

# FINANCIAL STABILITY: MAIN VULNERABILITIES AND RISKS



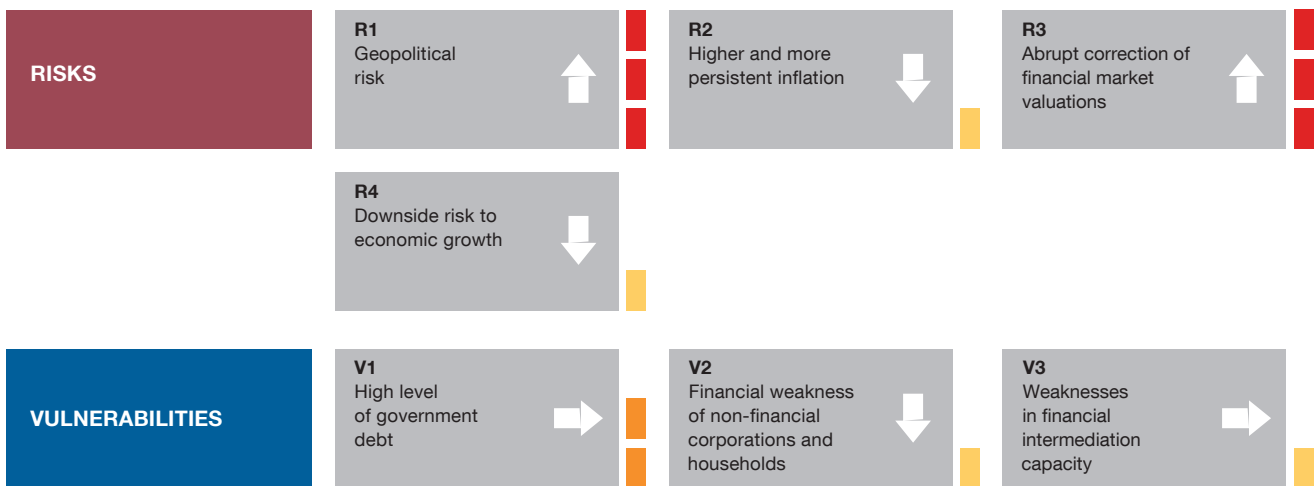
## FINANCIAL STABILITY: MAIN VULNERABILITIES AND RISKS

Since the last Financial Stability Report (FSR) was published, the vulnerabilities and risks then identified have evolved unevenly (see Figure 1).

Notably, risks linked to high inflation have decreased significantly across all geographical areas. The risk of lower growth in the short term in Spain has also declined. Amid this more favourable macroeconomic setting, the escalation of geopolitical tensions remains the main risk to financial stability, compounded by the intensification of the conflicts in eastern Europe and the Middle East. Also, the high valuations of some risky financial assets and other factors, such as the concentration of equity market value in only a few technology firms, increase the risk of abrupt financial market corrections. In any event, it is worth noting that the different risks identified interact with each other and that the materialisation of any of them may exacerbate others.

As regards the analysis of vulnerabilities, government debt has continued to decline, although it remains well above the European average. Against this background, an adequate implementation of the recently announced medium-term fiscal-structural plan is necessary to

Figure 1  
Financial stability: main risks and vulnerabilities (a) (b) (c)



SOURCE: Banco de España.

- a In this report, the **vulnerabilities** are defined as economic and financial conditions that increase the impact or probability of materialisation of **risks to financial stability**, which in turn are identified as adverse changes in economic and financial conditions, or in the physical or geopolitical environment, with an uncertain probability of occurrence, which hamper or impede financial intermediation, with negative consequences for real economic activity.
- b The risks and vulnerabilities shown here are measured using the following scale: one yellow block denotes a low level, two orange blocks a medium level and three red blocks a high level. The arrows denote the change in the levels of the risks and vulnerabilities since the last FSR.
- c In the last FSR, the R3 risk referred to greater risk aversion among agents, its main component being a possible abrupt financial market correction. In view of its greater relative importance, in this FSR it has been decided to identify the risk as a whole with its main component.

make progress in the application of the new European fiscal rules, reduce the level of structural deficit and ensure the consolidation of public finances in Spain. Households and NFCs have fared well in terms of income and continue to lower their debt ratios, reducing their degree of financial vulnerability.

The Spanish banking sector's financial position remains favourable, with high profitability underpinned by the growth of net interest income and, to a lesser extent, net fee and commission income. However, this has not translated into a significant strengthening of their solvency ratios, with the CET1 ratio remaining comparatively lower than that of other European banking systems. Globally, there is still concern over the high leverage and build-up of liquidity risks at some non-bank financial intermediaries (NBFIs).

The main risks<sup>1</sup> to the stability of the Spanish financial system are discussed in greater detail below:

## **R1. Geopolitical risks**

The regional escalation of the conflict in the Middle East, and the increase in offensive actions in the Russia-Ukraine war heighten geopolitical risks, making it more likely for these conflicts to escalate and spread even further.

The assessment of other sources of geopolitical risk has remained relatively stable since last spring. However, it remains at a high level that requires ongoing monitoring. Particularly significant are the trade tensions between China and the United States and also the European Union. These affect various goods, especially certain technological products (see Chart 1). These are necessary to sustain and make headway in the digitalisation of economic activities and for the transition towards a more sustainable economy, both of which are key for long-term economic growth.

Moreover, the United States presidential election creates uncertainty about the country's policy stance, which has global effects. Foreseeably, the outcome of this election will be the most important geopolitical event in the coming months. In Europe, the outcome of elections in some countries, such as France, is also generating uncertainty about the economic policy stance, giving rise to some tightening in Europe's financial markets.

The possibility of a global intensification of geopolitically motivated cyber attacks remains.

For the time being, the effect of geopolitical tensions on global economic activity remains contained. The diversification of suppliers and the reorganisation of production processes

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<sup>1</sup> Risks to financial stability are defined as adverse changes in economic and financial conditions, or in the physical or geopolitical environment, with an uncertain probability of occurrence, which hamper or impede financial intermediation, with negative consequences for real economic activity.

