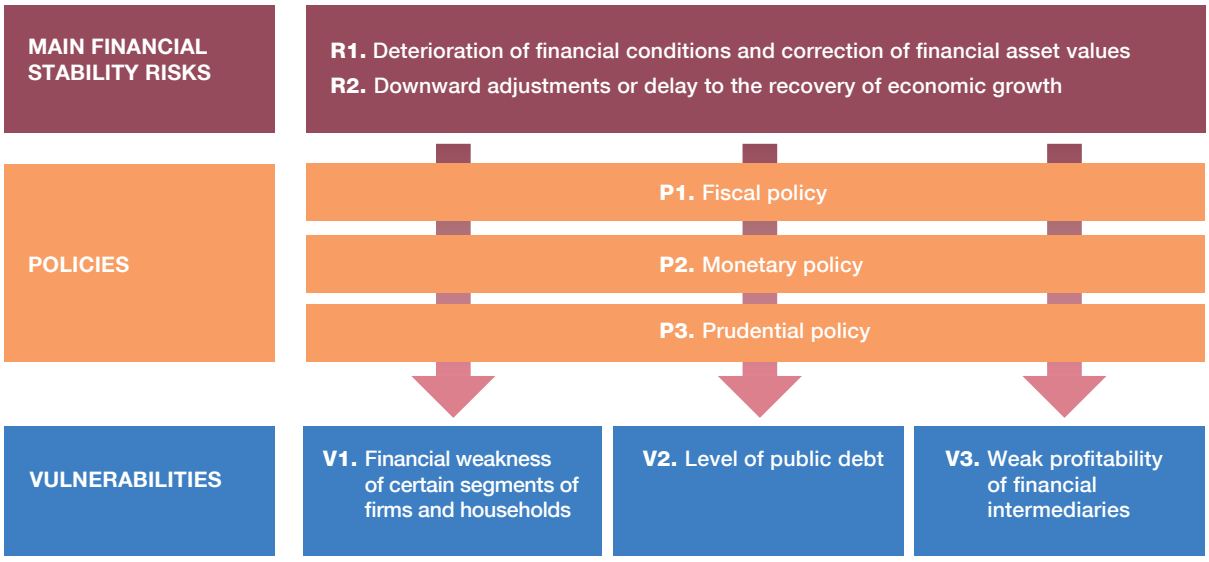
THE STABILITY OF THE SPANISH FINANCIAL SYSTEM: MAIN RISKS AND VULNERABILITIES

The macro-financial situation of the Spanish economy has improved since the publication of the last *Financial Stability Report* (FSR); however, vulnerabilities and risks are still at heightened levels. The progress in the vaccination of the population and the effectiveness of the measures implemented by the authorities to mitigate the impact of the pandemic have allowed activity to recover progressively, in line with the central scenario of forecasts, although the sectors most affected by the health crisis are still clearly below the level of 2019. These factors explain why there has been no increase in doubtful loans in the bank credit portfolio as a whole, although there are latent impairments whose materialisation will depend on the evolution of the economy and the pace of withdrawal of the measures. In this context, bank profitability has recovered to pre-pandemic levels, although this was low compared to other sectors and geographies. In any case, it is necessary to continue to maintain a close surveillance of the financial system, since, as detailed below, vulnerabilities remain high in relation to levels prior to the onset of the crisis, and there are risks whose materialisation could hinder the process of economic and financial normalisation (see Figure 1).

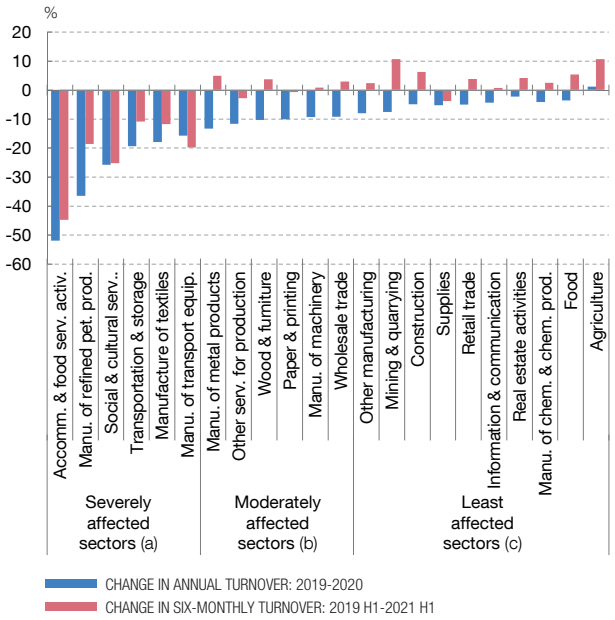
Figure 1
FINANCIAL STABILITY RISKS AND VULNERABILITIES – AUTUMN 2021 (a)



