

FINANCIAL STABILITY REPORT

Autumn 2019

31 October 2019






- Main risks to the stability of the Spanish financial system
 - Chapter 1. Risks linked to the macrofinancial environment
 - Chapter 2. Risks to the financial sector and its resilience
 - Chapter 3. Macroprudential policy
 - Boxes
 - Box 1.1. Spain's macroeconomic and financial exposure to the United Kingdom in the event of a no-deal Brexit
 - Box 1.2. The ECB's recent monetary policy decisions and their possible effects on bank profitability
 - Box 1.3. Credit standards and mortgage default risk
 - Box 2.1. European and US banks: differences in stock market valuations and profitability
 - Box 3.1. The financial system and climate change
 - Box 3.2. The Libra project: key characteristics and risks

- The risks to the stability of the Spanish financial system noted in the previous FSR (macroeconomic environment, low bank profitability and legal risk) remain in place, as do the degree of intensity (orange) and the direction of the arrows.
 - The assessment of risks 1 and 2 has worsened somewhat in the past 6 months owing to the downward revision of the global economic outlook
 - The risk of low bank profitability extends to the other financial sub-sectors

Table 1

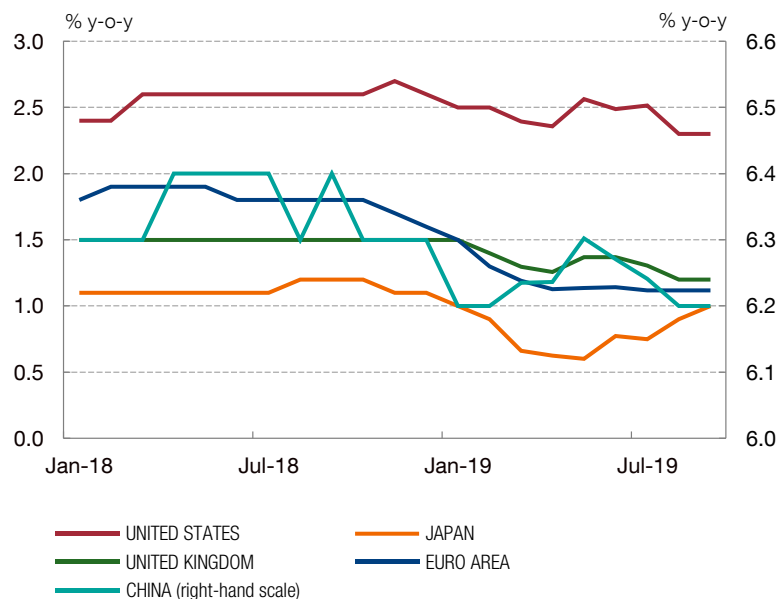
RISK FACTORS (a)

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.	

Global economic slowdown and geopolitical uncertainty

- The global economy continued on its slowing path amid high uncertainty
- Analysts have revised their growth forecasts for the main economies in 2019 downwards, in a setting of trade tensions, which have shrunk global trade and may significantly impact global activity
- Other geopolitical risks relate to Brexit and, in Spain, to the uncertainty over the economic policy stance

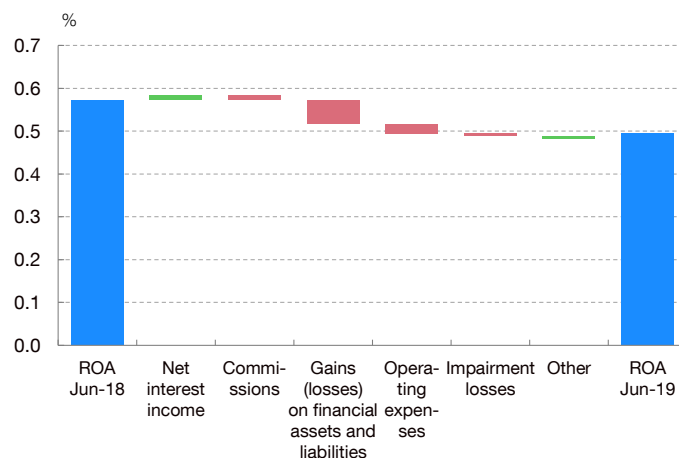
1 CONSENSUS FORECASTS FOR 2019



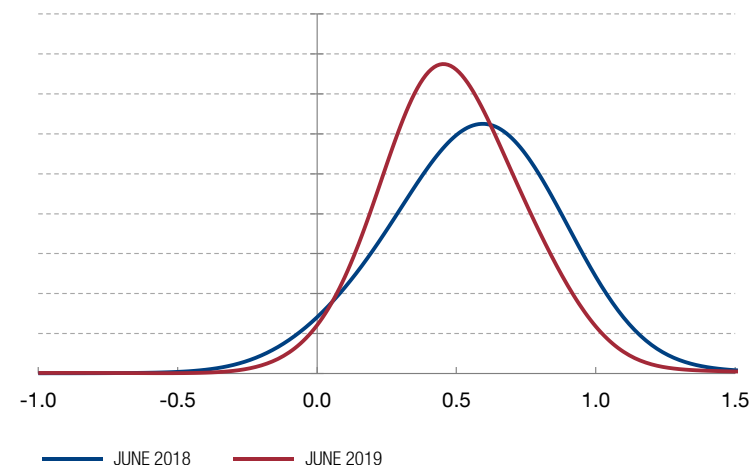
Low profitability of financial institutions

- In the first half of 2019, Spanish deposit institutions saw their consolidated profit decline by 11%, although gains (losses) on financial assets and liabilities and, to a lesser extent, extraordinary operating expenses account for much of the decline
- The reduction in banks' ROA was across the board, with this reduction greater among those banks that were more profitable
- Looking ahead, the slowdown in global activity and thus the prospect that interest rates will hold at low or even negative levels for a long time will exert more pressure on the results of all financial intermediaries

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

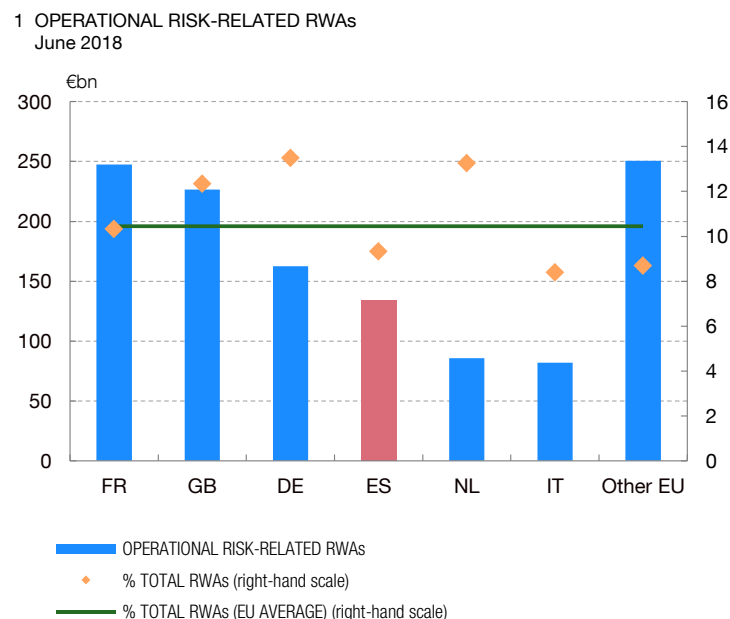


1 ROA DISTRIBUTION (%) (a)



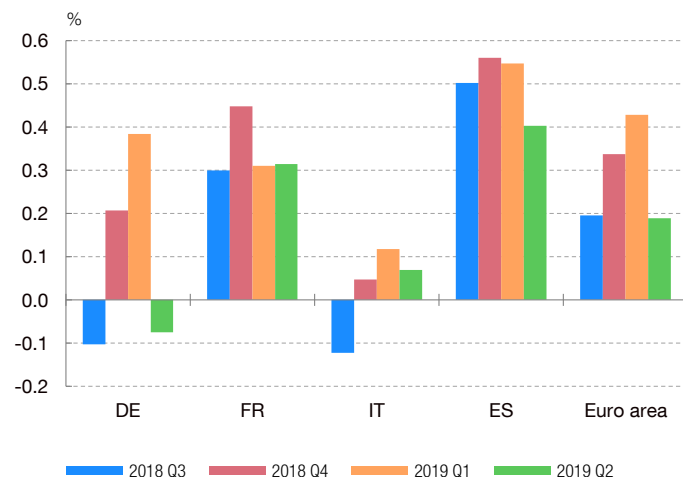
Legal risk

- The potential materialisation of costs associated with legal risks continues to contribute to Spanish deposit institutions' operational risk
- The most immediate legal risk in this respect is the CJEU's response to the pre-trial issues relating to the use of the mortgage loan reference index as a benchmark for mortgage loans
- Other operational risks flagged in the previous FSR relating to Brexit, and the transition European settlement systems and reference indices are undergoing, remain in place
- Relative to total RWAs, Spanish banks' operational risk stands at 9.3%, below the European average (10.5%) and below the main European countries

