BANCO DE ESPAÑA
Eurosistema

24.01.2024

Banking sector: challenges and opportunities

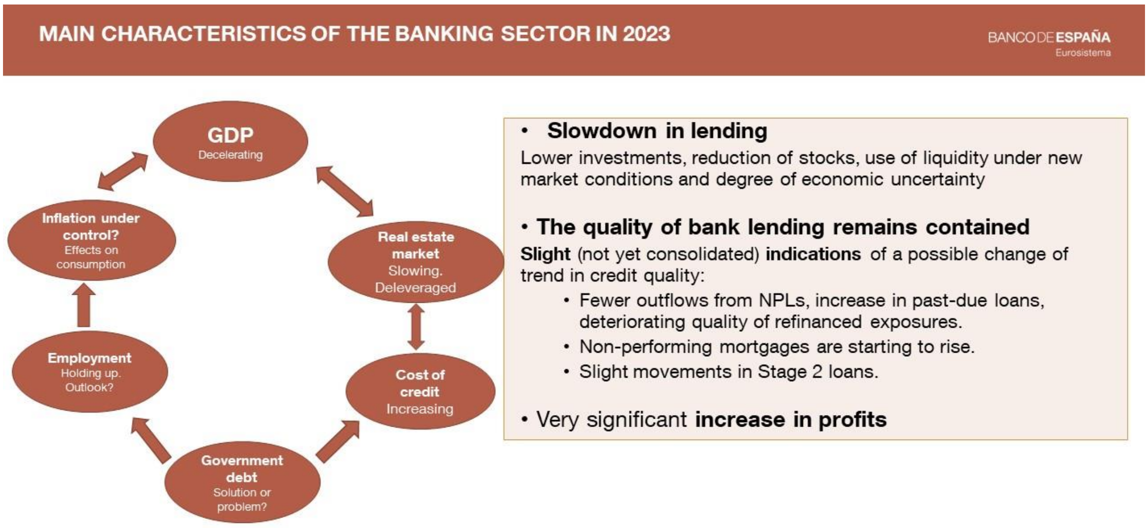
"Geopolitics and economics: How to survive a turbulent 2024". El Confidencial-PIMCO Forum

Madrid

Margarita Delgado
Deputy Governor

Good morning everyone.

To begin with, let me point out that we are now in the "quiet period" that precedes monetary policy meetings of the European Central Bank (ECB) Governing Council, which is taking place tomorrow. This means I cannot discuss any matters that might anticipate future monetary policy decisions. As a result, my remarks should not be interpreted as any insight into the monetary or economic outlook that might shape expectations regarding these decisions.



I will devote my speech today to analysing the banking sector's behaviour in 2023, specifically up to September, the most recent month for which we have data, while we await confirmation of the trends to end-2023.

Taking into account that year's highly turbulent geopolitical environment and the uncertainty to which we have become accustomed these days, European banking activity in general – and Spanish banking in particular – has been characterised by three elements: a slowdown – if not an actual drop – in lending, limited past-due loans and cost of credit and, lastly, profit growth.

Starting with the first, it should be noted that the stock of loans dropped by 3.7%.

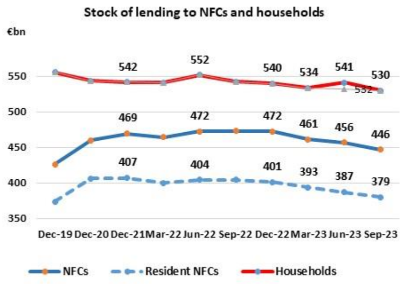
The fall in economic expectations (with economic contraction in some European countries), geopolitical uncertainty, the decline in inventories and perhaps the accumulation of liquidity during the pandemic, which later proved to be unnecessary, may be behind the fall in credit exposures.

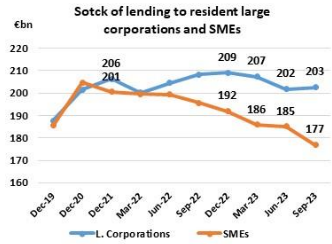
1. FALL IN THE STOCK OF LENDING: BY 3.7% IN THE FIRST 9 MONTHS OF 2023 AND BY 4% IN THE LAST 12 MONTHS

BANCO DE ESPAÑA Eurosistema

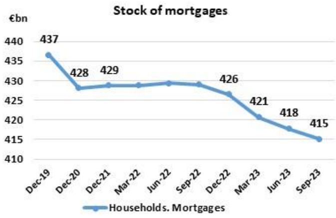
Firms: fall in the stock of lending by 5.5% in the first 9 months (2.2% in Q3).

