Sound Banks for Healthy Economies

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

A CGD-IDB Working Group Report

Chairs
Andrew Powell
Liliana Rojas-Suarez

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The CGD-IDB Working Group on Sound Banks for Healthy Economies in Latin America and the Caribbean

Chairs

Andrew Powell
Principal Advisor, Inter-American Development Bank Research Department

Liliana Rojas-Suarez
Director of the Latin America Initiative and Senior Fellow, Center for Global Development

Working Group Members

Gerard Caprio, Jr.
William Brough Professor of Economics, Williams College

Kevin Cowan
Commissioner, Financial Market Commission (CMF) of Chile

Arturo J. Galindo
Board Member, Banco de la República, Colombia

Pablo E. Guidotti
Full Professor, Torcuato Di Tella University, Argentina

Patrick Honohan
Honorary Professor of Economics, Trinity College Dublin; former Governor, Central Bank of Ireland

Giulia Lotti
Economist, Inter-American Development Bank

Pascual O'Dogherty
Secretary General, Association of Supervisors of Banks of the Americas (ASBA)

Eric Parrado
Chief Economist and General Manager, Inter-American Development Bank Research Department

Augusto de la Torre
Adjunct Professor, Columbia University; Former Governor, Central Bank of Ecuador

Philip Turner
Visiting Lecturer, University of Basel; Former Deputy Head of the Monetary and Economic Department of the Bank for International Settlements

Brian Wynter
Former Chairman of the Board of Directors, Central Bank of Jamaica

The recommendations and views expressed in this report are those of the CGD-IDB Working Group as a whole. Affiliations are for identification purposes only. Working group members participate in their individual capacity, and the views expressed should not be attributed to the institutions listed.

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Acronyms

ASBA	Association of Supervisors of Banks of the Americas
BIS	Bank for International Settlements
EFF	Extended Fund Facility
EMBI	Emerging Markets Bond Index
FCL	Flexible Credit Lines
FSB	Financial Stability Board
FIMA	Foreign and International Monetary Authorities
IDB	Inter-American Development Bank
IFC	International Finance Corporation
IIF	Institute of International Finance
IMF	International Monetary Fund
MDB	Multilateral Development Bank
NAFIN	Nacional Financiera
RCF	Rapid Credit Facility
RFC	Reconstruction Finance Corporation
RFI	Rapid Financing Instrument
SBA	Stand-by Arrangement
SCF	Stand-by Credit Facility
SLL	Short-term Liquidity Line
SME	Small and Medium Enterprises

Executive Summary

The COVID-19 crisis has already taken a large toll on Latin America and the Caribbean in terms of confirmed cases and deaths as well as sharp declines in economic activity—and it is far from over. It is still unclear how long the health crisis will persist and how soon and how fast economies will recover. The deep recession and the serious income losses for families and firms may provoke significant challenges for financial systems. Unlike recent financial or balance of payments' crises, this may be more of a slow-moving event in which credit risks take center stage. Good policies will be critical to navigate the coming months. The purpose of this report is twofold: to identify and discuss a set of challenges, and to develop key recommendations. The overarching goal is to provide support to policymakers in the region who may face difficult decisions to ensure that banks play a constructive role and support families and firms through and beyond the current crisis.

Most financial systems remain dominated by banks and will undoubtedly see nonperforming loans rise and suffer losses on other assets as well. Moreover, countries in the region have limited fiscal resources and debt positions had already risen significantly before the COVID-19 crisis hit. However, monetary frameworks have improved considerably. In most countries, inflation and inflation expectations remain well anchored and more countries have gained exchange rate flexibility by introducing inflation targeting regimes. Financial systems were also in relatively good shape before the crisis hit and banks had high capital and liquidity buffers. But the crisis and the immediate response present a set of subtle but extremely important dilemmas for policymakers dealing with financial sector issues.

Monetary Policy, Liquidity, and Central Bank Charters

In most countries, central banks lowered interest rates and provided liquidity, especially to banks by lowering reserve or liquidity requirements and through repos (repurchase agreements) or bond buying programs. Most central banks are restricted in the types of assets they can purchase, but some countries are changing central bank charters to provide greater flexibility to purchase public and private (nonfinancial) securities from primary (as opposed to secondary) markets. Experience, however, suggests that dangers are lurking in this area. Maintaining central bank independence and credibility is key. This report recommends **that central banks focus on liquidity provision and avoid the monetary financing of fiscal deficits and taking on private sector credit risks. Countries would be well advised to seek IMF support or additional resources from multilateral development banks before weakening central bank balance sheets in this fashion.**

Currency Mismatches, Corporate Refinancing, and Financial Stability

Over the last decade, firms in the region took advantage of low global interest rates and issued significant volumes of dollar-denominated bonds abroad. The dangers of currency mismatches when firms do not have access to dollar income has been highlighted in several recent reports, but the COVID-19 crisis and the collapse in trade has added a new dimension: many firms in the tradable sector that appeared to have been hedged have now lost their sources of dollar income. Most countries have regulations to restrict mismatches on banks' balance sheets, but countries now need to go further. **Central banks should ensure all foreign currency-denominated transactions are reported so the risks can be assessed. They should take a holistic view, perhaps by developing new stress tests, to model corporates' roll-over and solvency risks and how they may impact banks and other financial institutions and the likelihood that smaller firms will be crowded out of credit markets. Where the dangers are significant, policymakers may need to take preemptive action to help firms restructure debts or even provide equity or equity-like injections (discussed further below).**

Loan Classification, Moratoria, and Reprogramming

Many countries have introduced payment deferrals or facilitated loan reprograming in the domestic financial system with long grace periods. Loans included in such programs tend to be reported as in good standing and, therefore, not subject to additional provisioning. And yet, credit risk has surely risen given the substantial income losses. A danger is that these policies focus on the liquidity dimension rather than considering the growing solvency risks. Unfortunately, such policies magnify the uncertainty over the quality of banks' loan-books. **Payment deferrals should be explicitly designed and announced as temporary. And banks should always report loan quality reflecting the reality of the situation, so supervisors and central banks have good information**. Loan classification is normally tied to provisioning requirements. **The recommendation of this report is that provisioning rules should be maintained but supervisors may exercise discretion, allowing banks time to build up greater provisions where required**. This may imply that bank capital ratios dip from their relatively high pre-crisis levels. To allay concerns about capital losses, authorities may wish to communicate that bank buffers are there to be used on a temporary basis in such circumstances.

Safety Nets and Financial Inclusion

Given the crisis and the impact on the poor and vulnerable, countries have expanded social safety nets and introduced new transfer programs. Some countries have implemented such initiatives in a way to boost financial inclusion using electronic payment methods and with agreements with financial institutions, including banks and fintech companies, to create a simple and costless financial account. Other countries should follow suit and complement these efforts with a program of financial education. **The region lags in terms of financial inclusion, and harnessing transfer payments in this fashion could bring significant benefits, allowing unbanked families and firms access to financial services, providing a silver lining to the crisis**.

Guarantee Programs

Many countries also announced large public guarantee programs to support credit. Frequently, these programs are off fiscal balance sheets, raising the specter of growing contingent liabilities. Such programs should be transparent and adequate provisions should be made against losses. A significant problem with guarantee programs is that banks are reticent to lend unless the guarantee covers the whole loan, but full guarantees take away banks' incentives to choose creditworthy borrowers and limit risks. Wary of this and the potential fiscal losses that might result, in practice countries have typically offered partial guarantees but take up has been low. Despite large announced programs in some countries the actual volumes of guarantees awarded have been limited. **This report recommends loan guarantee schemes for a limited universe of formal firms, likely firms of at least medium size with good information on credit risks**. Guarantees give greater leverage (they can support larger volumes of loans) when they are partial and on loan portfolios. **Countries should monitor these programs carefully to ensure banks are not cherry-picking which loans are backed and that the results are as intended**.

Alternative Instruments to Support Viable Firms

Latin America and the Caribbean has a long tail of small and micro firms, many of which are family owned and not fully formal. **Assuming there is fiscal space, grants are likely a better instrument to support small and micro firms. However, grants should come with a system to gather information on the future viability of the firm and should be curtailed quickly if it becomes clear the firm does not have a future. If the firm had been supporting a poor family, the grant should morph into a transfer payment**. For those firms where debt is not excessive, extending subordinated debt might be preferable to a guarantee on a bank loan. **But given the level of uncertainty regarding which firms will be viable, equity or an equity-like instrument is likely preferable to debt, or to the use of guarantees**. The advantage of equity, or an equity-like instrument, is that it would provide governments with upside as well as downside risk, potentially minimizing overall fiscal losses (or even providing profits), and avoids creating a debt overhang for firms whose leverage ratios are already high. But the experience of public injections of equity into private firms in the region is at best mixed. **In those countries that have public banks with good governance structures, these institutions might be adapted for this purpose. Or, a mixed public-private council should be created to guide investments towards viable firms rather than investing in the firms of the politically connected. The report recommends that the private sector arms of multilateral development banks such as the IFC and IDB-Invest provide advice as to how to adapt current institutions or to design new ones, develop their rules of operation and provide funding where appropriate**. This approach has additional advantages; it could provide a mechanism to improve corporate governance in the region. Moreover, it is surely preferable to support firms with a good chance of flourishing once the crisis is over rather than risking more widespread defaults and then having to assist banks ex-post.

Exit Rules

Finally, given the magnitude of the recessions and the loss in income to firms and to families, many corporate bankruptcies are likely and some banks and other financial institutions will need to be closed. Most countries have deposit-insurance systems in place and many have improved bank resolution legislation since the crises of the 1980s and 1990s. **Policymakers should ensure such frameworks are operative; not only should the laws be in place but they should be regulated appropriately so they can be used if required**. The region also lags in terms of the legal protections afforded to supervisors. **If passing new legislation for this purpose is not feasible, then, at a minimum, central banks and bank supervisors should have a clear strategy and adequate resources to mount a rigorous defense against any cases brought in the wake of supervisors performing their legal duties to resolve financial institutions, if and when required. Governments and central banks should carefully monitor the evolving risks in the financial system and plan accordingly**. Bank resolution frameworks are focused by and large on resolving each individual institution rather than contemplating systemic risks. **Contingency plans should be developed if multiple institutions including some larger institutions begin to suffer from solvency risks**.

Final Remarks

The region will face challenging months ahead and concerns regarding financial stability may well surface. A lesson of previous financial crises is that confronting these concerns head on is better than trying to hide them if they emerge. Good policies appropriate to the nature of the problem at hand will boost confidence, help overcome the problems, and ensure that banks play a constructive role as suppliers of liquidity and credit in order for the economy to recover as swiftly as possible.

Section I.
Introduction

The COVID-19 pandemic is provoking an unprecedented health and economic crisis. Latin America and the Caribbean will suffer a major recession this year. The IMF's June World Economic Outlook estimated the loss in GDP at 9.2% for Latin America and the Caribbean and simulations from the Inter-American Development Bank (IDB) put GDP losses between 8% and 10%.[1] Given the precipitous decline in economic activity, financial sectors will undoubtedly be impacted. The purpose of this report is twofold: to identify and discuss a set of challenges, and to advance key recommendations. The overarching goal is to provide support to policymakers in the region who may face difficult decisions to ensure that banks play a constructive role and support families and firms through and beyond the current crisis.

