TRANSMISSION CHANNELS AND RISKS TO FINANCIAL STABILITY FROM THE COVID-19 PANDEMIC

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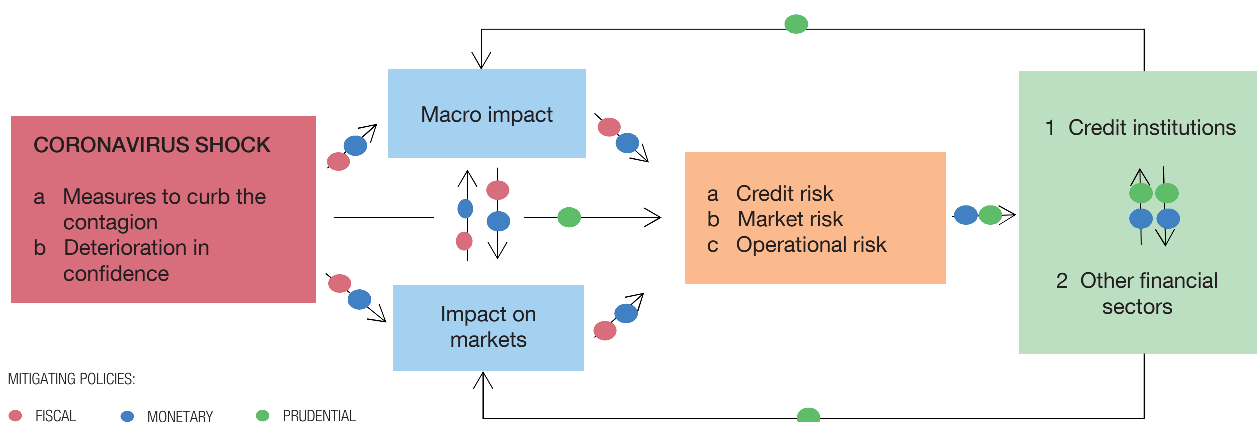
In the context of the crisis of the COVID-19 pandemic, Banco de España is conducting reinforced monitoring of the economic and financial situation, in particular, of the national banking sector. Given the far-reaching change and exceptionality introduced into the macrofinancial setting by the crisis, this Financial Stability Report (FSR) is in a special format. Specifically, it focuses on analysing the transmission channels of this shock (in particular, to the domestic financial sector), its potential and actual impact up to the cut-off date for this report, and the factors that may help mitigate its effect, including most notably the response of economic policies.

The coronavirus pandemic and the necessary containment measures applied are exerting a most severe impact on economic activity. As a result, the risks to global financial stability have increased substantially. The economic policy measures adopted – at the national, European and international levels – should help mitigate these risks.

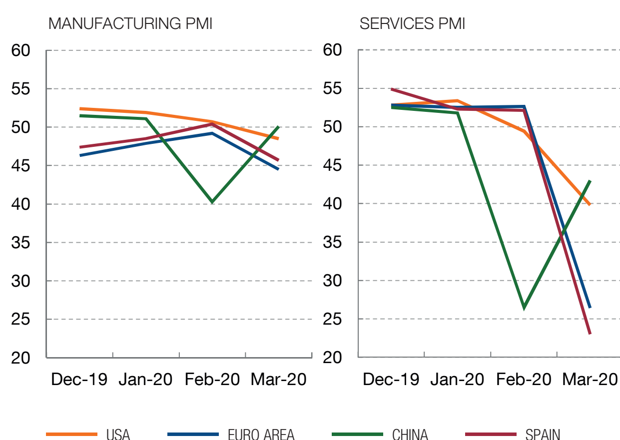
In the short term, the pandemic and the containment measures adopted by the authorities to control it directly impact economic activity and financial developments (see Figure 1) **via the reduction in the supply and demand for goods and services.** The containment measures drastically limit people's movements and entail the virtual full suspension of activity in certain productive

