

The G20 Finance Ministers and Central Bank Governors

March 19, 2020

Proposed Measures to Address Economic Elements of Current Pandemic Crisis

Dear Ministers and Governors,

The Systemic Risk Council (SRC) makes the following statement on the response of the financial and economic authorities to the economic elements of the current pandemic health crisis.

Unlike 2007/08, this is not a financial implosion that threatens the economy and society. It is not a shock from within the economy that threatens the stability of the financial system. It is a devastating shock to people's health that threatens their livelihoods, the businesses in which they work and invest savings, the wider economy, and therefore the financial system.

Weaknesses in the financial system are exacerbating the potential feedback loops, which risk deepening the downturn and impeding eventual economic recovery.

Over recent years, the SRC has expressed concern over the steps taken to reduce equity and liquidity requirements in banking.¹ That exercise, which has not been limited to the US, should stop now, and various measures reducing the system's resilience should be suspended at least. SRC has also urged greater vigilance over leverage and liquidity mismatches in shadow banking and trading markets.²

Instead, Covid-19 strikes the world at a time when too many corporations around the world are over-indebted, and after a period during which persistently favorable market conditions caused traders to take aggressive positions, exposing them and the system to spikes in volatility, let alone a collapse in asset values. Opportunities to restrain market leverage by raising margin or haircut requirements in capital markets were missed.

¹ See Letter from Systemic Risk Council to Jerome H. Powell, Chair, Board of Governors of the Federal Reserve System, and Jelena McWilliams Chair, Federal Deposit Insurance Corporation (July 16, 2019), *available at* <https://4atmuz3ab8k0glu2m35oem99-wpengine.netdna-ssl.com/wp-content/uploads/2019/07/SRC-Comment-Letter-on-Resolution-Planning-Requirements-for-US-Regional-Banks.1.pdf>; Letter from Sir Paul Tucker, Chair, Systemic Risk Council to Jerome H. Powell, Chair, Board of Governors of the Federal Reserve System, and Joseph Otting, Comptroller of the Currency (Aug. 8, 2018), *available at* <https://4atmuz3ab8k0glu2m35oem99-wpengine.netdna-ssl.com/wp-content/uploads/2018/08/SRC-Comment-Letter-on-eSLR-and-Volcker-Rule-Aug-8-2018.pdf>.

² See Letter from Sir Paul Tucker, Chair, Systemic Risk Council to Financial Stability Oversight Council (May 21, 2019), *available at* <https://4atmuz3ab8k0glu2m35oem99-wpengine.netdna-ssl.com/wp-content/uploads/2019/05/Systemic-Risk-Council-Statement-on-FSOC-Proposal-May-2019.pdf>; Letter from Sir Paul Tucker, Chair, Systemic Risk Council to Secretariat of the Financial Stability Board (Oct. 15, 2016), *available at* <http://systemicrisk.wpengine.com/wp-content/uploads/2016/10/Systemic-Risk-Council-Letter-to-FSB-re-Asset-Management-Proposals.pdf>.

All that is, for now, in the past. Priority must be given to the immediate needs, and to developing a strategy that, somehow, enables the financial and economic authorities to get ahead of events. In that spirit, we offer observations on what banks and their supervisors, central banks, and the executive and legislative branches of government should do.

As, over the coming weeks and months, businesses and households struggle, lacking customers or work, demand for credit will ratchet up. So far as possible, that demand should be met by the banking system, just when there will also be an uncertain amount of re-intermediation from capital markets to bank balance sheets. To assist in meeting this surge in demand, we recommend the following, acknowledging that in many jurisdictions measures of this kind are already being put in place:

- Banks should immediately cease all equity buy backs and dividends, and should be ready to suspend bonuses to a thick layer of senior and other highly remunerated staff in order to maximize their capacity to lend. If the health crisis lasts into next year, credit supply and the economy will be held back by distributions allowed during the current year,
- If banks seek to conserve capital, supervisors should permit them to use capital buffers to increase lending, and exercise prudent forbearance toward fundamentally sound borrowers, even if that reduces regulatory capital ratios in the short run.
- Supervisors should oversee a careful and appropriately gradual deleveraging of trading books by banks, dealers, and funds, including derivative books and repo and securities-lending books that are not supporting, including through market making, participants in the real economy or long-term investment institutions. This will entail difficult judgments, in the interests of ensuring that scarce financial system capital is deployed to the best possible purposes given the crisis.

