MAIN RISKS TO THE STABILITY OF THE SPANISH FINANCIAL SYSTEM

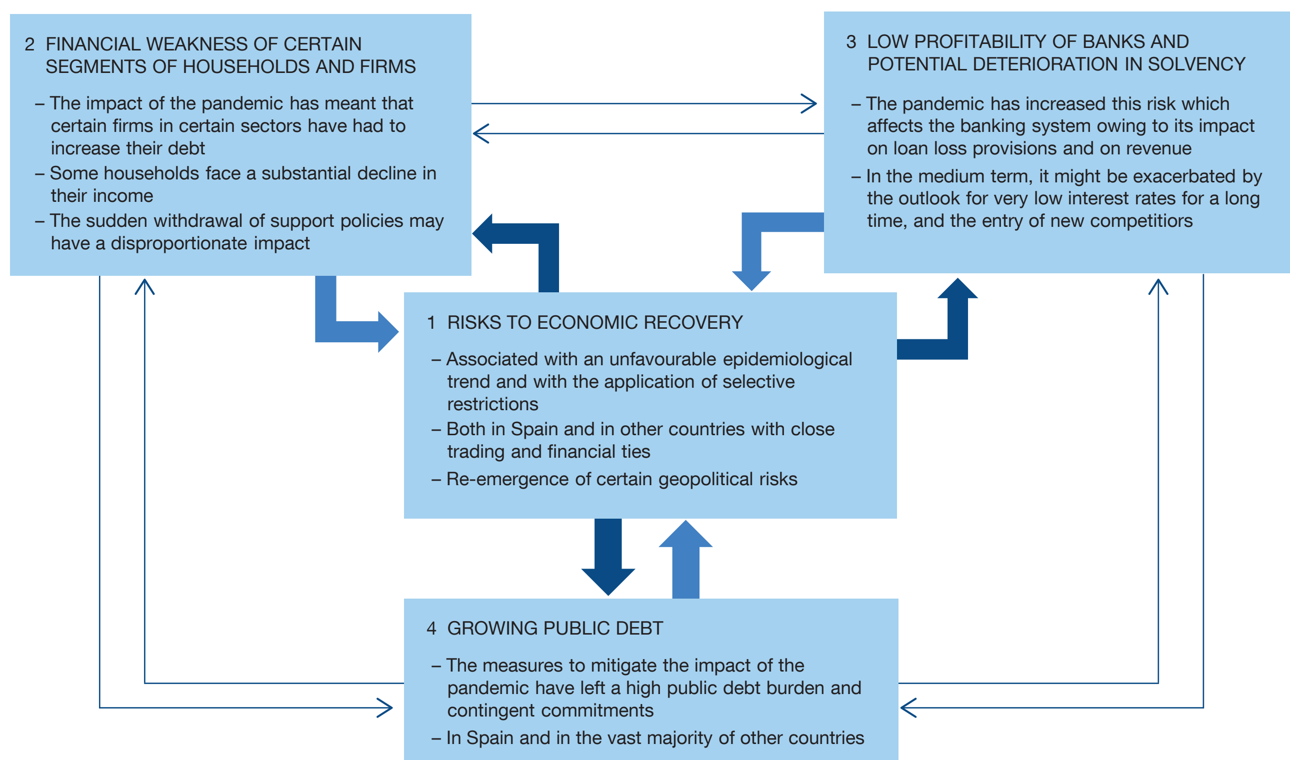
The COVID-19 pandemic and the restrictions implemented to contain it have had an unprecedented effect on global economic activity. They have likewise impacted Spain, notably raising the risks to financial stability, which have been mitigated by economic policy action. Specifically, the economic crisis prompted by the pandemic has significantly affected household and corporate income, although the economic policy measures have alleviated these effects through various means. In the case of non-financial corporations, the loss of revenue, which has been most significant in some productive sectors, has meant they have had to take on greater debt. However, the public guarantee programmes for bank lending have smoothed this process. As regards households, losses of income and jobs have run high, but would have been higher still had the various income support schemes not been implemented. Moreover, the possibility of postponing households' financial obligations by means of moratoria has also helped temporarily ease the pressure on their available funds.

The economic policy measures adopted have had a most significant mitigating effect on agents' incomes and on their financial position. In the absence of these measures, there would have been a marked and sudden increase in bad debts. That would have obliged financial institutions to assign a substantial volume of resources to provisioning, making it difficult for them to continue providing the funding needed to sustain productive activity. The outcome would have been a deepening of the recession and more lasting harm inflicted on the productive system. In any event, banks' income statements, which had already been squeezed before the pandemic, have been adversely affected by the crisis owing largely to extraordinary provisioning in anticipation of the potential credit impairment that might materialise in the coming quarters.

