BANCO DE ESPAÑA
Eurosistema

FINANCIAL STABILITY REPORT
Spring 2019

7 May 2019

DIRECTORATE GENERAL FINANCIAL STABILITY, REGULATION AND RESOLUTION

- **The new FSR still has four sections, but these have been reorganised:**
  - Main risks to the stability of the Spanish financial sector
    1. Risks in the macrofinancial environment
    2. Risks and resilience of the financial sector
    3. Macroprudential policy
- **The boxes included in this FSR are:**
  - 1.1. Determinants of the behaviour of the consumer credit portfolio
  - 1.2. Leveraged loans to corporates
  - 1.3. International investment position of Spain
  - 2.1. The reform of benchmark rates: from EONIA to €STR
  - 2.2. Central clearing counterparties and their implications for financial stability
  - 3.1. AMCESFI: the new macroprudential authority for the Spanish financial system
  - 3.2. Calculating the credit-to-GDP gap and financial cycle duration in Spain

OVERVIEW

- **The risks identified in the previous FSR have continued increasing…**
  - …and their nature has changed
- **There is a new, legal-type risk:**
  - Potential increase in legal demands against institutions
- **The vulnerabilities of the Spanish economy (high public and external debt) are broadened, with a group of highly indebted households**
  - Consumer credit is slowing, though it is growing at a double-digit rate
- **Financial institutions have improved their results, but their solvency ratio (CET1) has worsened, with differences from bank to bank**
  - Dividends distributed since 2015 account for 1.8% of RWAs
- **Risk factors**

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.	→

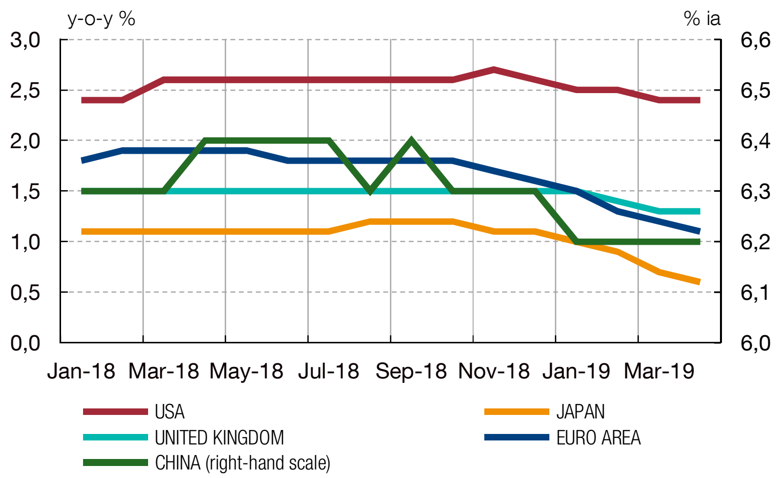
SOURCE: Banco de España.

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.

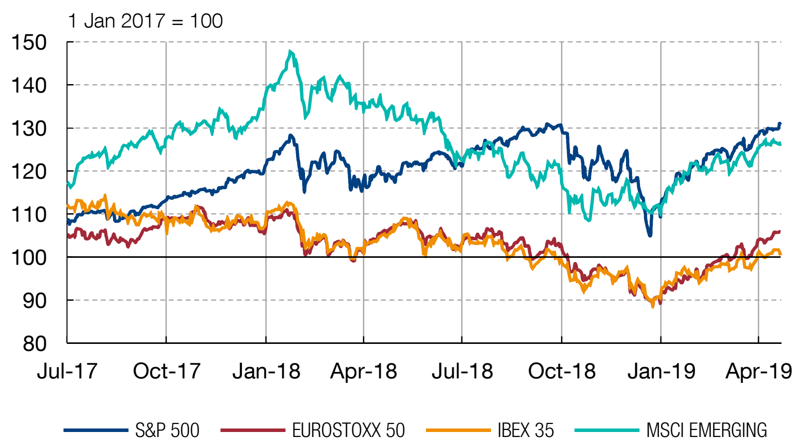
RISK 1: GLOBAL ECONOMIC SLOWDOWN AND ASSET VALUES

- **Geopolitical risks remain in place:**
  - Global trade war and slowdown in China
  - Brexit, Italian fiscal position and slowdown in Germany
  - Uncertainty over the future course of economic policies in Spain
- **Indeed, they are already affecting global activity…**
  - … but not the financial markets. After a correction in late 2018, stock markets have risen and risk premia have been compressed again

A CONSENSUS FORECAST FOR 2019



B STOCK MARKET INDICES

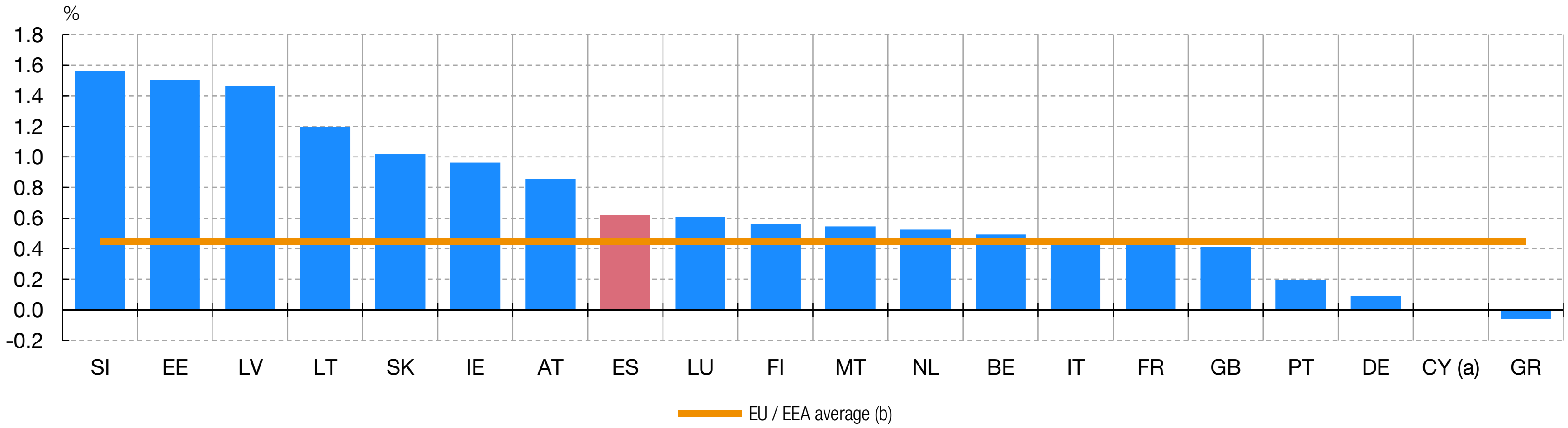


SOURCES: Consensus and Datastream.

RISK 2: GREATER PRESSURE ON THE PROFITABILITY OF DEPOSIT INSTITUTIONS

- **Deposit institutions' profits increased significantly in 2018 (25%) owing to the reduction in non-performing loans and extraordinary operations, but…**
  - …business margins remained flat
- **Looking ahead, the European economic slowdown will place greater pressure on institutions' margins**

RETURN ON ASSETS
December 2018



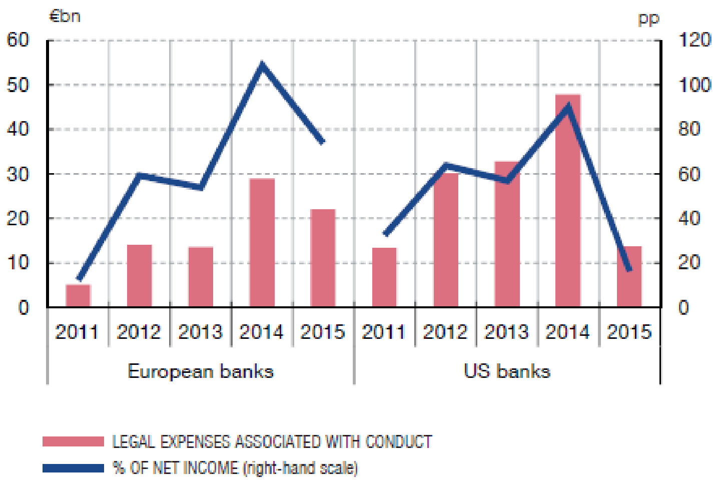
SOURCE: EBA.