Over the last two decades, the region's financial systems had been growing and made significant advances towards improving banking regulation and supervision. Building on the many macro prudential policies countries implemented after the crises of the 1990s, many supervisors were in the process of implementing Basel III to boost the quality of bank capital and introduce additional counter-cyclical buffers, and several countries developed stress-test procedures. In that context, banks have maintained high and stable buffers of both capital and liquidity. Thus, the region entered the COVID-19 crisis with strengthened banking systems. However, it also did so with weakened fiscal accounts. Fiscal deficits ballooned in the wake of the global financial crisis, spurred largely by greater government consumption rather than investment, leading to higher debt levels. While several countries pursued fiscal adjustment in recent years, the decline in commodity prices dealt another blow to the fiscal revenues of several countries, especially oil exporters. In addition, private sector external debt rose rapidly in several economies in the post-global financial crisis period, facilitated by a long period of low global interest rates. Leverage increased, with greater reliance on dollar-denominated debt.[2]

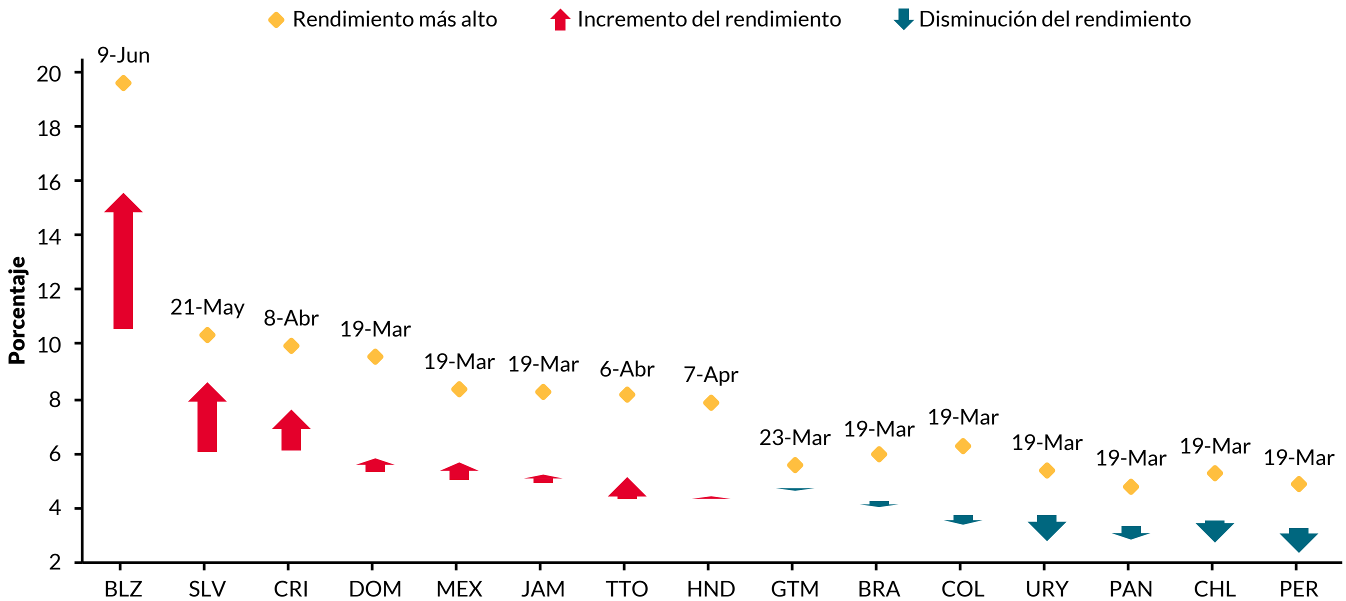
Against this background, the COVID-19 pandemic represents both a health and an economic crisis, exacerbating the region's external fragilities. The health crisis has reduced incomes and demand worldwide, but also represents a supply/productivity shock. Although international reserve levels remain relatively high compared to projected current account deficits in most countries, the external position of many countries is vulnerable. The pandemic and the subsequent closing of borders and strict lockdowns have decimated the dollar earnings of many corporations in Latin America and the Caribbean. Many firms that issued debt abroad have now lost their dollar income sources.

Income, employment, and tax revenues have fallen. Exceptional fiscal support has increased financing needs, raising debt trajectories. Sharply increased risk aversion in international capital markets in March 2020 led to a sell-off of foreign investor holdings of local currency bonds and capital outflows. Investors withdrew the equivalent of almost 4% of GDP from Latin American bond funds in March which triggered severe currency depreciations in some countries. Secondary market (EMBI) bond yields increased sharply

1. IMF (2020a) and IDB (2020).

2. See Chui, Kuruc, and Turner (2016).

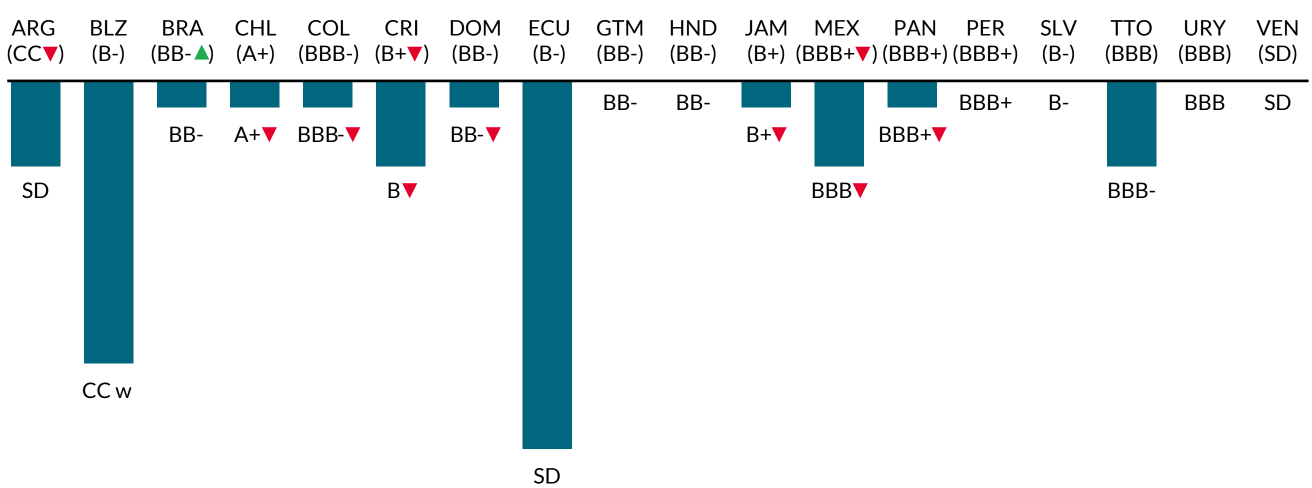
Figure 1a. EMBI yields in Latin America and the Caribbean, December 31, 2019-July 30, 2020



Notes: The arrows represent the direction of the change in EMBI yields from December 31, 2019 to July 30, 2020. The yellow diamond represents the date of the highest EMBI yield between December 2019 and July 2020.

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

Figure 1b. Sovereign ratings in Latin America and the Caribbean, December 31, 2019-June 1, 2020



Notes: The bars illustrate the change in S&P ratings between December 31, 2019 and June 1, 2020. The rating changes were scaled such that the longer the bar, the larger the downgrade—there were no upgrades over the period. S&P ratings in December 2019 (June 2020) are reported at the top (bottom) of the figure; ▼ after the rating indicates a negative outlook, ▲ indicates a positive outlook, "w" indicates a negative watch, and the absence of any symbol or letter after the rating indicates a stable outlook.

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

in March, despite declines in U.S. interest rates (see Figure 1a). Several sovereigns also saw their long-term foreign-currency bonds downgraded by international credit rating agencies (see Figure 1b).

While extremely volatile and varying widely among recipient countries, large capital outflows from emerging markets have turned into small inflows since May. This switch has been supported by expectations that the extraordinary expansion of liquidity in advanced economies, especially the United States, will not be reversed in the foreseeable future. This liquidity has incentivized some investors to seek returns in emerging market assets, especially in the fixed income asset class (a new, albeit incipient, wave of the so-called *search for yield*), although it is notable that to date inflows do not come close to the outflows experienced in March and uncertainty about investors' appetite for emerging market assets in the months ahead remains high. As shown in Figure 1a, by end-July 2020 EMBI bond yields had recovered partially, or even fully in some cases, from their peaks in March (or April) in most countries in the region. In other countries, however, such as Belize, El Salvador, and Costa Rica, bond yields remain high; other countries—Argentina, Ecuador, and Venezuela—lack access to international capital markets.

Countries are being hit by the crisis in different ways depending on their specific circumstances. Tourism, which is particularly important in the Caribbean and some countries in Central America, has collapsed. Mexico, the country in the region most integrated into global value chains, has suffered from collapsing demand and disruption in supply chains. Oil exporters watched their revenues shrink as oil prices dropped to unprecedented levels but have since recovered somewhat as advanced economies reopen.[3] Other commodity prices remain at relatively low levels compared to the 2002-2012 boom years. Some countries in the region, particularly in Central America and the Caribbean, are highly dependent on remittances, which could fall by unprecedented amounts, particularly given higher unemployment and recession in the United States.[4]

3. Powell (2020).
4. WB (2020).

Undoubtedly, the COVID-19 crisis and the resulting deep recession will place significant strain on financial systems with greater demand for liquidity and a sharp increase in both objective credit risk as well as credit risk aversion. The impacts will no doubt depend on the duration and intensity of the economic crisis. Governments, central banks, and financial supervisors have been active in adopting policies to lessen the impacts on families and firms.

Banks are well placed to help families and firms that have access to credit by extending lending during these hard and exceptional times. But the region remains underbanked and banks are likely very concerned about the high credit risks and the likelihood of a severe hit to their balance sheets. Indeed, the pandemic has reduced many firms' ability to service debt. Partial guarantees offered by public entities have been a common response to encourage banks to maintain or even expand lending to viable firms; but given the uncertainty over the viability of firms, banks likely will remain cautious. Financial stability and soundness must be preserved. A financial crisis, added to the current economic crisis, would deepen the recession, delay the recovery, and impact poorer families even more.

The objective of this report is to consider a set of issues related to financial systems provoked by this unprecedented situation and to develop specific recommendations for maintaining financial stability.[5,6] The following section presents a selective assessment of macroeconomic and financial conditions as background. Section III contains a discussion of selected, but key, issues under five headings: i) Currency mismatches, corporate refinancing needs, and monetary and liquidity policies; ii) Fiscal transfers and budgeting; iii) Loan classification, moratoria, and restructuring; iv) Assisting viable firms: guarantees vs other instruments; and v) Exit rules for banks. Detailed recommendations are developed under each of these five headings.

5. As financial systems in the region remain largely dominated by banks, this report focuses on the banking system.
6. Also see the IMF - World Bank (2020) joint note for an earlier discussion of related issues.

Section II.

Initial Conditions Matter: A Selective Assessment

A comprehensive assessment of economic and financial conditions in Latin America and the Caribbean is beyond the scope of this report. Rather, this section highlights selected aspects that are particularly important for the discussion of the financial issues at hand.

