3

SYSTEMIC RISK AND PRUDENTIAL RESPONSE TO COVID-19

This chapter analyses developments in systemic vulnerabilities and describes the prudential measures implemented to mitigate the adverse effects of the COVID-19 pandemic. The first section uses the map of indicators and the systemic risk indicator to assess the Spanish financial system's current level of vulnerabilities. The macrofinancial disruption caused by the spread of COVID-19, which is already reflected in the contemporaneous indicators such as the systemic risk indicator, has required the adoption of a series of supervisory measures, which are addressed in Section 2. These measures include decisions on macro- and microprudential instruments, a prudential response relating to accounting matters which takes into account that the shock is, in principle, temporary in nature and other supplementary measures to strengthen the solvency of banks.

3.1 Analysis of systemic vulnerabilities

Until end-2019 the map of systemic vulnerabilities did not show signs of systemic risk build-up.[1] In addition, all the categories of the map of indicators have remained stable since the latest FSR (see Chart 3.1). Therefore, the starting point of the financial cycle in the face of the shock triggered by COVID-19 does not show the vulnerabilities existing at the onset of the 2008 global financial crisis. Private indebtedness levels are currently substantially lower and no overvaluations in aggregate terms are observed in the real estate market. The situation at the beginning of the new phase also reflects that COVID-19 is a systemic risk that has not been generated endogenously by the financial system.

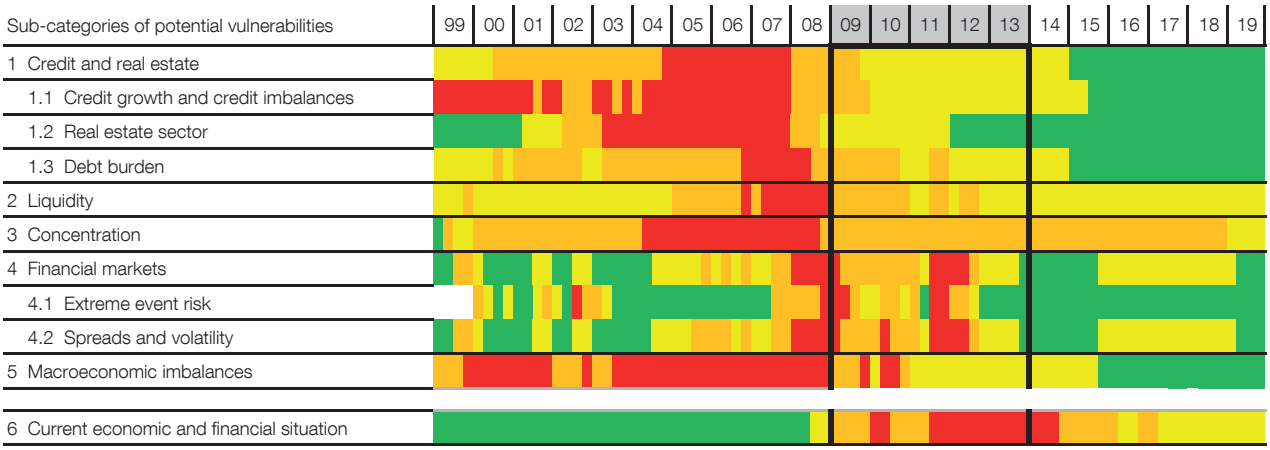
As a result of the substantial disruption of global activity and the foreseeable tightening of financial conditions in 2020 Q2 and Q3, some of the components of the map of systemic vulnerabilities, such as the financial market or liquidity components, may be significantly affected. These indicators are constructed using financial market data, which tend to react rapidly to changes in the macrofinancial environment. It is to be expected that the indicators of

1 The map of systemic vulnerability indicators aggregates information on a broad set of indicators based on their capacity to anticipate systemic banking crises. The definitions of the main categories correspond with those established in Recommendation ESRB/2013/1 of the European Systemic Risk Board on intermediate objectives and instruments of macroprudential policy. To interpret the chart, it should be borne in mind that the intensity of the warning signals in each of the categories represents a weighted average of the intensity of the indicators it includes. Intensity rises as the tone becomes redder, while green represents a normal situation. For further details about the specific indicators included in each category, and on the calculation of their weightings, see Mencía, J. and Saurina, J. (2016) "Macroprudential policy: objectives, instruments and indicators". Occasional Paper 1601, Banco de España.