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

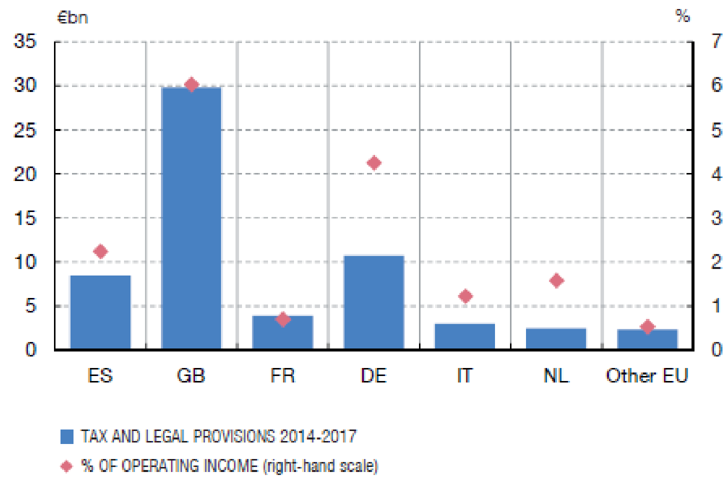
RISK 3: IMPACT OF THE POTENTIAL INCREASE IN LEGAL DEMANDS

- **Litigiousness involving Spanish deposit institutions has increased notably in recent years, impacting their costs**
  - Floor clause payouts to January 2019 have amounted to €2.2 billion
- **This is not an exclusively Spanish phenomenon**
- **The CJEU is expected to respond in the second half of the year with a preliminary ruling on the use of the IRPH benchmark index for mortgage loans**
  - Depending on that response, demands against banks may increase substantially, with a potentially significant impact, albeit an uneven one from bank to bank

A MISCONDUCT COSTS (a)

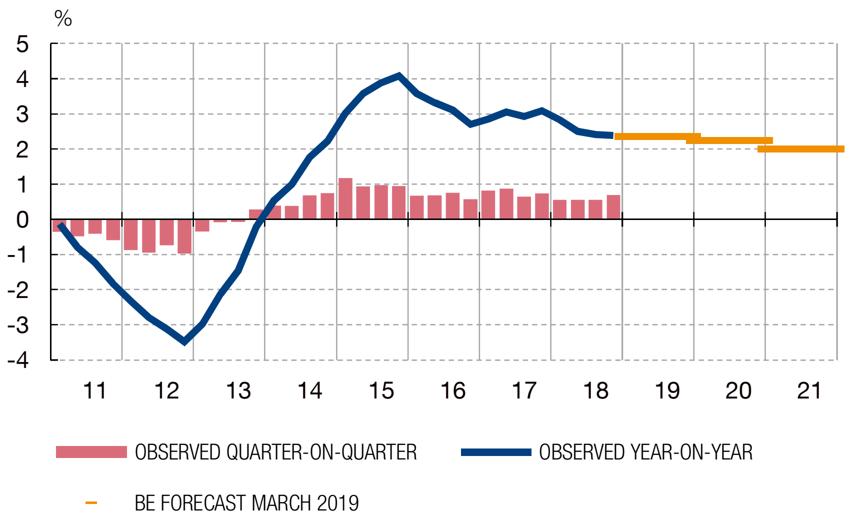


B PROVISIONS FOR LEGAL EXPENSES AND TAX LAWSUITS (b)

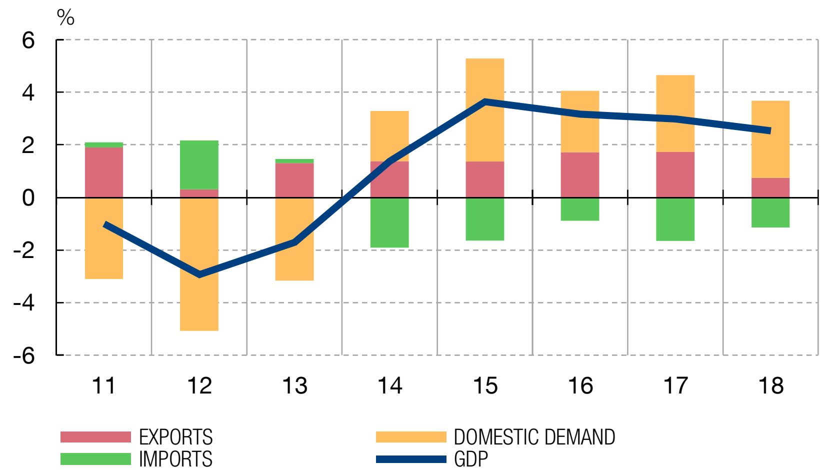


- **The Spanish economy is showing high resilience**
  - Based on domestic demand and, specifically, on private consumption
- **Factors such as the fiscal impulse and the buoyancy of consumer credit are key elements for explaining this phenomenon**

SPAIN. GDP CHANGE

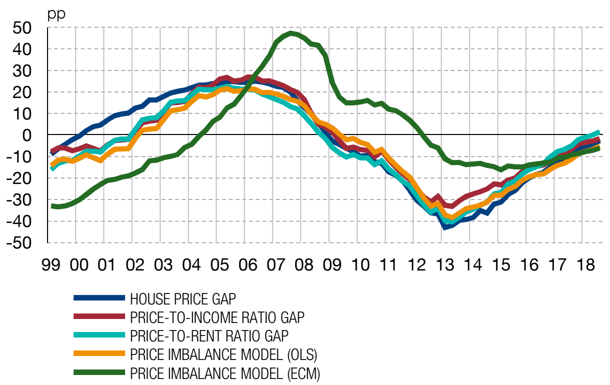


SPAIN. GDP CHANGE AND CONTRIBUTIONS IN PP

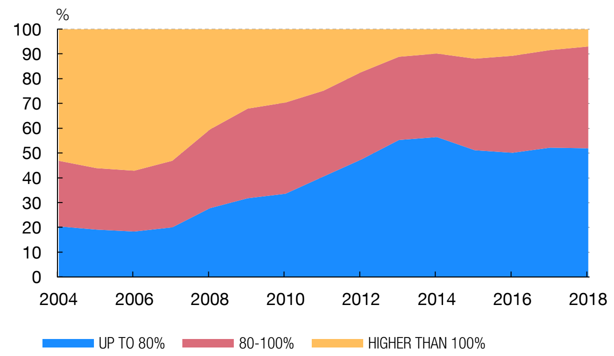


- **The Spanish real estate market continues to pick up**
  - Prices are close to their cyclical equilibrium level, but there are considerable regional differences
- **Lower-income households show high vulnerability**

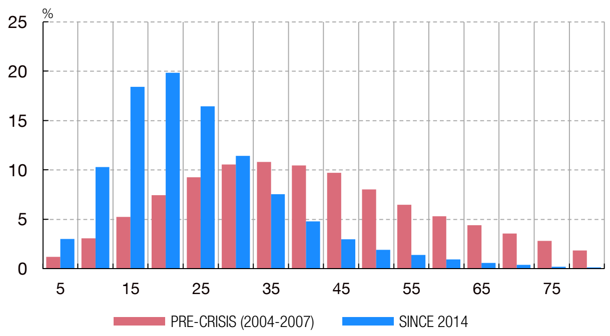
INDICATORS OF HOUSE PRICE IMBALANCES



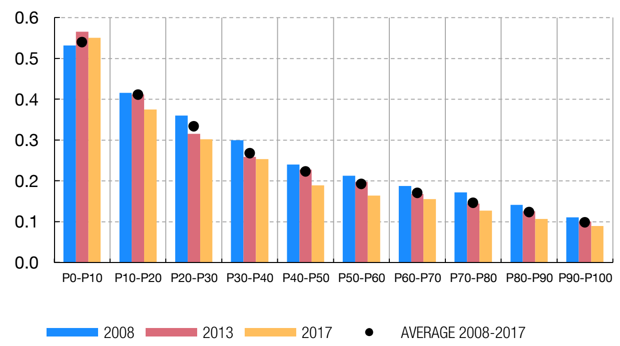
LTP RATIO. DISTRIBUTION (a)



LSTI RATIO. DISTRIBUTION (a)