The economic downturn and the measures implemented by the different tiers of government are proving to have a high cost in terms of the increase in public debt. In the absence of the measures, the harm to the business sector and the loss of jobs would have been greater, foreseeably resulting in a more marked worsening in public finances. In any event, this increase in public debt is, looking ahead, a factor of vulnerability.

How the risks to financial stability evolve will largely depend on the pandemic and its economic effects. Following the period of confinement, lockdown-easing allowed for a rapid but partial rebound in activity. However, during the summer there were increasingly patent signs of a loss of momentum in the recovery, in step with the heightening resurgence of the pandemic. The fresh outbreaks entail adverse

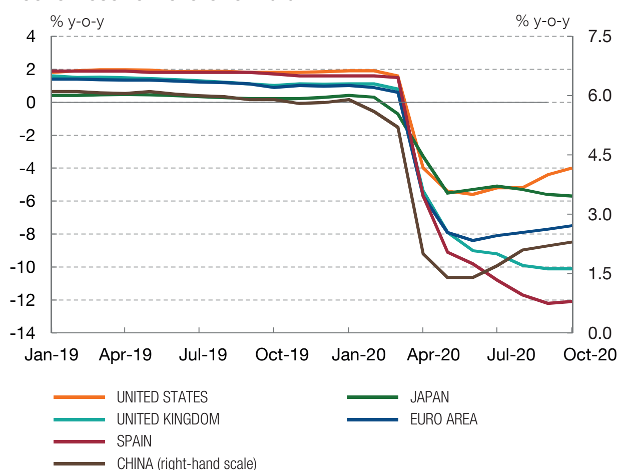
Scheme 1
MAIN RISKS TO FINANCIAL STABILITY IN AUTUMN 2020

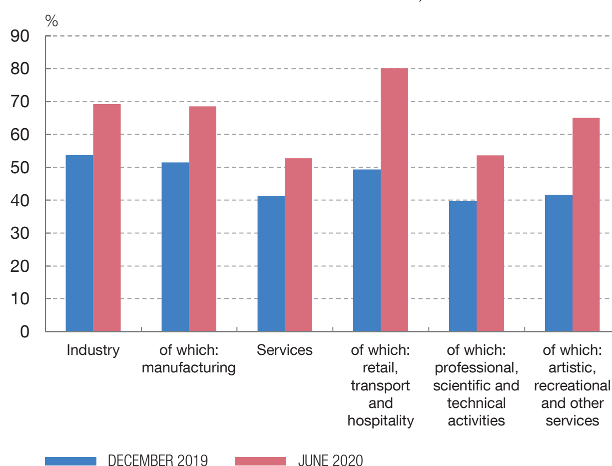


SOURCE: Banco de España.

consequences for economic activity through various channels. These include the need to restore infection-containment restrictions, the unfavourable effects of uncertainty on spending decisions and the emergence of turbulence on financial markets. Such effects might heighten pre-existing risks, in particular the financial weakness of certain households and firms, the low profitability of financial institutions and the increase in public debt (see Scheme 1).

The materialisation of these risks will also hinge critically on the economic policy reaction. In the current situation of partial, uneven and uncertain recovery, maintaining stimuli is crucial. The stimuli should now be much more targeted on the agents most affected and their timescale adjusted to the duration of the crisis. The worsening of the crisis and of the risks to financial stability would call for an additional and forceful European response. In parallel, economic policy action should be geared to assisting and supporting the adaptation of the productive system and of workers to the structural changes and harm caused by the pandemic and the efficient cross-sectoral and cross firm reallocation of resources. The task is a complex one but it is crucial for rooting the recovery in the short term and consolidating future potential growth.





SOURCES: IHS Markit, Consensus Forecast, INE and Banco de España.