Figure 1
IMPACT OF CORONAVIRUS PANDEMIC ON FINANCIAL STABILITY, AND MITIGATING POLICIES

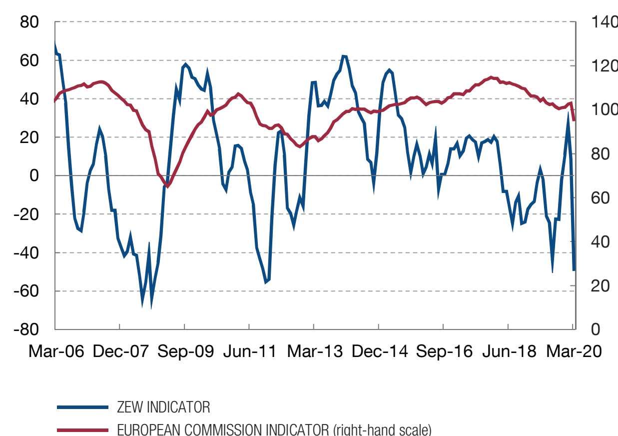


SOURCE: Banco de España.

1 PMI INDICATORS



2 CONFIDENCE INDICES



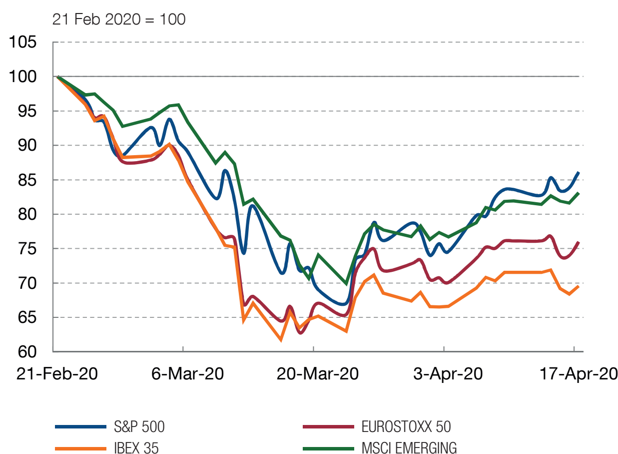
SOURCES: IHS Markit, European Commission and Leibniz Centre for European Economic Research (ZEW).

processes. Initially, the country most affected by these measures was China, which has now been joined by a growing number of economies, Spain among them. The leading indicators of activity show that the impact on Chinese output has been most significant, although the latest data point to a degree of recovery (see Chart 1). In Spain and in the other advanced economies, activity is also seen, with something of a lag, to be contracting most severely. This sharp adjustment is likewise feeding through to the emerging economies, including those of most importance in terms of exposure of Spanish financial institutions. These countries are highly dependent on global demand and on the course of commodities prices, which have collapsed.

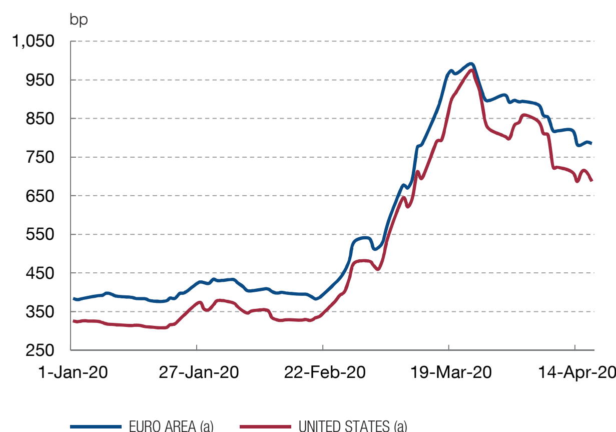
In parallel, the increase in uncertainty generated by the pandemic has caused a very marked downturn in agents' confidence and a strong fall in asset prices (see Chart 2). As a result of the uncertainty, agents have reconsidered spending decisions, in particular on durable goods consumption and on investment. Further, there has been a strong fall in asset prices, particularly those considered to be riskier, such as equities and lower graded bonds (see Charts 3 and 4), and those issued by the emerging economies, which have recently recorded sizeable capital outflows. This adjustment in financial market prices reflects both the increase in risk premia against a backdrop of high uncertainty and the worsening macroeconomic outlook. This, in turn, might exert an additional adverse impact on activity, if it entails a sustained tightening of financing conditions.