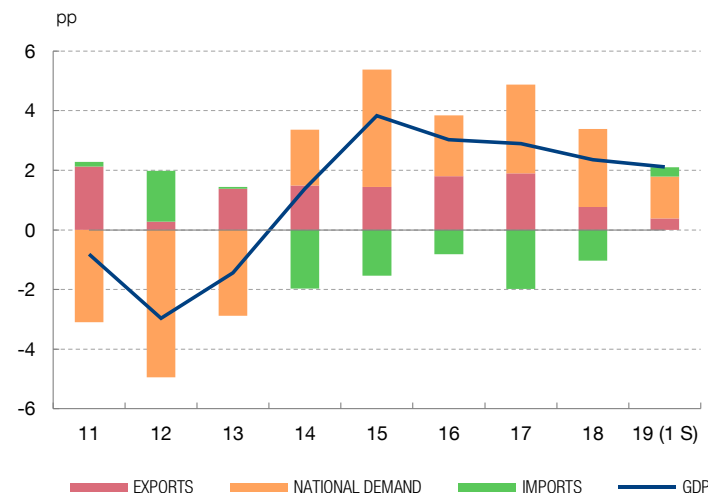


- In the euro area, economic activity increased very moderately in Q2 and the indicators available suggest this pattern has continued into Q3
 - Growth was particularly modest in the economies with greater industrial specialisation, such as Germany and also Italy
- The Spanish economy has slowed slightly in Q3
 - The employment figures suggest a loss of momentum in private-sector employment, quite extensive to all sectors
 - The medium-term baseline scenario envisages a continuation of the expansionary phase, albeit at more moderate rates and with downside risks

2 GDP BY COUNTRY
Quarter-on-quarter rate



2 SPAIN. CHANGE IN GDP AND CONTRIBUTIONS



BOX 1.1. SPAIN'S MACROECONOMIC AND FINANCIAL EXPOSURE TO THE UNITED KINGDOM IN THE EVENT OF A NO-DEAL BREXIT

- Uncertainty related to the form and date of the United Kingdom's departure from the European Union (Brexit) continues
- The European Council has adopted recently an additional extension, flexible, running to 31 January 2020. This should enhance the possibility of an agreement, but it cannot be ruled out that the future relationship between the UK and the EU may involve a lesser degree of integration than did the previous agreement
- In the case of the Spanish economy, exposure to the United Kingdom is significant, meaning that a no-deal exit might have considerable consequences
- There has been an increase in the volume of Spanish banks' loans in the United Kingdom relative to December 2014 levels and a reduction in the NPL ratio. These exposures are through subsidiaries with financial autonomy

Chart 4
GOODS AND SERVICES TRADE WITH THE UNITED KINGDOM (2017)

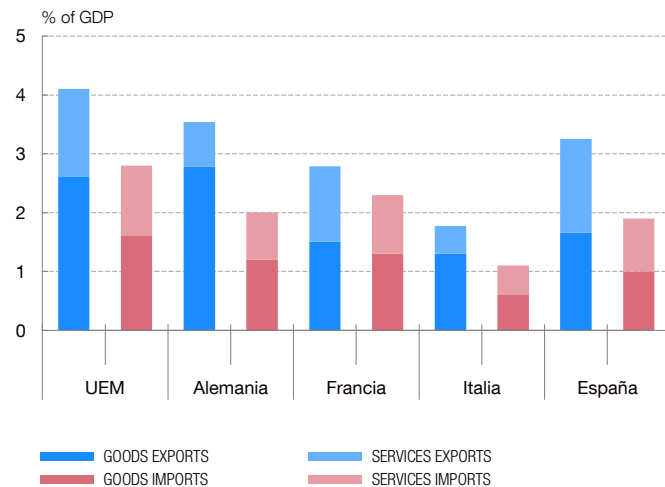
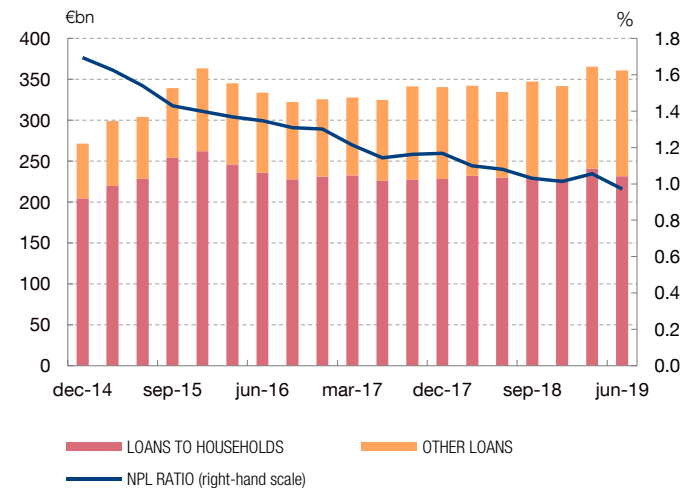
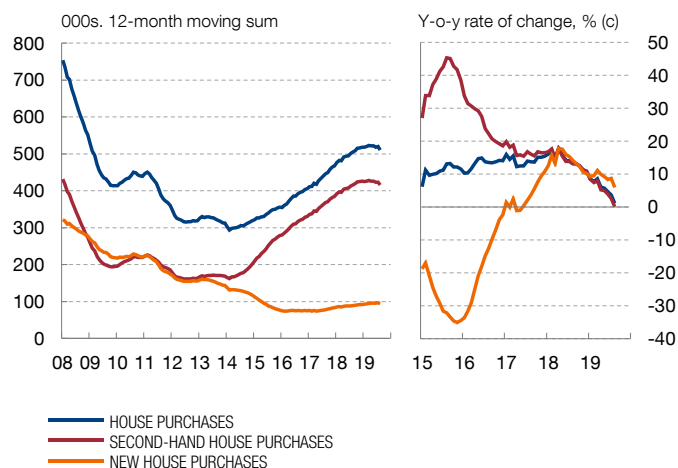


Chart 8
SPANISH BANKS' LOANS IN THE UNITED KINGDOM
June 2019

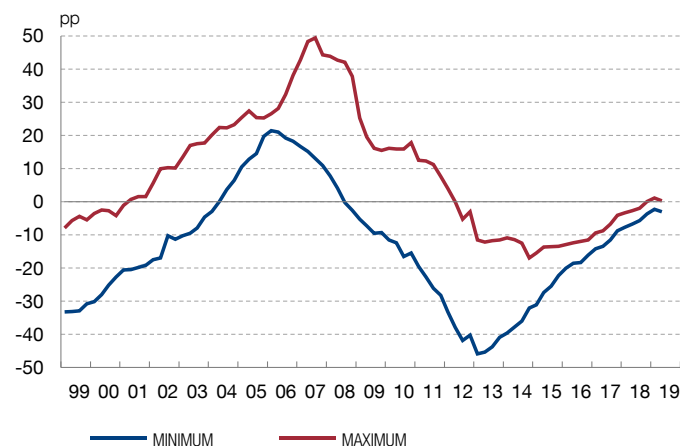


- The information available suggests a slowdown in real estate market activity in the first half of 2019
 - Second-hand house prices have recently slowed, while new house prices have accelerated
 - These developments are against a background of high geographical and segment-based heterogeneity
- In real and aggregate terms, house prices are still 29% below their 2007 Q3 peak, although prices are estimated to already be around their equilibrium level

