

SHORT AND MEDIUM TERM RISKS FOR THE SPANISH FINANCIAL SECTOR

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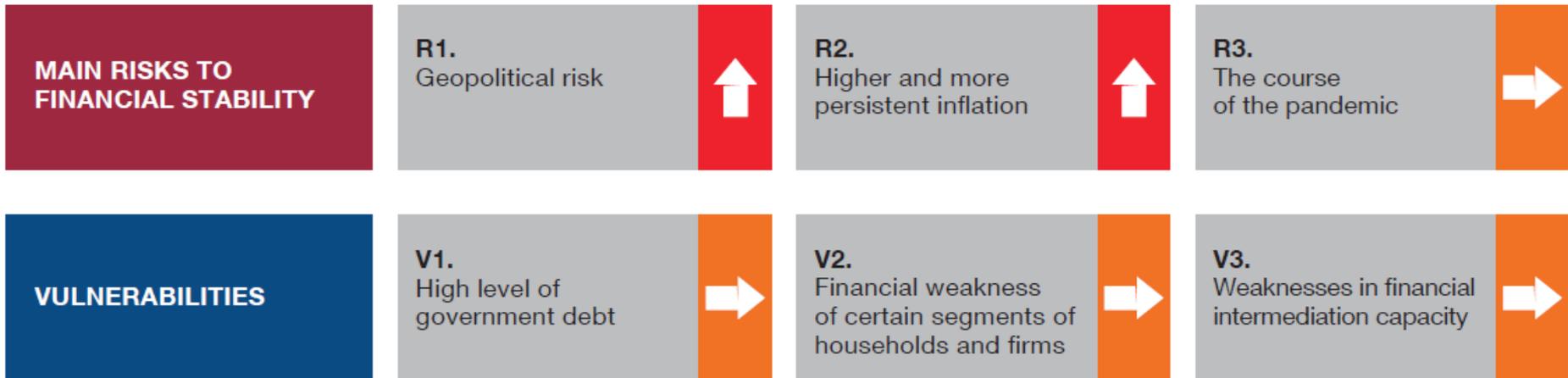
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THE MACRO-FINANCIAL SITUATION OF THE SPANISH ECONOMY CONTINUED TO IMPROVE UNTIL 2022Q1, BUT NEW RISKS HAVE EMERGED, MOST NOTABLY THE RUSSIAN INVASION OF UKRAINE

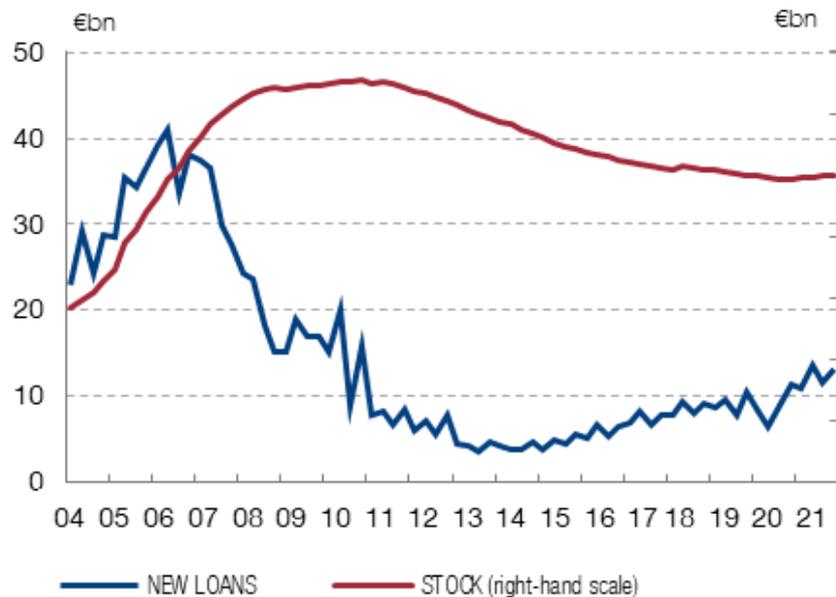
- This new shock to the Spanish economy comes amid a gradual recovery, which remained incomplete, uneven across sectors and **influenced by the course of the pandemic and continuous upside inflation surprises since mid-2021**
- In this environment, **banks should remain cautious and the supervisors closely monitor any potential materialisation of the identified risks**, in order to taken action to mitigate them



