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

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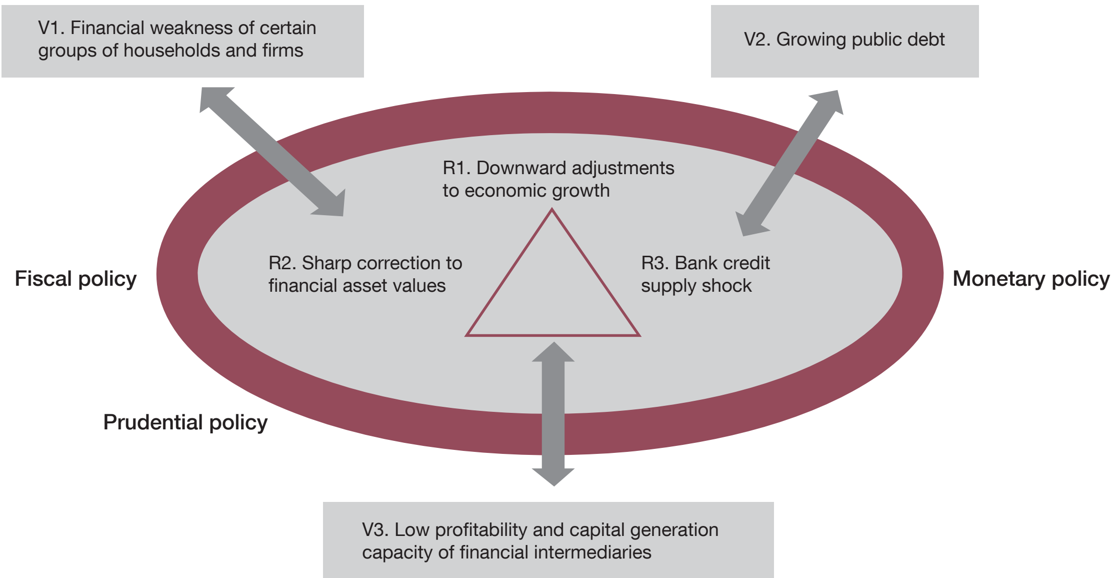
Since the last edition of the Financial Stability Report (FSR), published last October, the medical advances against the pandemic have improved the prospects of an end to the health crisis and, as a result, the economic outlook. That said, notable risks to financial stability persist. The economic crisis triggered by the outbreak of the pandemic has weakened the financial position of certain segments of households and firms. It has also reduced the profitability and the capital generation capacity of financial intermediaries, in particular in the banking sector. The mitigating response by the authorities, without which the recession would have been deeper and longer lasting, has significantly increased public debt. As a result of these developments, the Spanish economy's vulnerability to the possible materialisation of various perceived risks has increased. These include, notably, the risk of less favourable economic activity developments, the activity outlook still being subject to the uncertainty over the course of the pandemic. Also, recent financial market developments entail the possibility of sharp financial asset price corrections and adverse bank credit supply shocks (see Figure 1). The materialisation of these risks may hamper financial intermediation and weigh on real activity, compounding the effects of the pandemic.

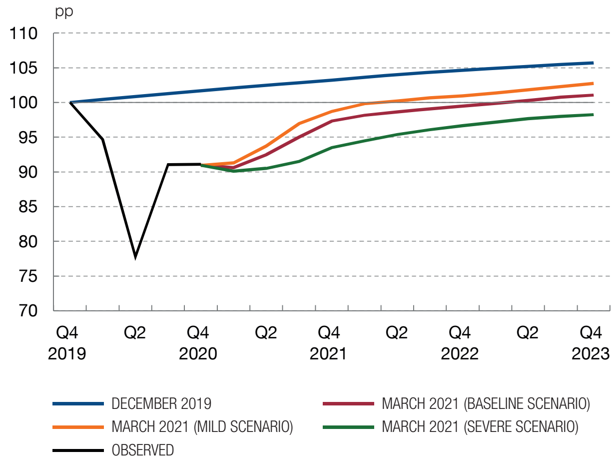
Figure 1
THE STABILITY OF THE SPANISH FINANCIAL SYSTEM: MAIN VULNERABILITIES AND RISKS (a)



