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Financial stability-related risks and vulnerabilities and situation of the Spanish banking system*

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* English translation from the original in Spanish.

I would like to begin by thanking elEconomista for inviting me to take part in this **Banking Forum**, allowing me to share with you the Banco de España's most recent analysis of our country's main financial stability-related risks and vulnerabilities, and of where the banking sector currently stands. To put this analysis in context, I will begin by briefly taking stock of recent developments in the Spanish economy and its future prospects.

1 Recent developments in the Spanish economy

Following strong momentum in the opening months of the year, the Spanish economy began showing signs of a slowdown in Q2, which carried through to the summer months. GDP growth stood at 0.6% and 0.4% in the first two quarters of the year, followed (according to the early estimate) by 0.3% in Q3, in line with the Banco de España's latest projections published in September.[1]

These projections forecast average growth of around 2.3% in 2023, while the outlook for the following two years suggests that momentum will slow somewhat (1.8% in 2024 and 2% in 2025).

Although these projections will be updated in December, the most recent forecasts drawn up by certain international organisations (the European Commission and the IMF) indicate a similar pattern, whereas those released by the OECD anticipate lower GDP growth in 2024 (1.4%).

Meanwhile, improvements on the supply side of energy markets since 2022 H2 and the effects of monetary policy tightening have done much to keep inflation in check. Thus, following upturns in previous months, inflation fell to 3.2% in November, while underlying inflation continued trending downwards.

According to the September projections, the 2023 inflation rate should be well below the 2022 figure (8.3%), at around 3.6%. In 2024, inflation will depend significantly on developments in energy and on decisions as to when to unwind the measures set in place to combat rising prices. In any event, taking a medium-term view, inflation is expected to fall gradually to around 2% in 2025.

This baseline projections scenario is relatively benign, given that GDP is expected to grow above potential throughout the entire projection horizon, with inflation set to converge progressively towards the ECB's target over the medium term.

Nonetheless, it should be stressed that the level of uncertainty over the macro-financial situation of the global and Spanish economies remains very high, and these projections may therefore be affected by the materialisation of various risks.

I will now turn to the main risks we have identified from a financial stability standpoint, as set out in our latest Financial Stability Report (FSR).

[1] See "Macroeconomic projections for the Spanish economy", September 2023.

2 Main risks to financial stability

2.1 The risks to economic growth remain tilted to the downside

The risks to economic growth remain on downside. Indeed, in the euro area, quarter-on-quarter GDP growth was slightly negative in Q3 (-0.1%), while the most recent data suggest very subdued growth in Q4, and a technical recession cannot be ruled out altogether. Moreover, H2 growth is below that anticipated in the ECB's September projections.

Meanwhile, the risks linked to geopolitical tensions (already high as a result, above all, of the war in Ukraine) have been further exacerbated with the emergence of a new flashpoint in the Middle East.

These tensions have so far had a very limited impact on the energy and financial markets, far less than that observed when the war in Ukraine broke out in February 2022. Recent weeks have even seen downward corrections in the price of both oil and gas, alongside a rise in stock prices.

However, a historical analysis of conflicts of this nature suggests that prudence is in order. In particular, the potential spread of the conflict across the region could have a significant impact on global economic activity and, by extension, on the Spanish economy.

Taking a more medium-term view, there is as yet no clear trend towards the deglobalisation of the world economy (although there are signs of globalisation changing shape, with a push towards more diversified supply chains). However, given the geopolitical context, the risk remains that the efficiency gains stemming from economic and financial globalisation could, at least partially, be reversed.

2.2 The risks to the inflation scenario are balanced

As I noted earlier, inflation has fallen significantly and the projections forecast a gradual decline to around 2% over the medium term in both the euro area and in Spain. This view is borne out by yesterday's flash estimate for the euro area, which shows that headline inflation dropped to 2.4% in November, with the underlying component falling to 3.6%. Moreover, the risks surrounding these projections are balanced.

On the one hand, the geopolitical factors I mentioned earlier are a source of upside inflation risk. Climate factors pose a similar risk for energy and food prices. And a higher than anticipated rise in wages and profit margins could trigger higher inflation than that projected in the baseline scenario.

Conversely, the materialisation of downside risks to growth or the stronger pass-through of monetary policy could bring inflation down.

Against this background, the ECB’s Governing Council considers that the current interest rates, maintained for a sufficiently long duration, will make a substantial contribution to ensuring that inflation returns to its 2% medium-term target. Even so, we insist that we will continue adjusting our monetary policy on the basis of the incoming data to ensure price stability.