3 TRANSACTIONS



2 HOUSE PRICE DISEQUILIBRIUM INDICATORS (b)



Lending standards and mortgage default risk

- Along these lines, there has been a loss of momentum in new lending operations to households for house purchase, with interest rates once more on the decline
- Loan-to-value (LTV) and loan-to-price (LTP) ratios also point to some tightening of mortgage lending standards
- The probability of foreclosure (after default) tends to be higher the higher LTV and LTP ratios are. However, for values exceeding 80% the LTV ratio does not appear to evidence an effective association with an increase in risk (**Box 1.3**)
- The reduction in the outstanding balance of bank lending has continued in construction and real estate development activities

2. LTP RATIO OF NEW MORTGAGE LENDING. DISTRIBUTION (a)

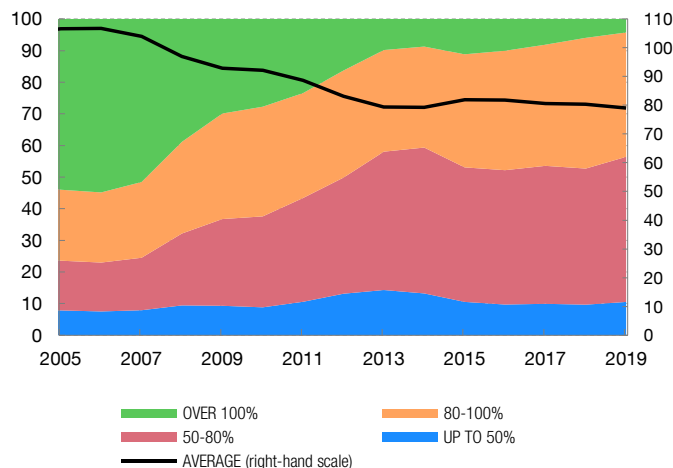
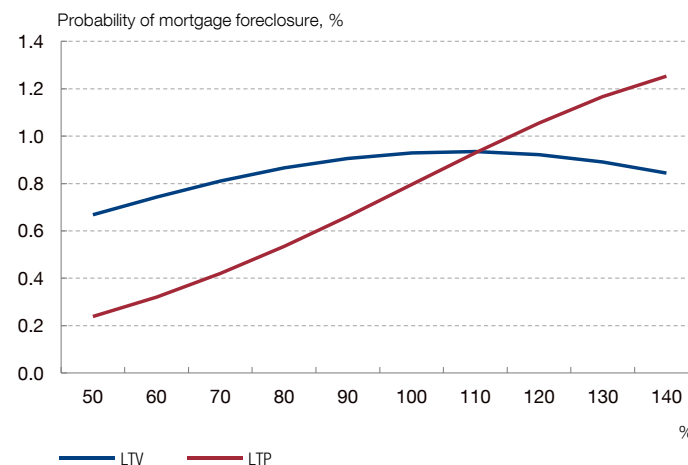
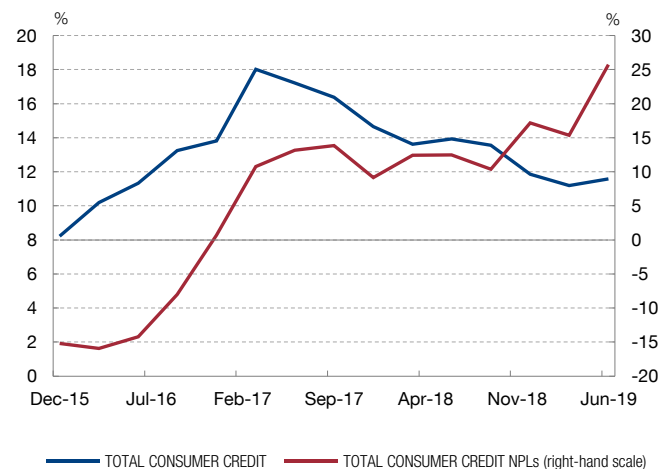


Chart 1
LTV, LTP AND PROBABILITY OF MORTGAGE FORECLOSURE (a)

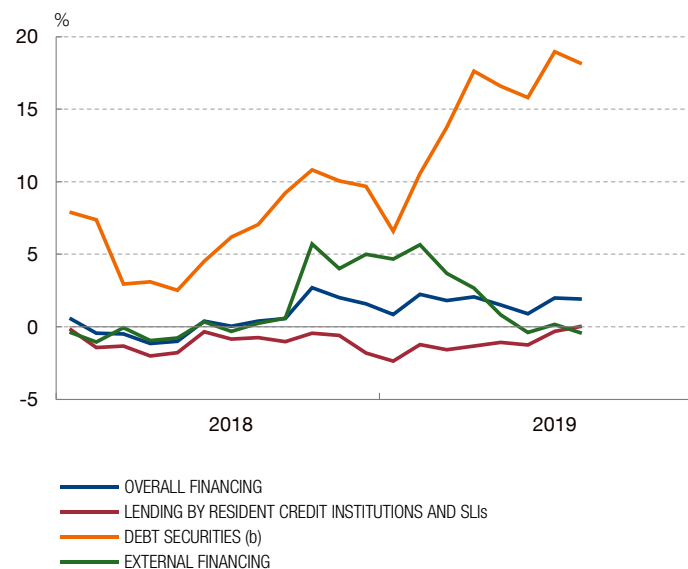


- Household financing is increasing very modestly, owing to the fact that the outstanding balance of mortgages has continued declining
- By contrast, lending for consumer goods purchases continues to grow at double-digit rates, although the trend has moderated and the growth rate of NPLs has risen significantly
- The cost of bond financing for companies has fallen sharply, which is why they have increased their resort to funding through debt securities issues

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

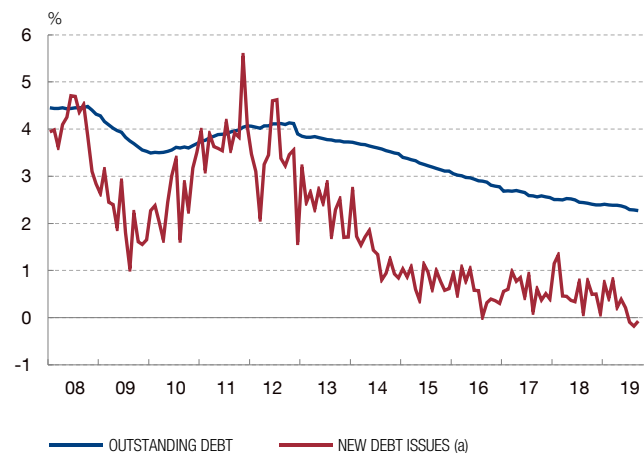


2 FINANCING TO NON-FINANCIAL CORPORATIONS
Year-on-year change

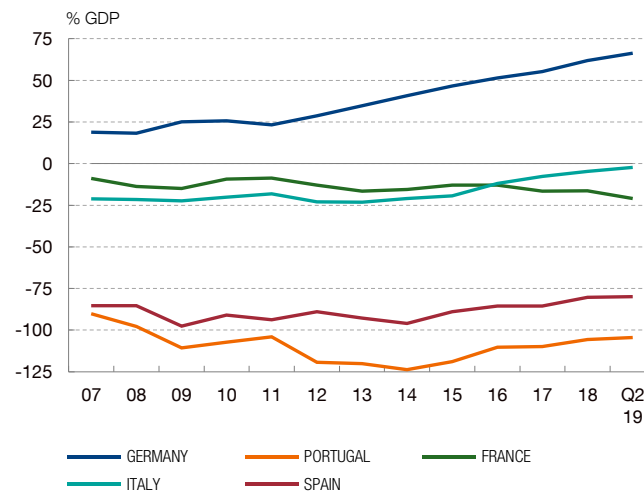


- In recent months, public-sector financing costs have fallen significantly; but public sector indebtedness remains high, entailing a factor of vulnerability
- However, Treasury issuance in 2019 has declined significantly
- The Spanish economy's net debtor position vis-à-vis the rest of the world remains at high levels from both a historical and international perspective, marking also a significant source of vulnerability for the Spanish economy