Accordingly, the pandemic has substantially increased the credit risk of exposures to non-financial corporations. Increased credit risk arises owing to the decline in companies' revenues, the outcome both of the fall in demand and of the dislocation of productive processes. That lessens companies' ability to repay the debt they have assumed, especially in the case of short-term debt. This effect is heterogeneous across economic sectors. In particular, some sectors, which in

3 STOCK MARKET INDICES



4 HIGH-YIELD BOND SPREADS OVER SWAP CURVE



SOURCE: Thomson Reuters Datastream.

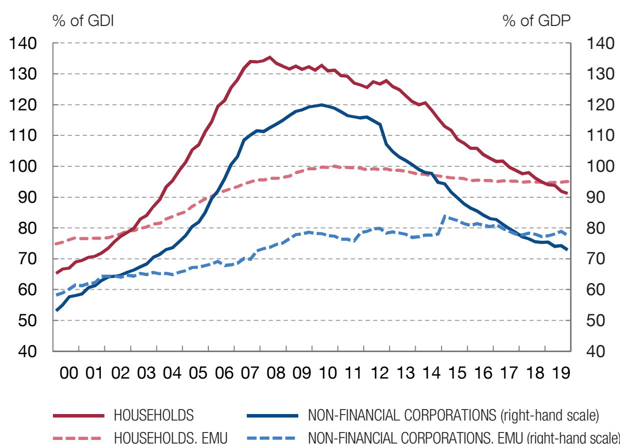
a ICE Bank of America Merrill Lynch Single-B High Yield Index.

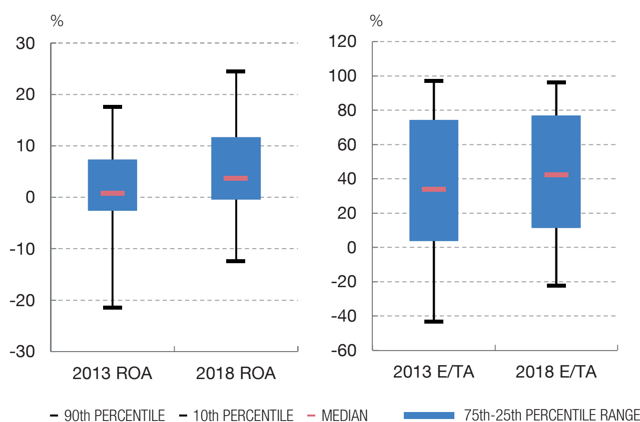
Spain's case account for around 25% of GDP, have been especially affected by the drastic restrictions on people's movements and the suspension of activity; cases in point are the hotel and restaurant trade and retail trade. Other sectors, such as the car industry, have halted production because of the standstill in demand and the interruption of supply chains.

Spanish firms are facing this shock in a more favourable financial position than that before the global financial crisis, but there are vulnerable segments. Spanish non-financial corporations have substantially reduced their debt levels in recent years (see Chart 5), which are now below the European average and have the support of higher liquidity buffers. Moreover, the sectoral distribution of activities is more balanced than in the situation prior to the previous crisis. That said, the scale of the shock is very significant and there are still segments of the Spanish corporate sector in a vulnerable position (see Chart 6).

The credit risk of exposures to households has also risen. The reduction in activity has given rise to substantial job destruction in the short term which, as on previous occasions, has been concentrated in temporary employment. As in the case of firms, households' financial position has improved significantly since the global financial crisis (see Chart 5), while mortgage lending standards have been much more prudent. However, in addition to the significant scale of the shock, in recent years, consumer credit has been growing at high rates and, on past experience, this is one of the first financial liabilities that households fail to pay when their income turns down.

