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RECENT DEVELOPMENTS IN FINANCING AND BANK LENDING TO THE NON-FINANCIAL PRIVATE SECTOR. 3RD QUARTER OF 2021

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ABSTRACT

In recent months, financing conditions for non-financial corporations and households have remained very favourable, while demand for credit has lost momentum. In this setting, the flow of new financing raised by these two institutional sectors and their outstanding debt have slowed down. Indeed, the volume of loans granted by deposit institutions to the resident private sector has declined slightly between June and September 2021, with no significant changes in credit quality over the quarter. The sectors of activity most affected by the health crisis have not shown any notable changes in 2021 Q3 in terms of volume and credit quality, although they continue to post the highest cumulative growth in bank debt, non-performing loans and Stage 2 loans since the start of the pandemic. The rise in the volume of credit since the onset of the heath crisis has helped to sustain banks' interest income, but has failed to offset the negative price effects of the widespread decline in interest rates.

Keywords: financing, lending, households, non-financial corporations, deposit institutions, non-performing loans.

JEL classification: E44, E51, G21, G23, G28.

RECENT DEVELOPMENTS IN FINANCING AND BANK LENDING TO THE NON-FINANCIAL PRIVATE SECTOR. 3RD QUARTER OF 2021

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Introduction

This article examines developments since June 2021 in funds raised by households and non-financial corporations (NFCs) from an aggregate standpoint and in resident deposit institutions' (DIs) credit exposure to these sectors.[1] The article also reviews the quality of the credit on DIs' balance sheets, paying special attention to Stage 2 loans and non-performing loans (NPLs) by sector of economic activity. Lastly, it includes a box analysing DIs' interest income from their credit operations.

Funds raised by the non-financial private sector

In recent months, financing conditions for the non-financial private sector have remained very favourable, underpinned, among other factors, by the European Central Bank's (ECB) accommodative monetary policy. Thus, average interest rates on new bank loans have fallen slightly further since the beginning of the summer, reaching record lows in most segments in October (latest available figure)[2] (see Chart 1.1). This decline has been more marked in lending to sole proprietors, where the cost fell between June and October by almost 30 basis points (bp), and in consumer credit to households, where it fell by around 20 bp in the same period.

Conversely, the average cost of long-term corporate debt issuance by NFCs increased between June and November (latest available figure) by slightly more than 15 bp to 1.8% (50 bp higher than before the outbreak of the pandemic). The pick-up in recent months is the result of the increase in both risk-free long-term interest rates

1 In these two approaches developments will not necessarily be identical, since households and NFCs do not obtain funding from these financial intermediaries alone. Households, in particular, may also obtain credit from specialised lending institutions (SLIs), especially consumer credit, while NFCs may tap capital markets by issuing corporate debt. For a detailed explanation of the differences between the two approaches and other statistical aspects, see Alves et al. (2019), Box 1, "Statistical information for the analysis of outstanding balances of financing and credit", of "Recent developments in financing and lending to the non-financial private sector", Analytical Articles, *Economic Bulletin* 3/2019, Banco de España.

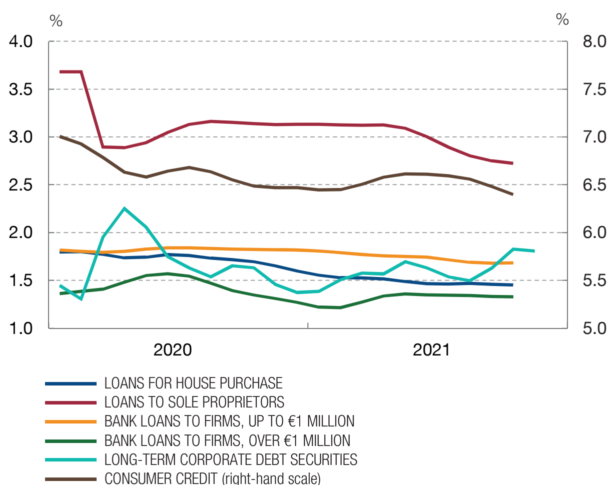
2 The lending interest rates analysed in this section are narrowly defined effective rates (NDERs), which exclude associated costs, such as repayment insurance premia and fees. They are also trend-cycle data (i.e. they are seasonally adjusted and their irregular component is subtracted) in order to obtain a clearer picture of their behaviour.

Chart 1

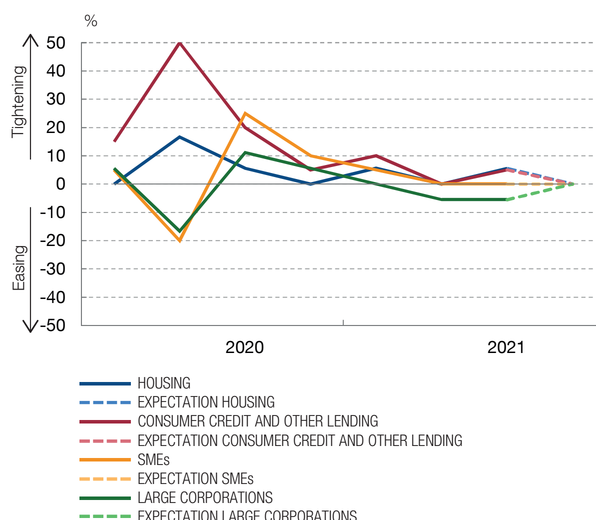
FINANCING CONDITIONS HAVE REMAINED VERY FAVOURABLE, WHILE DEMAND FOR BANK FINANCING HAS SLACKENED

Since early summer, average interest rates on new lending to households and firms have fallen slightly further, reaching all-time lows in most segments in October. According to the Bank Lending Survey (BLS), credit standards changed very little in 2021 Q3, while according to the SAFE, there was a small drop in the percentage of SMEs having difficulties obtaining bank loans between April and September 2021. The BLS also reveals slow growth in demand for bank financing in Q3 in most segments, while the SAFE points to a very low volume of applications for bank financing from SMEs between April and September 2021.

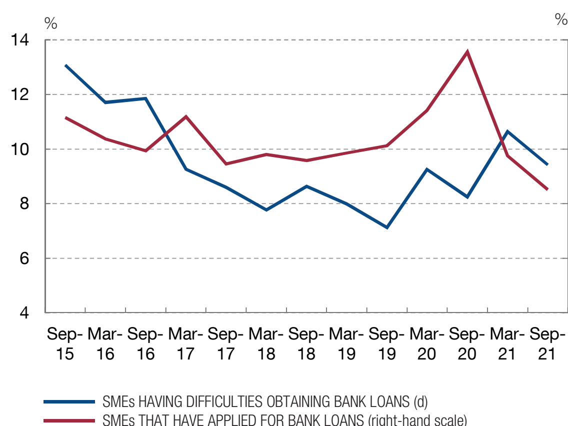
1 COST OF FINANCING: NON-FINANCIAL PRIVATE SECTOR (a) (b)



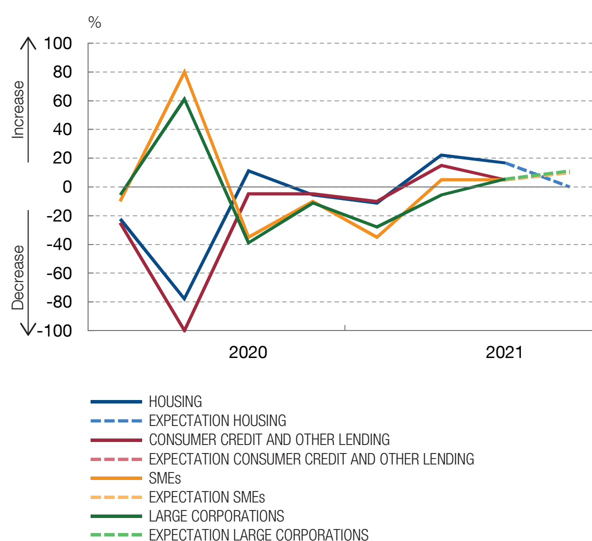
2 BLS: CHANGE IN CREDIT STANDARDS (c)



3 SAFE: SMEs HAVING DIFFICULTIES OBTAINING BANK LOANS AND SMEs APPLYING FOR BANK LOANS



4 BLS: CHANGE IN DEMAND FOR LOANS (e)



SOURCES: ECB, Banco de España and Refinitiv Datastream.

a Credit transactions include those with DIs and with SLIs.
b Bank lending interest rates are narrowly defined effective rates (NDERs), i.e. they exclude related charges, such as repayment insurance premia and fees. They are also trend-cycle interest rates, i.e. they are adjusted for seasonal and irregular components (small changes in the series with no recognisable pattern in terms of periodicity or trend).
c Indicator = percentage of banks that have tightened their credit standards considerably × 1 + percentage of banks that have tightened their credit standards somewhat × 1/2 – percentage of banks that have eased their credit standards somewhat × 1/2 – percentage of banks that have eased their credit standards considerably × 1.
d This indicator reflects the proportion of SMEs in one of the following situations: those whose applications for funds were rejected; those that were granted funds but not the full amount; those that were granted a loan but at a cost that they considered very high; and those that did not apply for finance for fear of rejection (discouraged from applying).
e Indicator = percentage of banks reporting a considerable increase × 1 + percentage of banks reporting some increase × 1/2 – percentage of banks reporting some decrease × 1/2 – percentage of banks reporting a considerable decrease × 1.

over this period and the credit risk premium, proxied by the spread over the interest rate swap at the same maturity, which rose by 10 bp.