2.3 Potential increase in risk aversion

The sudden global banking turmoil of March this year led to a slight rise in risk premia, which was rapidly and almost completely corrected in the months that followed. Thus, despite the increase in the financial burden on indebted households and firms and the prospects of still relatively high inflation and weaker growth, the risk premia on debt securities and equities remain at historically low levels.

In this setting, agents may prove less willing to take risks in the future as a result, for instance, of rising pessimism over of the probability of an adverse macro-financial scenario.

A potential increase in agents' risk aversion could, in turn, lead to higher borrowing costs, while consumers and investors may delay or scale down their plans out of caution. The current relatively high valuations of financial assets could lead to a larger, more abrupt price correction.

Meanwhile, vulnerabilities at global level for certain non-bank financial intermediaries, such as some open-ended investment funds with tighter liquidity positions, or the materialisation of losses on real estate investments, particularly in China, could also exacerbate these issues.

3 Vulnerabilities of the Spanish economy and financial system

From a financial stability perspective, the potential materialisation of some of the risks mentioned could have an adverse impact on economic agents' income and wealth or on the cost and availability of financing, making it harder for them to meet their financial obligations.

To properly assess how such risks might impact the Spanish economy or how likely they are to materialise, it is worth analysing the economy's main vulnerabilities.

3.1 High government indebtedness remains the main vulnerability

The high level of public debt and the large structural budget deficit remain a significant element of vulnerability for the Spanish economy, particularly in the event of scenarios entailing an abrupt change in market risk sentiment. Furthermore, they reduce the fiscal space to cushion potential shocks to the economy.

Thus, while it has fallen since its 2021 peak, the government debt ratio (on the data available for 2023 Q2) stands at 111.2%. Similarly, the government deficit remains high (4.4% of GDP in June 2023) and includes a sizeable structural component. Moreover, the 3.3 percentage point (pp) reduction in the government debt ratio seen over the past year was driven exclusively by the growth in nominal GDP, since the growth in interest paid and in the primary deficit would have increased the ratio by more than 11 pp since the 2021 peak.

Looking ahead, the Banco de España's projections envisage a gradual decline in the government debt ratio over the coming years, although it would still stand at very high levels in 2025 (around 108%).

Thus far, the long maturities of existing debt (on October data, government debt has an average total life of 7.9 years) and the repayment of debt issued at comparatively high interest rates during the sovereign debt crisis have tempered the impact of costlier new issuance[2] on the average cost of public debt.

However, the debt level envisaged, coupled with higher financing costs, is set to drive up Spain's public debt burden, which could reach 2.6% of GDP in 2025, up by 0.5 pp on the present figure and by 1 pp on the low recorded in 2008.

Against this backdrop, in line with the EU's recommendations, Spain should embark on a fiscal consolidation process in order to gradually bring down the debt level and the structural government deficit. Moreover, the appropriate deployment of the Next Generation EU funds and the roll-out of an ambitious programme of structural reforms would not only help lower the short-term costs of this consolidation process, it would also boost potential growth, thereby helping to correct fiscal imbalances.

3.2 Certain financial weaknesses of households and firms remain

Debt ratios continued to decline among non-financial corporations (NFCs) and households in the first half of 2023, by 4.6 pp and 2.4 pp of GDP, respectively, compared with end-2022. More broadly, these ratios have fallen by 53.3 pp and 35.8 pp at NFCs and households, respectively, from the peaks seen in 2010.

Firms, meanwhile, continued to post higher profits and better profitability during the first half of 2023, albeit somewhat unevenly across sectors of activity and sizes of firm.

Nonetheless, firms will continue to face profitability risks over the coming quarters. Weakening demand is likely to curb profit growth, due to both more lacklustre turnover and a more limited ability to pass through costs to selling prices. Moreover, the upward pressure on labour costs and energy inputs is likely to hurt profits, and the average cost of corporate debt will continue to rise as the interest rate hikes increasingly pass through.

Households, meanwhile, saw their nominal gross disposable income recover in 2023 H2, by nearly 8% year-on-year in nominal terms (1.7% in real terms), helping to mitigate the adverse effects of higher inflation and interest rates on their ability to consume and to meet their payment obligations.

However, higher interest rates continue to drive up the debt burden on indebted households, which has risen across all income quintiles, as well as the average cost of such debt. Thus, the average cost of outstanding mortgages stood at 3.5% in September 2023, 245 basis points (bp) up on the figure at end-2021.

