

MAIN RISKS TO THE STABILITY OF THE SPANISH FINANCIAL SYSTEM




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The assessment of the balance of risks to the stability of the Spanish financial system has worsened somewhat in the past six months owing, in particular, to the downward revision of the global economic outlook. Since the publication of the last *Financial Stability Report (FSR)*, growth projections have been scaled down in most economies. Indeed, the increase in global GDP this year is expected to be the lowest since the international financial crisis. Moreover, the balance of risks to this growth is tilted to the downside. This flatter economic activity may have implications both for financial and real asset valuations and for agents' decisions.

Against this background, the main factors of risk to the stability of the Spanish financial system are the following (Table 1):

Table 1

RISK FACTORS (a)

1	Global economic slowdown and geopolitical uncertainty. The economic slowdown is affecting Europe and the emerging economies more sharply and, along with high geopolitical uncertainty, might entail an increase in risk premia that reduces the value of financial assets. Moreover, it might also weigh down agents' income and raise their projected debt levels, thereby leading to revised consumption and investment plans.	
2	Low profitability of financial institutions. Financial institutions' profitability will be under additional pressure owing to the economic slowdown and, therefore, to the prospect that interest rates may hold at very low and even negative levels for longer than expected.	
3	Legal risk. Spanish deposit institutions face, with varying degrees of intensity, a legal risk arising from the potential consequences of the outcomes of legal demands against them.	

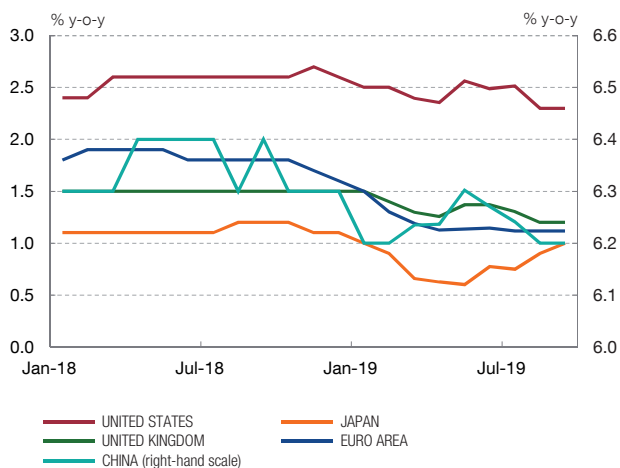
SOURCE: Banco de España.

a The risks which appear in this table are calibrated using three colours: 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. For each risk level, the arrows indicate whether risk has recently increased, held stable or diminished. Reclassification compared with a previous FSR of a risk factor to a different level (change of colour) involves posting a stable-trending arrow.

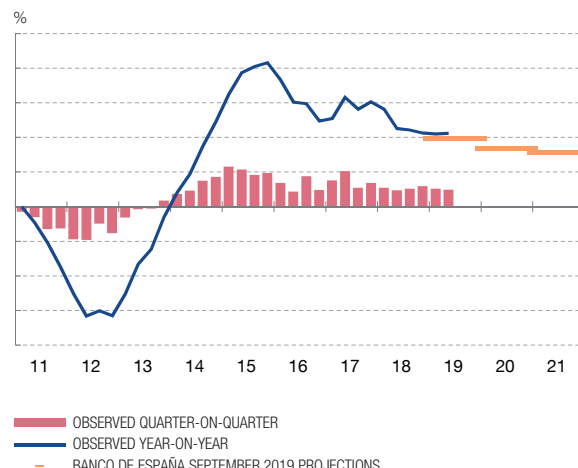
1 Global economic slowdown and geopolitical uncertainty.

One of the factors of risk identified in the previous FSR, relating to the slowdown in global economic activity, has already begun to materialise. A good number of the high-frequency conjunctural indicators are showing signs of substantial weakness, foretelling the entry into technical recession of some large economies and giving rise to a downward revision of growth forecasts.