Since the crises of the 1980s and 1990s, the region has made tremendous progress strengthening its financial systems. Countries in Latin America and the Caribbean were among the first to enact macroprudential regulations. Many countries implemented liquidity requirements that had macroprudential objectives and experimented with countercyclical rules on capital and provisions. Public credit bureaus, which were initially introduced to monitor loan quality and provisioning rules especially for large borrowers, were expanded to cover virtually all loans and became an extremely useful diagnostic tool for various aspects of supervision. Regulation of bank capital was tightened and while virtually all countries adopted Basel I (and then Basel II), they did so with significantly higher requirements than the minimum internationally recommended levels; most banks themselves chose to hold capital well in excess of those higher minimum requirements. Disclosure and transparency also improved.[7] Supervisors also tightened rules on currency mismatches (in most countries in the region mismatches on bank balance sheets are not permitted) and some restricted the amount of dollar lending; they allowed such lending only to those firms with dollar income from export activities.[8] Many countries in the region had announced their intention to adopt Basel III and some were well advanced in that process.

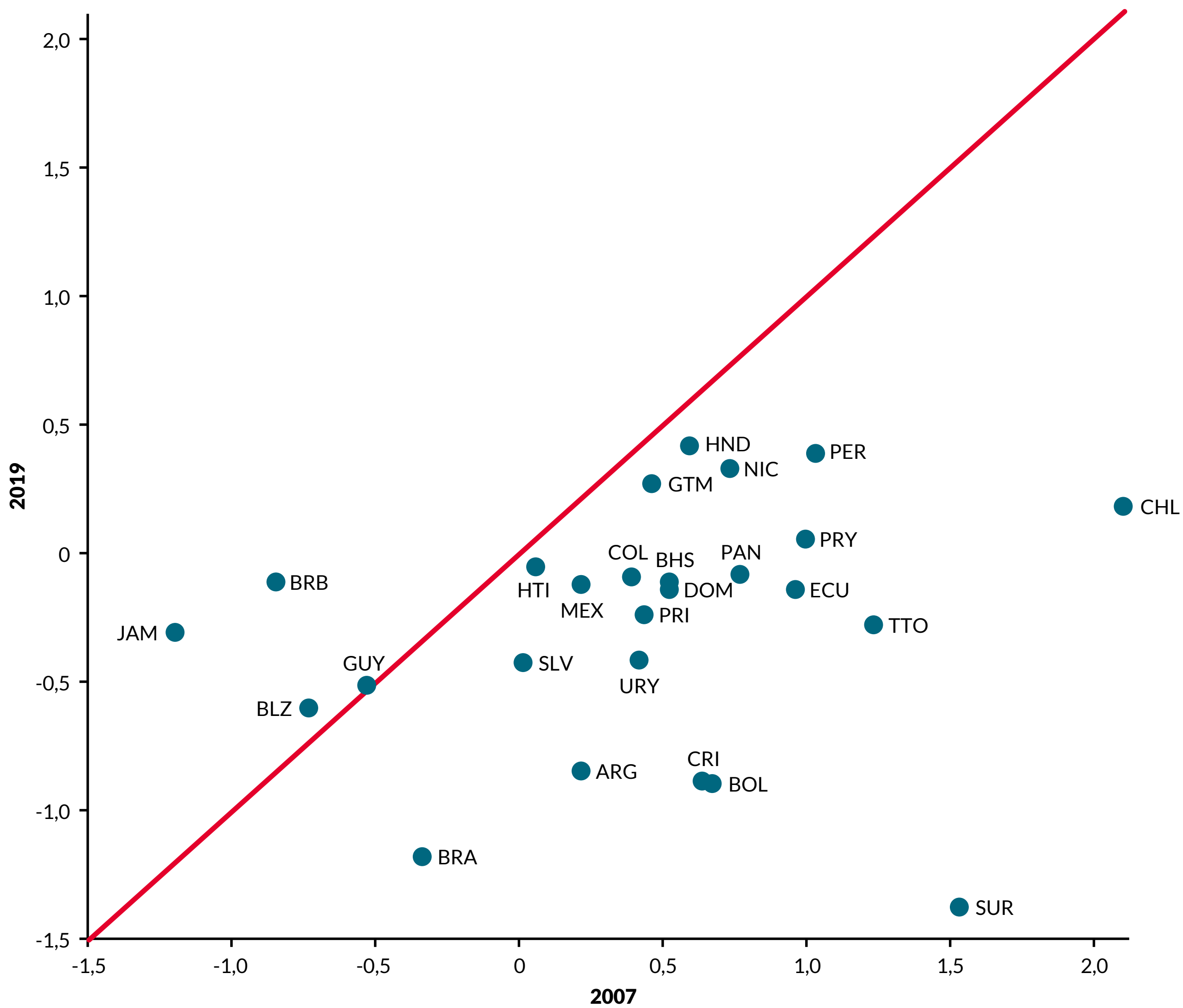
In several countries, the strength of banking systems has been enhanced within stronger monetary policy frameworks. For example, several countries (e.g., Brazil, Chile, and Colombia) have been operating inflation targeting regimes with highly flexible exchange rates for many years. Peru and Uruguay also have inflation targeting regimes, albeit with less exchange rate flexibility.[9] More recently, countries such as Costa Rica, Guatemala, Jamaica, and Paraguay have also been moving towards inflation targeting. This trend allowed for greater central bank independence, higher credibility, and the anchoring of inflation expectations.[10] In many cases, international reserve positions were also strengthened. Despite these advances, domestic savings in Latin America and the Caribbean remain low by international standards. And both assets and liabilities on bank balance sheets tend to be relatively short-term. Long-term loans such as mortgages have grown, but volumes remain low by international standards.[11] The public is still hesitant to save in long-term domestic currency instruments. Even in Chile, where the volume of longer-term domestic currency debt contracts is larger, much of it remains indexed to inflation rather than being denominated in nominal domestic currency units. And while central bank and financial supervisory independence has advanced in some countries, it remains a work in progress in others.

7. IMF (2007).
8. Fitch Ratings (2020).

9. Uruguay has experimented with alternative instruments and while it has maintained an inflation targeting framework, inflation rose above the target in several instances.
10. See Mariscal, Powell, and Tavella (2018) for evidence regarding how inflation expectations became more anchored.
11. See Grigoli, Herman, and Schmidt-Hebbel (2015) and Cavallo and Serebrisky (2016).

In contrast to stronger monetary policy frameworks in several Latin American and Caribbean countries, the fiscal stance has deteriorated significantly in the region. Compared to the pre-global financial crisis period, when a number of countries enjoyed fiscal surpluses, the COVID-19 crisis found most countries with much weaker fiscal positions. Nevertheless, fiscal strength varies widely across countries (see Figure 2). Argentina, El Salvador, and Ecuador have greater debt, higher financial requirements and more debt in foreign currency than Chile, Colombia, Guatemala, Honduras, Mexico, and Peru. The first group, then, has very limited fiscal space to respond to the current crisis. Interestingly, some countries with weak macroeconomic fundamentals appear to have strong banking systems, at least according to traditional indicators. In an environment of weaker economic fundamentals, banks need to maintain high liquidity and capital levels. In some countries, however, even before the pandemic,

Figure 2. Indicator of fiscal strength: 2007 vs 2019



Notes: The indicator of fiscal strength is the average of the following two components, both standardized within Latin America and the Caribbean: general government gross debt (% of GDP) and fiscal balance (% of GDP). The higher the indicator value, the stronger the country in terms of fiscal space. Venezuela is an outlier and is excluded from the figure.

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

sound banking indicators were not necessarily associated with high levels of credit to the nonfinancial private sector since banks were holding large quantities of public sector assets (government bonds) on their balance sheets. In these countries, therefore, despite strong traditional indicators such as liquidity and regulatory capital ratios at the onset of the pandemic, the banking system might not have played an important role in providing credit to the economy.

Given the initial conditions and the identified constraints, country authorities have been very active in providing relief to families and firms during the pandemic. Support has been delivered through a variety of fiscal measures, including transfer programs. Existing and relatively well-developed social assistance systems based on targeted cash (typically conditional) transfers to poor households have been expanded, and in some cases, conditions have been relaxed to extend funds rapidly. In addition, quasi fiscal measures, such as government credit guarantees and other contingent liabilities, have been put in place to support firms, particularly medium, small, and micro enterprises. In some countries, public banks have been actively engaged in providing credit.

Central banks have lowered policy interest rates, intervened in foreign exchange markets, reduced liquidity requirements (or reserve requirements) held at the central bank or elsewhere, and provided additional liquidity to banks. Some central banks have also extended liquidity to banks through repo or other operations. When their charters so permit, some central banks have also bought securities in secondary markets.

Banking supervisors have also been active. Many countries have facilitated some form of loan moratoria such that loan repayments need not be made for a particular period. In some countries, the rules on loan classification and provisioning have been relaxed and in others, while rules have not ostensibly changed, supervisors have exercised discretion, allowing banks to provision less than those ex ante rules might otherwise have dictated.[12] Tables 1a and 1b summarize fiscal, monetary, and financial sector policies undertaken since the onset of the pandemic.

International financial institutions are moving quickly to provide additional funds to mitigate the effect of the crisis. The IMF, for instance, has already provided emergency financial assistance to 15 countries in Latin America and the Caribbean through the Rapid Credit Facility (RCF) and the Rapid Financing Instrument (RFI). By the end of July 2020, the IMF also extended the arrangement under the Extended Fund Facility (EFF) for Barbados and approved greater access to the Stand-By Arrangement (SBA) and the Standby Credit Facility (SCF) for Honduras.[13] The IMF also recently renewed existing flexible credit lines (FCL) with Colombia and Mexico and established new FCLs with Peru and Chile. A Short-term Liquidity Line (SLL), which is a renewable credit line without ex post conditionality for countries with strong fundamentals and policy frameworks, is also being made available.[14] Multilateral Development Banks are also providing support through new operations in critical sectors and by redirecting funds from existing projects to measures to deal with the COVID-19 crisis. The World Bank and the Inter-American Development Bank (IDB) have approved additional lending for 2020, as has the Development Bank of Latin America (CAF).[15]

Central banks are also being assisted by bilateral partners. To ensure the provision of U.S. dollar liquidity, the Fed extended swap lines to Brazil and Mexico and established a dollar repo facility for countries that are not participating in these swap lines. Through the foreign and international monetary authorities, or FIMA Repo Facility, it lends dollars to foreign central banks in exchange for U.S. Treasury securities through overnight repurchase agreements (repos). However, the amounts of these repo agreements are usually

12. See Standard and Poor's (2020).
13. See IMF (2020b).
14. Okamoto (2020).
15. IDB (2019).

limited.[16] There are also other bilateral swap lines to central banks in the region.[17]

As the COVID-19 crisis hit, Latin America and the Caribbean had a relatively weak fiscal position that limited the extent of governments' responses. However, most relevant for this report, financial systems were in good shape and banks had significant buffers in terms of capital and liquidity. Still, the deep declines in economic activity pose serious risks. The next section presents selected issues related to how to manage the shock and offers specific recommendations.

