

FINANCIAL STABILITY REPORT Spring 2021

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- 2. Chapter 1. Risks linked to the macro-financial environment**
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- **The macro-financial outlook has improved since the last edition of this report, especially as a result of the medical advances against the pandemic, but ...**
 - ... the vulnerabilities have increased and the risks are high
- **Banks have continued to provide financing to the economy during the crisis, generally applying prudential criteria**
 - Public support programmes have enabled the flow of credit to also reach the groups that have been most affected by the pandemic and the most vulnerable ones
- **The NPL ratio decreased over the year, however, ...**
 - ... the measures applied by the authorities to mitigate the impact of the crisis are delaying the emergence of delinquencies; accordingly, ...
 - ... it is essential to analyse indicators of latent credit impairment in bank balance sheets, which seems significant
- **Banks recorded negative returns in 2020 mainly due to extraordinary factors (with no impact on solvency) and also the increase in provisioning**
 - The provisions in 2020 are significant relative to the impairment projections under the baseline scenario up to the end of 2022, although the situation varies from one institution to another
 - Thus, it will be necessary to persevere with the provisioning efforts this year and next year

- **The solvency of institutions has increased largely due to the economic policy support measures**
 - Notable among them are the “quick fix” regulatory reform undertaken by the European Union, the public guarantee scheme and the recommendation not to pay dividends
- **Uncertainty remains very high and the consequences of the crisis are still to be determined**
 - Economic policies need to remain sufficiently expansionary until the recovery takes hold
 - *Supporting viable firms that are in difficulty and the most affected groups and, also, ...*
 - *... designs are needed for an ambitious structural reform plan and a fiscal consolidation programme that can be gradually applied when the recovery becomes robust*
 - Continued close monitoring of the financial system is needed to identify and mitigate the risks arising from this situation
 - *Institutions should maintain their policy of anticipating the recognition of impairment*
 - *Available buffers may be used for this purpose; their rebuilding will be gradual and will not be required before the recovery is well under way*

➤ **R1. Downward adjustments to economic growth**

- Uncertainty persists regarding health developments and the consequences of the adverse economic effects already suffered by households and firms

➤ **R2. Sharp financial market correction**

- The increase in the prices of risky assets has occurred despite the persistence of uncertainty regarding economic activity developments and, in certain segments and areas, values are high relative to their fundamentals

➤ **R3. Adverse bank credit supply shock**

- The supply of credit may be hit by the materialisation of latent credit risk, the absence of new support measures or the premature withdrawal of the current ones

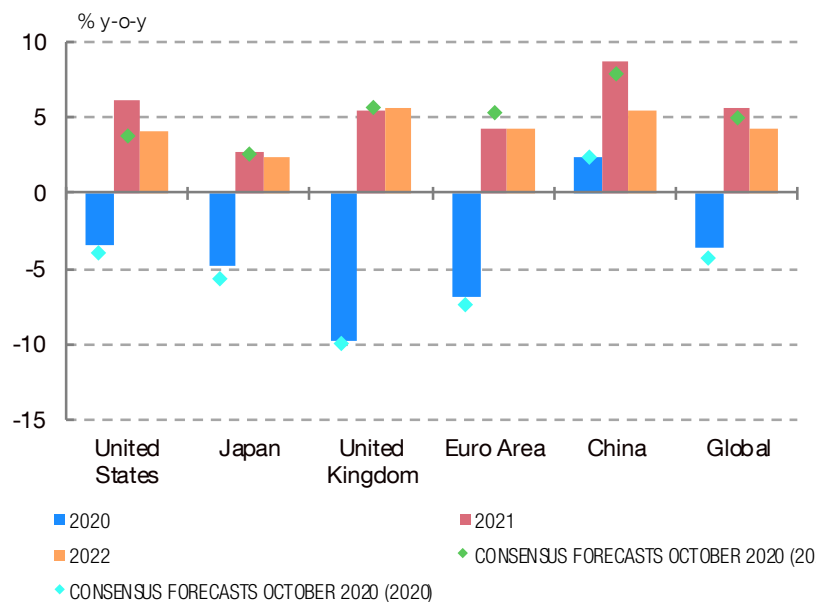
- **V1. Weak financial position of certain segments of households and firms**
 - The persistence of the pandemic continues to generate significant uncertainty regarding their income and ability to repay their debts, with notable heterogeneity in their financial position

- **V2. Growing government debt**
 - Increase in the deficit in 2020 and in the level of debt, the timely reduction of which will require the implementation of credible fiscal consolidation plans

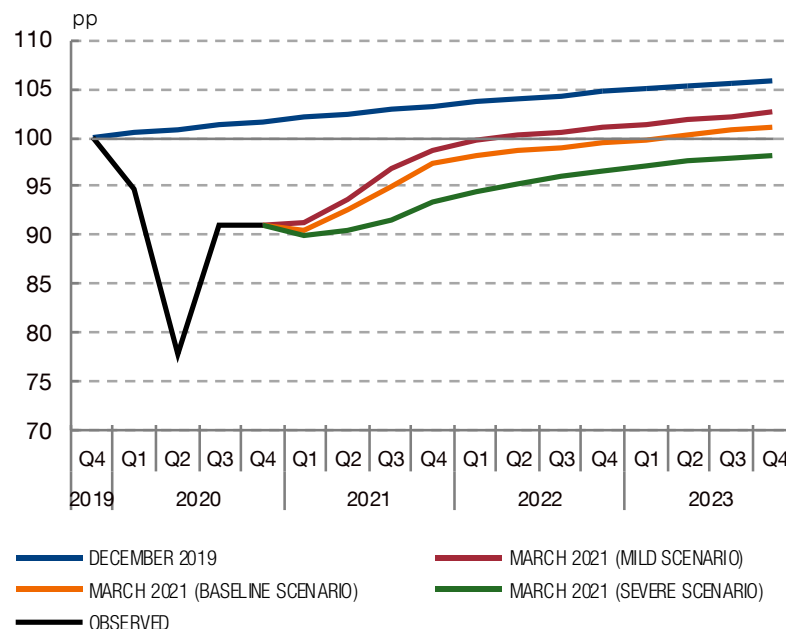
- **V3. Low bank profitability and capital generation capacity**
 - This low profitability hampers the ability to generate capital internally and puts downward pressure on the sector's valuation on the financial markets

- In the international setting, a gradual recovery in activity in 2021-2022 is discerned, but the particular circumstances of two economies of material importance to Spanish banks be noted:
 - The United States, whose recovery is based on a significant fiscal expansion
 - Turkey, which has recently been subject to financial turbulence
- The **baseline scenario for Spain assumes** a recovery in GDP to its pre-pandemic level by **mid-2023**

2 GDP GROWTH FORECASTS (2020-2022)
Consensus Forecast February 2021



2 REAL GDP LEVEL, SPAIN (b)
(2019 Q4 = 100)



- **Long-term yields on the highest quality sovereign debt have risen** and the US dollar has ceased to depreciate since the beginning of the year
- The progress in the rollout of COVID-19 vaccines has driven **price gains and a decline in premia for risk-bearing financial assets** in certain economies
 - Box 1.1 shows how the current levels of some risk premia are lower than would be expected, which may be due to public support measures and/or very optimistic investor expectations