According to the Bank Lending Survey[3] (BLS), credit standards saw minor changes during 2021 Q3. Specifically, they tightened slightly in loans to households, reflecting lenders' lower risk tolerance (see Chart 1.2). By contrast, in the case of bank financing granted to firms, they remained unchanged for SMEs but eased slightly for large corporations, owing to banks' lower risk perception as a result of the improvement in the general economic outlook and in the prospects for certain sectors and firms. Looking ahead to Q4, banks anticipate that credit standards will remain unchanged in all lending segments.

The results of the BLS also point to somewhat less restrictive overall terms and conditions for loans to households between July and September 2021, which were reflected in the narrowing of the margins on average loans. This appears to be the result of increased competition between lenders. In the case of bank financing to firms, overall terms and conditions remained unchanged during Q3, although in terms of prices, the margins applied on riskier loans widened slightly as a consequence of banks' lower risk tolerance.

The results of the latest ECB Survey on the Access to Finance of Enterprises in the euro area (SAFE) do not show significant changes in Spanish SMEs' access to bank financing. Specifically, between April and September 2021, the net share of these firms reporting an improvement in the availability of bank loans increased by 2 percentage points (pp), to 9%.[4] This survey also indicates that the percentage of SMEs reporting difficulties in accessing bank financing declined slightly, by somewhat more than 1 pp, to 9% (see Chart 1.3).

According to the BLS, demand for loans recorded very moderate increases in Q3 compared with Q2 (see Chart 1.4). Only in the house purchase segment did loan demand increase more sharply thanks to higher consumer confidence and, to a lesser extent, better housing market prospects. For 2021 Q4, the financial institutions participating in the BLS anticipate a somewhat stronger increase in demand for bank funds than in the previous quarter, except in loans for house purchase, where demand is expected to remain stable.

The SAFE points to a moderation in demand for bank financing by SMEs for the period from April to September 2021, with the percentage of SMEs that have applied for loans (23%) standing at its lowest level since the first round of the survey was published in 2009. This low volume of loan applications could be linked to firms'

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3 See Menéndez Pujadas and Mulino (2021).

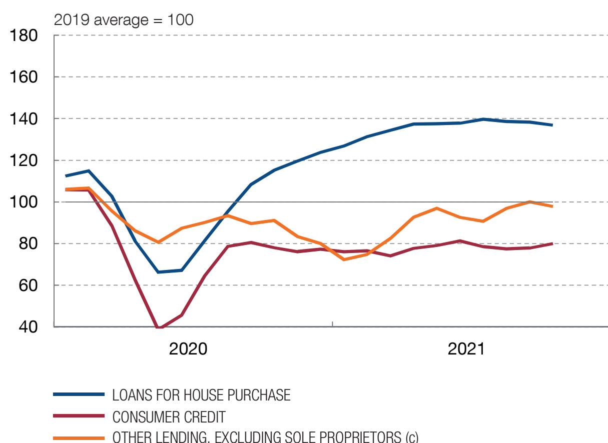
4 See Box 4, "Recent developments in Spanish SMEs' access to external finance according to the European Central Bank's six-monthly survey", in Quarterly report on the Spanish economy, *Economic Bulletin* 4/2021, Banco de España.

Chart 2

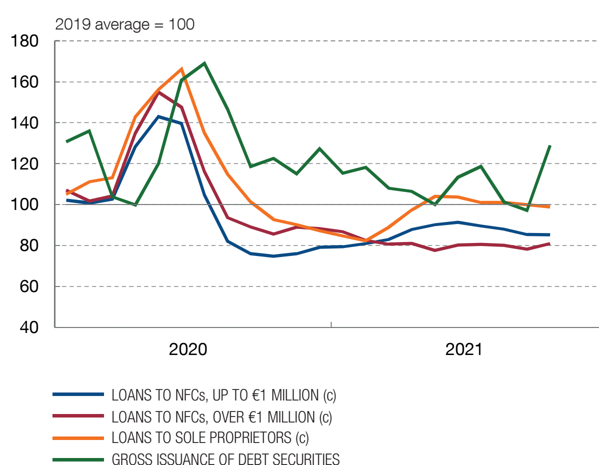
NEW LENDING TO THE NON-FINANCIAL PRIVATE SECTOR HAS WEAKENED IN RECENT MONTHS, REFLECTED IN SLOWER GROWTH IN OUTSTANDING DEBT BALANCES

The rate of growth of new lending has slowed across the board in recent months. Moreover, at October, the volume of new lending was below its pre-pandemic levels in most segments, with the exception of new lending for house purchase where activity levels are much higher than in 2019, despite having steadied in recent months. By contrast, new corporate financing on the capital markets showed strong momentum, concentrated in October. These developments translated into slower growth in the outstanding debt balances of households and NFCs, except in corporate financing via issuance of debt securities.

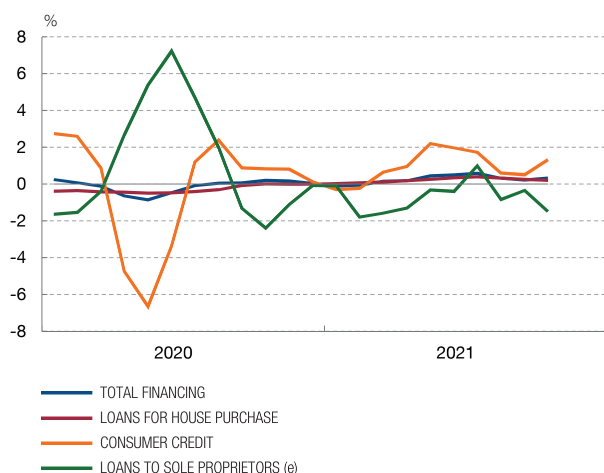
1 NEW LENDING TO INDIVIDUALS (a)
3-month cumulative seasonally adjusted flows (b)



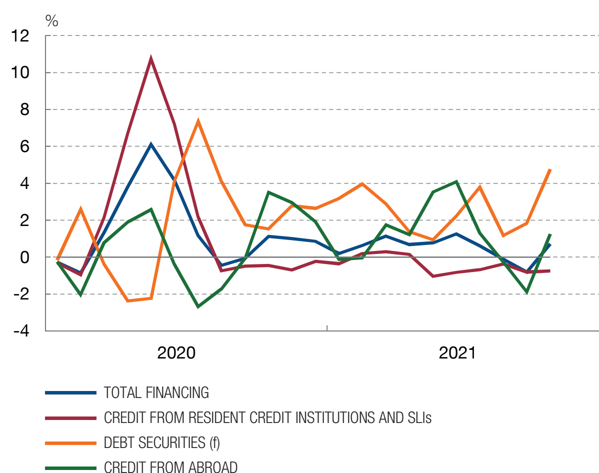
2 NEW LENDING FOR PRODUCTIVE ACTIVITIES (a)
3-month cumulative seasonally adjusted flows (b)



3 FINANCING TO HOUSEHOLDS. OUTSTANDING AMOUNTS (a)
Q-o-q change (d)



4 FINANCING TO NFCs. OUTSTANDING AMOUNTS (a)
Q-o-q change (d)



SOURCE: Banco de España.

a Bank financing series include financing granted by DIs and SLIs.
b Flows relative to the 2019 monthly average.
c Includes renegotiations of previous loans.
d Seasonally adjusted rates of change.
e Excludes securitised lending.
f Includes issues by resident subsidiaries of NFCs.

lower liquidity needs associated with the recovery in business turnover, the lower volume of debt maturities and the funds accumulated during the pandemic. In fact, the average life of firms' bank loans and bank deposits rose significantly last year as a result of the financing raised through publicly guaranteed ICO loans.[5]

This backdrop of stable credit supply and contained demand for bank funds resulted in a lack of dynamism in financing flows in recent months. Thus, the volume of new loans to households for house purchase stabilised in Q3 and declined slightly in October (in three-month cumulative terms), after the strong growth of previous quarters (see Chart 2.1). This continued to be the only segment where lending activity in the most recent period was clearly above pre-health crisis levels. New consumer credit declined between June and September and picked up in October, in three-month cumulative terms, to a level 20% below the average levels for 2019. By contrast, new loans taken out by households for purposes other than house purchase and consumption[6] have recently shown greater vigour, virtually returning to pre-pandemic levels.