Households: down by 1.9% in 2023 and by 2.1% in Q3.





Among firms, the decline in stock was more significant in SMEs.



The stock of mortgages fell by 3.2% in the last 12 months and by 2.7% during 2023.

This contraction is clearer in the case of firms – where the stock of loans fell by 5.5% in the first nine months of the year – than for households, whose exposure dropped by 1.9%. A more detailed analysis shows that, among firms, SMEs have seen the biggest reduction in their exposure during this period – by 7.9%. Their level of bank debt in absolute terms is also lower than before the pandemic, after rising in 2020 and 2021, partly owing to the granting of loans backed by the Official Credit Institute.

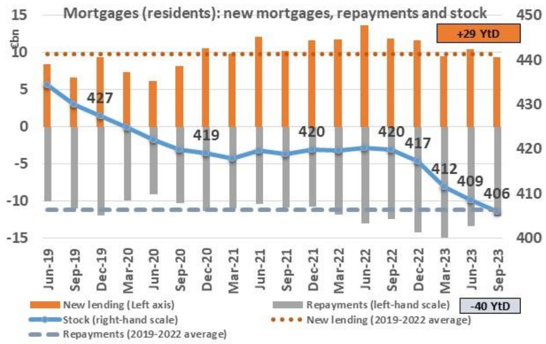
Large corporations, meanwhile, reduced their credit exposure to banks by 3% in the first nine months of 2023.

On the other hand, although the fall in lending to households has not been as pronounced, the stock of mortgages declined significantly, falling by 2.7% in 2023. This took place against the backdrop of a sluggish real estate market that saw significant falls in the number of housing transactions, down by almost 16% in a year,[1] and moderate increases in prices (4.5% year on year). The tightening of monetary policy has undoubtedly had an impact on this segment.

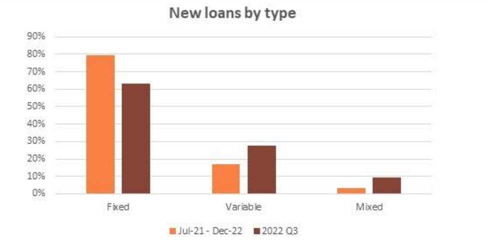
[1] Data from the Ministry of Transport, Mobility and Urban Agenda available here (link in Spanish).

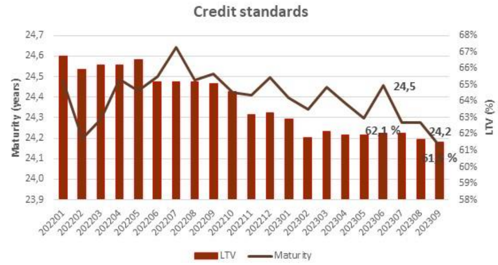
1. FALL IN THE VOLUME OF MORTGAGES

BANCO DE ESPAÑA
Eurosistema



- The stock of resident mortgages fell by a further €3 billion in 2023 Q3 (-€11 billion YtD)
- The high rate of repayments in Q1 is slowing down
- Credit standards remain unchanged





