

FINANCIAL STABILITY REPORT

Spring 2024

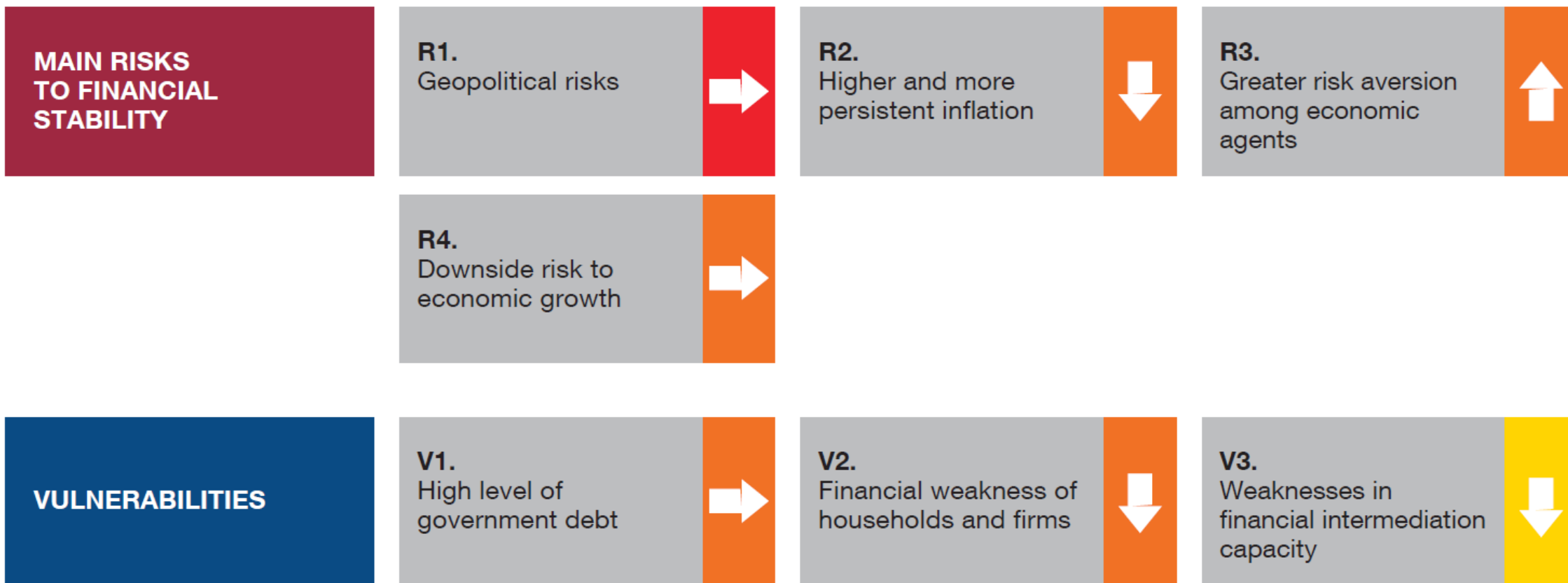
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Director General

Banco de España
15 April 2024

DIRECTORATE GENERAL FINANCIAL STABILITY, REGULATION AND RESOLUTION



THE RISKS TO THE STABILITY OF THE SPANISH FINANCIAL SYSTEM AND ITS VULNERABILITIES HAVE EASED SINCE THE LAST FINANCIAL STABILITY REPORT



- (a) The vulnerabilities are defined as economic and financial conditions that increase the impact or probability of materialisation of risks to financial stability, which in turn are identified as adverse changes in economic and financial conditions, or in the physical or geopolitical environment, with an uncertain probability of occurrence, which hamper or impede financial intermediation, with negative consequences for real economic activity.
- (b) The risks and vulnerabilities shown here are measured using three colours: yellow (low level), orange (medium level) and red (high level). The arrows denote the change in the risks and vulnerabilities since the last FSR.

GEOPOLITICAL RISKS ARE THE MOST SIGNIFICANT AT PRESENT, WHILE INFLATIONARY PRESSURES HAVE EASED CONSIDERABLY

- **The military conflicts in Ukraine and the Middle East continue to be geopolitical flashpoints**
 - They could have a significant impact if these risks result in greater economic uncertainty
 - Elections around the world in 2024 are a further source of geopolitical uncertainty
- **Inflation has fallen markedly over the last 12 months in various geographical areas ...**
 - ... and the forecasts signal that central banks will achieve their inflation targets shortly, ...
 - ... although upside risks persist, e.g. to energy prices in adverse geopolitical scenarios

Chart 1
GDP response to uncertainty shock (a)

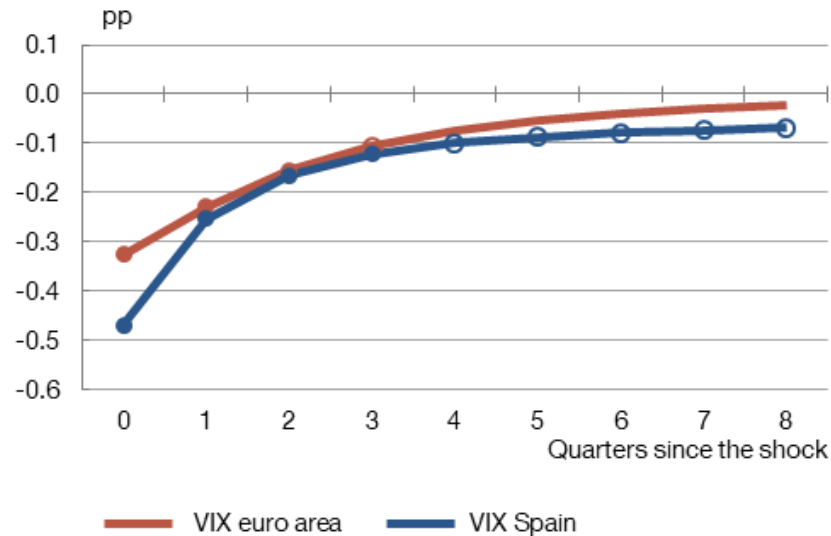
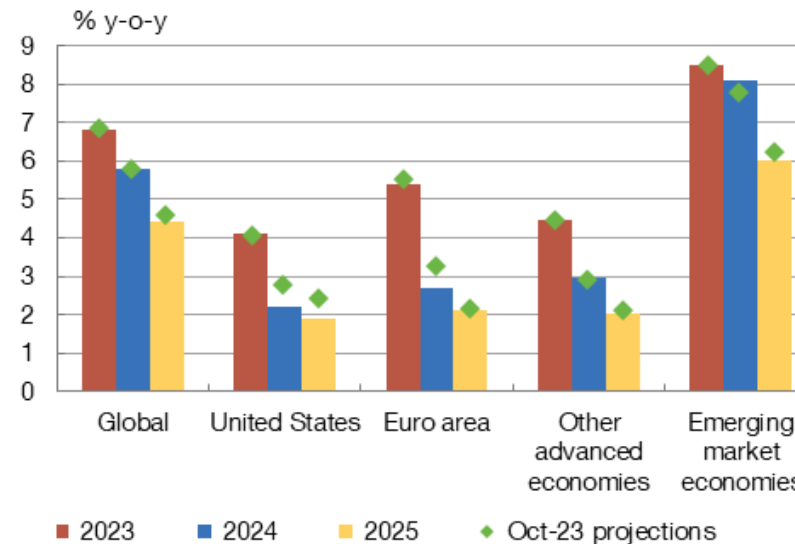


Chart 2
IMF inflation projections (b)



INTEREST RATE EXPECTATIONS HAVE BEEN REVISED DOWN, WHILE RISK PREMIA STAND AT HISTORICALLY LOW LEVELS

- Receding inflationary pressures have prompted a downward revision to financial market expectations of the future path of interest rates, although some uncertainty exists ...
 - ... and recent developments show expectations of interest rate cuts reversing partially
- Risk aversion is at very low levels in the financial markets, despite elevated geopolitical uncertainty and expectations of moderate global economic growth

Chart 3
Expectations about short and long-term interest rates (a) (b)

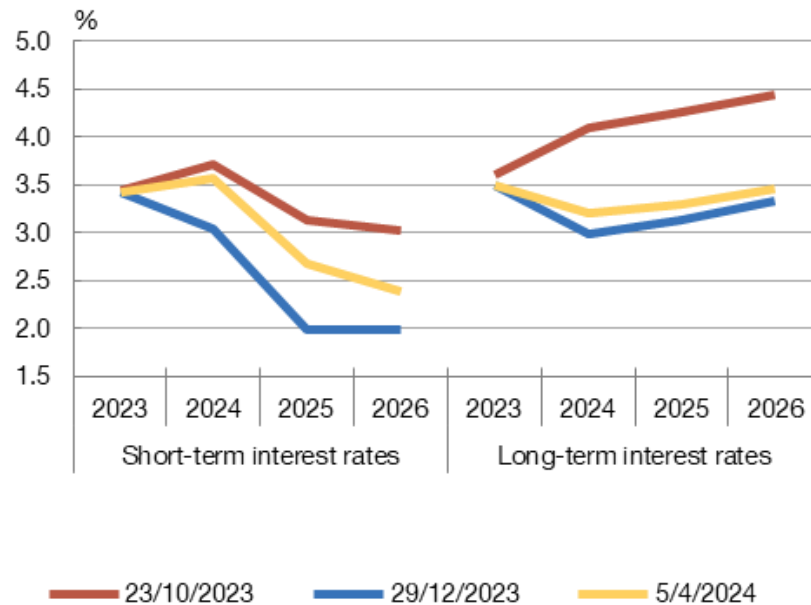
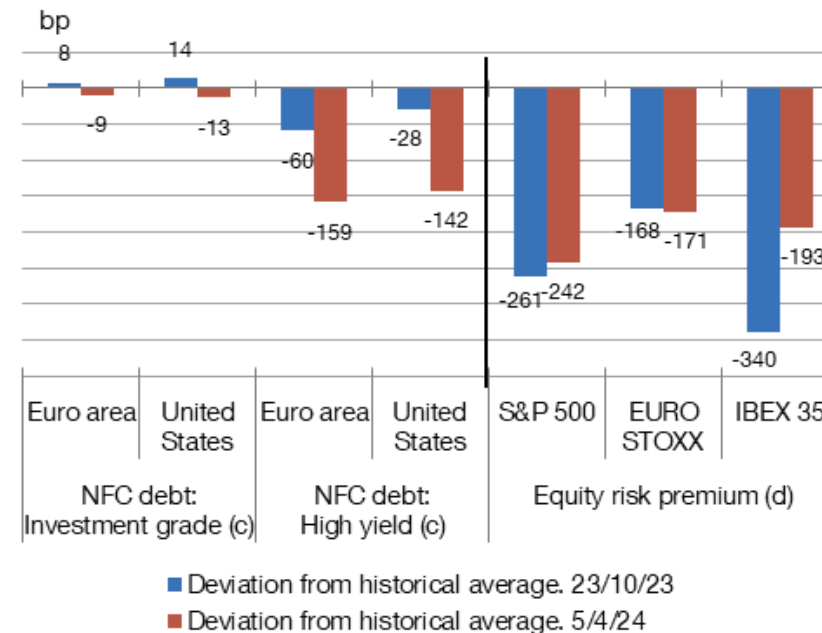