16. See Feldberg (2020).
17. See Okamoto (2020).

Table 1a. Summary of fiscal policies to deal with COVID-19

	Transfers to households	Reduction/deferral of labor taxes and social security contributions	Reduction/deferral of other taxes	Guarantees and other credit support programs	Salary compensation to workers
Argentina	X	X		X	X
The Bahamas	X	X	X	X	X
Barbados	X	X		X	X
Belize		X		X	X
Bolivia	X		X	X	
Brazil	X	X	X	X	X
Chile	X	X	X	X	X
Colombia	X		X	X	X
Costa Rica	X	X	X	X	X
Dominican Republic	X		X	X	X
Ecuador	X	X	X	X	
El Salvador	X		X	X	X
Guatemala	X	X	X	X	
Haiti	X		X		X
Honduras	X		X	X	
Jamaica	X		X	X	X
Mexico	X		X	X	
Panama	X	X	X	X	X
Paraguay	X		X	X	
Peru	X	X	X	X	X
Trinidad and tobago	X		X	X	X
Uruguay	X	X	X	X	X
Venezuela	X	X		X	X

Notes: "Guarantees & other credit support programs" includes credit lines for firms and other programs that support credit to SMEs.

Sources: Nuguer & Powell (2020) and internal IDB reports on country policy actions.

Table 1b. Summary of monetary and financial policies to deal with COVID-19

	Reduction in policy interest rate	Intervention in foreign exchange market	Central bank purchase of securities	Reduction in liquidity or reserve requirements	Temporary deferrals on loan payments
Argentina		X		X	X
The Bahamas		X	X		X
Barbados	X	X		X	X
Belize				X	X
Bolivia			X	X	X
Brazil	X	X	X	X	X
Chile	X	X	X	X	X
Colombia	X	X	X	X	X
Costa Rica	X			X	X
Dominican Republic	X	X		X	X
Ecuador				X	X
El Salvador				X	X
Guatemala	X				X
Haiti	X			X	X
Honduras	X			X	X
Jamaica	X	X	X	X	X
Mexico	X			X	X
Panama					
Paraguay	X	X		X	X
Peru	X	X		X	X
Trinidad and tobago	X	X		X	X
Uruguay		X		X	X
Venezuela					

Notes: "Temporary Deferrals of loan payments" may be voluntary or mandated by the supervisory authority.

Sources: Nuguer & Powell (2020) and internal IDB reports on country policy actions.

Section III.
Financial Systems to Support the Economy through and beyond the Pandemic: Key Issues and Recommendations

Given the unprecedented events in the region, a deep economic contraction, and uncertainty about the pace of recovery, banks will likely act conservatively and attempt to defend their solvency and liquidity positions.[18] At the same time, keeping credit lines open and providing temporary liquidity and credit would help families and firms manage the crisis. On the one hand, policymakers want to help families that have lost income and maintain as much of the productive economy intact during lockdowns and ready for the recovery phase. To do so, they will look to the financial sector to complement direct fiscal support, such as transfers. On the other hand, some of these efforts may risk financial instability or generate a financial crisis which, based on past experiences, would most likely turn what is hoped to be a temporary crisis into a potential depression or another lost decade. This document identifies the main issues associated with the pandemic that threaten the stability of the financial sector and could prevent banks from playing an effective role in supporting the economic recovery.

18. See Nuguer and Powell (2020) for an analysis of how banks have maintained stable capital ratios in recent years by restricting credit and reducing risk in bad times.

Currency Mismatches, Corporates' Refinancing Needs, and Monetary and Liquidity Policies

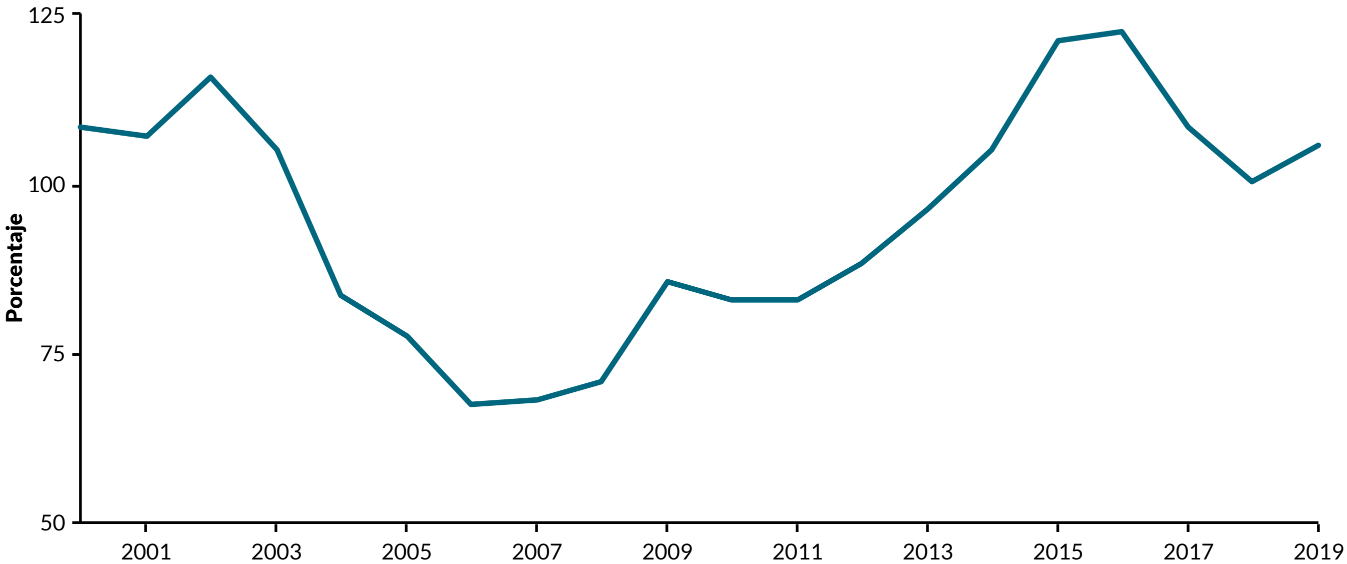
Central banks have been active during the pandemic. Given the credibility built up in many monetary regimes across the region, central banks have been able to reduce interest rates and expand liquidity by other means without de-anchoring inflation expectations. However, a number of characteristics, shared with other emerging market economies, challenge central bank efforts to support the economy during the pandemic. Three such constraints are the presence of currency mismatches, corporations' external refinancing needs, and central banks' limitations to undertake quantitative easing-like policies.

Currency Mismatches

A risk to allowing the exchange rate to fluctuate is that the exchange rate overshoots with a sharp depreciation, especially in the event of strong portfolio or other outflows, as happened in March 2020. High currency volatility can create risks for financial systems, especially in the presence of currency mismatches.

Latin America and the Caribbean has faced significant vulnerabilities given currency mismatches on both the public and private sector's balance sheet. In periods

Figure 3. Debt denominated in US$ as a percentage of exports



Notes: The figure shows the ratio of the average USD-denominated outstanding debt (USD billion) for Brazil, Chile, Colombia, Mexico and Peru in relation to the average of exports (USB billion).

Sources: BIS locational banking statistics (by residence); BIS debt securities statistics; United Nations Comtrade Database on international Trade Statistics.

of growth or stable exchange rates, mismatches are not an issue; but in economic downturns, if dollar liabilities are high relative to assets, the depreciation of a currency will increase the debt burden of countries and firms. By negatively affecting balance sheets, unexpected exchange rate movements amplify risks to financial stability. It is no surprise then that during the currency crises of the 1990s, countries with large currency mismatches suffered the deepest losses.[19]

In Latin America and the Caribbean, the aggregate economy-wide mismatch ratio, including both the official sector and the private sector, decreased in the first decade of the 2000s.[20] However, as can be seen in Figure 3, the currency mismatch ratio has risen since 2010, and the region has become more vulnerable to currency volatility.

Currency mismatches can raise vulnerabilities on both public and private balance sheets. In general, public sectors have seen both foreign currency assets (such as reserves) and debt rise. As financial integration proceeds, the dollar assets and liabilities of private sectors also tend to increase. However, considering aggregate figures for the private sector can hide vulnerabilities as the issuers of the debt are not necessarily the owners of the assets.

Historically, currency mismatches in the private sector were driven largely by firms in the non-tradable sector that contracted debt in foreign currency.[21] Firms operating in the tradable sector with dollar income are regularly considered to have a natural hedge against currency movements. However, since the eruption of the pandemic, firms in the tradable sector have lost much of their foreign currency revenue. Firms exporting commodities have seen commodity prices fall. The value of the natural hedge for such firms has thus decreased; on the one hand, they suffered the income loss and on the other their foreign currency debt has risen as a percentage of local assets given currency depreciations.[22]

19. Goldstein and Turner (2004).
20. Chui, Kuruc, and Turner (2016).
21. This was considered less of a problem in the tradable sector as firms have natural hedges through foreign currency revenues (Alfaro et al., 2019). However, given the collapse in trade, those natural hedges have largely disappeared for the moment.
22. See Rojas-Suarez (2020) and Nuguer and Powell (2020).

Corporations' External Refinancing Needs

While cross-border bank lending remains significant, many emerging economies have seen a shift to bond financing. Corporates have tended to issue greater volumes of bonds, mostly denominated in dollars (which has contributed to the rise of currency mismatches) and with longer maturities, thereby taking advantage of low long-term interest rates. While lengthening maturities has the advantage of reducing roll-overs, bunching of maturities may occur at particular dates. Considering the amortization schedules of bonds issued in the region, 2021 appears to be something of a "crunch" year, when many bonds will come due. If corporations cannot roll over such bonds, they may be forced to seek loans from local banks, which can have knock-on effects for the availability of credit to smaller enterprises. Moreover, if corporations have trouble repaying international borrowing, then, as they are also likely borrowers in the local financial system, credit risks for local banks will rise.

In addition, the rise of corporate external borrowing in international capital markets over the past decade has provoked a set of more opaque risks that lie outside standard regulatory frameworks with potential impacts for financial stability. Not all the proceeds of corporations' external borrowing were used for real investment. In some countries, firms deposited a share of the proceeds in local financial systems, often in local currency. Part of the increase in financial system depth in the region has then been funded by greater corporate deposits with nonbanks acting effectively as financial intermediaries.[23] But such deposits are frequently the first to flee when conditions change. If international market conditions shift and firms are prevented from rolling over international debt (or it becomes too costly to do so), then they will draw down their deposits in the local financial system that are normally of relatively short maturities to fund repayments or attempt to increase borrowing from the local financial system. Such times, which are likely moments of stress, may arise just as banks start to protect their liquidity and capital buffers and just as the demand for liquidity and credit rises more generally.

Quantitative Easing

Central banks in advanced economies have made significant asset purchases (buying government and private securities) to provide greater liquidity to markets. In Latin America and the Caribbean, central banks are typically highly constrained in terms of asset purchasing. Given the history of high inflation in the region, fueled largely by central banks financing fiscal deficits, most central banks can purchase only limited quantities of government bonds on secondary markets and at market prices. Moreover, given the history of financial crises and costly bailouts of both banks and borrowers, many central banks are prohibited from purchasing private sector assets.

However, given the high levels of credibility built by some monetary regimes in the region, a question is whether it is time to relax such constraints and allow central banks greater freedom to conduct quantitative easing-type operations. Some central banks are already moving in this direction. In Brazil and Costa Rica, the central bank charter has recently been changed as a result of the crisis to give greater freedom to the central bank to purchase public and private securities on secondary markets. In other countries, discussions along these lines are underway.[24]

Asset purchases of public securities may provide stimulus by injecting liquidity in these markets and may allow central banks to alter longer-term interest rates and shift the term premium; adjusting the policy interest rate would have a greater impact on short-term interest rates. Indeed, maintaining policy rates and purchasing government bonds at longer maturities may provide stimulus with a lower risk of an exchange rate overshoot. Asset purchases of government bonds may also help remove tail risks from the local bond market

23. See Powell (2014), Caballero, Panizza, and Powell (2015) and Bruno and Shin (2017).

24. See IIF (2020).

and if so, could even attract foreign investors back into domestic markets and strengthen the currency.