2 CORPORATE BOND SPREADS AGAINST THE SWAP CURVE (LEFT) (a) AND 10-YEAR GOVERNMENT DEBT SPREAD VS GERMANY (RIGHT)

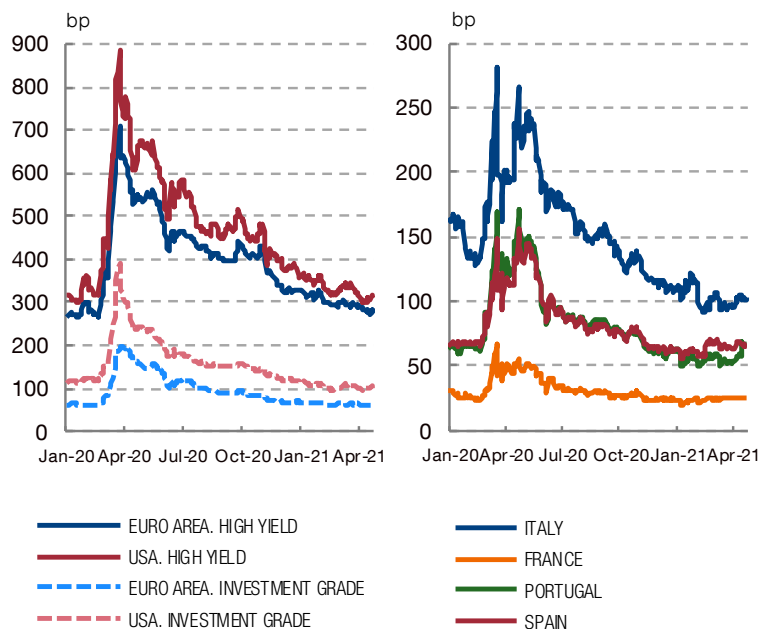
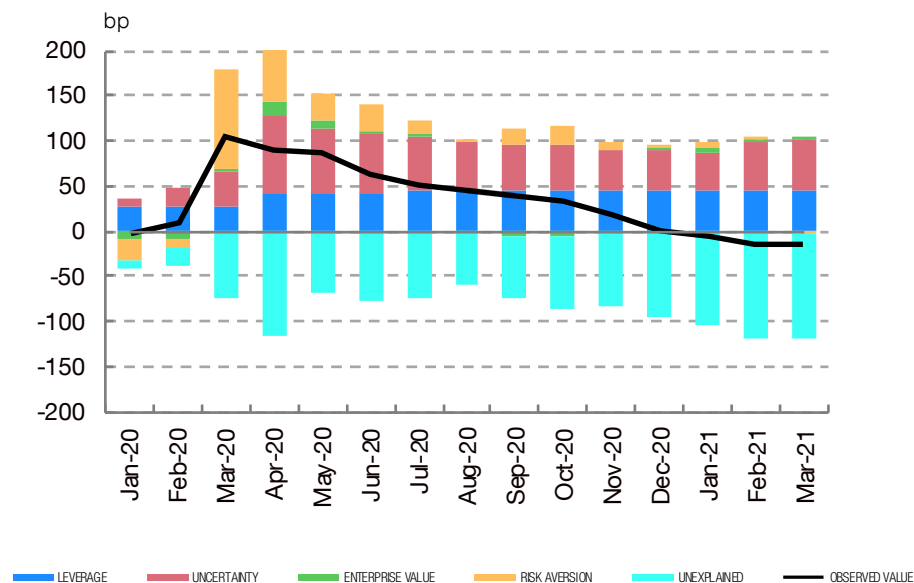


Chart 3
BREAKDOWN OF CORPORATE RISK PREMIA (a)
INVESTMENT GRADE. UNITED STATES



Note: The observed value and the explanatory factors in this chart are shown as deviations from their historical means.

Heterogeneity in the increase in bank debt during the pandemic

- The crisis has had a negative impact on the profitability of **firms**, which **have again increased their indebtedness**; **households** continue to reduce their debt, but **the fall in their income has slightly raised the sector's debt ratio**
 - Also, there is significant heterogeneity across agents; Box 1.2 shows how credit developments appear to have been guided by risk considerations
- In fact, **the growth of credit has been weaker for the segments of firms and individuals most vulnerable**, whose problem loans appear to have also increased to a greater extent
 - ICO guarantees and credit moratoria appear to have had a significant mitigating effect

Chart 1
YEAR-ON-YEAR CHANGE IN BANK CREDIT IN 2020
DIFFERENCES BY CHARACTERISTICS OF FIRMS, ID, Business in Spain (a)

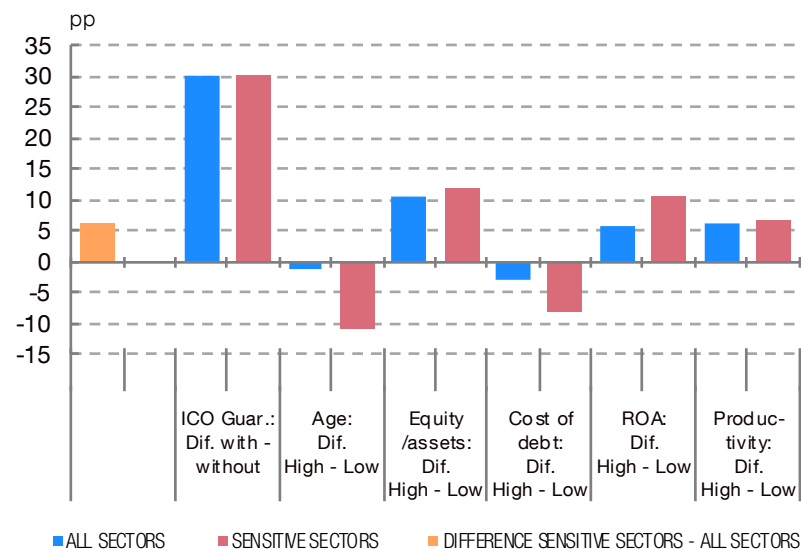
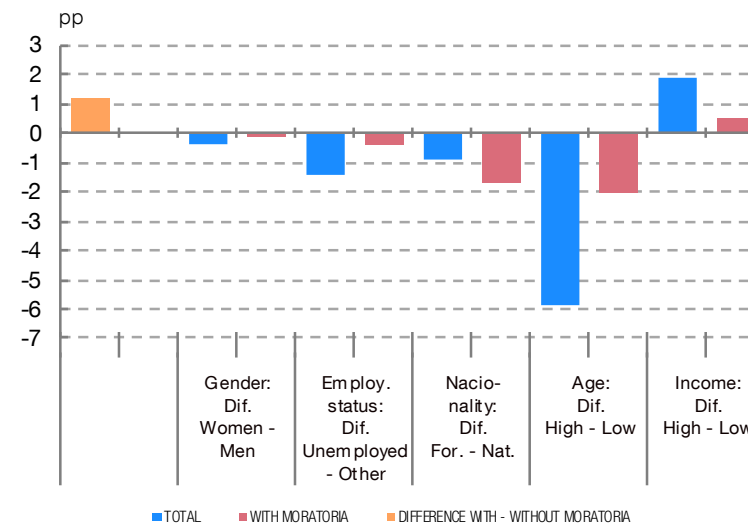
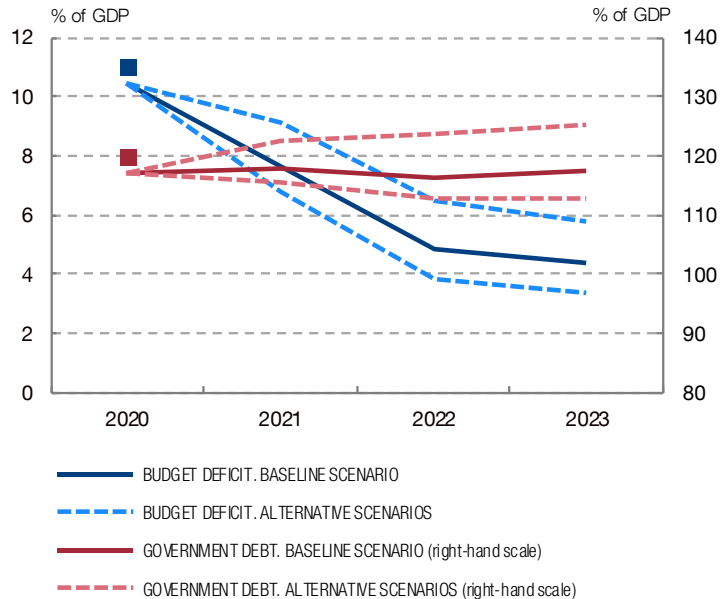


