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FINANCIAL STABILITY REPORT
Autumn 2023

Ángel Estrada
Director General

Banco de España
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DIRECTORATE GENERAL FINANCIAL STABILITY, REGULATION AND RESOLUTION

SOME OF THE RISKS TO FINANCIAL STABILITY HAVE INCREASED SINCE THE LAST FSR, THOUGH CERTAIN VULNERABILITIES HAVE ABATED

MAIN RISKS TO FINANCIAL STABILITY	**R1.** Geopolitical risks ↑	**R2.** Higher and more persistent inflation →	**R4.** Downside risk to economic growth ↑	**R3.** Increase in risk aversion among economic agents ↑
VULNERABILITIES	**V1.** High level of government debt →	**V2.** Financial weakness of households and firms →	**V3.** Weaknesses in financial intermediation capacity ↓	

GEOPOLITICAL RISKS COULD TAKE ON A NEW DIMENSION, DEPENDING ON HOW THE MIDDLE EAST CONFLICT UNFOLDS

Chart 4
Energy prices

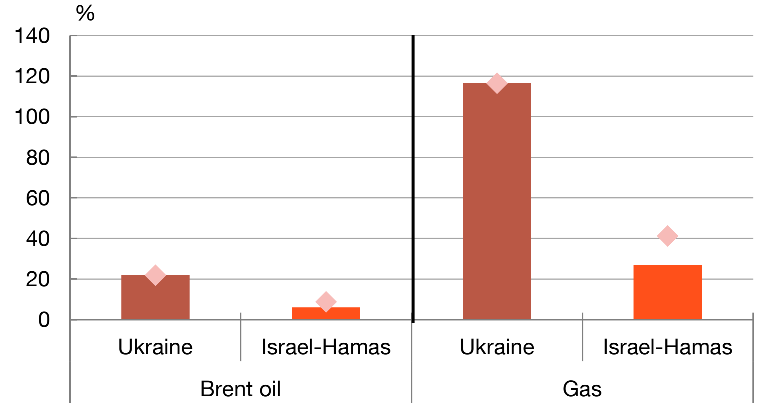


Chart 8
Brent oil price (a)

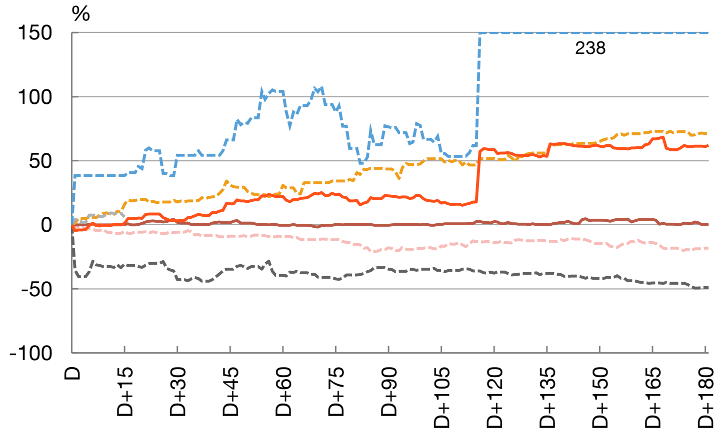


Chart 5
Fixed income (ten-year government bond yields)

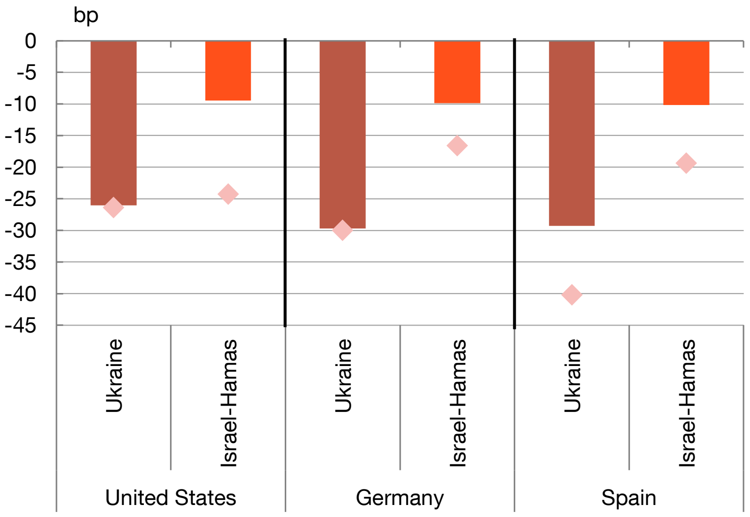
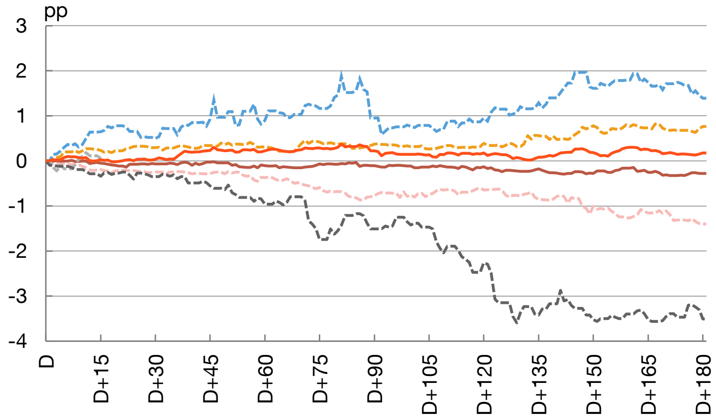


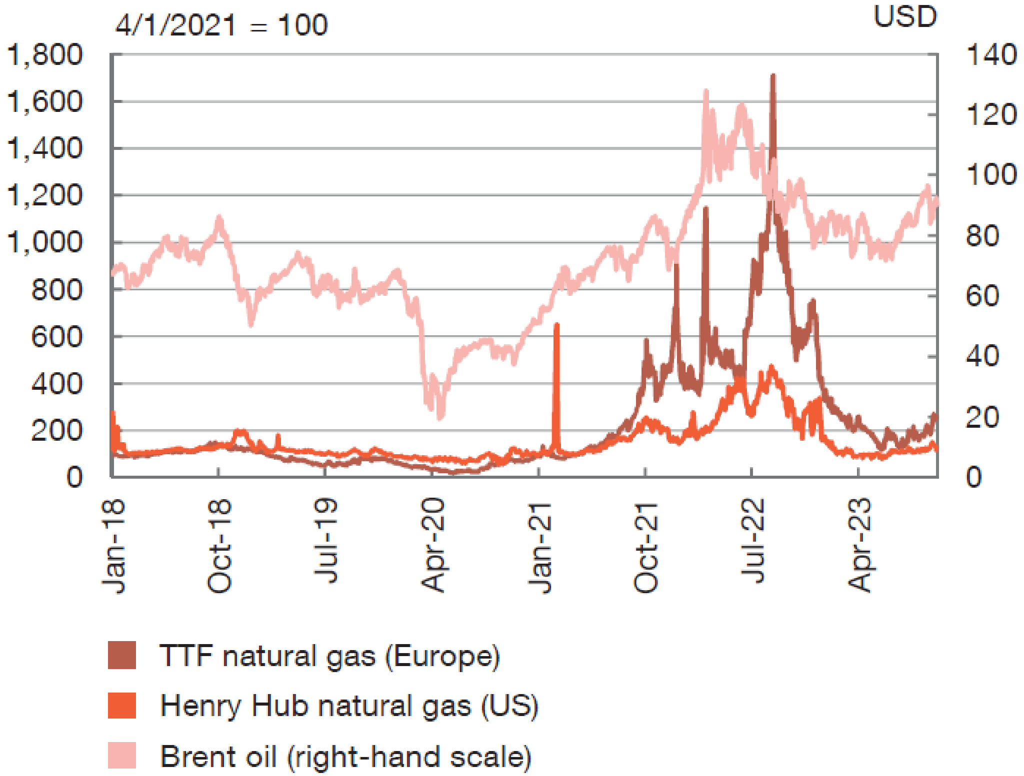
Chart 9
US 10-year sovereign bond (a)



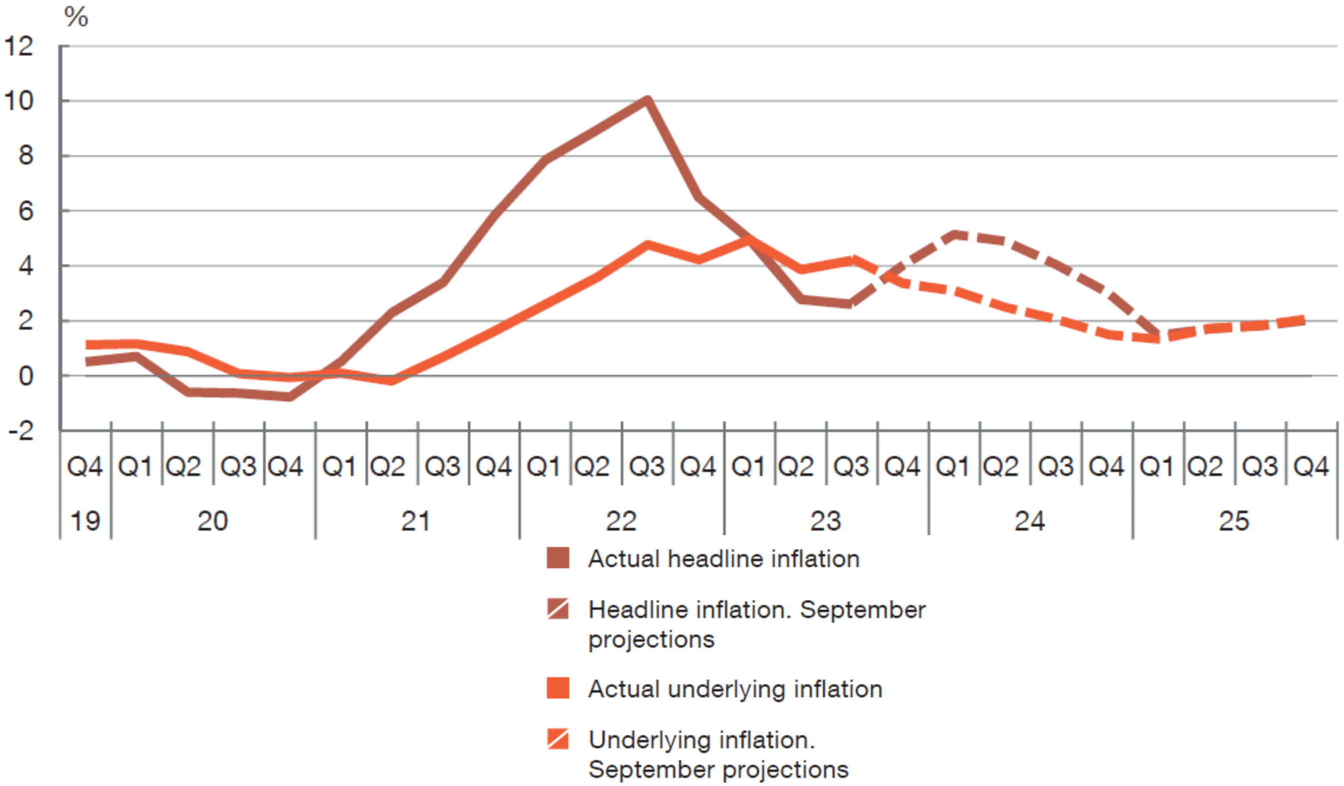
WHILE INFLATION HAS FALLEN SIGNIFICANTLY, THE UNDERLYING COMPONENT REMAINS MORE STUBBORN

- Moreover, OPEP+ have agreed to reduce the supply of oil, raising its price, and the Middle East conflict could push it up further
- Some of the fiscal measures set in place to curb price rises are also expected to be discontinued

Chart 1
Natural gas and oil prices (a)