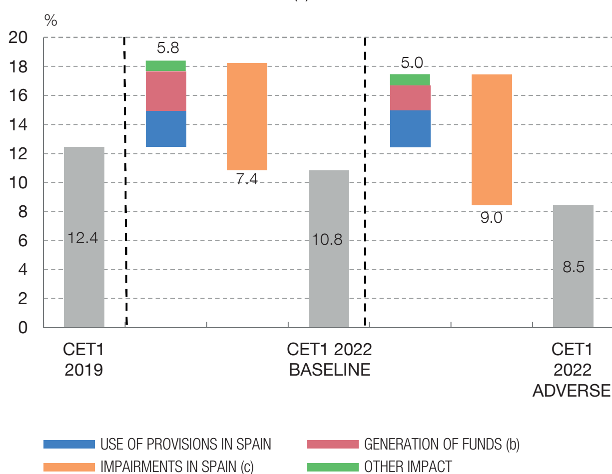
There follows a summary of the main risks to financial stability in the current environment:

1. **Risks to economic recovery.** As indicated, the worsening of the pandemic already appears to have adversely impacted economic activity (see Chart 1). A slower than expected recovery would mean that household and corporate income would be more modest and their financial vulnerability greater, with the pick-up in employment and in spending on consumption and investment being further delayed. Financial institutions would also see their profitability decline as they had to assume greater costs relating to asset impairment. Finally, weaker activity would lead to a further worsening in public finances.

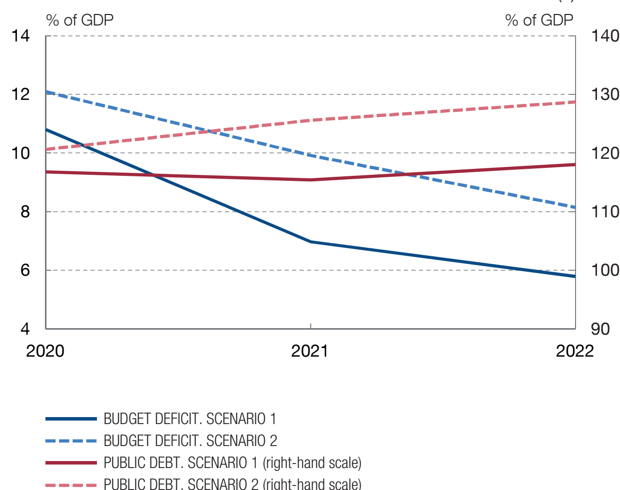
2. **Financial weakness of certain segments of households and firms.** The crisis has prompted an increase in the debt of the business sector, whose financial vulnerability is, therefore, higher. The process has not been uniform. It is affecting small-sized companies to a greater extent and, especially, those operating in the sectors most affected by the shock (see Chart 2). In the case of households, the reduction in income is increasing the financial pressure borne by certain segments, especially those with higher debt and whose income has been more affected by the shock. Against this background, there is a risk of a slowdown in consumption and investment and an increase in non-performing loans that would directly impact banks' results and public finances.

3. **Low profitability of banks and potential deterioration in solvency.** The risk associated with the low profitability of banks, which is below the cost of capital, had already become patent before the pandemic and was

3 FLESB PROJECTIONS. CET1 RATIO (a)



4 BANCO DE ESPAÑA BUDGET DEFICIT AND PUBLIC DEBT FORECASTS (d)



SOURCES: IGAE and Banco de España.

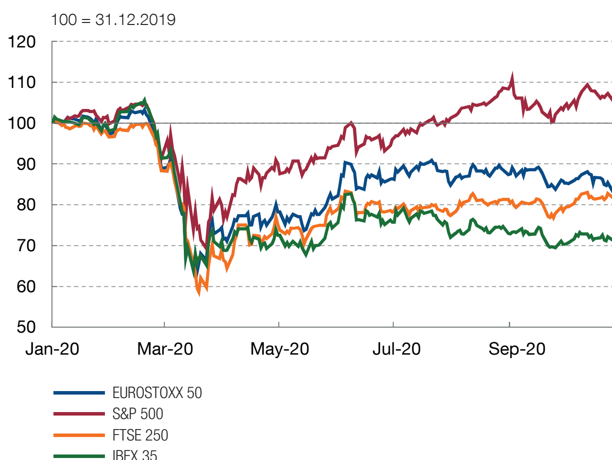
a The net effect of positive (negative) flows is indicated in the data label above (below) the related bar. The initial and final CET1 ratios are presented as "fully loaded". The remaining impacts include, among other effects, the change in RWAs from 2019 to 2022.
b This variable includes the operating margin in Spain and the net income attributable to business abroad.
c This variable shows the projection for the three years of the exercise of the gross loss due to credit portfolio impairment for exposures in Spain and other types of losses (associated with the fixed-income portfolio, with the management of foreclosures and with the sovereign portfolio).
d Macroeconomic scenarios of the Banco de España projections published in September 2020. Scenario 1 envisages the emergence of fresh outbreaks which, however, will solely require limited containment measures, both from the standpoint of regions and of the sectors affected. Scenario 2 envisages greater intensity of the fresh pandemic outbreaks which, nonetheless, would not need such strict and widespread containment measures as those in force prior to lockdown-easing.

