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The situation of the Spanish banking sector with regard to macro-financial risks*

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* English translation from the original in Spanish

I wish to begin by thanking *Expansión* for inviting me to this meeting, which, as every year, gives me the opportunity to address the main challenges posed by the macro-financial environment for the Spanish banking sector.

Generally speaking, the risks to financial stability have risen significantly since the Russian invasion of Ukraine. Indeed, the most significant risks at the present time are of a **geopolitical nature**, associated especially with the uncertainty surrounding the duration and possible escalation of the war.

The main transmission channel of the war has been higher energy and food commodity prices, which have driven a **sharp uptick in inflation**. In recent months, this increase in inflation has become more widespread and persistent, prompting a monetary policy response from the main central banks. This, along with the increase in risk premia associated with an environment of uncertainty, has led to a **tightening of financial conditions**.

Under these circumstances, it is not surprising that **growth projections have been progressively revised downwards**, while the risk of a global contraction in real activity is growing. At the same time, inflation projections have been revised upwards.

As I have said, all of this is taking place against a backdrop of a high level of uncertainty, with downside risks for growth and upside risks for inflation.

To understand the impact of this complex situation on the banking sector, we must first analyse its potential implications for other economic agents.

The impact on non-financial sectors

First, **households** have experienced sustained improvements in their gross income in recent quarters, mainly due to the sound performance of the labour market. For instance, in 2022 Q2, their gross disposable income was, in nominal terms, 3.2% above the levels recorded before the health crisis.

However, high inflation and the increase in interest rates are worsening their economic and financial situation, especially among lower-income households.

It is estimated that the cumulative average inflation in 2021 and 2022 would entail an average increase in indebted households' spending on non-durable goods of 3.9% of their income, with the impact being close to 10% in the lowest income quintile. This situation appears to be leading better-off households to save less and forcing lower-income households to reduce their spending on non-energy goods.

In terms of the impact of interest rate increases, it should first be noted that the pass-through of rate rises on the money markets to households' cost of debt is lower than that seen during past rate hike cycles, possibly owing to the modest increase in returns on bank deposits.[1]

[1] This could broadly be linked to the current ample liquidity and high loan-to-deposit ratios in the banking system.

In loans for house purchase, the pass-through to new lending (essentially fixed-rate loans) was 30% of the change in their benchmark rate,[2] which stands in contrast to the pass-through rate in excess of 100% that was seen during the 2010 hiking cycle. The pass-through from the 12-month EURIBOR to the average cost of outstanding debt between December 2021 and September 2022 has been below that recorded in the 2005 hiking cycle (26%). This may be a result, at least in part, of the increase in the relative share of fixed-rate mortgages in recent years.[3]

In any case, it should be noted that the bulk of variable-rate mortgages will roll over in the first half of 2024. It is estimated that an increase in the 12-month EURIBOR of 300 basis points (bp)[4] would raise the net borrowing costs of households carrying variable-rate debt by an amount equivalent to 2.3% of their income. This strain would raise the percentage of households with a high net interest burden[5] by 3.9 percentage points (pp) to 13.8%. Once again, all of these effects would tend to be stronger among lower-income indebted households.

The combination of higher interest rates and rising inflation could cause an average rise in household expenditure of 6%, or as much as 14% among lower-income households. Similarly, the percentage of financially vulnerable households could rise further, to nearly 15% for all indebted households and more than 35% among the lowest incomes.

The deterioration in households' financial wealth may have an impact on their ability to make repayments, although the empirical evidence available shows that a mortgage is one of the last financial obligations that Spanish households fall behind on. The bulk of defaults occur during the first five years of a mortgage's life and under exceptional circumstances, such as a significant drop in income (greater than 20%) or becoming unemployed, in both cases on a sustained basis (around two years).[6]

For the **real estate sector**, some signs of a downturn are already visible in the current context of economic slowdown, uncertainty and tightening of financial conditions.