1.3.b Headline and underlying inflation (a)



GREATER RISK AVERSION AMONG AGENTS COULD LEAD TO EVEN TIGHTER FINANCING CONDITIONS AND A FALL IN ACTIVITY

- Risk premia are at record-low levels despite the geopolitical and macroeconomic uncertainty
- The supply of bank lending has been negatively impacted by the uncertain environment and demand is shrinking

Chart 4
Spreads of NFCs' bonds against the swap curve (l-h panel) (b) and equity risk premium (r-h panel) (c). Deviations from historical average

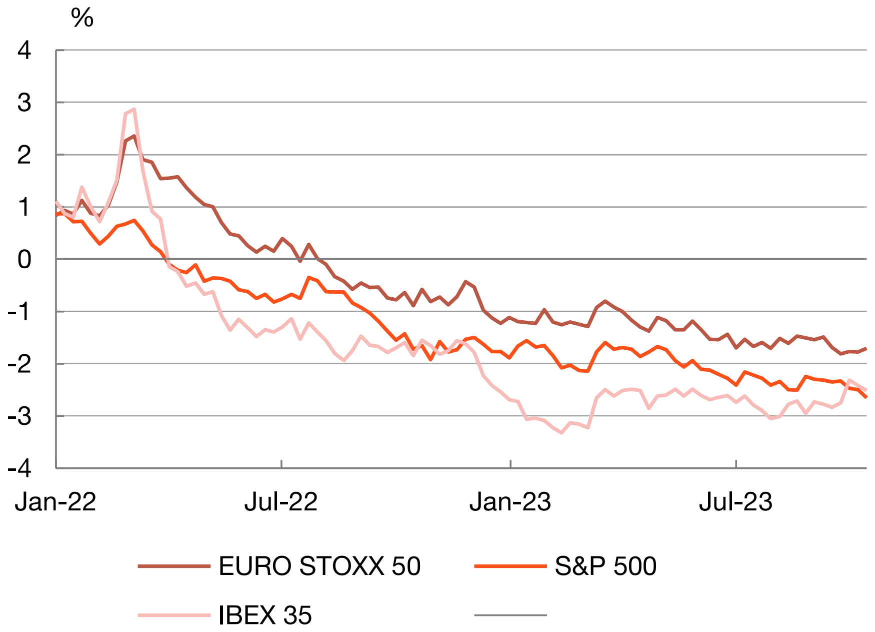
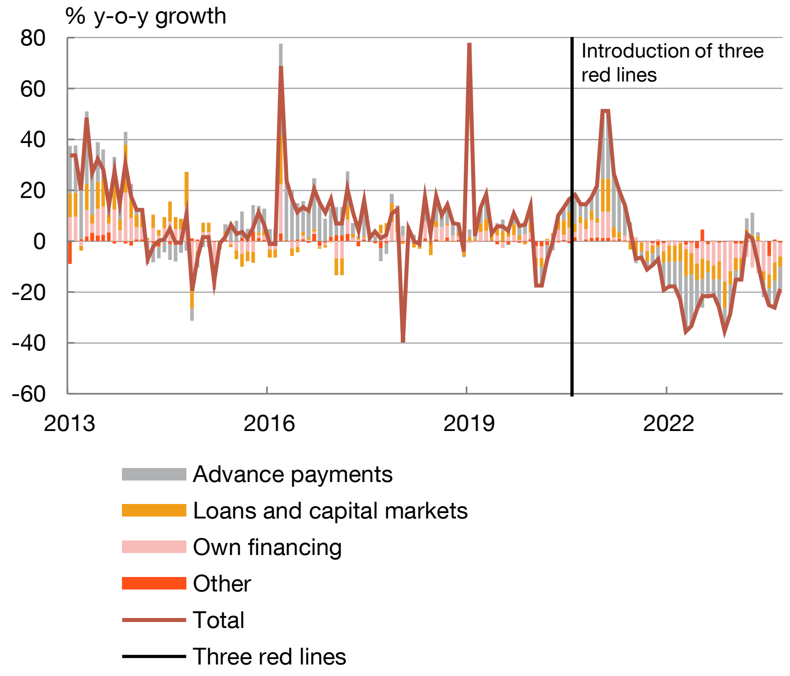


Chart 1
Bank lending, supply and demand (a)

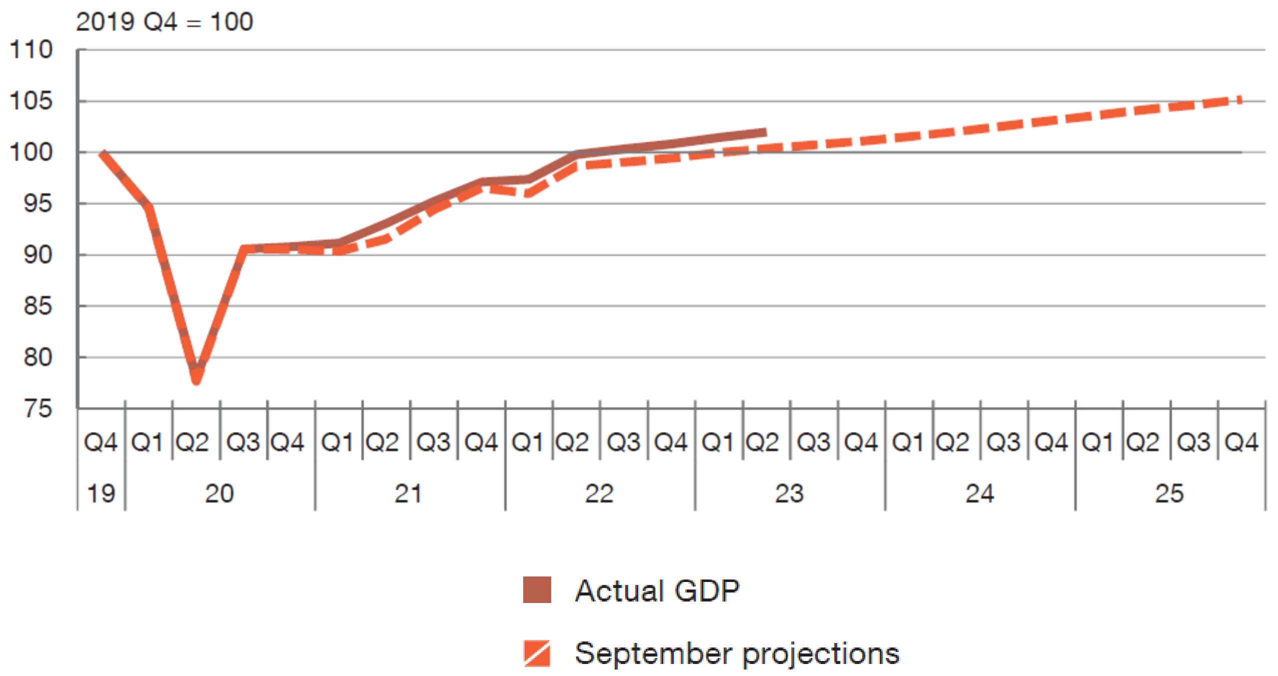
SIGNS ARE EMERGING OF AN INCREASING SLOWDOWN IN ACTIVITY ACROSS DIFFERENT GEOGRAPHICAL AREAS AND SECTORS

- In the European Union, the weakness already seen in the manufacturing sector is now being compounded by a downturn in services
  - China is facing an adjustment to its oversized real estate sector
- While activity in Spain is more robust, some of the factors underpinning this performance are somewhat temporary

Chart 1
Sources of financing for property developers (a)



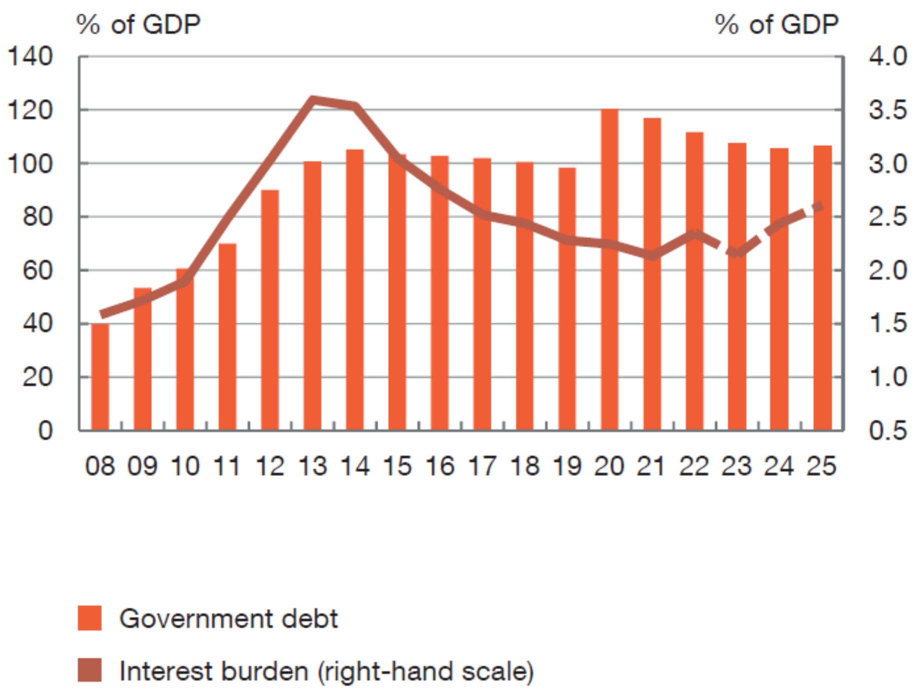
1.3.a Real GDP. Spain. Level (a)



HIGH GOVERNMENT INDEBTEDNESS IS LIKELY TO REMAIN ONE OF THE SPANISH ECONOMY'S WEAK POINTS IN THE COMING YEARS

- The growth in nominal GDP has reduced the government debt ratio and will continue to do so until 2025, although it will remain above 100% of GDP
    - Despite this, rising interest rates will drive up the interest burden as a percentage of GDP
- The fiscal policy stance must be consistent with the European Commission's recommendations, and a sustained process of fiscal consolidation should be initiated

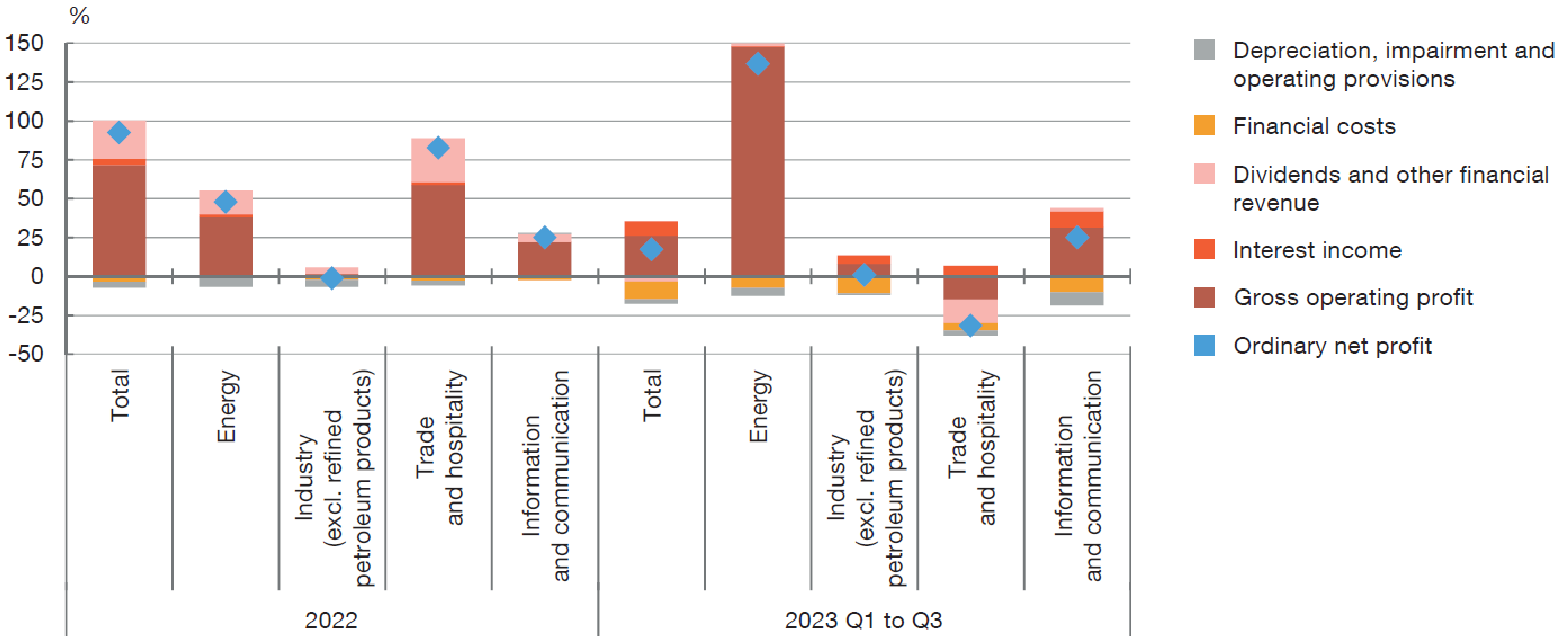
Chart 6
Spanish government debt and associated interest burden (b)