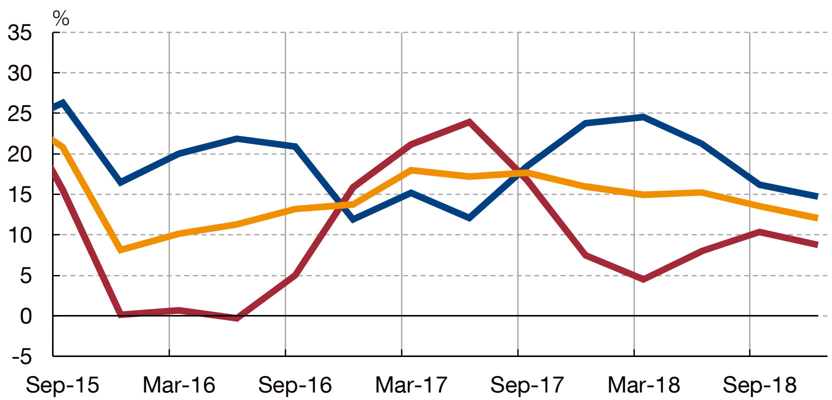
HOUSEHOLD DEBT/INCOME RATIO



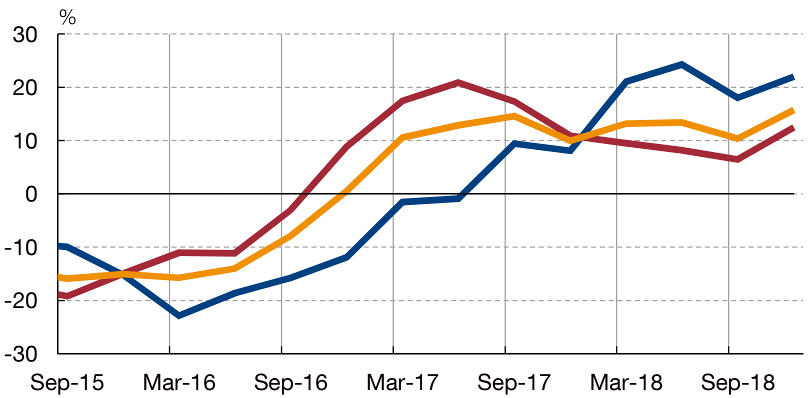
a. Loans with housing as collateral and an individual as the borrower are included. The principal of the loans is accumulated (per period) in the distributions in order to define each segment within the distribution. In this chart the following abbreviations are used: LTP (loan to price) and LSTI (loan service to income).

- **Consumer credit has posted double-digit growth in recent years**
  - It has recently slowed, but non-performing loans are growing significantly
- **Both demand- and supply-side factors explain this phenomenon**
  - Growth in this portfolio appears to be associated with the search for yield

YEAR-ON-YEAR RATE OF CHANGE OF CONSUMER CREDIT AND ITS COMPONENTS
Deposit-taking institutions and specialised lending institutions



YEAR-ON-YEAR RATE OF CHANGE OF NON-PERFORMING CONSUMER CREDIT AND ITS COMPONENTS
Deposit-taking institutions and specialised lending institutions



PURCHASE OF CONSUMER DURABLES
PURCHASE OF OTHER GOODS AND SERVICES
CONSUMER CREDIT

- **The two structural vulnerabilities are public debt and the Spanish economy's negative net international investment position**
  - While it has declined in recent years, it remains very high
- **Gross external debt is high, but its composition tempers vulnerability (longer maturities, public sector and central bank)**

Chart D
NET IIP. BREAKDOWN BY INSTITUTIONAL SECTOR (a)

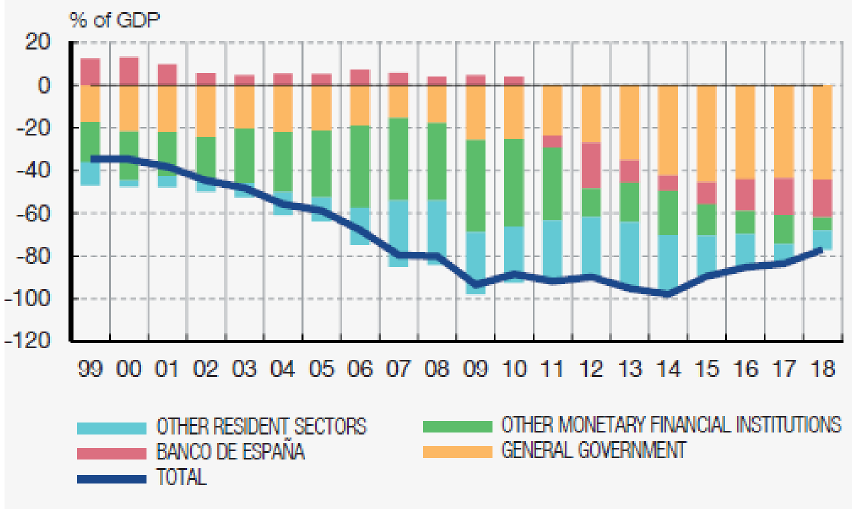
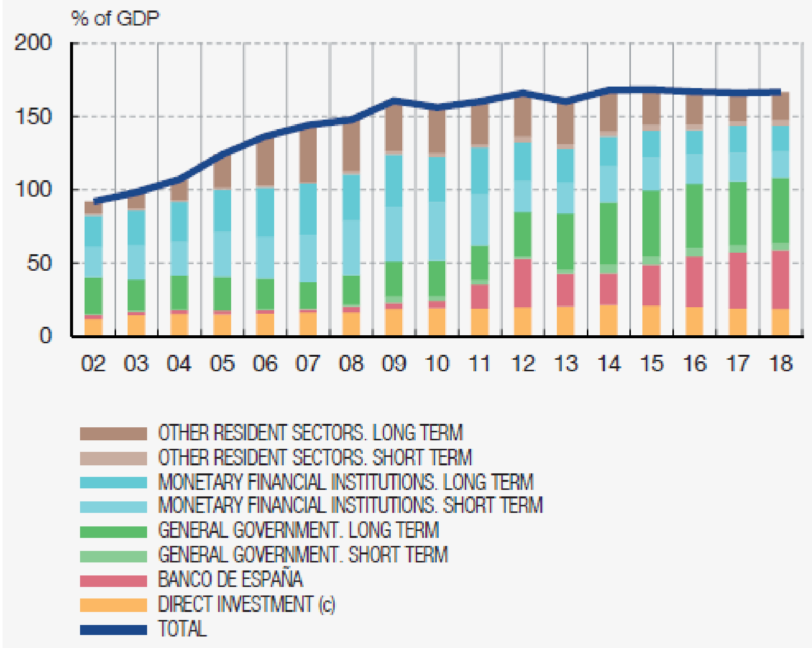
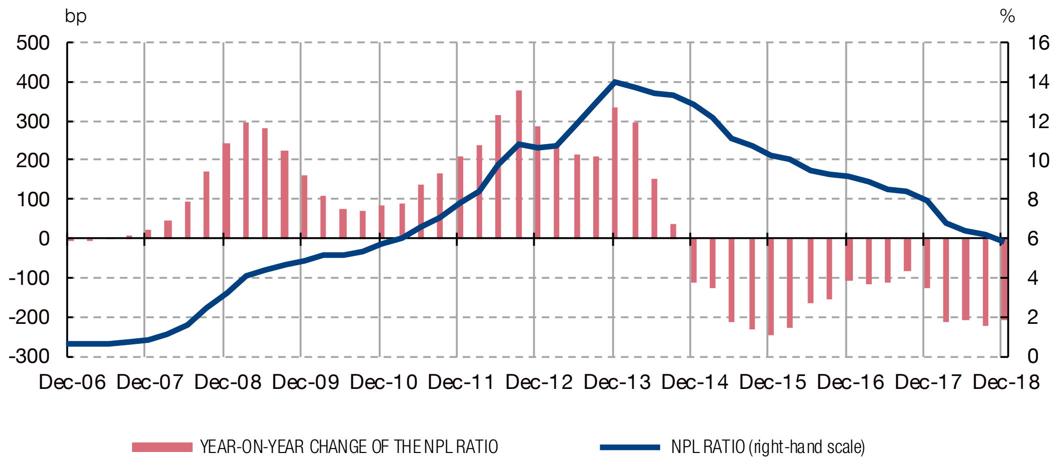


Chart F
GROSS EXTERNAL DEBT STRUCTURE BY INSTITUTIONAL SECTOR AND MATURITY (b)