Following growth of 20% in sales in Q2, the data for July and August showed easing, to 8% and 14.9%, respectively. Similarly, in very recent months, signs of slowdown can also be seen in new lending for house purchase, new building permits have lost momentum and the stock of loans to the construction and property development sector has continued to contract. Housing prices showed strong growth of 8% in Q2, slightly below the 8.5% of Q1.

In terms of their potential implications for financial stability, indicators of price imbalances in this market continue to show signs of overvaluation, although they remain contained. For their part, credit standards in relation to collateral values for new residential mortgages did

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[2] Measured by the 20-year interest rate swap.

[3] Fixed-rate mortgages have increased in proportion in recent years, amounting to around 25% of mortgage lending in 2021.

[4] The 12-month EURIBOR has risen by nearly 335 bp since the end of 2021.

[5] The net interest burden of a household is considered to be high when the ratio of (debt service expenses – interest income from deposits) to household income is over 40%.

[6] Currently, the non-performing loan (NPL) ratio for mortgages – which account for nearly 50% of loans granted by banks to the non-financial private sector – is 2.5%, below the ratio of 3.8% for total loans to the non-financial private sector. The share of mortgages classified as Stage 2 is 4.5%, compared with 7.2% for the portfolio as a whole.

not change significantly in 2022. By contrast, the ratios that relate loan amount to a borrower's disposable income have risen consistently since 2014, with a greater concentration of high ratios among lower-income households. Lastly, the spreads between interest rates for new mortgages and benchmark rates have reached very low levels, particularly in fixed-rate loans, which poses certain risks to their profitability in the face of potential increases in the cost of bank borrowing.

The rebound in **corporate sector** turnover and profits continued in the first half of 2022, in particular in the sectors most affected by the pandemic, which are now benefiting the most from the lifting of health restrictions.

However, some signals of financial deterioration were observed during the first half of the year among the sectors sensitive to energy costs and less affected by developments in the health situation (such as the chemical industry, plastics manufacturers, the wood industry and basic metals manufacturers).

As with lending to households, benchmark interest rates are being passed through to corporate lending by banks more slowly than in the past, both in new loans and the existing loan stock. In particular, the average cost of the outstanding amount grew between December 2021 and September 2022 by 25% of the change observed in the benchmark rate (three-month EURIBOR), well below the 61% seen in 2005. The lengthening of the average term of loans and operations backed by the Official Credit Institute (ICO), which have a relatively long maturity and tend to be fixed rate, would appear to have contributed to this reduced pass-through.

In any case, as monetary conditions continue to tighten and progress is made in the repayment of outstanding loans, we can expect a higher pass-through than has been recorded so far. In fact, the stock of bank credit to firms has shown signs of a slowdown in the latter part of the year.

It is estimated that an increase in market rates of 300 bp would imply an increase in the median debt burden ratio of indebted firms of between 2.6 pp and 5.6 pp, depending on the extent of short-term debt rollover. In this same scenario, the total share of corporate debt held by firms subject to high financial pressure,[7] which stood at 14.1% before the current interest rate hiking cycle, would rise by between 5.2 pp and 7.8 pp. No substantial differences in these impacts have been observed by firm size.

Of course, the economic slowdown that is anticipated in coming quarters could also have a negative impact on the economic and financial situation of firms and households.

With regard to Spain's **general government**, the aggregate data excluding local government available to August show a decline in the 12-month cumulative public deficit to 4% of GDP, 2.9 pp below end-2021. Similarly, it is expected that the growth in nominal GDP will allow a certain reduction in the public debt-to-GDP ratio, from 118.4% in 2021 to 109.9% in 2024.

However, the structural budget deficit and government indebtedness remain at very high levels, which constitutes a factor of vulnerability for the economy, especially in the context

[7] A firm is considered to be under high financial pressure when the ratio of (gross operating profit + financial revenue) to financial costs is below one.

of tightening financial conditions. Furthermore, it restricts the fiscal space to respond to new risks as they emerge.