Chart 3.1

THE MAP OF SYSTEMIC VULNERABILITIES REMAINED STABLE AND WITHOUT ANY SIGNIFICANT EARLY WARNING SIGNALS IN LATE 2019 (a)

The map of systemic vulnerabilities, whose aim is to emit warnings about systemic banking crises, held stable in 2019. Early warnings of risk were absent or low. Meantime, the macroeconomic and financial vulnerabilities of the Spanish economy continued to be corrected. This pattern of indicators as at December 2019 shows that the coronavirus crisis has not arisen endogenously in the financial system, but is rather an exogenous shock to it.



SOURCE: Banco de España.

a The colour scheme identifies four levels of risk: i) green denotes a normal, risk-free situation, ii) yellow indicates low risk, iii) orange is medium risk and, iv) red is high risk. The shaded band denotes the last systemic crisis. Some December 2019 indicators are based on provisional information.

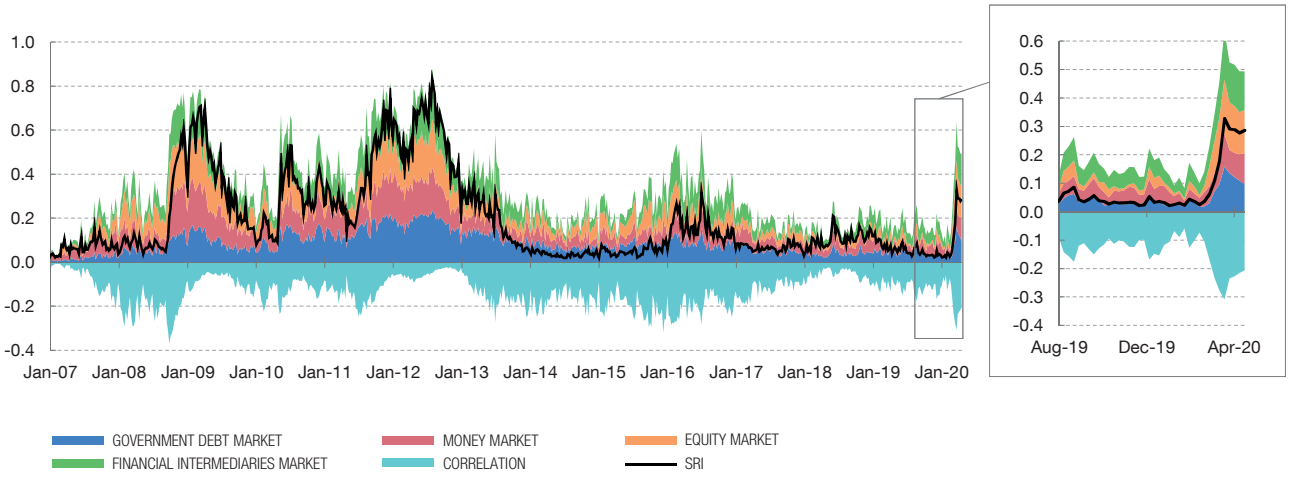
the current economic and financial situation will also start to show slightly more lagged warning signals, as the partial freeze of economic activity begins to spill over into changes in GDP, unemployment and the rest of variables in this category.

Against this backdrop, the systemic risk indicator (SRI) has rebounded strongly due to the increase in volatility in financial markets. (see Chart 3.2). The SRI belongs to the class of "contemporaneous" macroprudential indicators because it is designed to capture in real time increases in the level of systemic shocks. Indeed, it is a synthetic indicator including information about the four segments that are the most representative of financial markets (the money, government debt, equity and bank funding markets). Therefore, increases in this indicator capture simultaneous tensions in these four segments, such that SRI increases indeed reflect that this stress is systemic. This indicator has remained at low warning levels since the financial tensions which arose following the Brexit referendum in 2016, dropping to all-time lows at end-2019. However, it has rebounded strongly since February 2020, coinciding with the increase in volatility in the financial markets associated with COVID-19, and has already exceeded the levels recorded in 2016. In fact, the initial pace at which the SRI rose during this crisis exceeded that seen at the onset of the global financial crisis. Indeed, the latest data show a slight correction in the indicator, which might reflect the impact of the measures adopted, although it seems to have stalled in the past few weeks.

