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**The Spanish banking industry: developments and challenges against
a backdrop of uncertainty***

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* English translation from the original in Spanish.

I would like to thank the newspaper *Expansión* for inviting me to take part in this **14th Financial Meeting** and giving me this opportunity to share with you the Banco de España's latest assessment of the Spanish banking sector and the challenges ahead. To set this analysis in context, I will first outline the macroeconomic outlook and the most recent monetary policy decisions taken by the European Central Bank (ECB).

The euro area economy and monetary policy

Against a backdrop of high and persistent inflation, the ECB Governing Council has adopted very forceful measures since late 2021 to ensure that inflation returns to its 2% medium-term target.

Interest rates have been raised by 450 basis points (bp) since July 2022, the largest and fastest increase in the history of the euro area, with the deposit facility rate set at 4% in our September meeting. **The balance sheet reduction has also been extraordinarily swift**, even compared with other central banks.

In recent months the ECB has based its decisions on an overall assessment of the macroeconomic situation, the inflation outlook – in particular for underlying inflation – and monetary policy transmission. Allow me to outline my current view of these three aspects.

Economic growth in the euro area was very slow in the first half of year, with indicators for the third quarter suggesting that the weakness has intensified, spreading across sectors and countries, and is beginning to feed through to employment indicators. In fact, **the ECB's September projections for the second half of the year have been revised down and now point to stagnant economic activity**.

This more lacklustre near-term economic performance, coupled with slower global economic growth (particularly in China, although the United States and Japan have both outstripped growth expectations), surging energy prices, a further tightening of financial conditions and exchange rate appreciation all led the **ECB to significantly revise down its euro area growth projections for 2023-2025**.

Growth of 0.7% is now expected in 2023, followed by 1% in 2024 and 1.5% in 2025. In cumulative terms, the GDP growth projection for end-2025 is now 1% lower than that forecast in June.

Over the coming years, the **growth recovery will be underpinned by a range of factors, including improvements in real disposable income driven by higher nominal wages and the anticipated easing of inflation**. However, the considerable rise in interest rates will continue to weigh on economic activity.

Against a background fraught with **high uncertainty**, the **risks** associated with the growth forecasts are mainly **on the downside**. Specifically, growth could be weaker if monetary policy transmission were to prove stronger than anticipated, or if the global economy were to weaken due, for instance, to a further slowdown in the Chinese economy. In addition, geopolitical tensions remain a major source of uncertainty.

Inflation has fallen significantly from its peak in October 2022, easing to 4.3% in September. **Underlying inflation** (which excludes food and energy prices) **has declined more gradually**, down to 4.5% in September from its March peak of 5.7%.

Other measures of underlying inflation have also begun to come down and domestic inflationary pressures have stabilised. At the same time, the medium and long-term **inflation expectations** of consumers, analysts and market participants **remain anchored** at 2%.

Against this backdrop, **the ECB projections continue to envisage a gradual decline in inflation to 2.1% in 2025, very close to target** (compared with the 5.6% projected for 2023 and 3.2% for 2024).

Furthermore, **the risks associated with these inflation projections are balanced**. Inflation could be higher than expected if new upward pressures on energy and food prices were to emerge. Higher than anticipated increases in wages or profit margins could also prompt a pick-up in inflation, including in the medium term, not least because wage negotiations are taking place in a tight labour market, with a historically low unemployment rate and labour shortages, despite the considerable growth in labour market participation seen recently. Conversely, weaker demand resulting, in particular, from stronger than expected monetary policy transmission or a deteriorating economic environment (especially if due to the materialisation of geopolitical risks), would lead to slower growth and an easing of inflationary pressures.

Monetary policy transmission, for its part, is proving **very strong**, judging by bank lending rates, the stock of lending and credit standards. Indeed, the transmission has been more robust than was initially expected. Moreover, **a significant portion is thought to remain outstanding** and should feed through in the coming quarters.

Outlook for the Spanish economy

The Spanish economy also showed signs of a slowdown over the summer months, and these are expected to persist in the second half of the year. The **Banco de España's latest projections point to growth of 0.3% in the third quarter**,^{1,2} following growth of 0.6% and 0.5% in the first two quarters.

In any event, the Spanish economy has demonstrated greater resilience than some of its European peers in the last few months. The differences in terms of sectoral composition – the services sector and tourism account for a larger share of the Spanish economy – and our lower trade exposure to China explain at least part of this relative buoyancy. **However, the weakness in industry is beginning to spread to services, and tourism is likely to lose some momentum.**

¹ See "[Macroeconomic projections for the Spanish economy \(2023-2025\)](#)", September 2023.

