Global Financial Markets Policy Responses to COVID-19

OECD

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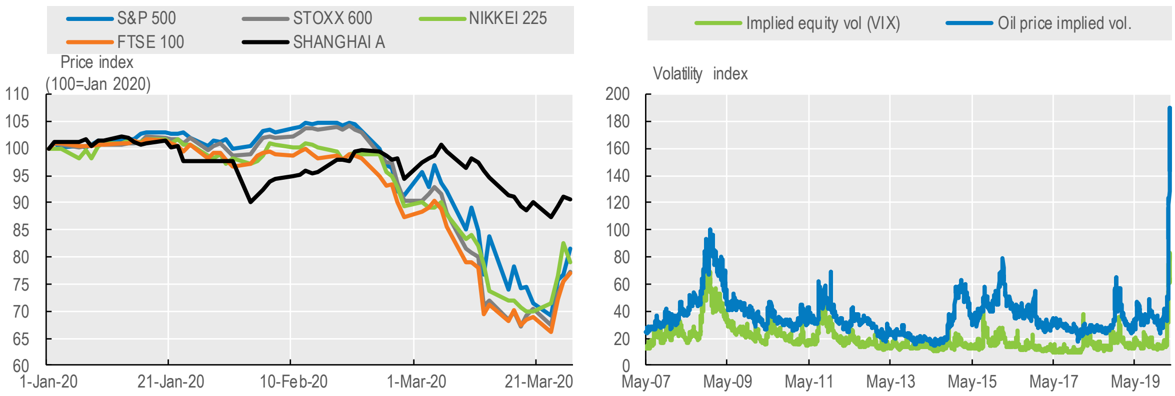
In early March 2020, the OECD's Interim Economic Outlook highlighted that the coronavirus outbreak had already caused a sharp decline in economic growth in China, and subsequent outbreaks in other countries were eroding prospects for economic growth. Since that time, the increasing spread of the coronavirus across countries has prompted many governments to introduce unprecedented measures to contain the epidemic. While necessary to contain the virus, these measures have led to many businesses being shut down temporarily, widespread restrictions on travel and mobility, financial market turmoil, an erosion of confidence and heighted uncertainty. This approach suggests that the shutdowns could lead to sharp declines in the level of output in many economies, with consumers' expenditure potentially dropping by around one-third. Changes of this magnitude would far outweigh the economic recession during the global financial crisis.

Turbulence in global financial markets

The economic impact of the global spread of COVID-19 has heightened market risk aversion in ways not seen since the global financial crisis. Stock markets have declined over 30%; implied volatilities of equities and oil have spiked to crisis levels; and credit spreads on non-investment grade debt have widened sharply as investors reduce risks (Figure 1). This heightened turmoil in global financial markets is occurring despite the substantial and comprehensive financial reforms agreed by G20 financial authorities in the post-crisis era.

Figure 1. Equity prices of major benchmarks and selected implied volatility indices



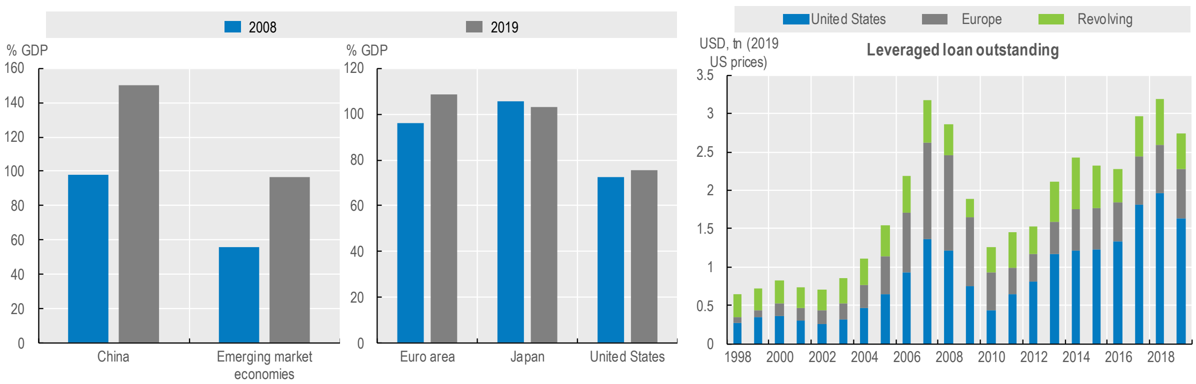
Note: VIX is implied equity volatility on US S&P 500. Oil implied volatility implied volatility of crude oil prices by applying the VIX methodology to United States Oil Fund, LP.
Source: Refinitiv, OECD calculations.

