REGULATORY FORBEARANCE IN THE AGE OF COVID-19

MAY 2020

Author: Michael Stramaglia, *Executive in Residence, Global Risk Institute*

GRI GLOBAL RISK INSTITUTE

INTRODUCTION

Global financial systems play a critical role in maintaining economic resiliency in the face of systemic threats. Prudential supervisors in turn play a key role in maintaining the safety and soundness of these financial systems, largely through the promotion of effective risk management practices.

The full economic impact of the COVID-19 threat is only beginning to unfold, and still largely uncertain, reflecting the unprecedented, wide-ranging and protracted nature of this public health crisis. But this much is already clear–global financial systems have entered largely uncharted territory. While existing pandemic and business continuity plans have been constructive in helping to mount a baseline response, there is no pre-established playbook capable of addressing the full scale of COVID-19's impact.

Navigating the current crisis therefore requires considerable professional judgement, which must be supported by a number of key elements, including; active stakeholder consultation, robust risk management information systems, effective governance and, importantly, guiding principles.

In response to this unique challenge, financial regulators have begun to implement a wide range of special policy actions. These include a number of forbearance measures, whereby regulated financial institutions have been granted various forms of explicit "relief" relative to established regulatory requirements. The fundamental economic and public policy intents underlying this regulatory relief are laudable, and these measures are well-positioned to play a decisive role in maintaining financial system resiliency.

However, it is important to recognize that any forbearance of established enterprise risk management (ERM) systems introduces the associated potential for unintended consequences. For example, these actions can create the erroneous perception that risk standards are being unduly "relaxed", precisely at the time when they are needed the most. Dynamic risk limits may also inadvertently mask the extent to which inherent risk positions have migrated through the course of the crisis. Any resulting stakeholder misstep could undermine the overall effectiveness of these relief actions and generate collateral impacts that may be felt far beyond the course of the immediate crisis.

While guiding principles always need to play an integral role in supporting the development of risk response strategies, they are absolutely critical for mitigating any associated potential for unintended outcomes during periods of extraordinary stress.

RISK RESPONSE PRINCIPLES

There are four guiding principles ("4 Ps") that should always be considered in formulating risk response strategies. It is proposed that these can collectively provide a useful basis for assessing regulatory relief actions in the context of extraordinary circumstances, such as the current COVID-19 economic shock.

Purpose-Driven/Fit-for-Purpose

Like all financial system participants, regulators must pursue their organizational purpose in the face of inherent uncertainty. Risk management systems endeavour to tame this uncertainty, thereby elevating confidence in the ability to realize this objective. The "fit-for-purpose" principle embodies this fundamental linkage between risk actions and objectives, reflecting the tenet that ERM is a means to an end, not an end in itself.

This implies that any forbearance actions must have a clear line of sight to the broader organizational purpose they aim to support. The predominant objective of financial regulation is to maintain the effective functioning and solvency of the financial system. In the current context, achieving this goal largely relies on supervised financial institutions being able to continue to supply liquidity, credit and risk transfer services to the real economy.

However, this objective can be impeded by the inherently dynamic and cyclical nature of market economies. In particular, policy actions that may be appropriate in one economic context can materially undermine the safety and soundness of financial systems under different economic conditions. This pro-cyclicality can be particularly damaging during periods of significant economic stress, when financial system vulnerability is markedly elevated. For this reason, flexibility naturally emerges as an important corollary to the fit-for-purpose principle in the context of prudential forbearance.

Proportionality

Proportionality is a fundamental ERM principle and has applicability at all levels of risk portfolio consolidation. Simply put, this principle prescribes that risk management resources should be focused on the most significant risks and opportunities. It also implies that a "one size fits all" approach is generally not appropriate for managing risks within a broader portfolio or system.

This principle is often reflected in elevated standards and ERM practice sophistication for managing more significant risks. For example, proportionality underpins the application of supplementary regulatory requirements, such as higher capital requirements and more intensive supervision, for financial institutions that are deemed to be "systemically important".

