BANCO DE ESPAÑA
Eurosistema

FINANCIAL STABILITY REPORT
Autumn 2020

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Director General

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DIRECTORATE GENERAL FINANCIAL STABILITY, REGULATION AND RESOLUTION

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MAIN RISKS TO THE STABILITY OF THE SPANISH FINANCIAL SYSTEM

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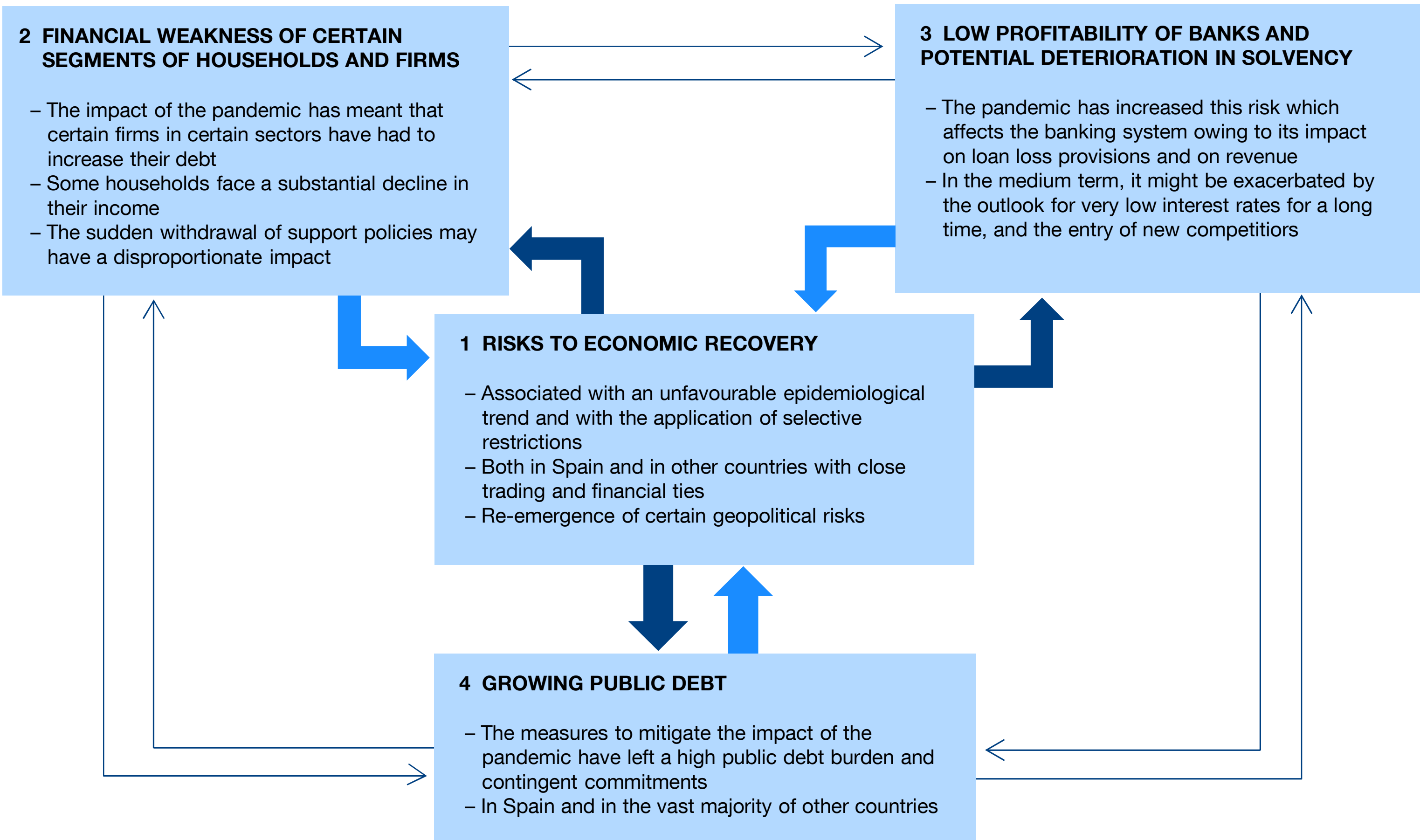
- The **COVID-19 pandemic** has had an unprecedented effect on economic activity in Spain and in the rest of the world, **notably raising the risks to financial stability**, which have been **mitigated by economic policy measures**
- The **second wave** of the pandemic could weigh on the **recovery of economic activity and heighten vulnerabilities** induced by the first wave



MAIN RISKS TO THE STABILITY OF THE SPANISH FINANCIAL SYSTEM

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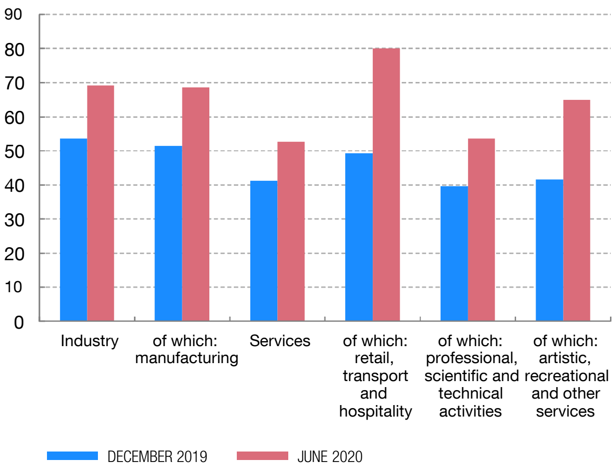
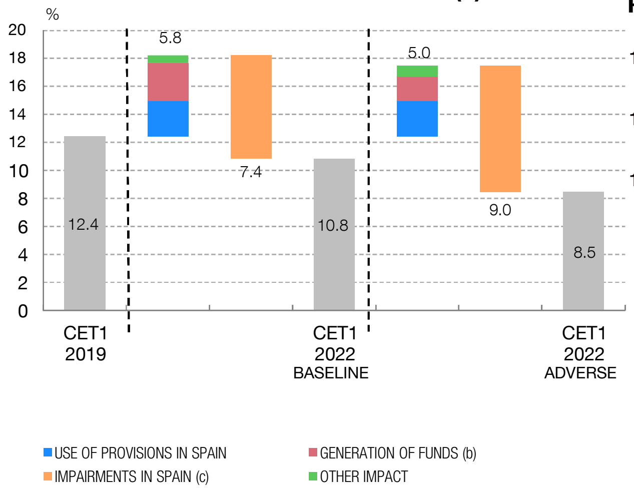
- **Financial weakness of certain segments of households and firms**
  - Many firms have had to resort to debt to cover, with the support of the public measures implemented, their liquidity needs
- **Low profitability of banks and potential deterioration in solvency**
  - Although their solvency has not been affected so far, the stress tests suggest that it could diminish substantially, even taking into account the impact of the measures adopted
- **Growing public debt**
  - The response to the crisis has resulted in a significant increase in public debt; when the effects of the pandemic abate, a credible and sufficient consolidation programme will be needed over a lengthy period of time