Recommendations

A. Central bank credibility has been an important asset for many countries, allowing central banks to lower interest rates and inject liquidity without de-anchoring inflation expectations. Countries should seek to maintain central bank independence and build credibility which could well be important to reverse the extraordinary measures taken as the health crisis abates.

B. The COVID-19 crisis has provoked new types of financial risks, some beyond the normal purview of central banks. Central banks need to take a holistic and systemic view of the liquidity and solvency risks faced by different sectors of the economy, including the financial sector, and understand the various interconnections, including those generated by currency mismatches and second round impacts of payments of dollar liabilities. Central banks should monitor and, where possible, model such risks.

C. Regulations that limit banks from carrying currency mismatches and only allow dollar lending to tradable firms have served a useful purpose. All countries should consider introducing regulations that establish direct limits on such lending or require adequate capital buffers to manage the risks. Still, as shown by the current crisis, these regulations do not protect exporting firms from losing dollar receipts if they are commodity exporters and commodity prices fall. Given the collapse in trade, these regulations have not protected firms in the current crisis. Some countries ask all firms to report all debt issued in foreign currency and all foreign exchange transactions including swaps and forward contracts. This is a good first step so authorities can monitor the risks.

D. But reporting may not be enough. Central banks should develop ways to model the various risks and conduct stress tests on how firms' external issuance may impact different sectors including financial systems. While acknowledging practical problems such as the possibility of arbitraging regulations (and recognizing that some trade agreements unfortunately include the commitment not to restrict some types of investment), authorities should consider introducing macro-prudential measures where those risks appear significant. In the coming months, some firms may have to restructure externally issued debt. Authorities should facilitate such restructurings as required, taking into account the potential impacts on local financial markets.

E. Governments considering changes in central bank charters to allow for greater asset purchases of public or private securities, should recognize the limitations and risks of such policies. In general, the restriction found in many countries that central banks can only buy government securities on secondary markets is sound. Only if critical markets are in danger of drying up for a lack of liquidity should central banks contemplate relaxing such restrictions and buy private securities. An exception for securities issued by banks (or other financial institutions) may be relevant to contemplate in the context of central banks' function as a lender of last resort to the financial system; but even if such an exception is made, central banks should respect the standard recommendations for such operations. Central banks should aim to provide liquidity and avoid monetary financing of fiscal deficits or taking private sector credit risk on their balance sheets.

F. Central banks should ensure they have adequate hard currency liquidity on hand and would be well advised to negotiate with bilateral and multilateral partners to boost access to hard currency liquidity preemptively. Countries should actively consider applying for the IMF's Flexible Credit Line or a regular Stand-By Agreement, depending on the strength of their fundamentals. Such contingent lines can backstop central bank reserves and be used to inject additional liquidity into markets if needed. They should not be used to transfer the liabilities of insolvent borrowers to the central bank or to the government.

Fiscal Transfers and Fiscal Budgeting

This report focusses on ensuring the effective contribution of financial systems during the pandemic, while safeguarding its stability; thus, it does not comprehensively review all the fiscal policy actions being taken across the region. Suffice it to say that fiscal authorities have been active in attempting to provide relief to families and firms given the fiscal constraints identified in section II. Table 1a summarizes these fiscal measures. The average fiscal package introduced due to the COVID-19 crisis is around 3% of GDP, but there is considerable heterogeneity across countries with some correlation between the size of the announced package and the available fiscal space; Chile and Peru announced relatively large packages while, for example, countries in Central America and the Caribbean with more limited fiscal space, announced smaller packages. While announced fiscal packages are on average around 3% of GDP, actual fiscal deficits will not necessarily increase by this amount. Indeed, the size of the fiscal deficit is uncertain. On the one hand, some programs may not be taken up 100% and some may be financed by cutting spending elsewhere (typically in public investment) or through efficiency measures. On the other hand, in some countries, governments may announce additional public expenditures. Moreover, in practically all countries in the region, the projected decline in economic activity will likely result in a significant decline in fiscal revenues and put upward pressure on the deficit.

Regarding actual policies, money transfer programs to assist poorer families have been expanded or new programs have been created. However, governments in some countries have had trouble reaching the poorest segments of the population because of inadequate financial inclusion and underdeveloped payment systems. Indeed, low financial inclusion is an entrenched problem in many countries in the region.[25] As shown in the literature, the difference in the probability of being financially included between the richest and the poorest individuals is significantly higher in Latin America than in comparator countries.[26]

Notwithstanding, some transfer programs implemented or expanded since the onset of the pandemic have the potential to boost financial inclusion by: i) facilitating the opening of bank accounts (as in Costa Rica and the Dominican Republic); ii) encouraging the usage of digital platforms (mobile money and e-wallets as in Chile, Colombia, Paraguay, and Peru); and iii) using ID cards as a way to deliver the transfer, which may lead to improvements in the ID systems that are crucial for increasing digital financial inclusion and the use of the ID card as an e-wallet (as in the Dominican Republic, Panama, and Paraguay). Table 2 provides some examples.

Many countries have also announced packages to help firms, particularly those in vulnerable sectors. These programs have typically consisted of tax breaks or deferrals of taxes or social security payments or other incentives for firms to keep employees on their books (see Table 1a). Fiscal authorities (often in coordination with central banks and bank supervisory authorities) have also announced programs to provide incentives for banks to maintain credit lines open or to stimulate new credit. Such programs typically consist of guarantees offered to banks, with a special emphasis on trying to encourage credit to micro, small, and medium-sized enterprises. Guarantee programs are discussed in a subsection below. Here, however, the point is that, often, guarantees are not included in the fiscal deficit estimates or projections and they may be budgeted “below the line,” on the balance sheet of some public entity (such as a national guarantee fund or a public bank). As countries are not making adequate provisions in budgets for expected losses, the true financing needs may be underestimated and budget deficits may end up being higher than anticipated.

25. See Didier and Schmukler (2013) and Rojas-Suarez (2016).

26. See Rojas-Suarez and Amado (2014).

Table 2. Monetary transfers and delivery methods in selected countries

	Number of programs	Cash payments	Bank account transfers	Electronic and innovative methods	Programs that have the potential to foster financial inclusion
Chile	2	Withdrawal	Transfer	Mobile banking	Ingreso Familiar Emergencia and Bono Emergencia COVID-19
Colombia	3	Withdrawal	Transfer	Mobile banking	Ingreso Solidario
Costa Rica	2		Transfer*		Subsidio de Emergencia
Dominican Republic	3		Transfer*	Transfer to ID card	Comer es primero (Expansión), Plan Quédate en Casa, Fondo Asistencia Solidaria al Empleado (FASE)
Panama	1			Transfer to ID card	Bono Solidario – Vale digital
Paraguay	3	Withdrawal/ATM	Debit card	E-wallet (in some cases ID related)	Tekoporã; Ñangarek; and Pytyvo
Peru	4	Withdrawal/ ATM and direct distribution	Transfer	Mobile banking	Bono Rural and Bono Familiar Universal

Notes: * Transfers in the Dominican Republic and Costa Rica include the opening of an account for those individuals who did not have one.

Source: Authors' elaboration based on national sources.

Recommendations

A. Given the extension of transfer programs to poorer families, authorities should consider payment modalities that boost financial inclusion, reduce the use of cash, and formalize payments. One possibility is to combine the offer of a free simplified bank account or free mobile money account with basic programs of financial education. Limits on transactions and on balances in simplified bank accounts can also be temporarily increased when needed.

B. To encourage the use of mobile money accounts for small payments and transfers by the poorest segments of the population, authorities should work with financial service providers to reduce or eliminate fees associated with these transactions. Temporary subsidies should be considered for this purpose.

C. Congress and policymakers should seize the opportunity to enact and implement pro-financial inclusion regulations, especially by reducing existing entry barriers to alternative providers of (small) retail payment services that can reach poor populations without threatening systemic financial stability.[27]

D. Guarantee programs that provide incentives for banks to maintain credit lines should be transparent and budgeted according to appropriate rules on contingent liabilities and reasonable provisions for losses should be made (as in the recommendations advanced in the IMF Manual on Fiscal Transparency).[28]

Loan Classification, Moratoria, and Restructuring

Loan Classification

An issue faced by many supervisors is whether to change actual regulations or maintain regulations as they are but exercise discretion regarding compliance. This issue is highly relevant for loan classification

27. See Claessens and Rojas-Suarez (2016).
28. IMF (2007).

and provisioning. Many countries in the region have large and sophisticated public credit bureaus, typically developed in the first instance to control loan quality and provisioning. Most such systems have several categories for new and performing loans, especially for lending to firms, and banks are requested to select the appropriate "rating" depending on an ex ante analysis of expected loss.

While credit risk has risen, current regulations in many countries allow the risk classification of loans to remain unchanged. Yet, the highest quality category might not be appropriate for many new loans given the uncertainties provoked by the COVID-19 crisis. The question becomes whether the rules should be changed or compliance under the current rules should be made more flexible. This decision has implications for provisioning requirements for banks.

Related to this discussion is whether banks should continue to report and disclose according to previous loan standards or whether disclosure and reporting should also be subject to some supervisory flexibility.

Loan Moratoria

A danger is that the measures currently being enacted in some countries to respond to the COVID-19 emergency may be treating the crisis more as a temporary liquidity shock than a deeper issue involving a significant loss of income. For example, loan moratoria, defined here as a deferral of loan repayments (sometimes known as a payments holiday), have been implemented in several countries.

In some cases, these moratoria are voluntary; they are agreed to between the bank and borrower as part of a loan reprogramming agreement. In other cases, they are mandated by supervisory authorities, or through other legal channels such as a law or a decree. Even when they are voluntary, supervisors have in some cases provided incentives by changing provisioning rules or exercising discretion over how to apply provisioning rules in the case of such moratoria. Typically, banks continue to report loans subject to such moratoria as performing and are not required to set aside additional provisions for potentially greater future losses, although some banks are indeed building up provisions as part of their own risk management. The duration of such moratoria has already been extended in some countries.

An issue with loan moratoria, especially if prolonged, is that banks and supervisors may lose information regarding the true nature of the risks in financial systems. Clearly, credit risk has risen but without the discipline of regular payments, banks may not be able to monitor risks effectively. If loan classification and reporting rules become flexible, then authorities will be unable to assess credit risk. Moreover, if banks are not required to make additional provisions, they may not be building up sufficient reserves to face future losses. Such moratoria raise three issues: whether they should be used; if they are used, whether they should be voluntary or mandated, and whether they should last for only a short period or for many months.

Table 3 provides information on the policies countries have implemented in relation to loan moratoria and loan restructuring.

Loan Restructuring/Reprogramming

Several countries have already announced regimes by which bank loans can be restructured or reprogrammed, which here refers to a simple extension of maturities and the introduction of a grace period while restructured implies a reduction in interest and/or capital payments. In those countries where moratoria continue for a prolonged period of time and no restructuring plan is in place, many borrowers will likely be unable to make good on missed payments and some form of loan restructuring will be needed.