1 AVERAGE COST OF GENERAL GOVERNMENT DEBT ISSUES

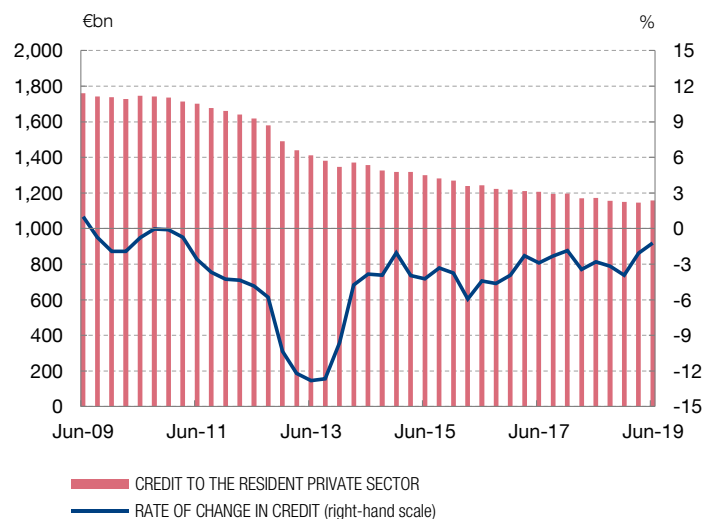


2 NET INTERNATIONAL INVESTMENT POSITION BY COUNTRY

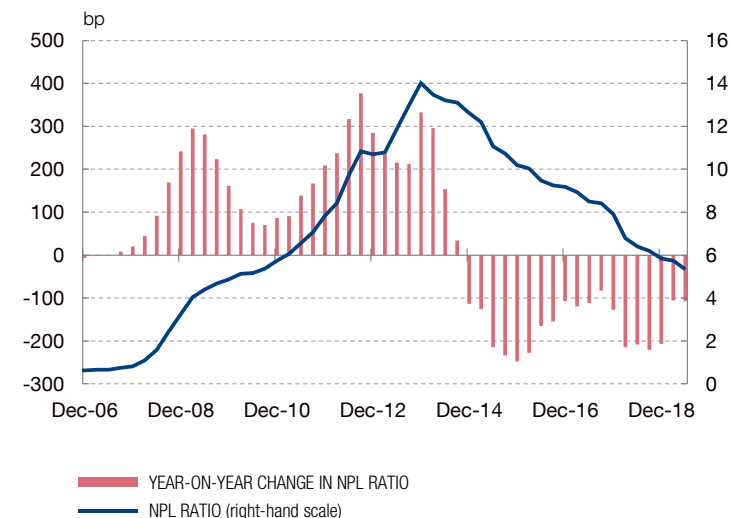


- Credit to the resident private sector continued to fall, but with its year-on-year rate of decline easing to 1.2% in June 2019
- In the past year NPLs have declined by 17.6%
- The NPL ratio continued on the decline observed in recent years, standing at 5.3% in June 2019, i.e. a year-on-year fall of over 1 pp

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



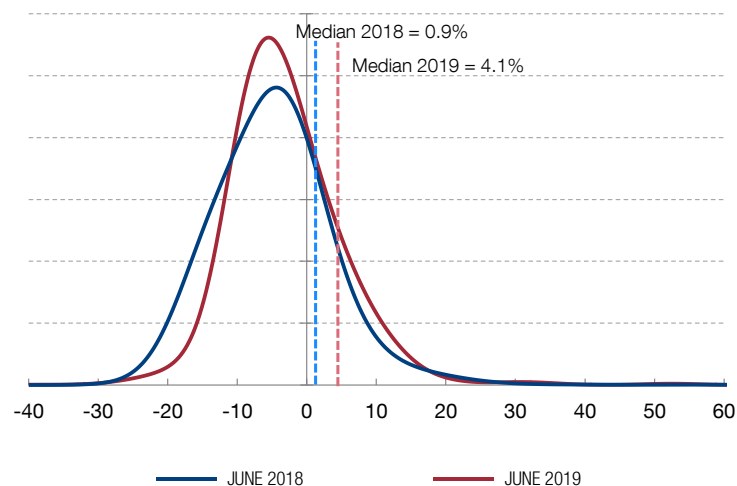
1 NPL RATIO. RESIDENT PRIVATE SECTOR
Business in Spain, ID



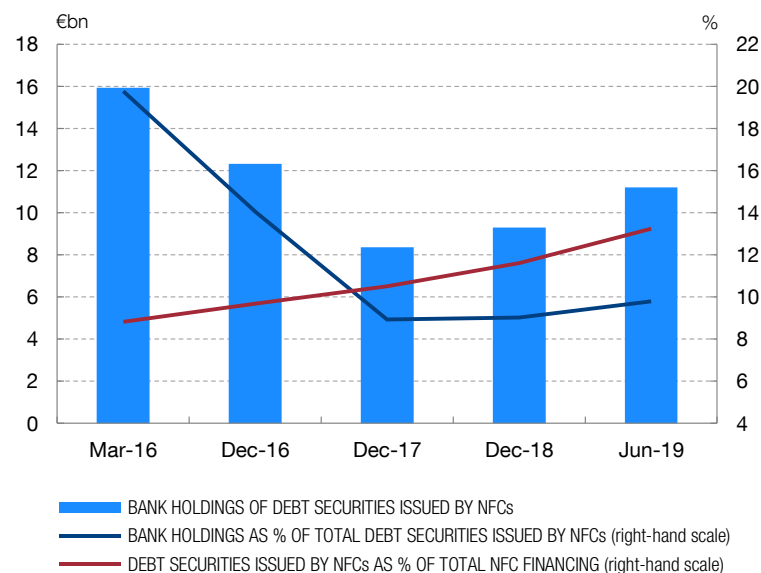
Credit growth distribution and financing to non-financial corporations

- The decline in credit was across the board among the largest institutions
- Small deposit institutions' loans to non-financial corporations increased
- As regards other bank financing to non-financial corporations, bank holdings of non-financial corporations' debt has risen somewhat since 2017, up to 10% of total issuances

2 DISTRIBUTION OF THE YEAR-ON-YEAR RATE OF CHANGE (%) OF CREDIT TO NON-FINANCIAL CORPORATIONS (a)

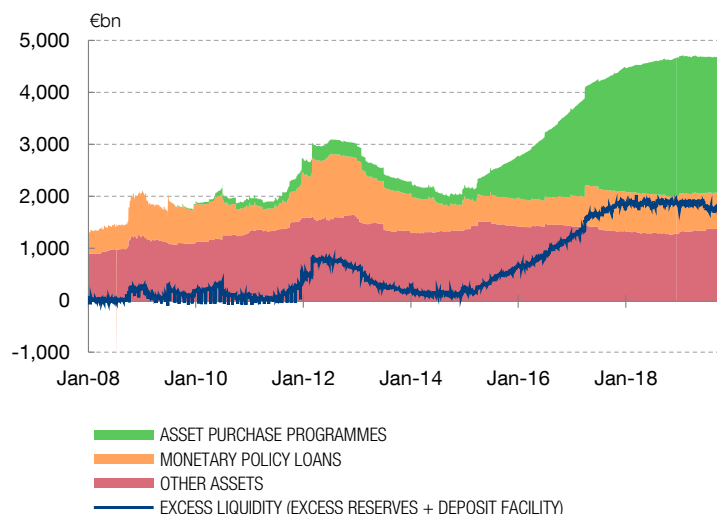


2 BANK HOLDINGS OF DEBT SECURITIES ISSUED BY NON-FINANCIAL CORPORATIONS (NFCs)

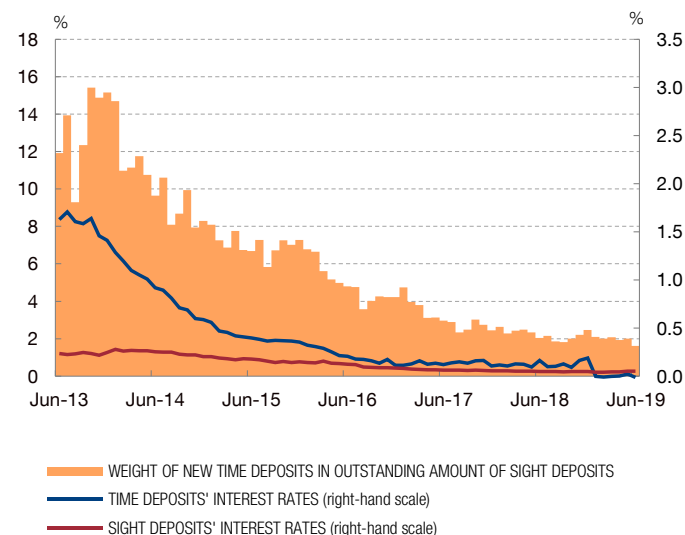


- The liquidity provided by the Eurosystem to banks will probably increase further to the monetary easing measures recently approved by the ECB (Box 1.2)
 - Thus, the decision to re-start net purchases from 1 November will lead to an increase in the Eurosystem balance sheet of €20 billion per month
- Interest rates on new term deposits have fallen significantly in recent years, to levels close to 0%,...
 - ... meaning that term deposits continue to decline and sight deposits to increase

