Box 2.5

CREDIT RISK UNDER SUPERVISORY SCRUTINY, IN A CONTEXT OF UNFAVOURABLE MACROECONOMIC EXPECTATIONS AND GEOPOLITICAL TENSIONS

Euro-area credit institutions' operations have been disrupted by the macro-financial consequences of Russia's invasion of Ukraine. The significant rise in energy and other commodity prices has, in the first instance, fuelled an escalation in the prices of other consumer products, including notably a number of market basket goods (especially foodstuffs), thus generating an increase in inflation to unexpected levels, followed by a rapid rise in interest rates in response by the major central banks. All this implies a deterioration in the growth outlook for the euro area and increased uncertainty in financial markets and, as a consequence, heightened risks for the European financial sector.

Against this background, the European Central Bank (ECB), the European Banking Authority and the Banco de España have set as a supervisory priority for the 2023-2025 period that credit institutions "strengthen their resilience to immediate macro-financial and geopolitical shocks", fearing that higher funding costs and lower disposable incomes of companies and households could lead to a deterioration in loan quality.

Non-performing loans of all European significant institutions (SIs) under ECB supervision continued to fall to 2.3%[1] on average in the third quarter of 2022. This reduction was also observed in the Spanish banking system, resulting in NPLs of 3.2%[2] for the total Spanish banking system at that date.

However, there are early warning indicators that could point to a deterioration in loan quality —for example, the ratio of loans of SIs under ECB supervision classified as stage 2 stood at around 9.8% in the third quarter of 2022.

This potential deterioration would affect both households and companies, albeit to a different extent, depending on their level of indebtedness and their exposure to the current macroeconomic shocks. In companies, the impact is expected to be greater in sectors related to the production and processing of raw materials, and in energy-intensive sectors, e.g. agriculture and transport. In the real estate sector, less impact is expected in the residential segment than in the commercial segment.

In this context, a strategic objective has been set whereby both SIs and LSIs remedy any shortcomings they may have in credit risk management, with a focus on exposures to vulnerable sectors. This includes potential structural weaknesses in the entire credit risk management cycle, from loan origination to risk mitigation and monitoring, including accounting classification and provisioning. In this way, banks should be able to quickly identify and mitigate any increase in risk in their exposures to sectors that are more sensitive to the current macroeconomic environment, especially those affected by the war in Ukraine and real estate portfolios.

The supervisor's work programme on this priority will focus on the sectors most affected by the consequences of the war in Ukraine and by the macroeconomic environment. Some of the main activities planned in the work programme for 2023-2025 are: (i) specific reviews of loan origination and monitoring (with a particular focus on residential real estate portfolios); (ii) specific reviews of International Financial Reporting Standard on financial instruments (IFRS-9) on supervisory expectations included in the 2020 "Letter to the CEO" and its modelling (including overlays); (iii) exhaustive analyses of the refinancing and restructuring practices set out in the aforementioned letter; (iv) on-site inspection campaigns on IFRS-9 and commercial real estate; and (v) monitoring of leveraged finance.

1 NPL ratio calculated without including demand deposits placed with central banks in the denominator.

2 NPL ratio calculated without including demand deposits placed with central banks in the denominator. If they had been included, the ratio would be 2.63%, as shown in Chart 2.3.