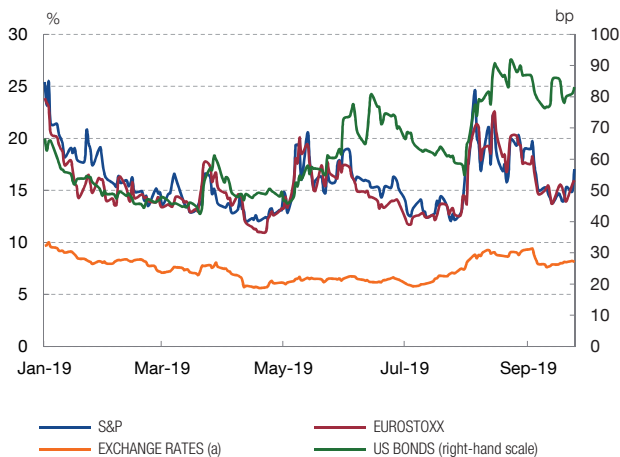
1 CONSENSUS FORECASTS FOR 2019



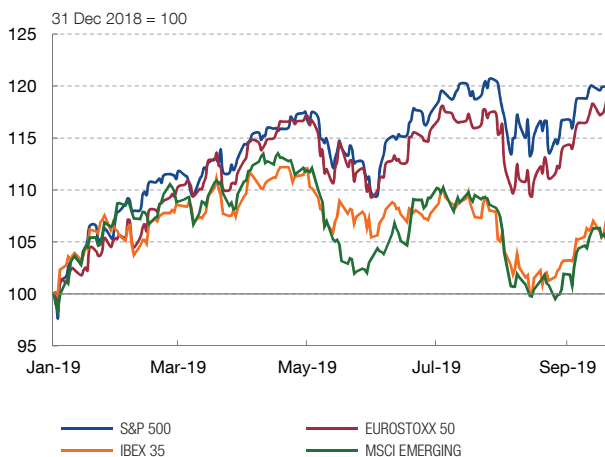
2 SPAIN. CHANGE IN GDP



3 VOLATILITIES



4 STOCK MARKET INDICES



SOURCES: Thomson Reuters Datastream, Consensus, INE and Banco de España.

a Average of 3-month volatilities for USD/EUR, USD/GBP and JPY/USD.

The revision of economic activity forecasts is across the board, but it has particularly impacted Europe, where Germany's export sector is showing notable weakness, and the emerging economies (Chart 1). Spain has also been affected by these downward revisions to the growth outlook (Chart 2).

Global geopolitical uncertainty remains high and is also starting to weigh on agents' decisions, especially those requiring a longer timeframe for realisation, such as investment.

The causes of this geopolitical uncertainty remain largely in place, and those that have disappeared have been replaced by other, fresh sources. Firstly, the US-China trade tensions continue,

a major cause of which is leadership in technological sectors. Further, the maximum tariffs that can be applied to certain products are being revised, potentially affecting US-European trade relations. Secondly, the risk of a no-deal Brexit still persists, despite the additional prorogue approved by the European Council. Tensions in the Middle East also seem to be intensifying. Conversely, the forming of a new government in Italy in September should contribute to stabilising the country's fiscal situation. Finally, in Spain, a new government could not be formed following the last elections; accordingly, fresh elections have been called for 10 November, prolonging the uncertainty over economic policy formulation. Further compounding this has been the impact of the latest developments in Catalonia.

To date, the international financial markets' reaction to the rise in global uncertainty has been contained, and has not taken the form of higher risk premia and lower asset prices (Charts 3 and 4). This has, partly, been the result of the resolute action by many central banks, which eased monetary conditions even further in the face of the scant convergence of inflation towards its objective and/or the implications of global developments for the growth outlook. In the euro area, monetary accommodation has been accompanied by additional measures to smooth bank funding (new more favourable conditions in the new series of quarterly refinancing operations, namely TLTRO III) and to mitigate the impact on profitability (a two-tier system for the remuneration of the reserves banks hold at the central bank).

In this respect, the economic slowdown and the potential materialisation of geopolitical risks might have adverse effects on financial stability through various channels. First, agents might be led to reassess their perception of risk, prompting a rise in the associated premia that could cause an acute and lasting adjustment in the prices of the financial assets affected, giving rise to losses in all agents' portfolios, including deposit institutions. Second, households' and non-financial corporations' income flows would decline, through lower employment creation and an easing in wage earnings (households) and a reduction in profits (companies). This means that the debt levels of both groups of agents might ultimately be higher than expected, with a further negative impact on future consumption and investment. Through this channel, which will gain in significance if the adverse situation persists over time, financial intermediaries' activity would also be affected, essentially the quality of their assets and the demand for financial services,

including credit. As a result, deposit institutions would encounter greater difficulties in further strengthening their balance sheets and, potentially, their solvency might worsen.