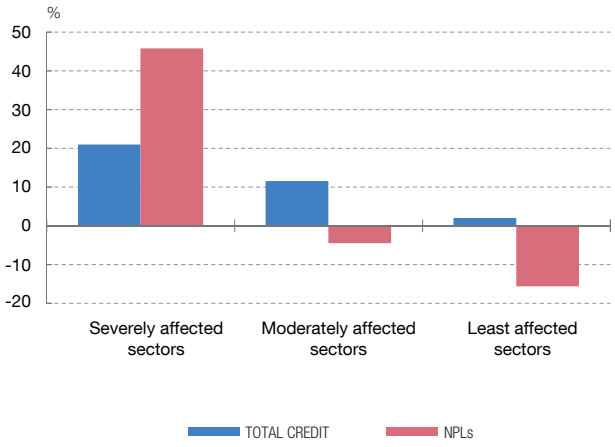
SOURCE: Banco de España.

a In this report, vulnerabilities are defined as economic and financial conditions that increase the impact or probability of materialisation of risks to financial stability. The latter are in turn identified as adverse changes in economic and financial conditions, with an uncertain probability of occurrence, which hamper or impede financial intermediation, with negative consequences for real economic activity.

1 BUSINESS TURNOVER BY SECTOR
Rate of change relative to the same period of 2019



2 CUMULATIVE CHANGE IN BANK CREDIT TO NON-FINANCIAL BUSINESS ACTIVITY BETWEEN DECEMBER 2019 AND JUNE 2021 (d)



SOURCES: Agencia Estatal de Administración Tributaria and Banco de España.

a The severely affected sectors are those whose turnover fell by more than 15% in 2020.
b The moderately affected sectors are those whose turnover fell by more than 8%, but less than 15% in 2020.
c The least affected sectors are those whose turnover fell by less than 8% in 2020.
d Credit to sectors affected to a differing degree by the COVID-19 crisis is measured on the assumption that the NACE sectors identified in Chart 1 correspond approximately to the sectors reported in template FI-130.

The main vulnerabilities[1] of the Spanish economy and financial system include:

— **V1. The weak financial position of certain segments of households and firms.** By the end of the first half of 2021, most sectors of activity had regained their pre-crisis turnover levels (see Chart 1). This has allowed profitability to recover, while favourable financing conditions have moderated liquidity risks, and average debt and financial burden ratios decreased. However, the recovery remains incomplete in the hardest-hit sectors (e.g. hospitality, transport and car manufacturing), which have recorded the largest increases in bank debt, and also non-performing loans (see Chart 2). These sectors also account for the bulk of the latent impairment of bank loans. For now, scenarios of significant increases in business failures appear to have been avoided, but it should be noted that extraordinary measures continue to provide very significant support. In the case of households, the overall trends of recovering income and employment (which is now close to its pre-crisis levels), and rising saving