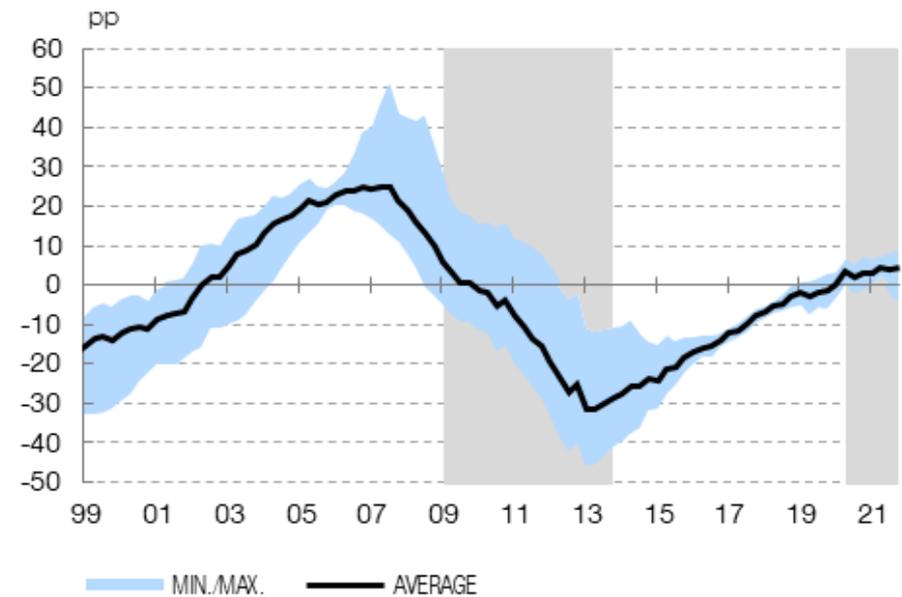
REAL ESTATE INDICATORS SHOW SOME INCIPENT SIGNS OF OVERVALUATION, BUT THEY ARE STILL AT LEVELS CLOSE TO THE EQUILIBRIUM

- **New mortgage lending rose sharply in 2021**, reaching the highest levels in a decade. However, the also high loan repayments implied that the **stock of mortgages increase** only slightly last year
- However, a close monitoring of this market -which is exposed to opposite sign effects due to the increase of inflation and interest rates- is required