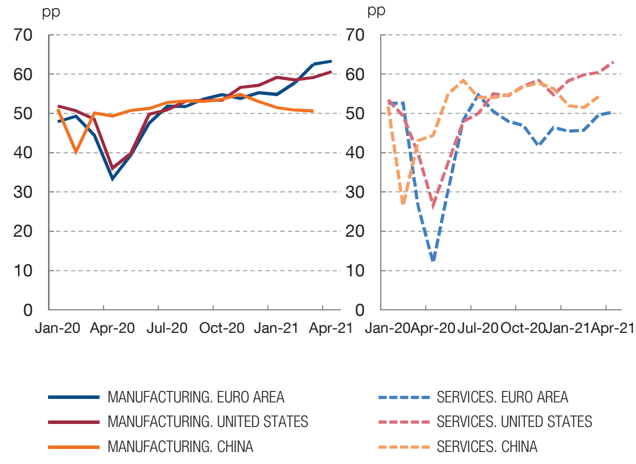
SOURCE: Banco de España.

a In this report, the vulnerabilities (V) are defined as those economic and financial conditions that increase the impact or probability of materialisation of the risks (R) to financial stability. The latter are identified in turn with adverse changes in economic and financial conditions, with an uncertain probability of occurring, which hamper or prevent financial intermediation, with negative consequences for real economic activity. Both concepts are interrelated, since the materialisation of risks can alter the level of vulnerabilities existing. The mitigating effects of the various economic policies (fiscal, monetary, prudential) improve the economic and financial conditions, and reduce the probability and expected impact of the materialisation of risks.

1 REAL GDP SPAIN. LEVEL (a)
(2019 Q4 = 100)



2 MANUFACTURING AND SERVICES PMI BY GEOGRAPHICAL AREA



SOURCES: Eurostat y Banco de España.

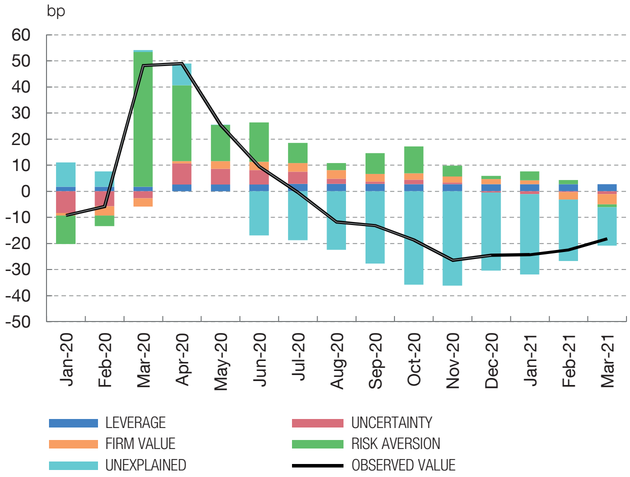
a A baseline scenario is projected for the Spanish economy, along with two alternative scenarios (mild and severe), which differ according to the assumptions regarding the pandemic and its medium-term consequences. For further information see Macroeconomic projections 2021-2023, March 2021.

There follows a brief description of what are currently perceived to be the main risks to financial stability and their interaction with the Spanish economy's vulnerabilities.

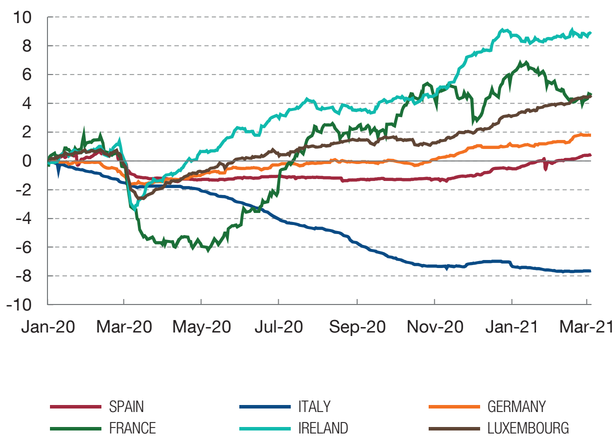
The main identified risks are:

— **R1. Downside risks to the economic growth outlook remain.** The approval by the health authorities of vaccines for the SARS-CoV-2 coronavirus, and the progress of their dispensation, has reduced the probability of the most unfavourable medium-term scenarios. However, developments in the last two quarters have been adversely affected by the need for fresh containment measures. Assuming that the progressive administration of vaccines will allow containment measures to be gradually withdrawn, so that they have practically disappeared by the end of 2021, Spanish economic growth will accelerate in the second half of the year and remain robust in 2022. In any event, a less favourable pandemic trajectory cannot be ruled out. This would increase the persistence of its negative economic effects, in the form of destruction of the productive system, higher unemployment and, thus, lower incomes for households and firms and a deterioration in their ability to pay their debts and, consequently, higher default rates on loans and other debt. Such adverse developments would lead to a less vigorous economic recovery than envisaged in the baseline projection scenarios (see Chart 1) and, foreseeably, an increase in its heterogeneity across geographical areas, industries and population groups (see Chart 2).