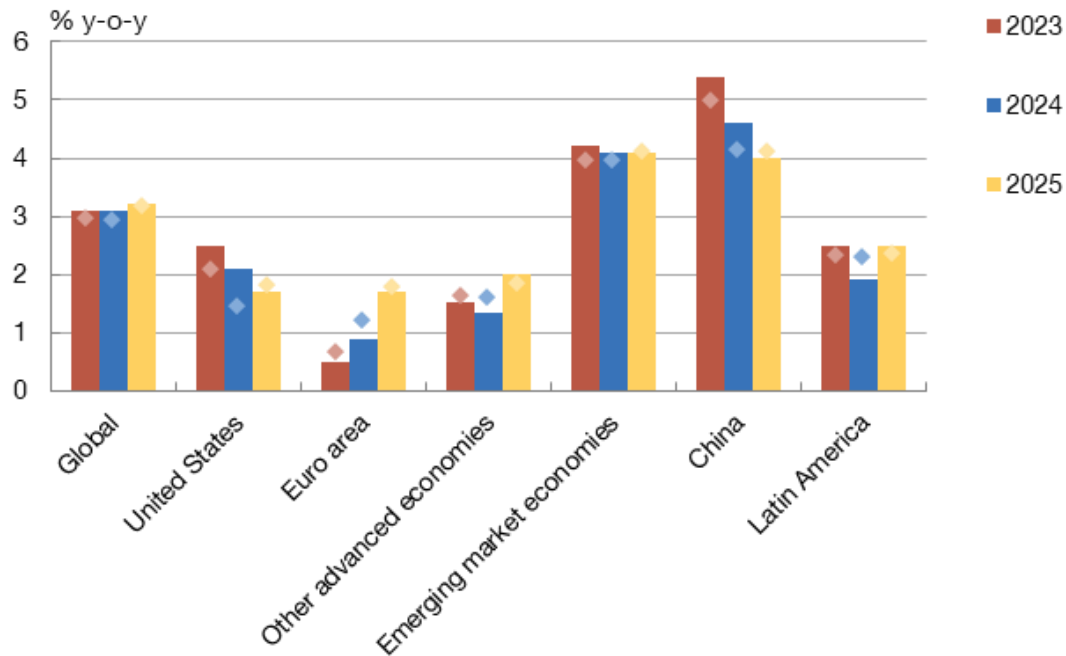
Chart 4
Risk premia (b)



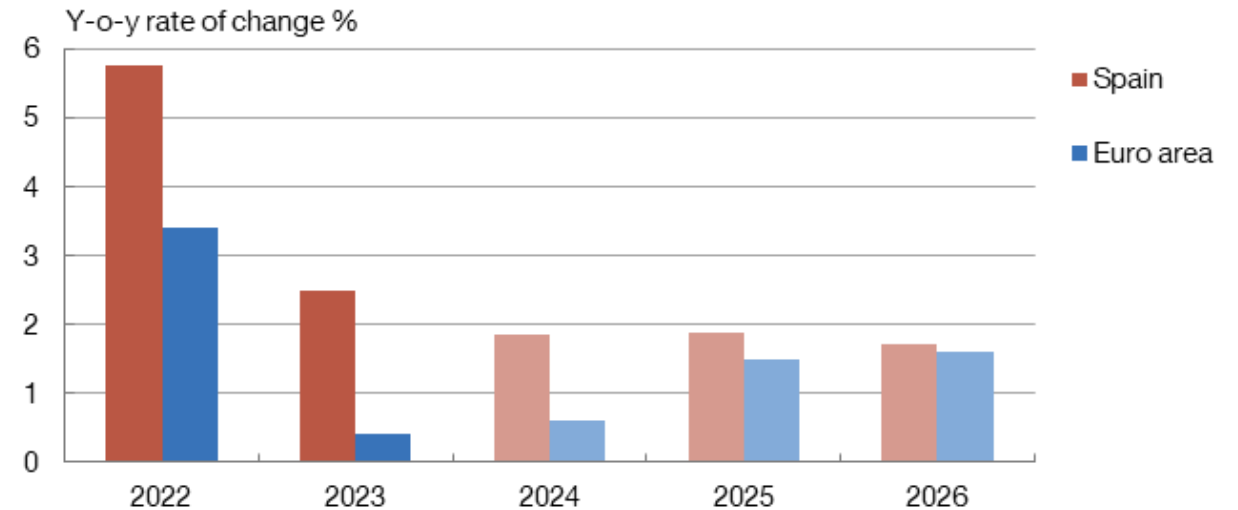
THE ECONOMIC GROWTH PROJECTIONS FOR SPAIN HAVE BEEN REVISED UP, BUT RISKS PERSIST, IN PARTICULAR DUE TO THE EURO AREA'S SLUGGISHNESS

- The upward surprises in economic growth in the recent period have been concentrated in the United States, China and some emerging market economies
 - By contrast, euro area activity is sluggish and the outlook is weak
 - *Activity in Spain is considerably more robust than the euro area average*
- The downside risks are linked to energy price developments, financial conditions and weak global demand

1.1.a GDP growth forecasts (a)

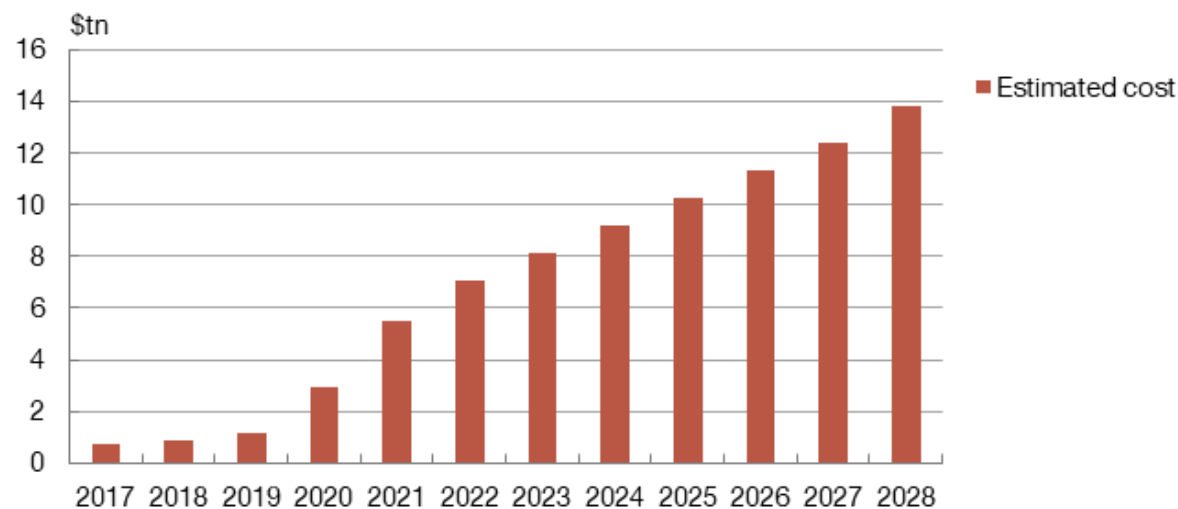


1.3.a Real GDP. Spain and the euro area (a)

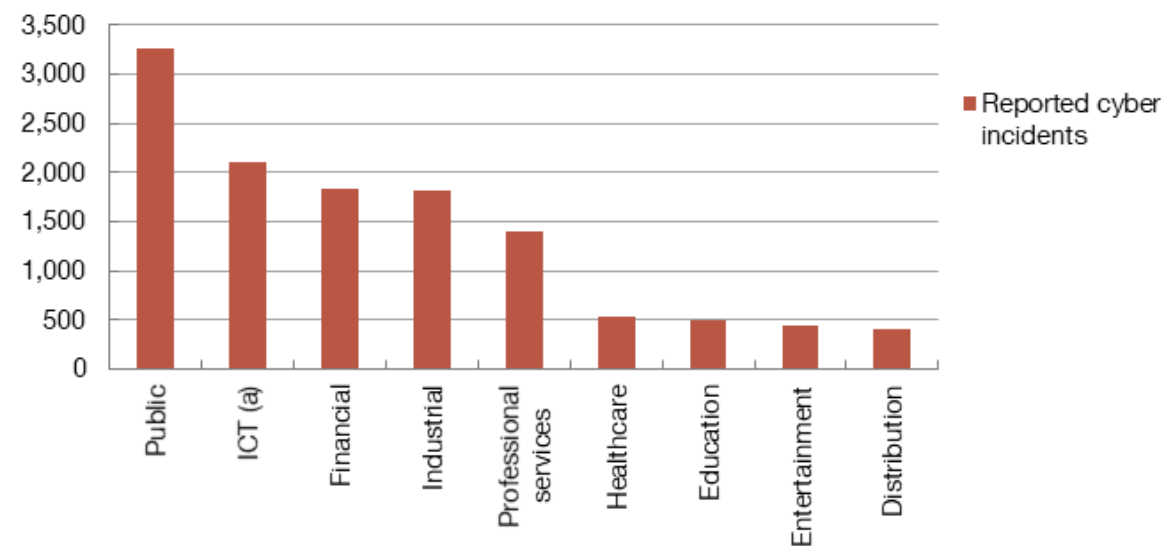


- The term cyber incident encompasses events resulting from malicious activity (caused by cyber attacks) and those caused by natural disasters, human error or accidental system failures
- The estimated cost of cyber crime globally has increased over the last five years and this upward trend is expected to continue
 - In addition, geopolitically motivated attacks have also come to the fore
- Globally, the financial sector remains one of the sectors that reports the most cyber incidents
 - The annual number of cyber incidents reported in the financial sector doubled between 2018 and 2022