The pandemic has also increased market risk. As stated, the uncertainty associated with the effects of the pandemic has made for a forceful rise in the



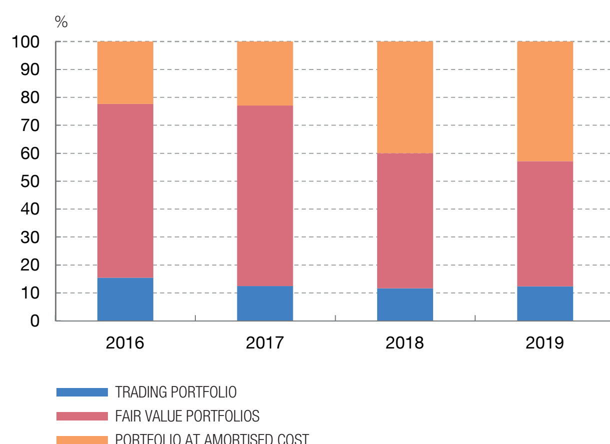


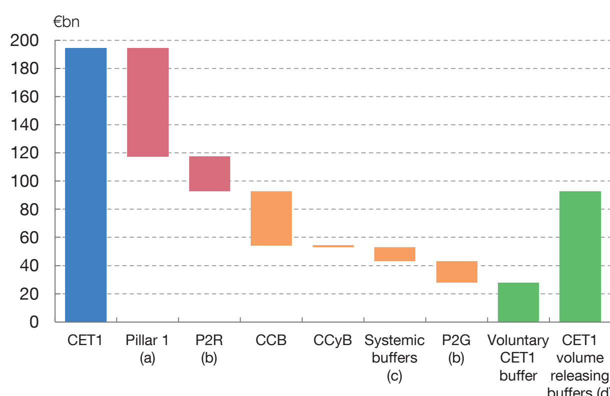
SOURCES: Banco de España and ECB.

volatility of asset prices traded on financial markets, the reflection of which has been a notable increase in risk premia (see Charts 4 and 10). This development, along with the foreseeable worsening in corporate profits, has prompted a sharp decline in risk-bearing asset prices, which might affect their value on financial institutions' balance sheets (see Chart 7).

One of the distinctive characteristics of this crisis is that it has also increased institutions' operational risks. Confinement has entailed the speedier activation of remote working protocols and of contingency plans so as to ensure the appropriate provision of financial services to customers. The urgency with which it has been necessary to adapt to the restrictions on movement entails vulnerabilities for information systems, processes, platforms and technological infrastructures, on which institutions are increasingly dependent. Under these conditions, cybernetic risks become particularly prominent. To date, institutions have managed to effectively adapt to the situation and financial markets have continued functioning correctly; but contingency plans must be pursued, ahead of the potential extreme operational events this crisis may involve.

The high degree of interconnectedness in the financial sector might amplify the financial impact of the shock. On one hand, the interconnectedness of global financial markets means that the mitigation of the effects of the pandemic is conditional upon how certain countries playing a central role in the international economic and financial architecture perform. On the other, the interconnectedness of financial sub-sectors, which may be direct (when these intermediaries have cross-exposures on their balance sheets or income statements) and also indirect (through common holdings of securities), may become an additional amplifying factor. In this latter case, it is of vital importance to prevent bouts of accelerated portfolio sales, which may further distort the functioning of financial markets. In this respect, it is





SOURCE: Banco de España.

a This item includes all of CET1 earmarked to meet Pillar 1 requirements, both the direct requirement of 4.5% and the requirement made to institutions which do not have sufficient AT1 and T2 to meet their respective requirements of 1.5% and 2%.
b P2R refers to Pillar 2 capital requirements, whereas P2G refers to Pillar 2 guidance. Supervisory guidance in response to COVID-19 allows for the release of capital linked to P2G and relaxes the rules on the composition of the P2R, with a lower weight of CET1.
c This item includes the buffer for global systemically important institutions and the buffer of other systemically important institutions.
d The capital that can be released in accordance with the supervisory guidance in response to COVID-19 includes the voluntary CET1 buffer, the capital conservation buffer, the countercyclical buffer, the systemic buffers and the capital linked to Pillar 2 guidance.