The latest Banco de España projections envisaged an increase of 0.7 pp in the average cost of government debt between 2021 and 2024 and of 0.6 pp in the debt burden as a percentage of GDP. These estimations include the impact of the upturn in interest rates and the increase in the cost of inflation-linked debt. This impact is limited in the short term since only slightly more than 20% of the debt matures over the next two years (owing to the lengthening of its average maturity in recent years) and a portion of that debt was issued at interest rates above current ones. On balance, each additional interest rate increase of 100 bp would drive up the financial burden as a percentage of GDP in 2024 by an additional 0.4 pp.

Thus, in the current context of high inflation and public debt, fiscal policy measures should be targeted and focus on lower-income households, which bear the brunt of inflation, and firms most vulnerable to this shock. Moreover, any measures should be temporary in order to avoid any further increase in the structural budget deficit.

In the meantime, it is necessary to embark on a process of fiscal consolidation that will help to progressively reduce the current fiscal imbalances and gain room for manoeuvre in responding to future shocks. In any case, offsetting the adverse effects of the current supply-side shock calls for ambitious policies to boost productivity growth and potential GDP. The role of Next Generation EU funds could also be particularly important to support and finance the necessary investment and structural reforms.

The banking sector's starting position

With this background in mind, I shall now turn to how the current context, along with the most extreme risk materialisation scenarios that we envisage, might affect the Spanish banking industry.

I should emphasise that the Spanish banking sector faces this situation from a relatively favourable starting position.

First, **the quality of banks' balance sheets has continued to improve**.

The decline in non-performing lending to the resident private sector gathered pace to 12.4% year-on-year in June 2022, similar to pre-pandemic levels. As a result, the NPL ratio stood at 3.8% in June 2022, a level not seen since December 2008, although in the sectors hardest hit by the pandemic it increased to 6.1% (5% at end-2019).

The pace of correction in Stage 2 loans likewise quickened, with a drop of nearly 10% year-on-year in June 2022. These now account for 7.2% of loans to the resident private sector, below the peak of 8.1% reached in September 2021 but still higher than pre-pandemic figures (5.9%).

Likewise, foreclosed assets stood at €21.3 billion in June 2022, following a broad-based decline across all banks of €4.6 billion (-17.8%) in the previous 12 months.

Lastly, ICO-backed loans to firms and sole proprietors continued to record some impairment, albeit at a slower pace than in previous six-month periods,[8] while the credit quality of outstanding loans linked to expired moratoria improved slightly.[9]

Second, **profitability has also continued to improve.**

In 2022 H1, net profit was up by 16.3% on the previous year, after stripping out the extraordinary profit recorded in June 2021. This translates into a return on equity (ROE) of 10%, up by more than 1 pp on the ROE excluding extraordinary items recorded a year earlier and higher than the estimated average cost of capital for H1 (7%).

The Q3 results of listed banks confirm the favourable profitability developments, although the cost of capital may plausibly have also risen as a result of higher risk-free rates.

The main determinants of this improved bank profitability were the increases in net interest income and in fees and commissions, which in both cases exceeded 10% year-on-year. For their part, impairment losses in the sector held relatively stable compared with 2021 H1 and at a similar level to June 2018 and June 2019.

As regards **solvency,** the common equity tier 1 (CET1) ratio stood at 12.9% in June 2022, down by 52 bp on a year earlier. This decline owed primarily to the increase in risk-weighted assets (up by 3.3% year-on-year), since the numerator of the ratio declined by just 0.7% year-on-year. Nonetheless, the CET1 ratio stands nearly 70 bp above its pre-pandemic level (12.2%), although it remains one of the lowest in the banking union. In any event, this solvency level implies a level of voluntary capital buffers that significantly exceeds regulatory requirements.