SF.2.a Estimated global cost of cyber crime



SF.3.b Global number of cyber incidents in 2022, by sector

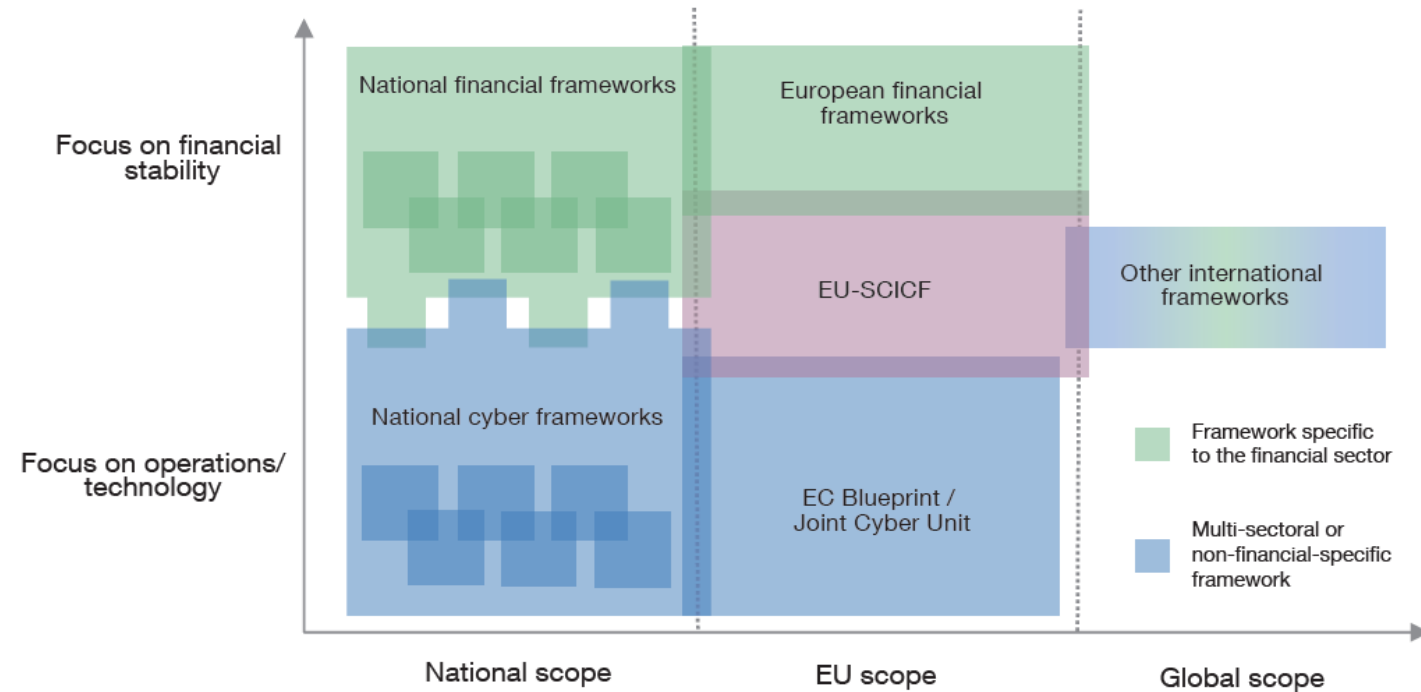


- Risk mitigation is pivoting away from cyber security towards cyber resilience
 - Minimising the probability of a cyber incident vs. assuming that it will take place and bolstering resilience

Main parts of DORA



Frameworks for coordination between authorities dealing with cyber risk



THE HIGH LEVEL OF GOVERNMENT DEBT REMAINS THE SPANISH ECONOMY'S MAIN VULNERABILITY

- Although the budget deficit decreased in 2023 (to 3.6% of GDP), the structural component is high (3.7% of GDP)
- The government debt ratio also declined, driven by robust nominal GDP growth, while the average cost of Spanish government debt increased slightly compared with 2022
- In the absence of the consolidation measures required to comply with the EU's new fiscal rules, the projections point to government debt reaching high levels in the future (approximately 120% in 2040)

1.13.a Budget balance in Spain (a)

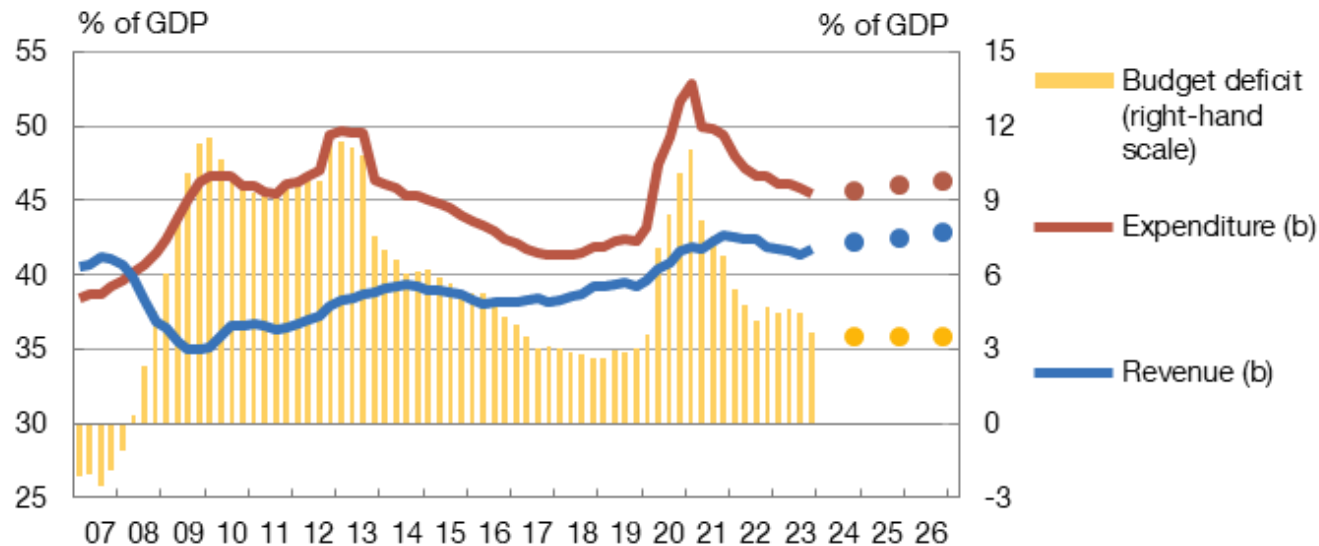
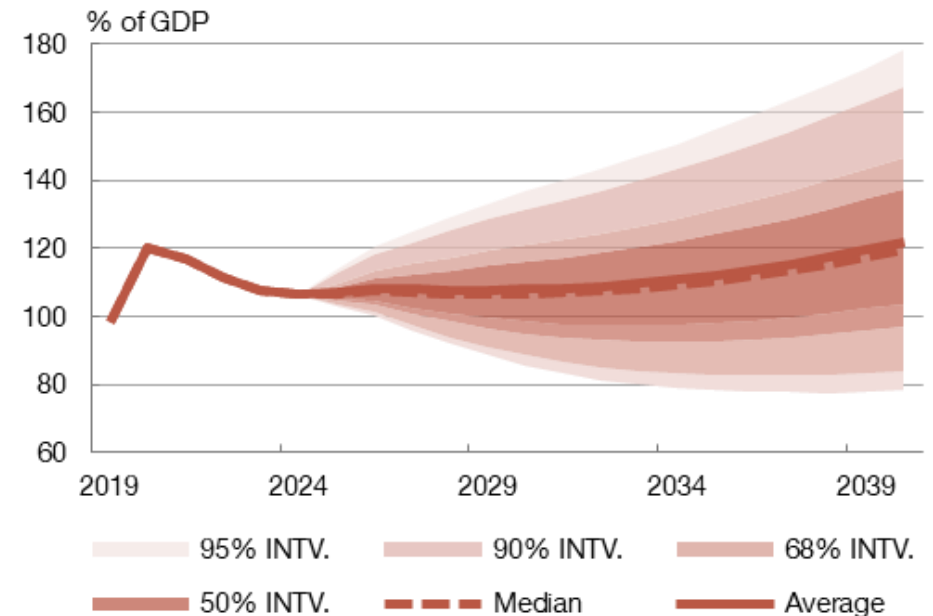


Chart 3

Simulated public debt-to-GDP path in Spain. No fiscal consolidation plan



THE FAVOURABLE DEVELOPMENTS IN FIRMS' AND HOUSEHOLDS' INCOME AND DEBT CONTINUED, BUT THEIR DEBT BURDEN HAS INCREASED

- **Firms' and households' debt is at its lowest level since 2002 and also below the euro area average**
 - However, higher interest rates continue to push up its average cost and the debt burden
 - *Interest rates being held at the current level or being cut will help ease financial pressure in 2024*
- **In any event, non-financial corporations' earnings continued to improve in 2023 and households' income continued to be boosted by the growth of employment and wages**

