sup>

Monitoring and coordination, guided by the FSB COVID-19 Principles, has discouraged 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, work to improve the regulatory framework for addressing NBFV vulnerabilities will help to address some of the cross-border externalities outlined in section 3.

---

<sup>25</sup> FSB (2022d).

<sup>26</sup> See FSB (2021c), *Promoting Global Financial Stability: 2021 FSB Annual Report*, October.

<sup>27</sup> See FSB (2020), *COVID-19 pandemic: Financial stability implications and policy measures taken*, April.



## 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. Most measures taken to deal with the COVID-19 shock 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 MMFs; G20 commitments on over-the-counter (OTC) derivatives market reforms; and IAIS standards. Most of these were temporary and have ended or will end by end-2022, while most of the remaining measures are using the flexibility embedded in international standards.<sup>28</sup>

In a few cases, individual measures have gone beyond the flexibility available in standards in order to provide additional operational flexibility to financial institutions as well as to limit the effects of volatility and to mitigate procyclicality. For example, among the measures that went beyond the flexibilities of the Basel III framework, a couple of jurisdictions have extended (with no end date) measures aimed at recognising certain liquid assets in the liquidity coverage ratio and mitigating the foreign exchange (FX) volatility impact on credit exposures in order to limit effects on cyclicity and volatility.

## 5.2. International standards and the design and unwinding of measures

International standards affected the design and implementation of domestic policy measures in response to COVID-19. Several jurisdictions, including some from outside the FSB membership, noted that such standards helped to anchor the design of their measures.

Where jurisdictions have used the flexibility in international standards and are unwinding in a return to the pre-COVID application of international standards, they are generally not encountering any challenges. Some jurisdictions that have unwound their measures note the importance of phasing out these exceptional measures gradually and communicating the timing of such unwinding to financial markets.

In October 2022 the BCBS issued a report on buffer usability and cyclicity in the Basel framework.<sup>29</sup> The report finds some indications of a positive relationship between lending and the capital headroom of banks (i.e. the surplus of a bank's capital resources above all minimum regulatory requirements and buffers), consistent with its previous analysis. Empirical evidence also indicates that temporary reductions in capital requirements supported lending during the COVID-19 pandemic, though there is weaker evidence for countercyclical capital buffer (CCyB) releases specifically, which may reflect more limited use of the CCyB to date. The report finds little evidence on whether reluctance by banks to use liquid asset buffers has affected their lending and market activity given the short-lived liquidity pressures during the pandemic.

---

<sup>28</sup> Some remaining measures relating to Basel III are attached to loans and programs initiated during the COVID-19 period that are still outstanding. These measures will terminate once the covered exposures amortise. Among the measures still in effect but with an end date in sight are the transition period on expected credit loss, buffer replenishment, and some exemptions on exposures, including the exemption of central bank reserves from the leverage ratio exposure.

<sup>29</sup> See BCBS (2022) *Buffer usability and cyclicity in the Basel framework*, October.

Similarly, the analysis finds little sign of procyclical effects on lending during the COVID-19 pandemic related to the introduction of the expected credit loss framework.

The FSB lessons learnt report noted several areas that warrant attention going forward, such as the functioning of capital and liquidity buffers, the need to strengthen resilience in the NBFIs sector, and issues relating to possible excessive procyclicality in the financial system.

The FSB and SSBs are making progress in each of these areas, and will continue to do so going forward.

- The main focus of the FSB's NBFIs-related work over the past year was to assess and address vulnerabilities in specific NBFIs areas that may have contributed to the build-up of liquidity imbalances and their amplification in times of stress. The work by the FSB and SSBs included work to enhance MMF resilience; assess effectiveness of international policies to address liquidity risk and its management in OEFs; analyse margining practices' transparency, predictability and volatility as well as market participants' preparedness to meet margin calls; examine the drivers of resilience and liquidity in bond markets; and assess the interaction between USD funding, external vulnerabilities, and NBFIs financing in EMEs.<sup>30</sup> Next year will see a shift towards policy work aiming to address underlying vulnerabilities that give rise to liquidity imbalances.
- Based on the BCBS's ongoing work on buffer usability and cyclicality in the Basel framework, the FSB will further discuss the issue of buffer use from a system-wide, macroprudential perspective, as appropriate.