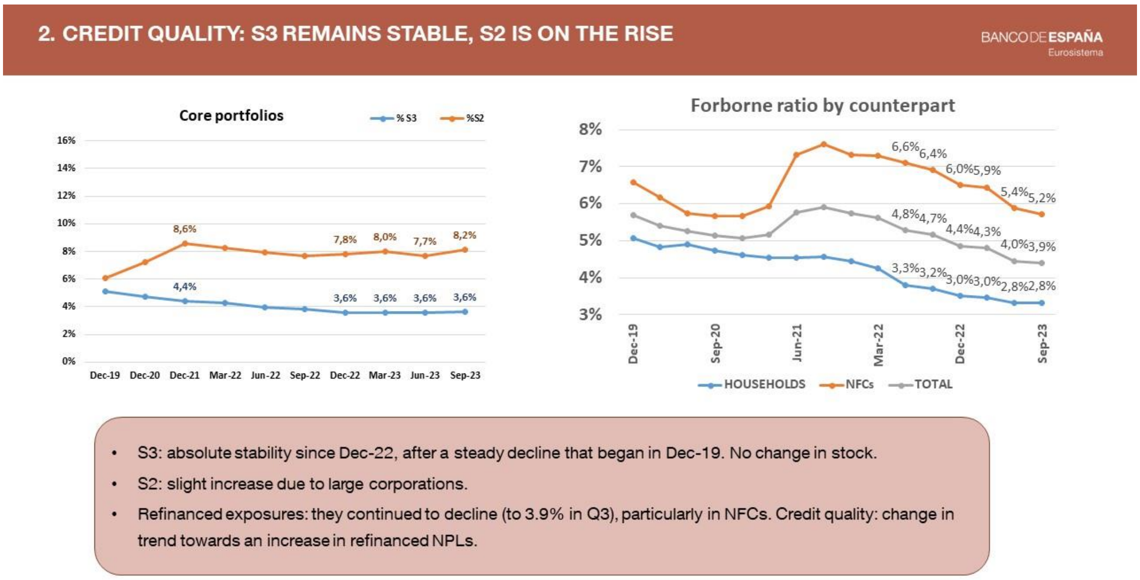
With regard to the mortgage sector, it is worth noting that 2022 and much of 2023 saw a highly vigorous rate of repayments, peaking in March at 34.8% above the average observed from 2019 to 2022. In an environment of rising interest rates, households have earmarked a portion of their savings to partially pay down mortgages, thereby cushioning the impact of the rate hike. However, this accelerated rate of repayment has already slowed significantly and is now once again close to its average level.

Meanwhile, the pace at which new mortgages are granted is 4.4% below the 2019-2022 average in this same period and there is a clear downward trend following the June 2022 peak. As a result, the stock of mortgages is dropping.

This reduction is mainly demand-side driven, since credit standards have not changed significantly. Currently, the average term for new lending is around 24 years and the loan-to-value ratio is 61.5%, which means that credit standards have not deteriorated.

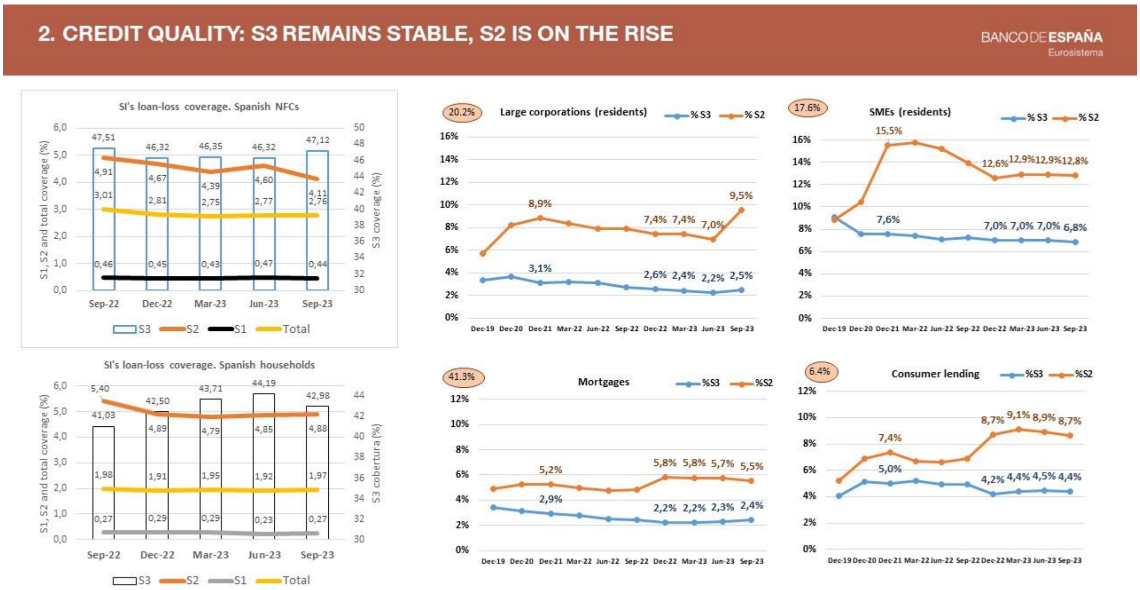
By loan type, the data indicate a lower rate of new fixed-rate mortgages. In 2023 Q3 they accounted for 63% of new mortgages, compared with an average of 80% for the period between July 2021 and December 2022. Interest rate expectations are certainly playing a role here.