Chart 3
YEAR-ON-YEAR CHANGE IN BANK CREDIT IN 2020
DIFFERENCES BY CHARACTERISTICS OF INDIVIDUALS
ID, Business in Spain (b)

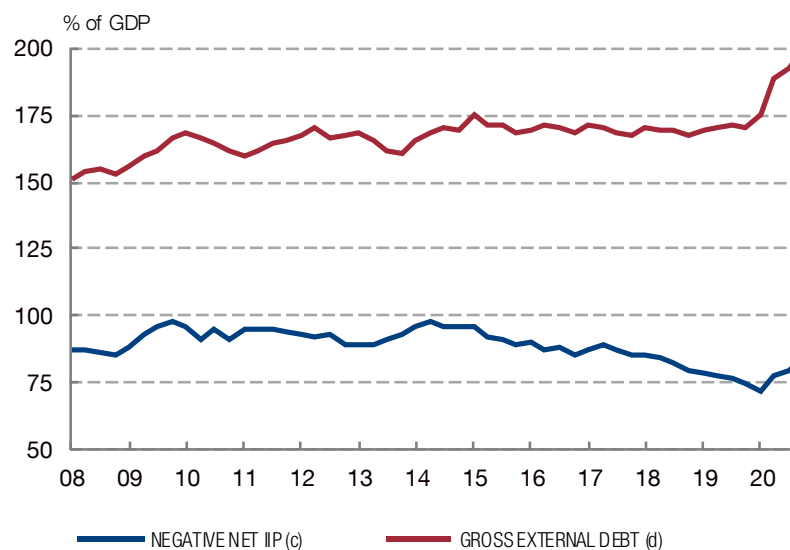


- The pandemic has involved a **notable deterioration in the financial position of Spanish general government**, entailing **greater vulnerability** to possible further shocks
 - Although in the short-term the favourable financing conditions and European programmes will allow fiscal policy to remain expansionary, in the medium-term, when the effects of the crisis are over, a credible and sustained fiscal consolidation process will need to be implemented
- In recent quarters, **the negative net international investment position of the Spanish economy and gross external debt have increased**, in terms of GDP

2 BANCO DE ESPAÑA FORECASTS OF PUBLIC DEFICIT AND DEBT (b) (c)

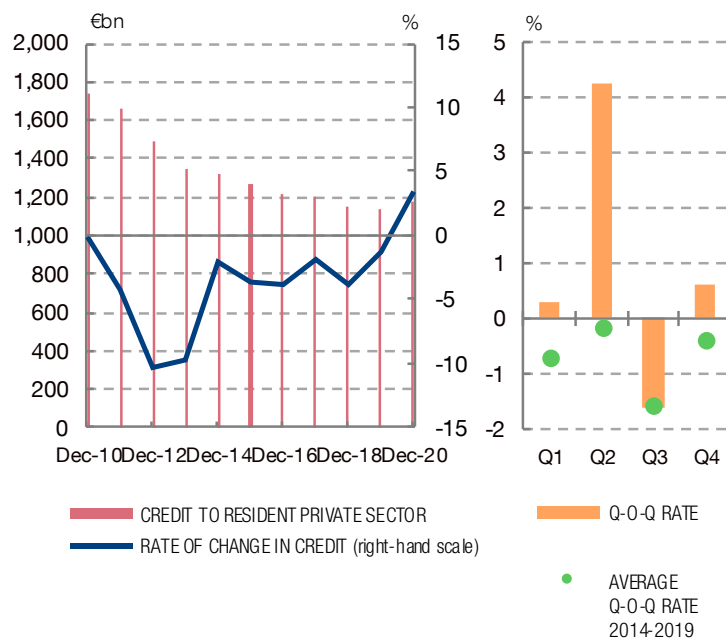


2 NEGATIVE NET IIP AND GROSS EXTERNAL DEBT

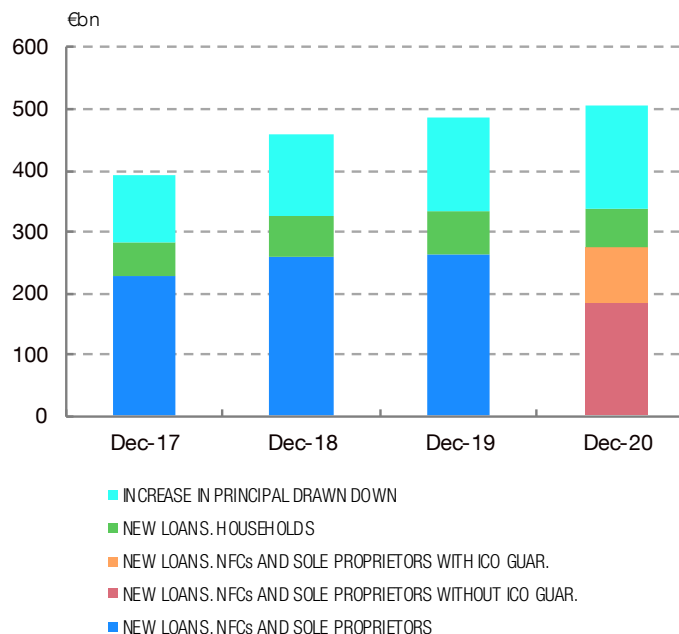


- The stock of **deposit institutions' credit to the private sector in Spain** grew by **3.5%** in 2020
 - In the second half of the year it was somewhat slack
 - The volume of new credit granted was 4.1% higher than in 2019
- **Credit to business activity with an ICO guarantee represented 34%** of the credit drawn down on new transactions for business activity,
 - Accordingly, it made a critical contribution to preventing a contraction in financing