Looking ahead, the pass-through of higher interest rates to the cost of household debt is expected to gather pace. Indeed, it is estimated that interest rates will rise by more than 1 pp on around 30% of variable-rate mortgages over the 12 months after June 2023.

[2] The cost of new government debt issuance was close to 3.85% in October 2023, well above the average of around 0.5% for the period 2013-2021.

Overall, the heavy financial pressure on some firms and households remains a vulnerability, which could be exacerbated if the downside risks to activity materialise.

3.3 The incipient build-up of imbalances in the real estate sector has been curbed

In the current setting of tightening financial conditions, the incipient build-up of imbalances in the real estate sector observed in 2022 has abated.

Thus, the downward trend in housing market activity and lending that began in 2022 Q3 has carried over to 2023 so far. In particular, Q3 saw the volume of house purchases and of new mortgage lending fall by just over 16% and around 25%, respectively, year-on-year. That said, both volumes remain above their pre-pandemic levels.

House price rises have also slowed notably since 2022, albeit with a slight uptick in 2023 Q2, which will have to be followed closely. For the time being, the house price imbalance indicators remain at values close to neutral levels.

Nor are there any signs of a loosening of mortgage lending standards. According to indicators estimated by the Banco de España, for new mortgages, the average loan-to-value (LTV) ratio and the share of mortgages with a high LTV ratio (above 80%) fell in the first half of the year. Meanwhile, the estimated loan-to-income (LTI) ratio for new mortgage loans has held stable, although the loan-service-to-income (LSTI) ratio has risen, driven by higher interest rates.

4 Recent developments in the banking sector

As for the banking sector, recent developments have been characterised by the following stylised facts:

4.1 Funding

Banking sector funding continues to be influenced by the tightening of monetary policy.

There has been a significant contraction in Eurosystem financing,[3] partly offset by reductions in the excess liquidity held by banks in the form of central bank deposits,[4] as well as greater reliance on interbank funding and increased debt issuance.[5] Deposits continued to grow at consolidated level, albeit more slowly, but were down for business in Spain.[6]

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[3] At consolidated level, the monetary normalisation process reduced central bank funding as a share of total assets by 6.4 pp between September 2022 and September 2023.

[4] In Spain, resident banks' central bank deposits fell from 12.3% of assets in June 2022 to 7.7% one year later (non-consolidated data).

[5] In September 2023, deposits from credit institutions saw their share rise by 2 pp, while that of debt securities rose by 1.4 pp.

[6] Consolidated deposits grew by 0.1% year-on-year, compared with 7.9% the previous year. In business in Spain, deposits by households and non-financial corporations (NFCs) fell by 1.6% year-on-year.

In parallel, the average interest expense on bank liabilities grew significantly, with the rate for the first three quarters of 2023 (2.4%) more than doubling that at end-2022 (1.1%). However, the rise in the EURIBOR has only partially passed through to the average cost of retail deposits in Spain,[7] although that pass-through has gathered pace in the most recent quarters. In any event, the pass-through to date has been less robust than in previous monetary tightening cycles.[8]

The estimated drop in the cost of equity softened the blow of rising funding costs,[9] since the higher risk-free rate has been more than offset by a lower stock market risk premium and narrowing spreads for Spanish banks.

Despite a significant volume of targeted longer-term refinancing operations (TLTROs) maturing in June 2023, liquidity ratios have remained comfortably above regulatory minimums.[10]

4.2 Assets

In September 2023, consolidated assets fell by 2.9% year-on-year. Financial assets in Spain declined by a notable 8.4%, compared with growth of 4.3% for such assets overseas.[11]

Most (82%) of the drop in financial assets in Spain was the result of shrinking central bank balances (down 36.6% year-on-year) and, to a lesser extent, the 3.5% decline in lending to the resident private sector.

By component, there was a 2.5% contraction in the stock of lending to Spanish households (-3.1% in the stock of mortgage lending) and a 5.3% fall in lending to NFCs and sole proprietors.

Higher interest rates have continued to pass through to lending rates. The 12-month EURIBOR stood above 4%, having risen by 465 bp since December 2021. In September 2023, the pass-through to average lending rates stood at around 50% in the case of loans for house purchase and business loans, and 30% for other loans to households.

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[7] Between December 2021 and September 2023, the cost of deposits with agreed maturity increased by 1.46 pp for households and by 2.08 pp for NFCs, while the 12-month EURIBOR rose by more than 4.6 pp.

[8] In September 2023, remuneration of retail deposits at consolidated level accounted for 41% of banks' total funding costs, owing to the preponderance of such deposits in banks' liabilities structure.