This firm and household deleveraging can also be seen in relative terms, as the consolidated debt of financial corporations has fallen from 72.1% of GDP in December 2019 to 65.5% and, in the case of households, from 56.8% of GDP to 48%.



The second notable element in this analysis of 2023 is the stability in credit quality, although there are as-yet-unconfirmed signs of change.

NPLs have held steady in recent quarters, with the ratio standing firm around 3.6%. However, in absolute terms, the volume of Stage 3 loans in the core portfolios has fallen by 9% in the last 12 months and by 2.8% in the last nine, in line with the aforementioned reduction in the stock of loans. In addition, the refinanced ratio continued to improve, reaching 3.9% in Q3. By type, loans that are non-performing for reasons other than arrears account for 51% among firms and 40.5% among households.



However, there was an increase in Stage 2 loans (those showing a certain increase in risk) in Q4, rooted in the large firm segment.

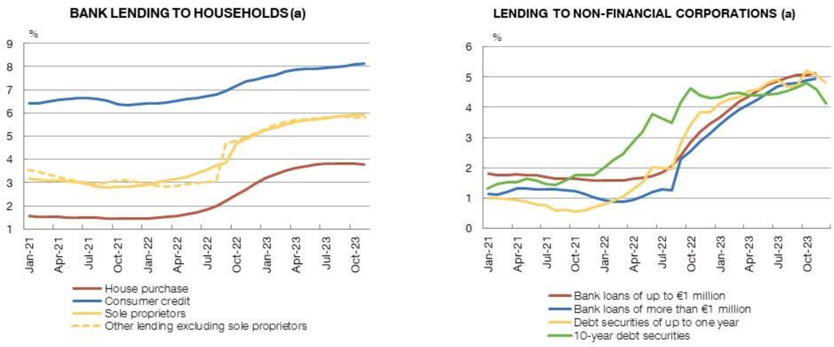
We must watch closely to confirm whether this was a one-time event or whether this trend will gain traction and spread to other portfolios.

Turning to SMEs, we see that the ratios have remained fairly stable, while mortgages already show a gradual increase in the Stage 3 ratio, albeit still incipient. It must be remembered that NPLs historically take between 12 and 18 months to appear after the shock to the mortgage segment. The relevance of this portfolio for Spanish banks goes without saying, since it comprises 41.3% of the total stock of loans in Spain.

These developments in portfolio quality are taking place against clear tightening in monetary policy, which has led to steep rises in interest rates on loans to firms and households. Therefore, the fact that NPLs have remained contained in these circumstances can be seen as a positive factor, in which the recovery of profit margins and households' real gross income have played a significant role.

1. THE COST OF NEW BANK LENDING CONTINUED TO RISE IN THE SECOND HALF OF 2023 BANCO DE ESPAÑA Eurosistema

- These rate rises gradually slowed as the monetary tightening cycle reached its peak



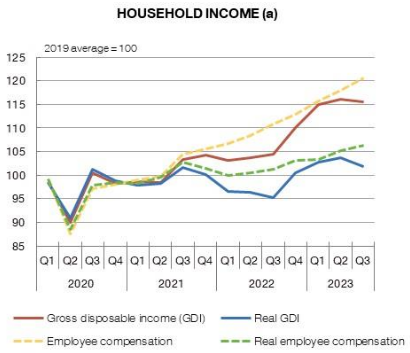
Sources: Bloomberg Datalicence and Banco de España. Latest figure: November (bank loans) and December 2023 (fixed income securities).
(a) Bank interest rates are narrowly defined effective rates, adjusted seasonally and for the irregular component.

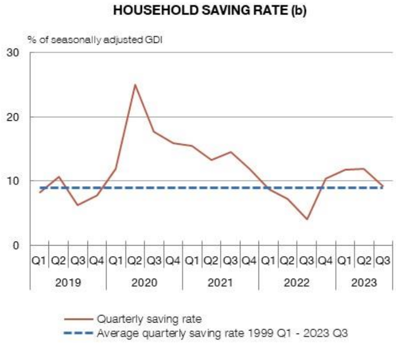
This containment has been driven by growth in both employment and wages. Adjusting for inflation, the year-on-year change in employee compensation stood at 5%, around 6% above pre-pandemic levels.