This principle is particularly important in the face of systemic shocks, which may reveal material differences in regulated entities' risk profiles and exacerbate demands on stretched risk management resources.

Progressive

Complex systems cannot be risk managed with singular interventions. They generally require an integrated portfolio of risk response measures where, as with any portfolio construction exercise, the aim is to ensure that the collective impact is greater than the sum of the parts. This often demands a progressive approach to development of risk responses, which embodies a number of interdependent attributes.

Staging refers to the manner in which these measures are implemented over the course of the risk event. An appropriately staged risk response provides valuable optionality to match mitigation actions to the progression of the evolving threat. This optionality can be extremely helpful in addressing significant financial system risk events, due to the often difficult to predict future transmission mechanisms or path dependencies. Progressive staging also facilitates the orderly unwinding of risk response measures once the targeted mitigation outcome has been achieved.

Timeliness is always of the essence in the application of risk response actions, particularly in the case of material systemic shocks. Early application can significantly increase the relative impact and reduce the associated cost of risk response actions. Early intervention measures should therefore be well represented in the construction of risk response portfolios.

This principle underscores the need to develop balanced portfolios of preventative, detective and mitigating response measures, and to adopt a **forward-looking** perspective for risk identification and assessment.

Practicality

Risk responses must be feasible to apply in practice and the implementation costs should not be disproportionately large relative to the expected risk mitigation benefits. This requires an intimate understanding of the operating environment in which they are being applied and a pragmatic approach to balancing the inevitable trade-offs between ideals and expediency. A raging crisis is never a good time to let perfection be the enemy of good.

Practicality is a critical design theme for mounting timely actions, where risk managers will often focus on opportunities to simply recalibrate existing control points for the initial wave of risk response actions, and reserve more complex and resource intensive interventions for subsequent stages.

REGULATORY RELIEF MEASURES

While global relief measures have been appropriately customized for each jurisdiction, a number of broadly recurring themes have begun to emerge. These can subsequently be assessed for the requisite alignment with the risk response principles previously outlined.

Operational Relief Measures

At any given time, regulators are directing a wide range of active policy consultations or new regulatory requirements/amendments. In addition to this ongoing stream of sector-level initiatives, regulated financial institutions must routinely address any undertakings that arise from entity-specific supervisory inspections. The period coinciding with the onset of the COVID-19 encompasses the typical active pipeline of these activities.

In recognition of the significant administrative demands that these efforts can impose, regulators have suspended or rescheduled many of these information requests and initiatives, thereby creating additional management and supervisory capacity to focus on the current COVID-19 related priorities.

As a further measure of relief, some regulators have provided FIs with options to early adopt or extend transitions to certain in-flight regulatory changes, where these elections might enhance the FI's ability to bolster its intermediation activities.

Operational relief measures exhibit a high level of alignment with the proposed risk response principles. For example, the rationale underlying the redirection of operational resources to the COVID-19 threat is compelling, and clearly reflects the **proportionality** principle in action. **Practicality** is well facilitated by their relative ease of application and short implementation lead times, securing their logical placement in the initial wave of **progressive** risk response portfolios.

Clarifying Guidance on Existing Regulatory Policies

Regulatory policies can include varying degrees of specificity regarding their applicability under exceptional circumstances. This can create operational and compliance challenges, particularly in respect of more principle-based standards.

In consultation with financial standard setters, regulators have issued supplemental guidance highlighting the range of available discretion within certain existing standards, and how this may be applied to help mitigate COVID-19's detrimental impact on financial system stability.

The application of IFRS 9 in the determination of credit loss provisions has been a particular area of this focus. For example, many regulators have issued supplemental guidance stipulating that payment moratoria made pursuant to broad borrower relief initiatives should not, in and of themselves, automatically trigger a reclassification of these loans to a higher risk category. This timely guidance supports broader policy objectives by dampening the pro-cyclical curtailment of banks' lending activities, thereby aptly promoting the **fit-for-purpose** principle.

Modifications to Regulatory Polices, Control Points and Limits

Perhaps the most highly visible, and ultimately impactful, relief measures involve varying forms of regulatory flexibility in respect of prevailing regulatory standards/guidelines, control points and limits.

