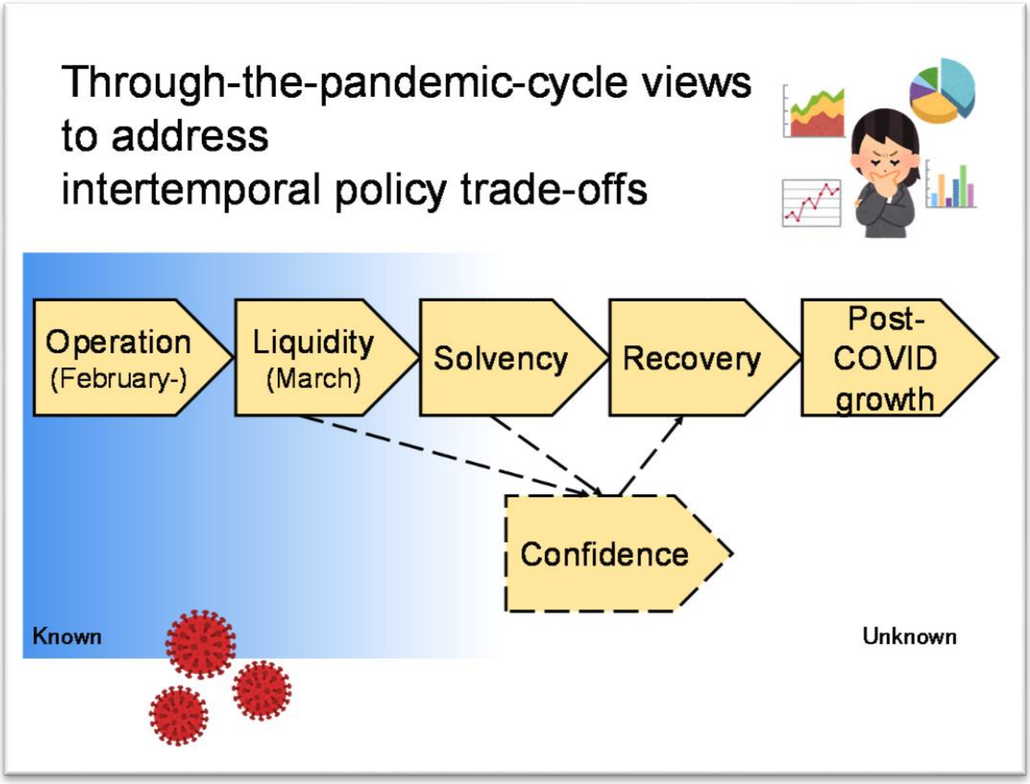
Looking through the six phases of the COVID cycle

Remarks by Himino Ryozo, Commissioner of the JFSA, at the Columbia SIPA webinar on Recent Lessons for Financial Regulation and Macroprudential Policy, September 8, 2020

Thank you, Trish [Patricia Mosser, Director, Central Banking and Financial Policy, Columbia SIPA].

I would like to argue for the need to look through the various phases in the pandemic cycle and take into account intertemporal tradeoffs in making policy choices.



I think there could be six phases in the cycle.

We have overcome the operational challenges arising from lockdown reasonably well so far. The massive central bank intervention stabilized the March liquidity panic as well.

These are what we have seen so far, and we do not know what will follow. But many anticipate a solvency phase to come. If things get worse, increased borrower insolvencies could affect bank solvency.

After the solvency phase, we hope a strong recovery phase will follow, but we should be mindful of the possibility of a confidence phase, or a crisis of confidence in financial stability, as well.

And the recovery will not just result in a return to the pre-COVID normalcy. We will observe a transformation in the economy and the society, and we hope the transformation will be the engine for the new growth.

What I would like to argue is that what we do in one phase will affect what we will see in the ensuing phases.

Let me cite some examples. We overcame the operational challenges by working from home, but this means we need to be more attentive to cyber security going forward.

Prudential policy should also look through the cycle. We can prohibit banks from paying dividends during the liquidity phase, but that may make it more difficult for banks to raise capital in the market during the ensuing phases.

We encourage banks to draw down their capital buffers to extend credit during the liquidity phase, but that may reduce the buffer which can absorb credit losses during the solvency phase. We face high degree of economic uncertainty and do not know the maximum loss amount in advance. Regulators need to be sure that they have the tools in place to withstand the confidence phase.

In this regard, I welcome the Financial Stability Board's June report on Too-Big-To-Fail reforms, which stated, "The resolution regime reforms give authorities more options for dealing with banks in distress, though which options are used is for individual authorities to consider in light of the particular circumstances."

In addition, we should start thinking about the recovery phase and the post-COVID growth phase. The priority during the liquidity phase is securing bridge financing to the corporate sector and to prevent bankruptcies resulting from cash shortage. At this early phase when we do not know which company will be affected to what extent and how long, we cannot distinguish between viable and non-viable firms.

But as more is known about the pandemic and its effects, banks and borrowers should start thinking about how to meet the challenges of the post-COVID era. If borrowers start addressing the challenges earlier, they will be less haunted by debt overhang. The recovery and the post-COVID growth will then be stronger. We do not want to see tightened lending standard now, but would like to see banks encouraging borrowers to design post-COVID business models.

As we move from the solvency phase to the recovery phase, policy makers will start moving toward exit from emergency measures. We should be mindful of the risk of taking strong medicine for too long, but we should also be careful about the cliff arising from the cumulative effects of the unwinding of multiple measures. Coordination among relevant authorities would be as critical in the exit as in the entry.

We may also want to think about broader governance issues. During a crisis, policy makers are tempted to micro-manage banking business. But we have intentionally designed the financial system to be composed of regulated private firms, not of state-owned banks. We should be sensitive to the longer-term consequences of shifting too much towards a command-and-control model.

I have cited only a few examples of many intertemporal issues we face. Policy makers tend to address issues of a specific phase one by one, but we should try to be as holistic as possible, looking through the various phases of the pandemic cycle.

Let me stop here. Thank you.