1 EUROSYSTEM BALANCE SHEET AND EXCESS LIQUIDITY

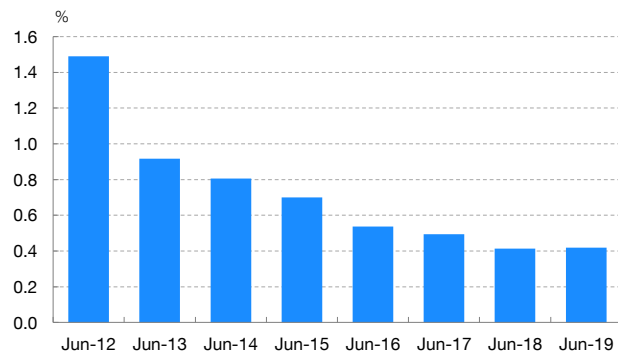


1 DEPOSITS FROM HOUSEHOLDS AND NON-FINANCIAL CORPORATIONS
New business

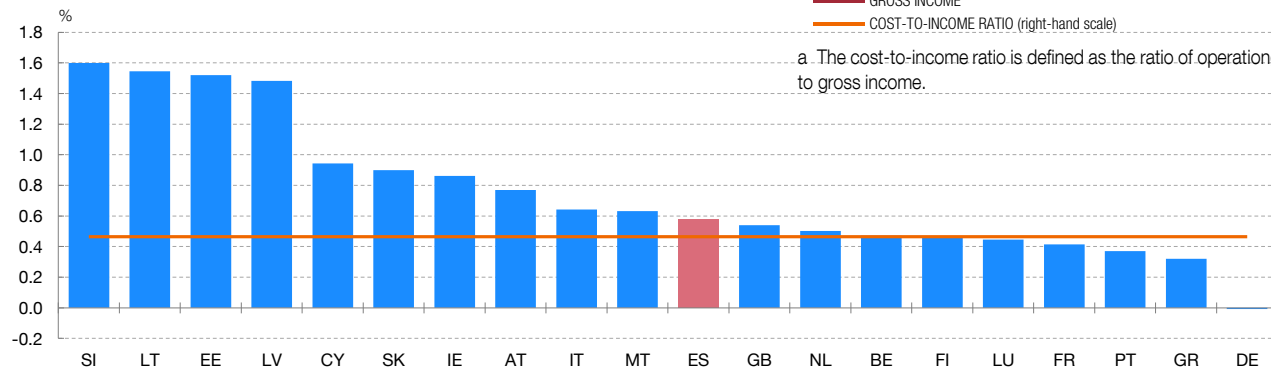


- Consolidated profit in the Spanish banking sector fell by around 11.5% y-o-y in June 2019
 - The increase in operating expenses, the decline in gains (losses) on financial assets and liabilities and a slight increase in impairment losses are the main factors behind this fall
- Despite this fall, the sector's ROA is above the European average and the main EU economies, with the exception of Italy

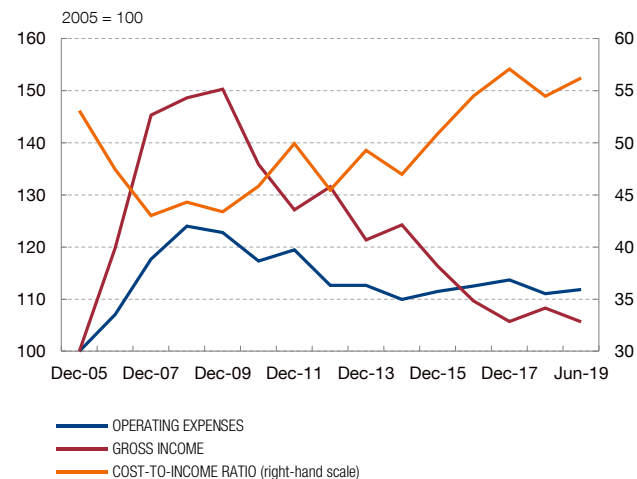
2 FINANCIAL ASSET IMPAIRMENT LOSSES AS % of ATA



1 ROA



1 COST-TO-INCOME RATIO (a)



a The cost-to-income ratio is defined as the ratio of operating expenses to gross income.

BOX 2.1. DIFFERENCES IN PRICE-TO-BOOK RATIOS AND PROFITABILITY OF EUROPEAN AND US BANKS

- Despite the fact that before and during the crisis the P/B ratios of the main European and US banks were similar, following the recovery P/B ratios diverged, and were higher in the United States
- There is a positive relationship between the P/B ratio and profitability
 - Both P/B ratios and ROA and ROE have been higher for US banks since 2011

Chart 1
P/B RATIO OF MAIN LISTED EUROPEAN AND US BANKS, 2007-2019 (a)

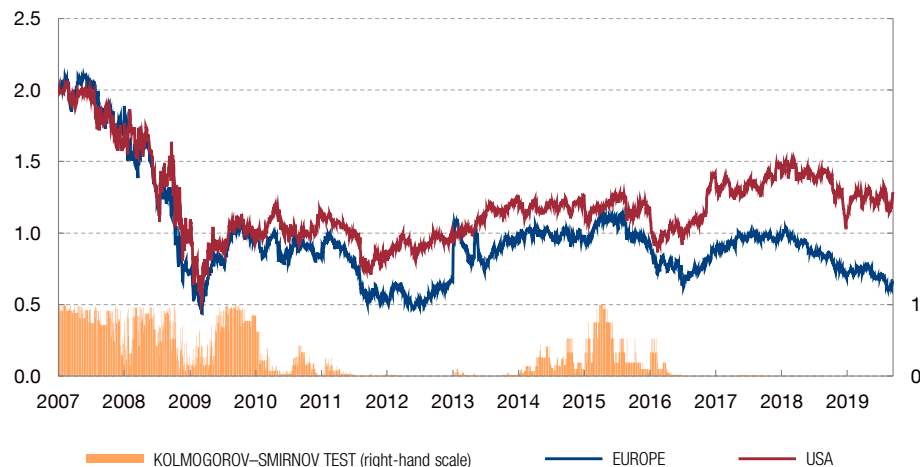
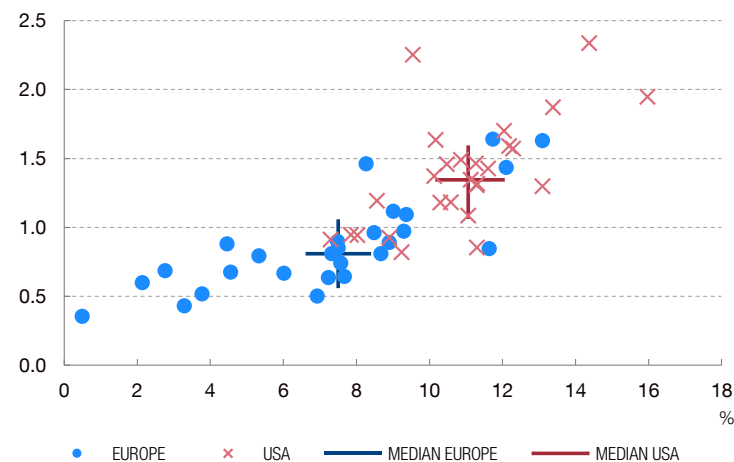
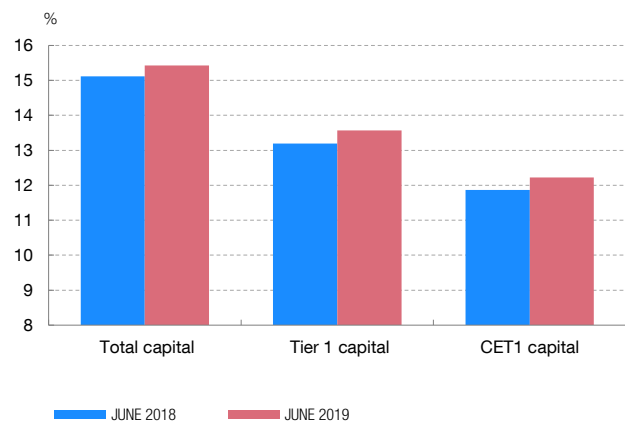


