BOX 9
COVID-19 Concessions and Moratoria: Challenges and Way Forward

The biggest economic challenge faced by humankind in the past century

COVID-19 is arguably the biggest health and economic challenge faced by humankind in this century. In 2020, over 90 per cent of the countries worldwide recorded contractions in their economic activities. The interconnectedness and interdependence of the global economy made the impact of the pandemic unprecedented, surpassing the effects of the two world wars, the great depression, and the global financial crisis (The World Bank, 2022).

How did Central banks react to COVID-19?

Central banks and monetary authorities worldwide introduced both conventional and unconventional policy responses to address the multifaceted challenges of the pandemic. These measures include monetary policy relaxations, asset repurchasing/quantitative easing programmes, and regulatory forbearances, as well as government-led fiscal measures such as tax reductions/ deferments, direct cash payments, insolvency support and payment freezes/moratoria (International Monetary Fund, 2022).

In the wake of the pandemic, the Central Bank of Sri Lanka (CBSL) also introduced a series of extraordinary policy measures to provide liquidity to the economy and regulatory forbearances to provide operational flexibility to licensed banks and non-banking financial institutions (NBFIs), (hereinafter referred to as financial institutions, FIs) to assist their customers.

Accordingly, CBSL requested FIs to provide a six-month moratorium on capital and interest payments on loans obtained by borrowers affected by the pandemic and to waive off any accrued and unpaid penal interest charged on such loans. Considering the subsequent waves of the pandemic, this was extended for more than 18 months for customers who were severely affected.

Additionally, CBSL also introduced a Rs. 50 billion refinancing and credit guarantee scheme to provide low-cost funding for Small and Medium Enterprise (SME) customers, reduced interest rates on targeted lending products, provided liquidity facility to the construction sector and other government suppliers, suspended recovery actions against non-performing loans, and reduced fees and charges on several banking services to provide relief to retail customers.

New Challenges and Opportunities created by the Pandemic

COVID-19 affected businesses disproportionately. Some businesses and economic sectors came to a complete standstill while some found new opportunities and avenues to grow their businesses amidst the pandemic.

As the pandemic unfolds, many businesses worldwide adopted remote working and flexible working arrangements, which have now become a norm due to its' versatility and cost savings. Similarly, many businesses have already replaced expensive business travels and meetings with online conferences and virtual meetings. These shifts in preferences have forced businesses to rewire their infrastructure to be predominantly hybrid (Sadun, Simcoe, & Conti, 2021; Nugent, 2021). Further, the increased consumer preferences towards digital services and online shopping have pushed many businesses in the service sector such as supermarkets, retail, fashion, and entertainment to bring their businesses mobile-first. This phenomenon was also apparent in the local context such as increasing demand for online retail shopping, video consultations for doctors, online learning and tuition service providers and reduced demand for cinemas, large wedding receptions, concerts, exhibitions, and events. While these changes affected some businesses and their value chains adversely, many firms have embraced the change to spur innovation turning the changes into opportunities.

Similarly, FIs as well as the financial sector witnessed their fair share of pains and gains during the pandemic. Liquidity and credit risks were the most significant challenges faced by FIs worldwide during the pandemic. Closure of businesses, loss of jobs and income due to the pandemic and induced economic disruptions made it increasingly difficult for borrowers to honour their debt repayment obligations. Even for those who were repaying promptly, the probability of default in the future increased significantly, due to the increasing uncertainty in the global economy. This significantly impacted the asset quality of FIs. Liquidity positions of FIs also tightened as borrowers delayed their repayments and depositors withdrew their monies more often. This impaired FIs' ability to lend, curtailing credit flows to revive economic activities.

Raising new funds and rolling over the existing funding lines was another challenge faced by FIs as lenders, depositors, and investors of FIs were reluctant to commit more funds due to the increased uncertainty. This increased the cost of funding and refinancing risk of FIs.

The pandemic also increased other risks such as operational risk, health & safety risk, and business continuity risk. The increased reliance on digital delivery channels elevated the cybersecurity risk and technology risk, compelling FIs to commit more resources to mitigate these emerging risks and threats. Ultimately, the foregoing translated into increased strategic risk. FIs were required to reassess their risks, rearrange their priorities, and refocus their business directions as strategies planned before the pandemic became no longer valid in the "new normal".

However, certain business segments such as online banking, cashless payments and digital wallets witnessed exponential growth during the pandemic. FIs benefited from the reduced interest rates generally observed globally and in the local context, and from the exchange rate movements, due to mark-to-market gains on foreign currency assets. CBSL monitored these developments and introduced timely regulatory measures, where necessary, to prudently manage the increased risks in the financial sector.