3 BREAKDOWN OF CORPORATE RISK PREMIA (a)
INVESTMENT GRADE. EURO AREA



4 INVESTMENT FUND FLOWS (b)



SOURCES: Datastream and Refinitiv.

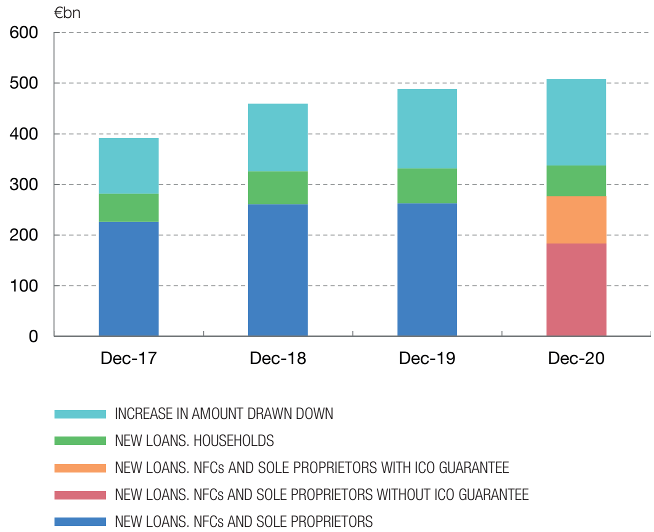
a The breakdown is based on a weighted average of different corporate bond valuation models. Risk aversion is the first component of VIX and VSTOXX. The unexplained factor is the difference between the observed value and the value predicted by the corporate bond model. The observed value of the risk premia and the breakdowns are calculated as deviations relative to the historical average of the period November 2001 to March 2021.

b Cumulative change in investment fund net capital inflows and outflows, as a percentage of the total net assets of the funds of each country on 15 January 2020, drawing on a representative sample of funds domiciled in euro area countries.

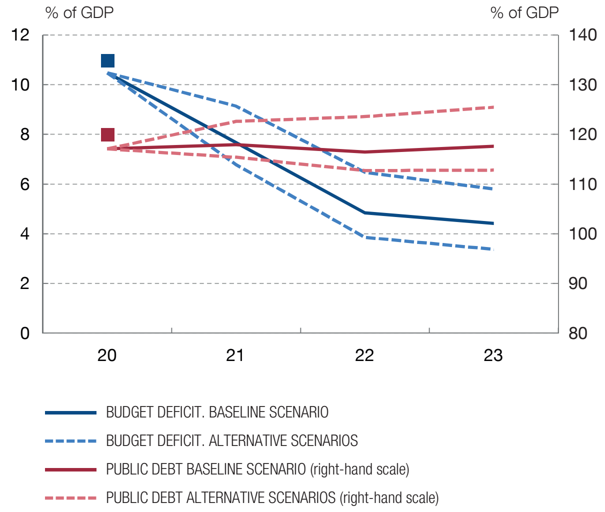
— **R2. Recent international financial market developments mean that a financial asset value correction cannot be ruled out.** The price of risky assets on international financial markets has been driven by lower risk aversion and improved growth expectations, despite the uncertainty over economic performance and the weak financial position of some agents. For certain asset classes in certain geographical areas, prices are higher than would be expected according to the historical relationship with their fundamentals (see Chart 3). Among the possible triggers for a potential abrupt correction of these overvaluations, the role of long-term interest rates, which have already increased in recent months, particularly in the United States, stands out. These interest rates may be subject to further upward pressure, in particular if there are further increases in inflation expectations in the United States that are passed through to other economic areas. Asset value corrections could also arise from downward revisions by investors to their expectations of future economic growth, to the corporate sector's ability to pay its debts or to the duration of public support programmes. Also, the presence of close interconnections between financial markets, as well as between different types of intermediaries, would facilitate the transmission of an initial correction in those markets with greater signs of over-valuation to others. Accordingly, the overall impact could be large and pervasive, affecting all the different types of financial intermediaries (see Chart 4).

