

Non-performance and cost of risk out of sync

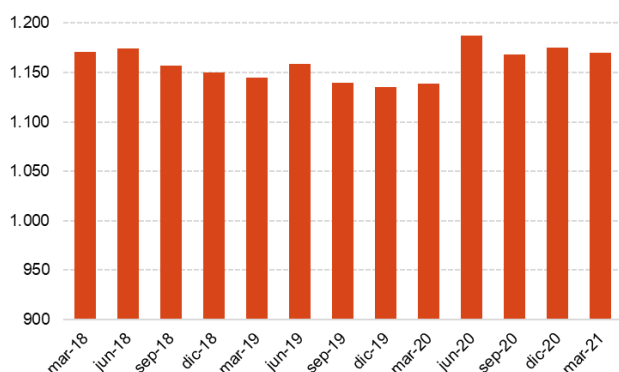
Fifteen months on from the start of the pandemic, in which the banks have released four sets of quarterly earnings, we have good insight into the trend in non-performance and the cost of risk, unquestionably two of the most important indicators and drivers of the banks' financial performance.

The trend in non-performance is significantly out of sync with the trend in the cost of risk: the volume of non-performing assets has been stable, actually falling over the course of 2020 and early 2021, while the cost of risk for the Spanish bank sector as a whole has been rising considerably.

The trend in non-performance has been shaped by the impact of the easing of accounting requirements and the explicit borrower support measures (such as the payment moratoria, the state loan guarantees and, of course, the furlough scheme), which have played a crucial role in borrowers' ability to keep servicing their loans.

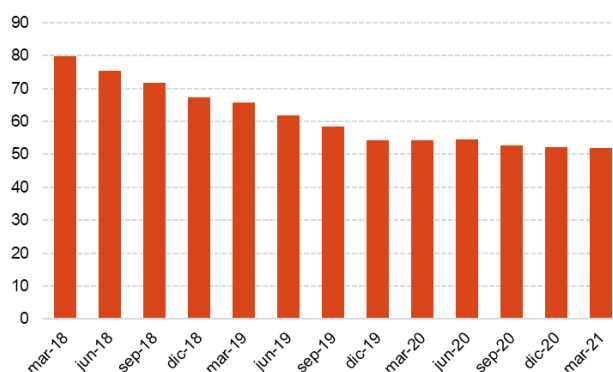
As a result of the decline in the volume of non-performing debt, coupled with growth in the denominator, driven by the impact of the guarantees articulated by Spain's official credit institute, ICO, to safeguard businesses' liquidity, the Spanish banking sector's NPL ratio has been trending lower since the onset of the pandemic. The reduction in the NPL ratio for the system as a whole coincided with a collapse, to the tune of 11% in GDP. Indeed, the NPL ratio has come down by more in Spain than in other countries that sustained smaller GDP contractions, posing an undeniable paradox that breaks with all the statistical models that correlate the two variables.

**Exhibit 1: Trend in credit
(€ bn)**



Source: Afi, Bank of Spain

**Exhibit 2: Trend in non-performing
exposures (€ bn)**

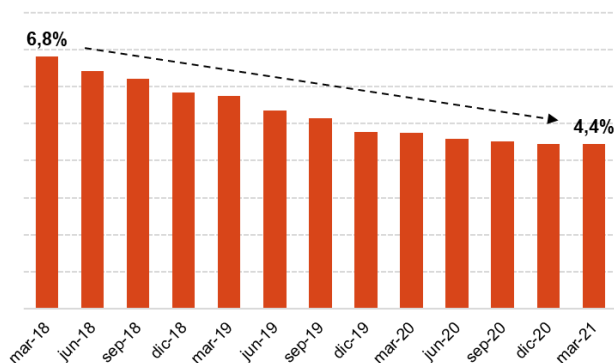


Source: Afi, Bank of Spain

However, that mismatch between non-performance and GDP is not the only paradox created by the pandemic in the world of banking. The other relates to the significant provisioning effort being made by the Spanish banks, anticipating the uptick in non-performance (hence the decoupling), all the more so in regulatory and accounting environments made laxer specifically to facilitate the deferral of those effects (hence the paradox).

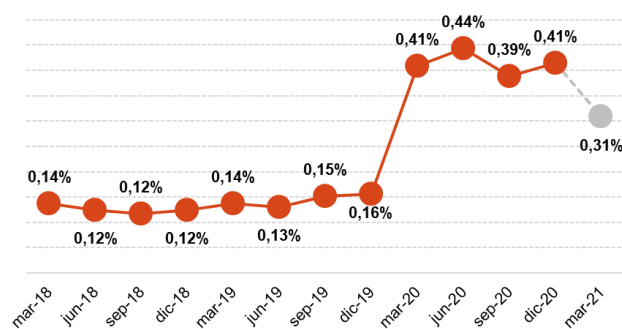


Exhibit 3: NPL ratio (%)



Source: Afi, Bank of Spain

Exhibit 4: Cost of credit risk (%)



Source: Afi, Bank of Spain, banks¹

As shown in Exhibit 4, in 2020 the Spanish banks were provisioning at three times the cruising speed reached during the two years prior to the pandemic. From what we have seen in the first quarter of 2021, the banks have pulled back significantly on the provisioning front by comparison with 2020 but continued to recognise loan losses at nearly twice the average level observed during the two years prior to the pandemic.