FIRMS ARE FACING HIGHER FINANCING COSTS, THOUGH PROFITS HAVE SOFTENED THE IMPACT

- Interest rate hikes are driving up firms' debt burdens, particularly as they roll over their existing debts
- The pressure exerted by labour costs and energy prices are additional risk factors

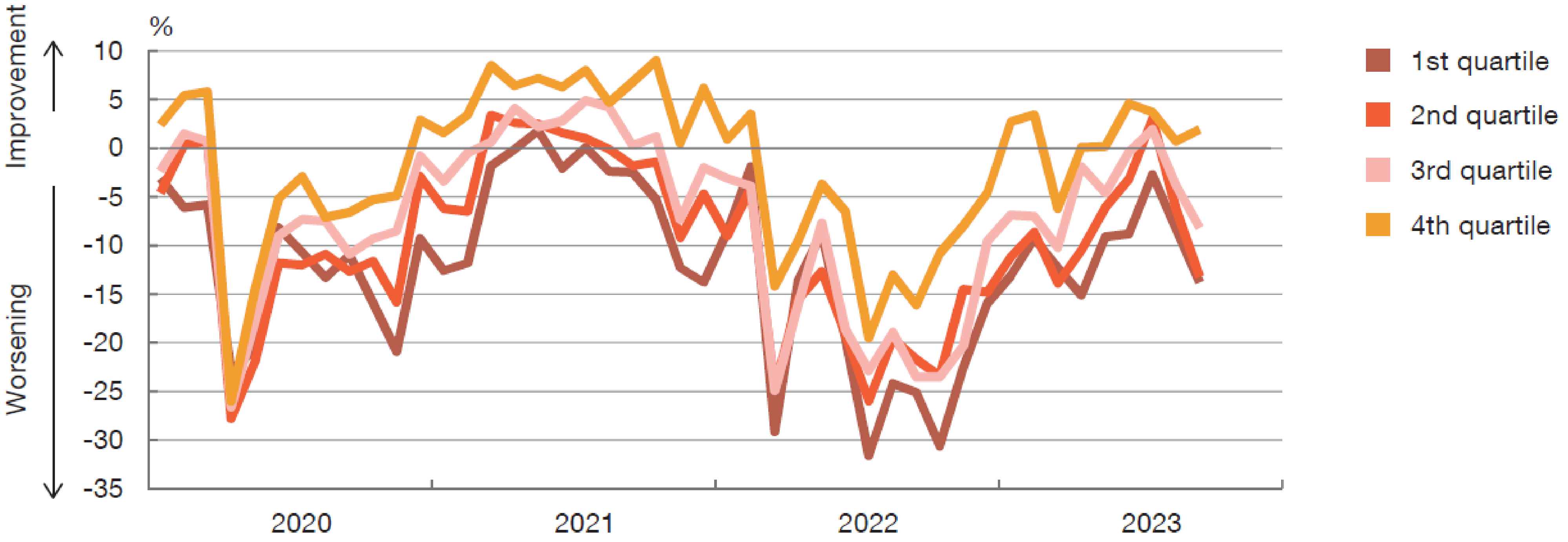
1.9.a Year-on-year ordinary net profit growth (a). Contribution by components. CBQ



HOUSEHOLD INCOME RECOVERED IN 2023 H1, BUT ANY POSITIVE IMPACT ON EXPECTATIONS APPEARS TO HAVE DISAPPEARED SINCE AUGUST

- Moreover, the debt burden on households is growing and will be higher in the second half of the year once floating-rate mortgage revisions have taken full effect
- The favourable employment situation is proving key to sustaining households’ capacity to generate income

1.10.a Households' outlook for their economic situation over the next 12 months (a)



THE NUMBER OF APPLICATIONS UNDER THE CODES OF GOOD PRACTICE WAS HIGH, THOUGH IT IS STILL EARLY TO ASSESS THEIR IMPACT AND EFFECTIVENESS

- The volume of CGP applications in just six months is high compared with the 2012 CGP: around 10% have already been implemented and 40% rejected (90% due to ineligibility),...
  - ...but only a short time has passed, and positive employment and income developments have eased the financial pressure on households
- There are some signs of greater risk associated with CGP operations, consistent with the target population

Chart 1
Take-up of CGPs (a)

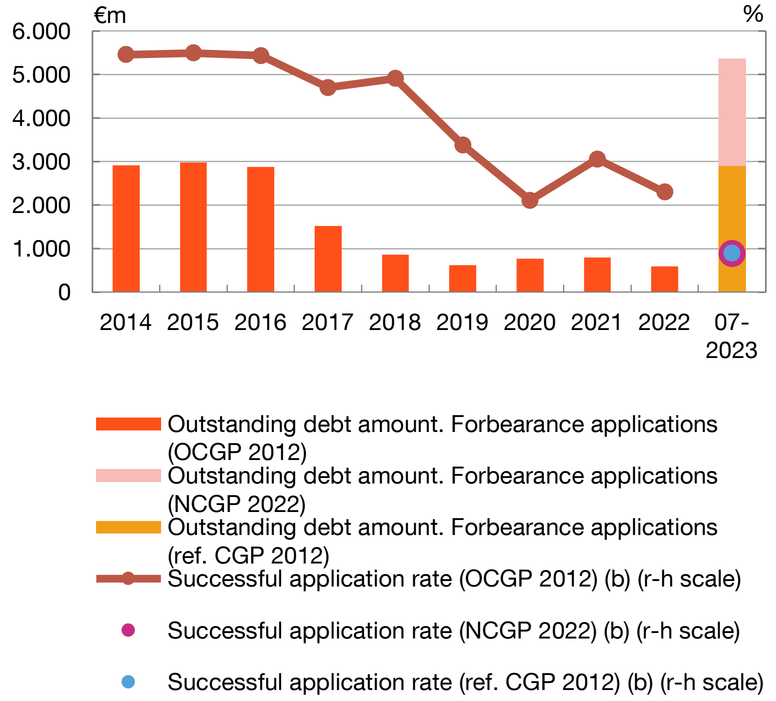
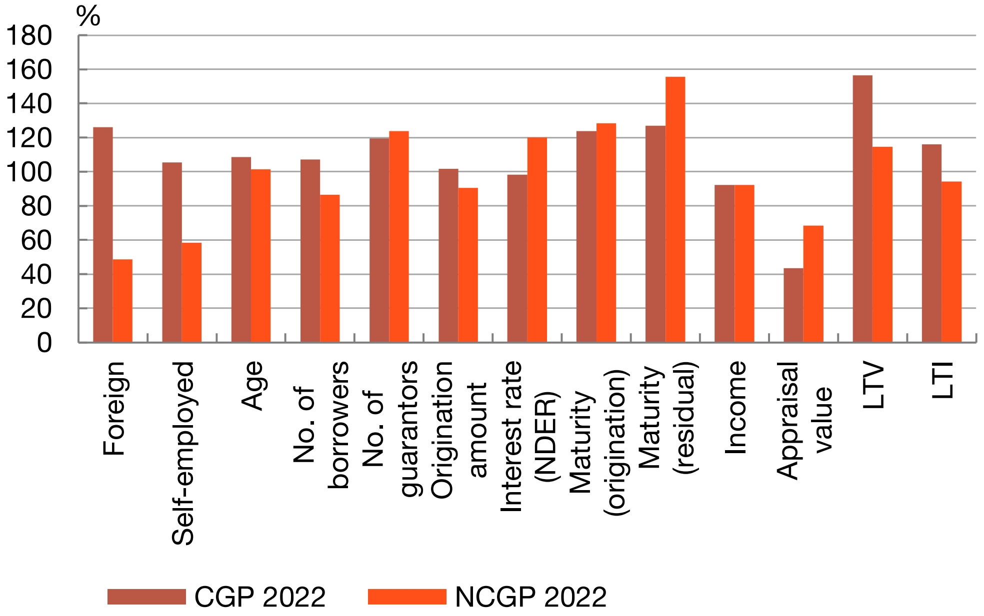
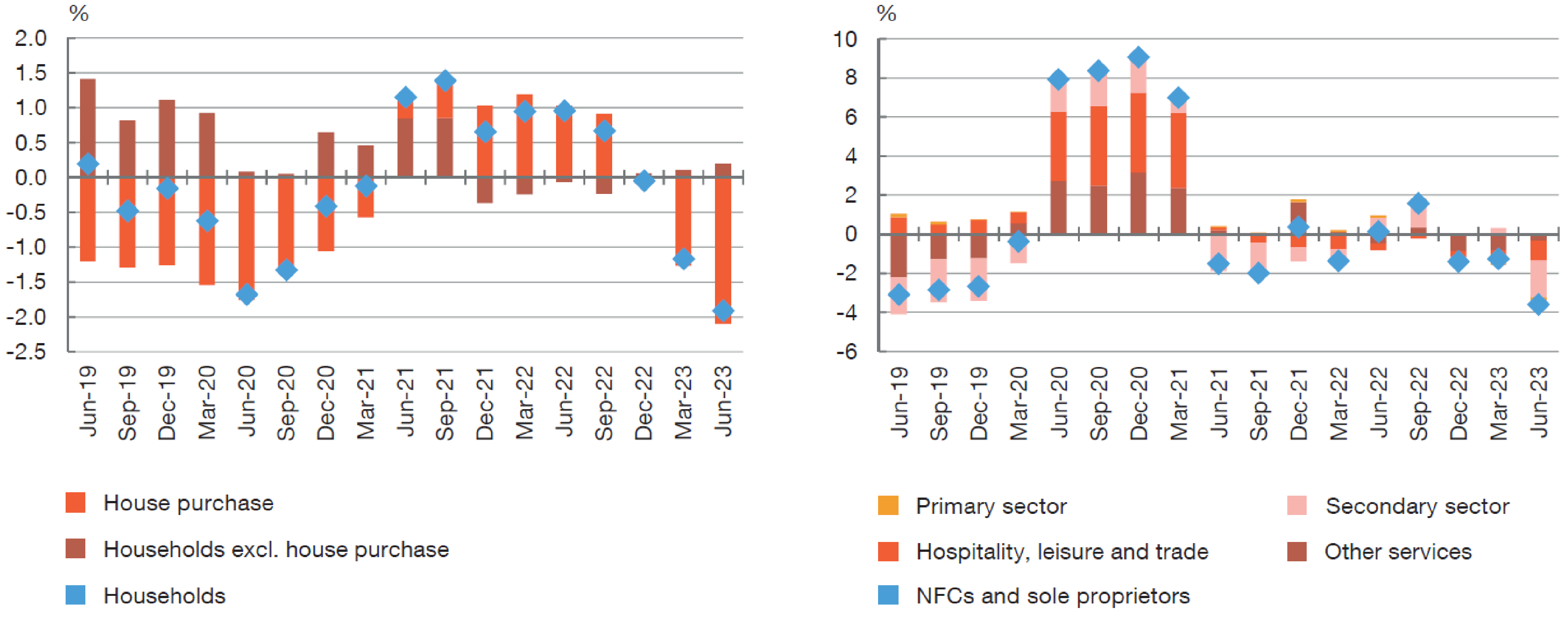


