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FINANCIAL STABILITY REPORT
Autumn 2021

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DG FINANCIAL STABILITY, REGULATION AND RESOLUTION

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MAIN VULNERABILITIES AND RISKS (I)

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- The **macro-financial situation** of the Spanish economy **has continued improving** over the past six months,…
  - …, but significant **vulnerabilities and risks** to **financial stability** persist, and must be closely monitored

- Business defaults remain very contained, but there is potential latent credit impairment, especially in the **sectors hardest hit by the pandemic**,…
  - … which have significantly increased their indebtedness.

- High **public debt** in Spain constitutes a second source of vulnerability; accordingly,…
  - … once the recovery takes hold, a fiscal consolidation programme conducive to reducing the level of debt and to sustainable and balanced growth should be implemented

- **Bank profitability**, underpinned by the pick-up in activity and the measures implemented by the authorities, has returned to pre-pandemic levels, mainly owing to the decline in provisions for impairment losses
  - However, it stands below the levels in other regions and some non-financial sectors, and there are latent risks
  - The stress test results this year show how, under the adverse scenario, banks – with heterogeneity across the sector – would consume part of their capital to absorb additional losses, but their aggregate level of solvency would still be adequate

MAIN VULNERABILITIES AND RISKS (II)

- Notable among risks is the possible **sudden worsening in financing conditions and correction of prices of risk-bearing financial assets**,
    - The recent spike in inflation is associated with transitory factors such as the increase in energy prices and the bottlenecks in global value chains,…
        - *…which should ensure that monetary policy retains an accommodative stance*
    - The prolongation over time of these factors might increase the medium term inflation expectations of the agents,…
        - *…with the risk that a premature withdrawal of the monetary stimuli may take place*

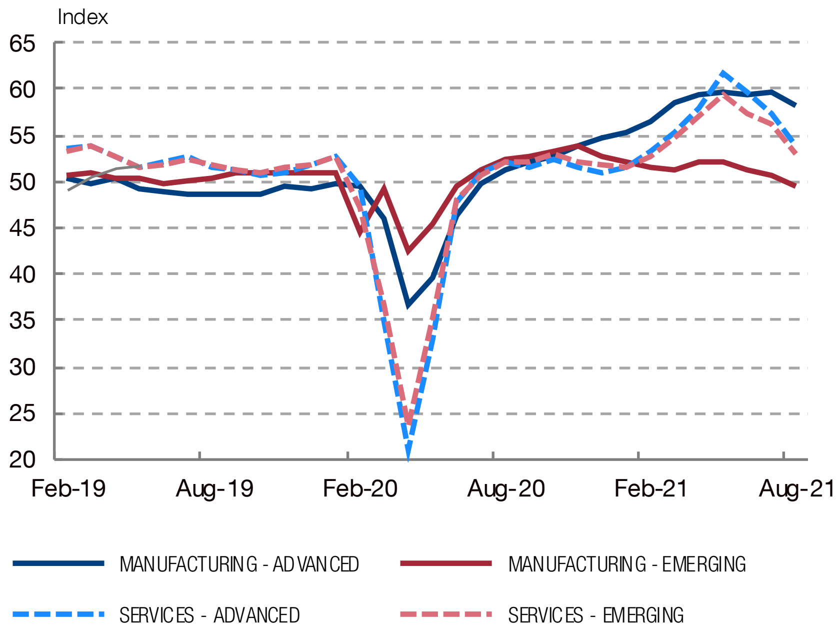
- The **economic recovery** might be adversely affected by how the pandemic unfolds, the rise in inflation and the tightening of financing conditions
- There are so far **no signs of a build-up in systemic risk** requiring the activation of macroprudential tools
    - The expected normalisation of output in the coming quarters will contribute to close the output and credit-GDP gaps
- In some advanced economies, the **housing market** is beginning to show signs of an incipient build-up of systemic risks.
    - Based on the latest indicators, this would not be the case for Spain,…
        - *…although economic activity and prices have shown greater dynamism in recent months*

MAIN VULNERABILITIES AND RISKS (III)

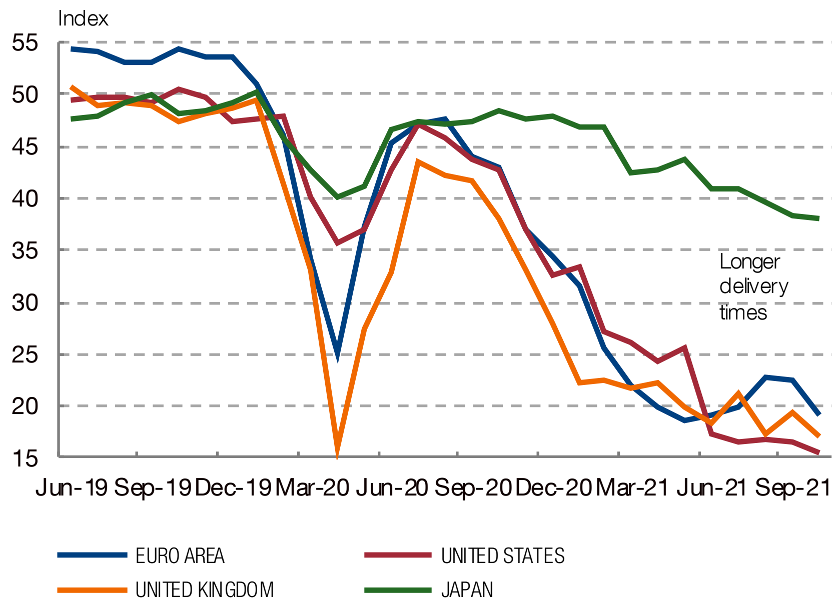
- The COVID-19 crisis has not made any less pressing the **medium and long-term challenges** the Spanish banking sector faces – including most notably **digitalisation and competition from Bigtech** and, most especially, **the impact of climate-related risks** –.
    - This FSR presents the initial findings of the effects of the materialisation of transition risks on the banking sector. They are moderate in terms of profitability and credit quality
    - A further analysis also indicates that the costs of inaction in the face of climate change would exceed, in terms of credit quality impairment, those linked to the transition to an economy with lower emissions
    - **That would substantiate the need not to postpone the adoption of measures to improve the sustainability of economic activity**

- Albeit with a **divergent outlook between the advanced and emerging economies**, owing in part to heterogeneity in vaccination take-up and the degree of economic policy support
- There are also **downside risks** arising from uncertainty over how the pandemic will evolve, the increase in **energy prices** and the persistence of **bottlenecks** in global value chains