NEW LOANS FOR HOUSE PURCHASE AND STOCK OF MORTGAGE LOANS



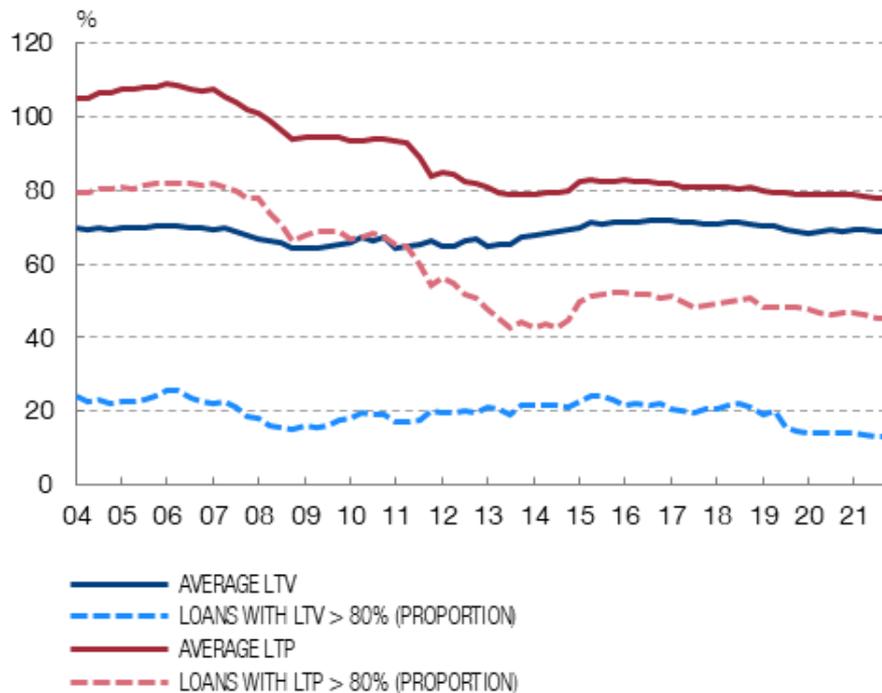
INDICATORS OF HOUSE PRICE IMBALANCES



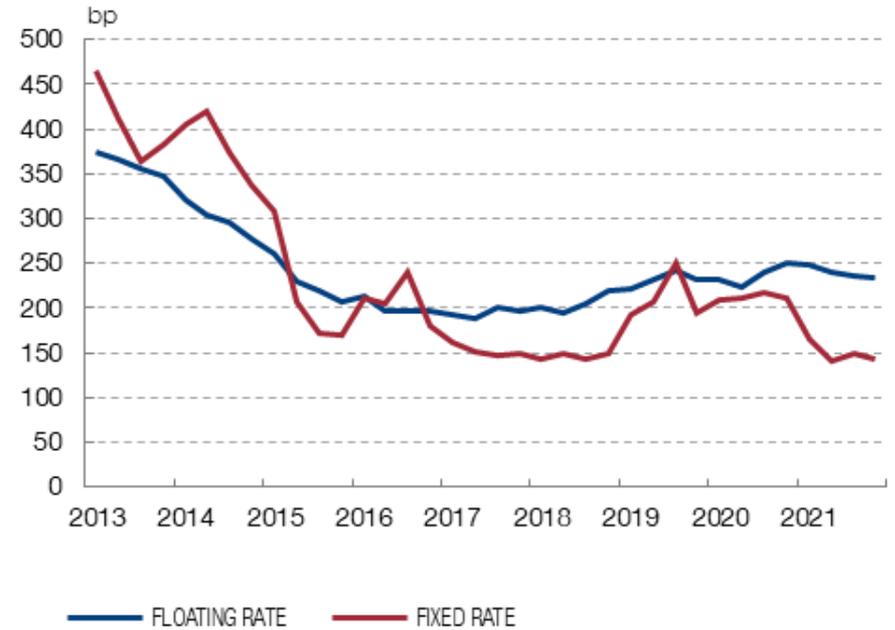
THERE WAS NO SUBSTANTIAL CHANGE IN CREDIT STANDARDS FOR NEW RESIDENTIAL MORTGAGES IN 2021; HOWEVER, SOME OF ITS DIMENSIONS REQUIRE A CLOSE MONITORING

- **The average loan-to-value (LTV) and loan-to-price (LTP) ratios**, which measure borrowers' indebtedness in new mortgage loans, **remained stable** at prudent levels
- Over the course of 2021 **the average interest rate spread for fixed-rate mortgages**, which currently account for the bulk of new mortgage lending, **narrowed to its lowest level in recent years**

LOAN-TO-VALUE AND LOAN-TO-PRICE RATIOS OF NEW MORTGAGES



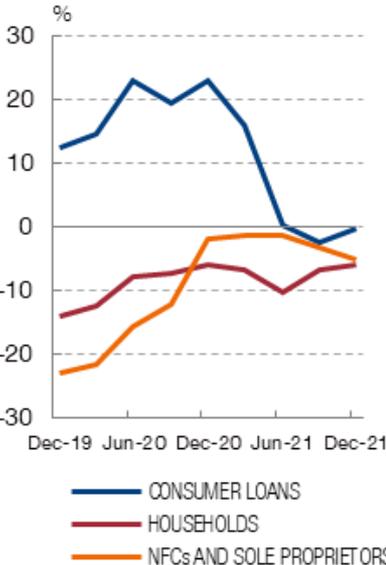
SPREADS OVER RISK-FREE RATES



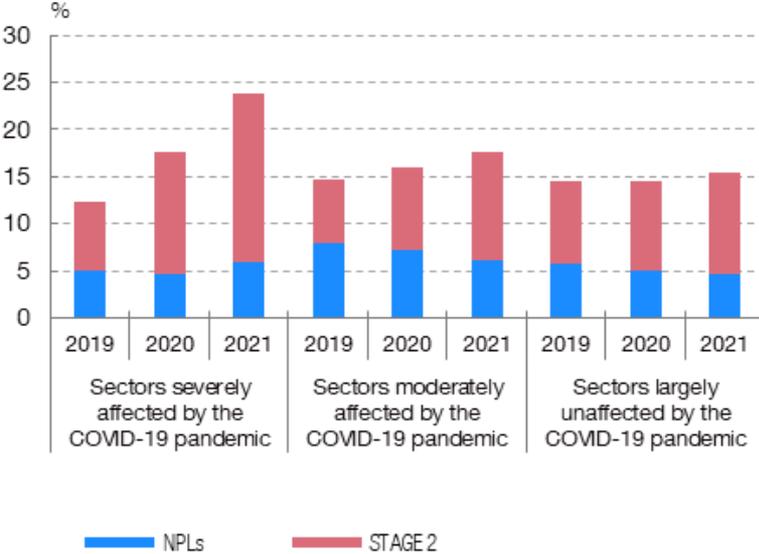
NON-PERFORMING ASSETS CONTINUED TO DECLINE IN 2021, BUT LATENT SIGNS OF IMPAIRMENT PERSIST