2. EMPLOYMENT AND WAGE GROWTH CONTINUED TO DRIVE HOUSEHOLD INCOME

BANCO DE ESPAÑA
Eurosistema

- Labour income continued to drive household income in 2023 Q3, due both to employment growth and growth in compensation per employee
- The sharp rise in consumer spending lowered the household saving rate, although it remained slightly above its historical average

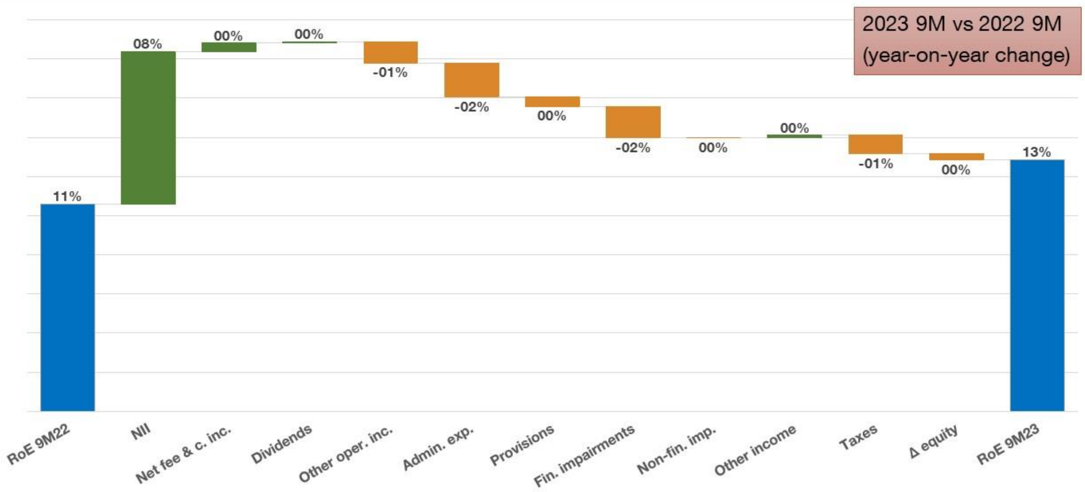




The third element that has defined banking activity in 2023, and perhaps the one that has attracted the most media attention, is the increase in bank revenue.