1 PMI IN ADVANCED AND EMERGING MARKET ECONOMIES

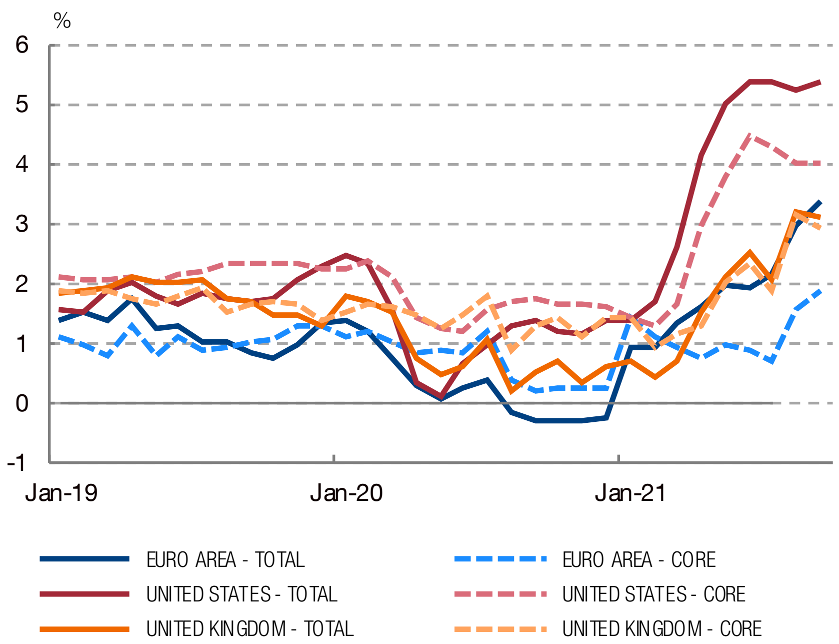


2 PMI MANUFACTURING: SPEED IN SUPPLIER DELIVERY TIMES

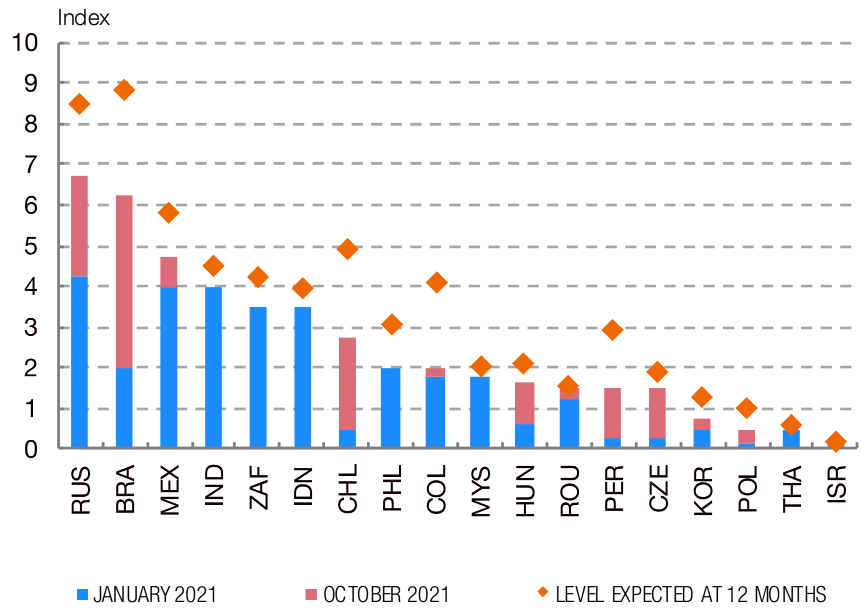


- This inflationary rise has originated mainly from factors mentioned earlier (energy prices, bottlenecks, etc.), which would be **transitory** in nature
  - Monetary policy should thus remain accommodative
- The inflationary tensions might be a bigger problem for the **emerging economies**, where there has already been **some tightening of financial conditions;…**
  - …the pace at which monetary policy in the advanced economies normalises will be key

3 INFLATION IN ADVANCED ECONOMIES

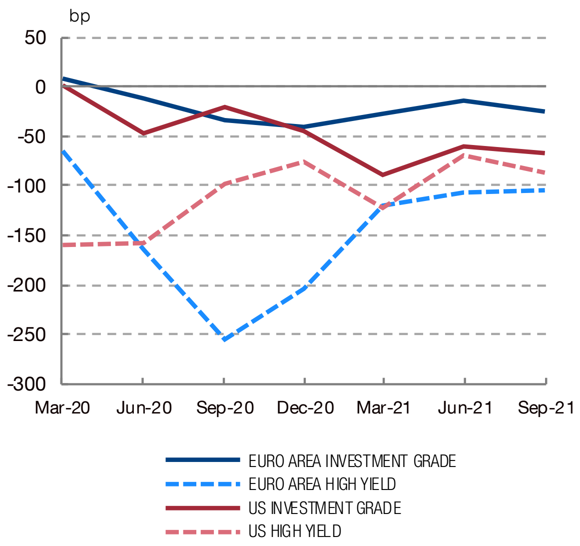


1 POLICY INTEREST RATES IN EMERGING MARKET ECONOMIES

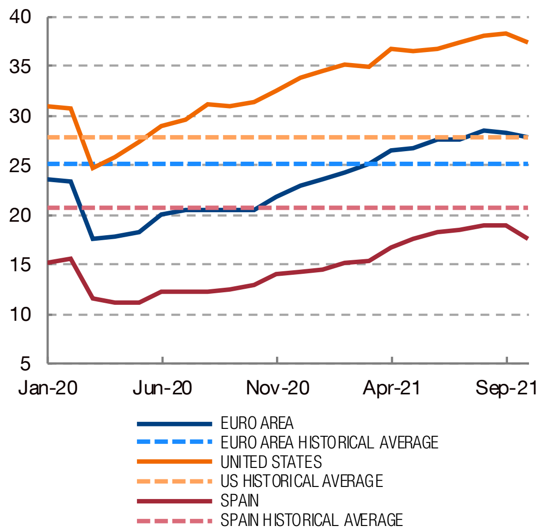


- The **prices of risk-bearing financial assets** are still **high relative to determinants** such as business profitability, leverage and risk-aversion
- The historically high levels of these prices are largely underpinned by very low real long-term interest rates...
  - ...meaning that any future premature and swifter-than-expected withdrawal of monetary stimuli by central banks might trigger corrections in asset prices and a worsen financing conditions

1 CORPORATE CREDIT RISK PREMIA, DEVIATIONS FROM HISTORICAL DETERMINANTS (a)



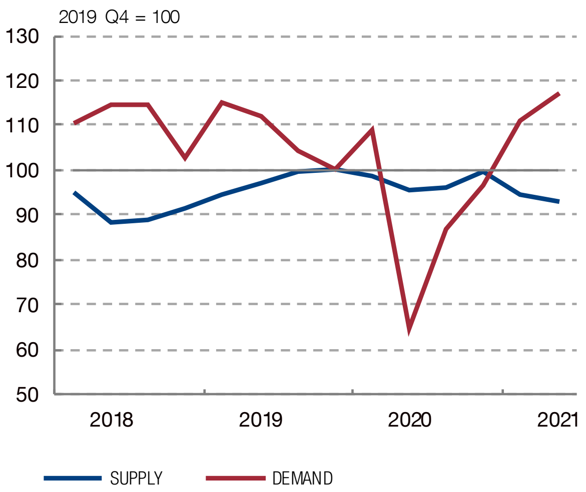
2 CYCLICALLY-ADJUSTED PER



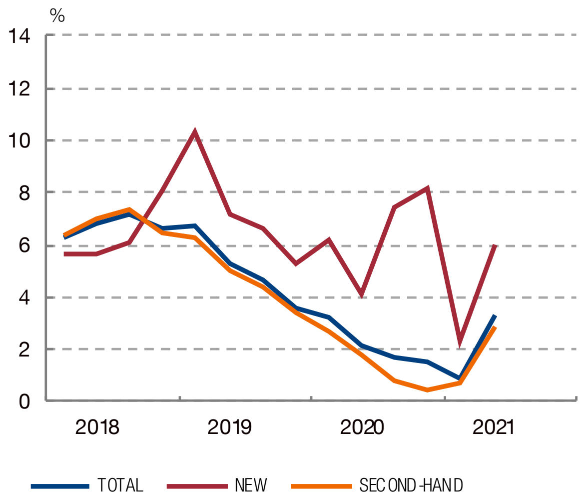
3 10-YEAR REAL INTEREST RATE

- However, the price disequilibrium **indicators** remain **very close to equilibrium and there are no signs of an easing of credit standards**
- So far, there are **no signs of alarm in this market**, but the sector should continue to be closely monitored
  - Some European countries are in fact activating macroprudential tools precisely to contain the excessive build-up in real estate risks

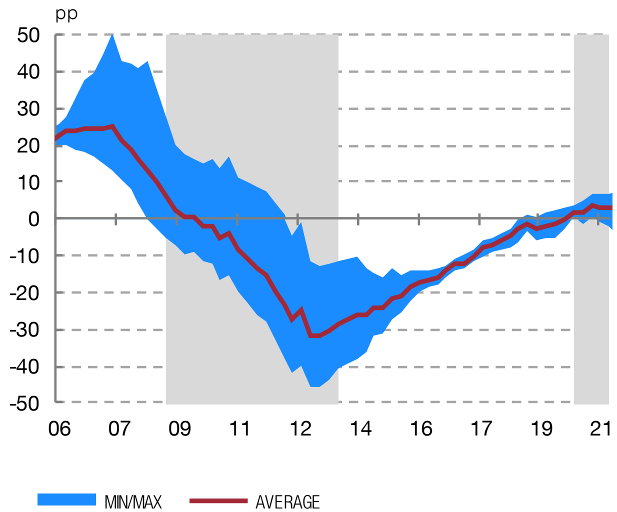
1 HOUSING SUPPLY AND DEMAND (a)