In general, countries face alternatives ranging from less intrusive to more intrusive arrangements for such restructurings. The least intrusive option is simply to let banks and their clients restructure loans as required on a voluntary basis. This restructuring might range from extending maturities to providing actual relief in terms

Table 3. Summary of loan moratoria or loan restructuring/reprogramming measures

	Argentina	Bahamas	Barbados	Brazil	Bolivia	Chile	Colombia	Costa Rica	Dominican Republic	Ecuador	Honduras	Jamaica	Mexico	Paraguay	Peru	Uruguay
1. Facilitate payment deferrals		X	X		X					X		X				X
1a. No provisioning required					X					X						
1b. No change in loan classification		X	X		X					X						X
1c. No additional fees		X	X		X					X						
2. Facilitate restructuring/ reprofiling/reprogramming				X		X	X	X	X				X	X	X	
2a. No or reduced provisioning required relative to normal standards				X		X	X	X	X				X	X	X	
2b. No change in loan classification				X		X	X	X	X				X		X	
2c. No additional fees						X	X	X					X	X		
2d. Grace period/deferral						X	X	X	X				X			
3. Mandated payment deferrals	X				X						X					
3a. No provisions required	X				X						X					
3b. No change in loan classification	X				X						X					
3c. No additional fees	X				X						X					

Notes: Bolivia facilitates for high value loans, mandated for low value loans. Paraguay only allows financial institutions not to provision only for new loans between March 16 and December 31 2020.

Sources: National authorities, IMF and KPMG.

of lower interest or capital repayments. Relying on this least intrusive option may make sense for larger loans to medium-sized and larger firms that can be considered on a case by case basis, but may be insufficient or infeasible for large numbers of smaller consumer loans or loans to smaller companies. While under this less intrusive option such restructurings may be voluntary, supervisors can offer incentives to agree on new loan terms; they can publish how such restructurings will be treated in terms of additional provisioning or how such loans will be charged off, which might include less stringent terms than under normal rules. If they restructure, banks will effectively dip into current capital buffers, smoothing the impacts on their balance sheets. Thus, the benefit of this less intrusive option is that loan restructurings can be tailored to actual requirements, thereby limiting restructurings and minimizing the impact on banks. A danger is that if banks have considerable market power and clients and borrowers facing difficult financial positions cannot easily switch to other lenders, then banks may attempt to exploit that power. Still, in general, it will not be in the interest of a bank to make the terms of restructurings so harsh that financially strapped clients fail and default, especially given the delays and costs in most countries of seizing any underlying collateral.

In the case of many small consumer loans or loans to small or micro enterprises, banks may be encouraged to offer standardized restructuring terms to groups of loans. Again, supervisors can provide incentives by offering a provisioning regime for loans included in such restructurings that is more flexible than standard rules.

A more intrusive option is for supervisors to mandate loan restructurings. Inevitably, such mandates will be more standardized. Still, mandated restructurings can be tailored to some degree. The parameters of the restructuring may vary depending on the type or size of loans or the type of clients. Such mandates may be restricted in certain ways, such as only applying to loans in good standing before any moratorium was announced. Supervisors need to assess how to treat such restructurings in terms of provisioning and rules regarding charge-offs. Again, some relaxation of normal rules could smooth the impacts such that banks need not increase provisions dramatically during this time of stress; on the other hand, bank buffers may be reduced over this period. The drawback of mandated (and more standardized) restructurings is that loans that need not be restructured will be restructured anyway while other loans will be restructured along standardized terms that may not be sufficient. Standardization is, then, inefficient as each restructuring is not tailormade to the individual circumstances of the client and the loan in question. The advantage is that standardized restructurings tend to be easier to implement, are considered by some to be "fairer" (as restructurings are on similar terms), and may be seen as defending smaller clients that feel they are at a disadvantage when negotiating with banks with local monopoly power.

Consider Argentina's 2002 asymmetric pesification[29] (which was in effect a standardized loan restructuring) compared to the more loan-by-loan tailor-made approach adopted by Ecuador for corporate loans following its maxi-depreciation and subsequent dollarization in 2000. The policies in Argentina were highly inefficient, bailed out many clients that did not need restructuring, and wiped out most of the capital of private banks. The approach in Ecuador was more efficient in focusing restructurings where they were truly needed and appeared to work relatively well.[30]

More generally, supervisors and central banks must strike a difficult balance between allowing banks to dip into capital buffers over this period and ensuring confidence in the solvency of the financial system. Clearly, banking supervisors and central banks will have to work closely together to determine the appropriate policies. In some countries, politicians have also joined the debate, calling for widespread debt relief. Unfortunately, such calls are frequently made without due diligence as to their impacts on banks and the risks to financial stability. Central banks and supervisors must be proactive to stave off such political moves, especially while banks have some buffers (as outlined in the introduction to this report). Widespread debt relief could reduce bank capital to dangerous levels, threaten confidence in the financial system, and likely entail compensatory fiscal measures to assist banks.

Recommendations

A. The independence of banking supervisors should be maintained. To ensure bank supervisors and central banks know the risks individual banks and the financial system are facing, banks should be asked to assess and report the risks to outstanding loans to determine who will—and will not—be able to honor their debts in a timely manner. These reports should follow standard regulations and procedures; loan reporting standards should not be diluted.

B. The frequency of supervisory stress tests should be increased, and appropriate scenarios should be developed given the uncertainty regarding the pandemic. Stress tests should be used pro-actively to

29. The 2002 mandated asymmetric pesification converted loans denominated in U.S. dollars on bank balance sheets to Argentine pesos at an exchange rate of 1 to 1 and U.S. dollar denominated deposits held in banks to Argentine pesos at an exchange rate of 1.4 to 1. The exchange rate depreciated from 1 to 1 against the U.S. dollar to more than 4 Argentine pesos to 1 U.S. dollar in this period.

30. On Ecuador see IMF (2000); on Argentina see Powell (forthcoming).

detect banks that may deplete their capital buffers and ensure a plan is in place to rebuild those buffers over a period of time. Early intervention is key to prevent problems in specific institutions from becoming more systemic.

C. Wherever feasible, supervisors should maintain regulations on capital, provisioning, and liquidity but exercise discretionary forbearance where needed on a case by case basis. Suspension of backward-looking provisioning rules that do not consider expected losses may be justified during this period of exceptional uncertainty. However, in general, loan-loss provisioning should continue to be on an expected loss basis to ensure transparency. If this drives capital ratios below regulatory minima, it should be tolerated during the pandemic since capital buffers are intended to be used during exceptional periods for unexpected losses. Capital buffers can be restored in subsequent months. However, the operation of an undercapitalized bank should be subject to the overarching control of an official administrator to prevent asset-stripping.

D. A significant problem with a moratorium (meaning a simple deferral of payments), is that the likelihood of a required restructuring increases with time. Such programs hide the true state of the financial system and create uncertainty over the solvency of banks. Loan moratoria, if used, should be temporary in nature.

E. Payment deferrals will likely be insufficient and some fraction of loans will need to be restructured in most countries. Authorities should seek less intrusive options to restructure loans. Supervisory authorities can set up and publish a special loan restructuring regime that banks can adopt on a voluntary basis. This regime may provide details on loan categorization and provisioning.

F. Supervisors and central banks should be proactive in stimulating regimes for loan restructuring. In some countries, there have been calls for widespread debt relief, which would likely be inefficient and may jeopardize financial stability.

G. An extensive program of debt relief would likely require a complementary fiscal program to bolster banks. Assuming adequate fiscal space, a better approach would be targeted fiscal programs to assist families and viable firms directly.

Assisting Viable Firms: Guarantees vs. Other Instruments

Guarantee Programs

Loan guarantee programs have become popular with governments to support firms in difficult times without having to provide cash immediately. Yet they can ultimately be costly to the budget if offered extensively. In theory, the costs can be contained by ensuring that the lender (typically a bank) carries some of the risk of the loan as the bank has an incentive to select the borrowers most likely to repay; however, when uncertainty is high and banks perceive a high risk of loan losses, take-up may be low.

In some cases, the headline announcement of such programs indicates that they may be very large; for example, in Chile, Colombia, and Peru, programs of around 6% of GDP or more have been announced. These programs raise several issues. Unfortunately, the crisis has elevated credit risks substantially; consequently, losses on such programs are likely to be significant, particularly if guarantees cover a large proportion of any loan. At the same time, unless guarantees cover a very large proportion of the loan (close to 100%), banks are unlikely to lend beyond the safest customers, due to high perceived credit risks. But if guarantees are 100%, banks will have no incentive to seek information to select viable firms, fiscal losses will be even larger, and the scheme will not help reallocate resources in the economy towards those firms or sectors with greater potential.

In addition, banks may not always use the guarantees as intended. If banks know loan default probabilities,

Table 4. Guarantee schemes in selected countries

	Credit allocated (billions of local currency)	Total credit available (billions of local currency)	Total allocated/ total available (%)	Total allocated/ GDP (%)	Program size/ GDP (%)	Date
Chile	7,800	18,412	42.4	3.6	8.5	July 31
Peru	52	60	86.7	6.8	7.8	August 3
Colombia	6,062	24,217	25.0	0.6	2.3	August 6
Brazil	38	70	54.2	0.5	1.0	July 24

Notes: "Credit allocated" refers to credit that will be supported by guarantees. Figures are not meant to be compared across countries as there is heterogeneity in the reporting (e.g. in Colombia "Credit allocated" refers to credit disbursed, while in Chile and Peru it refers to credit approved).

Source: National authorities.

they may cherry-pick applying guarantees to loans with a higher risk of losses. Arguably, banks may have incentives to place guaranteed loans in default and call the guarantees before they expire.[31]

In practice, countries have announced programs with partial guarantees and some programs require banks to provide substantial information on the borrowers (including cash flow estimates and other indicators of the borrower's risk). These requirements may reflect the fear of fiscal losses and a lack of legal protection for public officials designing such programs. Consequently, in general, the take-up has been low. Table 4 provides information on guarantee schemes and the actual amount of guarantees awarded. International evidence also suggests low take-up in guarantee programs in advanced economies.[32]

Guarantees can be written in different ways: partial or full, first-loss versus pro-rata, and whether guarantees are written on single loans or back a portfolio. Guarantees tend to have greater leverage when applied to a specified portfolio; the public bank, Nacional Financiera (NAFIN), in Mexico has been using this technique for many years.[33] Still, most programs in the region have a simple structure of a single (first loss) guarantee applied to a loan. And programs vary on how the prices of guarantees are set, how they are awarded, and the transparency of the processes involved.

Finally, the question remains whether guarantees are the right instrument given the characteristics of this crisis. Guarantees can be useful to maintain or stimulate credit, but they likely work best in conditions of moderate risk when a partial guarantee preserves banks' incentives to monitor their clients effectively and they can push banks to lend more at the margin. If partial guarantees cannot persuade banks to lend to small or medium-sized firms given the current high degree of uncertainty, guarantees may not be the right instrument and alternatives should be considered. Or guarantees might be employed in a more nuanced way, for example, to support medium-sized or even larger firms that are facing difficulties but that should be viable in future months; in other words, they will likely survive the crisis. In other cases, the guaranteed pandemic loans could be designed to be converted (or converted ex post) into an equity (or other form of profit-sharing) stake in a firm that finds itself over-indebted post-pandemic.