imperative to monitor both withdrawals of collective investment institutions' funds and the decisions credit rating agencies take (whose re-grading of ratings may mean specific securities contribute to raising the risk profile of funds' portfolios and lessening the value of those securities as collateral), and also to scrutinise these institutions' and markets' liquidity. In addition, the reduction in market funding arising under these circumstances for certain agents must not entail an additional burden for other intermediaries.

Banks have higher solvency levels and must play a leading role in the absorption of this shock and in the response to the crisis. As part of the regulatory response to the international financial crisis, the banking sector has improved significantly balance sheet quality and increased its solvency levels over the past decade. In Spain's case, as can be seen in Chart 8, financial institutions have significantly higher capital levels than the minimum regulatory requirements, which can be used to absorb unexpected losses. In this respect, the readiness of capital buffers to accommodate a shock that has not originated in the banking sector itself coupled with their proximity to customers means that – with the support of government – banks can become key players in the response to the pandemic. Specifically, banks should be in a position to provide financing to agents that, prior to the pandemic, had a good payment record but now have liquidity needs.

Nonetheless, the magnitude of the short term economic deterioration has no close precedent, which, together with the doubts regarding its duration,

compels to maintain careful monitoring. The challenge for banking entities is very important given the size of the short term shock – larger than in stress test exercises conducted in the past- and the uncertainty about its persistence. Experience in previous stress test exercises indicates that periods of significant economic deterioration followed by swift recoveries do not entail very pronounced deteriorations in the banking system's aggregate solvency. However, the consequences of protracted adverse economic scenarios can significantly undermine aggregate solvency. Even in these latter scenarios, loss-absorbing items make possible a non-immediate erosion of solvency , providing scope for action, which must be used for an unequivocal response of economic policy.

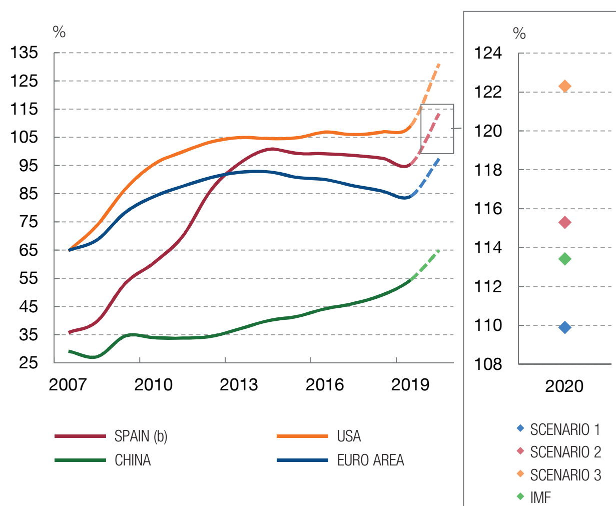
The impact on the financial situation of banking entities is expected to be heterogeneous. In this regard, entities with greater exposure to productive sectors and geographic areas that are most affected by the pandemic, and those that start from a worse initial situation in terms of balance sheet quality and profitability, will experience a larger negative impact on their profit and loss account and solvency levels.

The challenges for the banking sector arising from the effects of the pandemic are added to those that already existed. In recent years, the profitability of the European banking sector has remained at low levels and below the cost of capital. Besides, the non-performing loan ratio in Spain, despite the significant reduction since 2014, was still above the levels previous to the crisis and it will experience a rebound in the current circumstances. It must also be taken into account that, at least partly, the low profitability in the sector is associated with low nominal growth and low, and even negative, interest rates, which are likely to persist for longer after this crisis. Indeed, the banking sector, not only in Spain but also internationally, has seen one of the largest drops in stock market valuations.