Chart 1  
Semiconductors. Share of main world exporters (a)

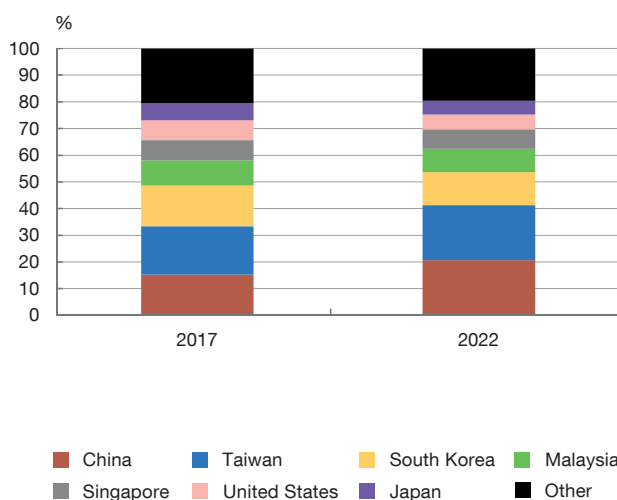
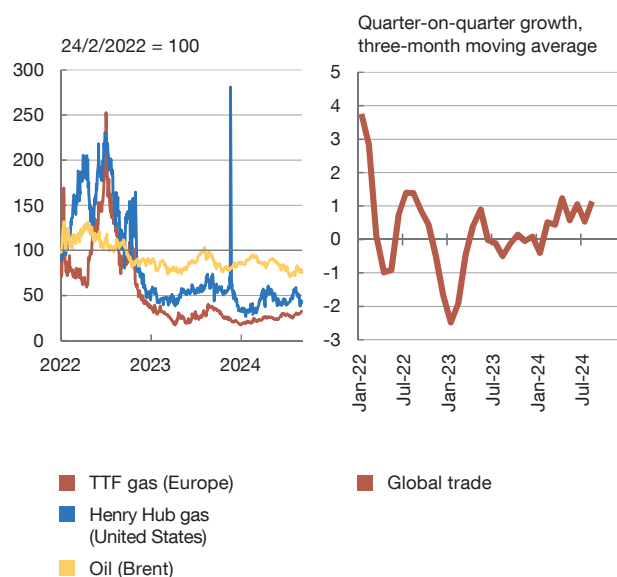


Chart 2  
Changes in natural gas and oil prices (b), and in global trade



SOURCES: Centre d'Etudes Prospectives et d'Informations Internationales, Refinitiv Eikon and CPB.

- a The data for China are adjusted and do not contain re-exports by Hong Kong of products from mainland China, to avoid double counting of flows.  
b The spot prices for the three markets are expressed in euro for comparison purposes.

have helped mitigate the impact of various geopolitical shocks (e.g. on Russian energy supplies or on shipping traffic in the Red Sea). The resilience of global trade flows and the absence of energy supply problems are noteworthy (see Chart 2). However, oil prices have seen a recent increase in volatility linked to the Middle East conflict.

However, if a scenario of global escalation of geopolitical tensions were to materialise, stronger negative supply shocks and a broad-based deterioration in investor confidence could arise, with very adverse consequences for global economic and financial activity, as well as for inflation. In particular, inflation could be affected through disruptions in international supply chains, especially of energy and other commodities.

The persistence of geopolitical tensions over an extended period of time also influences public policies (e.g. rising trade protectionism, greater military spending and larger armed forces) and increases the likelihood of a divided world order becoming entrenched. This would reverse the efficiency gains of globalisation, for instance through a broad-based increase in tariffs, and could hamper the ability to absorb future shocks.

The assessment of other risks in this summary is based on a stable global level of geopolitical tensions, while other shocks that may affect the stability of the Spanish financial system are assessed separately. Box 1.1 analyses more broadly the trade risk channels for the European Union and Spain linked to geopolitical tensions.

Chart 3  
Changes in inflation (a)

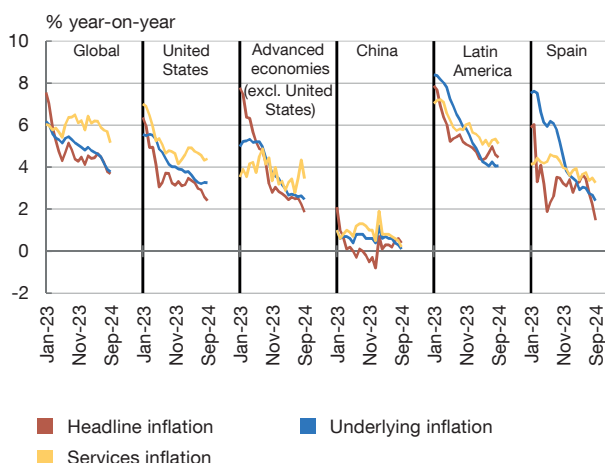
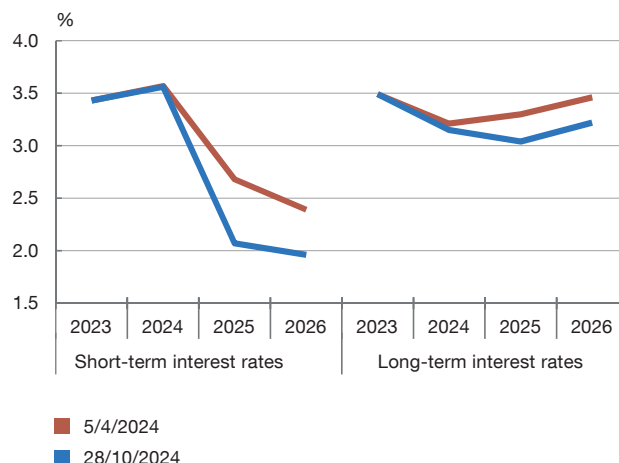


Chart 4  
Expectations of short and long-term interest rates in the euro area (b) (c)



SOURCES: National statistics, Refinitiv Datastream, ECB and Banco de España.