Alternative Instruments

Analyses of firms in Latin America and the Caribbean reveal a long tail of small enterprises that account for a substantial fraction of employment. Many of these small enterprises are informal and have had no or limited access to credit. Many such firms are in the service and retail sectors and have had to close down, hopefully temporarily, due to the lock downs and have suffered significant losses of income. In general, little

31. See Gobbi, Palazzo, and Segura (2020).
32. See Anderson, Papadia, and Véron (2020).
33. See De la Torre, Gozzi, and Schmukler (2017).

information is available on these firms as they may not have close relations with a bank and are not listed or issue any public security. The only available information comes largely from employment and other surveys. These firms have few alternatives, except for grant funding as fiscal resources permit. An interesting question is whether such grants could be administered in a way that elicits information and provides incentives to register and formalize. In turn, this may then allow them to access credit in the future.

For firms with outstanding bank loans, an important question as moratoria end is whether it is better to allow widespread debt restructuring, which may then entail assisting banks, or firms, or both, directly. Firms might be placed in three categories: i) those that will be viable with little or no loan restructuring and for whom uncertainty is limited; ii) firms that might be viable with significant restructuring of debts (but for whom the outcome is uncertain; and iii) firms that will not be viable, even with significant loan restructuring.

As remarked above, guarantees may be an appropriate instrument when uncertainty is limited (category i); but when uncertainty is high (category ii), alternative instruments may be preferable and it may be better to help firms directly rather than assisting banks that may face large losses from these types of enterprises.

In general, such assistance is expected to be a profitable business proposition, assuming enough of the assisted firms survive and flourish. However, not all will, and uncertainty over which firms will make it and which ones will not is high. In such circumstances, it may make sense for public authorities to offer assistance based on a contract that provides greater returns if the firm does well and fewer returns if the firm does badly. In other words, an equity or equity-like contract may be best. Considering the portfolio as a whole, if an equity-type contract is used appropriately, then fiscal costs may be more limited.

The United States and other countries have taken equity stakes in private companies, most notably during the great depression and following the global financial crisis.[34] However, in the past, Latin America and the Caribbean has fared poorly when the public sector takes equity stakes in private companies. Frequently, these public incursions have been associated with expropriations or bail-outs provided to friends of those in power—crony capitalism—or outright corruption. For this route to succeed, the institutional structure and instruments to be used must be carefully considered.

Three alternatives, each with their own costs and benefits are to i) harness public development banks where they exist i) create a new dedicated institution, or iii) develop a public-private council to guide equity investment by the relevant ministry or public authority.

The experience with public development banks in Latin America and the Caribbean is mixed; However, in some countries, good governance in these institutions has favored lending to good firms that might otherwise have faced a significantly higher cost of credit rather than lending to the politically connected. Under these circumstances, public banks can play a highly constructive role. An advantage of this alternative is that where they exist, these institutions could implement such a program relatively quickly.

During the Great Depression, the United States deployed a dedicated institution known as the Reconstruction Finance Corporation, (RFC). It assisted banks and firms and, interestingly, its activities proved to be profitable. The RFC was particularly useful given the length of the Depression, which of course no one knew at the time. Moreover, it insulated the Fed's balance sheet. In Latin America and the Caribbean, a dedicated institution of this type might also protect against the use of central bank balance sheets in the months ahead. While a new, dedicated institution might be preferable as it could be designed for this specific purpose, creating such an institution would likely take time. This option might be more relevant in the medium term as the health emergency abates.

A third option would be to develop a council of representatives from both the public and private sectors.

34. Calomiris et al. (2013).

This alternative has the advantage of bringing together a variety of views and perspectives to inform the decision-making process and support socially adequate outcomes. Moreover, by definition, the council should only operate on a temporary basis. The challenge of this modality lies in selecting members that ensure objective decisions based on unbiased judgement.

Regardless of which institution is used, any equity positions taken should be temporary—firms should be given several years to buy out the equity—and there should be strict transparency requirements as well as limits on paying out managers or other investors. The institution or council could also be used as a vehicle to instill better management and corporate governance practices in recipient firms in the region.

An alternative to equity is to use an instrument that provides a return schedule similar to equity, at least on the upside, but that does not confer control rights to the holder—for example, a warrant.[35] Such an instrument requires transparency regarding firms' valuations and confidence that a valuation coming from an equity market is a reliable guide to the firm's value. On the one hand, given weaknesses in corporate governance in Latin America and the Caribbean there might be risks for public authorities to use an instrument that does not allow for some control rights. On the other hand, good governance rules could be made a condition for using such an instrument, which could come with certain incentives attached.

Recommendations

A. Loan guarantee programs have been a popular response to support credit in the region but are difficult to implement successfully and are likely only appropriate for certain loans and borrowers. Authorities should consider alternative instruments and decide where guarantees can truly add value while limiting fiscal risks, and where other instruments might be superior.

B. Support to micro and very small firms (typically owner operated and frequently not fully formal) may be best provided through grants rather than loans backed by guarantees. Over time it may become clear which of these smaller and likely informal firms are viable and which are not. In the case of firms that are not viable, grants to those firms should be discontinued. Governments may want to use transfers to support poorer households that have lost income due to these business closures.

C. If banks are deployed to deliver such grants and transfers, then they should be linked to incentives towards formalization and financial inclusion.

D. In countries where public banks enjoy strong governance and risk assessment capabilities, these institutions can complement the role of private banks in channeling credit or other types of assistance to firms. Over time, as the viability of firms becomes apparent, assistance to non-viable firms should be curtailed. Still, given the uncertainty, losses on public bank balance sheets may be significant and assistance to firms should be carefully calibrated to limit the potential fiscal costs of needing to recapitalize these institutions.

E. For firms, tax relief (particularly on labor taxes or on social security payments) may be a better instrument than providing guarantees. The costs and benefits and the complementarities between providing tax relief and subsidized loan guarantees should be analyzed.

F. Guarantees provide greater leverage when they are applied to portfolios. Where guarantees are extended, partial guarantees should be applied on a portfolio basis and implemented in a way that provides incentives for banks to shift lending to smaller firms. Programs should be designed to extend beyond banks in those countries where nonbank intermediaries are relevant sources of funding for SMEs and regulation is adequate. Guarantee schemes should be transparent (auctioning guarantees and making the results of such auctions public is perhaps the model procedure), and the take-up

35. See Stein (2020).

and the type and success of the ultimate beneficiary should be monitored carefully. The operation of the scheme should also be monitored carefully to ensure that its design does not allow banks to cherry-pick the better clients.

G. To avoid overburdening firms with debt, funding may also be provided through equity, or through an equity-like instrument. The most suitable instrument will depend on the firm's financial state, whether it is listed on a stock market, and the depth and sophistication of financial markets. Where capital markets are less developed, the choice of instrument will be more limited and, in some countries, political resistance to the government owning actual equity is strong. If the firm can support more debt, a subordinated debt instrument might be appropriate or where the instrument exists and can be used, preferred stock might be employed. In more sophisticated markets, a warrant or a hybrid instrument—such as preferred stock that converts to a warrant or to common equity if equity prices fall more than a certain limit—might also be considered. An equity-like instrument is helpful to avoid exacerbating debt overhangs, providing the government with upside, rather than just downside, risk and thus mitigating the overall fiscal costs of support packages, especially to firms.

H. The COVID-19 crisis is changing economic structures; some sectors will suffer while others may gain. Investment is needed in areas that might support growing firms and extending assistance in sectors that are shrinking should be limited. Injecting equity (or using an equity-like instrument) may require creating a new institution and/or council to administer the program or adapting an existing institution such as a second-tier public development bank. The private sector arm of MDBs (such as IDB-Invest or the IFC) could play an important role in designing the program, developing the rules, and even assessing which firms should benefit from equity injections. This will be important for the recovery phase and in the medium term might also lead to better corporate governance and deeper capital markets for the future.

I. Considerable expertise is needed to separate companies that are viable from companies that are not. Banks should be better informed about the overall financial status of their corporate clients and, they should make this information available to the institution or council in charge of assessing the viability of firms. Any public assistance provided should be complementary to continued credit being offered by banks and may be conditioned on restructuring the firm's balance sheet to ensure the firm's viability in the longer-term.

Exit Rules for Banks

The COVID-19 crisis will undoubtedly weaken banks' balance sheets. Unlike recent financial crises, in which bank weakness derived mainly from off-balance-sheet and derivatives' losses as well as management deficiencies, in the current situation the challenges likely reflect more standard credit risk, albeit from a novel source. Despite an initially favorable situation with strong bank capital and liquidity positions, income losses for firms and households are likely to translate into significant loan losses.

Unlike most banking crises that take regulators by surprise and force them to react in an emergency, the current situation differs in three ways: i) the banking system starts from a position of strength with solid management; ii) the shock is exogenous to the system; and iii) asset deterioration may be more of a slow-moving train that allows regulators time to develop an adequate response. Therefore, it is particularly important to design adequate bank exit rules that make the resolution of forthcoming bank problems as efficient as possible.

A first question is whether the problems will be limited to a few individual institutions or whether a more systemic crisis could emerge. Both are assumed to be relevant in what follows. A second question relates to objectives and tradeoffs in designing bank exit rules, particularly should a systemic crisis emerge. Any approach should seek three main objectives: i) protect the integrity and functioning of the payment system; ii) protect depositors, particularly small (and presumably uninformed) depositors; and iii) avoid the rapid depletion of bank asset value in lengthy liquidation proceedings and, where justified, keep in place valuable bank-management knowledge and skills. Designing appropriate bank exit rules involves a major tradeoff: on the one hand, the fiscal cost of bank resolution and, on the other hand, the risk of contagion fueled by the perception that government resources are too limited to prevent massive bank bankruptcies.

Impinging directly on this trade-off are two crucial elements: i) the existence and parameters of the deposit insurance scheme in place; and ii) the degree of bankruptcy protection afforded banks by the legal system.

In most countries, creditors cannot force a bank's bankruptcy. That decision (usually called liquidation) is the exclusive prerogative of the central bank, the banking regulator and supervisor, or a judge acting on their behalf.

When designing bank exit rules in developing and emerging market economies, legal instruments must be established that allow for an efficient bank resolution, protect as much as possible bank asset value, and minimize the attendant fiscal costs. One useful instrument is to assign seniority to certain bank liabilities that facilitate meeting the objectives set out above.

Argentina established a new regime for bank liquidation in 1995 that illustrates these issues and turned out to be crucial in successfully managing the systemic banking crisis that ensued in Argentina following the Mexican devaluation of November 1994. This regime is particularly interesting to examine because it was efficiently applied in practice, versions of the regime were copied in other countries, and elements could be applied to others (see Annex 1 for details on the Argentine experience in the late 1990s).

