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Financial stability situation in Spain

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Good morning ladies and gentlemen.

Let me first thank the organisers for inviting me to participate in this tenth edition of the Financial Sector Meeting. On this occasion my address will focus on the Banco de España's assessment of the main factors of risk to financial stability at present, the potential impact on deposit institutions and the tools available to the Banco de España and the other authorities to mitigate such risk.

Assessment of the balance of risks to financial stability

The balance of risks to the Spanish financial system's stability has worsened somewhat in the past six months. This has been due in particular to the downward revision of the global economic outlook.

Indeed, global GDP growth continued to ease, to a year-on-year rate of 2.8% in 2019 Q2, more than 0.5 pp lower than a year earlier. This slowdown is particularly affecting some emerging economies and Europe.

Moreover, growth projections have been revised downwards in recent quarters in most economies. In fact, the increase in global GDP this year is expected to be the lowest since the international financial crisis.

This downturn in activity has likewise affected the Spanish economy. As a result, the Banco de España revised its growth projections for our economy down last September, to 2% in 2019, 1.7% in 2020 and 1.6% in 2019.

In addition to this baseline projections scenario, a series of risks persist in the geopolitical and economic policy areas. Should these risks materialise, they might bear down even further on future growth.

At the global level the US-China trade conflict, prompting increases in the maximum tariffs applicable to specific products, continues to be the main source of uncertainty. These disputes, which feed through to all countries through global value chains and which especially affect Europe owing to its high degree of openness, are exerting a significant adverse impact on trade and putting back investment projects.

Regionally, the risk of a no-deal Brexit has increased and Germany is on the verge of an economic recession. In Spain, uncertainty persists over the future course of economic policies, a situation which should be resolved following the general elections in November.

Flatter economic activity and the potential materialisation of geopolitical risks may have implications for financial stability through various channels.

Firstly, this may lead financial market players to reassess their perception of risk. That would mean that the currently very compressed risk premia on financial instruments would increase, thereby reducing asset prices and, therefore, wealth and collateral values. These developments might affect to a greater extent the more vulnerable segments, such as that of debt with lower credit quality, including leveraged loans and CLOs, and markets with high valuations. And they might extend to other assets.

Secondly, agents' income flows may be affected, with implications for their consumer spending and investment decisions. In the case of households, employment creation and wage growth might decline. As to non-financial corporations, the rise in their profits might diminish. The public sector would also see its balance of revenue and expenditure affected by the operation of the automatic stabilisers. That would all mean that both private and public levels of debt might ultimately be higher than expected, with further implications both for spending decisions and financial markets' perception about the debt sustainability path.

Logically, the deteriorating macroeconomic context would also affect deposit institutions. Compounding the fall in the value of some of their assets would be lower demand for credit. Moreover, asset quality might worsen, given that the ability of their borrowers to pay would be negatively affected. They would also face greater difficulty in continuing to jettison their non-earning assets. As a result, their income statements would be subject to downward pressures. This is particularly significant in a context, such as the present, in which banks are posting low profits.

Against this background, it would be desirable in economic policy terms that, after the elections, a stable government were formed. That would lessen uncertainty over the future course of economic policies, give fresh momentum to structural reforms and see a resumption of fiscal consolidation, with the aim of improving potential growth and reducing the main sources of vulnerability in the Spanish economy, in particular high public and external debt levels.

The added pressure of the economic environment on bank profitability is the second element of the balance of risks that I would like to highlight. Once again, this is not something specific to the Spanish financial system. Indeed, Spanish banks' profitability is higher than the European average, but it remains below the cost of capital. Maintaining appropriate profitability is crucial, among other factors, if banks are to generate capital organically and, in this way, reinforce their solvency levels.

Spanish bank profits in the first half of the year, down by 11.5% in year-on-year terms, are a sign of the growing likelihood of this risk materialising. Contributing to this decline have been the reduction in gains on financial operations and, to a lesser extent, the increase in operating expenses, although a portion of this was due to extraordinary expenditure associated with the restructuring of certain banks.

In addition, the ongoing reduction in impairment losses that began in 2012 is showing some signs of exhaustion. Indeed, in terms of their year-on-year rate, impairment losses increased for the first time since 2012, posting a rise of 3.9%. And we should not forget that, at present, the NPL ratio is still significantly above that recorded before the financial crisis. Specifically, in terms of lending to the resident private sector, in business in Spain, the NPL ratio stood at 5.3% in June 2019, 8.7 pp down from the December 2013 high. Foreclosed assets evidenced a further decline, standing below €40 billion in June 2019. That marks a 50% reduction from the 2011 peak. Against this backdrop, banks should persist in their management efforts to enhance the quality of their balance sheets, which is a fundamental factor for the recovery of profitability in the medium term.