2 Low profitability of financial institutions. In the first half of 2019 Spanish deposit institutions saw their consolidated net income fall by around 11% compared with the same period a year earlier. A more detailed analysis shows that much of the decline is due to the lower gains on financial assets and to the increase in extraordinary operating expenses, meaning that recurrent operating income did not decline so much. Moreover, net interest income increased slightly (Chart 5). Indeed, the level of profitability observed in June 2019 is one of the highest of the post-crisis period, above the European average, although it has still not exceeded the cost of equity (COE).

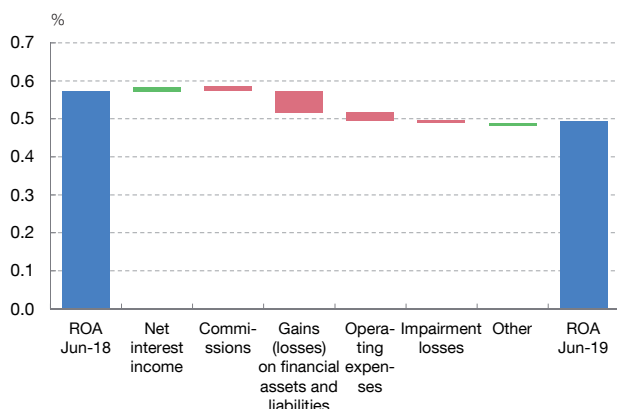
Looking ahead, the downward revision of the growth and inflation outlook and, as a result, the stronger prospect that interest rates will hold for longer at very low or even negative levels, will pose a notable challenge for the recovery of profitability levels in step with the COE. In fact, the markets have in recent months lowered their expectations about banks' profit growth.

Lower profitability hampers the organic generation of capital. However, institutions have slightly raised their top-quality capital ratios in the recent period, reversing the downward trend of the past two years. Moreover, the stress tests conducted by the Banco de España suggest that their resilience in the face of the risks identified materialising has increased and is appropriate at the aggregate level. In any event, while largely exceeding regulatory requirements, the relatively low ranking of Spanish institutions Europe-wide and the future roll-out of the last part of the Basel III reforms advise further perseverance in their shoring up of solvency.

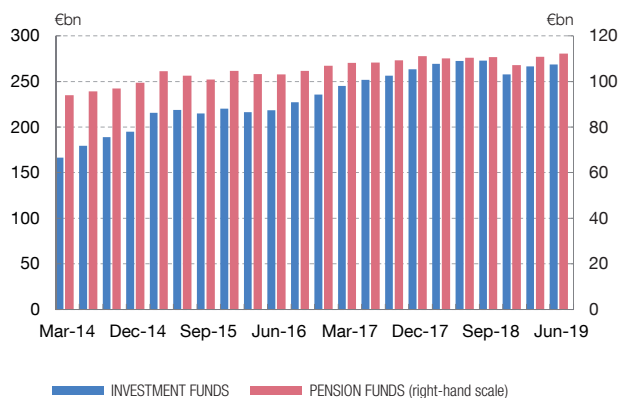
On the favourable side, the lower cost of financing that the context of very low interest rates entails will contribute to facilitating deposit institutions' issuance of eligible liabilities to comply with the MREL (minimum requirement for own funds and eligible liabilities), which is designed to avoid the use of public funds in the resolution of non-viable institutions.

The risks around profitability do not only affect the income statements of deposit institutions but also those of other financial

5 BREAKDOWN OF THE CHANGE IN PROFIT (a)
Consolidated profit attributable to the controlling entity as a percentage of ATAs



6 NET ASSET VALUE OF INVESTMENT FUNDS AND PENSION FUNDS



SOURCES: Banco de España, Inverco and CNMV.

a The red (green) colour of the bars indicates a negative (positive) contribution by the related item to the change in the consolidated result for June 2019 compared with June 2018.