## 6. Conclusion

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. In many EMDEs, limited ability to provide additional policy support, in particular in the form of fiscal stimulus, weighed on the recovery. 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 high food and energy prices weigh on firms' and households' already weakened financial buffers. Moreover, a more uneven global recovery increases the risk of negative international spillovers and a sustained retrenchment of global investors into core markets. Finally, the combination of much tighter global financial conditions, a weaker and more uncertain outlook for growth, and record-high debt levels in the non-financial sectors globally

---

<sup>30</sup> This work programme is being carried out within the FSB as well as by SSBs and international organisations. See FSB (2022b) *Enhancing the Resilience of Non-Bank Financial Intermediation*, November.

may expose vulnerabilities in the financial system, which may in turn affect monetary and fiscal policy choices.

Taken together, these setbacks imply that the scarring effects from the pandemic, Russia's invasion of Ukraine and the repercussions of these shocks are likely to 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 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.

While policy decisions will reflect country-specific circumstances and needs, the FSB will support a strong and equitable global recovery going forward in three main ways: first, through intensive monitoring of vulnerabilities in, and assessments of the resilience of the global financial system; second, through regular exchange of information and experiences with prudential policy measures; and lastly, through the continuation of its work, in cooperation with IOSCO and other standard setters, to strengthen the resilience of NBFIs.

## Annex: Overview of public feedback

The FSB invited public feedback on its interim report to the G20 on *Exit Strategies to Support Equitable Recovery and Address Effects from COVID-19 Scarring in the Financial Sector*.<sup>31</sup> To this end it organised a public virtual outreach meeting on 12 September 2022, bringing together representatives of the official sector and industry, to discuss scarring effects, risks for financial stability from COVID-19 and the role of the financial sector in supporting equitable recovery, especially in light of recent developments in the global macroeconomic outlook. Another workshop was hosted by the FSB on 27 September, with member authorities of the FSB Regional Consultative Groups (RCGs).

The following summarises the main themes that were discussed during the outreach sessions and the written feedback received. It does not necessarily represent the views of FSB member authorities or reflect consensus views expressed by participants.

### Scarring effects and risks for financial stability

Respondents broadly supported the conclusions of the FSB interim report. It was acknowledged that pre-existing challenges have been exacerbated by Russia's invasion of Ukraine, a shock of exogenous nature. Increased energy cost and global supply chain issues had caused a liquidity type of shock, not a solvency type of shock as in the Global Financial Crisis (GFC) of 2008. This shock was noted to be more difficult to manage from a policy aspect, with a greater need for fiscal considerations, and less monetary policy.

According to the speakers, a key element to mitigate scarring effects to the real economy is for jurisdictions to ensure continued effectiveness of the domestic policy mix to safeguard companies and households. Policies should also aim at containing cross-border spillovers and manage debt overhang issues. Unwinding of support measures introduced during COVID-19, such as tax deferrals, government grants and loan guarantee schemes, should be gradual so as to avoid cliff effects.

A speaker noted they had a moratorium scheme in place until 2021 but had not observed any cliff effects from ending it. Moreover, non-performing loans had decreased since the pandemic. Many small and medium enterprises (SMEs) had never used external funding before and used the government loan scheme for liquidity. For some, extending maturity of those loans is becoming relevant in the current environment.

A speaker noted that the current uncertainty meant a setback for the move towards a greener economy. It was also noted that many banks had undergone a digital transformation during COVID-19 and that the financial industry needs further digital transformation to reduce cost and improve granularity of data for risk management.

Different representatives pointed out that although no cliff effects had been observed in most countries, risks are particularly high for EMDEs, as their capital flows are more volatile and subject to investors' uncertain appetite; on top of this their situation is usually aggravated by a

---

<sup>31</sup> FSB (2022a)

lack of safety net measures. It was noted that in an EMDE jurisdiction, small companies had been reluctant to take on (more) debt and preferred to engage in loan restructuring early on. The sovereign outlook for many EMDE jurisdictions is deteriorating with potential impact on the respective banking systems as well. Mitigating measures for this strengthened sovereign-bank nexus could include debt reduction, surveillance of the banking sector and improved transparency about the sovereign-bank nexus.