[9] Cost of equity is unobservable and can be estimated only with a great deal of uncertainty. In any event, the central estimate shows a decline of 1.5 pp between December 2021 and October 2023, when it stood at 9%.

[10] In September 2023, the average liquidity coverage ratio (LCR) stood at 179%, compared with 199% a year earlier, while the net stable funding ratio (NSFR) was 131%. Furthermore, retail deposits cover a very substantial portion (around 75%) of the total stable funding needs, above the European average of 60%.

[11] In September 2023 overseas assets represented 54% of the total, up by 3.3 pp on a year earlier and compared with 32% in 2008. The rise in overseas financial assets during the last year owed more to the growth in debt securities (12%) than in lending to the resident private sector, which held steady. In consolidated terms, debt securities grew by 7.8% and accounted for 14.3% of total assets in September 2023 (10.6% in June 2007).

4.3 Credit quality

The non-performing loan (NPL) ratio declined from 3.7% in September 2022 to 3.5% in September 2023,[12] its lowest level since 2008. Stage 2 credit was up slightly to 7.4%, standing 1.5 pp above its pre-pandemic level.

Lending to households has performed relatively poorly in the latest period. The NPL ratio for such lending continued to decline (0.1 pp year-on-year, to 2.9% in September), but the proportion of Stage 2 loans rose (by 0.8 pp, to 5.5% in September). The volume of NPLs extended to households also climbed in 2023 Q3.[13]

5 Profitability

The return on assets (ROA) continued to improve in the first three quarters of 2023, reaching 0.8% in September 2023, one of its highest levels in the last decade. Meanwhile, the return on equity (ROE) stood at 12.6%, up by more than 2.3 pp from a year earlier and higher than the central estimate for Spanish banks' average cost of equity.[14]

The improvement stemmed mainly from the growth in net interest income, which increased by 26.3% year-on-year, benefiting from the speedier pass-through of the increase in key policy rates to loans than to deposits. On the other hand, operating expenses rose by 8.5%, due to the effect of high inflation, and impairment losses increased by 24.7%, owing to higher provisions for international activity.

In business abroad, ordinary profit improved notably (by 13%), driven mainly by the strength of business in Mexico. Along with the growth in ordinary profit in the United Kingdom and Turkey, this was sufficient to offset the decreases in Brazil and in the United States. Thus, the Spanish banks with the most international activity posted ordinary profit in excess of pre-pandemic levels.

5.1 Solvency

In September 2023, the CET1 ratio climbed by 21 bp relative to September 2022, since the increase in CET1 capital of 3.6% more than offset the 1.9% growth in risk-weighted assets. Thus, the CET1 ratio stands approximately 50 bp above its pre-pandemic level.

I should mention here the pass-through of the ECB's minimum buffer rates for other systemically important institutions (O-SIIs) to capital requirements in Spain, causing the

[12] The 12-month change in this ratio was -0.1 pp (from 3% to 2.9%) for households and -0.45 pp (from 5% to 4.5%) for the non-financial corporate sector.

[13] NPLs grew by 2% year-on-year in September. However, they remain around 6% below their level a year earlier.

[14] Excluding the impact of the windfall tax on banks, the ROA stood at 0.83% and the ROE at 13.15%. As noted above, equity estimations have something of an uncertainty interval. In any event, current ROE values appear to stand towards the upper range of that interval.

minimum buffer rates required of Spain's two most systemically important institutions to increase by 25 bp.[15]

5.2 Potential impact of the risks identified on the banking sector

Overall, the Spanish banking sector has shown notable resilience to the various extraordinary shocks of the last few years, including the most recent. Indeed, profitability, solvency and credit quality have all improved.

This improvement has been driven, in part, by the internationally agreed regulatory reform, which in the European Union applies to all banks, irrespective of size. Also, its strongly retail-oriented business model has been an advantage for the Spanish banking industry.

However, this confidence in our banking system does not negate the need to carefully monitor the effects of a potential materialisation of the risks identified. Namely:

- The substantial improvement in net interest income cannot be considered long-lasting; if interest rates remain high, bank funding costs may reasonably be expected to rise further.
- The contraction in lending involves a reduction in turnover, and there has been a fall in the value of fixed-income financial exposures (such as bond holdings, especially with longer maturities), which immediately leads to impairment of positions valued at fair value.[16]
- In a context of lower growth and high interest rates, a decline in credit quality is likely, although its speed and severity will depend on the materialisation of the risks identified.
- Changes in agents' perceptions could lead to downward corrections in the value of some financial assets, triggering losses and higher borrowing costs.