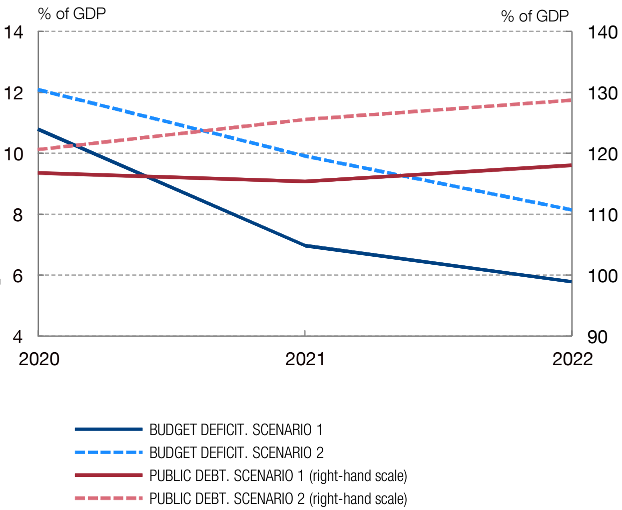
2 BANK LENDING RELATIVE TO GROSS VALUE ADDED, BY SECTOR OF ACTIVITY



3 FLESB PROJECTIONS. CET1 RATIO (a)

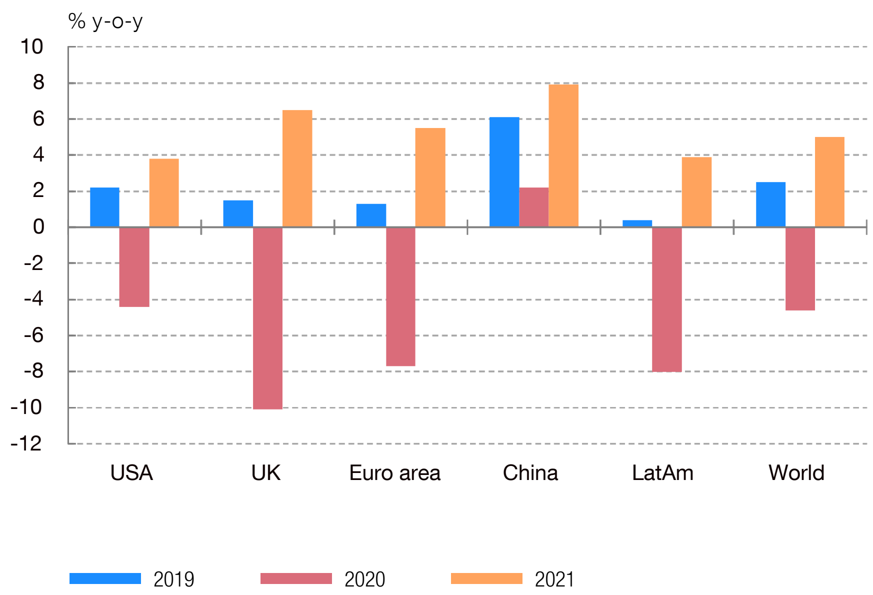


4 BANCO DE ESPAÑA BUDGET DEFICIT AND PUBLIC DEBT FORECASTS (d)

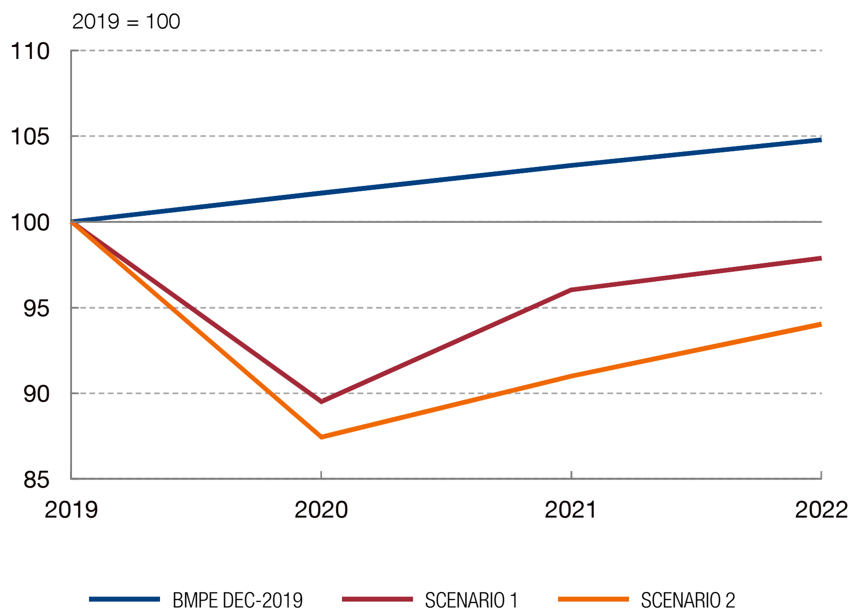


- The measures adopted to contain the pandemic led to a **historic contraction in global activity** in Q2, and **Spain was no exception**
  - Besides, the impact is particularly sizeable in some countries of material significance to Spain
- The easing of lockdown measures led to a certain pick-up in economic activity; **more recently this recovery has slowed, owing to fresh outbreaks of infection**

2 REAL GDP GROWTH FORECASTS. CONSENSUS SEPTEMBER 2020

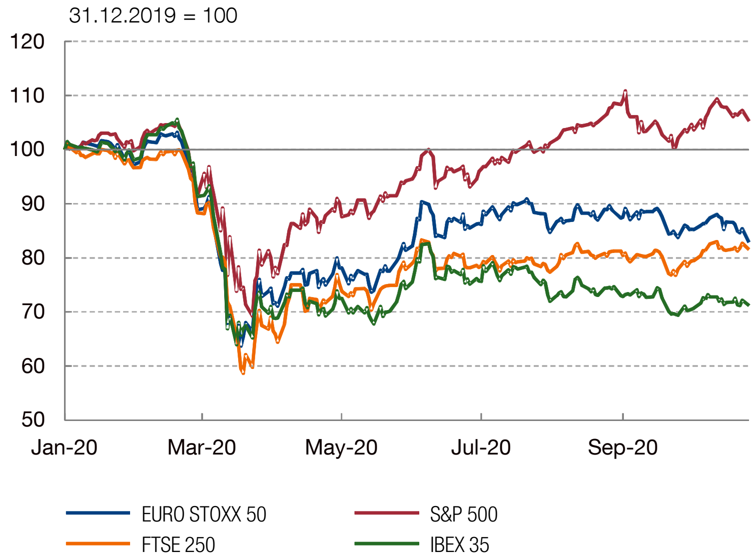


4 ANNUAL GDP LEVELS

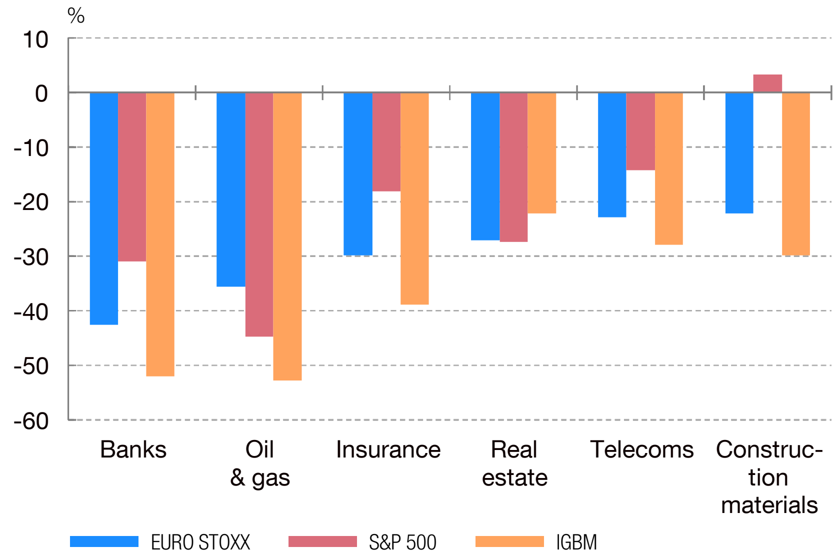


- After a strongly negative reaction from the **financial markets**, there has been a **subsequent recovery,** largely associated with the measures adopted:
  - The stock market recovery has been uneven across sectors, with the highest losses so far being in the banking sector
  - Prices of other risk-bearing financial assets have also tended to recover
  - Sovereign risk premia in the euro area have declined, assisted, in particular, by the ECB's asset purchase programme and the agreement adopted on the European support fund