1 CREDIT VOLUME AND YEAR-ON-YEAR RATE OF CHANGE
BUSINESS IN SPAIN, ID

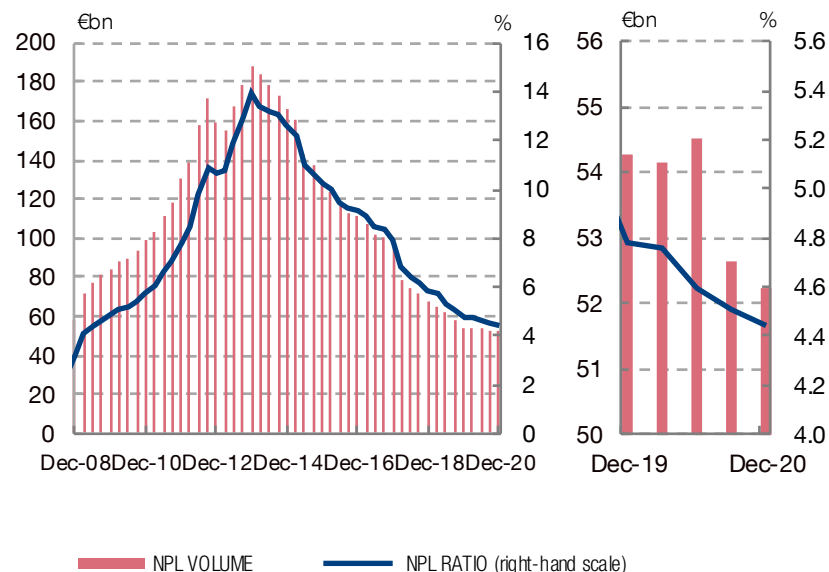


2 VOLUME OF NEW CREDIT IN THE PAST 12 MONTHS. HOUSEHOLDS,
NFCs AND SOLE PROPRIETORS
Business in Spain, ID

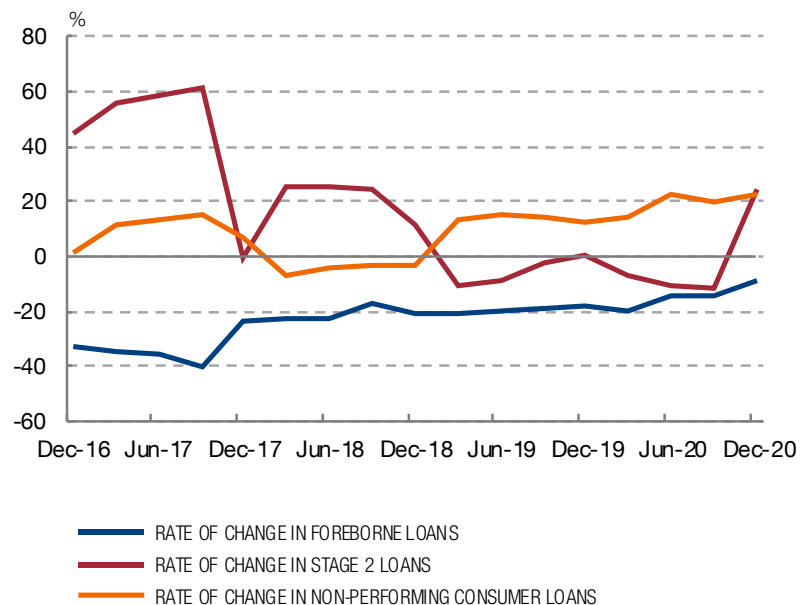


- **NPLs continued to decline** in 2020 (by 3.8%), **albeit to a lesser extent** than in previous years (19% in 2019 and 29% in 2020)
 - Combined with the increase in credit, the NPL ratio continued to decline (to 4.4%)
- In this crisis, **NPLs have reacted much less to the fall in GDP** than in the past
 - Support measures for the private-sector appeared to be playing a very significant role
- **NPLs did increase in specific segments** (e.g. consumer) and ...
 - ... Stage 2 credits increased strongly, a clear sign of latent risk

1 RESIDENT PRIVATE SECTOR'S NPLs AND NPL RATIO
Business in Spain, DI



4 SIGNS OF EARLY IMPAIRMENT IN RESIDENT PRIVATE SECTOR LOANS
Business in Spain, ID



Box 2.1: ICO public guarantee scheme

- **The amount guaranteed by the ICO schemes** stood at around **€88 billion** and the **total financing** granted to firms and the self-employed around **€115 billion**
 - Firms accessing the scheme had, *ex ante*, a higher risk profile
- A **high percentage** of this financing is associated with **borrowers with some sign of impairment in the system as a whole**:
 - 36% of NFC in Stage 2, 5% non-performing for subjective reasons and 5.5% objectively non-performing
 - These percentages are much lower in the case of the guaranteed loans themselves

Chart 3
FINANCIAL CHARACTERISTICS OF FIRMS MAKING USE OF THE ICO GUARANTEE SCHEME (a)

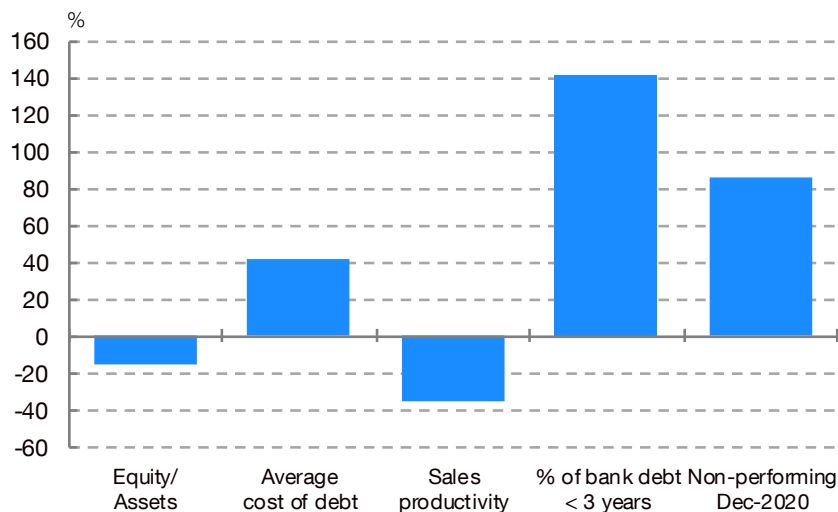
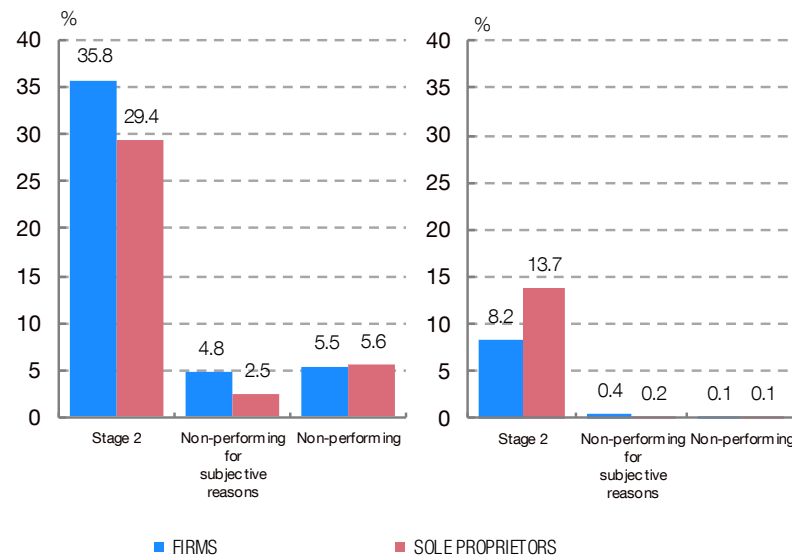


Chart 4
PROPORTION OF ICO-BACKED LOANS OF CUSTOMERS WITH SIGNS OF CREDIT IMPAIRMENT. DECEMBER 2020. (b)
Individual data. Business in Spain. Deposit institutions



Box 2.2: loan moratoria

- **Moratoria have been granted amounting to more than €56 billion, of which ...**
 - ... €22 billion expired in 2020, so that the outstanding volume at the end of the year amounted to some €34 billion (95% are conventional moratoria and 5% legislative, owing to the transfers between them)
 - More than 50% expire in April or May
- The loans under moratoria of the **most indebted households, with lower income and poorer credit history** or in regions with greater employment losses are those which **have a higher probability of being classified as problem loans when the moratoria expire**
 - Of the loans subject to expired moratoria, around 20% are in Stage 2 and somewhat less than 10% are non-performing

Chart 2
EXPIRIES BY MONTH OF THE MORATORIA OUTSTANDING IN DECEMBER 2020 (% OF TOTAL)