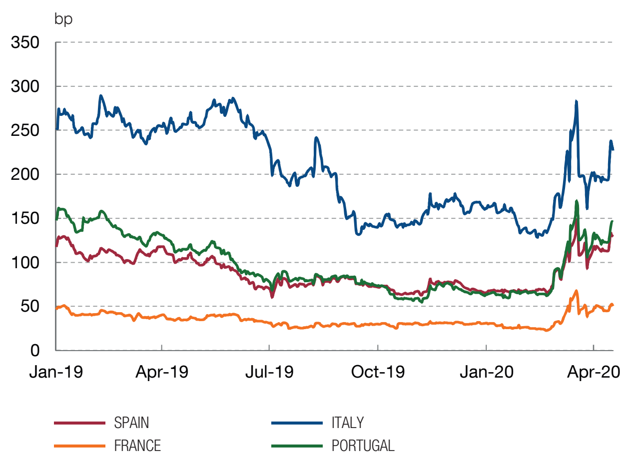
A forceful, swift and coordinated response by the economic authorities is crucial to mitigate the effects of the crisis and prevent them from being durable. The response should encompass national, European and global economic policies and cover the fiscal, monetary and prudential areas. The aim is to mitigate the earlier-mentioned transmission channels and to prevent a shock that has an essentially transitory effect – albeit a most severe one – on activity and financial stability from becoming more persistent (see Figure 1). This economic policy response must be adapted, both in terms of magnitude and duration, to the economic effects of the pandemic.

Fiscal policy stands as the first line of defence. It is indeed the fiscal authorities that have the most appropriate and powerful instruments to ensure agents' incomes and, from the financial stability perspective, to reduce the potential increase in credit risk. In Spain's case this has meant injecting liquidity into companies by means of payment deferrals on certain tax obligations and providing for temporary staffing adjustments without employees forgoing all their income. In the case of households,

9 PUBLIC DEBT AS A PERCENTAGE OF GDP (a)



10 10-YEAR GOVERNMENT BOND YIELD SPREAD OVER GERMANY



SOURCES: IMF, Thomson Reuters Datastream and Banco de España.

a Data for 2020 correspond to current IMF projections.
b For 2020, the dashed lines correspond to the IMF's current outlook for Spain and to the "Reference macroeconomic scenarios for the Spanish economy after COVID-19", *Analytical Articles, Economic Bulletin,* 2/2020, Banco de España.

unemployment benefits have been reinforced and basic supplies ensured, and it has also been announced the upcoming implementation of a subsidy for very-low-income households. Further, a moratorium has been approved on mortgage debt and on other non-mortgage loans, including consumer loans, for individuals affected by the crisis. In this connection, a large-scale guarantee programme has also been launched, the appropriate use of which should enable firms to finance their liquidity requirements. This will help ease the closure of companies and prepare the productive system for a potential recovery once the pandemic containment measures can be relaxed. Logically, these measures will have to be adapted to the actual duration of the confinement and be in step with the economy during the ongoing recovery of normality. In this accompaniment process, the measures will have to be tailored to the different speeds at which the different sectors of activity will foreseeably move.

This necessary fiscal policy response will lead to a most significant increase in public debt globally, the reduction of which must be faced once the effects of the crisis fade. The aforementioned measures, along with the operation of the automatic fiscal stabilisers, in a context of strong deterioration of activity, will significantly raise public-sector borrowing requirements and debt ratios in all countries. And this in a situation in which global public debt had already increased significantly in the wake of the international financial crisis (see Chart 9). Unsurprisingly, in this setting, tensions have fed through to sovereign risk premia, although their effect is being mitigated by the actions of central banks (see Chart 10). In Spain's case, the public debt/GDP ratio stood at end-2019 at 95.5% of GDP, more than 60 pp above its 2007 level, and the budget deficit was at 2.8% of GDP. Against this background, fiscal

policy has a necessary role to play in the current crisis, as a guarantor of household and corporate income. However it should be accompanied by a medium-term fiscal consolidation programme that, once the effects of this crisis fade, will reduce public finances imbalances, and by structural reforms that provide for an increase in the Spanish economy's growth potential.