A commenter noted that the war in Ukraine had led many countries to use direct transfers as a policy to fight scarring effects. Another remark invited to focus more on the non-financial risks, including the threat of the 'entrenchment effect' of the increased resilience of the Global North as opposed to the solidification of Global South's vulnerabilities. One participant pointed out the complexity in distinguishing viable from non-viable borrowers. It was also stressed that Out-of-court workouts (OCWs) procedures for insolvencies should target both large companies and SMEs; currently some countries still struggle with the latter.

## The role of the financial sector in supporting equitable recovery

Lead discussants focused on how to improve data quality to accurately capture risks and vulnerabilities, which would be useful for policy-makers in order to reach an informed decision when they design phase-in and -out of support measures. Speakers also provided remarks on the role the financial sector can play in supporting equitable recovery.

According to presenters, a crucial factor for the orderly unwinding is to account for the different shocks and find a proper balance between the need of short-term support and the will to ensure long-term resilience. For this reason, some jurisdictions preferred to implement a more cautious approach when introducing new fiscal stimulus.

On the other hand, speakers broadly agreed that the new framework designed by Basel III and the post-GFC reforms were able to absorb the shock effects and shield the financial system from the risk of insolvencies, yet more progress is needed on the data side in order to identify and manage risks in timely fashion.

Representatives placed emphasis on the analytical side and stressed that data collection and disclosure are fundamental in order to monitor developments, analyse consequences of shocks as they come along and act upon them by introducing targeted measures: data collection to inform such measures should include metrics on credit conditions, financial system health and economic performance. One of the main challenges identified was to distinguish financially weak from economically viable companies. In order to do that, data gaps issues need to be addressed, for instance by linking company-level credit register data to banks' lending and borrowers' repayment behaviour as well as tax information. A commenter suggested his jurisdiction's approach to separate viable from non-viable companies by using cash-flow indicators, for instance from credit registers, to assess the ability of the firm to generate sufficient cashflow to service debt. Another speaker noted economic viability should disregard the debt accumulated during the pandemic, which is rather an indication of financial viability. Excessive debt in some firms may be a drag on growth. Especially as some of that debt is guaranteed by governments, upon expiry of the guarantee banks will have an incentive to enforce the guarantee rather than to restructure the loan.

A commenter suggested inflationary pressure may have been created by the fiscal and monetary stimulus launched during COVID-19, however a lead discussant found this issue to be country-specific.

In follow-up to the outreach session, two sets of written feedback were received from stakeholders. One contribution is published<sup>32</sup> and discusses the impact of public support on the Single Supervisory Mechanism (SSM) banks and suggests the design of a ‘transition phase’ as a mechanism of accountability to improve the understanding of uncertainties related to financial instability. Another response notes its concern over the impact and potential increase in institutional stress that a rapid withdrawal of relief could cause in particular to small lenders and encourages the FSB to continue to provide maximum flexibility within its guidance to national-level regulators to withdraw relief measures based on their local circumstances.

## COVID-19 Policies and International Standards

RCG member authorities generally agreed that international standards acted as an anchor in guiding the design and implementation of domestic regulatory or supervisory measures in response to COVID-19. Several measures they introduced were in line with relevant international standards and were largely temporary. In some instances, however, there was reduced regulatory flexibility for jurisdictions to draw upon at the outset of the pandemic (e.g. where jurisdictions had not adopted Basel III and did not have buffers to use). In addition, relaxations to asset classification and loan provisioning rules – particularly from emerging market economies – have allowed banks to postpone or suspend loan loss provisioning. RCG member authorities emphasised the need to assess the effectiveness of introduced measures to draw lessons for consideration in future times of stress.

---

<sup>32</sup> IADI (2022), Sponsored Paper Series “[ECB Significant-Bank Risk Profile and COVID-19 Crisis Containment: What Approach in the Transitioning Phase?](#)”, September.