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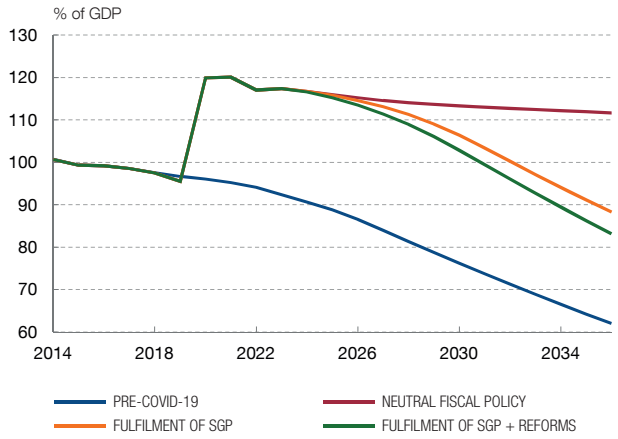
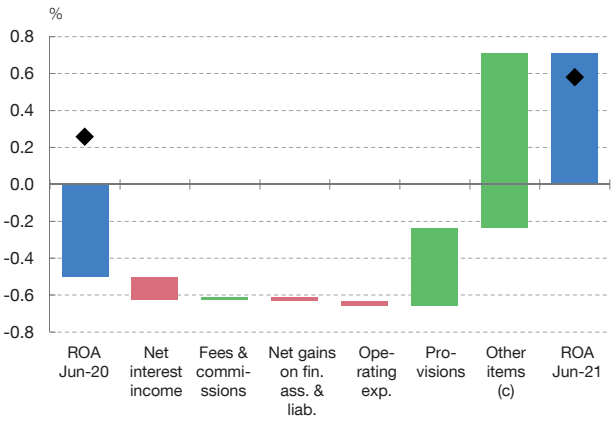
3 SIMULATED PATHS OF PUBLIC DEBT (a)



4 A BREAKDOWN OF THE CHANGE IN PROFIT OF THE BANKING SECTOR
Consolidated net profit as a percentage of ATA (b)



SOURCES: Intervención General de la Administración del Estado (IGAE) and Banco de España.

a The pre-Covid-19 scenario replicates the simulations of public debt over GDP ratio produced with data and projections with the cut-off date December 2019. The neutral fiscal policy scenario simulates the projections of debt using the last Banco de España's forecasts, see Macroeconomic Projections for the Spanish Economy (2021-2023), with no additional restrictions on the structural balance variation. The fulfilment of the SGP scenario assumes a consolidation plan for public debt with a reduction in the structural deficit, up to the budged balance, of 0.5 pp of GDP every year. The last scenario adds structural reforms that would lead to an increase of potential GDP in 0.6 pp in the long term.

b *The red (green) colour of the bars* indicates a negative (positive) contribution of the item concerned to the change in consolidated profit for June 2021 with respect to June 2020. The black diamonds show ROA excluding extraordinary items. In particular, in June 2020: goodwill adjustments (-€12.2 billion), deferred tax asset adjustment (-€2.5 billion) and asset management business sale (€0.3 billion); and in June 2021: extraordinary income as a result of a merger (€2.9 billion) in particular, negative goodwill; segregation of an insurer (€0.9 billion) and extraordinary restructuring costs (-€1.2 billion).

c Includes, inter alia, the extraordinary items mentioned in the previous note.

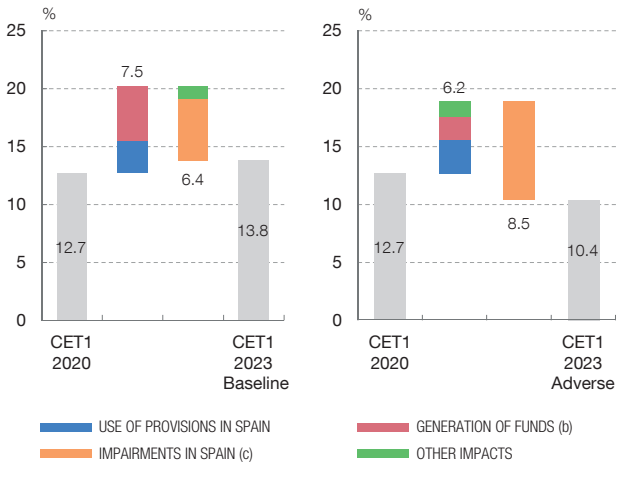
are firming. However, households with close links to employment in the sectors hardest hit by the health crisis and those with low incomes have benefited less from the recovery and are especially vulnerable. Moreover, their borrowing behaviour differs from that of other households. A slower than expected recovery in activity or an increase in financing costs may lead to significant increases in non-performing loans in these more vulnerable segments of households and firms.