Chart 7
Debt ratio of households and NFCs

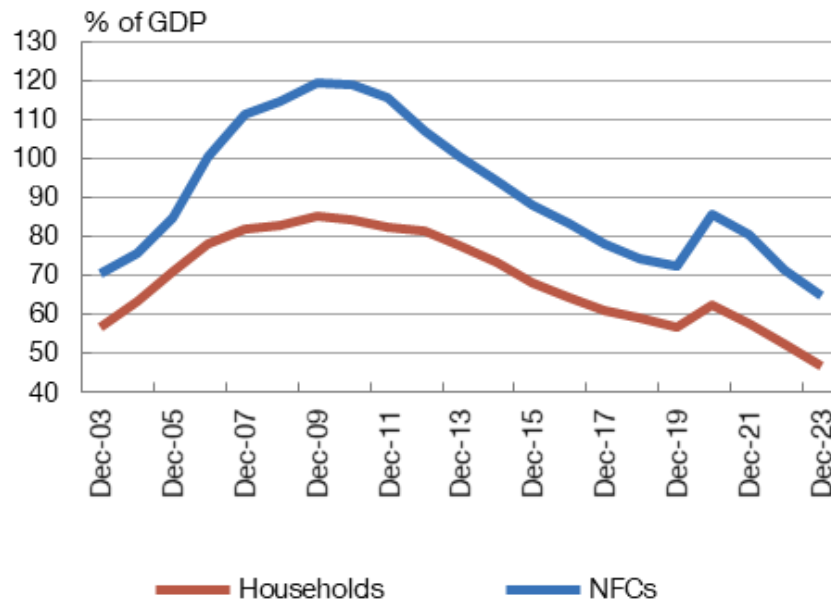
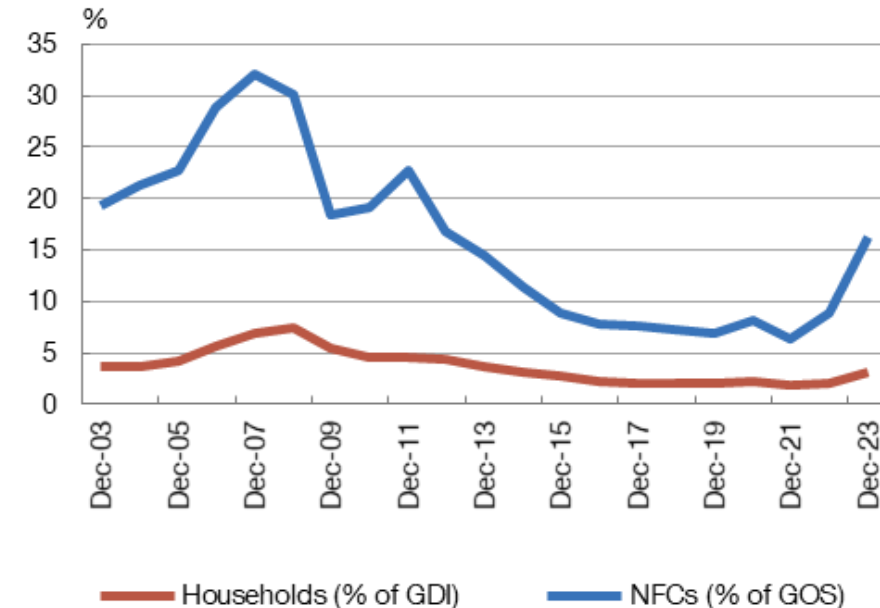


Chart 8
Interest expenses of households and NFCs



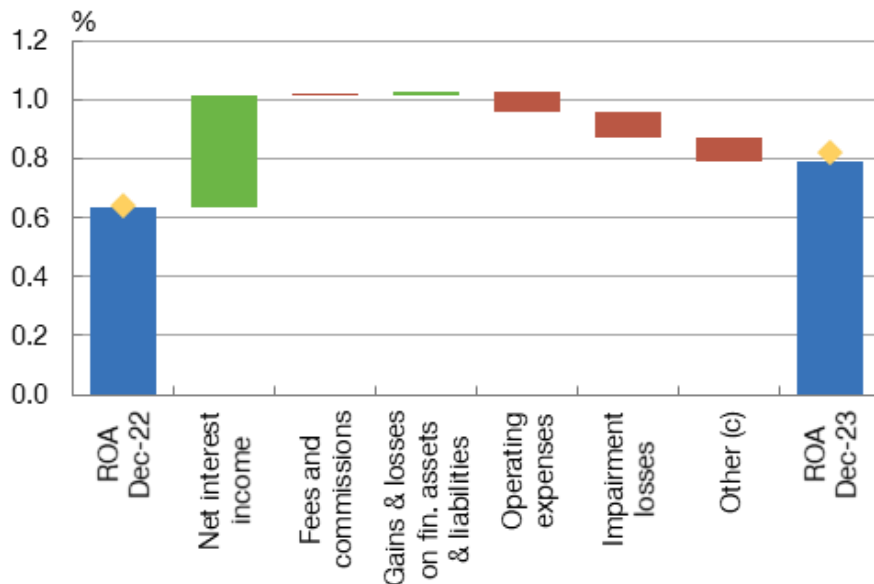
BANK PROFITABILITY PERFORMED VERY POSITIVELY IN 2023, WITH THE VULNERABILITIES ASSOCIATED WITH FINANCIAL INTERMEDIATION EASING

- The sector's earnings increased by 28% in 2023, driven by the increase in net interest income
- Liquidity and funding conditions remained comfortable and solvency improved, albeit very slightly and less so than in other European banking systems
- Given that the improvement in net interest income could peter out, banks should step up their efforts to bolster their resilience

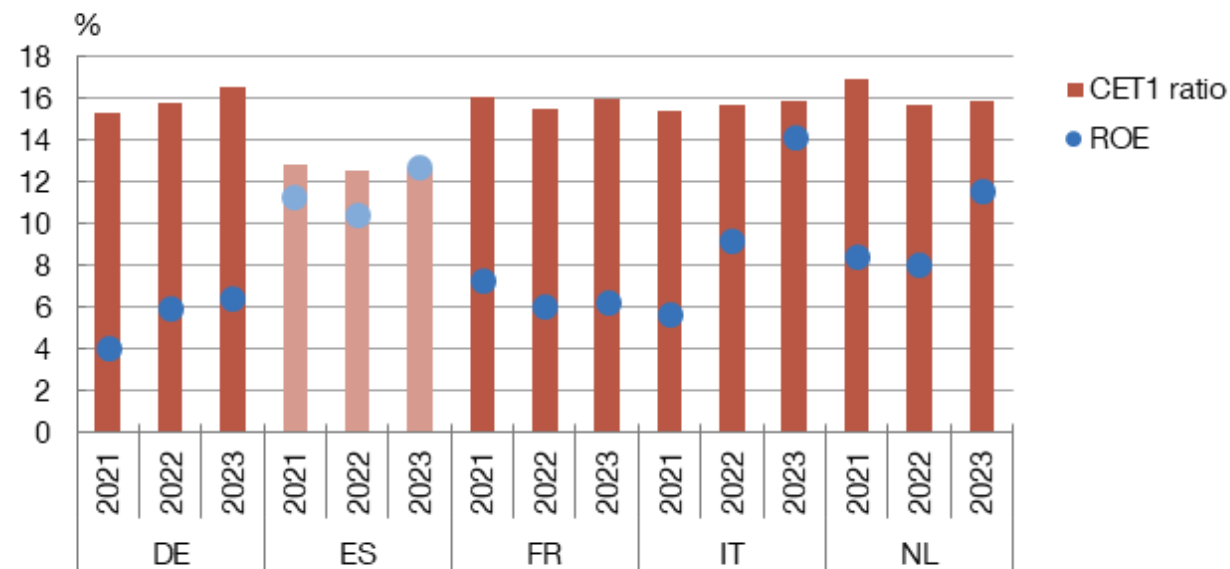
Chart 8

Breakdown of the change in bank profit.

Consolidated net profit as a percentage of ATAs (b)



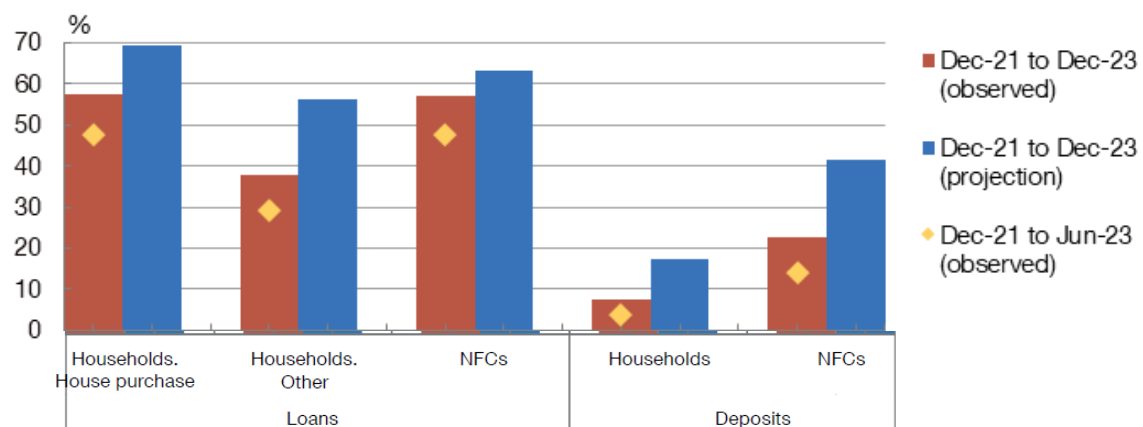
2.21.b European comparison of the CET1 ratio. Consolidated data. December 2021-2023



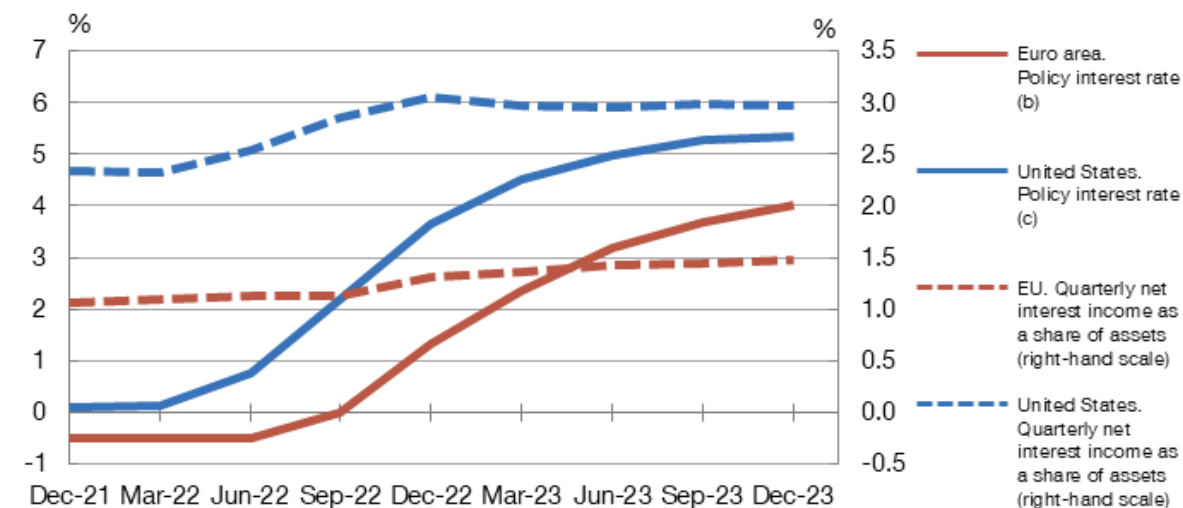
INCREASES IN REFERENCE RATES HAVE PASSED THROUGH MORE TO BANK LENDING THAN TO BANK DEPOSITS