- a The “Global” aggregate includes the United States, the euro area, the United Kingdom, Canada, Norway, Sweden, Switzerland, the Czech Republic, Poland, Hungary, Russia, Türkiye, Japan, China, India, Indonesia, Malaysia, Thailand and the Philippines, as well as the “Latin America” aggregate (comprised of Brazil, Chile, Colombia, Mexico and Peru). “Services inflation” excludes the Czech Republic, Russia, India, Indonesia, the Philippines and Thailand. The “Advanced economies (excl. United States)” comprises the euro area, Japan, the United Kingdom, Sweden, Switzerland, Norway and Canada.
- b For the projection period, the figures are technical assumptions, prepared following the Eurosystem methodology. These assumptions are based on futures market prices or on proxies thereof and should not be interpreted as a Eurosystem prediction as to the path of these variables.
- c The date 5/4/24 refers to the cut-off date for the last FSR.

## R2. Higher and more persistent inflation

The disinflation process has continued at the global level in recent months, although it has been constrained by persistent inflationary pressures in services (see Chart 3). Despite this, short-term inflation expectations have been revised downwards since April, particularly in the United States, and are consistent with a future prolongation of the disinflationary process.

In the euro area inflation has continued on a downward trend in recent months, temporarily standing below the monetary policy target, as it dropped to 1.7% year-on-year at September 2024. This behaviour is due not only to lower energy and food inflation, but also to a decline in underlying inflation, largely reflecting that the process of monetary policy tightening has kept agents’ inflation expectations anchored. In Spain, inflation also stood at 1.7% in September,<sup>2</sup> with broadly similar changes and drivers to those of the euro area as a whole.

In any event, the projections of the European Central Bank (ECB) continue to point to inflation evolving towards the 2% target in the medium term, both in the euro area as a whole and in Spain. Against this backdrop, the Governing Council of the ECB lowered its key interest rates three times (in June, September and October) by 25 basis points (bp).

<sup>2</sup> The Harmonised Index of Consumer Prices (HICP) is used to compare changes in inflation in the euro area and in Spain. In Spain, inflation according to the consumer price index (CPI) stood at 1.5% in September.

The Governing Council of the ECB has continued to indicate that possible further monetary policy interest rate reductions will be data-dependent. Since the last FSR was published, market expectations have shifted towards larger rate cuts and consistently towards lower short and long-term interest rates in the euro area (see Chart 4).

Labour markets in the euro area remain buoyant, although there are signs of greater slack and some moderation in wage growth, although this is expected to be sufficient to allow workers to gradually recover the real income lost in previous years. This moderation could be key for containing inflationary pressures in the services sector. However, these remain the main concern in this area for now.

Also still important is the possibility that inflation will be more persistent than expected in the United States, in which case it could adjust its monetary policy rate path upwards, tightening global financial conditions.

Conversely, the materialisation of downside risks to growth, amid some signs of weak global demand, or a potentially greater impact of the current monetary policies could lead to inflation being lower than projected. In particular, slower growth in China could help lower inflation in other economies through various financial and trade channels, mainly owing to its effects on global demand for commodities.

### **R3. Risk of an abrupt financial market correction**

The measures of uncertainty in the financial markets remain at historically low levels (see Chart 5) despite the environment of high geopolitical tensions and the persistence of some risks to inflation and growth.

Likewise, risk premia for various financial assets are at historically low levels. Notably, this is observed not only in the US stock markets, but also in other asset classes, such as both European and US high-yield corporate bonds (see Chart 6).

Persistently high valuations of risky financial assets with the current level of uncertainty may make investors' perceptions fragile. Even in the absence of major shocks associated with geopolitical risks, limited changes in macro-financial conditions may make investors more pessimistic and lead to financial market corrections. This fragility is illustrated by the turmoil in early August (a sharp fall in the value of the equity market in Japan and, to a lesser extent, in other geographical areas).

When assessing financial market risks, the high concentration of the stock market in the technology sector, in particular among a small number of US firms (see Box 1.2), should be taken into account. Thus, shocks to expectations about the value of new technologies (e.g. artificial intelligence) or the ability of various firms to retain the efficiency gains they generate can lead to significant swings in stock market indices.

Chart 5  
Changes in equity VIX and credit VIX (a)

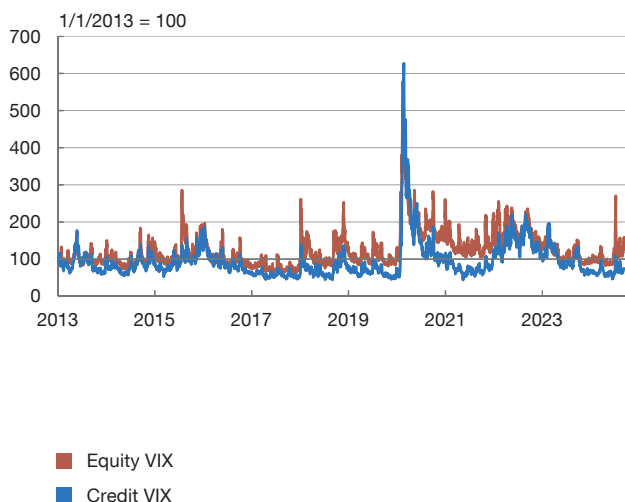
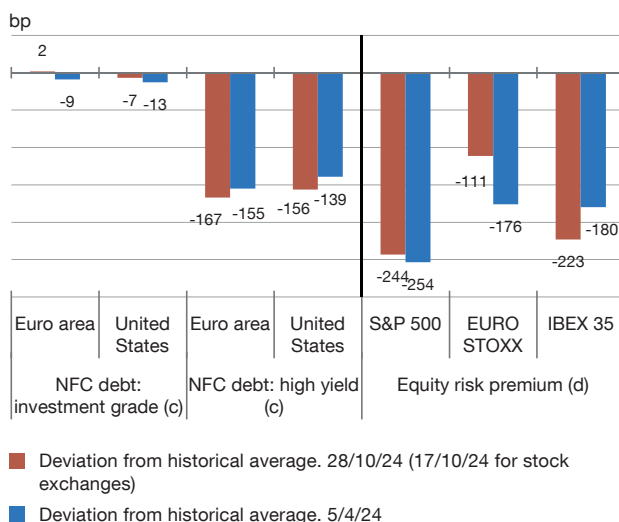


Chart 6  
Risk premia (b)



SOURCES: Refinitiv Datastream, Refinitiv Eikon and Banco de España.