- **Particularly in the sectors most affected by the pandemic, and in the growth of forborne and stage 2 loans**
- **The credit quality of ICO-guaranteed loans continued to worsen in the second half of 2021, albeit at a slower pace than observed in the previous semester. The stage 2 category continued to account for the bulk of the impairment in this sub-portfolio**

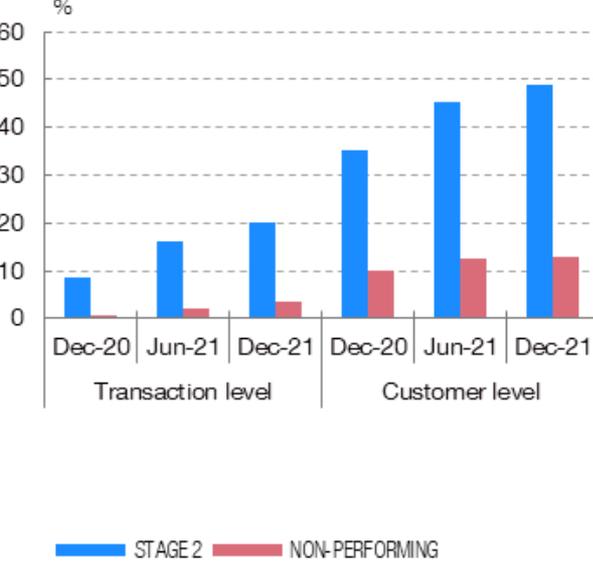
YEAR-ON-YEAR RATES OF CHANGE IN NPLs
Business in Spain, ID



SHARE OF NON-PERFORMING AND STAGE 2 LOANS.
NFCs AND SOLE PROPRIETORS
Business in Spain, ID



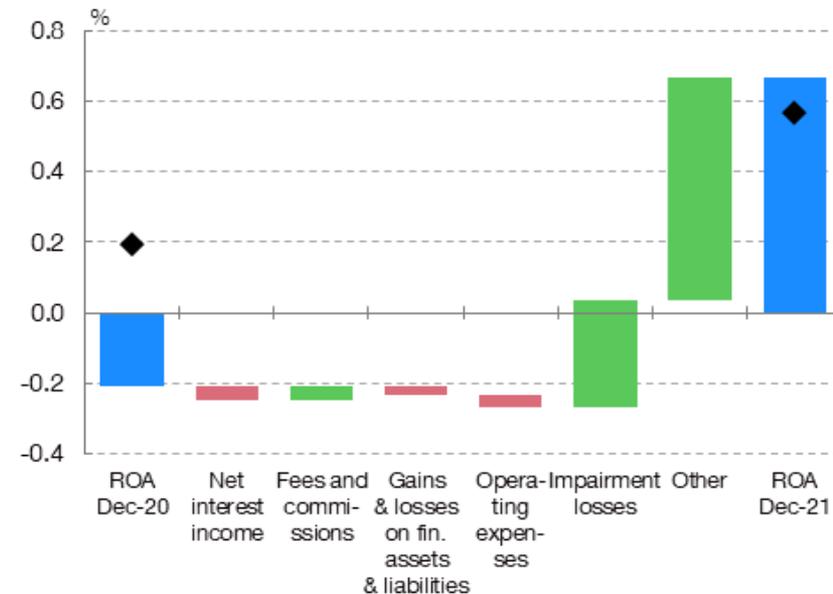
CREDIT QUALITY OF THE STOCK OF ICO-BACKED LOANS