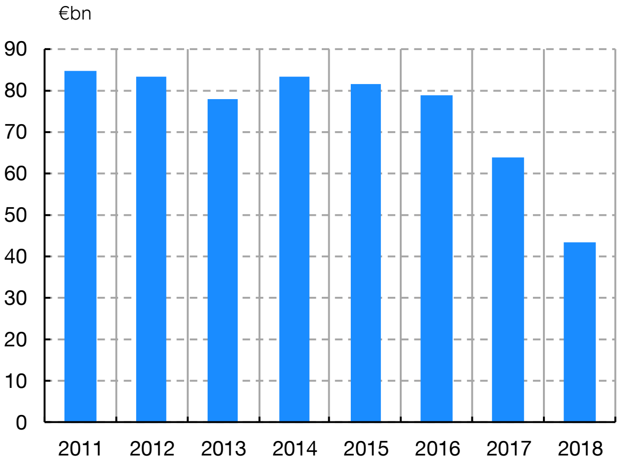


- **The non-performing loan ratio in the resident private sector continued on the decline observed in recent years**
  - It stood at 5.8% in December 2018 (2 pp down on 2017)
- **The declining trend of foreclosed assets stepped up in 2018**
  - They have fallen by more than €20 billion compared with December 2017, a year-on-year decline of over 30%

NPL RATIO. RESIDENT PRIVATE SECTOR
Business in Spain, ID. Deposit institutions

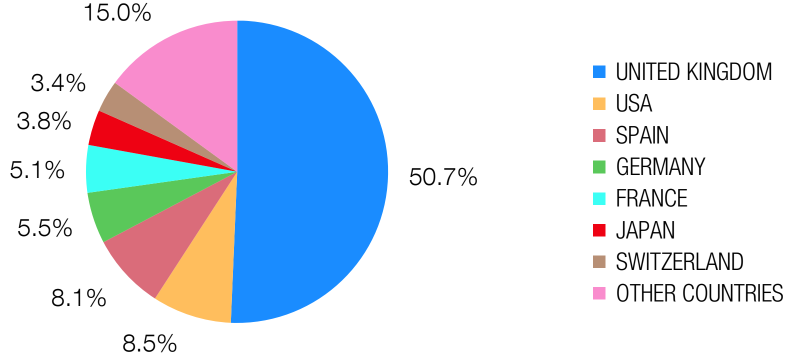


FORECLOSED ASSETS



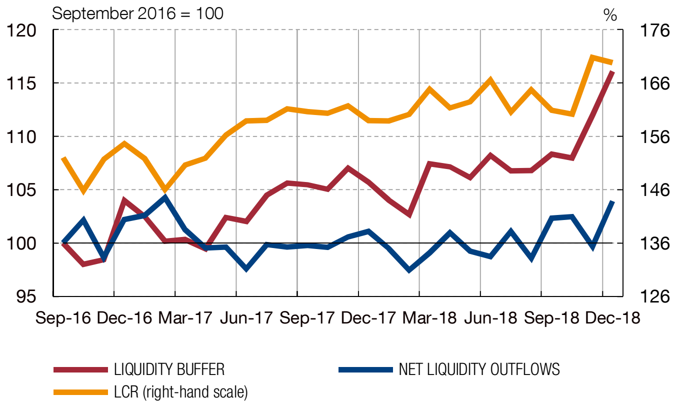
- **Particularly salient in the 2014-2018 period was the growth of loans in Europe (without the United Kingdom), and the reduction in loans in Latin America**
- **As at September 2018, foreign banks' exposure in the United Kingdom remained similar to that of domestic banks**
  - Among the foreign banks, US (8.5%) and Spanish (8.1%) institutions were prominent
  - The internationalisation model of Spanish banks (subsidiaries with financial autonomy) means that the most significant risk of Brexit for them is that linked to UK macroeconomic developments

EXPOSURE TO THE UNITED KINGDOM
September 2018

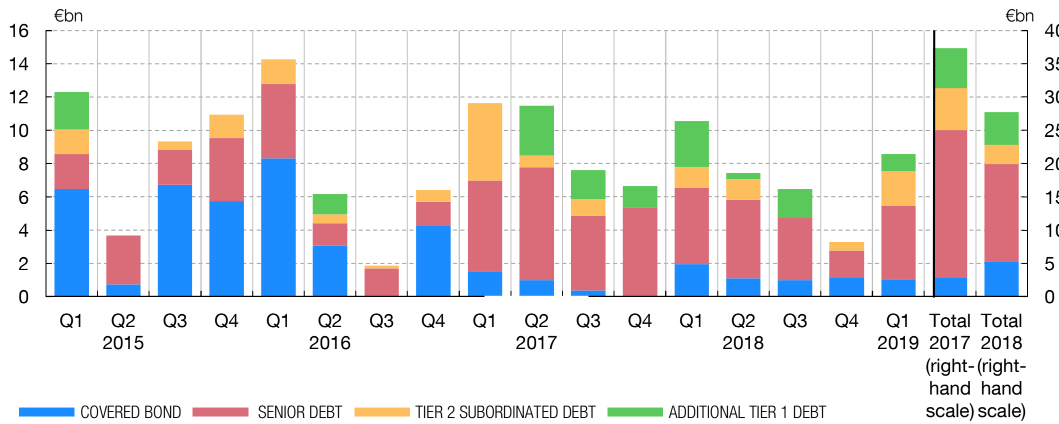


- **Spanish deposit institutions' LCR ratio has been on a rising course since its enforcement**
  - This increase has been mainly due to the build-up in liquid assets
- **Spanish institutions' aggregate issuing activity declined in 2018 relative to the previous year**
  - However, in the coming years they will have to issue MREL

AGGREGATE LCR
September 2016-December 2018

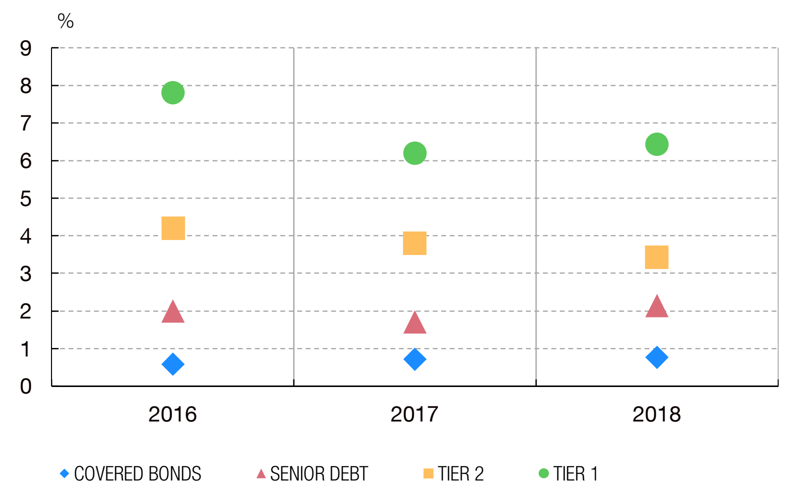


MAIN ISSUES OF SPANISH INSTITUTIONS IN MEDIUM- AND LONG-TERM WHOLESALE MARKETS

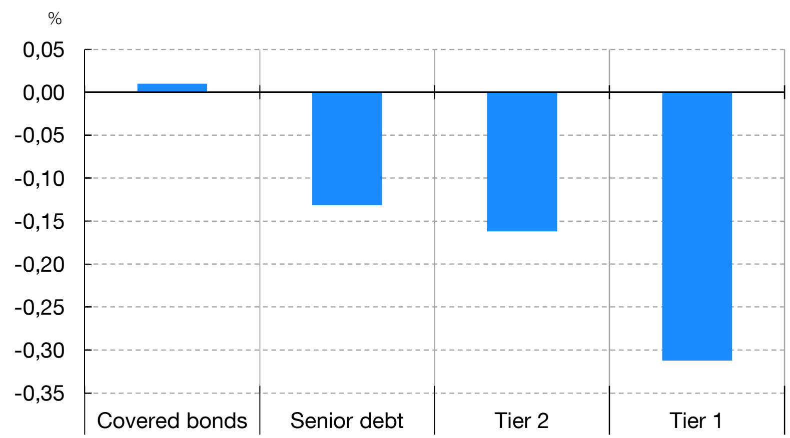


- **There is an inverse relationship between the order of seniority of the various debt instruments and the cost of this financing**
- **The higher the CET1 ratio institutions have, the lower the issuing cost…**
  - …and this effect is accentuated the more similar the debt instrument is to an equity instrument