- a The equity VIX and the credit VIX measure, respectively, the one-month volatility of the S&P 500 index and of the US high yield credit market through the five-year CDX HY index.
- b The date 5/4/24 refers to the cut-off date for the last FSR.
- c Spreads against the swap curve of the ICE Bank of America Merrill Lynch indices. The historical average refers to the period 1998-2024, and is 78 basis points (bp) for euro area investment-grade bonds, 131 bp for US investment-grade bonds, 448 bp for euro area high-yield bonds and 441 bp for US high-yield bonds.
- d The equity risk premium is calculated using a two-step dividend discount model (Russell J. Fuller and Chi-Cheng Hsia. (1984). "A simplified common stock valuation model". Financial Analysts Journal, 40(5), pp. 49-56). The historical average refers to the period 2006-2024, and is 500 bp for the S&P 500, 653 bp for the EURO STOXX and 774 bp for the IBEX 35.

Although technology concentration and other risk factors of financial markets are specifically linked to the United States, the central position of its financial system in global markets and the high degree of interconnectedness between them mean that these factors are globally important.

In a scenario of valuation corrections, as noted in previous FSRs, there is a specific risk of such corrections spreading owing to the procyclical behaviour of NBFIs. In some segments of this sector (e.g. hedge funds, family offices), high leveraging and signs of a build-up of liquidity risks continue to be detected, making their behaviour more sensitive to various shocks.

This scenario of financial market risk materialisation would also adversely affect banks by tightening their wholesale financing conditions.

#### R4. Downside risk to economic growth

The tempo of global economic activity remains positive overall and somewhat more buoyant than anticipated in the previous FSR (see Chart 7), although some signs of weakness also persist.



Chart 7  
GDP growth forecasts (a)

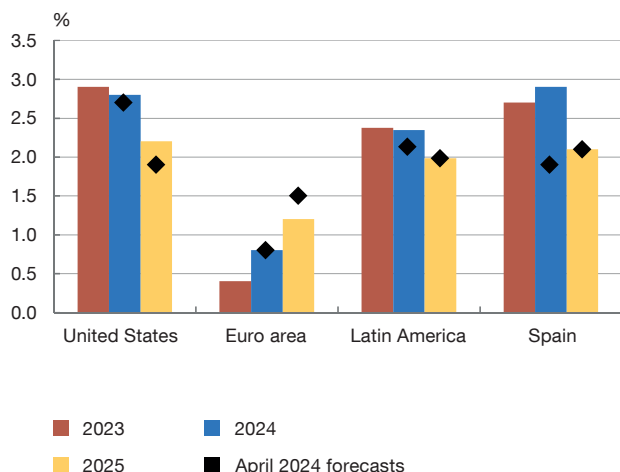
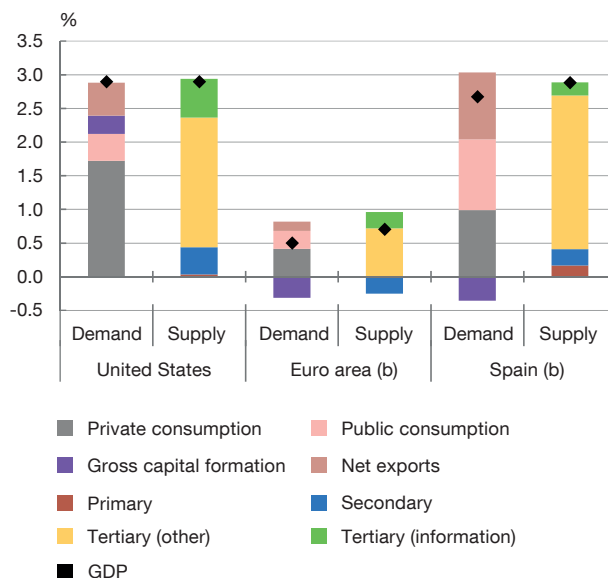


Chart 8  
Contributions to GDP growth (2023)



SOURCES: World Economic Outlook (IMF) and national statistics.

- a The bars represent the IMF's October 2024 World Economic Outlook (WEO) forecasts. The diamonds correspond to the April 2024 forecasts. WEO aggregates except for Latin America (Brazil, Chile, Colombia, Mexico and Peru).
- b The supply contributions explain the growth in gross value added, without taxes, so that they do not coincide exactly with the contributions on the demand side.

Economic activity in the euro area remained weak in 2024 H1. A slow and gradual recovery is expected, albeit somewhat weaker than envisaged last spring, with growth projected to remain, in any event, at low levels in the medium term.

Short-term indicators point to weaker momentum in Q3 in certain geographical areas, and recent data suggest a global slowdown in manufacturing activity and resilience in the services sector.

The Spanish economy maintained strong momentum in 2024 H1, with growth clearly above that observed in the euro area as a whole. In addition, the estimates for the years immediately following the pandemic were revised upwards, with pre-pandemic GDP levels recovered significantly sooner. Spanish GDP growth in recent quarters has been underpinned by net exports, owing to the strength of exports – especially those of travel services – and the slight decline in imports. Domestic demand surprised on the downside, mainly on account of the continued relative weakness of private consumption and gross capital formation.

The latest economic data suggest that the pace of activity growth in Q3 in Spain may have edged down from H1, but remains high.

Even in the absence of escalating geopolitical tensions (this being the most extreme case, as discussed previously), the materialisation of the financial market risks identified and, in some

cases, inflation risks (e.g. higher monetary policy interest rates in the face of more persistent inflation) could also prompt tighter financial conditions and entail downside risks to activity.

Furthermore, the weakness of real GDP growth in some European economies and the insufficient effectiveness of the stimulus measures announced in China could have an impact on economic activity in Spain through various trade and financial channels. Also, the high level of government debt in the United States continues to pose a risk to global economic activity. This is due not only to that economy having less fiscal space, but also because this high level of government debt is conducive to an environment of higher long-term real interest rates, which could be accompanied by bouts of uncertainty in the financial markets.