The reduction in provisioning by the banks in the first quarter is probably the reason why the regulators and supervisors are urging the banks not ease up on their front-loading of provisions - with non-performance still expected to rise - in order to boost profit and, ultimately, be able to pay the dividends that in 2020 they could not.

What lies in store in the coming months?

In the midst of the debate about whether the levels of provisions in 2021 should keep up with the thrust of 2020 or whether there is justification for a degree of relaxation, given that the worst is now behind us, we believe it is timely to share our outlook for the possible trend in asset impairment and the banks' ability to absorb the losses.

To do that we have prepared credit impairment projections based on econometric models, introducing adjustments in order to capture different aspects of vital importance to analysing the banking business, including:

- The economic recovery and expected macroeconomic scenario;
- The volume of savings pent up during the lockdown and restrictions, which will be released as those restrictions are removed or relaxed;
- The impact of the extraordinary measures implemented to mitigate the effects of the crisis, such as the furlough scheme, maturity extensions and grace periods for secured transactions, and the recapitalisation of certain entities;
- The NGEU funds.

We believe that non-performing assets will peak in the second half of 2022, going on to recover slightly in 2023 and more intensely in 2024. Specifically, we expect non-performance to be close to but still just above pre-Covid levels in 2024. In relative terms, we think that the - traditionally vulnerable - consumer lending segment will be the hardest hit, with the mortgage sector suffering an increase in non-performance following the withdrawal of the furlough scheme, albeit faring better than all other segments.

¹ Cost of risk estimated as of March 2021 by means of a wide sample of banks that represent 90% of the total sector.



In absolute terms, the business loan segment will take the biggest blow, albeit shaped by considerable differences by sector and region: non-performance is expected to increase significantly in the sectors more exposed to the pandemic (hospitality, leisure, transport, etc.), with only small increases, or even declines, in non-performance in the more resilient sectors (primary sector, etc.). That uneven sector outlook was touched upon by the European Central Bank in its last Financial Stability Review given the increase in transfers of ECLs from Stage I to Stage II, a phenomenon being observed more intensely in the sectors most sensitive to the pandemic, a possible prelude to an increase in non-performance (refer to the [Afi report here](#)).

Table 1. Volume of impaired credit (€ bn, % chg. YoY)

	NFC	RE	Housing	Consumption	Total
2018	24 -23,5%	12 -55,8%	20 -14,5%	10 -3,7%	67 -28,7%
2019	21 -14,1%	7 -39,2%	16 -17,7%	9 -8,4%	54 -19,2%
2020	22 3,5%	6 -13,9%	15 -9,7%	9 0,6%	53 -3,2%
2021 (E)	24 12,3%	7 3,4%	16 11,2%	10 10,5%	57 9,0%
Peak expected	45 85,7%	8 18,4%	24 43,2%	17 71,8%	93 63,3%

Source: Afi, Bank of Spain

Table 2. NPL ratio (%)

	NFC	RE	Housing	Consumption	Total
2018	5,9%	10,7%	3,9%	9,2%	5,9%
2019	5,2%	6,7%	3,3%	8,0%	4,8%
2020	4,8%	6,0%	3,0%	7,8%	4,5%
2021 (E)	5,5%	6,4%	3,3%	8,8%	5,0%
Peak expected	10,2%	7,7%	4,7%	14,5%	8,1%

Source: Afi, Bank of Spain

How would that prognosis affect the banks' earnings?

Given that path in impairment attributable to the effects of the pandemic (around €40 billion between 2021 and 2022), and assuming average NPL coverage of 60%, the banks would have to recognise around €24 billion of impairment allowances over a three-year time horizon (including 2020). The significant effort made by the Spanish banks to front load their loan loss provisions in 2020 means they

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have already recognised roughly half (47%) of the allowances corresponding to the estimated uptick in non-performance. As a result, and based on our estimates for non-performance, the Spanish banks would still have to recognise a little over €12 billion of loan impairment allowances against their earnings in 2021 and 2022.

To test the fit between these forecasts and the actions taken by the banks in early 2021, we analysed the results already published by a wide sample of entities representing 90% of the overall sector. Based on those figures, the provisions recognised during the first quarter of this year mark a significant slowdown year-on-year but remain higher than those recorded in 2019. More specifically, the volume of provisions recognised in 1Q21 is practically twice the average recognised in 2018 and 2019 but half of the level recognised in 2020.

If the provisioning effort of 1Q21 were to be maintained for all of 2021, the banks would recognise one-third of the estimated balance outstanding in the wake of the effort of 2020 this year, so that full digestion of the effects of the pandemic would be spread out until the end of 2023, a timeframe that the supervisor will possibly consider overly lax.

If, alternatively, it was deemed desirable to bring the full provisioning effort forward to the end of 2022, the banks would have to step up their provisioning somewhat in 2021 (by a further ~20%) compared to that observed during the first quarter.

In terms of the impact on overall system profitability (ROE), we estimate that the difference between digesting the impact over two versus three years is equivalent to around one percentage point of ROE in 2021, a year in which earnings are set to increase very considerably from 2020, when the system as a whole registered a return of around 1.5%, before factoring in the impairment of goodwill outside of Spain, which put that metric into negative territory.