1 STOCK MARKET INDICES

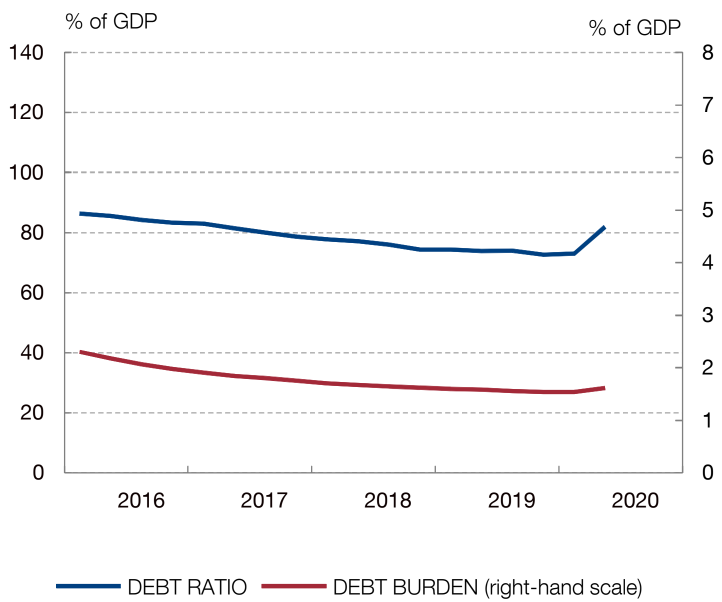


2 EURO STOXX SECTORS WITH MOST LOSSES AND EQUIVALENT FOR S&P 500 AND IGBM (FROM 21.2.2020 TO 26.10.2020)

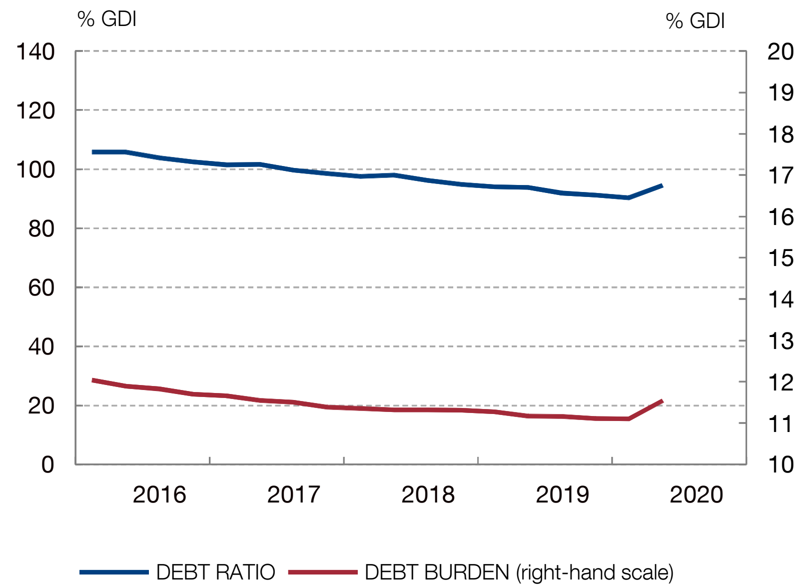


- The health crisis is causing a **sharp fall in firms' profits and returns** which, along with the increase in debt, is affecting their solvency
  - Some types of firms in certain sectors are being particularly affected
- The **outstanding balance of lending to households has decreased** owing to both supply and demand-side factors
  - But the debt and debt burden ratios have risen as a result of the decline in income, especially for certain groups

4 FIRMS' DEBT AND DEBT BURDEN RATIOS (d)



3 HOUSEHOLD DEBT AND DEBT BURDEN RATIOS (d)



BOX 1.2: LOAN MORATORIA. CHARACTERISTICS OF BENEFICIARIES AND POTENTIAL IMPACT ON NPL

- The total number of **moratorium applications** has risen over time, with **acceptance rates remaining at high levels since May**
  - Moratoria represent 4.7% of bank credit to the non-financial private sector
- The findings of the analysis show that **the more vulnerable households**, already before the pandemic, are those that **have made most use of the moratoria**
  - Once the payment holiday comes to an end, there is a high risk that these households may default on their debts, if economic activity has not returned to normal
- **Larger banks and those with a higher NPL ratio** account for a **higher percentage of moratoria**

Chart 1
CHANGE IN CUMULATIVE TOTAL APPLICATIONS AND IN RATE OF ACCEPTANCE BY MORATORIUM TYPE (a) (b)

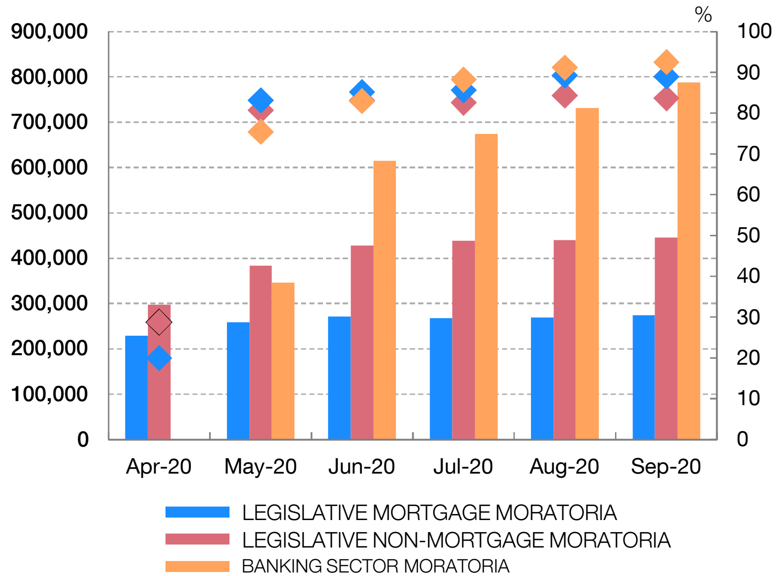
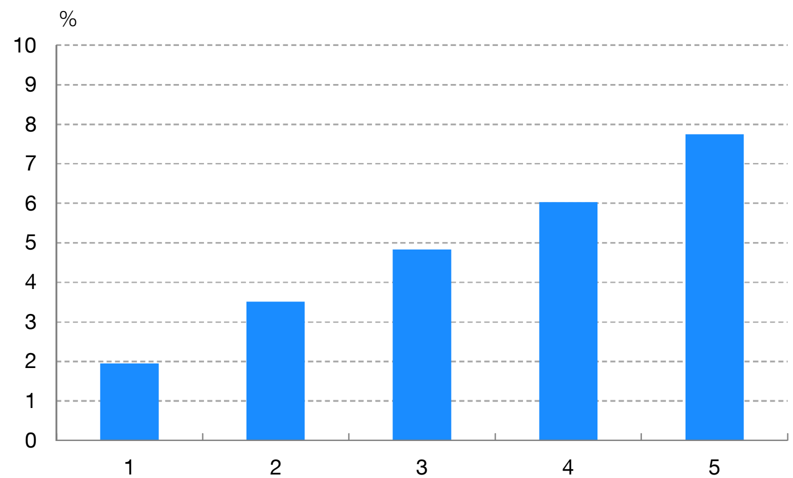
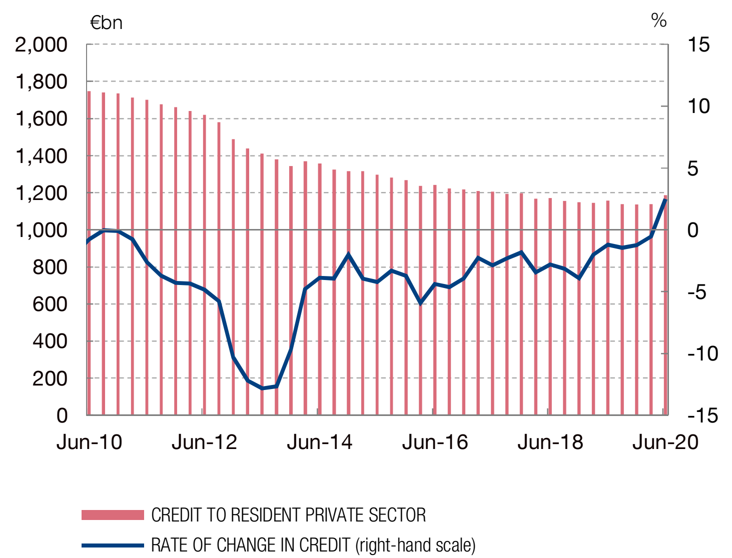