- The end of the monetary tightening cycle suggested by the current setting would limit the possibilities of further growth in interest income
 - The rates on new loans have already started to decrease ...
 - ... while some headroom appears to still exist for increases in Spanish banks' deposit rates
- European banks' net interest income as a share of total assets showed some signs of levelling off in the final stretch of 2023 and even fell for US banks

2.15.b Pass-through of the increase in the EURIBOR to loan and deposit interest rates (b)

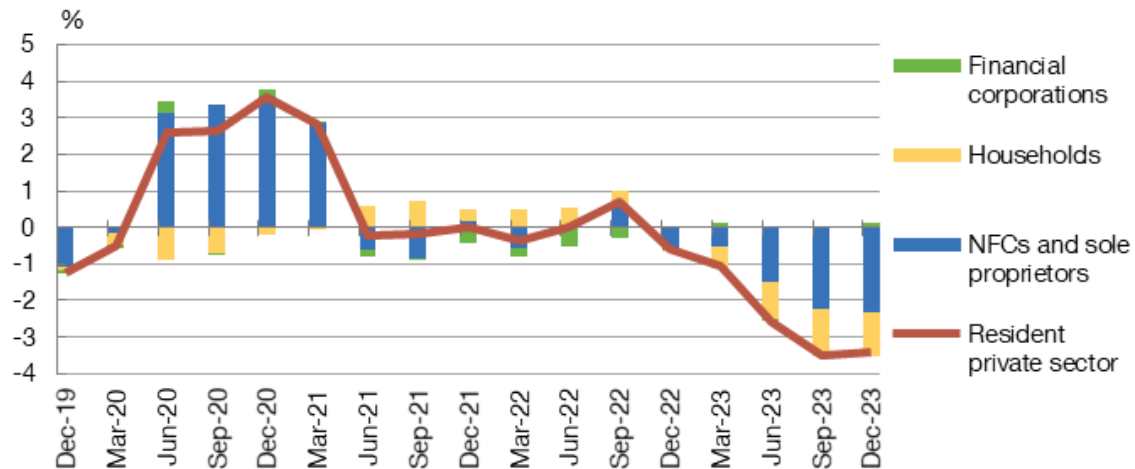


2.17.a Net interest income and policy rates in the euro area and the US (a)

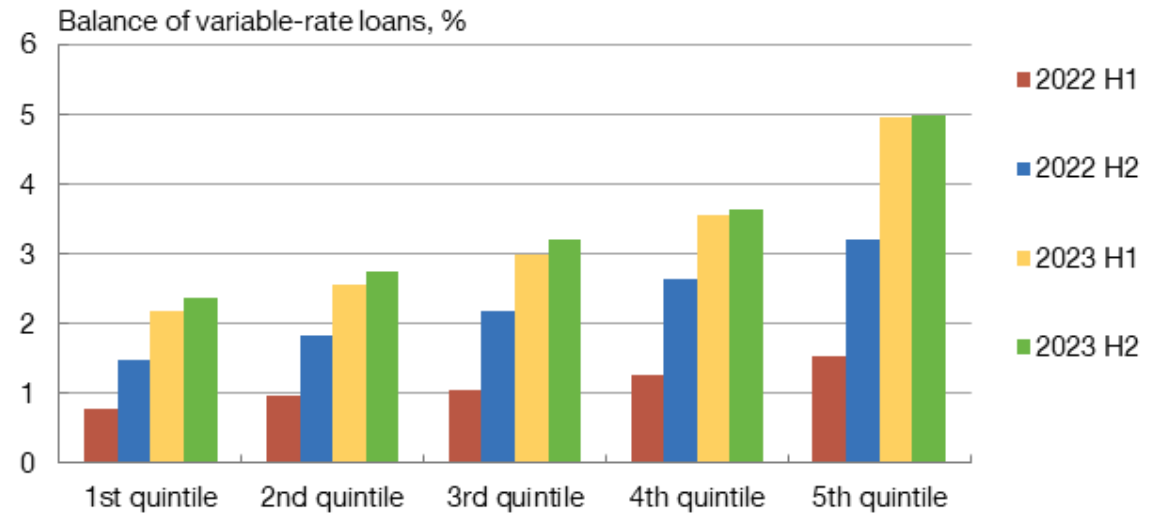


- **The contraction in lending was widespread across sectors and banks**
 - The volume of lending to the non-financial corporate sectors fell more in 2023 than in 2022, above all in small firms
 - The stock of lending to households fell in 2023, driven by developments in loans for house purchase
- **Extraordinary repayments of loans are playing a leading role in this deleveraging process**

2.1.c Contributions to year-on-year rates of change in credit to the resident private sector, by sector. Business in Spain. ID



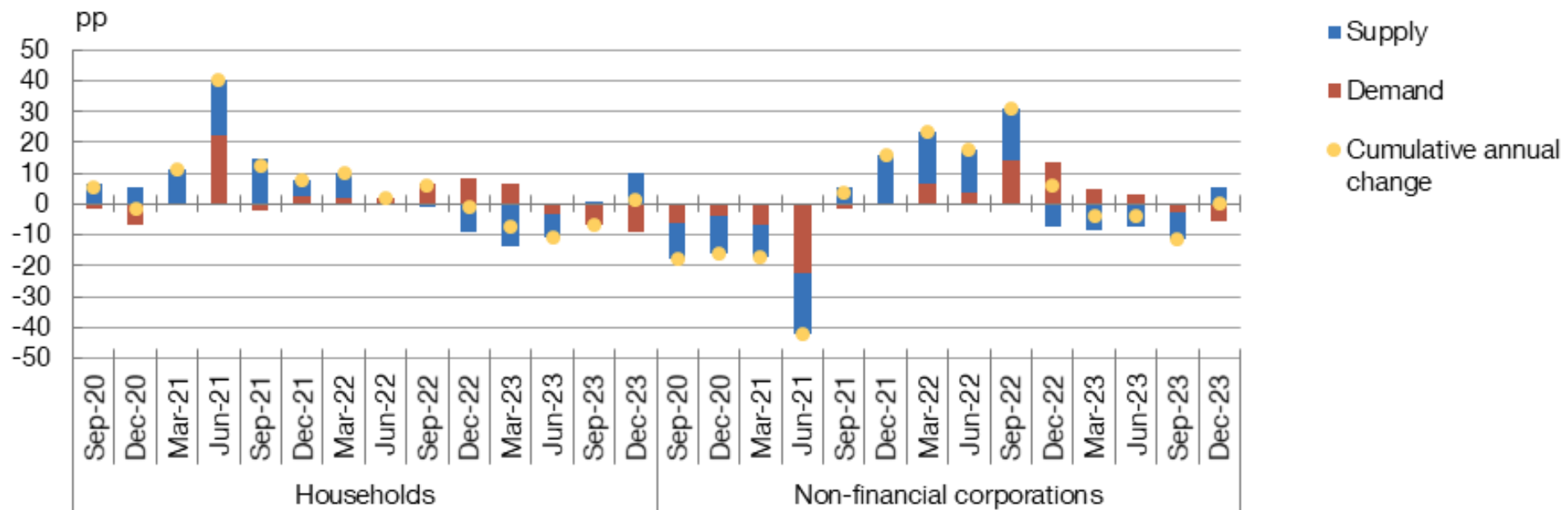
1.8.b Early repayment of variable-rate mortgages by income quintile (b)



NEW LENDING TO FIRMS AND HOUSEHOLDS STEADIED IN LATE 2023, WITH SUPPLY AND DEMAND FACTORS PULLING IN OPPOSITE DIRECTIONS

- Specifically, supply factors had a positive effect on new lending to both firms and households, ...
 - ... while demand factors continued to weigh it down
 - The recent interest rate cuts suggest that loan demand will perform more favourably in the coming quarters

3.5.a Macroeconomic decomposition of new lending to households and non-financial corporations, by supply and demand factors (a)



- **Financial impairment losses increased by 23% year on year at consolidated level**
- **Growth in impairment was much more contained in business in Spain**
 - In fact, the non-performing loan ratio remained stable, since the slight fall seen among firms was offset by a slight rise among households (mortgages)
 - The share of Stage 2 loans grew somewhat in both groups
 - *As was to be expected, the credit quality of the portfolios of loans backed by the Official Credit Institute and subject to the Codes of Good Practice deteriorated more*

