In the past six months, the risks to the stability of the Spanish financial system have increased. As in the global economy, macrofinancial risks have stepped up in Spain. This increase is the outcome, above all, of the recent global economic slowdown, particularly in Europe and China, and of the widespread increase in uncertainty. This setting might prompt increased volatility on financial markets and a rise in risk premia. And it might also trigger additional downside pressures on the profitability of the banking sector, which remains at low levels. Further, a specific risk to Spanish deposit institutions has been identified, derived from the potential increase in legal demands. Thus, the main factors of risk to the financial system identified in this Financial Stability Report (FSR) are the following (Table 1):

RISK FACTORS (a) **TABLE 1**

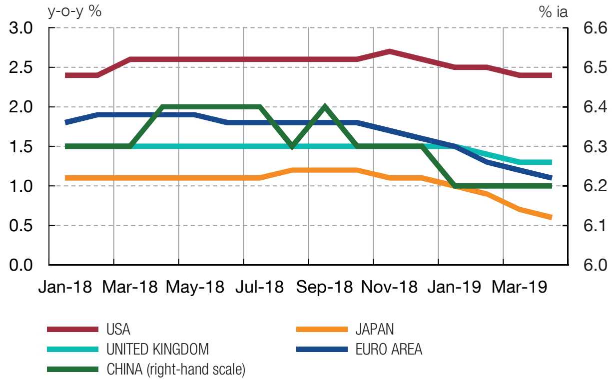
1	The global economic slowdown and, in particular, of Europe and China, combined with heightened geopolitical uncertainty, may mean a significant increase in risk premia which negatively impacts financial asset prices, both of corporate and government bonds and equities.	↑
2	In a setting of low margins, the profitability of Spanish banks will be subject to further pressure due to the consequences of the economic slowdown.	↑
3	Spanish deposit institutions are facing, with varying intensity, the legal risk of a potential increase in legal demands brought against them.	→

SOURCE: Banco de España.

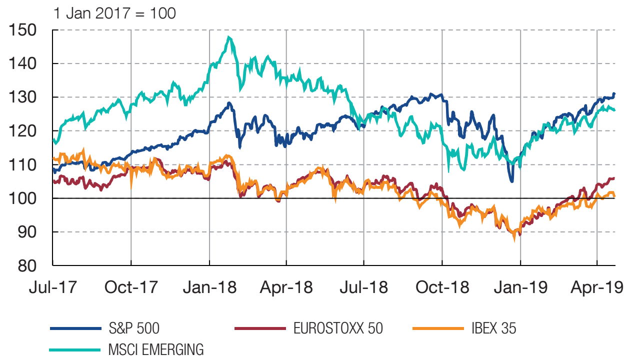
a The risks which appear in this table are calibrated using four colours: green denotes an absence of risk, yellow indicates low risk, orange, medium risk, and red, high risk. Consequently, at present the three risks are at a medium level. The time horizon for which these risks are defined is set by the FSR's frequency, i.e. half-yearly. The arrows indicate whether risk has recently increased, held stable or diminished.

1 **Economic slowdown and geopolitical uncertainty with a potential impact on asset prices through higher risk premia.** In 2019 to date, the sources of economic and geopolitical uncertainty in place in late 2018 appear to have increased. Global trade tensions persist and negotiations to achieve new agreements are facing substantial difficulties. Indeed, the indicators of the Chinese economy are feeling the effects of the trade tensions with the United States and of China's own macrofinancial imbalances. A significant slowdown in this economy might have major repercussions for other emerging economies that are recipients of its investment and the source of its goods and services imports. It is notable here how financial market tensions have returned in recent weeks in Turkey and Argentina, following the calm after drastic monetary and fiscal measures were adopted last year and the IMF financial assistance to Argentina. The economic recession in both countries, the low coverage of international reserves in Turkey and the scant headway in Argentina in macroeconomic stabilisation constitute their main vulnerabilities. In Europe, the risk of a disorderly Brexit has, following the European Council agreement, been put back to 31 October this year. Elsewhere, the uncertainty

A CONSENSUS FORECAST FOR 2019



B STOCK MARKET INDICES



SOURCES: Consensus and Datastream.