These challenges are also very different to the previous financial crisis. Understanding current market fragilities, paths of market contagion, and policy implications calls for a sober assessment of the changing structure of global markets and financial intermediation in the post-crisis era.

Corporate sector indebtedness and market vulnerabilities

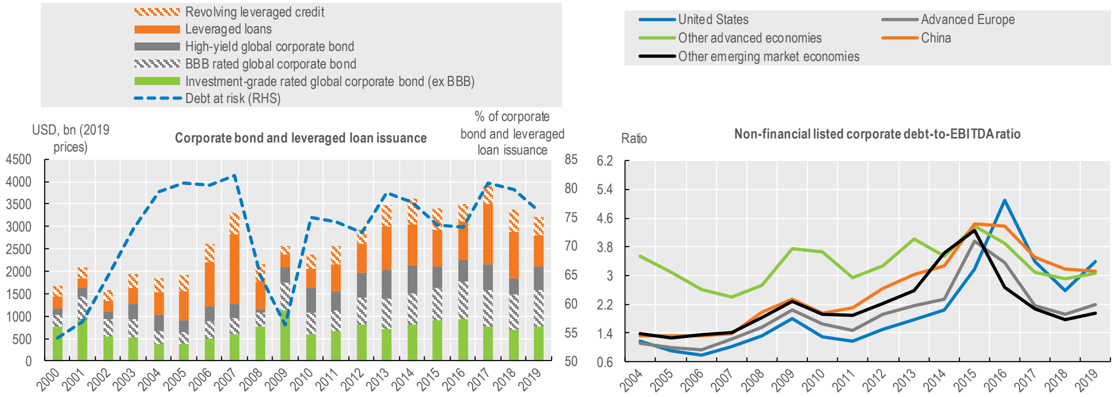
In many countries, businesses have become highly indebted, and are now vulnerable to deteriorating economic and market conditions. Amid an extended period of accommodative monetary policy, the very low cost of borrowing has contributed to unprecedented corporate debt issuance. Consequently, corporate debt stands at very high levels in many G20 countries, and the growth of leveraged loans outstanding in the US and Europe have offset a slowdown in bank lending to provide indebted corporates with financing(Figure 2). Many corporates used this debt to pay dividends and buy back shares, increasing leverage that has made them more vulnerable to sharp declines in operating earnings (Figure 3). Also, lower-rated credit issued in the form of BBB bonds, non-investment grade bonds, and leveraged loans (Figure 3) has risen to elevated levels. This, as well as loans securitised in collateralised loan obligations, has been distributed throughout the financial system to a range of investors, including insurers, pension funds, and retail investment funds.

Figure 2. Credit to non-financial corporates and leveraged loan outstanding



Note: Credit statistics cover borrowing activity of non-financial corporates including loans and bonds. Leveraged loan outstanding data are compiled from leveraged loan deals in the United States and in Europe over the period 1990-2019 including financial and non-financial companies. Outstanding amounts are presented in 2019 USD adjusted by US CPI.
Source: Bank for International Settlements, Refinitiv, OECD calculations. OECD (2020) Structural Developments in Global Financial Intermediation.

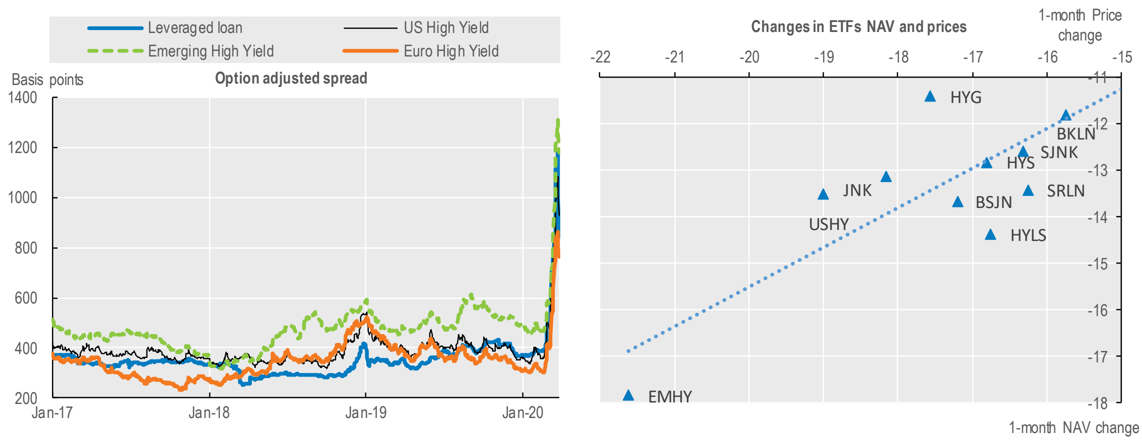
Figure 3. Global corporate bond, leveraged loan issuance and firms' leverage