2.18.a Impairment losses

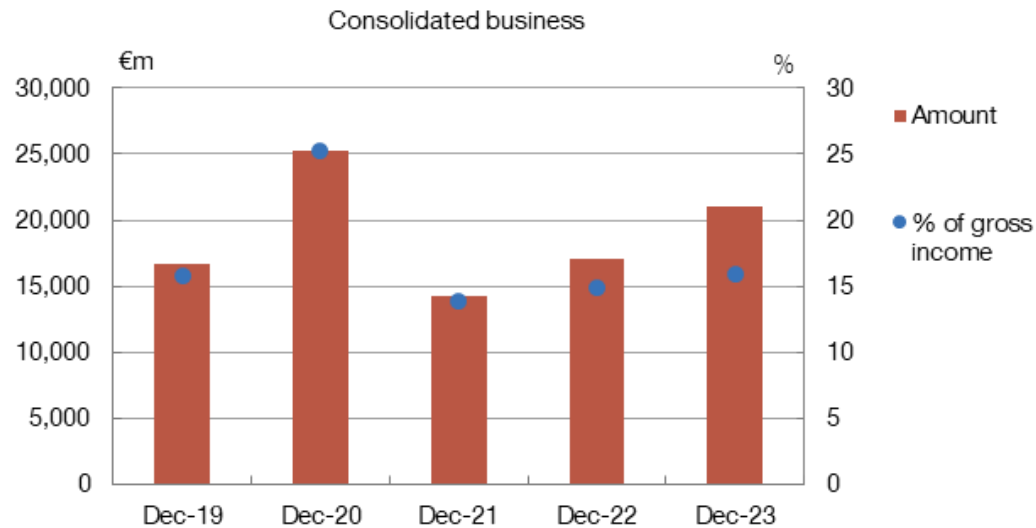
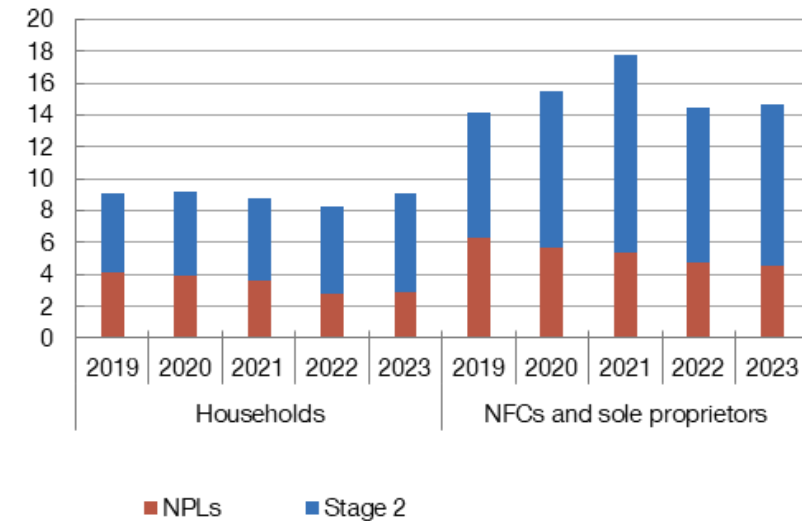


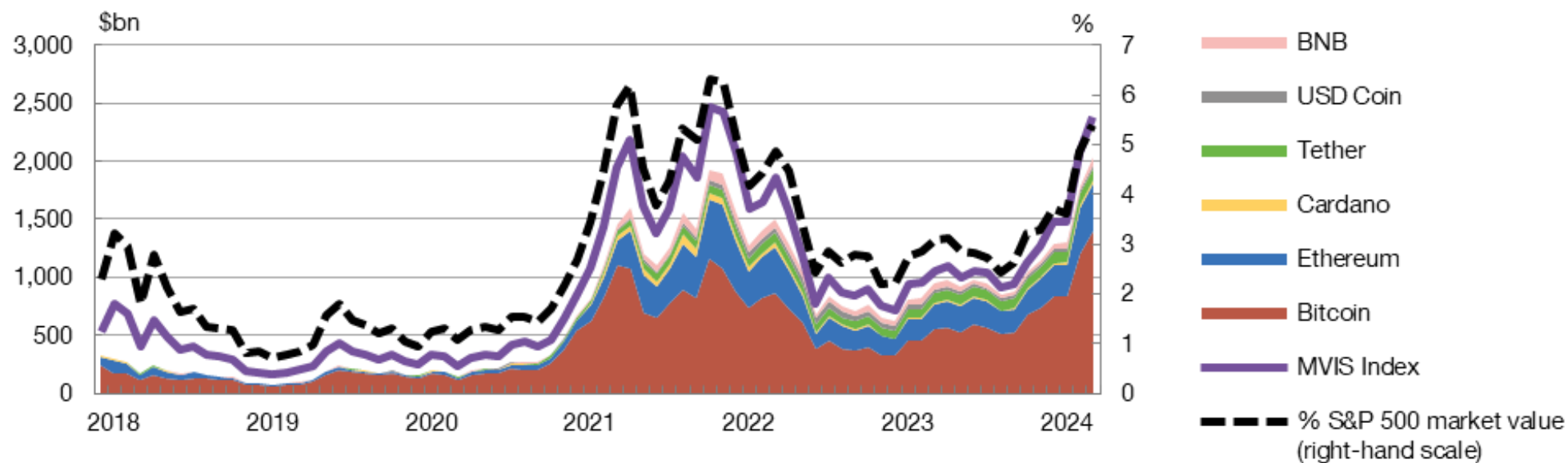
Chart 9

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



- **The market value of the major cryptocurrencies – both backed crypto-assets and other cryptocurrencies – rallied markedly in 2023**
 - The expectation that the monetary policy tightening cycle was nearing an end, as well as permission for their inclusion in exchange-trade fund portfolios in the United States, may have increased appetites for this asset class
- **Despite this strong growth, crypto-assets continue to account for only a small fraction of the financial markets and banks' exposure to these instruments has not changed significantly**

2.26.a Market value of main crypto-assets (a)



- The decline in the credit-to-GDP gap has slowed and it remains in negative territory, while the output gap consolidated at values close to the equilibrium
- The performance of various macro-financial indicators tended to be: still contractionary in the case of lending, neutral in the case of output, and slightly expansionary in the real estate market and wholesale financial markets

3.3.a Credit-to-GDP gap and output gap (a)

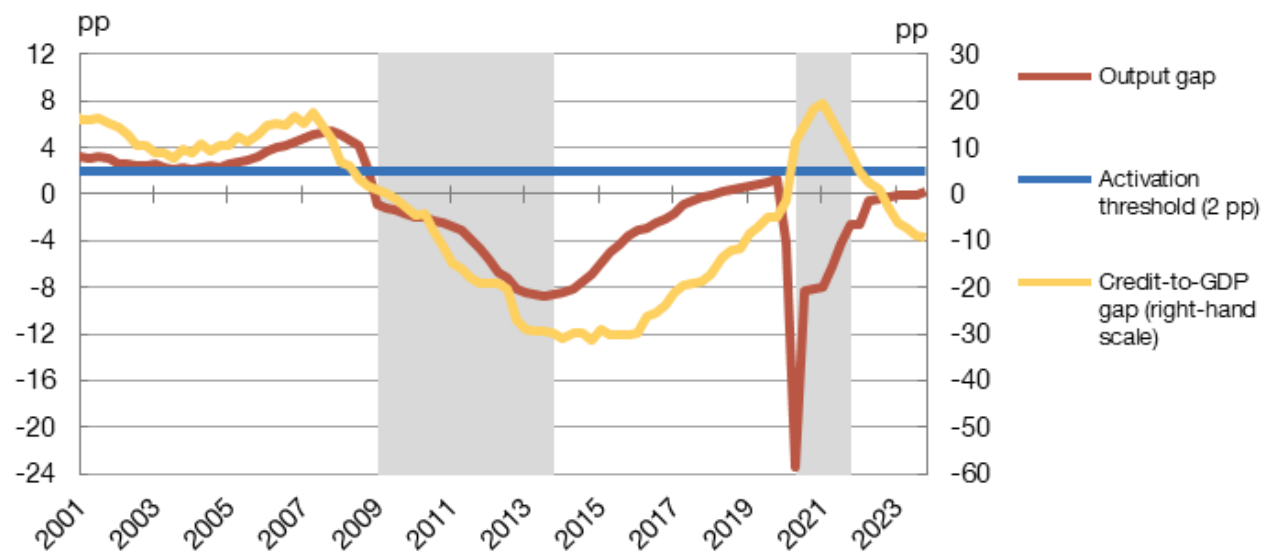
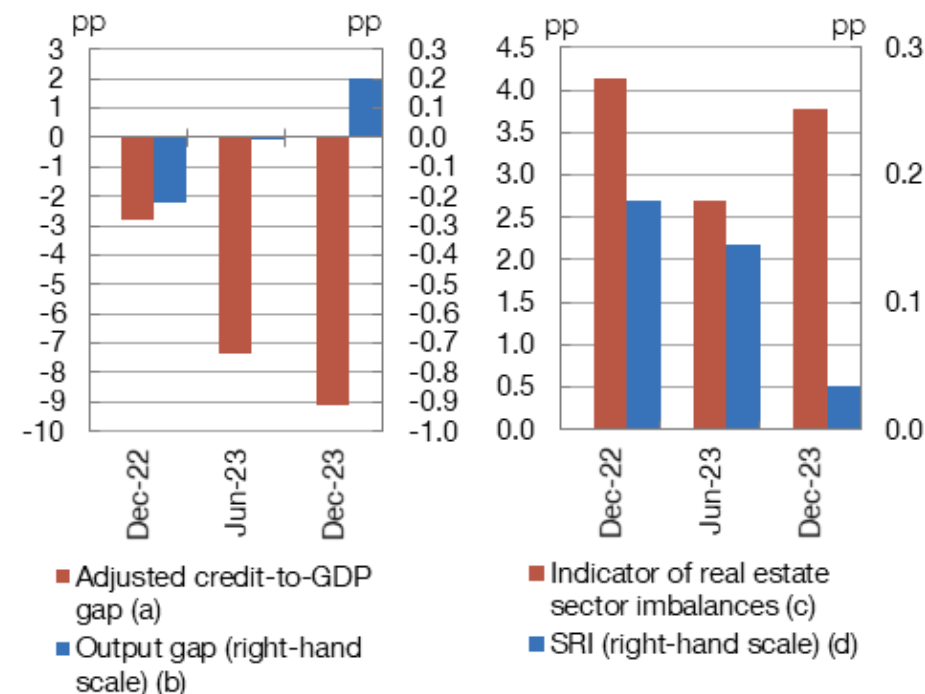
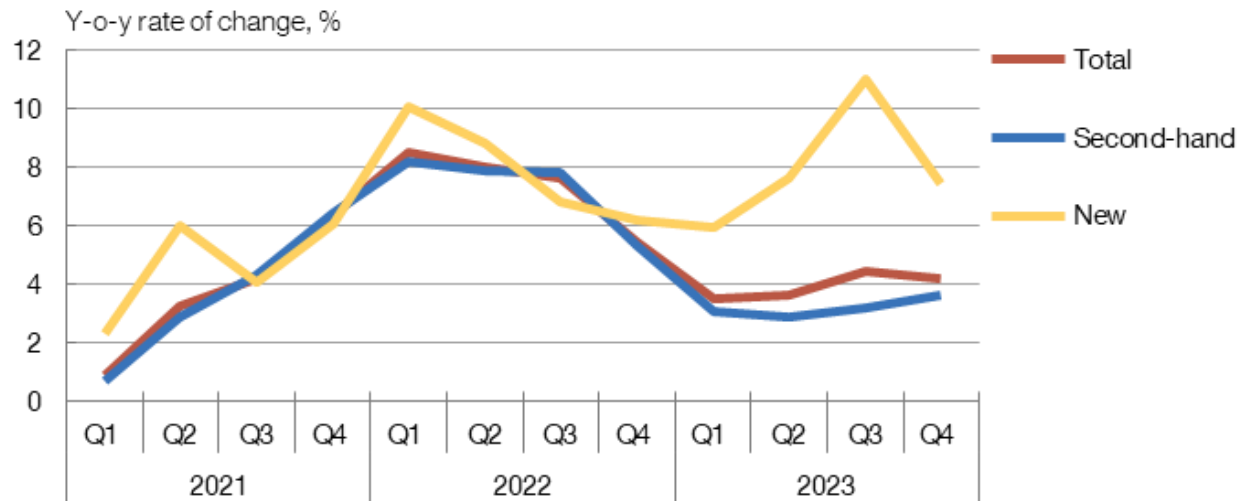