² After these projections were published, the National Statistics Institute (INE) released a revision of the Annual National Accounts series for 2020-2022 and likewise for the corresponding Quarterly National Accounts (QNA) series up to 2023 Q2. In particular, the revised QNA series entail a slightly smaller drop in GDP in 2020 (-11.2% vs -11.3%) and stronger growth in 2021 and 2022 (6.4% and 5.8%, respectively, vs 5.5% previously in both cases). The resulting upward revision meant that Spain recovered its pre-pandemic GDP level (i.e. the level at end-2019) in 2022 Q3 (rather than in 2023 Q2, as per the previous series). However, the assessment of the latest economic activity trends remains largely unchanged. Therefore, our September projections, as an indication of the foreseeable course of the economy in the short and medium term, remain valid.

Against this backdrop, the GDP growth forecast for 2023 remains at 2.3%, unchanged on the June projection. **However, the growth rates projected for 2024 and 2025 have been revised down, by 0.4 percentage points (pp) and 0.1 pp to 1.8% and 2%, respectively.**

There was a certain increase in inflation over the summer, reaching 3.2% in September, compared with 1.6% in June. This increase was mainly the result of rising heating and vehicle fuel prices, along with base effects linked to the drop in oil prices in 2022 Q3.

However, **in the case of food and non-energy industrial goods, inflation has remained on a declining trend, with the exception of certain products** such as olive oil and some fruits and vegetables, owing to the adverse weather conditions in recent months. Conversely, prices in entertainment, hospitality and tourism showed strong momentum over the summer season.

The most recent projections place headline inflation at 3.6% for this year, 0.4 pp above the June estimate. **The forecast inflation rate for 2024 has also been raised, by 0.7 pp to 4.3%**. This is the result of rising energy prices and the continuation to end-2023 of some inflation-related measures, mainly the reduced VAT rate on food and public transport subsidies. **Inflation will drop considerably in 2025, falling to 1.8%.**

As has been seen across the euro area, **uncertainty surrounding these predictions are still significantly high** and the risks remain on the downside for activity and balanced for inflation.

Recent developments and challenges in the banking sector

Against the backdrop described above, developments in the Spanish banking sector can be characterised by the following stylised facts.

1.1 Funding

Banking sector funding continues to be influenced by the tightening of monetary policy in recent quarters.

There has been a **significant contraction in Eurosystem financing**,³ which has been partly offset by **cutbacks in the excess liquidity** held by banks in the form of central bank deposits,⁴ as well as **greater reliance on interbank funding and more debt issuances**.⁵

³ At consolidated level, the monetary normalisation process reduced central bank funding as a share of total assets by 6.2 pp between June 2022 and June 2023.

⁴ In Spain, resident banks' central bank deposits fell from 12.3% of assets in June 2022 to 7.7% one year later (non-consolidated data).

⁵ Deposits from credit institutions saw their share rise by 2.6 pp, while that of debt securities rose by 1.4 pp.

Deposits continued to grow at consolidated level, albeit more slowly, but were down for business in Spain.⁶

In parallel, the **average interest expense on bank liabilities** grew significantly, with the 2023 Q1 rate (2.3%) doubling that of 2022 (1.1%). However, **the rise in the EURIBOR has only partially passed through to the average cost of retail deposits in Spain⁷** and less so than in previous monetary tightening cycles.⁸

In any case, the **drop in the cost of equity** (around 2 pp between December 2021 and August 2023, when it stood at 8.5%) softened the blow of rising funding costs,⁹ since the increase in the risk-free rate was more than offset by drops in the stock market risk premium and the spread for Spanish banks.

Despite a significant volume of targeted longer-term refinancing operations maturing in June 2023, liquidity ratios have remained comfortably above regulatory minimums (100%).¹⁰

1.2 Assets

Consolidated assets fell by 1.2% year-on-year in June 2023. The **8.6% fall in financial assets in Spain is noteworthy**, in the light of growth of 6.4% for such assets overseas.¹¹

Most (92%) of the drop in financial assets in Spain was the result of shrinking central bank balances (down 41.1% year-on-year) and, to a lesser extent, the **1.7% decline in lending** to the resident private sector.