Forward-looking assessment of the banking sector's solvency

Evidently, going forward **the banking industry's profitability and solvency could be adversely affected by the current macro-financial environment.**

First, higher interest rates will drive up households' and firms' financing costs, and – together with the slowdown in their nominal income and the inflation-driven decline in their real income – will erode their ability to pay, which could lead to higher credit impairment provisions. Moreover, although higher interest rates will boost banks' income, they will also exert upward pressure on their financing costs.[10]

It is important to analyse the potential net impact of this complex setting on the banking sector by means of an analytical framework that considers all of the relevant channels. To this end, the Banco de España has its **own methodological framework for stress testing**, known as the Forward-Looking Exercise on Spanish Banks.

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[8] The percentage of ICO-backed loans classified as Stage 2 climbed from 20.2% in December 2021 to 22.8% in June of this year. Meanwhile, NPLs increased as a percentage of ICO-backed loans by just over 1 pp in the same period, from 3.5% to 4.8%. However, the share of total ICO loans held by customers with at least one non-performing exposure (ICO-backed or otherwise) declined slightly as compared with the previous quarter, from 12.9% to 12.6%.

[9] For these loans, the percentage of non-performing exposures stood at 10.7% in June 2022, compared with 11.1% in December 2021. The percentage classified as Stage 2 has increased slightly, from 20.2% to 20.6%.

[10] To June 2022, the average cost of consolidated liabilities for Spanish banks remained at subdued levels (1%), 30 bp higher than estimated 12 months ago.

In our last Financial Stability Report, we simulated how the sector would fare under two macroeconomic scenarios: "baseline" (applying our June macroeconomic projections) and "adverse" (assuming an extreme but plausible worsening of macro-financial conditions). In addition, given that in October we significantly revised the central scenario for growth (down) and for inflation (up), the sensitivity of the baseline scenario to this new central scenario was analysed.

Under the baseline scenario, the Spanish economy's cumulative real GDP growth[11] in the period 2022-2024 stands at nearly 10%. This compares with real growth under the new central scenario – based on the October projections – of 9%, while under the adverse scenario the simulation points to a cumulative contraction of 1.3% in that period. One determinant behind this lower growth is the increase in inflation – driven by additional rises in energy and food prices –, which would reach 20.6 pp over the projection horizon and would also translate into far tighter financial conditions.

Under the baseline scenario, the set of banks under analysis[12] is expected to be capable of increasing their CET1 solvency ratio in the period 2022-2024. The combination of sustained economic growth and an environment of rising interest rates underpins profit generation, which, coupled with the existing provisions, provides sufficient loss-absorbing capacity. However, that capacity is uneven across banks, depending on their business model and balance sheet distribution.

Overall, under the baseline scenario the banks' solvency would increase by some 60 bp, or by 50 bp factoring in the impact of the new temporary levy on the banking sector (currently under discussion in parliament).

Updating these simulations for the most recent macroeconomic projections (corresponding to October) would ease this growth estimate for the banking sector solvency ratio to around 30 bps, or to 20 bps factoring in the impact of the levy.

Under the adverse scenario, impairment provisions rise very significantly, which would be the main driver behind a 2.4 pp reduction in the CET1 ratio for the system as a whole (2.6 pp including the levy effect). This represents a significant capital charge, but **the sector's aggregate solvency would hold at adequate levels, although these would be uneven across banks**.

The main conclusion drawn from these simulations is that, in a setting as uncertain as the present one – in which the risks to financial stability have increased, and with them the probability of more adverse scenarios –, **banks must use the higher profit generation in the short term to bolster their resilience**.

In addition, banks must maintain a **prudent strategy in their provisioning and capital planning policies**, and closely monitor macroeconomic developments to enable a swift response should the risks envisaged ultimately materialise.

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[11] The scenarios used also consider the main economies where Spanish banks conduct their international business.

[12] The analysis includes all of the significant institutions supervised by the Single Supervisory Mechanism and the less significant institutions under the direct supervision of the Banco de España.