Note: Leveraged loan issuance data are compiled from leveraged loan deals in the United States and in Europe over the period 2000-2019 including non-financial companies only. Issuance amounts are presented in 2019 USD adjusted by US CPI. EBITDA represents income before interest, taxes, depreciation and amortisation. Total debt includes loans and short and long term bonds. Leverage calculations are performed using a global sample of 12,220 listed non-financial companies with available financial statement data in Refinitiv over the period 2004-2019. Annual consolidated financial statements are collected on an annual basis, at the firm level and in current USD. All data are trimmed at the 1st and 99th percentile levels to reduce the effect of outliers. Global corporate bond issuance are calculated including non-financial companies. "Debt-at-risk" is the sum of BBB rated corporate bond, high-yield corporate bond, leveraged loan issued and revolving leveraged credit facilities. It is reported as a share of total corporate bond and leveraged loan (including revolving credits) issuance.
Source: OECD (2020) Corporate Bond Market Trends, Emerging Risks and Monetary Policy, OECD (2020) Structural Developments in Global Financial Intermediation, Refinitiv, OECD.

During this same period, the structure of global financial intermediation has also changed. While large banks and broker-dealers continue to provide credit and market intermediation, market-based finance by non-banks has grown. Investment funds and Exchange Traded Funds are playing a larger role in credit intermediation, and facilitate demand for corporate debt by offering liquidity to investors. **During periods of acute market stress, however, high levels of investor redemptions may force funds to rapidly sell corporate debt including high-yield bonds and leveraged loans (Figure 4).** This dynamic is rapidly eroding market liquidity and causing the price of traded debt to rise, thereby raising businesses' cost of financing.

Figure 4. Credit spread widening and high-yield and leveraged loan ETF flows



Note: Option-adjusted spreads are derived from ICE BofAML high-yield corporate bond indices. Leveraged loan spread is calculated as the difference between yield-to-maturity of S&P/LSTA U.S. Leveraged Loan 100 Index and 3-month US Dollar LIBOR rates. ETFs funds included in the left hand chart are among the top 25% of fixed income high-yield corporate ETFs by asset under management (AUM) value. This list includes: Shares iBoxx USD High Yield Corporate Bond ETF, SPDR Bloomberg Barclays High Yield Bond ETF, iShares Broad USD High Yield Corporate Bond ETF, Invesco Senior Loan ETF, SPDR Bloomberg Barclays Short Term High Yield Bond ETF, SPDR Blackstone / GSO Senior Loan ETF, First Trust Tactical High Yield ETF, PIMCO 0-5 Year High Yield Corporate Bond Index ETF, Invesco Bullet Shares 2022 High Yield Corporate Bond ETF, Invesco Bullet Shares 2023 High Yield Corporate Bond ETF and iShares J.P. Morgan EM High Yield Bond ETF. Percent change in 1-month net asset value (NAV) and price are calculated as of February 26rd, 2020.
Source: ETF.com, Refinitiv, OECD.

The unfolding contagion in corporate credit markets has begun to erode the solvency of businesses across affected countries. Businesses, particularly those with high debt, are finding it difficult to meet short-term cash need for debt repayments, taxes, and significant operational expenses. Faced with these shortfalls, businesses will have little choice but to reduce costs and employment to withstand insolvency pressures. Consequently, rising unemployment will reduce household consumption and consumers' capacity to repay loans. In combination, higher defaults on business and household debt would erode the asset quality of banks and other lending institutions.