3. EARNINGS IMPROVED

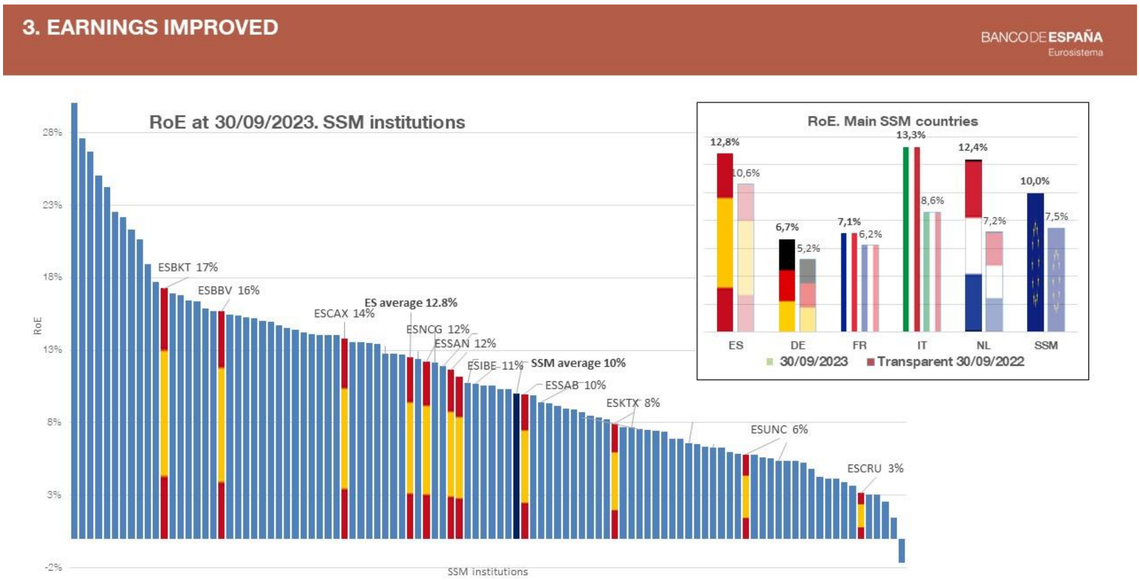
BANCO DE ESPAÑA
Eurosistema



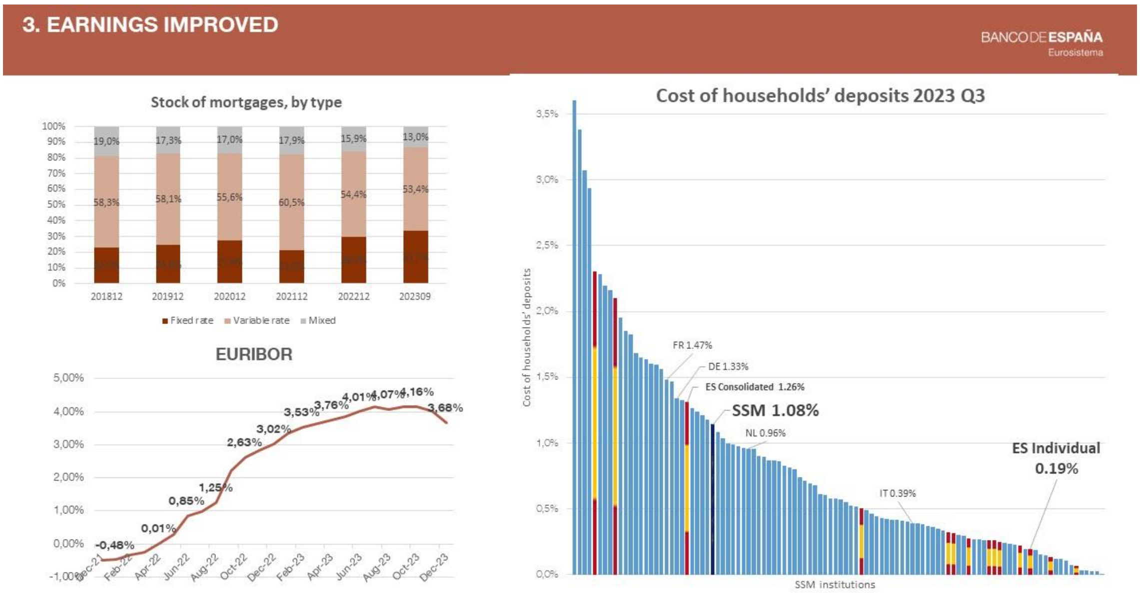
In particular, significant institutions' aggregate after-tax profit in the first three quarters grew by 24% year-on-year, bringing the return on equity to 12.8% in September 2023, compared with 10.6% a year earlier. This increase is explained by the clear improvement in net interest income, which grew by 25% because the increase in financial revenue was not matched by a similar increase in financial costs, especially for retail deposits. Financial revenue has risen solely as a result of the price effect in an environment of falling volumes.

By contrast, operating costs grew by 8% year-on-year, driven by personnel costs, which are rising faster than inflation. On balance, the efficiency ratio improved by 3.5 percentage points (pp) to 46.2%, mainly owing to the stronger revenue growth.

Finally, credit impairment, including cross-border business, grew both year-on-year (by 22%) and in Q4 in line with the average of the last five years, but below banks' own expectations for 2023.



The robust performance of significant institutions in 2023 has led to their return on equity standing above the SSM average and also above that of most large economies, with the exception of Italy. Almost all significant entities in Spain lie above that average.



As we have seen, the strong results are the result of the clear improvement in net interest income. This increase stems from the repricing of the loan portfolio over the course of the year, which has gone in lockstep with the increase in interest rates.

For example, the average one-year EURIBOR rose from 2.23% in September 2022 to 4.15% a year later, markedly affecting loans that were repriced in that period. Spanish banks' portfolio is mostly comprised of variable-rate loans, which are, therefore, sensitive to rate changes, despite the fact that fixed-rate loans have gradually been gaining ground in recent years. In September 2023 53.4% of mortgages in Spain were variable rate, with fixed rate mortgages growing by more than 10 pp in the last five years.

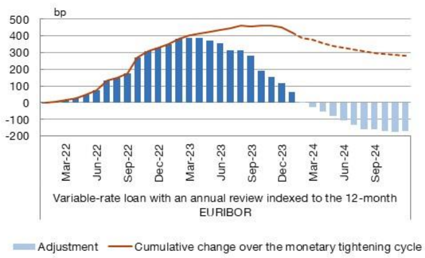
For its part, the pass-through of the rate hike to household deposits is occurring at a slower pace than on the asset side. Relative to the rest of Europe, it stands below the SSM average (0.19% vs. 1.08%). Spanish banks' high levels of liquidity banks may be one of the reasons for lower deposit remuneration.