— **R3. Possible adverse bank credit supply shocks.** The banking sector has supplied abundant financing during the crisis (see Chart 5), in the face

5 VOLUME OF NEW CREDIT IN THE PAST 12 MONTHS. HOUSEHOLDS, NFCs AND SOLE PROPRIETORS



6 BANCO DE ESPAÑA FORECASTS OF PUBLIC DEFICIT AND DEBT (a) (b)



SOURCES: IGAE and Banco de España.

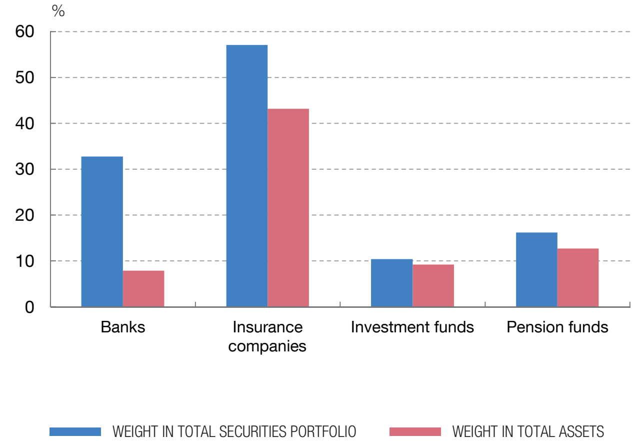
a The budget deficit and government debt estimates for 2020 and 2021-2023 do not include the assumption of Sareb debt by the general government, a fact known after the preparation of the forecasts.
b Macroeconomic scenarios of the Banco de España projections published on March 23, 2021. The squares of 2020 correspond to the data published by the IGAE six days later.

of a significant increase in the liquidity needs of households and firms as a result of their reduced revenues. The supply of bank credit has been fostered by the numerous monetary, fiscal and regulatory policy support measures adopted. Looking ahead, the negative effects of the possible materialisation of downside risks to economic activity and of the deterioration in the credit quality of households and firms could be exacerbated by a credit supply contraction, especially given the doubts regarding the incentives for financial institutions to use the available capital buffers.

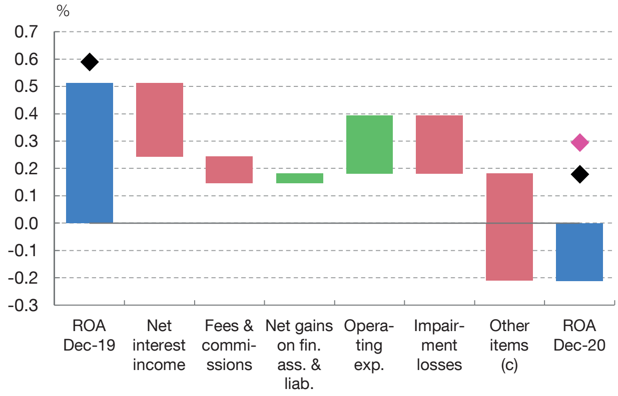
Turning to the Spanish economy's vulnerabilities, the main ones are:

— **V1. The weak financial position of certain segments of households and firms.** The persistence of the pandemic continues to have negative effects on firms' revenues, especially in those activities most affected by the crisis. Against a background of rising corporate indebtedness in recent quarters, this jeopardises the viability of some firms, constrains investment and employment plans and exposes firms to a deterioration in financing conditions. In the case of households, the increase in the saving rate and the reduction in the volume of credit at aggregate level mask the existence of segments that have seen their financial fragility increase significantly. The materialisation of the risks mentioned above would generate a further reduction in the ability of households and firms to repay their debts, increasing the credit default rate and leading to further deterioration in the banking sector's financial position.

7 HOLDINGS OF SECURITIES ISSUED BY SPANISH GENERAL GOVERNMENT. 2020 Q4 (a)



8 BREAKDOWN OF THE CHANGE IN PROFIT OF SPANISH DEPOSIT INSTITUTIONS
Consolidated net profit as a percentage of ATA (b)



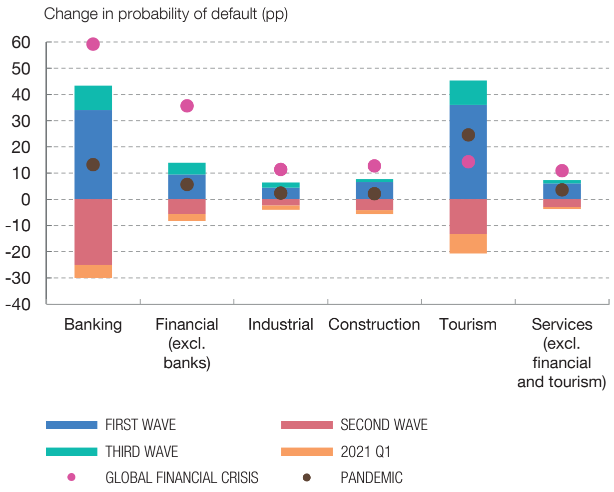
SOURCES: Securities Holding Statistics by Sector and Banco de España.