— **V2. The increase in government debt.** As noted in the FSRs published since spring 2020, a corollary of the necessary and decisive economic policy response has been an increase in public debt. In Spain, the expected reduction in the budget deficit in the coming years is notable, as a result of the improvement in the cyclical situation. However, a significant reduction in public debt in the medium term will require the elimination of the structural component of the budget deficit, in line with European regulations and, in the absence of an adequate fiscal consolidation plan, the level of debt may remain high for an extended period (see Chart 3). During this process, the high level of public debt makes the Spanish economy vulnerable to any deterioration in financing

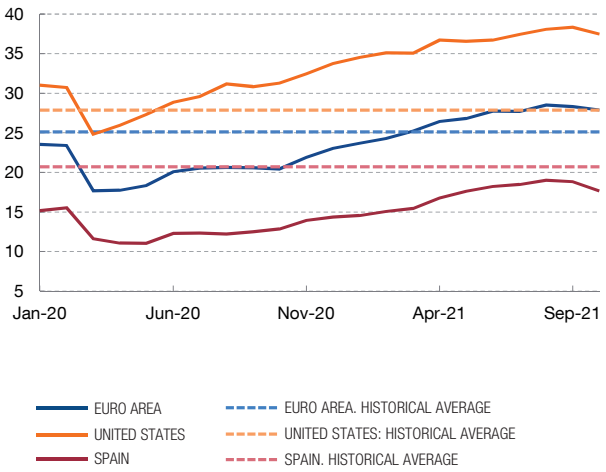
conditions and reduces its capacity to respond to a potential risks that materialise. The cost of the increase in public debt has, so far, been limited by the expansionary monetary policy and this effect will last some time longer, given that the debt that is currently maturing was issued at higher interest rates. In this context, the recent increase in inflation stems from temporary factors, so that the monetary policy stance can be expected to remain accommodative; indeed, if monetary policy is normalised more rapidly than expected, the potential impact of this vulnerability will increase. The yield on long-term sovereign debt would probably be that most affected by the uncertainty that could arise in the financial markets in the event of a premature withdrawal of the central bank purchase programmes launched to mitigate the impact of the pandemic. In Spain, the relatively long sovereign debt maturities would reduce the immediate impact of these shocks to the interest burden.

— **V3. The weak profitability of financial intermediaries.** The revival of the economy and the improved outlook have led to a reduction in the expected losses anticipated by the banking sector and, consequently, in the provisions for financial impairments. This, along with the absence of the extraordinary charges recorded in 2020, explains the rise in bank profitability in the first half of 2021, to its pre-crisis levels, even when the extraordinary income for this half is excluded (see Chart 4). The contribution of international business to Spanish banks' performance has also returned to normal in the first half of 2021, reflecting how, in contrast to initial expectations, geographical diversification is allowing to cushion the impact of this global crisis the impact of the crisis on the profitability of the banking sector, up to mid-2021, can be considered contained. This highlights the effectiveness of economic policy measures in mitigating the impact of the crisis, as reflected in the results of the stress tests for this year (see Chart 5), which show more contained capital charges under the adverse scenario than last year, although a certain degree of heterogeneity is observed across banks. In any event, the distribution across banks of the CET1 ratio under this scenario would not suggest the need for extensive supervisory intervention. However, this does not mean that there may not be latent impairment in credit portfolios that may materialise in the coming quarters and reduce the profits generated by the sector, which would further weaken the intermediation capacity of those banks with a lower level of solvency. Also, the structural challenges for the generation of profit by the banking sector and other financial intermediaries, which the health crisis has made no less pressing, continue to exist. These include, in particular, the generation of profitable business volume in a low interest rate environment, growing competition from technology firms, the increase

5 FLESB STRESS TESTS. IMPACT ON THE CET1 RATIO IN THE BASELINE SCENARIO (L-H CHART) AND ADVERSE SCENARIO (R-H CHART) (a)



6 CYCLICALLY ADJUSTED PER (d)



SOURCES: Refinitiv Datastream and Banco de España.

a The net effect of positive (negative) flows is indicated by the figure above (below) the bar in question. The initial and final CET1 ratios are presented as "fully-loaded". Other impacts include, the change in RWAs between 2020 and 2023 and the effect of ICO guarantees. Aggregate results, including both institutions directly supervised by the SSM and the Banco de España.
b This variable includes net operating income in Spain and net income attributable to business abroad. Thus, the possible funds generated by the banking group as a whole are compared with the impairment losses in Spain (the focus of these tests).
c This variable shows the projection over the three years of the exercise of gross losses due to credit portfolio impairment for exposures in Spain and other types of losses (associated with the fixed-income portfolio, the management of foreclosures and the sovereign portfolio).
d The cyclically adjusted PER is calculated as the ratio between the price of the shares and the 10-year moving average of profits. The historical averages are calculated for the period 1997-2021.