Chart 4
Characteristics of loans forborne under CGP 6 2012 and NCGP 19 2022 (a) (h)



- This was particularly affected by the fall in housing loans and lending to non-financial corporations, especially in sectors such as industry, accommodation and food service activities and wholesale and retail trade

2.1.b Contributions to the year-on-year rate of change of lending to households (l-h panel) and NFCs and sole proprietors (r-h panel). Business in Spain. ID



…CONVERSELY, NEW LENDING CONTINUED TO GROW UP TO JUNE

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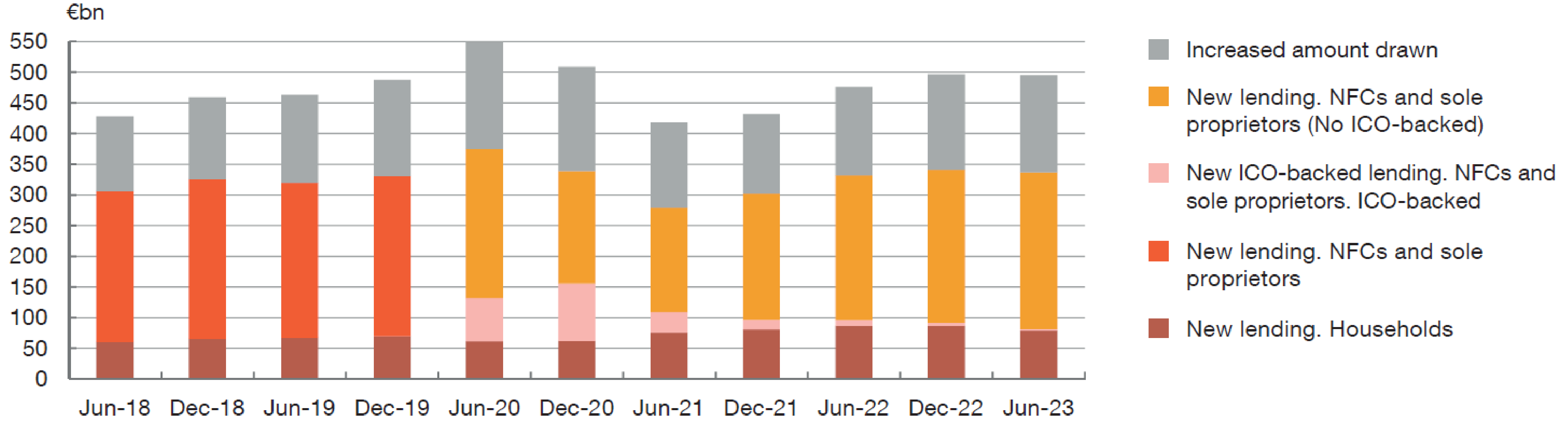
- Although this varies across portfolios, since lending to households contracted, in part owing to the decline in new mortgages…

  … and the flow of new lending has ebbed in recent quarters

- Thus, repayments are having a significant impact on the stock of credit

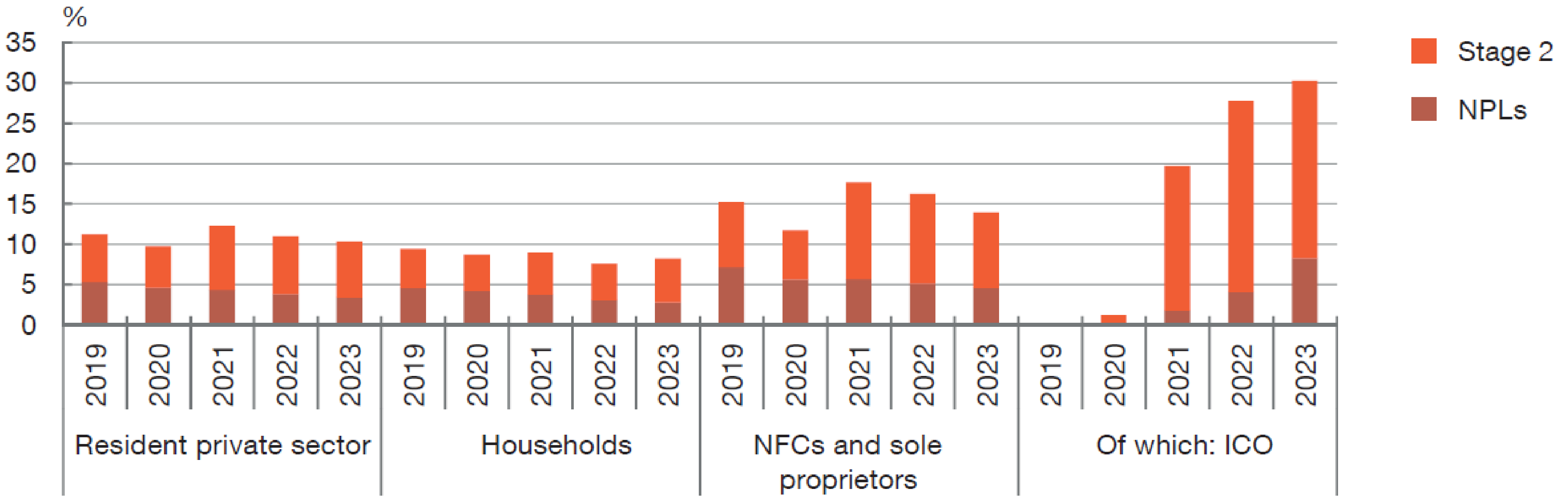
2.2.a Cumulative 12-month volume of new lending. Households and NFCs and sole proprietors (a). Business in Spain. ID



THERE ARE NO SIGNIFICANT SIGNS OF CREDIT QUALITY IMPAIRMENT

- The share of household loans in Stage 2 increased somewhat, though the NPL ratio continued to decline, despite a slight rise in NPLs in Q2
- While the Stage 2 ratio fell in the ICO portfolio, the NPL ratio increased, partially driven by repayments in this portfolio, although the volume of NPLs also increased year-on-year

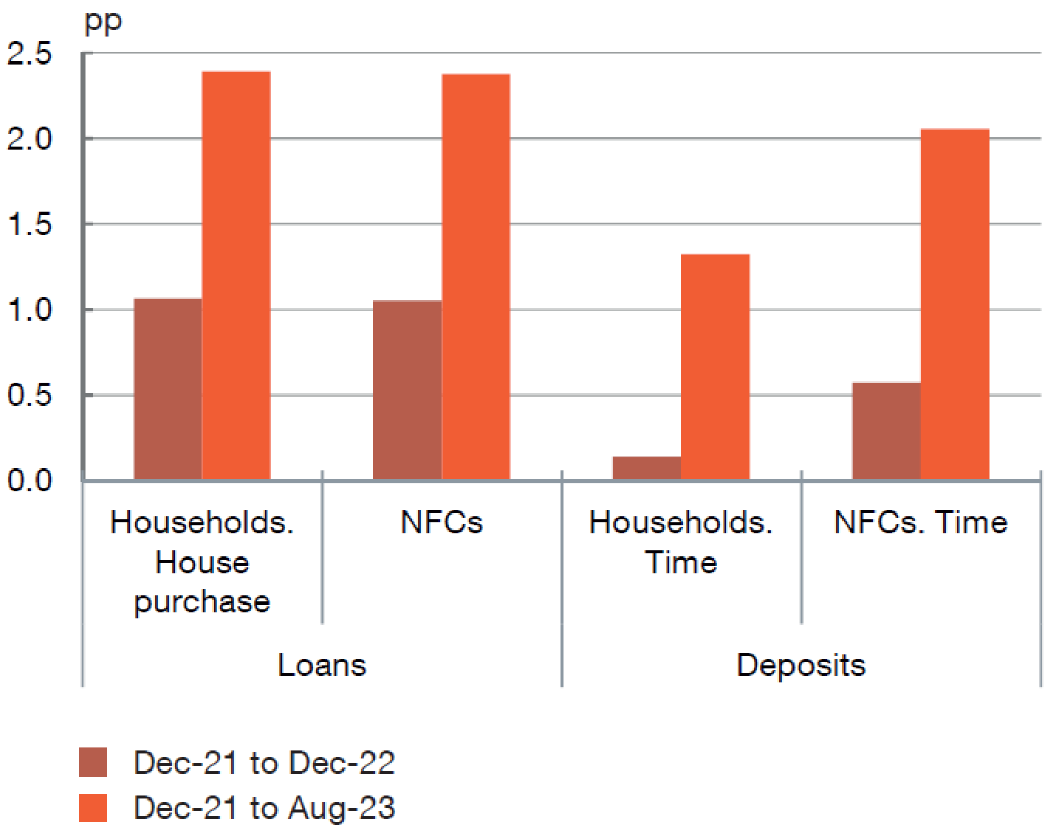
2.4.a Share of lending classified as non-performing and in Stage 2. June of each year. Business in Spain. ID



MONETARY POLICY TIGHTENING CONTINUES TO PASS THROUGH TO BANK LENDING AND BORROWING RATES

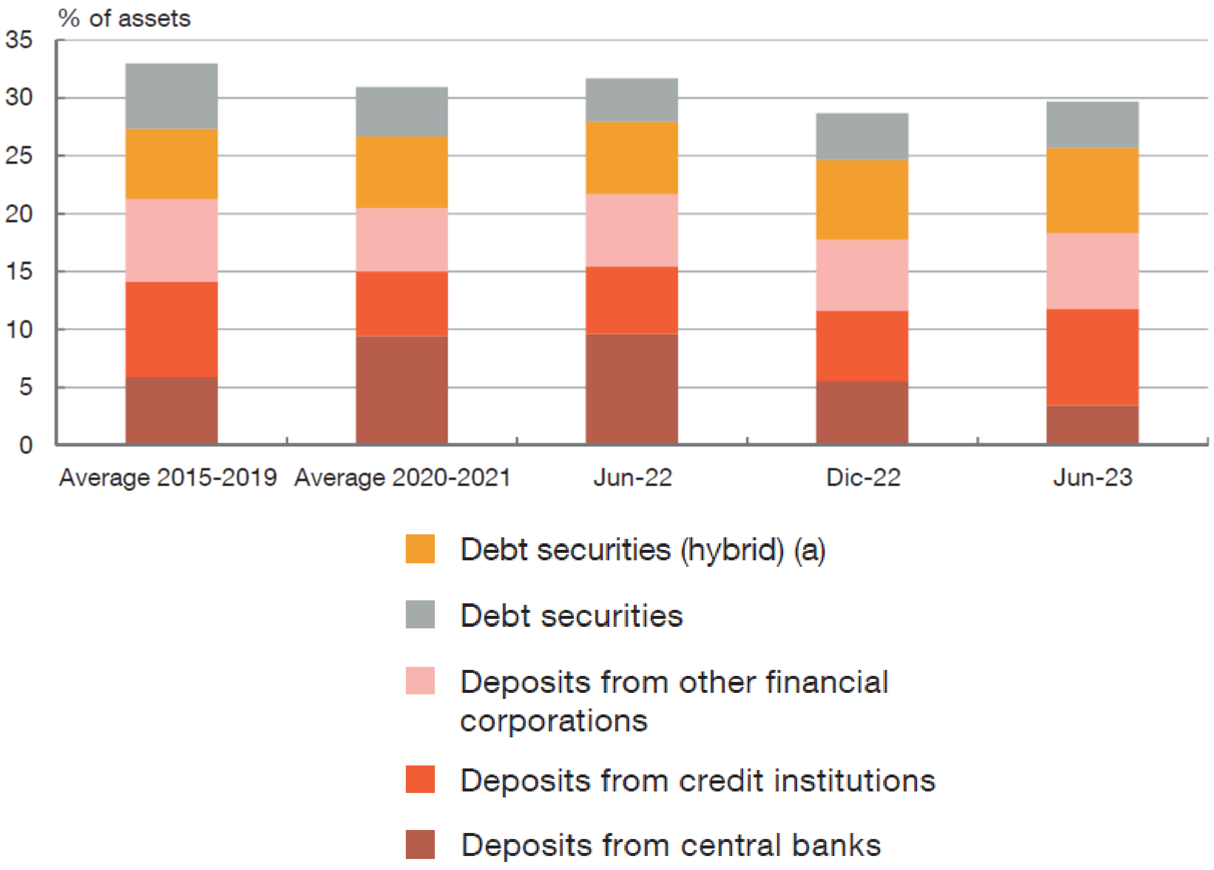
- The pass-through appears to have gathered pace recently for both loans and deposits, albeit more so in the case of the former