There was a 1.9% contraction in the stock of lending to Spanish households (-2.6% in the stock of mortgage lending) and a 3.6% fall in lending to NFCs and sole proprietors. Notable here were the marked declines in lending to the industrial sector (6%) and to hospitality, entertainment and wholesale and retail trade (4.1%). These falls are partly the result of the extraordinary levels of debt incurred by these sectors as a result of support policies put in place during the pandemic.

⁶ Consolidated deposits grew by 1.3% year-on-year, compared with 6.8% the previous year. In business in Spain, deposits by households and non-financial corporations (NFCs) fell by 1% year-on-year in aggregate terms.

⁷ Thus, between December 2021 and June 2023, the cost of time deposits increased by 1.04 pp for households and by 1.85 pp for NFCs, while the 12-month EURIBOR rose by more than 4.5 pp.

⁸ In June 2023, remuneration of retail deposits at consolidated level accounted for 40% of banks' total funding costs, owing to the preponderance of this deposit type in the makeup of bank liabilities.

⁹ Including a higher inflation risk premium in the Banco de España's cost of equity calculation would raise the estimate from 6.5% to 8.5%.

¹⁰ The average liquidity coverage ratio stood at 177%, compared with 206% one year earlier, while the net stable funding ratio was 131%. Furthermore, retail deposits cover a very substantial portion (74% as at March 2023) of the total stable funding needs, above the European average of 59%.

¹¹ Overseas assets now represent 55% of the total, which is a year-on-year increase of 3.8 pp (and well above the 32% seen in 2008). Against the current backdrop of a depreciating euro, the rise in financial assets overseas during the last year is mainly the result of growth in debt securities (13%) and lending to the resident private sector (4.3%). In consolidated terms, debt securities grew by 8.9% to 14.2% of total assets in June 2023 (compared with 10.6% in June 2007).

The pass-through of higher interest rates to lending rates has continued. The 12-month EURIBOR stood above 4%, having risen by 451 bp since December 2021. Altogether, the pass-through to the average lending rates exceeded 47% in the case of loans for house purchase and business loans, and 20% for other loans to households.

1.3 Credit quality

Credit quality continued to improve: the non-performing loans (NPL) ratio stood at 3.4% in June 2023,¹² its lowest level since 2008, and Stage 2 credit at 6.9%,¹³ still 1 pp above its pre-pandemic level.

Lending to households, however, performed relatively poorly in the latest period, giving mixed signals. The NPL ratio for this type of lending continued to decline (0.3 pp year-on-year, to 2.8% in June), but the proportion of Stage 2 loans rose (by 0.9 pp, to 5.4% in June).¹⁴

For its part, **ICO-backed credit still shows certain signs of impairment:** its NPL ratio increased by 4.2 pp over the 12 months to June 2023, to 8.3%, although the share of Stage 2 loans fell by 1.7 pp to 22.0%. This impairment was partly due to the automatic outflow of performing loans upon their repayment.¹⁵

1.4 Profitability

The return on assets (ROA) continued to improve in the first half of 2023, reaching 0.76% in June 2023, one of its highest levels over the last decade. Meanwhile, the **return on equity (ROE) stood at 12.1%,** up by more than 2.1 pp from a year earlier and above the average cost of equity.¹⁶

This improvement stemmed mainly from the growth in net interest income, which increased by 27% year-on-year, benefitting from the speedier pass-through of the increase in market interest rates to loans than to deposits. On the other hand, **operating expenses rose by 9.1%, due to the effect of high inflation, and impairment losses increased by 26.8%, owing to higher provisions for international activity.¹⁷**

In business abroad, ordinary profit improved notably (by 10.8%), driven mainly by the strength of business in Mexico. Along with growth in ordinary profit in the United Kingdom and Turkey, this was sufficient to offset the decreases in Brazil and in the United States. Thus, the Spanish banks with the most international activity obtained ordinary profit in excess of pre-pandemic levels.

¹² Between June 2022 and June 2023, the NPL ratio decreased by 0.4 pp (from 3.8% to 3.4%). By institutional sector, the 12-month change (June 2022-June 2023) in this ratio was -0.3 pp (from 3.1% to 2.8%) for households and -0.6 pp (from 5.1% to 4.5%) for the non-financial business sector.

¹³ Between June 2022 and June 2023, the share of Stage 2 credit fell by 0.3 pp (from 7.2% to 6.9%). By institutional sector, the 12-month change (June 2022-June 2023) in this share was 0.9 pp (from 4.5% to 5.4%) for households and -1.7 pp (from 11.1% to 9.4%) for the non-financial business sector.