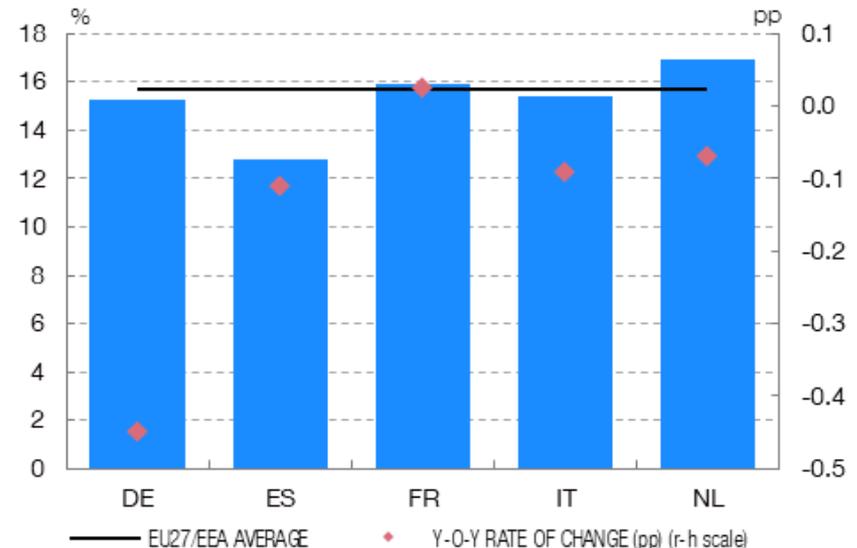
THE BANKING SECTOR'S PROFITABILITY IMPROVED SUBSTANTIALLY IN 2021 FOLLOWING THE LOSSES RECORDED IN 2020: NOW IT IS ABOVE THE EUROPEAN AVERAGE AND THE CoE

- The improvement was mainly attributable to the extraordinary results (positive in 2021 and notably negative in 2020) and to lower impairment losses. In 2022Q1 the other lines of the profit & loss account showed a progress
- **The CET1 ratio of Spanish banks remained stable in 2021**, as in the rest of Europe, after the increase experienced in 2020. The solvency differences with Europe have therefore stabilised after converging slightly in 2020

BREAKDOWN OF THE CHANGE IN PROFIT
Consolidated net income as a % of ATA



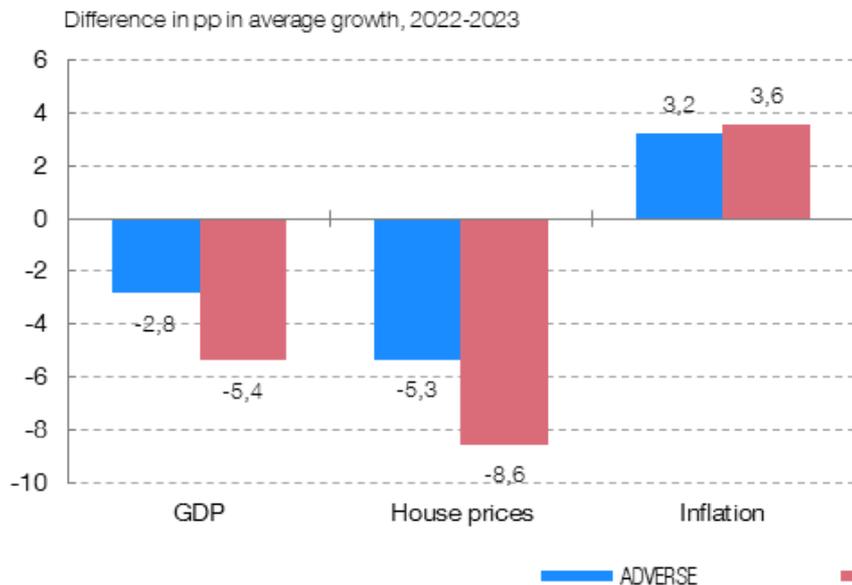
CET1 RATIO: EUROPEAN COMPARISON
Consolidated data. December 2021



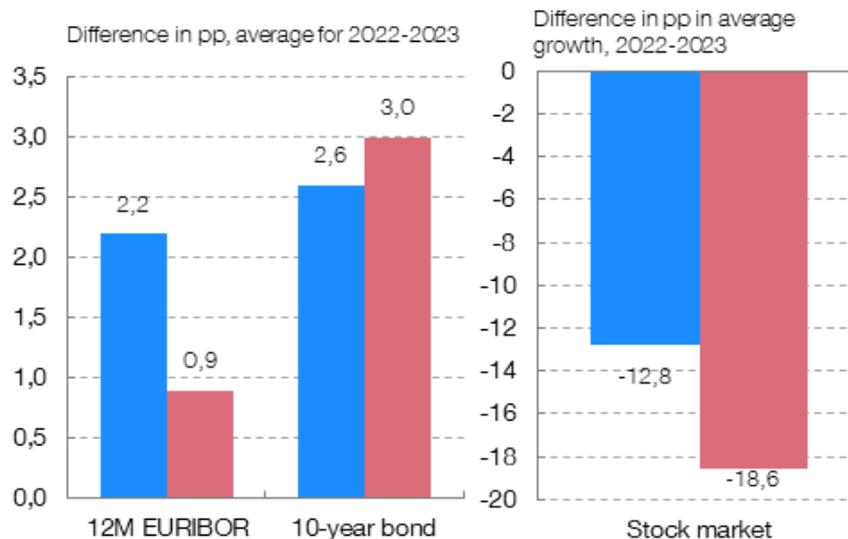
THE STRESS TEST EXERCISE CONSIDERS HYPOTHETICAL SCENARIOS IN WHICH THE RISKS IDENTIFIED AFTER THE OUTBREAK OF THE CONFLICT MATERIALIZE WITH INTENSITY