2 HOUSE PRICES
Year-on-year change

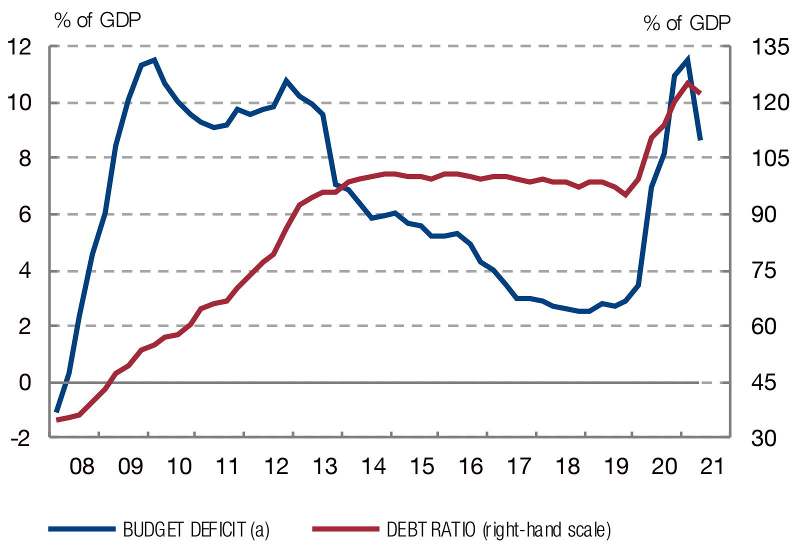


2 INDICATORS OF HOUSE PRICE IMBALANCES (c)

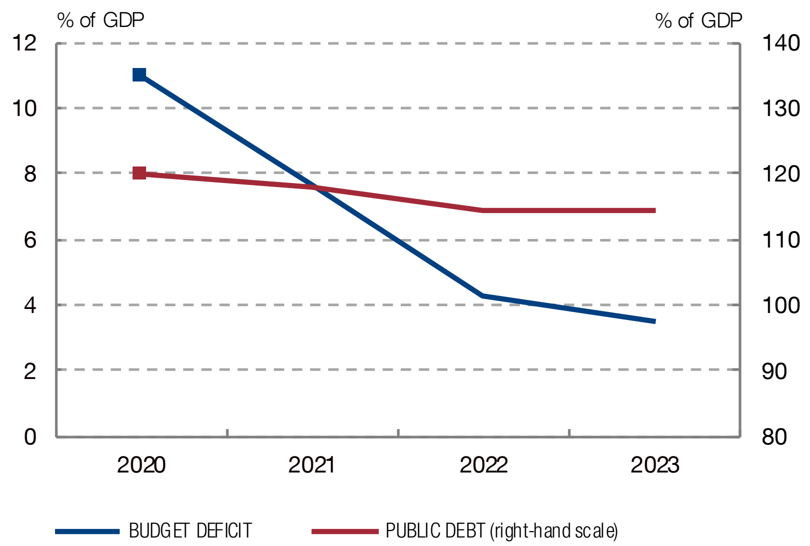


- There has been a **decline in the general government deficit** in the first half of the year, which is expected to continue in the coming years.
- In the short term, **fiscal policy should continue contributing to strengthening the economic recovery** under way, **focusing increasingly** on the sectors and groups most affected by the crisis
  - It is also advisable to **define a medium and long-term consolidation programme**, to be implemented once the recovery is self-sustainable

1 FINANCIAL POSITION OF GENERAL GOVERNMENT

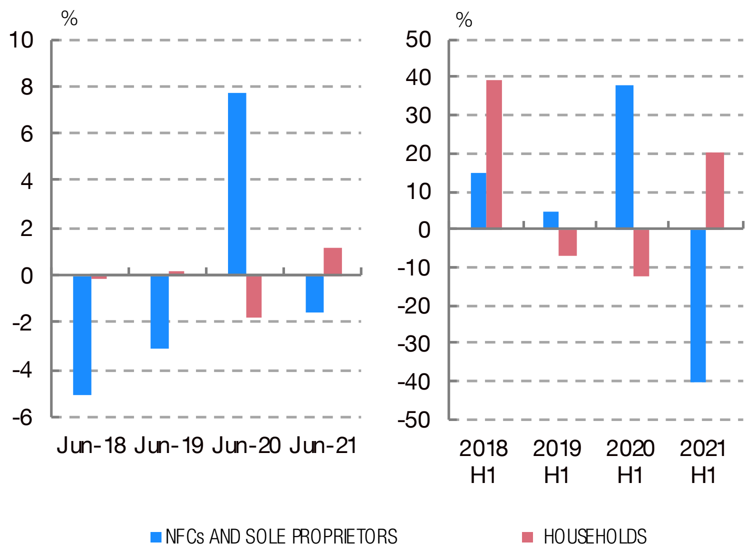


2 PUBLIC DEBT AND BUDGET DEFICIT FORECASTS (b)

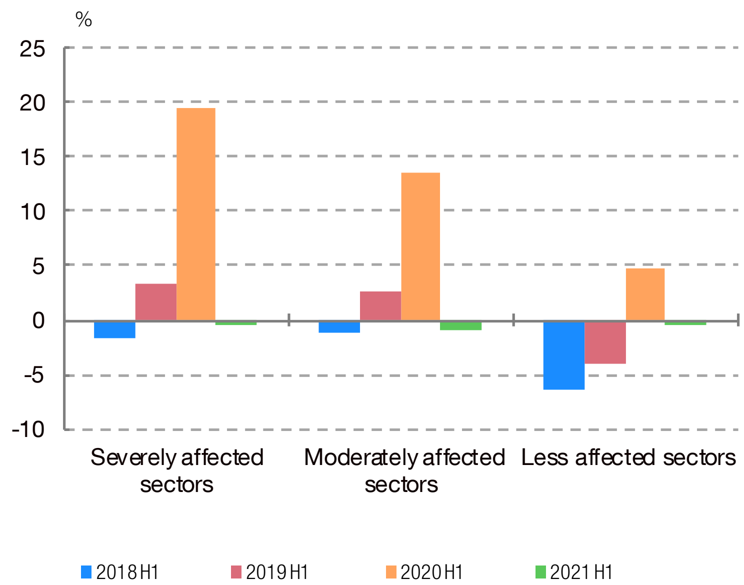


- The stock of **credit in Spain**, which grew at the start of the pandemic as a result of the support measures, **stabilised in the past 12 months** (-0.2% year-on-year in June 2021)
- However, there is some **heterogeneity** across portfolios:
  - On one hand, new lending to **households grew notably** in the past six months, in particular in the case of mortgage loans
  - On the other, the stock and flow of lending to **firms** declined, independently from the degree of sectoral impact of the pandemic

1 YEAR-ON-YEAR RATE OF CHANGE IN THE STOCK OF LOANS LEFT) AND NEW LOANS (RIGHT)
Business in Spain, ID

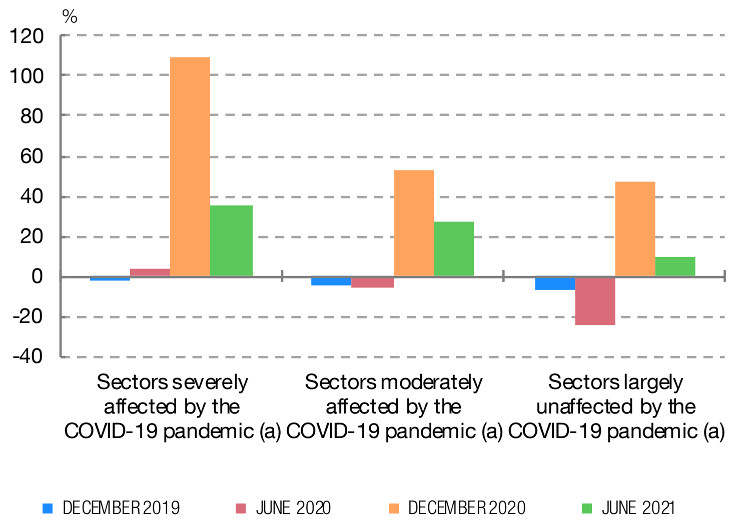


2 SIX-MONTHLY RATE OF CHANGE IN LENDING. NON-FINANCIAL CORPORATIONS AND SOLE PROPRIETORS
Business in Spain, ID (a)

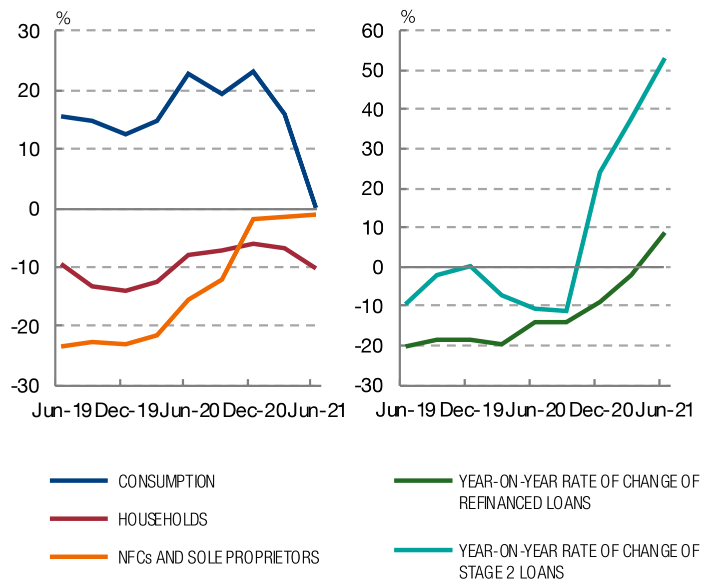


- Although they are **increasing in the sectors severely affected** by the crisis
- There are also some **signs of a diminishing ability** of borrowers to repay their loans:
  - **Strong increase in Stage 2 loans** (particularly in those sectors of activity most affected by the pandemic and, therefore, in the ICO-backed portfolio)
  - **Year-on-year increase in forborne loans in the case of firms** (also in connection with the ICO program)**,** a development not seen since the end of the Great Financial Crisis