Chart 3.2

THE SYSTEMIC RISK INDICATOR FOR THE SPANISH FINANCIAL SYSTEM HAS RISEN FORCEFULLY OWING TO THE SPREAD OF THE COVID-19 PANDEMIC (a)

The Systemic Risk Indicator (SRI), which held at very low levels throughout 2019, has risen forcefully owing to the effects of the coronavirus on the financial markets. The level of stress in the different markets on which the indicator draws is not homogeneous; it is particularly high in the equity market and not so high in the money market.



SOURCES: Datastream and Banco de España.

a The Systemic Risk Indicator (SRI) aggregates 12 individual indicators of stress (volatilities, interest rate spreads, maximum historical losses, etc.) of different Spanish financial system (markets for money, government debt, equity and financial intermediaries). In calculating the SRI, the effect of cross-correlations is taken into account, whereby the SRI posts higher values when the correlation between the four markets is high (i.e. situations in which there is a high – or low – level of stress in the four markets at the same time), and lower values when correlation is lower or negative (i.e. situations in which the level of stress is high in some markets and low in others). For a detailed explanation of this inidcator, see Box 1.1 in the May 2013 FSR.

3.2 Prudential actions in response to COVID-19

3.2.1 Macroprudential policy actions

Macroprudential policy aims to mitigate the impact of systemic financial shocks, such as that generated by COVID-19, on the real economy. The COVID-19 pandemic and the measures necessary to contain it are severely disrupting economic activity worldwide. Although this may be a temporary shock, the persistence of its effects will largely depend on public policy response and on the behaviour of the economic agents. Against this backdrop, credit institutions can and should play a key role in contributing to stabilise the economy. Their role as intermediaries of flows of funding allows economic agents to meet their short-term financial needs, transforming them into longer-term liabilities.

One of the main objectives of macroprudential policy is to help institutions continue to provide the financing required by households and businesses, even in adverse environments such as the current one. To this end, certain

previously established capital buffer requirements can be eased to help institutions be in a better position to absorb the foreseeable increase in losses and to try to prevent them from being forced to restrict the credit supply for projects that were financially viable before the shock. In keeping with this reasoning, several European national authorities have recently taken macroprudential measures, according to the specific circumstances of each country and based on the calibration of the capital buffers built up prior to the outbreak of the pandemic (see Box 3.1).

Macroprudential policy works through the building of capital buffers and ensuring that loan granting conditions are suitable in the phases of risk accumulation, and releasing these buffers when risks materialize. In this way, this policy would contribute to smooth the financial cycle, by limiting the build-up of systemic risk in expansive phases and mitigating the adjustment to credit activity in recessive phases. Under the current circumstances, facing an exogenous shock rather than the materialization of a risk generated endogenously by the financial sector, the release of previously constituted capital buffers would allow banks to absorb the foreseeable increase in losses without constraining credit supply to financially viable projects. In this manner, it would be avoided that the financial sector aggravates the economic recession, by keeping the provision of financing to firms and households.