Chart 7
Increase in interest rates on loans and deposits (a)

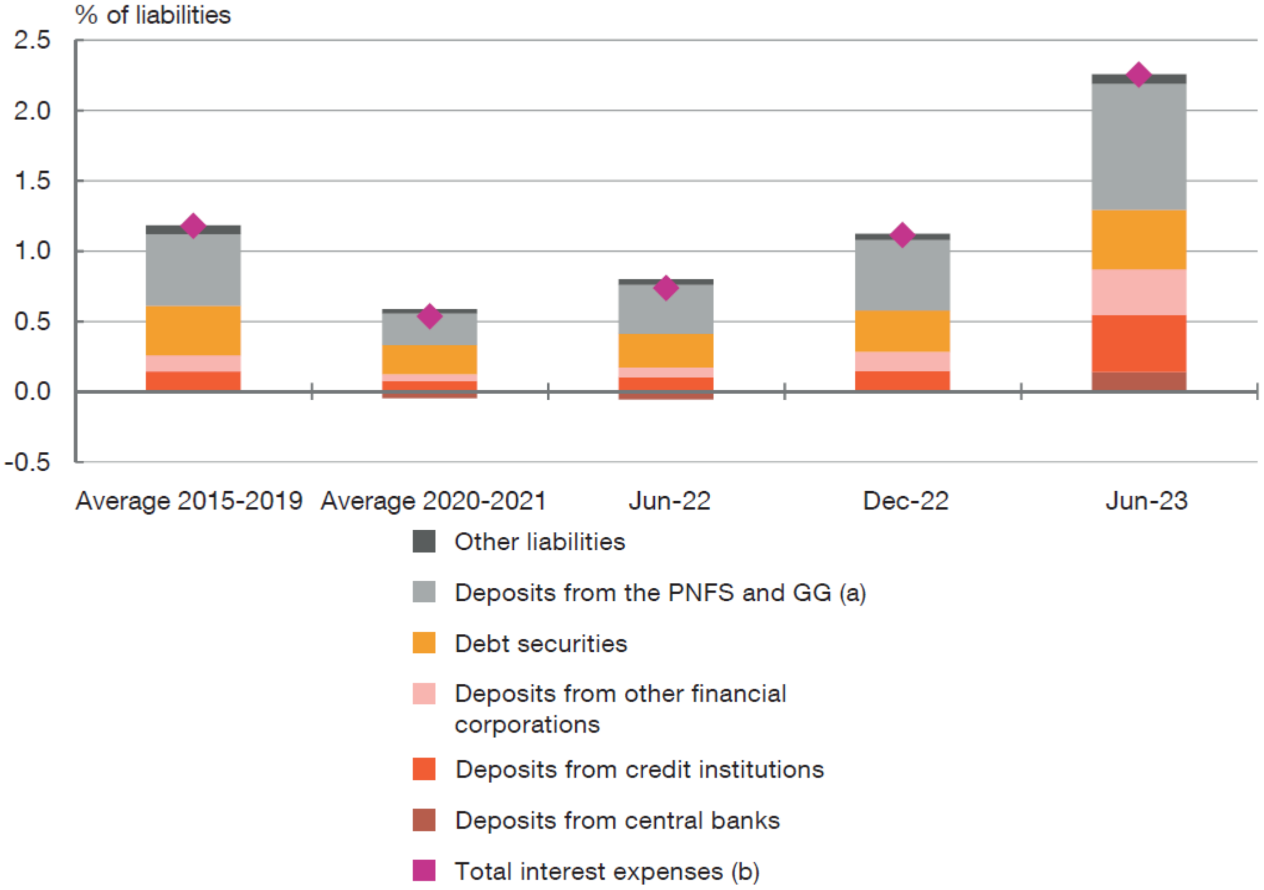


- Institutions are replacing Eurosystem funding with debt issuance and borrowing on the interbank market
  - At the same time, remuneration of deposits increased, pushing up the cost of liabilities to 2.2%

2.11.a Deposits from the financial sector and debt securities issued. Consolidated data



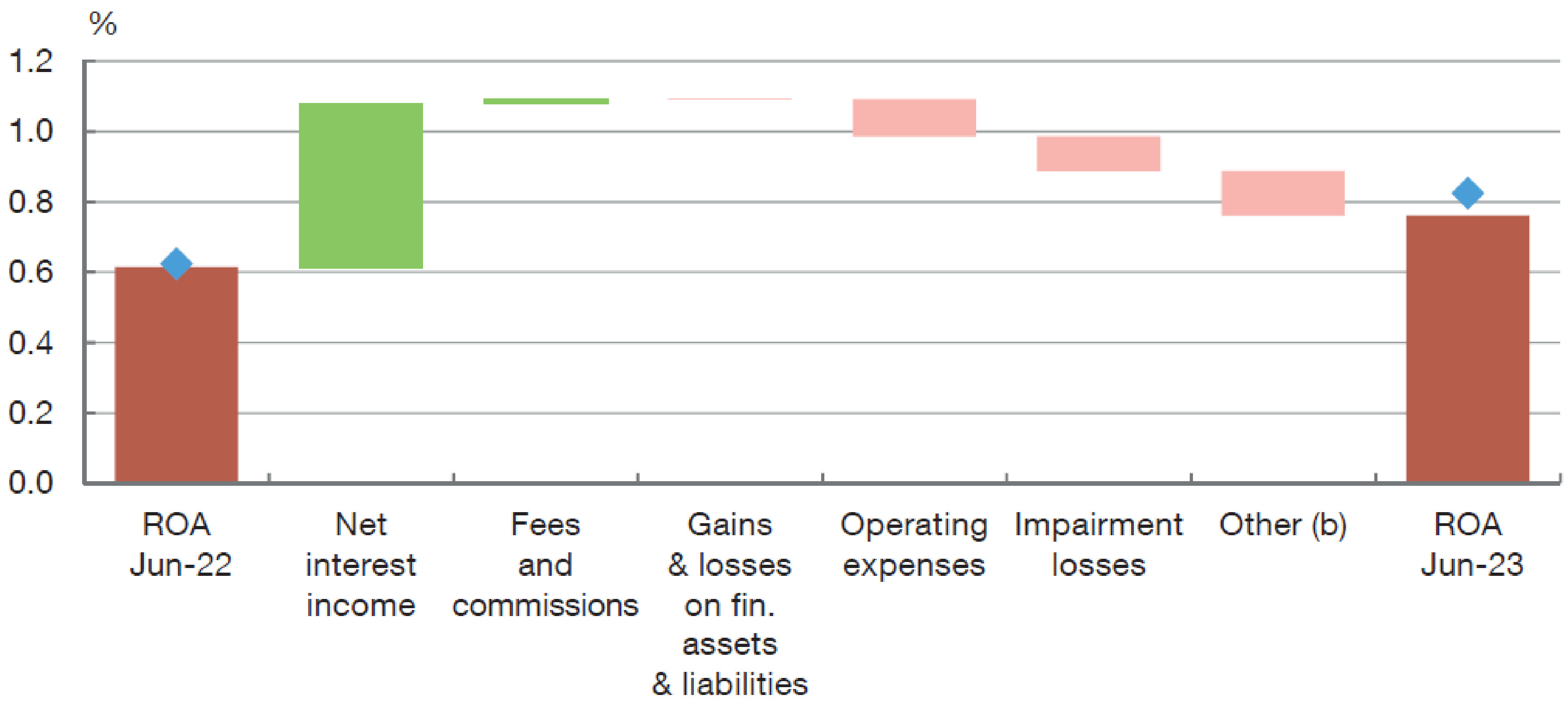
2.12.a Interest expenses on funding. Annualised data at consolidated level



BANK PROFITABILITY CONTINUED TO PERFORM WELL, UNDERPINNED BY STRONG NET INTEREST INCOME

- This increase in net interest income more than offset the deterioration in operating costs (inflationary environment), impairment losses (concentrated in business abroad) and other items (extraordinary levy on the banking sector)
    - The temporary extraordinary levy represents 4.1% of institutions' overall consolidated net profit

2.17.a Breakdown of the change in profit. Consolidated net profit as a percentage of ATAs (a)



- In the baseline scenario, institutions improve their CET1 ratio by 1.2 pp, while it declines by 3.3 pp in the adverse scenario
- By group of banks, as in previous exercises, the CET1 ratio fell to a greater extent in the Other SSM group

Chart 10
FLESB stress tests. Impact on CET1 ratio under baseline scenario (l-h panel) and adverse scenario (r-h panel) (c)

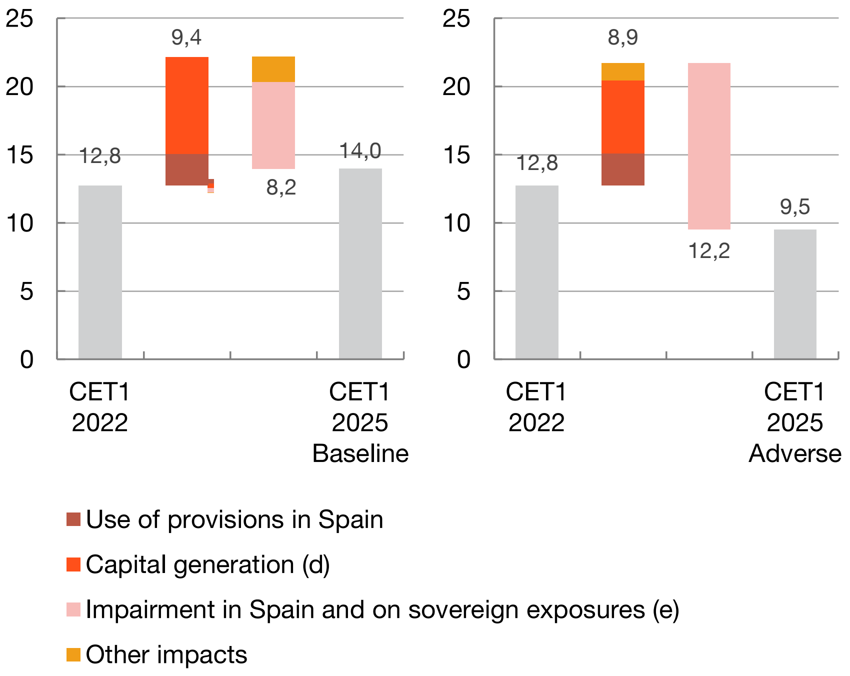
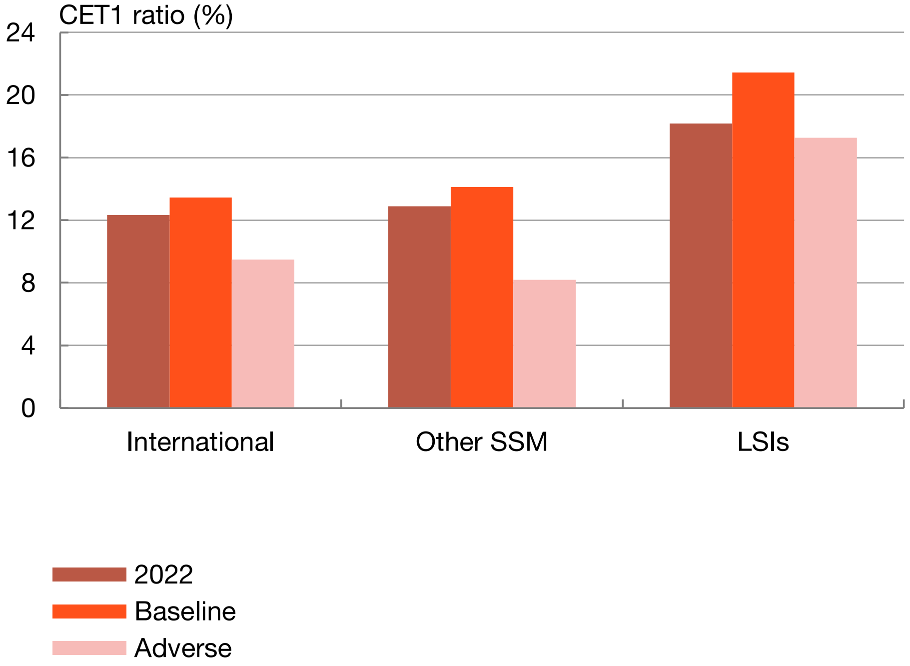