common to most European banking systems. The crisis is expected to exacerbate this situation as a result of the increase in loan impairment provisioning, the reduction in revenue and the additional adjustments in the valuation of other assets. Against this backdrop, the stress tests performed anticipate adverse effects on banks' solvency ratios, on a scale that depends on the scenario considered (see Chart 3).

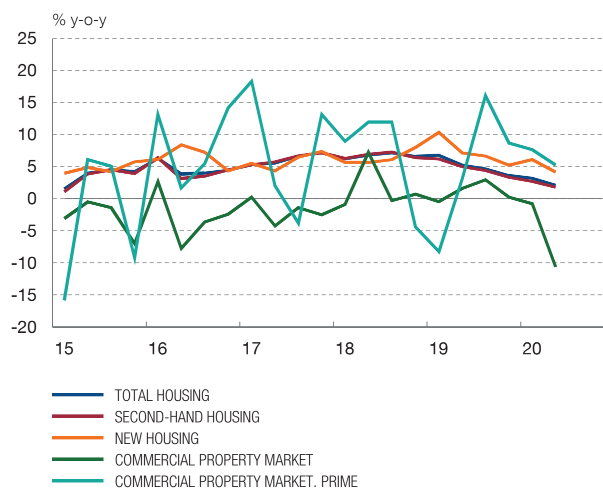
4. **Growing public debt.** The general government response to the crisis has served largely to mitigate the initial sudden impact of the pandemic on households and firms, but it has resulted in a sizeable increase in public debt (see Chart 4). Action by the European Central Bank (ECB) and the European fiscal response have so far prevented this deterioration in public finances from translating into an increase in the yields demanded on sovereign debt. But maintaining high public debt over time is a factor of chronic vulnerability to changes in market sentiment. Accordingly, a plan is needed to re-balance public finances. It should be launched once a path of economic recovery has firmed and should gradually, but in a sustained fashion over time, reduce the debt to which the crisis has given rise.

Beyond these risks, in recent months the prices of risky assets on international financial markets have recovered significantly from their slump at the start of the pandemic. This recovery has been assisted by the unprecedented economic

5 STOCK MARKET INDICES



6 HOUSING AND COMMERCIAL PROPERTY MARKET PRICES

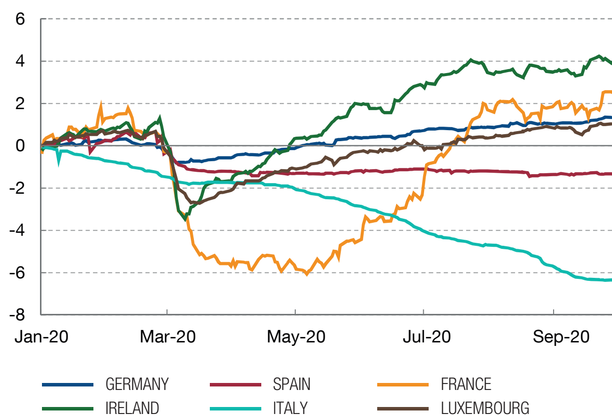


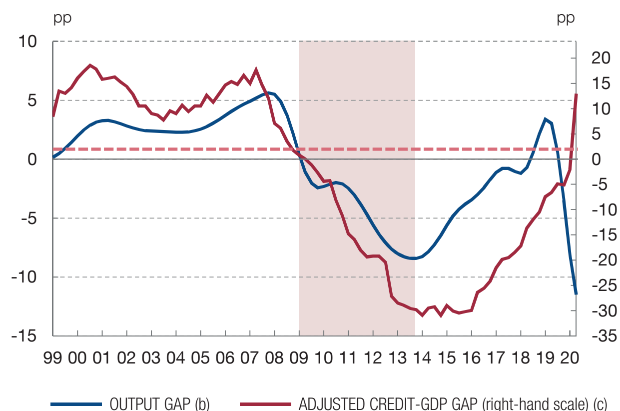
SOURCES: Thomson Reuters Datastream, Tinsa and Colegio de Registradores.

policies implemented. They include most notably more expansionary monetary policies, conventional and unconventional alike. In some cases assets have appreciated most considerably, posing the possibility of a disconnect between financial markets and real activity. So far, this risk appears to be concentrated in certain geographical areas, sectors and instruments (see Chart 5).