Chart 3
PERCENTAGE IN 2019 OF MORTGAGES SUBJECT TO MORATORIA BY QUINTILES OF TBD/AI RATIO (a) (b)

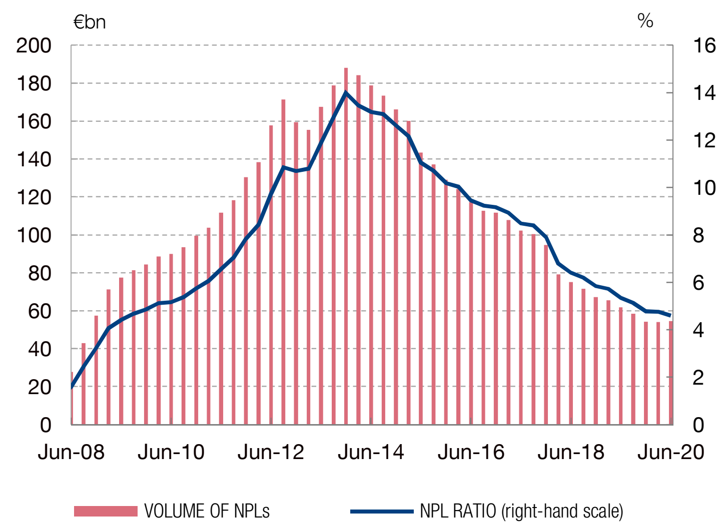


- **Lending had increased 2.5% year-on-year in June**, for the first time since the end of the 2008 financial crisis; since then, the rate of growth has stabilised
  - The public guarantee scheme has largely enabled this growth: 41% of the volume of new business loans granted during 2020 H1 is guaranteed by the State
- So far, **the sharp contraction in activity has moderately passed-through to growth in NPLs**, owing to the effect of the adopted measures which, together with the increase in credit, has caused the NPL ratio to continue to decline

1 CREDIT VOLUME AND YEAR-ON-YEAR RATE OF CHANGE
Business in Spain, ID



1 RESIDENT PRIVATE SECTOR'S NPLs AND NPL RATIO
Business in Spain, ID



BOX 2.1: EFFECTS OF THE PANDEMIC ON THE BANKING SYSTEMS MOST RELEVANT TO SPAIN

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- The **five countries most relevant** to the Spanish banking system are among those **most affected by the COVID-19 pandemic**
  - These countries have launched wide-ranging economic policy measures to promote the granting of credit, provide the system with liquidity and mitigate the adverse impact of the crisis
- **Lending in these banking systems continued to grow** in H1 and the **NPL ratio has not yet increased** significantly
  - As in Spain and in our European partners, the main indicators of these banking systems have not worsened substantially so far

Chart 5
LENDING TO THE PRIVATE SECTOR (a)

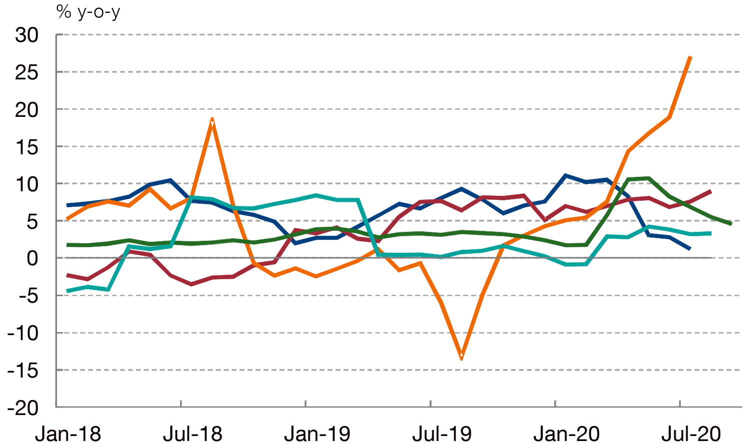
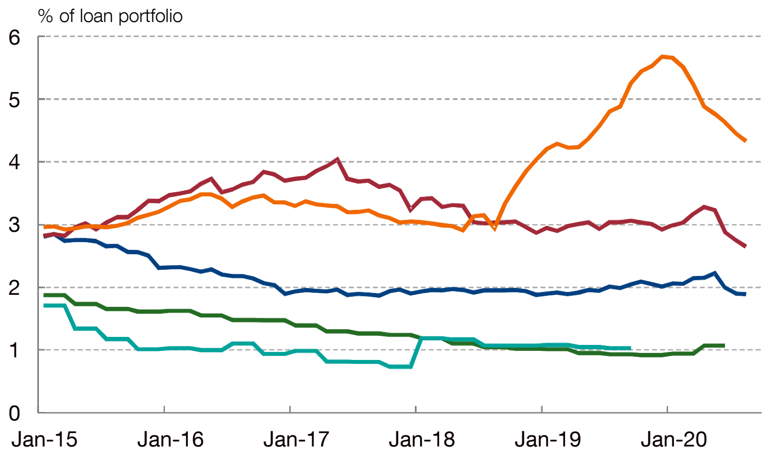