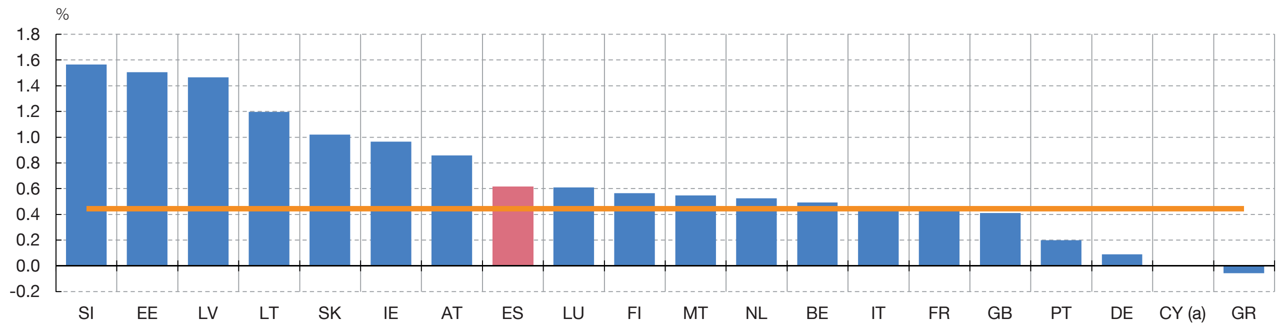
associated with Italy's fiscal situation remains in place, against a background of economic recession in the second half of 2018, and the German economy has slowed significantly. In Spain, uncertainty persists over the future course of economic policies.

This uncertain environment is affecting global economic activity. There have been particularly marked downward revisions in GDP forecasts (Chart A) across the board in the euro area. Yet stock market valuations (Chart B) have recouped much of the downward correction they underwent in late 2018 and risk premia have held at low levels. Compared with the previous FSR, the heightening of this slowing trend in the global economy might trigger a correction, via higher risk premia, of international financial market prices, with adverse consequences for global financial conditions and those in Spain. But the likelihood of a correction associated with sharper-than-expected monetary policy normalisation is fading, since central banks are prolonging ultra-expansionary policies to bolster activity, against a background of contained inflation expectations.

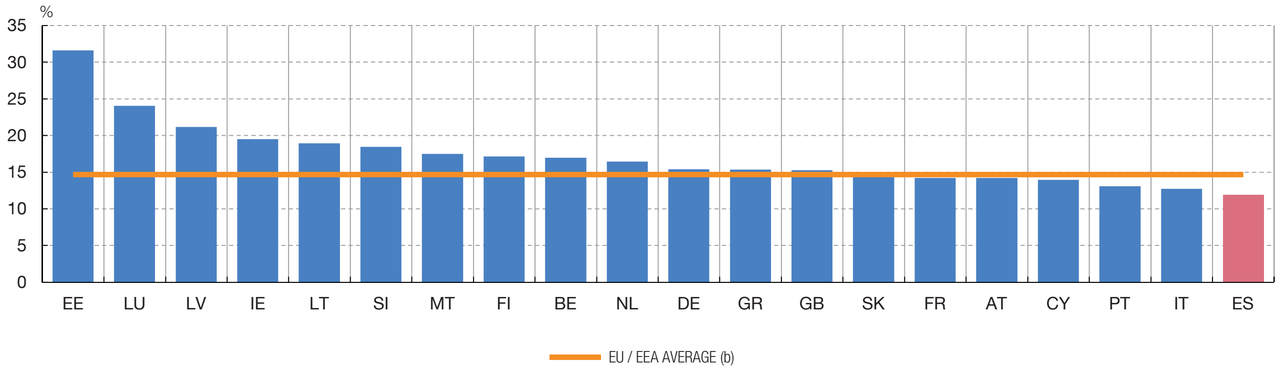
2 **Low margins and pressure on the profitability of Spanish financial institutions.** The net consolidated income of Spanish deposit institutions grew significantly in 2018. This was largely due to the greater positive contribution of extraordinary income, and to the decline in asset impairment losses. Yet ROA remained low, though it was above the average for European banks (Chart C). Looking ahead, the expectations of a global – and in particular European – economic slowdown and the subsequent delay in the ongoing monetary policy normalisation will subject deposit institutions' margins to greater pressure.

3 **Legal risk arising from the potential increase in legal demands against deposit institutions.** In recent years, the legal risk linked to legal suits affecting Spanish banks has increased significantly. Banks have been involved in a high number of legal processes, in which certain contractual conditions in their mortgage lending operations were questioned. The cost of these processes for institutions has materialised in a number of cases (e.g. in floor clauses, with more than €2.2 billion returned to customers up to January 2019), but there are still very important legal procedures pending resolution. The European Union

C RETURN ON ASSETS
December 2018



D CET1 RATIO
December 2018



SOURCE: EBA.

a Data not published by the EBA.
b EBA data include Iceland.

Court of Justice (EUCJ) is expected to respond in the second half of the year to legal issues tabled in relation to the use of the mortgage loan benchmark index (IRPH by its Spanish abbreviation). Depending on how the EUCJ rules, there might be an increase in legal demands against Spanish banks. This would impact those banks with a higher volume of IRPH-linked mortgage loans, requiring them to properly measure the potential contingent impact and to take suitable management and prevention measures.

More generally, the emergence of legal risk, among other factors, has led to a loss of reputation for the banking sector, both in Spain and in other countries. Banks should strive to reverse this development by providing their customers with financial products tailored to their needs and capabilities, while supplying the pertinent information clearly and transparently. Reputation and customer confidence are essential for developing banking business.

