Sound Banks for Healthy Economies:

Challenges for Policymakers in Latin America and the Caribbean in Times of Coronavirus

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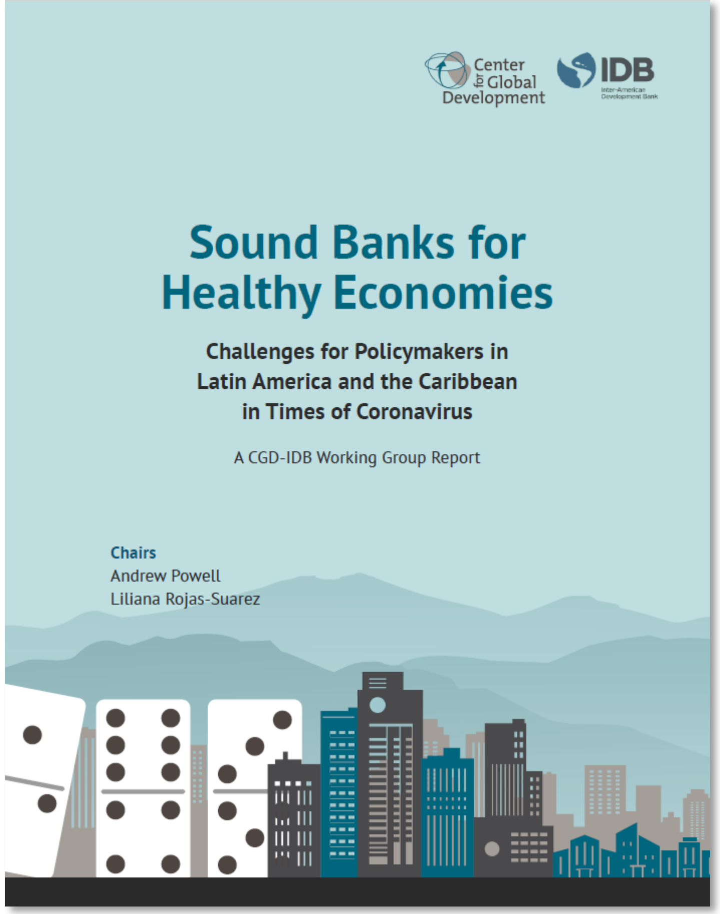


Purpose of the report

The Report advances **recommendations for policymakers** to ensure that banks play a constructive role and support families and firms through and beyond the pandemic

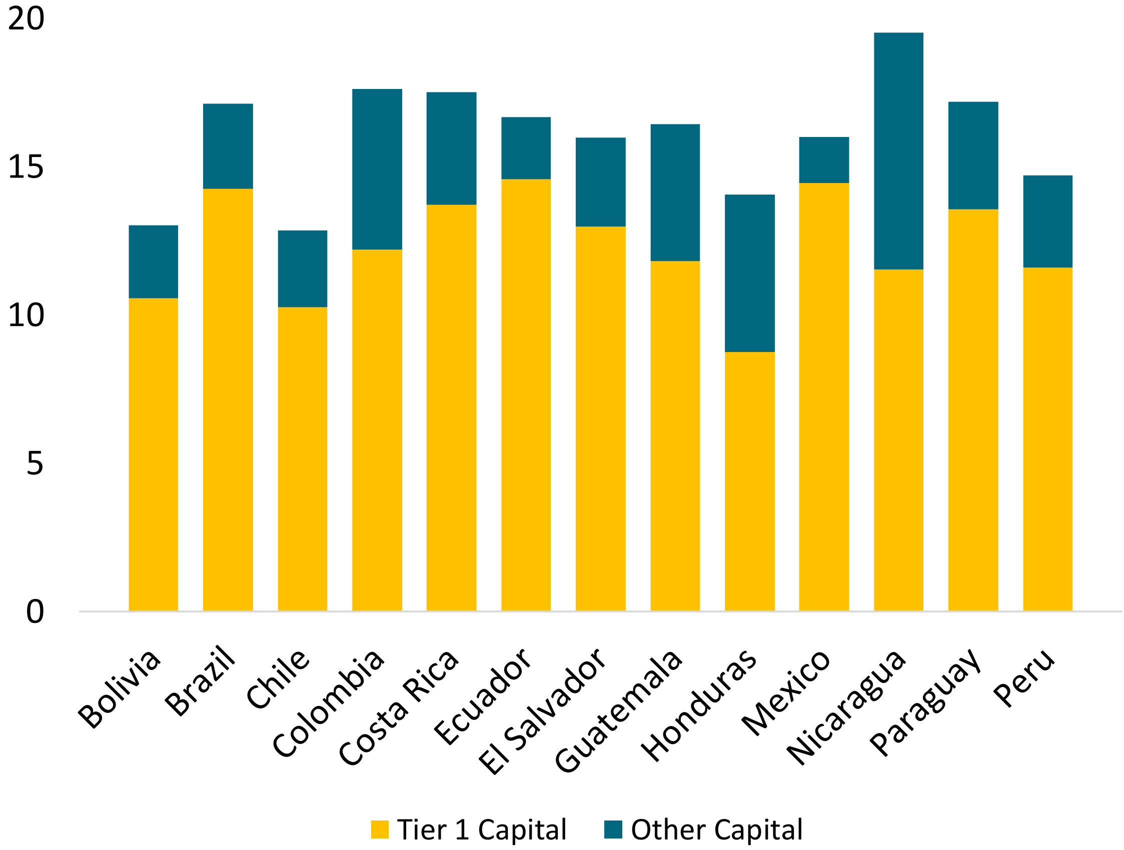
Financial stability must be preserved. A financial crisis added to the current economic crisis would deepen the recession, delay the recovery and impact poor families even more