The other lever in banks' hands is to improve their efficiency, through a more appropriate management of their costs that does not limit their capacity to adapt to an increasingly more technified environment. In this respect, we should note that, in business in Spain, the efficiency ratio at the individual level, without taking into account severance payments, has increased (worsened) by somewhat over 9 pp since 2014, to 58.8%. As to the composition of operating expenses, the weight of personnel costs has diminished, and that of IT and communications, outsourced services and amortisation has increased, reflecting to some extent the ongoing digitalisation and technological change at banks.

It should be borne in mind that operating expenses are one of the most significant levers over which banks have direct control to increase the profitability of their business. In any event, it should also be stressed that Spanish banks' efficiency ratio at the consolidated level, calculated as the ratio of operating expenses to gross income, is one of the lowest (best) in Europe.

The actual and projected reduction in the euro area economy's rate of nominal growth and, as a consequence, the fact that interest rates are going to be at lower or even negative levels for longer, may ultimately affect financial institutions' profitability. Indeed, in recent months the markets have lowered their expectations in terms of the growth of European banks' profits.

Low or negative interest rates restrict the unit interest margin banks can obtain. However, from a general equilibrium perspective, they also increase credit, reduce bad debts and raise the value of the financial and real assets banks hold on their balance sheets. As a result, the net aggregate effect on bank profitability in general has so far been positive overall. That said, this effect will foreseeably diminish insofar as the situation of negative interest rates is prolonged over time. Indeed, a positive note regarding the most recent developments in profitability is that net interest income has increased following years of stagnation at low levels.

In any event, the decisions adopted by the ECB Governing Council at its meeting on 12 September, including the 10 bp reduction in the deposit facility rate to -0.5%, the resumption of net purchases under its asset purchase programme and the strengthening of forward guidance, have been accompanied by mitigating measures. These include the application of a two-tier system for reserve remuneration, designed precisely to ensure the effectiveness of monetary policy transmission through the bank channel.

There is also theoretical and empirical evidence that low interest rates transmit the monetary impulse by encouraging banks and other financial intermediaries to take risks. Fortunately, we currently have various macroprudential policy instruments, which I shall refer to later, designed to mitigate the potential build-up of risks that may affect financial stability through this channel. So far, deposit institutions do not appear to be significantly increasing their exposure to risk, although there are some factors where we are exercising greater watchfulness.

In fact, the total volume of lending granted by deposit institutions in Spain to the non-financial private sector has continued to fall (-1.2% in June), or shows muted increases when the construction and real estate development sectors are excluded. Moreover, the debt ratios of the non-financial private sector have continued falling, standing at levels below the euro area average. Specifically, the debt/GDP ratio of the non-financial private sector was slightly above 130%, 3 pp down on a year earlier, and 2 pp less than the euro area average, having declined by more than 70 pp from its peak during the crisis.

In the case of non-financial corporations, overall external financing has continued to expand at year-on-year rates of close to 2%, with significant growth in bond financing and a fall-off since the start of the year in new bank lending extended to non-financial corporations. Overall, the reduction in the deleveraging of non-financial corporations exceeds 50 pp of GDP, from the peak reached during the crisis. Further, in recent years banks appear to be setting greater store by variables such as productivity in lending standards, which results in a more efficient allocation of credit. Nonetheless, some firms still show a certain degree of financial fragility.

In the case of households, the credit terms of mortgage loans are much stricter than those observed pre-crisis, and in recent quarters no signs of easing have been perceptible. For example, in the case of the loan-to-price ratio (LTP), there has been a reduction in the weight of more leveraged transactions (with an LTP of over 80%) compared with the crisis years. Moreover, the average LTP is also lower. By way of exception, consumer lending and its attendant bad debts quickened once again in the final quarter to year-on-year rates of 12% and 26%, respectively, slightly raising the NPL ratio of this business segment to 5.6%. And this against the background of the considerable slowdown in private consumption in the economy.

In terms of solvency, from June 2018 to June 2019 the CET1 ratio increased by somewhat over 30 bp to stand slightly over 12%. The rise was based essentially on an increase in reserves. This improvement in solvency was concentrated in the biggest institutions which are, precisely, those showing lower levels. Moreover, the bulk of the capital materialises in instruments with the biggest loss-absorption capacity.

Compared with the other European countries, Spanish institutions have a top-quality CET 1 capital ratio almost 3 pp below the European average, whereas in terms of the leverage ratio, Spain stands slightly above the same average.

It is well-known that this difference in Spain's relative position in respect of these two solvency measures is due to the fact that the density of risk-weighted assets is higher in Spain. This greater density is linked to the higher use in Spain of the standard approach when calculating risk-weighted assets and to the very risk profile of the portfolios. In fact, for banks and portfolios for which the IRB approach is used, no appreciable difference in the density of risk-weighted assets is discerned, on average, compared with other Single Supervisory Mechanism (SSM) banks and countries.