- **Adverse Scenario:** Rising risk premia, larger increases in energy commodity prices and bottlenecks drive up inflation and force a monetary policy response
- **Severe Scenario:** Adverse Scenario + erosion of agents' confidence, entailing a less aggressive monetary policy response

ADVERSE AND SEVERE SCENARIOS FOR SPAIN. MACROECONOMIC IMPACT



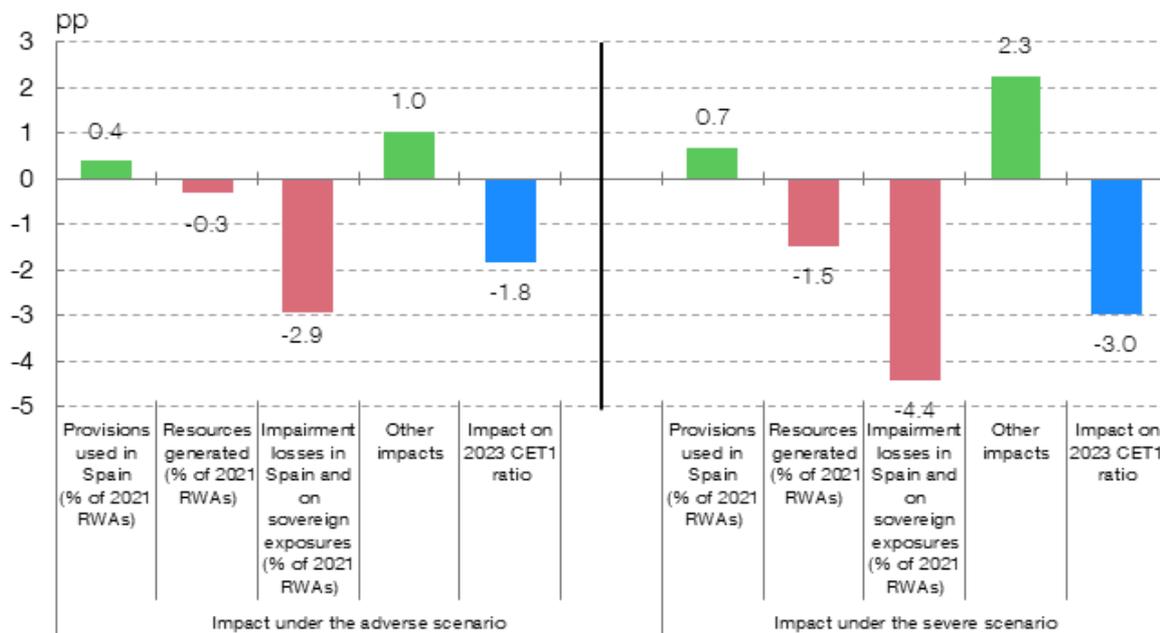
ADVERSE AND SEVERE SCENARIOS FOR SPAIN. IMPACT ON THE FINANCIAL ENVIRONMENT



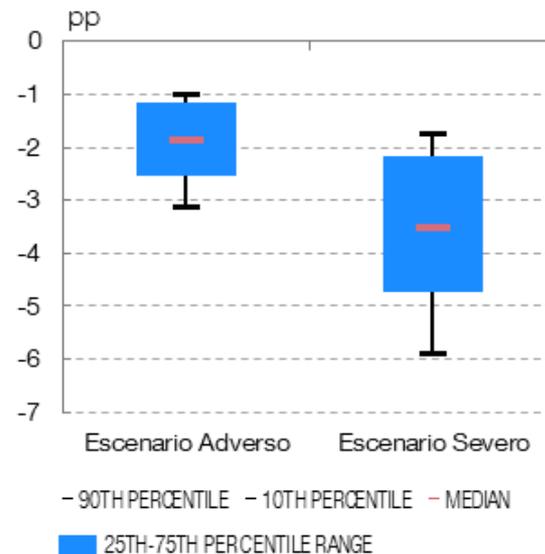
THE STRESS TEST RESULTS SHOW THAT THE AGGREGATE RESILIENCE WOULD SUFFICE TO ABSORB THE IMPACT OF THE CRISIS