The reaction of central banks has also been crucial to keeping monetary policy transmission channels fully operational and avoiding the fragmentation of financial markets. In the euro area, the ECB Governing Council has approved new long-term refinancing operations (LTRO and TLTRO-III), under very favourable conditions, an extension of the volume of asset purchases under the APP and a new Pandemic Emergency Purchase Programme (PEPP), under which it will purchase both public and private securities worth at least €750 billion over the rest of this year. These measures are key to preventing any tightening of economies' financing conditions and any financial fragmentation in the euro area, against a background of strongly increasing public treasury financing needs. Besides, the ECB Governing Council has reiterated its determination to do all that is necessary to ensure that monetary policy is transmitted to all economic segments and all countries in the area. Specifically, the ECB Governing Council is ready to increase the size of PEPP and adjust its composition, to the required extent and for the necessary time.

Both micro- and macroprudential policy decisions have been aimed at enabling use of the capital buffers, built up precisely to withstand unexpected losses, and at limiting profit distributions. As earlier indicated, following the regulatory reforms in response to the global financial crisis, financial institutions have raised their capital levels significantly. Banks' capital is conceived precisely to absorb unexpected losses in the face of adverse shocks and to smooth, in these situations, the continuing supply of financing to agents. To this end, the ECB and the national authorities, integrated into the Single Supervisory Mechanism (SSM), have allowed institutions to use the voluntary, countercyclical, systemic, conservation and P2G-derived capital buffers, and also to operate temporarily below the levels set for the liquidity ratio, in response to the current crisis. Moreover, they have recommended that banks should not distribute dividends and that they should exercise prudence in the payment of bonuses to their employees. In this way, both measures may contribute to shoring up their solvency in this crisis situation.

The measures approved have also sought to prevent unwanted potential procyclicality in the application of accounting and prudential regulations. Accountingwise, and given the, in principle, transitory nature of the shock, the ECB has stated that it will be flexible in its consideration of borrowers benefiting from public support measures (such as guarantees and moratoria) as non-performing. The ECB will also take into account these circumstances, in the application of the provisioning expectations under Pillar 2, accepting the possibility of operating below the pillar's recommendation. In addition, the ECB has recommended that institutions

avoid procyclicality in their provision-estimation models and that they incorporate a medium-term outlook into their calculation. Along these same lines, the European Banking Authority (EBA) has called for flexibility and pragmatism in the application of the prudential framework, clarifying that, in the event of a public or private debt moratorium, there should be no automatic classification as a non-performing loan or any accounting reclassification. The EBA has also supported the recommendations on the use of capital and liquidity buffers and on limits on dividend payouts.

The measures approved by the national authorities and by the ECB should be complemented with a forceful European response. The pandemic and its economic impact are affecting all euro area and, by extension, EU countries. Tackling it requires resolute and ambitious measures by Community authorities and institutions using the financial and budgetary instruments currently available, as well as possible new tools. In this respect, on 9 April the Eurogroup agreed to set in train a raft of support measures, including most notably a credit facility from the European Stability Mechanism (ESM) to provide financing to Member States; a European Investment Bank (EIB) programme to smooth the funding of SMEs; and a fund to defray part of the costs associated with temporary layoff arrangements by companies. In addition, the European Council supported on April 23th the creation of a Recovery Fund at the proposal of the European Commision, to be funded with the 2021-2027 multiyear European budget. Among other possible new instruments that might be required, priority should be given in all the cases to those that reinforce the capacity of the EU as a whole to promote appropriate financing conditions with which to defray the sizeable costs of the crisis and the repairing the growth capacity of all the Member States harmed by the pandemic. Given the current crisis it is more pressing than ever to make headway in completing the optimal monetary zone that the euro area aspires to be.