In any event, precisely to limit variability between weightings obtained through the IRB approach and the standard approach, the final phase of the Basel III reform includes the so-called *output floor.* Here, the density of the risk-weighted assets of institutions' aggregate portfolio may not be lower than 72.5% of that obtained applying the standard approach. Accordingly, this constraint should affect Spanish banks to a lesser extent. However, the set of reforms pending implementation will foreseeably have some impact on banks' capital requirements in the coming years. In this respect, the bigger the capital buffers Spanish institutions have, the greater their capacity to cushion the impact of the full adoption of the reforms and their pass-through to European regulations.

Beyond the need for compliance with regulatory requirements, the level of solvency is particularly significant in a financially globalised world. Thus, there is empirical evidence that the cost of financing with instruments convertible into capital falls significantly the greater banks' level of solvency. And we should remember that banks, owing to MREL requirements, will have to issue a lot of these instruments in the coming years, a task that has been made easier in recent months by the ECB's monetary policy. In addition, there is evidence that banks with higher solvency levels are those best adapted to uphold their profitability against a background of negative interest rates.

One way of evaluating the suitability of banks' solvency levels involves subjecting them to stress tests. The Banco de España performs such exercises annually on all Spanish institutions. To do so it takes as a starting point highly granular data from the balance sheets of banks at the close of the previous year and defines a baseline macroeconomic scenario which coincides with the forecasts of the Banco de España available at the time the exercises are performed. It then takes another, stressed scenario, which seeks to reflect the effect of the risks identified previously materialising. The difference between both scenarios reflects the degree of stress of the exercise which, in the test this year, is slightly higher than that of the previous year owing to the intensification of the risks mentioned in the first part of my address.

While the results of these tests will be published in greater detail in the forthcoming *Financial Stability Report,* allow me to offer you in advance some of the main conclusions.

The results obtained in relation to the resilience of Spanish banks as a whole are, in general, positive. The capital needs arising under the adverse scenario are moderate at the aggregate level, although there is considerable heterogeneity across banks. Specifically, the reduction in the CET1 capital ratio for large institutions with a significant international presence is 0.4 pp, standing at 2.7 pp for other SSM-supervised banks and at 0.6 pp for less significant institutions.

The difference obtained between internationally active institutions and other institutions supervised by the SSM shows the significance of geographical diversification in absorbing shocks. The lower decline in the capital of the less significant institutions is largely due to their lower credit risk and the lesser weight of their exposure to the real estate sector, i.e. to their better asset quality.

The results obtained are generally more favourable than last year. This is because banks have made use of the past year to lessen their exposure to changes in the prices of certain assets, such as foreclosed assets. Specifically, banks have offloaded considerable packages of foreclosed assets during 2018 and in 2019 to date.

Turning once more to the main sources of risk to financial stability, the last such source I wish to mention relates to **financial institutions' operational risk**. Operational risk accounts for 9.3% of Spanish deposit institutions' volume of risk-weighted assets, slightly below the European average (10.5%). In any event, the deterioration of solvency associated with an operational risk event may be high based on past experience. Indeed, for European banks affected by big operational events, this deterioration has stood at over 1.25 pp of CET1 in the past five years, with a rise to 2.1 pp in 2018.

In Spain's case, **the potential materialisation of costs associated with legal risks continues to contribute to deposit institutions' operational risk**. The processes linked to past litigation such as that of the floor clauses have had an estimated cost for the sector of over €2.2 billion to June 2019. Moreover, there are other significant legal processes still pending resolution.

In any event, legal risk and certain other factors relating to banks' conduct have had a considerable impact on the reputation of the banking sector, and not only in Spain. It is worth recalling here that reputation and customer confidence are fundamental to the banking business. Therefore, institutions should strive to reverse this tendency by providing their customers with financial products and services suited to their needs and capabilities, and they should likewise supply the relevant information clearly and transparently.

Lastly, in relation to the systematic assessment of the balance of risks to financial stability that we regularly make at the Banco de España, we are including other elements, whose materialisation could occur over a longer horizon. I refer here to the potential **changes technological innovation may entail for the market structure of the financial sector, and those arising from climate change. The importance banks give to these changes will have to increase accordingly.**

Macroprudential policy

As you all know, a macroprudential authority (AMCESFI) has been in place in Spain since the start of the year. Its main task involves contributing to the coordination and exchange of information on financial stability-related aspects between the Banco de España, the Ministry of the Economy and Enterprise, the National Securities Market Commission and the Directorate General of Insurance and Pension Funds.

In parallel, the supervision of the financial system as a whole has been bolstered by the extension of the macroprudential tools available to the sectoral supervisory authorities. Some of these new tools, in particular those of the Banco de España based on borrowers' ability to pay, aim to prevent an excessive easing in lending standards on the part of banks and to contribute to the sustainability of household and corporate debt. These new instruments complement those already being used by the Banco de España: the countercyclical capital buffer, the systemic risk buffer and the buffer for systemically important institutions, among others.