New lending to productive activities has moderated in recent months across all segments (although in October a pick-up was seen in transactions of more than €1 million), which is consistent with the weak demand for loans reported by the SAFE (see Chart 2.2). Conversely, fund-raising through gross issuance of corporate debt securities was highly buoyant, with momentum concentrating mainly in October, bringing it close to 30% above pre-pandemic levels. This led bank financing flows in three-month cumulative terms to stand in October at levels below those prior to the health crisis, with the exception of new lending to sole proprietors, which stood at around pre-pandemic levels. Moreover, the share of new lending to productive activities channelled through ICO-managed public guarantee facilities[7] has continued to decline since the start of the summer, barely accounting for 5% of the total.

These developments in bank finance flows were reflected in the behaviour of outstanding amounts. Thus, between June and October (latest available figure) the quarter-on-quarter growth rate (on a seasonally adjusted basis[8]) of the balance of financing obtained by households eased by 0.2 pp to 0.3% (see Chart 2.3). By segment, this was the result of falling quarter-on-quarter growth rates in loans for house purchase (0.2% in October, 0.1 pp less than in June) and of the slowdown in

5 The average maturity of these loans was almost five years. For further details, see Chapter 3 "The effects of the COVID-19 crisis on the productive sectors in Spain: economic and financial implications", *Annual Report 2020,* Banco de España.

6 Excluding new lending to sole proprietors.

7 See Royal Decree-Law 8/2020 of 17 March 2020 on urgent extraordinary measures to address the economic and social impact of COVID-19, and Royal Decree-Law 25/2020 of 3 July 2020 on urgent measures to support the economic recovery and employment.

8 These rates are calculated by comparing the amount for one month with that observed three months earlier and seasonally adjusting. All the quarter-on-quarter rates presented in this section are obtained using this approach.

the outstanding balance of consumer credit (which grew at 1.3% quarter-on-quarter in October, compared with 2% four months earlier). Together they more than offset the slight reduction in the rate of decline of other lending.

Similarly, the balance of financing raised by productive activities grew in October at a slower pace than four months earlier (see Chart 2.4). Thus, in seasonally adjusted quarter-on-quarter terms, the rate of decline of the outstanding amount of sole proprietors' bank debt stepped up to 1.5% in October, 1.1 pp more than at the end of 2021 Q2. The balance of total financing raised by NFCs continued to grow in October, albeit at a slower pace (0.7% quarter-on-quarter, down 0.5 pp on the end of 2021 H1).

The breakdown by instrument shows that the outstanding balance of lending by resident financial institutions to NFCs has continued to contract in recent months at a quarter-on-quarter rate of 0.8% (the same figure as four months earlier). The decline in the balance of outstanding bank debt would be due to both the weakness of new loans and the increase in repayments, which would partly reflect the fact that some firms are using part of the liquidity buffers they built up during the most severe stage of the pandemic to repay bank debt. In addition, some larger firms, with access to capital markets, can be expected to have opted to replace part of their bank loans with bond issues, to take advantage of the favourable financing conditions in the debt markets over a long time horizon (typically longer than that of bank loans), which would offset their higher cost. This would allow these firms to reduce the rollover and interest rate risk in the event of a future tightening of financial conditions. Against this background, the balance of corporate funding raised in the debt securities markets has continued to grow, doing so in October at a higher rate than four months earlier (4.8% quarter-on-quarter compared with 2.2% in June). Lastly, funds from abroad, which tend to have greater volatility, slowed sharply in recent months.

Lending by the resident banking sector

The outstanding amount of credit granted by DIs to the resident private sector in Spain fell by 0.2% between September 2020 and September 2021, the same year-on-year rate of decline as in June 2021 (see Chart 3.1).[9] These slight year-on-year declines represent a reversal of the year-on-year growth of more than 2.5% seen in the four quarters from June 2020 to March 2021, reflecting the remarkable credit growth over the spring and summer of 2020. This credit performance was highly influenced by the health crisis, which raised firms' financing needs, which in turn were largely met by the raft of measures implemented by the authorities to mitigate

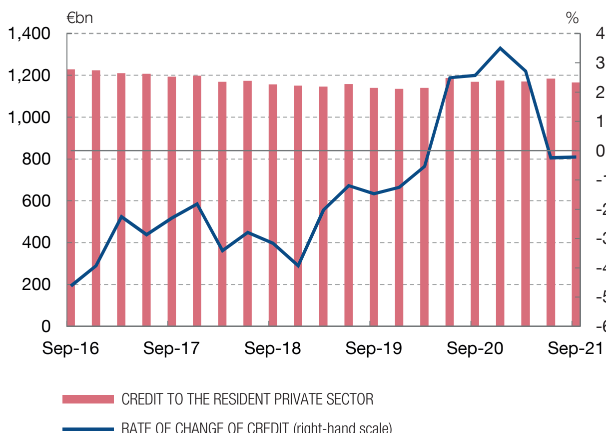
9 The change in September 2021 was affected by a corporate transaction consisting of the absorption of an SLI into a significant DI. Excluding this transaction, the year-on-year decline in credit would be 0.7%.

Chart 3

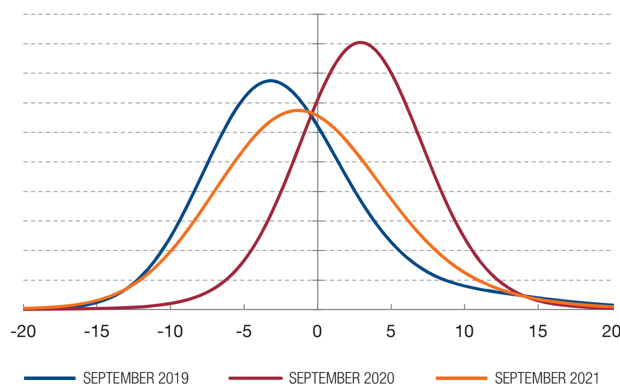
THE STOCK OF BANK LENDING TO THE RESIDENT PRIVATE SECTOR FELL SLIGHTLY BETWEEN JUNE AND SEPTEMBER 2021, WITH A GENERAL LOSS OF MOMENTUM ACROSS ALL LENDING INSTITUTIONS

At September 2021, the outstanding balance of credit to the resident private sector in Spain was down 0.2% year-on-year, the same rate as in Q2, in contrast to growth (of over 2.5%) in the previous quarters. This turnaround in credit stock growth in the last two quarters is widespread across banks, with a shift in the growth distribution towards negative values, with a profile similar to that observed before the start of the health crisis.

1 VOLUME OF CREDIT AND YEAR-ON-YEAR RATE OF CHANGE. DIs



2 DISTRIBUTION OF THE YEAR-ON-YEAR RATE OF CHANGE (%) IN CREDIT (a)



SOURCE: Banco de España.

a The chart shows the density function of the year-on-year rate of change in Spanish DIs' credit stock, weighted by the amount of credit stock. This density function is approximated through a kernel estimator which allows a non-parametric estimate of the density function, yielding a continuous and smoothed graphical representation of that function.

the economic and social impact of the pandemic. As the macro-financial situation has tended to normalise, credit developments have moved closer to the patterns observed before the pandemic (when bank lending to the resident private sector was falling in year-on-year terms).