Pre-COVID: Sound banks

- Major progress in **improving financial regulation and supervision** in the last two decades
- Generally, banks had **sufficient liquidity** and were **adequately capitalized**

- **But the pandemic-induced deep recessions are provoking significant challenges for local financial systems and their supervisors**

Capital Requirements of Select Latin American Countries (end of 2019, % of Risk-Weighted Assets)

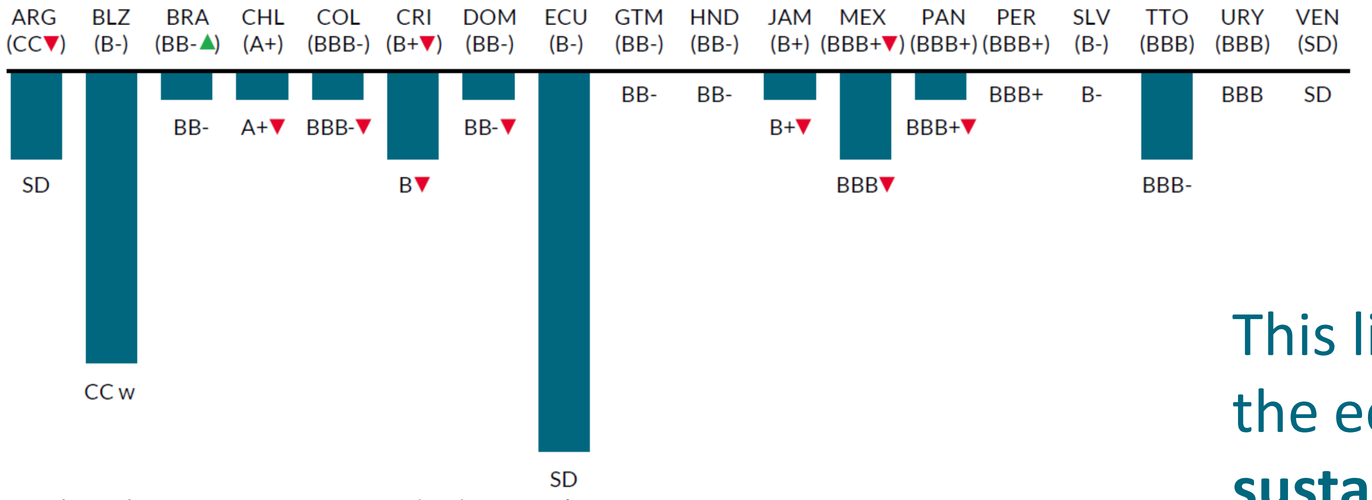


Source: IMF-FSI

Policy responses to support firms and families

- **Improved monetary frameworks** allowed for lower interest rates and the provision of liquidity, while maintaining inflation expectations well anchored
- But countries had **weaker fiscal positions** relative to before the 2008 global financial crisis