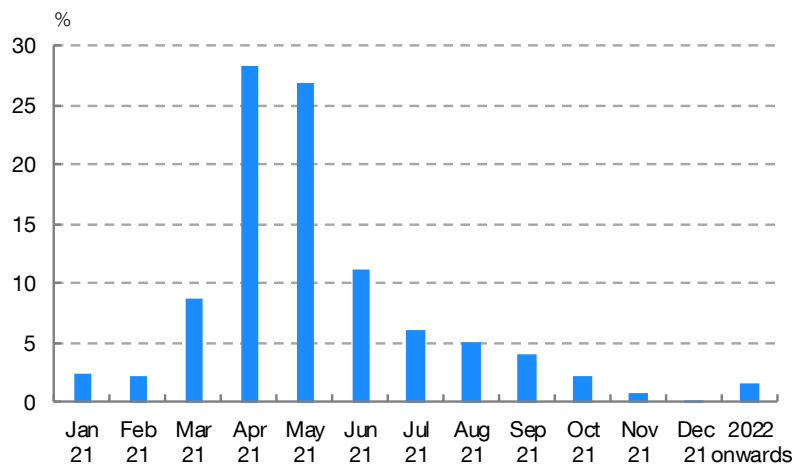
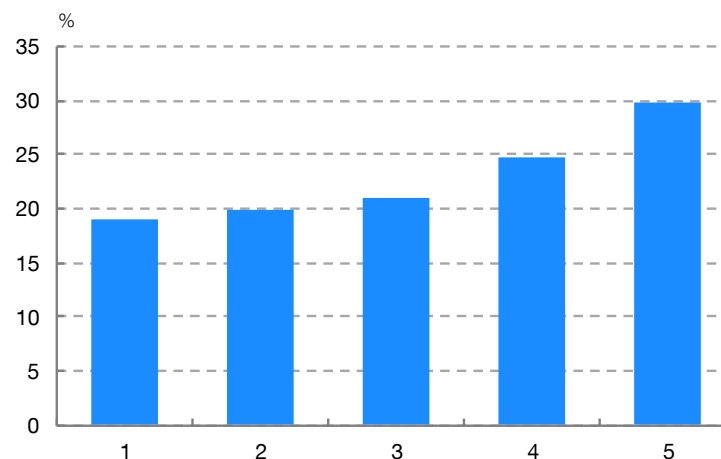


Chart 4
PERCENTAGE OF NON-PERFORMING AND STAGE 2 LOANS THAT WERE SUBJECT TO MORATORIA NO LONGER IN FORCE AT THE END OF 2020, BY HOUSEHOLD INDEBTEDNESS QUINTILES



- The implied **probability of default** for non-financial firms can be assessed using **stock market information**
 - It increased significantly following the outbreak of the pandemic, but without reaching the levels seen during the global financial crisis
 - In the second wave of infections this probability fell and, despite certain upticks in the third wave (December 2020-January 2021), the increases at the end of 2021 Q1 appeared to be contained
- The **increases** in the probability of default show some persistence in the **tourism sector** and for **Spanish listed firms the increases have been larger** since the start of the pandemic than for those in the other main European countries.

Chart 3
CHANGE IN IMPLIED PD OF EUROPEAN FIRMS BY SECTOR AFTER THE PANDEMIC AND IN THE GLOBAL FINANCIAL CRISIS (a)

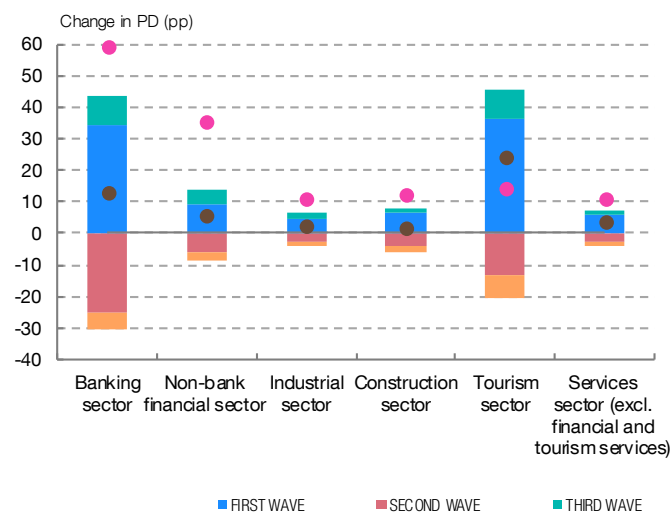
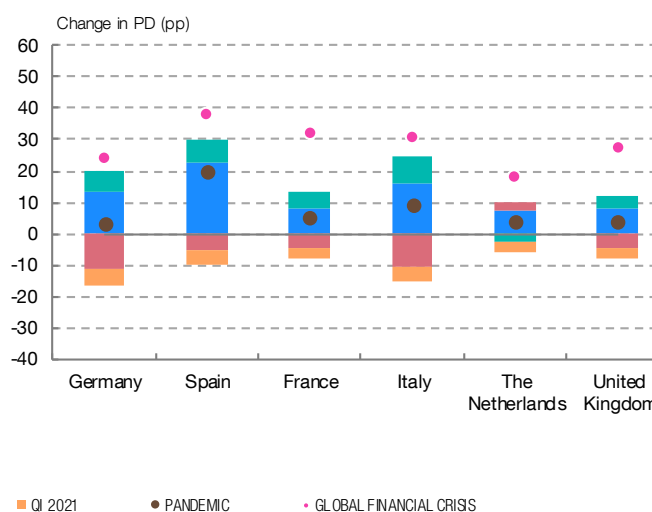
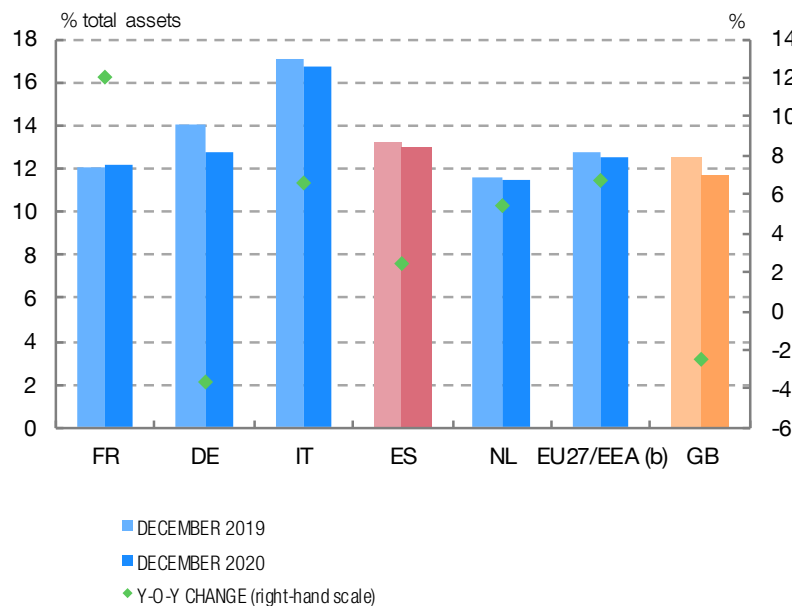


Chart 4
CHANGE IN IMPLIED PD OF EUROPEAN FIRMS BY COUNTRY AFTER THE PANDEMIC AND IN THE GLOBAL FINANCIAL CRISIS (a)