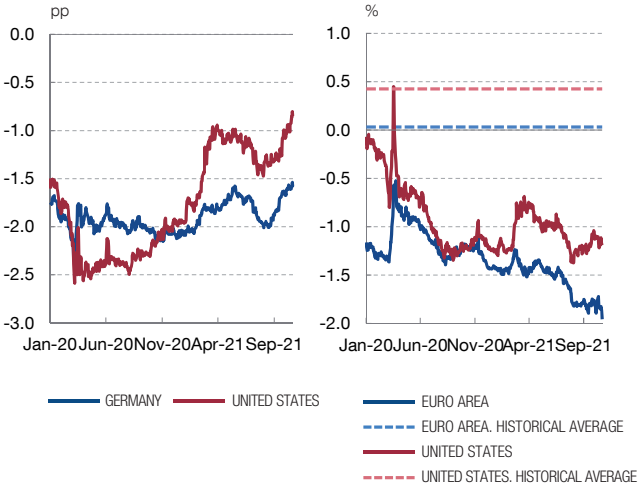
in cyber risks and the potentially negative effects associated with climate risks.

There follows a discussion of the main risks[2] to the stability of the Spanish financial system:

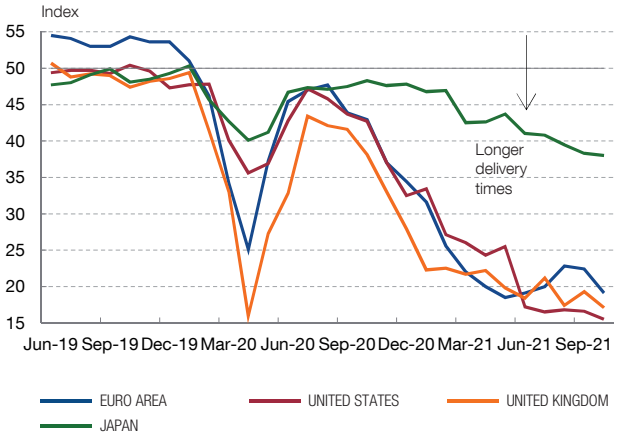
— **R1. Possible deterioration of financing conditions and the correction of financial asset values.** Despite some temporary correction episodes in the first half of the year, the prices of risk-bearing assets on international financial markets remain high (see Chart 6). The low equilibrium level of long-term real interest rates, as a result of structural factors, such as demographic and productivity trends in developed countries and the demand for safe assets, which monetary policy attempts to accommodate through significant central bank bond purchase programmes, is an important factor supporting these valuations (see Chart 7). In this respect,

2 In this report, risks are identified as adverse changes in economic and financial conditions, with an uncertain probability of occurrence, which hamper or impede financial intermediation, with negative consequences for real economic activity.

7 DEVIATION OF THE TERM RISK PREMIUM IN THE INTEREST RATE ON 10-YEAR PUBLIC DEBT FROM ITS HISTORICAL AVERAGE (L-H PANEL) (a) AND 10-YEAR REAL INTEREST RATE (R-H PANEL) (b)



8 MANUFACTURING PMI: SPEED IN SUPPLIER DELIVERY TIMES



SOURCES: IHS Markit, Refinitiv Datastream and Banco de España.

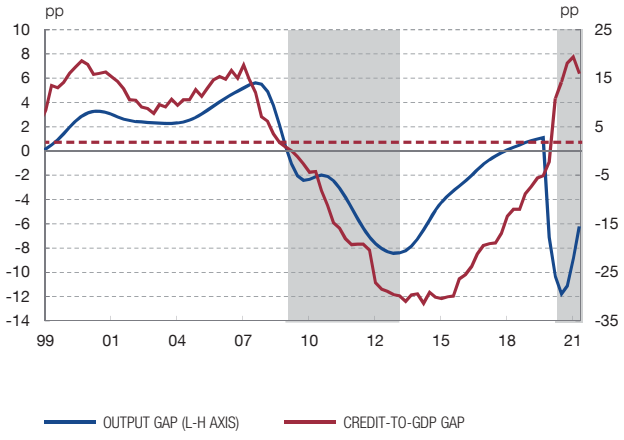
a Risk premia are obtained from a decomposition of 10-year interest rates into term risk premia and expectations about short-term interest rates. Expectations are obtained by predicting the instantaneous short-term interest rates using an ARFIMA model on each of the components of the yield curve (long-term level, slope and curvature) estimated daily. Once the short-term rate expectations are obtained, the premia can be had taking the difference between 10-year rates and short rate expectations. The historical averages of the term premia are calculated for the period 2003-2021.