Stress tests are particularly useful for quantifying the impacts of the potential materialisation of risks. For instance, those published by the European Banking Authority (EBA) in July[17] show that both the Spanish and the European banking sectors are highly resilient to very severe macro-financial scenarios. Overall, for the Spanish participating banks, the CET1 capital ratio is projected to increase by 2.8 pp under the baseline scenario and to decrease by 2.4 pp under the adverse scenario, while for the European participating banks it is projected to increase by 1.4 pp under the baseline scenario and to decrease by 4.6 pp under the adverse scenario.

Although these impacts are more favourable for Spain than for the EU overall, the fact that Spanish banks start from a lower CET1 capital ratio means that, by the end of the projection horizon, their solvency levels should be similar to the European average.

[15] See the press release "Banco de España updates the list of other systemically important institutions and sets their macroprudential capital buffer rates for 2024".

[16] In positions held at amortised cost, "latent impairment" may be generated, which is not passed through to the income statement. However, an ad hoc analysis published by the EBA in July shows that in Spain such impairment affects less than 1.2% of risk-weighted assets at December 2022. See "EBA publishes findings of ad-hoc analysis on banks bonds' holdings".

[17] See "EBA publishes the results of its 2023 EU-wide stress test".

The top-down stress tests conducted by the Banco de España for Spanish banks overall, which are published in our Autumn Financial Stability Report, broadly bear out these results.

6 Risk management and regulatory and supervisory considerations

As this analysis confirms, it remains imperative that banks implement prudent provisioning and capital planning policies, to ensure that part of any short-term increase in profit is used to bolster their resilience, leaving them better placed to address the worst risk scenarios.

Indeed, under the macroeconomic projections baseline scenario, the results of the stress tests show that organic capital generation is feasible for the Spanish banking sector. This potential organic capital generation could be used to increase the banks' voluntary capital buffers or, alternatively, could stem from the release of macroprudential buffers.

The international experience of recent years shows that having macroprudential capital buffers that can be released by the authorities during downturns in the cycle can be crucial to ensuring that banks effectively make use of these buffers and, thus, help to sustain the flow of financing to the economy and stabilise the cycle.[18]

Under the current macroprudential framework, the main releasable buffer is the countercyclical capital buffer (CCyB). Hence, precisely to ensure the availability of a capital buffer that can be released in adverse situations, in recent years various authorities have opted to set the CCyB at a positive rate even in the absence of signals of credit imbalances that would in themselves trigger the activation of the CCyB. This is known as setting a positive neutral CCyB rate.

The Basel Committee on Banking Supervision (BCBS) welcomes the concept of positive neutral CCyB rates, but leaves their implementation to the discretion of the national authorities on the basis of each country's specific circumstances. Like other authorities for their respective banking systems, the Banco de España is assessing the costs and benefits of adopting this approach for the Spanish banking sector.

Furthermore, the short and medium-term challenges stemming from the recent period of extraordinary crises do nothing to lessen the pressing need to address the banking sector's structural challenges, such as those linked to digitalisation, growing competition from tech firms and climate-related risks.

On the point of climate-related risks, under the framework for prudential disclosures now laid down in banking regulations, in 2023 financial institutions reported their environmental, social and governance (ESG) risks for the very first time, paving the way for a preliminary estimate of their exposure to so-called physical risks and transition risks.

For our part, we supervisory and regulatory bodies must support the system's resilience through a regulatory framework that is conducive to strength, trust and transparency.

[18] See my speech of 2 October 2023 "The role of macroprudential policy in the stabilisation of macrofinancial fluctuations".

The priority for the BCBS must remain the complete and consistent transposition of the last leg of the Basel III regulatory reforms across all jurisdictions where this remains pending.

Likewise, the BCBS' stocktake of the lessons learnt from the banking turmoil of March flags the need to reinforce banking supervision at the global scale and identifies different regulatory issues that require more in-depth analysis, such as liquidity risk and interest rate risk.[19] Addressing these issues will be a priority for the Committee over the coming months.

From a European standpoint, a smoother-functioning euro area with improved governance would contribute hugely to making the European financial system less vulnerable. In particular, the creation of a fully mutualised European deposit insurance scheme would boost both public and market confidence. It would also contribute to greater risk-sharing in the euro area, and thus help reduce potential fragmentation episodes. Progress towards a capital markets union should also be stepped up.

[19] See the BCBS Report on the 2023 banking turmoil of 5 October 2023.