The most straightforward measures involve pre-established regulatory mechanisms that have been explicitly designed and calibrated to respond to systemic stress scenarios. The drawdown of cyclical capital buffers represents the most prevalent example of this form of regulatory forbearance. These important macroprudential tools contribute to the overall stability of global financial systems by proactively managing the linkage between changes in capital/liquidity capacity and emerging economic conditions. A number of global financial regulators have recently lowered prescribed capital and liquidity buffers, creating timely capacity for banks to absorb losses and facilitate the ongoing supply of credit.

Since these measures use existing policy mechanisms, they typically represent the most immediate, direct and easily communicated forms of regulatory relief. These attributes are well suited to advancing the **practicality** and **progressive** ERM principles. However, their potential mitigation capacity is limited by the accrued buffer levels in effect at the onset of the downturn, which can vary widely by jurisdiction.

Outright changes to previously established regulatory policy provisions and risk limits are generally regarded as the most marked form of observed regulatory forbearance. These changes are generally positioned as temporary, with pre-established sunset or review dates. Compared to the various other forms of regulatory relief measures, these measures may also introduce the most predominate sources of operational, transition and unintended consequence risks. Given these characteristics, many observers may expect that these measures would be reserved for only the most extraordinary circumstances.

However, others may take the view that these modifications simply reflect the ongoing judgement inherent in any principle-based regime. In that context, while many of these measures may indeed be unprecedented, they should still be considered as a natural and expected part of the regulatory tool kit. This sentiment may be inspired by the continually evolving nature of global financial services regulation, which is largely driven by the dynamic feedback loop between risk management practices and evolving stress events.

From either perspective, the recent broad application of this category of measures provides an unambiguous confirmation of the exceptional nature of the COVID-19 threat.

A global survey of regulatory relief actions reflects a wide range of such temporary measures, including: changes to definitions of qualifying capital and leverage ratios, allowing FIs to operate below prescribed capital and liquidity coverage ratios, flexibility regarding classification of debtors subject to payment moratoria, increases in permissible covered bond limits and special exemptions or offsets for the increasing capital requirements arising from market volatility models. It is also important to note that the regulatory notices accompanying these actions invariably include undertakings to monitor and, if necessary, respond with further measures in support of the broader policy goals. The integrated span, staging and communication of these measures explicitly embody the **progressive** principle.

Financial risk management structures and control points are largely informed by historical experience. By definition, the unprecedented nature of the COVID-19 threat, and the economic stimulus responses being mounted to address it, suggest that the calibration of current risk management policies does not adequately reflect this scale of shock.

In these circumstances, the continued mechanical application of existing regulatory provisions would be highly pro-cyclical and actually undermine policy objectives for financial stability. Regulatory flexibility and the resulting selective relief measures therefore seem well warranted in support of the **fit-for-purpose** principle.

CONCLUSION

Based on this assessment, it is reasonable to conclude that the COVID-19 regulatory relief actions taken to date are generally well aligned with sound ERM risk response principles. This alignment should support the overall effectiveness of these measures, while mitigating any associated potential for unintended consequences. As these ongoing relief measures are expanded, regulators are encouraged to continue to take this principle-based approach and to tactically implement these measures with communication plans that explicitly highlight the linkage back to the applicable risk response principle(s) in which it is rooted.

Regulators' capacity to dynamically apply relief measures in conformance sound risk response principles is a clear testament to the advanced level of ERM maturity within these regulatory bodies and, by extension, the financial systems and entities that they oversee. However, as the scope and complexity of risks facing global financial systems continue to escalate, so too must the proficiency of these collective ERM practices.

These ERM advancements must be grounded in sound risk management principles and the recognition that ERM practices have been continuously strengthened through a long history of turning adversity into new capability. Indeed, many of the measures being now put into play were developed in direct response to lessons derived by prior significant risk events. With these precepts in mind, risk managers will be well positioned to embrace the valuable new insights that the COVID-19 challenge will undoubtedly present.