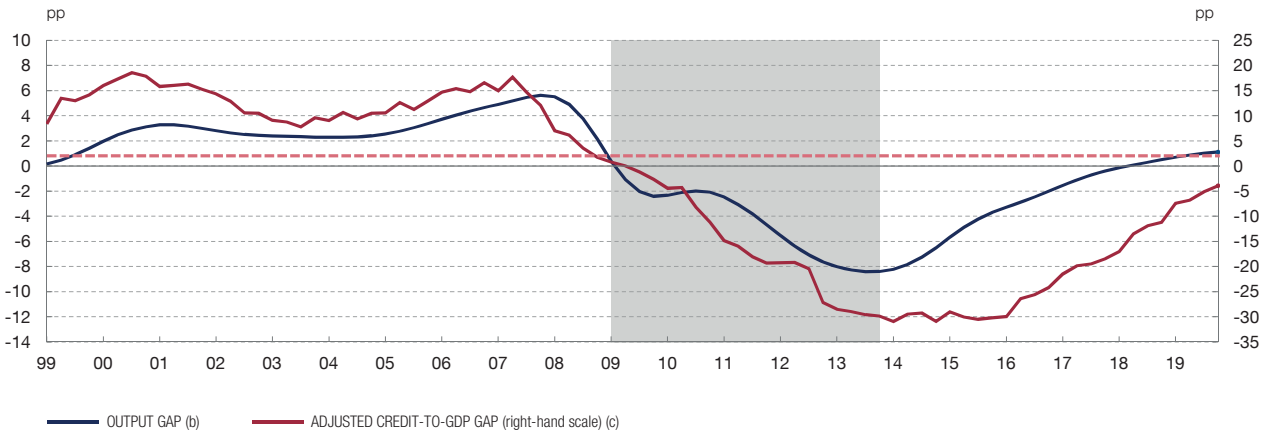
The Banco de España has maintained the countercyclical capital buffer (CCyB) at 0% and the current circumstances advise to maintain this level, unless until the economic and financial effects of the coronavirus crisis have faded.[2] In fact, the authorities of other European countries that had activated this instrument in the past, in most cases owing to excessive credit growth in their economies, have now proceeded to provide for its release (setting it at 0%, see Box 3.1). In Spain's case, the countercyclical capital buffer is currently set at 0%, given the previous analysis of the absence of warning signals. In any event, it is anticipated that this instrument will not be activated over a prolonged period, at least until the main economic and financial effects arising from the coronavirus crisis have been dispelled. In this connection, an important lesson from the effects of this shock is the need to explore all the possibilities provided by the original framework designed by the Basel Committee on Banking Supervision (BCBS), so that decisions to activate this instrument are not limited exclusively to situations of excessive credit growth. It also reveals the need for the capital requirements that are more adjustable to the macrofinancial cycle to gain weight in the total requirements for institutions (see Box 3.2 for a cost-benefit analysis of the build-up and release of macroprudential measures).

2 See press release of 31 March 2020: "The Banco de España maintains the countercyclical capital buffer at 0%". In 2019 a review was once again conducted of the buffers set for Other Systemically Important Institutions (O-SIIs) with effect in 2020 and Global Systemically Important Institutions (G-SIIs) for 2021, as described in the press release of 25 November 2019: "Banco de España updates the list of systemically important institutions and sets their capital buffers" of 25 November 2019. The list of identified O-SIIs and G-SIIs and the associated capital buffers did not change with respect to those announced in the previous year.

Chart 3.3

THE CREDIT-TO-GDP GAP SWIFTLY DREW CLOSER TO ITS ACTIVATION THRESHOLD IN 2019, BEFORE THE SUDDEN OUTBREAK OF THE COVID-19 CRISIS (a)

In late 2019 the output gap continued to show positive values, while the credit-to-GDP gap continued to close. The foreseeable downturn in GDP in 2020 will alter these trends, changing the interpretation of the credit-to-GDP gap in relation to the recovery period.



SOURCE: Banco de España.

a The shaded area shows the last period of systemic banking crisis (2009 Q1-2013 Q4). The horizontal broken line depicts the CCyB activation threshold (equal to 2 pp).
b The output gap is the percentage difference between actual and potential GDP. Values calculated at constant 2010 prices. See Cuadrado, P. and Moral-Benito, E. (2016), "Potential growth of the Spanish economy", Occasional Paper 1603, Banco de España.
c The credit-to-GDP gap is calculated as the difference, in percentage points, between the observed ratio and the long-term trend calculated using a one-sided Hodrick-Prescott filter with a smoothing parameter equal to 25,000. This value is more in line with the financial cycles historically observed in Spain.

The credit-to-GDP gap, which is the main indicator for identifying credit imbalances in advance, remained below the long-term equilibrium level before the pandemic (see Chart 3.3).[3] There will foreseeably be a significant downturn in GDP this year, although there is much uncertainty over the magnitude of the drop. Some empirical research shows that during this phase of adjustment of activity GDP can drop faster than credit, since GDP is a flow measure that reacts more rapidly than stock measures such as total credit.[4] This could result in the credit-to-GDP gap, as well as other similar imbalance indicators, sending misleading signals. Therefore, the indicators normally used to identify unsustainable developments during upturns in the financial cycle are less useful during this new phase of disruption of activity, which has, additionally, been caused by factors not related to the financial cycle. Consequently, it is necessary to include contemporaneous indicators of systemic risk such as the SRI in the CCyB-related decisions during GDP contraction phases.

3 Box 3.2 of the May 2019 Financial Stability Report contains a description of the credit-to-GDP gap used by the Banco de España and its performance. For details about its calculation and a comparison with the standard specification of the credit-to-GDP gap by the Basel Committee on Banking Supervision and other alternatives, see Galán, J.E. (2019). (2019), "Measuring credit-to-GDP gaps. The Hodrick-Prescott filter revisited". Occasional Paper 1906, Banco de España.