Chart 2
RELATIONSHIP IN 2018 BETWEEN P/B RATIO (VERTICAL AXIS) AND ROE (HORIZONTAL AXIS) OF MAIN LISTED EUROPEAN AND US BANKS (a)

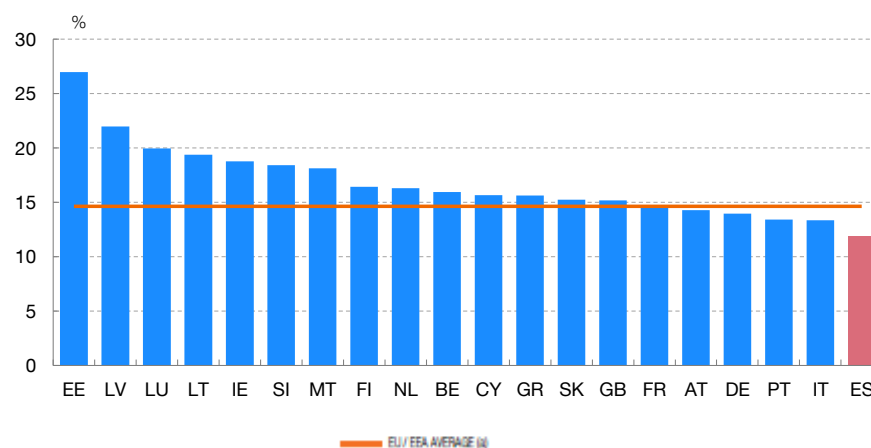


- The CET1 ratio increased by 36 bp over the past year owing to the greater accumulation of reserves of the large institutions, to stand at 12.2% in June 2019
 - The Tier 1 capital and total capital ratios increased by 37 bp and 32 bp, respectively
- Despite this increase, Spanish institutions' solvency ratios were lower than those of other European countries in June 2019
- Although their position is better in terms of the leverage ratio

1 CAPITAL RATIOS

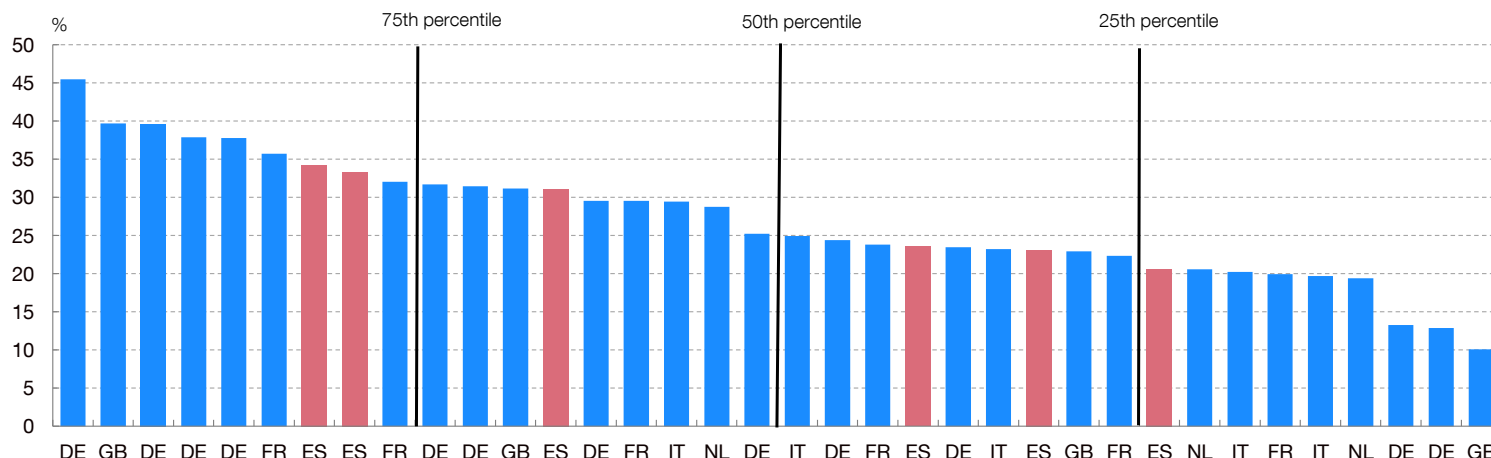


1 CET 1 RATIO



- One of the reasons for Spanish institutions' lower CET1 ratio compared with their European counterparts is Spanish banks' more intensive use of the standard approach (SA)
- However, there do not appear to be significant differences in the densities obtained with IRB models between Spanish banks and those under other European jurisdictions

EUROPEAN COMPARISON OF RWA DENSITY IN THE IRB PORTFOLIO (a)
MAIN SSM COUNTRIES AND UNITED KINGDOM. June 2018
Consolidated data

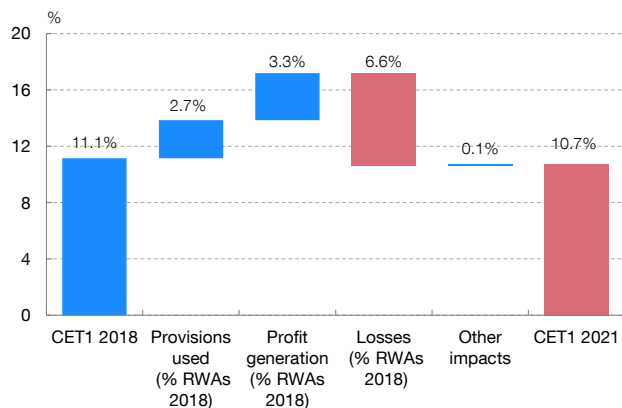


FLESB. Resilience of the Spanish banking sector (2019-2021)

- Under the baseline scenario, where the likelihood of occurrence is greatest, the three groups of institutions see their capital ratio increase by around 1 pp
- Under the adverse scenario, the banks that would experience the biggest impact would be the other SSM institutions. These would see their CET1 (FL) ratio decline by 2.6 pp, a far greater fall than that of SSM institutions with significant international activity (0.4 pp) and that of less significant institutions (0.6 pp)
- Therefore, Spanish deposit institutions show, at the aggregate level, appropriate resilience in the event of the materialisation of the risks identified under the adverse scenario, though they should not ease back on their efforts to raise their level of solvency