b The historical average real 10-year interest rate in the euro area and the United States is calculated for the period 2004-2021. Until July 2008 in the euro area and June 2007 in the United States data are used for indexed bonds in France and the United States. After those dates, the real interest rates are calculated in the euro area as the difference between the 10-year overnight indexed swap rate and the compensation for inflation with the same term and in the Uinited States as the difference between the 10-year government bond and the compensation for inflation with the same term.

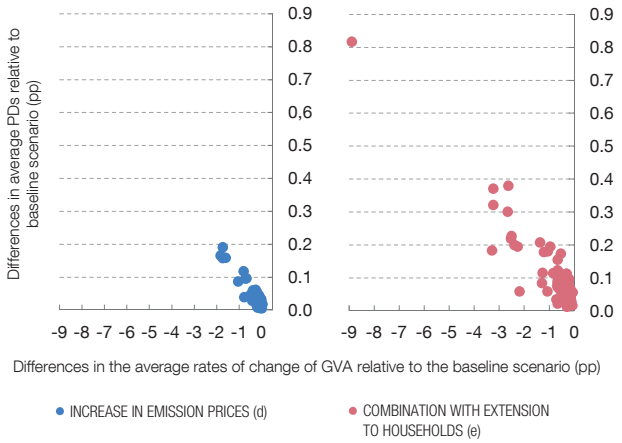
a fall in asset prices and a tightening of financial conditions (with an increase in the currently very low maturity premia, in particular) may be triggered if monetary stimulus is withdrawn at a faster rate than the financial markets expect. These adverse developments could also occur if investors' expectations of future economic developments or the solvency of certain segments of the corporate sector deteriorate. This process may spread to other assets and geographical areas given the close interconnections between markets and financial intermediaries.

— **R2. Downside risks to economic growth continue to be present, although the baseline scenario is more favourable than in previous quarters.** The progress made with vaccination programmes in 2021 has strengthened the confidence of economic agents. At the same time, economic policy measures have continued to prove their effectiveness in averting the less favourable growth scenarios that the pandemic could have given rise to. That said, downside risks - albeit more contained - remain. These are linked to adverse developments in the health situation, which might require the introduction of restrictions on certain activities. Also, the risks to activity are now skewed downwards as a result of the

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



10 EFFECT OF THE TRANSITION COSTS ON CREDIT IMPAIRMENT PROBABILITIES (PD) (c)



SOURCES: Instituto Nacional de Estadístico and Banco de España.

a The shaded areas show two periods of financial crisis identified in Spain since 2009. These correspond to a period of systemic banking crisis (the last crisis: 2009 Q1-2013 Q4) and the crisis caused by COVID-19 (2020 Q1-2021 Q2).

b The output gap is the percentage difference between actual GDP and its potential value. Values calculated at constant 2010 prices. See Cuadrado, P. and Moral-Benito, E. (2016), Potential growth of the Spanish economy, Occasional Paper No 1603, Banco de España. The credit-to-GDP gap is calculated as the difference in percentage points between the actual ratio and its long-term trend, calculated by applying a one-sided Hodrick-Prescott filter with a smoothing parameter equal to 25,000. This parameter is calibrated to fit the financial cycles observed in the past in Spain (see Galán, J.E. (2019), Measuring credit-to-GDP gaps. The Hodrick-Prescott filter revisited, Occasional Paper No 1906, Banco de España). Data available to June 2021. The broken red horizontal line represents the reference CCyB activation threshold of 2 pp for the credit-to-GDP gap.

c Each point in the chart coresponds to a sector of business activity in accordance with the NACE Rev.2 classification and represents the difference of the average PD (weighted by the number of borrowers) for this sector over a three-year horizon between a baseline trend scenario without the application of measures and adverse scenarios resulting from different extensions of the CO2 Emissions Trading Scheme. See Box 3.1 for further details.