Chart 10
Macroprudential indicators

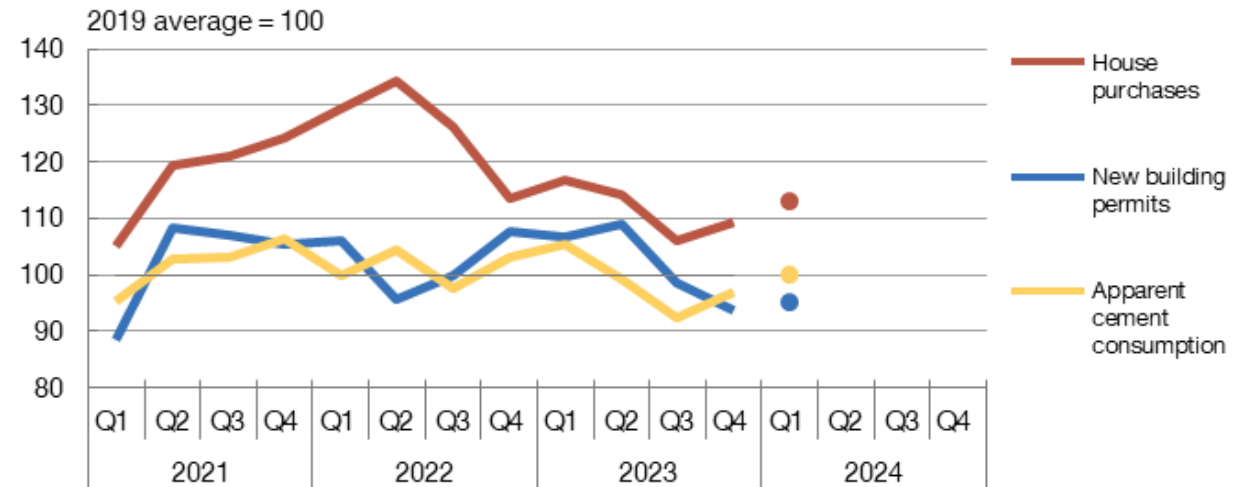


- House price increases were steeper in the new-build segment
- House purchases fell significantly, although the latest data point to a change in trend, at the same time as construction indicators falter

1.6.a House prices



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

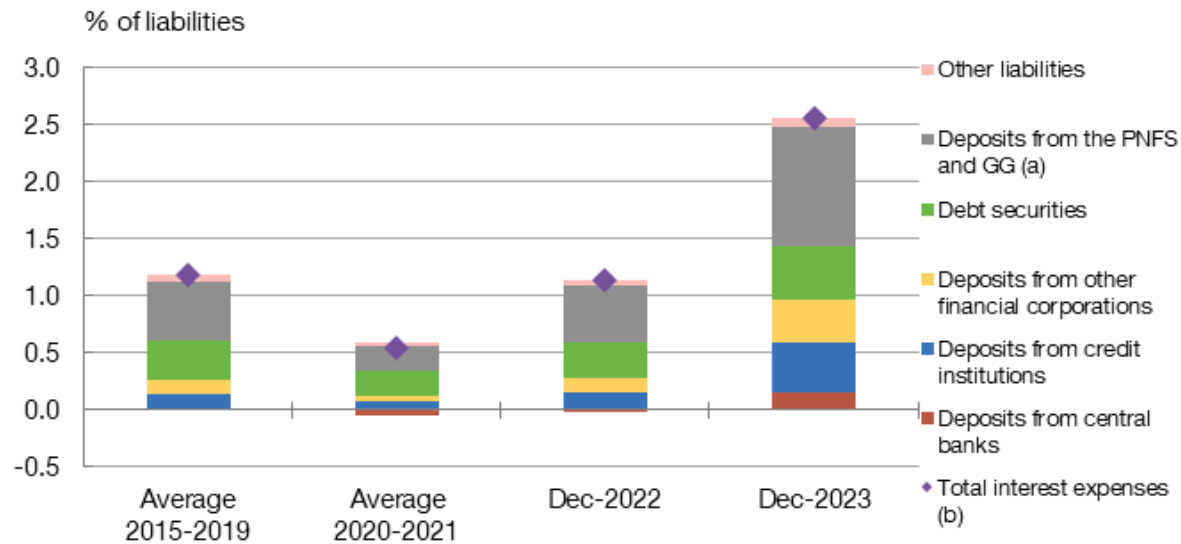


THANK YOU

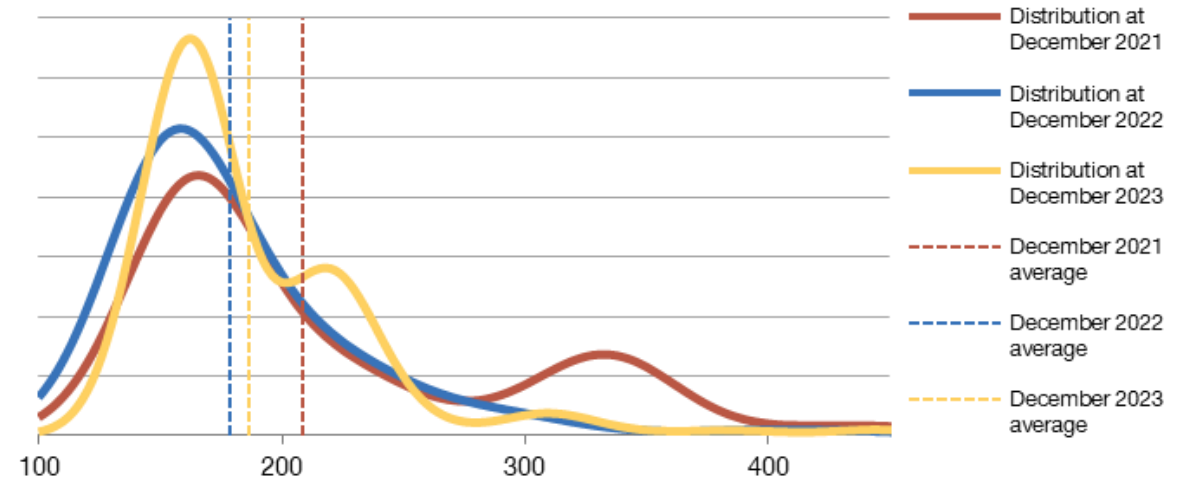
THE AVERAGE COST OF BANK LIABILITIES INCREASED IN 2023, BUT ROBUST LIQUIDITY AND FUNDING CAPACITY CONTINUED

- In December 2023 the average cost of bank liabilities stood at 2.6% – an increase of more than 140 basis points over end-2022 (1.1%)
- Remuneration of household's and non-financial corporation's deposits rose in 2023, although the average cost continued to be highly contained
- The liquidity coverage ratio stood at 186% in December 2023, around 8 percentage points (pp) above its December 2022 level (178%), and comfortably clear of the regulatory requirement (100%)

2.11.a Interest expenses on funding. Data at consolidated level



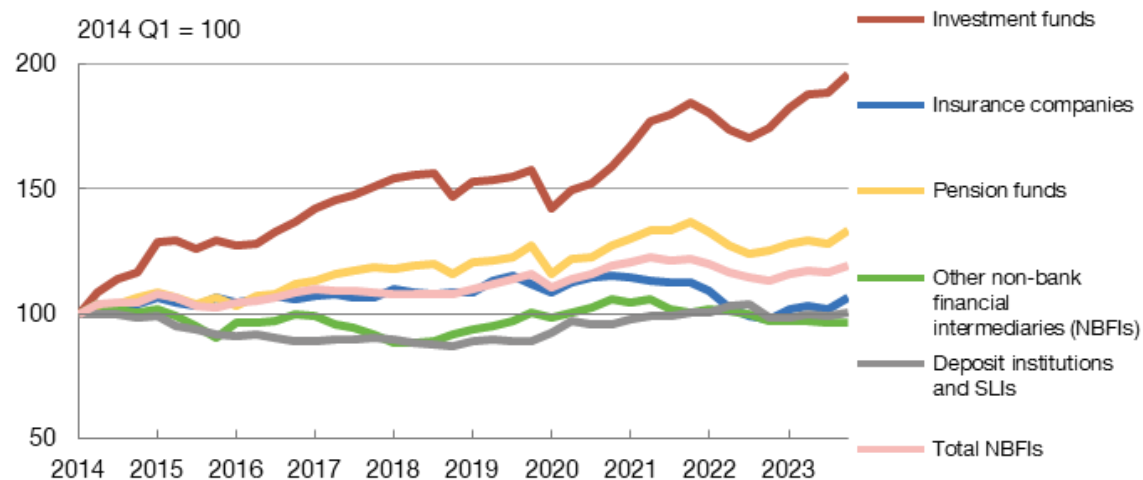
2.13.a Distribution of the LCR. Consolidated data (a)