In light of global market contagion, recent actions by central banks to lower policy rates and extend bond purchasing programmes and special crisis facilities are important steps to address these liquidity challenges. In addition, international regulatory bodies have called upon national authorities to lower countercyclical capital buffers, and use post-crisis regulatory tools in an appropriately flexible manner. Nevertheless, **addressing short-term liquidity in the financial system will not be enough to address acute insolvency risks from COVID-19. An immediate, comprehensive policy response is needed to address the emerging solvency challenges that are rapidly engulfing businesses affected by the pandemic.**

Policy considerations

A rapid, comprehensive policy programme to safeguard the solvency of businesses and households could rest upon several pillars:

Expand central bank liquidity support

Many central banks in OECD countries have taken actions to provide further monetary policy accommodation to provide ample liquidity to ensure well-functioning markets. Further actions could follow:

- **Central banks should give careful consideration to terms of their programmes to ensure that indebted corporates with acute liquidity challenges are granted needed liquidity.** Central bank policies generally adhere to investment grade bonds as collateral in operations, quantitative easing programmes, and even crisis facilities. A significant portion of corporate assets are either non-investment grade or are rated BBB, which is vulnerable to downgrade to non-investment grade level in deteriorating operating conditions. As such, central banks should consider how to adapt policies during this crisis environment. Appropriate collateralisation policies and risk monitoring can help ensure taxpayer resources are not exposed to material credit risk.

- At the same time, **central banks should consider how to address moral hazard associated with programmes to lower-rated issuers**. Appropriating pricing of lending facilities to take into account risks would create market-oriented mechanisms to attract only those borrowers with genuine need. Where possible, central banks could link the terms of their facilities to equity and guarantee programmes by finance ministries to ensure needed financing while mitigating risks.

- **Central banks and bank supervisors should consider market-based solutions to address rising non-performing assets on bank balance sheets.** Where rising defaults weigh on bank asset quality, banks will be less able and willing to make new loans to support business and consumers. Financial authorities may wish to consider ways to reduce the burden of non-performing assets through asset-disposal vehicles, which have been utilised in prior financial crises to allow banks to improve their asset quality.

Urgent fiscal support to viable businesses

To address growing insolvency concerns, fiscal authorities could:

- **Implement much greater targeted spending toward affected businesses and employees**, to strengthen market and business confidence immediately.
- **Channel a combination of equity, debt and credit guarantees to affected businesses.** Programme design and terms of conditionality will be central to effectiveness while addressing moral hazard.
    - Programmes could be delivered through existing banks, development banks and SME loan agencies that are already well equipped to evaluate those solvent

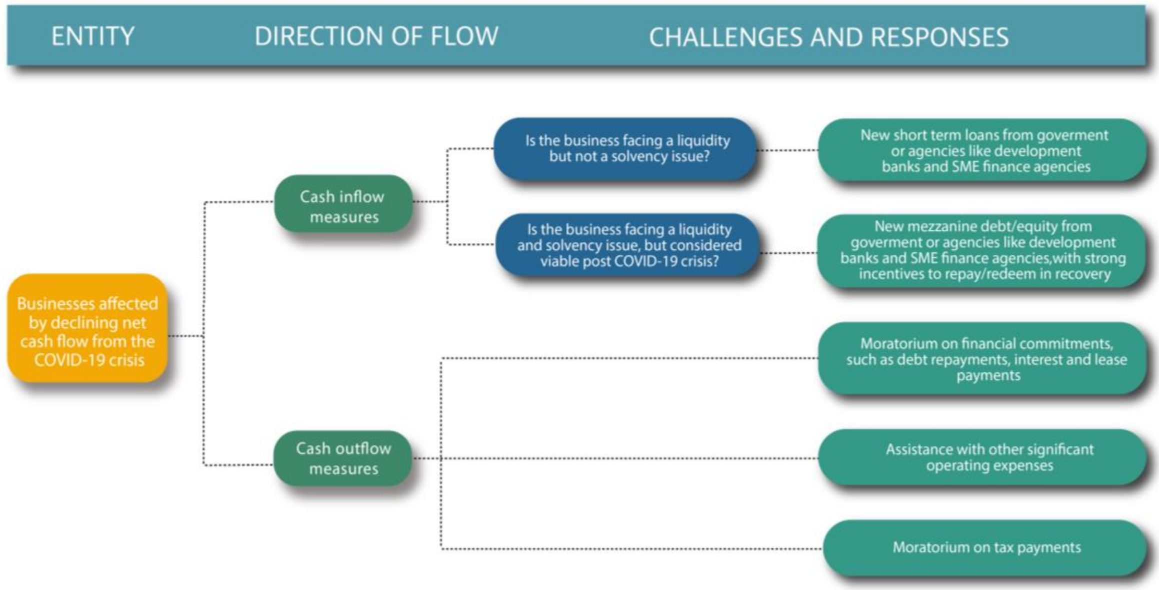
entities that would benefit from interim financing until economic conditions improve.