a Government bond holdings are shown according to their market value at the end of 2020 Q3. The information relates to resident financial sectors, at unconsolidated level.
b The red (green) colour of the bars indicates a negative (positive) contribution of the item concerned to the change in consolidated profit for December 2020 with respect to December 2019. The black diamonds show ROA excluding the goodwill adjustments recorded in 2019 (-€2.8 billion) and 2020 (-€12.2 billion) and the deferred tax asset adjustment in 2020 (-€2.5 billion). The pink diamond shows ROA in 2020 excluding, in addition to the adjustments already mentioned, the decline in value due to accounting reclassification of a significant institution (-€5.6 billion) and the positive extraordinary profit for 2020 (€1.2 billion).
c Includes the goodwill adjustment and other extraordinary adjustments.

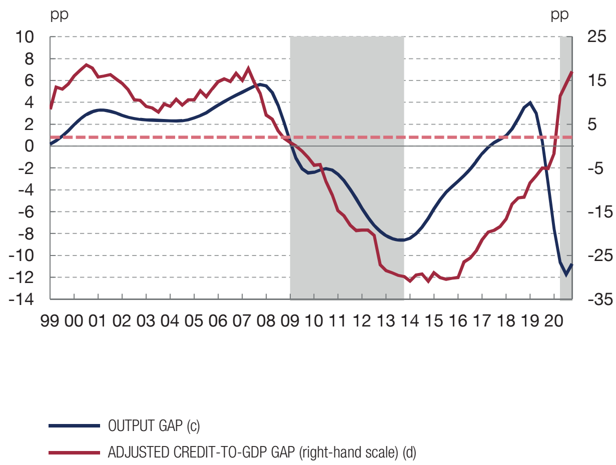
— **V2. The significant increase in government debt.** The corollary of the economic deterioration arising from the health crisis and the application of public support measures to mitigate its impact has been a substantial increase in the general government deficit and debt in 2020 (see Chart 6). The action of the European Central Bank during the crisis, including a new pandemic asset purchase programme, for public debt in particular, has so far maintained highly favourable financing conditions for the public sector. However, the increase in indebtedness along with the elevated structural general government deficit has increased the Spanish economy's vulnerability to possible changes in financing conditions and in investor sentiment, which may be passed through to other economic agents (see Chart 7).

— **V3. Low bank profitability and capital generation capacity.** The economic crisis caused by the pandemic has put downward pressure on the profitability of financial intermediaries, particularly as a result of provisioning requirements, lower net interest income and intangible asset impairment (see Chart 8). To date, the impact can be considered contained, given the magnitude of the activity shock, as a consequence of the important economic policy measures adopted. In fact the non-performing loan ratio has remained steady and capital levels have increased over the past year. However, the materialisation of the risks mentioned would put further upward pressure on credit risk and would increase the volume of

9 CHANGE IN THE IMPLIED PROBABILITY OF DEFAULT OF EUROPEAN FIRMS BY SECTOR SINCE THE OUTBREAK OF THE PANDEMIC AND IN THE GLOBAL FINANCIAL CRISIS (a)



10 OUTPUT GAP AND CREDIT-TO-GDP GAP (b)



SOURCE: Banco de España.

a The chart depicts the change in the aggregate probability of default by sector in percentage points, after weighting each firm's probability by its market value within the relevant sector or country. The brown dot represents the change between the average pre-pandemic value (January-February 2020) and the value at end-2021 Q1. The stacked bars depict the change attributable to the first wave of the pandemic (March-May 2020), to the period between the first and second waves (June-November 2020), to the third wave (December 2020-February 2021) and to the period of 2021 Q1 after the third wave (February-March 2021). The pink dot represents the peak change in 2008-2009 with respect to the 2006-2007 average.