The bank-level distribution of the year-on-year rate of change of bank credit was largely in negative territory in September 2019 (pre-pandemic stage), before shifting sharply to the right in 2020 and moving to significantly positive values that September. Recently it has shifted back to the left, with both positive and negative values, although the latter prevailed in September 2021, but without reaching the levels of decline of 2019 (see Chart 3.2).

Bank loans granted by the institutional sector have performed unevenly since the outbreak of the pandemic. On the one hand, 2020 saw a deepening of the pre-crisis contraction in loans to households, with the year-on-year change dropping from -0.2% in December 2019, to -0.6% in March 2020, before bottoming out at -1.8% in June 2020. However, this rate of contraction has since eased gradually, to the point that these loans have begun to post year-on-year growth in the last two quarters (1.2% in June 2021 and 1.4% in September), owing primarily to the behaviour of

lending for house purchase, which has progressively quickened from a 2.2% decline in June 2020 to 0.7% growth in September 2021. Consumer and other loans to households (which account for a smaller share – less than 20% – of total household lending than loans for housing) have grown at year-on-year rates of more than 4% in the last two quarters. Their behaviour, however, continues to be more subdued than before the crisis.

By contrast, bank lending to NFCs and sole proprietors fell 2.1% year-on-year in September 2021 (a steeper rate of decline than the -1.6% posted in June), reversing the trend of year-on-year increases of more than 6.8% in each of the four quarters between June 2020 and March 2021. One key factor in these developments in the outstanding amount of credit extended to NFCs and sole proprietors was the ICO-managed public guarantee scheme,[10] which was geared to ensure these agents' liquidity needs are covered. Chart 4.1 shows changes in the stock of bank loans to NFCs and sole proprietors since the start of the crisis, divided into two three-quarter periods. On the one hand, from end-March to end-December 2020, new drawdowns on business loans secured by public guarantee amounted to €93.4 billion. This exceeded the net decline in the rest of the stock of loans to NFCs in that period (€62.6 billion), prompting an increase of almost €31 billion in the overall balance of outstanding business credit. On the other, in the first nine months of 2021, new drawdowns on loans guaranteed by the ICO facility fell to €11.7 billion, which was not sufficient to offset the net decline of over €21 billion in other loans to NFCs, leading the overall balance of outstanding business credit to fall by nearly €10 billion in 2021.

Chart 4.2 shows the differing impact of the COVID-19 pandemic on loans to NFCs and sole proprietors based on the extent to which they have been affected by the health crisis.[11] The largest increase in bank credit was seen in the sectors severely affected by the pandemic, where, in June 2020, it had already risen by 19.5% in cumulative terms since December 2019. It then levelled off and, since March 2021, has decreased slightly. A similar trend is observed in lending to the moderately affected sectors. However, in this case, the initial increase in loans was somewhat smaller (13.4% in June 2020) and it was followed by a levelling-off and, from March 2021, a slight acceleration. Lending to the largely unaffected sectors increased

10 See Royal Decree-Law 8/2020, which establishes a guarantee scheme for a maximum amount of €100 billion. Additionally, Royal Decree-Law 25/2020 establishes a second guarantee facility to support business investment, for a maximum amount of €40 billion.

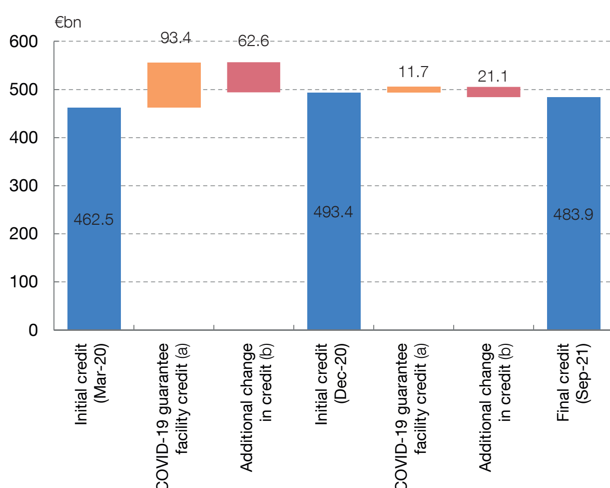
11 Drawing on the FI-130 regulatory return, three groups of sectors are proxied, according to the intensity of the fall-off in turnover in 2020: (i) sectors severely affected by the pandemic (those whose sales fell by more than 15%); (ii) moderately affected sectors (sales down by between 8% and 15%); and (iii) largely unaffected sectors (the rest). Based on this classification and the information available in the FI-130, the severely affected sectors include accommodation and food service activities, the manufacture of refined petroleum products, social services and entertainment, transportation and storage, and the manufacture of transport equipment; the moderately affected sectors include basic metals, the manufacture of machinery, other manufacturing, professional services, mining and quarrying, wholesale and retail trade, and repair of vehicles. Lastly, the largely unaffected sectors comprise the group of other productive activities.

Chart 4

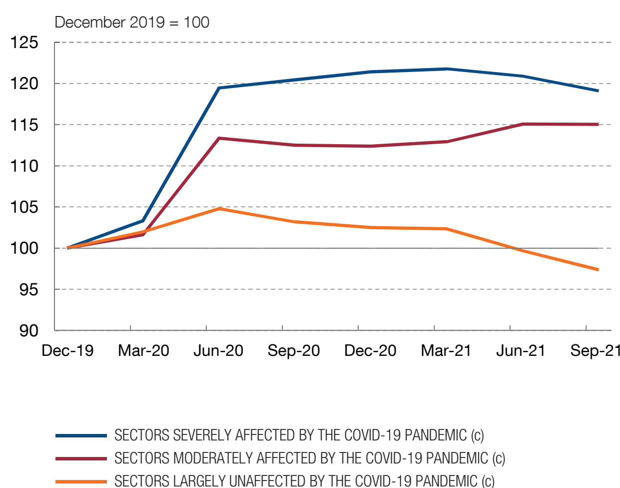
NEW DRAWDOWNS UNDER THE GUARANTEE FACILITY HAVE BEEN VERY LOW IN THE FIRST THREE QUARTERS OF 2021, AND CREDIT IN THE SECTORS MOST SEVERELY AFFECTED BY THE PANDEMIC HAS STABILISED IN 2021, WHILE DECLINING IN THE LEAST AFFECTED SECTORS

Drawdowns linked to business loans secured by public guarantee amounted to €11.7 billion in the first three quarters of 2021, compared with over €93 billion extended between March and December 2020. Lending to the severely and moderately affected sectors grew markedly in the initial months of the COVID-19 crisis and subsequently stabilised at above pre-pandemic levels. By contrast, the least affected sectors showed a moderate initial uptick in lending and a subsequent decline to below pre-pandemic levels.

1 CHANGE IN CREDIT TO NFCs AND SOLE PROPRIETORS BETWEEN MARCH 2020 AND SEPTEMBER 2021. DIs



2 CHANGE IN CREDIT BY SECTOR OF ACTIVITY. DIs



SOURCES: ICO and Banco de España.

a COVID-19 guarantee facility of Royal Decree-Law 8/2020 up to a total of €100 billion, increased by a further €40 billion under Royal Decree-Law 25/2020. The total guaranteed credit granted up to September 2021 amounted to €131.4 billion, with around €105 billion actually drawn down by NFCs and sole proprietors.

b The additional change in credit to NFCs and sole proprietors reflects the change in the stock of credit not explained by the implementation of the COVID-19 guarantee programme, which corresponds to the net difference between new lending outside the guarantee programme and repayments and write-offs.

c Lending to the more severely affected sectors is proxied by that corresponding to sectors with a fall in turnover of more than 15% in 2020 that can be identified in the FI-130 regulatory return. These include hospitality, oil refining, social services and entertainment, transportation and storage, and the manufacture of transport equipment. Lending to moderately affected sectors is proxied using the following sectorisation in the FI-130 regulatory return: metallurgy, manufacture of machinery, other manufacturing, professional services, mining and quarrying, wholesale and retail trade, and repair of vehicles. All other productive activities make up the largely unaffected sectors.

slightly in 2020 (3.4% in June 2020) and has in recent quarters declined to around 3% below its December 2019 level.

Box 1 analyses the extent to which the developments in the volume of lending during the health crisis have helped sustain banks' revenue and net interest income generation, relative to other factors such as the widespread decline in interest rates. The findings of the analysis show that, while the growth in credit to the private sector (concentrated in the NFC segment) has helped sustain income, it has failed to offset the adverse effect associated with the widespread decline in average returns on financial assets. Thus, interest income has fallen and, although interest expenses have also moderated owing to price effects, they have done so to a lesser extent, leading to a reduction in net interest income.