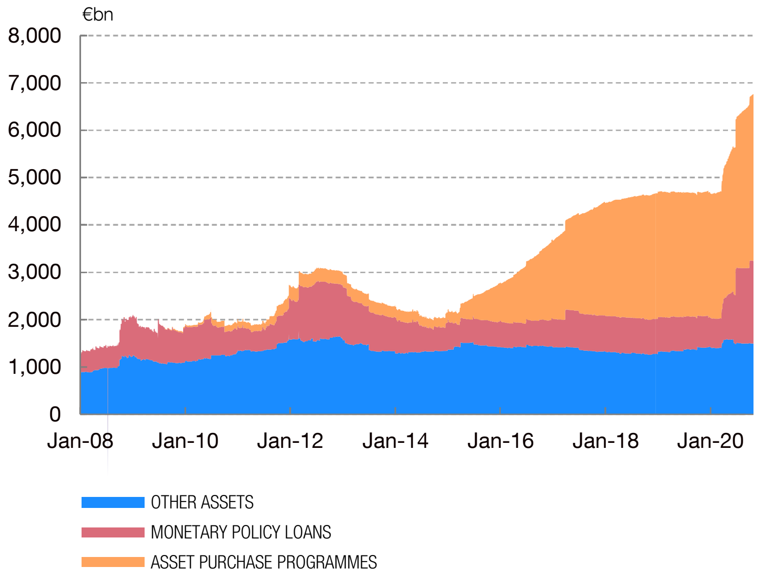
Chart 6
NON-PERFORMING LOANS



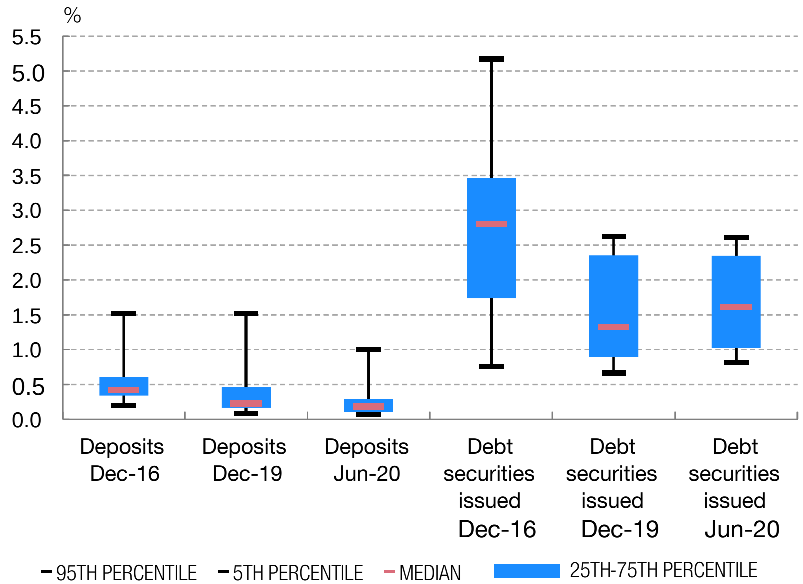
MEXICO BRAZIL TURKEY USA UNITED KINGDOM

- The volumes allotted in the refinancing operations and the expansion of the purchase programmes have entailed a **substantial increase in the liquidity provided by the Eurosystem**
  - Central banks' liquidity programmes have led to an increase in the weight of direct central bank financing to deposit institutions
- **Along with the rest of the measures,** these programmes have enabled Spanish deposit institutions' **financing costs** to remain at **relatively low levels**

1 EUROSYSTEM BALANCE SHEET AND LIQUIDITY SURPLUS

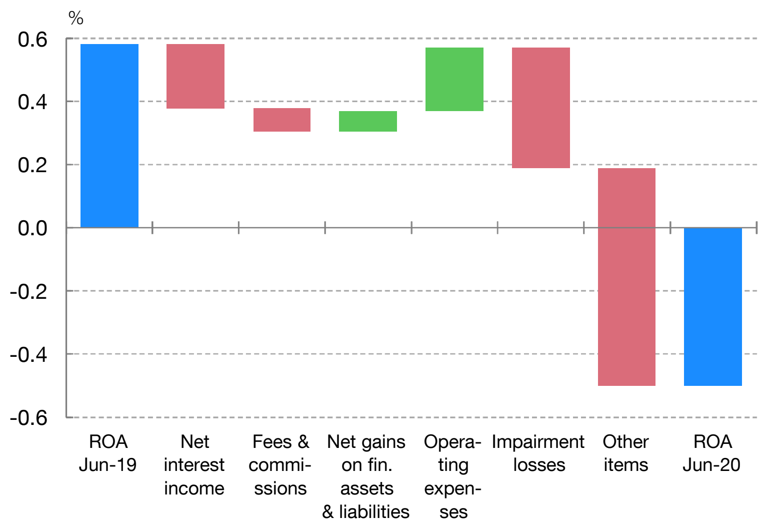


1 RATES ON DEPOSITS AND DEBT SECURITIES ISSUED (a)
Consolidated data

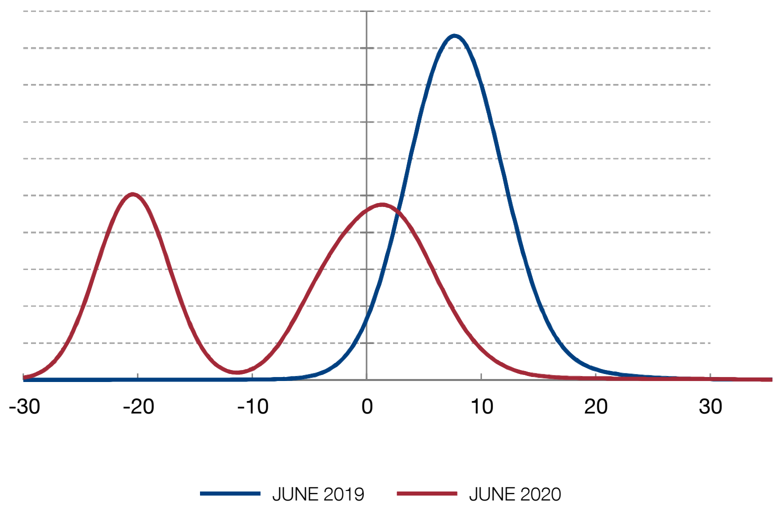


- The **impact of the pandemic on banking sector profitability in Spain has been very severe**: the consolidated net loss reported in June 2020 was €9.5 billion
  - The loss was concentrated at the two largest institutions and was primarily due to a significant negative adjustment to goodwill, with no implications for solvency
- **Most of the rest of the sector reported profit, albeit considerably down on the 2019 figure**:
  - Higher provisions and lower net interest income and commissions were the main determinants of the fall in profit
- **Profitability declined across the board in Europe**, with several countries' banking systems posting a loss

2 BREAKDOWN OF THE CHANGE IN PROFIT
Consolidated profit as a percentage of ATAs (a)

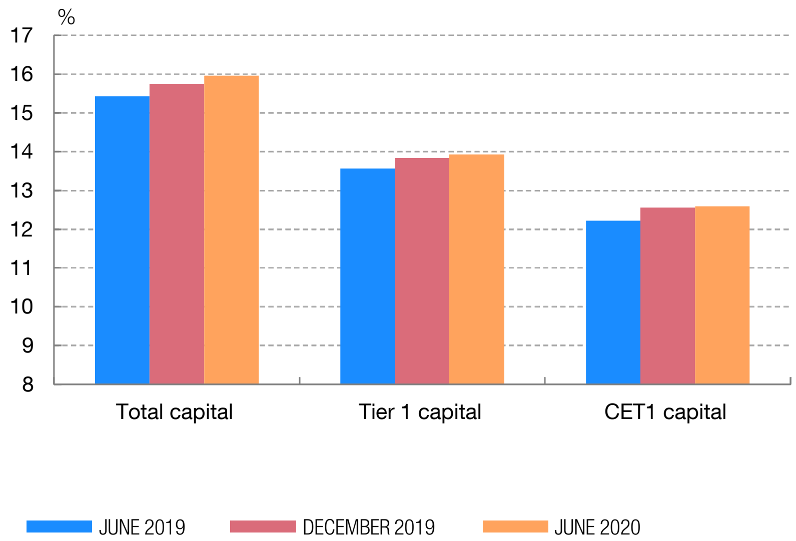


2 DISTRIBUTION OF THE ROE (a)

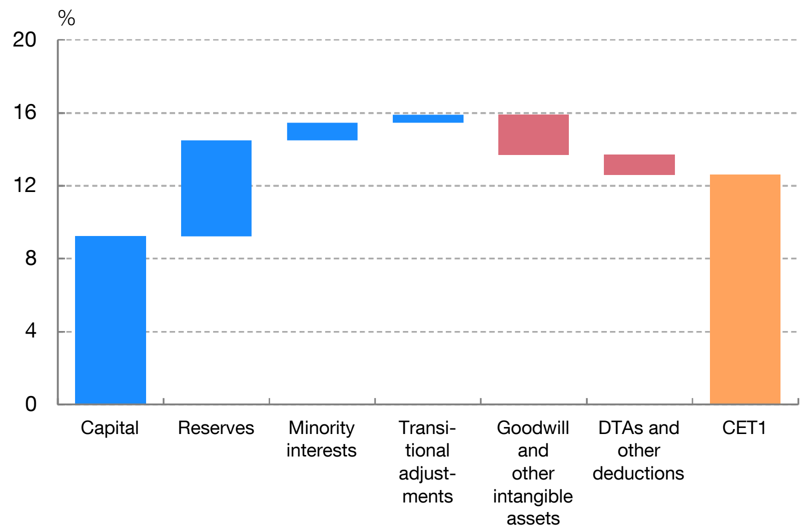


- The **CET1 ratio** of the Spanish banking system **rose over the past 12 months** to stand at 12.6%
  - The increase was due to the decline in risk-weighted assets (-3.1% year-on-year), while CET1 capital held steady from June 2019 to June 2020
- **In other European jurisdictions, the CET1 ratio also rose somewhat**, assisted by the measures adopted. These have resulted in lower RWAs at the European level
- **Capital instruments and reserves account for more than 90% of CET1 eligible items**, while deductions of goodwill have decreased owing to its impairment in 2020 H1