4 Repullo, R. and J. Saurina (2011). "The countercyclical capital buffer of Basel III: a critical assessment". CEPR Discussion Paper No. DP8304.

Banks will be allowed to operate temporarily below the structural macroprudential requirement levels. Although Spain has not yet activated the CCyB, over the last few years Spanish banks have built up buffers and capital requirements precisely with the aim of using them to absorb losses in the face of scenarios such as that generated by COVID-19. The ECB, the EBA and the BCBS have encouraged credit institutions to use the capital and liquidity buffers available and to make appropriate use of the flexibility existing in prudential regulation to adapt to the new situation. Furthermore, the BCBS has decided to postpone the implementation of the revised methodology for identifying Global Systemically Important Institutions by one year (from 2022 to 2023) and the full implementation of Basel III. The BCBS has also postponed to 1 January 2028 the conclusion of the transitional period for the floor for capital requirements stemming from internal models.

3.2.2 Microprudential policy actions

The microprudential authorities have implemented a series of operational, prudential and regulatory flexibility measures to prevent disruptions in the operation of the banking system and to ensure the continuity of the flow of bank credit. Spanish deposit institutions have received a series of guidelines on these flexibility measures through recent statements issued by the EBA, the SSM and the Banco de España. As a competent national authority and member of the SSM, the Banco de España has assumed the measures announced by the SSM, applying them to the institutions under its direct supervision to the extent possible.

In the first place, the supervisory processes have been adapted to release the operational resources of banks that can be directed at ensuring the continuity of the business. The EBA decided to postpone the stress test exercise to 2021, expanding the content of the 2020 transparency exercise with the aim of releasing banks' resources to allow them to prioritise the continuity of the business. At the same time, it recommended the national supervisory authorities to act in this line in all supervisory reporting areas that are not essential for closely monitoring the situation during the crisis. Along the same lines, to ensure operational continuity, the SSM requested banks to address pandemic risk in their contingency plans and to revise their business continuity plans, while ordering a series of measures aiming to alleviate the supervisory burden and compliance with capital requirements. Thus, the extension of deadlines was announced for compliance with the corrective measures required in on-site inspections and the finalised internal model reviews, as well as for the flexible application the ECB guidance on non-performing assets.

In addition, supervisory requirements have been adjusted to allow banks to make use of the buffers available to absorb unexpected losses associated with the COVID-19 pandemic. The EBA has encouraged banks to use their liquidity buffers. Likewise, the SSM has also announced that banks would be allowed

to operate temporarily below the levels defined by the P2G, the capital conservation buffer and the liquidity coverage ratio, and the possibility of meeting the P2R with capital other than CET1 capital would be brought forward, all with the aim of maintaining credit. Finally, the Single Resolution Mechanism also clarified that a forward-looking approach would be used to monitor MREL compliance and that this requirement would not limit making use of the capital buffers released by the macro- and microprudential authorities.

3.2.3 Prudential response relating to accounting matters

Both national and international bodies (the Banco de España,[5] the ECB,[6] the EBA,[7] the European Securities and Markets Authority (ESMA)[8] and the Committee of European Auditing Oversight Bodies (CEAOB)[9] have issued different statements to clarify the effects of COVID-19 on financial reporting by banks and, in many cases, providing greater flexibility to the regulatory framework and the prudential impact of such reporting. The measures focus on clarifying the existing accounting regulations for an adequate calculation of credit risk impairment of financial assets in 2020, distinguishing temporary from permanent effects and recognising the role of public measures in sustaining credit. The key elements of the supervisory guidelines clarify the following matters:

— The existence of amounts past due more than 30 days as a result of the pandemic crisis does not entail the automatic classification of the exposure as Stage 2.

— The existence of liquidity difficulties in the case of borrowers with a good payment history will not automatically lead to identification of forbearance in the event of modifications of transactions as a result of the COVID-19 crisis.

— When estimating expected credit losses banks should consider the entire life of the transaction and give more weight to longer-term projections.

5 Briefing note of 30 March 2020 on the use of the flexibility envisaged in the accounting standards in view of the shock caused by COVID-19. Updated at 3/4/2020.