Quality of bank lending

The impact of the COVID-19 crisis on the quality of banks' balance sheets contrasts with the effects of other previous crises in the Spanish economy, when NPLs surged in the first year of economic contraction.[12] In the current crisis, no widespread increase in non-performing assets has so far been observed. The lower sensitivity of such assets to the contraction in activity can be largely explained by the public support measures (e.g. the furlough schemes, tax moratoria, guarantee schemes and debt moratoria), which appear to have enhanced economic agents' ability to pay, thus mitigating the adverse effects of the pandemic.

Thus, non-performing bank loans to the resident private sector continue to decrease, falling by 5.1% year-on-year in September 2021 (an admittedly lower rate of decline than the double-digit rates posted before the pandemic). The year-on-year decline of 3.4% in NPLs to NFCs and sole proprietors in September was somewhat below the overall rate. This decrease has steepened in 2021 to date (-1.5% in March and -1.8% in June), owing largely to the slowdown in NPLs extended to activities other than construction and real estate, which grew by just 0.6% in September (compared with 3.6% in March and 2.9% in June). NPLs extended to construction and real estate activities have continued to fall at rates of around 15% in 2021 to date (see Chart 5.1).

The year-on-year decline in non-performing bank loans to households has remained relatively stable at rates of around 7% in recent quarters (6.9% in September 2021). The decrease continues to be sharpest in NPLs for house purchase (8.2% in September 2021), albeit easing by almost two points, in part as a result of the end of the moratoria set in place during the pandemic. NPLs for purposes other than house purchase, which had remained relatively flat between June 2020 and March 2021 (with even the occasional slight increase) also decreased by 4.6% in September 2021 compared with the same date a year earlier (see Chart 5.2). This decline is the result of decreases both in consumer NPLs (2.5%) and in NPLs in other lending (6.3%). In the case of consumer NPLs, this reduction represents a change in trend from the growth that had been observed in recent years, which pre-dated even the pandemic.

Turning to Stage 2 bank loans to the resident private sector, the year-on-year increase stood at 53% in September 2021, similar to the Q2 level, thereby continuing the upward trend that began in late 2020. As has been the case since 2020 Q4 (when this asset class began to increase), this growth was notably attributable to the increase in Stage 2 loans to NFCs and sole proprietors, where they rose 87% year-on-year in September 2021. For their part, Stage 2 loans to households also rose in September 2021, but at a much lower year-on-year rate of 18.5%.

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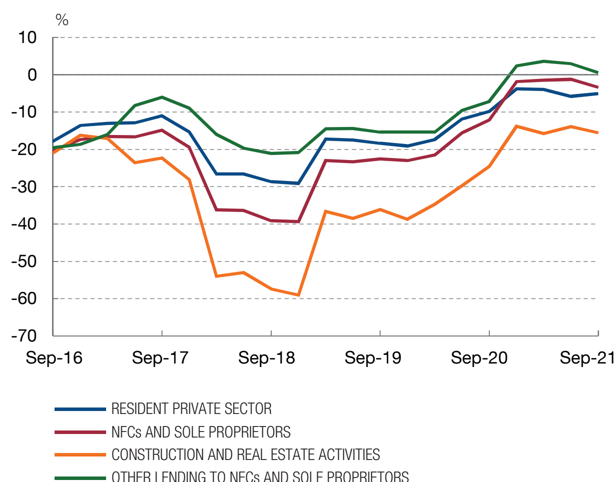
12 See, for example, "Report on the Financial and Banking Crisis in Spain, 2008-2014", *Collection publications,* Banco de España (2017).

Chart 5

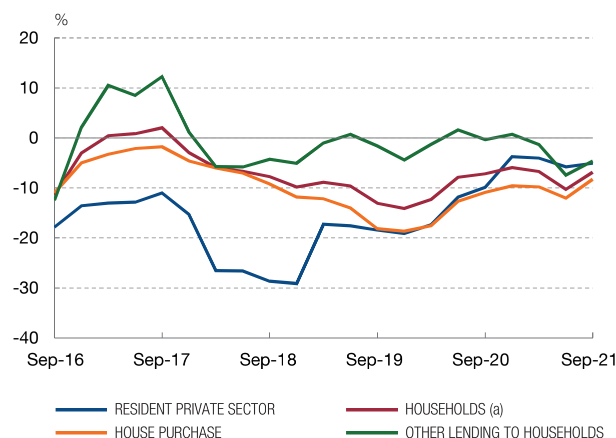
IN THE CURRENT CRISIS, NO INCREASE HAS YET BEEN OBSERVED IN NPLs. INDEED, THESE CONTINUE TO DECLINE, ALBEIT UNEVENLY ACROSS THE SECTORS AND AT A SLOWER PACE THAN PRIOR TO THE PANDEMIC

NPLs to the resident private sector fell by 5.1% year-on-year in September 2021, owing to the decline in NPLs to both NFCs (3.4%) and households (6.9%). NPL ratios continued to decline across all institutional sectors over the last 12 months, albeit at a very slow pace. In particular, no significant changes were observed in NPL ratios in Q3. Since 2016, NPL ratios in construction and real estate activities and in the other sectors have converged to a substantially lower level, closer to that corresponding to the household segment; the COVID-19 crisis has not changed this pattern.

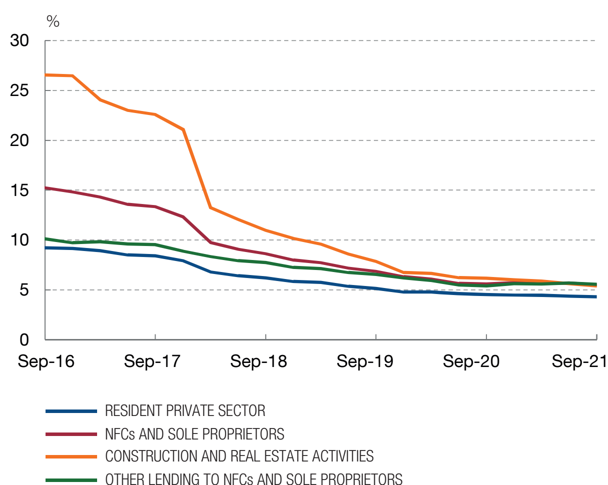
1 NPLs TO NFCs AND SOLE PROPRIETORS. Y-O-Y RATE OF CHANGE. DIs



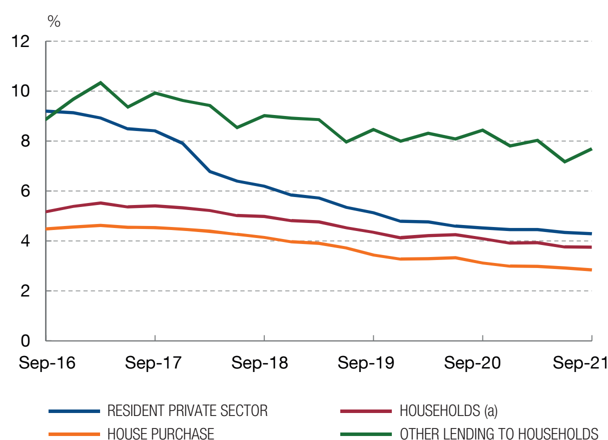
2 NPLs TO HOUSEHOLDS. Y-O-Y RATE OF CHANGE. DIs



3 NPL RATIO. LENDING TO NFCs AND SOLE PROPRIETORS. DIs



4 NPL RATIO. LENDING TO HOUSEHOLDS. DIs



SOURCE: Banco de España.

a Excluding lending for business activities, which is classified as lending to sole proprietors.

The NPL ratio for the resident private sector, and those for NFCs and sole proprietors and for households, have continued to decline in the last 12 months, albeit very slowly (see Charts 5.3 and 5.4). This decrease owed to the year-on-year fall-off in NPLs being sharper than the slight year-on-year decrease in lending (mentioned in

the previous section). This reduced the NPL ratio for the resident private sector by 22 bp in the last 12 months, to stand at 4.3% in September 2021, with almost no change observed in 2021 Q3.