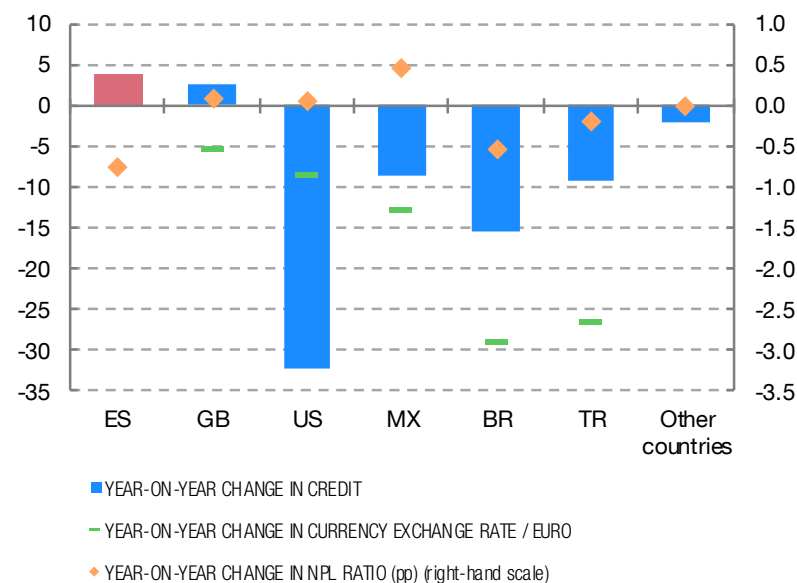


- The greater issuance of public debt to finance support measures has been reflected in the **growth of the sovereign debt of European banks**
 - In Spain, one of the countries in which it grew least in 2020, its weight is very close to the European average
- The volume of **credit abroad** of the main Spanish deposit institutions has been **adversely affected by currency appreciation**, especially in emerging countries
 - The sharp fall in credit in the United States is attributable to an institution's divestment decision

1 SOVEREIGN EXPOSURES OF EUROPEAN BANKS (a)
Consolidated data. December 2020

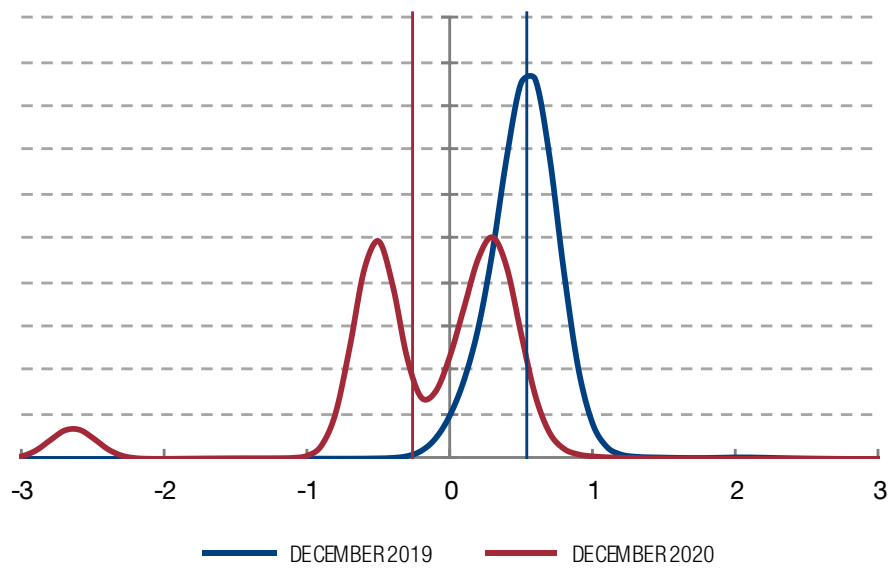


1 LOANS AND NPL RATIO IN SPAIN AND ABROAD
Year-on-year change. Consolidated data. December 2020 (a)

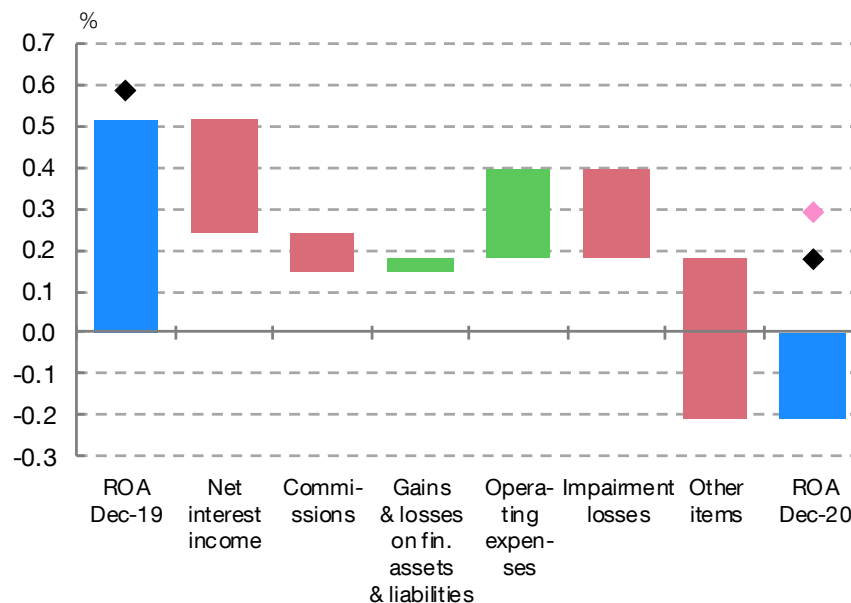


- **The impact of the pandemic on the profitability of the Spanish banking sector has been severe:** the consolidated net profit was a negative amount of around -€8 billion
 - The negative extraordinary adjustments (impairment of goodwill, fiscal assets and valuation adjustments due to merger) explain the losses
- **Net interest income and fees and commissions** fell by almost **10%** in 2020, while **provisions increased significantly**
 - Gains on financial assets and liabilities and operating expenses improved with respect to 2019

1 DISTRIBUTION OF THE ROA (a) (b)

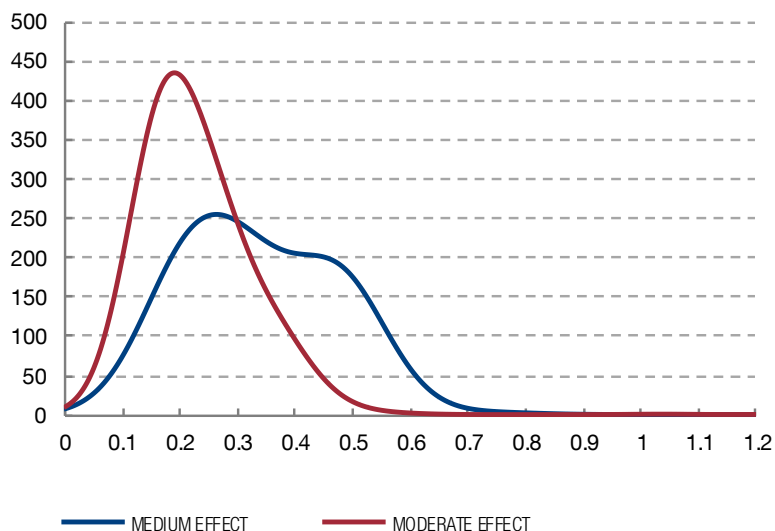


2 BREAKDOWN OF THE CHANGE IN PROFIT
Consolidated net profit as a percentage of ATA (a)

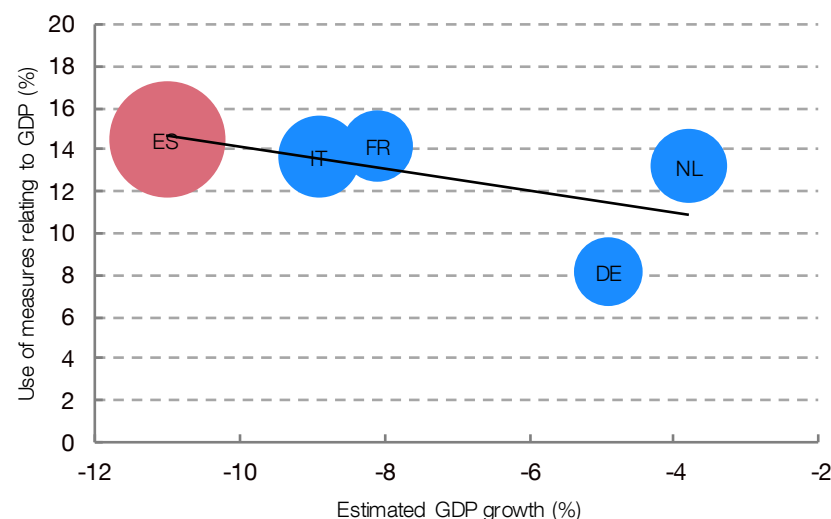


- The **pace of provisioning in 2020 appears to have been very significant**, and on aggregate in keeping with the level **estimated** in the baseline scenario of the stress test for 2020-2022...
 - ... although significant dispersion is observed among institutions
- Accordingly, institutions **must, at least, sustain this effort this year and next year** to fully cover the credit impairment
- Among the banks of the main European countries, an **inverse relationship** has been observed **between the performance of GDP and the pace of provisions**, and a weaker one between the actual use of measures and GDP