1 CAPITAL RATIOS



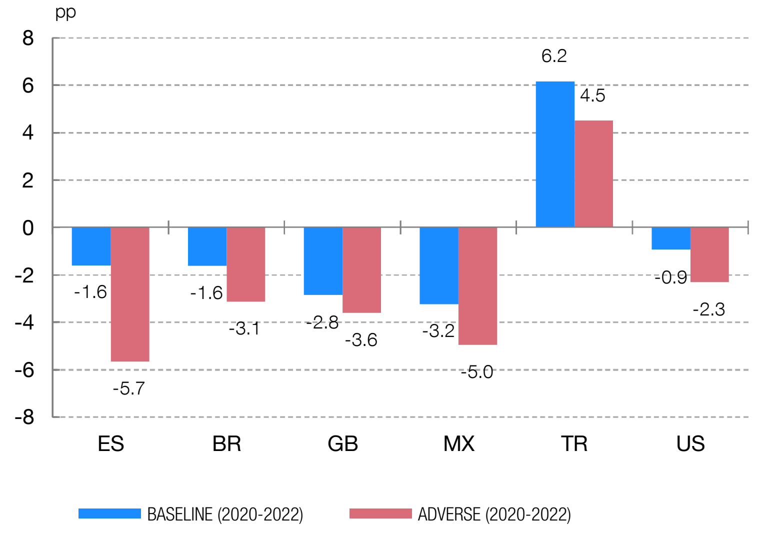
2 BREAKDOWN OF THE CET1 RATIO AS A % OF RWA



- As a result of the grave economic crisis caused by the COVID-19 pandemic, **the scenarios are markedly contractionary,…**
    - …defined by a severe shock the first year and a gradual recovery afterwards
    - The baseline scenario for Spain reflects a cumulative fall in GDP of 1.6%, with the decline much exacerbated under the adverse scenario (- 5.7%)
- **At the international level the scenarios reflect a similar pattern** to that of Spain
    - Only Turkey posts positive average growth thanks to a vigorous recovery (albeit one accompanied by imbalances)

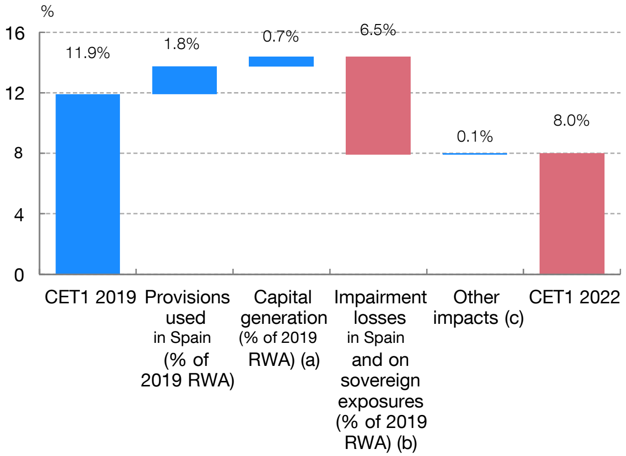
	Baseline scenario 2020-2022	Adverse scenario 2020-2022
GDP (cumulative growth)	-1.6	-5.7
Unemployment rate (% of labour force) (average)	18.6	23.5
Price of housing (cumulative growth)	-3.8	-11.6
Lending to households for house purchase (cumulative growth)	-5.4	-11.1
Lending to households for other purposes (cumulative growth)	-12.0	-17.6
Lending to businesses (cumulative growth)	-2.2	-5.9
12-month interbank interest rate (average)	-0.3	-0.2
10-year sovereign bond interest rate (average)	1.0	1.3

1 YEAR-ON-YEAR RATE OF CHANGE OF GDP UNDER THE BASELINE AND ADVERSE SCENARIOS (a)

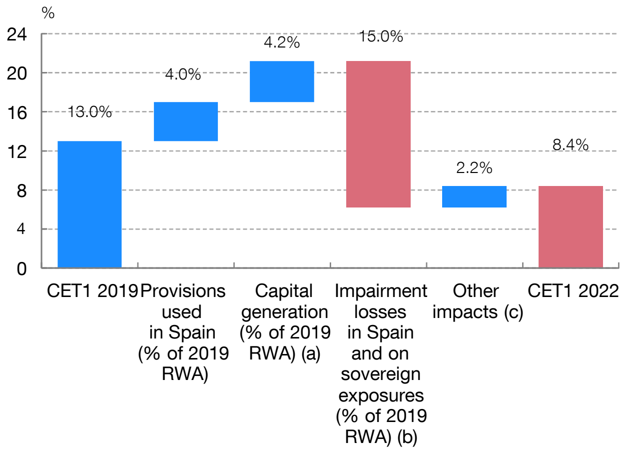


- The **institutions with significant international activity record a decline of 2 pp in their CET1 ratio** under the **baseline scenario** and of **3.9 pp under the adverse scenario**
- **The other institutions supervised by the SSM** record a **decline of 1 pp in their CET1 ratio under the baseline scenario and of 4.6 pp under the adverse scenario**
- Lastly, **the institutions supervised directly by the Banco de España** see **their CET1 ratio increase by 0.8 pp under the baseline scenario**, but **fall by 1.3 pp under the adverse scenario**
- The **three groups considered show appropriate overall resilience**, given the unprecedented impact the COVID-19 pandemic has had on the economy, but they **face considerable uncertainty and evidence heterogeneity**