Balancing Basics: Concessions and Stability

CBSL, as the apex financial authority in the country, took timely measures to provide concessions and revive the affected economic sectors while avoiding excessive risk buildup which can impact the core objectives of CBSL: to maintain economic and price stability and the financial system stability.

CBSL introduced the debt moratorium as a short-term remedy for borrowers who faced cashflow difficulties amidst the pandemic and to prevent loans of such borrowers from getting into non-performing category and its ensuing consequences. However, as the tenure of the moratoria and the value of loans grew bigger, FIs had to find alternative funding to pay their depositors and to meet other operating costs during the moratorium period. Considering the above, CBSL permitted FIs to charge a nominal interest on the moratoria, sufficient to cover the costs of funds. Subsequently, CBSL initiated preparatory works to introduce a mechanism to provide a least-cost solution to both borrowers and FIs, having considered the difficulties faced by borrowers due to charging additional interest.

Despite sparking much debate among the public, this additional interest allowed FIs to permit their borrowers to defer loan repayments for more than 18 months, without creating undue stress on depositors' funds and maintaining the stability of the individual FIs and the financial system.

Unwinding Moratoria: The Importance of Timing

As economic activities are returning to normalcy and countries opening their borders for trade, Central banks worldwide gradually phased out the extraordinary policy measures placed in response to COVID-19. However, experts warn that a premature upliftment of support measures that maintained liquidity and solvency of the economy may cause widespread credit constraints, debt foreclosures, insolvencies, and increased unemployment. This can be detrimental to post-pandemic economic revival and the self-reinforcing nature of these effects can have both short and long term consequences due to the feedback effect (Financial Stability Board, 2021).

On the other hand, maintaining support measures for too long can result in increased indebtedness, excessive risk-taking by firms and households, increased credit risk and creating moral hazard. The cost of running concessions for too long can be prohibitively expensive for countries with tight fiscal positions. Further, it can also slow down the necessary economic adjustments such as culling weak and unviable business/business models to reallocate economic resources to more efficient sectors, and technological transformation (Financial Stability Board, 2021).

What's beyond moratoria?

Unwinding moratoria and other relief measures can be challenging for both borrowers and FIs. As discussed above, the pandemic made permanent changes in several industries making some business models no longer profitable as they used to be (Jacobides & Reeves, 2020).

From a business continuity point of view, the pandemic was an acid test for firms that lack capital, contingency planning and agile decision making. For some firms, the main factor that kept such businesses afloat during the pandemic was the concessionary measures. Therefore, any efforts to revive businesses by FIs should focus on firms that are financially viable but suffering from liquidity and solvency problems caused directly by the pandemic. Also, such interventions should be transparent and should not distort the market competition (OECD, 2021).

Considering the above, CBSL issued guidelines to licensed banks to establish post-pandemic economic revival units in licensed banks to revive viable businesses. Accordingly, licensed banks will formulate revival plans and identify under-performing and non-performing borrowers with viable businesses who require rehabilitation assistance, including those who require liquidity support to unwind moratoria.

A mix of financial and non-financial assistance will be available to such borrowers to restructure/reschedule their existing credit facilities and will also grant additional credit facilities and/or any other appropriate support measures on a need basis to revive their businesses.

However, these will not be available to borrowers that have been identified as willful defaulters, defaulters who have diverted the borrowed funds for other purposes and those with unviable businesses or business projects and those who have defaulted due to mismanagement and/or fraud in their businesses.

The Way Forward: A Sustainable, Inclusive Economic Recovery

The end goal of all the above interventions is to minimise disruptions to the economy and restore normalcy in the livelihood of the people. In this regard, all stakeholders of the economy should collectively reflect on the lessons learnt from the pandemic and make conscious efforts to secure a sustainable and inclusive post-pandemic economic recovery.

Going forward, both FIs and firms should rethink their business models, explore new business opportunities created by the pandemic and redesign their processes and procedures to improve efficiency and competitiveness. Investing in technology and upgrading IT infrastructure while prudently managing increased risks will be another priority going forward. In doing so, they may also have to be mindful of their debt levels and seek to consolidate, restructure, or reschedule their debt to match their new cashflows and repayment capacities or find alternative avenues for low-cost funding or internal capital formation to maintain solvency and support such growth.

In this regard CBSL has initiated several policy measures to promote internal capital formation, recovery planning, technology risk management, provide long-term low-cost funding and orderly disposal of non-performing assets of FIs.

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