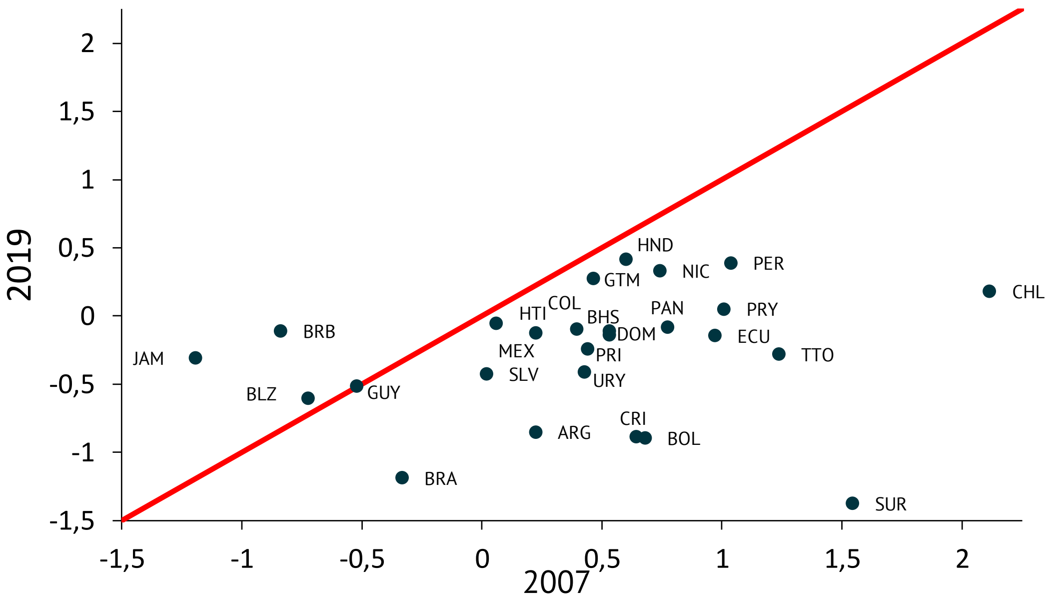
Sovereign ratings, December 31, 2019 – June 1, 2020



Source: Bloomberg Finance L.P, Standard & Poor's

Note: By end of September 2020, the ratings for Argentina and Ecuador were CCC+ and B-, respectively

Indicator of fiscal strength



Source: Authors' calculations based on Kose et al. (2017)

This limits governments' capacity to support the economy without generating **debt sustainability** problems

Should the scope of central bank activities be enlarged?

- By law, most central banks in the region are **highly constrained in terms of asset purchases**

- Does their **improved credibility** warrant greater freedom to purchase public and private (nonfinancial) securities from primary markets?

Recommendations: central banks

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- *Preserving central bank **credibility** and **independence** is a must. They will be needed to reverse expansionary monetary policies as the pandemic abates*

- *Restricting central banks to buy government securities only on secondary markets is adequate. **Avoid monetary financing of fiscal deficits***

- *If changing central bank charters to allow for greater asset purchases is considered, restrict purchase of private securities to:*
  - ✓ *extreme situations of **liquidity shortages** in critical markets and*
  - ✓ *interventions only in **secondary markets***

- *Seeking **support from the IMF and/or MDBs is much preferred** to weakening central banks' balance sheets by taking on public and private sector credit risks*

Corporates external debt poses financial sector risks

- Firms in the tradable sector with high foreign debt that appeared to have been hedged have **lost their sources of dollar income**

- These firms are also **clients of local banks**

Recommendations: on corporates

- *Central banks should ensure all foreign currency-denominated transactions are* ***reported***
- *Use of* ***macroprudencial regulations*** *that prevent over indebtedness need to be considered*
- ***A holistic view is needed****. New stress tests should model the effects of corporates' risks (currency mismatches, roll-over risk on foreign debt and solvency risks) on local financial institutions*

Regulatory treatment of loans may prevent recognition of solvency problems

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- Deferrals of loan payments are now commonly used in the region