Overall, this new institutional framework and the attendant powers mark progress and the strengthening of financial stability in Spain. In fact, in my opinion[1], the introduction of macroprudential policy instruments to complement monetary and fiscal policy is probably one of the most significant advances in the wake of the international financial crisis. For countries which, like Spain, belong to a monetary union, these tools are particularly important. They are some of the few instruments available in the national realm to ensure the stability of the domestic financial system.

In relation to this macroprudential policy, the Banco de España is responsible for setting quarterly the so-called Countercyclical Capital Buffer (CCyB). The CCyB is a macroprudential instrument that leads to credit institutions building up a capital buffer during expansionary periods so that this buffer may be released during a subsequent contractionary phase. In this way, the CCyB strengthens the banking system's solvency

[1] See the opening address at the Second Financial Stability Conference (Banco de España/CEMFI) delivered by by the Governor of the Banco de España, "A framework for the CCyB", June 2019.*

during growth phases, which is when risks usually build up, and helps mitigate the decline in the flow of new lending to the economy when these risks materialise. Consequently, the CCyB contributes to smoothing credit cycle fluctuations, and to increasing credit institutions' capacity to withstand potential future losses.

During 2019 Q3 and Q4, the Banco de España has kept the CCyB percentage at 0%. This decision is underpinned by a technical analysis of quantitative indicators mixed with qualitative information.

The set of quantitative indicators shaping decisions on the CCyB include indicators that seek to capture developments in the credit cycle of the non-financial private sector and its excessive growth, the potential overvaluation of house prices, the effort entailed for households and firms in paying interest and repaying the principal of loans (debt service), the external deficit and the macroeconomic environment.

The technical analysis assesses the recent trend of the indicators, their current status and also their expected behaviour in the coming quarters consistent with the macroeconomic forecasts prepared quarterly by the Banco de España. The forward-looking analysis is particularly relevant in this context since, in the event of the CCyB being activated, banks have 12 months to comply with the requirement.

According to these indicators, the credit cycle continues to show values below the activation thresholds (having regard to the credit-to-GDP gap, which remains below its long-term trend value), although it is progressively converging on the long-term equilibrium level. In fact, forecasts as to how it will trend in the coming years indicate that this indicator will turn positive towards 2021 Q1 and might exceed the activation threshold in 2021 Q2.

Some complementary quantitative indicators are along the same lines. This is particularly the case for credit intensity, which shows the weight of the change in credit relative to GDP, and the overvaluation of house prices currently show values close to equilibrium, with an upward trend that is forecast to continue over the next two years. Non-financial private-sector debt service, for its part, has maintained the reduction that marked its path at the start of the global financial crisis. Foreseeably, this reduction will continue, albeit more moderately so over the coming two years, given that the process of debt reduction has eased significantly and interest rates have less margin for further cuts. Finally, the current account balance continues to be slightly in surplus and is expected to remain relatively stable over the coming years.

The output gap in the economy has, since the start of the year, been in positive figures, and forecasts about its future course retain the prospect of the gap widening. Bear in mind that, moreover, set against the current recovery in the Spanish economy, the business cycle has tended to be a leading indicator of the credit cycle.

Overall, the analysis performed warrants holding the CCyB at 0%. However, if the baseline scenario forecasts for the Spanish economy hold, in early 2021 several reference indicators would exceed the activation thresholds. If this macroprudential instrument is activated, the credit institutions concerned would have 12 months in which to comply with the requirement. This analysis, however, is conditional upon fulfilment of the baseline scenario forecasts which, at present, as I stressed earlier, are subject to numerous downside factors of risk. If such risks were eventually to materialise, with a significant impact on Spanish GDP, the former diagnosis would consequently be altered.

Allow me to conclude. The downward revision of global economic prospects is the main argument warranting some deterioration in the balance of risks to the stability of the Spanish financial system. This flatter economic activity may have adverse implications both for financial and real asset prices and for agents' incomes, raising their levels of debt. Further, in this macroeconomic environment, which also makes the prolongation of the period of low interest rates more likely, banks' profitability will be subject to additional downward pressure. Against this backdrop, financial institutions should strive to improve the quality of their balance sheets, to raise efficiency and solvency levels and to increase their efforts so as to enhance their reputation. Economic policies should focus on reducing the vulnerabilities still in place in our economy, such as public and external debt, and on raising medium and long-term growth through the implementation of appropriate structural reforms. Lastly, macroprudential policy should concentrate on mitigating the potential generation of risks that may affect financial stability and on the accumulation of buffers for use, when needed, in more adverse macroeconomic scenarios.

Thank you for your attention.