C AVERAGE COST OF DEBT INSTRUMENTS ISSUANCE PER YEAR



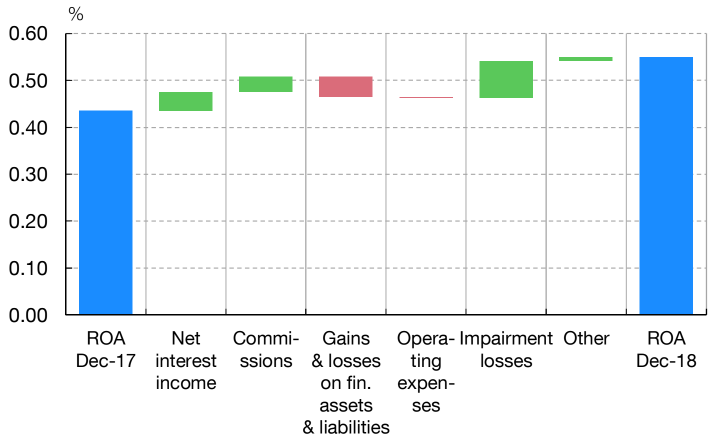
D CET1 EFFECT ON THE COST OF DEBT INSTRUMENTS (b)



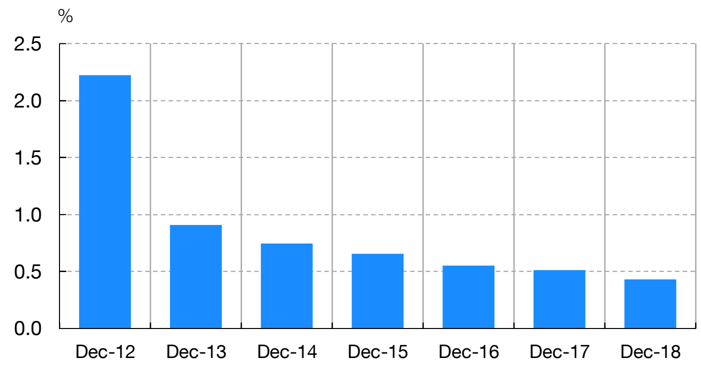
b. For each type of instrument, the chart shows the coefficient relating to the CET1 ratio in a multivariate regression with the issuance cost as a dependent variable, and other characteristics of the issue (maturity, volume), of the issuer (total assets, solvency, nationality), and market conditions (index of the European banking sector, interest rate on government debt of the country of residence of the issuer with the maturity closest to that of the issue) as explanatory variables. For example, the coefficient of -0.3 for Tier 1 indicates that a 1 pp increase in the CET1 ratio of an issuing bank is associated, all things being equal, with a -0.3 pp reduction in the issuance costs of this instrument. The estimation is made on issues by banks from Germany, Spain, France, Italy and the United Kingdom for the 2016-2018 period.

- **In 2018 the consolidated result for the Spanish banking sector was €19.44 billion, 25% up on 2017….**
  - …which translates into a 11 bp increase in ROA (from 0.44% to 0.55%) and a 1.2 pp increase in ROE, from 6% in 2017 to 7.2% in 2018
  - In any event, the ROE is still lower than the COE, though it is drawing closer
- **The main determinant of the improved Spanish banking sector result in 2018 was the reduction in impairment losses (-16.3%),…**
  - …while business margins remained flat

A BREAKDOWN OF HE CHANGE IN CONSOLIDATED PROFIT ATTRIBUTED TO THE PARENT INSTITUTION IN DECEMBER 2018 WITH RESPECT TO DECEMBER 2017 AS A % OF ATA (a)



FINANCIAL ASSET IMPAIRMENT LOSSES AS A % of ATA

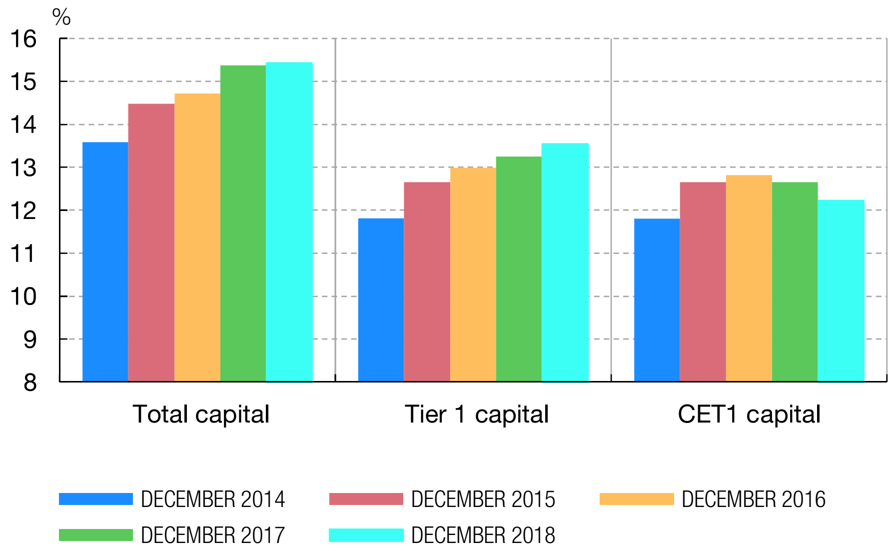


SOURCE: Banco de España.

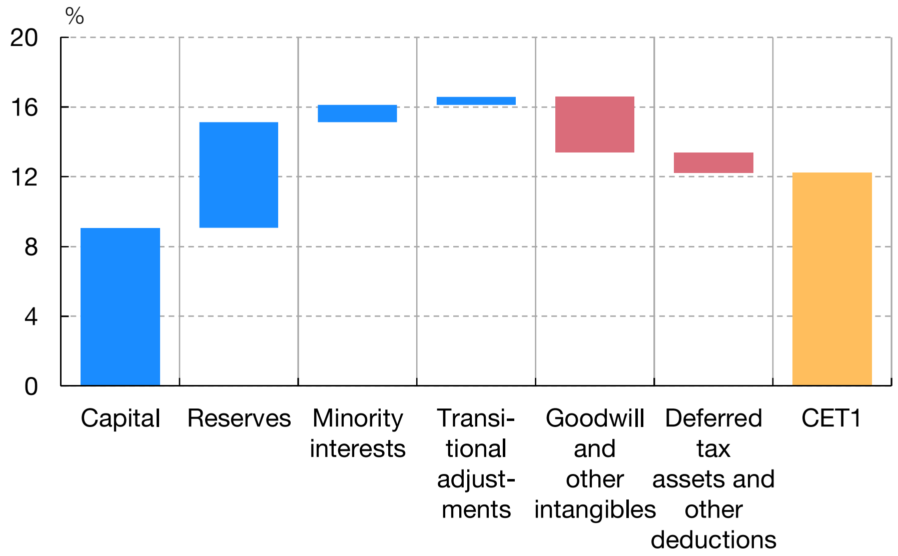
a. The red (green) colour of the bars indicates a negative (positive) contribution of the corresponding item to the change in consolidated profit in December 2018 with respect to December 2017.

