Foreword by the Governor Pablo Hernández de Cos

2020 has been marked by the unprecedented global health and economic crisis triggered by COVID-19. Activity and employment have experienced a very pronounced fall, which has been especially intense in those countries, like Spain, whose business sectors have smaller-sized firms, more temporary employment and a higher weight of the economic sectors that have been hardest hit, owing to the greater social interaction required. This sharp initial impact has been followed by a recovery that remains partial, uncertain and uneven. In any event, this crisis has highlighted the importance of resolutely tackling the structural challenges faced by our economy.

The economic authorities have taken forceful action to address the challenges prompted by the COVID-19 crisis, and the degree of coordination achieved has been particularly positive. Given the global nature of the crisis, cross-country coordination was essential in order for any response to be effective. This was especially important in European Union (EU) countries, owing to our high degree of economic and financial interconnectedness and the institutions that we share. The swift and forceful monetary policy measures taken by the European Central Bank have allowed financial conditions to remain highly favourable in all countries. This have paved the way for fiscal policy measures at both national and EU level (in particular through the approval of the Next Generation EU programme), aimed at preventing the pandemic's economic effects from becoming persistent and adversely affecting long-term growth potential.

In the financial arena, the European authorities with prudential powers, in coordination with national and international authorities as well, adopted numerous decisions to enable the financial system to contribute to overcoming the crisis. The prudential supervisors revised their guidelines on capital and liquidity buffers and allowed banks to temporarily operate below the regulatory level set for some of these requirements, in order to help them continue to provide the financing needed by households and firms in an adverse environment. Various recommendations have also been approved on restricting dividend distribution, aimed at increasing the build-up of banks' loss-absorbing resources amid the heightened uncertainty. The accounting authorities have also been explicit about the need to bear in mind the exogenous and, in principle, temporary nature of the crisis when applying regulations, which include the flexibility required to accommodate this situation.

In this context, the banking sector has played a key role in applying some economic support measures, by facilitating the transmission of monetary policy decisions, ensuring accommodative financial conditions and implementing some of the financial and tax initiatives, such as the moratoria and State guarantee schemes. This has borne out the importance of the improvements made over the last decade in the quality of the sector's balance sheet and in its solvency levels, which have left it better placed to absorb the impacts of this crisis and to continue lending. In this respect, we should note the effect of the far-reaching international financial reform which has, so far, allowed the financial system to act as a mitigating, as opposed to an amplifying, factor of the impact of this crisis.

This improved starting position, together with the swiftness, decisiveness and complementarity of the response from the different authorities, helped to absorb the initial impact of the shock, contributed to maintaining the provision of credit to the economy and prevented systemic risks from materialising. However, we have to acknowledge that the crisis has had a considerable impact on non-financial companies' income statements and on household income, impairing their solvency. Similarly, financial institutions' results deteriorated significantly in 2020, owing above all to the anticipated credit impairment provisions. Banks must continue to recognise this deterioration in an appropriate and timely manner. Only in this way will it be possible to have a reliable diagnosis of the situation that prevents dislocations when allocating financial resources to productive activities and fosters the adoption of the measures needed for a robust and sustained recovery.

Looking to the coming months, it is important to recognise that the final impact of the crisis on the banking sector will depend both on its scale and duration and on the effectiveness of the economic policies in alleviating its effects on households and firms. The current status of the economic recovery (partial, uncertain and uneven) warrants maintaining a large part of the exceptional economic support measures, in particular for certain sectors and individuals.

One of the most concerning consequences of the persistence of the crisis is that the initial liquidity difficulties of the hardest-hit non-financial corporations could morph into solvency problems. Should such solvency problems materialise, they would not only lead to a destruction of the productive system and employment, but they would also eventually affect the financial position of the banking sector, which might respond by restricting lending. That would, in turn, fuel the negative effects on the capacity for recovery and medium-term economic growth.

Against this backdrop, March 2021 saw the approval of an aid package that could be a useful tool for specifically reducing the risk of the pandemic triggering the closure of those firms and businesses that are particularly stressed as a result of the pandemic, but which remain viable. To this end, a swift and homogeneous execution will be particularly important, as will allocation mechanisms to selectively and precisely focus this aid on viable firms with solvency problems, and an ongoing assessment of the amount of funds committed in the light of the course of the pandemic and the possible materialisation of risks. In the case of non-viable firms, winding-up processes would have to be expedited in order to prevent them from consuming resources that could be more beneficial in other activities.

This support would help prevent the crisis from taking on an additional financial element that would make it potentially much more persistent, as shown by the last global financial crisis. Thus, as it has been so far, the banking sector could continue to be part of the solution to the crisis, by lending to households and firms and helping to reactivate the economy when the pandemic is over. For this, a smooth functioning of the credit channel — of such importance in European economies and, of course, in the Spanish economy — will surely be required.

Beyond the short term, the crisis has further exposed the importance of tackling one of the sector's main challenges: its low profitability. To this end, banks need to improve their efficiency by cutting costs and making more use of new technologies.

Consolidation processes in the industry regained vigour in Spain last year with the announcement of two major operations and could prove to be an additional appropriate way of tackling future challenges from a better position. Nevertheless, the merits of each merger proposal need to be individually assessed. Our work as supervisors is to analyse the impact on financial stability, guarantee the solvency of the resulting institutions and their prudent and effective management, and oversee the execution of the operations to ensure that the potential synergies are indeed harnessed. In this regard, transnational European mergers would be particularly positive. They would deepen the Banking Union, reduce the sovereign-bank risk nexus, and provide greater potential for diversification.

Lastly, we need to continue emphasising that the response to the pandemic-induced crisis must continue to be European, in the banking sphere as well. In particular, it is essential that we complete the third pillar of the Banking Union (with the approval of a fully mutualised European Deposit Insurance Scheme), further develop the Capital Markets Union project and reach an agreement to create a common European procedure for the administrative winding-up of credit institutions that benefits from the instruments developed for their resolution.

Pablo Hernández de Cos
Governor of the Banco de España