The NPL ratio for households fell at a slightly steeper rate of 33 bp, from 4.1% in September 2020 to 3.8% in September 2021. In the case of loans for house purchase and other lending, the NPL ratio decreased in the last 12 months, with the decline being sharpest in the latter (0.7 pp). The NPL ratio for NFCs and sole proprietors saw a smaller decline of just 7 bp, to 5.5%, in the last 12 months. Nevertheless, changes in this ratio have not been linear, alternating between slight increases and decreases quarter-on-quarter owing to the behaviour of the NPL ratio for loans extended to activities other than construction and real estate. For its part, the NPL ratio for loans extended to construction and real estate activities continued to decline in all quarters. In 2021 Q3 no significant changes with respect to end-H2 were observed in the NPL ratios, either in the loans to business or in the households segment.

To analyse in greater detail the behaviour of the credit quality of NFCs and sole proprietors, Charts 6.1 and 6.2 present changes in Stage 2 exposures[13] and non-performing loans, respectively, since the onset of the crisis, by sector of activity based on the extent to which they have been affected by the pandemic. The Stage 2 category is indicative of latent default risks owing to a worsening of the risk profile of the borrower firms. These Stage 2 loans showed a highly similar performance across the three groups, with no significant variations, up to September 2020. Since then, three clearly differentiated behaviours have been observed. First, Stage 2 loans extended to the sectors largely unaffected by the pandemic have remained relatively stable. Second, those extended to the moderately affected sectors rose somewhat sharply, by 87% in cumulative terms between December 2019 and September 2021 (see Chart 6.1). Lastly, in the case of the severely affected sectors, Stage 2 loans saw very strong growth from 2020 Q3, and their volume in September 2021 (€16.8 billion) tripled their pre-pandemic level (€5.5 billion in December 2019).

NPLs also showed a similar performance across all sectors up to September 2020, although developments since have been mixed. NPLs to the sectors largely unaffected by the pandemic began to decrease, falling by over 17% in cumulative terms from December 2019 to September 2021. Those to the moderately affected sectors declined, but to a much smaller extent, posting a cumulative fall of 3.6% in the same period. Lastly, NPLs to the severely affected sectors grew sharply, albeit to a lesser extent than Stage 2 loans to the same sectors. And, in contrast to Stage 2 loans, the increase in such NPLs came to a halt in June (when they posted

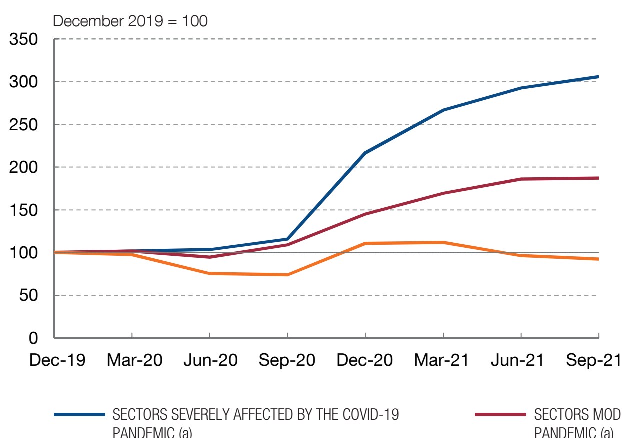
13 Pursuant to Circular 4/2017, a loan is classified as a Stage 2 exposure when credit risk has increased significantly since initial recognition, even though no event of default has occurred.

Chart 6

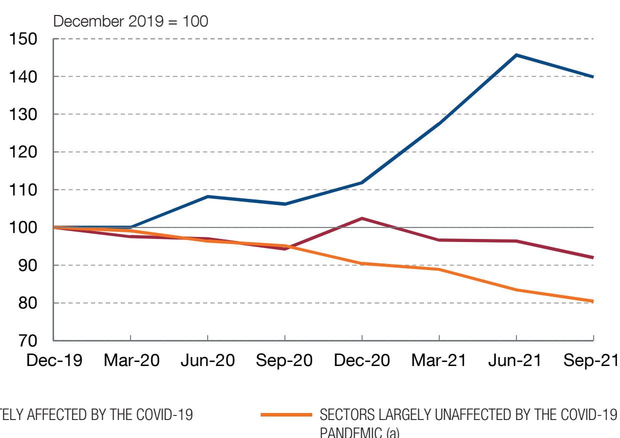
THE IMPACT OF THE CRISIS ON CREDIT QUALITY REMAINS FAR HIGHER IN THOSE SECTORS WHOSE ACTIVITY HAS BEEN MORE SEVERELY AFFECTED BY THE PANDEMIC

In the severely affected sectors, Stage 2 loans surged while NPLs ceased to rise between June and September. Stage 2 loans likewise grew significantly in the moderately affected sectors, but NPLs declined slightly. Lastly, the largely unaffected sectors recorded no increase in Stage 2 loans and NPLs continued to decline.

1 CHANGE IN STAGE 2 LOANS BY SECTOR OF ACTIVITY. DIs



2 CHANGE IN NPLs BY SECTOR OF ACTIVITY. DIs



SECTORS SEVERELY AFFECTED BY THE COVID-19 PANDEMIC (a)
SECTORS MODERATELY AFFECTED BY THE COVID-19 PANDEMIC (a)
SECTORS LARGELY UNAFFECTED BY THE COVID-19 PANDEMIC (a)

SOURCE: Banco de España.

a Lending to the more severely affected sectors is proxied by that corresponding to sectors with a fall in turnover of more than 15% in 2020 that can be identified in the FI-130 regulatory return. These include hospitality, oil refining, social services and entertainment, transportation and storage, and the manufacture of transport equipment. Lending to moderately affected sectors is proxied using the following sectorisation in the FI-130 regulatory return: metallurgy, manufacture of machinery, other manufacturing, professional services, mining and quarrying, wholesale and retail trade, and repair of vehicles. All other productive activities make up the largely unaffected sectors.

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cumulative growth of 46% since December 2019). Thus, between June and September 2021, NPLs to the severely affected sectors fell by 4% (see Chart 6.2).

Lastly, the NPL coverage ratio[14] for the resident private sector stood at 45.7% in September 2021, 0.7 pp up on September 2020, on account of the growth recorded in Q3. This quarter-on-quarter growth is observed in both the coverage ratio for lending to NFCs and sole proprietors and in the coverage ratio for lending to households, even though the ratios for these sectors had followed different trajectories in previous quarters. The coverage ratio for firms had been declining since December 2020 whereas, in the case of households, it has followed an upward path since September 2019 (see Chart 7.1).

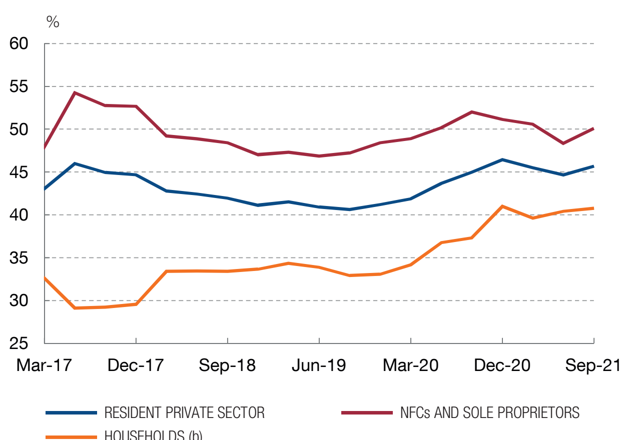
The NPL coverage ratio presents differences across the sectors of activity based on the extent to which they have been affected by the pandemic (see Chart 7.2). It is important to note that the pre-pandemic starting position already varied across the

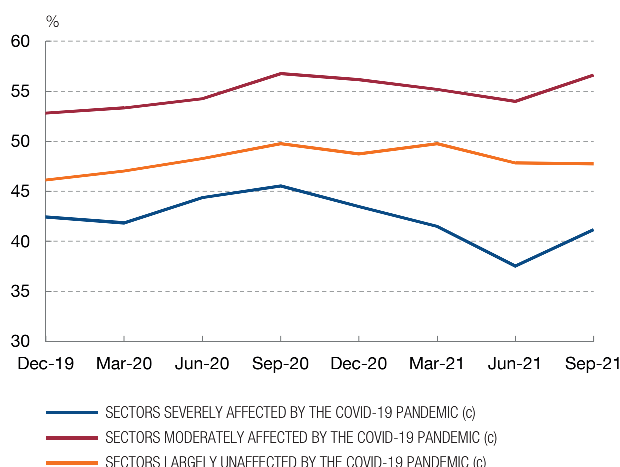
14 The ratio of loan loss provisions to NPLs.