Chart 6
CET1 ratio observed in 2022 and results in 2025 of baseline and adverse scenarios



EUROPEAN BANKS' LIQUIDITY POSITION REMAINS STRONG, ALTHOUGH IT HAS DECLINED SINCE 2021

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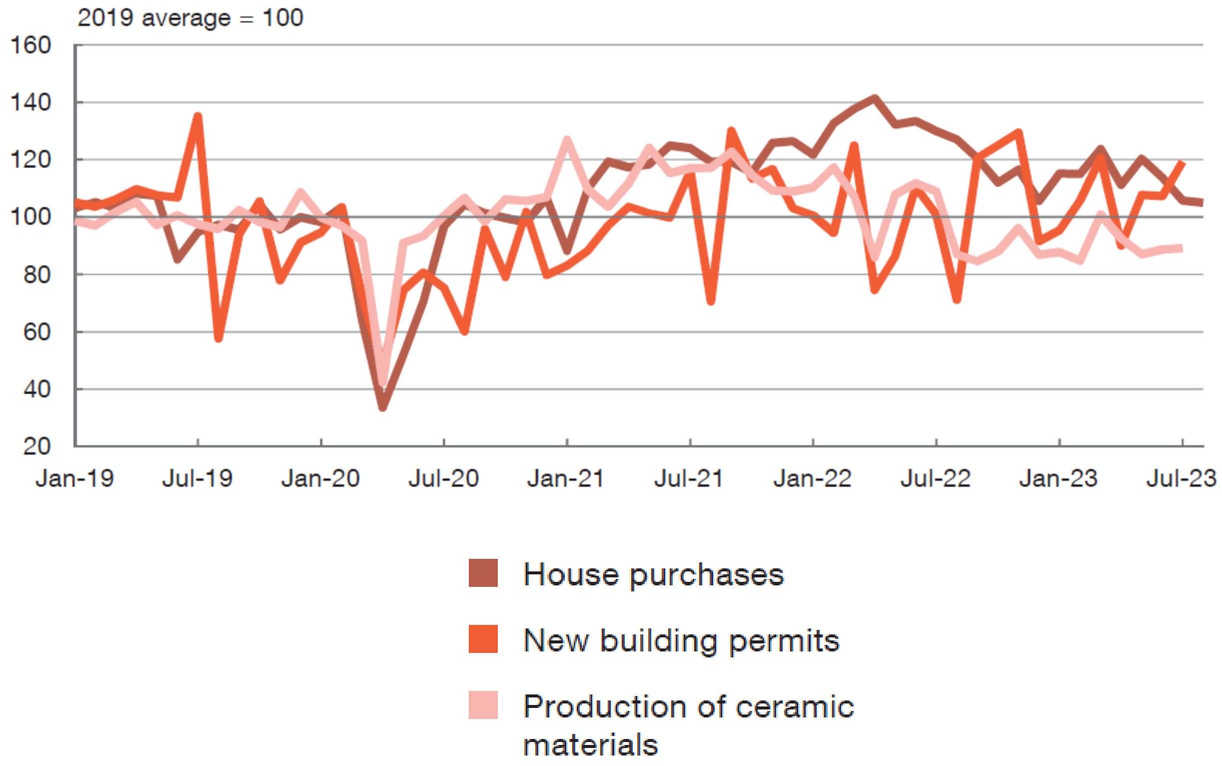
- Spanish banks have a relatively high LCR compared to their peers, although it has fallen significantly since 2021
- Cash and central bank reserves account for a lower relative share of liquid assets at Spanish banks

2.16.a LCR and composition of liquid assets (a)

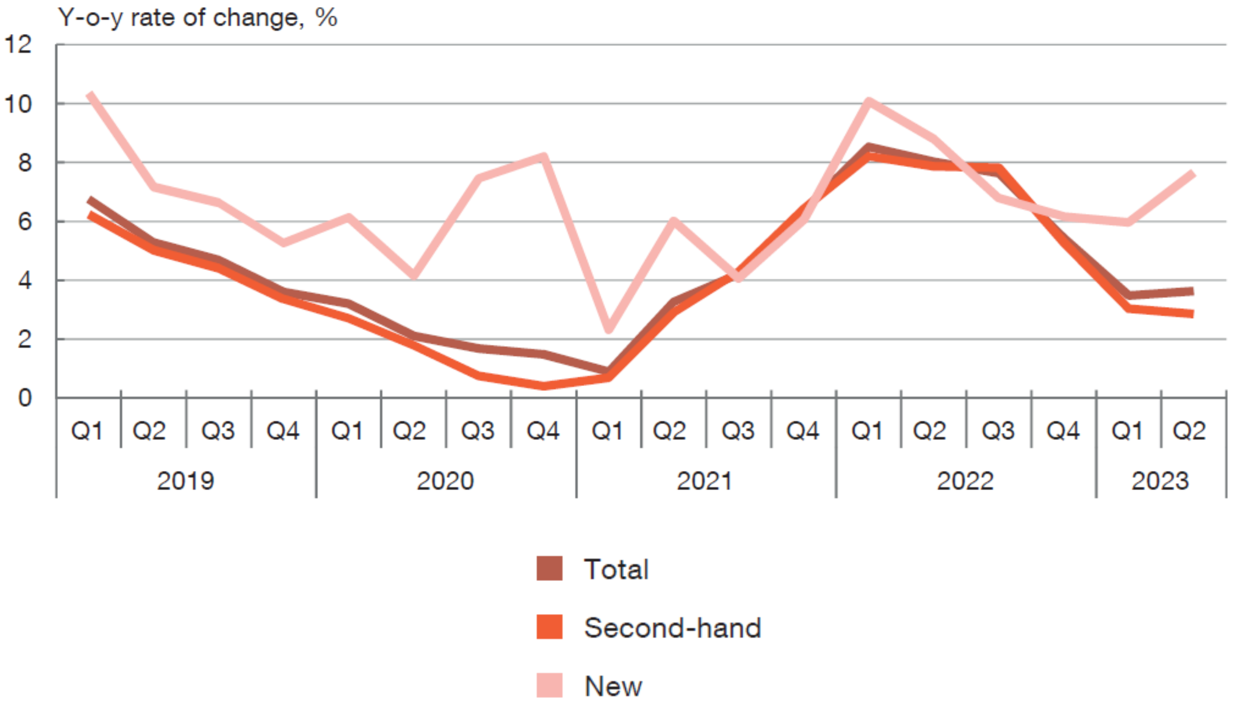
THE RESIDENTIAL REAL ESTATE SECTOR SAW AN ADJUSTMENT IN TERMS OF VOLUME, AND HOUSE PRICES ARE SLOWING

- However, new house prices have picked up, due to a number of as yet unidentified factors
  - This sector is no longer considered a risk factor, but still needs to be closely monitored

1.7.a Indicators of activity in the residential real estate sector (a)



1.6.a House prices

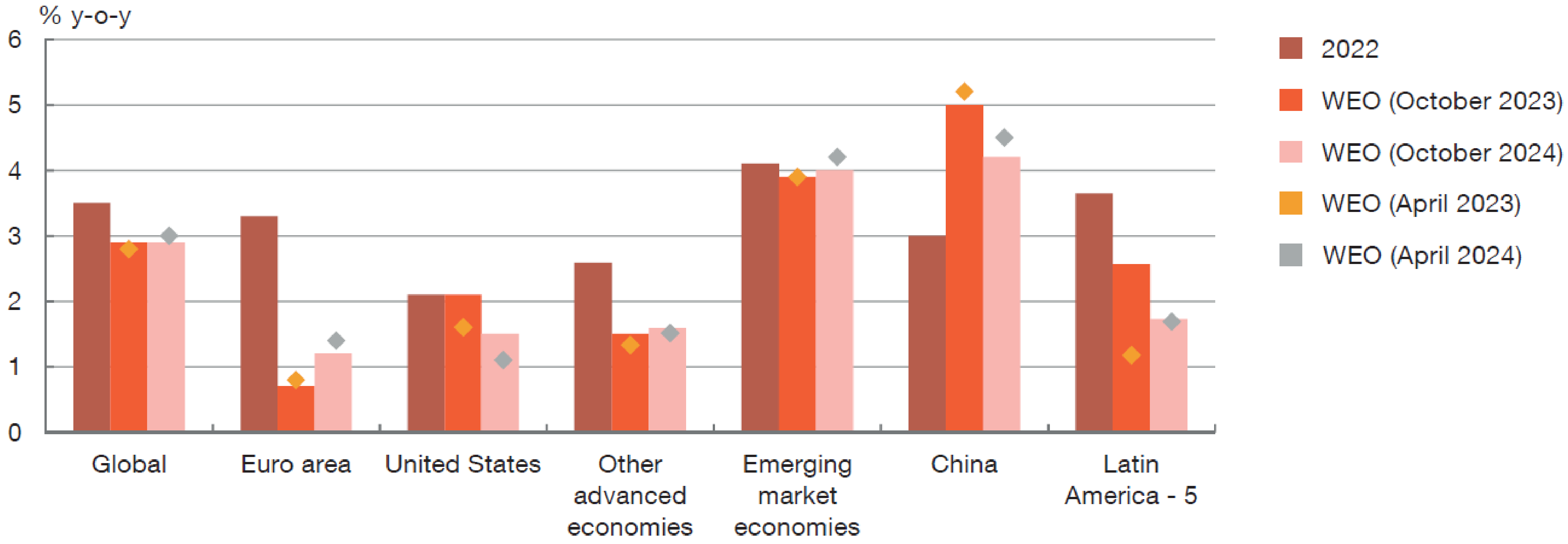


THANK YOU FOR YOUR ATTENTION

ADJUSTMENTS TO GROWTH PROJECTIONS HAVE BEEN UNEVEN ACROSS GEOGRAPHICAL AREAS

- The downward revisions in the euro area and China stand out
  - In the United States the projections were revised up somewhat, but remain at historically low levels
  - In Latin America they were revised up