Compliance with the new European fiscal rules may hinder growth somewhat over the coming years, but will help strengthen the sustainability of public finances. There are certain mitigating factors for these risks to activity. First, a less restrictive monetary policy in the major world economies would provide more support to growth in the short term. Second, at the domestic level, the high household saving rate and the impact of Next Generation EU (NGEU)-related projects may support consumption and investment, respectively.

Lastly, also at the domestic level, it is worth noting that the current composition of growth may be a persistent vulnerability for the Spanish economy even if the current expansionary path takes hold and short-term risks to activity dissipate (see Chart 8). On the expenditure side, GDP growth has been sustained to a significant extent by external demand for services, especially tourism, and government consumption, in contrast to a lower contribution from private consumption and, in particular, business investment. As regards sectors of activity, the contribution to growth of low productivity sectors (e.g. hospitality) is high.

In this setting, the main vulnerabilities<sup>3</sup> of the Spanish economy and financial system include:

## **V1. High level of government debt**

The budget deficit in cumulative 12-month terms is estimated to have stood at 3.3% in June, down 0.2 pp from end-2023. The government debt-to-GDP ratio fell by 3.5 pp year-on-year, essentially because of the increase in nominal GDP, to stand at 105.3% in 2024 Q2. This level of government debt is some 20 pp below the peak following the start of the pandemic in March 2021, although it is also approximately 18 pp above the euro area aggregate (see Chart 9).

The average cost of new debt issuance was 3.3% in the first eight months of 2024, down 0.2 pp from its average 2023 level. The average cost of the most recent issuance, in September, was 2.9%, reflecting the prospects of less monetary restriction. However, the progressive increase in the average cost of outstanding debt is expected to continue, insofar as the

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<sup>3</sup> In this report, vulnerabilities are defined as economic and financial conditions that increase the impact or probability of materialisation of risks to financial stability.

Chart 9  
Public sector debt in the euro area

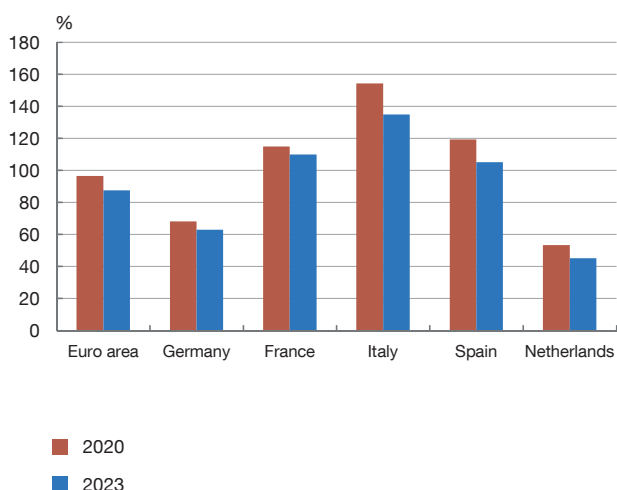
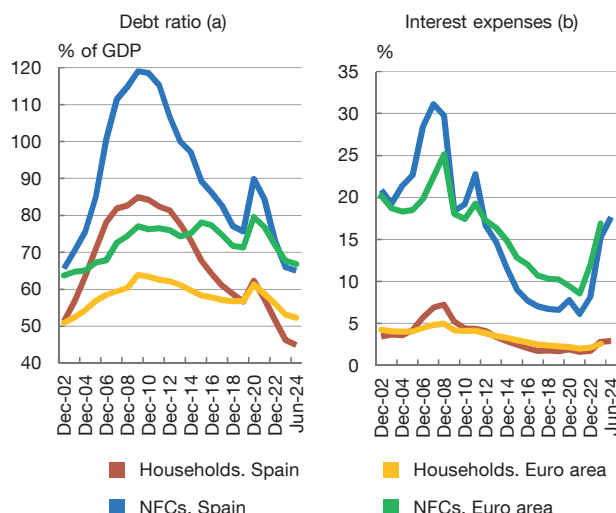


Chart 10  
Debt ratio and interest expenses of households and NFCs



SOURCES: Eurostat, INE and Banco de España.

a Debt balances are seasonally adjusted.

b Interest expenses are not adjusted for financial intermediation services indirectly measured (FISIM). Seasonally adjusted quarterly series. The ratio for households is calculated by dividing interest expenses by GDI and for NFCs by GOS.

average term to maturity of Spanish government debt is about eight years and issuance between 2016 and 2021 was at rates below the current levels and those expected by financial markets for the coming years.

If the new European fiscal rules are not applied, the path of government debt and interest payments will be moderately upward over the next few years. This is because of the large structural component of the Spanish budget deficit and certain factors that will place upward pressure on public spending, such as population ageing, climate change-related investment needs, digitalisation and defence spending.

It should not be forgotten that the high level of government debt increases the sensitivity of spending to changes in market financing conditions. If we also bear in mind the need to generate fiscal space to mitigate the impact of possible adverse shocks, it appears to be absolutely essential that the fiscal consolidation plan recently announced in Spain, along with certain structural reforms, be implemented rapidly and rigorously in order to resolve this vulnerability and minimise its impact on activity. This is especially important insofar as the plan proposes a timeline of decreasing growth in spending. This facilitates its achievement in the early years when a more favourable cyclical position is assumed, but means that it becomes more restrictive towards the end of the adjustment period.<sup>4</sup>

<sup>4</sup> On 15 October, the Government presented its first medium-term fiscal-structural plan which proposes a linear structural adjustment of 0.4 pp of GDP per year for seven years. Given the macroeconomic assumptions of this plan, it translates into a downward trajectory for net primary spending throughout the adjustment period (2025-2031).

## V2. Financial weakness of non-financial corporations and households

In the first half of 2024, Spanish non-financial corporations reported favourable earnings developments, while continuing to reduce their debt relative to GDP. This has led to a reduction in their financial vulnerabilities.

Corporate earnings performed well in the first half of 2024, although there was cross-sector heterogeneity. According to information from the tax authorities, the gross operating profit (GOP)<sup>5</sup> of the non-financial corporate sector increased in nominal terms by 6.5% year-on-year in 2024 Q1, and by 9.2% in Q2.