Chart 7

THE NPL COVERAGE RATIO HAS RISEN SLIGHTLY IN THE LAST QUARTER ACROSS ALL INSTITUTIONAL SECTORS. THE COVERAGE RATIO PRESENTS DIFFERENCES ACROSS THE SECTORS OF ACTIVITY BASED ON THE EXTENT TO WHICH THEY HAVE BEEN AFFECTED BY THE PANDEMIC

The NPL coverage ratio for the resident private sector stood at 45.7% in September 2021, 0.7 pp up on September 2020. At the onset of the crisis the coverage ratio for the severely affected sectors stood below that of the other sectors; it has since declined, while that of the other sectors has risen.





SOURCE: Banco de España.

a The coverage ratio is defined as loan loss provisions as a percentage of non-performing loans.
b Excluding lending for business activities, which is classified as lending to sole proprietors.
c Lending (and the corresponding provisions) to the more severely affected sectors is proxied by that corresponding to sectors with a fall in turnover of more than 15% in 2020 that can be identified in the FI-130 regulatory return. These include hospitality, oil refining, social services and entertainment, transportation and storage, and the manufacture of transport equipment. Lending to moderately affected sectors is proxied using the following sectorisation in the FI-130 regulatory return: metallurgy, manufacture of machinery, other manufacturing, professional services, mining and quarrying, wholesale and retail trade, and repair of vehicles. All other productive activities make up the largely unaffected sectors.

three groups, with the highest coverage ratio in the moderately affected sectors (52.8% in December 2019), followed by the largely unaffected sectors (46.1%), and the lowest ratio in the severely affected sectors (42.4%). These differences have been compounded since then, with the coverage ratio for the moderately affected sectors growing the most in this period (by almost 4 pp to 56.6% in September 2021), that of the largely unaffected sectors rising to a lesser extent (by 1.6 pp to 47.7%), and that of the severely affected sectors decreasing (by 1.3 pp to 41.2% in September 2021) (see Chart 7.2). The contained behaviour of accounting hedges during the crisis seems attributable, at least in part, to the use of the ICO guarantee scheme, limiting the exposures not covered by a guarantee and, therefore, the provisioning needs when a loan becomes non-performing.

21.12.2021.

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Box 1

RECENT DEVELOPMENTS IN NET INTEREST INCOME AND INTEREST INCOME IN THE SPANISH BANKING SECTOR

Low profitability is one of the banking sector's main challenges, and one that it was already facing before the outbreak of COVID-19. This situation has its roots in the conditions prevalent in the banking business following the global financial crisis, and represents a handicap when it comes to dealing with the structural changes that are now starting to affect the sector, such as the entry of new digital competitors or the impact of climate change. In particular, over the past decade the sector has undergone a process of deleveraging after its past excesses and a gradual offloading of troubled assets, against a backdrop of sharply falling interest rates to extremely low levels (below zero on certain instruments). These factors have been detrimental to net interest income (NII) (the difference between interest income and expenses) and, by extension, to profitability. Conversely, profitability over this period has been buoyed by a reduction in overcapacity and by consolidations. The progressive clean-up of balance sheets (decline in the relative share of non-performing loans (NPLs) and foreclosed assets) has also gradually lessened the adverse impact of impairment charges on bank profits.

The health crisis has spurred bank lending, which, all else being equal, should boost net interest income. However, the pandemic has also affected interest rates, exerting downward pressure. The aim of this box is to examine in depth the overall impact of price and quantity effects on NII and, in particular, on the income component, for the sector in Spain (proxied by the data obtained from banks' individual financial statements).

Between September 2019 and September 2021, NII[1] at Spanish banks fell by around €1,100 million (see Chart 1), accounting for a decline of approximately 5% over this two-year period. This represents a substantially larger decrease than the fall of around €500m (a relative change of -2.2%) observed in the immediately preceding comparable period, running from September 2017 to September 2019. This deterioration is due to the fact that the fall in interest income outstripped the fall in interest expenses.

To explain these changes in NII and its component parts (income and expenses) over the period following the

Chart 1
CHANGE IN NII AND INTEREST INCOME AND EXPENSES IN THE PERIOD SEP 2017-SEP 2019 AND SEP 2019-SEP 2021 (a)

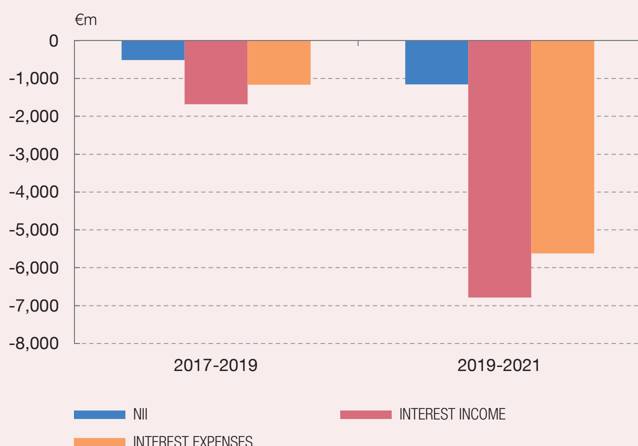

Chart 2
COMPOSITION OF THE CHANGE IN NII AND INTEREST INCOME AND EXPENSES BETWEEN SEP 2019 AND SEP 2021 (a) (b)

SOURCE: Banco de España.

a Interest income at each date is presented as the four-quarter cumulative flow: that accumulated over the first three quarters of that year and Q4 of the previous year.
b The quantity effect is calculated as the product of the change in investments (in the case of income) or funding (in the case of expenses) and the return (income) or cost (expenses) held constant at the values of the initial period. The price effect is calculated as the product of the change in return (income) or cost (expenses) and the investments (income) or funding (expenses) held stable at values of the initial period. The mixed effect is a residual calculated as the difference between the total change and the sum of the price and quantity effects. The effects on NII are calculated as the difference between the effects on interest income and interest expenses.

1 NII and interest income and expenses, as measured in a particular September, are calculated as the sum of flows over four quarters.

onset of the health crisis, two aspects are first broken down: changes in activity (the quantity effect) and changes in profitability or cost (the price effect). The breakdown is performed by varying one of the two aspects (quantity or price) between the two dates to be compared, the other aspect remaining constant. In other words, the quantity effect reflects what would have happened to NII had prices remained unchanged between the two dates, while the price effect reflects the outcome had the quantities remained unchanged. The sum total of both effects is the total change in NII.[2]

The results in Chart 2 reveal three key features. First, the price effect is negative for NII, income and expenses. In other words, the decline in profitability (cost) explains the fall in interest income (expenses). Second, the quantity effect is positive, again whether for NII or for income and expenses. This can be explained by the balance sheet expansion, with an increase in financial assets and liabilities. Lastly, the quantity effect and the price effect are both comparatively greater in the case of income. Thus, changes in income represent the key driver of NII dynamics.

To examine these changes in income in greater detail, it is broken down below by financial instrument and counterparty.[3] First, variations in average profitability, obtained by dividing the income generated by the corresponding average asset volumes, are examined (see Chart 3). Profitability shows a decline across the board, albeit to varying degrees. Such declines account for around 40 basis points (bp) since September 2019, both in total and for lending to non-financial corporations (NFCs), holdings of debt securities and other instruments overall, the latter performing particularly poorly. The decline in average returns on lending to households was less steep, accounting for 24 bp in the same period. This reduction in the average returns on the various assets reflects, inter alia, the fall in the interest rates levied on new financial contracts since the onset of the health crisis, as detailed in section one of this article.

Second, Chart 4 details the change in interest income by financial instrument and counterparty (in respect of the corresponding quantity and price effects) between September 2019 and September 2021. First of all, in line with the fall in profitability shown in Chart 3, it can be seen that the price effect is negative in all cases, with a larger relative decline in holdings of debt securities and, above all, other financial assets. This is due to the fact that the fall in profitability of around 40 bp in these categories accounts for a larger share of the average pre-pandemic profitability than in the case of lending to NFCs. Second, the quantity effect on both lending to households and debt securities is very limited, while it is clearly positive (11% in terms of relative change) for loans to non-financial corporations and for other financial assets (an increase of around 29%). The positive quantity effect regarding lending to non-financial corporations is linked to the financing arranged under the ICO-managed public guarantees programme referred to in the main body of the article.[4] The positive quantity effect associated with the other assets is in large part offset by the negative mixed effect, which reflects the fact that the notable increase in quantity in this category is matched by a marked fall in profitability. Lastly, it can be seen that the negative price effect outweighs the quantity effect in all categories, and interest income therefore fell across the board between September 2019 and September 2021.