Summary of Loan Moratoria or Loan Reprogramming Measures

	Argentina	Bahamas	Barbados	Brazil	Bolivia	Chile	Colombia	Costa Rica	Dominican Republic	Honduras	Jamaica	Mexico	Paraguay	Peru	Uruguay
1. Facilitate payment deferrals		X	X		X						X				X
2. Facilitate reprofiling/reprogramming				X		X	X	X	X			X	X	X	
3. Mandated payment deferrals	X				X					X					

Sources: National authorities, IMF and KPMG

In 11 out of the 15 countries <u>no additional provisioning is required</u>

Regulatory treatment of loans may prevent recognition of solvency problems

- Typically, banks continue to report loans with payment deferrals as performing and are **not required to set aside additional provisions**

- If prolonged, payment deferrals may result in the **loss of information** for banks and supervisors about the **true risks of borrowers**

A danger is treating a solvency crisis as if it were a liquidity problem

Recommendations: Deferrals

- *Payment deferrals, if used, should be **temporary** to avoid deep restructurings*
- *Bank loan **reporting** standards should not be diluted*
- *As feasible, regulations, including on provisioning should be maintained, but supervisors should exercise **discretionary forbearance** on a case by case basis*
- *Loan-loss provisioning should continue to be on an **expected loss** basis*
  - ✓ *If capital buffers decline below regulatory minima, it can be tolerated with a **plan for restoration and under close oversight***
- *Maintaining **supervisory independence** is key*

Trade-offs with guarantees

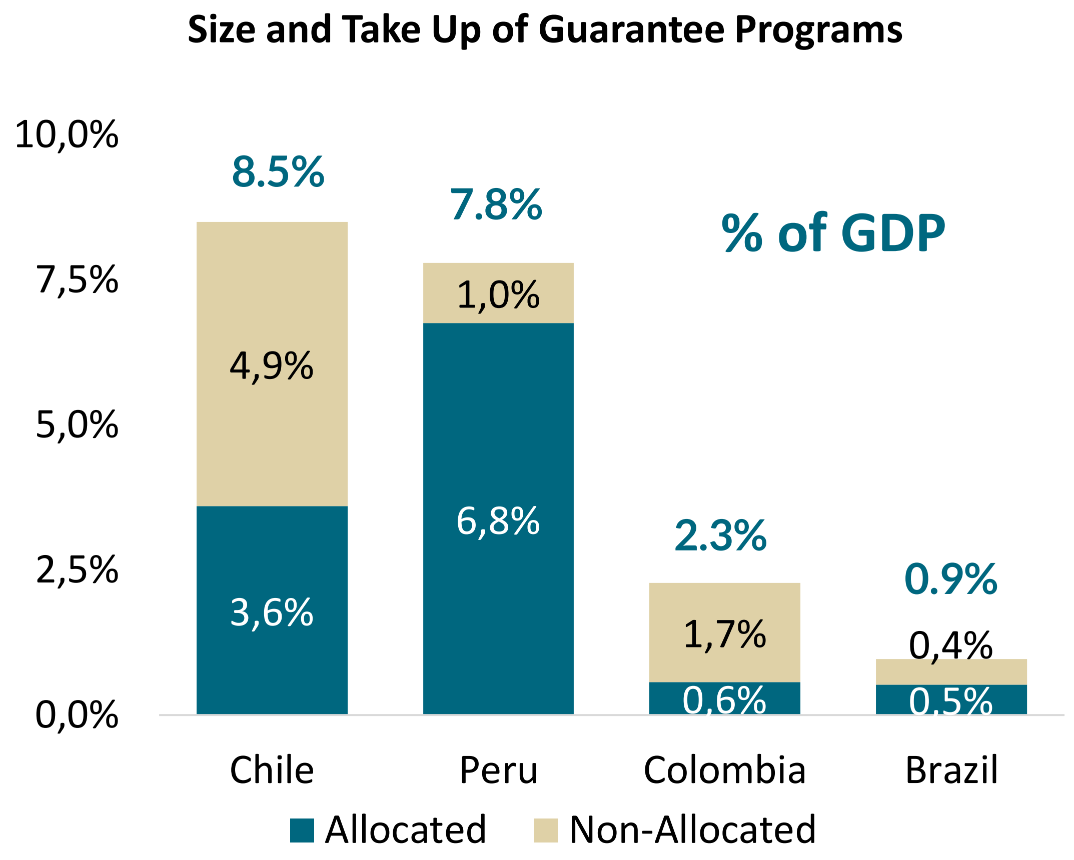
- **Loan guarantee programs** have been announced by various governments to support firms, with particular attempts to support smaller enterprises