3 SIX-MONTHLY RATE OF CHANGE OF STAGE 2 LOANS. NFCs AND SOLE PROPRIETORS
Business in Spain, ID

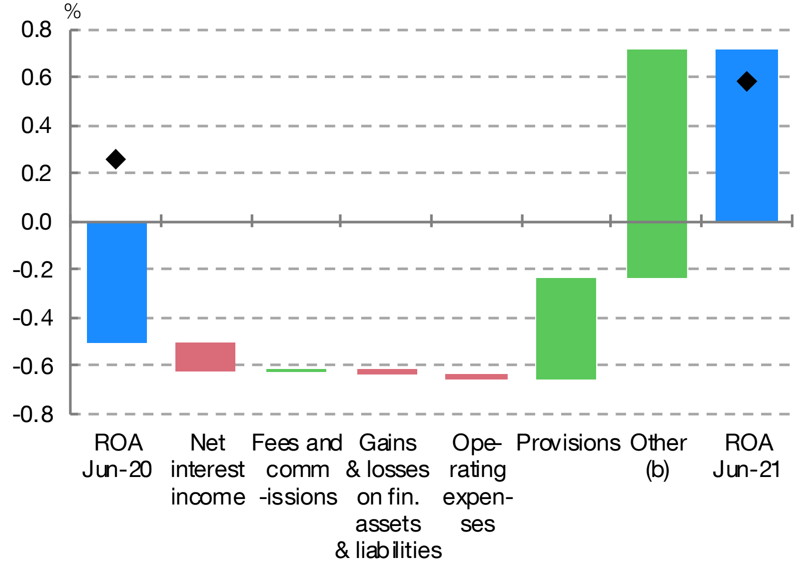


2 YEAR-ON-YEAR RATES OF CHANGE OF NPLs (LEFT) AND SIGNS OF EARLY IMPAIRMENT IN LENDING TO RESIDENT PRIVATE SECTOR (RIGHT)
Business in Spain, ID

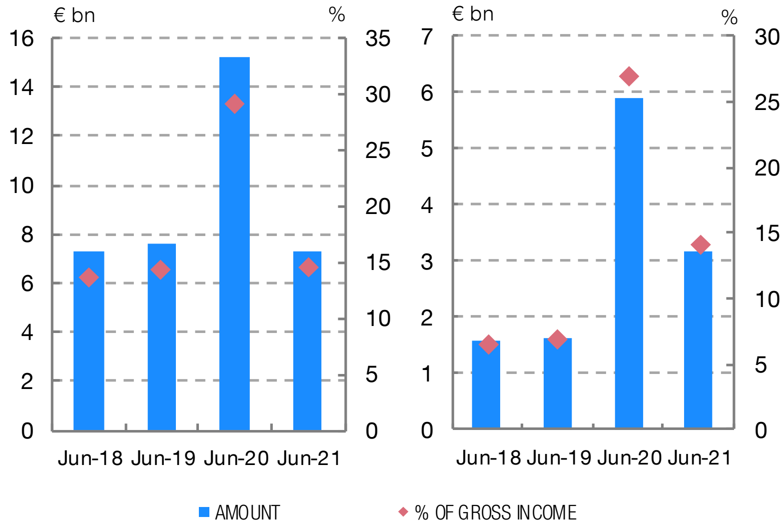


- **Bank profitability improved across the board**
- And it was mainly due to the change in **extraordinary items** (positive in June 2021 and notably negative in June 2020), and to the **decline in provisioning,…**
  - …which **fell by half** from the amounts recorded the previous year, returning to pre-pandemic provisioning levels at the consolidated level, but not so for business in Spain
- In any event, this level of profitability continues to stand **below that of other regions and sectors**

1 BREAKDOWN OF THE CHANGE IN CONSOLIDATED PROFIT
As a % of ATA (a)



1 PROVISIONING
Consolidated data at global level (l-h side) and individual data on operations in Spain (r-h side)



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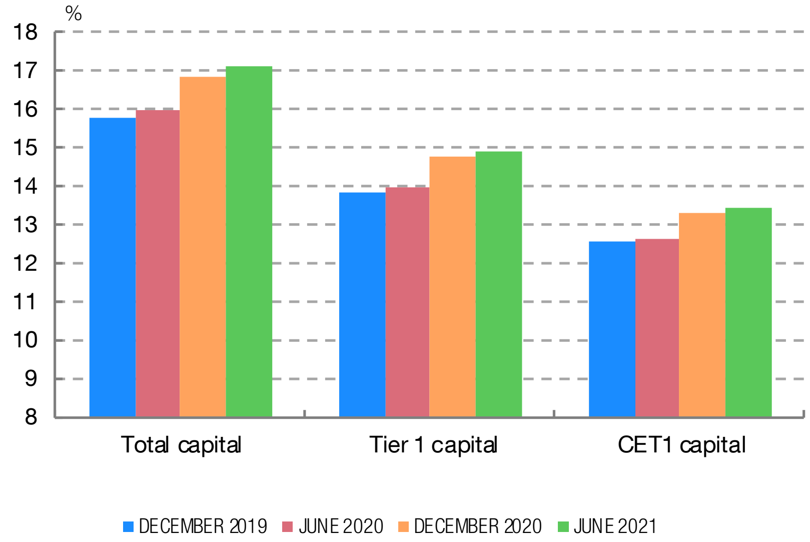
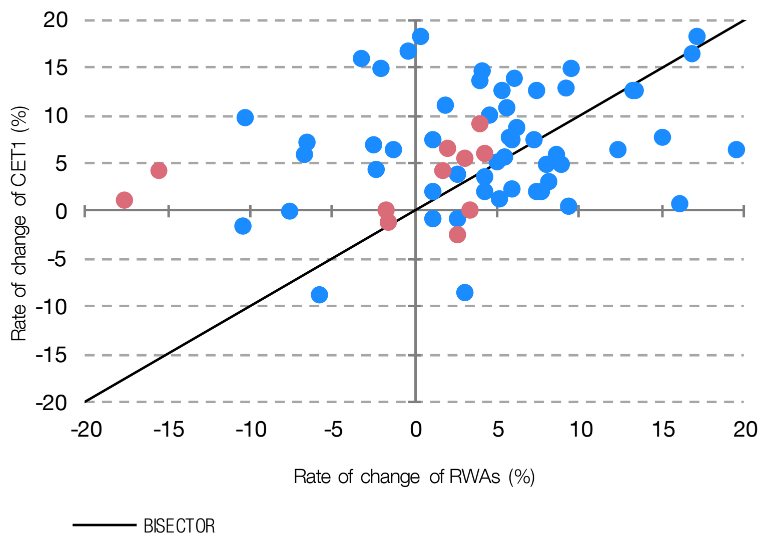
- The **CET1 ratio increased slightly (by 14 bp) in the first half of 2021,** and significantly over the course of the past 12 months (83 bp), standing at 13.4% in June 2021
  - This improvement was in line with that in other European countries
- The increase in ratios was due both to the **rise in capital levels** (numerator), which was across the board at banks, and to the **decline in risk-weighted assets** (denominator), especially in some significant institutions
- The **measures implemented** by the authorities to mitigate the impact of the pandemic **account for a large fraction of the improvement in solvency**