- **The CET1 (highest-quality capital) ratio stood at 12.2% in December 2018…**
  - …43 bp down year-on-year
- **Conversely, the Tier 1 and total capital ratios increased over the past year to 13.5% and 15.4%, respectively, and the CET1 FL held stable (11.8%)**

CAPITAL RATIOS

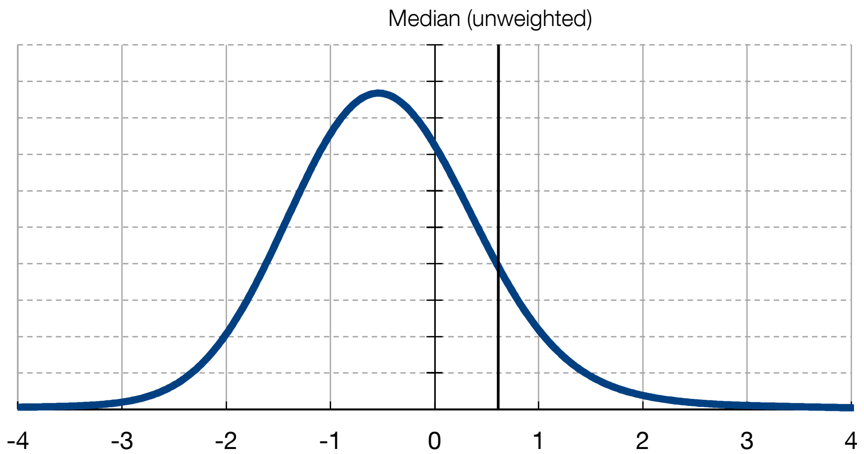


COMPOSITION OF THE CET1 RATIO RELATIVE TO RISK-WEIGHTED ASSETS

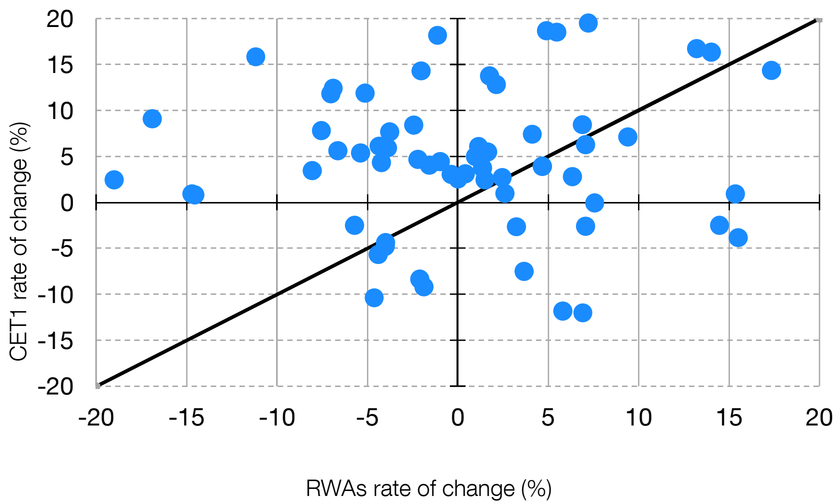


- **The reduction in the CET1 ratio seen at the aggregate level was due to the behaviour of the largest banks, since smaller institutions shored up their solvency**
- **There are many and varied cases:**
  - Many institutions have increased CET1 and reduced RWAs (4th quadrant) or have increased CET1 more than they have RWAs (above diagonal line)
  - But others have increased CET1 less than they have RWAs (below diagonal line) or have increased RWAs and reduced CET1 (second quadrant)

DISTRIBUTION OF THE CHANGE IN THE CET1 RATIO

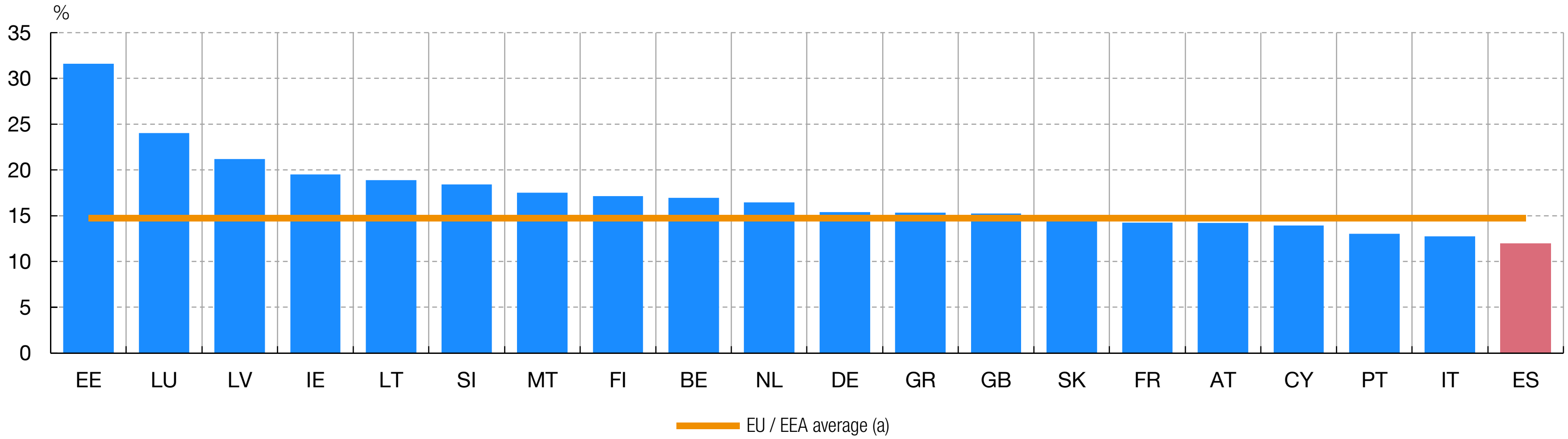


RATE OF CHANGE IN THE CET1 RATIO AND IN RWAs IN 2018



- **Spain continued to rank last in Europe in terms of average solvency with the CET1 ratio**
- **Dividends distributed in the 2015-2018 period accounted for 1.8% of RWAs in 2018**
  - In 2018, dividends amounted to 0.6% of RWAs (pay-out ratio around 50%)

CET 1 RATIO
December 2018

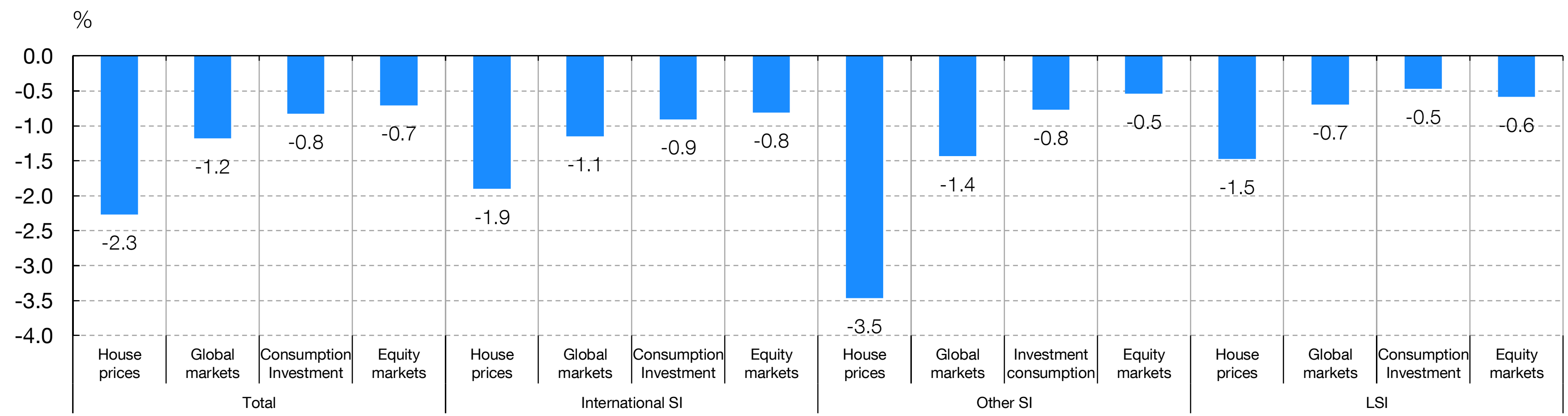


SOURCE: EBA.

a. EBA data include Iceland.