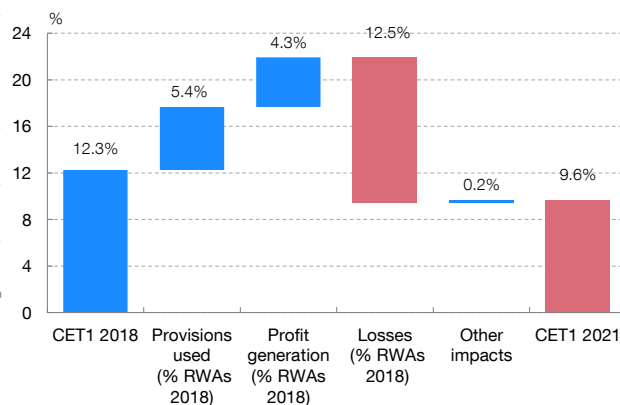
INSTITUTIONS WITH SIGNIFICANT INTERNATIONAL ACTIVITY

2 ADVERSE SCENARIO



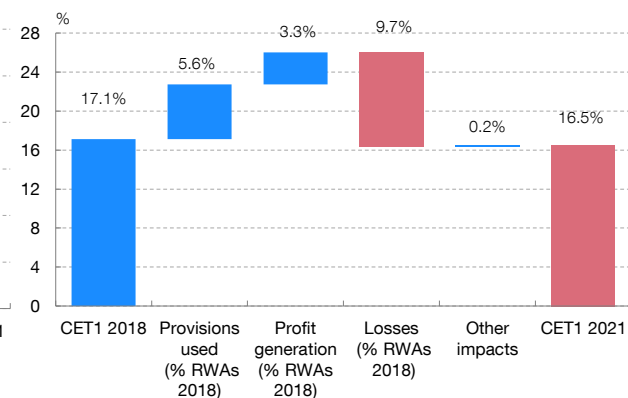
OTHER SSM INSTITUTIONS

2 ADVERSE SCENARIO



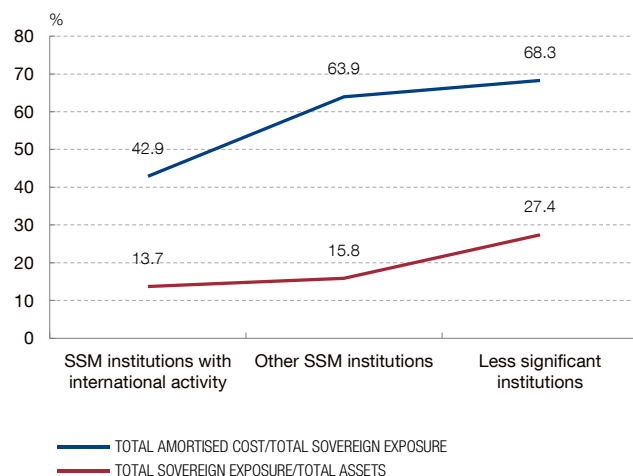
LESS SIGNIFICANT INSTITUTIONS

2 ADVERSE SCENARIO

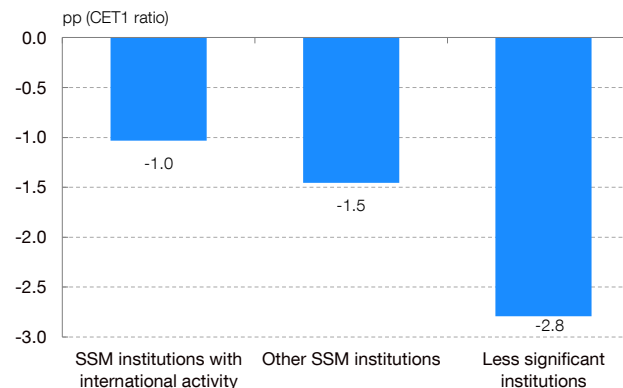


- On the basis of the stress test, a sensitivity analysis is conducted reclassifying all sovereign exposure at amortised cost under the fair value criterion
- This analysis shows a broad reduction in the CET1 ratio under the adverse scenario:
 - The institutions with the biggest impact are the less significant institutions, which would see their CET1 (FL) ratio fall by a further 2.8 pp, a greater figure than that for other SSM institutions (1.5 pp) and for SSM institutions with significant international activity (1 pp)

1 SOVEREIGN EXPOSURES (a)
December 2018

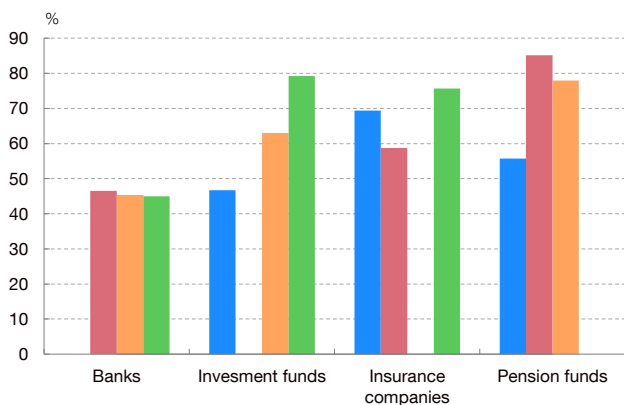


2 SENSITIVITY TO THE ACCOUNTING CLASSIFICATION OF SOVEREIGN EXPOSURE (b), ADVERSE SCENARIO. CHANGE IN CET1 RATIO

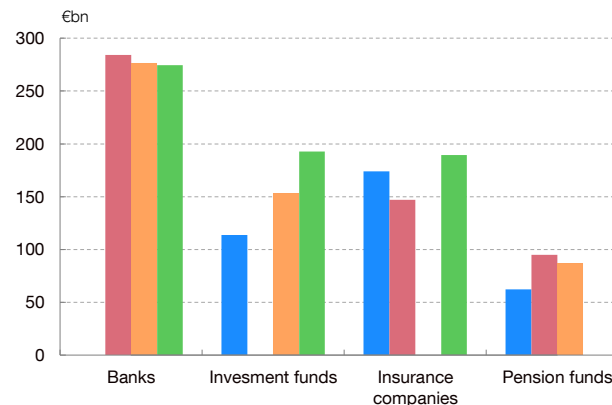


- Indirect interconnections among financial sub-sectors capture the similarities between their marketable securities portfolios
 - This may be a contagion channel, since if a financial intermediary is in trouble and sells a portion of its portfolio, affecting the price of such securities, the other intermediaries holding the same securities will incur losses
- The percentage of common exposures with other financial sectors in the portfolios of marketable securities of banks, funds and insurance companies resident in Spain exceeds 45%