1 CAPITAL RATIOS
Consolidated data

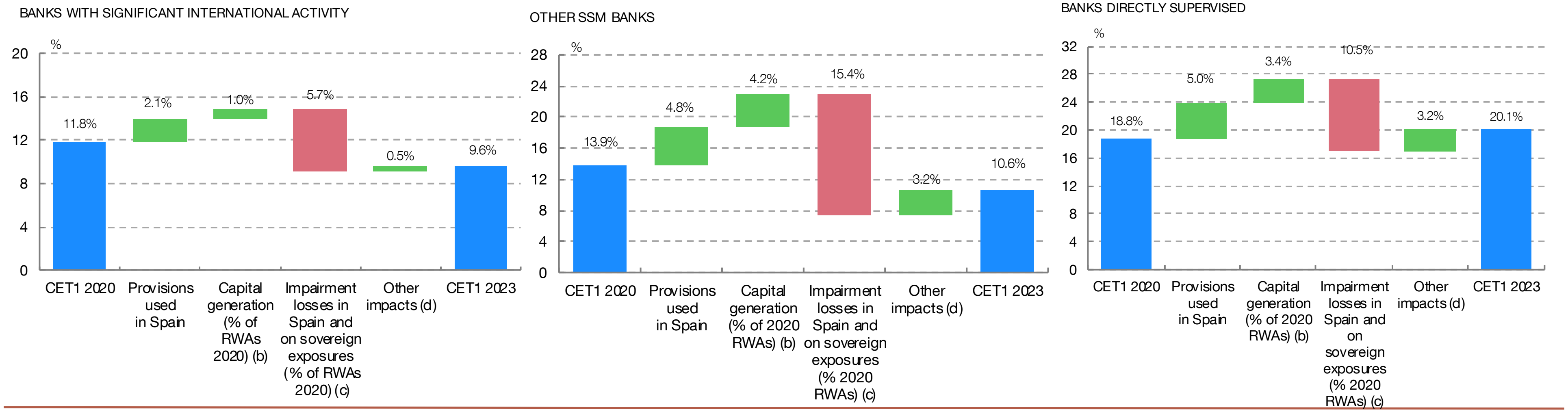


1 RATE OF CHANGE IN CET1 AND IN RWAs BETWEEN JUNE 2020 AND JUNE 2021 (a)



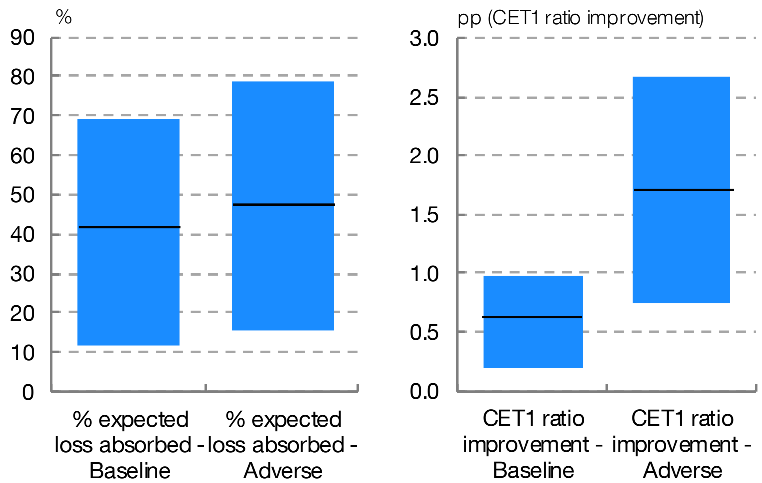
- Although there is some **heterogeneity across banks**
- Under the **baseline scenario, the three groups of banks would improve their CET1 ratio** at the end of the year, with the use of provisions, and the generation of capital would exceed impairment losses and other impacts
- Under the **adverse scenario, significant SSM institutions** (with and without significant international activity) **would see their CET1 ratio decline**; but the ratio would in any event **hold above the minimum required thresholds**
  - The reduction is less in the case of internationally active banks, reflecting how, even in the face of a global shock, geographical diversification can cushion against adverse impacts

RESULTS UNDER THE ADVERSE SCENARIO

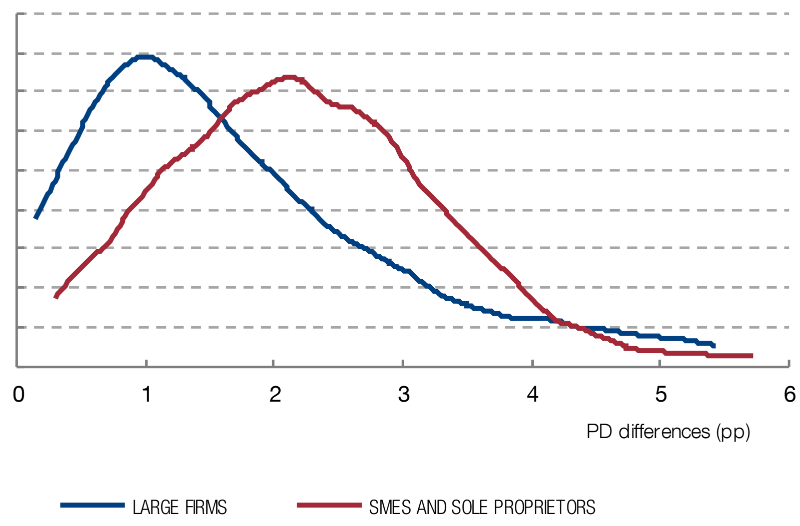


- And it also has a **positive effect** on the baseline scenario
  - By limiting in both scenarios the reduction in the CET1 ratio owing both to the lower losses banks have to assume and to the lower risk weighting of these exposures
- The **increased probability of default** under the adverse scenario (relative to the baseline) for each bank **depends on their exposure to SMEs and to the sectors most affected by the crisis**

1 EFFECT OF ICO GUARANTEE FACILITY (a) (b)

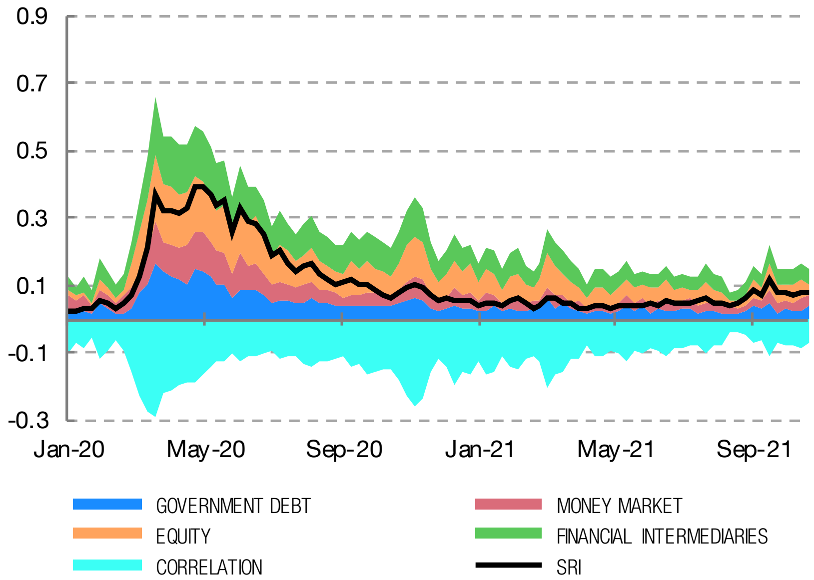


2 DISTRIBUTION BY SECTOR AND SIZE OF PD DIFFERENCES BETWEEN THE ADVERSE AND BASELINE SCENARIOS (c)

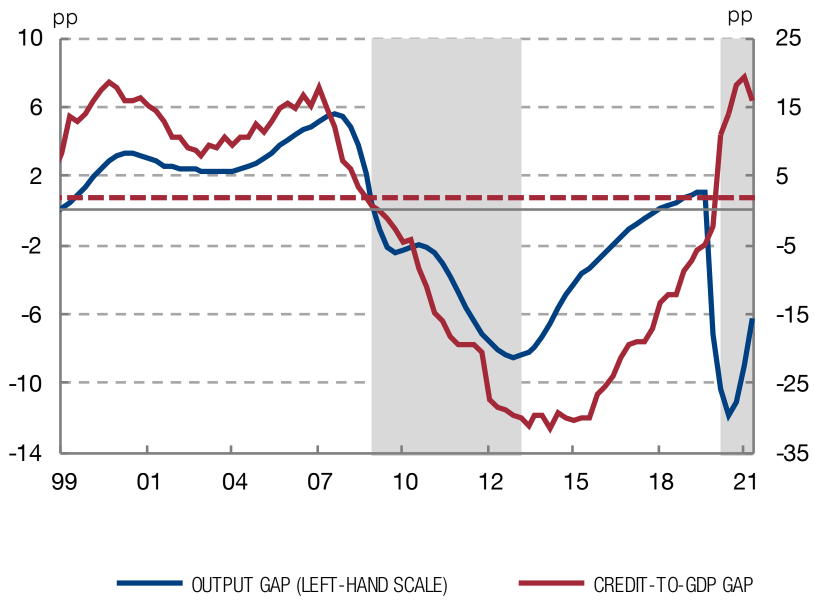


- The **SRI has risen since August** 2021 owing to the increased volatility on financial markets (equity markets in particular), although the indicator remains **far from the tension levels reached at the outbreak of the pandemic**
- The **credit-GDP gap** (and the intensity of credit) has shown **corrections as a result of the recovery in economic growth**, which is increasingly closer to its potential, albeit without attaining pre-pandemic levels

1 SYSTEMIC RISK INDICATOR (a)



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



BOX 3.1

Estimates suggest that the cost for banks of averting climate change would be far lower (but more immediate) than that of its materialization

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- This box includes the first BdE exercise to estimate the impact of the **climate change-related transition risks materialising** in Spanish banks
- As to banks, credit risk-related losses would have a **significant adverse impact on their profitability** in 2021-2023…
  - …in scenarios with higher prices for CO2 and extension of the rights system
- Although credit quality in the short run is better if no action against climate change is taken, **materialization of physical risks in the long run would imply a strong and growing deterioration**