- **Shocks reflecting certain macro risks are applied to the baseline scenario of the FLESB and EBA exercises for the 2018-2020 horizon**
- **In the biggest-impact scenario, the CET1 ratio would decline by 2.3 pp in 2020, with a greater impact on the other significant institutions**

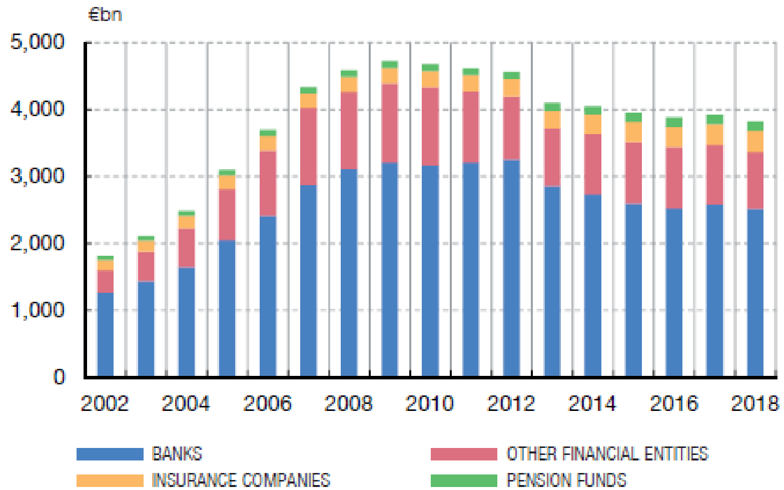
RESULTS OF FLESB SENSITIVITY ANALYSIS (a)



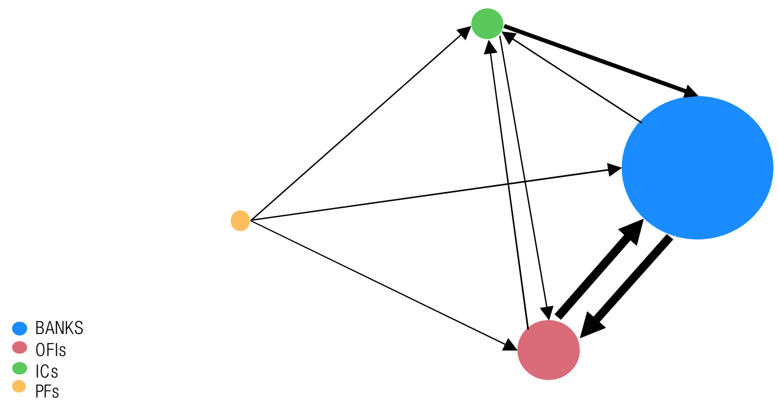
a. The results are presented in terms of the difference in the CET1 capital ratio (FL) at the end of the analysis horizon in each of the adverse scenarios compared with the level attained under the baseline scenario (coinciding with that designed for the stress test coordinated at the European level by the EBA). Solely the scenarios associated with the 1st percentile of the distribution of these four sets of shocks are included. The results are shown both for the total and for each type of institution: International SI (significant institutions under the SSM supervision with significant international activity), Other SI (other significant institutions under SSM supervision) and LSI (less significant institutions under direct national supervision).

- **The Spanish financial system continues to be heavily banked, despite the reduction in bank assets in the post-crisis years**
  - The institutions that have most increased their volume in recent years are non-monetary investment funds
- **Interconnections in the financial sector help risk-absorption, but they can also act as contagion channels**
  - Banks' assets and liabilities with OFIs are the most significant interconnections in terms of volume; however, they account for a small percentage of bank assets

A FINANCIAL ASSETS OF BANKING AND NON-BANKING FINANCIAL SECTOR



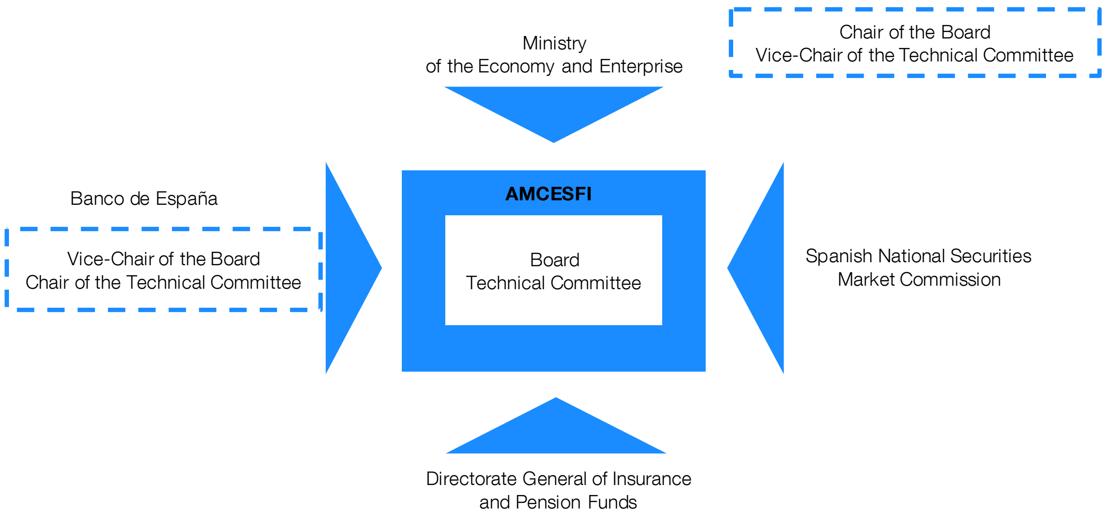
INTERCONNECTIONS BETWEEN BANKS, INSURANCE COMPANIES, PENSION FUNDS AND OFIs
September 2018



SOURCE: Banco de España.

- **Royal Decree 102/2019 creating the Macroprudential Authority Financial Stability Board (AMCESFI) was approved on 1 March. AMCESFI is tasked with identifying, preventing and mitigating systemic risk**
- **It can issue warnings and recommendations, and also opinions on proposed macroprudential measures previously notified by the supervisory authorities**

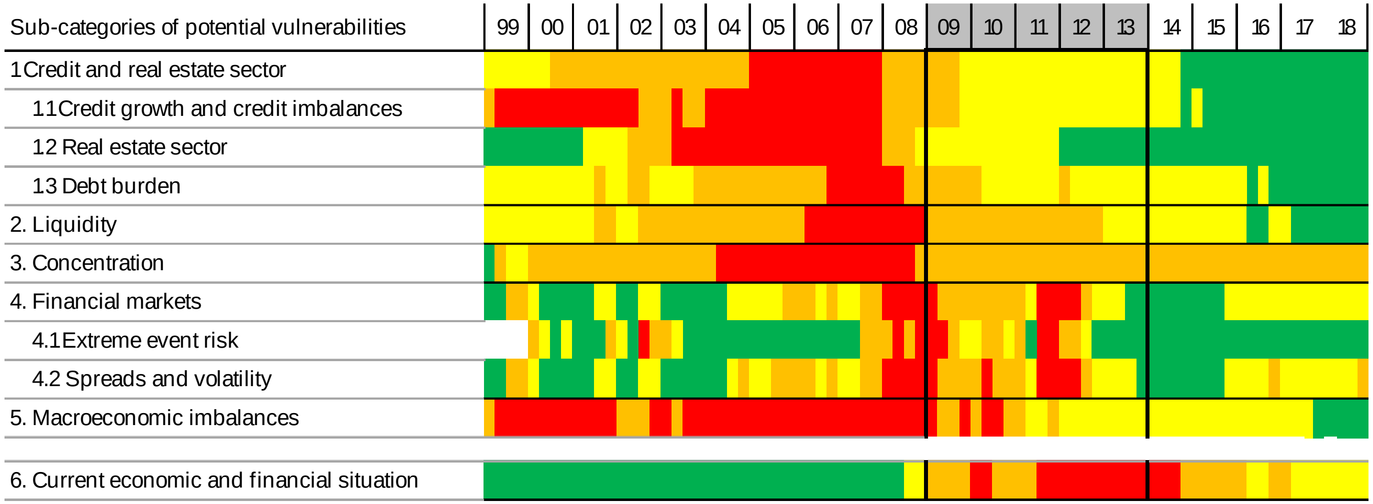
INSTITUTIONAL MEMBERSHIP OF THE SPANISH MACROPRUDENTIAL AUTHORITY (AMCESFI)



- **In parallel, Royal Decree-Law 22/2018 on macroprudential tools was validated, extending the macroprudential tools of the BdE, the CNMV and the DGSyFP**

- **The map of indicators of systemic vulnerabilities groups together a high number of indicators that have historically been good predictors of systemic banking crises in Spain**
- **Systemic vulnerabilities have held stable compared with the previous FSR**
  - There has only been a rise in the segment of interest rate spreads and volatility

HEAT MAP BY SUB-CATEGORY (a)

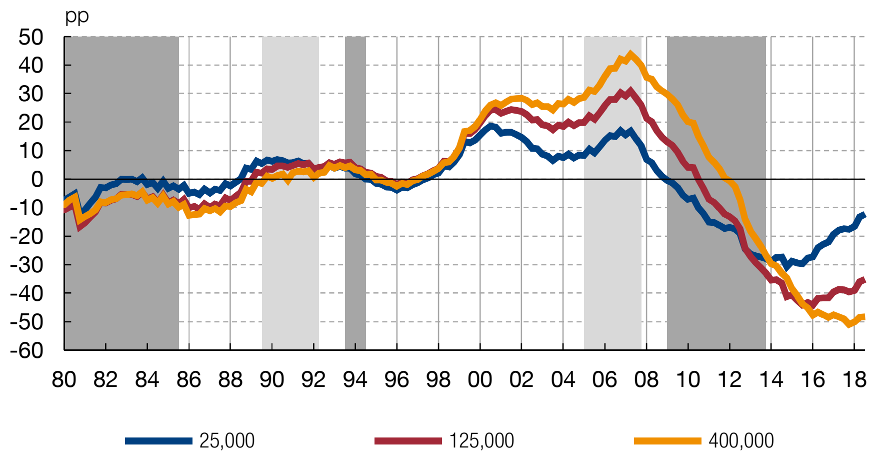


SOURCE: Banco de España.

a. The colour scheme identifies four levels of risk: i) green denotes a normal, risk-free situation, ii) yellow indicates low risk, iii) orange is medium risk and, iv) red is high risk. The shaded band denotes tha last crisis. Some indicators as at December 2018 are based on provisional information.