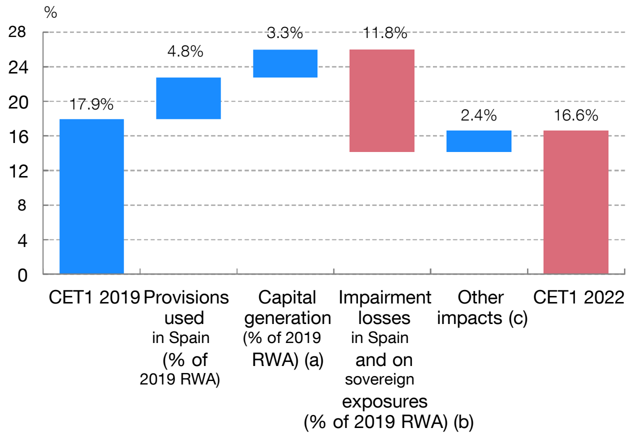
2 ADVERSE SCENARIO INSTITUTIONS WITH SIGNIFICANT INTERNATIONAL EXPOSURE



2 ADVERSE SCENARIO OTHER SSM INSTITUTIONS

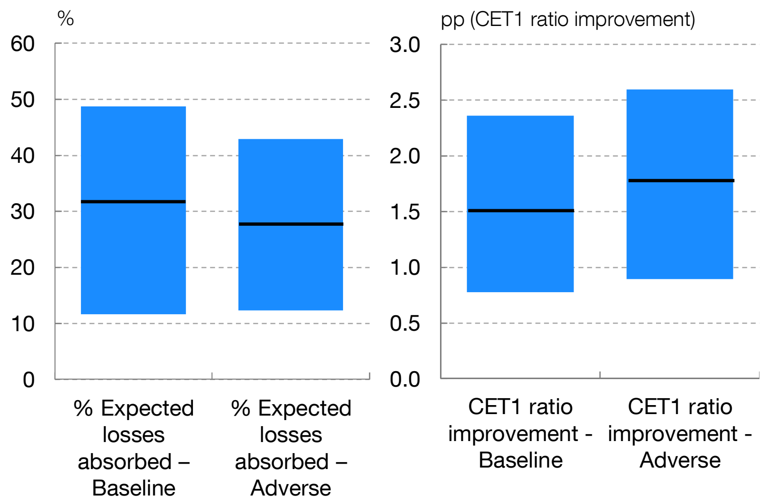


2 ADVERSE SCENARIO LESS SIGNIFICANT INSTITUTIONS

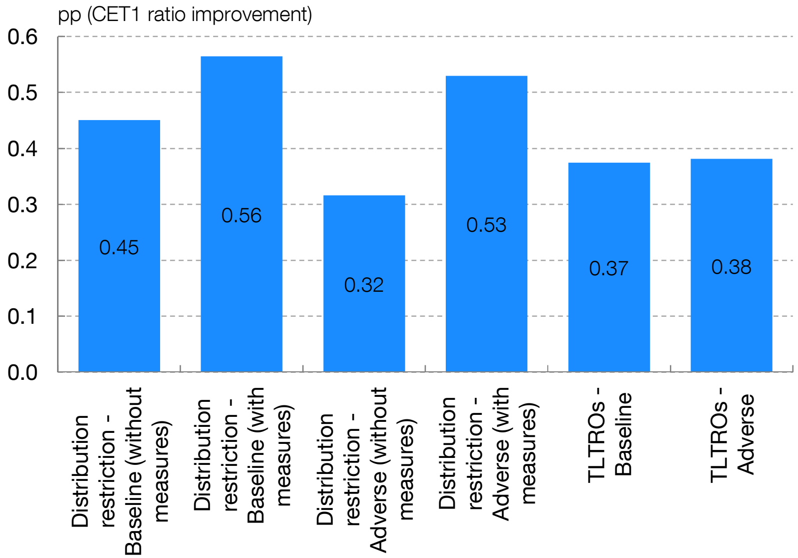


- The FLESB framework was used to assess the **impact of the measures adopted on the solvency of Spanish institutions**, under certain methodological assumptions
  - The guarantees have a significant favourable impact on the CET1 ratio under both scenarios, with a degree of variation in the final impact according to the default risk of the portfolio guaranteed
  - The restrictions on dividend distribution and the new TLTRO programme also have a positive impact, but one smaller than that of the guarantees
- The effect of **the restrictions on dividend payouts is reinforced by the other measures**

1 EFFECT OF THE ICO GUARANTEE FACILITY (b)

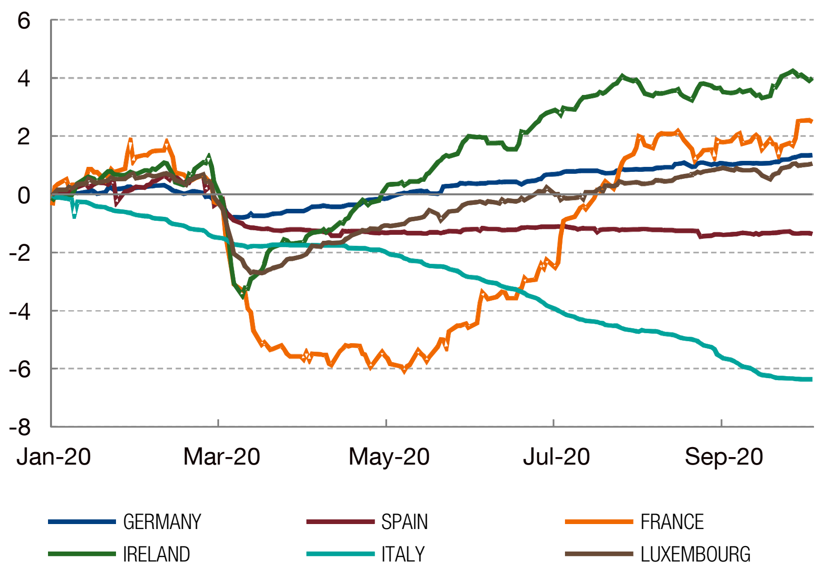


2 EFFECT OF THE DIVIDEND DISTRIBUTION RESTRCTION AND THE TLTRO SERIES (c)

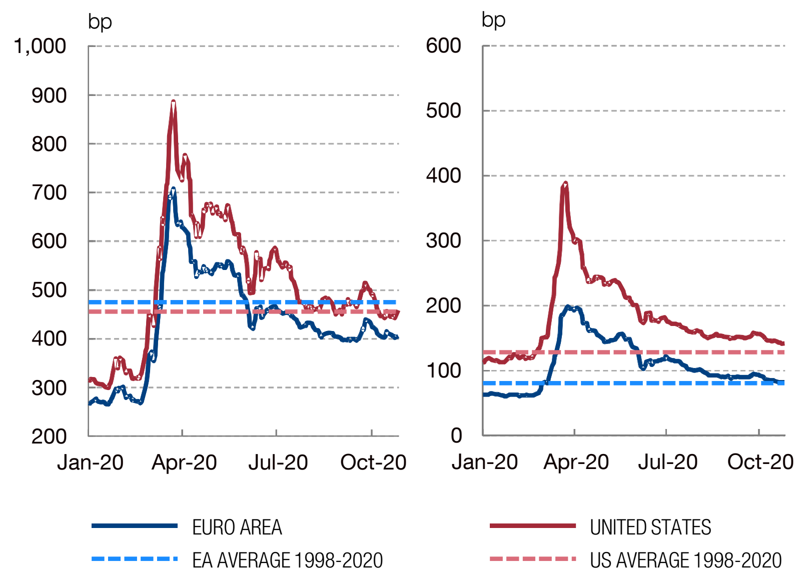


- **In March**, the health crisis triggered widespread capital outflows from investment funds, whereas since April the inflow/outflow balance has **recovered, albeit highly unevenly**
- One of the main **risks for the sector is the possibility of widespread rating downgrades of securities** held on the balance sheet, prompting large-scale fire sales of securities if they lose their investment-grade status
  - To date, rating agencies have made fewer downgrades than during the global financial crisis, but the risk is high, especially if the pace of the recovery slows