Chart 3
EFFECT OF TRANSITION COSTS ON THE RATIO OF PROFIT AFTER TAX TO RWAs (d) (e) (f)

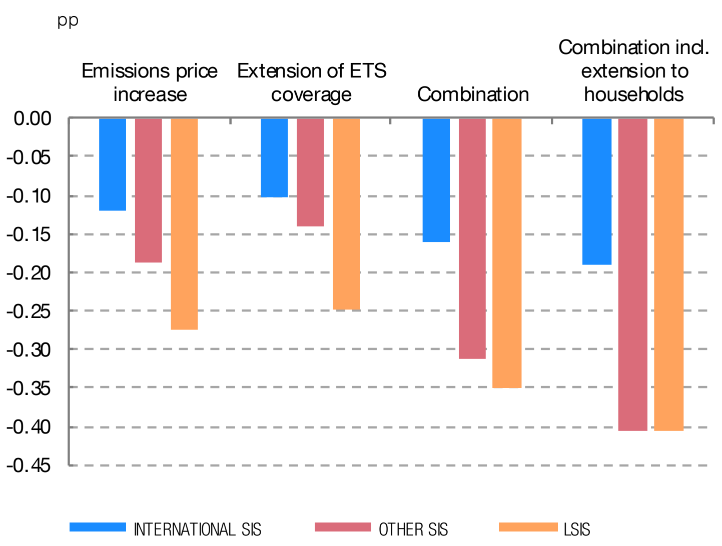
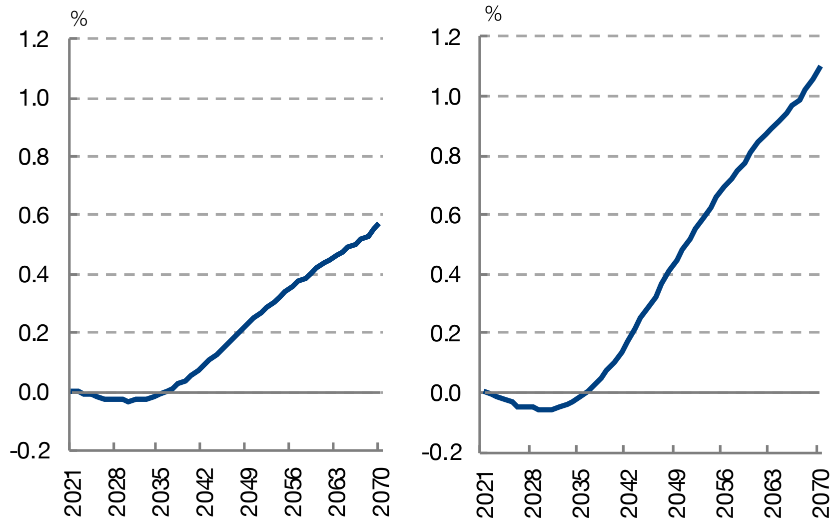


Chart 5
DIFFERENCES IN PROBABILITY OF DEFAULT, HOT HOUSE WORLD SCENARIO WITH RESPECT TO ORDERLY TRANSITION SCENARIO



In fact, the costs associated with the materialisation of physical risks may turn out to be very significant

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- This box **measures the implications of the environmental degradation in the Mar Menor** on the real estate market. The exercise can illustrate and offer guidance as to the quantification of the impact of the materialisation of **climate change-related physical risks**
- The impact of the environmental degradation in the Mar Menor is estimated by comparing changes in house prices in nearby (less than 10 km away) coastal areas, but…
  - …some of them are on the Mar Menor and others on the Mediterranean
- A **significant relative decrease is observed in real estate prices on the Mar Menor coast** after the start of the ongoing environmental degradation

Chart 1
MEDIAN PRICE PER SQUARE METRE OF HOUSING IN AFFECTED (MURCIA) AND UNAFFECTED (ALICANTE) POSTCODES (a)

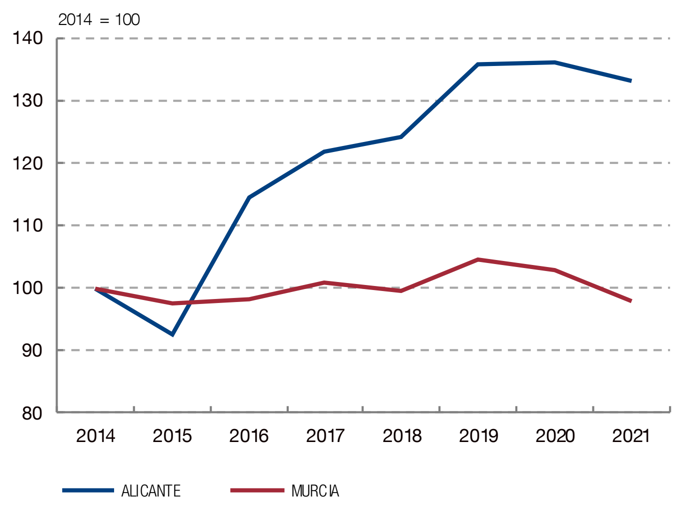
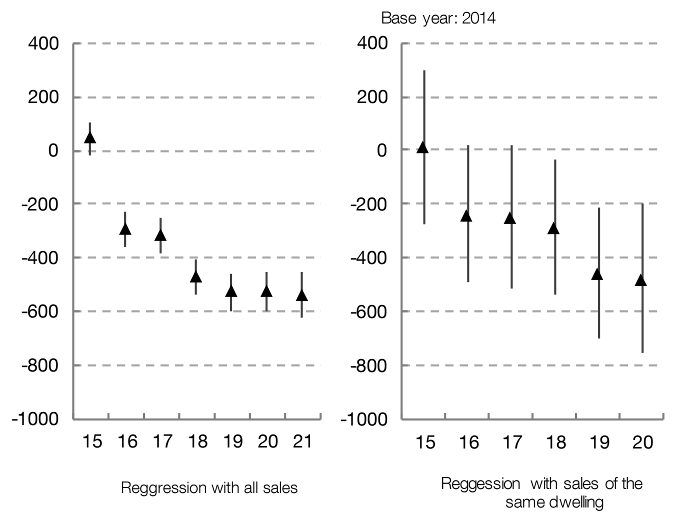


Chart 2
ESTIMATED DIFFERENCE BETWEEN THE PRICE PER SQUARE METRE IN AFFECTED (MURCIA) AND UNAFFECTED (ALICANTE) POSTCODES (b)



THANK YOU FOR YOUR ATTENTION

There is sectoral heterogeneity in the degree of economic recovery

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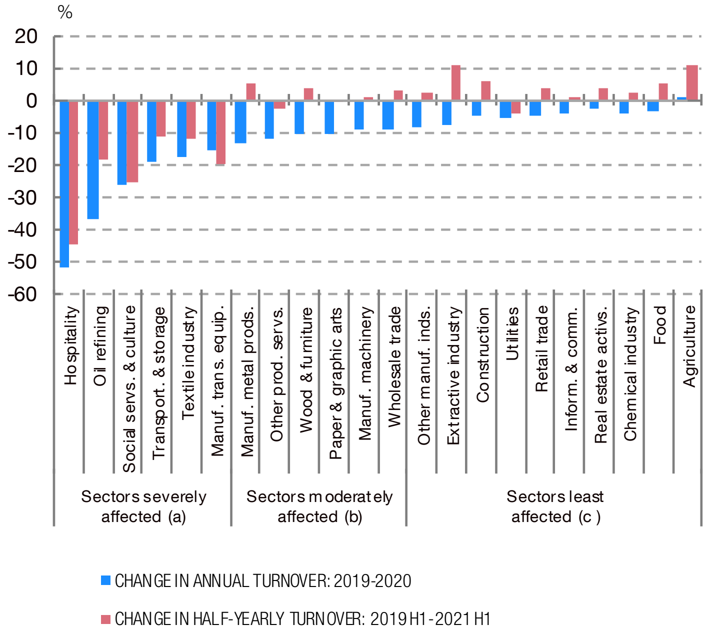
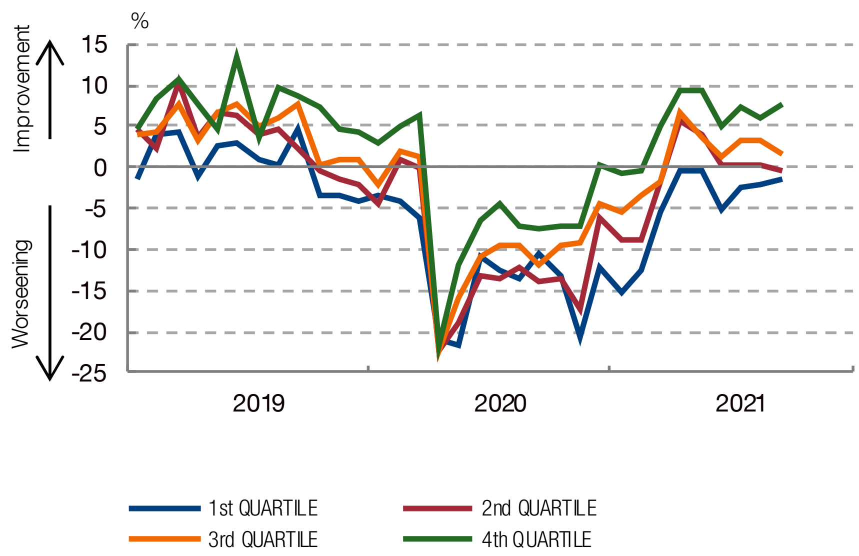
- Earnings in **most branches of activity** have returned to pre-pandemic levels, resulting in what is admittedly an still incomplete **improvement in profitability**…
- …although, in those **sectors severely affected by the health crisis**, **activity** remains **clearly below 2019** levels
- Turning to **households**, their economic situation recovered in the first half of 2021 and their **income and employment have improved, albeit unevenly** across cohorts