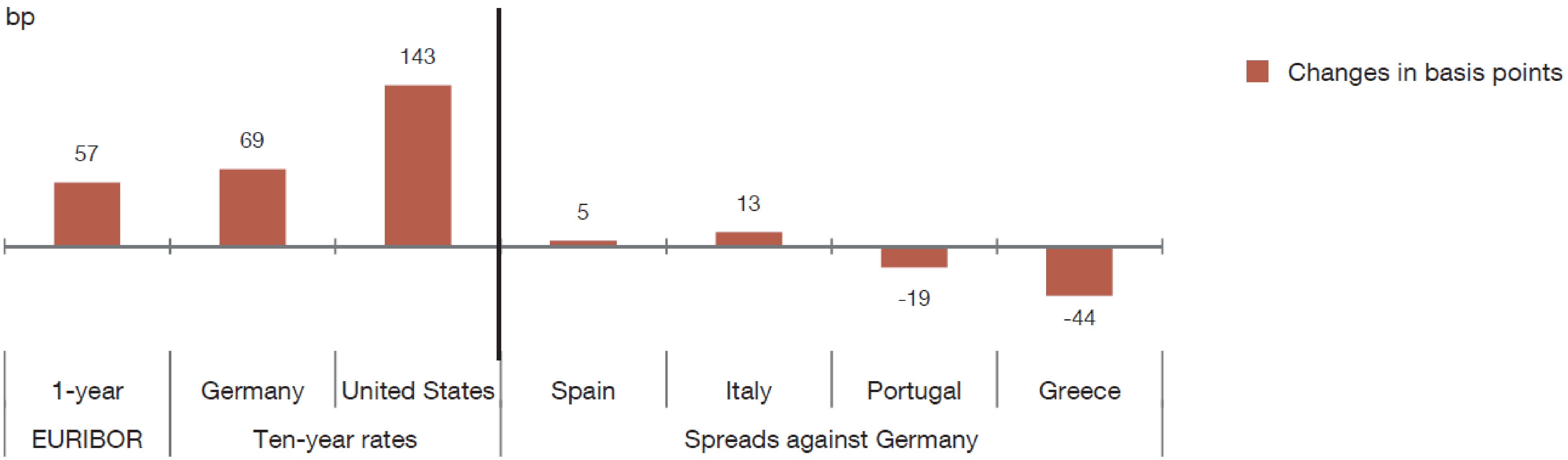
1.1.a GDP growth outlook (2022-2024) (a)



MONEY MARKET AND LONG-TERM SOVEREIGN BOND INTEREST RATES CONTINUED TO RISE

- This increase is due to the monetary policy rate hikes, but there are no signs of tightening risk premia

1.4.a EURIBOR and 10-year sovereign debt. Change in basis points between 10/4/23 and 23/10/2023



NEGATIVE SUPPLY DEVELOPMENTS ARE CONTRIBUTING TO THE CONTRACTION OF NEW LENDING TO HOUSEHOLDS AND NON-FINANCIAL CORPORATIONS

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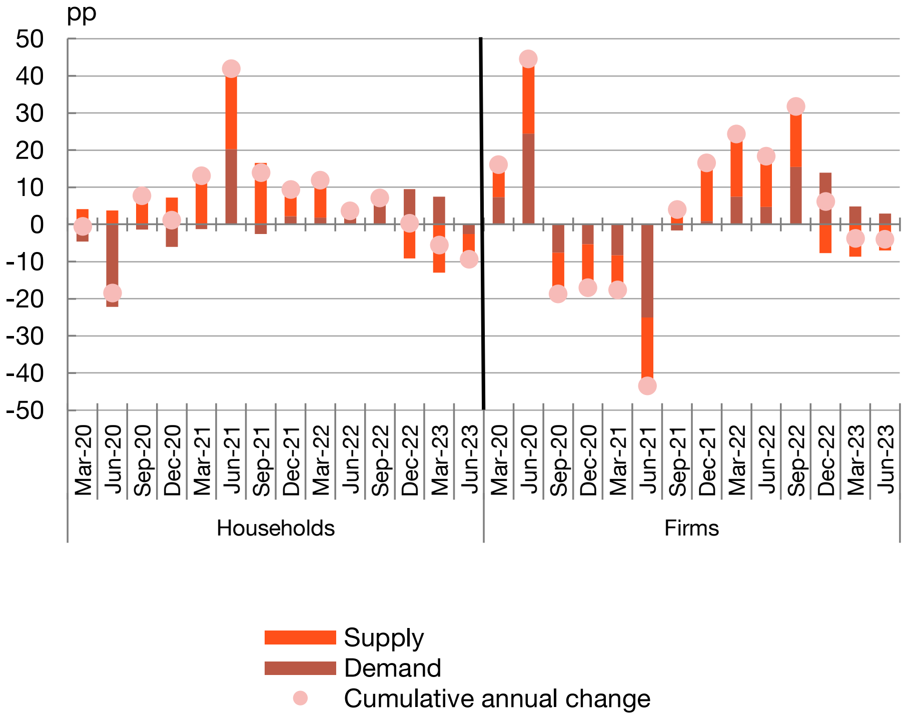
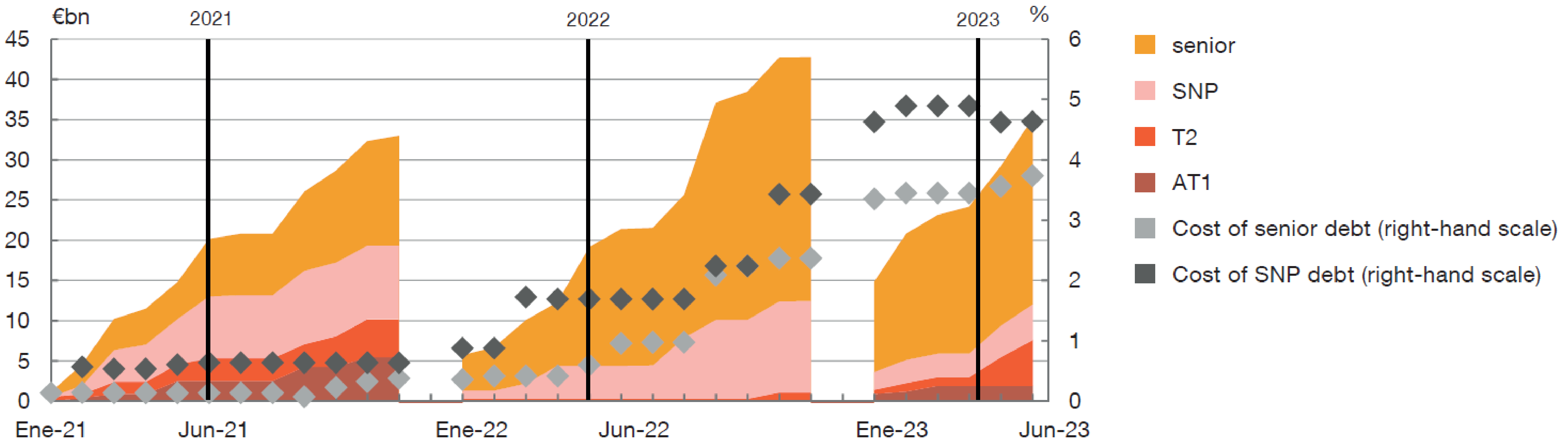
- The econometric decomposition shows supply had a negative effect for both households and firms
  - Similar results are obtained from the analysis based on survey data (BLS)
- The last few quarters have also seen a weakening of demand, which is even starker when set against the extraordinary debt repayments observed

Chart 2
Macroeconomic decomposition by supply and demand factors of new lending to households and firms (b)



- The March turmoil only dampened issuance temporarily and cost developments do not reflect tighter risk premia
- However, part of the issuance volume may stem from a pre-emptive strategy, to avoid higher future issuance costs

2.10.a Volume (12-month cumulative) and cost of issuance on primary market (a)



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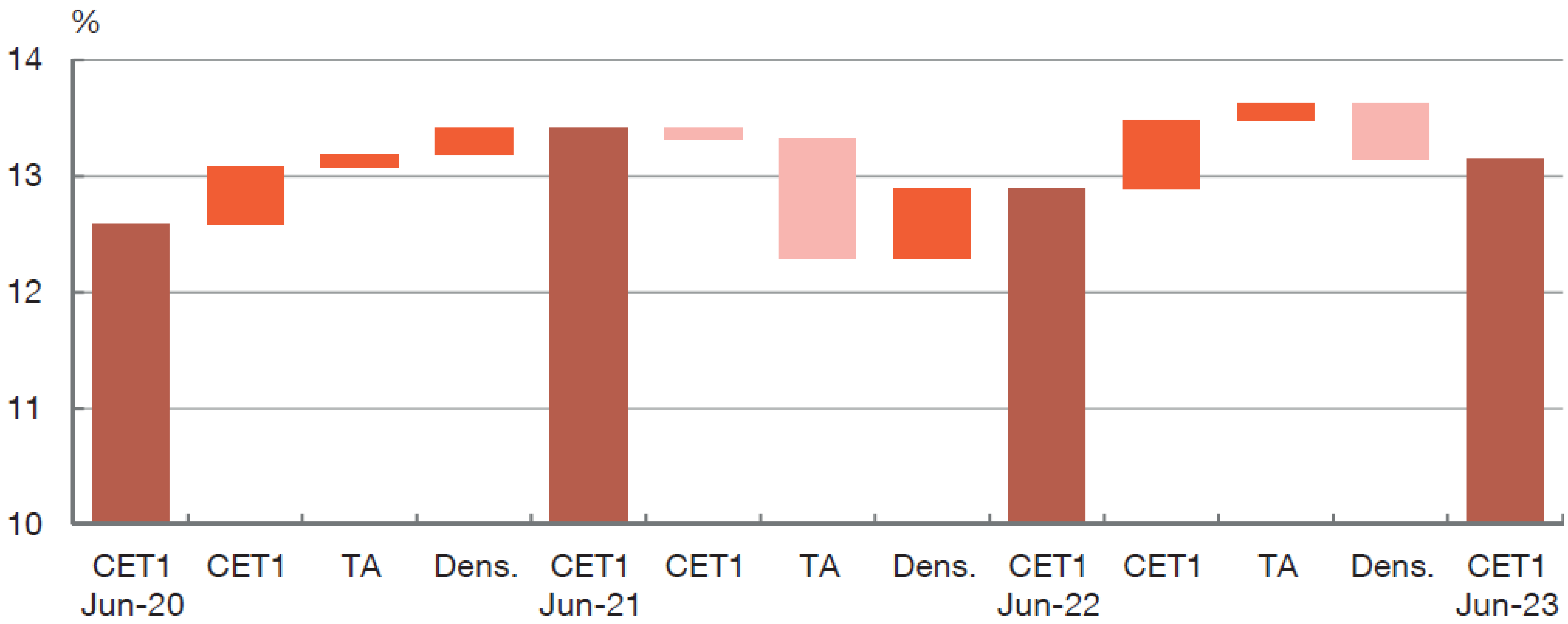
THE CET1 SOLVENCY RATIO IMPROVED BY 25 BP IN YEAR-ON-YEAR TERMS TO JUNE 2023

- The improvement is attributable to the increase in the numerator, which more than offset the rise in RWAs due to greater risk density