- **The impact on the CET1 ratio was 1.8 pp and 3 pp in the adverse and severe scenarios, respectively**
- However, **there is cross-bank heterogeneity** attributable to differences in: (i) the composition of their credit to the private sector and sovereign exposures, (ii) international presence, (iii) coverage of the ICO programme, etc.

IMPACT OF THE RISK MATERIALISATION SCENARIOS ON BANK SOLVENCY. CONSOLIDATED BUSINESS



DISTRIBUTION AMONG BANKS OF IMPACTS ON LOAN IMPAIRMENT PROVISIONS RELATIVE TO 2021 RWAs. OPERATIONS IN SPAIN



CRYPTOASSETS PRESENT RISKS INHERENT TO THIS NEW TECHNOLOGY AND ALSO TO FINANCIAL STABILITY

- The dependence of the current value of crypto-assets on the **expectations** of buyers and sellers as to their value in future transactions creates **significant market and liquidity risks**. These risks are more marked in the case of unbacked crypto-assets (than in the case of stablecoins)
 - Unbacked crypto-asset markets have higher volatility than equity markets
- A more widespread **use of stablecoins** could entail medium-term structural risks to financial stability through an increase in the **interconnectedness with the traditional financial market** and the **erosion of the banking sector's deposit-taking capacity**
 - This could potentially alter the effects of monetary policy, reduce the effectiveness of macroprudential policy and affect capital flows
- The **opacity and lack of user protection** in broad segments of the crypto-asset markets, the absence of regulation and technological uncertainty may also generate **credit and fraud risk** in crypto-asset transactions
- The **innovative technologies** on which crypto-assets are based also pose **operational risks** that may undermine **trust** in them in future transactions. Operational risks associated with crypto-assets also have **legal, regulatory and market design dimensions**
- Crypto-assets also pose **physical and transition climate-related risks** due to the **high energy consumption** of certain operations

BANCO DE ESPAÑA DOES NOT HAVE THE CAPACITY TO REGULATE, AUTHORIZE OR SUPERVISE THE ACTIVITY OF THE CRYPTOACTIVE MARKETS OR THEIR PARTICIPANTS

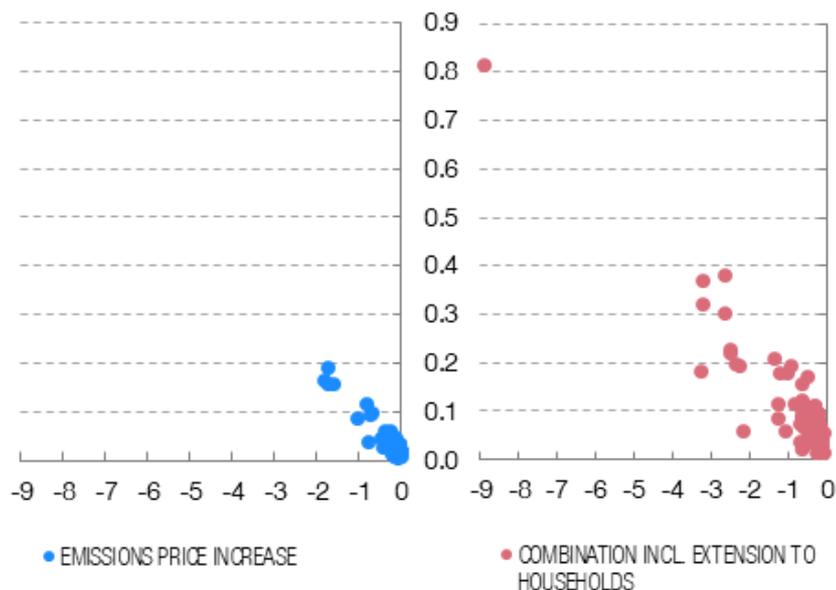
- The regulation of crypto assets poses new challenges. International coordination in a segment of the financial market that is susceptible to creating regulatory arbitrage is essential.
 - Diversity of players that shape the ecosystem of issuance and provision of services of crypto assets, sometimes operating in a totally decentralized manner
 - New developments
 - Need to develop a regulatory framework with a flexible approach
- There are different supranational initiatives in the development stage.
 - These initiatives are largely motivated by a growing consensus among regulators on the importance of the potential risks associated with this segment.
 - *In the EU, the MiCA Regulation – which is under negotiations – aims to provide legal certainty and adequate protection to crypto assets' users.*
 - *The Basel Committee is developing a proposal on how to treat bank's exposures to crypto assets*