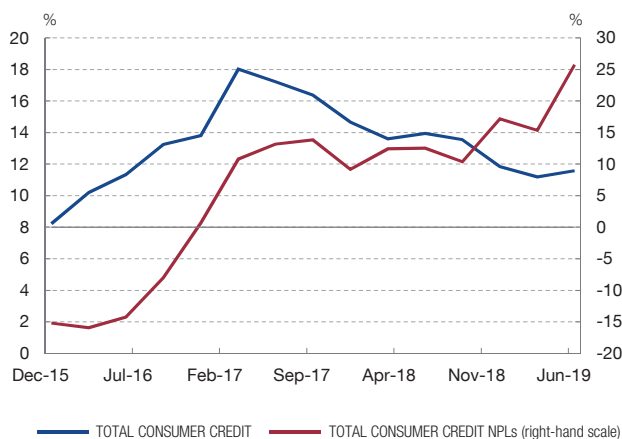
institutions, such as investment and pension funds and insurance companies, which have gained in importance in the financial sector post-crisis (Chart 6). This is especially so when these institutions guarantee a specific profitability for their customers and also if their operational funding requirements are not sufficiently covered.

Against this background, financial intermediaries may have incentives to offset the low profitability of their normal business with greater risk-taking; accordingly, greater watchfulness will be required to prevent the build-up of systemic risks.

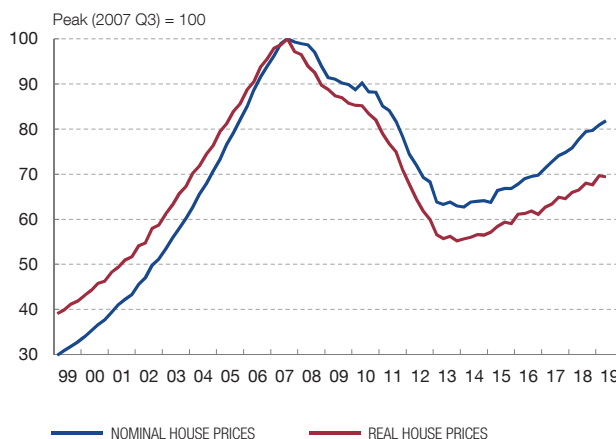
3 Legal risk. As noted in the previous FSR, the cost for Spanish deposit institutions of legal processes relating to certain mortgage agreement clauses has been high. And, at the same time, other significant legal processes are still to be resolved. In particular, the Court of Justice of the European Union (CJEU) is expected in the coming months to unveil its response to the pre-trial questions raised in relation to the use of the mortgage loan benchmark index (IRPH by its Spanish abbreviation).

In this setting, banks should continue to strive to provide their customers with financial products suited to their needs and capacities, and to furnish the relevant information on their products and services clearly and transparently. The recent regulatory changes in the mortgage market might help further this objective. It should be borne in mind that reputation and customer confidence are essential factors for developing banking business.

7 RATES OF CHANGE OF CONSUMER CREDIT AND NPLs IN DEPOSIT INSTITUTIONS AND SLIs



8 HOUSE PRICES



SOURCES: Banco de España and INE.

This FSR includes additional elements of analysis related to the risks to financial stability. In particular, it analyses potential factors of vulnerability, such as the level of debt and the financial position of the non-financial private sector and of the public sector. It further looks at developments in the real estate market, solvency and liquidity stress tests for the banking sector and systemic risk indicators. Lastly, it describes the macroprudential policy stance, which is the main tool for mitigating the potential impact of the risks identified.

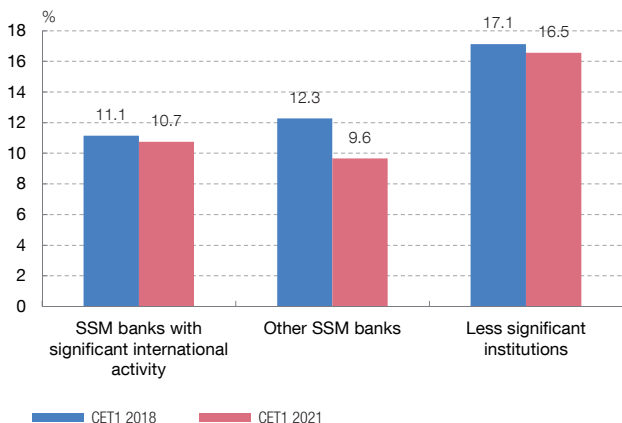
Non-financial private sector debt ratios have continued to decline, standing below average euro area levels. Indeed, the non-financial private sector debt ratio relative to GDP stood at 132%, 5 pp down on a year earlier and 4 pp below the euro area average. This deleveraging process has been generalised across both households and firms, although in both sectors there continue to be vulnerable groups with high levels of debt. In this respect, consumer credit grew in June 2019 at a year-on-year rate of around 12%, and non-performing consumer loans at 26%, raising the NPL ratio slightly to 5.6% (Chart 7).