6 ECB Press release of 20 March 2020 on further flexibility to banks in reaction to coronavirus.

7 EBA Statement of 25 March 2020 on the application of the prudential framework regarding default, forbearance and IFRS 9 in light of COVID-19 measures.

8 ESMA Statement of 25 March 2020 on accounting implications of the COVID-19 outbreak on the calculation of expected credit losses in accordance with IFRS 9.

9 CEAOB decision on areas that are of high importance in view of COVID-19 impact on audits of financial statements. Adopted on 24 March 2020.

— Flexibility shall be applied, on a temporary basis, with respect to the classification of debtors as non-performing for reasons other than arrears when banks call on public guarantees granted in the context of COVID-19, legal moratoria or moratoria established by the banking sector which meet certain conditions.

— All public aid received as a result of COVID-19 will be taken into consideration in calculating expected losses.

These measures will contribute to prevent a procyclical and mechanistic behaviour of provisions that would lead to a downward adjustment of the volume of credit in the face of the COVID-19 crisis, also moderating the impact on profitability.[10] The supervisory expectation of an adequate application of accounting standards, with the aim of differentiating temporary liquidity problems from permanent credit quality impairment, will prevent a mechanistic and abrupt adjustment of credit ratings, restricting the automatic reclassification of exposures affected by temporary shocks to non-performance and forbearance. Consideration of the positive impact of public guarantees and moratoria on private sector agents' ability to pay also mitigates credit rating deterioration. The two effects would provide banks with incentives to maintain their credit intermediation function and avoid automatic reductions in credit volume that would compound the impact of the COVID-19 crisis. The distinction between temporary and permanent deterioration of credit quality and the consideration of the value of public aid granted would also limit the pace of growth of impairment provisions and moderate the negative impact on profitability.

The application of ongoing and adequate supervision, within the scope of the operational needs imposed by the COVID-19 pandemic, must avoid delays in the identification and recognition of the risks that effectively materialize. The measures aim to prevent the mechanistic application of accounting standards from causing a procyclical effect. However, an inappropriate use of them could lead to certain inadequate accounting practices, delaying the recognition of effective deteriorating credit quality in certain exposures. For this reason, the supervisory guidelines also consider that these flexibility measures should not prejudice the appropriate identification of credit impairment or the assignment of reasonable credit risk coverage, providing banks with the incentives necessary to maintain standards adapted to supervisory expectations. These also include the adaptation of banks' internal systems for the correct identification of transactions affected by the measures that have been put into place to adapt accounting to the COVID-19 crisis.

10 For a more in-depth analysis of the potential impact of a mechanistic application of accounting standards in the face of a temporary shock, see: Abad, J. and J. Suárez (2017): "Assessing the cyclical implications of IFRS 9 – a recursive model", ESRB Occasional Paper Series, No. 12.

Authorities are also trying to temporarily reduce the amount of accounting information banks are required to report. Given the operational implications of the pandemic, authorities are also prioritising the reporting of information that allows monitoring the impact of the crisis more closely and the effectiveness of the measures adopted. In this connection, the Banco de España is collecting from banks all the information needed to closely monitor the way in which banks are making use of the public measures in place to combat the crisis and relating to accounting adaptation. At the same time, a temporary moratorium is being provided for the submission of other types of information deemed secondary in this situation.

3.2.4 Other actions

The suspension of the distribution of dividends and the practice of prudence in the payment of bonuses to employees, as recommended by the EBA and the ECB to the banks under the latter's supervision and as extended by the Banco de España to the less significant institutions in Spain,[11] are necessary instruments aiming to channel the generation of income to the strengthening of solvency. The ECB[12] Banco de España and subsequently the EBA[13] have approved recommendations in which they ask banks not to distribute dividends for 2019 and 2020, at least until 1 October 2020, and to refrain from share buy-backs aimed at remunerating shareholders. The Spanish National Securities Market Commission and the Registrars Association of Spain have issued a joint statement to indicate how entities which have approved a dividend and wish to make changes should proceed.[14]

Banks have the capacity to adjust their dividend distribution policies to adapt to the guidelines issued by the microprudential supervisors and so strengthen their solvency. Generally, All Spanish significant institutions that may legally suspend or postpone the dividend distribution out of profit for 2019 have followed the ECB's recommendation and carried out these actions. As an illustration, Chart 3.4 shows changes in profits and in the dividend distribution policy of six Spanish deposit-taking institutions in recent years. Against a backdrop of declining profits in the sector in 2019, prior to the ECB's recommendation of 27 March 2020, one of the banks which had posted a decline in profits anticipated a dividend cut and the other four envisaged maintaining their dividends. Following the recommendation, the first bank announced a more drastic cut and another bank adhered to the adjustment. The rest were unable to comply with the recommendation owing to legal obstacles