Meanwhile, the data from the Banco de España Business Activity Survey (EBAE) for Q3 show a decline in inflationary pressures on selling prices and intermediate input and labour costs. Also, more favourable conditions are identified in terms of access and cost of funds. Concerns persist however over the uncertainty surrounding economic policies, the availability of labour and possible energy cost surges.

Against this background, the consolidated debt of Spanish non-financial corporations increased by 1.3% year-on-year in June 2024. However, the debt of this sector stood at 65% of GDP in Q2 (see Chart 10), down 3.6 pp from 12-months earlier, and the lowest level of the series since September 2002. In addition, this ratio was 1.8 pp below the sector average for the euro area as a whole, which stood at 66.8% in the same period.

The financial vulnerabilities of households also decreased, driven by the resilience of employment, the growth of gross disposable income (GDI) and the decline in their debt relative to GDP.<sup>6</sup>

Specifically, the unemployment rate according to the Spanish Labour Force Survey (EPA) stood in June 2024 at 11.3%, down 0.4 pp from twelve months earlier, a rate not observed since 2008 Q3. In this context, real household GDI<sup>7</sup> grew at an average year-on-year rate of 3.8% (as against 4.4% in the previous six months), and stands at 2.8% above its level prior to the pandemic.<sup>8</sup> The volume of household debt increased in Q2, the first rise since summer 2022, while gross household wealth continued to climb. The higher growth in income than in debt levels meant that the household debt ratio fell to 44.9% of GDP in 2024 Q2, a level not seen since 2000 and 7.5 pp below the euro area average.

Despite these positive income and debt developments, the average cost of debt and the debt burden of households and non-financial corporations remain at relatively high levels in

5 GOP is obtained by deducting intermediate consumption (costs of production and other operating expenditure) and personnel costs from output (sales and other operating income).

6 Household indebtedness relative to GDI displays a similar pattern.

7 GDI includes compensation of employees, the gross operating surplus and gross mixed income, property income and net transfers received (state benefits less taxes and social security contributions). Real income is calculated by applying the private consumption deflator to the nominal values. In June 2024, the number of households grew by 0.8% year-on-year.

8 In seasonally adjusted terms.

comparison with the low rate period following the global financial crisis. The progressive adjustment of monetary policy and the rate reset periods in variable rate contracts mean that the decline in the debt burden of these sectors can be expected to take place gradually, so that indebted agents will be subject to some degree of vulnerability in the short term.

Specifically, the debt burden ratio (interest expenses divided by the gross operating surplus) of non-financial corporations increased in 2024 Q2 to 17.7%, up 5.3 pp from the figure recorded 12 months earlier, and the highest level of this metric since 2012 (see Chart 10, right-hand panel). The proportion of vulnerable firms in the Central Balance Sheet Data Office Quarterly Survey (CBQ) did not change significantly in the period to June 2024, with uneven behaviour among the various financial fragility indicators (e.g. losses, high debt burden). In any event, these indicators stand below the average level observed over the period 2014-2023.

In the case of households, the aggregate debt burden (financial costs divided by GDI) stood at 2.9% in June 2024, with a year-on-year increase of 0.5 pp (see, again, Chart 10, right-hand panel). This debt burden level is the highest in the series since 2014.

Favourable income developments continue to contain the increase in the proportion of households with a high gross debt burden (over 40% of household income). However, inflation in this period, in particular the cost of consumer staples such as food and energy, has put further pressure on their ability to meet their financial commitments.

### **V3. Weaknesses in the financial sector's intermediation capacity**

The profitability of the Spanish banking sector continued to increase in the first half of 2024, with the ROA (return on assets) standing at 0.91% and the ROE (return on equity) at 13.9%, up 16 bp and 2.2 pp respectively from June 2023.

The monetary policy rate hikes led to a general increase in European bank profitability, with Spanish banks significantly more profitable than the average. This positive differential in the profitability of Spanish banks has not translated into an improvement in their relative position in terms of the CET1 solvency ratio (see Chart 11). The favourable profitability forecasts would help to strengthen bank solvency and compliance with additional capital requirements, such as the activation of the countercyclical capital buffer (CCyB) for exposures in Spain, as described below.

The various components of bank profit have displayed the same qualitative pattern of change as in 2023: profitability has been driven mainly by the marked growth in net interest income, and by a more moderate contribution from net fee and commission income and other gross income items. Together these two components more than offset the poor performance of other items, such as impairment charges. The latter continue to post contained growth despite the sharp rise in key policy rates since 2022. Operating expenses continued to rise in an inflationary setting, and the levy on lending in Spain continued to absorb a limited part of profitability (in its absence,

Chart 11  
ROE and CET1 ratio. European comparison (a)

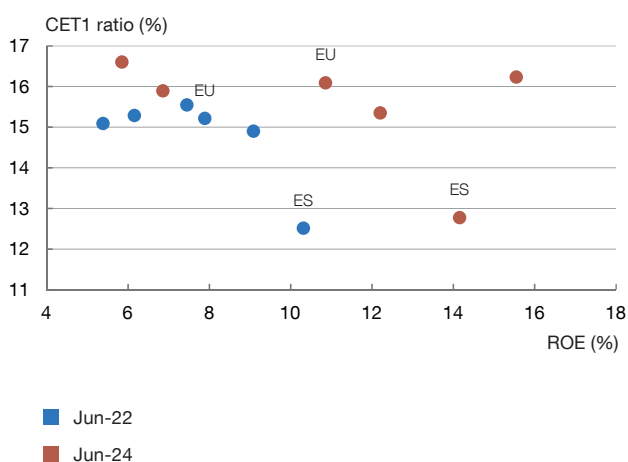
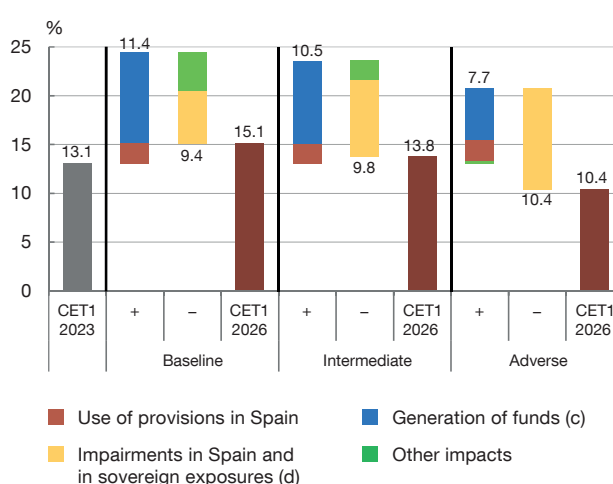


Chart 12  
FLESB stress tests. Impact on CET1 ratio under different scenarios (b)



SOURCES: EBA and Banco de España.