More generally, in 2011 the Financial Stability Board (FSB) adopted a set of key attributes for effective bank resolution regimes[36] and in 2015, the Association of Supervisors of Banks of the Americas (ASBA) conducted a study on the challenges financial authorities in the region face in coordinating members of safety nets.[37] While resolution regimes vary widely in the region, the study identified several common challenges:

- Institutional legal frameworks and coordination arrangements did not make clear distinctions of the responsibilities, scopes, and mandates of each of the participant authorities in a resolution process. Many jurisdictions recognized the need to enact legal reforms to clarify mandates, objectives, and powers.
- Determining the point of non-viability is difficult. Moving away from compliance-based judgments to determine a point of non-viability and trigger a resolution process remains a challenge, since courts may override the decisions of resolution authorities. Although many legal frameworks provided powers to require corrective action and trigger resolution processes based on a wide range of qualitative and quantitative criteria, the majority of supervisors viewed the breaching of minimum capital thresholds as the basis for closing insolvent operations and preparing them for judicial liquidation.
- Treatment of Holding Companies and Financial Groups. Many jurisdictions reported having limited power to create rules for financial holding companies and financial groups or conglomerates. They also lacked authority to develop rules for holding companies that carry out mixed activities.
- Implementing Recovery and Resolution Planning. Most jurisdictions did not require recovery and resolution planning.
- Identifying and Managing Systemic Events. According to survey results, the legal frameworks in many jurisdictions did not provide specific tools for determining the systemic importance of failing institutions.

36. Financial Stability Board (2014).
37. ASBA (2015).

Given the current context, these last two findings are particularly relevant. Depending on the duration of the health emergency and the impacts on families and firms, banks may face significant losses. Banks with weaker balance sheets (typically smaller entities with more concentrated loan books focused on clients hit particularly hard by the fall-out from the pandemic) may need exceptional assistance or may need to be resolved.

In planning for such an eventuality, supervisors could go one step further and design bank corporate structures in advance to facilitate a resolution if required, bearing in mind the objectives outlined above. This might be referred to as a "living will" type arrangement.[38]

When entering a resolution stage, the potential legal risks to supervisors remains an important issue and the lack of effective protections in many countries may limit the effectiveness of the regime in place. In response, countries can develop strategies to defend supervisors: ensuring proper documentation; employing third parties where possible as part of the resolution process and involving the judiciary in specific steps during the process.

Unfortunately, if defaults become widespread, more systemic problems may emerge. Here the issue may not be how to resolve one or two smaller and weaker entities but rather how to keep the payments and financial systems operating despite lower levels of bank capital.

38. Lead supervisors have asked international banks to draw up living wills, although the focus here is more on their international subsidiary and branch structures.

Recommendations

A. Notwithstanding temporary forbearance on capital ratios and early intervention to attempt to restore capital buffers, severe losses by some banks could lead to the need for formal resolution. Authorities should ensure they have an efficient bank resolution regime in place to deal with failed banks and that it conforms to the key attributes advanced by the FSB. Many countries have passed laws to provide new legal frameworks to resolve banks, but those laws need actual regulations to make them effective. Authorities should ensure such regulations are in place and bank resolution can be operationalized quickly if required.

B. In particular, authorities should ensure adequate resolution planning; if weaker entities run into problems, those plans can be put into effect swiftly.

C. The legal protection of supervisors is an important element in the resolution process. Ideally, supervisors should be afforded adequate legal protection under the law. If not, strategies should be developed to ensure that supervisors can mount a strong legal defense for resolution actions if needed.

D. At the time of writing, the possibility that the health emergency continues and the economic fall-out deepens cannot be ruled out. In this scenario, the challenges facing the financial system may become more systemic in nature. It would be useful to have contingency plans in place that define what instruments might be used to support banks in this instance. If institutions are allowed to continue operating with relatively low capital ratios, then authorities should ensure governance mechanisms that also maintain good risk management and avoid perverse incentives.

Annex
Reforms to Argentina's Bank Resolution Process in the 1990s

Argentine legislation provides that a bank liquidation can only be decided by the central bank as the bank regulator. However, once the liquidation is decided, the central bank withdraws the banking license and the bankruptcy is handled by the judicial system, as any other commercial bankruptcy proceeding.

In this context, Congress passed legislation in 1995 allowing the central bank to initiate a bank restructuring/resolution process prior to withdrawing the banking license. In this legislation, three liabilities were given seniority: i) deposits; ii) loans/rediscounts owed to the central bank (provided as lender of last resort); and iii) labor liabilities.

While understanding the seniority of depositors and the central bank is straightforward, the inclusion of labor liabilities may require additional clarification. Labor liabilities were declared senior in order to maintain bank operations during the resolution period, when normally the bank is suspended by the central bank. The objective of keeping the bank operating (despite being prevented from acquiring new assets and liabilities in the suspension period) was precisely to continue collecting on existing assets in order to protect bank value.

With these three liabilities established as senior, the 1995 legislation allowed the central bank to extract from the failing bank a package—of equal value (or zero net value)—composed of all senior liabilities and the best-quality bank assets and sell this package to another bank that would qualify in terms of its capital and liquidity strength. Once the purchase was completed, the residual bank was sent to bankruptcy proceedings in the justice system.

The use of this instrument had the following advantages: i) by taking place before the actual bankruptcy proceeding, it allowed bank restructuring to occur without fiscal costs; ii) in contrast to usually lengthy (universal) bankruptcy proceedings, resolution was made more efficient and timely; iii) it avoided adding unnecessary unemployment, as the assets and liabilities acquired by the purchasing bank included, for instance, the bank branch network and most employees were maintained by the new organization.

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Biographies of Working Group Members

Chairs

Andrew Powell is the Principal Advisor in the Research Department (RES) of the Inter-American Development Bank (IDB). After a DPhil. (PhD) from the University of Oxford, he was an academic in the United Kingdom (University of London and University of Warwick) and Head of Economic Research and Chief Economist of the Central Bank of Argentina. He then joined the IDB's Research Department, was Regional Economic Advisor and returned to RES as the Principal Advisor. He has published many academic papers on diverse topics in leading economic journals. He was recently an invited speaker at the First Latin American Conference on Financial Stability and Sustainability (Peru), at RIDGE (Uruguay) and at LACEA (Mexico). He was editor of the IDB's 2020 flagship on infrastructure.

Liliana Rojas-Suarez is the director of the Latin America Initiative and a senior fellow at the Center for Global Development. She is also an adjunct faculty member and senior research scholar at the School of International and Public Affairs at Columbia University and the chair of the Latin American Committee on Macroeconomic and Financial Issues (CLAAF). Previously, she served as managing director and chief economist for Latin America at Deutsche Bank and held senior positions at the Inter-American Development Bank and the International Monetary Fund. Ms. Rojas-Suarez holds a Ph.D. in economics from the University of Western Ontario.

Working Group Members

Gerard Caprio, Jr. is William Brough Professor of Economics at Williams College and Chair of the Center for Development Economics. Previously, he was the Director for Financial Sector Policy at the World Bank and Head, Financial Sector Research. Earlier positions include: Vice President and Head of Global Economics at JP Morgan, economist positions at the Federal Reserve Board and the IMF and Visiting Professor at Trinity College Dublin and George Washington University.

Kevin Cowan is currently Commissioner of the Chilean Financial Market Commission (CMF) and a lecturer at the Universidad Adolfo Ibañez. He holds a BSc in Commercial Engineering from the Catholic University of Chile, and a Ph.D. in Economics from the Massachusetts Institute of Technology (MIT). Prior to his position in the CMF he was Executive Director for Chile at the Inter-American Development Bank (IDB), where he also had held the position of Regional Economic Advisor. He has had several positions in the Central Bank of Chile, including Head of the Financial Policy Department. Mr. Cowan lectures at the Universidad Adolfo Ibañez on international finance and financial regulation and has published several articles on financial markets and macroeconomics.

Arturo José Galindo is a member of the Board of Directors of the Banco de la República, the central bank of Colombia. Previously he was Chief of the Strategic Planning and Monitoring Division at the Inter-American Development Bank, Chief of the Strategy Development Division, and Regional Economic Advisor for the Andean Region at the same institution, Chief Economic Advisor of the Banking Association of Colombia, Advisor to the Ministry of Finance, Advisor to the Government of Colombia on Coffee Affairs, Professor of Economics at Universidad de los Andes, Research Economist at the IDB, and Economist at the Central Bank of Colombia. He holds a PhD in Economics from the University of Illinois at Urbana-Champaign.

Pablo E. Guidotti is Professor and Member of the Board of Directors of Universidad Torcuato Di Tella. He is a founding member of the Latin American Committee on Macroeconomic and Financial Issues and is a Member of Argentina's National Academy of Economic Sciences. Dr. Guidotti was Deputy Minister of Finance and Secretary of the Treasury of Argentina, Co-Chairman of the G-22 Working Group on Strengthening Financial Systems and Second Vice President of Argentina's Central Bank. He has published numerous articles in books and journals and holds a Ph.D. from the University of Chicago.

Patrick Honohan was Governor of the Central Bank of Ireland from September 2009 to November 2015. He is currently affiliated with Trinity College Dublin and the Peterson Institute for International Economics. Previously, he was a Senior Advisor on financial sector issues at the World Bank. He received his PhD in Economics from the London School of Economics in 1978.

Giulia Lotti is Economist at the Inter-American Development Bank (IDB) and Research Associate at CAGE Warwick. She previously worked in the Department of Andean countries at the IDB and as a consultant for the World Bank. Her research interests include applied microeconomics, labor economics and international finance. She holds a PhD degree in Economics from the University of Warwick and a Master of Science in Economics from University College London (UCL).

Pascual O'Dogherty is Secretary General of the Association of Banking Supervisors of the Americas (ASBA) since January 2019. During his 30 plus years at Banco de Mexico, he had different responsibilities in the areas of Financial Stability, Financial System, and Central Bank Operations. He also was Executive Secretary of the Mexican Financial Stability Council and member of the boards of the Mexican National Banking and Securities Commission and the Insurance Commission. He represented Banco de Mexico at the Basel Committee on Banking Supervision, the FSB Task Force on Resolvability, and the BCBS Task Force on Sovereign Exposures. He received a bachelor's degree in economics from ITAM and completed his doctoral studies in economics at Northwestern University.

Eric Parrado Herrera is Chief Economist and General Manager of the Research Department of the Inter-American Development Bank (IDB). Before joining the IDB, he was a professor of economics and finance at the ESE Business School of the Universidad de los Andes in Santiago, Chile. Mr. Parrado is a visiting professor at Oxford University and the Central European University, and member of the World Economic Forum's Global Future Council on Financial and Monetary Systems. He was the Superintendent of Banks and Financial Institutions in Chile (2014-2018) and Manager of the Chilean SWFs (2007-2010). He received his PhD in Economics from New York University.

Augusto de la Torre is Adjunct Professor at Columbia University's School of Public and International Affairs, in New York City; directs the Economics Research Center at the Universidad de las Américas (UDLA) in Quito, Ecuador; and is a member of Ecuador's Council of External Economic Advisors. He was the World Bank's Chief Economist for Latin America (2007-2016), served as the Governor of the Central Bank of Ecuador in the mid-1990s, and worked at the IMF in his early professional career.

Philip Turner is Visiting Lecturer at the University of Basel and Visitor at the National Institute of Economic and Social Research, London. Until 2016, he was Deputy Head of the Monetary and Economic Department and a member of Senior Management of the BIS, which he joined in 1989. He previously held various positions at the OECD. He completed a B.A. in Economics at Churchill College, University of Cambridge, and obtained a PhD from Harvard University.

Brian Wynter, CD, OJ is a company director and consultant. A graduate of the London School of Economics (LSE), The City University (London), and Columbia University's School of International and Public Affairs (SIPA) with financial markets experience in the private sector and the IMF's Caribbean RTAC, he is also a qualified attorney. He was the founding CEO of Jamaica's Financial Services Commission and, most recently, Governor of Jamaica's central bank during a decade of successful economic transformation.