Lessons learnt from the COVID-19 pandemic from a financial stability perspective. Interim report of the Financial Stability Board. International Bulletin of November 2021.

The COVID-19 pandemic is the first major test of the global financial system since the G20 reforms were put in place following the great financial crisis (GFC) of 2008. Unlike the previous crisis, this time the problem originated outside the financial system. The pandemic, together with the lockdown measures introduced by governments, brought economic activity to a halt and put the financial system under pressure, culminating in a serious strain on liquidity in March 2020. Unprecedented measures were then taken to prevent negative effects on the economy and to stabilise the markets.
The objective of this interim report, which has been prepared by the Financial Stability Board (FSB) in collaboration with international standard-setting bodies, is to identify preliminary lessons for financial stability from the COVID-19 experience and aspects related to the functioning of the G20 financial regulatory reforms that may warrant further attention at the international level.

The report is structured around certain aspects that are significant for global financial stability, such as *institutional and market resilience, operational resilience*, and *crisis management preparedness*.
The main conclusions of the report are the following:

Thus far the global financial system has weathered the pandemic thanks to greater resilience, supported by the G20 reforms after the 2008 financial crisis, and the swift, determined and bold international policy response. Effective implementation of G20 reforms meant that core parts of the system entered the pandemic in a more resilient state than during the 2008 financial crisis. Large banks hold more capital, have more liquidity and are less leveraged, which allowed them to cushion, rather than amplify, the macroeconomic shock. Financial market infrastructures, particularly central counterparties, also functioned as intended. However, the pandemic also highlighted differences in resilience within and across financial sectors. For instance, funding markets experienced acute stress in March 2020, forcing authorities to take decisive and unprecedented action to sustain the supply of financing to the real economy and support market functioning.

The reforms put into place by the G20 post-2008, and the flexibility built into those, supported an effective policy response during the initial phase of COVID-19. A wide set of monetary, fiscal, regulatory and supervisory measures cushioned the impact of the COVID-19 event on the financial system. Reflecting jurisdiction-specific circumstances and needs, authorities broadly used the flexibility provided by the G20 reforms to support financing to the real economy.

The March 2020 market turmoil has underscored the need to strengthen resilience in the non-bank financial intermediation (NBFI) sector. The impact of the COVID-19 event has highlighted vulnerabilities in the NBFI sector, which may have caused liquidity imbalances and propagated stress during the 'dash for cash'. The turmoil has also underlined the importance of interconnectedness within the NBFI sector and with banks.

The FSB has therefore developed a comprehensive work programme to enhance the resilience of the NBFI sector while preserving its benefits.

The functioning of capital and liquidity buffers may warrant further consideration. Banks generally have not needed to use their capital and liquidity buffers to meet loan demand thus far. They maintained strong capital positions during the pandemic, supported by public measures. However, some evidence suggests that banks may have been hesitant to use their buffers had it been needed, in spite of the flexibility embedded in the regulatory framework.

Some concerns about excessive financial system procyclicality remain. Margin calls in some derivatives markets during the peak of the March 2020 turmoil may have been larger than expected or insufficiently anticipated by market participants, adding to the overall demand for cash. Furthermore, the actions of certain investors may have contributed to the amplification of liquidity imbalances and their propagation through the financial system. More generally, it may be too early to draw conclusions about financial system procyclicality as support measures may have dampened or delayed the impact of potential amplification mechanisms.

The pandemic highlights the importance of effective operational risk management arrangements being in place before a shock hits. Precautionary lockdown measures tested the contingency plans of all financial market participants. Financial institutions and market infrastructures successfully invoked business continuity plans and adopted work-from-home arrangements at short notice. Notwithstanding new challenges, financial institutions have generally been able to continue operations in this mode for a much longer period than expected, ensuring that financial markets remained open and orderly, even in some cases with significantly increased trading volumes.

Authorities should continue to take steps to further enhance crisis management preparedness. Cross-border mechanisms established in recent years, such as supervisory colleges and crisis management groups, facilitated timely and effective information sharing and cooperation among authorities. Scenario-based stress tests helped authorities to adjust their policies, while recovery and resolution planning have improved firms' capabilities. However, authorities should continue exploring opportunities to enhance information sharing further and to continue to adapt supervisory and regulatory policies to the changing underlying circumstances, including by addressing identified data gaps and enhancing analytical tools.

Identifying systemic vulnerabilities remains a priority. The COVID-19 pandemic could continue to test the resilience of the global financial system. The current low level of corporate insolvencies seems predicated on continued policy support. However, banks and non-bank lenders could still face additional losses as these measures are unwound. Recent bank stress tests suggest that the largest banks are well capitalised and will remain resilient under a range of recovery scenarios, although there may be questions about how banks would maintain real economy financing in an environment of generally deteriorating credit quality.

One of the legacies of the pandemic may be a build-up of leverage and debt overhang in the non-financial sector. High corporate and, in some cases, sovereign indebtedness was already a concern before the outbreak of COVID-19. Credit support from the authorities has increased debt levels even further, especially in the hardest-hit sectors. Addressing debt overhang, including by facilitating the market exit of unviable companies, and by promoting the efficient reallocation of resources to viable firms, may be a key task for policymakers going forward.

The COVID-19 crisis reinforces the importance of completing remaining elements of the G20 reform agenda. Those parts of the global financial system where reforms were implemented prior to the COVID-19 crisis have displayed more resilience. The financial stability benefits of the full, timely and consistent implementation of the reforms, including with respect to Basel III, over-the-counter (OTC) derivatives, resolution frameworks and NBFI, remain as relevant as when they were agreed.

COVID-19 has reinforced the need to promote resilience amidst rapid technological change in the economy and the global financial system. The widespread implementation of working-from-home arrangements has propelled the adoption of new technologies and accelerated digitalisation in financial services. While outsourcing to third-party providers, such as cloud services, seems to have enhanced operational resilience at financial institutions, increased reliance on such services may give rise to new challenges and vulnerabilities. Effective management of these risks is essential to mitigating operational and cyber risk.

This interim report will be used to engage with stakeholders on the initial findings and the analysis carried out to date. The final report, to be presented at the G20 Summit later this year, will highlight the conclusions drawn from these talks and set out next steps to address the issues identified.

Useful link:

Lessons learned from the COVID-19 pandemic from a financial stability perspective: Interim report