¹⁴ The volume of NPLs rose by 2.9% in Q2, but in June still stood around 12% below its level a year earlier.

¹⁵ For example, the volume of loans granted under this facility fell by 10.3% in 2023 Q2 alone.

¹⁶ Excluding the impact of the windfall tax on banks, in June 2023 the ROA stood at 0.82% and the ROE at 13.11%.

¹⁷ In business in Spain, impairment losses fell by 2.8% in the first half of 2023.

1.5 Solvency

The CET1 ratio increased by 25 bp relative to the first half of 2022, since the increase in CET1 capital of 4.6% was greater than the growth in risk-weighted assets (2.7%). Thus, **the CET1 ratio stands at approximately 60 bp above its pre-pandemic level.**

1.6 Challenges and outlook

Overall, the Spanish banking sector has shown notable resilience to the various extraordinary shocks of recent years, allowing profitability, solvency and credit quality to actually improve.

This improvement has been driven, in part, by the internationally agreed regulatory reform, which in the European Union applies to all banks, irrespective of size. Also, its strongly retail-oriented business model has been an advantage for the Spanish banking industry.

However, **confidence in our banking system must not allow us to overlook the existing risks**, which remain significant.

- **The substantial improvement in net interest income cannot be considered long-lasting; if interest rates remain high, bank funding costs may reasonably be expected to rise further.**
- **The contraction in lending involves a reduction in turnover, and there has been a fall in the value of fixed-income financial exposures** (such as bond holdings, especially with longer maturities), which immediately leads to impairment of positions valued at fair value.¹⁸
- In a context of lower growth and high interest rates, **a decline in credit quality is likely**, although its speed and severity will depend on the materialisation of the risks identified. Thus, although **private-sector debt has fallen notably over the last decade**,¹⁹ it is estimated that **a 450 bp rise in market interest rates, similar to that observed in the 3-month EURIBOR since December 2021**,²⁰ could lead to **an increase of between 6.5 pp and 10.3 pp in the proportion of debt held by firms under high financial pressure**,²¹ relative to the situation at end-2021. **In the case of households, a 500 bp increase in the 12-month EURIBOR**²² would **increase the percentage of households with a high net interest burden**²³ by 4.2

¹⁸ In positions valued at amortised cost, "latent impairment" may be generated, which is not passed through to the income statement. That said, an ad hoc analysis carried out by the EBA and published in July shows the limited extent of this type of impairment. In Spain, on balance sheet data at December 2022, it does not amount to even 1.2% of risk-weighted assets. See "[EBA publishes findings of ad-hoc analysis on banks bonds' holdings](#)".

¹⁹ From highs of 119.9% and 85.6% of GDP, respectively, in 2010, to 70% and 51.1% in 2023 Q1.

²⁰ The 3-month EURIBOR is the main benchmark rate for non-financial corporations' funding costs.

²¹ A firm is considered to be under high financial pressure when the ratio of (gross operating profit + financial revenue) to financial costs is less than one.

²² The 12-month EURIBOR is the main benchmark rate for households' funding costs.

²³ The net interest burden is considered to be high when the ratio of (debt service expenses - interest income from deposits) to household income is over 40%.

pp. That said, the limited use to date of the Code of Good Banking Practice (CGP), and the fact that it only entered into force a short time ago, shows that households have managed to maintain their ability to pay in 2023.²⁴

- As far as **financial markets are concerned, we cannot rule out** gradual or sharp changes in agents' perceptions leading to **downward corrections in the value of some financial assets, which would translate into losses and higher borrowing costs.**

In this setting, the results of **the EBA and ECB stress test published in July²⁵ show that both the Spanish and the European banking sector are highly resilient to very adverse scenarios.** Overall, for the Spanish participating banks, the CET1 capital ratio is projected to increase by 2.8 pp under the baseline scenario and to decrease by 2.4 pp under the adverse scenario, while for the European participating banks it is projected to increase by 1.4 pp under the baseline scenario and to decrease by 4.6 pp under the adverse scenario.

Although these impacts are more favourable for Spain than for the EU overall, the fact that Spanish banks start from a lower CET1 capital ratio means that, by the end of the projection horizon, their solvency levels are similar to the European average.

Challenges for economic policies and bank management

I now wish to sum up my view of how economic policies should respond in this macro-financial setting and what financial institutions' priorities should be.