FAILURE TO ACT ON CLIMATE CHANGE WILL ENTAIL HIGHER COSTS FOR THE FINANCIAL SECTOR IN THE LONG TERM THAN IMPLEMENTING MEASURES TO PREVENT IT IN THE SHORT TERM

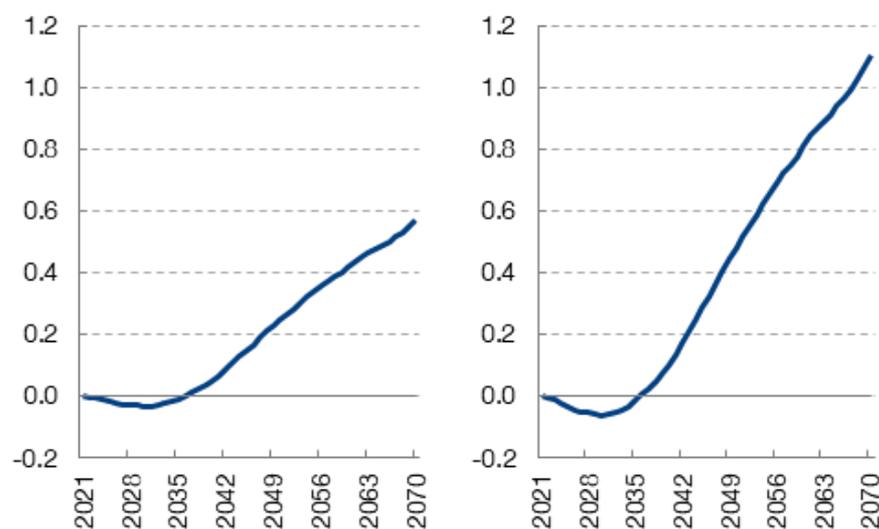
- The **increase in CO2 prices and the extension** to other sectors of the rights payment system in order to start the energy transition process would have, **in the short run, a moderate negative impact on activity** -uneven across sectors-, and on the quality and profitability of credit
- However, **not acting against climate change would cause an intense materialization of physical risks** (Hot House World) and, thus, a strong economic and credit deterioration in the medium-long run, much higher than in an **Orderly Transition scenario**

EFFECT OF TRANSITION COSTS ON PROBABILITIES OF DEFAULT (PD)

X axis: differences in average rates of change in GVA vis-à-vis the baseline scenario (pp)
 Y axis: differences in average PDs vis-à-vis the baseline scenario (pp)



HOT HOUSE WORLD SCENARIO VS. ORDERLY TRANSITION SCENARIO
 DIFFERENCES IN PROBABILITY OF DEFAULT
 Households (left) and firms (right)



THERE IS A CONSENSUS THAT THESE RISKS WILL MANIFEST THEMSELVES IN FINANCIAL ENTITIES THROUGH THE TRADITIONAL CATEGORIES OF FINANCIAL RISKS

- However, the risks associated with **climate change incorporate some particularities**, which must be taken into account for the design of the appropriate regulatory framework
- Worth mentioning in particular:
 - The consequences of climate change are unprecedented and will occur over a very long time horizon
 - Physical and transition risks are interrelated, possibly subject to tipping points, in a non-linear way
 - Global dimension, as well as heterogeneity of its impacts both sectoral and geographical
- From the perspective of prudential regulation and supervision, **the objective is to ensure that entities adequately identify, measure and manage the financial risks** related to climate change.
 - For this reason, work is already being done in several regulatory areas at a supranational level with the following objectives:
 - *Address existing information gaps in this area*
 - *Improve measurement methodologies of climate risk impact (stress test, scenario analysis)*
 - *Evaluate the different alternatives to incorporate these risks into the prudential framework (Pillar 1, buffers, Pillar2)*

THANK YOU FOR YOUR ATTENTION