b The vertical shaded bands represent the period of the last financial crisis in Spain (2009 Q1-2013 Q4) and the crisis unleashed by the pandemic as from 2020 Q2. The December 2020 data are provisional. The broken red horizontal line depicts the CCyB activation threshold of 2 pp for the credit-to-GDP gap.

c 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.

d The adjusted 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 value best fits the financial cycles observed historically in Spain (see Galán, J.E. (2019), Measuring credit-to-GDP gaps. The Hodrick-Prescott filter revisited, Occasional Paper Nº. 1906, Banco de España).

non-performing loans and the negative effects on bank profitability (see Chart 9). Moreover, bank profitability was already low before the crisis as a result of various factors, including: the existence of over-capacity, despite significant capacity reductions in recent years; the balance sheet clean-up, which is also well advanced, although still relevant for some institutions and assets; and the challenges of a low (or even negative) interest rate environment, which may hamper the generation of net interest income. These challenges are compounded by those arising from adaptation to digitalisation and the emergence of new competitors.

Economic policy (monetary and fiscal) is the main factor mitigating the identified risks and must remain sufficiently expansionary until the recovery takes hold. To avoid intensifying the vulnerabilities that affect financial stability, it seems essential that economic policy should be appropriately adapted to the health and economic situation (see Chart 10) and to the uneven persistence of the damage to the productive system across sectors and population groups. To this end, a broad set of instruments is needed that can be flexibly adapted to the rate of recovery of activity in each sector, as well as the outlook for its future viability. A premature withdrawal of support may aggravate the economy's vulnerabilities and financial stability risks.

In the current context, economic policy needs to focus especially on supporting those firms that are viable but face financial difficulty and the most severely affected population groups. In line with this objective, various measures have recently been adopted, including, among others, the extension of guarantee scheme durations and payment holidays and direct financial aid to compensate businesses and the self-employed for the fall in their turnover, in the sectors and geographical areas most affected, and to recapitalise firms. The effectiveness of these schemes will depend on their rapid and homogeneous implementation and on the distribution mechanisms allowing assistance to be selectively focused on viable firms with solvency problems. The volume and use of the committed funds also need to be flexible, so they can be adapted to the course of the pandemic and the possible materialisation of risks.

At the same time, there is a pressing need for implementation of an ambitious programme of structural reforms to enhance the growth potential of the economy and for a fiscal consolidation plan to be designed that can be gradually implemented when the recovery takes hold. The European NGEU funds may be particularly important for these objectives, provided that projects capable of increasing the growth potential of the economy are prioritised.

In the banking supervisory and regulatory sphere, the priority must continue to be the identification and mitigation of the risks arising from the crisis. We supervisory authorities have continued to stress that it is appropriate for capital buffers to be used by banks for credit impairment recognition and to continue providing solvent credit to households and firms. Banks will have sufficient time to comply once again with their capital requirements and the start of the process of reconstitution will never be before the main effects of the pandemic have dissipated. At the same time, given the uncertainty still persisting, that the impact of the pandemic has not yet been fully manifest in bank balance sheets and that banks continue to have the benefit of various public support measures, we have recommended that banks act with extreme prudence in their dividend distribution policies. Also, banks must pursue a policy of early recognition of impairment losses, ensuring that this is appropriate and timely, as stipulated in supervisory guidelines. Finally, the results of new supervisory stress tests will be published in the middle of the year which will help to calibrate the resilience of the sector to possible adverse macroeconomic scenarios.

We supervisors and regulators must also ensure that the resilience of the financial sector is maintained in the face of the new risks that emerge. In this respect, it should be noted that the Basel III global reforms, which all members of the Basel Committee on Banking Supervision, including the European ones, have committed to, are still to be fully and timely implemented. As regards new risks, the need to address those arising from the greater importance at global level of non-bank intermediation, which is being analysed by the Financial Stability Committee, stands out. Also notable are those relating to the impact of digitalisation and climate change. Regarding the latter, early and decisive policy intervention can facilitate an energy transition that is orderly and predictable, mitigating physical and transition risks with a high impact on financial stability. We supervisors must ensure that banks correctly assess these risks and incorporate them into their management. Lastly, it should be noted that in February the Banco de España presented for public consultation a project to amend Circular 2/2016 on the supervision and solvency of credit institutions, in order to introduce the new macroprudential instruments recently provided by national primary legislation. These will allow the Banco de España to establish a countercyclical capital buffer requirement in specific sectors, limits on the sectoral concentration of lending relative to bank capital and requirements for credit standards (e.g. the loan-to-collateral value ratio).