

Platform for Shaping the Future of Financial and Monetary Systems

Impact of COVID-19 on the Global Financial System

Recommendations for Policy-Makers Based
on Industry Practitioner Perspectives

April 2020



Background

This briefing is the outcome of several multistakeholder dialogues organized by the World Economic Forum's Platform for Shaping the Future of Financial and Monetary Systems. Since mid-March, the Forum has virtually convened senior leaders from financial institutions, international organizations, central banks and other institutions for several discussions about the impact of COVID-19 on the financial system.

These discussions aimed to identify emerging financial stability risks, understand adjustments to consumption and investment due to COVID-19, discuss where policy-maker attention is required, and share emergency measures implemented by firms as well as lessons learned from this crisis and earlier times of market stress.

This briefing summarizes the key findings of these discussions, providing insight into financial market trends, private-sector views of government responses to date and priorities for future policy, areas of risk and uncertainty, and expectations for the future. While some context on market activity and policy decisions is provided, the focus is on sharing the views expressed by the participants in these Forum-hosted discussions, rather than a comprehensive overview of the situation.

The goal is to present the current state of debate among key financial system stakeholders. As the human and economic impacts of COVID-19 continue to be felt, the Forum will convene similar discussions and share this learning.

Summary of policy recommendations

- 1** “Flattening the curve” of firm mortality must be a top policy priority, and governments will have to expand the size and scope of support programmes over time.
- 2** Governments, including regulators and central banks, must continue to coordinate policy on a global level to help maintain financial stability. Within countries, policy guidance must be clear and consistent across regulatory agencies.
- 3** Policy-makers must ensure that the financial system remains capable of safely meeting the public’s need for financial services through digital channels.
- 4** Advanced economies may need to further expand the support offered to emerging markets and developing economies.

Key insights

1. The global financial system has emerged from an initial period of extreme stress, in large part due to governments' efforts to stimulate the economy, central banks' speed at addressing market disruptions, and the resilience of financial institutions.

At the end of February 2020, financial markets entered a risk-off phase with significantly increased volatility across markets. Equity markets began declining rapidly, losing around 30% of market value in a matter of weeks, with the speed of the sell-off exceeding that of the global financial crisis of 2008-2009 (GFC).

By early March, short-term funding markets and international US dollar funding markets started to show signs of stress and, in the weeks to follow, there were signs of illiquidity in the US Treasury market, the deepest and most liquid financial market in the world. These stresses carried through into credit markets, making it difficult for firms and governments to borrow funds at any tenure.

Central banks reacted quickly to the emerging signs of stress, applying lessons learned during the GFC. Participants from across the financial system noted that the US Federal Reserve and other central banks began addressing funding market impairment in a matter of days, as opposed to the months it took in some cases during the GFC. In doing so, they prevented stresses in underlying funding

markets from propagating into market-wide disruptions. At the same time, central banks announced plans to expand asset purchase programmes, with the goal of reintroducing liquidity into key asset classes, surprising some participants, who said they expected a more moderate central bank response.

In late March, equity markets began to rebound following announcements of substantial fiscal support packages by large advanced economies. According to market participants, this rebound reflects expectations that the size and targeting of the fiscal packages – averaging 10% of GDP across the United States and Europe, with a focus on supporting small businesses and hard-hit industries – will effectively address the macroeconomic slowdown.

Moreover, throughout this period, equity market infrastructure remained remarkably resilient, which, according to some participants, enabled markets to remain fully functional and begin to rebound. Exchanges utilized tools like market-wide circuit breakers, stock-specific guardrails and dynamic restrictions on short selling to maintain both orderly functioning and market liquidity. Participants also noted that post-trade infrastructures remained fully operational at record high volumes and volatility, in addition to effectively managing margin requirements to prevent potential settlement failures from spilling over.

In credit markets, the story has been somewhat mixed to date, but participants have been generally encouraged by the direction of developments. Whereas primary bond markets had effectively closed in early March, by early April investment banks reported strong demand for new credit issuance by investment-grade borrowers. Participants attributed the re-opening of primary credit markets to central bank action as well as a somewhat improved macroeconomic outlook. On the other hand, high-yield markets and secondary bond markets remained largely closed, although there is some optimism that new central bank corporate credit facilities could provide a backstop in these markets.