    - Focus should be on getting cash to businesses on a timely basis, particularly by reducing bureaucratic obstacles to cash transfers.
    - There must be incentives to repay as the business recovers, for example, restrictions on dividends. Use of equity warrants could help ensure taxpayer funds are amply compensated during business recovery.
    - A clear path to exit this extraordinary support, so as not to raise sovereign debt sustainability concerns.

- **Further support to improve near-term cash flows,** which could include permitted delays in tax filings, and support for particular operating expenses.
- **Where fiscal initiatives include new forms of temporary to medium-term state ownership, adherence to the OECD Guidelines on Corporate Governance of State-Owned Enterprises is important** to ensure that governments are effectively managing their responsibilities as company owners. This will help to make state-owned enterprises more competitive, efficient and transparent.
- **Emphasise commitments to internationally recognised instruments of responsible business conduct, such as the OECD Guidelines for Multinational Enterprises and the OECD Due Diligence Guidance for Responsible Business Conduct,** which can help ensure that businesses benefitting from fiscal support are appropriately managing the broader environmental, social or governance risks.
- **Assess the need to temporarily share fiscal burdens from businesses affected by the pandemic** where individual States are unable to shoulder the burden of the health and economic consequences of the pandemic. In this respect, extending lending facilities may serve to alleviate temporary pressures of countries undergoing a major upsurge in fiscal deficits to address the economic and health challenges from the virus.

Such measures could give the financial sector confidence to make use of increased balance sheet availability from reduced capital buffers, and credit – through government loans, guarantees, or central bank facilities – could effectively address solvency concerns of viable businesses to overcome the economic effects of COVID-19. Furthermore, if implemented effectively, such programmes can mitigate moral hazard and even generate gains that can offset the costs of containing the growing health crisis.

Corporate cashflow challenges need tailored policies
COVID-19 crisis responses



Other fiscal support to small businesses and households

- **Offer guidance for banks to temporarily ease repayment terms to businesses and households.** This effort could be combined with partial guarantees by fiscal authorities to give banks incentives to increase financial intermediation during periods of uncertainty.

- **Provide cash directly to employees and consumers** to address short-term cash flow challenges in managing household finances, thereby allowing them to continue with the discretionary spending and retail investing that underpins economic growth.

- **These measures should be implemented quickly and efficiently,** avoiding bureaucratic obstacles that disincentivise businesses and households from their use.

Market regulatory approaches

Currently, international regulatory bodies have already enhanced coordination to oversee the continued implementation of G20 financial reforms in a flexible manner due to the crisis. Regulators should:

- **Reiterate the importance of sufficient liquidity buffers in investment funds and other collective investment vehicles** as a precautionary measure, such as where funds are investing in less liquid markets. This could be handled through domestic and international guidance with respect to liquidity risk practices of regulated funds.

- **Redouble efforts to operationalise the FSB/IOSCO principles for liquidity management and other tools of asset managers, to ensure that open-ended funds have sufficient liquidity available to meet unexpected redemptions**. This is particularly important in less liquid fixed-income markets affected by the corona virus. Also, market regulators should clarify the appropriate use of gates and suspension of fund redemptions, so as to reduce the potential for runs.

- **Consider conditional regulatory relief**, **such as allowing delays in public filings**. At the same time, regulators could emphasise that public issuers provide investors with insight regarding their assessment of, and plans for addressing, material risks to their business and operations resulting from the coronavirus.

- **Give greater scrutiny to high-frequency and algorithmic trading**, with greater attention to review of algorithm strategies that are more likely to malfunction during periods of acute market stress.

The global financial crisis underlined the importance of comprehensive and coordinated efforts – within and across countries – to ensure business and market confidence is restored. As the impact of COVID-19 erodes market and business confidence, financial authorities are encouraged to implement early and ambitious policy responses in their respective jurisdictions.

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The OECD is compiling data, information, analysis and recommendations regarding the health, economic, financial and societal challenges posed by the impact of Coronavirus (COVID-19). Please visit our dedicated page for a full suite of coronavirus-related information – www.oecd.org/coronavirus.