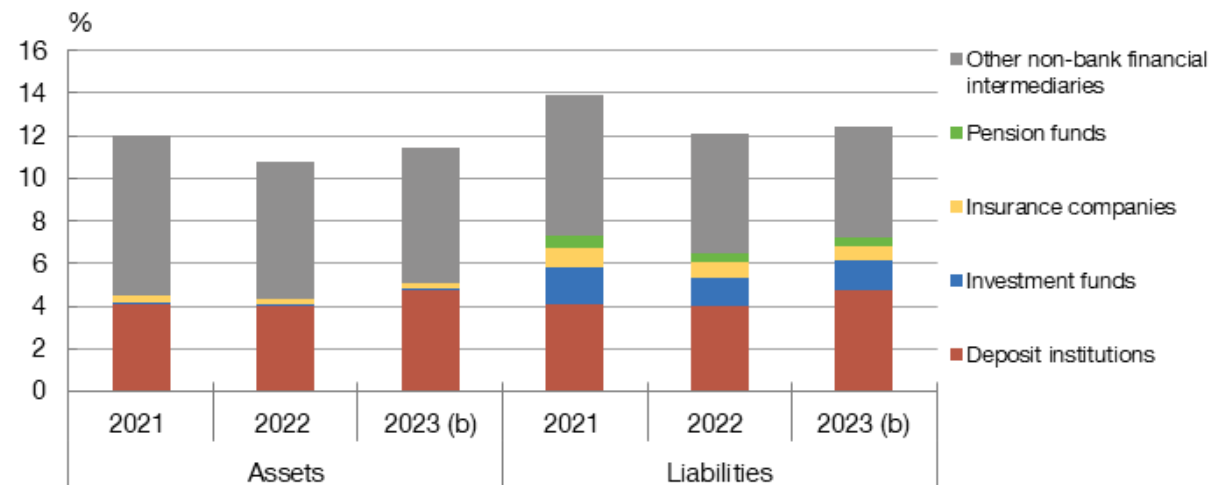
TOTAL ASSETS OF THE NON-BANK FINANCIAL SECTOR STABILISED IN SPAIN OVER THE COURSE OF 2023

- **This performance stands in contrast to the declines seen in 2022**
 - Within the sector, there was notable growth among investment funds, which continued to increase their holdings of government debt (as part of a portfolio reallocation seen as early as 2022 H2)
- **Direct interconnections between the banking sector and other Spanish financial sectors continued to decline in 2023, although far more moderately than in 2022**
- **Indirect interconnections via holdings of debt instruments, especially sovereign bonds, are still significant**

2.22.a Total assets in the different financial sectors in Spain. Non-consolidated data (a)



2.24.a Breakdown of banking sector assets and liabilities from exposures to other financial sectors (% of total assets) (a)



THE BANKING SECTOR'S SOLVENCY WOULD ALLOW IT TO ABSORB SIGNIFICANT SHOCKS IN THE RESIDENTIAL REAL ESTATE MARKET

- A hypothetical adverse scenario is analysed, in which housing prices and investment dive, which would significantly dampen construction and development and have spillover effects on other productive sectors, investment and employment, which would also affect household consumption
 - The impact would manifest through several channels: increased probabilities of default, higher loss given default owing to lower collateral value, but also a lower volume of aggregate activity
- The estimated impact on the current aggregate CET1 ratio of Spanish banks would be 0.2 pp by the end of the exercise's two-year horizon, although there is marked heterogeneity across banks

Chart 2
Macroeconomic impact of adverse scenario (a)

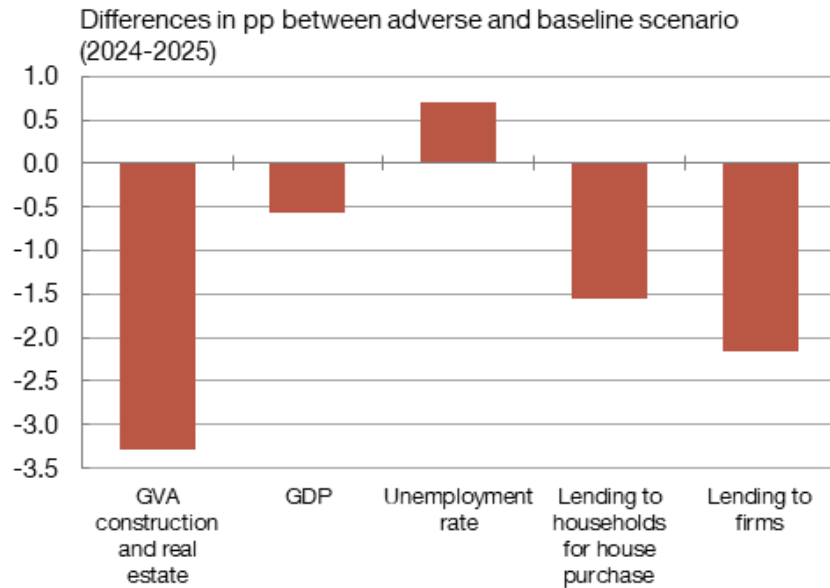
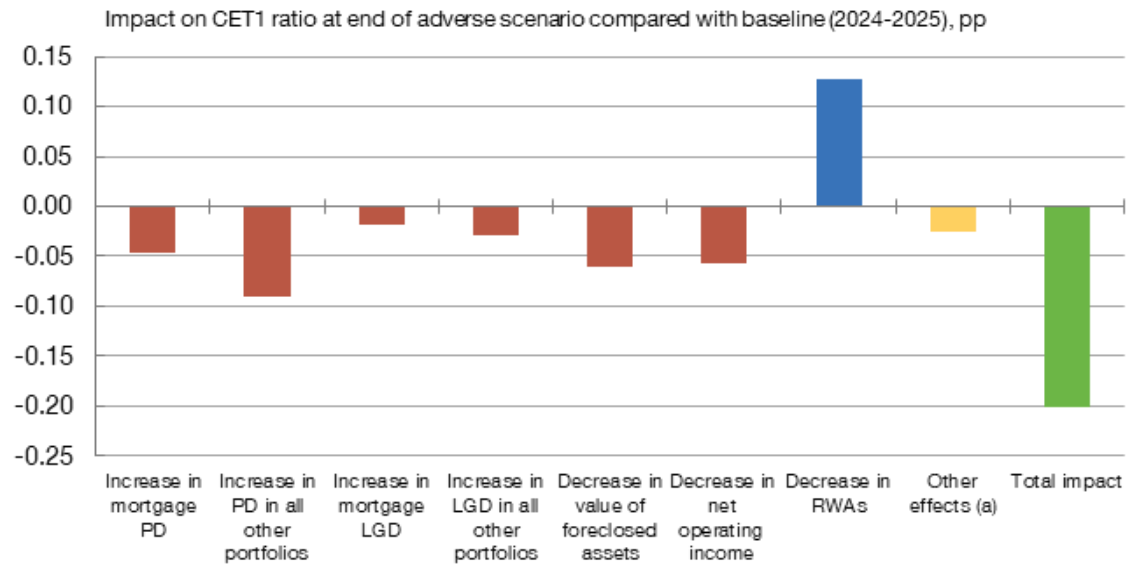


Chart 3
CET1 ratio impact channels



THE FINANCIAL SITUATION OF MOST REAL ESTATE AND CONSTRUCTION FIRMS IS FAVOURABLE, ALTHOUGH SOME SUB-GROUPS ARE MORE VULNERABLE

- Their debt is highly sensitive to interest rate changes (70% of loans are variable rate)
 - Rollover risk is low (long residual maturity)
- The bank debt interest coverage ratio also rose in comparison with pre-pandemic levels
- The results of simulations suggest that some firms could have problems paying interest on their bank debt if activity drops

Chart 2
Residual maturity of bank loans to construction and real estate activities firms at Dec-23 (b)

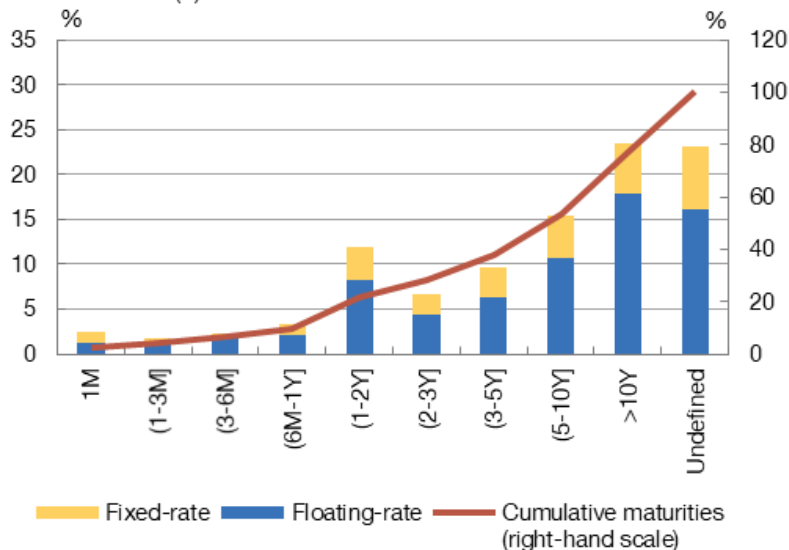


Chart 6
Ratio (EBITDA-Interest expenses on bank debt)/assets x 100 (b) (c)

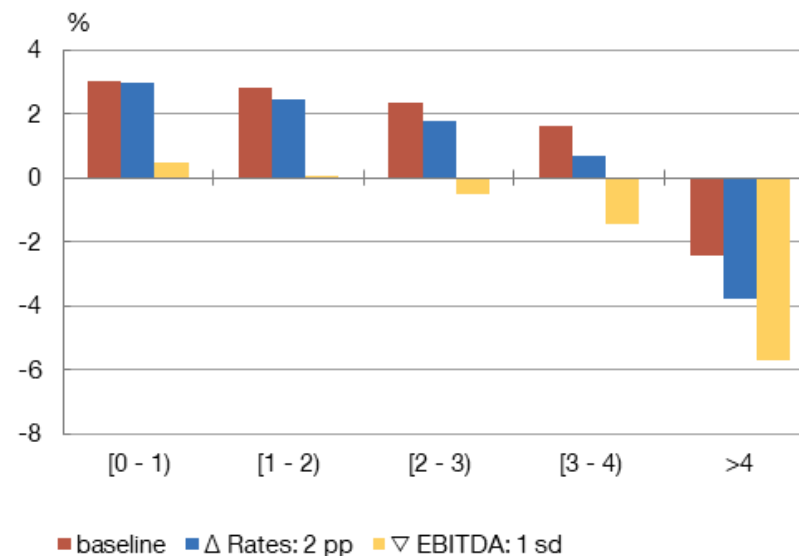


Chart 7
Share of loans by ratio of bank interest expenses to assets (2023, in %)