Participants from the private sector and policy-makers agree that a key difference between the GFC and this crisis has been the role of banks. Unlike the GFC, this crisis is fundamentally a public health emergency that has become an economic downturn as governments have taken measures to stop the spread of the disease. But, rather than contributing to the problem, banks are now a major part of the solution, due in large part to the strength of their balance sheets.

The post-crisis regulatory framework has led to substantial increases in capital held by large advanced economy banks, in addition to more liquid assets and more stable sources of funding. Not only are banks relatively stable, but they are also serving as the primary transmission mechanism for much of the business support components of many countries' fiscal packages. Participants advocate that the focus of regulatory and central bank policy should be on maintaining this stability while enabling banks to meet the needs of the real economy, which may be a difficult balance to achieve.

2. While the initial acute phase of the financial crisis may have eased, firms and policy-makers remain concerned about a range of risks that could present a threat to financial stability and, ultimately, the economic recovery.

All stakeholders have repeatedly highlighted the degree of uncertainty currently plaguing financial markets and institutions. There is uncertainty about how badly the virus will affect different countries, how long containment measures must persist in different markets, how effective policy will be at mitigating lost activity, and how households and firms will change their behaviour in the medium term.

While financial system resilience, fiscal support, regulatory flexibility and liquidity provision to date have helped ensure that the financial system is supportive of economic recovery, a more protracted slowdown may present new risks to the financial system. Thus, while the initial phase of the crisis has eased, participants are keenly aware that there may be greater turmoil affecting the financial system as the economic fallout continues, potentially precipitating a financial crisis down the line.

While equity markets have rebounded somewhat since their March lows, these rebounds may be premature, with market valuations not reflecting potential extreme downside scenarios. Participants noted that volatility in equity prices likely reflects oscillation between more optimistic and pessimistic macroeconomic outlooks among investors. However, some participants argued that, even when equity markets reached their lowest levels in March, market valuations of firms may not have priced in the most severe, yet plausible, downside scenarios.

One view of such a scenario would involve a severe protracted recession in advanced economies leading to a credit crunch – as banks face greater credit losses than their balance sheets can withstand, despite ongoing central bank support – which, in turn, would deepen the recession. While this scenario is not seen as likely, some participants said they believe that equity market investors should be more cognizant of downside risks.

While investment grade borrowers have begun issuing new bonds, secondary markets have remained largely closed. Asset managers have reported that it is difficult to find any price signals in the markets. Many participants argued that this illiquidity has become a structural issue, as banks are no longer the primary market makers for much of the fixed-income market, stemming from post-crisis regulatory changes.

While it is too early to judge how effective the US Federal Reserve's corporate credit purchasing programmes will be at easing illiquidity in these markets, there is concern that persistent illiquidity could present a risk, particularly in the event of forced sell-offs by asset owners or managers due to credit rating downgrades. Although there have been limited ratings downgrades to date, a longer slowdown with limited additional government support could push many firms' debt profiles below investment grade, thereby requiring certain asset owners, such as pension funds, to offload bonds into an illiquid market.

A number of participants have argued that middle-market firms in the hardest-hit sectors are the firms most at risk of insolvency, which could lead to significant macroeconomic and financial fallout. Whereas many small businesses and large corporates have been targeted by a range of fiscal and central bank support programmes, participants said they feel that mid-size firms have been largely excluded. Concurrently,

high-yield credit markets – middle-market firms' traditional source of capital and liquidity – are largely closed due to crisis-driven risk aversion. Given the scale of high-yield and leveraged loan markets globally, participants fear that failure to support these firms could lead to large balance sheet losses for both banks and investors, in addition to additional blows to employment and income.

3. The economic and financial crisis in emerging market and developing economies may be more severe than in advanced economies.

Both private-sector participants and policy-makers remain concerned about the range of risks presented by weaknesses in many emerging market and developing countries. Most importantly, participants highlighted the risk of a true human tragedy if countries are unable to contain the spread and deadliness of COVID-19.

While these issues were not the focus of the discussions, participants from certain countries in sub-Saharan Africa, Latin America and South Asia spoke of economic conditions that could lead to the virus's rapid spread (e.g. lack of access to clean water in some areas, limited infrastructure for remote working and population density), in addition to weak public health systems that are not equipped to manage the needs of the population in a pandemic.