11 See Banco de España press release of 27 March 2020.

12 See ECB press release of 27 March 2020.

13 EBA Statement on dividends distribution, share buybacks and variable remuneration (31 March 2020).

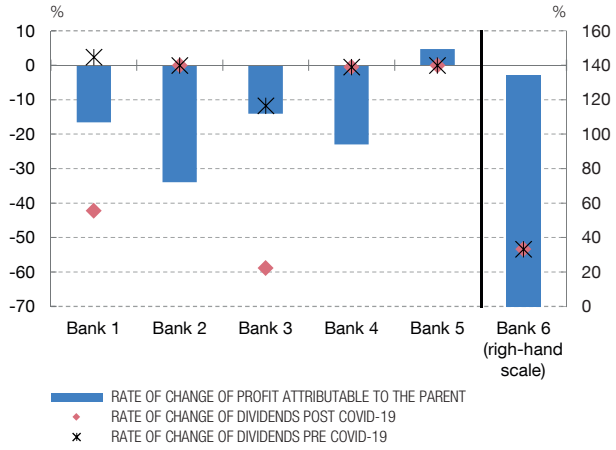
14 Joint statement issued by the Registrars Association of Spain and the Spanish National Securities Market Commission in relation to annual accounts and the proposed distribution of profit of corporate entities in the context of the health crisis resulting from COVID-19 (26 March 2020).

Chart 3.4

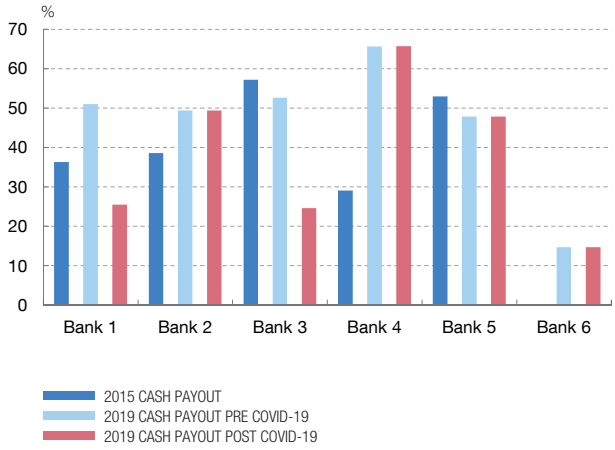
THE ECB AND THE BANCO DE ESPAÑA'S RECOMMENDATION TO SUSPEND DIVIDEND PAYMENTS WILL ENABLE BANKS TO STRENGTHEN THEIR CAPITAL LEVELS TO DEAL WITH THE IMPACT OF THE CRISIS

The volume of distributed dividends generally remained stable in 2019 for Spain's major listed banks, despite the average decline in income in the past year, with payout ratios higher than those for 2015 at four of the six listed banks. As a result of the ECB's recommendation of 27 March 2020 on the distribution of dividends during the COVID-19 pandemic, banks with the legal capacity to limit the distribution of dividends out of profit for 2019 took action, which has generated a significant reduction in cash payouts with respect to their plans prior to the expansion of the coronavirus pandemic. The ECB's recommendation will also have a moderating effect on the 2020 payout ratios.

1 CHANGES IN 2019 IN CONSOLIDATED PROFIT ATTRIBUTABLE TO THE PARENT AND IN DIVIDENDS (a)
Top listed banks in Spain



2 CASH PAYOUT RATIO (a) (b)
Top listed banks in Spain



SOURCE: CNMV.

a The dividends refer to dividends out of profit for the related year, regardless of the year in which they are paid.
b The cash payout ratio is calculated as the ratio of the cash dividend (disregarding scrip dividends) to profit attributable to the parent.

relating to the previous approval of the distribution of dividends at their shareholders' meetings. In consequence, the average cash payout ratio (ratio of cash dividends to profit attributable to the parent bank) has decreased as regards the initial plans to distribute dividends against profit generated in 2019. This ratio will likely decrease even further in 2020.