Against this background, the Spanish economy retains some factors of vulnerability. High public and external debt means that both the general government sector and the economy as a whole are comparatively more exposed to potentially costlier funding. This is associated, for instance, with potential rises in risk premia or with adverse macroeconomic developments. Households' financial position has tended to strengthen thanks to the reduction in their debt in recent years, and to the improvement in incomes and in employment as a result of the economic recovery. But some Spanish household segments remain in a situation of great fragility, with the household aggregate saving rate at a very low level. That is partly linked to households' greater resort to consumer credit which, despite having eased in recent months, continues to grow at a notable pace. The business sector has also continued reducing its levels of debt, and new loans by financial institutions are concentrated in the most productive firms. That said, some segments remain more vulnerable, specifically smaller firms and, above all, those operating in the real estate and construction sector.

Regarding the real estate sector, the recovery in activity and in prices remains ongoing. In particular, the average level of estimates of prices in the sector veering off their medium term trend has increased, moving away from the negative range but currently standing close to equilibrium values. While no easing has been seen in lending standards for new loans, their growth rate is high. It will thus be necessary to remain vigilant in this market. In any event, new loans are not yet offsetting repayments of existing loans, meaning that lending to households for house purchase will continue falling at the aggregate level.

Deposit institutions continue to face the challenge of improving their levels of profitability and solvency. Indeed, the (best-quality) CET1 solvency ratio of Spanish banks fell over the past year, standing last among European jurisdictions (Chart D). That said, they announced an increase in their target capital ratios. Here, improving the statement of income is key to shoring up solvency levels, as is too the measurement of risks and their coverage through appropriate interest rates. Moreover, reducing operating costs, investing in new technologies and judiciously selecting business strategies are further factors for improving the profitability of the business in the medium and long term. Greater solvency will also contribute to meeting the MREL (Minimum Requirement for own funds and Eligible Liabilities) requirements with which Spanish banks must progressively comply in the coming years. These requirements may pose significant challenges for small and medium-sized institutions, with mainly retail funding sources and with less scope to access the wholesale funding markets.

The sensitivity of banks' capital ratios to the individual materialisation of some of the macroeconomic risks is high, but the banking system's aggregate solvency ratio is expected to hold at an appropriate level. As part of the stress tests and using specific elements of the Banco de España's FLESB methodology, this FSR analyses the potential impact of the independent materialisation of various identified macrofinancial risks. In particular, there are estimates for the impact of: i) a decline in global activity, ii) a reduction in consumer and business confidence in Spain, iii) a reversal of stock market prices, and iv) a reduction in house prices. The shocks are calibrated to capture extreme situations. For the 2018-2020, period, the maximum cumulative effect of the individual materialisation of these risks on Spanish GDP growth is around 6 pp and almost 30 pp on the growth of house prices. This would translate into an impact on financial institutions' average solvency ratio of 2 pp on average in this three-year horizon. However, it should not be forgotten that, in an adverse economic scenario, the simultaneous materialisation of several of these risks is possible.

Analysis of Spanish deposit institutions' interrelations with the rest of the financial system shows the Spanish economy to be highly banked and evidences the limited scale of direct interconnections. Deposit institutions amass a large portion of the Spanish financial system's assets, as is the case in the other European continental economies. However, their weight has declined since the global financial crisis, following a trend likewise seen in other jurisdictions. This has its advantages, since it enables both those supplying and demanding funds to broaden their investment and funding options, and allows risks to be better diversified. But it also poses challenges. By increasing interconnections among financial institutions, the possibilities of contagion are duly raised. It is important to analyse and understand the sources of risks that these other actors might generate, given that they could operate through channels other than those traditional to banks. In Spain's case, while these interconnections have increased, they remain limited. Moreover, major short-term risks have not been detected in non-bank financial institutions (investment funds, insurance companies and pension funds).

The macroprudential policy stance pursued by the Banco de España in recent months has held stable. It is evident that i) systemic risk indicators are at low levels viewed from a broad historical perspective; ii) that there is some slowdown in consumer lending; and iii) that the analysis of the individual materialisation of macroeconomic risks identified shows that such risks would exert a significant but bearable impact on the average level of institutions' solvency. In light of this it has not been considered necessary to activate new macroprudential measures or re-calibrate those currently applicable. In particular, the countercyclical capital buffer (CCyB) holds unchanged at 0%, in keeping with the credit-to-GDP gap and other quantitative indicators of cyclical systemic risk. Nonetheless, the Banco de España is developing procedures to adapt the credit-to-GDP gap to the reality of the Spanish financial cycle and to take into account its relationship to other fundamental variables. At the same time, it will monitor other quantitative indicators and the medium-term projections for them.