Participants are also vigilant about the financial and economic risks for emerging-market and developing economies, many of which face a multifaceted crisis unlike those experienced in the 1990s or during the GFC. Factors include the massive decline in commodity prices stemming from a simultaneous supply-and-demand shock, disruptions in supply chains, dramatically reduced exports given recessions in advanced economies and, of course, the need to implement COVID-19 containment measures domestically.

Whereas most advanced economies are addressing emerging recessions with large fiscal packages, many emerging-market and developing economies lack the fiscal space to adequately respond. Moreover, since the beginning of the crisis, investors have fled from emerging markets, with portfolio outflows exceeding those during the GFC and other periods of major stress.

While some emerging markets are better positioned to withstand and address these shocks, many are seeking various forms of liquidity support from advanced economies. There has been record demand for emergency programmes from the International Monetary Fund (IMF) and multilateral development banks, which these institutions have met by expanding the size and breadth of the support offered.

Some emerging market economies without access to bilateral swap lines with the US Federal Reserve have instead begun using the Fed's new FIMA Repo Facility; participants representing banks from some of these countries said they are optimistic that this facility will effectively provide much-needed short-term US dollar liquidity.

Nevertheless, despite the increase in support to many countries, participants remain concerned that deep crises across emerging markets could prevent governments from being able to protect vulnerable populations, in addition to presenting significant losses to investors and lenders that could hurt balance sheets globally.

One area of uncertainty for emerging-market and developing countries is the future of financial technology (fintech) companies. In some countries, like China, fintech companies have been important in the policy and financial system response, with regulators allowing fintechs to digitally originate loans to SMEs, local governments

disbursing household support through fintech platforms, and banks developing partnerships with fintechs to rapidly transform their digital and contactless offerings.

However, in other countries, there is growing concern that many fintech companies – which have grown rapidly over the past decade by lending to SMEs and households – could collapse under the stress of severe credit losses. Given that in many countries fintechs have helped expand access to financial services, participants felt that the loss of fintech ecosystems in these countries could be a major blow to financial inclusion.

Recommendations for policy-makers

1. “Flattening the curve” of firm mortality must be a top policy priority, and governments will have to expand the size and scope of support programmes over time.

Most participants agreed that supporting SMEs and larger businesses is key to maintaining both employment and financial stability, and many have been encouraged by the speed with which advanced economies have rolled out support packages to firms. However, there is concern that the size of packages may prove insufficient for the duration of the crisis; that disbursement may be slower than is needed; that not all firms in need would be targeted; and that such programmes may be overly reliant on debt financing.

To prevent short-term liquidity problems from becoming solvency issues, participants agreed, governments must remain vigilant about the availability of funds for SMEs and larger firms as the crisis persists. Moreover, given that SMEs have short windows of cash on hand, programmes must be designed to ensure rapid disbursement of funds through simple, all-digital channels.

Many participants said they feel the experience of China – where banks, fintechs and government worked hand-in-hand to deliver emergency support to SMEs – is instructive. Many also felt that, as the economic crisis unfolds, it will be necessary for the government to provide support to so-far-excluded companies, such as middle-market firms lacking access to capital markets.

While most agreed that, in the short term, the focus should be on liquidity support, there was also some consensus that, ultimately, governments might need to take equity in some firms in order to keep them afloat, which would require developing the tools to fairly and efficiently do so. Some participants highlighted the risk of adding additional debt to firms, which, before the crisis, already had record levels of borrowing.

Many participants said they feel that, as the crisis develops from a “liquidity phase” into a “solvency phase”, it will be necessary for governments to consider a range of policy tools, including efficient bankruptcy and restructuring systems, government guarantees and other support for private investments, programmes for sector-specific government equity injections, and establishing asset management companies.

Given that many governments lack the requisite expertise and structures for owning and operating businesses, they should build on domestic institutions with relevant experience (e.g. sovereign wealth funds), partner with the private sector where appropriate, and move early to design these programmes, with transparency and fairness in mind.

2. Governments, including regulators and central banks, must continue to coordinate policy on a global level to help maintain financial stability. Within countries, policy guidance must be clear and consistent across regulatory agencies.