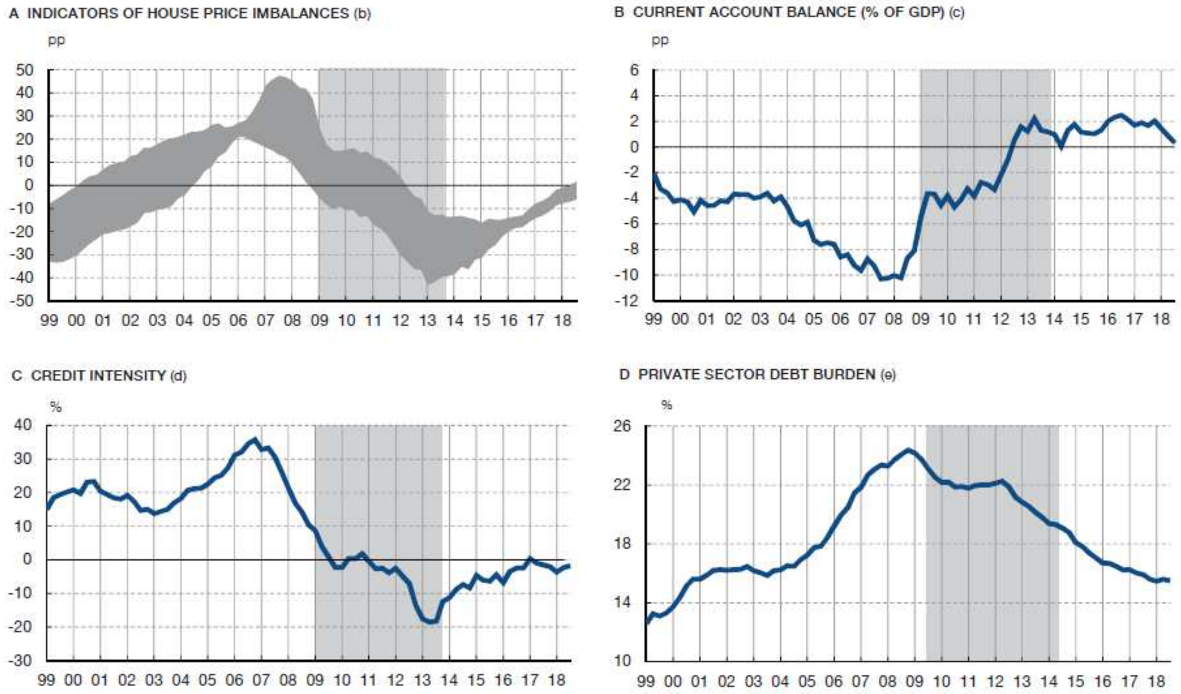
- **The BdE is exploring adaptations of the Basel statistical filter that assume a lesser duration of the credit cycle in keeping with Spain's past experience**
- **In particular, durations of the financial cycle around 15 years increase its predictive power in respect of systemic banking crises**

Chart A
CREDIT-TO-GDP GAPS ADAPTED TO CREDIT CYCLES LASTING BEWEEN 15 AND 20 YEARS (a)



a. The lines represent estimates of the gaps assuming a credit cycle of 15, 20 and 30 years, approximately corresponding to smoothing parameter values of 25,000, 125,000 and 400,000. The latter was adopted by the Basel methodology. The dark grey shaded area represents the three systemic periods identified in Spain from 1970, namely two periods of systemic banking crises (1978 Q1 to 1985 Q3 and 2009 Q1 to 2013 Q4) and one idiosyncratic event (1993 Q3 to 1994 Q3). The light grey shaded area represents the periods between five and sixteen quarters prior to the occurrence of the systemic events, during which it is advisable to identify signs of cyclical risk in order to adopt measures sufficiently in advance.

- **Complementary quantitative indicators also point to maintaining the CCyB at 0%. But the recent performance of some indicators, mainly those relating to house prices, suggest a more expansionary phase of the financial cycle**

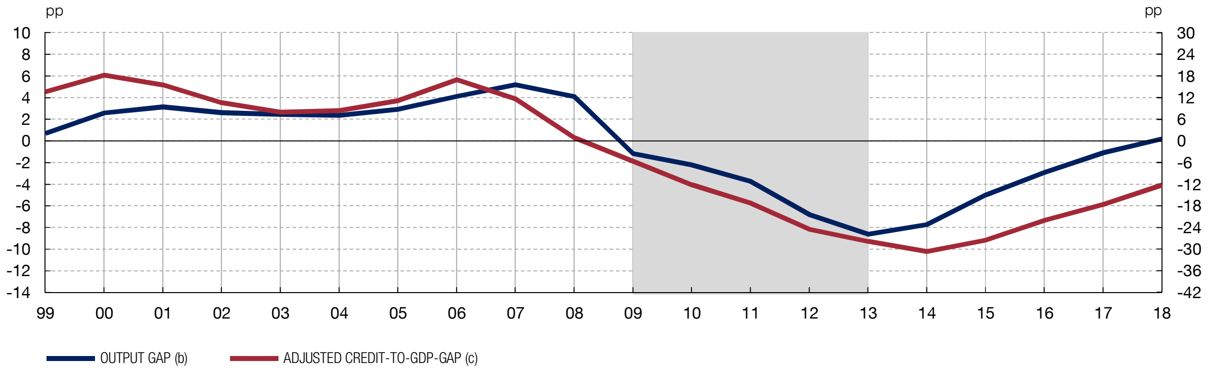


SOURCE: Banco de España.

a The shaded area shows the last period of systemic banking crisis (2009 Q1-2013 Q4).
b The shaded area represents the range between the minimum and maximum values of the set of five indicators of imbalances in the real estate sector.
c The current account balance series is expressed as a percentage of GDP and seasonally adjusted.
d The credit intensity indicator is calculated as the annual change in credit to the non-financial private sector divided by cumulative GDP of the last four quarters.
e Ratio of debt service in the non-financial private sector calculated as specified in Drehmann M. and M. Juselius (2012) "Do debt service costs affect macroeconomic and financial stability?", BIS Quarterly Review, September.

- **Other countries are activating the countercyclical capital buffer, despite their systemic risk indicators being at low levels**
  - They consider that it is when economic conditions are favourable that these buffers should be constructed
- **In Spain the output gap has begun to be positive this year**
  - Before the crisis the financial cycle led the business cycle
  - Following the crisis it is the business cycle that leads

OUTPUT GAP AND CREDIT-TO-GDP GAP (a)



SOURCE: Banco de España.

a. The shaded area shows the last period of systemic banking crisis (2009 Q1-2013 Q4).
b. The output gap is the percentage difference between the observed GDP and potential GDP. Values calculated at constant 2010 prices. See Cuadrado, P. y Moral-Benito, E (2016). Potential growth of the Spanish economy. Banco de España Occasional Paper 1603.
c. The credit-to-GDP gap is calculated as the difference, in percentage points, between the observed ratio and the long-term trend calculated using a one-sided Hodrick-Prescott filter with a smoothing parameter equal to 25,000. This value is more in line with the financial cycles historically observed in Spain (see Box 3.1).

THANK YOU