1 COMMON HOLDINGS AS A PERCENTAGE OF TOTAL PORTFOLIO



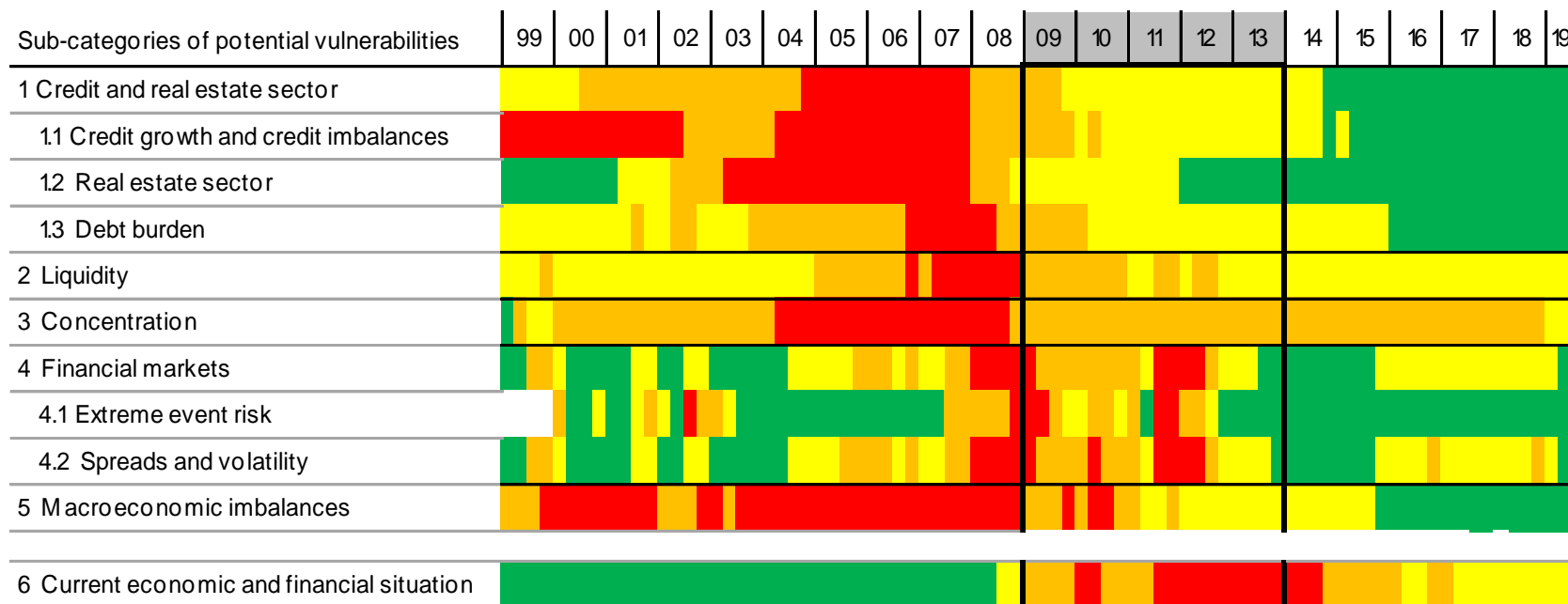
2 VOLUME OF COMMON HOLDINGS



■ BANKS
 ■ INVESTMENT FUNDS
 ■ INSURANCE COMPANIES
 ■ PENSION FUNDS

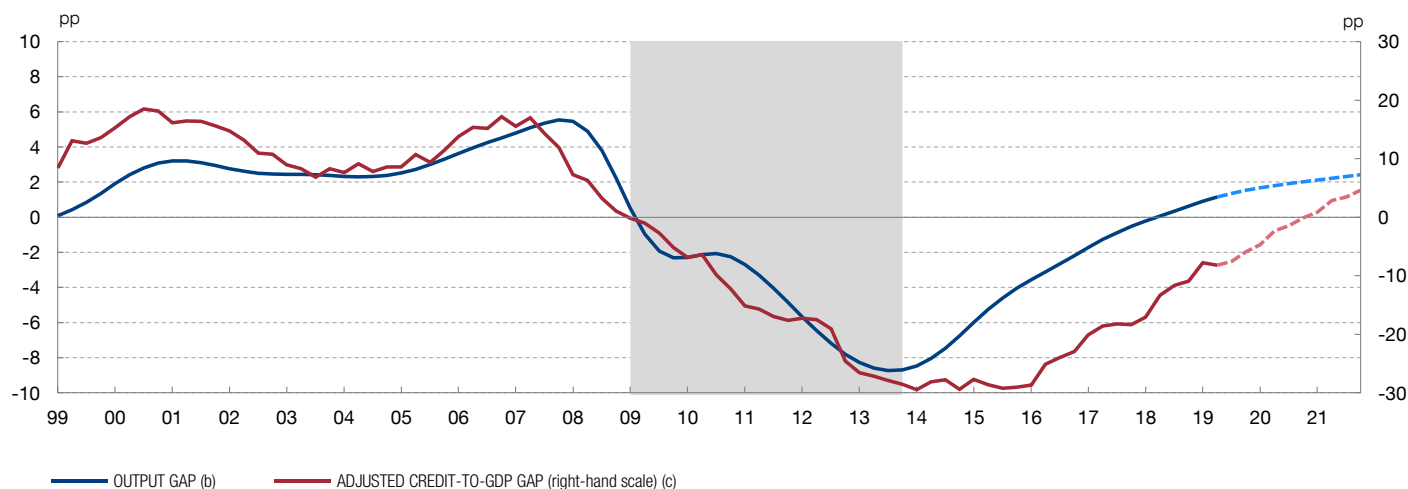
- The map of indicators of systemic vulnerabilities, which aggregates the information on a broad set of indicators in terms of their ability to anticipate systemic banking crises, does not show signs of a build-up of systemic risk

HEAT MAP BY SUB-CATEGORY (a) (b)



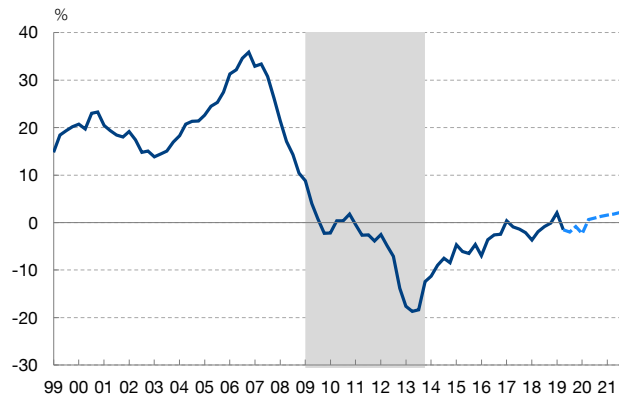
- In 2019 Q3 and Q4, the Banco de España kept the CCyB at 0%
- The credit cycle continues to show values below the systemic risk thresholds, although it is converging progressively to them
- The output gap has been positive since the start of the year, and in the future it is forecast to continue growing

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

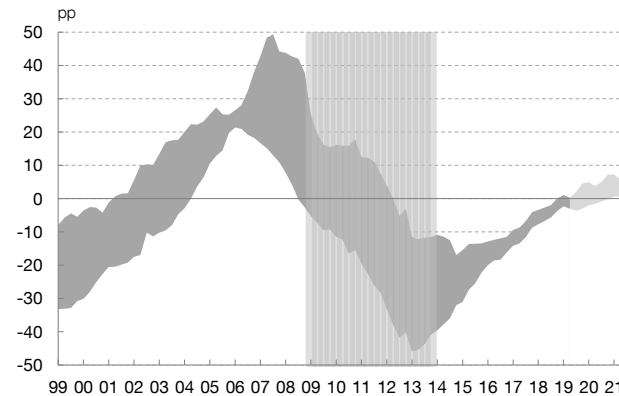


- Some supplementary quantitative indicators also point to a growing trend over the next two years, particularly credit intensity and house prices imbalance

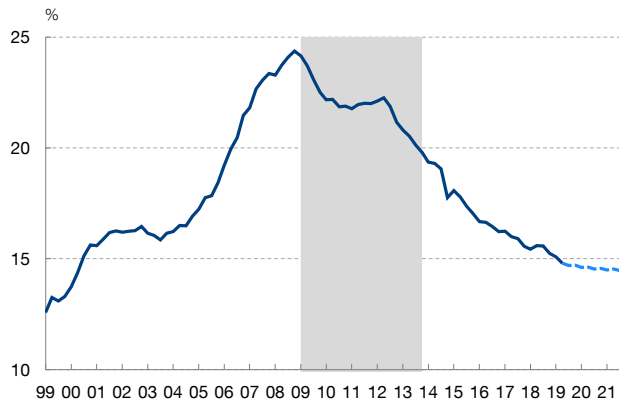
1 CREDIT INTENSITY (b)



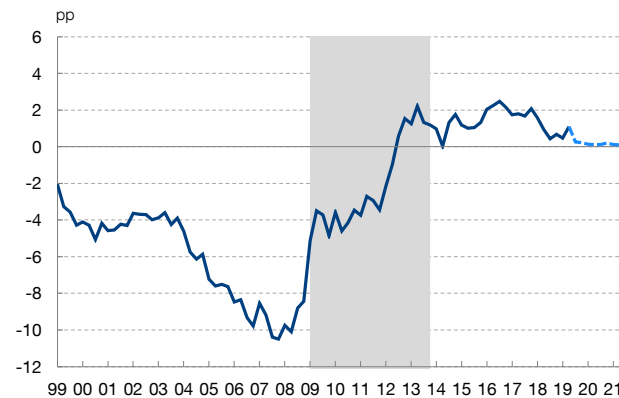
2 INDICATORS OF HOUSE PRICE IMBALANCES (c)



3 PRIVATE SECTOR DEBT BURDEN (d)



4 CURRENT ACCOUNT BALANCE (% OF GDP) (e)



- On current available forecasts, several benchmark indicators would exceed the activation thresholds for this buffer in the first half of 2021
- While the macroeconomic environment is potentially conducive to the activation of the CCyB, this diagnosis is contingent upon the materialisation of the forecast baseline scenario which, at present, is subject to numerous downside risks
- The CCyB is an instrument designed to be released in recessionary phases. The decision on the specific release time would be adopted on the basis of a range of quantitative and qualitative indicators on the position of the financial cycle
- In the event of the release of the CCyB, its effect on institutions' requirements would be immediate
- The empirical evidence available for Spain highlights significant asymmetry between the (relatively) low costs of activating the CCyB and the (relatively) high benefits of its release in recessionary phases

- The Banco de España is starting to analyse other medium- and long-term risks to financial stability:
- The energy transition and climate change risk (**Box 3.1**)
 - *Climate change might have a most significant adverse impact at the macroeconomic level, and on the financial sector (physical risks and transition risks, with a possible impact on credit, market and operational risks). The impact would be above all in the medium and long term*
- Technological change risk (cryptocurrencies) (**Box 3.2**)
 - *The creation of virtual currencies (e.g. Libra by Facebook) may significantly affect monetary policy effectiveness and financial stability (procyclicality of aggregate money supply, impact on financial institutions and on their stability, impact on foreign exchange markets, additional vulnerability in countries with some degree of financial instability, etc.). Other issues include the possible private appropriation of seigniorage, control over private financial information, AML, etc.*

THANK YOU FOR YOUR ATTENTION