3. EARNINGS IMPROVED

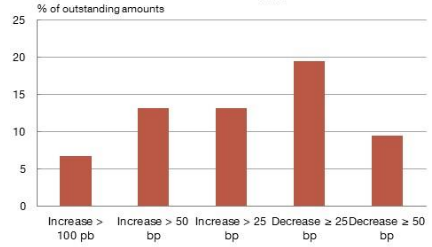
BANCO DE ESPAÑA
Eurosistema

- Interest rate hikes have been almost fully passed through to interest payments on outstanding loans
- A large percentage of households would see the interest rates on their debt fall in 2024
- The cumulative rise in interest rates appears to have raised the percentage of vulnerable households, albeit to a limited extent (from 10.5% in 2020 to 11.2% in 2023 Q3) thanks to the mitigating effect of higher income

AN EXAMPLE OF CHANGES IN REFERENCE RATES (a) (b)



MORTGAGES EXPOSED TO INTEREST RATE ADJUSTMENTS BETWEEN DEC-23 AND MAR-24 (a) (b)



Sources: CCR, Refinitiv Datastream, ECB and Banco de España

(a) Mixed-rate loans are considered to be variable-rate loans

(b) For each month, the chart depicts the change in interest rate for a loan whose interest rate is reviewed that month. A lag of one month is applied to the reference rate. The latest figure is for December 2023. Thereafter, EURIBOR expectations are used, based on listed financial derivatives at 29 December 2023.

In addition, we have found that the interest rate hikes have been almost fully passed through to interest payments on outstanding loans. Indeed, with current yield curves, almost 20% of the stock of variable-rate mortgages would see interest rate cuts in 2024 Q1. In the case of variable-rate loans to firms, this percentage would stand slightly above 30%. In this context, it is therefore very likely that the profit growth seen in 2023 will not be repeated this year.

We can conclude that both the fall in the stock of loans and unit margins will clearly affect bank’s profits in 2024. On a positive note, the potential drop in financial costs for firms and households should help keep credit quality levels stable.

CHALLENGES FOR THE FUTURE

BANCO DE ESPAÑA
Eurosistema

- **Uncertain macroeconomic environment with added geopolitical tensions**
  - Potential deterioration in credit quality: possible impact on employment and activity
  - Reduced lending activity: possible impact on investment
- **Monetary policy tightening has been fully passed through**
  - Deposits: increased competition as excess liquidity is reduced
  - Downward repricing of loans in 2024
- **The current increase in margins and profitability is not sustainable**
  - Unit margin growth is tailing off
  - Expected increase in provisions?

In the **short term**, the current improvement in margins should be able to absorb any potential asset **impairment.**

In the **medium and long term**, it should allow the necessary investments to be made to address the challenges of **digitalisation** and **business model transformation**

Conclusion

The analysis presented here is entirely retrospective and, although it is not easy to predict the future, it is essential that European institutions in general, and Spanish ones in particular, are prepared to face a 2024 that is, once again, fraught with uncertainty.

New geopolitical conflicts make it necessary to call for prudence, as their potential impact is not easily quantified. For example, they could have consequences for inflation if trade routes are affected or the conflicts spread. In addition, the economic outlook remains weak in Europe according to the latest projections and we will have to wait and see whether the labour market continues to behave with the robustness that it has shown so far, which is key to sustaining low NPL ratios.

Therefore, while we still await the definitive year-end data, we can conclude that institutions have enjoyed an especially good year in 2023 in terms of financial performance, with remarkable profits and limited NPLs.

Supervisors have been highlighting the risks properly, but it is true that they have only partially materialised. However, we are already seeing signs of upward pressure in NPL ratios in some portfolios, such as mortgages. Until now, credit quality has been buoyed by improved firm and household debt ratios, the recovery of profits and real wages and the labour market's dynamism. In this new year, we will have to be watchful for changes in these and other variables that are key to the real and financial economy.

In this regard, I maintain that a good credit risk management framework, with prudent credit standards, adequate early warning mechanisms and robust provisioning policies, will be essential for the banking sector to continue to operate successfully in the uncertain environment in which we live.

This does not diminish the fact that banks must face these immediate challenges as well as other more structural ones that also affect other sectors of the economy, such as the demands of the digital transformation, and the transformation of business models towards more sustainable ones.

Thank you very much.