In Spain's real estate market there has been a significant decline in transactions and in the residential segment's activity during the lockdown, while the adjustment in prices has been on a lesser scale. The initial contraction in activity in the sector has been followed by a partial recovery as the restrictive measures eased. Prices have slowed, but an across-the-board decline has not been observed so far. In the commercial property segment, the fall-off in activity has also been very significant and accompanied by declines in valuations; that said, prices in prime zones have shown greater downward stickiness (see Chart 6).

The potential withdrawal from funds by collective investment institutions and the forced disposal of assets appear to be the main risks in the non-bank financial sector. At the onset of the pandemic a substantial withdrawal of funds by holders was witnessed. In many cases these funds were used to cover liquidity needs, but in others they sought to reduce the associated losses, shifting these funds – inter alia – to bank deposits. This meant collective investment institutions had to put a portion of their assets up for sale, exerting further pressure on market prices. Currently, these withdrawals have declined substantially (see Chart 7), but many of these funds have significant investments in assets whose risk rating is just above investment-grade. In this respect, an across-the-board downgrade to these securities by the main rating agencies, which have so far acted fairly selectively, would entail a risk to the system as a whole.





SOURCES: Refinitiv and Banco de España.

a The shaded area shows the last systemic banking crisis period (2009 Q1 to 2013 Q4). The horizontal dotted line represents the activation threshold of the CCyB equal to 2 pp.
b The output gap depicts the percentage difference between actual GDP and its potential value. Values calculated at 2010 constant prices. See Cuadrado, P., and E. Moral-Benito (2016). Potential growth of the Spanish economy. Occasional Paper No. 1603, Banco de España.
c The adjusted credit-GDP gap is calculated as the difference in percentage points between the actual ratio and its long-term trend, calculated applying a one-sided Hodrick-Prescott filter with a smoothing parameter equal to 25,000. This value fits the financial cycles historically observed in Spain better.

Changes in the systemic risk indicators are being influenced by the strong decline in GDP prompted by the pandemic. Indeed, many of these indicators are designed to capture the endogenous build-up in systemic risk. This is why they are directly influenced by variables that mark the economy's position in the financial cycle, such as credit and house prices, and are inversely related to the variables that allow their course to be relativised, usually GDP, household income and business revenue. The use of these indicators to activate preventive macroprudential tools is not appropriate when it is the latter variables that collapse, as is the case at present (see Chart 8), with the indicators that reflect the impact of the crisis on economic activity – such as the output gap – taking on much more importance. Consequently, the activation of the countercyclical capital buffer or other macroprudential capital buffers is not foreseen for a prolonged period, until the main effects of the pandemic on the economy have abated.

In the coming quarters, further credit impairment on bank balance sheets could materialise, and the authorities should be ready to respond appropriately so as to prevent this leading to an interruption in the flow of financing to the economy that adversely affects the recovery. Banks have significant capital buffers to absorb these potential losses and the supervisory authorities have reiterated that, if they fall below the previously set levels, banks will have sufficient time to replenish them. However, the use of the buffers also depends on the markets' reaction. And this is largely determined by banks' capacity to restore to health their income statements in the future. In this respect, banks have room to improve their efficiency, by cutting costs and using new technologies more intensively.

Consolidation processes in the banking sector might prove to be a useful response to the crisis, provided that banks submit a business plan that generates value and allows for the harnessing of existing synergies. Corporate operations are the responsibility of bank management teams and owners, but it is for supervisors to assess their viability case-by-case. In this connection they use cost-benefit analysis, which tests the potential benefits of the operations for financial stability, and cost and revenue synergies, against potential adverse impacts. Prudential measures can mitigate these potentially adverse effects, by being adapted to the risk profile of the merged banks and to the systemic risk resulting from the sector's consolidation.

In any event, the European policy response in respect of the banking sector should also play a key role, as monetary and fiscal policy are doing. This response might include, for example, the completion of the Banking Union with the launch of the European Deposit Guarantee Scheme. That would smooth transnational corporate operations, with greater potential for risk diversification and revenue synergies than national operations, but with a lesser immediate impact in terms of cost-cutting. So far, discussions have begun in the European setting on the need to set in place additional measures to those envisaged to date, should more adverse than expected scenarios materialise.