Beyond that, central banks can take various steps. While it is widely understood that their capacity to stimulate aggregate spending in the economy is more limited than when the Great Financial Crisis began, neither the zero lower bound for interest rates nor anything else limits their capacity to provide liquidity support to the economy. The immediate priority is maintaining the functioning of those parts of the real economy judged by governments to be essential, and those financial markets that support those productive activities. To that end, they should:

- Encourage use of discount-window facilities by banks and other eligible borrowers, as some already are doing;
- Get ready to open the Window to other financial intermediaries whose distress would materially damage the real economy (with a clear understanding that, later, when there is time, regulatory measures will be needed to accompany the provision of liquidity insurance from the monetary authority);
- Widen the collateral used in their longer-term market operations, with legislatures (for example in the US) permitting them to conduct repo operations against suitable privately issued securities where that would be useful (and where subject to suitable haircuts and prudent valuations);
- Prepare to act as market makers of last resort in capital markets that are fundamentally sound but in which malfunctions will be socially costly;
- Prepare for and, where necessary, promptly conduct wider outright purchases of private securities (and, in jurisdictions where this is necessary, for such purchases to be guaranteed by governments);

- Ensure government programs to protect their citizens and the economy can be funded whatever the circumstances.

As is already clear, those measures will not be enough to protect households and businesses from an economy that is freezing up as workers stay at home, physical outlets in the leisure sector and other businesses close, and as people become frightened about spending. Businesses small and large, local and global, will find themselves in peril. The collective consequences could be catastrophic, and banks and other financial intermediaries could face massive losses that disable them just at the moment when their social role in providing credit and payments services is most urgent. Governments, as necessary with legislative backing, therefore need to make clear that:

- They will guarantee new loans by banks to businesses or households in distress, which should be eligible as collateral in central bank facilities;
- Provide direct aid to business sectors that are vital to addressing the health crisis, or essential to reviving the economy when the health crisis eventually subsides, while as necessary guiding a reallocation of productive capacity in the short run to ensure that essential goods and services continue to be produced;
- Provide direct aid to households who lose work or, for other reasons, cannot cope financially even though they remain healthy;
- Ensure that no one is prevented from getting the health care they need, when they need it, whatever their financial situation;
- Prepare plans, even if not published, for providing Capital-of-Last-Resort support to distressed but essential businesses for which funding support is not enough, but whose failure would unnecessarily impair economic prosperity once the health crisis has passed. (Probably via convertible securities, which experience during 2008/09 and its aftermath suggested was the best way of providing support while creating healthy incentives to redeem quickly once crisis passes.);
- Prepare debt management strategies that, as far as possible, insulate states from the longer run economic (and international political) consequences of having to borrow a lot more. In particular, if public debt skyrockets, states should be cautious about relying upon external sources of funds, and so prioritize distribution to domestic long-term investors.

None of this will be easy. All of it (and more) will be needed. The economies of the most advanced economies in the world have already entered a phase of dislocation and incipient seizure not seen in developed countries outside wartime. Debates about whether there will be a recession miss the point. As parts of the economy go into suspended animation, people and businesses need to be protected, by government, for their own sake, and to ensure that the economic costs of this health crisis will, eventually, be temporary even when, very tragically, the human costs to families and friends will not be.

If things deteriorate a lot more, whether quickly or slowly, governments may find themselves facing the question, not seen outside major wars, of whether to steer the economy's production priorities, whether to support household spending with subsidies and welfare payments much higher than in normal circumstances, and whether to fund themselves via their jurisdiction's monetary authority. Obviously the threshold for steps of that kind should be very high given the interference with normal freedoms and constraints. But governments should be conducting contingency planning to think through the issues in advance rather than, however remote it seems, being overtaken by events.

For all their interventions, governments and central banks should incorporate into their design incentives for smooth exit when conditions permit. That is as important for forbearance in banking supervision as it is for central banks' market support measures, and government subsidies and guarantees.

Finally, the authorities of the major economies must work together more closely, and the international financial institutions must step in to support and guide smaller emerging-market and developing economies. Their goal, collectively and individually, must be to avoid a devastating depression, harming families and people for a generation.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Paul Tucker', written in a cursive style.

Sir Paul Tucker, Chair

On behalf of the Systemic Risk Council

www.systemicriskcouncil.org

Cc: The Hon. Randal K. Quarles, Chair, Financial Stability Board

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