1 BUSINESS TURNOVER BY SECTOR
Rate of change compared with same period of 2019



2 EXPECTATIONS FOR THE ECONOMIC SITUATION OF HOUSEHOLDS FOR THE NEXT 12 MONTHS, BY INCOME QUARTILE (c)



ANNEX 2

There are signs of credit quality impairment in loans linked to moratoria and guarantees

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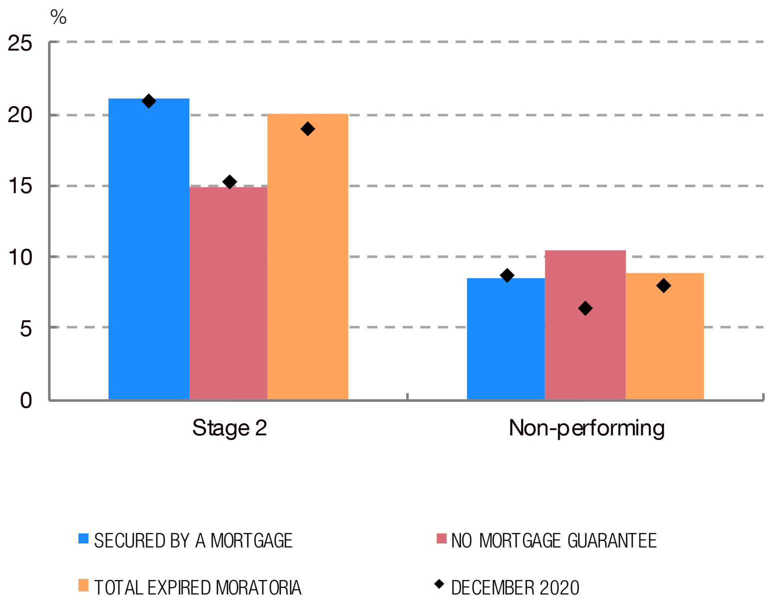
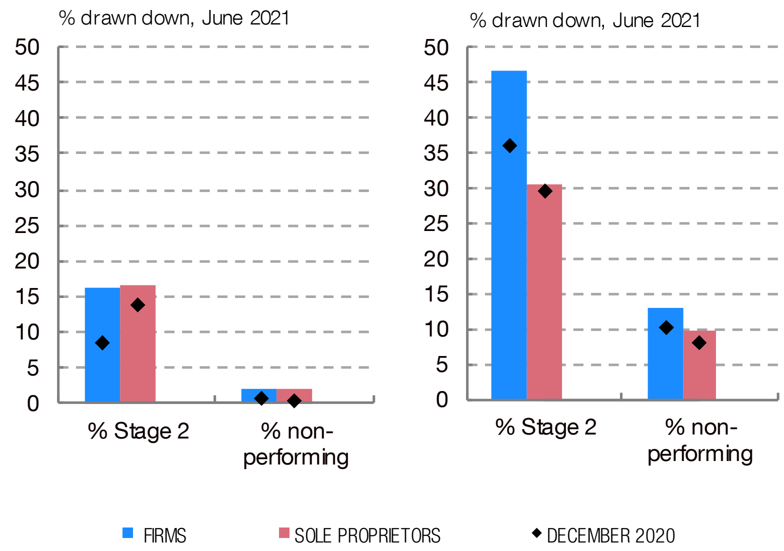
- The rates of credit quality **impairment** of loans linked to **expired moratoria** as of June 2021 **have held** at close to their end-2020 levels, standing at 20% for Stage 2 and 9% for NPLs
  - However, there has been a greater deterioration in non-mortgage loans, and the volume of expired moratoria in June is much higher than in December 2020
- **ICO-backed loans** also showed **higher impairment in June** than in December, as the percentage of both Stage 2 loans and NPLs has increased

1 CREDIT QUALITY OF LOANS LINKED TO EXPIRED OR CANCELLED MORATORIA IN JUNE 2021



2 STATUS OF ICO-BACKED LOANS IN JUNE 2021
Loan level (l-h side) / Customer level (r-h side) (a)



ANNEX 2
The maturity and/or payment holiday of a high proportion of ICO-backed loans has been extended

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- The level of ex-ante **risk**, the firm being an **SME** and its belonging to a **sector affected** by the pandemic are associated with **a greater likelihood of a firm accessing loans** with ICO guarantees
- The granting by a bank of a loan with an ICO guarantee to a firm is associated with an increase of **that bank's share of the total financing** received by that firm and a reduction in its share of **bank loans without an ICO guarantee…**

…particularly of those that have matured or are close to maturity

Chart 3
IMPACT OF THE GRANTING OF AN ICO-BACKED LOAN ON THE CHANGE IN THE LENDING BANK'S SHARE OF FINANCING, ACCORDING TO THE BORROWING FIRM'S PRE-EXISTING RESIDUAL BANK DEBT MATURITY (c)

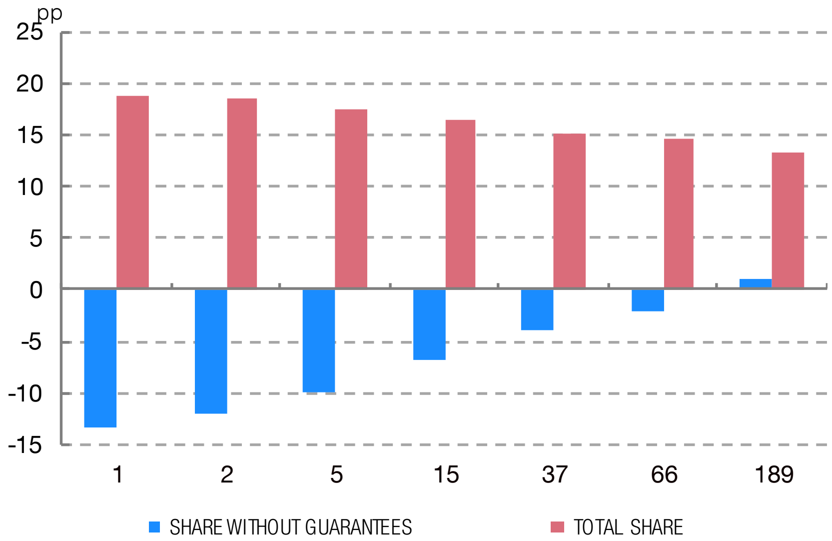
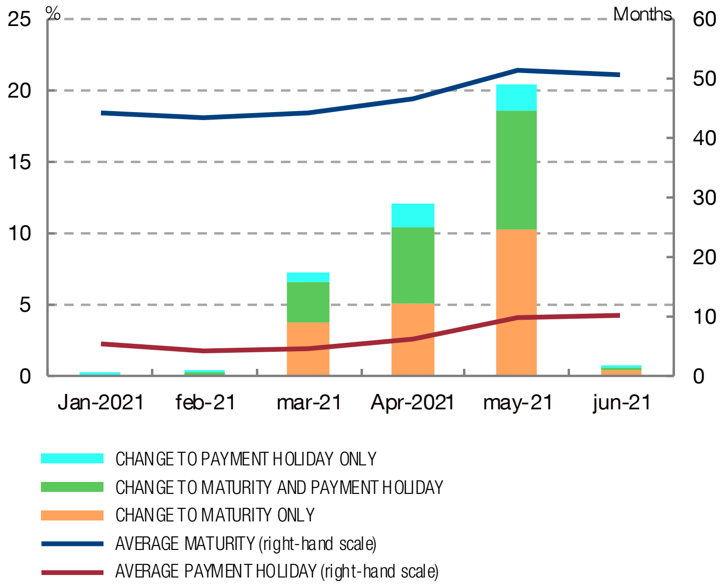