1 NET INFLOWS ACCUMULATED SINCE 15 JANUARY 2020
As % of initial assets (a)

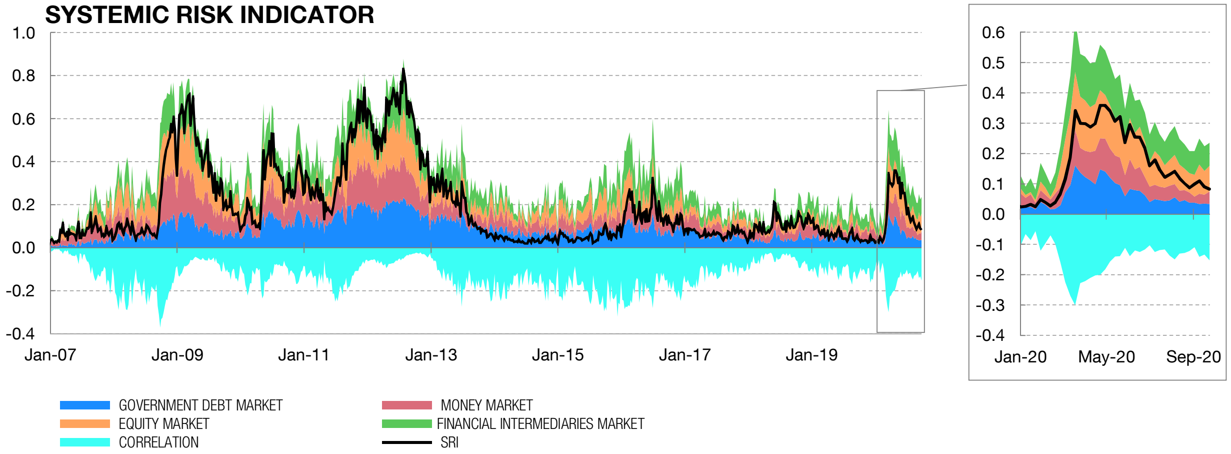


2 CORPORATE BOND YIELD SPREADS RELATIVE TO SWAP CURVE (a)
HIGH YIELD (left) AND INVESTMENT GRADE (right)

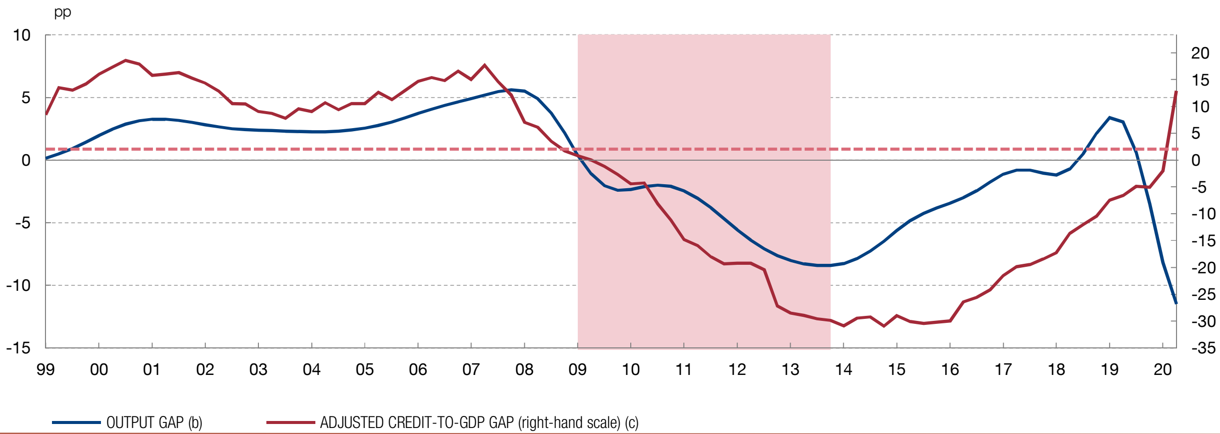


- The **systemic risk indicator (SRI)** for the Spanish financial system **fell gradually** from end-April to end-September
- **The credit-to-GDP gap crossed the activation threshold** in June owing to **the sharp fall-off in GDP;** accordingly, it was not a systemic warning and the CCyB was held at 0%

SYSTEMIC RISK INDICATOR



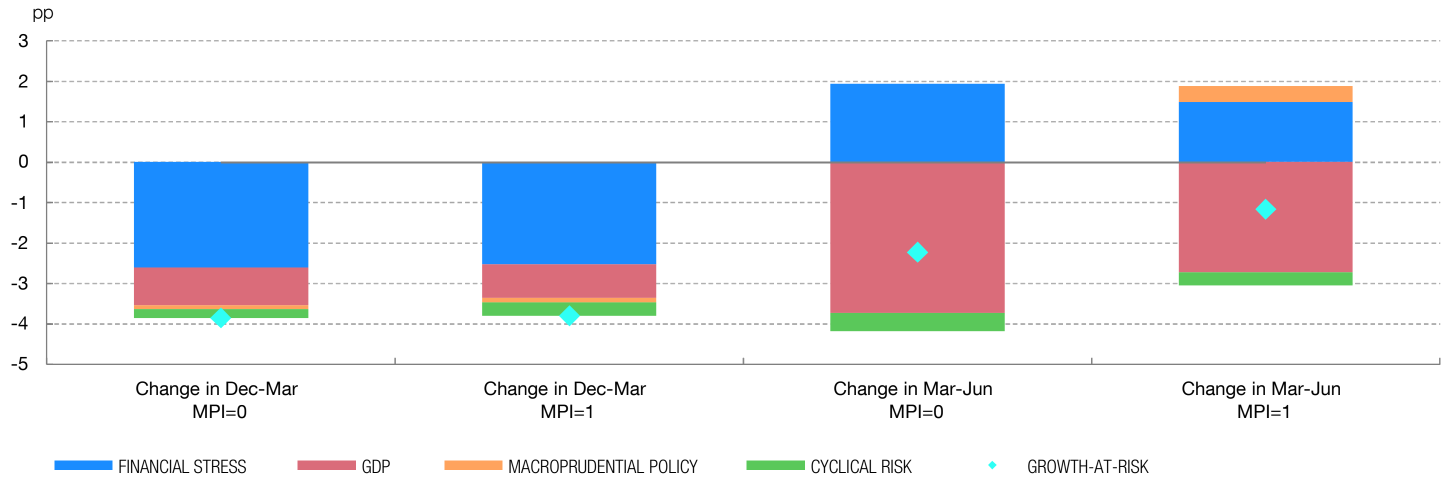
CREDIT-TO-GDP GAP



BOX 3.1: IMPACT OF THE PANDEMIC ON GROWTH-AT-RISK AND MITIGATING IMPACT OF THE MACROPRUDENTIAL MEASURES ADOPTED

- Not only has **the pandemic** had a **negative impact on** observed **growth** and on growth forecasts for the coming quarters,…
  - …but it has also adversely affected growth under a stressed scenario
- Initially, **market turmoil** was behind this deterioration; when this eased, the deterioration was on account of the **inertial effects of the decline in GDP**
- Countries that **had macroprudential space** (in many cases because their systemic risk had previously risen somewhat) were able to use that headroom to mitigate the impact to some extent
  - The net effect of greater systemic risk and the release of buffers is slightly positive

Chart 2
BREAKDOWN BY FACTOR OF THE QUARTERLY CHANGE IN ESTIMATED GROWTH-AT-RISK IN COUNTRIES THAT HAVE NOT EASED MACROPRUDENTIAL MEASURES



- The **coordinated action of** macroprudential, microprudential and accounting **policies** remains geared to **supporting the financial intermediation function**, as a key mitigator of the economic impact of the pandemic
- The **initial response enabled the initial impact of the shock to be absorbed** and prevented the materialisation of a systemic risk that would have further exacerbated the economic crisis
- **Alternative measures, which may be necessary if the crisis persist,** should be considered
- Thus, an **easing of the macroprudential and microprudential** capital **requirements** for banks would boost lending to the economy, but it would under certain assumptions reduce loss-absorbing capacity
  - The simulation exercises conducted show that the use of capital buffers would have a significant impact on GDP and on loss-absorbing capacity in the sector
  - The simulation confirms the hypothesis that the market response to the use of capital buffers is also a key element to determine the cost-benefit balance of the measure
- **Consolidation of the sector, if done appropriately, is one – but not the only – way for banks to gain efficiency** and prepare for the medium-term challenges ahead
  - Investment in new information management technologies is a key element

- **In the European setting**, discussions have begun on the need to set in place additional measures to those envisaged to date, should more adverse scenarios materialise, for instance:
    - Extension of guarantee and moratorium schemes
    - Selective approach in implementation of these schemes
    - Possible interventions (increase in corporate capital, medium-term restructuring of households' and firms' debt)
    - Other more hypothetical measures would be to create asset management companies (bad banks) or strengthen banks' capital positions

- The ultimate aim of all these measures is to ensure the flow of credit to the economy and underpin the financial situation of households and firms with sound long-term solvency prospects

- In any event, **any discussion of the hypothetical adoption of such measures should be governed by caution and should include detailed analysis and the cost-benefit implications**, correctly weighing the benefits of preserving activity and repayment incentives against their implications for the banking sector and their fiscal costs

THANK YOU FOR YOUR ATTENTION