- But there is a difficult **trade-off:**

  - ✓ **Loan guarantees of 100%:** Reduce the incentives of banks to analyze risks, many loans may end in default, leading to inefficiency and large fiscal liabilities

  - ✓ **Partial guarantees**: In this case banks may not be willing to lend, particularly to smaller firms where there may be greater risks

Take-up for guarantee programs…



- In general, partial guarantees are offered, **take-up has been mixed**
- On average, take-up across these programs has been **just over 50%**
- Programs tend to be **off-budget** so those that are extended may be adding to **contingent liabilities**
- There is also a danger banks "**cherry-pick**" whose loan is guaranteed

Recommendations: Guarantees

- *Guarantee programs should be* ***transparent and budgeted*** *according to appropriate rules and reasonable provisions for losses should be made*

- *Guarantee schemes should be* ***monitored*** *carefully to ensure that they do not allow banks to "cherry-pick" which loans are guaranteed and that the results are as intended*

- *Guarantees work best when they are* ***partial****, but where risks are moderate, likely more appropriate for medium-sized firms that have a high likelihood of survival*

- *Elsewhere* ***other instruments*** *are needed…*

One instrument does not fit all

- **Small and informal firms** are very common across the region: there tends to be little information available, and many may not have a relationship with a bank

- Some formal firms have **high debts**: more debt (even if guaranteed) is not the answer

- In some cases, the **uncertainty** is very large: a firm could be viable, but the risks are high, here the tradeoff for guarantees is most acute

Recommendations: Instruments

- ***Grants:*** *for small and informal firms assuming there is fiscal space, but they should be accompanied by an information gathering system*

- ***Guarantees****: medium-sized firms with moderate debt*

- ***Equity*** *injections (or financing via an equity like instrument) preferable when uncertainty is very high, they give the public sector* ***upside*** *as well as downside risk and can* ***minimize fiscal losses****, may even yield profits*

- *BUT* ***great care*** *must be taken…*

Recommendations: Equity program

- *Public equity injections into private firms have* ***several dangers****, public resources must be protected and also private property rights*

- ***Good institutional design is key****:*
  - ✓ *A new institution designed for the purpose*
  - ✓ *A private-public council could advise*
  - ✓ *Or adapt an existing institution e.g.: development banks with strong governance*

- *Private sector arms of* ***multilateral organizations*** *may provide advice and funding*

- *If done correctly, this could be a conduit to* ***improve corporate governance***

Exit rules for banks

- Financial systems will come under **greater stress**, some weaker banks may fail
- Most countries have deposit insurance and **improved bank resolution** systems
- But not all are in **fully operational**, laws may lack regulations
- And the **legal protections** for banking supervisors are weak
- The key is to have a **good resolution process for individual banks**, to prevent a more systemic crisis from developing

Recommendations: Bank exit rules

- *Ensure bank resolution frameworks are **fully operational***
- *Work on improving **protections for supervisors** or at least have a system to provide a **good legal defense** if cases do arise*
- *Countries should have **stress tests,** understand **the links between institutions,** and have **contingency plans** in place in case any problem in an individual bank become more widespread*

Boosting financial inclusion

Monetary Transfers: Delivery Methods in Selected Countries

Chile	Mobile banking
Colombia	Mobile banking
Dominican Republic	Transfer to ID card
Panama	Transfer to ID card
Paraguay	E-wallet (in some cases ID related)
Peru	Mobile banking

- **Social safety nets** have been expanded
- Some countries have encouraged **innovative electronic payments' methods**
- Financial institutions have offered a simple **cost-free financial account**
- **A silver lining** of the crisis is that these initiatives may **boost financial inclusion** going forward

- ***Recommendation: other countries should consider implementing such initiatives***

Conclusions

- The region faces serious challenges going forward
- Financial systems are likely to come under significant stress
- Good policies are required to navigate these choppy waters
- We hope this report will provide a useful discussion and a set of recommendations that will be helpful for policy-makers in the region and beyond

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CGD Website

https://www.cgdev.org/soundbanks **(English & Spanish)**

IDB Website

English: www.iadb.org/soundbanks

Spanish: www.iadb.org/bancossolidos

Thank you!