Much as health experts have called for governments to work together to contain the spread of COVID-19, participants advocate deep coordination by financial sector policy-makers. Most agreed that international cooperation to date has been meaningful, including through fora like the Basel Committee and the Financial Stability Board. However, many said they feel that, given the speed with which the crisis has evolved, small differences in policy adjustments between countries could place undue operational burden on firms. Thus, regulators, supervisors and central banks should continue to coordinate financial stability policy across countries, as is appropriate.

While participants agreed that regulatory policy within countries has generally moved in the same direction, many expressed concern that, in certain areas, regulators and supervisors are not sufficiently harmonized in their approach. For example, with regard to calculating expected credit losses under IFRS 9 accounting regulations, some participants representing banks said they feel they are receiving mixed messages from prudential supervisors and from their accounting

firms, which often receive guidance from securities regulators. Policy-makers should ensure that regulatory and supervisory changes are coordinated across the relevant domestic institutions to prevent confusion from limiting the effectiveness of policy action.

3. Policy-makers must ensure that the financial system remains capable of safely meeting the public's need for financial services through digital channels.

Given the need to quickly disburse fiscal support to households and small businesses – in addition to the broader need to deliver financial services at a time when populations are being asked to socially distance – financial institutions must have leading digital capabilities. However, the crisis has so far exposed the variation in digital maturity among institutions. While many have rapidly adapted to digital operating models and met customers' needs through digital channels, some banks lack the operational and customer-facing capabilities to deliver in this new environment.

In the short term, policy-makers should leverage the strengths of the entire financial system, including fintechs, to rapidly deliver support to small businesses and households. Moving forward, banks can explore partnerships with fintechs to quickly and safely introduce new products. Policy-makers should also encourage banks to continue to explore other technologies and partnerships that enable them to better serve digital-first customers and to operate in a more agile fashion.

Participants also advocated quickly updating regulations that restrict digital operations, citing the example of Chinese regulators temporarily lifting certain restrictions on fully digital lending. Regulators should use a risk-based approach to ensure that new AML/CFT risks are not introduced.

Given increased reliance on e-commerce and contactless payments, policy-makers should continue to explore technologies that enable fast, inexpensive, and ubiquitous payments through a resilient payment system. Participants highlighted the challenge of ensuring inclusion, given the number of households that are unbanked or lack access to smartphones and other technologies. Some participants recommended stablecoins and blockchain-based central bank digital currencies as solutions with the potential to address key challenges, while others spoke of the need to improve the speed of existing payment networks.

4. Advanced economies may need to further expand the support offered to emerging markets and developing economies.

Advanced economies have moved to increase their support to emerging markets and developing countries through both bilateral and multilateral channels; but, as the crisis in these countries unfolds, additional assistance may be required. Participants agreed that advanced economy policy-makers, as well as investors and financial institutions, must continue to develop and expand programmes to support these countries.

Next steps

The World Economic Forum's Platform for Shaping the Future of Financial and Monetary Systems will continue to convene meetings of the Financial Services COVID-19 Response Network to discuss practitioners' perspectives on emerging financial stability risks, the evolving public policy response and long-term challenges for the financial system.

If your institution is interested participating in these dialogues, please contact Matthew Blake (Matthew.Blake@weforum.org).

Acknowledgments

The World Economic Forum would like to thank the institutions participating in the Financial Services COVID-19 Response Network for their commitment and contributions to this multistakeholder dialogue, as well as members of the Platform for Shaping the Future of Financial and Monetary Systems who have participated in these discussions.

ABN AMRO	Citi	Organisation for Economic Co-operation and Development (OECD)
Absa Group	CLS Bank International	Oliver Wyman
Allianz SE	Compagnie Financière Tradition	PayPal
AMTD Group	CPP Investments	Ping An Technology (Shenzhen) Co. Ltd
Ant Financial	Deloitte	RBC (Royal Bank of Canada)
Banco Santander SA	European Commission	Refinitiv
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China Reinsurance (Group) Corporation	Mastercard	Willis Towers Watson
China UnionPay	Motive Partners	Zurich Insurance Group
Circle Internet Financial	Nasdaq Inc.	
	Naspers Limited	

We are grateful to our colleagues on the Platform team for their collaboration on this effort, including Mary Emma Barton, Haleh Nazeri, Meagan Andrews, Derek Baraldi, Andre Belelieu, Kai Keller, and Drew Propson. We are very thankful to Janet Hill for editing work, Michela Dorbolò for graphic design and layout, and Madeleine Hillyer for guidance on messaging.

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