The fall in interest income in the “Other financial instruments” category is particularly striking. This category includes, on the one hand, interest on lending to the central bank, credit institutions, other financial institutions and general government; and, on the other, net income from derivatives, hedging instruments and other assets. Various factors explain this poor performance. First, the losses associated with derivatives and hedging instruments in September 2021, in contrast to the returns on such items in previous years. Second, the rise recorded in asset-related finance expenses, leading to more negative net income from activities with central banks (with the impact on profitability being worsened by the larger share of institutions' balance sheets represented by such assets) and very low returns from operations with credit institutions. Lastly, the decline in income from lending to general government, which has also dropped off significantly since 2019.

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2 The breakdown is rounded out with a mixed effect (a residual), calculated as the difference between the total change and the sum of the price and quantity effects. The effects on NII (price, quantity and mixed) are calculated as the difference between the corresponding effects on interest income and interest expenses.

3 The breakdown by counterparty is partial, since, while a distinction is drawn between the behaviour of lending to households and NFCs and lending to other counterparties (included in the “other” category), debt securities and, more generally, financial assets other than loans, are not broken down by counterparty.

4 See footnote 10 of this article.

In keeping with the mixed performance of interest rates and asset volumes described above, the decline in aggregate returns as a percentage of total financial assets is largely driven by certain items. Thus, worth noting is the resilience of the relative contribution of lending to households and NFCs (see Chart 5). The resilience of the contribution made by household lending can be explained in part by the more moderate price effect referred to above. Meanwhile, lending to NFCs is driven by higher volume growth (see Chart 4), since profitability has fallen in line with that of other asset

Chart 3
AVERAGE RETURNS BY FINANCIAL INSTRUMENT AND COUNTERPARTY (a) (b)

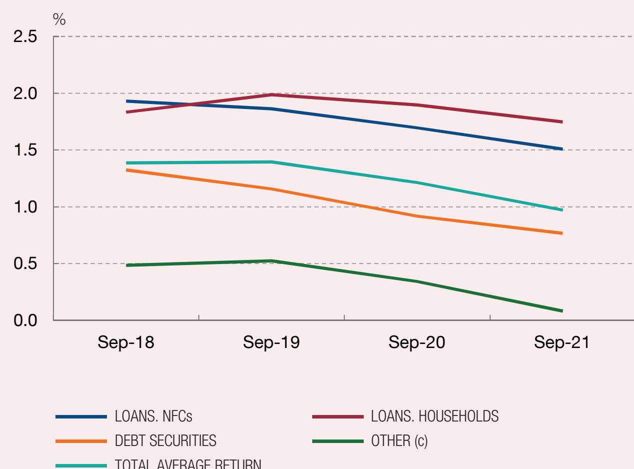


Chart 4
COMPOSITION OF CHANGE IN INTEREST INCOME BETWEEN 2019 AND 2021, BY FINANCIAL INSTRUMENT AND COUNTERPARTY (b) (d)

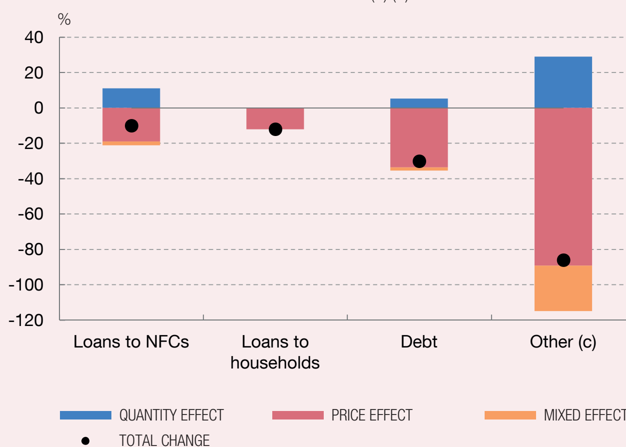


Chart 5
INTEREST INCOME AS A PERCENTAGE OF TOTAL EARNING ASSETS, BY FINANCIAL INSTRUMENT AND COUNTERPARTY (b)

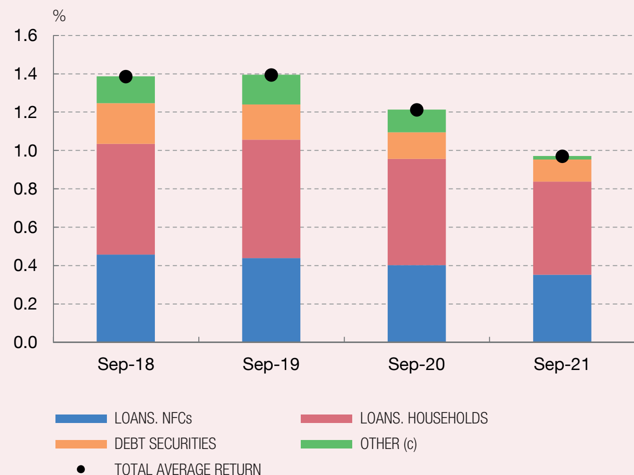
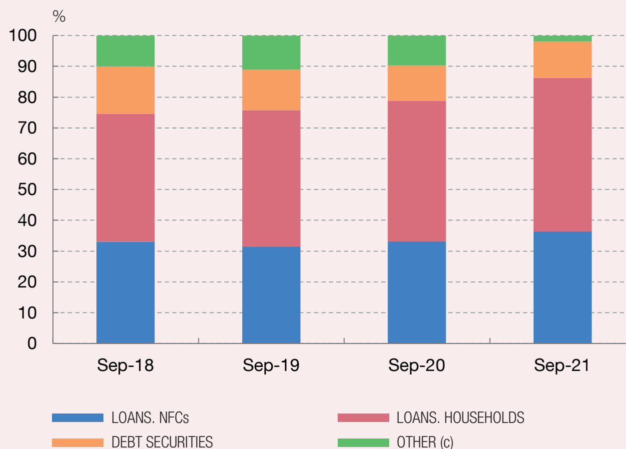


Chart 6
PERCENTAGE STRUCTURE OF INTEREST INCOME, BY FINANCIAL INSTRUMENT AND COUNTERPARTY (b)



SOURCE: Banco de España.

a The average return for each of the components and for total earning financial assets is approximated by dividing interest income by the 12-month average volume of the corresponding assets.
b Interest income at each date is presented as the four-quarter cumulative flow: that accumulated over the first three quarters of that year and Q4 of the previous year.
c This category includes, first, interest on loans to the central bank, credit institutions, other financial institutions and general government; and, second, net income from derivatives, hedging instruments and other assets.
d The quantity effect is calculated as the product of the change in investments (in the case of income) or funding (in the case of expenses) and the return (income) or cost (expenses) held constant at the values of the initial period. The price effect is calculated as the product of the change in return (income) or cost (expenses) by the investments (income) or funding (expenses) held stable at values of the initial period. The mixed effect is a residual calculated as the difference between the total change and the sum of the price and quantity effects.

classes. This greater resilience of lending to households and firms has led to a change in the composition of the total interest income. Indeed, the share of the contribution of loans to such sectors has risen by over 10 percentage points (pp), from 75.7% in September 2019 to 86.2% in September 2021, while the share of the contribution of debt securities and, above all, other instruments has fallen (see Chart 6). Since September 2019, the proportion of interest income from lending has risen in both lending to households (5.7 pp) and to NFCs (4.8 pp).

The analysis set out in this box reveals that the post-pandemic fall in returns on assets has contributed to the reduction in institutions' NII, while the growth in lending to certain sectors (such as NFCs) has only partially offset the loss of income. None of which means that a possible interest rate rise would necessarily improve the profitability of banks, and the foreseeable negative effect on quantity, together with the positive effect on price, would have to be assessed in such a scenario. This will in large part depend on the factors driving the interest rate rise. In particular, if such a rise is not accompanied by better prospects for potential economic growth, higher interest rates would curb the flow of credit and worsen credit quality, thus reducing profitability by requiring higher provisioning expenses.