- a The dots correspond to the values observed in the main European banking sectors (Germany, Spain, France, Italy and the Netherlands) and the average for banks in the European Union. The latter is identified individually (EU), as is Spain (ES).
- b The net effect of the positive (negative) flows is indicated in the data label above (below) the corresponding bar. The initial CET1 ratios (13.1% in 2023) and final CET1 ratios (projected for 2026 under each scenario) reflect the fully-loaded basis. Other impacts include, among other effects, the change in RWAs between 2023 and 2026, and the effect of ICO guarantees. Aggregate results, including institutions under the direct supervision of both the SSM and the Banco de España.
- c This variable includes net operating income in Spain and net income attributable to business abroad. Thus, the funds that the banking group as a whole may generate are compared with the impairment losses in Spain and on the sovereign portfolio (the focus of these tests).
- d This variable shows the projection over the three years of the exercise of gross losses due to credit portfolio impairment for exposures in Spain and other types of losses (associated with the fixed-income portfolio, the management of foreclosures and the sovereign portfolio).

the ROA in June 2024 would have been 4 bp higher, at 0.95%, and the ROE 0.6 pp higher, at 14.5%). In terms of risk weighted assets (RWA) as at June 2024 the levy amounted to 0.11%.

Looking ahead, insofar as the forecast scenarios are concerned, the impact of the reduction in interest rates on bank profitability is expected to be limited and gradual. This is because the potentially adverse effects on unit profits will be at least partially offset by more favourable developments in the volume of business and impairment charges, and banks have various interest rate management instruments. In fact, the results of the Banco de España's stress tests<sup>9</sup> show that the Spanish banking sector would retain organic capital generation capacity under the scenarios in question (see Chart 12).

In contrast, the materialisation of the identified macro-financial risks would significantly reduce the sector's profitability. Indeed, the results of the stress tests indicate that under the most adverse scenario (with intense materialisation of multiple risks, see Box 2.1) a certain amount of capital depletion would occur (see Chart 12). These results point to notable resilience on the part of the Spanish banking sector at the aggregate level. However, the reduction in their

<sup>9</sup> These tests are conducted in accordance with the top-down Forward Looking Exercise on Spanish Banks (FLESB) methodological framework, developed and implemented in a centralised way by the Banco de España. See Box 2.1 for further details of the framework and of the latest results.

solvency under this adverse scenario would limit their intermediation capacity and would make a certain degree of deleveraging likely. This would also occur, albeit less intensely, under scenarios in which systemic risks materialise less fully.

Under these less extreme risk scenarios, in which a lower number of risks materialise and they do so less strongly, the profitability of the Spanish banking sector would also be reduced, although by a much smaller amount. For example, the stress test exercises have examined a resurgence of inflation with a negative effect on activity, although without a significant recession or a marked correction in the financial markets, as occurs under the most severe case. Under this intermediate scenario, no reduction in the CET1 solvency ratios is observed, which reinforces the diagnosis of reduction in the level of inflation-linked risks (see risk R2).

Also, Spanish banks have a comfortable liquidity position, with a liquidity coverage ratio (LCR) of 185.7% in June 2024, well above the requirement of 100%, and are not facing funding pressures, with loan-to-deposit ratios of 97.3% and 79.9% at consolidated level and for business in Spain. All of this limits the likelihood of shocks to profitability translating into liquidity and funding stress.

As already mentioned at the beginning of this summary, concerns persist at global level over tight liquidity positions and the leverage of some NBFIs (e.g. hedge funds and family offices). Also, the expansion of the NBFIs sector means that it is increasingly important for financial stability, while it remains necessary to further develop their macroprudential framework, which needs to be sensitive to the heterogeneity of the intermediaries that make up this sector. Improving the information available on NBFIs and the interconnections between them is a crucial step in this respect.

## **Real estate market developments**

The monetary policy tightening cycle initiated in mid-2022 led to a reversal of the expansionary trend in activity and acceleration in house prices observed from 2021 after the pandemic. Thus, in 2022 Q4 and 2023, double-digit year-on-year declines were recorded in volumes of purchases and new mortgages, while the growth in house prices slowed from a peak of 8.5% in 2022 Q1 to around 4% at the end of 2023.

Since 2023 Q4, increased housing market activity has been observed, as the moderating effects of the high interest rate environment have tailed off. House purchases and the flow of new mortgages have strengthened, approaching in mid-2024 the high levels reached in 2022. At the same time, house prices have accelerated, reaching a year-on-year growth rate of 7.8% in Q2. There has also been notable growth in the cost of housing rental, which will help to sustain prices in the housing market. The price of commercial property has also recovered somewhat, with year-on-year growth of 3.8% in 2024 Q2, as against the reductions seen in 2022 and 2023.