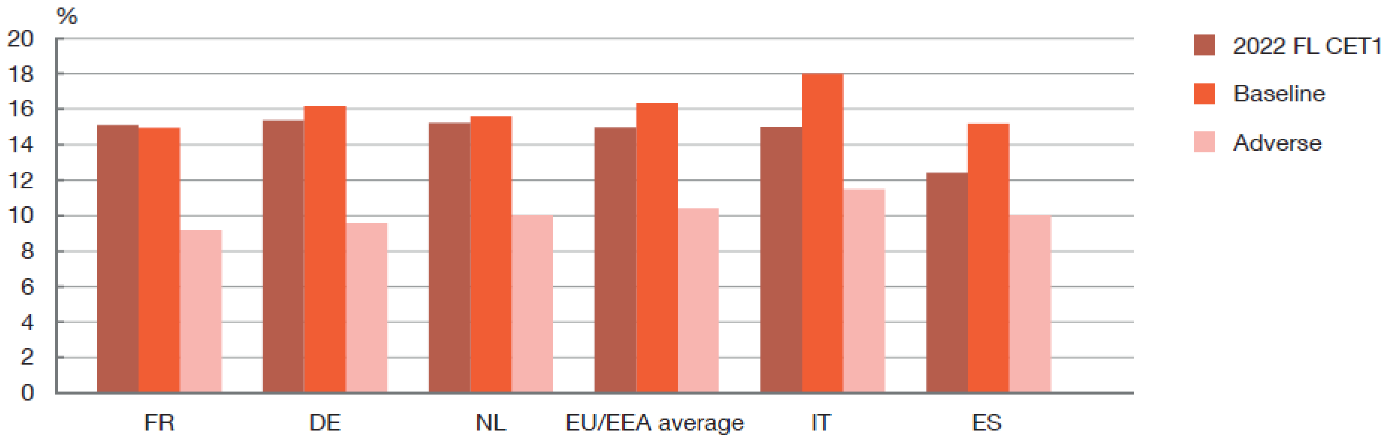
2.21.a Breakdown of the change in the CET1 ratio between 2020 and 2023 (a). Consolidated data



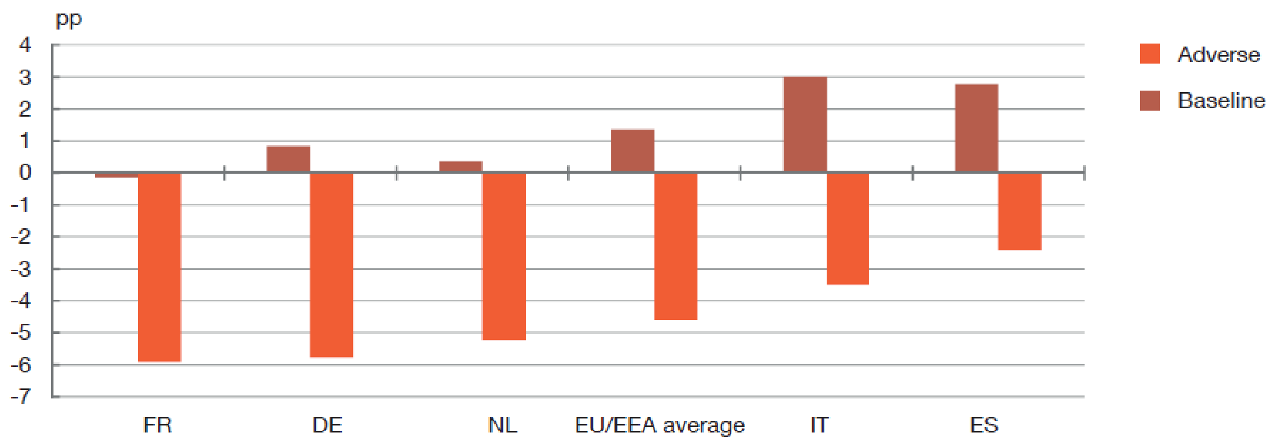
THE EBA'S STRESS TESTS SHOW SHOCK-ABSORBING CAPACITY IS HIGH DESPITE THE SEVERITY OF THE SCENARIO

- EU banks' solvency ratio at the end of the exercise is 10%, after consuming almost 5 pp of CET1
    - Spanish banks consume less capital, but their low ratio at the outset weighs on the final result

2.23.a Initial FL CET1 ratio and results of the EBA's stress test



2.23.b Change in the FL CET1 ratio at the end of the exercise's horizon



- The requirements for Santander and BBVA (the two most systemically important institutions) rise by 25 bp
  - This would lead to a modest reduction in Spanish banks' recapitalisation needs under a scenario of severe financial crisis

Chart 2
Breakdown by indicator of the O-SII scores in 2024 (b)

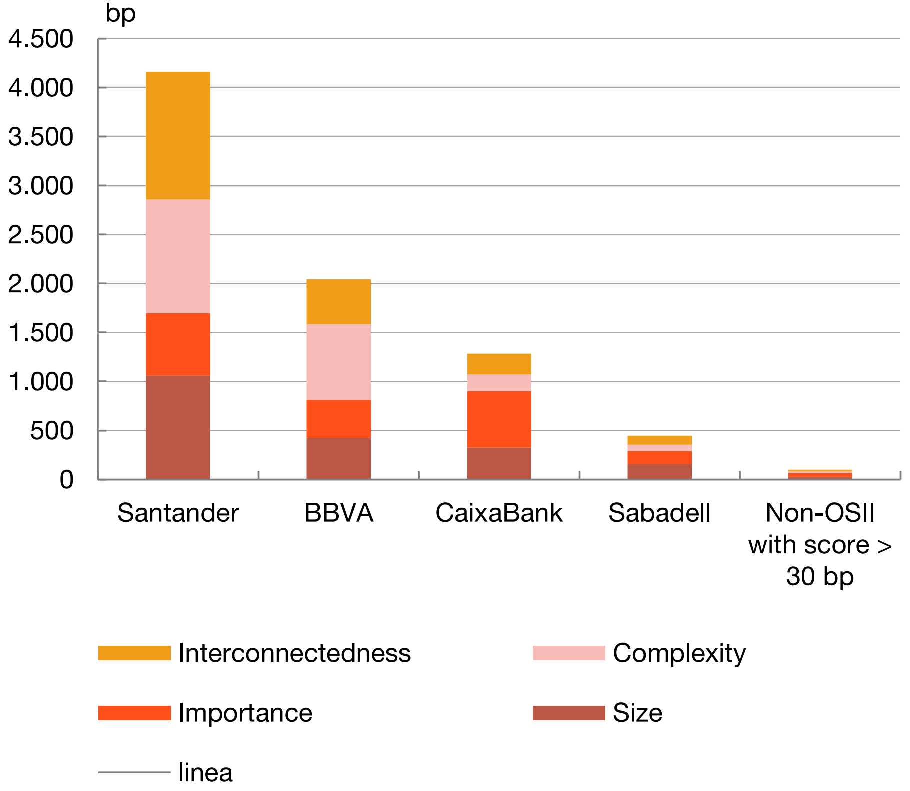
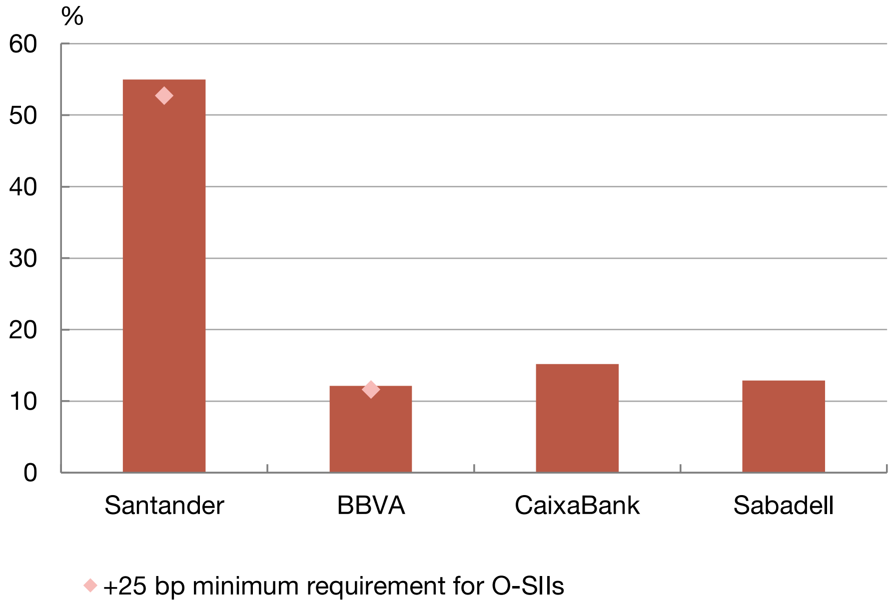


Chart 3
Systemic risk contribution of Spanish O-SIIs relative to the total contribution of the Spanish banking sector. Data for 2020-2022 (c)



THE START OF ESG REPORTING REVEALS RELEVANT EXPOSURES TO TRANSITION RISKS

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- These data should be taken with due caution, as these are the first such reports and because of the limited granularity of the information

Chart 1
Transition risk of exposures to NFCs (a)
Consolidated data at 31 December 2022

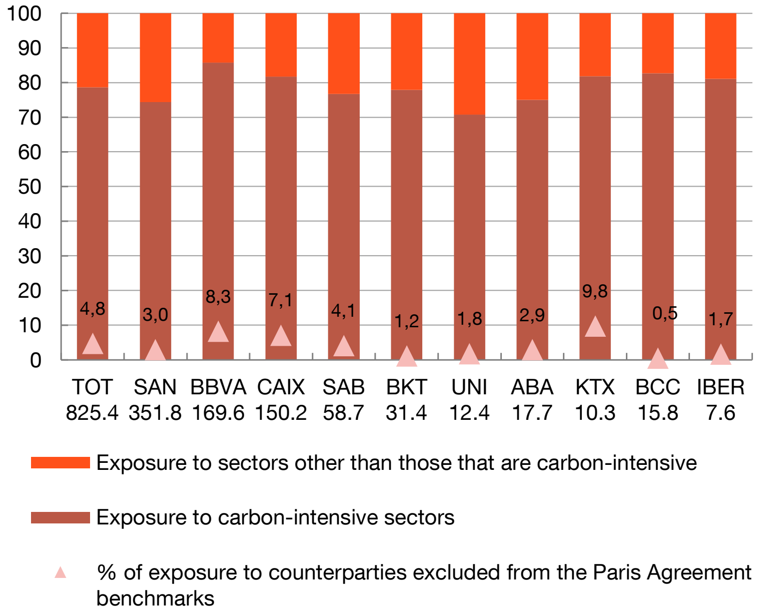

Chart 2
Energy efficiency of real estate used as collateral in loans granted in the EU by Spanish banks.
EPC (a) (b) (c)

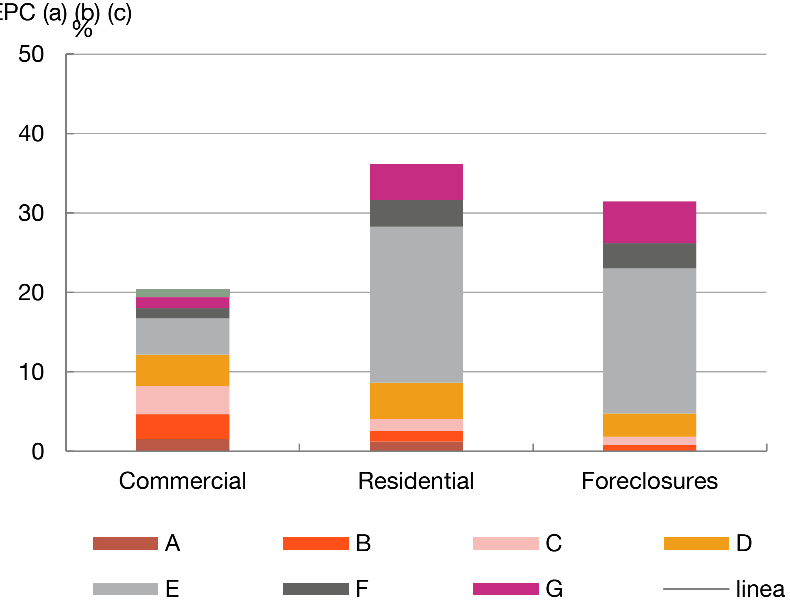

Chart 4
Exposures to NFCs subject to physical risk