d This adverse scenario considers an increase in the price of CO2 emission allowances from €25 to €100.

e This adverse scenario considers the combination of the scenario described in (d) with an extension of the requirement for allowances to more productive sectors and to households.

sharp increase in the price of energy and the emergence of global production chain bottlenecks (see Chart 8). This is leading to increases in inflation that erode agents' purchasing power and, consequently, the incipient reactivation of activity. In addition, if these factors that temporarily raise inflation were to be prolonged over time, they could end up raising the medium-term inflation expectations of the agents, and they may contribute to a tightening of financing conditions in the short term, and dampen further the potential for economic recovery (see Chart 9). A slowing of the recovery would have a negative effect on the quality of credit to households and firms, especially in the most vulnerable sectors. These may see an increase in non-performing loans even amid a general recovery, if this is asymmetric and fails to reach the hardest-hit sectors. Economic activity faces greater risks in the emerging economies; the ability of economic policy to react to shocks to activity is limited by the stronger inflationary pressures in these economies and they are exposed to a tightening of financing conditions as a result of the normalisation of monetary policy in the advanced economies.

Precisely tuned monetary and fiscal policies continue to be essential for the recovery in economic growth to firm. The expansionary stance of these policies still needs to be maintained in the short term since, although financial stability risks and vulnerabilities stemming from the pandemic have moderated in recent months, they continue to be high. A flexible approach adapted to changes in the economic situation and risk profile also needs to be maintained, avoiding a premature withdrawal of the stimulus before the recovery firms.

Developments in inflation expectations and the rate of recovery of activity will be decisive in the positioning of monetary policy. Monetary policy is expected to be less accommodative in the coming months, in particular as a result of the winding down of asset purchase programmes in Europe and the United States. However, the baseline scenario continues to assume that the increase in inflation will be temporary, so that the rate of policy tightening is not expected to accelerate.

Fiscal policy must remain expansionary in the short-term, but a medium-term fiscal consolidation programme to contain and reduce the vulnerabilities associated with high public debt needs to be drawn up. The fiscal policy measures deployed during the crisis need to be increasingly selective and focused on the economic sectors and population segments for which the recovery is proving to be slowest. In addition, an ambitious structural reform programme to boost the potential growth of the Spanish economy would also contribute to this objective and mitigate the other risks considered. Effective application of the Next Generation EU (NGEU) funds would help to reconcile these two aims.

In the absence of signs of systemic financial imbalances building up in Spain, a loose prudential policy, without the activation of macroprudential tools, is also advisable. It should be noted that, in spite of the support measures adopted, the pre-pandemic levels of activity have still not been recovered. Key indicators of financial imbalances, such as the credit-to-GDP gap, are still dominated by the sudden fall in output in Spain in 2020 and their high level should not be interpreted as signalling a build-up of risk (see Chart 9). The negative output gap has begun to close and, in line with the expectations for recovery, a significant reduction is expected by the end of next year. In any event, the reduction of output and credit gaps is subject to downside activity risks and also to the vulnerability of certain segments of households and firms, so that continuous monitoring is needed for early detection of signs of risk.

In some European countries macroprudential policy tightening has already begun, mainly as a result of warning signals in their property markets. In Spain, the real estate cycle does not appear to be as advanced. At aggregate level, housing is not showing signs of overvaluation; new mortgage credit is growing strongly in 2021, but from very low levels, without a significant increase in the stock or any loosening of credit standards. However, if the expansionary trend in real estate

intensifies, this risk diagnosis will need to be reassessed. In this respect, the reform of Circular 2/2016 will provide new macroprudential tools to address with a more effective and focused approach the potential build-up of risks in the future.

Other more long-term risks must also continue to be taken into account, including those of financial digitalisation and climate change. Digitalisation is not only generating new financial products and changing the way in which the markets that trade them are organised, but also making the financial system more vulnerable to cybernetic risks. Climate change may also have important financial stability effects, through the materialisation of both physical and transition risks. In the case of the latter, the estimated impact on bank solvency is still moderate, but adds to the pressure of the low bank profitability. At the same time, the materialisation of physical risks would potentially have a very significant long-term economic impact, which would exceed the impact of the transition costs. Thus, according to this analysis, the action required to achieve an environmentally sustainable productive model that does not contribute to the materialisation of climate change should be taken without delay.