Chart 13  
Indicators of house price imbalances (a) (b)

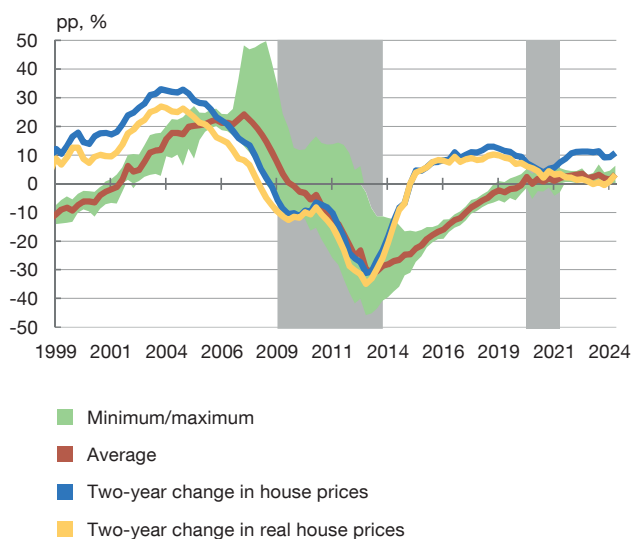
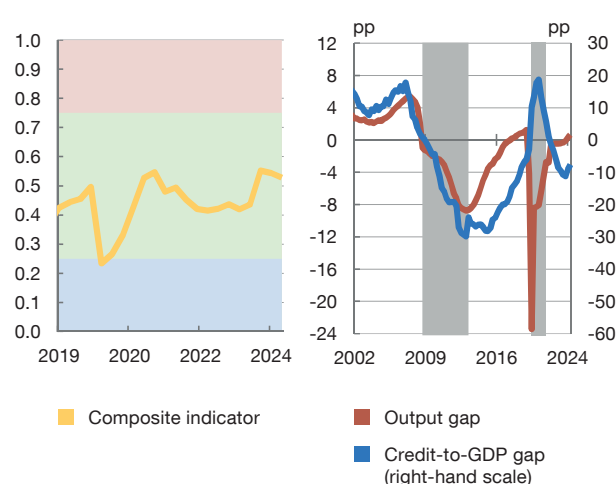


Chart 14  
Composite indicators, and credit-to-GDP and output gaps (a) (c)



SOURCES: Banco de España and INE.

- a The vertical grey shaded areas indicate two crisis periods identified in Spain since 2009: the last systemic banking crisis (2009 Q1-2013 Q4) and the economic crisis triggered by the COVID-19 pandemic (2020 Q1-2021 Q4). Data updated as at June 2024.
- b The green shaded area denotes the minimum and maximum values of four indicators of house price imbalances: (i) the real house price gap; (ii) the house price-to-household disposable income ratio gap; (iii) the ordinary least squares (OLS) model that estimates house prices based on long-term trends in household disposable income and mortgage rates; and (iv) the error correction model that estimates house prices based on household disposable income, mortgage rates and fiscal effects. The long-term trends for indicators (i) to (iii) are calculated using a statistical one-sided Hodrick-Prescott filter with a smoothing parameter equal to 400,000. All four indicators have an equilibrium value of zero. The two-year cumulative price growth in nominal and real terms is also included.
- c The composite indicator is defined on a scale from 0 to 1 based on the percentile of its historical distribution. The blue (green) [red] range indicates a low (standard) [high] level sign of cyclical systemic risks. The output gap represents the percentage difference between observed GDP and its quarterly potential level. Values calculated at constant 2010 prices. See Pilar Cuadrado and Enrique Moral-Benito. (2016). "Potential growth of the Spanish economy". Documentos Ocasionales, 1603, Banco de España. The credit-to-GDP gap is calculated as the percentage point difference between the observed ratio and its long-term trend calculated by applying a one-sided statistical Hodrick-Prescott filter with a smoothing parameter of 25,000. This parameter is calibrated to the financial cycles historically observed in Spain. See Jorge E. Galán. (2019). "Measuring credit-to-GDP gaps. The Hodrick-Prescott filter revisited", Documentos Ocasionales, 1906, Banco de España.

Population growth – largely associated with migration – and favourable developments in employment and Spanish household income have helped drive the demand for rented and owned housing. The demand for owned housing of non-residents has also been notably vigorous. Given the relatively inflexible supply of housing and the use of a growing proportion of it for tourism rather than residential purposes (due to the expansion of non-hotel tourism), the boom in demand has pushed prices upwards, as described above. The favourable performance of household income has, however, prevented the emergence of notable price imbalances (see Chart 13).

Up until now, significant loosening of mortgage lending standards relating to the value of collateral or income has not been detected. In fact, in 2023 and in the first half of 2024 there were reductions in loan-to-income (LTI) and loan service-to-income (LSTI) ratios in new mortgage loans, which implies less risk taking in this area. However, the loan-to-value ratio increased in the first half of 2024 relative to its average level in 2023, which entailed only a slightly riskier standard according to this metric.



The interest-rate spreads applied to new mortgage lending (as compared with the market benchmarks) remain low, despite the year-on-year increase in spreads observed to June 2024. The increase in the average cost of bank funding and the decline in benchmark interest rates have brought their levels closer into line, reducing the ability to set the rates on mortgages and other loan products at lower levels relative to benchmark rates and, at the same time, to generate a positive interest margin. In any event, these still narrow spreads appear to reflect, among other factors, the high level of competition in this segment and expectations of lower interest rates in future. If these expectations are dashed then the profitability of these transactions will be reduced.

The progressive lowering of interest rates will foreseeably stimulate the expansionary trend in the housing market, which could spread to the real estate market as a whole, so it will need to be closely monitored.

### Macprudential policy stance

The Banco de España has approved a CCyB requirement of 0.5% of risk-weighted assets for exposures located in Spain from 2024 Q4 (effective in 2025 Q4). This instrument has been activated as a result of a review of the framework for setting the CCyB approved in 2024 Q4.<sup>10</sup> This new framework means that, from now on, banks will have to maintain a releasable buffer of 1% when cyclical systemic risks are at an intermediate level, as they are perceived to be at present (see Chart 14). This modification, which follows the recommendation of the main international and European organisations, will help banks continue to provide financing to the Spanish economy, even in adverse situations, thereby contributing to its stability.

Since the last issue of the FSR, the activation of the systemic risk buffer (SRB) for credit exposures located in Portugal and Italy should also be noted. This was the result of the reciprocal application of measures relating to this buffer activated by the macroprudential policy authorities in these countries. The impact of these reciprocal measures on consolidated capital requirements is very moderate, but their activation will contribute to consistent and efficient application of macroprudential policy in the banking union.

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<sup>10</sup> See [methodological document](#) on the revised CCyB framework for exposures located in Spain and also Estrada et al. (2024) “Analysis of cyclical systemic risks in Spain and of their mitigation through countercyclical bank capital requirements” with further technical details on different analyses applied to assess and calibrate the revision of this framework.