1 PROVISIONS RECORDED IN 2020 VS. ESTIMATED PROVISIONS FOR 2020-2022
Business in Spain. Estimate obtained under the FLESB framework (a)

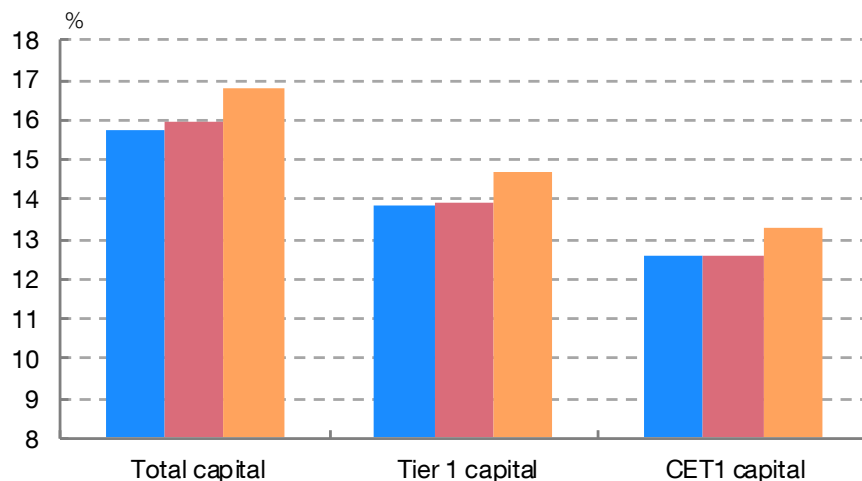


2 INTENSITY OF PROVISIONING, FALL IN GDP AND SUPPORT MEASURES - 2020
Consolidated data by jurisdiction (b)

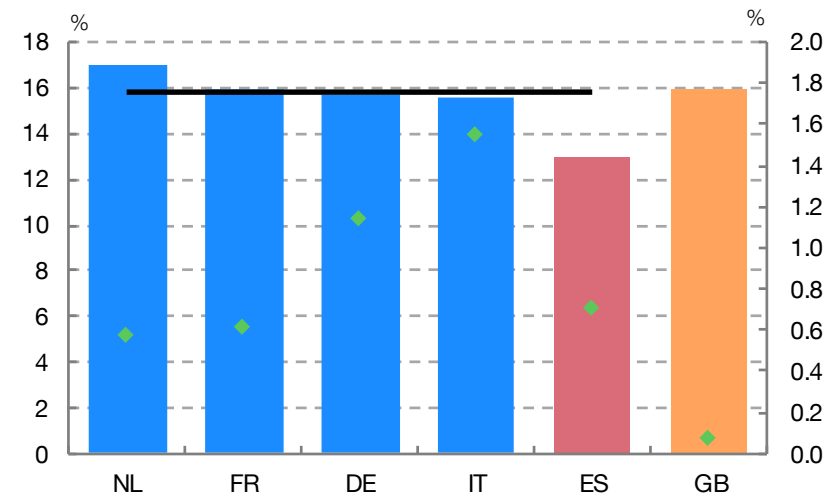


- During 2020, the aggregate **capital ratios** of the banking sector **increased**
 - This improvement was a result of the measures adopted, the European “quick fix” reform of capital requirements, the guarantee scheme and the restrictions on dividend payments
- Despite this, **the CET1 ratio of Spanish banks** remained **the lowest** among the largest European countries
 - This is attributable, to some extent, to structural elements, such as the greater use of the standardised approach to calculate risk weights

1 CAPITAL RATIOS



2 CET1 RATIO (a)
Consolidated data. December 2020



DECEMBER 2019 JUNE 2020 DECEMBER 2020

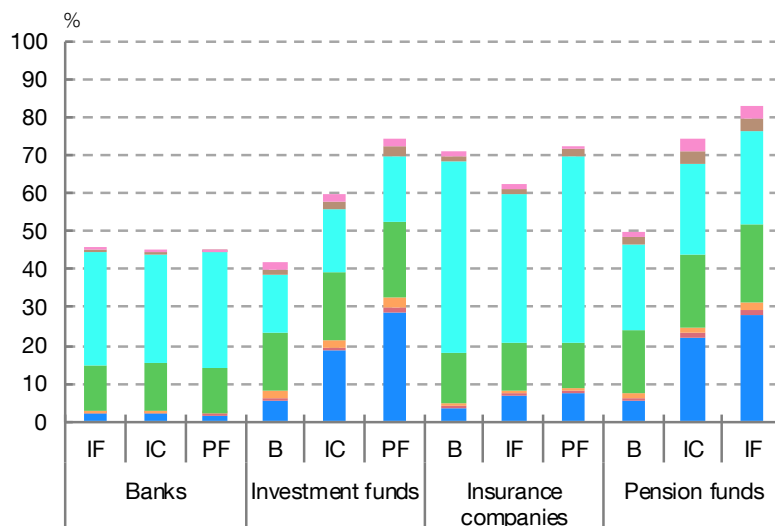
EU27/EEA AVERAGE (c) YEAR-ON-YEAR CHANGE (pp) (right-hand scale)

Recent corporate transactions in the Spanish banking sector

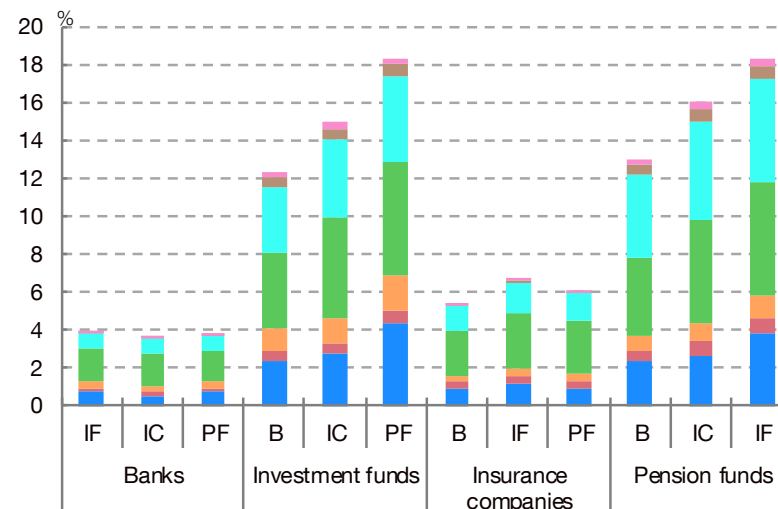
- The Spanish banking sector is currently undergoing a **new consolidation process** in which four of the 12 significant Spanish banks are combining in two mergers
 - Both the CaixaBank-Bankia merger and the Unicaja-Liberbank one attempt to improve profitability and solvency, with lower overheads and greater economies of scale to facilitate digitalisation and financial market access
- The absorbing bank in the first merger, **CaixaBank**, will become the largest bank in terms of business in **Spain**, with an overall market share of around 25%, while the share of Unicaja-Liberbank would be 4.2%
- **Market reaction**, upon the announcement of the negotiations and upon confirmation of the agreements, **was positive**, with rises in the securities of the four banks involved
- The ECB has just published its **Guide on the supervisory approach to consolidation in the banking sector** which envisages:
 - That credible integration plans will not be penalised with higher capital requirements (P2R and P2G) than those derived from applying the weighted average of the banks' consolidated pre-combination capital requirements
 - Prudent recognition of goodwill, which cannot be distributed as dividends until the sustainability of the business model is established
 - Temporary acceptance of the use of existing internal models, subject to a roll-out plan