In the real estate sector, lending standards for household loans broadly continue to be prudent and the indicators of activity appear to be showing signs of slowing. However, prices continue to grow at a high pace (Chart 8), meaning its future course will require continued monitoring.

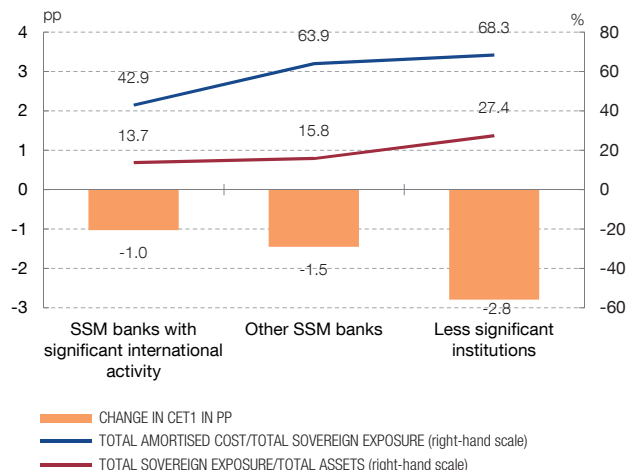
Public sector debt is holding at a high level and the Spanish economy's net international investment position remains significantly negative. That is a source of vulnerability ahead of any future changes in sentiment on international financial markets or of a downturn in the macroeconomic situation.

The stress tests conducted by the Banco de España this year on the banking sector show adequate resilience at the aggregate level. The adverse

9 IMPACT ON CET1 FL RATIO UNDER ADVERSE SCENARIO



10 SENSITIVITY TO THE ACCOUNTING CLASSIFICATION OF SOVEREIGN EXPOSURE UNDER THE ADVERSE SCENARIO (a)



SOURCE: Banco de España.

a The percentage of the sovereign exposure classified in portfolios under the amortised cost criterion (i.e. which is not classified under the fair value criterion) is, for December 2018, presented for each group of institutions, as is the sovereign exposure/total assets ratio. For the 2019-2021 horizon, the chart depicts the additional consumption expressed in pp of the CET1 ratio that would arise under the adverse scenario were the sovereign exposure under the amortised cost criterion to be reclassified under the fair value criterion.

macroeconomic scenario used on this occasion for the stress tests involves a slight increase in severity relative to the test the previous year. Notwithstanding, the reduction in banks' capital (Chart 9) is somewhat less than in 2018. This is essentially due to the fact that the institutions' opening balance sheets are in a better position, with lower NPL ratios and a lower volume of foreclosed assets. In the adverse scenario the exercise also shows limited capacity on the part of the banks to generate operating income and significant deleveraging. On this occasion there was an additional sensitivity test under the adverse scenario, subjecting the sovereign exposures at amortised cost (i.e. not subject to changes in valuation based on market price developments) to the same stress as the sovereign exposures at fair value (Chart 10). Capital consumption in this case increases substantially, revealing the significance of the risk associated with the decline in the valuation of certain assets.

The Banco de España has kept its macroprudential policy stance towards systemic risks unchanged. The analysis set out in the FSR endorses holding the Countercyclical Capital Buffer (CCyB) at 0%. However, under the baseline projection scenario several benchmark indicators would exceed the activation thresholds in the first half of 2021. Were this macroprudential instrument activated, the credit institutions affected would have 12 months in which to comply with the requirement. Nonetheless, this diagnosis is conditional on there being no deviations from the baseline projections scenario. At present there are numerous factors of downside risk (possibility of a no-deal Brexit, the stepping up of trade tensions and a delay in the resumption of economic growth in the euro area). Their potential materialisation would involve a change in this assessment.