Chart 1
IMPACT OF ROYAL DECREE-LAW 34/2020 ON THE MATURITY AND PAYMENT HOLIDAY OF ICO-BACKED LOANS TO FIRMS (a)



ANNEX 2

Euro area investment funds have recorded an increase in net capital inflows

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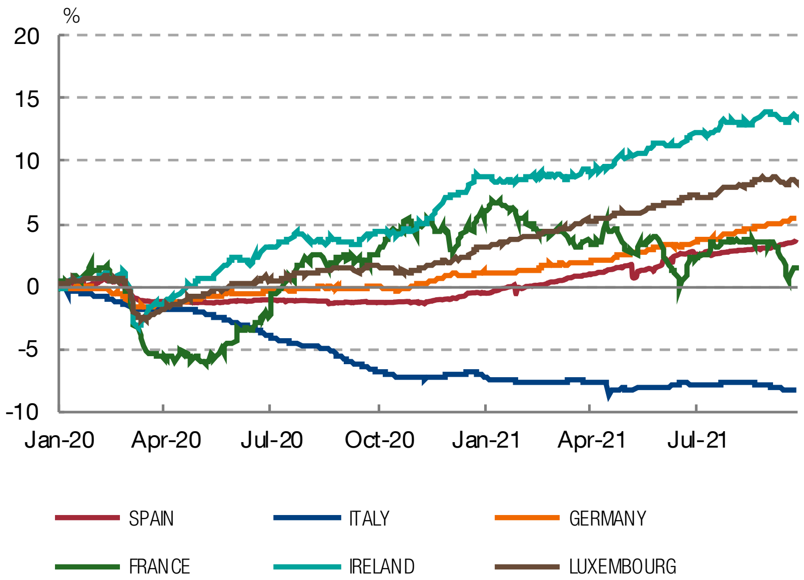
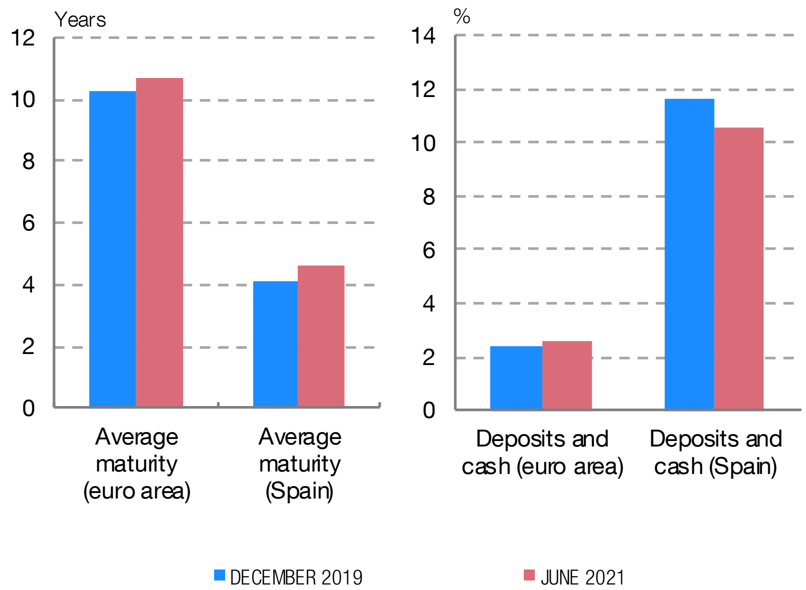
- This is mainly attributable to the increase in flows in **equity funds**
- **Spanish** investment funds are characterised by having assets with **shorter maturities** (around four and a half years) than the average for euro area funds (around ten years)…
- …and by their **larger liquidity holdings**, with deposit and cash holdings as a percentage of total assets being five times higher in funds domiciled in Spain

1 INVESTMENT FUND FLOWS (a)

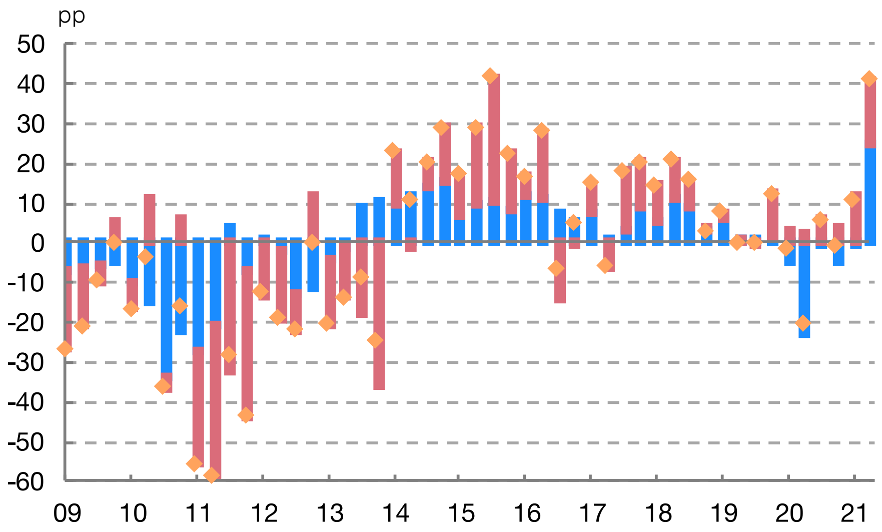


2 INVESTMENT FUNDS IN SPAIN AND THE EURO AREA:
AVERAGE FIXED-INCOME PORTFOLIO MATURITY (left panel)
AND LIQUIDITY OF HOLDINGS (right panel) (b)

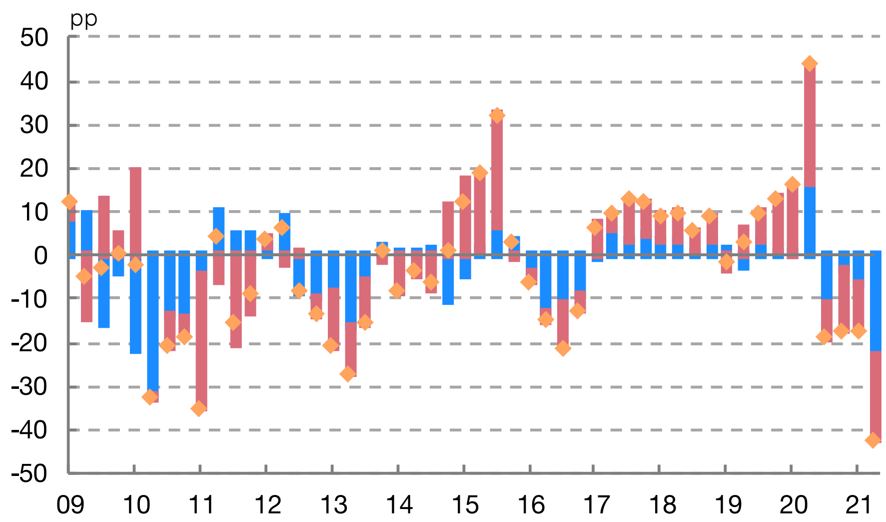


- As the **supply-side factors** appear to have **increased** significantly
- The **decline in new lending to firms** in the first semester of 2021 owes to supply-side factors (now that the public support schemes have already been largely deployed) **and demand-side factors** (lower liquidity needs)

1 BREAKDOWN OF NEW LENDING TO HOUSEHOLDS INTO SUPPLY AND DEMAND-SIDE FACTORS (a)



2 BREAKDOWN OF NEW LENDING TO FIRMS INTO SUPPLY AND DEMAND-SIDE FACTORS (a)



- Since the publication of the last FSR, the Europe-wide recommendations launched on **restrictions on profit distribution** by banks and other financial institutions have been **repealed**
  - According to various studies, these limitations have had a significant positive impact on new lending and on solvency ratios
- The **European macroprudential framework** in the capital requirements regulations (CRR and CRD) will be **reviewed in 2022**
  - To this end, the European Commission has requested advisory reports from the ECB, the EBA and the ESRB
- The European Commission has published a **draft legislative proposal** to implement the **final parts of the Basel III framework** on prudential regulation of the banking sector in the EU
- The continued **growth and innovation** seen in **crypto-assets and stablecoins** have led the BCBS and the FSB to **analyse** their implications for the stability of the financial system and their prudential treatment
- The transposition in Spain of the changes in the bank recovery and resolution framework (BRRD II) continues to progress
- The European Commission has started to **review the bank crisis management and deposit insurance framework**, with the aim of making it more flexible and efficient and increasing depositor protection, ensuring they receive equal treatment
- Lastly, faced with the increasing **relevance** of **climate-related impacts on finance**, both the EBA and the BCBS have published reports on this matter. **This FSR contains two boxes** on the subject