As regards monetary policy, **the information currently available**, which I have summarised in the first part of my address, **suggests that, if maintained over a sufficiently long period, the current level of interest rates will be broadly consistent with hitting our inflation target of 2% over the medium term.** This view is currently shared by most analysts and financial markets. The significant increase in real interest rates – especially at longer maturities – in recent days, primarily as a consequence of developments in the United States rather than in the euro area, reinforces this view.

In any event, this view is conditioned by the information available today. Given the present high level of uncertainty, new shocks cannot be ruled out, and our response will depend on the origin and the scale of those shocks.

In this respect, **our future decisions will ensure that interest rates remain at sufficiently restrictive levels for as long as necessary** and we will continue to follow **a data-dependent approach.** This is particularly important to avoid insufficient monetary policy tightening, which would prevent us from achieving our target, and also excessive monetary policy tightening, which would cause unnecessary harm to economic activity and employment.

²⁴ The CGP was approved in late 2022 and focuses precisely on providing for orderly debt restructuring for household segments with a high degree of socio-economic vulnerability. Also, temporary payment facilities are now envisaged for those households at risk of becoming vulnerable.

²⁵ See ["EBA publishes the results of its 2023 EU-wide stress test"](#).

However, it is **vital that all other economic policies also help to reduce inflationary pressures**. Governments should **continue to reverse budgetary support measures** and, should energy prices remain high, replace them with **more focused** ones. It is also very important that **fiscal policy becomes restrictive in 2024**, to gradually bring down the high public debt and deficit levels and gain room for manoeuvre to be able to respond to future shocks. All this is tremendously important to prevent an increase in inflationary pressures in the medium term, which would require an even more resolute monetary policy response.

Ambitious structural reforms that will boost potential growth are also needed, and in this respect it is also **vital that efficient use be made of the NGEU funds**.

For their part, **financial institutions must deploy prudent provisioning and capital planning policies, to ensure that part of any short-term increase in profit is used to bolster their resilience, leaving them better placed to address any potential losses should the worst-case risk scenarios arise**.

And this, while at the same time bearing in mind that the short and medium-term challenges resulting from the recent period of extraordinary crises do not make **tackling the banking sector's structural challenges** – such as those linked to management of climate-related risks, digitalisation and growing competition from technology firms – **any less urgent**.

Just as the banking sector must be ready to address the risks posed by the current environment, as regulatory and supervisory bodies we must likewise **contribute with a regulatory framework that provides strength, confidence and transparency**.

In this respect, **the Basel Committee on Banking Supervision (BCBS) has reviewed the financial turmoil that occurred in March this year, to comprehend its scope and implications and extract conclusions**.²⁶

Drawing on the conclusions of this review, the BCBS is to develop a series of initiatives. First, it is to prioritise work to **strengthen supervisory effectiveness and identify issues that could merit additional guidance at a global level**. It also intends to undertake analytical work, based on empirical evidence, to assess whether specific features of the Basel Framework – such as liquidity risk and interest rate risk in the banking book – performed as intended during the turmoil, and to assess the need to explore regulatory policy options over the medium term.²⁷

Apart from this future work, **the priority must continue to be the complete and consistent transposition of the last leg of the regulatory reform, known as Basel III, in all the jurisdictions where this is still outstanding**.

²⁶ See “Basel Committee discusses recent market developments, agrees to consult on Basel Core Principles, and advances work on cryptoassets”, June 2023, and “Governors and Heads of Supervision endorse initiatives in response to the banking turmoil and reaffirm priority to implement Basel III”, September 2023.

²⁷ See “Basel Committee discusses recent market developments, agrees to consult on Basel Core Principles, and advances work on cryptoassets”, June 2023.

From a European standpoint, improving the governance and functioning of Economic and Monetary Union would be a huge step forward in reducing the vulnerability of the European financial system. In particular, the creation of a fully mutualised European deposit insurance scheme would boost confidence among the general public and the markets. It would also contribute to greater risk-sharing across the euro area and, therefore, to fewer potential fragmentation episodes. Progress towards a **capital markets union should also be speeded up.**

In turn, the **reform of fiscal governance** in the EU should be concluded before year-end, with the definition of a framework that will ensure the sustainability of member countries' public finances, thereby gaining room for manoeuvre for budgetary policies to be able to respond to future shocks and providing incentives for those policies to make a greater contribution to economic growth through an improvement in their quality. This framework should be complemented with the **creation of a permanent European macroeconomic stabilisation mechanism**, which could also serve as a basis for the joint financing of European public goods needed to address strategic autonomy and the fight against climate change, among other EU objectives.