- **The interconnections** between financial subsectors through common holdings of marketable securities are a potential **risk propagation channel**
- This channel is especially important for marketable securities **rated as bordering on investment grade**, since these are **more vulnerable** to a deterioration in the economic situation
- The **weight of common holdings** of these marketable securities bordering on investment grade is relatively **high in the case of investment and pension funds**, while this proportion is **low** in terms of the total portfolio of the banking sector and insurance companies

1 TOTAL COMMON HOLDINGS AS A PROPORTION OF TOTAL PORTFOLIO (a)
2020 Q4



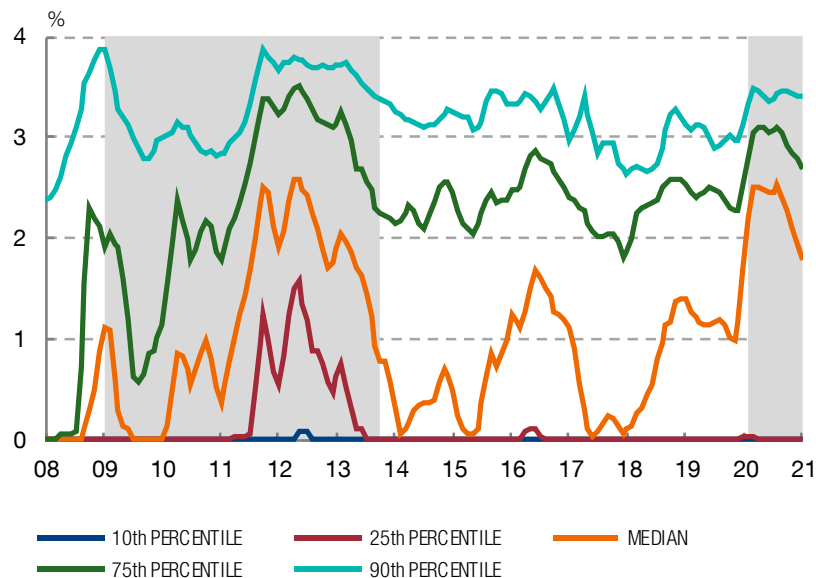
2 TOTAL COMMON HOLDINGS OF CORPORATE SECURITIES AS A PROPORTION OF TOTAL PORTFOLIO (a)
2020 Q4



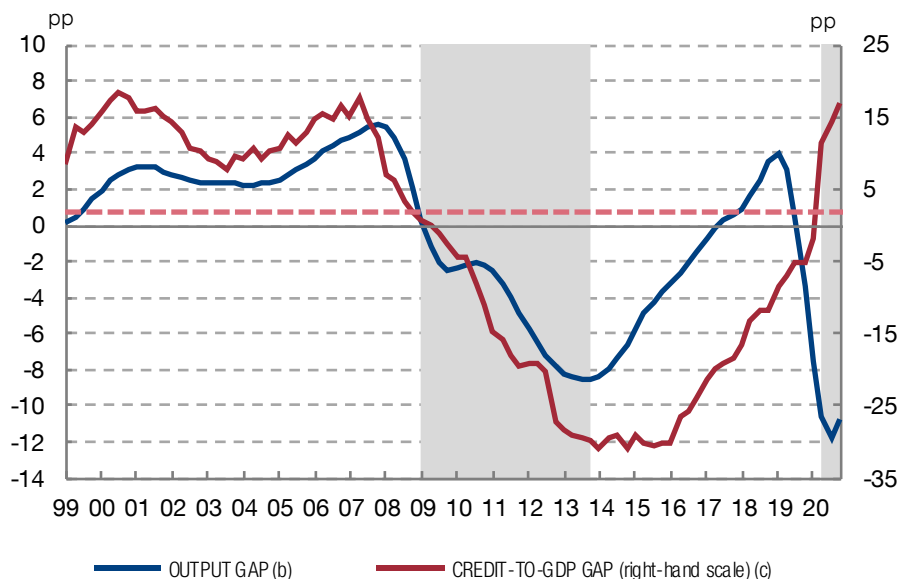
NOT RATED CCC AND BELOW FROM BB+ TO B- FROM BBB+ TO BBB- FROM A+ TO A- FROM AA+ TO AA- FROM AAA+ TO AAA-

- **Systemic risk** in the Spanish financial system **has fallen gradually** since the end of April 2020, but ...
 - ... other indicators, such as the SRISK indicator, which had displayed historically high levels after the outbreak of the pandemic, have fallen significantly following the approval of vaccines
- **The credit-to-GDP gap remains above the threshold** for standard activation of the CCyB; however, ...
 - ... this is attributable to the sharp fall in GDP and not the endogenous build-up of systemic vulnerabilities in the financial system, so that ...
 - ... activation of the CCyB would not be appropriate

1 DISTRIBUTION OF THE SRISK SYSTEMIC RISK INDICATOR (a)



OUTPUT GAP AND CREDIT-TO-GDP GAP



- The **coordinated action of** macroprudential, microprudential and accounting **policies continued to facilitate the financing of the real economy**, mitigating the economic impact of the pandemic
 - The easing of solvency and liquidity requirements for European banks remains in force
 - Different authorities have continued to recommend credit institutions to exercise prudence regarding dividend distribution during the pandemic
 - The CRR has been reformed in line with the quick fix provisions to modify favourably the potential treatment of certain software programs
- Moreover, **further measures have been adopted**
 - In December 2020 the EBA reactivated its guidelines on legislative and non-legislative moratorium
 - The European Commission sent a communication on non-performing loans, proposing greater proactivity to anticipate an increase, at the same time as it extended the State aid Temporary Framework to end-December 2021
 - In Spain, the durations and grace periods of loans with public ICO guarantees have been extended and RDL 05/2021 has introduced extraordinary measures to improve business solvency, including direct aid and measures to facilitate the restructuring of debt with an ICO guarantee

- The reform of Circular 2/2016 **significantly expands the toolkit** available to the Banco de España in its role as **macroprudential authority**:
- **1. Sectoral component of the countercyclical capital buffer (SCoCCyB)**
 - Permits the countercyclical capital buffer to be established for the exposures of a specific sector
 - The empirical evidence suggests that it should be activated in the early stages of development of systemic risk and that it is important to monitor the spill-overs to other sectors
- **2. Sectoral concentration limits for credit exposures (SCLs)**
 - The limitation of exposure is defined in terms of a measure of capital
 - Its activation would limit the growth of sectoral concentration of credit more directly than the SCoCCyB, which is more appropriate in the event of a greater build-up of systemic risk
 - Also, it is necessary to ensure its activation does not generate imbalances in other sectors
- **3. Limits and conditions for the grant of loans or other transactions (Borrower-Based Instruments or BBIs)**
 - Limits on credit standards at the time of the granting of loans, such as the value of collateral, the term of the transaction, the financial capacity of the borrower, etc.
 - This instrument should be activated in the intermediate stages of the development of systemic risk

THANK YOU FOR YOUR ATTENTION

